KPMG
cutting through complexity

Reinvention of UK banking

UK banks: performance benchmarking report

Full year results 2013

kpmg.com/uk/bankingresults

Basis of preparation

This report summarises and makes reference to the 2013 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 are 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.

Reinvention of UK banking

UK banks: performance benchmarking report

Full year results 2013

Executive summary

Richard McCarthy
UK Head of Banking

As the UK banks announced their 2013 full year results, the good news was that a number of the positive themes seen in the first half continued, with all the major UK banks back in the black. Although RBS announced their largest loss since the financial crisis, it was in the black at the operating level before impairment losses.

In 2013, underlying core profits were increasing, loan impairments were trending down and there were modest green shoots in lending volumes. Over the last five years the banks have become safer, with an additional £93bn of capital, have deleveraged by £1.7tn, reduced their risk appetite and have improved funding profiles.

Why a fundamental reinvention is needed and is underway

There are still major issues around the banks' business models:

1 Average Return on Equity (RoE) continues to trade in single digits, lower than the banks' cost of capital. Margins remain compressed and cost cutting and headcount rationalisation continues.

2 The evolving regulatory landscape is driving much more capital and less leverage. As the philosophy of 'country-first' regulation takes hold, universal banks are facing the challenge to become less global; less multi-disciplinary. The drive for localisation – viability, sustainability and resolvability – will put further pressure on RoE, reduce customer's choice and make products more expensive.

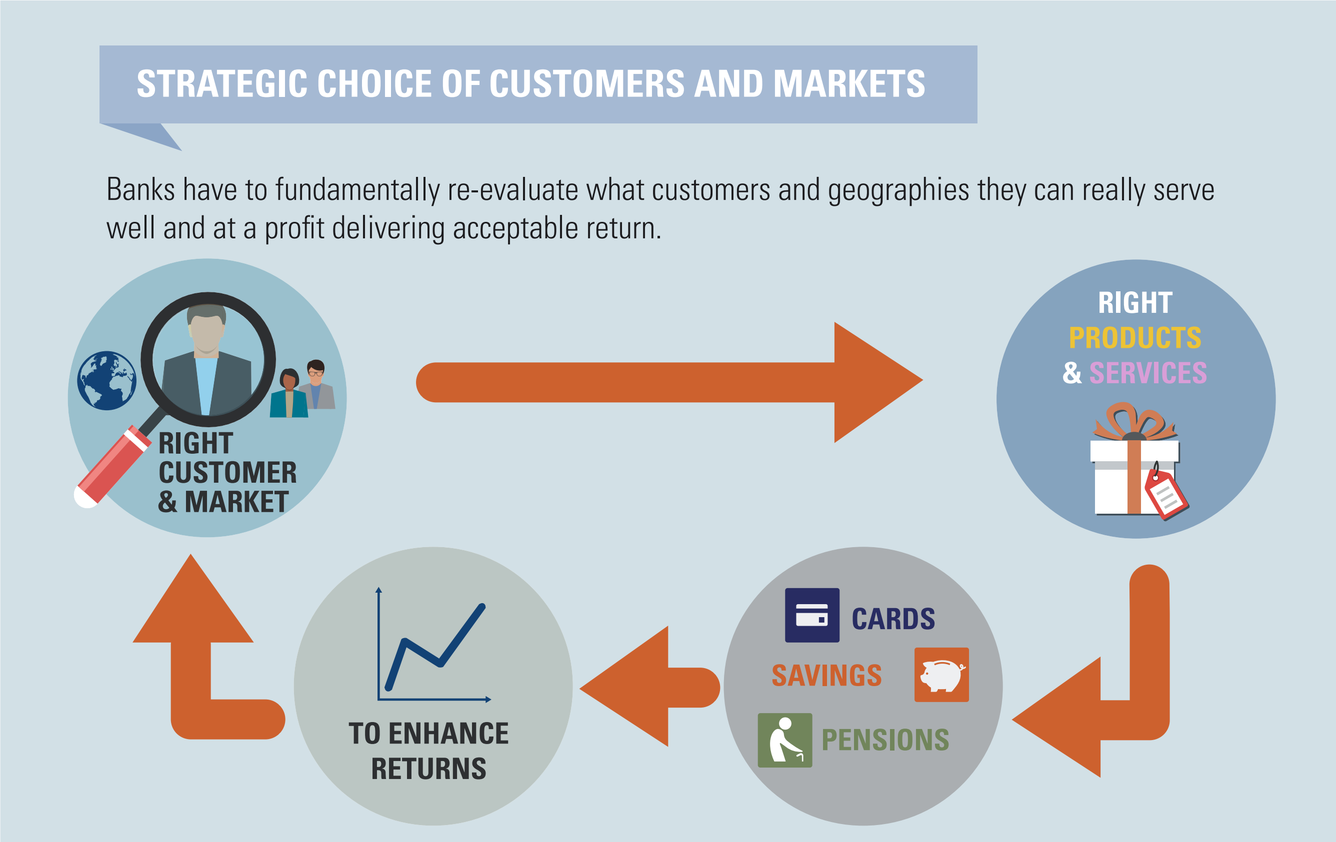
3 Conduct failings and remediation of past misselling issues are still dominating the banking agenda and costing a fortune. For 2013, it represents approximately 80% of the cumulative profits of the 5 banks. More crucially, customers still do not feel that they are getting the products, the level of service, or the understanding they require.

Banks have deleveraged
£1.7tn
in the last five years

The key things that need to be done to reinvent banks

We believe that providing the right returns to shareholders and the right products to the customers and meeting much more onerous regulations will require nothing less than a complete metamorphosis of business models. The absolute priorities are:

1. **Strategic choice of customers and markets:** Banks have to fundamentally re-evaluate what customers and geographies they can really serve well and at a profit which delivers acceptable returns. They must also revisit their product portfolio and pricing strategy to significantly boost their RoE to secure access to capital, a critical ongoing need for the sector.

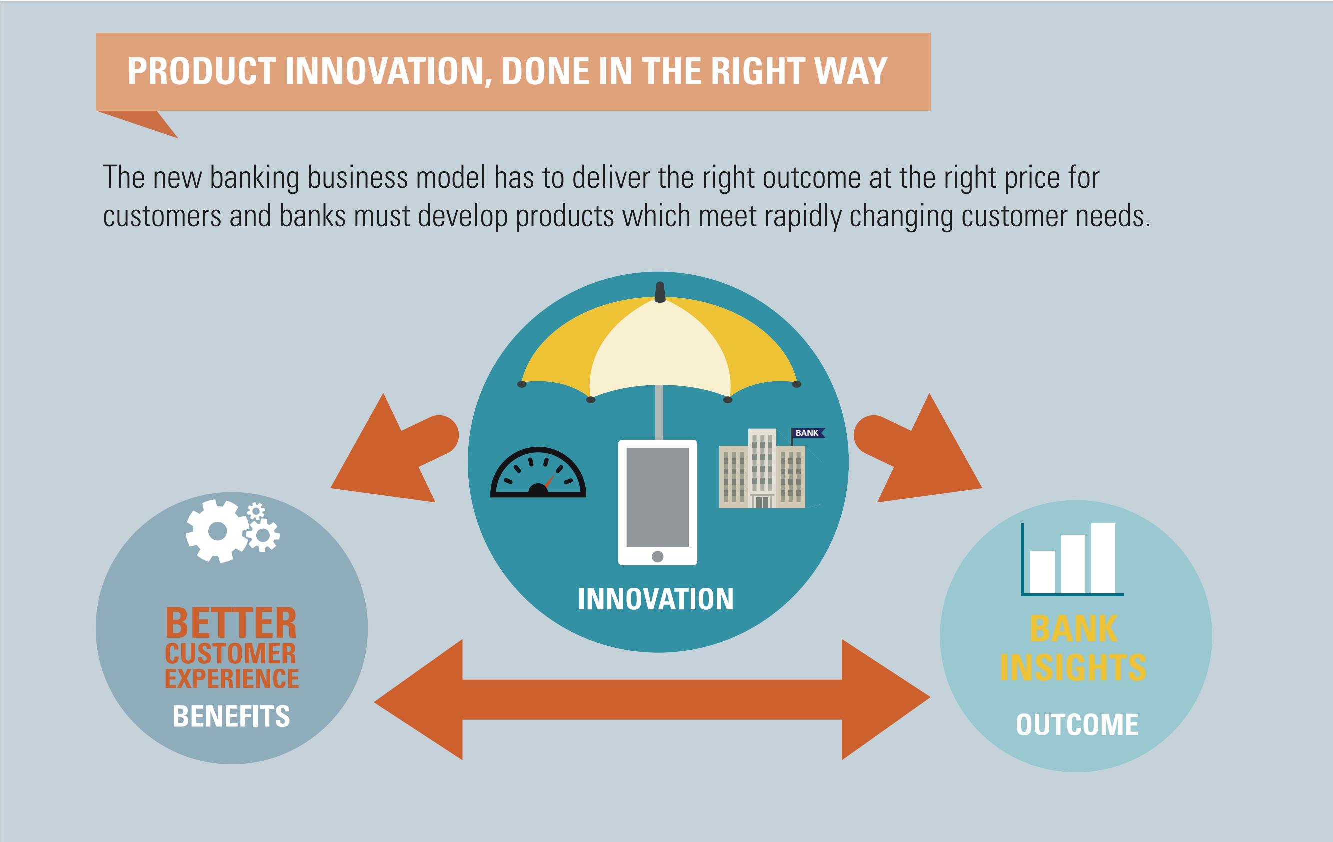


Source: KPMG LLP (UK) 2014

2. Product innovation, done in the right way:
The total bill for litigation, fines and customer redress since 2011 has reached £28.5bn or a staggering two-thirds of the cumulative profits of the five banks. This needs to change in terms of how products are offered and distributed and this will require significant innovation. The new business model has to deliver the right outcome at the right price for customers and banks must develop products which meet rapidly changing customer needs. The key to this is likely to be much better use of information about customers and their needs, and new ways of working with customers. Digital platforms, mobile banking, smart phones and tablets have undoubtedly revolutionised the way customers buy products.

In a recent survey, 64% of global banks said they have either gone live or are planning to roll-out mobile applications for corporate clients. On the client side, while 25% of US businesses and corporations had adopted mobile banking at the end of 2013, the number is expected to rise to 40% in the next two years.[1]

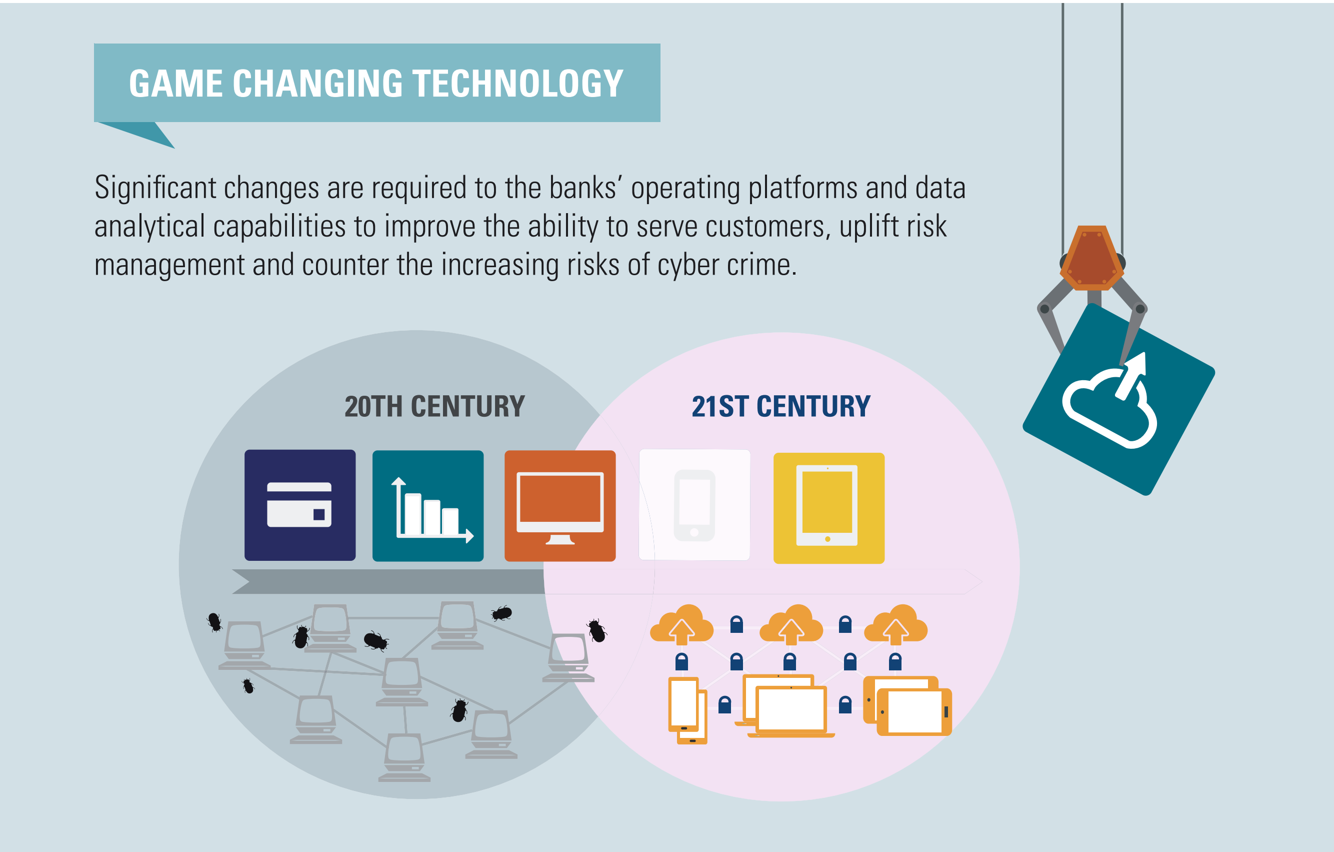
[1]AITE – The Future of Institutional Banking



Source: KPMG LLP (UK) 2014

3. **Game changing technology:** Technology is "mission critical" to the future health of the banks, and not just because of the customer. Significant changes are required in operating platforms and data analytical capabilities to improve the ability to serve customers, enhance risk management and counter the increasing risks of cyber crime.

New and improved systems will also help address the need to radically revisit the cost base to deliver customers the products they need, at a price they are willing and able to pay, at a return that meets shareholder demands. These will require a massive level of investment right now, but in the long-term, will provide the banks with more efficient, robust and user friendly platforms.



Source: KPMG LLP (UK) 2014

Two-thirds of cumulative profits of the five banks or

£28.5bn

has been spent on litigation, fines and customer redress since 2011

Reinvention will be especially challenging in the current environment

None of the above is easy, but there are some very specific challenges right now and all stakeholders will need to step forward in response!

1. **Confidence to make the investment**
   We face a period of lower returns which constrains efforts of the banks to invest in the future. The scale of technological investment required, without immediate pay off, will cause a further drag and pressure shareholder returns, especially in the short run, making capital raising even more challenging at a time the sector needs it the most. This situation is not helped by the massive costs of remediation for past mistakes – money that otherwise could have been used for rebuilding the bank.

2. **Customer products: Who's in charge – customers, boards or regulators?**
   The balancing act of driving product innovation for customers that fits within the regulator driven view of suitable products is difficult. This could mean banks will increasingly offer what the regulator allows, rather than what certain customers want or need, thereby reducing flexibility and choice. This could build up real challenges for the future, especially with changing demographics.

3. **Rebuilding trust and reputation**
   Most board members and executive management of UK banks are fairly new in role and are committed to the transformation required in their business models. This generation of management were not responsible for the creation of the problems but are both addressing the clean up and rebuilding the bank for the future. Investors, media, regulators, government, politicians and indeed the general public need to give new management time to do their job and rebuild the trust and reputation in the banks.

Watch our banking sector experts discuss the full year results and explain the three key things that need to be done to reinvent the banks.

kpmg.com/uk/bankingresults

At a glance

	Barclays		RBS		Lloyds		HSBC		Standard Chartered	
	2013	2012	**2013**	2012	**2013**	2012	**2013**	2012	**2013**	2012
Ranking										
By profit before tax	**3**	3	**5**	5	**4**	4	**1**	1	**2**	2
By total assets	**2**	2	**3**	3	**4**	4	**1**	1	**5**	5
By net assets	**2**	3	**3**	2	**4**	4	**1**	1	**5**	5
Statutory profit/(loss) before tax (£million)	**2,868**	797	**(8,243)**	(5,277)	**415**	(606)	**14,430**	13,030	**3,878**	4,323
Net interest margin (basis points)	**176[4]**	184[4]	**201**	192	**212**	193	**213**	232	**210**	220
Cost to income ratio	**79.0%**	84.0%	**68.0%**	63.0%	**52.9%**	55.1%	**49.2%**	52.0%	**54.3%**	57.1%
Loan Impairment charge (statutory) (£million)	**3,071**	3,340	**8,432**	5,279	**2,741**	5,149	**3,868**	5,149	**1,034**	755
Return on Equity (RoE)	**1.0%[3]**	(1.2%)[3]	**4.6%[5]**	8.9%[5]	**–**	–	**9.2%[3]**	8.4%[3]	**11.2%**	12.8%
Impaired loans to loans and advances to customers	**3.0%**	3.5%	**9.4%**	9.1%	**6.3%**	8.6%	**3.3%**	3.8%	**2.5%**	2.0%
Impairment cover	**54.6%**	51.9%	**64.0%**	51.7%	**48.7%**	47.0%	**41.6%**	41.7%	**49.5%**	51.3%
Redress, regulatory and litigation costs (£million)	**2,000**	2,750	**3,844**	2,191	**3,455**	4,225	**1,207**	2,655	**–**	421
Total assets (£million)	**1,312,267**	1,488,335	**1,027,878**	1,312,295	**847,030**	934,221	**1,619,834**	1,665,335	**408,931**	390,402
Net assets (£million)	63,949	59,986	59,215	70,448	39,336	42,581	115,491	113,265	28,403	28,485
Core Tier 1 ratio	**13.2%[1]**	10.8%	**10.9%**	10.3%	**14.0%**	12.0%	**13.6%**	12.3%	**11.8%**	11.7%
RWAs (£billions)	**355[2]**	387[2]	**385**	460	**264**	310	**663**	695	**195**	187

Source: KPMG LLP (UK) 2014

[1] Barclays Core tier 1 ratio is based only on the CRD III capital. [2] Barclays RWAs include only the CRD III RWAs and exclude the CRD IV Capital Management RWAs. [3] Return on Average Shareholder's Equity is used for Barclays and HSBC. [4] NIM is the total of RBB, Corporate and Wealth business, and excludes Barclaycard. [5] RBS Return on Equity is reported as positive as it is based on core operating profits. Lloyds did not report return on equity.

2013 results – key messages

Pamela McIntyre
UK Head of Banking Audit

At the end of the first half of 2013, UK banks showed encouraging signs of being on the road to recovery. All the major UK banks were in the black, underlying core profits were increasing, loan impairments were trending down and there were modest green shoots in lending volumes. As the UK banks announced their full year results, the good news is that a number of these positive themes continued, albeit for RBS announcing their largest loss since the financial crisis.

However, some of the dark clouds which loomed over the UK banks in the first half of the year remain and have become darker. Banks continue to need more capital, margins continue to compress, RoEs are still much lower than pre-crisis years and most importantly, costs, fines and penalties for customer redress and misconduct issues continue to dominate the agenda. The charge in the second half of 2013 for misselling and misconduct issues was £7.1bn, bringing the cumulative total to a staggering £28.5bn for the UK banks since 2011. In other words, it is equal to 64% of the total cumulative profits (2011-2013) for the five UK banks.

Total asset base and RWA declined by £575bn and £177bn respectively in 2013

At £5.2tn, the total assets of UK banks are down from £6.9tn in 2008, a drop of approximately 25% over five years. While the decline primarily relates to reduced derivative exposures, lending and trading strategies, including the mix of assets, have also undergone a paradigm shift with reduced risk appetite as indicated by the declining RWA position. In 2013, a mixed picture emerges – HSBC, SCB and Lloyds continue to experience modest growth in loans and advances to customers, notably in wholesale banking, while RBS saw run offs in its loan books driven by a reduction in its international banking business.

The charge in the second half of 2013 for misselling and misconduct issues was

£7.1bn

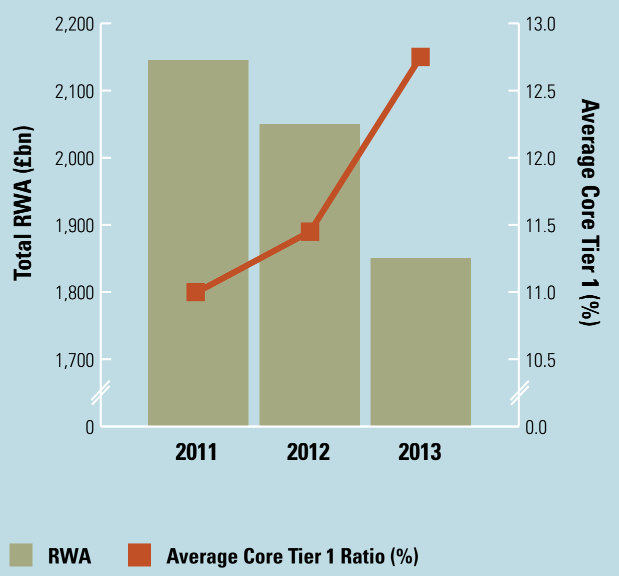
Core Tier 1 Capital increased by £93bn between 2008 and 2013

The increases to core tier 1 capital are in response to the evolving prudential regulations primarily Basel III. Banks have adopted a two pronged strategy to meet the challenging targets. Traditional capital raising and profit retention is being increasingly complemented by targeted reductions of RWA.

Modest growth in the customer deposit base at three percent or £72bn

The funding base continues to be healthy with the range of loan to customer deposit ratios improving from 74-124% (2012) to 74-115% (2013). Customers continued their preference for holding higher balances in readily accessible current and saving accounts.

Average Core Tier 1 Capital Ratio and Total Risk Weighted Assets (2011 – 2013)



Source: KPMG LLP (UK) 2014

Back in the black

The 2013 profit story was characterised by compressed Net Interest Margins (NIMs) offset by some customer remediation expense reductions and improving credit impairment trends. Barclays saw a 2.6% fold increase in profits year on year, HSBC's was up 9%, SCB's declined 11% and Lloyds turned its loss into a profit in 2013. RBS was the outlier after incurring a loss before tax of £8.2bn, an increase of £3.0bn compared to 2012 on account of redress costs and loan impairment charges of £12.3bn during 2013.

Continuing margin contraction from 251 basis points (bps) in 2007 to 202 bps in 2013

Gross yields have sharply declined due to competitive pressures and selective disposals of high yielding (riskier) loan books. The marginal reduction in cost of funds owing to the continued migration to low interest bearing current accounts partially offset the impact of gross yields.

Cost of conduct failings represent about 80% of the cumulative profits for 2013

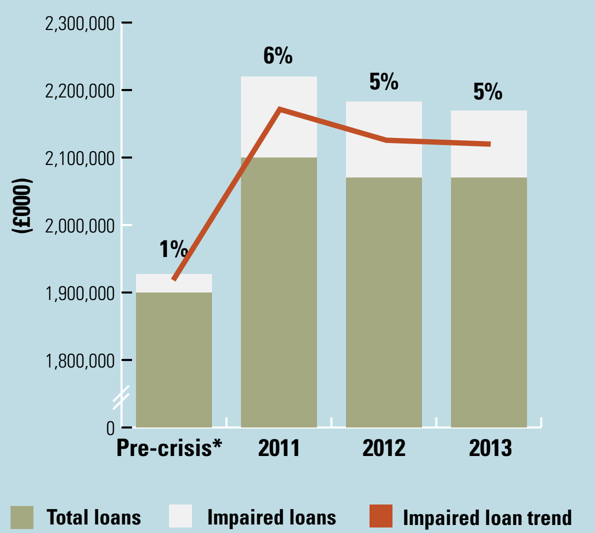
Cumulatively, the banks incurred charges amounting to £10.5bn in 2013 for Payment Protection Insurance (PPI), Interest Rate Hedging Products (IRHP), other redress costs and fines bringing the total cost of customer remediation conduct failings and fines to £28.5bn since 2011. During 2013, a fresh number of potential wholesale, and more global, conduct issues came to light such as the alleged foreign exchange manipulation, which is under investigation.

Overall credit impairment charges declined by nearly three percent to £19.1bn in the year

Gross non-performing loans have been on a declining trend at £101bn in 2013 compared to £114bn in 2012 and £128bn in 2011. HSBC, Lloyds and Barclays benefitted from the overall improvement in credit conditions. Conversely, RBS and SCB reported higher credit impairment charges in 2013 emanating primarily from increased losses in the bad bank at RBS and the maturing effect of the growth in unsecured lending and increased levels of provisioning in Korea for SCB.

While on the whole the credit story seems to be getting back on track there is a long way to go, as average impaired loans as a percentage of total loans remain high at 4.6% (5.6% in 2011) compared to a pre-crisis level of 1.6% in 2007. This reflects continuing macroeconomic uncertainty and weaker conditions than the pre-crisis years.

Non-performing loans



* Pre-crisis: 2007

Source: KPMG LLP (UK) 2014

Bank workforce shrinks by 15%

Cumulative restructuring costs over the last three years amounted to £6.3bn as banks continue to cut jobs. The total workforce in the five banks has dropped by 15% from 805k in 2008 to 688k in 2013. Consequently, the cost-income ratio which all banks are trying to keep down has instead gone up by 10 percentage points (53% in 2007; 63% in 2013), due to the impact of restructuring costs. Reduced dependency on people increases the importance of technology as an enabler, both for customers and for creating a more resilient operating environment.

Why a fundamental reinvention is needed and is underway

Suvro Dutta
UK Banking Partner

Six years after the crisis, all banks have significantly higher levels of capital, but continue to need more. At the same time, net profits, whilst in most cases improving, are still at much lower levels than the pre-crisis years.

The cumulative profit of the 5 UK banks in 2007 was £34.2bn as compared to £13.3bn in 2013, a drop of 61%. Consequently, RoE, is mostly trading in single digits, compared to very high teens in the pre crisis years. Regulatory demands and costs continue to add pressure, especially the complexity of the 'country first' regulations which is impeding global strategies.

Also, there does not appear to be an end in sight to the cost and scale of conduct-related issues facing the UK banks as the total bill for customer redress, fines and penalties stand at £28.5bn over the last 3 years - and there is more to come, with fresh issues on an increasingly global scale, like the alleged foreign exchange rates manipulation issue which is currently being investigated.

So, banks are neither delivering the right products in the right way to their customers nor delivering the right returns to their investors. This needs to change.

The banking sector needs a fundamental overhaul and we see a period of metamorphic change ahead.

We believe this overhaul should be premised on three key priorities.

Cumulative profits of the 5 UK banks dropped
61%
in the last six years

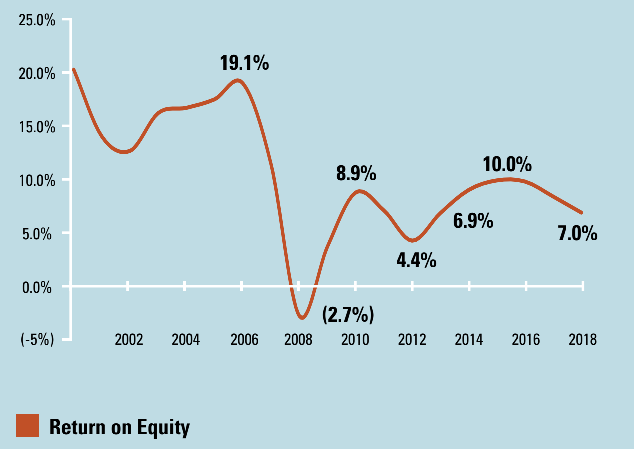
Global banks will struggle to deliver returns in excess of the average cost of equity of

12%

Strategic choice of customers and markets

The combination of much higher levels of capital requirement and lower levels of profits has meant that RoEs for UK banks have continuously fallen since 2007 from an average of 19% to current levels of 7%, similar to the trend observed for global banks. Local entity viability, sustainability and resolvability, leverage ratio targets and more stringent regulatory liquidity ratios are all driving down RoEs. Additionally, product profitability continues to be depressed, as the net interest margins for UK banks have steadily declined from 251 basis points in 2007 to 202 in 2013 and increased compliance and conduct related costs continue to add further pressure on margins. Consequently, our medium term expectation is that global banks will struggle to deliver returns in excess of the average cost of equity of 12%. If this trend continues, this will be a crucial hurdle in the rehabilitation of the banking sector as banks may struggle to secure the long-term access to capital that they require.

Average return on equity



Source: KPMG LLP (UK) 2014: Selected Global Bank Financial Statements

Improving returns will require a clear strategy, local and or regional, underpinned by a client and product focus in order to create the right operating model which will require money, patience, resilience and above all – bold, radical thinking. The short-term impact will be costly but the long-term impact should support a recovery in returns.

We believe that banks will have to fundamentally rethink their strategy on which products they sell, to whom they sell and which geographies they should concentrate on, aligned with a clear focus on the customer needs and outcome. This is already happening, but it is a long, hard journey. Banks are increasing their focus on RWA management which, in turn, is sharpening their strategy on which products to sell, depending on the levels of capital they consume and the returns they make.

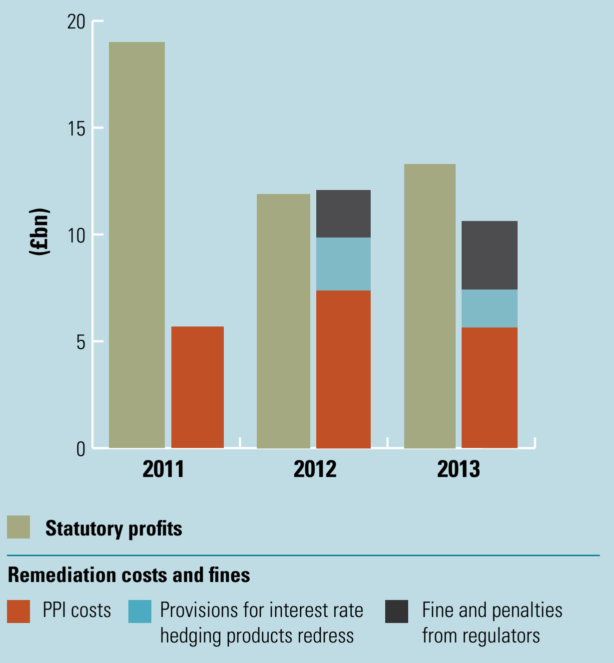
Similarly, better pricing of risk is important to make sure that bespoke product margins reflect the higher risk. Lastly, funding costs and increased regulatory costs need to be reflected and allocated to product pricing. Banks will need to also re-evaluate their geographical footprint as local regulations on capital and funding requirements start to bite, along with the heightened concerns about anti-money laundering and financial crime, especially in certain emerging markets.

Product innovation, done in the right way

In 2013, while the 5 UK banks cumulatively posted statutory profits of £13.3bn, the total bill for litigation, fines and customer redress was £10.5bn or 80% of their total profits. And it is not just a 2013 story as over the last three years, conduct related fines, penalties and redress represents a staggering two-thirds of the cumulative profits of the 5 banks. And as the ongoing investigations into the alleged foreign exchange rate manipulations suggest, conduct failings continue to create hurdles in the 'restoring trust' agenda for banks.

This needs to change. Delivering the right outcome for customers is critical and that means replacing the 'product push' approach of the past with a much more thoughtful and transparent 'product life cycle' approach.

Statutory profits vs remediation costs



Source: KPMG LLP (UK) 2014

Both banks and regulators should continue to focus on product suitability and evolve methods to measure a much more outcomes driven view rather than just the traditional customer satisfaction measures.

In addition, customer needs are changing rapidly. On one hand, a large section of the population continues to need basic products at lower prices, while others, driven by structural demographic changes, needs higher yielding products to support their longer term livelihoods. People are living longer and younger savers are in an environment with prolonged low returns on savings which might mean that their current pension provisions may not provide adequate long-term security. Banks and regulators need to develop a blueprint to deliver to both these sets of customers.

On the wholesale side, conduct issues have been driven by cultural failings, ineffective governance, poorly designed processes and controls, inadequate training and underinvestment in technology. All of these will need to be addressed collectively as there is no single answer to the causes. Going forward, this might result in exiting or curtailing business activities in certain customers segments, markets and products.

Delivering the right outcome for customers is critical and that means replacing the 'product push' approach of the past with a much more thoughtful and transparent 'product life cycle' approach.

Game-changing technology

First, digital platforms, mobile banking, smart phones and tablets are revolutionising the way customers buy products, both in retail and corporate segments. In a recent survey, 64% of surveyed global banks said they have either gone live or are planning to roll-out mobile applications for corporate clients. On the client side, while 25% of US businesses and corporations have adopted mobile banking at the end of 2013, the number is expected to rise to 40% in the next two years.[2]

The heightened risk of cyber attacks are testing the resilience of bank's technology infrastructure and operating platforms. As we see an increase in online frauds, state sponsored hacking and 'hacktivist' revenge incidents, the need to replace and bolster legacy systems and platforms is becoming increasingly more urgent.

[2]AITE – The Future of Institutional Banking

Lastly, digitalisation, automation, advanced data analytics and investments in cutting edge technology is not just a cost management tool but a response to richer customer engagement and more robust risk management, especially in response to the evolving conduct agenda.

However, the scale of investment required to fund this technological revolution will be massive, with consequent impact on short-term profitability and RoE.

Making reinvention happen – banks, investors, regulators and governments all play a role

Suvro Dutta
UK Banking Partner

Achieving these three priorities will require a metamorphosis, rather than incremental changes. This will require innovation, and in turn, investment of a transformational scale, but it is not going to be without a number challenges to achieve these priorities.

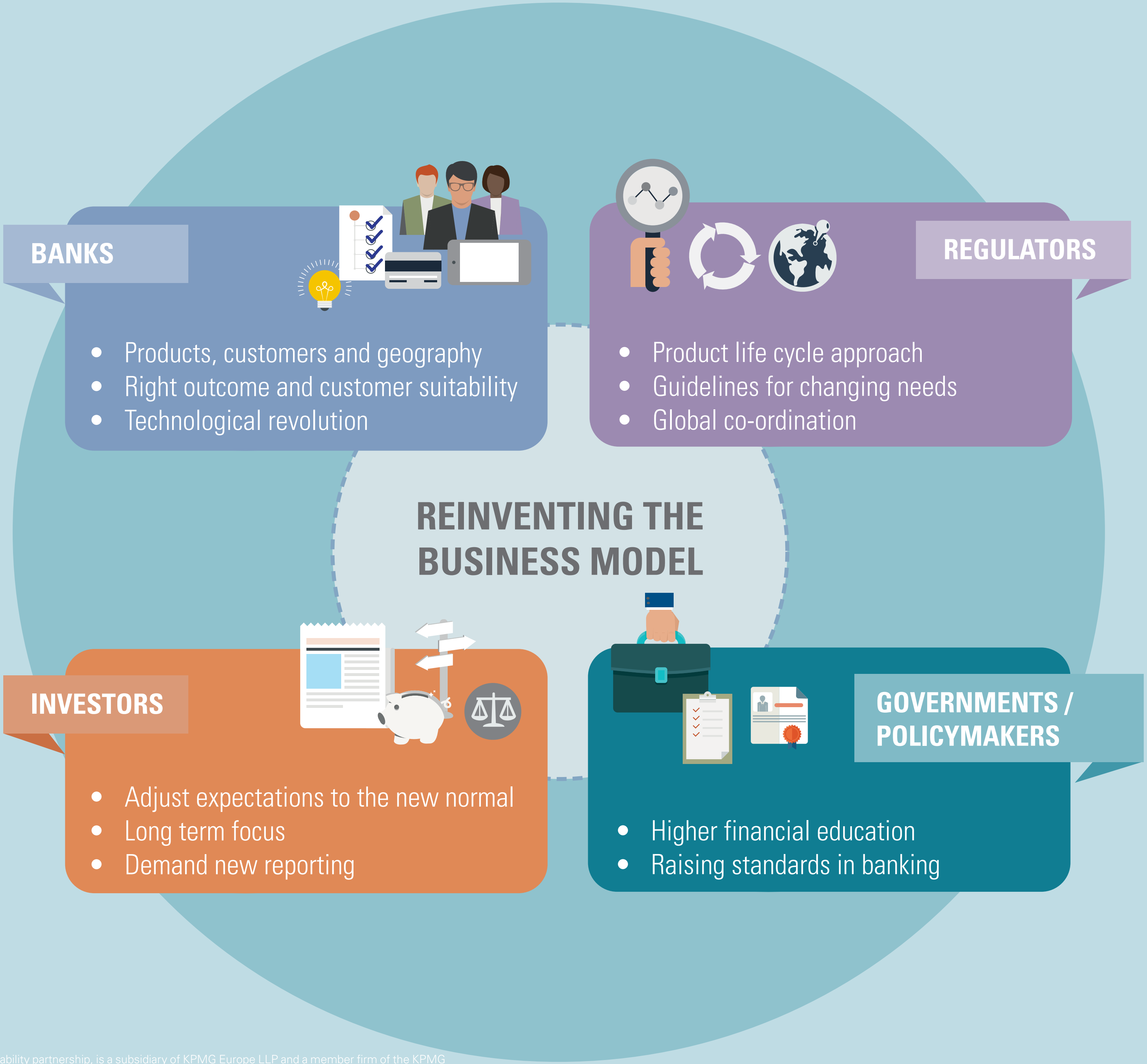
The challenges include the:

- confidence to make investments given such investments will not offer an immediate pay-off and will thus further reduce short-term RoE;
- balancing act of providing the best product but which meets the regulator driven product suite and at the same time not reducing the choice and flexibility to customers; and
- enormous task of restoring trust in the sector and executing this transformation agenda by a new generation of bankers.

These are not easy challenges. However, if we cannot resolve them, the future of the UK banking sector, and indeed the health of the wider economy, both of which are at a critical juncture, is at stake. Thus, all stakeholders need to act – together and decisively. Banks need to lead the charge on transformation and own the agenda but regulators, investors and the government need to rally around them and play an important supportive role.

In this section, we discuss some of the key areas where action is required and the role to be played by each stakeholder.

Banks need to lead the charge on transformation and own the agenda


BANKS
Products, customers and geography
Right outcome and customer suitability
Technological revolution
REGULATORS
Product life cycle approach
Guidelines for changing needs
Global co-ordination
REINVENTING THE BUSINESS MODEL
INVESTORS
Adjust expectations to the new normal
Long term focus
Demand new reporting
GOVERNMENTS / POLICYMAKERS
Higher financial education
Raising standards in banking

Banks

Products, customers and geography

Banks are fundamentally re-thinking their product mix, anchored on three factors – capital efficiency, returns and suitability. Driven by capital constraints, stringent liquidity ratios and regulatory changes, banks are aggressively managing RWAs, both in the trading and the lending book. Between 2011 and 2013, net RWAs have reduced by 14% and this de-risking trend is likely to continue as certain products and businesses become less attractive, both in terms of capital consumption and returns generating capacity.

Similarly, there is increasing focus on customer segmentation. In the wholesale banking space, banks are focused on deepening client relationships and exiting customers with lower returns. They are doing this through more sophisticated ways of analysing customer segments to increase share of wallet, looking at ways to generate more fee income, rather than lending balance sheets, and also standardising processes and innovating to design cost effective ways to deliver products. This will have dual benefits in the long run - improved returns and a more robust business and operating model.

Banks are also seriously re-evaluating geographical strategy and there are a number of drivers – balkanisation and a country first agenda on regulations, greater focus on core activities and in some cases, the heightened focus on financial crime and anti-money laundering. This has meant that several retail and corporate banks have generally pulled back sharply from international business activities, given the cost of greater localisation resulting in a lesser ability to manage capital, liquidity and funding efficiently at a global level.

In the retail banking space, free banking continues to be the ever-present 'elephant in the bank'. Ross McEwan, chief executive of the Royal Bank of Scotland, warned as recently as March 2014 that the end of free-if-in credit banking was coming in the longer term as it would lead to greater transparency about how banks funded themselves.[3] However, market forces alone cannot make this happen –

[3]The Telegraph: 1 March 2014

the first bank to introduce charges would be likely to lose significant numbers of customers and by acting together, they would break competition rules. This is again an area where a collective response and transparent action by banks and regulators are required to break the deadlock.

All of the above strategic initiatives by banks have very significant consequences. Return for investors in the banking sector may need a structural revision, the universal banking model may not survive, a smaller number of large scale players may emerge and banks may become smaller and less diversified. Time will determine if this is the right blueprint for the banking model of the future, but most importantly, all stakeholders must work together and not lose sight of these possible outcomes, such that the current initiatives and reforms do not have unintended longer term consequences.

Right outcome and customer suitability

All banks are driving a cultural revolution within their organisations. Banks need to rebalance stakeholder interests and move away from a disproportionate focus on returns and remuneration seen in the pre-crisis years to greater focus on customer outcomes and longer term product suitability. Fundamental changes are required in the incentives framework, sales practices and the training regime for employees. All banks are on the journey, but implementation and embedding a wholly different culture will take time and serious willpower and determination. Industry initiatives like the professional standards board, being set up by Sir Richard Lambert needs to complement and bolster what banks are already doing and in turn, need full support and collaboration from banks and regulators alike.

Customer engagement and treatment is undergoing radical surgery, as it should. Key elements should involve a new approach to product suitability, a different mould for product manufacturing which truly reflects customer needs in a much more transparent way, and much more transparent disclosure of what customers are buying. On the wholesale side, the conduct failings around LIBOR manipulations, issues on financial crime and money laundering have turned the spotlight on governance reforms, processes and controls and incentive structures. Structural changes in this area is very much work in progress.

Technological revolution

We are already witnessing a wide range of technological innovations. In the retail world, for example, elegant solutions are being developed which allow customers to access banking products and services at a time and place of their choosing using mobile or tablet devices. This trend is likely to improve customer outcome. We could also see the use of in-branch (or home) video conferencing to sell more complicated products such as mortgages. This would mean that a customer could gain access far more quickly and easily to a specialist member of staff with the right expertise to offer better quality advice.

On the wholesale side, similarly, banks are investing heavily in enhancing cash management capabilities, building e-platforms and automating to have more straight through processing of trades.

Banks should also be viewing 'digital' as an enabler to raise the bar on the conduct agenda. With sophisticated data analytical capabilities, big data can transform the way banks evaluate, understand and deliver to customers. On the retail side, data analytics can provide much more meaningful insight into customer needs and suitability and drive a product suite that is more cognisant of customer outcomes and consistent with the recommendations of the Financial Conduct Authority (FCA). In the wholesale banking space, big data analysis can help in tackling issues like financial crime, anti-money laundering checks and responding more effectively to 'know your client' requirements.

Investors will have to show patience to allow banks to carry out their transformation

Again, there are consequences. Firstly, without these investments, on one hand, banks will not be able to keep up with the times in terms of product capability or delivery, but on the other hand, it will reduce an already falling RoE and thus test short-term investor patience. Secondly, if the banking sector becomes synonymous with the 'simple' mantra, then it might mean that real innovation comes from the less regulated, non traditional sector like the peer-to-peer (P2P) lending and 'crowd sourcing' channels.

However, the scaleability of these alternative channels remain to be seen. For example, while the P2P market in UK has tripled in size in the past three years and is expected to be £1bn by 2016, it will take time before they can emerge as a serious alternative.

Investors

Adjust expectations to the new normal

Current RoEs are low, with some UK banks in very low single digits and our and our expectation is that medium term RoEs will remain in the single digits. Investors need to therefore realign their return expectations to this 'new normal.' However, this may be acceptable if investors are compensated by lower underlying risk in the business model.

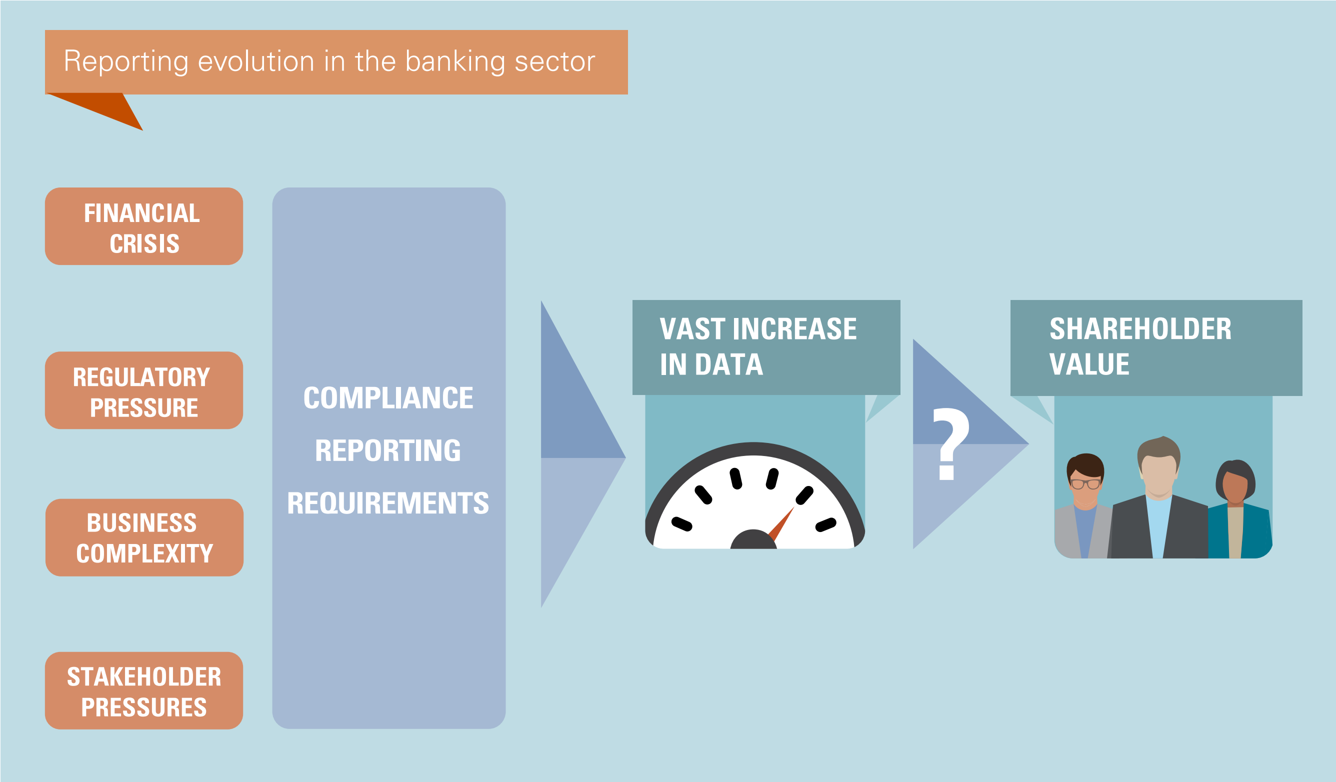
Long term focus

At the same time, it is not all doom and gloom for the banking industry. An effective overhaul of the business model should enable banks to deliver a better RoE in the longer term than current levels, but in the meantime, investors will have to show patience to allow banks to carry out their transformation.

Demand new reporting

Lastly, it is time to ask whether banks' financial reports could be better aligned with shareholder value. Currently bank financial reporting is groaning under the weight of new compliance requirements – financial statements have become significantly more transparent but it is difficult to discern the overall message. Investors are left with an abundance of financial data but struggle to identify relevant information.

Against this background, three changes could help move banks' financial reports from data tables to documents that better support analysis of shareholder value.



Source: KPMG LLP (UK) 2014

1 The link between earnings and the financial risk choices taken needs to be made clearly

More than any other industry, the risk choices taken by a bank have an immediate impact on financial performance. They are essential context for an understanding of current earnings. Recent reporting initiatives by financial services regulators, securities regulators and industry working parties (e.g. the Enhanced Disclosure Task Force) have significantly improved the information on the risks being taken by banks. However, we believe investors need help to connect this information with its implications for current and medium term business performance.

A significant step would be to bring an earnings focus to the extensive balance sheet risk information now being provided. Linking risk reporting with earnings performance could help investors compare underlying profitability across banks following different risk strategies.

2 Focus on operational performance to explain business prospects

Analysis of earnings and balance sheet risk provides part of the story of how enterprise value has been developed and protected but a broader perspective should address the key assets on which business prospects depend. For a retail bank, development of the customer base, and operating platform will be central to business prospects. For a wholesale bank, a key part of value may lie in its market position, staff base and product range. The back-to-basics approach of many banks' strategies has recognised these operational assets as key drivers of value.

Bank reporting needs to catch-up. Showing how key business assets such as the customer base have been developed and protected could support a more complete assessment of business prospects. This is an area that is beginning to evolve both in internal and external reporting. As it does so, we suggest that banks look to the most relevant measures of performance, whether they be indicators of operational risk (such as key staff retention), indicators of progress in managing risks and opportunities (such as the status of retail branch refresh programmes), or operational outcomes (such as customer churn rates). In some cases, the value of this information may lie in its comparability across the sector, in other cases, the bank's track record over time may be most relevant.

3 'Business as usual' cannot be taken for granted – reports should reflect this

Like any highly regulated business, banks' relationships with customers, counter-parties, society and government should be central to their long-term future. Financial reporting requirements will continue to evolve in the wake of the financial crisis. But, one of the principal investor concerns will remain: 'what are the bank's long-term business vulnerabilities and how does it manage them?' Reporting needs to provide investors with credible, objective information if it is to support their assessment of the actions taken to preserve the long-term prospects of the business in this area.

Regulators

Product life cycle approach

In the context of achieving the right long-term outcome for customers, the banks need to move from a product push to a product life cycle approach to regulation that considers appropriate implications of this approach for product design and development (including suitability), customer treatment and channels of distribution. Regulators in the UK have already been emphasising the importance of the product life cycle approach. To achieve a customer outcome-focused approach we believe that banks need access to and make use of all the right data about customers to make an informed sales decision. For example, there should be wider use of data to check the suitability of a product for a customer (e.g. employment status) to provide the right customer outcome. Clearly, this is a sensitive topic in terms of data confidentiality and joint action is required between regulators and banks to agree an appropriate framework for data sharing with an overriding principle that it must be in the customer's interest.

Guidelines for changing needs

Regulators should provide space for banks to design, target and document products in a way that reflect evolving customer needs. The regulatory framework needs to be fair and place proportionate accountability on banks and customers. While banks will have to have a greater consideration for suitability in designing such products, the regulatory guidance should be proportionate such that banks can operate without the fear of being held solely responsible if there was a market downturn.

Global co-ordination

Another critical need is a coordinated regulatory response. While legislation needs to be tailored to suit national needs, it also needs to be co-ordinated to allow banks to run truly global business models. Disappointingly, this is still not being seen.

There should be wider use of data to check the suitability of a product for a customer to provide the right customer outcome.

While a number of these reforms are already happening, we are seeing a range of approaches from the various national authorities. For example, the fundamental 'MiFID2' package of reforms on enhanced transparency in product design and documentation was only agreed in January 2014. These reforms included a strategic focus on customers, a need for product manufacturers to design, target and document the product in a way that reflects investor needs and a focus on transparency. However, there is divergence in practices within the EU. The UK stands at one end of this spectrum, with its long-standing emphasis on the importance of the product life cycle approach and Austria and Germany stands at the other end of the spectrum, with others in between.

Similarly, in the wholesale space, the European Markets infrastructure Regulation (EMIR), which is essentially directed at reducing systemic risk through centralised clearing of derivatives were finalised in 2013. However, a continuing failure to achieve consistency between US and EU regimes continues to add costs and uncertainty, especially for global banks.

Government

Financial education

Banking is an essential service and the small number of banks dominating the industry implies limited alternatives for customers. Hence a 'caveat emptor' approach akin to the warning signs of tobacco manufacturers may not be entirely appropriate for the sector. There is a growing recognition that transparency and disclosure to retail customers is not sufficient, because they remain in a weak position in terms of their lack of understanding of many financial products leading to a position where the balance of power is always in favour of financial institutions.

However, while banks will have to bear the primary responsibilities for the right outcome, suitability and transparency, financial education of customer's needs to improve. This will always be crucial – both in terms of improving safety and giving regulators greater confidence in customers bearing a greater level of personal accountability for their banking decisions.

For example, financial literacy would benefit from being on the national curriculum. This becomes particularly relevant as demographics change towards an aged population. A greater proportion of the population need to have sufficient savings for retirement and may seek higher yielding (riskier) products to achieve this. Such individuals must be able to comprehend the risk-return profile of the products they invest in.

Initiatives to restore trust

As we have discussed, all banks are working on a massive conduct agenda and undergoing a cultural revolution. The million dollar questions are 'How will we measure success?' and 'How will banks be able to assess if they are truly restoring trust?'

One of the recent initiatives, based on the recommendations of the Parliamentary Commission on Banking, was to form a professional standards body to raise current standards in banking and this is being led by Sir Richard Lambert.

Given the enormous cultural failings in recent times, we believe that this is a step in the right direction, but will be a real challenge to implement. The body should prompt bold and radical thinking, raise the bar on standards, borrow good practices from other industries and professions and develop innovative ways to measure if there is real progress and change in culture over time. However, for this initiative to be successful, it would need active engagement, embedding of the new standards and support from the banks, co-ordination with other professional bodies and regulators, including the Financial Conduct Authority (FCA)' and a greater sense of responsibility from individuals working in banks.

Conclusion

Is it possible to simultaneously achieve a strategy that provides the right choice of products, customers and geographies; delivers innovative products in the right way; and delivers through game changing technology?

We believe it is possible but these are not easy challenges and will require bold, innovative actions and all stakeholders have a critical role to play. There are also exciting opportunities but the real challenge is to balance the interests and needs of the various stakeholders: from banks, investors, regulators and politicians.

It will be a rocky road to recovery, but co-ordinated action remains our only hope to building a better banking sector and indeed more widely, a better economy.

To discuss your challenges or any of the themes in this report, contact us:

Bill Michael
EMA Head of Financial Services
T: +44 (0) 207 311 5292
E: bill.michael@kpmg.co.uk

Richard McCarthy
UK Head of Banking
T: +44 (0) 207 694 2785
E: richard.mccarthy@kpmg.co.uk

David Sayer
Global Head of Banking
T: +44 (0) 207 311 5404
E: david.sayer@kpmg.co.uk

Pamela McIntyre
UK Head of Banking Audit
T: +44 (0) 207 311 5107
E: pamela.mcintyre@kpmg.co.uk

Suvro Dutta
UK Banking Partner
T: +44 (0) 207 311 1466
E: suvro.dutta@kpmg.co.uk

We would like to acknowledge the efforts of the principal contributors to the publication, who include:

Soumak Bose, Stephen Bates, Muhammed Ebrahim, Max Harmer, Michael McGarry, Vaibhav Shah, Joseph Wood and Achin Kukreja

kpmg.com/uk/bankingresults

Oliver for KPMG | OM 010898A | April 2014 | Printed on recycled material