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FINANCIAL SERVICES

Road to recovery?

What the future holds for UK banks

Half year results 2013

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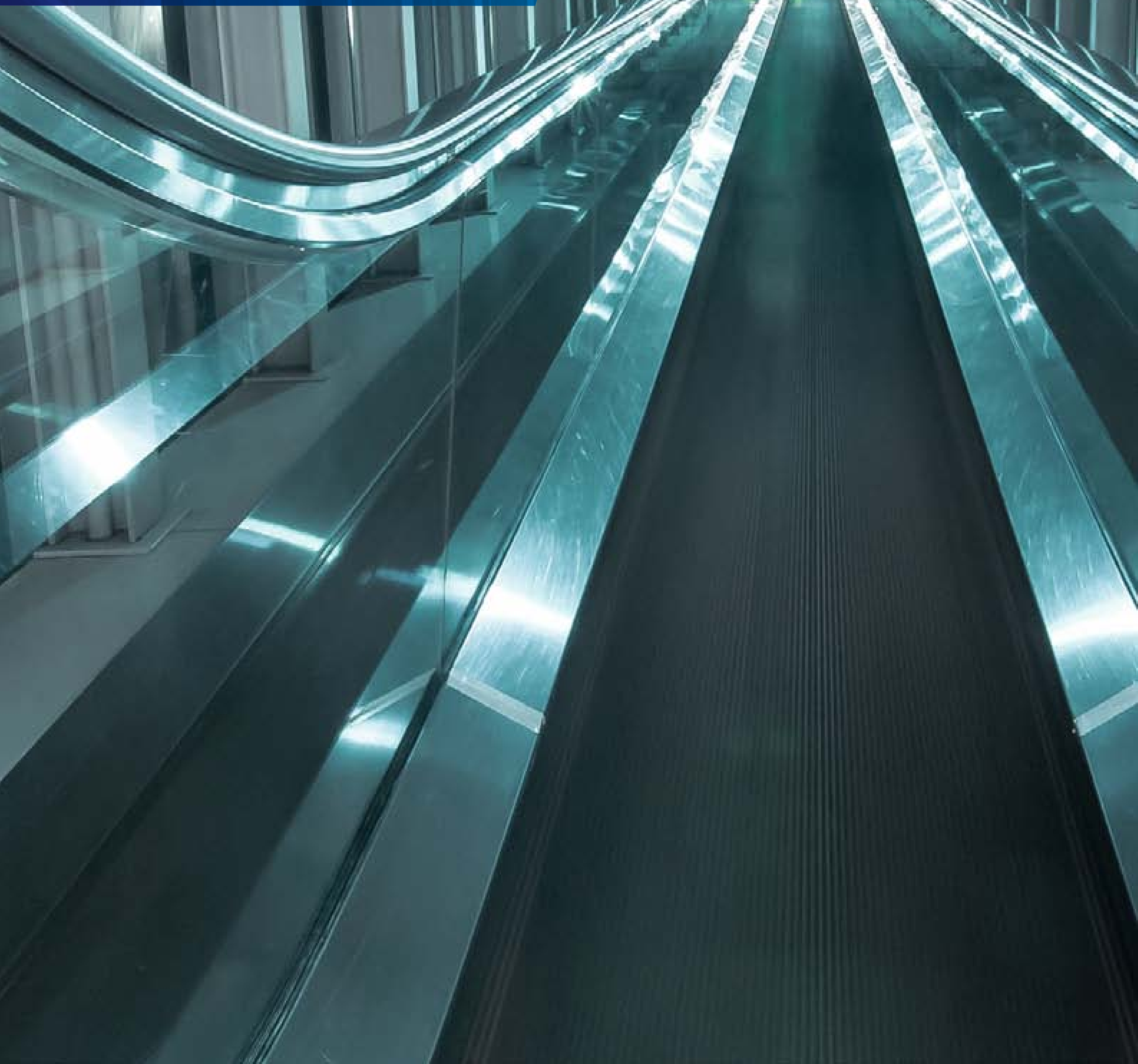

Basis of preparation

This report summarises the 2013 interim results of the following UK headquartered banks: Barclays, HSBC, Lloyds Banking Group (Lloyds), Royal Bank of Scotland (RBS) and Standard Chartered (SCB).

Information has been obtained solely from published interim and year end reports (including analyst packs from results presentations). Where total numbers are presented it is the total of the five banks in the review. As an example, total assets is the sum of the total assets of 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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Introduction

Bill Michael, EMA Head of Financial Services

The UK economy is at a critical juncture. In the past few weeks, underlying economic data has hinted at signs of a recovery that some suggest is gaining momentum. The first-half results of the five major UK headquartered banks seem to have a similar dynamic. For the first time in three years, all the banks are back in the black. More importantly, the gap between statutory profits and core profits is narrowing, suggesting that the post-crisis restructuring efforts are starting to pay dividends. There are several encouraging trends in the results: rising mortgage volumes, a continued downward trend in impairment and reduced dependence on wholesale funding as customer deposits increase.

However, a few dark clouds remain. Banks continue to pay for their past mistakes. Customer remediation and redress costs accounted for about 20 percent of the H1 2013 profits. While banks are strengthening their capital positions, regulators are still asking for more. The downward trend in margins since 2007, primarily due to low interest rates and de-risking, challenges business models.

In light of these first-half results, what, then, might UK banking look like in the next three to five years? In this report, we explore a number of key issues and themes facing and re-shaping the industry. (These challenges must all be considered in light of the fact that most banks have new leaders at the helm and all of them are also working in a much more onerous personal accountability framework).

First, we discuss the effect of waves of recent regulatory reforms and consider whether these have passed a 'tipping point' beyond which they damage growth. Our second debate revolves around the sustainability and shape of UK banks' retail and investment banking business models, which are unlikely to be the same again. Then we deliberate whether it is possible to run a truly international bank any more, given the increasing localisation of banking markets, with countries imposing their own rules. Finally, we question whether banking is focused largely on 'fighting the last war' or if there are other potential threats that could cause the next big systemic shock.

In short, banking is going through a major rehabilitation. Nonetheless, the world economy is showing signs of a modest, fragile recovery. As we discuss in this report, it is critical that banking – the lifeblood of the economy – continues its journey to recovery.

> "While it's great that the most recent results are in the black, and certain things are improving, the real issue is actually the shape of these business models going forward."

At a glance

	Barclays		RBS		Lloyds		HSBC[2]		SCB[2]	
	2013	2012[3]	2013	2012[3]	2013	2012[3]	2013	2012	2013	2012[3]
Ranking										
By profits before tax	**4**	3	**5**	5	**3**	4	**1**	1	**2**	2
By total assets	**2**	2	**3**	3	**4**	4	**1**	1	**5**	5
By net assets	**3**	3	**2**	2	**4**	4	**1**	1	**5**	5
Statutory profit / (loss) before tax (£ million)[1]	**1,677**	871	**1,374**	(1,682)	**2,134**	(456)	**9,112**	8,077	**2,153**	2,496
Net interest margin (basis points)	**177**	186	**197**	190	**201**	193	**217**	237	**220**	230
Cost to income ratio[4]	**64.9%**	61.3%	**63.9%**	63.6%	**50.2%**	54.6%	**53.5%**	57.5%	**51.4%**	52.1%
Impairment charge (statutory) (£ million)	**1,631**	1,710	**2,150**	2,649	**1,683**	2,728	**2,018**	3,043	**473**	365
Return on equity[5]	**2.6%**	0.6%	**7.4%**	9.4%	**–**	–	**12.0%**	10.5%	**13.3%**	13.8%
Impaired loans to loans and advances to customers[6]	**3.1%**[7]	4.2%[7]	**9.6%**	9.1%	**7.7%**[8]	8.6%[8]	**3.9%**	3.8%	**2.0%**	2.0%
Impairment cover	**53.8%**[7]	51.5%[7]	**51.6%**	51.7%	**49.9**[8]	47.0%[8]	**40.9%**	41.7%	**54.9%**	56.1%
Total assets (£ billion)	**1,533**	1,488	**1,216**	1,312	**877**	934	**1,739**	1,665	**427**	390
Net assets (£ billion)	**60.1**	60.0	**69.7**	70.4	**43.7**	42.6	**119.8**	113.3	**29.8**	28.5
Core Tier 1 ratio[9]	**11.1%**	10.8%	**11.1%**	10.3%	**13.7%**	12.0%	**12.7%**	12.3%	**11.4%**	11.7%
Risk weighted assets (billion)	**387.2**	387.4	**436.0**	460.0	**289.0**	310.0	**1,105.0**	1,124.0	**212.9**	186.8

1. All numbers and ratios that relate to the income statement are for the six months ending on 30 June of the year and the balance sheet numbers and ratios are as at 30 June 2013 and 31 December 2012 respectively.
2. HSBC's and SCB's numbers are reported in US dollars, converted to sterling so as to present the data in the same currency. The exchange rates used were obtained from www.oanda.com, using period-end rates, for balance sheet items and average rates for income statement items.
3. Restated figures.
4. The cost to income ratio for Lloyds is calculated on an underlying basis while all other cost to income ratios are as reported by the banks. Items considered as the costs in arriving at cost to income ratio are not consistent for all banks. Payment Protection Insurance (PPI), Interest Rate Hedging Products (IRHP), fines and penalties, integration and restructuring costs, and the bank levy are part of the costs for HSBC, whereas for RBS and Lloyds these costs are not included. SCB includes all the aforementioned items except fines and penalties. Barclays includes fines and penalties, integration and restructuring costs, and Bank Levy.
5. Lloyds did not report return on equity. RBS' return on equity is for 'Core' only.
6. Impairment cover and impaired loans to loans and advances to customers exclude reverse repos for Barclays and RBS. For Lloyds, HSBC and SCB reverse repos are included.
7. The calculation of impaired loans to loans and advances to customers, and impairment cover uses 'credit risk loans' published by Barclays in its interim results.
8. Lloyds' impairment cover, and impaired loans to loans and advances to customers are calculated based on an underlying basis.
9. Reported Core Tier 1 capital under the regulatory requirements effective for the relevant period.

Section 1

Financial performance

Analysis of core profits

The banks' statutory results include a number of notable or unusual items that have had a significant impact on the reported profits but do not necessarily form part of the core results. In addition, each bank makes adjustments to arrive at its own underlying profit measure; and it can be challenging to achieve a consistent measure in making comparisons.

The table below shows adjustments of the statutory profit and loss for these items to derive a theoretical 'core' profit measure.

	Barclays[1]			RBS			Lloyds			HSBC[3]			SCB[3]		
	H1	H2[2]	H1[2]	H1	H2[2]	H1[2]	H1	H2[2]	H1[2]	H1	H2	H1	H1	H2[2]	H1[2]
£ million	2013	2012	2012	2013	2012	2012	2013	2012	2012	2013	2012	2012	2013	2012	2012
Statutory profit / (loss) before tax on continuing operations	1,677	(74)	871	1,374	(3,483)	(1,682)	2,134	(150)	(456)	9,112	4,968	8,077	2,153	1,830	2,496
(Profits) / losses on sale / acquisition of businesses					39	(152)	(167)			(709)	(2,171)	(2,728)		9	
(Gain) on disposal on investment in BlackRock, Inc. / Ping An			(227)							(358)					
Redress, regulatory and litigation costs[4]	2,000	1,700	1,040	620	1,931	260	575	3,150	1,075	267	1,390	1,297	–	419	–
Other one-off items															
Impairment of associates														38	6
Integration and restructuring costs	640			271	796	619	786	733	513	154	197	357			
(Gain) from gilt and bond sales				(61)	(512)	(368)	(780)	(2,549)	(658)						
(Gain) / loss on revaluation on own debt	(86)	1,634	2,945	(376)	1,675	2,974	166	(117)	387	12	1,912	1,376	(153)		
(Gain) / loss on debt buy back and extinguishments				(191)	123	(577)	97	397	(168)						
Government Asset Protection Scheme fee					(1)	45									
Volatility in insurance businesses							(485)	(333)	21						
Pension scheme adjustments							104		(250)	(278)					
Goodwill impairment and amortisation of intangible assets purchased upon acquisition				79	203	99	200	240	242				648		
Loss on reclassification to held for sale										181					
UK Bank Levy		345			175			179			275	22		109	
'Core' profit before tax and exceptional items[5]	**4,231**	**3,605**	**4,629**	**1,716**	**946**	**1,218**	**2,630**	**1,550**	**706**	**8,381**	**6,571**	**8,401**	**2,648**	**2,405**	**2,502**

1. Barclays does not disclose amounts relating to volatility in insurance business (only disclosed by Lloyds) and pension scheme adjustments.
2. Restated figures.
3. HSBC's and SCB's numbers are reported in US dollars, converted to sterling so as to present the data in the same currency. The exchange rates used were obtained from www.oanda.com, using period-end rates, for balance sheet items and average rates for income statement items.
4. Includes PPI, IRHP, other redress costs and fines and penalties from regulators.
5. The 'core' profit measure is a theoretical profit measure that is calculated by adjusting statutory results for a number of exceptional or unusual items and does not refer to core/non-core business that some banks report on.

> Core profits across all banks are stronger but past mistakes continue to be a significant drag, with about 20 percent of statutory profits eaten up again by customer remediation and there is no immediate end in sight.
>
> **Suvro Dutta**
> Director, KPMG

Income statement[1]

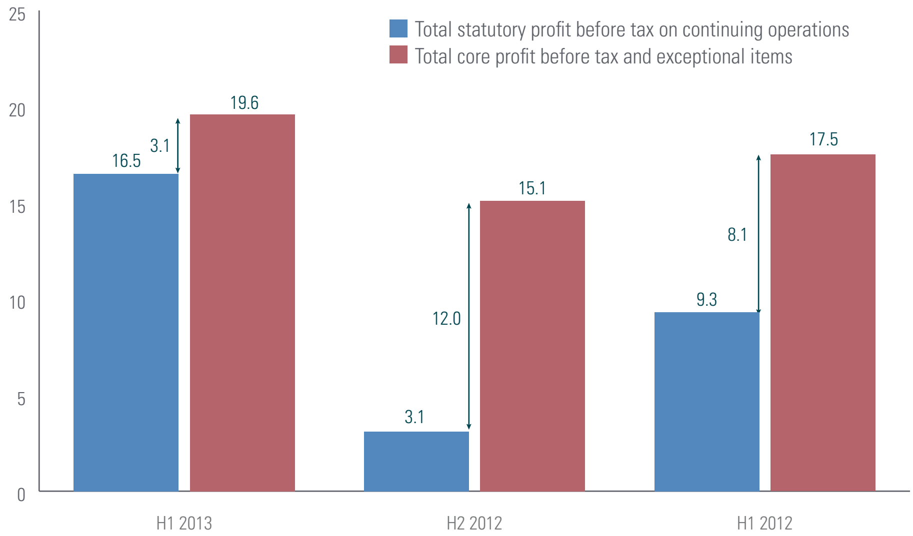
UK banks are back in the black. This is the first half year in which all five UK headquartered banks covered in this report have shown a profit since the first half year of 2010. Lloyds and RBS returned to statutory profit in H1 2013.

RBS, Lloyds and SCB also delivered a core profit[2] that improved period on period. The cumulative core profit of the five banks was up overall by 12 percent compared to H1 2012 and up 30 percent compared to the second half of 2012. More encouragingly, the gap between statutory profits and core profits has narrowed, and the number of one-off items decreased, signalling that the post-crisis restructuring efforts are starting to pay dividends (see graph below). The key one-off item remains the cost of customer remediation. However, significant fair value losses on revaluation of own debt in H1 2012 were not repeated in the first half of 2013.

There seems to be no end in sight to customer remediation charges. Increases in these costs continue to be a feature of the UK banks' results as their previous estimates had to be adjusted upwards. Cumulatively, the five banks provided an additional £2.3 billion for payment protection insurance (PPI) and £700 million for interest rate hedging products (IRHP) in the first half year of 2013. These costs equate to approximately 20 percent of total statutory profits. As the banks acknowledge, risks and uncertainties still remain in relation to the total expected complaint volumes and the average cost per complaint.

- Total exceptional items and one-off adjustments decreased by 61 percent compared to H1 2012 and 74 percent compared to H2 2012

The gap between statutory and core profit is narrowing (GBP billions)



Source: KPMG LLP (UK) 2013

1. All narrative refers to changes compared to the first half of 2012 unless stated.
2. The 'core' profit measure is a theoretical profit measure that is calculated by adjusting statutory results for a number of exceptional or unusual items and does not refer to core/non core business that some banks report on.

Cutting costs remains in focus. The cost to income ratios (see footnote 4 on page 2) of the five banks vary widely, ranging between 50 percent to 65 percent. This reflects the diversity, complexity and the geographical dispersion of their respective operations. While all banks have continued to focus on disciplined cost management, ratios are not declining at the same pace. We discuss this further on page 17. This is due in part to the incremental cost of compliance with new regulatory standards and the complexity of rationalising banks' businesses. Also, the range of cost to income ratios reflects the fact that banks are at different stages in their cost rationalisation exercises. Most have initiated large strategic programmes that are focused on targeted disposals or closures and the re-engineering of systems and processes. Using these programmes, the banks are cumulatively targeting additional sustainable annual cost reductions of more than £5.7 billion[3] in the next two to three years.

The trend in net interest margin (NIM) since 2007 is down. The overall average NIM across all the UK banks has steadily declined from 238 bps in H1 2007 to 202 bps in H1 2013[4], putting pressure on banks' profitability and existing business models. The downward NIM trend is primarily a feature of the prolonged low interest rate environment and balance sheet de-risking.

Recent movements in NIM reflect the fact that influencing factors for each individual bank – for example changes in banks' operational activity, including disposals and funding mix – are different. In H1 2013, Lloyds and RBS report an increase, while Barclays, HSBC and SCB show a decline.

RBS UK retail, Lloyds retail and both banks' commercial business reported an increase in NIM, partly driven by improvement in savings and deposit margins. Barclays' decrease in NIM primarily reflects reduced contributions from its hedges that convert short-term interest margin volatility into a more stable medium-term rate. Decreases in NIM at HSBC and SCB were partly due to lower yields on surplus liquidity.

3. This is not a comprehensive number across the five banks but is based on publicly disclosed targets by certain banks in their H1 results.
4. As reported in previous versions of KPMG's UK Banks: Performance Benchmarking Report.

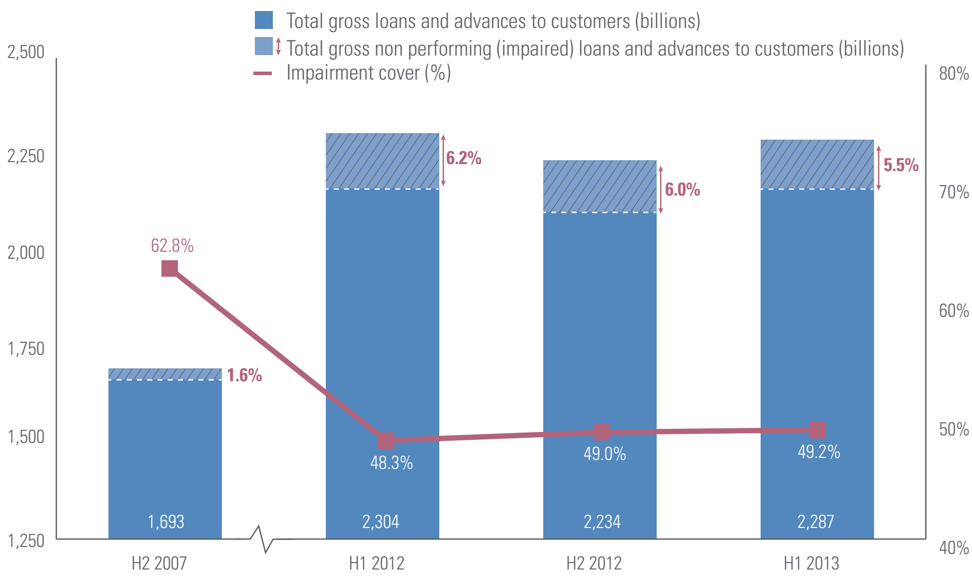
Impairment charges have fallen significantly. Overall impairment charges declined by 24 percent to £8.0 billion, driven in part by the disposal of non-core assets and the continued low interest rate environment. In some cases, charges were partially offset by increases from specific events such as large single-name provisions and higher impairment charges in certain geographies, for example Latin America for HSBC and in Korea for SCB.

While the impairment charge story is generally good, average impaired loans as a percentage of total loans remains high at 5.5 percent compared to the pre-crisis level of 1.6 percent in H1 2007. This reflects the continued weak macroeconomic conditions and uncertain outlook (see graph below).

Additionally, public debate over the adequacy of banks' provision models continues and there are ongoing developments in accounting standards. This will mean that in the future, banks will have to provide for loans on an expected loss basis, which will result in additional provisions. The PRA[5] estimates that the additional capital resources for expected future losses and the cost of conduct redress could amount to approximately £35 billion for the five banks.

Total impaired loans as a percentage of the loan portfolio remain high (GBP billions)

- Total impaired loans to total loans and advances remains at elevated levels compared to 2007
- The impairment cover[6] remains relatively stable compared to HY1 2012 and HY2 2012



Source: KPMG LLP (UK) 2013

5. Prudential Regulation Authority (PRA) news release, 20 June 2013.
6. Impairment cover is calculated as total provisions on loans and advances to customers over total gross loans and advances to customers.

Balance sheet

Capital positions are stronger, but regulators will want more. Core Tier 1 ratios strengthened for the UK banks. Increasing profits replenished capital resources and risk weighted assets (RWAs) reduced as banks managed the composition of their total assets. Primarily due to these factors, Lloyds and RBS reported the largest increase in Core Tier 1 ratio (+170bps and +80bps respectively). The reduction in total RWAs was partially offset with changes in the PRA's treatment of the loss given default floor for sovereign exposures and commercial real estate exposures. SCB reported a small decline in Core Tier 1 ratios of 30 bps due partly to the timing of dividend payments and growth in RWA. The half year reports also make note of new leverage ratio requirements and the banks' readiness for Basel 3 / CRD 4. The need for more capital continues: this is discussed further in Section 2.

Total assets remain stable. At £5.8 trillion, the total assets of UK banks are unchanged from the year-end, although down £1.1 trillion from 2008. The deleverage since 2008 is largely driven by derivatives, but net lending is marginally higher. In June 2013 the PRA published the results of its capital shortfall exercise with major UK banks, disclosing a range of CET1 leverage ratios from 2.9 percent (Barclays) to 4.6 percent (HSBC) at 31 December 2012 against the PRA target of three percent. As we discuss further in Section 2, the PRA leverage target has placed increasing scrutiny on the underlying composition of a bank's balance sheet and total assets. During the first half, Lloyds and RBS have reduced total assets as their deleveraging continues with the running off or selling of non-core assets. Other banks saw total assets increase due to higher market demand for collateralised lending. Derivative assets declined across all banks through a combination of volume reduction and a reduction in fair values due to fluctuations in interest rates.

Lending growth is modest. Overall lending to customers is on the rise but at 3 percent, the growth is modest and it is an uneven picture. UK mortgage lending for the five banks showed some increase, with 0.8 percent, or £4.8 billion, overall. There was net growth in UK mortgage lending at Barclays of £7 billion and at HSBC of £0.8 billion, on a constant currency basis. This offset the declines at Lloyds of £2.2 billion and RBS of £0.8 billion. While Barclays reported the highest growth, with lending up 11 percent to £470 billion, it was due mainly to an increase in settlement balances in the investment bank and the acquisition of ING Direct. For Lloyds and RBS, the reduction was driven by the run-off and disposal of non-core assets.

Funding profiles improved. The total loan to deposit ratio improved for the UK banks over the period, with HSBC and SCB continuing to maintain the strongest ratios, with 74 percent and 77 percent respectively. Strong growth in customer deposits of 6 percent, or £135 billion, across the UK banks was reported during H1 2013 as customers continue to rebuild their personal balance sheets and corporate customers continue to retain cash as their investment outlook remains cautious. As at 30 June 2013, the growth in customer deposits enabled the banks to somewhat reduce their wholesale funding dependence.

Section 2

The future of UK banking

David Sayer, Global Head of Banking

> A year ago people were looking at the future with a kind of weary resignation, that there is lots of regulation, lots of challenges and economic headwinds. Now I think people are saying, "This is our opportunity. This is the chance for our generation to re-invent banking."

Where will it be in three to five years?

Last year's sparkling summer – marked by Olympic glory, the Diamond Jubilee and Ryder Cup drama – was always going to be a hard act to follow. Thankfully, 2013 has not disappointed: Andy Murray's historic Wimbledon triumph, Chris Froome's Tour de France victory, England retaining the Ashes and, at last, the first prolonged heatwave since 2006. And while they may not attract the same headlines, UK banking fortunes seem to be finally on the rise. Asset prices are generally up, helped by the ECB's pledge to do 'whatever it takes' to keep the Eurozone intact.

First half results from the large UK banks have been robust and there are many encouraging signals within these numbers:

- All five major UK banks are back in the black for the first time since H1 2010
- Underlying core profits are up significantly as well, with fewer one-offs
- Impairment charges are trending down
- Aggressive deleverage continues, especially for non-core and legacy assets
- There is a modest rise in new lending volumes, particularly for mortgages

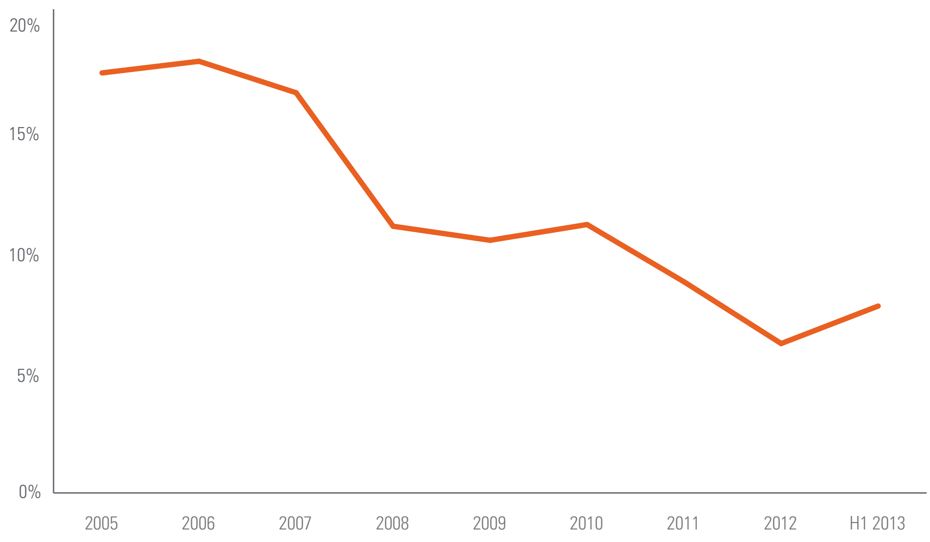
However when we look forward, several underlying issues emerge that question whether these numbers are sustainable:

- While capital positions are stronger, regulators are pressing for further increases
- Customer remediation costs continue to create a drag on the results
- Margins continue to remain compressed in several business areas
- Recent economic data is positive, but the outlook remains uncertain
- The speed of cost rationalisation remains a challenge

The return on equity (ROE) conundrum

What we see is an industry in the midst of a major transformation – buffeted by waves of regulatory reforms, significant leadership changes, rapidly changing business models, continuing deleverage, and a continuing battle to rein in costs. Once synonymous with impressive ROE of 17 to 21 percent in the pre-crisis years, banking faces a future with returns potentially half or even less than half of those levels.

ROE (%)



Source: KPMG LLP (UK) 2013

Given this uncertain and volatile background, we debate what UK banking might look like in three to five years and consider some of the key trends:

1. **New bank leadership faces a daunting task**
2. **Regulation could be at a 'tipping point' where it impacts growth**
3. **Banks' business models will probably never be the same again**
4. **Speed and ambition of cost rationalisation needs to be realistic**
5. **The next systemic shock may be from an unexpected source**

1 New bank leadership faces a daunting task

Myriad regulatory changes and a fragile global macroeconomic environment mean an uncertain future for banks. However, another major shift is reshaping UK banking: a new group of leaders at the helm, setting new courses.

Across the five major UK banks between 2006 and 2012, more than 75 percent of non-executive directors are new, along with 72 percent of executive management (including 80 percent of CEOs and CFOs).

These new leaders face multiple challenges. They need to restore trust and credibility by re-establishing the bond with customers, effect a transformation within their institution, and make big, bold decisions about their business models. This will need new thinking, direction and innovation. Combined with the new twin peak regulatory regime, a new central banker and several new members of the Financial Policy Committee, means that UK banking is already a very different landscape.

A tougher 'individual accountability' regime raises the stakes further. In response to a recommendation by the Parliamentary Commission on Banking Standards to make reckless misconduct by senior bank staff a criminal offence, the government plans to introduce a tough new Senior Persons Regime governing the behaviour of senior bank staff to stengthen individual accountability. The enhanced expectations and increased personal responsibilities of executives and non-executives demand that governance, prudence and risk are at the forefront of the agenda.

Executing the agenda is key

As welcome as the overhaul of the governance regime is, reforms are not without peril.

In the face of all the external pressure, there is a risk that boards and senior management may become short-termist and risk-averse, focused on their institution's (and indeed their own) immediate safety and survival, rather than thinking long term and having the headroom and risk appetite to look for a sustainable route back to growth.

The new leaders have a daunting task ahead as they reshape their banks. They are demonstrating that they have learnt from the crisis and are trying to resolve the long list of legacy issues. The regulators need to help them execute this challenging agenda.

2 Regulation could be at a 'tipping point' where it impacts growth

Banking is the lifeblood of the economy. A strong economic revival requires a strong banking sector.

"Overall, the global economy is getting back on track, but recovery cannot be taken for granted. Meeting even the IMF's relatively modest expectations will depend on policymakers doing the right thing." – Andrew Smith, KPMG's chief economist.

Effective regulation is in everybody's interest, and the financial crisis rightly prompted an overhaul. A robust and proportionate regulatory regime makes the system safer for taxpayers, which is essential given the implicit guarantee they extend to banks.

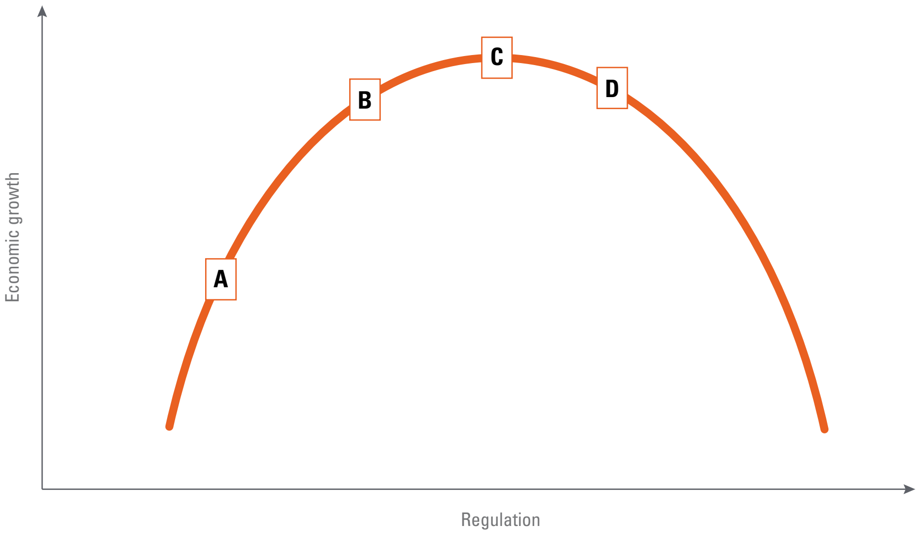
Additional regulation is however, not a 'free good.' Regulatory initiatives impose costs on financial institutions, may deter innovation, and affect the price and availability of credit, trade finance and risk management services to customers. Ultimately, this could reduce economic growth.

The first wave of regulatory reforms is already upon us. It brings the Basel 3 package of tougher capital and liquidity requirements; a tougher approach still for systemically important banks; moves to standardise and centrally clear derivatives; and the alignment of remuneration with longer-term and risk-adjusted returns. But just behind this, a second wave of reforms is building. Still in development, this long list of upcoming requirements includes: resolution regimes and the bailing-in of a wide range of liabilities; structural separation in various guises (Volcker, Vickers and Liikanen); regulation of shadow banking; risk governance; the EU Banking Union; and a potential major upheaval to the use of internal models by banks to calculate RWAs.

These waves of regulatory reform appear to be pushing some countries – and the global financial system – beyond the 'tipping point' at which the negative impact of regulation on economic growth in normal times begins to exceed its benefits[7].

Regulation versus economic growth

- Before the financial crisis we were at point **A**. Too little regulation contributed to the costs of financial crises on economic growth
- As a result of Basel 3 capital and liquidity reforms, the industry moved to point **B**: official estimates indicated scope for further reform before reaching the optimal point, **C**
- Now, evidence suggests that we have moved beyond point **C** to point **D**; excessive regulation impacts the wider economy and the net impact has become negative



Source: Moving on: The scope for better regulation, KPMG International, May 2013

7. KPMG International, Moving on: The scope for better regulation, May 2013.

The impact of this regulatory onslaught is already being seen most clearly in Europe, with a downward spiral of negative economic growth, weak bank lending, active deleveraging, severe strains on government finances and the emerging linkages between sovereign debt and bank recapitalisations. The IMF estimates that major European banks will reduce their assets by up to US$4 trillion between the middle of 2011 and the end of 2013[8]. Given the current economic outlook (see box below), calibration of the international regulatory response is critical to ensure that the banks can move forward.

Economic outlook

Looking ahead, the IMF forecasts paint a picture of a slow but steady recovery, albeit at slower growth rates than before the crisis. Certainly there are signs that the worst of the slump in the advanced economies is behind us. But the path ahead is unlikely to be smooth.

Demographics still favour emerging markets, but they have a number of imbalances to address. China is suffering from too much investment and too little consumption, while Brazil and Russia have the opposite problem – over-consumption and not enough investment during the commodity boom to underpin the economy in the current downswing.

Of the major advanced economies, the US has experienced the strongest recovery, thanks in part to expansionary policies. Growth looks increasingly sustainable as unemployment declines and balance sheets improve. But it could yet be knocked off course by political gridlock.

The major structural problems besetting Europe appear the most intractable: loss of competitiveness in the periphery and its consequent lack of growth; high sovereign and private debt levels; a fragile banking system and associated disparities in credit availability and pricing.

For its part, the UK's recovery has been exceptionally slow, although the economy has finally strengthened this year, with some of the sharp downside risks subsiding. And provided potential output has not been damaged irrevocably during the slump, some catch-up growth in the medium to longer term seems feasible.

8. Global Financial Stability Report, International Monetary Fund, October 2012.

> There is a danger in the UK that we are front running some of the regulatory requirements, which raises the question: are UK banks disadvantaged, compared to international peers.
>
> **Giles Williams**
> Partner KPMG

Faster, tougher, higher-impact

Regulatory reform has been exacerbated by the speed at which changes are being implemented. Basel 3 envisaged a carefully stepped roll out through to 2019. Instead, official stress tests, accelerated regulatory implementation and investor and market analyst focus have served to turn the higher proposed minimum capital and liquidity requirements into binding constraints much earlier.

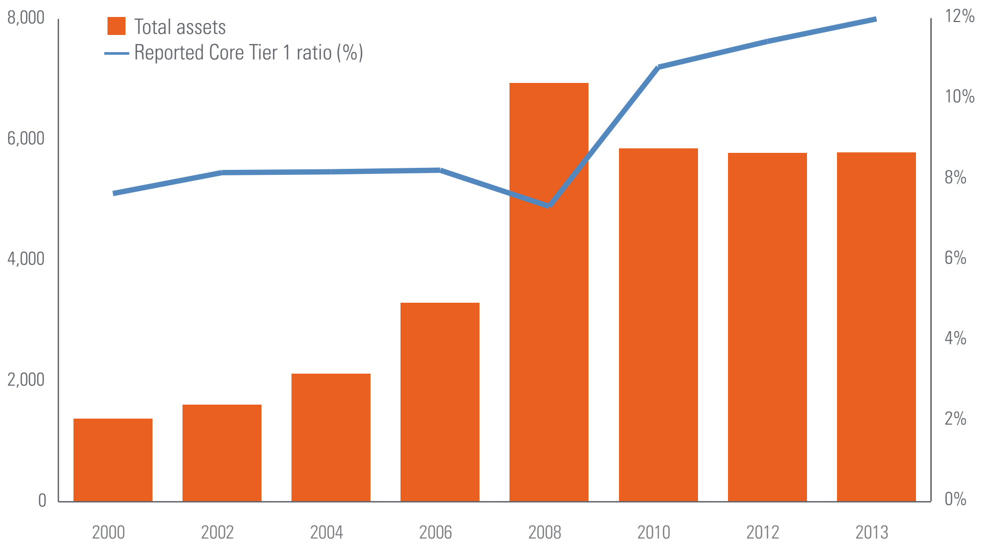
In the UK, these pressures for tougher and more rapid implementation have been highlighted by the PRA's recent actions. First, it judged the capital adequacy of major UK banks against a tough stress scenario, an immediate full implementation of the Basel 3 minimum capital and leverage ratio (and against a super-equivalent leverage ratio based on only the highest quality capital). Second, it announced an accelerated implementation of the EU's 'CRD 4 package' and took a generally tough approach to the use of any national discretions allowed under that package. The long-term impact of these changes remains to be seen, although Barclays has already announced that along with a rights issue and other steps, it will need to implement a 'prudent reduction in leverage exposure'[9].

As a result, banks are enhancing their capital ratios far ahead of the regulatory timetable. All five banks have reported progress against Basel 3 rules to date.

"It's a race to 10 percent and beyond," Deutsche Bank co-chief executive Anshu Jain told the Economist[10]. "By 2014, we will all be Basel 3 compliant."

Deleveraging continues along with increased capital accumulation (£ billions)

- The rapid five-fold expansion in banks balance sheets seen from 2000-2008 has been reversed through active deleverage
- Reported Core Tier 1 ratios, after lagging asset growth for eight years have continued to increase, although at a slower rate



Source: KPMG LLP (UK) 2013

While banks have boosted capital by raising fresh equity and through retained earnings, much of the improvement in capital ratios has been achieved by rebalancing asset bases, including through the sale of non-core businesses and the divestment of capital and funding-intensive assets. At the same time, banks are under increasing pressure to lend more to specific sectors, especially to the mortgage market and small businesses.

9. Barclays leverage plan, 30 July 2013
10. The Economist, 11 May 2013

No more truly international UK banks

Further complications are in store for the UK's international banks. They face higher costs, not only from meeting tougher international standards at group level, but also from the increasing localisation of banking markets as different jurisdictions impose their own capital, liquidity, governance and structural requirements in the scramble for greater control over what happens on their home turf. We are in a period of globalisation: currently global trade is growing faster than domestic GDPs and we need international banks to facilitate this. However, regulatory fragmentation looks more and more likely to constrain international banks' ability to provide financial services efficiently to their international corporate customers. Indeed, it begs the question: is it possible to run a truly international bank anymore?

These pressures are being seen across the globe. In the US, major foreign banks will be required to establish an intermediate holding company in the US and to meet US capital and liquidity standards. In the UK, we have already seen regulatory pressure on many non-EEA foreign banks to operate as subsidiaries rather than branches, and to meet tough local liquidity requirements. And in the Asia Pacific region, several regulators require, or are moving towards requiring, foreign banks to operate as subsidiaries. They also want local operations to be funded increasingly on a stand-alone basis, and are tightening up on outsourcing.

Lack of cross-border consensus between global regulators is also holding back their ability to develop resolution strategies that can be made workable for systemically important international banks.

Better behaviour

A continuing problem for banks is that their history of misbehaviours and conduct failings are making their task of regaining confidence and trust a daunting one.

Political and public policy pressures – as exemplified by the report of the Parliamentary Commission on Banking Standards – are pushing banks to drive major changes in their organisation's standards and culture. This relates both to reining in the excessive risk-taking sometimes seen in the run-up to the financial crisis, and to the treatment of customers.

The Financial Conduct Authority has followed the Financial Services Authority in placing increasing emphasis on whether banks are putting their customers' interests and suitability at the top of their agenda.

Collective action is also required by the government and the wider finance industry to make wholesale improvements to drive greater national financial literacy.

Banks are expending significant effort in all these areas. But they need to be seen to meet regulators' growing expectations by bringing in real changes that are driven through the entire organisation. Restoring trust and credibility is key. While banks have made progress, more needs to be done.

3 Banks' business models will probably never be the same again

While local and global regulatory initiatives are an evident game-changer, the combination of macroeconomic conditions, competition, margin pressures, investor demands and changing customer expectations are also radically altering the environment for banks. Not only will business models probably never be the same again, there are a number of challenges on the horizon:

- Single digit ROEs could be the expected new norm in investment banking
- UK banks are de-emphasising their investment banking operations
- The offshoring model, an important cost lever, is under regulatory scrutiny
- Retail banking profitability remains under pressure
- Using digital channels present an opportunity to restore customer engagement.

Declines in investment banking ROEs

Today, the potent combination of market and regulatory pressures – including increased capital for high risk businesses, a potential ban on proprietary trading, changes in funding models, OTC derivatives reform and margin compression, with the additional proposed requirement of ring-fencing – are taking their toll on investment banks.

As at the end of 2012, Boston Consulting Group (BCG) estimated that ROEs across the investment banking sector had fallen to between 10 and 13 percent, well below the 20 to 25 percent routinely achieved pre-crisis. As new regulations kick in, BCG estimates those levels will be depressed even further, to between 7 and 10 percent.

UK investment banking losing ground

On top of the ROE pressure felt by investment banking, UK banks appear to be de-emphasising their overall presence in this sector.

After a number of years of threatening to break into the Ivy League of investment banking, UK banks are losing ground in light of revised priorities and regulatory challenges in their home market. Faced with such challenges and impact of the leverage ratio, Barclays, the only UK bank currently inside the investment banking top 10[11], is likely to have to rebalance its investment banking operations.

RBS has publicly announced its aim to become a more UK-centric, commercial bank and others have announced or enacted plans to reduce certain investment banking activities.

11. FT, Investment Bank League Tables, First Half 2013

The preference appears to be for a smaller, more 'vanilla' sector, but if so it will not be able to compete with a resurgent Wall Street. Current trends indicate that large, universal model banks, particularly those in the US – bolstered by large home markets, a common language and a global standard currency – are set to dominate the global stage. Beneath this top tier, other institutions will need to develop niche roles or exploit complementary aspects of their business model to succeed.

It remains to be seen how UK banks will each reshape to achieve this.

The offshoring lever – "not in service"

Just when it is important that all available cost levers are at the disposal of banks to combat the ROE conundrum, one popular approach over recent years may need a rethink. Banks have all called upon offshoring to varying degrees as a way to control costs; now some regulators are challenging the offshoring and outsourcing model and how it fits into banks' recovery and resolution planning. Pressure in this direction may limit the frequency and the extent to which management can continue to pull this lever in future.

Redesigning retail banking

H1 results show that pricing pressures continue to impact retail banking. This is partly due to the low interest rate environment and margin compression. Further, more conservative product development from a heightened conduct risk agenda will also influence future profitability.

In future, retail banks will need to focus on the customer rather than on enterprise profitability. Product design, development and distribution, as well as staff training and incentive structures will need to be reconfigured to ensure banks deliver better outcomes for customers. One unintended consequence may be that customers have less choice due to lesser innovation from banks. But one thing is certain in a simplified product environment: gross customer revenues will decline. Therefore, banks need to rethink their target operating models to achieve reasonable rates of return in the face of lower expected revenues.

Changing customer engagement

Traditional bricks and mortar branch networks constitute approximately 75 percent of a retail bank's total distribution costs. As a result, the UK banks have reduced further spending on their branch networks, while investing heavily in self-service internet and mobile propositions. Digitalisation is not only a response to cost management but an investment for the future. Customers with a digital relationship typically have more products, more transactions and are more profitable, which deepens customer relationships. The leading banks are transforming their business by building highly efficient digital channels and more efficient back-office solutions. If banks get it right, digitalisation will achieve the twin benefits of growth as well as deeper, richer customer engagement.

4 Speed and ambition of cost rationalisation needs to be realistic

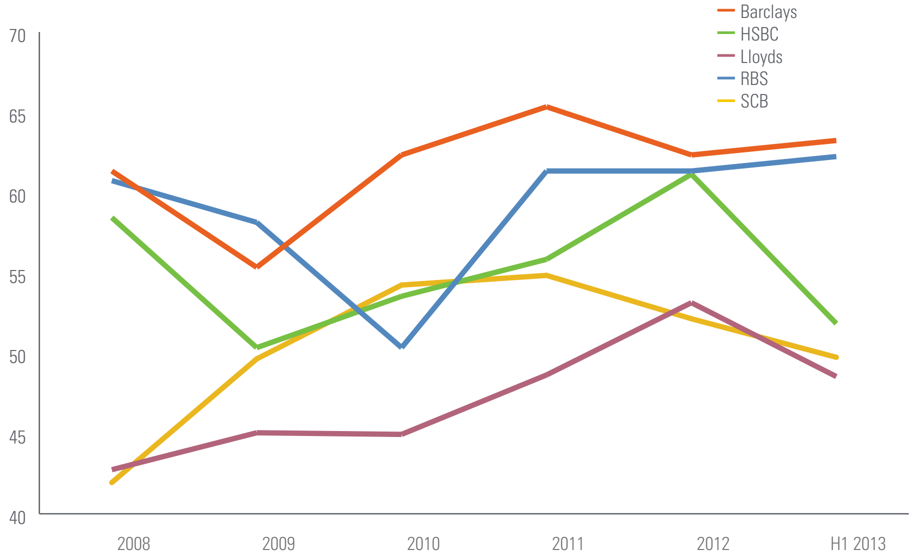
The ability of UK banks to get their business models back on course is also dependent on them being able to get a handle on costs, and fast.

Cost control is a critical item on all banks' agendas, and as seen in the first half results, a number of strategic programmes are underway. While banks may be at different stages of the journey, all are pulling the same traditional cost levers, with initiatives focusing on making complex processes leaner, increasing automation through straight-through processing, rationalising and centralising sourcing, and extending the use of self-service channels.

But how realistic are banks' cost cutting ambitions? Simon Samuels, an analyst at Barclays, points out that banks are targeting cost to income ratio improvements of 3.3 percent a year over the next three years, whereas in the 12 years preceding the crisis the average annual improvement was only 0.6 percent[12]. The graph below illustrates the movement of cost to income ratios across all banks and amplifies the scale of the challenge ahead.

Cost to income ratio (%)

- Cost to income ratio has fluctuated at all the banks
- No consistent reductiontrend is evident as yet although improved revenues have generally helped in the first half of 2013



Never-ending redress

The remediation, redress and litigation sagas continue. The five major UK banks' total bill for regulatory and litigation costs during 2011 and 2012 equalled £17.8 billion. Just as markets started to expect this bill to taper off, the first half of 2013 saw another £3.5 billion of charges hitting the bottom line. Barclays led the pack with a £2 billion hit, mainly from PPI. As a result the total remediation costs of the past two and a half years to the five UK banks equates to 45 percent of total profit before tax over the same period.

As banks continue with their multi-year redress programmes, it is also proving difficult to estimate a number for the next two to three years. However, if the last two years are any indication of the future, this issue certainly does not look like its being resolved soon.

12. The Economist, 11 May 2013

5 The next systemic shock may be from an unexpected source

The last few years since the crisis have seen a huge surge of initiatives and reforms to guard against the recurrence of factors leading to another banking crisis. However, we need to ask the question: are we still fighting the last war? Will the next systemic shock spring from a liquidity crunch or inherent capital weakness? Or is it more likely to come from an as yet unforeseen event or network of events such as a massive payment outage or a new breed of cyber attack?

What could the next systemic shock be?

Example: Cyber-security

A recent survey[13] of global business leaders, by the specialist insurance market Lloyds, found cyber risk has moved from 12th (malicious) and 19th (non-malicious) positions in its 2011 report to become the world's number three risk overall. Traditionally, banks have been leaders in IT security, at the cutting edge of innovation, but their ability to combat future security threats is increasingly debatable. After years of improvement, UK banks suffered a 12 percent increase in online account fraud last year. Furthermore, the motivation for cyber assaults is shifting, from financial crime to political and ideological attacks, with the number of state-sponsored hacking and 'hacktivist' revenge incidents growing.

13. Lloyds Risk Index 2013

Conclusion

So what does UK Banking look like in the next three to five years?

Richard McCarthy, UK Head of Capital Markets

It's a difficult one to call. The future of the UK banking industry, and indeed the health of the wider economy, are both at a critical point. The business models of banks, whether for investment or retail banking, face transformational challenges. The regulatory reform agenda is massive and in many cases, the impact uncertain. More worryingly, six years after the crisis, we are yet to see a co-ordinated approach to key reforms by international regulators. In fact, what we are seeing is the opposite. In many areas, there seems to be divergence rather than convergence.

The financial crisis was a collective failure by all stakeholders. Banks are continuing their journey to repair their balance sheets, strengthen their capital and liquidity positions, get leaner and fitter in respect of their cost base and restore and reinvent the basic currency of banking – trust and confidence. However, the recovery of the banking sector is now inextricably intertwined with government policy and regulatory actions. Regulators and politicians must show equal resolve and have a clear, articulate position on what they want the future banking model to look like. Banking is about appropriate risk taking. However, what is needed is a clear view of the level of risk that the various stakeholders are happy for the banks to run, in the context of the economic growth they want to achieve.

As banks deleverage aggressively, the recipients of these assets are increasingly hedge funds and private equity outfits. Are we then looking at a banking sector that gets narrower, with less customer choice and with more of its existing activities shifting to the unregulated sector? Any move in that direction must surely make the financial system less, rather than more safe. Could we also see the return of traditional utility banking in the next few years, but without the same returns?

The world economy is showing signs of recovery, but it is modest and vulnerable and we cannot afford another shock to the system. So effective, co-ordinated regulation alongside meaningful sustained reforms by banks is an absolutely essential combination. If we are not careful, the unintended consequences of the current reforms and policy actions may come back to haunt us.

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