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The search for growth

Banks struggle to recover momentum in 2015

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Annual results from the top five UK banks in 2015 suggest that the recovery seen in the previous year has faltered. Despite an improving UK economic picture during the year, low interest rates and high costs continued to put downward pressure on profits. With concerns over their operating models in the face of market forces and regulation, it is not yet clear where banks will find the route back to growth.

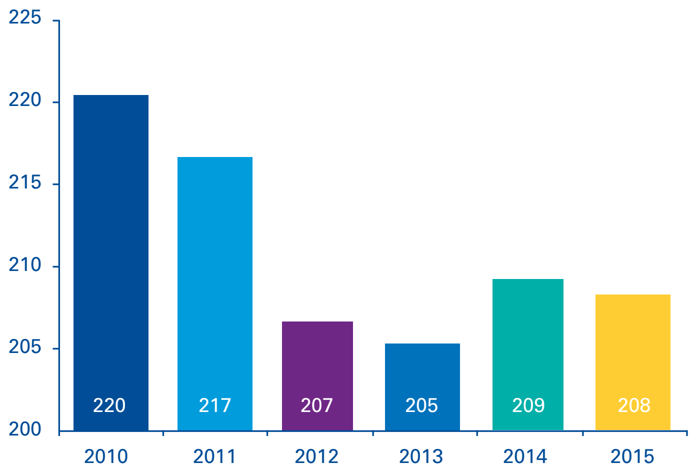
Growth on hold

Any upward momentum in profits seen in 2014 has now stalled. With a drop of 40 percent to £12.4 billion, the top five banks' 2015 pre-tax profits have returned to levels seen in 2013 and 2012 (£12.7 billion and £11.5 billion) after a sharp rise to £20.6 billion in 2014. RBS made pre-tax losses from continuing operations of £2.7 billion mainly due to litigation and conduct costs, and Standard Chartered posted losses for the first time in 26 years of £1 billion mainly as a result of significant impairment charges.

The reduction in profit contributed to low Return on Equity (RoE) figures ranging from -4.7% to 7.2%, with 4 of the 5 banks reporting a fall in RoE.

At the same time, there is little evidence of revenue growth. Average net interest margins of 208 basis points have remained stable (falling by one basis point) in an environment dominated by low interest rates and fiercer competition, both between banks and from new challengers.

Average net interest margin (bps)



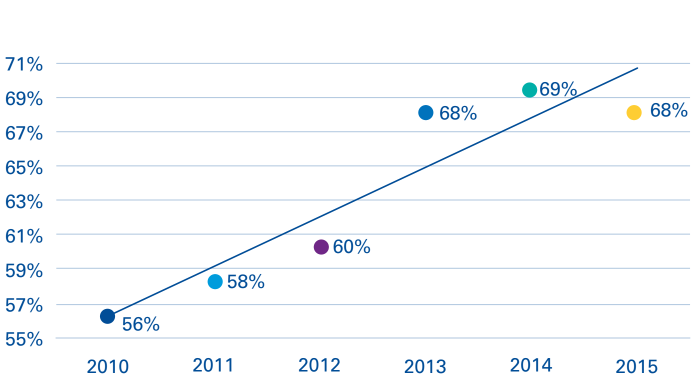
> "With a drop of 40 percent to £12.4 billion, the top five banks' 2015 pre-tax profits have returned to levels seen in 2013 and 2012... after a sharp rise to £20.6 billion in 2014."

Costs stay high

Costs remain a major brake on profitability. Remediation, comprising a now-familiar mix of payment protection insurance (PPI), interest rate mis-selling and FX fixing, continues to punch a hole in bank results. From 2011 to 2015, remediation cost a total of £55 billion, accounting for 72 percent of banks' profits during that period. In 2015, banks spent £14.3 billion on remediation of past misconduct, up 35 percent on the previous year. For Lloyds and Barclays, increased PPI provision was behind this increase, with both banks citing the FCA's potential PPI complaints deadline of 2018 and the implications of a 2014 UK Supreme Court judgment, Plevin vs Paragon Personal Finance Limited, as reasons for this. During the year, RBS has provided £2.1 billion for litigation related to mortgage-backed securities in the US, while SCB posted little change in remediation costs. The exception was HSBC, which showed a 28 percent reduction in these costs in 2015 thanks to lower provision for interest rate hedging products and the fact that it had made a \$550 million settlement payment to the Federal Housing Finance Authority in the previous year.

Despite ambitious programmes that currently target savings ranging from £0.8 billion to £3.4 billion in the period 2016 to 2018, there is limited evidence to date of banks' ability to cut costs in a big way. Excluding remediation, costs fell by 2.9 percent during 2015. And while headcount is down across all banks, compensation costs of £38 billion are still the largest component of operating expenses, accounting for 51 percent of these costs once remediation is excluded.

Average cost-to-income ratio (%)



Rising taxes

Tax has been bearing down on banks in 2015 and the bank levy charge remains high for all banks. Tax contributions increased marginally from 2014 to 2015, with taxes paid increasing by 1.5 percent to £5.3 billion. Across the top five, the bank levy rose 21 percent to £2.2 billion, with four out of the five institutions seeing an increase in 2015. All banks recognise the potential impact of changing tax regulation, with the majority expecting to see an increase in the effective tax rate as a result of the eight percent surcharge on banking profits. While all banks welcome the proposed reduction in the bank levy, this is tempered by concerns over the impact of the bank surcharge.

At least impairments are stable

Impairment charges were little changed from 2014 for the majority of the banks. RBS, Lloyds and Barclays all noted the influence of the UK's positive economic climate on impairments, with RBS booking another overall release in impairments in 2015. This continued stabilisation comes at the end of a five-year period in which impairment charges had seen dramatic growth. SCB is a notable outlier, seeing a steep rise in impairments due to challenges in emerging markets and commodities.

Annual report disclosures indicate that banks are increasingly performing more detailed internal stress testing in addition to regulatory stress tests, as part of their risk management processes. In 2015 the falling oil price was a consistent theme in stress testing, but only Barclays quantified its impact on its impairment charges.

Implementation of IFRS 9 in 2018 (subject to endorsement in the EU) will almost certainly increase impairment costs for banks as they move to the expected loss model for recording impairments. However none of the banks have so far disclosed a number on this

Lending down

Lending is not driving growth in the industry. A five percent decline to £1,959 billion from 2014-2015 marks the continuation of a 14 percent downward trend since 2009. However, the overall loan book is less risky and of a higher quality, with non-performing loans reducing by 30% since 2014.

The impact of ring-fencing

The UK Financial Services (Banking Reform) Act 2013, which requires retail and SME deposit-taking activity to be carried out in a separate ring-fenced entity, is creating a fundamental change in banks' operating models. Most banks discuss the impact of ring-fencing in the context of legal, regulatory and operational risks and the increased compliance costs that would follow. There is little quantitative analysis. The narrative in the Chairman and CEO statements around progress being made to restructure the banks and meet the regulatory requirements, reflect the level of importance and attention to this structural reform in the board room agenda.

The path to growth remains unclear

Given the many contemporary pressures on banks – low interest rate environment contributing to low margins, costs, regulation, competition and taxation – it is not clear where growth is going to come from. How would economic conditions need to improve in order to support growth for banks? Or does the answer lie in innovation and doing things differently? Or to put it another way: is it the economy that needs to change, or is it banking itself?

There are some green shoots in the otherwise barren picture presented by the top five banks' 2015 results. Banks are better capitalised than during the financial crisis, and should therefore be safer and more stable. Their considerable expenditure on digital infrastructure could also be creating a platform for future growth. And the fact that they are now focusing on net promoter scores and customer satisfaction as key metrics creates greater disclosure and transparency that benefits investors. However, the overall narrative from the top five UK banks in 2015 is one of a continued struggle to find the path back to growth in the face of formidable obstacles.

BASIS OF PREPARATION

This report summarises and makes reference to the 2015 results of the following UK headquartered banks: Barclays, HSBC, Lloyds, RBS and SCB.

Information has been obtained solely from published 2015 year end reports (including results presentations and accompanying analyst packs). Where total numbers are presented, it is the total of the five banks in the review. As an example, total remediation costs are the sum of the remediation costs by the five banks, expressed in sterling. Similarly, if an average number is presented, it is the average of the five banks in the review. We have used simple headline numbers in our analysis unless stated otherwise; each bank has its own way of reporting performance and this has proved to be the most consistent method of presenting their results.

Where we have averaged a key performance indicator (KPI), we have included in the average only those banks that we consider prepare the KPI on a materially consistent basis. 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.

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↓40%

Total profits have reduced by 40% between 2014 and 2015 to £12.4bn.

15%

Between 2009 and 2015 loans and advances to customers have decreased by 15% to £1,959bn.

1bp

Net interest margins remain low with a decrease of 1bp year on year.

↓5%

2014 £2,055bn

Loan balances remain stable with a marginal decline by 5% from £2,055bn in 2014 to £1,959bn in 2015.

2015 £1,959bn

↓30%

Total loans impaired across the banks has significantly decreased by 30% from £81.7bn in 2014 to £56.9bn in 2015.

ATM

Cost to income ratios have worsened over the last 3 years for four of the five banks.

↑35%

Total remediation costs have increased by 35% between 2014 and 2015.

Between 2011 and 2015, remediation costs equal 72% of profits.

↑ 1.5%

Total taxes paid across the banks has increased year on year by 1.5%.

21% ↑

Bank levy charges are higher for 4 out of the 5 banks. The total levy increased from £1.8bn in 2014 to £2.2bn in 2015, a 21% increase.

Overall, headcount is down, but total compensation has stayed level with only a 0.1% increase between 2014 and 2015.

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