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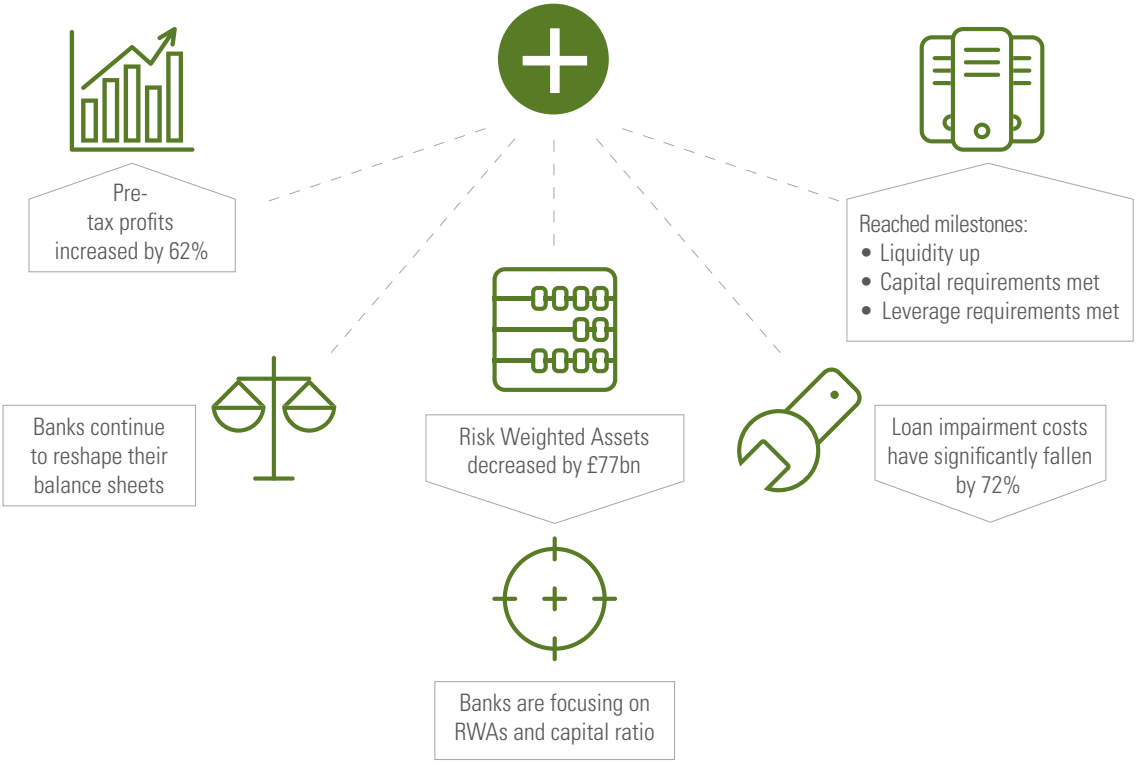
cutting through complexity

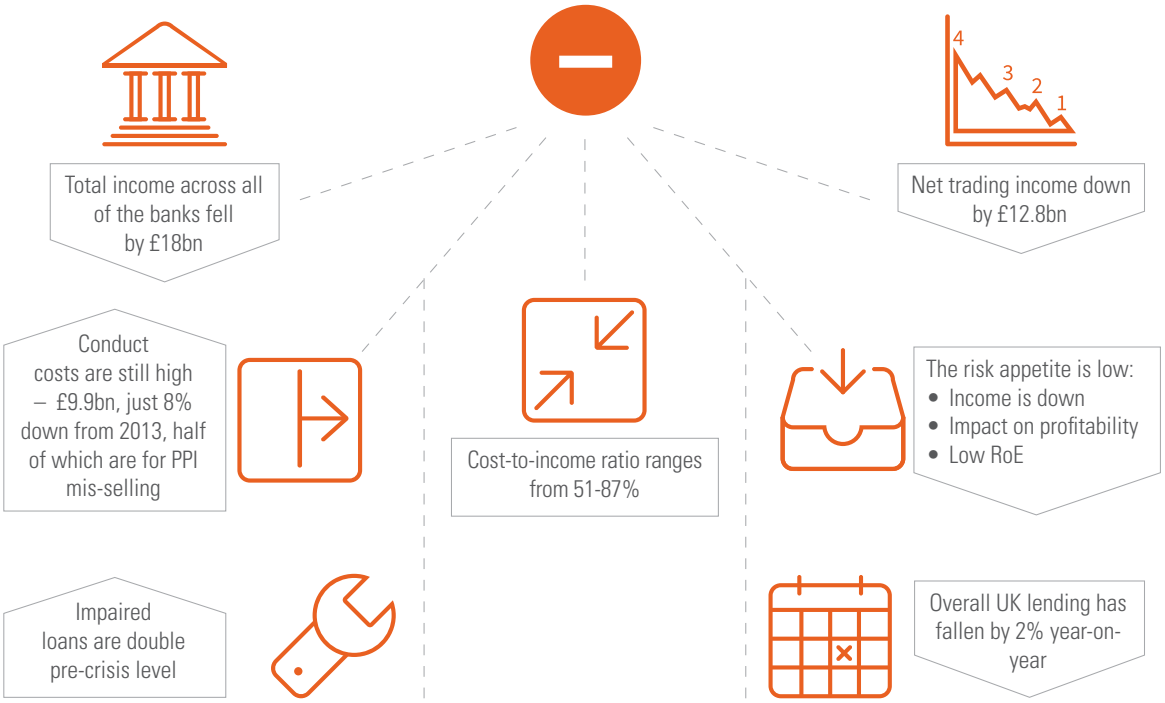
A paradox of forces

BANKING RESULTS: What do they mean for you?

April 2015

BANKING RESULTS 2014 SNAPSHOT





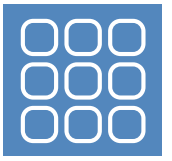
BEHIND THE NUMBERS

Net Promoter Score – 4 out of 5 banks announced. This is a good sign that banks are adopting a more customer centric strategy.

No bank has a RoE higher than 8%. Banks need to work harder to become more profitable.

Leverage ratios across all banks range between 3.7% to 4.9%. Ring-fenced banks will have to meet ratios above 4%.

3 out of 5 banks trading below book value, this highlights the ongoing market challenges.



The cumulative cost of customer remediation and conduct between 2011 and 2014 is £38.7bn – that's over 60% of the profits during the same time.

The rise of the bank levy rate to 0.21% of banks' balance sheets will cost the industry an additional £900mn a year with the consequence that banking in the UK becomes less effective and increases the risk of operations being moved out.

INTRODUCTION

The 2014 annual banking results show clear signs of recovery and improvement in the industry. A lot has been written and said about banking since the crisis, however banks deserve credit for the reduction on risk-weighted assets (RWA) and impairment costs, as well as improved liquidity and increased profits (**page 9**).

We see five organisations developing very differently; organisations with decreased profitability and income, with issues that question the sustainability of the banks' cost structures and business model efficiency. Banks need to fully realise the value and impact of a solid digital strategy and improved cultural governance (**page 5**).

Concurrently, new regulatory demands on a UK and EU level, capital market reforms and geopolitical uncertainty put further pressure on the main players (**page 17**).

Our banking experts examine how the different forces at play are simultaneously accelerating and disrupting the industry.

THE POWER OF CULTURE AND TECHNOLOGY

Much has been achieved since the onset of the financial crisis. That's good. But how do you keep up the momentum?

The recent results show that the banking industry is moving in the right direction. A lot has been achieved and all the banks have posted higher profits. Lloyds has the lowest cost structure in the industry as well as the highest common equity tier 1 (CET1). RBS has turned a £8.8 billion loss into a £2.2 billion profit.[1] HSBC and Standard Chartered Bank (SCB)[2] have the highest return on equity (RoE) among the big five and Barclays, amongst others, has increased mortgages and SME lending to its UK customers. On top of this, all the banks have reshaped their balance sheets and are on course to meet their targets for capital, leverage and liquidity.

We are also seeing an acceleration of changes as the competitive landscape evolves and new forces disrupt the banking industry. Challenger banks and peer-to-peer platforms are offering customers a new set of deposit and borrowing alternatives. Technology-led services such as PayPal and e-wallets are changing the way we transfer money and pay for goods and services. Technology is clearly a disruptive force on UK banking.

> Four of the five institutions have taken the significant step of including customer satisfaction information in their annual reports.

Regulation accelerates and disrupts inevitable reform

None of the banks has a RoE higher than 8 percent. Even without further regulatory activity, this requires radical use of new technologies to increase returns from delivering more customer value and reducing costs. These changes are coming on stream at a time when the major banks are being held to greater account for their conduct. This regulatory tightening is enshrined not only in the FCA's conduct risk principles but also in their proposed Senior Managers Regime (SMR) legislation. Banks face ring-fencing of retail and non-retail operations in the long term. Meanwhile, the Fair and Effective Markets Review may generate further regulatory reforms. All in all, regulation is both a disruptor and an accelerator to the banking industry. Plus, the rise of the bank levy in the March 2015 Budget will put further pressure on the industry, as UK banks will need to find an additional £900 million a year. But the debate will move on and push banks to re-evaluate and radically reform their operations and business strategies for a future fit.

Culture and customer centricity

A total of £9.9 billion in conduct remediation costs was posted for 2014, and this will act as a painful reminder that banks must put customer requirements ahead of short-term profits. Clearly cultural change remains an imperative. It took a generation to mess things up; will it take a generation to repair the damage? This is an increasingly popular view.

There is a genuine commitment at board level to create customer-centric organisations and a recognition that good conduct must link

86% of adults would trust banks more if they would act in society's best interest.[3]

directly to ethics, personal morality and integrity. Regulation alone cannot fix this problem; that would be like painting by numbers.

Banks must take a broad view of ethics and values, and demonstrate that leadership actions, incentives, promotion and recruitment are consistent. They have found it challenging to cascade values and ethics defined at board level down through organisations in a meaningful way. Ultimately, culture change cannot be a bolt-on activity. Good intentions will only flow through the banks if the underlying business models are congruent.

> Some participants will follow a path of gradual evolution; others will opt for a complete strategic change.

Failure to bring about cultural change carries real financial and legal risks. Banks face penalties for conduct risk breaches, and from 2016 the SMR legislation will expose executives to the prospect of sanctions under criminal law. Nonetheless, preparations for the new regime will provide banks with an opportunity to tighten existing governance procedures and renewed emphasis for creating fundamental culture change.

The role of digital is not understood

The banks surveyed have all stated their commitment to improving customer service and four of the five institutions have taken the significant step of including customer satisfaction information in their annual reports. However, banks continue to be organised and deal with customers through product and channel silos and therefore the overall promise to focus on the customer experience remains somewhat unfulfilled. Digital and mobile solutions have a major role to play in bridging those silos – from a direct customer experience perspective but also by equipping banking staff with the digital tools to bring the disparate information together to support the customer service promise. There is significant progress to be made and banks have not yet harnessed the power of digital or understood how it can be a positive disruptor.

While the need for improved service is clearly recognised at all levels within the banks, the appreciation and understanding of the role of digital in that battle is not as widely understood. Going forward banks must embed digital within their DNA, while accelerated digital transformation must be at the core of business strategy in order for them to succeed.

The banking landscape is changing and innovation is driving new levels of customer expectation. New forces are evidently impacting the market and giving banks the chance to explore new growth opportunities. Some participants will follow a path of gradual evolution; others will opt for a complete strategic change. Whatever their strategy, as long as the customer is put first and a resilient digital DNA is mapped out, we believe banks should be in a place of optimism to move forward with confidence.

[1] Consists of profit/(loss) before tax from continuing operations.
[2] SCB presents RoE on an underlying basis.
[3] YouGov Reports Challenger Banks survey, 2014.

THE GAME CHANGERS?

The challenger community will be looking closely at the annual results of the big five for opportunities to increase its grip on the UK market.

As it stands, challengers nearly doubled their share of retail lending from 4 percent in 2010 to 7 percent in 2013.[1] If these growth rates continue the challengers could capture at least 15 percent of the market by 2020, against the backdrop of a decline in total loans and advances to customers from the traditional players.

These institutions are playing an important role in opening up a sector that has traditionally been led by a handful of major players. Metro Bank was the first new bank to launch in more than a century after gaining a full banking license in 2010. Since then another six challenger banks have been launched – with more to follow, such as Atom Bank and Civilised Bank.[2] Larger retailers including Tesco, Sainsbury's and M&S have created their own financial services offerings, with product ranges increasing year on year. In the last 18 months, Virgin Money, TSB, Aldemore, One Savings Bank and Shawbrook have all undertaken IPOs, meaning they are well capitalised for future growth.

Many of these challengers operate in niche markets, with smaller product offerings than the large high street banks. In addition, they tend to have limited legacy issues, both in terms of conduct risk and IT systems, which has contributed to greater profitability and higher RoEs (up to 31%[3]).

It remains to be seen whether the challenger banks can continue a growth trajectory while maintaining these strong RoEs. There is mixed evidence that they are making progress across the board. According to research by TNS UK in 2015, Santander was the biggest current accounts winner, as a result of the Payments Council Current Account Switch Service (CASS) with an 11 percent net gain, while Halifax and Nationwide saw growth of 6 percent and 5 percent respectively.

The challengers have yet to make a sizeable impact on the market but they may do so in the near future. Also, the results of the Customer Market Authority review into banking is eagerly awaited, as they see it as a potential opportunity to level the playing field. Further analysis of the challenger bank market will be set out in our upcoming challenger banks report. For now, the message to the big five is clear: the challengers have arrived and they are driving innovation and offering agile services that are developed with the customer at heart. The established banks must think like challengers and truly put the customer first in order to defend their market share.

86%

of current account holders have their main current account with one of six big banking groups.[4]

[1] KPMG analysis, 2014
[2] www.cityam.com/211041/civilisedbank-there-s-another-new-challenger-bank-scene-imminent-uk-launch-plans
[3] www.osb.co.uk/#section5
[4] YouGov Reports Reputation of Banking survey, 2014

ANALYSIS OF THE BANKING RESULTS

The figures on this year's bank profits, margins and lending reveal a great deal about the state of the economy as a whole – and paint a mixed picture.

In common with other institutions, the big five UK banks are continuing on a path that has already seen them reshape their balance sheets, with a focus on RWAs and capital ratios – essential measures for locking-in stability and satisfying regulators' demands.

On the flipside, there has been a continuation of a lower appetite for risk, which has affected income, profitability and RoE. The big five recorded total pre-tax profits of £20.6 billion, an increase from £12.7 billion in 2013. But while Lloyds and RBS continued to show improved profitability, the three global banks all recorded a decrease in profitability.

KEY POINTS

- **Profitability:** All banks recorded pre-tax profits of £20.6 billion – an increase of 62% from £12.7 billion in 2013.
- **Conduct and loan impairment costs:** The total conduct cost across the banks in 2014 was £9.9 billion, only 8 percent down on 2013 (£10.8 billion) and 19 percent on 2012 (£12.2 billion). Total loan impairments have fallen significantly by 72 percent, from £18.7 billion in 2013 to £5.2 billion in 2014.
- **Cost-to-income ratio:** Costs remain high on the agenda – all banks are going through optimisation programmes. Cost-to-income ratio ranges from 51 percent up to 87 percent.
- **Return on equity:** None of the banks has a RoE higher than 8 percent.
- **Balance sheet:** Total assets* increased for four banks, totalling £5.4 trillion. In comparison, total RWAs have decreased £77 billion to £2 trillion.
- **Reported leverage ratios:** Range from 3.7 percent to 4.9 percent.

* Total assets figure for Barclays decreased from 2013 to 2014 in US$, but appears to increase due to conversion rates to GBP.

	Ba
	2014
Statutory profit/(loss) before tax (£ million)	2,256
Total income[2] (£ million)	25,768
Net interest margin (basis points)	408[3]
Cost-to-income ratio	81.0%
Impairment charge (statutory) (£ million)	2,168
Return on equity[4]	(0.2%)
Impaired loans and advances to customers	2.0%[5]
Impairment cover[7]	58.4%
Redress, regulatory and litigation costs (£ million)	2,360
Total assets (£ million)	1,357,906
Net assets (£ million)	65,958
Leverage ratio	3.7%
Liquidity coverage ratio[13]	124%
Total loan to deposit ratio	100%
Loans and advances to customers (£ million)[16]	427,767
Deposits to customers (£ million)[17]	427,704[18]
CET1 ratio (%)[19]	10.3%
RWAs (£ billions)	402

> UK banks are continuing on a path that has already seen them reshape their balance sheets, with a focus on RWAs and capital ratios.

rclays		RBS		Lloyds		HSBC		SCB	
2013		2014	2013	2014	2013	2014	2013	2014	2013
2,868		2,643[1]	(8,849)	1,762	415	11,343	14,430	2,571	3,878
28,444		15,150	16,737	29,892	37,985	45,293	50,097	11,132	12,008
402		223	201	245	212	194	213	190	210
79.0%		87.0%	95.0%	51.2%	52.9%	67.3%	59.6%	60.2%	54.3%
3,071		(1,352)	8,120	752	2,741	2,338	3,740	1,300	1,034
1.0%		(8.0%)	(18.7%)	3.0%	(1.3%)	7.3%	9.2%	7.8%	11.2%
2.8%		6.8%	9.4%	2.9%[6]	6.3%	2.7%	3.3%	2.8% [6]	2.4%
54.6%		64.0%	64.0%	53.5%[8]	48.7%	42.2%	41.6%	42.0%	41.0%
2,000		2,194	3,844	3,125	3,455	1,990[9]	1,478[9]	182	–
1,343,628[10]		1,050,763	1,027,878	854,896	842,380	1,695,595[11]	1,619,887	467,271	408,944
63,949		60,192	59,215	49,903	39,336	128,726	115,494	30,085	28,404
3.4%[12]		4.2%	3.4%	4.9%	3.8%	4.8%	4.4%	4.5%	4.7%
96%		112%	102%	– [14]	– [14]	– [15]	– [15]	>100%	110-120%
101%		95%	94%	107%	113%	72%	73%	70%	76%
434,237		334,251	390,825	482,704	492,952	627,389	601,603	183,258	176,285
431,998		354,288	414,396	447,067	439,467	869,408	825,491	260,926	231,078
9.1%		11.2%	8.6%	12.8%	10.3%	10.9%	10.8%	10.5%	10.9%
442		356	429	240	271	785	737	220	201

Footnotes:

1. Consists of profit/(loss) before tax from continuing operations.
2. Total income is presented gross of insurance claims.
3. Barclays net interest margins relate to their core business that includes Personal and Corporate Banking, Barclaycard and Africa Banking.
4. Represents return on average shareholder's equity for all banks except for RBS, which represents return on tangible equity, and Lloyds which reports return on required equity. SCB presents RoE on an underlying basis.
5. Calculated total credit risk loans as a percentage of gross loans and advances.
6. Lloyds and SCB include reverse repurchase agreements.
7. Calculated as Total Impairment Allowance/Total Credit Risk Loans.
8. Differs from the published percentage as it includes retail and consumer finance loans.
9. Excludes the effect of unwinding of discounts.
10. Restated from £1,312,267 due to adoption of IAS 32R.
11. Total assets figure has decreased from 2013 in US$ but appears to increase due to conversion rates to GBP.
12. Figure as at 30 June 2014.
13. Pending guidance from the PRA, the calculation method may change over time and may not be consistent across the banks.
14. No exact ratio reported, but reported that upcoming requirements are met as at 31 December 2014.
15. Not reported.
16. Lloyds and SCB include reverse repurchase agreements.
17. Lloyds and SCB include repurchase agreements.
18. Figure is based on Customer Accounts.
19. All CET1 ratios are on a transitional basis except for Barclays and RBS which are on an end-point basis.

> If RoE performance is to improve, the banks will have to concentrate on cost reduction.

A mixed picture on profits

Collectively, the UK's big five banks recorded pre-tax profits of £20.6 billion in 2014 compared with £12.7 billion in 2013. However, that umbrella figure disguises a mixed picture. The partly state-owned banks both posted improved profitability – Lloyds recorded pre-tax profits of £1.8 billion (up from £0.4 billion) while RBS turned a £8.8 billion loss into a £2.6 billion profit.[1] In contrast, the pre-tax profits of HSBC, Barclays and SCB fell by 17 percent, 21 percent and 30 percent respectively.

The total income across the five banks fell by £18 billion (12.4 percent) to £127.2 billion. Trading income was the biggest contributor to the overall decline, depressed by a reduction in volatility and lower average balances and falling from £32.8 billion to £20 billion – a difference of 39 percent or £12.8 billion. There was little change in net fee income.

A consistent theme in the banking sector over the last few years has been downward pressure on margins. However, 2014 saw some signs of improvement with three of the big five recording increases in net interest margins. Data analysis reveals that the predominantly UK-focused banks have achieved this by re-pricing deposits and targeting specific customer portfolios. HSBC's decrease is mainly due to lower yields on customer lending in North America and Europe while SCB's margin compression was largely driven by decreases in Greater China, Africa and Europe.

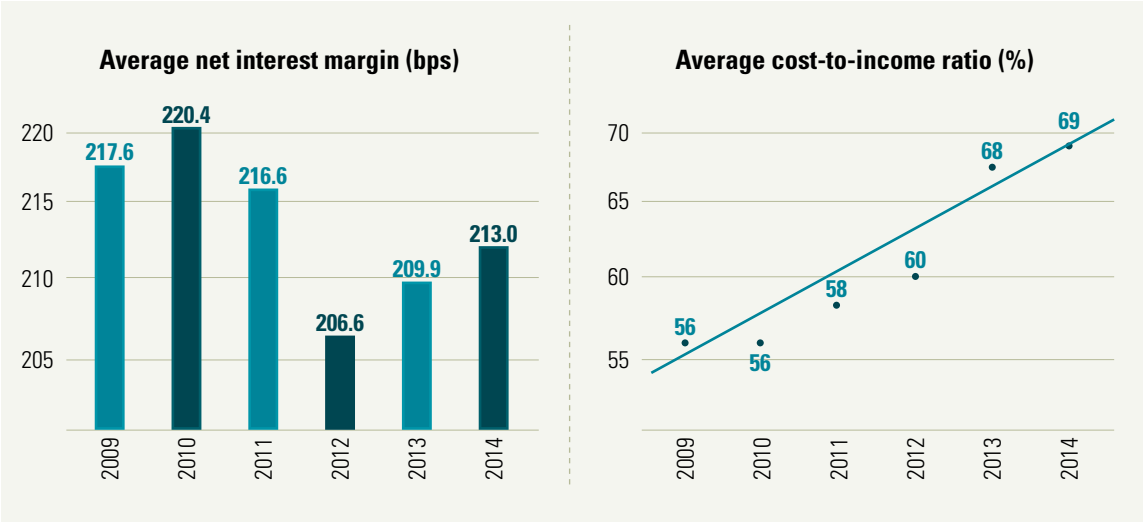
Cost savings: the key to improved RoE

Three out of the five banks were trading below book value at the end of 2014[2], highlighting the ongoing challenges banks are facing in the market place.

Also the RoE recorded by the big five ranged from -8.0 percent to 7.8 percent; a marked deterioration from 2007 when the average stood at 17.7 percent. Some banks have reported their target RoEs for the next two to three years, some of which are lower than the targets previously stated (the lowest being 'over 10 percent'). It remains to be seen whether these targets are achievable given the 2014 figures. Targets are likely to be lower than the cost of equity.

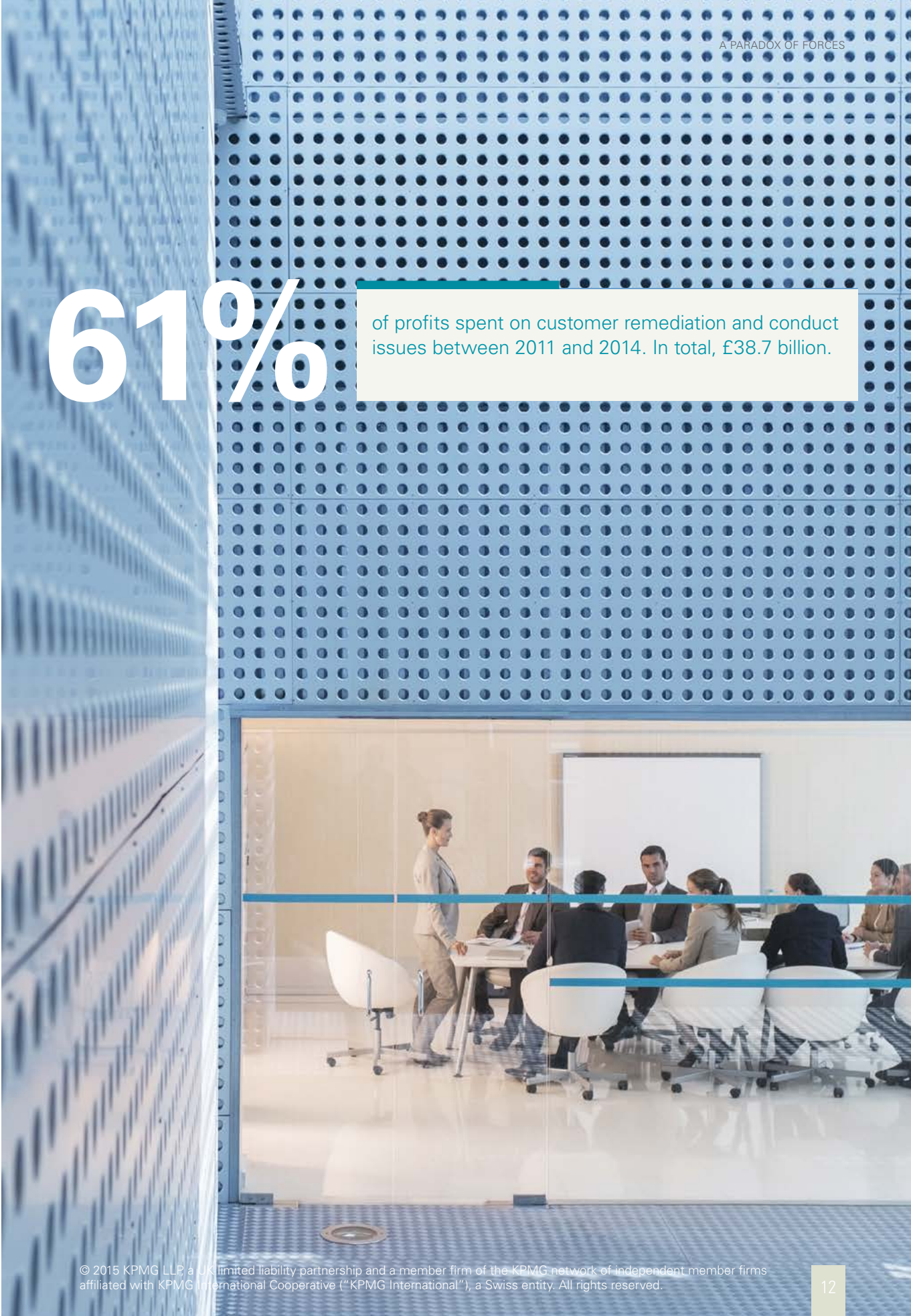
If RoE performance is to improve, the banks will have to concentrate on cost reduction. There has been some progress but although the big five are all committed to cost optimisation programmes, they are at different points on the journey. This is reflected in the broad range of cost-to-income ratio figures, which run from 51 percent, up to the RBS ratio of 87 percent (down from its 2013 figure of 95 percent). Contributing factors to the cost-to-income ratio for

[1] Consists of profit/(loss) before tax from continuing operation.
[2] KPMG analysis, 2015.



61%

of profits spent on customer remediation and conduct issues between 2011 and 2014. In total, £38.7 billion.



> While the Basel III accord put an initial focus on capital adequacy, 2015 sees the introduction of a liquidity coverage ratio requirement.

HSBC and SCB include the increase in redress, regulatory and litigation costs, and the continued investment in strategic initiatives.

Remediation costs: the problem that won't go away

It is not easy to draw direct comparisons between the cost reduction efforts of the big five but a major factor is the ongoing burden of remediation payments and penalties related to conduct. The cumulative cost of customer remediation and conduct issues between 2011 and 2014 now stands at £38.7 billion – a figure that represents over 60 percent of profits during the same period. There were some encouraging signs in the first half of 2014, when the banks provided £2.4 billion for conduct issues – a sharp fall from the same period a year earlier. However, hopes of a downward trend have been dashed by figures for 2014 as a whole. In addition to the first half figure, the banks provided a further £7.5 billion, raising the total to £9.9 billion, just 8 percent down from 2013.

More than half that amount relates to compensation for mis-sold payment protection insurance (PPI) and interest rate hedging products. Banks provided £1.8 billion against PPI claims in the first half of the year, and a further £2.9 billion in the second half. The £350 million recognised for interest rate hedging products is split fairly evenly across the 12 months. Meanwhile, the legacy of foreign exchange fixing manifested itself in fines totalling £2.3 billion.

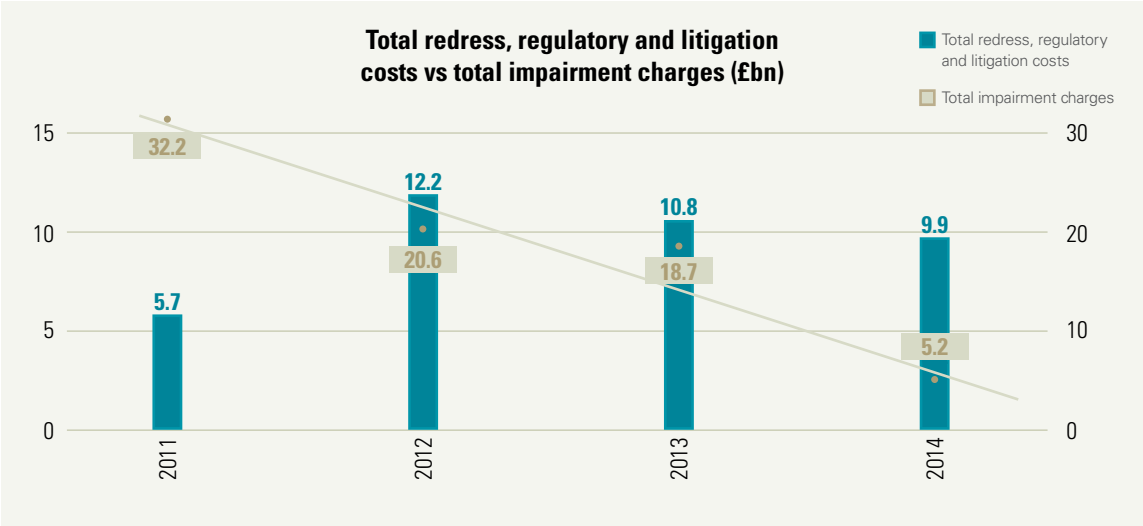
If costs related to customer redress and conduct breaches continue to grab headlines, we shouldn't forget that banks are also seeing an overall increase in the cost of compliance (for example, with the Consumer Credit Act).

Loan impairment costs fall sharply

This year's reports confirm that strengthening economic conditions have helped to reduce impairment charges, which fell by 72 percent to £5.2 billion in 2014. Of the five banks, only SCB failed to see an improvement.

The partly state-owned banks showed good progress, with RBS leading the way – the bank presented a net impairment release of £1.4 billion, a £9.5 billion reduction on 2013. The releases were recorded principally in RBS Capital Resolution and Ulster Bank and reflect the bank's proactive debt management and favourable economic and market conditions. Meanwhile, Lloyds posted an impairment charge decrease of £2 billion.

We also see a fall in the level of impaired loans as a percentage of total loans and advances to customers,



> Despite a strengthening UK economy, lending fell by 2 percent (£41 billion) in 2014.

from an average of 4.8 percent in 2013 to 3.4 percent in 2014. However, despite the improving situation, the 2014 figure is still well above the pre-crisis level of 1.6 percent. It is also worth noting that average impairment cover continued to increase, to 52 percent.

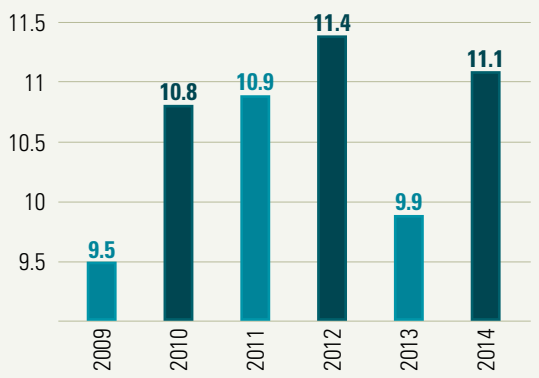
Lending dips but the devil is in the detail

Despite a strengthening UK economy, lending fell by 2 percent (£41 billion) in 2014, a 12 percent drop from the 2009 figure. However, the overall lending picture has been blurred by reclassifications, currency effects and the results of actively managed run-offs, in accordance with the banks' strategies.

The trend in RBS and Barclays' lending volumes has been affected by the classification as held for sale of RBS' Citizens and of Barclays' Spanish business respectively. RBS, Barclays and Lloyds have continued deliberate reductions through portfolio run-offs and disposals, as per their strategies. SCB's volumes have been impacted by de-risking across unsecured, commercial and corporate lending, as well as adverse foreign currency movements.

On the positive side, RBS, Barclays, Lloyds and HSBC have achieved growth in their respective target segments. Common growth areas for Barclays, Lloyds and RBS include mortgages and SME lending, while HSBC has mainly been driven by growth in Asia and the Americas.

Average CET1 ratio (2014, 2013 common equity tier 1 ratio; 2012-2009 core tier 1 ratio) (%)



Lending behavior will impact macroeconomics

With the capital requirements set out in the Basel III agreement now a given, four of the big five have raised their common equity tier one (CET1) capital ratios. The impact of this has been to raise the average CET1 ratio for all banks from the 2013 average of 9.9 percent to 11.1 percent at the end of 2014.

Each bank has its own approach to raising capital but in 2014, Barclays, HSBC and Lloyds all issued AT1 instruments (additional tier one bonds) with a total value of £11.1 billion. Looking ahead, the two remaining banks have indicated that they also plan to issue AT1 instruments in 2015.

The overall increase in capital ratios reflects a rise of 7 percent in total CET1 capital, coupled with a 4 percent reduction in total RWAs but this wasn't across the board. The RWAs at Barclays, Lloyds and RBS together fell by £145 billion, reflecting the portfolio management strategies of each bank. In contrast, HSBC and SCB increased their RWAs by £48 billion and £19 billion respectively.

As reflected in the issue – or planned issue – of AT1 capital, focus has mainly been on the numerator of CET1 ratio. However, the Basel Committee's consultation on the revisions to the standardised approach for credit risk introduces a renewed focus on the denominator. The impact of this proposal, if implemented, will depend on the risk profile of each bank's lending portfolio and the proposed revised credit risk mitigation that is in place. Any changes are likely to drive lending behaviour, which will have real macroeconomic consequences.

Banks ahead of the curve on leverage

Reported leverage ratios currently stand at well above the 3 percent minimum set out in the Basel III accord. In fact, the big five recorded leverage ratios of between 3.7 and 4.9 percent at the end of 2014. But this isn't a static landscape: banks are facing structural reform in the shape of ring-fencing to separate retail and investment bank activities. Ring-fenced banks will have to meet leverage ratios of above 4 percent.

> Banks have been working to restore trust and improve the customer experience.

Liquid logic

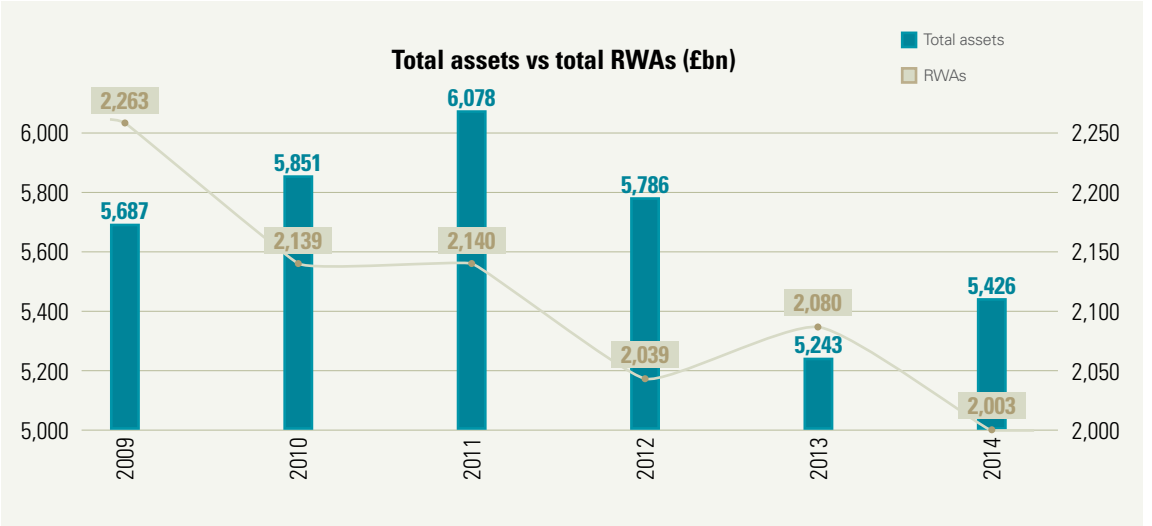
Britain's major banks have made real progress in funding retail lending through retail deposits: four are funding entirely from deposits, while the fifth is heading towards a 100 percent loan-to-deposit ratio. This means banks have less requirement to fund from sources other than core deposits, which is reflected in a decline of total wholesale funding of 13 percent compared to 2013.

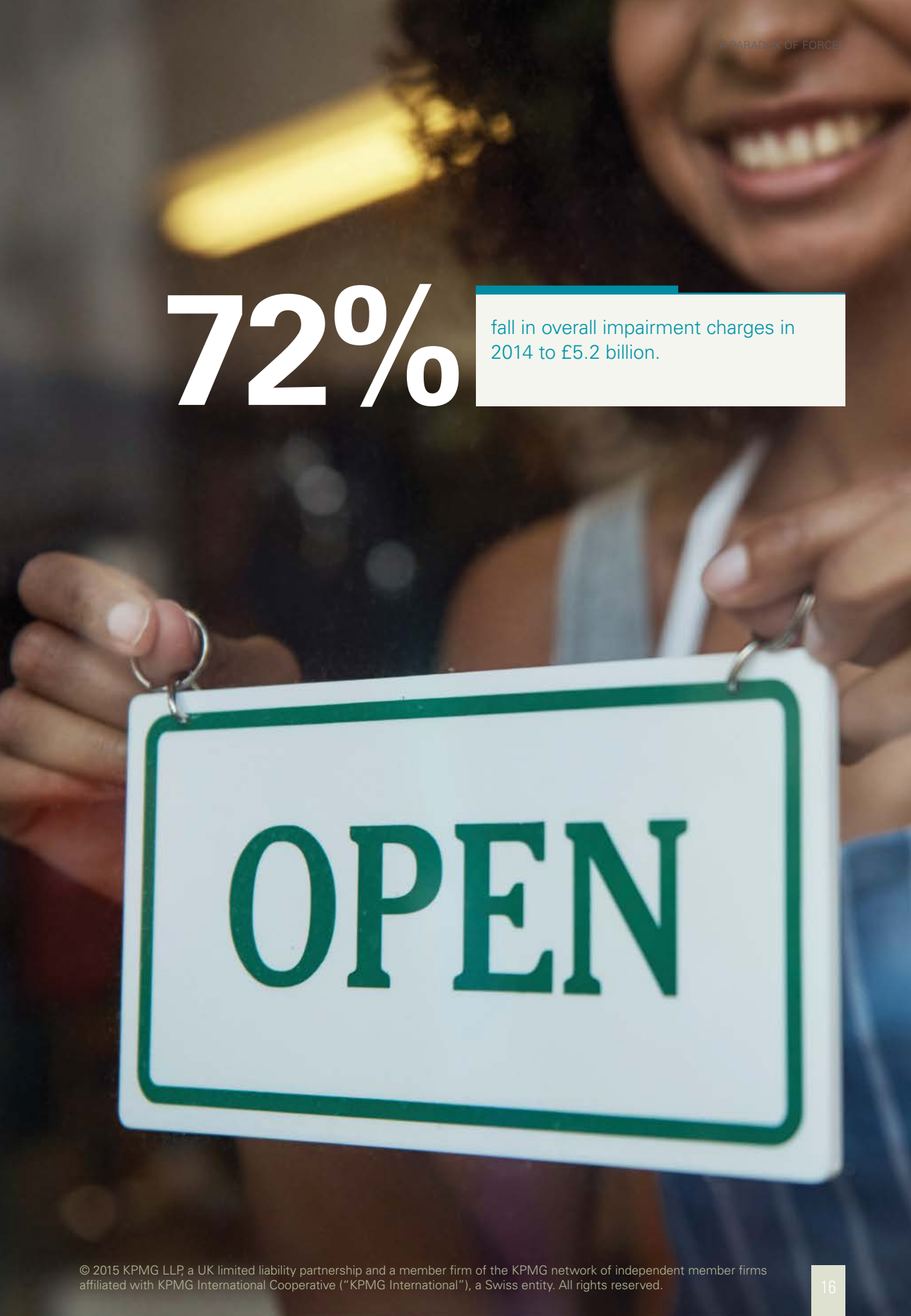
While the Basel III accord put an initial focus on capital adequacy, 2015 sees the introduction of a liquidity coverage ratio requirement. Barclays, Lloyds, RBS and SCB confirm in their 2014 reports that they have already met the new requirement. As such, the UK's big banks have passed some important milestones in terms of capital requirements, leverage and liquidity. However, with the Basel Committee and regulators proposing further changes to the regulatory environment, continued forward planning is required.

Keeping customers satisfied

The financial crisis saw a sharp downturn in customer trust. Since then, banks have been working to restore that trust and to improve the customer experience. This has partly been driven by new conduct regulations and the need to remain competitive compared to major rivals and the new generation of challenger banks.

This focus is noted in some of the reports and four of the banks included information on customer satisfaction and targets. However, there is no consensus on how to present this information. In some cases, progress is measured in terms of metrics such as net promoter scores, while other banks take a narrative approach, describing measures taken to improve the customer experience. It will be interesting to see how this important theme is developed in subsequent reporting years.





72%

fall in overall impairment charges in 2014 to £5.2 billion.

THE DIVERGING PATHS OF BANKING

Anyone looking for clues to the future shape of the banking industry will not find all the answers in the latest full-year reports from HSBC, Barclays, RBS, Lloyds and SCB.

The results flag up some common and ongoing challenges, notably a low RoE. But what they don't reveal is how the big five, and by extension the wider banking industry, will carve out a future in the face of increasingly competitive markets.

> Today could be described as 'the age of comparability'. So, will CIOs become as important as CEOs in the future?

The annual reports confirm these very different organisations are each on a distinct flight path in the UK and the lack of homogeneity is becoming more apparent. Lloyds is primarily focused on the domestic market, while RBS still has international operations but is now going through a phase of intense restructuring. On the other side, HSBC, Barclays and SCB are global players with active commercial and investment banking operations – with a range of their own issues. No doubt you could define broad patterns, however in reality they all face different challenges. These will not only define how the five players reshape their business in coming years, but also how they will adapt to existing and upcoming strategy changes, driven to a great extent by regulatory policy, not least the proposed ring-fencing.

Banks are recalibrating their business plans in response to regulatory policy changes. However, what that will mean in terms of sustainable profitability probably won't become apparent until 2016.

Cost-cutting will undoubtedly be a significant part of the story. We can also expect continued investment in the technologies infrastructure that will allow banks to improve services and cut costs. Banks also face challenges in terms of accessing data, integrating information across silos and complying with the Basel Committee expectations. Today could be described as 'the age of comparability'. So, will CIOs become as important as CEOs in the future?

New opportunities for SME lending

The European Union and the European Central Bank (ECB) are already playing a vital role in shaping the financial services market. The European Commission has now published Green Paper plans for a Capital Markets Union to harmonise the capital markets in all 28 member states. The aim is to replicate at least some of the vibrancy of capital markets in the US, as the proposed framework would make it easier for SMEs to raise funds and reduce their over-reliance on bank finance. Implementation of these plans will provide new opportunities for banks and other financial services organisations.

The ECB has established itself as a bold regulator. It is clearly differentiating its approach from that of the national competent authorities, with a focus on sustainable business models and greater rigour in assessments. From its Frankfurt base, the ECB has adopted

70% of business finance in Europe is provided by banks, compared to 20% in the US[1]

a data-driven approach to regulation with a strong emphasis on direct comparability between banks. The stress tests have been rigorous, revealing non-performing assets to the value of €879 billion (Oct 2014), €136 billion or 18% more than the banks had reported. The result of that would be a 2.1 percent reduction of CET1 ratio and we're now seeing an unprecedented risk transfer process, with asset managers, private equity firms and pension funds moving in to buy non-performing loans. Meanwhile, it has pressed ahead with a €1 trillion quantitative easing programme, injecting €60 billion a month into the Eurozone economy. The volume of non-performing exposures now being managed in non-core bank divisions totals approximately €1.2 trillion,[2] which is many multiples of new bank lending in any given year.

The ECB's activities will change the face of European banking. In the short-term, there will be pressure on banks to reshape their balance sheets and, in some countries, there will be negative interest rates. But how much consolidation will there be across the Eurozone?

London's future as a global financial centre

London faces its own regulatory upheaval. The City's pre-eminence as a financial centre has largely been built on non-retail banking. Indeed, London is unique in terms of the willingness of institutions to book financial instruments that are not held elsewhere.

> The intention is to reduce the reliance of SMEs on bank finance, the plans will provide new opportunities for banks and other financial services organisations.

These are assets that regulators don't want to see on banks' balance sheets. To date, regulators have been unable to successfully split retail and non-retail banking. If further regulation creates too many strictures, London risks losing its relevance.

The prospect of the UK's exit from the EU – the so-called 'Brexit' – also places a question mark over the future of London as a financial services centre. London has a deep well of expertise that would remain in demand even if the UK chose to leave the EU and is the leading location for financial services in Europe. If the current passporting arrangements should not survive the Brexit negotiation process, it seems inevitable that this pre-emminence would be threatened. If London continues to innovate in terms of market development and the regulatory environment this can be mitigated.

A paradox of forces

From global regulatory developments – including the prospect of ring-fencing – to a changing competitive landscape, technology demands and proposed Capital Markets Union within the EU, the banking industry faces a period of great change, with individual banks facing their own challenges. However, there is room for optimism and time will serve to clarify what opportunities are to be seized and where growth can be achieved. It's up to the industry to make it a success.

[1] Financial News, 16 March 2015
[2] KPMG analysis, 2015

BASIS OF PREPARATION

This report summarises and makes reference to the 2014 results of the following UK headquartered banks: Barclays, HSBC, Lloyds, RBS and SCB.

Information has been obtained solely from published 2014 year end reports (including results presentations and accompanying analyst packs). Where total numbers are presented, it is the total of the five banks in the review. As an example, total loans and advances to customers are the sum of the loans and advances to customers by the five banks, expressed in sterling. Similarly, if an average number is presented, it is the average of the five banks in the review. We have used simple headline numbers in our analysis unless stated otherwise; each bank has its own way of reporting performance and this has proved to be the most consistent method of presenting their results. HSBC and SCB present their results in US dollars ($). These have been translated into sterling using the relevant period end or period average rate. Where percentage changes are presented for HSBC or SCB, these percentages are based on the dollar amounts disclosed by the banks, rather than on the sterling translation of those amounts.

Note that any discussion of 'underlying' results reflects a number of adjustments to statutory figures, as determined by management. Underlying results will therefore not be comparable from bank to bank. Management reporting in the bank results focuses on underlying figures.

Adjustments commonly include:

- Elimination of currency translation gains and losses.
- Elimination of goodwill, profits and losses on acquisitions and disposals of subsidiaries and businesses.
- Exclusion of liability management gains or fair value changes on own debt.
- Inclusion of shares of profits of associates and jointly controlled entities with underlying non-interest income.
- Exclusion of certain write-downs and one-off items.

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