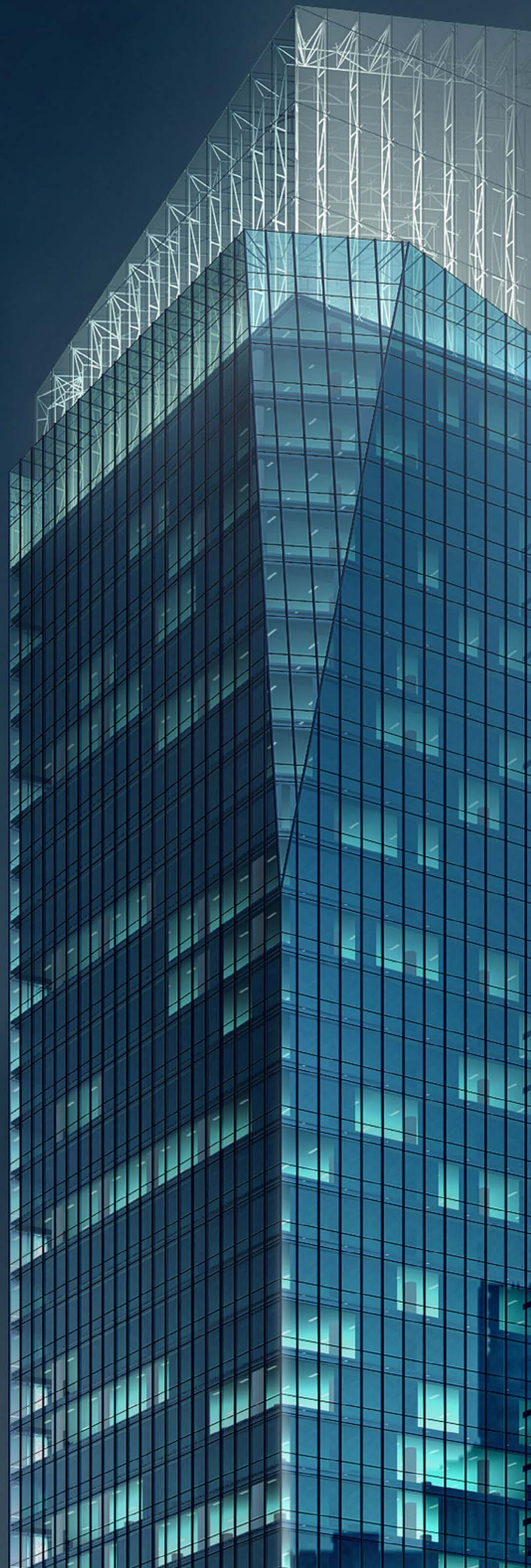
State of the Banks

The road to post-pandemic recovery



FY21 edition

KPMG The Netherlands

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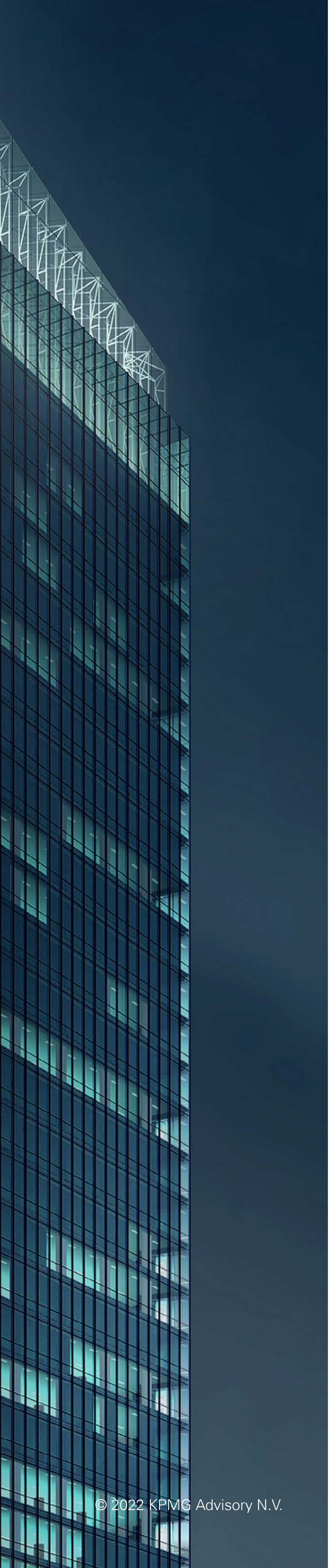

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Foreword

After a year of managing the challenges of the pandemic, the outlook on the European continent (and beyond) has only become more challenging with the crisis in Ukraine. Our thoughts and hopes are with those who struggle to see a glimpse of normality any time soon.

In this fourth edition of the State of the Banks analysis (FY21) we offer you a moment of reflection and some perspective on what might lie ahead for Dutch banks. As banks find themselves in a complex and challenging environment, we reflect on the key trends for the Dutch banking sector.

The crisis in Ukraine, still accommodating monetary policy and low interest rates, pandemic fiscal stimulus packages throughout Europe, increasing climate and environmental related risks and post-pandemic supply chain disruptions dominate boardroom agendas. At the same time, as a result of the pandemic, we have seen banks successfully accelerate the digitalization of their client service models and seen strong financial performance in line with post-pandemic economic recovery.

The ECB expects headline inflation to decline in the second half of the year, but these projections are surrounded by significant uncertainty on account of the war in Ukraine. Whether the ECB will turn the tide on its expansionary policy or is forced to act on a recession triggered by higher energy and food prices remains to be seen. We do expect the road for this year to be covered with supply chain disruptions that have already started to affect the still fragile post-pandemic economic recovery.

We hope you enjoy reading this publication. Feel free to contact us about it.

Lennart de Vries
Head of Banking Advisory
KPMG The Netherlands

Birgitta Herngreen
Head of Banking Audit
KPMG The Netherlands

At a glance

Full Financial Year (FY) 2021 results snapshot

	Movement indicator	Movement indicator
Income	Total net interest income decreased by 1.3% to EUR 27.9 bln	Total net commission and fee income increased by 13.0% to EUR 7.3 bln
Earnings	Total cash profit after tax increased by 163.8% to EUR 9.9 bln	Average net interest margin decreased by 12 bps to 129 bps
Costs	Average Cost-to-Income ratio increased by 3.9 pts to 70.4%	Remediation provisions for variable interest rates of revolving credit facilities totaled EUR 876 mln in FY21
Asset quality	Credit impairment charge decreased by EUR 6,991 mln compared to FY20	Total non-performing loan exposures decreased by EUR 1,993 mln to EUR 7,140 mln
Capital	Average CET1 ratio decreased by 2.2 pts to 18.1%	Average Liquidity Coverage Ratio increased by 33 pts to 192%

At a glance

	ING		Rabobank		ABN AMRO		de Volksbank	
	FY21	FY20	FY21	FY20	FY21	FY20	FY21	FY20
Financial performance – P/L								
Interest income (EUR mln)	21,114	22,698	13,263	13,776	7,018	7,815	1,043	1,148
Profit before tax (EUR mln) – statutory basis	6,782	3,809	4,877	1,496	1,838	356	218	233
Profit after tax (EUR mln) – statutory basis	4,905	2,563	3,692	1,096	1,234	-45	162	174
Performance measures – P/L								
Net interest margin – cash basis (basis points)	144	149	131	131	131	152	111	130
Cost-to-Income ratio – cash basis (%)	60.5%	63.2%	63.8%	65.8%	76.4%	66.4%	80.7%	70.6%
Return on average equity (%) – cash basis	8.9%	4.7%	8.8%	2.7%	5.7%	-0.2%	4.2%	6.0%
Credit quality measures								
Impairment charge (EUR mln) (statutory basis)	516	2,675	-474	1,913	-46	2,303	-58	38
Total loan loss provision to credit RWA (%) – B/S	1.7%	1.9%	1.7%	2.3%	2.1%	3.1%	0.8%	1.6%
Stage 1 ratio (%) – BS	91.7%	89.3%	91.2%	89.0%	89.2%	86.4%	95.1%	92.9%
Stage 2 ratio (%) – BS	6.5%	8.5%	6.7%	7.9%	8.2%	10.2%	3.6%	5.7%
Stage 3 ratio (%) - BS	1.8%	2.2%	2.1%	3.1%	2.6%	3.4%	1.2%	1.4%
Financial positions – B/S								
Total assets (EUR mln)	951,290	937,275	639,575	632,258	399,113	395,623	72,081	67,484
Total equity (EUR mln)	53,919	54,637	43,402	40,632	21,999	20,989	3,486	3,450
Capital measures – B/S								
CET1 ratio	15.9%	15.5%	17.4%	16.8%	16.3%	17.7%	22.7%	31.2%
Tier 1 Capital ratio	18.1%	17.3%	19.2%	19.0%	18.0%	19.5%	22.7%	31.2%
Tier 2 Capital ratio	2.9%	2.8%	3.4%	5.2%	4.4%	4.2%	3.6%	4.9%
Total Capital ratio	21.0%	20.1%	22.6%	24.2%	22.4%	23.7%	26.3%	36.1%

Executive summary

Key highlights

Persistent low interest margins are putting pressure on the income of the four banks. Despite this challenge, ING and Rabobank were able to record an increase in income, whereas the income of ABN AMRO and de Volksbank declined, resulting in a total aggregated cash profit after tax of EUR 9.9 bln for all banks. We see a positive development in the diversification of income, which we expect will continue in the coming years.

The four banks are struggling to get a grip on the costs. The rise in costs is mainly caused by the increase in AML/CFT efforts (incl. fines and investigations), compensating clients for revolving credit products with variable interest rates, and continued investments for the acceleration of digitalization. As a result, the cost increase has offset increase in income, which resulted in the average Cost-to-Income ratio of the four banks increasing to 70.4%.

With the Dutch economy improving in 2021, it allowed for a decrease of EUR 7 bln in loan impairments – also a stimulus for bank profitability. Bankruptcies declined with the help of government support packages and there is now a positive outlook with the economy fully reopened. However, there is a new level of uncertainty moving forward due to geopolitical, inflationary and viability influences.

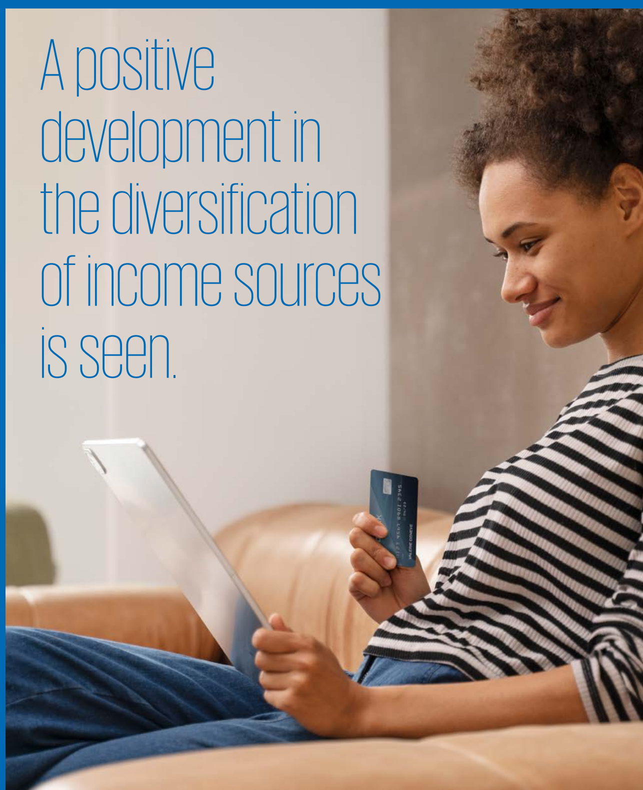
Strong capital positions and low loan losses were maintained by Dutch banks in 2021 with the average CET1 ratio decreasing by 2.2 pts to 18.1% in FY21 compared to FY20. The resulting capital buffers, strong liquidity and government support helped mitigate the financial effects of COVID-19. However, with government support ending in Q2 2022, loan repayment difficulties could arise leading to a negative effect on the bank's loan book and capital positions.

Going forward

Going forward, banks are competing in the search for new customers and are assessing which customer needs are underserved. The 'Connected Bank' includes banking services into a wider ecosystem and prioritizes customer centricity instead of product centricity. This view on offering banking services drives innovation in banks' business models and enables future growth. We will see new initiatives emerge, which could replace current products and services.

In line with future-fit banking, the gatekeeper function of banks in relation to KYC continues to be a key area in which banks are investing to stay in line with AML and CFT regulations. The investments are needed in efforts to remediate and to ensure a future-fit operating model remains front and center.

In the loan book we expect banks to accelerate their efforts in decarbonization. Prioritizing the development of ESG frameworks, policies and procedures, working towards industry standards, and embedding ESG in the credit acceptance standards are front and center of the current efforts. Additionally, focus should be kept on the core capability of banks: assessing risks. Current events could hinder post-pandemic recovery.



Income

The low interest environment continues leaving its mark on the income side of the four banks. ING (+5%) and Rabobank (+13%) were able to realize an increase in income compared to FY20. Income figures of ABN AMRO (-4%) and de Volksbank (-10%) showed a decline compared to FY20. The dependency on interest income remains a risk from a business model perspective. Compared to previous years ABN AMRO, ING and Rabobank are showing positive developments regarding the diversification of their income sources – becoming less dependent on just net interest income. De Volksbank is showing improvements as well, but follows suit. We expect this trend to continue – and preferably increase growth figures – in the coming years.

Table 1 Net Interest Income (NII) and Net Interest Margin[1] (NIM)

Bank	FY21	FY20	Movement (%, bps)
NII (EUR mln)			
ING	13,615	13,604	0.1%
Rabobank	8,351	7,997	4.4%
ABN AMRO	5,210	5,863	-11.1%
de Volksbank	775	850	-8.8%
NIM (bps)			
ING	144	149	-5
Rabobank	131	131	0
ABN AMRO	131	152	-21
de Volksbank	111	130	-19

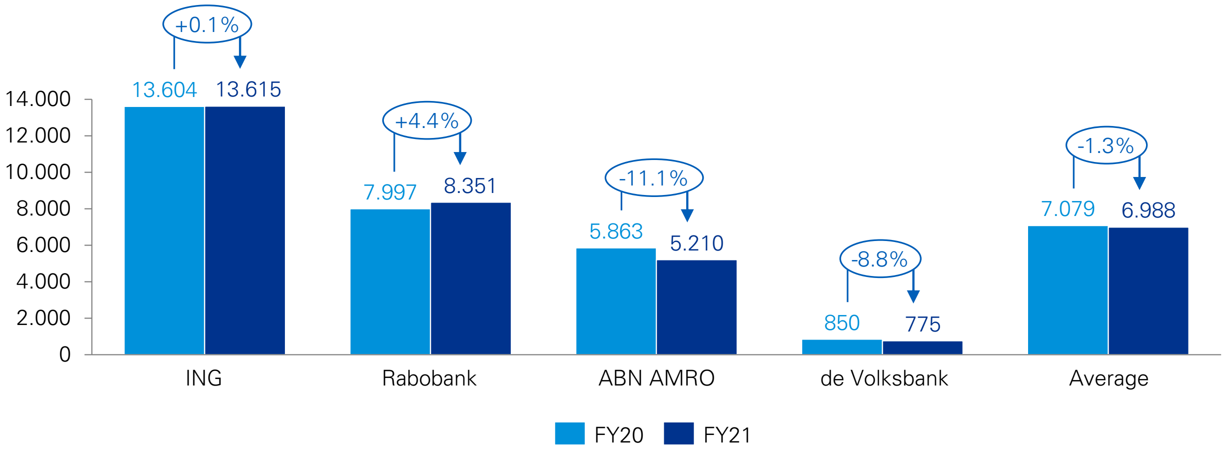
Interest income

The continued pressure on interest margins affected the profitability of interest products again. Since FY20, when three of the four banks realized their lowest net interest income in five years, ING (+0.1%) and Rabobank (+4%) showed recovery and were able to maintain or grow NII and grow their lending book. ABN AMRO (-11%) and de Volksbank (-9%) have not yet been able to stop the downward trend. Both ABN AMRO and de Volksbank saw their NII decline for the fourth and fifth year in a row respectively. Although FY21 was a commercial success in terms of growth, de Volksbank took a hit on their mortgage portfolio due to clients refinancing at lower rates. On the other hand, de Volksbank is showing promising results in diversifying its interest income sources by increasing its SME loan book by 16%.
Next to the tight interest margins, ABN AMRO also saw a decline in interest income due to lower average corporate loans volumes, as a result of the divestment of the CIB non-core portfolio.

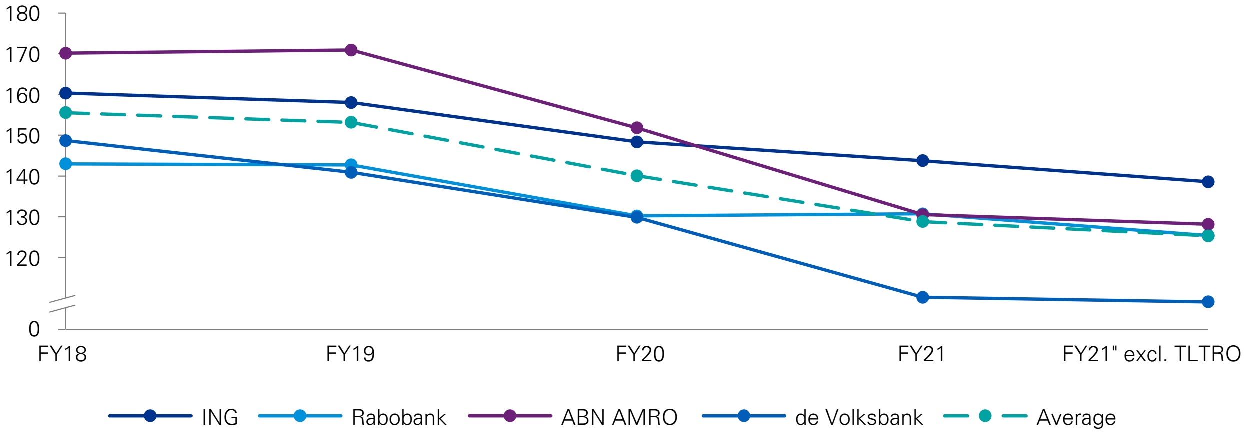
The TLTRO III program of the ECB had a significant impact on the interest income in last year. ABN, ING and de Volksbank would have realized a lower net interest income in FY21 compared to FY20, if the compensations of the TLTRO III program were not included. Rabobank was the only bank that managed to maintain its NII level without this discount of the ECB. In order to be eligible for the maximum benefit of the TLTRO III program the major banks massively increased their retail and corporate loan portfolio in the last quarter of the year. All four banks hurried in Q4 in order to reach the same size of their loan portfolio of October 2020 by the end of December 2021. During the last month of the year, the banks performed a final sprint by offering client discounts and favorable term on loans. With result, because the banks realized five to six times the loan volume in December compared to an average month.

[1] Net Interest Margin is calculated by dividing total net interest income by the year-end average total balance sheet (e.g. 31/12/20 and 31/12/2021). Reported NIMs can deviate from individual bank's Annual Reports due to different rolling average selection (e.g. monthly or quarterly average of total balance sheet).

Graph 1 Net Interest Income, 2020 – 2021 (EUR mln)



Graph 2 Net Interest Margin (including FY21 normalization for TLTRO III discount), 2018 - 2021 (bps)



Net Interest Margin (NIM)

The trend of declining net interest margins continued in FY21. The average NIM of the four major Dutch banks has declined from 156 bps in FY18 to 129 bps in FY21, characterized by the low interest environment and a significant increase in savings by customers on their deposit accounts. This increase in deposits in combination with the pressure on margins, also led to the introduction and/or announcement in FY21 of all four banks, to charge a negative interest on amounts exceeding EUR 100.000 on saving accounts.

The TLTRO III program had an ambiguous impact on the NIM of the banks. On the one hand, the goal to maintain the October 2020 loan book level led to an increase in loans on the balance sheet, having a negative impact. On the other hand, the TLTRO discount of 1% had a positive impact on the NIM. The impact of the TLTRO program also becomes visible when the NIM is corrected for the discount. The average FY21 NIM with discount is 129 bps and without discount the NIM is 126 bps.

The rising inflation together with an expected (modest) increase in interest rates could lower the pressure on the NIM in the nearby future, however this could be set off against higher losses in case the economy enters into a recession. This will be closely monitored in the upcoming period.

Non-interest income

FY21 was a good year for all four banks in terms of their net fee and commission income as ABN AMRO, ING and Rabobank were able to increase this income source with, respectively, 7%, 17% and 13%. De Volksbank's net fee and commission income declined by 15%, however was offset by the EUR 18 mln reclassification of RegioBank's commission fee model. Without this one-off, net fee and commission fee would have risen by EUR 11 mln. This positive development for the Dutch banks is due to improved results from event driven business activities (e.g. M&A and Corporate Finance), higher fee income from mortgages and investment products, increased income from higher package fees and a surge in the number of payment transactions.

ECB TLTRO III program

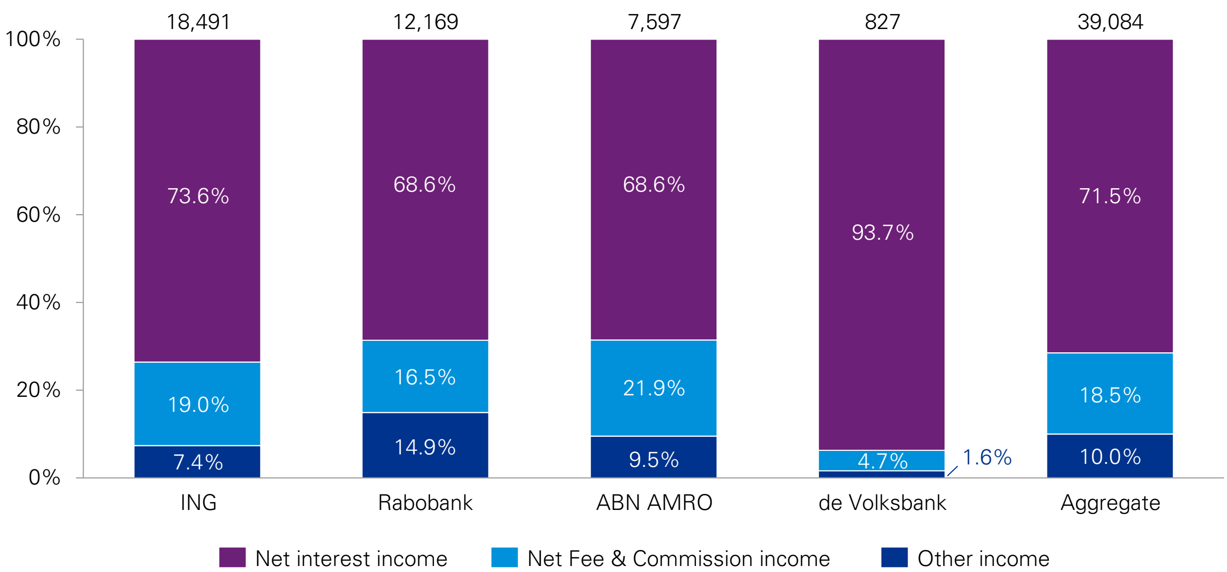
The TLTRO III discount was introduced by the ECB in order to maintain economic activity during the pandemic and make it more accessible for consumers and organizations to obtain credit. Furthermore, the ECB intended to compensate banks for the negative interest that should be paid to deposit savings at the ECB.

This discount of 1% will be lowered to 0.5% by the ECB as of June 2022. However, it is expected that this loss in compensating the banks will be met by giving the 0.5% discount on twelve times the reserves that should be deposited at the ECB (i.e. tiering) – instead of the current six times.

Next to the net fee and commission income, ABN AMRO (+46%), ING (+33%) and Rabobank (+80%) also saw an increase in their Other Income[2]. Unfortunately, de Volksbank's showed a decline of 52%, which can be attributed to results on lower fixed-income investments sold as part of asset and liability management. The increase of the other three banks can be explained by the positive influence of the economic tailwind on their investment portfolio, higher trading income, increased valuation of participations and exceptional one-off gains (e.g. ABN AMRO's sale and leaseback of HQ).

These positive developments in non-interest income (total of net fee and commission income plus other income) should also be placed in the context of the exceptional market recovery following the pandemic. Therefore, these numbers can also give a slight distorted picture given the huge amount of government support that has been provided to the economy (according to CBS EUR 26.5 bln in FY21). Nevertheless, we encourage the four banks to continue this positive trend of diversifying their income sources and becoming more resilient towards the low interest environment.

Graph 3 Operating Income distribution (incl. total income), 2021 (EUR, %)



[2] Other income also includes investment income.

Time to shift gear in decarbonizing balance sheets

Bart van Kampen, Director Strategy & Operations and **Jeroen Heijneman,** Senior Manager Financial Risk Management

Banks have embarked on their journey to integrate new ambitions around ESG in their business strategies, which has far reaching consequences for virtually all aspects of business operations. They are expected to strengthen their sustainability policies on themes such as climate change, biodiversity, human rights and equal remuneration. Although all important topics, most banks start with climate change – and in particular with reducing financed emissions.

A fundamental shift towards more sustainable finance is emerging. European policy makers are using new regulation to redirect capital flows towards more environmentally sustainable finance. As billions of euros are required to mitigate and adopt climate change and as bank financing is prominent in Europe, banks need to play a crucial facilitating and catalyzing role. Regulations on disclosures are important as they discipline the banks.

Disclosures about climate change by banks have been improving over the past two years. We see three major trends:

— Banks have overhauled their **governance** structures to deal with climate-related risks. Board-level and top management involvement is highlighted as a key success factor, as shown in our recent survey on ESG risk management practices, covering around 30 banks in the EU.

— Banks become increasingly aware of the **risks** that climate change poses to them and their customers and they are adapting their strategy to deal with these risks. There is less clarity in the disclosures about the **opportunities** and, as also recently pointed out by the ECB, there is little substance given to identified risks and what banks are doing to manage climate and environmental risk exposures.

— Banks increasingly set **net-zero ambitions** for 2050 and provide insights in their **financed emissions**. Consequently, measurement techniques are also seeing an uplift and are starting to mature.

Banks, first agree upon governance

ESG has found its way into the business and portfolio strategies of the banks. Those who have familiarized themselves with what the ramifications are can be easily overwhelmed by the comprehensiveness and complexity. Setting up a clear governance with the bank is pivotal to prioritize, guide and implement cross functional sustainability topics. Several recently surveyed European banks[3] indicate that defining clear responsibilities is highly prioritized and challenging in itself due to the sheer number of departments and functions who need to play a role.

We see that the integration of sustainability aspects in business processes, risk management and reporting,

[3] KPMG 2022 survey among Significant Institutions in the EU on ESG risk management practices.

quickly results in questions around who has which role to play. Existing governance arrangements help to answer some of those questions. However more often we see discrepancies and intervention at board level is required to resolve key questions around goal and limit setting, measurement and reporting. It requires responsibilities to be made even more explicit. The way forward, firstly, requires inspiring leadership from executive boards, followed by a central coordinating role. Leadership should address the most fundamental aspects around ambitions and the roles of the business, sustainability, risk management, finance and IT in order to achieve the (revised) ESG ambitions of the bank.

The operationalization can, subsequently, be decentralized yet does require continuous involvement from leadership as external demands are rapidly evolving in the next 2-3 years. In addition, there are still many questions on data and methodologies on the way to net-zero which will only be answered along the way implying banks need to be quite agile in pursuing a lasting change.

Banks, identify your risks and opportunities

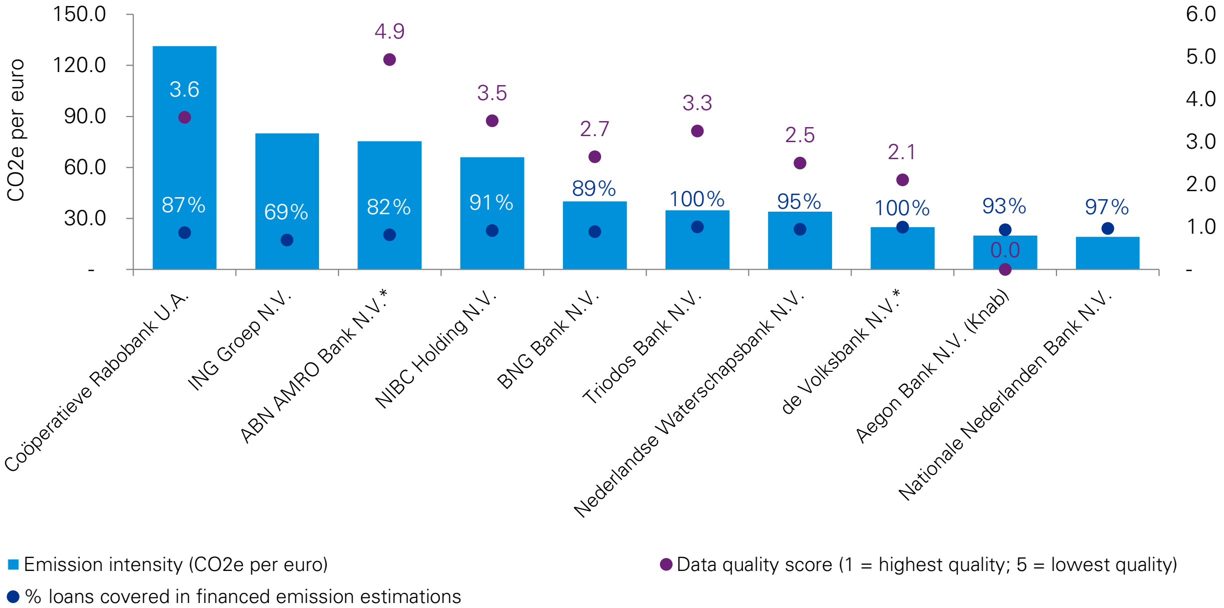
Risks and opportunities are two sides of the same coin. A strong lending concentration in high-emitting sectors, such as Oil and Gas, means elevated climate risks for the bank. However, it also gives an opportunity to engage with clients to reform their business models. Underlying to both sound risk management and business cases are sound analyses. Methodologies to assess risks and opportunities are rapidly evolving. Although there are no industry-wide standards on such methodologies, common industry practices start to emerge. We see that the most successful banks apply a risk-based and iterative approach. Start with unraveling which ESG factors, such as flooding, wildfires, drought, extreme weather events, carbon taxes, etc., are relevant and assess those using relatively simple methods. Developing, subsequently, a view on the specific risks and opportunities that are material from a financial or reputational perspective will help banks to focus their time on what matters most and improve methods where it makes most impact.

Banks, steer your portfolios towards net zero

Net-zero ambitions and commitments take center stage in most recent changes to business strategies. Even banks without such clear ambitions start disclosing their financed emissions. Banks finance emissions of other companies through their loans, investment and other financial services. Measuring those emissions is a key challenge as banks ideally need emission data from their clients, which is often not fully available. In absence one needs to resort to estimations. Fortunately, harmonization in accounting for emissions is beginning to pay off. Dutch banks have embraced the standards developed by the Partnership for Carbon Accounting Financials (PCAF), where disclosures start to cover the most relevant parts of their loan books. Also, our recent European survey underpins the importance of reducing financed emissions as the vast majority of the banks mention it as a key performance or risk indicator. Yet only half of the banks also disclose their financed emissions, which suggests there is some discomfort to overcome.

Financed emissions can be looked at per euro lent. Different greenhouse gases can be described in a common unit, i.e. carbon dioxide equivalents (CO_2e). The CO_2e per euro lent is on average 64 CO_2e per euro for Dutch banks, which is mostly driven by corporate loan books. Banks scoring above average have relatively large concentrations in their loan books to high-emitting sectors, such as agriculture, industry and shipping. Besides financial emissions, some banks also disclose avoided emissions – however, due to missing standards such figures are more difficult to compare.

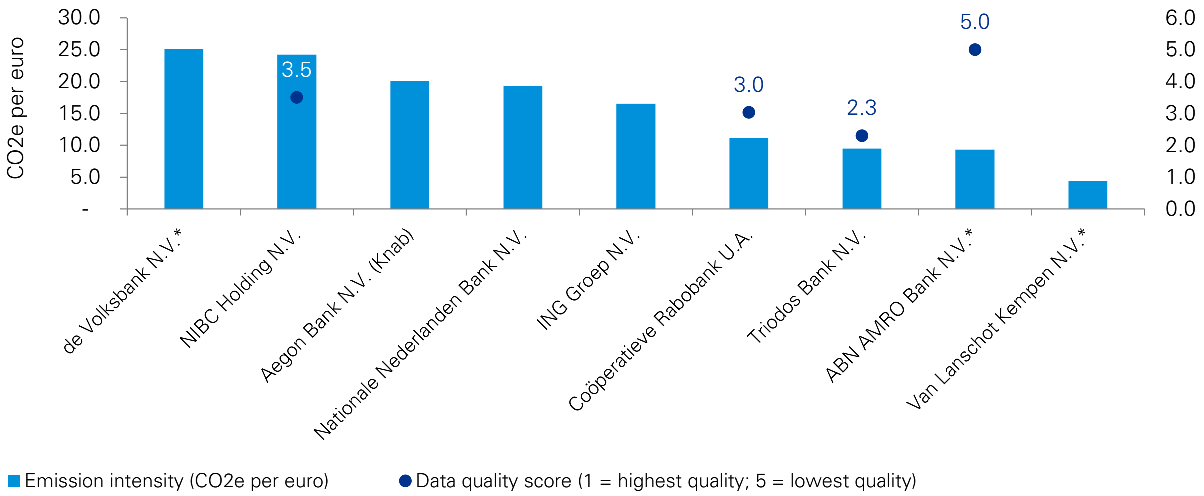
Intensity of financed emissions
Loan books[4]



*Reference date is 31-12-2021 whereas for other banks the reference date is 31-12-2020.

The CO2e intensity per euro is much lower for (residential retail) mortgage books, i.e. 16. As mortgages take up a large share in the loan books of most (retail) banks, their carbon footprint is also largely driven by the financed emissions stemming from residential real estate.

Intensity of financed emissions
Residential real estate (retail mortgages)

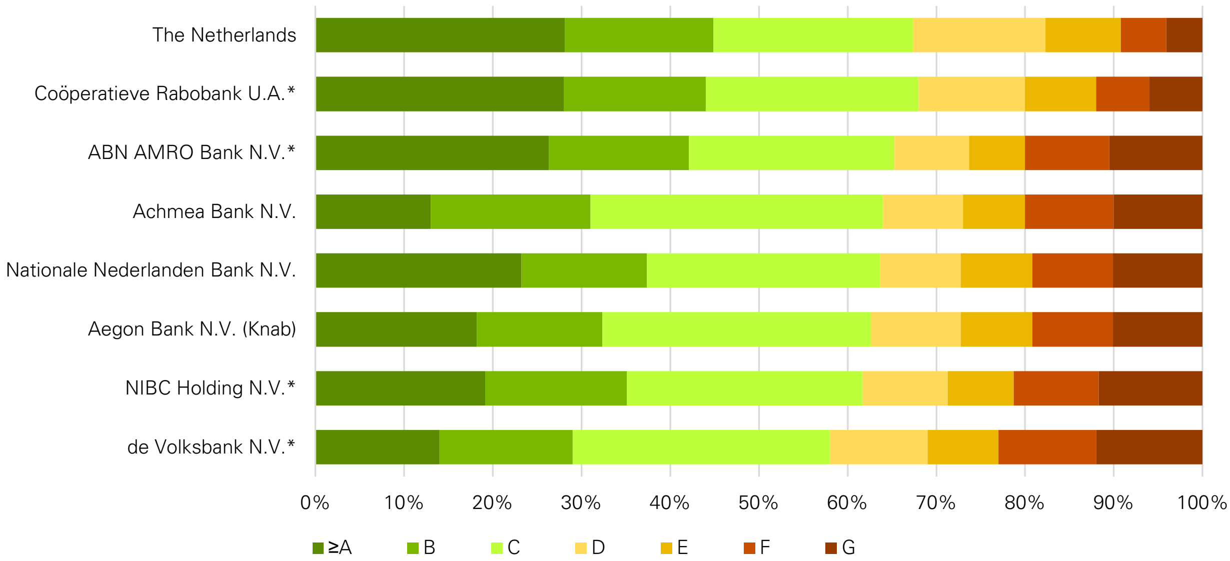


*Reference date is 31-12-2021 whereas for other banks the reference date is 31-12-2020.

Energy labels have also become more important as performance indicators for mortgage loan books in recent years. As most banks use energy labels to estimate financed emissions for real estate, there is a strong correlation between the two indicators. There are methodological differences blurring the picture on financed emissions stemming from the mortgage books. Some banks, such as ABN AMRO, use loan-to-value ratios to attribute emissions to properties while others, such as de Volksbank, attribute conservatively full emissions from properties to the loans. Hence energy label disclosures provide useful complementary information. The simple average energy label for the Dutch banks is around C-D, which is slightly below the average C label for Dutch residential real estate.

[4] The analysis considers loan books only. For Triodos Bank N.V. only information covering both the loan book and funds' investments was available.

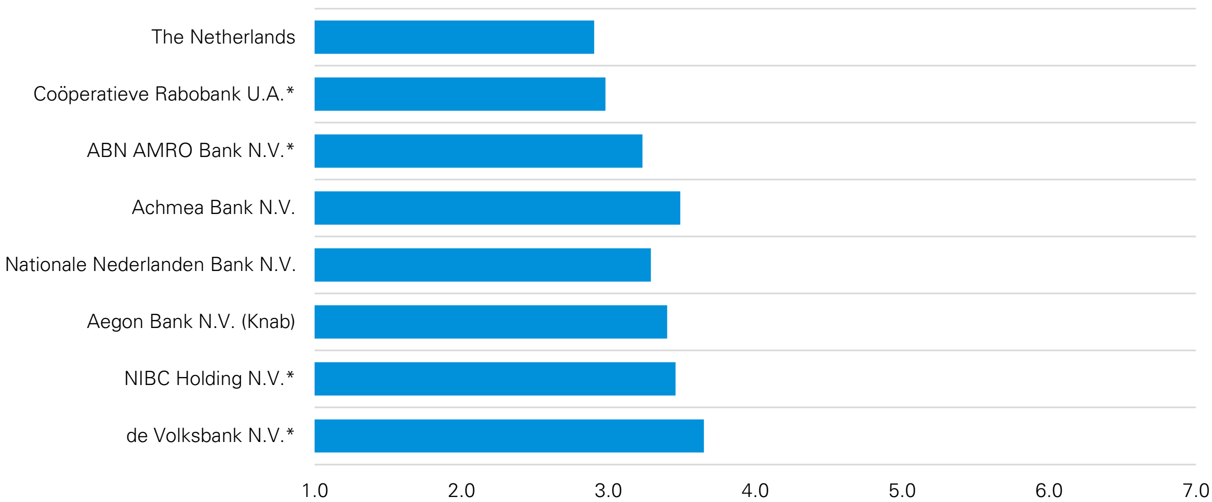
Energy labels residential real estate (retail mortgages)



*Reference date is 31-12-2021 whereas for other banks the reference date is 31-12-2020.

It paves the way to set tangible portfolio targets to achieve net-zero emissions by 2050. By also establishing intermediary targets for years between 2030 (or sooner) and 2050 one sets portfolio pathways or glide paths to 2050. It will require a mix of instruments, such as pricing, product innovation, underwriting standards and client engagement for banks to steer their portfolios along those paths to net zero.

Average energy label residential real estate (retail mortgages)



*Reference date is 31-12-2021 whereas for other banks the reference date is 31-12-2020.

The number on the X-axis corresponds with the type of energy lable (e.g. 1 = ≥A lable and 7 = G lable).

Asset quality

Recovery of the Dutch economy in 2021 has created the opportunity for the four large retail banks to release loan impairment provisions to EUR 62 mln (a decrease of EUR 7 bln). Government support packages have (so far) largely curbed bankruptcies, and the economy is reopened. The distortion of normal operations and geopolitical influences do bring uncertainty going forward.

Table 2 Overview of IFRS 9 stage ratios[5], 2020 – 2021 (%)

	ING		Rabobank		ABN AMRO		de Volksbank	
	FY21	FY20	FY21	FY20	FY21	FY20	FY21	FY20
Stage 1 ratio	91.7%	89.3%	91.2%	89.0%	89.2%	86.4%	95.1%	92.9%
Stage 2 ratio	6.5%	8.5%	6.7%	7.9%%	8.2%	10.2%	3.7%	5.7%
Stage 3 ratio	1.8%	2.2%	2.1%	3.1%	2.6%	3.4%	1.2%	1.4%

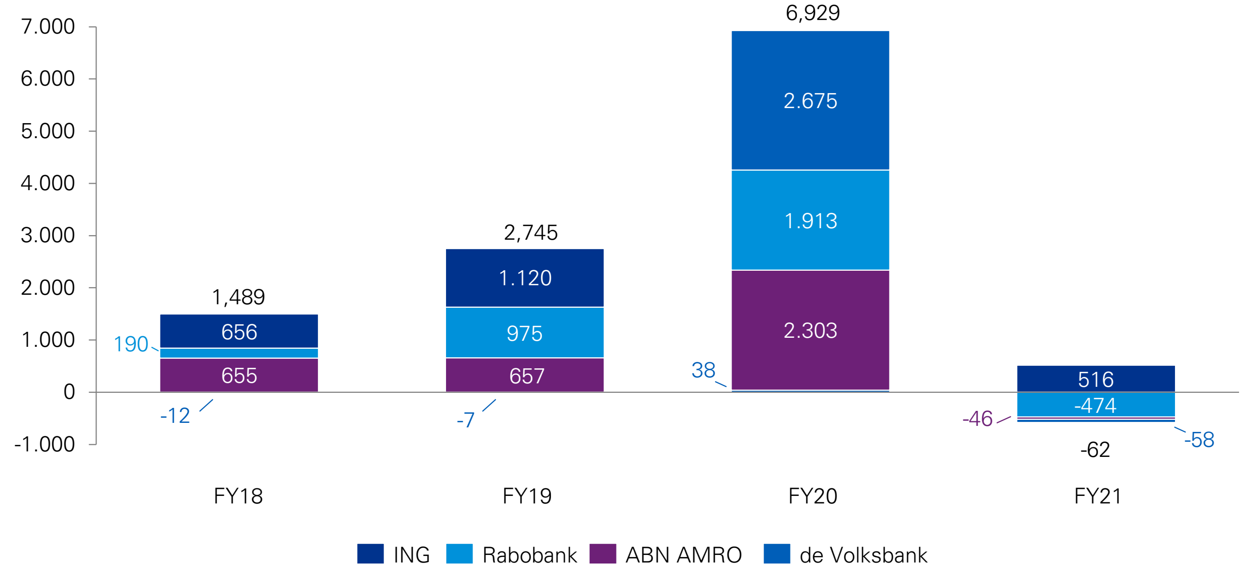
The COVID-19 pandemic continued to have implications on the global and Dutch economy in 2021. Lockdowns, quarantine measures and restriction of travel have disrupted daily operations and created an uncertain financial year. Despite these challenges, the asset quality of Dutch banks has improved. Earlier significant provisions taken at the onset of the pandemic are being released, incidentally – but significantly – increasing the financial performance of Dutch banks.

Loan impairment

Impairment charges for the four banks have decreased by EUR 7.0 bln compared to FY20. The uncertain outlook in FY20, when the impairment charges totaled EUR 6.9 bln, seems behind us based on the end-of-year figures. The large deltas indicate that banks did not expect such a swift turnaround. ABN AMRO, ING and Rabobank all reduced their impairment charge between EUR 2.1 bln (-10.9%) and EUR 2.4 bln (-33.5%). De Volksbank reduced its impairment charge by EUR 96 mln (- 10.5%).

Expected credit losses (ECL) and impairment charges are based on forward-looking scenarios with associated weights. So far, the FY21 figures are positive, also attributed to the major support efforts of the Dutch government to minimize negative impact on the economy with significant government support.

Graph 4 Loan impairment charge, 2020 – 2021 (EUR mln)



[5] Based on Gross carrying amount Loans and Advances to all customers. Excluding IFRS Fair value adjustment and Loans at fair value through P&L.

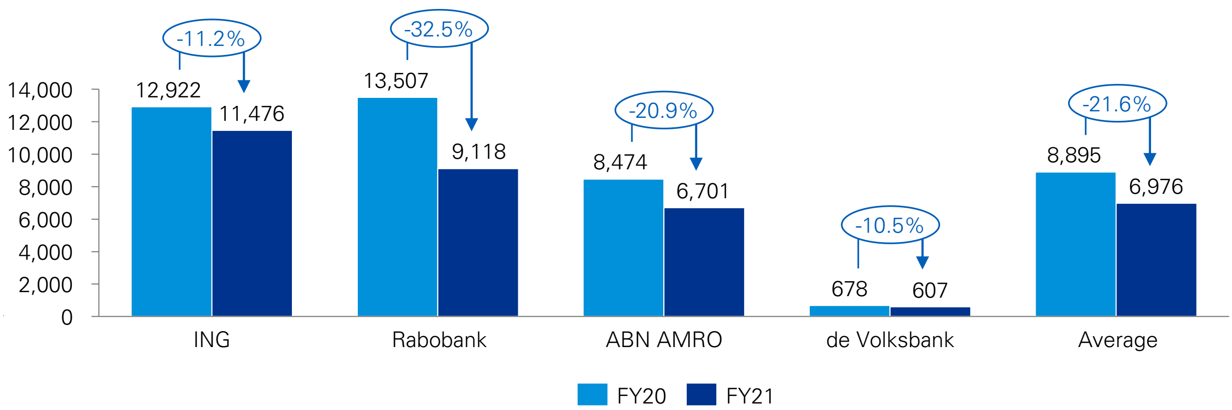
Change in credit quality recognition

Stage 2 and 3 ratios of all four banks have improved (resp. by 1.59% and 0.54% on average). Reasons for these improvements are bank specific. ING indicates that clients could be removed from watchlists and move back to stage 1 – indicating a healthier loan book driven by an upturn in the economy in 2021. ABN AMRO achieves the results from the wind-down in their Corporate and Institutional Banking division lowering loans classified in stage 3. De Volksbank sees the effects in the economy on SME loans and a reduction in expected insolvencies.

Whereas FY20 was characterized by an inflow of customers in stage 2 due to granting of payment holidays and an increase in payment arrears, we see a reversal in FY21. Looking forward, COVID-19 affected hospitality, cultural and aviation sectors, but the recent developments in Ukraine are expected to differ in nature. Sectors with higher export/import, dependency on commodity prices and an international supply chain are most likely sensitive to current shocks.
Credit risk management practices will be tested due to the unique impact in different sectors. A sectoral view using cross sections on a detailed level, combined with close monitoring of real-time deterioration of the loan books credit quality is needed to prevent above average credit losses going forward.

In line with the reduction of stage 2 and stage 3 assets, we see a significant decline in non-performing loans (NPL) of 21.8% on average for the four banks. Rabobank even reported a 33.5% reduction this year, continuing a declining trend since 2018 as a result of pursuing an active NPL strategy. On industry level, Rabobank, ING and ABN AMRO have been able to prevent significant increased NPL exposures in the COVID-19-sensitive sectors. Interestingly, ABN AMRO is the only bank having increased NPL exposure for private individuals by 7.9% - even though the total gross carrying amount remained stable.

Graph 5 Non-performing exposures (to all customers)[6], 2020 – 2021 (EUR mln)



[6] Based on IFRS 9 stage 3 classification for Gross carrying amount Loans and Advances to all customers.

Forward looking provisioning remains urgent due to new uncertainties

As we have seen, post-pandemic economic recovery positively impacted the financial performance of the four Dutch banks. However, we observe three factors that stress the importance for banks to monitor their credit characteristics, while taking a forward-looking stance on loan loss provisioning.

Firstly, the recent events and distortions concerning Ukraine can harm post-pandemic recovery. Sanctions resulting from the war in Ukraine will have (direct or indirect) impact on the asset quality of the corporate loan book. In addition, disruption on commodity- and energy markets has strongly increased the cost of production in several sectors, but is not being equally compensated with higher consumer prices, hence increasing margin pressure.

Secondly, the ECB announced to accelerate phasing out unconventional monetary policy (UMP) measures. It signals the ECB believes non-transitory high inflation needs to be curbed and this further drives the expectation for interest rate increases. The increased rates can severely impact repayment capacity of private households and also refinancing capacity of short-term financed corporates. We see ING already acting prudently by taking an additional EUR 124 mln provision for their residential mortgage portfolio.

Thirdly, the expected pandemic-related shock of bankruptcies might not be fully prevented, but instead be delayed. Empirical research[7] finds evidence for increased presence of unprofitable, but still operating companies being sustained by accommodative credit conditions and non-forborne debt. This trend is called 'zombification' and poses a threat to the banking system as research finds no significant price differentiation in bank interest rates among zombie and non-zombie companies. This can result in a distorted bank portfolio and increased (unexpected) credit losses when viability of zombies is being challenged during strong economic downturn and increased scrutiny by supervisors to harmonize NPLs throughout Europe.

While new uncertainties also require a forward looking stance, banks should at least closely monitor in light of the factors described above. Going forward, sectoral variables for credit assessments could have changed post-pandemic. Due to the absence of a persistent economic recession and through-the-cycle testing, the accuracy of banks incorporating expected credit losses has not yet been fully revealed.

[7] Helmersson, Tobias, et al (2021). Corporate zombification: post-pandemic risks in the euro area. *Financial Stability Review*.

The Future Bank is Connected

Paul Koetsier, Director Digital and **Tom Sprong**, Senior Manager Strategy & Operations

These are pivotal times for Dutch banks. Customers are increasingly demanding that banks transform from a business model that was relatively separate from other industries, into a new way of working where banking services are connected with and to other industries. Our research[8] involving retail banking strategy decision makers indicates that eight out of ten retail banking organizations are putting customer-centricity front and center. However, a lack of brand differentiation puts banks' relevance and future growth of banks at risk.

Despite substantial improvements in the area of digitalization, banks can still improve on digital customer intimacy compared to large technology players from other sectors. These disruptors include fintech firms and tech titans, who keep raising the bar for customers' experiences and expectations.

Banks must also negotiate a multitude of shifting factors — from changing customer behaviors to economic headwinds, intensifying competition, regulatory pressures and technological disruption. Security, technology, and business-silo hurdles stand between organizations and the successful execution of customer-focused strategies.

A significant gap has already opened between leading customer-centric banks who demonstrate strength across a range of capabilities critical for enabling digital transformation against their peers — and our research indicates this gap in capability may widen further.

But while there are challenges, change also provides opportunities. Banks that can drive a truly differentiated proposition have the potential to secure a significant competitive advantage. These banks put the customer experience at the heart of everything they do and make a connection across the enterprise. Connected Enterprise is KPMG's customer-centric, enterprise-wide framework to digital transformation to capture these opportunities.

The framework defines eight clear capabilities of a Connected Enterprise. Research shows that firms that make a moderate or significant investment in all eight capabilities and increase their maturity are 2x as likely to succeed[9]. Success is measured in delivering a customer experience that exceeds expectations, successful execution on one or multiple customer-centric objectives and in achieving return on investment on one or more metrics.

Figure 1 Eight Connected Capabilities

Insight-driven strategies and actions	Innovative products and services	Experience-centricity by design
Seamless interactions and commerce	**2x Impact**	Responsive operations and supply chain
Aligned and empowered workforce	Digitally-enabled technology architecture	Integrated partner and alliance ecosystem

Based on the results of our global research we have defined what good looks like when delivering banking services. Prioritizing investments to connected capabilities can enable a winning business and operating model. Please see the next page for a set of capabilities defining 'what goods look like'.

[8] A commissioned study conducted by Forrester Consulting on behalf of KPMG, October 2020
[9] A commissioned study conducted by Forrester Consulting on behalf of KPMG, 2018

How mature is your bank?

We invite you to assess your maturity by scoring your maturity for the capabilities.

Capabilities	Average maturity level	What Does Good Look Like?	Grey = Average maturity level of retail banks, globally				
			1	2	3	4	5
Insight-driven strategies and actions	2	At any point in time the bank has a 360 (single, integrated) customer view					
		The bank actively uses third-party data sources to extend the customer view					
		The bank utilizes predictive analytics when addressing the customer					
		The bank's management has access to integrated, holistic management information					
Innovative products and services	2	The bank's proposition development methodology is fully customer focused					
		The bank's proposition development is agile					
		The bank actively explores and assesses resilient, innovative value-streams					
		The bank actively includes ESG into proposition development					
Experience centricity by design	4	The bank enables the human side of digital					
		The bank leverages behavioral insights to improve CX					
		The bank is able to personalize the experience					
		The bank actively turns negative experiences into positive memories					
		The bank puts employee experience at the same level as the customer experience					
Responsive operations	3	The bank's investments are geared at those capabilities that are brand defining					
		AML & CFT defences are continuously finetuned for an optimal cost-benefit					
		Workflows operate in an end-to-end manner, de-silo-ing the organization					
Integrated partner & eco-system	3	The bank has a company-wide strategy to identify, select and engage with partners					
		The bank actively orchestrates the ecosystems in which it operates					
		The bank follows a clear strategy and has the technology to flexibility integrate partners					
Digitally enabled technology architecture	4	The bank has a clear strategy for digitalization					
		The bank leverages the power of cloud					
		Agility and resilience + control are balanced in an optimal way					
Aligned and empowered workforce	3	The bank actively tracks and recruits the competences required to reach business goals					
		The bank is a great place to work					
Seamless interactions and commerce	4	All channels operate seamlessly in an omnichannel manner					
		The bank proactively engages with customers at the relevant time					
		Front-, mid- and back-offices operate seamlessly within the bank					

Average score on capability level, based on study conducted by KPMG among 412 professionals at retail banks, globally.

Costs

The four large banks have been struggling to keep their costs under control, mainly driven by AML/CFT efforts, digitalization, costs relating to the deposits and continuing remediation efforts. The average Cost-to-Income (CtI) ratio increased by 3.8 percentage points to 70.4%. The average CtI ratio is skewed upwards by ABN AMRO and de Volksbank. The average operating expenses increased from EUR 6,038 mln in FY20 to EUR 6,358 mln in FY21.

AML and CFT still a hot topic

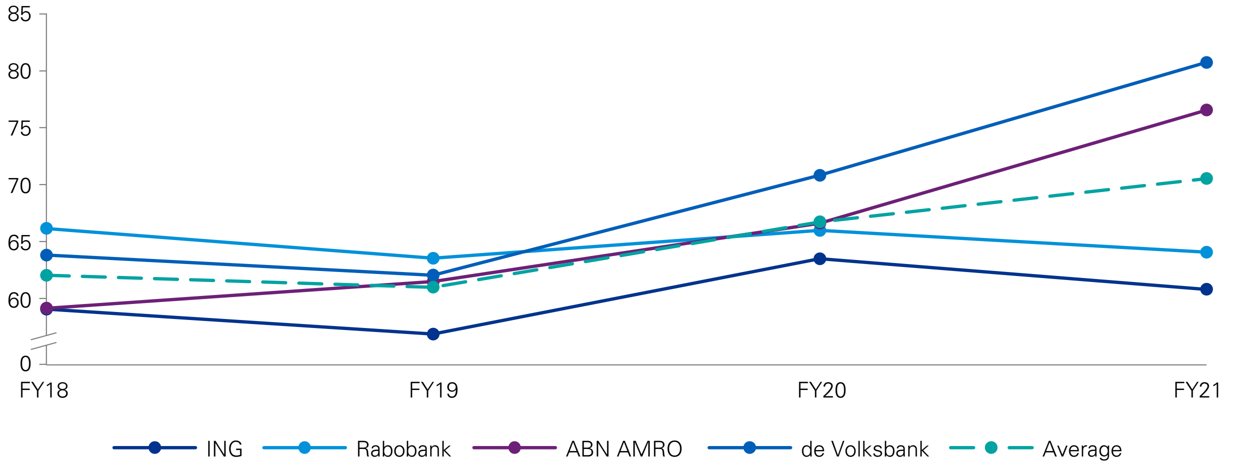
In the past few years, the four banks have been heavily investing in human capital, systems and processes to comply with the stringent Anti-Money Laundering (AML) as well as the Combating the Financing of Terrorism (CFT) regulations. Approximately 10 to 15% of total FTEs are currently employed to encounter financial crime and the banks struggle to get it right.

Last year, the DNB determined that Rabobank did not meet the requirements of the Dutch AML and CFT regulations. Rabobank received a draft instruction in 2018 which was subject to a EUR 500,000 penalty. In February FY21 Rabobank received a final official instruction to remedy these deficiencies by the end of 2023 at the latest, resulting in the penalty being forfeited. Accordingly, Rabobank provisioned EUR 249 mln to continue the increased efforts and investment in expertise, technology and systems to meet the requirements. In the period 2014 - 2020, ABN AMRO also went through an investigation of their activities, but did receive a fine of EUR 480 mln from the Netherlands Public Prosecution Service. On top, ABN AMRO provisioned EUR 66 mln for their AML program in FY21 and recruited AML/CFT employees totaling 5100 FTE's which is almost 20% of the total FTE's.

De Volksbank too was part of an investigation from the DNB relating to AML and CFT remediation program regarding customer integrity to improve processes and compliance with policies. ING Luxembourg has also been informed that shortcomings in AML processes will be investigated, despite ING Group having received a EUR 775 mln fine in FY18.

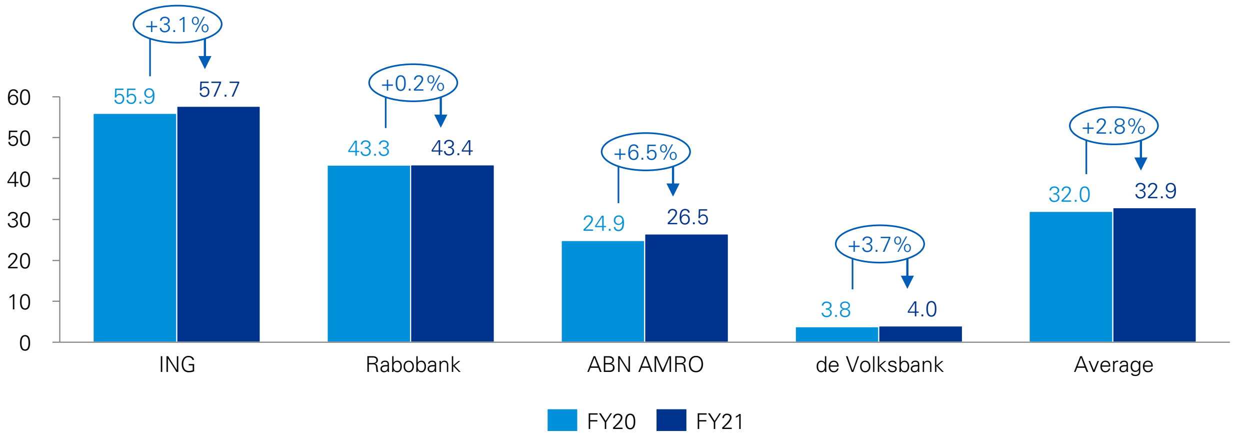
Dutch banks agreed to keep the payments service accessible to all by limiting the costs of having a payment account. However, the increasing AML/CFT costs and the risk of fines resulted in banks excluding entire branches from their services such as cash-intensive businesses like small car dealers. ABN AMRO - as first-mover – is passing AML costs on certain industries such as coffeeshops by raising the costs of a coffeeshop having a bank account by 1000%. This development is closely monitored by the peers. We expect that other banks will follow shortly as the regulatory authorities indicating pricing to be a banking matter and excluding entire branches raises other issues.

Graph 6 Cost-to-Income ratio[10] , 2018 – 2021 (%)

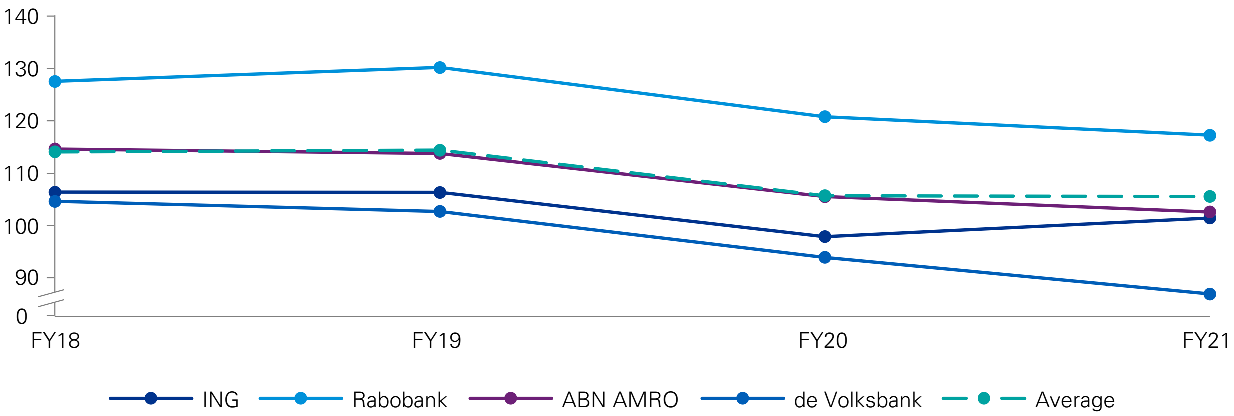


[10] Cost-to-Income ratio is calculated as total operating expenses divided by total income. Total operating expenses include regulatory levies and exclude loan loss provisions.

Graph 7 FTE Development, 2020 – 2021 (#k)



Graph 8 Loan-to-Deposit ratio, 2018 – 2021 (%)



ABN AMRO, ING, Rabobank, Triodos Bank and de Volksbank combined forces in the Transaction Monitoring Nederland (TMNL) initiative in FY20 to increase effectiveness of AML and CFT operations by consolidating transaction data and to gain insights. Cutting edge progress has not (yet) been attained due to strict privacy regulations (AVG). Another initiative was launched in February 2021 called Fintell Alliance NL, which is a collaboration between the four large banks and FIU-Nederland working together in one location to increase the effectiveness of flagged transactions. Looking ahead, in June 2021, the EU presented an action plan on AML to harmonize the rules across member states and proposes direct supervision at EU level.

Digitalization

Digitalization of banking services – which accelerated during the pandemic – enabled centralization and closing of local offices and buildings for ING, ABN AMRO and Rabobank. De Volksbank is focused on a localized strategy offering a direct physical service through the opening of offices. Still, the aggregate land & building of the four large banks decreased by EUR 451 mln to EUR 3,682 mln, resulting in less housing, office and depreciation costs. In addition, the total costs for travel, hotel, training and other similar staff-related costs declined by EUR 351 mln to EUR 1,885 mln in FY21 (also because of the various lockdowns).

The four banks are struggling to increase efficiency and lower costs in day-to-day operations relating to legacy IT systems. The four banks are investing heavily in IT-systems by implementing new digital client service models and digitalizing their risk and control frameworks. Rabobank saw their IT costs rise by EUR 22 mln and the IT costs of ABN AMRO went up by EUR 7 mln, still comprises about a third of the total general and administrative costs. De Volksbank almost doubled their IT costs from EUR 35 mln to EUR 60 mln executing their new strategy with digitalization at its core. ING is the exception with a 3.8% decrease of EUR 31 mln.

Negative interest

The average Loan-to-Deposit (LtD) ratio of the four banks has been decreasing in the past 4 years, which has been accelerated at the outbreak of the COVID-19 pandemic, when lockdowns and disruption of daily consumer life led to a significant accumulation of savings. In FY21 total deposits on paying and saving accounts for the four banks increased by EUR 38.2 bln (FY20: EUR 42.6 bln). The declining LtD trend suggests that banks are not able to put the abundance of deposit funding to good use. Moreover, banks have been forced to store money at the ECB against a negative interest rate of 0.5%, which costs all Dutch banks approximately EUR 1.4 bln every year.

To mitigate these effects, Rabobank, ING and de Volksbank are passing on negative interest rates to their customers with payment and savings accounts containing balances exceeding EUR 100,000 (previously EUR 250,000), since 1 July 2021. ABN AMRO followed suit regarding the lowered threshold on 1 January 2022. Looking forward, Dutch banks are considering lowering the threshold even further to EUR 75,000, which will depend upon the behavior of businesses and consumers with regard to their savings.

Dutch banks are also trying to reduce deposits by winding down services in other countries. Rabobank terminated their online deposit service in Belgium and Germany and ING parted from their deposit clients in Austria and Czech Republic and withdrew from the French consumer industry in December 2021. ABN AMRO announced in FY20 that they were going to terminate their deposit bank subsidiary MoneyYou.

Remediation

The Dutch Financial Services Complaints Tribunal (Kifid) received many complaints on variable interest rates of revolving credit facilities, which were not in line with more favorable market rates. In March 2021, Kifid ruled in favor of those complaints, which was followed by Credit Agricole Consumer Finance initiating remediation projects compensating clients with these particular products leading to a EUR 175 mln provision. Other banks followed suit. ABN AMRO and Rabobank were front-runners and provisioned, respectively, EUR 348 mln and EUR 333 mln for their remediation programs. ING also offered similar products and provisioned EUR 180 mln. De Volksbank – with a primarily residential mortgage portfolio – provisioned a smaller EUR 15 mln.

The banking journey on non-financial reporting (NFR) - do all roads lead to Rome?

Marco Frikkee, Partner Sustainability and ESG Reporting, **Leonie Jesse**, Senior Manager Sustainable Finance and **Sergi Vázquez**, Senior Consultant Sustainability

Current snapshot and trend

The banking industry has progressively been stepping up its commitment towards the measurement and reporting of its social and environmental footprint. This can be plainly witnessed by assessing the increasing relevance that sustainability received in the annual reports of each and every bank during last decade, including the four major Dutch banks (ING, ABN AMRO, Rabobank and de Volksbank).

The modest common NFR metrics

The standardization of metrics connected to consumers is increasingly consistent among peers. Clear examples are metrics that refer to relevant themes such as consumer satisfaction (NPS) or digitalization (channels availability). The same could be said with regard to the environmental impact of the banks' own operations, embodied by increased reporting of KPIs, such as scope 1 and 2 C02 emissions or water consumption. Undoubtedly, the new sustainability disclosure requirements will lead to further alignment.

NFR standards in place, and to come

Over the course of the last few weeks, significant announcements were made by a myriad of reporting bodies. On the one hand, the EFRAG published the European Sustainability Reporting Standards and the US SEC proposed climate-related disclosures, while, on the other hand, GRI and IFRS reported a collaboration agreement to align their respective standard setting bodies. However, are they all the banking sector needs?

Back in 2014, SASB turned a frontrunner by proposing specific disclosure to apply for commercial banks. A distinct quantitative requirement of the Commercial Banks Sustainability Accounting Standards was FN0101-17, requiring banks to report the amount and percentage of lending and project finance that employed integration of ESG factors or sustainability themed lending. However, in 2017 that same body proposed the removal of this metric, indicating that it was 'unlikely to provide additional marginal value over the other metrics', which essentially referred to the integration of ESG factors along the lending process.

ESG impact from the loan book and investments; the big sectorial NFR challenge

As a result, the banking industry, for years, has lacked a standardized and homogeneous metric to gauge its most crucial sustainability metric. Needless to say, definitely the largest impact that can be attributed to banks' portfolios arises from activities they finance, in the shape of both equity and debt. In this arena, there is a visible willingness by the banks to report their steady improvement and relentless commitment to steer their lending and investment portfolios towards sustainable targets. However, at the moment this endeavor equates to an individual time trial with no references; each bank rides blindly, unaware of the performance of its peers as there is no standardized measure of time. In this race to Rome, time happens to be the social and environmental impact of the borrowers and the investees.

On this journey, if the finish line is placed in the FY21 annual reports, the existing roads, so far, are named: climate neutral balance sheet (de Volksbank, using PCAF methodology), sustainability acceleration asset volumes (ABN AMRO), as well as a portfolio of both sustainable products and sustainable financing (Rabobank), or a parallel route labeled as climate finance and social impact portfolio and sustainable investments (ING). In addition, references are made to metrics, such as the millions poured into green mortgages and loans (Rabobank), or the estimation of scope 3 emissions of the lending portfolio (ABN AMRO), leading to the picture of what remains a rather unpaved pathway. All in all, the methodologies in place to determine the claimed figures are mainly tailor-made by each bank.

EU Taxonomy and Paris Agreement, the common tailwind

Certainly, the implementation of the new regulatory standards (i.e. EFRAG) by the borrowers and investees will provide an extensive and consistent data tool for financial institutions. However, it is still required by the banking industry to determine the key metrics that most correctly measure the actual ESG impact of the lenders and investors. This clearly calls for alignment in order to be able to provide consensual solutions, for instance regarding which stake of the emissions is attributable to the lender and the investor, or how double counting is avoided.

In addition to this, certain topics are brought into the spotlight by the different reporting bodies, such as circular economy, impact on biodiversity, water intensity consumption by the borrowers and investees, or the embedding of ESG factors into board remuneration policies, potentially shaping a governance landscape that has hitherto been scarce in KPIs. In this regard, although the four major Dutch banks target all of these topics, a lack of a consensus on how to better gauge the quantitative impacts still remains. This limitation, partially, defeats the purpose of current metrics as the absence of comparability hinders the assessment of the performance of individual banks on these themes.

Luckily, there is light at the end of the tunnel. Though controversially drawn, the line between green and brown investments, as determined by the EU Taxonomy, and the clear climate targets pictured in the Paris agreement set the direction and pace to follow. When generally implemented, the banks will enjoy a compelling tailwind cycling the NFR race.

Recap – where is Rome?

All in all, though there are few NFR metrics that are consistent across the banking sector, the upcoming implementation of new non-financial disclosure requirements shall allow further alignment, as more ESG data will be available. That is especially crucial in regard to measuring the ESG footprint of both the lending and investment portfolios, the obvious impact cornerstone of the banking industry. At the moment, the lack of common standards appears to be a bottleneck pushing all banks to develop self-made methodologies and metrics. Conscious of this, the public and reporting bodies are taking the lead with the aforementioned initiatives (EU Taxonomy, EU SEC proposal, GRI and IFRS collaboration and others), but the banking sector still needs to cherry-pick the best ESG metrics to steer the direction of both their investments and loan book – indicators that shall pinpoint the way to Rome.

Capital

In 2021, Dutch banks continued to show resilience with strong capital positions and low loan losses on their books. As a result of the built-up capital buffers, a strong liquidity position and targeted support packages from the government to businesses, banks were well prepared to curb the negative effects of the COVID-19 pandemic. As we described under 'Asset quality', new surrounding uncertainties such as the war in Ukraine, inflation and delayed bankruptcies can (directly or indirectly) have a negative impact on banks' loan books, emphasizing the importance of solid capital positions and forward-looking provisioning.

Table 3 Capital adequacy ratios

Bank	ING		Rabobank		ABN AMRO		de Volksbank	
Years	FY21	FY20	FY21	FY20	FY21	FY20	FY21	FY20
CET 1 ratio	15.9%	15.5%	17.4%	16.8%	16.3%	17.7%	22.7%	31.2%
SREP target	10.5%	10.5%	10.0%	10.0%	9.6%	9.6%	9.7%	9.4%
Tier 1 capital ratio (%)	18.1%	17.3%	19.2%	19.0%	18.0%	19.5%	22.7%	31.2%
Tier 2 capital ratio (%)	2.9%	2.8%	3.4%	5.2%	4.4%	4.2%	3.6%	4.9%
Total regulatory capital ratio	21.0%	20.1%	22.6%	24.2%	22.4%	23.7%	26.3%	36.1%

Capital Adequacy

Dutch banks managed to increase their CET1 ratio from below 10% in 2008 (measured as Tier 1 ratio under Basel II) up to 17% in 2020, the year in which the pandemic started. With a sector average CET1 ratio of 17.2% (based on HY21 data) the Dutch Banking industry remains solid.

In FY21, ABN AMRO and ING achieved a CET1 ratio of 16.3% and 15.9%, respectively, which is well above their FY21 internal- (13% and 12.5%) and SREP target ratios (9.6% and 10.5%), but slightly below the sector average. Whereas ABN AMRO saw a consecutive drop in its CET1 ratio since 2018 due to an increase in Risk-Weighted Assets (RWA) and a decrease in CET1 capital, ING saw a consecutive increase since 2018, due to extraordinary circumstances.

Rabobank and de Volksbank, however, reported an above sector average CET1 ratio of 17.4% and 22.7%, respectively, and also achieved their FY21 internal- (14% and 19%) and SREP target ratios (10.0% and 9.7%). Whereas Rabobank saw a consecutive increase of its CET1 ratio, de Volksbank showed a noticeable decrease compared to FY20, owing an increase in RWA according to temporary changes in their internal credit risk model for residential mortgages.

Since the global financial crisis, authorities set considerable stricter capital adequacy and liquidity demands. At the beginning of 2020, the DNB temporarily lowered the requirements to mitigate the impact of the pandemic at its offset. In FY21, the four banks still reported high capital headroom, which may lead to inefficiency concerns. Early lessons[11] from the pandemic, however, indicate that European banks with more headroom tend to have lend more during the COVID-19 crisis, thus contributing to absorbing the consequences of the pandemic.

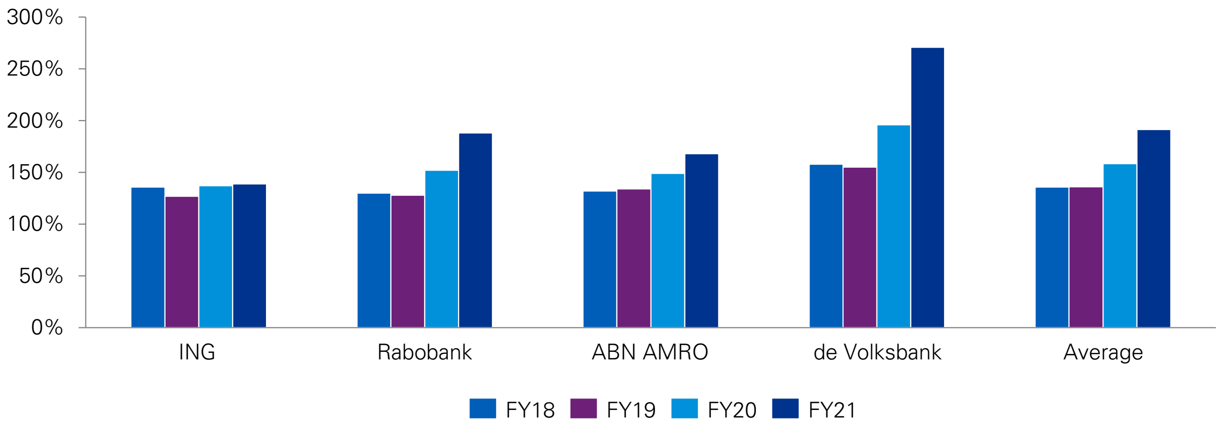
In the EBA stress test of mid-2021 it was also found that the CET1 ratio of Dutch banks was more than 1.5% higher than the average CET1 Ratio of other European banks. ABN AMRO, ING, Rabobank and de Volksbank met the capital requirements of EBA and ECB and preventive measures for banks with deteriotated asset quality were released. From September 2021, listed banks were also allowed to pay out dividends again. Next to paying out dividends, ABN AMRO and ING also initiated share repurchases.

Liquidity

In 2021, the liquidity position of Dutch banks was favorable. Compared to 2020, the liquidity coverage ratio (LCR) of ABN AMRO, ING, Rabobank, and de Volksbank

[11] Basel Committee on Banking Supervision. (2021). Early lessons from the Covid-19 pandemic on the Basel reforms. *Bank for International Settlements.*

Graph 9 Liquidity Coverage Ratio (LCR), 2018 – 2021 (%)



increased. In 2021, Dutch banks were better prepared to absorb market-wide shocks related to the COVID-19 pandemic compared to the global financial crisis in 2008. However, they were hardly forced to draw from those buffers. In Q3 2021, the LCR of European banks increased to 173.2%, indicating a favorable position according to the Basel III guidelines.

In 2021, Rabobank and de Volksbank achieved an LCR of 184% and 271%, respectively. Both banks scored above the European sector average. While Rabobank's LCR has been fluctuating since 2018, de Volksbanks' LCR has been increasing. ABN AMRO and ING, also scored above the European sector average, achieving an LCR of 168% and 139%, respectively. Both banks have seen their LCR increase since 2018.

The current favorable liquidity position of banks is, however, sensitive to market sentiment. The liquidity of the highest liquid assets, such as government bonds, strongly decreased during the COVID-19 pandemic. This may indicate that the current liquidity position of Dutch banks may be distorted as the real position may shift when the market sentiment changes.

Contact us

For more information, please contact:

Lennart de Vries (deVries.Lennart@kpmg.nl, +31 6 1187 8596)
Jelle Dijkers (Dijkers.Jelle@kpmg.nl, +31 6 1064 3981)
Immo van der Veen (vanderVeen.Immo@kpmg.nl, +31 6 1328 4040)

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Bart van Kampen	Time to shift gear in decarbonizing balance sheets
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Kasper Burger	Time to shift gear in decarbonizing balance sheets
Paul Koetsier	The Future Bank is Connected
Tom Sprong	The Future Bank is Connected
Marco Frikkee	The banking journey on non-financial reporting (NFR) – do all roads lead to Rome?
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Lennart de Vries
Jelle Dijkers
Frank de Crom
Immo van der Veen
Hatim Cheppih
Adnaan Rasoelbaks
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State of the Banks **FY19**

State of the Banks **FY20**