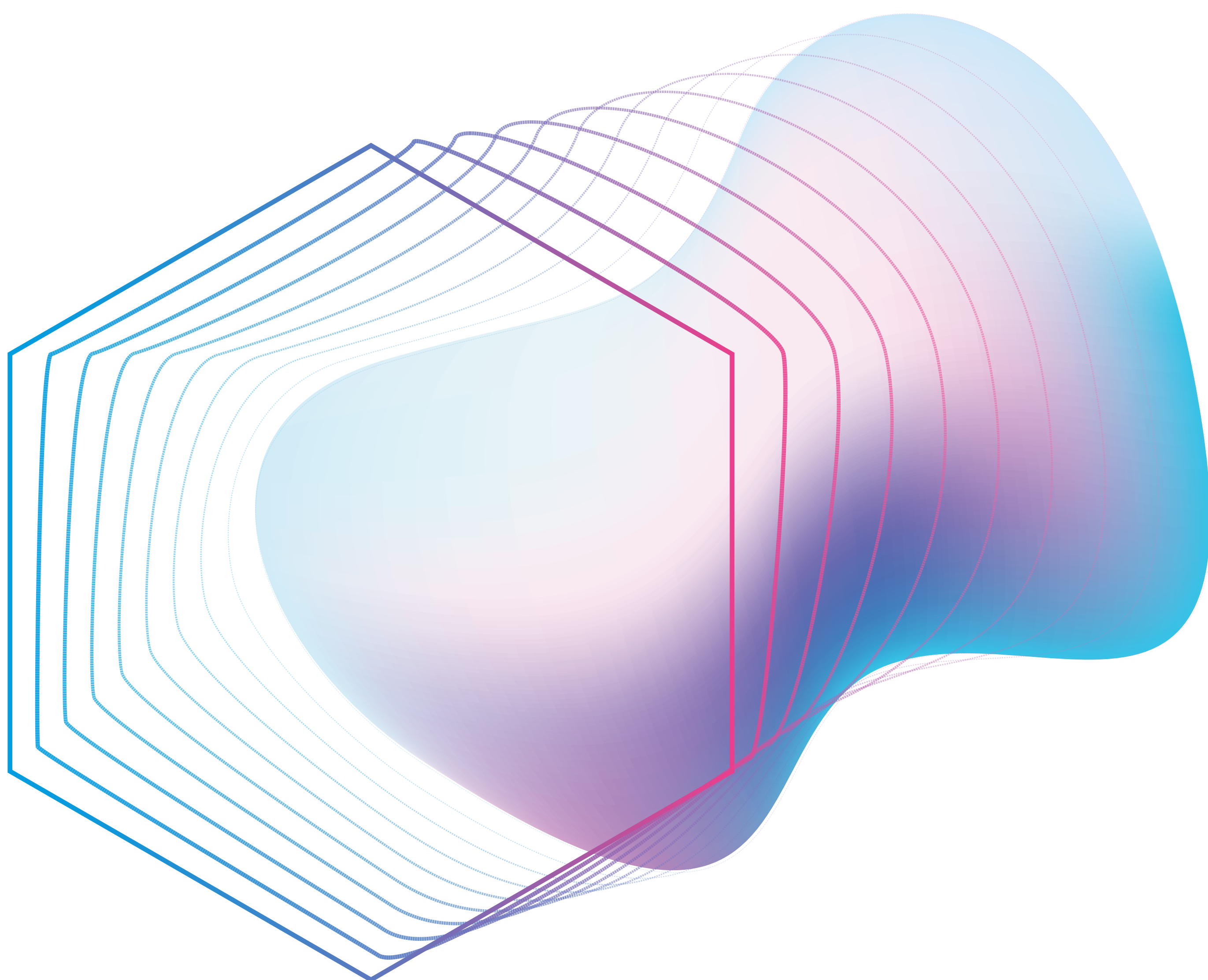
The State of Financial Services

THE NEW MONETARY ORDER

European Perspectives



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Dear Reader,

The global financial system transformed after the global financial crisis in response to a unique policy that lasted roughly a dozen years, ending only recently.

This period of expansionary monetary policy, coupled with a significantly evolved regulatory environment, had a strong impact on the level of debt in the system and how that debt was distributed across the various market participants. These forces have reshaped the financial system in profound ways, affecting liquidity and funding structures, capital levels, the amount of interest rate risk in the system, and the growth of different forms of credit.

In Europe, bank balance sheets remained stable and de-risked and return on assets declined, impacting bank profitability. Non-bank financial institutions assumed a more important role as financers, gaining market share in lending from banks and holding the riskier (and more profitable) part of the assets. Central bank balance sheets quadrupled, and governments took advantage of low rates to raise record levels of debt to fund reforms, social expenditures, and economic stimulus measures needed to navigate multiple crises.

What does the future hold?

Whether or not you believe the world has moved into a longer period of inflation, it is clear that the era known as Low for Long is over. This represents a major paradigm shift that will undoubtedly have profound implications on the financial system and various market participants. They will very likely have to adapt to higher interest rates, lower liquidity, revalued assets, and higher cost of risk.

What are the implications for banks, insurers, private equity, and non-bank financial corporations? What considerations apply to government economic and fiscal policies? What is the call for action?

In our State of Financial Services work on the New Monetary Order, we explore these questions in detail. In past editions we analyzed the dynamics in the United States and Asia; this paper focuses on our European perspectives. We hope you enjoy the research.

Sincerely,

Elie Farah
Managing Partner–Head of Financial Services Europe

EXECUTIVE SUMMARY

The global financial crisis of 2008 marked the beginning of almost 15 years of expansionary monetary policy in Europe, the United States, and other developed countries, commonly referred to as the Low for Long era. Quickly realizing that simply lowering rates was not sufficient to counter deflationary tendencies, central banks applied unconventional monetary policy (UMP) strategies, including negative interest rates, large-scale asset purchasing programs such as quantitative easing (QE), and forward guidance to assure market participants of a very accommodative monetary environment in the medium term.

In the eurozone, one of the objectives of UMP was to prevent fragmentation by maintaining low borrowing rates for member states, considering the fiscal and debt challenges faced by several countries. Originally envisioned to be only of a temporary nature, these policies persisted for a decade and a half as inflation remained low and economic growth remained muted. The European Central Bank's (ECB) interventions were even further expanded starting from 2020 to mitigate the impact of the COVID-19 crisis and provide breathing space for governments, banks, corporates, and households. As a result, the eurosystem's balance sheet quadrupled during the Low for Long period.

Exhibit 1: The eurosystem's balance sheet quadrupled since the GFC
2000–2022, Trillion €

Source: ECB, Oliver Wyman analysis

DEEP DIVE 1

Which mandates central banks pursue

In Europe, central banks' primary mandate relates to price stability. Low and stable inflation makes corporates and households more confident and thus more inclined to make financial decisions such as borrowing, spending, and investing from a long-term perspective that favors sustained economic growth and the stability of the financial system.

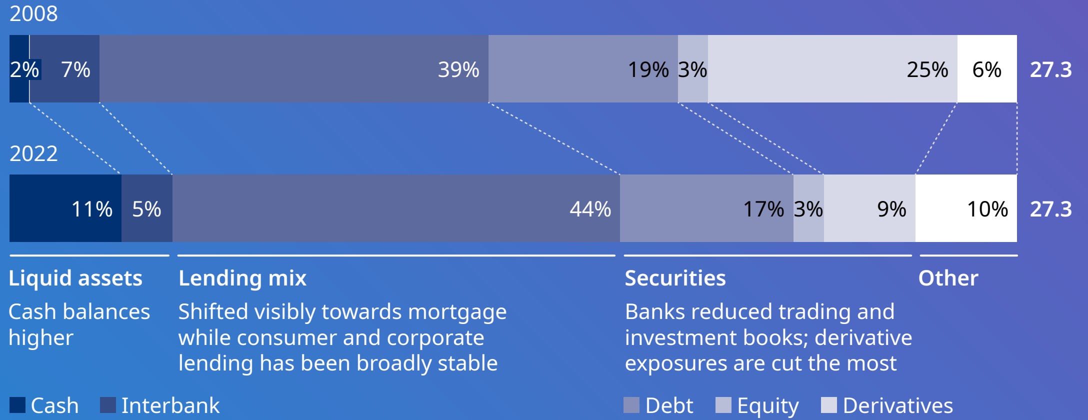
Such mandates are provided for by law or even by a country's constitution, as in the following examples:

- **ECB:** "maintain price stability. This means making sure that inflation remains low, stable and predictable. The Governing Council considers that price stability is best maintained by aiming for 2% inflation over the medium term."
- **Bank of England (BoE):** "Our mission is to promote the good of the people of the United Kingdom by maintaining monetary and financial stability. To keep inflation low and stable, the Government sets us an inflation target of 2%. This helps everyone plan for the future."
- **Swiss National Bank (SNB):** "The SNB conducts the country's monetary policy as an independent central bank. Its primary goal is to ensure price stability, while taking due account of economic developments. In so doing, it creates an appropriate environment for economic growth. The SNB equates price stability with a rise in consumer prices of less than 2% per annum."

The Low for Long period was marked by a significant transformation of Europe's financial system, particularly in leverage and risk-taking dynamics. The role of European banks in funding the real economy diminished as they deleveraged and simplified their balance-sheet structure under more stringent regulations (Exhibit 2). Deleveraging also impacted the effectiveness of the banking system as a transmission channel for monetary policy: Loan volumes experienced only modest growth, with a shift toward mortgages as consumer and corporate lending remained stable and the share of liquid assets increased. Concurrently, non-bank financial institutions (NBFI) and their investors in search for yield assumed a more important role as financers, gaining market share in lending from banks (Exhibit 3). This was part of a broader shift from NBFIs toward riskier investments (Exhibit 4), significantly supporting increases in asset prices (stocks, private equity, real estate, and so on) financed with inexpensive debt.

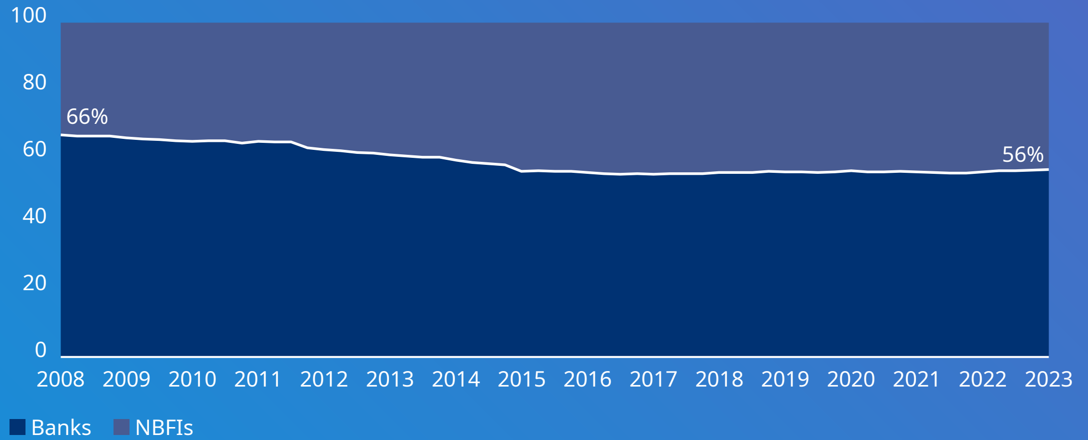
Governments also took advantage of low rates to fund reforms, social expenditure, and economic stimulus: Several member states raised debt to navigate crises while also avoiding expenditure-reduction measures that could have exacerbated a recession. Further, major funding programs were also launched at the EU level (such as "NextGenerationEU") that were able to reach majority only because of the very favorable financing conditions at the time.

Exhibit 2: European banks deleveraged and simplified their balance-sheet structure under more stringent regulations
Trillion €



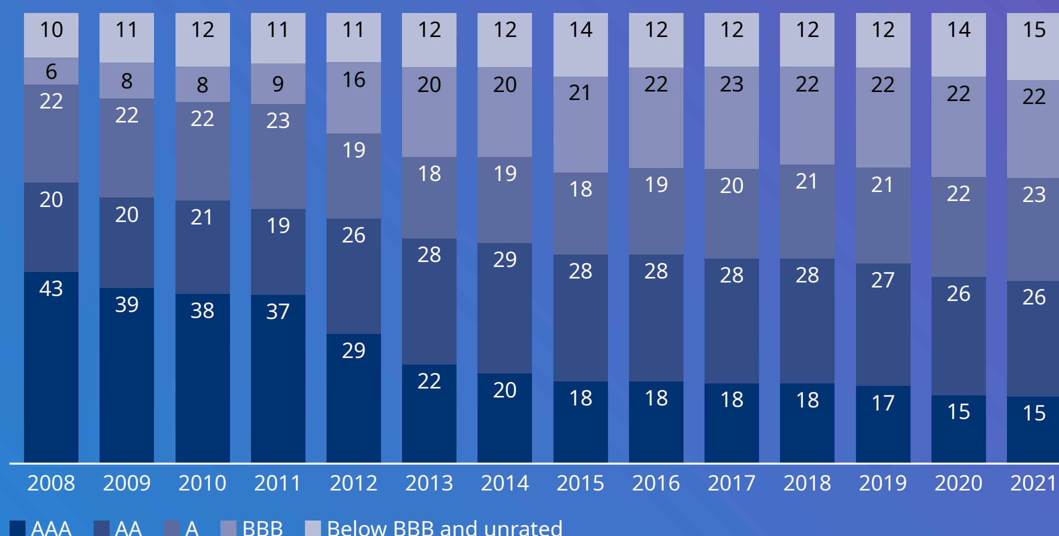
Source: S&P Capital IQ, Oliver Wyman analysis

Exhibit 3: Non-bank financial institutions gained market share in lending from banks
Euro area, 2008–2023, in %



Source: BIS, Oliver Wyman analysis

Exhibit 4: NBFIs in search of yield shifted to riskier and less liquid investments
Sample of 56 European[1] Life Insurers, % of total bond holdings



1. Including UK, Norway, and Switzerland
Note: Example for life insurers
Source: IMF, S&P Capital IQ, Oliver Wyman analysis

The Low for Long era came to an abrupt end in 2022 as central banks swiftly raised interest rates and started to unwind balance sheets in response to rampant inflation. This was caused by a combination of accommodative monetary conditions, large-scale stimulus programs, supply-chain disruptions, and other external shocks in the aftermath of the COVID-19 crisis and amid geopolitical tensions. In 2022, inflation surged to an unprecedented level, peaking at 9% in the European Union (Exhibit 5). After it became evident that inflation was not transitory as initially believed, the ECB implemented a series of 10 consecutive interest rate hikes, totaling 450 basis points, between July 2022 and October 2023 (Exhibit 6). The ECB also initiated the phaseout of its asset purchasing program, originally reducing reinvestments by 15 billion euros per month in March 2023 before fully discontinuing them in July 2023. As inflation remains above target levels, interest rates are likely to stay "higher for longer."

We have termed the resulting environment with a combination of high inflation, substantially enlarged balance sheets, and high public debt as the New Monetary Order (NMO).

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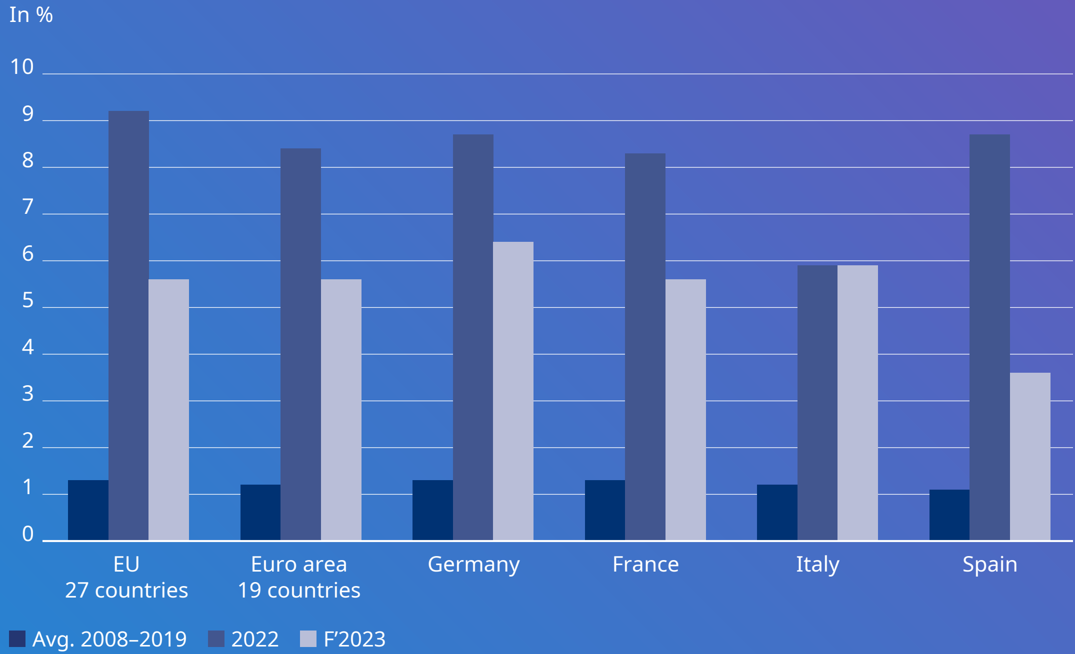
Exhibit 5: Inflation surged to an unprecedented level in 2022, peaking at 9% in the EU

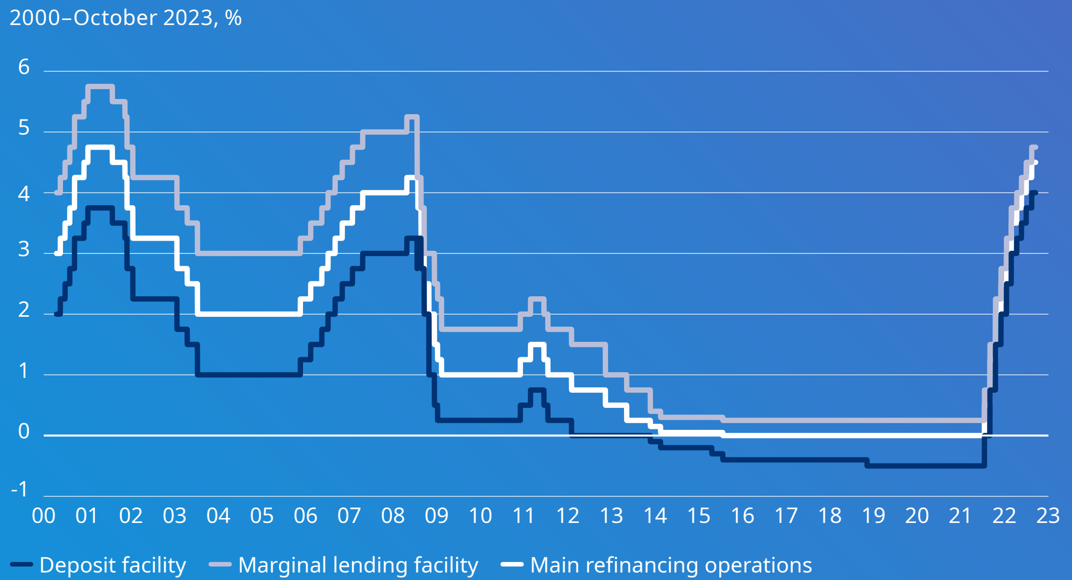
In %



Source: Eurostat, OECD, Refinitiv Datastream, Oliver Wyman analysis

Exhibit 6: The ECB increased interest rates by 450 basis points in total since July 2022

2000–October 2023, %



Source: ECB, Oliver Wyman analysis

The New Monetary Order is reversing more than a decade of developments, causing short-term blowouts and raising questions about long-term sustainability of business models for financial institutions, non-financial corporations, and sovereigns. Banks for now enjoy the benefits of increased net interest margins (NIM) (Exhibit 7); however, the profitability upturn is expected to be short-lived as funding costs increase. Vulnerabilities will persist on bank balance sheets due to their exposure to devalued fixed-income assets acquired during the Low for Long period. Life insurers, meanwhile, face short-term liquidity risk from a decrease in net inflows (Exhibit 8), although solvency and profitability are expected to improve in the long term, and they could further struggle to create positive real returns in case real rates and economic growth remain muted.

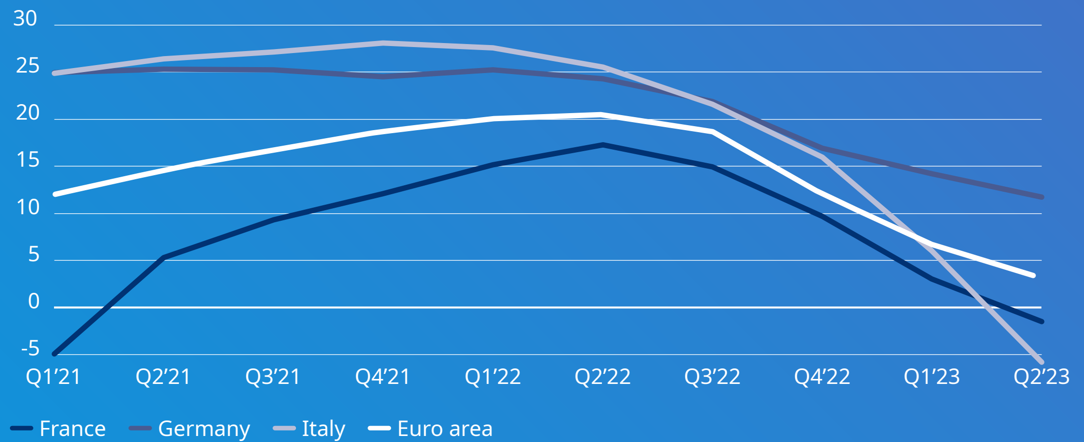
Exhibit 7: Banks for now enjoy the benefits of temporary higher NIMs

Euro area, 2021–June 2023, %

Source: ECB, Oliver Wyman analysis

Exhibit 8: Life insurers are facing a net inflows[1] decrease, causing liquidity risk

Euro area and selected EU countries, 12-month rolling average, %



1. Net premiums earned minus net claims incurred

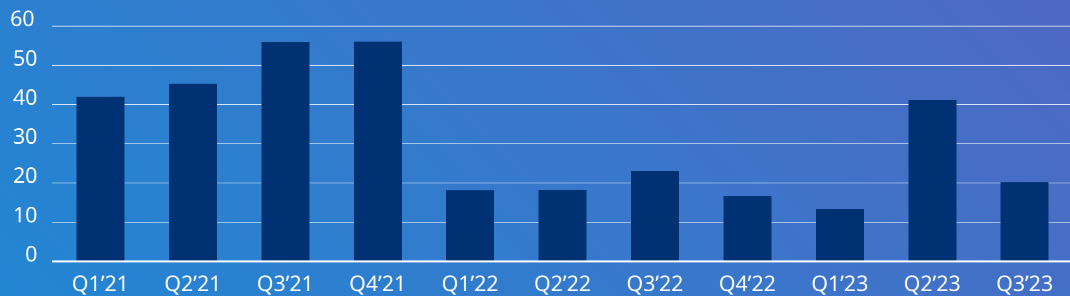
Source: EIOPA, Oliver Wyman analysis

Private equity and leveraged loans turned bearish in 2022 (Exhibit 9), with financing getting scarcer and more expensive, inflationary pressures being felt across value chains, and economic uncertainty starting to hamper value-creation plans. Non-financial corporations have been hit in two phases, first by inflation and unprecedented supply-chain challenges (Exhibits 10 and 11) and second by inflation-induced rates hikes having dampened growth outlooks and increased debt costs.

Public bodies also found their room for maneuver significantly constrained, as cost-of-debt became an important consideration with government bond yields rising by 3% to 3.5% between January 2022 and October 2023 across the European Union (Exhibit 12). In this context, the actions of member states and EU policymakers will increasingly face scrutiny by markets and voters as they face challenging tradeoffs and structural decisions.

Exhibit 9: The private equity industry turned bearish in 2022

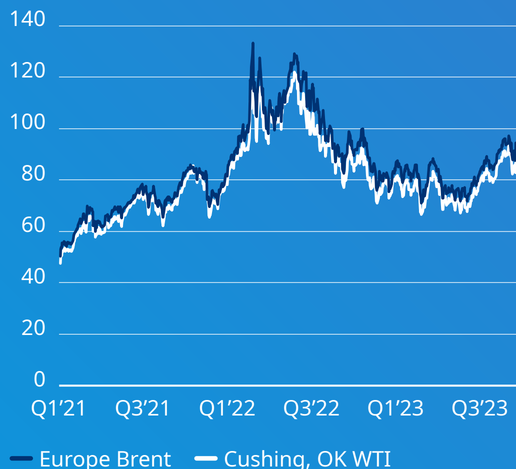
2021–Q3 2023, Billion €



Source: Preqin, Oliver Wyman analysis

Exhibit 10: NFCs have been hit by inflation, notably higher energy costs …

Spot price FOB, US$ per barrel



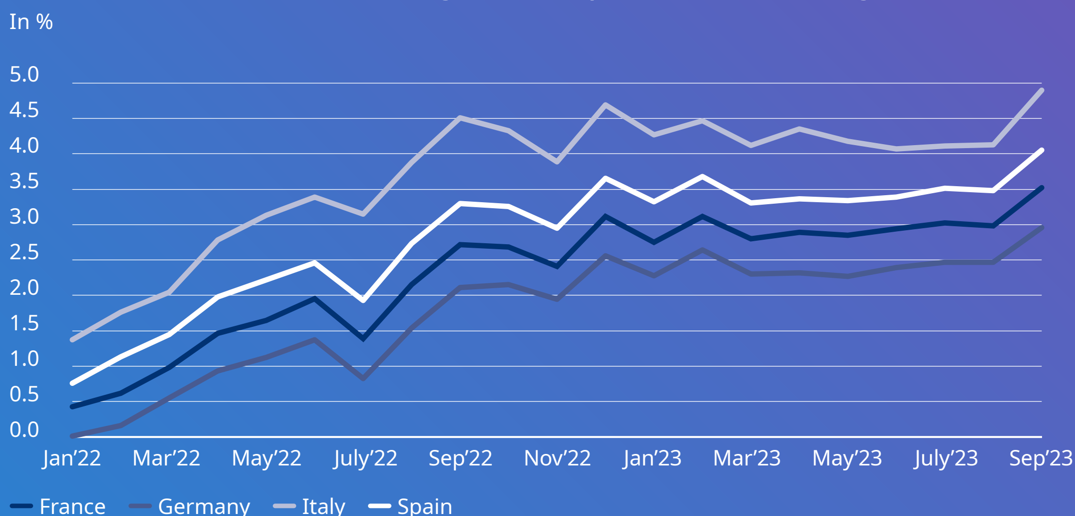
Source: EIA, Oliver Wyman analysis

Exhibit 11: … and supply-chain challenges

Container Freight Rate Index, US$

Source: Drewry, Oliver Wyman analysis

Exhibit 12: Cost-of-debt has re-emerged as an important constraint for governments
In %



Source: Refinitiv Workspace, Oliver Wyman analysis

The nature and extent of vulnerabilities may still not be fully known and understood. This is relevant for financial stability, with history having demonstrated that financial interlinkages contribute to contagion, and more broadly to the real economy, influenced by numerous and complex drivers outside the financial realm, and which ultimately shape real returns. This specifically applies to NBFIs, also called "shadow banking" participants. The real estate market is also crucial, since banks as well as the overall economy (including households) are significantly exposed to this asset class. Higher interest rates have raised concerns over borrowers' ability to generate the necessary cash flows to service debt and generate returns. Real estate valuations have declined significantly due to higher financing costs, and new lending contracted significantly at a time when some European economies face significant housing supply shortages.

Moreover, geopolitical tensions, technological disruptions, climate change, and aging populations add to substantial funding pressures for already indebted European economies, with recent rate hikes having reignited concerns about debt sustainability for both corporates and governments. The reversal of globalization, driven by geopolitical tensions and the pursuit of strategic autonomy, has resulted in the fragmentation of international supply chains and necessitated costly relocation initiatives. Artificial intelligence (AI) has the potential to catalyze a new economic supercycle; however, investments in research and development, data infrastructure, and cybersecurity are crucial while compensatory measures will be needed to mitigate impact on labor markets and societal disruptions. The transition to a greener European economy also involves large capital expenditures (such as scaling-up renewable energy production, shifting

to eco-friendly production methods) and is expected to have negative effects on real growth in the medium-term, given the dependence of so many industries on hydrocarbons. Finally, population aging poses structural constraints on economic growth (reduced workforce, decline in consumption), generates additional healthcare costs, and challenges the sustainability of social security schemes.

Financial institutions and non-financial corporates will need to clarify impacts and revamp business models, with support from the public sector, to successfully navigate the new monetary and economic realities. This entails identifying and qualifying impacts, gaining a deeper understanding of opportunities and risks, capturing readily available efficiency gains, allocating resources more effectively, and building buffers to anticipate challenges. Public bodies should ensure these structural evolutions are facilitated, directing resources to foster change and cushion short-term impacts while not allowing unsustainable structures to survive. We outline concrete, segment-specific proposals below (Exhibit 13).

Finally, central banks should be steadfast in safeguarding price stability given the corrosive effects of inflation. The adverse consequences of escalating prices are well understood, drawing lessons from previous inflationary periods. Inflation acts as an indirect tax, impacting all segments of society due to its negative effect on purchasing power. In addition, if inflation expectations become unanchored over an extended period, trust in the economic system and in the societal contract itself may erode. This is particularly concerning at a time when political systems are facing challenges in various countries. Therefore, it is also important not to burden central banks with extensive mandates, and that governments directly address non-monetary challenges themselves, while being realistic about ambitions and transparent about tradeoffs.

Exhibit 13: Industry-specific issues and calls for action (summary)

	Transition to New Monetary Order	Calls for action
Banks	• Best return on equity (RoE) in years, boosted by NIM increase, with loans repriced faster than deposits and deposits volatility historically low • NIM expected to quickly return to pre-hike levels, due to competitive pressure and regulatory factors • Unrealized losses on assets (notably fixed-income assets) held to maturity constraining balance sheet rotation and causing liquidity risk	• Monitor carefully cost-of-risk, especially for players exposed to more vulnerable business areas (such as leveraged finance) • Reactivate asset-liability management (ALM) capabilities, notably leveraging advanced pricing techniques for deposit steering • Ensure approaches to the management of interest rate risk in the banking book (IRRBB) allow banks to deliver balance sheet and earnings stability, examine liquidity reserves, and revamp crisis preparedness • As devalued assets mature, use additional balance sheet capacity for productive lending to the economy, also aiming to regain market share (such as from NBFIs)

Life insurers	• Higher liquidity risk, with surge in net inflows in some cases forcing insurers to realize losses • In the longer term, expected improvement in solvency and profitability • Business-model sustainability ultimately depends on invested assets to generate positive real returns, which requires real economic growth	• Work on retention, focusing sales efforts and using reserves to improve competitiveness • Focus on collection to rebalance portfolio, such as with alternative guaranteed policies (short-term, temporary) and with unit-linked policies exposed to higher-yielding assets classes
Private equity	• Significant inflows of investor funds in search of yield during the Low for Long period, further boosted by significant return prospects • During the hiking period, uncertain prospects of target and portfolio companies due to uncertain economic outlook, limited deal volume • Due to higher cost of debt, limited availability of leverage negatively impacting valuation of exit transactions • Significant volumes of dry powder available	• As market-driven excess returns have come to an end given the challenging environment, need to refocus target selection and portfolio management processes on value creation • Hone capabilities to invest into companies in need of restructuring due to the current higher interest rate and high uncertainty environment, as these might come with significant upside potential • Establish continuation funds to allow for extending the holding period of well-performing assets or those in need of further patience, while providing liquidity to PE investors
Non-financial corporations (NFCs)	• Major supply chain challenges from natural disasters, geopolitical tensions, COVID-19 crisis; significant investment needs to support innovation and green transition, increasing costs and constraints due to regulatory initiatives • Margins under pressure from inflation, higher cost-of-debt and muted growth outlook • Credit risk materialization, with bankruptcies having increased by approximately 30%	• Re-evaluate capital structure and consider financial restructuring as well as strategic and operational performance optimization, especially for overleveraged NFCs • (Re)explore energy sourcing reconfiguration also in anticipation of the green transition and its effects on sources and cost • Switch from a supply chain mainly based on cost efficiency to one focusing on resiliency and trust, also exploring the relevance of reshoring
Governments and other public authorities	• Debt servicing to become a binding fiscal constraint again, as inexpensive debt matures, with government bonds yields having increased by approximately 3.5% across the EU • EU ambitions under pressure given that previously leveraged financing arrangements have significantly reduced capacity and higher funding costs are the reality in a high interest rate environment	• Review and make necessary tradeoffs to rebalance unsustainable finances • Direct expenditures toward building long term public assets and growth-enhancing reforms (education, innovation, infrastructure) • Take action to ensure the sustainability of social security systems • Take measures to cushion the failure of companies that are not viable in today's environment (such as due to higher financing costs or requirements related to the green transition) in a way that does not perpetuate unsustainable business models and provides time for a market-led transition • Review and reduce regulatory red tape

THE MONETARY ORDER

Central banking and monetary policy have always been a core factor of the economy and financial intermediation. The ability and privilege to issue legal tender is a key tool for sovereigns to define and implement economic policy, thereby determining a key aspect of the environment that businesses, financial firms, and individuals operate in. Economic history equally shows that monetary policy can help keep an economy on a stable path, but that choices and decisions have material side effects and take place amid significant uncertainty. Today, many central banks are legally mandated to pursue "price stability," by keeping inflation below a certain threshold, such as 2%. The US Federal Reserve has an additional primary mandate to support keeping the economy at maximum sustainable employment. Considering the importance of the financial system for the economy, most central banks are also tasked with protecting financial stability.

With the outbreak of the global financial crisis (GFC), central banks stepped up to prevent the collapse of the financial system and to mitigate the impact of the financial turmoil on the broader economy. This came after the episode of the "great moderation," when many economists assumed that financial and monetary policy tools had become so developed that — at least in advanced economies such as the eurozone — inflation had been eradicated for good and financial crises were a thing of the past. Rather, as governments staged large-scale banking rescues, it became clear that the growth of previous years had been partially "bought" with excessive credit. The ensuing balance sheet recession hit many economies hard and led central banks to launch large-scale monetary stimulus programs. Policymakers looked back to the Great Depression, when a tight monetary environment contributed to the length and depth of a very difficult time for the economy and societies. Concluding that simply lowering rates would not be sufficient to counter deflationary tendencies, central banks also developed unconventional monetary policy (UMP) tools, including negative interest rates to keep policy rates below the assumed neutral rate of interest (r*), large-scale asset purchasing programs, and forward guidance to assure market participants that an accommodative monetary environment would continue over the medium term.

Originally envisaged to be only of short-term nature, UMP lasted more than a decade and was even reinforced to mitigate the negative economic impact of the COVID crisis. Central banks in the United States and Europe implemented UMP to fend off with decisive action what they thought were temporary dislocations. But expansionary monetary policy persisted for more than a decade, while inflation remained low or negative. Then the COVID-19 crisis struck, triggering an unprecedented contraction in economic activity, and central banks provided additional liquidity to markets through large scale purchasing programs of government and corporate bonds.

In the eurozone, keeping borrowing rates for member states in check was a welcome side effect, if not one of

the objectives of UMP. In the early 2010s, the risk of a breakup of the eurozone was tangible. Several countries were on the verge of default, including Ireland, Portugal, Spain, Italy, Greece, and Cyprus. While the underlying reasons differed, all these countries became reliant on international financial assistance and had to embark on ambitious reform programs. In return, the ECB agreed to support these members with significant purchasing programs of public debt securities, substantially narrowing the yield spreads among eurozone members.

More than 10 years of UMP reshaped the economic and monetary system. UMP came with significant side effects that, while not unexpected, grew significantly over time. Central bank balance sheets and monetary aggregates expanded massively, with the eurosystem's balance sheet having quadrupled since the GFC. Public and private sector debt levels increased as well, making economies vulnerable to financial shocks. Finally, asset values also took off, as households and investors benefiting from low financing costs searched for attractive placements. Between 2009 and 2021, home prices rose by 46% in the eurozone, and the STOXX600 index of European stocks increased by 101%.

DEEP DIVE 2

How central banks implement their mandate

Today, central banks implement monetary policy through market operations — that is, financial transactions with banks. In doing so, they indirectly set the price of money. Other tools, such as steering monetary aggregates or minimum reserves, play no significant role anymore **in countries with floating exchange rate regimes**, although use of the minimum reserve tool has featured in recent discussions.

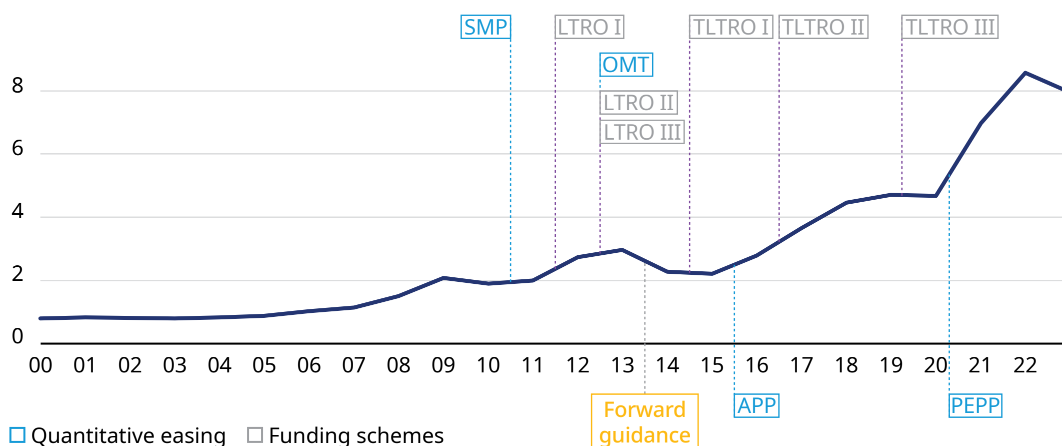
Different types of implementation instruments are commonly used:

- Setting short-term **interest rates** for deposit and lending facilities accessible to banks
- **Repo transactions** in the open market with banks based on a defined collateral basket of high-grade securities (mostly sovereign bonds and high-grade corporate bonds)
- Purchasing **longer-dated assets** in financial markets
- Communicating **forward guidance** to influence market expectations and behavior in the long term
- Establishing **specific facilities offering loans under narrow conditions and with a defined policy objective**, typically to financial institutions and to a lesser extent directly to corporations. Examples include the ECB's TLTRO to boost lending to the corporate sector and COVID-19 facilities to ensure liquidity provisioning to non-financial cooperations

The eurozone is unique in that the monetary policy is decided by the ECB Governing Council as the eurosystem's top-level decision-making body, but implementation is partially delegated to eurosystem members.

In the eurozone, the ECB implemented UMP measures when the debt crisis started in late 2009. The ECB cut its deposit rate in late 2008, and started to intervene massively as the debt crisis spread and threatened the European monetary union. ECB President Mario Draghi announced he was prepared to do "whatever it takes" to preserve the euro. Measures included the purchase of government securities, such as Greek bonds, under the Securities Market Program (SMP) in 2010. This was replaced in 2012 by the Outright Monetary Transaction (OMT) program, though this was never activated. In 2011, the ECB began long-term refinancing operations (LTRO), the direct provision of liquidity and financing at favorable conditions to help banks grant credit. Later, still facing low growth and deflationary pressure, both bond-purchase and liquidity-provision programs were expanded further. Notable examples included the targeted long-term refinancing operations (TLTRO) launched in 2014 and the Asset Purchase Program (APP) initiated in 2015.

Exhibit 14: Eurosystem balance sheet size
2000–2022, Trillion €



Source: ECB, Oliver Wyman analysis

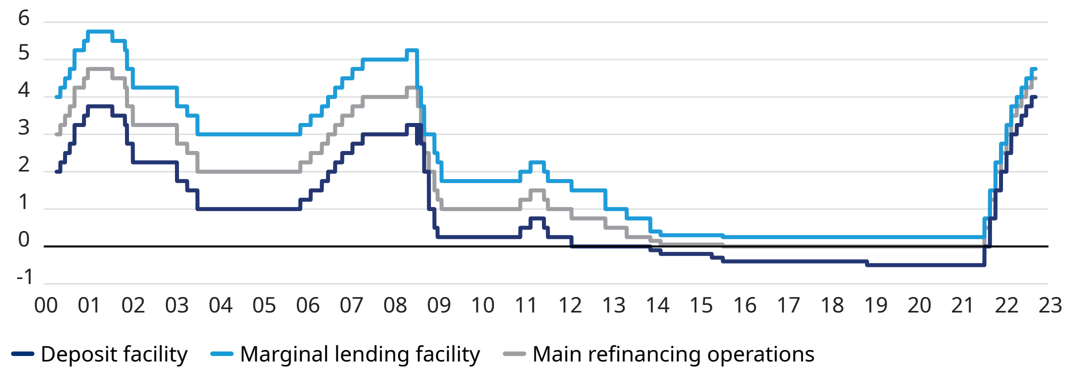
The ECB's interventions were further expanded to counter the impact of COVID-19 and to provide breathing space for governments, banks, corporates, and individuals. The ECB introduced the Pandemic Emergency Purchase Program (PEPP) in 2020, "a temporary asset purchase program of private and public sector securities to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the coronavirus." The ECB purchased a total of €1,850 billion in assets under the program. At the same time, the ECB expanded existing programs, scaling up the APP and recalibrating targeted long-term refinancing operations under TLTRO III. The central bank also eased capital requirements and accounting rules, such as those on the classification of non-performing loans.

Central banks were forced to act in 2022 against the sudden and sharp increase in inflation. After the initial impression of inflation being transitory because of pandemic-related dislocations, the ECB increased its three key interest rates by 450 basis points in 10 consecutive steps between July 2022 and October 2023 (Exhibit 15).

Another motivation for the ECB was to prevent eurozone spreads from widening. The ECB also phased out the APP while continuing to reinvest proceeds from maturing sovereign bonds under the PEPP. In doing so, it rebalanced the allocations across member states: Up to the APP, the ECB's programs were designed to allocate the value of securities purchased from member states in line with their capital keys. However, the ECB's market operations under the PEPP and the Transmission Protection Instrument (TPI) could divert from the capital key to benefit certain member states "facing severe financial difficulties." Data show that in their PEPP reinvestments, the ECB made significant use of this option (Exhibit 16).

Exhibit 15: The ECB increased interest rates by 450 basis points in total since July 2022

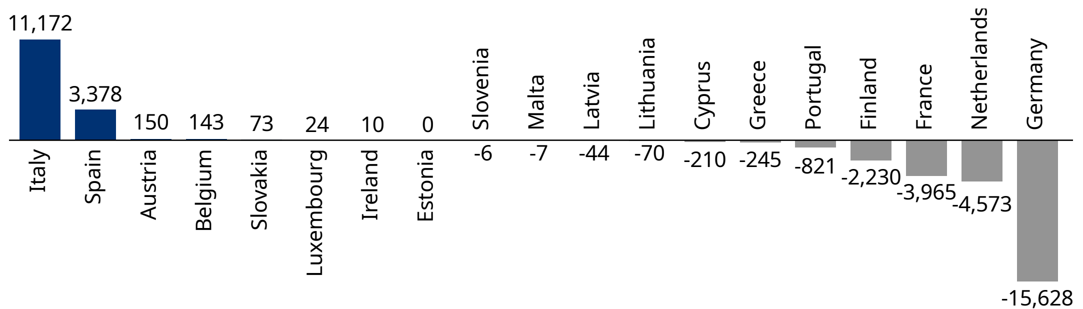
2000–October 2023, %



Source: ECB, Oliver Wyman analysis

Exhibit 16: Net PEPP purchases (reinvestments[1]) of Eurozone government bonds by the ECB

April 2022–September 2023, in Million €



1. Spending after PEPP discontinuation in March 2022

Source: ECB, Oliver Wyman analysis

DEEP DIVE 3

How monetary policy decisions impact the economy

Monetary policy passes to the economy through several channels.

- **Credit channel:** Higher interest rates increase the cost of borrowing, reducing the demand for credit. This, in turn, leads to lower investment and consumption, ultimately dampening economic activity and inflation
- **Foreign exchange channel:** Higher interest rates make a currency more appealing to foreign investors, resulting in capital inflows and currency appreciation. The higher exchange rate lowers import prices and helps control inflation, especially considering the significant reliance of modern economies on imports, particularly energy
- **Asset price channel:** Higher interest rates cause a decline in asset prices by reducing their net present value. As a result, banks have less collateral available to lend against, leading to decreases in consumption and investments
- **Savings and investment channel:** Higher interest rates provide an incentive for both households and corporations to save, in turn reducing spending and investments

The financial system plays a critical role in transmitting monetary policy to the real economy through its involvement in these transactions. The effectiveness of monetary policy implementation with regard to the ultimate mandate is also very dependent on the extent and the speed of banks' changes in credit and deposit conditions. Importantly, the passthrough of monetary policy to the economy is subject to significant time lags and uncertainty. As such, conditions for which monetary policy decisions have been calibrated for might have changed by the time these decisions show their effect. The quality of decisions therefore heavily depends on the ability to forecast future economic conditions as well as a deep understanding of the underlying structure of the economy. In reality, monetary policy decisions are taking place under significant uncertainty, in particular in scenarios where structural shocks (for example, COVID-19, geopolitical stress but also longer-term developments such as (de)globalization or demographic changes) impact the environment in a way that is not fully understood.

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BANKS

The years of Low for Long fell together with a substantial revamp of the business models of European banks in a challenging economic environment. Several European banks got severely impacted due to the fallout of the US subprime and the EU sovereign debt crises and related dislocations, requiring banks to realize losses and perform costly mitigation work. At the same time, significant resources were spent on making banks more resilient to shocks, also in response to regulatory demands.

The persistent low interest rate environment as well as limited growth in the eurozone further reduced the profitability of European banks, while previously profitable capital markets activities had to be scaled down given new market realities, regulatory requirements, and lack of scale. This limited strategic options, including the ability to consolidate and build scale within the banking union. Further, a significant share of lending to the economy is today performed by private credit funds that are not subject to the same stringent regulation as banks, but might have important links to the latter. As a result, while European banks are more resilient today, their ability to evolve, to support the economy, and to present a credible value story to bank investors is limited.

The European banking industry has built up substantial capital reserves and considerably improved its ability to absorb losses, as shown by the 8.7 percentage point increase in the CET1 (core capital) ratio between 2011 and 2021 (Exhibit 17).

European banks also have reduced their exposure to liquidity risk. New liquidity and funding requirements were introduced as part of the Basel III framework and the corresponding domestic implementation. The newly introduced liquidity coverage ratio (LCR) today requires banks to hold significant quantities of high-quality liquid assets (HQLA), which “can be easily and immediately converted into cash at little or no loss of value.”The net stable funding ratio (NSFR) requires banks to hold stable funding — that is, a “portion of capital and liabilities expected to be reliable over one year.” That said, recent crisis episodes in the United States and Switzerland have demonstrated that the framework might require revisions.

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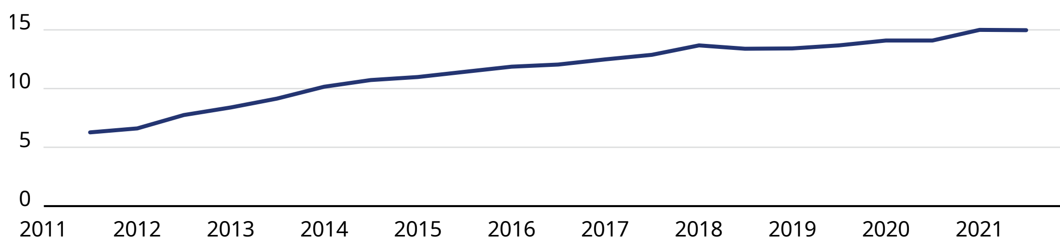
Exhibit 17: Common equity tier 1 ratio
Euro area, 2011–2021, %



Source: Basel Committee on Banking Supervision, Oliver Wyman analysis

For systemic banks, additional requirements apply. The GFC showed that banks might be "too big to fail," necessitating public-sector bailouts at taxpayers' expense to avoid negative impact on the financial system and the broader economy. To address this, systemic banks must hold larger capital and liquidity buffers, prepare themselves for recovery and resolution through adequate planning and removal of any barriers to implementation, and be subject to more intense supervisory oversight.

Specifically in the European Union, these requirements apply to banks that exceed a certain size, are important from a systemic perspective, have significant cross-border activities, or benefit from direct public financial assistance.[1]

European banks simplified their operations, exiting business areas not at scale and restructuring their geographical footprint. Overall, banks reduced exposure toward capital market-related activities such as trading and market-making and rebalanced their engagements toward a more pronounced home bias, becoming more selective and focused on their international banking ambitions.

In several European countries, banks had to work out legacy assets, which absorbed capital and came with significant operational costs. The eurozone debt crisis drove deep recessions and the bursting of credit bubbles in many eurozone economies, leading to marked losses in banks' loan portfolios. This not only required large-scale write offs, but also saddled banks with non-negligible recovery costs that dragged down profitability for several years.

Finally, in response to past misconduct, European banks strengthened the teams in charge of risk control. US banks were hit particularly hard in the immediate aftermath of the financial crisis, but European banks were not immune either, as shown by incidents such as Libor manipulation, Russian mirror trading, and the Archegos failure. In response, teams and capabilities had to be reinforced, costly mitigation programs had to be implemented, and, more generally, the appetite for non-financial risks has decreased.

As a result of more stringent regulations, European banks also tightened credit conditions, especially in the immediate aftermath of the GFC, and decreased exposure to credit risk (Exhibit 18 and 19).

1 Detailed criteria from the ECB: https: Banking Supervision Europa

Exhibit 18: Loan-to-deposit ratios declined

In %

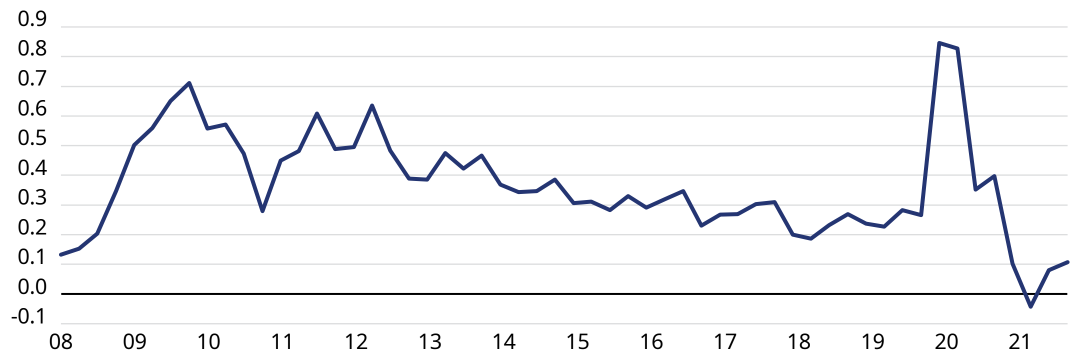
2000–2008

2009–2021

Source: ECB, Oliver Wyman analysis

Exhibit 19: Loan-loss provision ratios declined from their peak of approximately 70 basis points in 2009 to approximately 25 basis points in 2019

Top 30 banks in Europe, incl. UK & Russia, 2008–2021, %



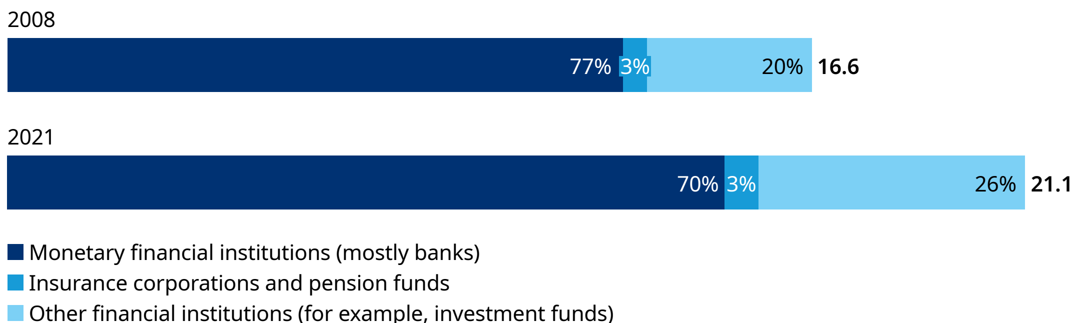
Source: S&P Capital IQ, Oliver Wyman analysis

In the meantime, NBFIs assumed a more important role as financers, gaining market share in lending from banks (Exhibit 20). This was part of a broader shift from life insurers, pension funds, investment funds, and others in search of yield toward riskier investments, also significantly supporting increases in asset prices (for example, stocks, private equity, real estate) financed with inexpensive debt.

The European banking sector experienced a sizeable decline in profitability during the Low for Long era. European banks' return on equity (RoE) declined from 12.7% between 2001–2007 to 5.7% from 2011–2021. The decline was significantly greater than that for US banks, whose RoE decreased by only 3.2 percentage points over the period (Exhibit 21).

Exhibit 20: Loans granted (stock), by type of lender

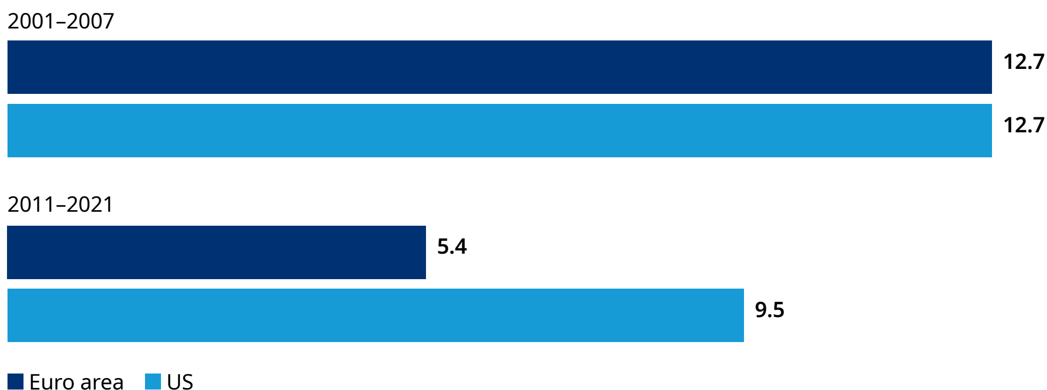
All counterparts, Euro area, 2008–2021, in Trillion € and %



Source: ECB, Oliver Wyman analysis

Exhibit 21: Average banks' return on equity, Euro area vs. US

In %



Source: ECB, FRED, Oliver Wyman analysis

The decline in profitability was mostly driven by expansive monetary policy, low economic growth, and financial regulation.

Net interest margins declined from 1.7% in 2009 to 1.2% in 2021 as a result of very low or negative interest rates and flattening yield curves amid the low-growth environment and monetary policy.

Equity levels were forced up: Common equity tier 1 (CET1) ratios increased from 6.3% in 2011 to 15.0% in 2021, driving up the cost of capital while increasing banks' resilience against shocks.

Banks incurred additional costs to address non-financial risks, notably as they executed large-scale mitigation programs, paid substantial fines, and established extensive control functions that come with a sustained increase in operational expenses.

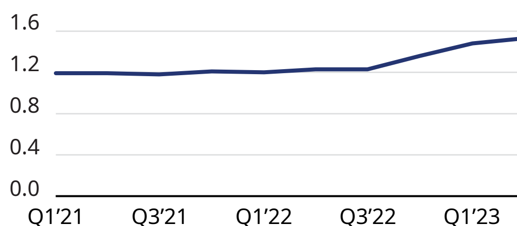
European banks posted their best RoE in a decade in the second quarter of 2023, aided by rising interest rates. Following rapid rates hikes, NIM increased (Exhibit 22) as loans were repriced faster than deposits and deposit volatility remained historically low; this in turn boosted RoE (Exhibit 23).

However, the relief is likely to be short-lived, as already shown by French banks' results in 2023 (Exhibit 24). As of October 2023, the ECB has remunerated overnight bank deposits at 3.5%, while the average interest rate for overnight bank deposits with an agreed maturity by households and corporations stands at 0.35%. This distortion cannot persist. We expect net interest margins to rapidly go back to pre-hike levels, as customers eventually seek higher yields and banks are forced to pass on the benefits of higher interest rates under pressure from public bodies and competitors. This has already happened for example with France's regulated Livret A savings accounts (Exhibit 25). It is worth noting that the intensity of the "deposit war" is expected to vary significantly among countries depending on the structure of their banking industries.

European banks face limitations in their ability to rotate their balance sheets and remain exposed to capital and liquidity risks. As a result of interest rates hikes, European banks are impacted by unrealized losses on assets theoretically held to maturity (fixed-income assets, large reserves accumulated during the Low for Long period, and so on). This hinders banks' capacity to reallocate their resources and provide productive lending to the economy. This vulnerability can also have severe consequences if deposit holders, who are becoming more informed and responsive, rapidly lose confidence. In the most extreme scenarios, banks may be forced to liquidate assets and realize losses.

Exhibit 22: Banks' net interest margin

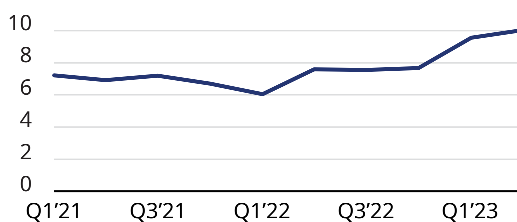
Euro area, 2021–June 2023, %



Source: ECB, Oliver Wyman analysis

Exhibit 23: Banks' return on equity

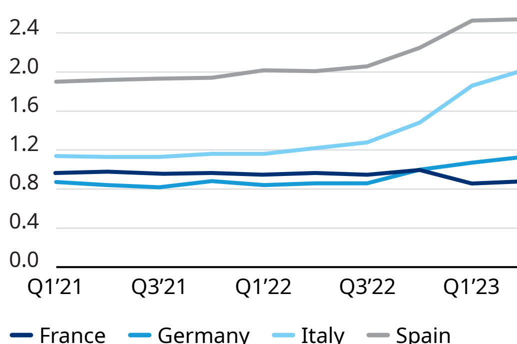
Euro area, 2021–June 2023, %



Source: ECB, Oliver Wyman analysis

Exhibit 24: Net interest Margin

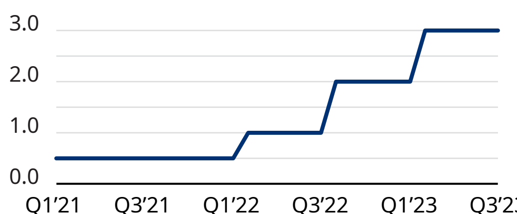
Selected EU countries, 2021–June 2023, %



Source: ECB, Oliver Wyman analysis

Exhibit 25: "Livret A" interest rate

France, 2021–October 2023, %



Source: French government, Oliver Wyman analysis

Going forward, the European banking sector will continue to be subject to external and structural headwinds and needs to navigate the environment carefully:

Macroeconomic conditions, a key driver of banking profitability, continue to be challenging, with GDP forecasts for the eurozone standing at 0.7% and 1.4% for 2023 and 2024, respectively, below the global average of advanced economies (according to the IMF World Economic Outlook from October 2023). By comparison, US growth is projected at 1.9% and 1.4%, respectively, whereas emerging markets are expected to grow above 4% per year over the same period. The ability of governments to provide further stimulus is also limited amid high debt levels.

The interest rate outlook remains uncertain. While inflation has subsided recently and talk about rate cuts has started, rates are unlikely to go back to Low for Long levels anytime soon. Credit risk is likely to remain elevated due to (re)financing risks of bank borrowers, in particular in the corporate, retail, and especially the commercial real estate segment. Further vulnerabilities might appear in the NBFIs, especially credit funds, where the link to the banks is still unclear.

Many European banks continue to operate sub-scale, depriving them of the ability to leverage possible investments in digitization and new business models, and to implement a pan-European strategy that helps them thrive in the heterogenous European economic area.

The lessons drawn from recent bank failures will trigger adjustments to regulation and supervision, with focus on liquidity and business models. This can be expected to lead to higher buffer requirements for banks as well as further challenges to their business models, in particular when profitability is lacking.

Call for action: Banks

Funding	European banks should reactivate their deposit gathering muscle, through better understanding of deposit behavior and advanced pricing capabilities supported by models that inform volume and margin tradeoffs and liquidity positions aligned with bank targets. This requires targeted, client segment specific commercial actions, revisiting fund transfer pricing and relationship manager incentives supported by marketing campaigns. The ultimate objective should be to extend the maturity profile of funding at reasonable cost.
Interest rate risk	European banks should ensure their interest rate risk in the banking book (IRRBB) setup is fit for purpose in the new environment to deliver balance sheet and earnings stability. Given the speed of rate hikes, this requires increased management attention and reinforced governance.
Liquidity buffers	European banks should examine liquidity reserves, including the ability to monetize securities positions under stress scenarios, and revamp their crisis preparedness, including revisiting resolution and recovery plans and running tabletop exercises that address the potential impact of social media in a bank run.
Lending to support economic growth	European banks should use their additional balance sheet capacity for productive lending to the economy, also aiming to regain market share. To do so given capital constraints and limited ability to take additional risks, banks should actively explore and encourage clients to leverage existing and future programs of state-sponsored development banks, in particular related to policy priorities such as the green transition, which will require significant investments for the years to come.
Credit risk	As higher funding cost, a muted economic outlook, geopolitical risks, and the impact of the green transition weigh on the viability of especially those corporates that are highly leveraged, banks will need to revise their industry-sector strategies and lending standards, as well as proactively address any restructuring needs.
Innovation and consolidation	Although opportunities and capacity remain constrained, banks should continue to invest in innovating their business models toward more digitization as well as explore consolidation options across the eurozone.
Regulation	As additional requirements, especially on liquidity, are to be expected, banks should address the discussions proactively. Further, banks should be able to demonstrate the long-term viability of their business model and obtain clarity on the relevant drivers and levers.

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LIFE INSURANCE

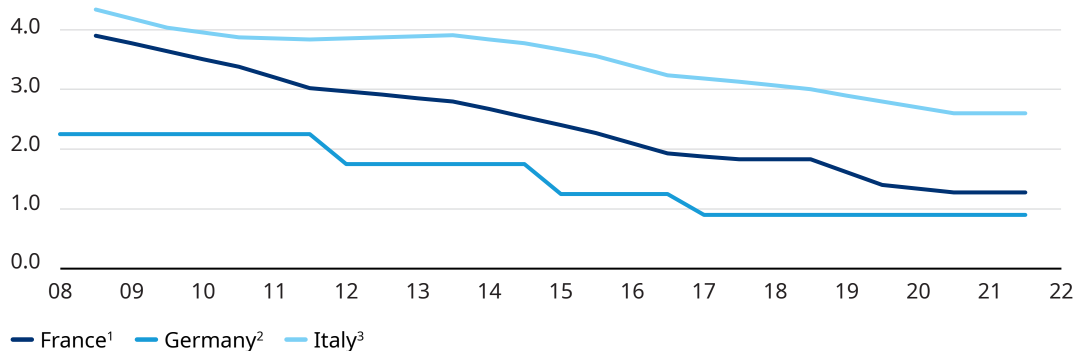
In advanced economies such as Europe, life insurers play an important role in the economy and financial markets. On the one hand, they are accumulating the retirement savings of the insured, who require a positive return on their savings that later supplements their pay-as-you-go pension incomes. On the other hand, life insurers build large asset pools that are important sources for long-term investment into the economy, including public debt.

It is obvious that the business model works only if the investments generate risk-adjusted positive real returns. This was a challenge during the Low for Long period, negatively impacting the solvency and profitability of insurers. Given the substantial investment needs in Europe, preserving the investment component of the life insurance sector is important. The return of positive nominal rates is a first step. Ultimately, real economic growth will be required to deliver positive real returns for insurers and policyholders. At the same time, life insurers need to adjust the products they offer to the clients to the risk-return profile that can be achieved.

Life insurers' solvency and profitability have been under strain during Low for Long. Life insurers' assets tend to have a lower duration than their liabilities, so decreasing interest rates negatively impacted their available capital and solvency ratios. At the same time, low interest rates across the term structure made it difficult for life insurers to offer guaranteed returns to policyholders and generate profits.

Exhibit 26: Life Insurance guaranteed rate

Selected EU countries, 2008–2021, %



1. Average "Fonds en Euros" yield
2. Maximum guaranteed rate of return for new business ("Höchstrechnungszins")
3. Average return on segregated funds ("gestioni separate") linked to traditional policies

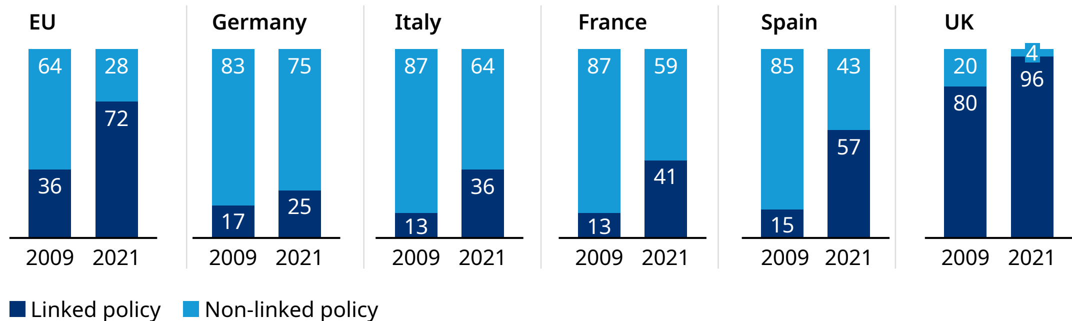
Source: France Assureurs, IVASS, DAV and Oliver Wyman analysis

In response, life insurers reviewed their offering strategies and reoriented their new business mix toward variable-payout (unit-linked and hybrid) policies, following the example of the UK life insurance market (Exhibit 27). They used several levers: they adjusted the pricing of their guaranteed-payout policies, charging higher premiums or reducing guarantees, and conditioned their access; they introduced new product designs with lower guarantees and/or more flexible options; and they re-oriented sales efforts. These changes were also carried out in the context of the EU's Solvency II Framework (2016), with reduction in guarantees enabling life insurers take some risk off their balance sheets.

Life insurers also acted on assets and liabilities management (ALM). Notably, they diversified their asset allocations for guaranteed-payout policies, shifting slightly toward riskier investments. They reduced their holdings of cash and government bonds and reallocated these resources to riskier bonds and to private markets, such as private debt, private equity, infrastructure, and real estate (Exhibit 28).

Exhibit 27: Annual life policy premiums split between linked and non-linked[1]

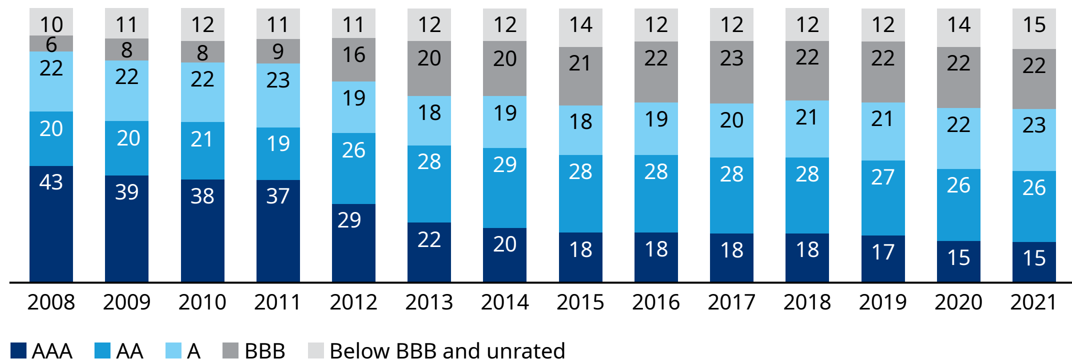
In % of total



1. Insurance with profit participation
Source: EIOPA, AMBest, Oliver Wyman analysis

Exhibit 28: Life Insurers' bond rating allocation

Sample of 56 European[1] Life Insurers, % of total bond holdings



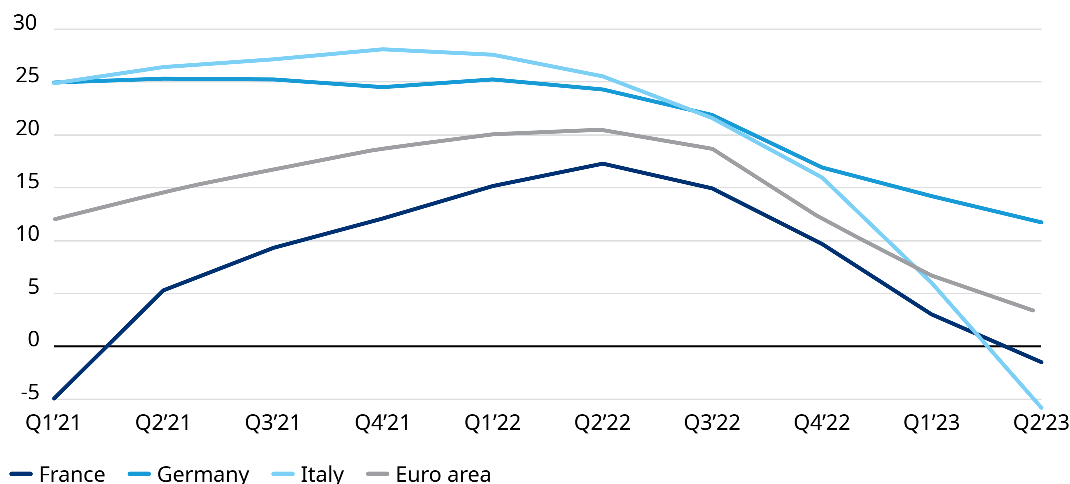
1. Including UK, Norway, and Switzerland
Source: IMF, S&P Capital IQ, Oliver Wyman analysis

In the short term, life insurers are facing turbulence from the decrease in net inflows, particularly on guaranteed-payout policies, which is causing liquidity risk. In the new environment, the performance of guaranteed-payout policies has been constrained by low-interest fixed-income securities acquired during the Low for Long period. In addition, the competition from banks, asset managers, and investment funds has intensified. Consequently, net inflows have decreased across Europe (Exhibit 29), and there has been a notable increase in policy lapses (Exhibit 30), although the situation varies significantly among countries. In this respect, some life insurers have been in trouble due to sizeable net outflows, which have created substantial liquidity needs and forced them to realize significant losses on devalued assets.

In the medium to long term, life insurers' solvency and profitability should benefit from the New Monetary Order, following the opposite mechanics at work in the previous decade. As interest rates lift, fixed income assets, which are a pillar of a life insurer's investment strategy, will once again generate positive returns nominal returns. For the attractiveness of life insurances as a savings vehicle, however, it is important that returns are also positive from a real perspective, adjusted for inflation. The monetary and economic environment will therefore be key. High debt levels in the economy could provide an incentive for central banks to put downward pressure on rates. Further, policymakers could be inclined to use regulation to direct investment in mind of policy objectives that do not positively correlate with investment returns. Whether insurers deploy their assets in Europe and provide the necessary investment to evolve the European economy will and should ultimately depend on the European economy achieving higher growth.

Exhibit 29: Life insurance net inflows[1] over net premiums earned

Euro area and selected EU countries, 2021–Q2 2023, 12-month rolling average, %



1. Net premiums earned minus net claims incurred
Source: EIOPA, Oliver Wyman analysis

Exhibit 30: Median policy lapse rate (all products)

European Union Life Insurers, in %

Avg. 2016–2021

2022

Source: EIOPA, Oliver Wyman analysis

Call for action: Insurers

Increase net inflows through active retention	Although guaranteed-payout policies offer limited leverage to control the behavior of policyholders likely to surrender, active retention programs targeted to specific customers and reserves can be used to boost yields and increase competitiveness. However, reserve schemes exist only in certain countries and their use is highly regulated. Examples include the "Rückstellung für Beitragsrückerstattung (RfB)" in Germany and the "Provision pour Participation aux Excédents (PPE)" in France.
Increasing net inflows with new bussiness underwritings	Rising interest rates provide an opportunity for life insurers to increase profitability in the short-term; however, they should carefully aim at finding the right balance between retaining additional earnings and increasing competitiveness of guaranteed-payout policies to attract new business. New business could potentially be boosted revitalizing guaranteed-payout policies through different forms of guarantee (such as temporary, short-term, or alternative) or exposing unit-linked products to alternative and higher-yielding asset classes such as private debt, private equity, infrastructure, and so on.
Expanding the investment universe	Insurers should be able to invest into a broader universe of assets to increase returns and to have a larger share of the economy benefiting from their investment activities. However, such expansion needs to be subject to strict risk management procedures and guidelines. Given that regulation such as Solvency II limits and also steers the sector's risk-taking behavior, the framework might require targeted adjustments (such as the United Kingdom considering changes to the "matching adjustment" approach). Ultimately, care should be taken that investments are not disproportionally targeting public debt.

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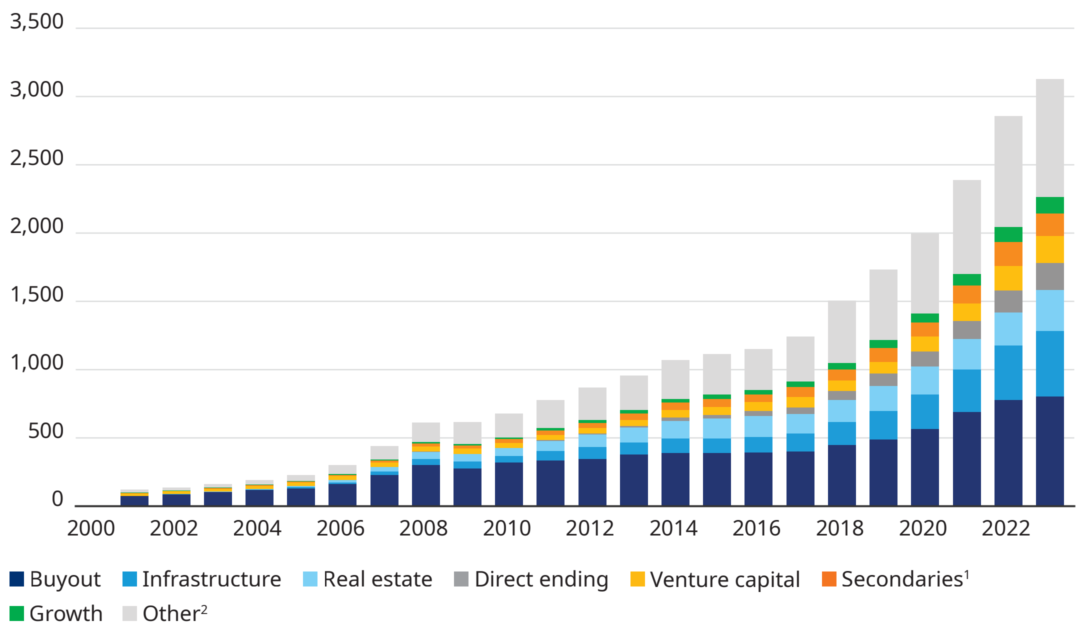
PRIVATE EQUITY

The private equity industry exhibited strong performance during most of the Low for Long period, driven by the search for yield by investors, cheap debt financing available to portfolio companies and buyout investors, and strong nominal equity valuations. Interest rate rises, uncertainty on the future interest rate path, inflation, and economic uncertainty related to the business prospects of targets caused a significant downturn in entry and exit deal volumes. As these uncertainties subside, a rebound of private equity activity can be expected in the short to medium term.

Private markets enjoyed strong tailwinds during the Low for Long period, boosted by low interest rates, high credit availability, and attention from investors searching for yield. Their strong performance also amplified these effects, creating a virtuous cycle. In addition to buyouts (the focus of this section), private markets evolved into a multifaceted asset class that included private debt, real estate, and infrastructure.

Exhibit 31: Assets under management in private markets

Investment funds located in Europe, 2000–2023, US$ Billion



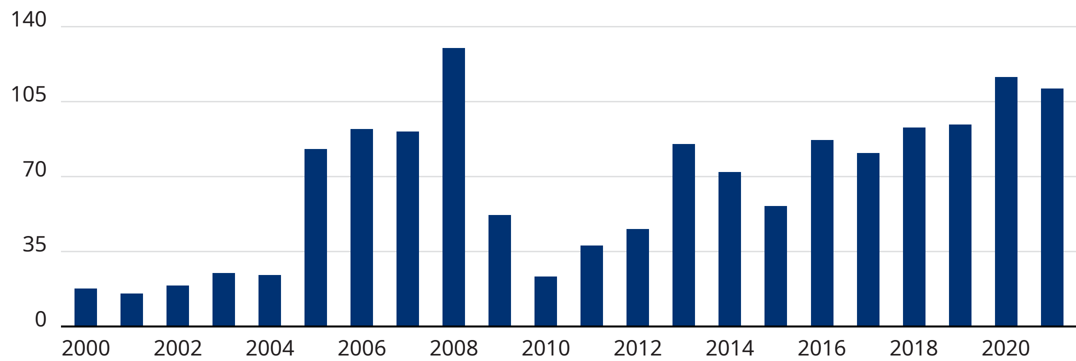
1. Secondaries inlcudes Direct Secondaries
2. Other includes Private equity (excl. Secondaries, Growth, and VC), Natural Resources, and Private Debt (excl. Direct Lending) AuM

Source: Preqin, Oliver Wyman analysis

The private equity industry reached new heights, and even the pandemic did little to slow the momentum, except for the first few months. All key indicators improved during the Low for Long period: fundraising (Exhibit 32) and deals (both in numbers and value) grew steadily (Exhibit 33); multiples continued a decade-long upward march (Exhibit 34); and internal rates of return (IRR) rapidly increased, also beating public equities (Exhibit 35).

Exhibit 32: Buyout capital raised

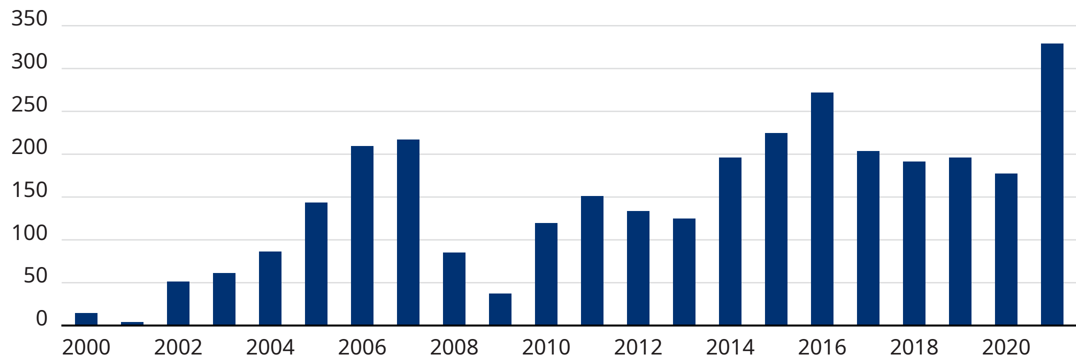
Private equity funds located in Europe, 2000–2021, Billion €



Source: Preqin, Oliver Wyman analysis

Exhibit 33: Buyout deal value

Private equity funds located in Europe, 2000–2021, Billion €



Source: Preqin, Oliver Wyman analysis

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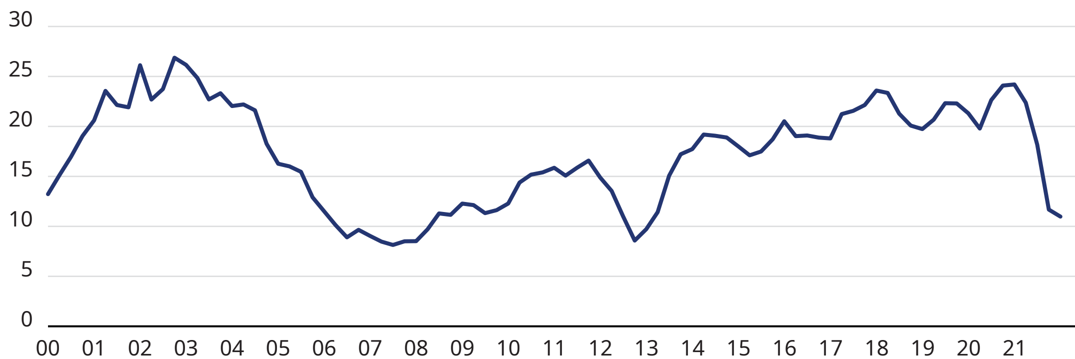
Exhibit 34: Median buyout EV-EBITDA[1] multiples

Private equity funds located in Europe, 2000–2021

1. EV=enterprise value; EBITDA=earnings before interest, taxes, depreciation, and amortization
Source: Preqin, Oliver Wyman analysis

Exhibit 35: Median buyout internal rate of return[1]

Private equity funds located in Europe, 2000–2021, % 12-month rolling average

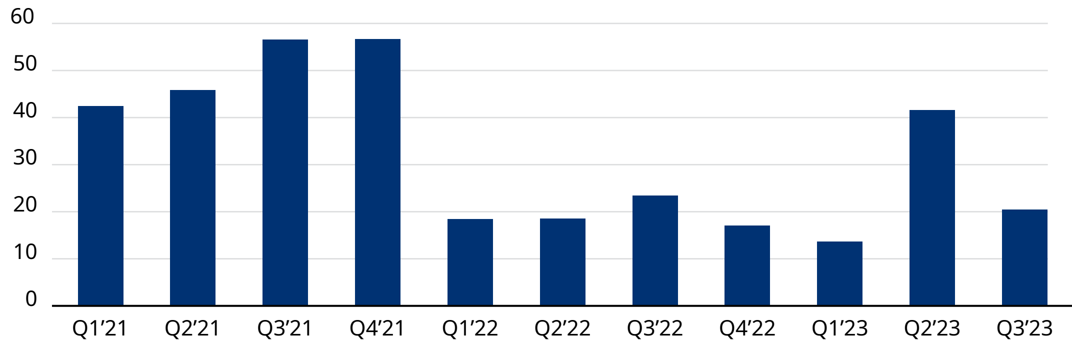


1. By year of exit
Source: Preqin, Oliver Wyman analysis

The industry turned bearish in 2022, particularly affecting private equity firms in greater need of liquidity. The end of the Low for Long era spilled into the buyout market, with all key indicators declining from the peak years (Exhibit 36) and all traditional exit options (mergers and acquisitions, initial public offerings, new leveraged buyouts) becoming less accessible and lucrative. A few private equity firms in need of liquidity were forced to sell some of their portfolio companies at valuations well below initial expectations.

Exhibit 36: Buyout deal value

Private equity funds located in Europe, 2021–Q3'23, Billion €

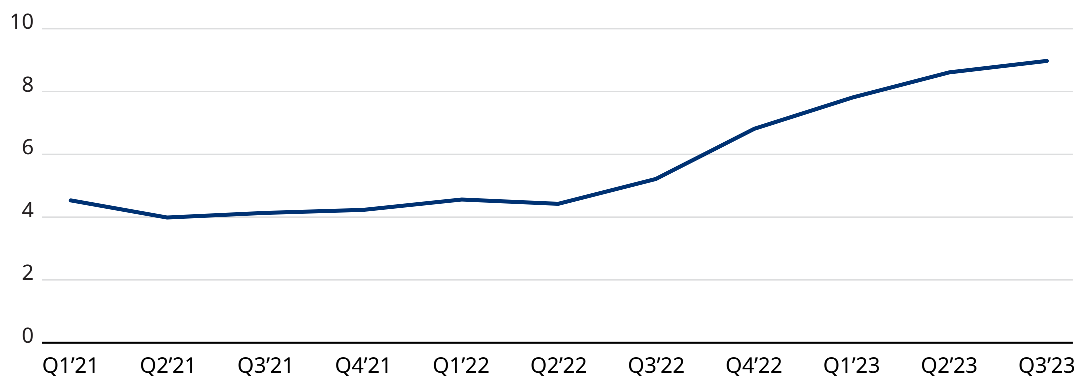


Source: Preqin, Oliver Wyman analysis

The higher interest rate environment brought several challenges for the private equity industry due to the combination of higher financing costs, depressed equity valuations, and limited mergers and acquisitions (M&A) activity. On the target side, higher financing costs and uncertain growth prospects in an inflationary and recessionary environment depressed valuations of target companies. On the investor side, buyout financing became scarcer and more expensive as banks pulled back from the leveraged buyout (LBO) market (Exhibit 37), constraining the valuations achievable in an exit; inflationary pressures were felt across value chains; and economic uncertainty started to hamper value-creation plans.

Exhibit 37: LBO average yield to maturity[1]

Private equity funds located in Europe, 2021–Q3 2023, %



1. For Term Loan B (amortization over 5 to 8 years with large bullet payment in the final year)
Source: Pitchbook, Oliver Wyman analysis

Going forward, a significant volume of dry powder combined with a perceived greater clarity on the interest rate environment seems to create more favorable conditions for the industry. The recent deal drought and economic uncertainty have caused private equity funds to accumulate marked volumes of available funds ready to be invested. Markets assuming an end of the hiking cycle given subsiding inflation has boosted equity valuations at a time when financing conditions for companies are already easing and growth prospects are improving. The industry can therefore be expected to rebound, although the European segment might be more challenging than regions that are expected to grow more strongly, in particular the United States.

Call for action: Private equity

Value creation	The era when multiple expansion was the primary driver of gains has come to an end, while the higher cost of capital is exerting increased pressure to generate returns. That means it is time for private equity firms to renew their focus on value creation. More than ever, private equity firms need to find their alpha to beat the market. They can achieve this by identifying relevant sectors and themes to specialize in and building deals and operational capabilities around these. They should also implement the necessary operational improvements and transformative strategies in their portfolio companies, recognizing that the set of value creation levers has broadened with the rapid evolution of technology such as generative AI and the growing importance of sustainability.
Additional opportunities	As rates stabilize and fundraising resumes, opportunities will arise for those private equity firms that are prepared to move quickly. The best deals are often made in downturns and the restructuring pipeline is expanding. Financial sponsors that are skilled at screening markets for targets and at uncovering value with active and operationally focused ownership will undoubtedly emerge as winners. In addition, private debt has seen continued momentum in the transition to the New Monetary Order, with several mega-fund closures. Private debt provides sponsors focused on private equity with a resilient, diversifying asset class that benefits from banks pulling back from the LBO market. While not fully immune to the macroeconomic cycle, the diversity of strategies provides a diverse playground in which sponsors can find their niches.
Continuation fund	The New Monetary Order will require a broader playbook to navigate the value creation cycle. Continuation funds provide sponsors with additional runway for their best-performing portfolio companies and for those facing temporary market headwinds. They also offer liquidity for investors without the typical term constraints associated with primary funds. In addition, general partner general partner-led secondaries and traditional refinancing via private debt provide a means for sponsors to extract value while maintaining the optionality with the value creation agenda.

NON-FINANCIAL CORPORATIONS

The protracted Low for Long environment did not lead to European non-financial companies (NFCs) on average significantly building up leverage given limited access to financing, tight lending standards, and limited desire and potential for debt-facilitated growth. Still, NFCs benefited from low financing costs. Increased interest cost now impacts net margins negatively. NFCs with already low operating margins that survived only because of low financing cost ("zombies") face viability and bankruptcy risks. Although the end of the hiking cycle seems to be in sight, funding costs will not materially decline in the medium term. Going forward, growth and operating margin improvement should be the primary priority, with NFCs being mindful of elevated geoeconomic and business risks, and devoting sufficient investment to innovating and managing the green transition.

Despite low interest rates and the ECB's supportive funding programs (such as TLTRO), European NFCs deleveraged during the Low for Long period (Exhibit 38 and 39). On the supply side, many banks tightened credit standards (Exhibit 39) under the more-stringent regulatory requirements that followed the financial crisis and the European sovereign debt crisis. On the demand side — with the corporate sector in Europe being heterogenous across countries and industry segments — investment needs stagnated in the European Union (Exhibit 40). Manufacturing and supply chains globalized, services played a greater role in the economy, and innovation made certain traditional capital assets less relevant. The transition to a service-led, digital economy has driven a shift from tangible to intangible assets, with intangible assets being poor collateral not conducive to accessing lending and not requiring the same upfront capital expenditure as traditional physical assets.

Exhibit 38: NFCs leverage

Euro area, 2000–2021, loans % total financial liabilities

Source: ECB, Oliver Wyman analysis

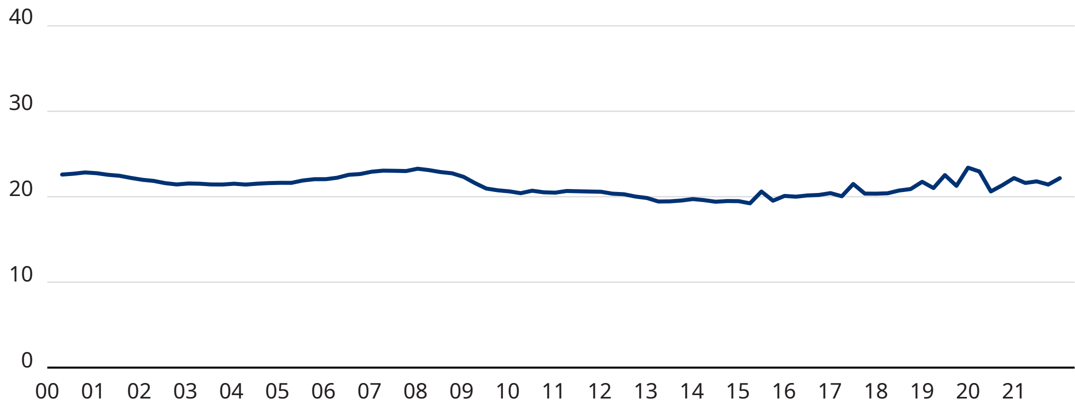
Exhibit 39: Banks credit standards to NFCs

Euro area, 2000–2021, % perceived evolution

Source: Eurostat, ECB, Oliver Wyman analysis

Exhibit 40: Level of investments in the economy

Euro area, 2000–2021, gross fixed capital formation % gross domestic product



Source: Eurostat, ECB data warehouse, Oliver Wyman analysis

Still, European NFCs benefited from the Low for Long era, which was characterized by stable growth prospects, low inflation, and inexpensive, easily accessible financing. Their profits rebounded from post-financial-crisis lows (Exhibit 41) as debt servicing costs decreased (Exhibit 42). Equity indexes doubled, and there was a rise in business ventures, notably in the technology sector. However, low-performing but highly leveraged businesses also appeared as viable, with zombie firms able to generate profits and obtain financing at low yields that did not reflect their true riskiness.

Exhibit 41: Profit rate[1]

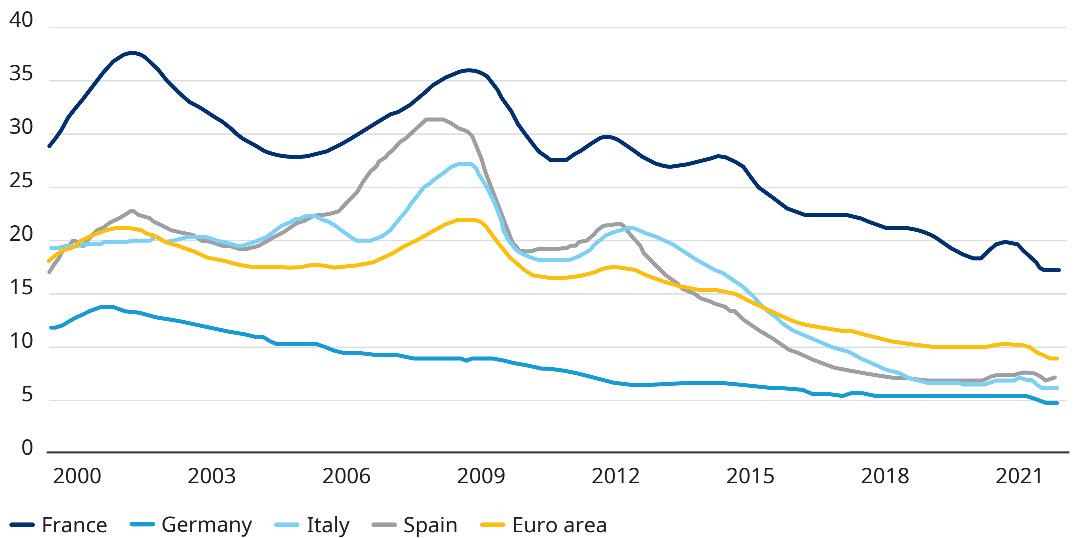
Euro area, all non-financial corporations, 2000–2021, %

1. Entrepreneurial income over value added, measures the efficiency of a business in generating income relative to the value it adds

Source: ECB, Oliver Wyman analysis

Exhibit 42: Gross interest payments

Four-quarter moving sums as a percentage of gross operating surplus



Source: ECB

Nevertheless, European businesses have been lagging those in the United States. European stock indexes have fallen behind US counterparts (Exhibit 43), Europe's exponential growth in unicorns has been significantly below that in the United States (Exhibit 44), the European technology ecosystem is still dominated by US GAFAs, and Europe's per capita GDP is still some 30% lower than that of the United States.

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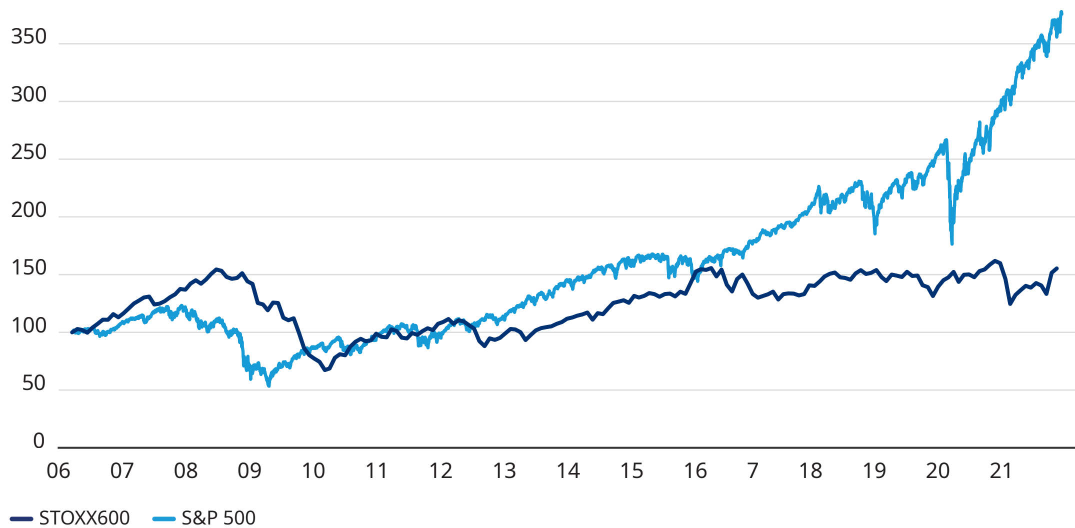
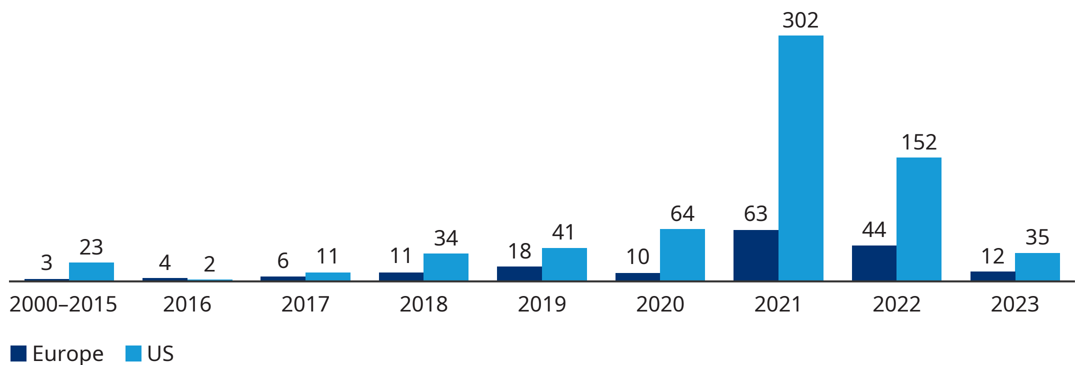
Exhibit 43: European (STOXX600) and US (S&P 500) equity indexes

2006–2021, index 2006 = 100



Source: Refinitiv Datastream, Oliver Wyman analysis

Exhibit 44: Number of new unicorns, Europe vs US

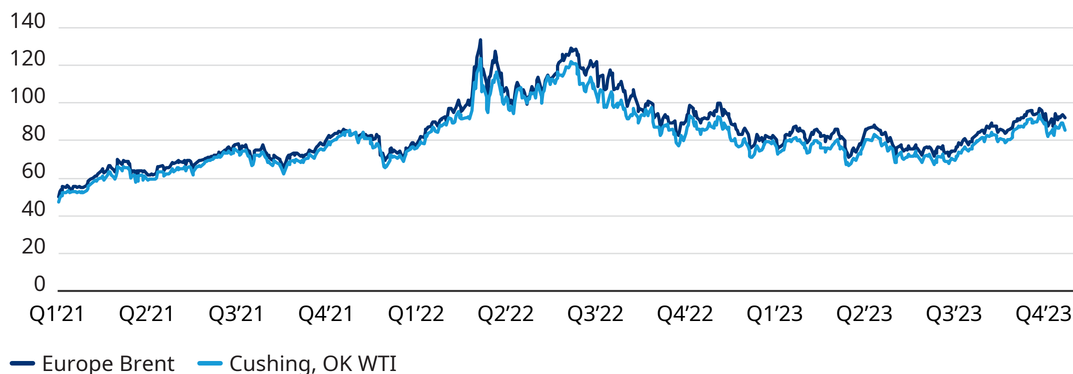


Source: CB insights, Oliver Wyman analysis

On the back of geopolitical tensions, natural disasters, and pandemics, NFCs have faced unprecedented supply chain challenges, with early signs of relocation emerging, and have also been hit by pervasive inflation, notably with rising and more volatile shipping and energy prices (Exhibits 45 and 46). There has been a notable acceleration in the re-localization of the manufacturing of specific parts or products to domestic markets, which has also been favored by government policies ranging from subsidies to bans. As for inflation, "greenflation," with demand for renewable energy rapidly rising, and "climateflation," with increasingly frequent severe environmental events (tornadoes, floods), are expected to increasingly impact NFCs.

Exhibit 45: Oil price

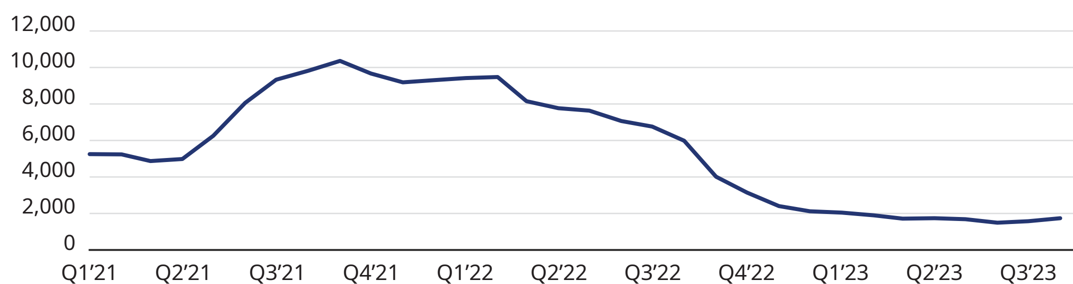
Spot price FOB, 2021–Q4 2023, $ per barrel



Source: EIA, Oliver Wyman analysis

Exhibit 46: Container freight rate index

2021–Q3 2023, $



Source: Drewry, Oliver Wyman analysis

NFCs, especially those with lower credit ratings, have also suffered from the inflation-induced rate hikes weighing on resilience and profitability. The higher cost of debt had direct, negative impacts on cost baselines and reduced NFCs' ability to obtain more financing to invest in growth in areas such as digital technology and the green transition. Some NFCs that have not secured long-term financing might cease to be viable if forced to refinance a significant share of maturing debt at higher costs.

Due to pressure on margins, an increasing number of European NFCs have been unable to fulfill their debt obligations and have been forced to cease operations. Markets' perceptions of solvency worsened, with credit default swap spreads rising rapidly (Exhibit 47), while the number of bankruptcies rose by approximately 30% since the start of the rate hikes.

However, important variations occurred across sectors, as demonstrated by the different trajectories in equity markets over the last two years (Exhibit 48). At one extreme, the highly debt-reliant real-estate sector particularly struggled, as higher borrowing costs weighed on demand.
At the other extreme, the energy sector thrived amid soaring prices caused by recent geopolitical tensions such as the Russia-Ukraine war.

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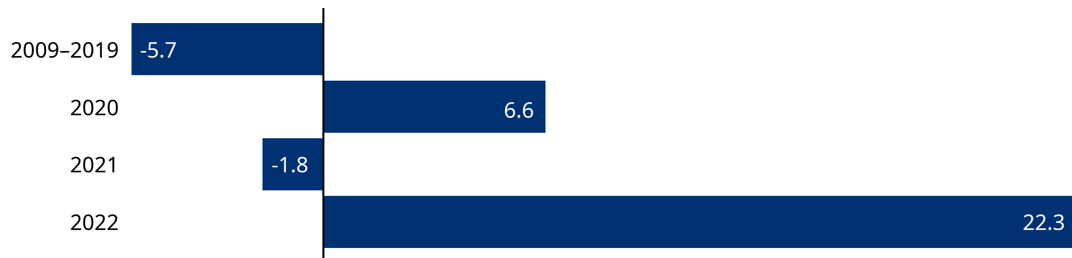
Exhibit 47: Credit default swap

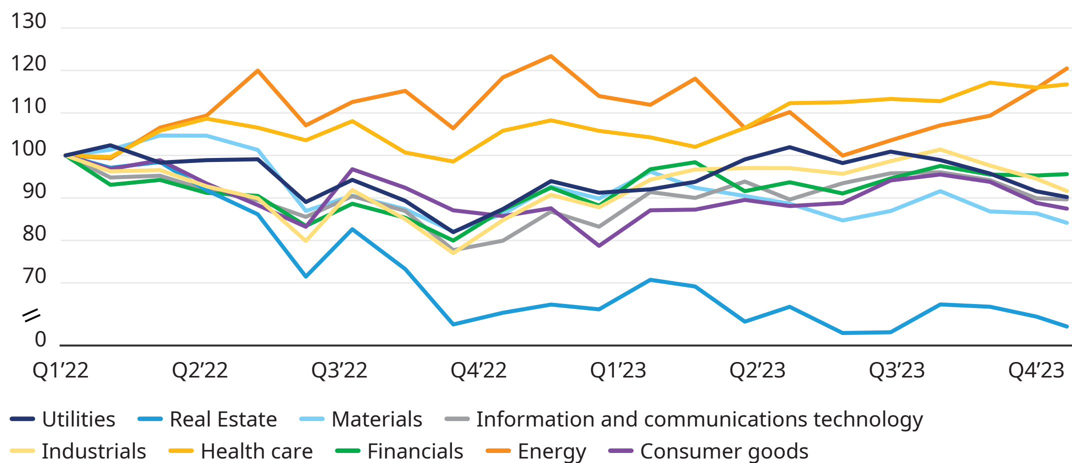
2009–2022, average % YoY evolution for STOXX600 NFCs



Source: S&P Capital IQ, Oliver Wyman analysis

Exhibit 48: Average market capitalization by sector

STOXX600, 2022–2023, index 2022 = 100



Source: Refinitiv Datastream, Oliver Wyman analysis

Call for action: Non-financial corporations

Debt reduction	NFCs that are overleveraged need to re-evaluate the relevance of their capital structures and take urgent action to reduce their debt burdens. These measures can require strategic, operational, and financial restructuring, while the needed time and buffers are still available. Freeing up cash is critical and can be achieved through various levers, such as reducing dividends, improving the management of working capital (for example, collecting accounts receivable earlier, delaying accounts payable, and optimizing inventory), and reducing noncritical expenditures. However, the possible consequences should be analyzed in depth before decisions are made, as some effects may be negative — for example, a loss of confidence from shareholders and markets, worsening supplier-client relationships, and reduced staff motivation.

Margin defense	To relieve the additional pressure on margins arising from inflation and the rising cost of debt, NFCs should explore — or reexplore — pricing management, cost excellence, and energy source reconfiguration.
Pricing management	Counterintuitively, inflation provides opportunities to inject product value into pricing discussions and make long-term changes to pricing practices. No single solution will fit all companies, so NFCs should pursue a variety of measures: Implement agile pricing solutions; set up a solid governance system that coordinates pricing, sales, and procurement teams to address complex, volatile environments; set value-based target prices using advanced analytics models; and modernize pricing processes over the medium to long term.
Cost excellence	Achieving cost excellence must be a pillar of any business strategy to thrive in the new environment. Cost excellence focuses on transforming company performance for the long term, not simply pursuing tactics with limited, short-term impact. It requires a fundamental rethinking of a company's operating model, as well as a shift in culture, so that the workforce is engaged and motivated to adopt new, winning behaviors and make the transformation sustainable.
Energy sourcing reconfiguration	Record-high and volatile energy prices, combined with more stringent regulations and ambitious commitments, have made it clear that European NFCs need to review their energy source configurations. This applies especially to those that consume large quantities of energy, in sectors such as manufacturing, transportation, and construction. NFCs should fully embed energy procurement into their strategic roadmaps through scenario analysis (for example, of variations in energy prices) and reviews of their financial capabilities to decide on the most relevant levers. Examples could include generating their own energy, power purchase agreements, and hedging. Beyond resilience and cost optimization, NFCs have a concrete opportunity to turn themselves into frontrunners in the global energy transition and to stand out from competitors accused of greenwashing.
Supply-chain relocation	NFCs need to switch from a methodology that is mainly based on cost efficiency to one focusing on resiliency and trust, also exploring the relevance of a more local supply chain. Reshoring would be particularly relevant in case geopolitical tensions worsen, while automation should also make the case more compelling in the long term by reducing costs and improving efficiency. If NFCs consider this path, they should understand their geopolitical risk exposure, decide which products to relocate, choose which markets to relocate to, and ensure regular checking of new suppliers.

GOVERNMENT ECONOMIC AND FISCAL POLICY

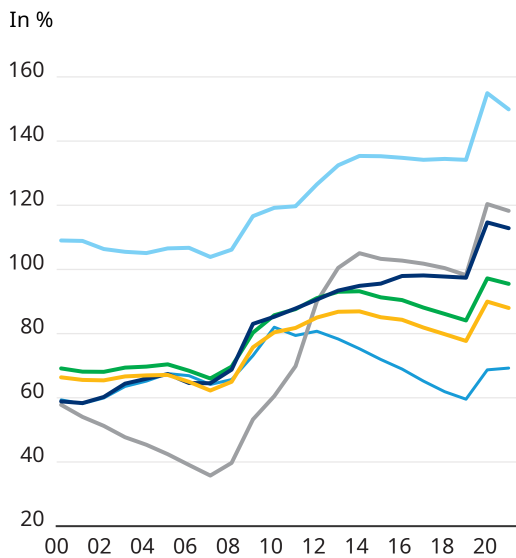
The Low for Long era came with record-low financing costs for European governments, some being able to take on debt at negative interest rates. The ECB's monetary policy also contributed to the narrowing of spreads across the eurozone so that economically weaker countries benefited from the accommodative environment. This environment was conducive to governments taking on more debt, and some of them did so with limited longer-term prudence. Yet the accommodative environment enabled European countries to create large-scale support and stimulus packages during the COVID-19 period, saving economies from broader and sustained damage.

The return of positive rates has now increased cost of debt for European countries. Fiscal strength and debt sustainability are of concern at a time when significant investment is needed and geopolitical risk is high. Going forward, with cost of debt not reaching Low for Long levels anytime soon, it is important to direct expenditure toward growth-enhancing investment and reforms and otherwise exercise fiscal prudence.

During the Low for Long era, many European Union member states significantly increased public debt levels (Exhibit 49). Governments ran significant deficits (Exhibit 50), taking advantage of near or below zero cost-of-debt (Exhibit 51) as the ECB implemented measures to stabilize the eurozone debt crisis. At the same time, the economy grew more slowly than before the financial crisis, and the impact of expansive monetary policy on stimulating the economy fell short of expectations (Exhibit 52). One factor was that the lending channel became less efficient as banks tightened credit standards under new regulatory constraints, and corporations reduced their leverage (see dedicated sections). Countries forced to reduce their deficits, such as Greece, Spain, and Italy.

Exhibit 49: Consolidated debt/GDP

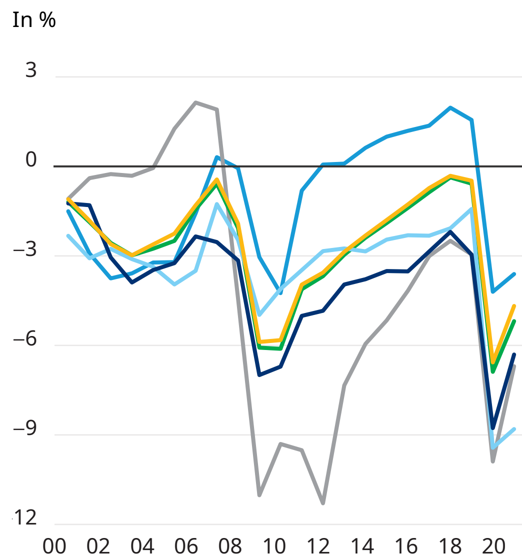
In %



Source: Eurostat, Oliver Wyman analysis

Exhibit 50: Net lending or borrowing/GDP

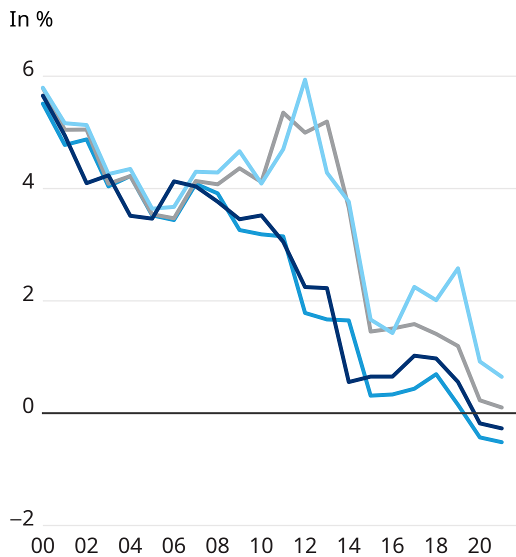
In %



Source: Eurostat, Oliver Wyman analysis

Exhibit 51: 10-year government bond yields

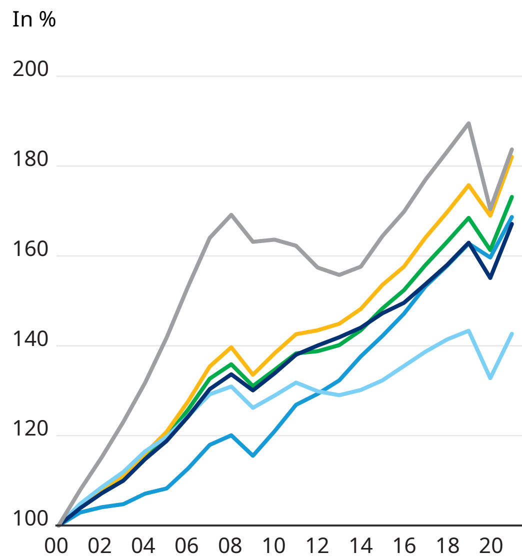
In %



Source: Refinitiv Datastream, Oliver Wyman analysis

Exhibit 52: Gross domestic product [GDP]

In %



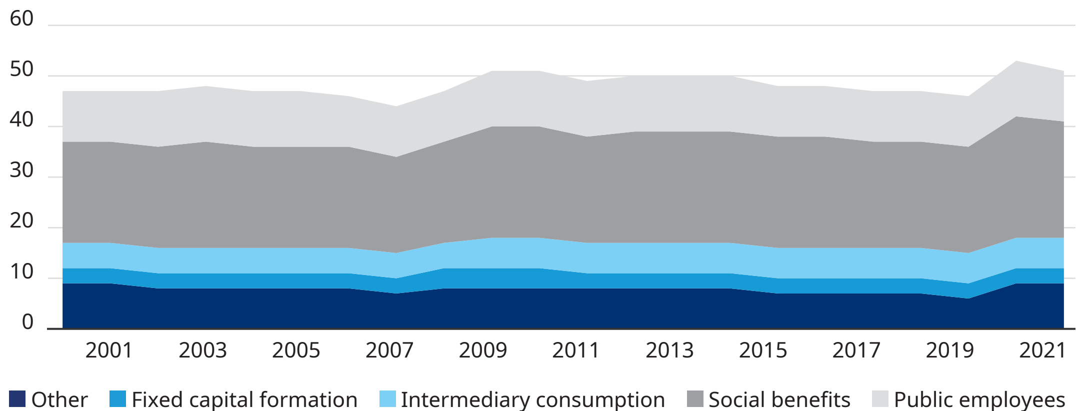
France Germany Italy Spain EU 27 countries Euro area 19 countries

Source: Eurostat, Oliver Wyman analysis

Debt accumulated during the Low for Long era served to navigate or overcome difficulties, including the financial crisis, the sovereign debt crisis, and the impact of the COVID-19 pandemic. It also helped to avoid austerity measures that might have led to recession. Many EU member states used debt to stabilize their financial sectors — by bailing out banks in some cases — and to support fiscal stimulus, particularly through higher social benefits aimed at mitigating the effects of recession-induced issues such as unemployment (Exhibit 53). Inexpensive debt enabled governments to avoid cutting public spending and limited rises in taxes or social contributions (Exhibit 54), which could have further depressed economic growth. Political considerations may also have played a role, and some decisionmakers prioritized the use of debt to avoid social discontent.

Exhibit 53: Expenditures

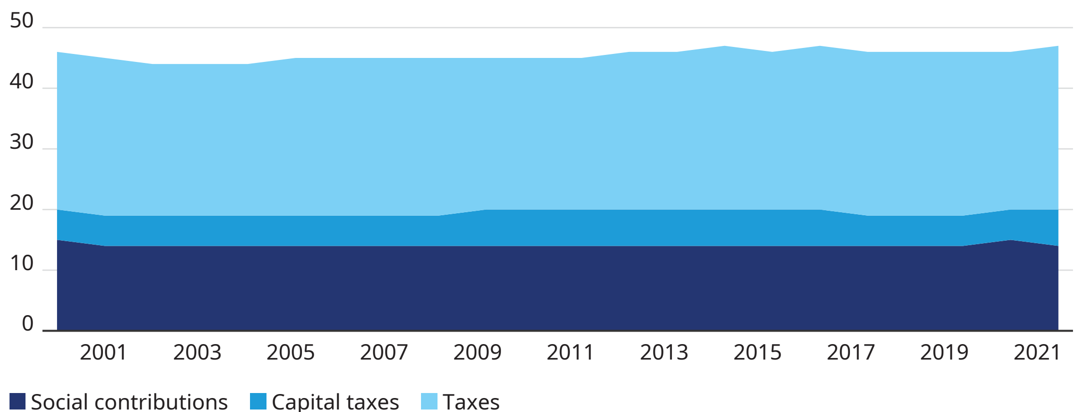
European Union-27 countries, % GDP



Source: OECD, Oliver Wyman analysis

Exhibit 54: Revenues

European Union-27 countries, % GDP



Source: OECD, Oliver Wyman analysis

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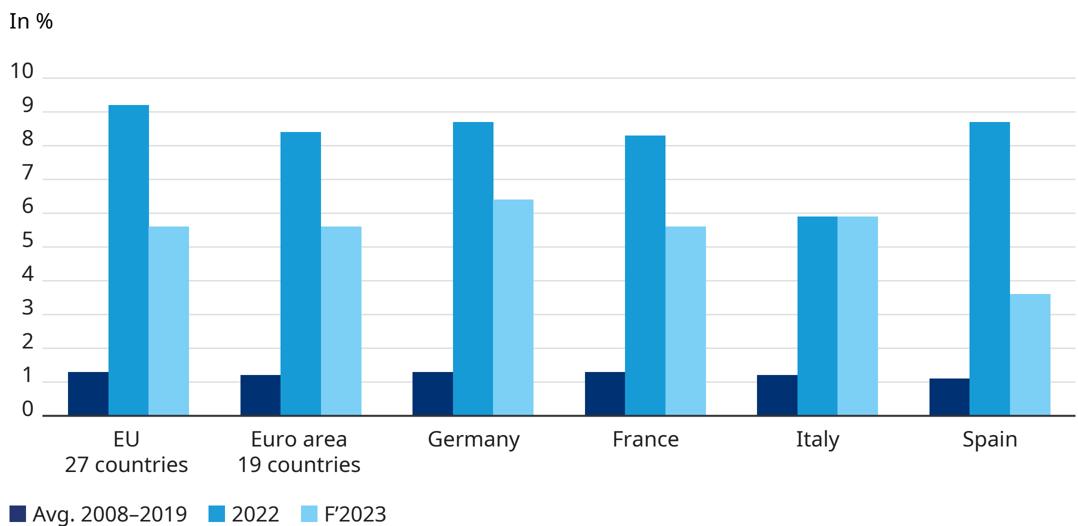
EU member states that accumulated debt during the Low for Long era will see their fiscal space pressured due to higher debt expenditure. The ECB's tightening cycle to fight inflation (Exhibit 55) pushed up government bonds yields by around 3 to 3.5 percentage points between January 2022 and September 2023 (Exhibit 56). As inexpensive debt matures, and as many European countries have not used the low-interest rate period to extend the maturity profile of their borrowings, this increase in borrowing costs will eventually weigh on national budgets, and member states will be forced to take action to keep their debt at more-sustainable levels. They will need to find the right balance between debt management and provision for additional future challenges. These include sustaining pension systems as populations age, fostering long-term economic growth, notably through the net-zero transition and digital transformation, and improving crisis preparedness and responsiveness.

Exhibit 55: Inflation

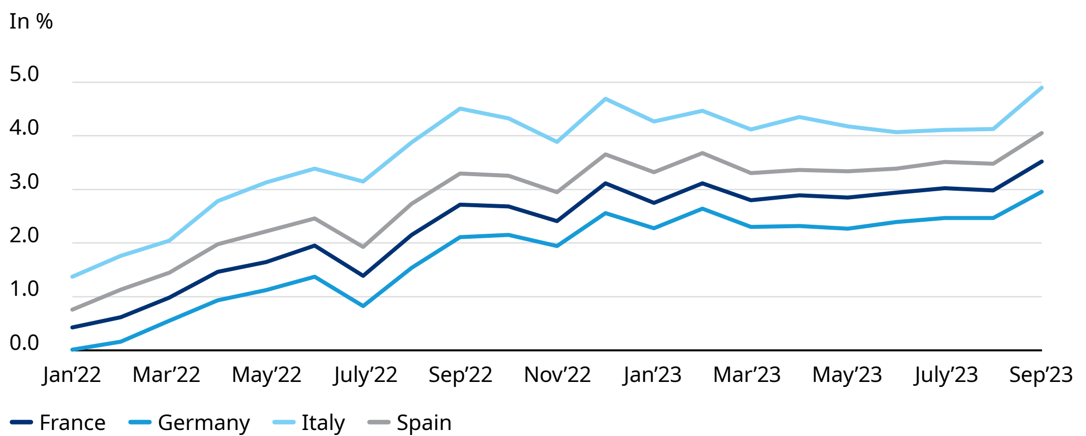
In %



Source: Eurostat, OECD, Refinitiv Datastream, Oliver Wyman analysis

Exhibit 56: 10-year government bond yields

In %



Source: Refinitiv Datastream, Oliver Wyman analysis

In response, many critics renewed calls for major reforms of the EU fiscal framework, which has produced very mixed results historically. In 2022, 13 members states reported debt that was over 60% of GDP, and 11 had budget deficits over 3% of GDP. Thus, many stakeholders have long been advocating major reforms, for example on reference aggregates, thresholds, and adjustment paths. In response, the European Commission (EC) presented a series of initial proposals in April 2023 "to strengthen public debt sustainability and promote sustainable and inclusive growth in all Member States [and] address shortcomings in the current framework." Just before the end of 2023, EU finance ministers agreed on a reform of the Stability and Growth Pact (SGP). While the key benchmarks of a maximum of 60% debt-to-GDP ratio and a 3% limit on primary deficits remains in place, member states obtain more flexibility on the path to achieve these targets. Under the new rules, the EC will define spending plans for countries exceeding the defined limits so that debt and deficits are put on a downward trajectory. Importantly, spending toward investment ("growth-enhancing reforms") obtains a more favorable treatment. At the same time, enforcement procedures will be strengthened. The EC has already established that the 2024 budgets of several member states are not in compliance with the proposal, which also needs to be approved by the (more lenient) European Parliament first.

In the long run, EU ambitions could be threatened by additional budget pressures. The European Union has launched several initiatives during the last decade on specific themes or to achieve specific transformational objectives, such as NextGenerationEU — a plan for a post-pandemic recovery that is green, digital, healthy, strong, and equal; Horizon Europe, a research and innovation funding program; and the LIFE Program, named after the French abbreviation for "funding instrument for the environment and climate action." These programs rely on funding from member states, either directly or indirectly (for example, via the EU budget or EC bonds), which in turn rely on the credit rating of the economically strongest members. Consequently, if member states become less inclined to coordinate and pool resources or if debt costs of the stronger members rise, the ability of the EU to finance these and future programs could be at risk. While there are debates on allowing the EU to raise revenues directly through taxation, they need to take into account that such taxes would add to the overall tax burden for EU businesses and households.

Call for action: Government economic and fiscal policy

Public bodies should act to avoid a further rise in public debt	Considering the burden of social security expenditure, challenged sustainability of pension systems, the need to invest, and the demands for military spending, significant tradeoffs will be required as unsustainable finances will need to be rebalanced. Carefully evaluating impact and coordinating policies will be critical to maximize effectiveness, to address ongoing challenges in an equitable manner. Governments should respect the ECB's price stability mandate and not expect monetary support for sustained and increasing public debt levels.
Expenditures should be directed to achieve maximum long-term impact and priority should be given on spending related to investment and reforms that create broad economic growth	This involves investing in the future and focusing on initiatives generating real returns (education, innovation, infrastructure) while also making sure to address the most pressing challenges of our era and associated consequences (technology disruptions, climate change, population aging, and resulting pressure on social security schemes).
Subsidies should be directed to cushion short-term impact, while not allowing unsustainable structures to survive	Zombie companies, with nonviable business models that used to benefit from attractive funding conditions and special packages (such as during the COVID-19 crisis) should no longer be supported given their negative contribution to the European economy.
Levers on the revenue side — such as tax increases, social contributions, and so on — should also be explored	Increasing government revenues, such as through tax hikes or a broadening of the tax basis, could be used to finance additional expenditures without increasing public debt. However, the room for maneuver vary significantly across countries in Europe, given different relative tax burdens.

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GLOSSARY

AI	Artificial intelligence
ALM	Asset and liability management
APP	Asset Purchase Programme
BoE	Bank of England
CET1	Common equity tier 1
CMU	Capital Markets Union
EC	European Commission
ECB	European Central Bank
EU	European Union
GDP	Gross domestic product
GFC	Global financial crisis
HQLA	High-quality liquid assets
IRR	Internal rate of return
LBO	Leveraged buyout
LCR	Liquidity coverage ratio
LTRO	Long-term refinancing operations
MMT	Modern monetary theory
NBFI	Non-bank financial institution
NFC	Non-financial corporation
NIM	Net interest margin
NMO	New Monetary Order
NSFR	Net stable funding ratio
OMT	Outright monetary transaction
PEPP	Pandemic Emergency Purchase Program
PPE	Provision pour Participation aux Excédents
RfB	Rückstellung für Beitragrückerstattung
RoE	Return on equity
SMP	Securities Market Program
SNB	Swiss National Bank
TLTRO	Targeted long-term refinancing operations
TPI	Transmission protection instrument
UMP	Unconventional monetary policy

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