# **RISK ASSESSMENT** OF THE EUROPEAN BANKING SYSTEM

DECEMBER 2013

EBA
EUROPEAN
BANKING
AUTHORITY

**Europe Direct is a service to help you find answers to your questions about the European Union**
**Freephone number** (*):

00 800 6 7 8 9 10 11

(*) Certain mobile telephone operators do not allow access to 00 800 numbers or these calls may be billed.

More information on the European Union is available on the Internet (http://europa.eu).
Cataloguing data can be found at the end of this publication.

Luxembourg: Publications Office of the European Union, 2013

ISBN 978-92-95086-52-4
doi:10.2853/58292



*Printed in Luxembourg*
PRINTED ON WHITE CHLORINE-FREE PAPER

# RISK ASSESSMENT OF THE EUROPEAN BANKING SYSTEM

DECEMBER 2013

EUROPEAN BANKING AUTHORITY

# Contents

# Executive summary

*There are several indicators showing that confidence is returning.* Throughout the second semester of 2013, following the publication of the EBA's last report on the risks and vulnerabilities of the European Banking System (July 2013), the EU banking sector has continued to observe improvements in market confidence, from both debt and equity investors. Following the EBA's recapitalisation exercise, the weighted average Tier 1 ratio excluding hybrid instruments for the largest European banks stood at 11.1% at June 2013, in line with major international peers. Funding activity returned to dynamic levels with heavy issuance across the EU including by larger banks in financially stressed countries, which have been able to benefit from a benign market sentiment. Nevertheless, a dislocation between financial markets and the real economy continues to be observed. Macroeconomic data and forward-looking leading indicators continue to point to the broad-based weakness of the economy and subdued monetary dynamics. As a result, significant challenges within the EU banking sector persist due to a likely rising level of provisions, persistent asset quality deterioration and squeezed profit margins.

*The funding conditions across the EU benefited from the improvements in market confidence, with some banks' consistently issuing unsecured debt across Europe.* Issuers from both highly rated and financially stressed countries were able to expand their funding, satisfying an increasing demand from EU and non-EU investors for European bank debt. At the same time, whilst the return of calmer conditions paved the way for a return in market confidence, developments in the global money and financial markets still remain fragile and susceptible to a sudden switch of market sentiment, having the potential to negatively affect economic conditions. Among the upside risks, a sudden reassessment of expectations regarding the liquidity programmes of major central banks may trigger significant corrections in markets. At the same time, the sovereign-bank linkage persists and there is evidence of differences in funding conditions and funding costs between banks domiciled in highly rated sovereigns and those domiciled in financially stressed sovereigns. The institutional reforms at EU level are critical to breaking this pernicious linkage, in particular the establishment of the banking union, including the creation of a more integrated framework for bank resolution and a single deposit guarantee scheme.

*However, uncertainties about asset quality persist and remain a fundamental issue across the EU.* There is evidence of a continuing deterioration of quality in large segments of banks' loan portfolios throughout 2013. The ratio of impaired loans and past due (> 90 days) to total loans increased on average from 6.4% in December 2012 to 6.7% in June 2013 (the highest since 2009). The 75th percentile continues to present worrisome high levels of approximately 15%, which is well above historical levels for this ratio. The deterioration in asset quality not only influences earnings and capital strength of the EU banks but also casts a shadow over near future economic performance. Although there is evidence of banks' active efforts in dealing with problem assets, these efforts have been hampered by the absence of a lively secondary market in banks' assets in the EU.

*The uncertainties about asset quality have heightened the need for rigorous Asset Quality Reviews (AQRs), with consistent definitions, across the EU.* The EBA agreed, in May 2013, and published in October 2013 on recommendations to supervisors to conduct asset quality reviews on major EU banks. The recommendations were issued in order to dispel concerns over the deterioration of asset quality and to contribute to a coordinated approach in the way in which competent authorities evaluate banks' credit portfolios across the EU. In addition, the EBA proposed harmonised definitions on forbearance and non-performing exposures. These consistent EU-wide definitions are a key step in the early identification of risks to the financial stability at EU level and will facilitate further actions, such as asset quality assessments. The final standards will be sent to the European Commission for their adoption as EU regulations that will be directly applicable throughout the EU. In a separate note in late 2013, the EBA decided to provide updated disclosures on capital and some exposure classes to fill in information gaps after the 2011 stress test exercise and the 2012 Recapitalisation details.

*The need for bank restructuring and changes to business models will remain a challenge.* Throughout 2013, the EU banks' income and profitability has continued to be faced with significant headwinds, which are unlikely to dissipate in 2014. The risk premium on EU banks remains relatively high because of profitability concerns, and the low interest rate environment creates pressure on bank net interest margins. Combined with the new regulatory environment and sluggish growth, the sustainability of banks' business models will continue to present a challenge for management. There are indicators that a downsizing of banks' balance sheets has started and continues to take place in order to complete the repair of balance sheets. Over the last six months, total assets decreased by 3.5% for the banks in the KRI sample and further changes to banks' balance sheets are expected as business models adapt to a new environment. Supervisors will need to maintain their focus on analysing banks' business models across the EU to assess inter alia banks' profit and funding models, business mix, management strength and strategy, and take action where sustainability is in question.

*As well as reputation risk, the potential prudential impact of conduct-related issues also remains a concern.* A number of detrimental business practices of European banks have significantly affected consumer confidence and had an adverse impact on the respective banks involved. These prudential risks have crystallised and costs have increased markedly. Therefore, a more general reassessment of the relationship between banks and their customers remains warranted.

*A coordinated policy action remains fundamental for the coherence of the single market.* The new swathe of regulatory requirements for banks, notably CRR/CRD IV and the Bank Recovery and Resolution Directive (BRRD), are fundamental for the ongoing repair of the EU banking system in the medium to long term, although elements of regulatory uncertainty remain challenging for banks in their implementation. Initiatives such as the asset quality reviews (AQR), common definitions on 'non-performing exposures' and 'debt forbearance', and the 2013 transparency exercise form part of broader policy actions aimed at addressing the current situation in the EU by restoring stability and confidence in the markets. The EU banking sector continues to be fragmented and the need for continued regulatory and supervisory convergence across the EU will remain a key challenge for the EBA.

# 1. Introduction

This is the fourth semi-annual report on risks and vulnerabilities of the European banking sector conducted by the European Banking Authority (EBA). The report describes the main developments and trends that affected the EU banking sector in the second semester of 2013 and provides the EBA's outlook on the main micro-prudential risks and vulnerabilities looking ahead.

With this report, the EBA discharges its responsibility to monitor and assess market developments and provides information to other EU institutions and the general public, pursuant to Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010, and amended by Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013. The EBA considers that the information contained in the report provides the relevant stakeholders with a useful benchmark for analysis.

The report draws on the views of banks and national supervisors to construct a forward-looking view of risks that are of concern to regulators and policy-makers. Among other sources of information, this report is based on four main exclusive data sources, namely:

(a) EBA key risk indicators (KRI);

(b) EBA risk assessment questionnaire for banks (RAQ);

(c) EBA risk assessment questionnaire for market analysts (RAQ for market analysts); and

(d) Micro-prudential expertise and college information gathering.

The EBA key risk indicators (KRI) are a set of 53 indicators collected on a quarterly basis by national supervisors, from a sample of 57 European banks in 20 EEA countries from 2009 onwards. The banks in the sample cover at least 50% of the total assets of each national banking sector. Most of the indicators are not publicly available; therefore these data provide a unique and valuable source of information. The reference date for the most recent data is 30 June 2013. Information about the sample and descriptive statistics of the latest KRIs can be found in both the appendix and annex. The weighted average ratios are described unless stated otherwise. Since KRI are collected at a point in time, they tend to be backward-looking in nature. They are thus complemented with various forward-looking sources of information and data, such as semi-annual and ad-hoc surveys.

The risk assessment questionnaire (RAQ) is a semi-annual survey conducted by the EBA, asking banks and/or their financial supervisors a number of multiple-choice questions. Information from the questionnaire completed in April and November 2013 and comparisons with previous answers from a representative sample of 39 European banks, listed in the appendix, was used for this report. In addition, the EBA conducted a survey (RAQ for market analysts) asking market analysts (19 respondents) a number of questions in a multiple choice format with responses reflecting the degree of agreement to the statement made.

The report also analyses information gathered by the EBA from the European colleges of supervisors and from informal discussions as part of the regular risk assessments and ongoing dialogue on risks and vulnerabilities of the EU banking sector. The report views EU banks as a set of balance sheets and is organised as follows.

Chapter 2 looks at the external environment and processes by which EU banks' assets and liabilities are developing in a given market sentiment and macroeconomic environment, taking into account the regulatory developments and structural and institutional reforms at EU level. Chapter 3 focus on the assets side, explaining the ongoing de-risking process, the respective influence in banks' business models and risk appetite, the dynamics of asset quality, as well as policy implications and possible measures to address these prudential issues. Chapter 4 provides an overview of the banks' capital positions and respective positive trends, taking into account the challenging conditions in financial markets and the national efforts progressing towards strong capital buffers. Chapter 5 considers in more detail the liabilities side, presenting the evolution of funding conditions. It also discusses the development of asset encumbrance and highlights remaining structural fragilities and challenges, in particular in countries having experienced some sovereign stress, as well as policy implications and possible measures to address prudential issues. Chapter 6 describes banks' income and profitability and the significant headwinds during the second semester of 2013 and beginning of 2014. Finally, Chapter 7 touches on aspects of banks' consumer issues and reputational concerns, business conduct, effective and potential financial costs stemming from mis-selling and other unfair past business practices, policy implications and possible measures to address these prudential issues.

# 2. External environment

## Market sentiment and macroeconomic environment

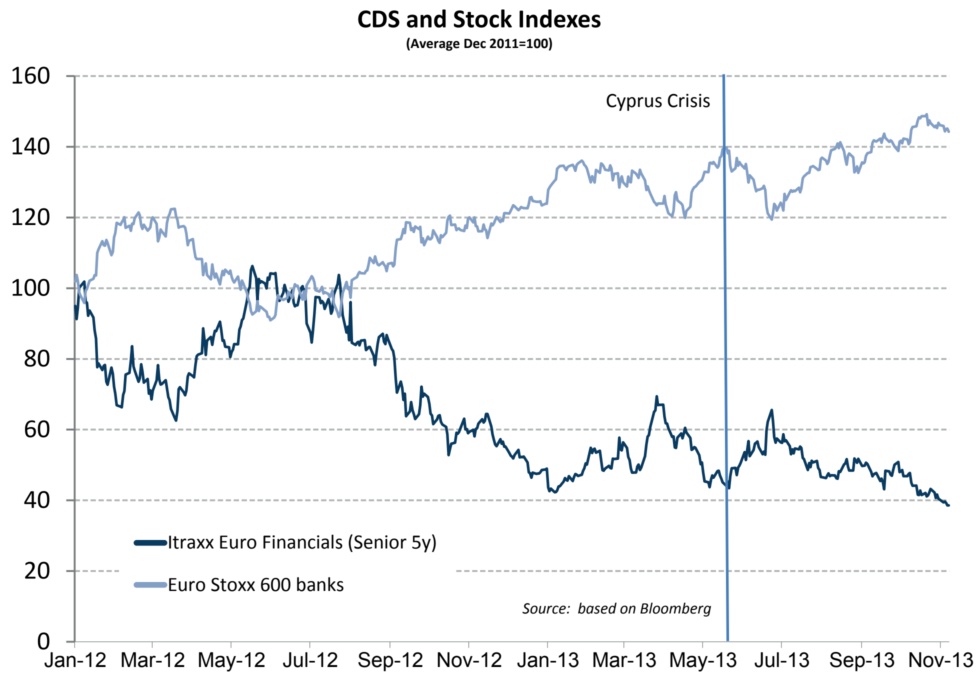
There is a wide consensus that funding conditions have improved during 2013 as a consequence of decisive policy measures and regulatory steps. Bank debt issuance has continued to develop positively in benign funding conditions and even banks in countries with financially stressed sovereigns have continued to access the markets. Examining various aspects of banks' issuance, it is perceptible that the situation in bank funding has improved. Nevertheless, the existence of a weak macroeconomic environment and subdued indicators continue to present signs of economic retrenchment. Risks towards the global outlook remain evident and continue to show some dislocation between the financial markets (see figure 1) and the real economy.

### *Investor demand continues to be high, indicating a positive market sentiment*

Funding conditions have particularly improved for banks in financially stressed countries — both large and small — and they continued to be active issuers over the last few months, suggesting that wholesale funding markets are open for most EU banks. Banks continue to be issuing less senior debt as they maintain their gradual deleveraging process, in order to meet upcoming capital standards, and as they have increased the share of deposits in their funding structures. In general, there is a low issuance activity level despite significant refinancing needs and the long term refinancing operation (LTRO) repayment deadline approaching. The lower issuance volumes led to tighter credit spreads as investor demand continues to be high, indicating a positive market sentiment, especially for higher yielding European credit. In the interim, banks have more funding avenues available; in particular, deposit growth remains positive in most countries and maturities are similar to last year's level.

A better and positive market sentiment is also visible through a declining trend in EU banks' expected-default frequencies (EDF), in part related to the positive actions that were taken to strengthen EU banks' capital. The tightening of the EDF quartiles and the

**Figure 1:** Stoxx 600 banks share price index (*source:* Bloomberg)



reduction in the respective volatility are also positive signs during 2013 in comparison to previous years (see figure 2).

### *The side-effects of monetary accommodation will need special attention*

European funding markets are facing a long road of increasing uncertainties after a prolonged period of monetary accommodation and expectations of a subsequent normalisation of monetary conditions. There are substantial risks from future wind-down of stimulus such as higher than anticipated long-term interest rates and greater market volatility. The reassessment of risk premia in global markets may produce some turbulence, following a prolonged period of safe-haven flows and a search for yield. Managing these side effects may prove challenging and will consequently need special attention from policymakers. While EU banks displayed resilience in light of October 2013 events regarding the debt ceiling in the US, they may be vulnerable to the possibility of repeated similar events. In addition, temporary market uncertainty during the summer following shifting expectations regarding liquidity programmes of some major central banks with sudden reassessments of risk premia has shown that EU banks may also be vulnerable to such risks.

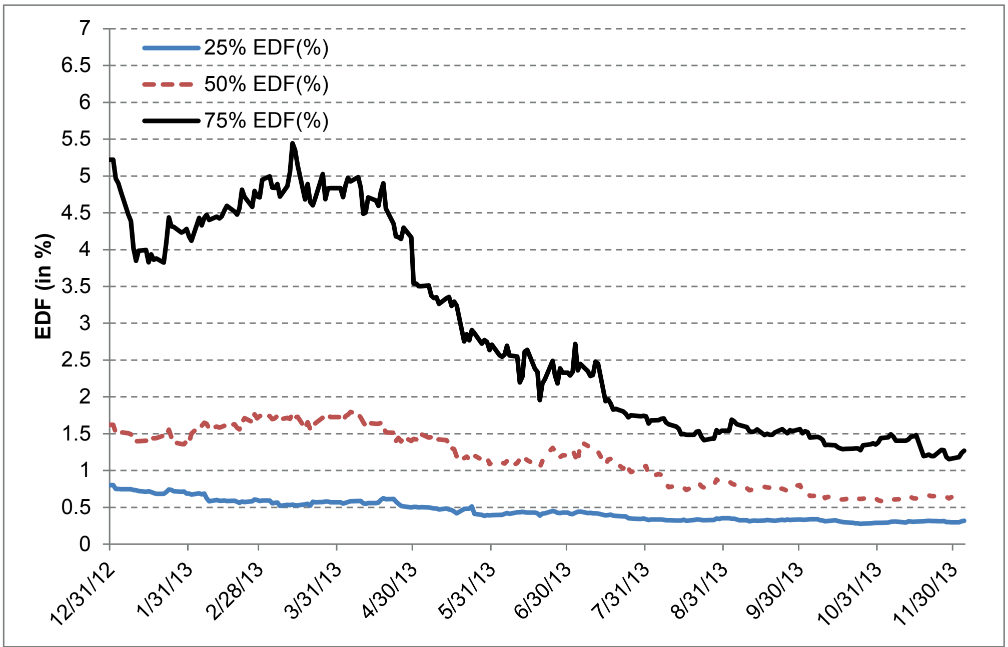
Risks to the global outlook remain tilted towards the downside, and forward-looking macroeconomic indicators continue to show signs of a weak macroeconomic environment. The outlook for EU real GDP development continues to be weak, and on an annual basis, real GDP growth in 2013 was estimated by the European Commission in October 2013 at 0% in the EU and -0.4% in the euro area. While some uncertainty has receded, it remains elevated and threatens to remain a drag on growth.

Available information on non-financial corporates' access to financing continues to indicate tight and unchanged credit standards in several EU countries in comparison to previous semesters, and in particular for SMEs. Nonetheless, looking ahead, banks expect a lesser net tightening of credit standards for non-financial corporates. As contributing factors towards the developments in credit standards there is no change in the contribution of banks' capital positions, thus indicating some ongoing need for adjustments to banks' balance sheets. The AQR and deleveraging are pushing EU banks to complete their balance sheet adjustments and, therefore, are essential processes which have a positive contribution to the banking sector and to the recovery of the European economy.

## Regulatory developments

The regulatory initiatives and derived products are providing a key contribution to a significant enhancement of the Single Rulebook in banking regulation. In particular, the legislation approved early 2013 on capital requirements, the 'CRD IV package', which implement the Basel III framework in Europe, provide a considerable step forward. Also the legislative proposals on recovery and resolution will help in creating a com-

**Figure 2:** Expected default frequencies (source: KRI banks – listed; Moody's KMV)



mon framework for European banks going forward.

New or significantly revised mandates were introduced for the EBA following the finalisation of the Capital Requirements Directive IV (CRD IV) and of the Capital Requirements Regulation (CRR). These legal texts set deadlines for numerous technical standards and guidelines.

Simultaneously, other measures are being discussed and therefore becoming increasingly clear as concepts and these may also result in further regulation. The EBA's regulatory work in 2014 will particularly focus on credit and market risk, the prudential areas of liquidity and leverage, as well as on recovery and resolution. The new regulatory environment is creating significant strategic challenges, forcing banks' business models and a range of activities to adjust given the new capital and liquidity levels. The numerous regulatory reforms still under way continue to be an issue of concern for investors and other market participants, well acknowledged in the RAQ responses, in particular in regard to the timing and respective contents. Given the concerns on the integrity of the single market it is fundamental to press ahead with structural and institutional reforms at European level.

In October 2013, the Council adopted regulations creating a Single Supervisory Mechanism (SSM), thus establishing one of the main elements of Europe's banking union. The SSM is composed of the European Central Bank (ECB) and the supervisory authorities of the Member States. It covers the euro area as well as non-euro area countries that choose to participate. It is envisaged that the ECB will assume its supervisory tasks 12 months after entry into force of the legislation, i.e. end-October 2014, subject to operational arrangements. The SSM, coupled with other measures to drive further integration such as bank resolution schemes, the European Stability Mechanism (ESM) and harmonised deposit guarantee scheme(s) will be instrumental in breaking the adverse bank-sovereign link and a major step in promoting the unity and integrity of the EU single market.

The SSM and the proposed Single Resolution Mechanism (SRM) will not encompass the whole European Union as a whole. More than two thirds of the banking groups headquartered in the euro area have significant market shares in other Member States. Out of the 43 large EU cross-border banking groups that are subject to the monitoring of the EBA, only five have business exclusively within the euro area. Thus, the EBA continues to strongly support colleges of supervisors as the proper forum for discussion and agreement on appropriate supervisory measures for cross-border banking groups. The EBA will have to play a new role in ensuring that the SSM and the other competent supervisory authorities in the EU develop common supervisory methodologies and practices, which can support closer cooperation in colleges of supervisors and the capacity to effectively anticipate and manage a crisis of a cross-border group.

At the same time, the EBA will continue pursuing its objectives in advancing towards an EU-wide Single Rulebook and promoting regulatory convergence across the Union, in both rules and practices. An EU-wide Single Rulebook envisages key technical rules to be adopted through EU regulations which are directly applicable in all 28 Member States and leave no room to national choices. The EBA is playing a key role in designing technical standards. The unity and integrity of the EU single market will thereby be achieved through the development of uniform rules in key areas - the Single Rulebook - and implemented with the convergence in supervisory practices within the EU as a whole.

# 3. Assets side

The quality of banks' loan portfolios continued to deteriorate throughout 2013 as suggested by the KRI and the responses to the RAQ.

As a direct result of the financial crisis, economic uncertainty and regulatory reform, banks are adapting to the new business environment. There is an ongoing reduction of balance sheets and loan books across the EU. However a number of European banks have not yet completed the cleanup of their balance sheets. The financial crisis has exposed weak business models and business lines, and the wave of global regulatory reform is considerably altering the risk return dynamics of numerous business lines going forward. There is still a need for adjustments in order to remove excess capacity and to restructure balance sheets, and to set the basis for a more stable and sound banking sector. As a result, it is still necessary to reduce further and strengthen European banks' balance sheets.

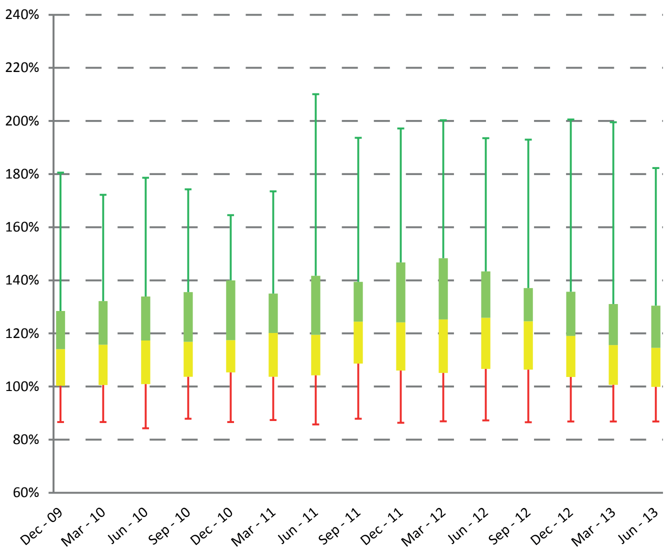
## De-risking

Deleveraging and de-risking are very important components for the strengthening of the EU banking sector. Completing the action of balance sheet repair in the banking sector, far from hampering growth is instead a precondition for kick-start lending into the real economy. Some indicators show that a downsizing of banks' balance sheets has started and continues to take place. Over the last six months, the debt-to-equity ratio decreased from 18.1 to 17.5, the loan-to-deposit ratio declined, and customer deposits over total liabilities increased. For the same period, the sum of total assets decreased by 3.5%, and further changes to banks' balance sheets are expected as business models adapt to a new environment. Deleveraging has mostly been achieved through run-off, rather than sales of assets, but there is some evidence of sales of portfolios and lines of businesses during 2013. Some evidence also suggests that banks do their utmost to frontload the adjustments that will result from the EU-wide asset quality review and the stress-test of 2014. In parallel, the loan-to-deposit ratio has shown a general downward trend in the last few semesters, indicating a steady reduction in the on-balance-sheet financial sector leverage to lower levels within the EU.

Not only has the weighted average of the loan-to-deposit ratio been decreasing since September 2011 (from 120% to 114% in June 2013), but so also have the 75th percentile (from 139% to 131% in June 2013). The 75th percentile declined to 131% in June 2013, and 18 percentage points less than its March 2012 maximum value). This trend is observed within the EU per size class, with different intensities across geographies (see figure 3).

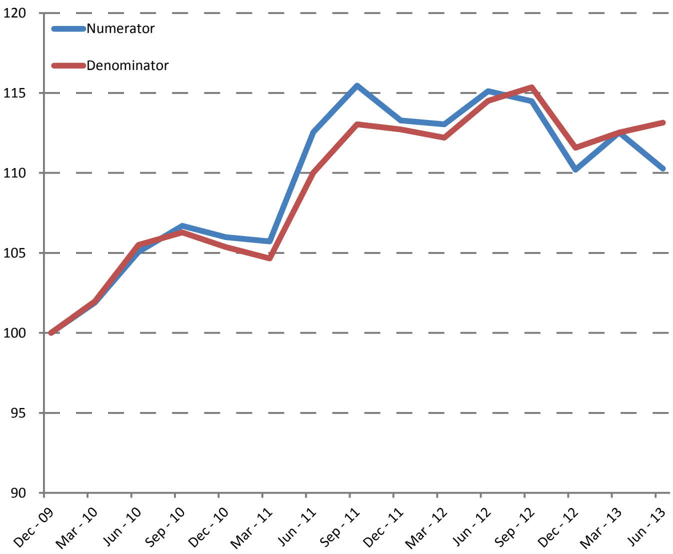
**Figure 3:** Loan-to-deposit (source: KRI) – 5th and 95th percentiles, interquartile range and median, and by size class – medians (as of June 2013)

**Dispersion**




5th and 95th pct, interquartile range and median.

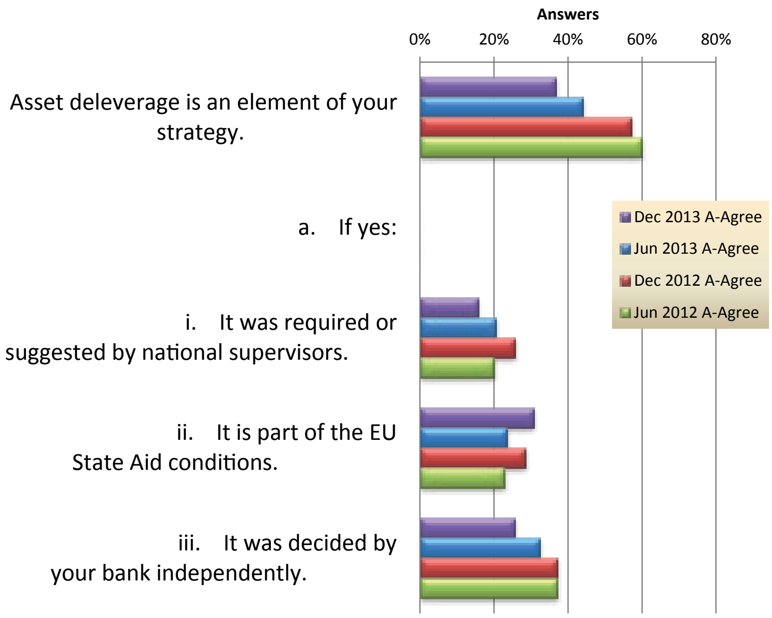
**Numerator and denominator: trends**




Total numerator and denominator. December 2009 = 100.

This trend also seems to be confirmed when looking at the outcome of the RAQ. While most of the RAQ respondents agree that the asset deleverage is an element of their strategy, however this majority is decreasing. The majority state that they were deleveraging for both 'private' drivers as described earlier, i.e. according to their own business strategy reasons, and for 'public' drivers according to official requirements as part of the EU State Aid conditions (see figure 4).

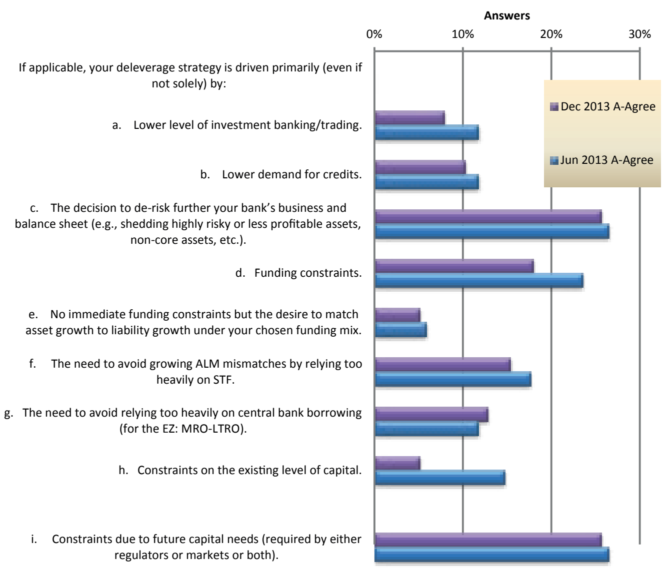
**Figure 4:** Deleverage (source: RAQ)

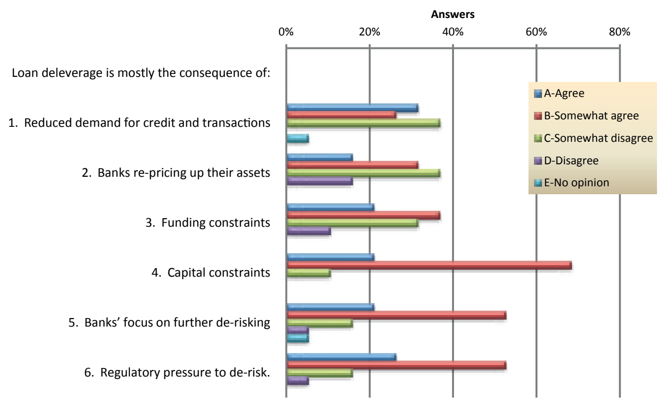



Most RAQ respondents continue to consider that their deleverage strategy is mainly driven by the decision to de-risk a bank's business and balance sheet, for instance, shedding highly risky or less profitable assets, followed by constraints due to future capital needs. Market analysts also agree that loan deleverage is mostly the consequence of capital constraints, bank's focus on further de-risking and regulatory pressure to de-risk (see figure 5).

When banks envisage achieving an asset reduction from the current level and over the next 24 months, the majority of RAQ respondents still indicate that the reduction will be below 2% of total assets. However, the num-

**Figure 5:** Deleverage drivers (source: RAQ and RAQ market analysts)



ber of answers that refer between 4% and 6% reduction of total assets increased significantly in the last semester of 2013. Market analysts also agree that the asset deleverage will continue in the next 12 months despite an improved funding and market climate. The areas for deleveraging are mostly expected to be in investment banking, trading and cross-border wholesale assets (see figure 6).

## Asset quality

The quality of banks' loan portfolios continued to decline in 2013. The deterioration in asset quality is spread across the EU; however, the declining intensity continues to vary considerably across portfolios and geographies. The asset quality and the coverage ratios remain a concern, as signalled in the 2013 July Risk Assessment Report, harmfully contributing to the existing elevated risk premium levels on European banks.

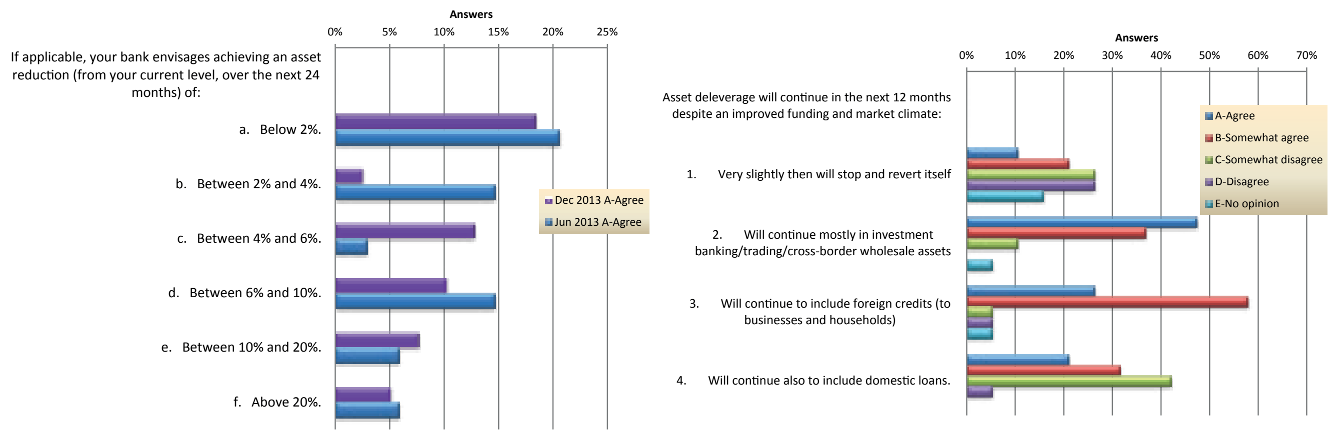
According to the KRI, loans in arrears, and impaired assets in particular, continue to increase, confirming that asset quality is still declining. At the same time, in some cases provisioning has not increased in conformity with rising credit risks. Whilst the weighted average of the coverage ratio has been slowly increasing since December 2011, an increasing dispersion is being observed and translated into more banks and respective assets with a coverage ratio of less than 25%. The mixed picture in terms of coverage ratio is confirmed when looking at data from the second semester of 2013, which continues to raise several questions about the extent to which provisioning is adequate and about the capacity of some banks to cope with rising credit risks. A composition effect by refocusing on some activities or improvements in credit risk management might partly explain a reduction in the coverage ratios (e.g. mortgage lending instead of commercial lending, more guarantees). However, whereas it is known that mortgage portfolios have generally recognised lower losses, the average provisioning levels for exposures to real estate continues to raise some concerns.

The RAQ respondents also expect the level of non-performing loans to remain high. The market analysts' expectation is that asset quality will stabilise or improve in the next 12 months, though continuing to believe that banks in general maintain insufficient loan-loss coverage. The increase in the level of impairment provisioning may pose challenges to the maintenance of adequate capital levels in some cases, and may also adversely affect already subdued earnings.

Furthermore, significant market uncertainties are created by different national approaches as well as banks' widely differing practices at EU level to address asset quality concerns and debt forbearance. The lack of comparability of asset quality across EU banks causes an additional challenge in Europe due to different definitions of key aggregates, as for instance the definition of non-performing loans.

Impaired loans continue to show an increasing trend. The ratio of impaired and past due (> 90 days) loans to total loans increased from 6.4% in December 2012 to 6.7% in June 2013 (6% in June 2012, and the highest since 2009). The median increased again in June 2013, after a significant decrease in December 2012. The 75th percentile continues to present high levels of approximately 15%, which is well above historical levels for this

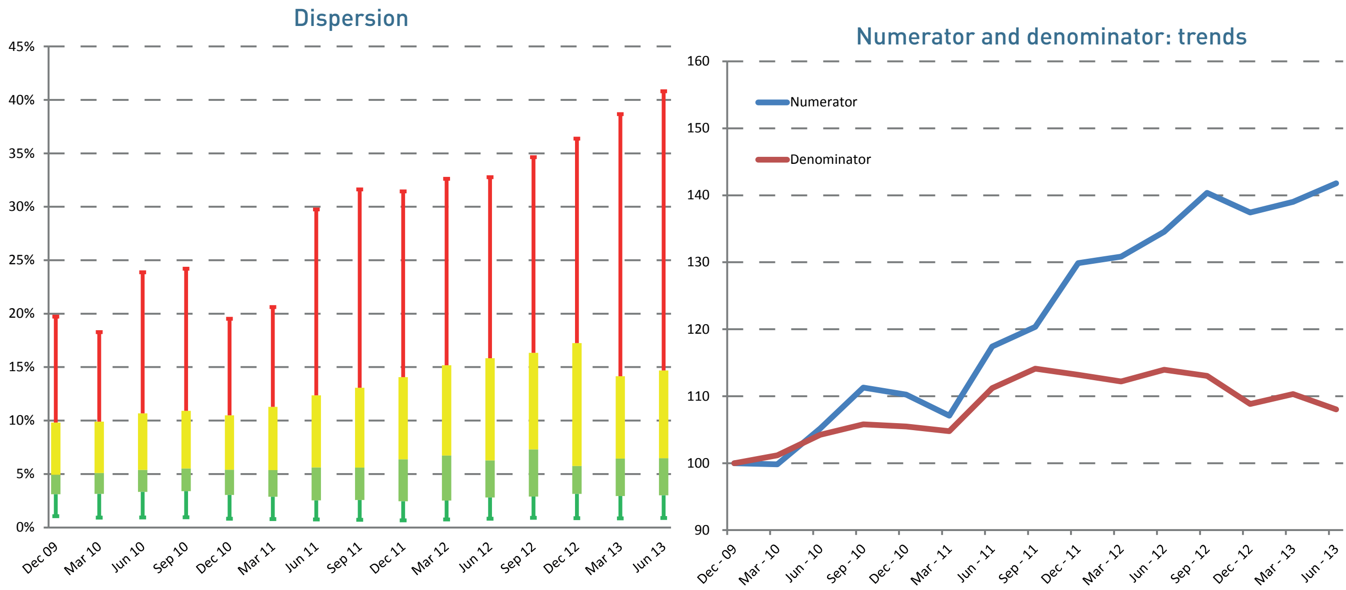
**Figure 6:** Deleverage drivers (source: RAQ and RAQ market analysts)



ratio. However, this is also influenced by the decrease in the denominator. The dispersion also continues to be significant, achieving the highest level since 2009 (see figure 7).

Banks with a ratio of more than 10% represented 14% of total assets in June 2013 (from approximately 12% and 12.7% in June 2012 and December 2012, respectively).

**Figure 7:** Impaired loans and past due (>90 days) loans to total loans (source: KRI) – 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (Dec 2009 = 100)

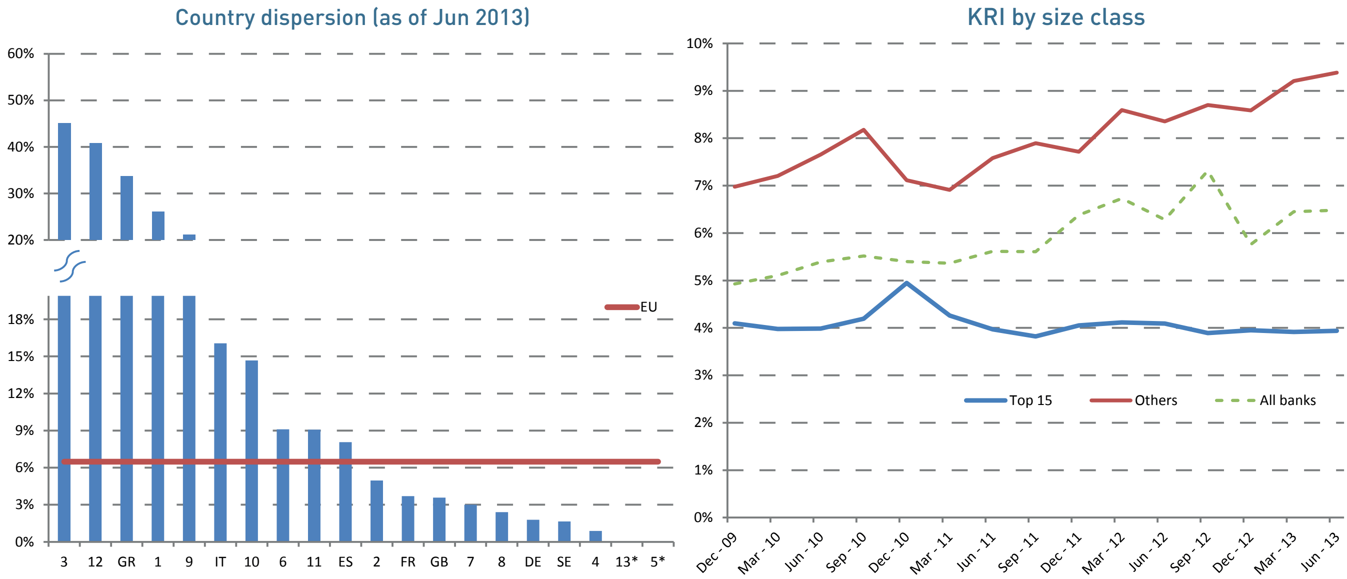



5th and 95th pct, interquartile range and median.

Total numerator and denominator. December 2009 = 100.

Impairments continued to increase particularly in banks in financially stressed countries. Real estate portfolios have been particularly affected and continue to deserve particular attention. Banks from five countries have median values of impaired loans and past due loans to total loans of more than 20% (see figure 8).

**Figure 8:** Impaired loans and past due (>90 days) loans to total loans (source: KRI) – country dispersion – medians by country and by size class (as of Jun 2013)

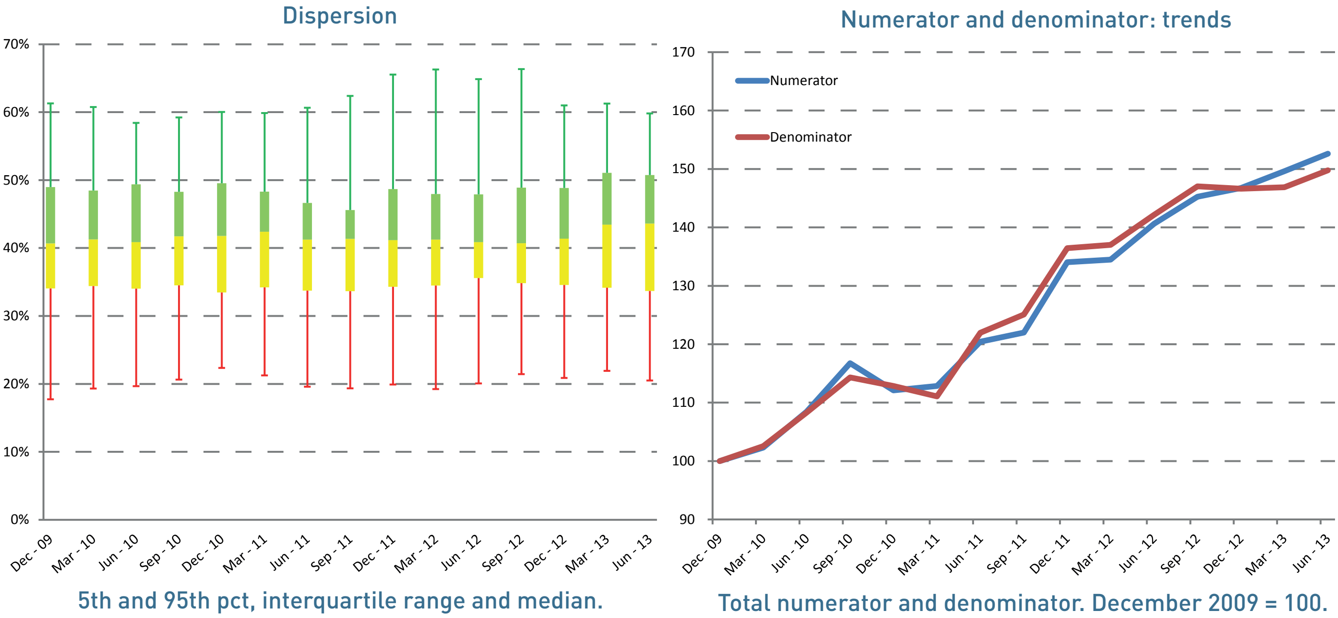



( * ) Not reported. Medians by country. The name of the country is disclosed if reporting institutions are more than 3.

Banks are classified in the size class according to the their average total assets between Dec. 2009 and Jun 2013

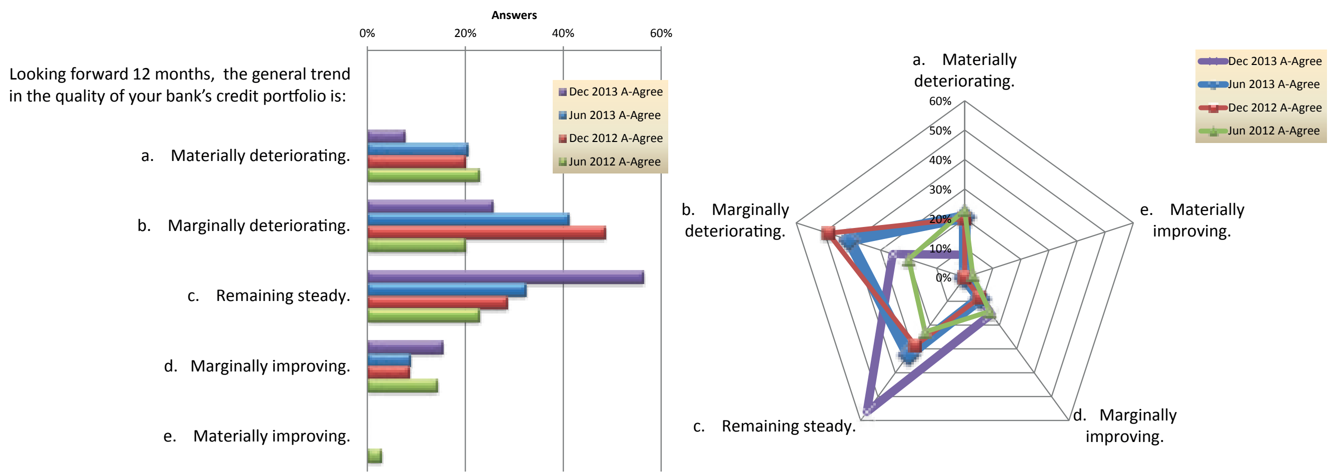
In regard to the coverage ratio (see figure 9), whereas the weighted average has been increasing since December 2011 and shows one of the highest levels since 2009 (42.8%), the 25th percentile continues to slowly decrease since June 2012 (from 35.6% to 33.7% in June 2013). The share of banks with a coverage ratio of less than 25% increased and represented 14% of total KRI sample assets in June 2013 (from 13.1% in December 2012, and the highest value since December 2009). Similarly, the share of banks with a coverage ratio higher than 50% also significantly increased and represented 37% of total assets in June 2013 (from approximately 24% in June 2012 and 29% in December 2013). The general trend is not clear, but it seems that some banks are diverging from the majority and presenting lower coverage ratios.

**Figure 9:** Coverage ratio (specific allowances for loans to total gross loans; source: KRI) – 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (Dec 2009 = 100)




Looking ahead 12 months, responses to the RAQ indicate expectations of lower marginal deterioration in asset quality in comparison to previous semesters (see figure 10). In fact, currently there are more responses indicating that the general trend in the quality of banks' credit portfolios is remaining steady (55% in December 2013 against 32% in June 2013 and only 23% in June 2012). At the same time, there is a strong increase in responses indicating that the general trend is marginally improving (an increase from 9% in June 2013 to 16% in December 2013). In addition, the responses regarding the trends in credit quality and impairment levels over the period of the next 12 to 18

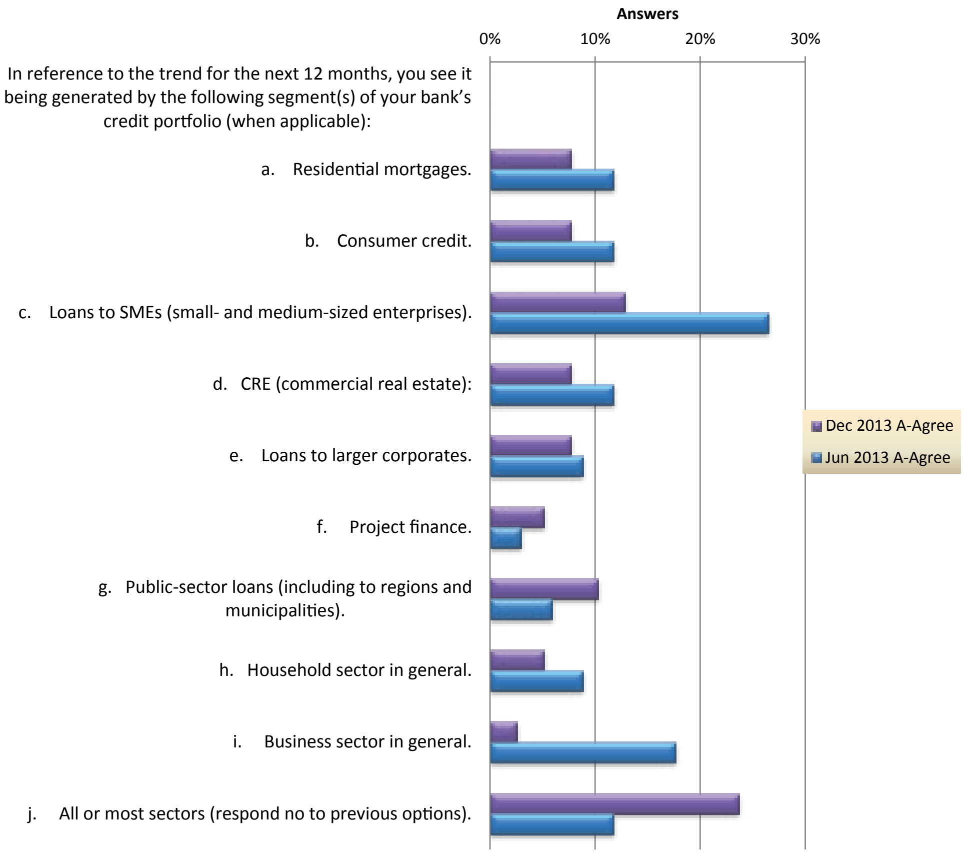
**Figure 10:** Quality of loan portfolios (source: RAQ)



months show expectations that the impairment provisions will remain at roughly the same level.

Nevertheless, further reflecting on the expectations of asset quality concerns for the next 12 months (see figure 11), the large majority of the RAQ respondents continue

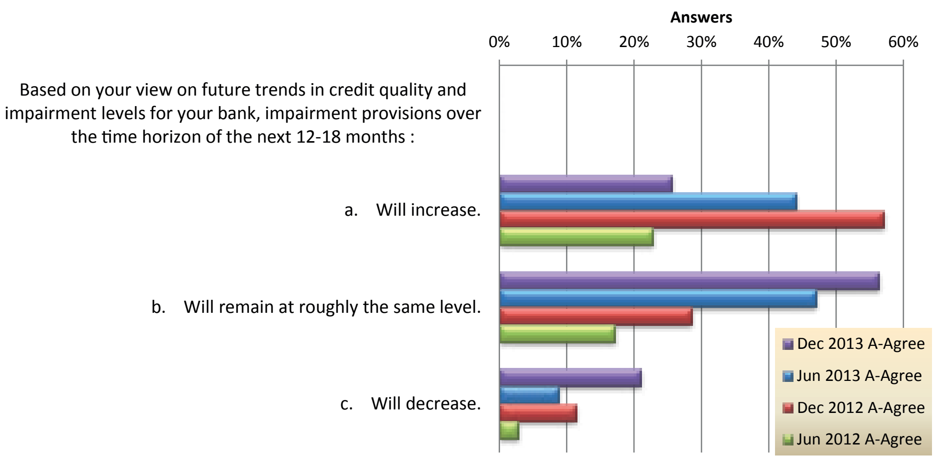
Figure 11: Drivers of asset quality trend (source: RAQ)




to state that the poor quality of loan portfolios is being generated by the same segments, in particular in SME lending portfolios, residential mortgages and commercial mortgages, consumer credit, loans to larger corporates and public sector loans (including to regions and municipalities).

Most of the RAQ respondents stated that the impairment provisions over the time horizon of the next 12–18 months will remain at roughly the same level. Some RAQ respondents, despite being less numerous, still believe that the impairment provisions will increase (see figure 12).

Figure 12: Expectations for impairments (source: RAQ)



The majority of the RAQ respondents continue to state that the overall composition of loan portfolios is relatively well balanced, with no material sector or exposure concentration. From both the RAQ for banks and the RAQ for analysts, the trends in impaired loans continue to be driven primarily by SME loans, some particular sub-sectors such as shipping loans, mortgages and loans to real estate developers, and would occur primarily in specific geographies (see figure 13).

Moreover, the majority of the RAQ respondents continued to step up their efforts to monitor institutions' asset quality, and this process appears to have achieved its final objectives. There was a reduction in the percentage of RAQ respondents who agreed that they have introduced or strengthened regular reviews of different loan portfolios conducted to assess their current quality. There was also a reduction in the percentage of RAQ respondents who agreed they have introduced or strengthened reviews of existing policies for arrears management (see figure 14).

**Figure 13:** Drivers of impaired loans trends (source: RAQ and RAQ market analysts)

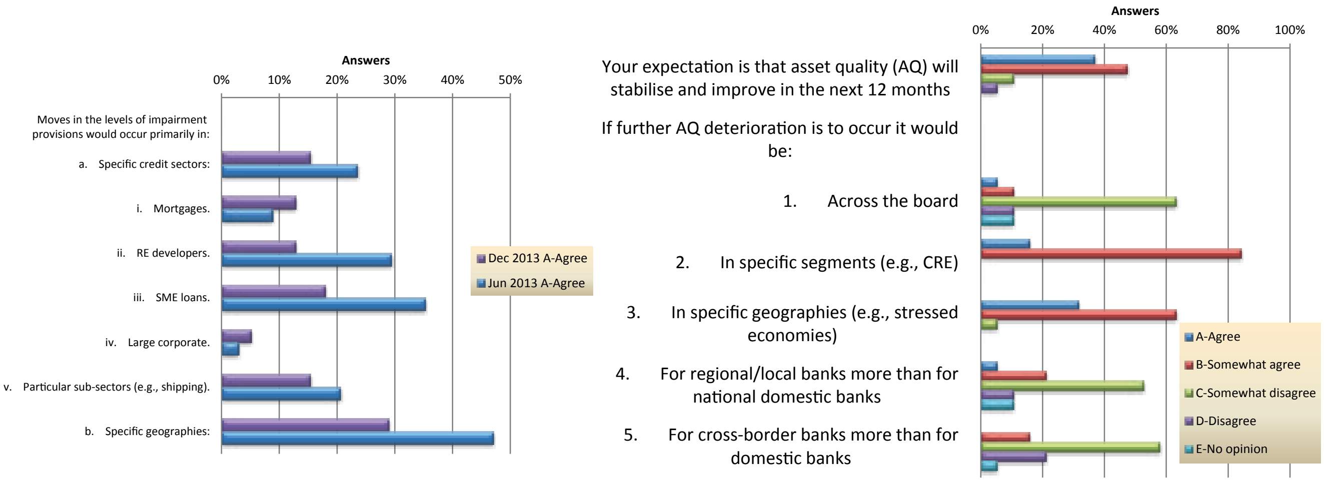
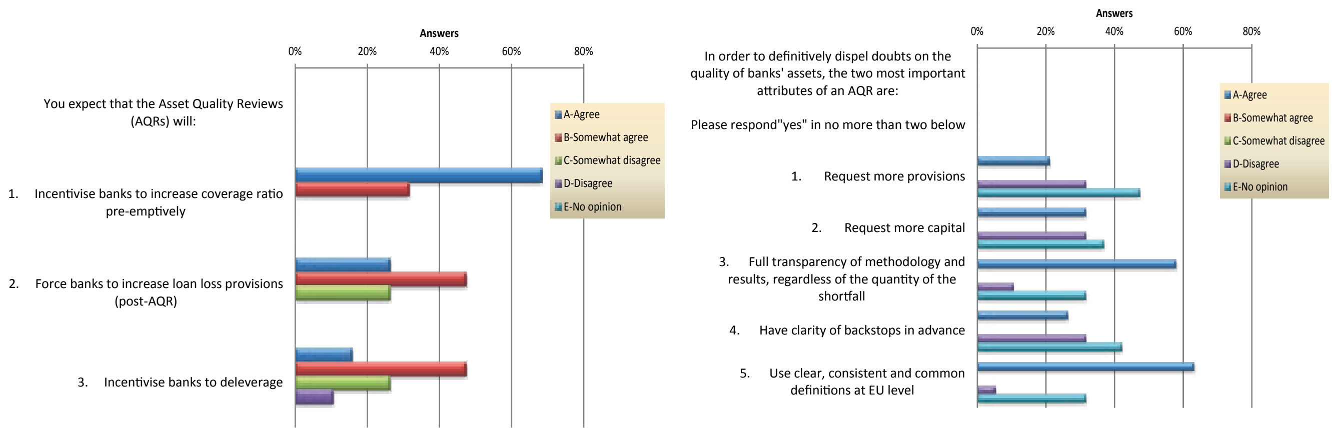
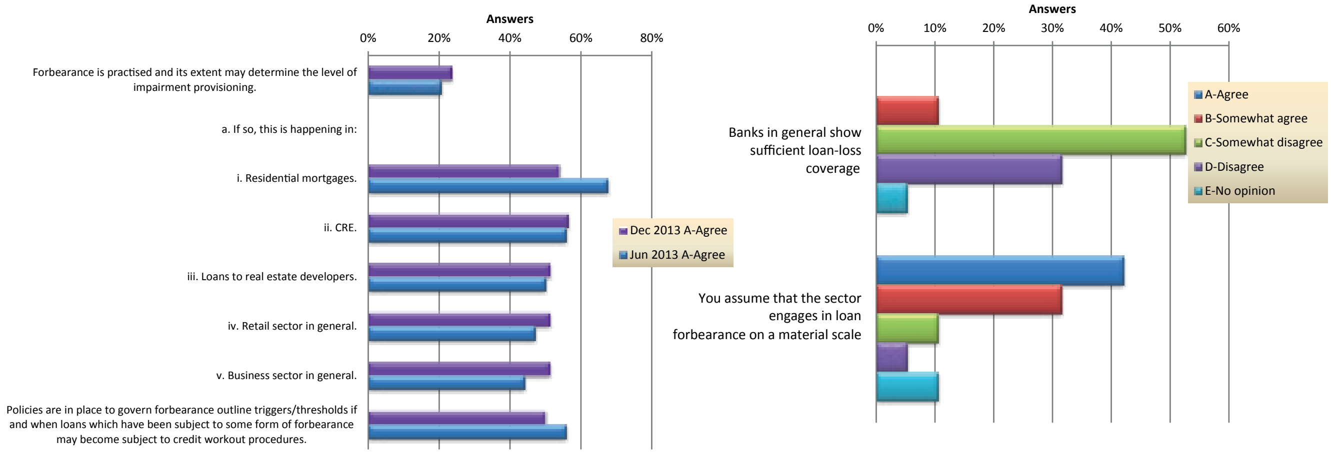



**Figure 14:** Asset quality reviews (source: RAQ market analysts)



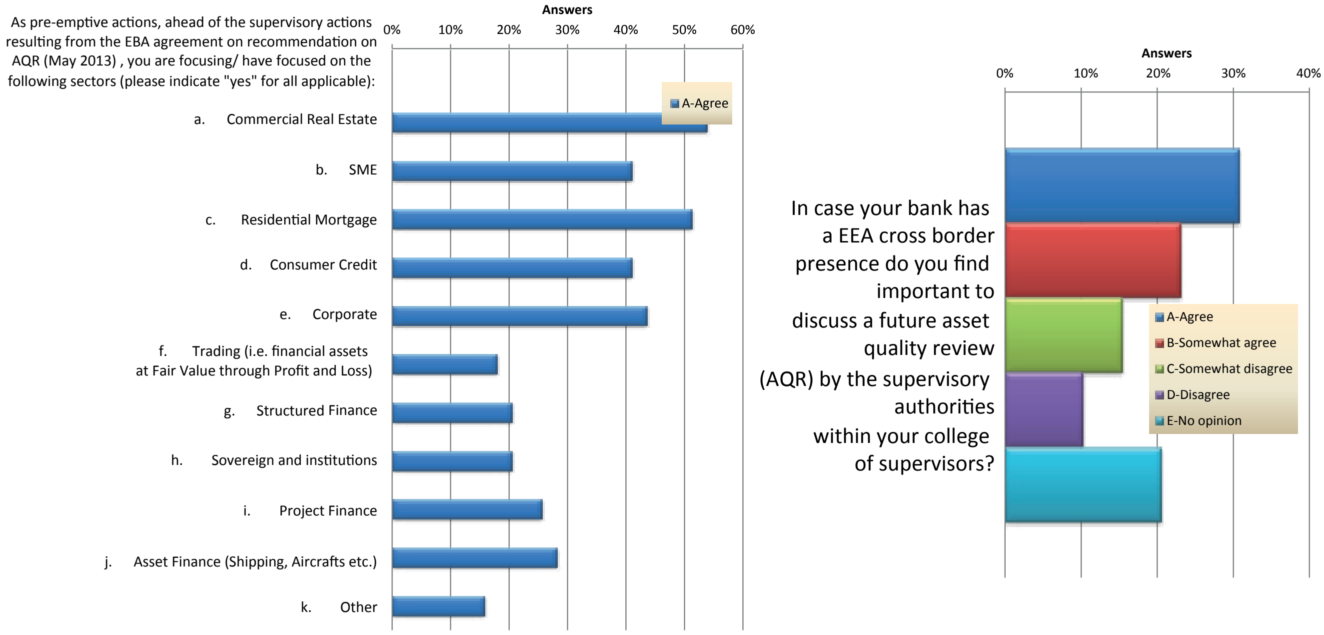
Regarding forbearance issues (see figure 15), the majority of the RAQ respondents agreed (e.g. somewhat agree represents 39% of the answers) that forbearance is practised and its extent may influence the level of impairment provisioning. Market analysts also agree that the sector is engaging in loan forbearance on a material scale, and would like to have a better view of asset quality. According to market analysts' views, the AQR is giving banks incentives to increase the coverage ratio pre-emptively, and they somewhat agree that it is also incentivising banks to deleverage.

**Figure 15:** Forbearance practices (source: RAQ and RAQ market analysts)




As pre-emptive actions ahead of the supervisory actions resulting from the EBA recommendation on AQR the majority of the RAQ respondents agreed that in their reviews they are focusing on quantitative assessment of provisions, collateralisation and the values of exposures. Moreover, the majority of the RAQ respondents state that they have focused on commercial real estate loans, residential mortgage loans and corporate loans (see figure 16). In this context, the most important activities are

**Figure 16:** EBA recommendation on AQR and pre-emptive actions (source: RAQ)



the review of provisioning and risk coverage, quantitative portfolio analysis, data integrity analysis, the review of collateral management and assessment practices, as well as the review of non-performing loans (NPL) and arrears management practices. Furthermore, the majority of the RAQ respondents agreed that in case their banks have an EEA cross border presence they find it important to discuss the AQR with the supervisory authorities within the respective college of supervisors.

Finally, market analysts point out that the most important attributes of the AQR for definitively dispelling any doubts on the quality of banks' assets are the full transparency of methodology and results, regardless of the quantity of the shortfall, as well as the use of clear, consistent and common definitions at EU level.

## Policy implications and possible measures

There is a need to have a clear picture of the quality of European banks' assets in order to dispel remaining concerns and reassure potential investors about the robustness of the EU financial system. There are still concerns being raised on the adequacy of asset values reported by EU banks, essentially challenging the impairment recognition and in turn implying that corrections of asset values on European banks' balance-sheets have not yet taken place to the necessary extent.

In October 2013, the EBA issued recommendations to competent authorities for their existing and/or planned work on asset quality reviews (AQRs)([1]) across the European Union, including the work of the Single Supervisory Mechanism (SSM) and its balance sheet assessment. The aim of these recommendations was to contribute to a coordinated approach in the way in which competent authorities evaluate banks' credit portfolios. The EU-wide AQR could be an important catalyst for addressing uncertainties surrounding EU banks' asset quality in the current context and will support ongoing and future monitoring of levels and changes in asset quality. The competent authorities should complete their respective AQRs during the first semester of 2014 and report to the EBA, in due time, the preliminary outcomes to ensure that they can be taken into account and support the next EU-wide stress test.

At EU level there are differences in loan classifications (e.g. performing loans, non-performing loans (NPLs), 'doubtful' loans and 'watch list'). There are also differences in the way in which forbearance is defined, assessed, classified and reported. Thus, for the purpose of the AQR, the EBA recommends([2]) that competent authorities to apply, to the extent possible, the common definitions on 'non-performing exposures' and 'debt forbearance' published in October 2013. The standards on Non-Performing Exposures and Forbearance provide common definitions and reporting templates to allow supervisors to assess the level of forbearance activities and non-performing loans on a comparable basis across the EU. The proposed definitions of non-performing and forbearance exposures rely on the existing concepts of default and impairment, but provide for specific harmonisation features. These definitions apply to all loans and debt securities that are on balance sheets, except for those held for trading, as well as to some off-balance sheet exposures. The proposed common definitions are seen by bank investors and the wider market as fundamental for the credibility of the AQR. The final standards will be sent to the European Commission to be adopted as EU regulations that will be directly applicable throughout the EU.

Importantly, in order to ensure transparency and comparability over the years, appropriate disclosure on the actual exposures of the EU banking sector is also a fundamental measure. The EBA decided to provide updated disclosures to fill in information gaps after the 2011 stress test exercise and the 2012 Recapitalisation details.

([1]) EBA recommends supervisors to conduct asset quality reviews

http://www.eba.europa.eu/documents/10180/449802/EBA-Rec-201304+Recommendations+on+asset+quality+reviews.pdf

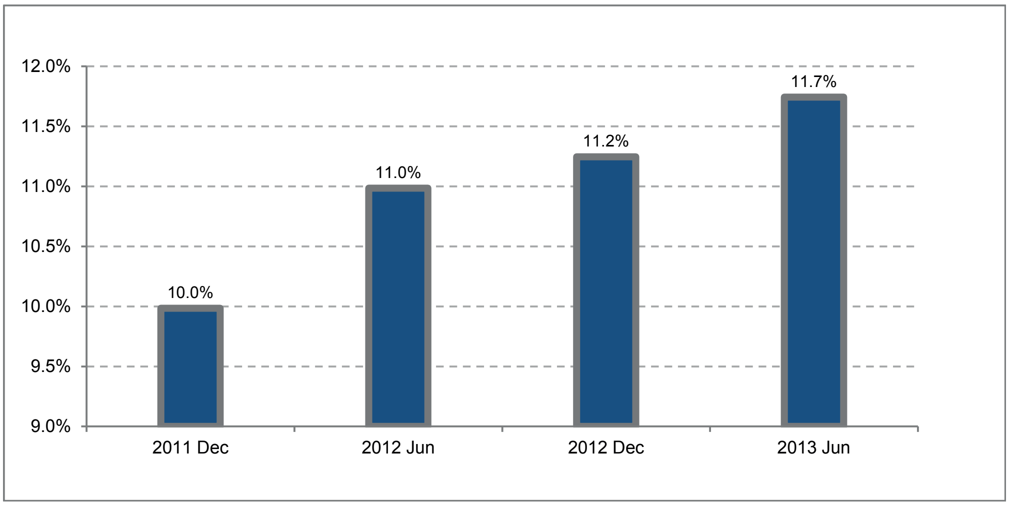
([2]) EBA publishes final draft technical standards on NPLs and Forbearance reporting requirements

http://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-npls-and-forbearance-reporting-requirements

# 4. Capital

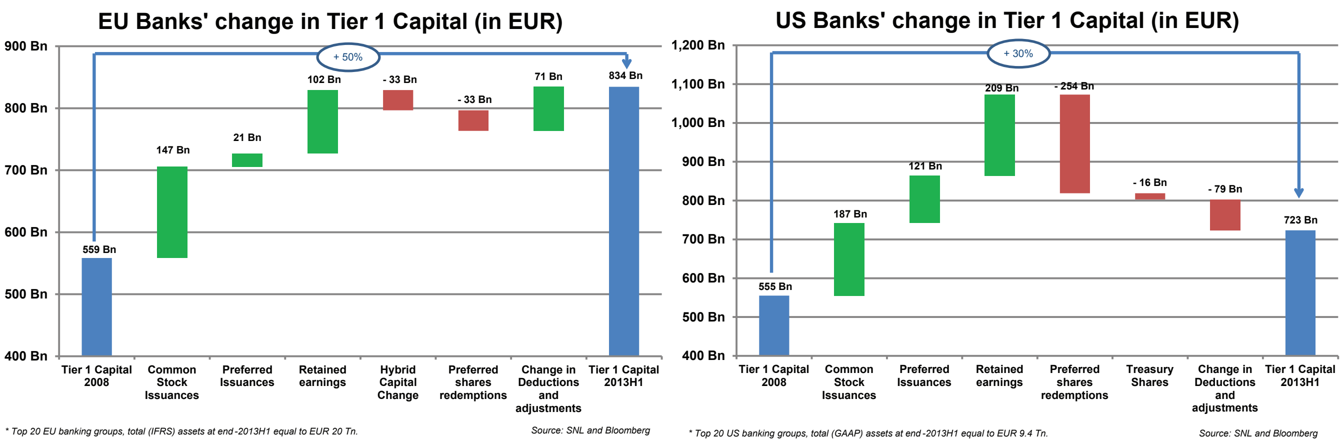
Over the course of 2013, EU banks' capital positions have continued to maintain an important increasing trend. In particular, over the first half of 2013, notwithstanding challenging conditions in financial markets, the banks' capital position has strengthened (see figure 17). This evolution is the result of the EBA recapitalisation exercise as well as the national efforts progressing towards strong capital buffers, leading to substantial infusions of capital into European banks. Following the EBA's recapitalisation exercise, completed in 2012, the weighted average Tier 1 ratio excluding hybrid instruments for the largest European banks stood at 11.1% at June 2013, in line with major international peers. Data also reveals that the EBA's recapitalisation exercise has triggered capital increases despite some reductions in risk weighted assets (RWAs).

**Figure 17:** Core Tier 1 ratio after the EBA's 2011 Recommendation



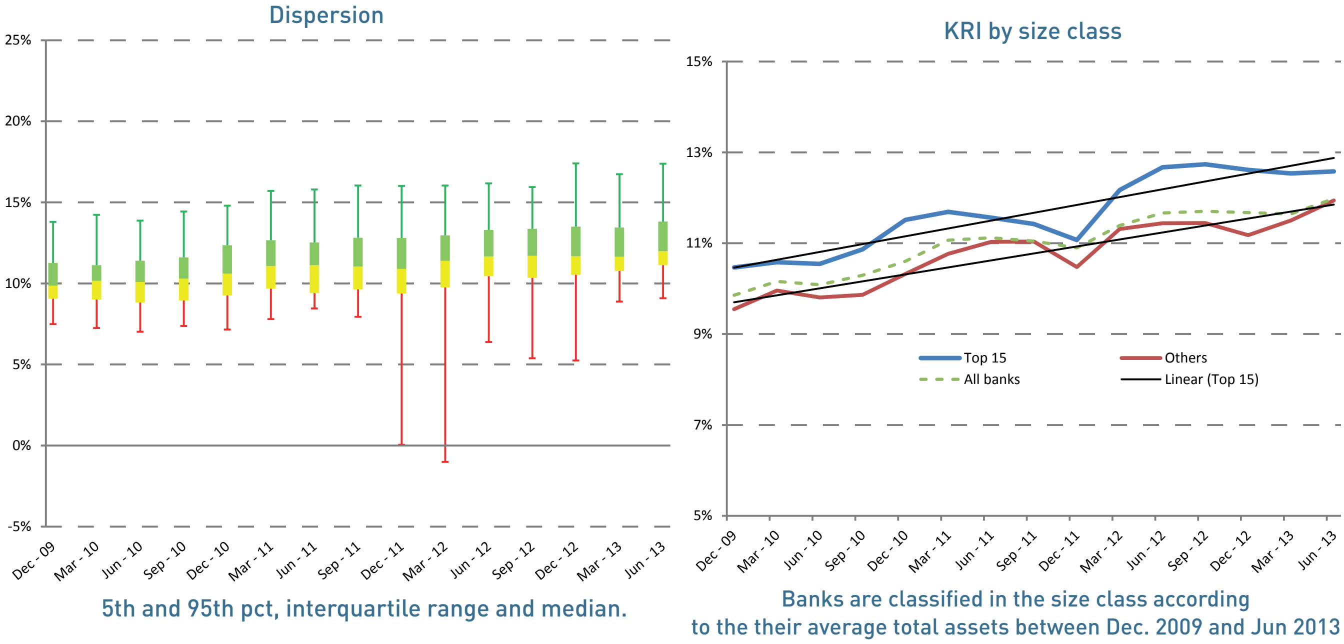

Thanks to the progress made in the last few years, EU banks' capital positions are on a comparable basis to those of US banks. The largest 20 banks in the US and in the EU had approximately the same absolute amount of Tier 1 capital at the end of 2008, and the EU banks have increased capital more than their transatlantic competitors (see figure 18). It should be noted that US banks have issued more fresh equity and retained earnings to a larger extent, but also conducted significantly more buy-backs.

**Figure 18:** Top-20 EU banks' change and Top-20 US banks' change in Tier 1 Capital (in EUR) (source: SNL, Bloomberg)



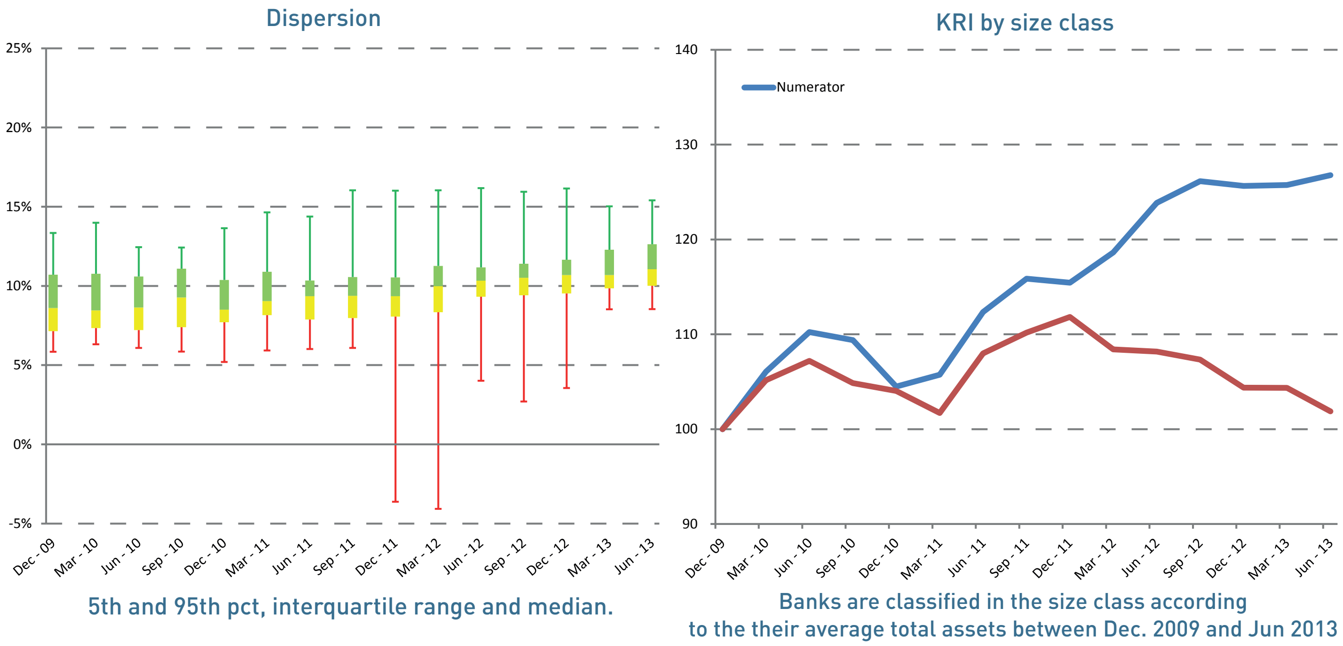
The KRI confirm this positive evolution (see figure 19). Throughout the past two years, capital positions have improved significantly. The Tier 1 ratio rose by more than 1 percentage point to 12.6%. In the first semester of 2013, the median Tier 1 ratio increased by 30 basis points (from 11.7% to 12%), after an increase of almost 1 percentage point, from 10.9% to 11.7% in the previous year. Banks with Tier 1 ratio lower than 9% decreased and represented only 0.2% of total assets in June 2013 (from around 2% in December 2012). The share reduction of banks' total assets with a Tier 1 ratio above 12% from 71% to 58% is mainly explained by a few banks which in the first quarter of 2013 recorded a relevant reduction of Tier 1 capital due to a change in accounting/regulatory treatment of some items. The positive evolution of the Tier 1 ratio and the respective trend is also confirmed by the size class of banks, i.e. top 15 banks, in terms of total assets, and the remaining banks of the KRI sample.

**Figure 19:** Tier 1 ratio (source: KRI) – 5th and 95th percentiles, interquartile range and median, and by size class (medians)



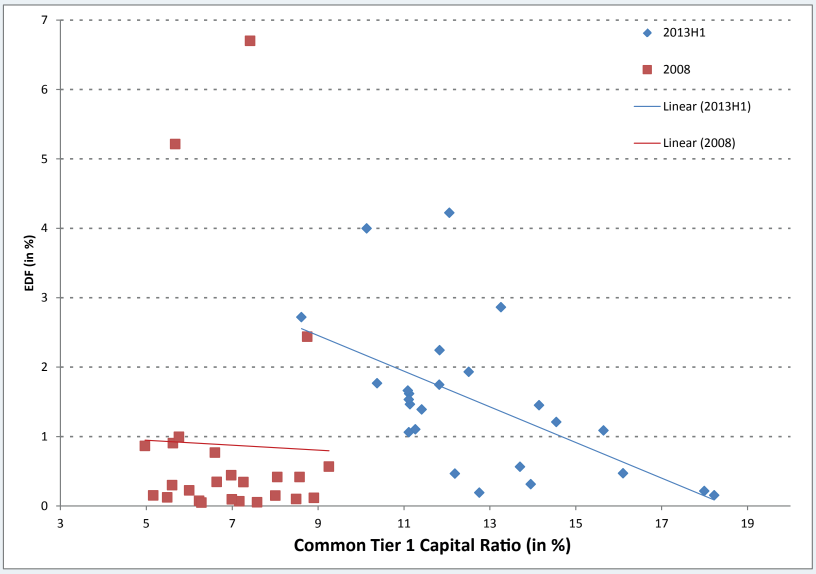

This positive trend is also confirmed when looking at the median of Tier 1 ratio excluding hybrid instruments (a rough proxy of the Core Tier 1 ratio (CT1)), which increased from 10.7% to 11.1% (see figure 20). At the same time, banks with Tier 1

**Figure 20:** Tier 1 ratio (excl. hybrid instruments) (source: KRI) – 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (Dec 2009 = 100)



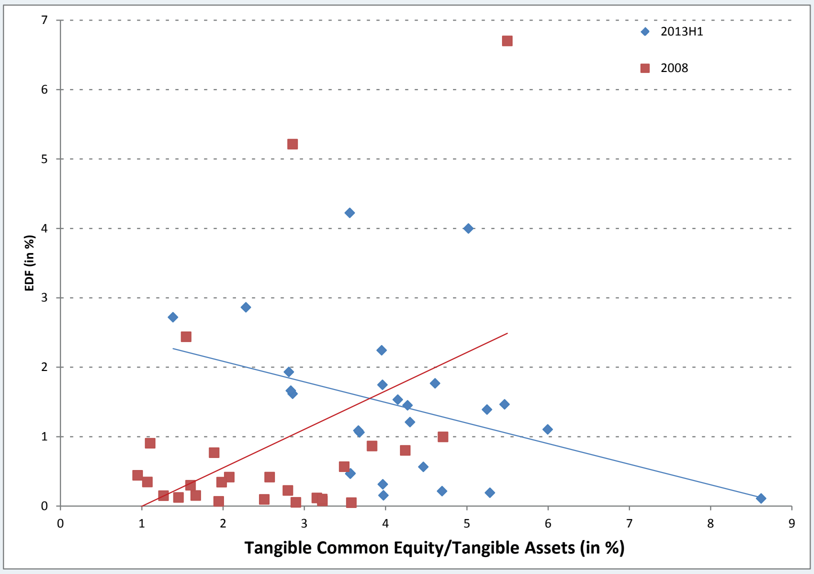
## CAPITAL RATIOS – MARKET PERCEPTIONS

The relation between the Common Tier 1 Capital Ratio and the Expected Default Frequency (EDF, Moody's KMV) is negative as expected, i.e. higher levels of supervisory capital allows for lower expected defaults. However, the importance of the supervisory capital levels in relation to the expected default frequencies has changed in the last few years. For a sample of listed 25 KRI banks, a comparison between 2008 and 2013 is presented.




The data are based on both bank expected default frequencies (EDF) calculated by Moody's KMV feeding observed asset prices and volatilities into a modified Black–Sholes–Merton formula (see Crosbie and Bohn, 2003 for details) and Common Tier 1 Capital Ratio from Moody's KMV (for European banks, this excludes transitional capital adjustments when available). .

In 2008, the Common Tier 1 Capital Ratio was shown as a much less important indicator for explaining banks' credit quality, i.e. the banks' EDFs were similar even when considering significant different banks' capital levels. Interestingly, during the last few years the relation between these two indicators has changed significantly. In 2013, supervisory capital levels are more important than before for explaining banks' credit quality. Among many reasons, this may reflect market participants' preference for well capitalised banks as safer investments. In addition, the same banks present better capitalisation levels (as also shown through the KRI) and higher dispersion at both the supervisory capital and EDF levels. The same change has occurred when comparing the ratio of tangible common equity to tangible assets with the EDFs for the same listed 25 KRI banks.




The ratio of tangible common equity to tangible assets can be considered to be a proxy for the leverage ratio. Most of the KRI banks are above the 3% ratio, and when lower than the 3% ratio their EDF are in the upper EDF quartile.

ratio excluding hybrid instruments higher than 10% increased and represented 76% of total assets in June 2013 (from 72.8% in June 2012). The dispersion of capital indicators continues to decrease markedly, suggesting that banks in the sample are converging towards a more conservative solvency base. The Tier 1 ratio excluding hybrid instruments is now above 11% and EU banks have approximately EUR 180 billion available as loss absorbing capacity in excess of a 9%.

In the case where the capital adequacy is assessed according to the fully loaded Basel 3 standards, which are supposed to be in place only in 2019, the core tier ratio of the largest EU banks drops to 8.4%, displaying a shortfall of around EUR 70 billion([3]). This shortfall looks largely manageable, as it is just slightly in excess of the profits realised by the same banks in 2012. In reference to the structure of banks' balance sheets, the leverage ratio is close to the regulatory benchmark of 3% and comparable to international peers if similar accounting metrics are considered.

While capital positions are stronger than in the past, there is no room for complacency. It is expected that the level of non-performing loans will continue to require increasing impairment provisioning, in line with deteriorating asset quality. In some cases, this may pose challenges to the maintenance of adequate capital levels.

([3]) Fourth report of the Basel III monitoring exercise on the European banking system:

http://www.eba.europa.eu/-/eba-publishes-results-of-the-basel-iii-monitoring-exercise-as-of-end-2012

# 5. Liabilities side

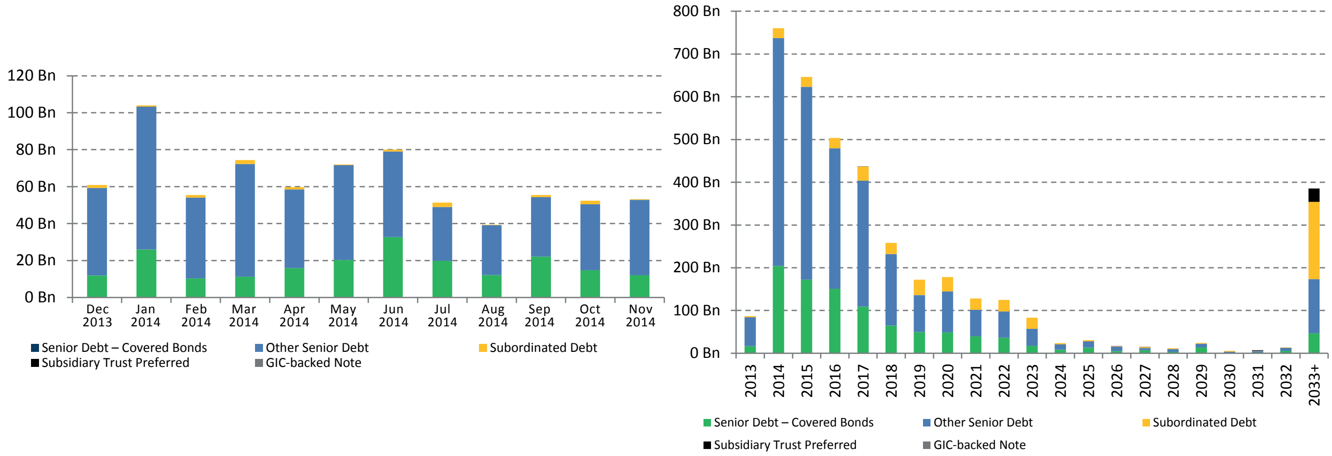
The funding conditions continued the improving trend observed since the second semester of 2012, with some consistent bank issuance of unsecured debt, predominantly at the beginning of 2013. Market funding is slowly replacing early repayments of the two three-year refinancing operations (long-term refinancing operations (LTRO)) provided by the ECB, and thus decreasing reliance on official sources of funding, though in small size and with a recent deceleration of the LTRO repayments pace and possible signs of a division between stronger and weaker institutions. Across Europe a stabilisation of Target 2 balances has developed over the past few months, and a continuous evidence of deposit inflows from both retail and corporate customers was observed, including into banks domiciled in financially stressed sovereigns. At the same time, the average cost of equity of banks in the EU has decreased and there is a continuation of a compression in bank equity prices when comparing banks from non-financially stressed countries and financially stressed countries.

Despite improved funding conditions, financial markets remain in an overall fragile state and continue not to reflect an enhancement in the fundamentals. Improvements are mainly due to decisive policy measures adopted since the sovereign and bank funding crisis. These policy measures and central banks' engagement in unconventional policies to support macroeconomic stability and bank funding have improved market sentiment, reduced the perceived equity risk premium and helped ease funding pressures. However, fundamental fragilities and continued structural funding challenges remain, in particular in countries having experienced some sovereign stress.

## Funding

Market funding conditions have been relatively benign during 2013. The pricing of both short-term and long-term funding has significantly improved in comparison to one year ago. Large banks, including highly rated banks domiciled in financially stressed sovereigns, have been issuing unsecured debt, particularly in the first quarter of the year, and European banks have significantly improved their liquidity positions and already maintain an average Liquidity Coverage Ratio above the 100% minimum requirement that will be in force only in 2019. Nonetheless, the absence of fundamental improvements is demonstrated by the significant negative reaction of the financial markets throughout the months of May and June 2013 to suggestions of tightening of the liquidity programmes of the major central banks. For instance, USD funding represents a significant proportion of the European banks' overall funding. Moreover, European banks continue to be negative net issuers, with a decreasing net issuance trend for both senior unsecured bonds and covered bonds, which primarily account for changing funding structures and ongoing bank deleveraging rather than for adverse funding conditions. Overall, refinancing rates in 2012 were low, started strong in the beginning of 2013 and have slowly declined since then (see figure 21). For covered bonds, data for 2014 and beyond may not be different, given further substantial covered bond redemptions.

**Figure 21:** Bonds - Aggregated Debt Maturity Profile – 20 year breakout and Next 12-Month Breakout in EUR million (source: SNL)



Reduced covered bond issuance has been driven by deposit growth, robust liquidity buffers, and the deleveraging process. The efforts to use funding alternatives and shrinking residential mortgage lending in most EU countries are also reasons for the reduced covered bond issuance. In parallel, the spreads on new issues of senior unsecured bonds and covered bonds remain dispersed with banks domiciled in financially stressed sovereigns still facing significant higher spreads in comparison to their counterparts in 'core' EU regions. There is persistent evidence of differences in funding conditions and funding costs between banks domiciled in highly rated sovereigns and those domiciled in financially stressed sovereigns. Even some large banks from highly rated countries are also part of the negative outliers.

Overall, the sovereign-bank linkage seems to persist, despite the deposit flows stabilisation in financially stressed countries as well as decreasing Target 2 imbalances and all the efforts developed so far to loosen this linkage (see figure 22). Spreads within the EU have been widening, including divergent rates to corporate with comparable risk profiles. The RAQ respondents also confirm the sovereign-bank linkage with a relatively strong correlation in market sentiment on their banks and their respective home countries' sovereign debt (see figure

**Figure 22:** Evidences of fragmentation of the EU single market (source: BIS)

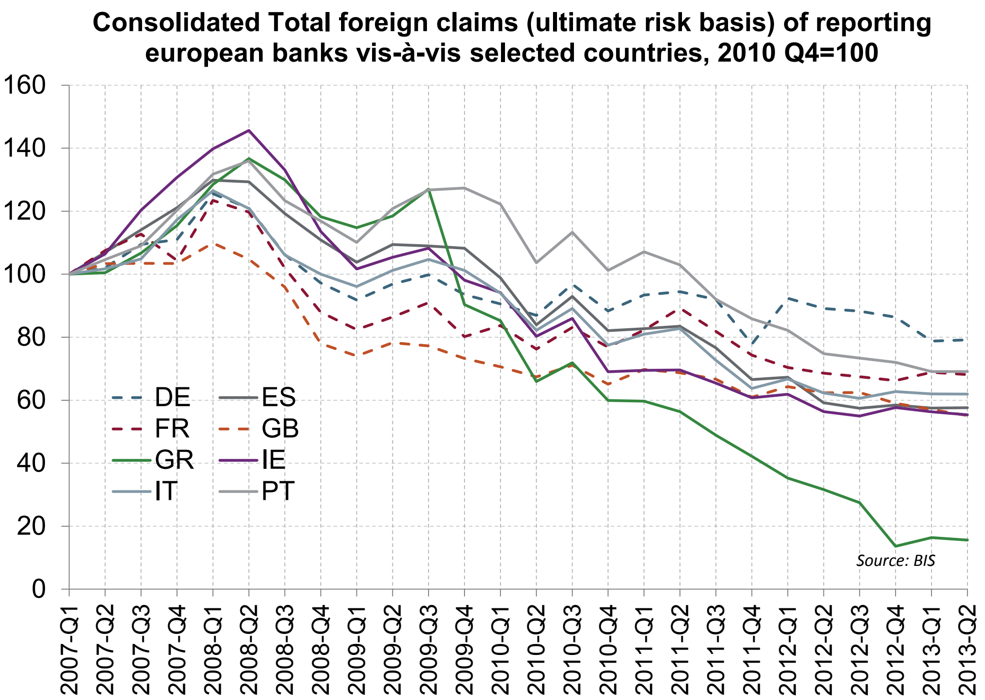
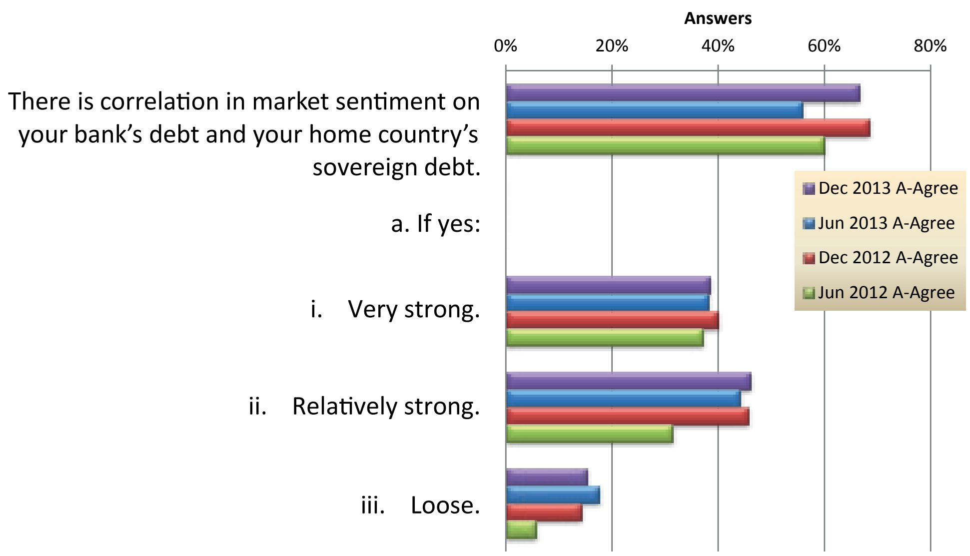



**Figure 23:** Evidence of sovereign-bank linkage (source: RAQ)



23). In addition, smaller banks are facing relatively higher funding costs, cross-border lending continues to fall, and cross-border interbank markets continue to be subdued and fragile in many jurisdictions, thereby contributing, among other reasons, to a continuing dependency of some banks on the central banks' liquidity providing operations.

Looking ahead, based on the RAQ answers, banks continue to expect unsecured debt to become again a significant source of funding. This is paving the way to reducing concerns regarding the levels of encumbered assets, i.e. assets earmarked as collateral for specific secured funding. Nevertheless, several banks remain dependent on central bank support, and future withdrawals of public funding sources continue to be a challenge for most of them. With regard to deposits, their importance for bank funding continues to increase. However, some behavioural changes may be expected for deposits not covered by deposit guarantee schemes, and for this reason heightened supervisory attention is necessary.

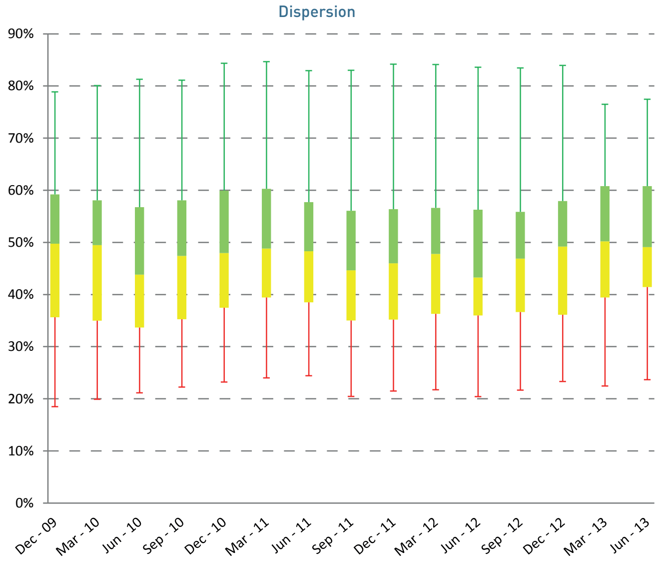
## Deposits

Strong pressure for deleveraging emerged in Europe in the last few years with a need for de-risking and for aligning bank business models to the market's expectations. The deleveraging process was visible during 2013 and will continue throughout 2014, bringing EU banks' leverage to more conservative levels. The EU banks are also rethinking their dependence on less stable funding sources, such as short-term wholesale financing, which have become more expensive in the new market environment. There is evidence that, as part of the deleveraging process, EU banks are strengthening their liquidity and funding positions by attracting more deposits. In this regard, EU banks have been able to meet their funding needs not only via refinancing operations, but also by reducing their overall balance sheet and reducing the need to attract new funding, as well as by strengthening of their deposit base. This is allowing EU banks to attain lower loan-to-deposit ratios and leading to greater balance sheet stability and a better funding mix.

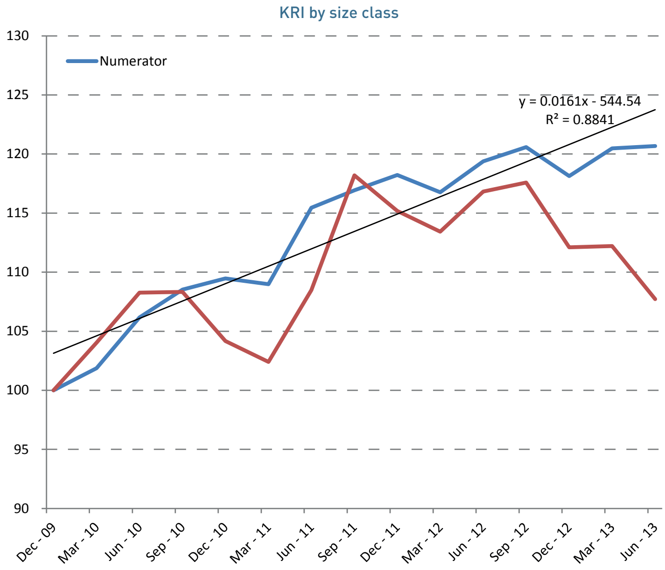
The customer deposits to total liabilities ratio (see figure 24) has been increasing since September 2011 and shows the highest level since 2009 (in June 2013 was 45.4% and in December 42.7%).

At the same time, aiming for higher reliance on deposit funding may result in an increase of in-market competition among banks for

**Figure 24:** Customer deposits to total liabilities (source: KRI) – 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (Dec 2009 = 100)

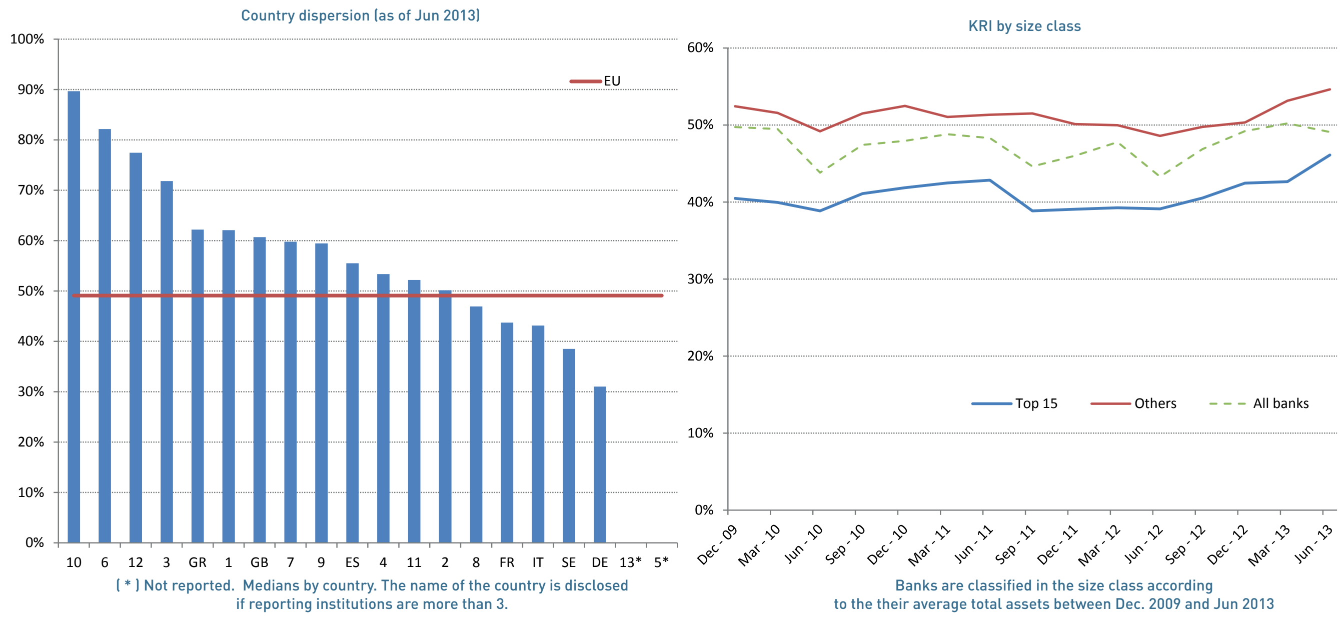



5th and 95th pct, interquartile range and median.




Banks are classified in the size class according to the their average total assets between Dec. 2009 and Jun 2013 new deposits in some geographies (see figure 25). This potential competition may raise overall funding costs and thus potentially challenge bank profitability. Additionally, increasing reliance on deposits could also pose vulnerabilities as deposits have the potential to become more volatile as new resolution and bail-in requirements emerge. Therefore, some funding challenges may persist, particularly in financially distressed countries owing to concerns that excessive deposit pricing competition in the

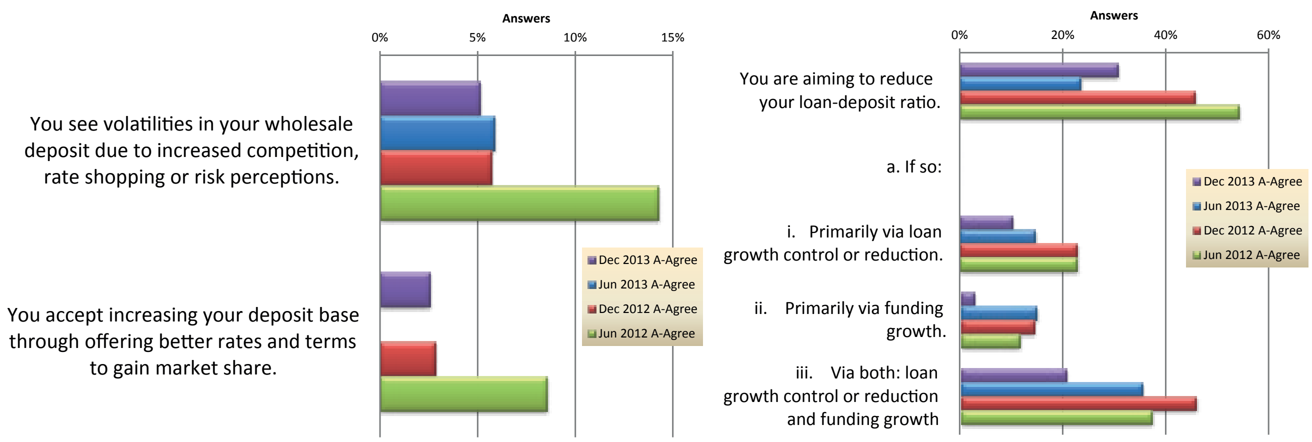
**Figure 25:** Customer deposits to total liabilities (source: KRI) – country dispersion and by size class (medians)




term deposit market may emerge. For this reason, supervisors in some financially distressed countries are taking actions to mitigate such risk.

The RAQ respondents reduced their apprehension for increased market competition in retail deposits and wholesale deposits (see figure 26). Simultaneously, the RAQ respondents

**Figure 26:** Deposits (source: RAQ)



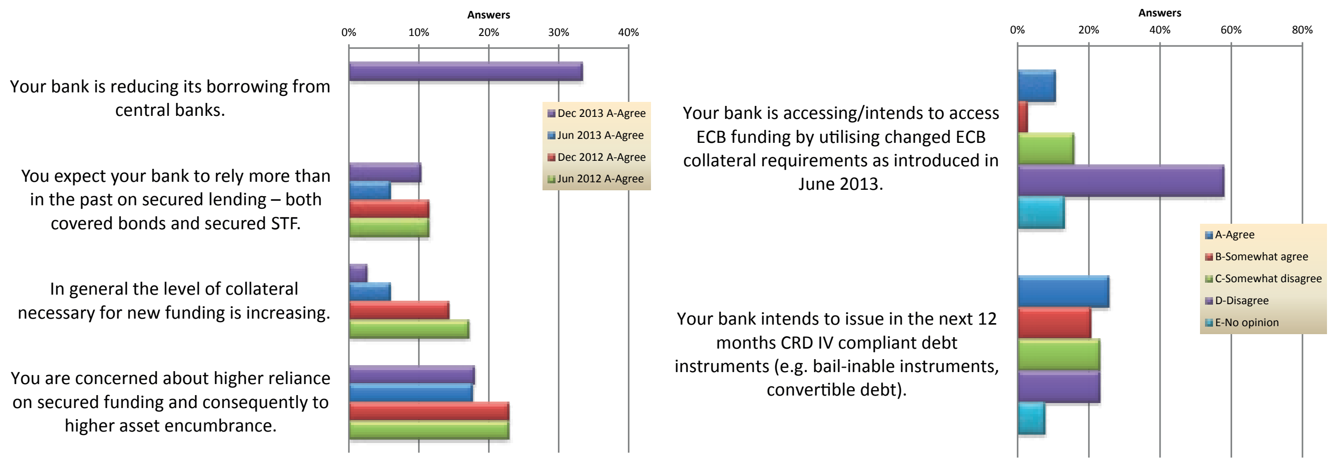

also reduced their support to increase deposit base through offering better rates and terms to gain market share, consequently reducing competition for deposits. The majority of the RAQ respondents are still aiming to reduce the loan-to-deposit ratio via both loan growth control or reduction and funding growth, however the number of answers that agree to further reductions in loan-to-deposit ratios fell significantly in the last two semesters.

## Asset encumbrance and collateral

The reliance on secured funding in the last few years has created a substantial amount of asset encumbrance. Amongst many reasons, the high reliance on central bank borrowing required banks to earmark significant amounts of collateral in their balance sheets. At the same time, forthcoming regulations are likely to lead to an increase in the demand for collateral. However, it is known that in cases where it exceeds certain thresholds, asset encumbrance could be harmful and self-reinforcing. Consequently, a sustainable development needs to consider the necessity to restore market access for banks, both in terms of costs and availability, as well as a moving away from central bank support towards the increasing use of unsecured funding on private markets.

Looking ahead, a majority of RAQ respondents continue to consider and agree that there will be less need for central bank borrowing (see figure 27). Also, there is again

**Figure 27:** Central bank and secured funding (source: RAQ)

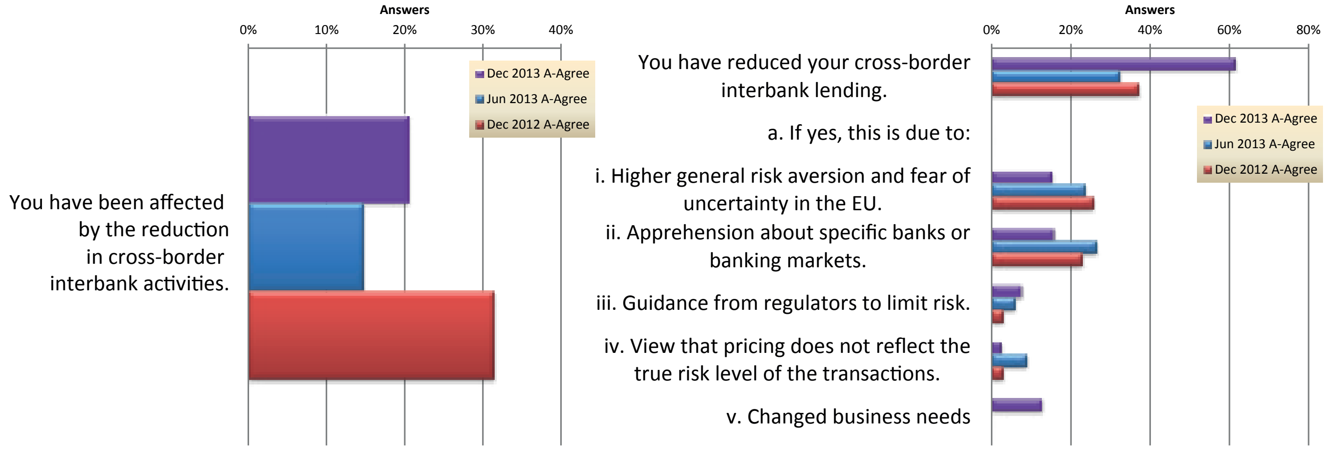



a strong reduction of responses in saying that the level of necessary collateral for new lending is increasing. In addition, the percentage of respondents which are concerned about higher reliance on secured funding and consequently of higher asset encumbrance has reduced. On the other hand, the percentage of respondents that intend to rely more on secured lending increased in the last semester. Interestingly, a majority of the RAQ respondents disagree that their banks are accessing or intends to access ECB funding by utilising changed ECB collateral requirements as introduced in June 2013. Simultaneously, most respondents agree that their banks intend to issue in the next 12 months CRD IV compliant debt instruments, for instance bail-in instruments and convertible debt.

The re-emergence of an active cross-border interbank market within the banking system would be a strong sign of regained confidence. However, signs of fragmentation of the single market continue to be identified in funding conditions, as is also evidenced by continued low cross-border interbank activities. In some jurisdictions, supervisory interventions have also had the effect of lowering cross border transactions (e.g. liquidity transfers). Regardless of a benign funding environment, EU banks remain susceptible to a sudden switch of market sentiment. Therefore, the sustainability of benign conditions remains fragile.

The RAQ respondents provide some signs of deterioration (in comparison to June 2013) with both an increase in the number of banks affected by the reduction in cross-border activity and also with the majority of RAQ respondents agreeing to a reduction on their cross-border interbank lending (see figure 28). The main reasons for the reduction of cross-border interbank lending are the higher general risk aversion and fear of uncertainty in the EU, and the apprehension about specific banks or banking systems.

**Figure 28:** Cross border borrowing and lending (source: RAQ)




## Policy implications and possible measures

Recovery and resolution plans call for a serious reconsideration of the structure of banking firms. Senior management and boards need to take greater ownership and use this framework to drive the unavoidable change process, in close cooperation with and challenged by their respective supervisors.

In this field, the EBA adopted a formal recommendation to ensure that 39 major EU cross-border banking groups completed their recovery plans by the end of 2013. The plans were submitted to the respective competent authorities and discussed within colleges of supervisors. The aim of the recommendation was to spur the development of recovery plans and to foster convergence on the highest standards across the Union. The EBA has been active in addressing this issue and has been increasingly using a mediation toolkit with some important non-public successful outcomes.

Group recovery plans were drafted in accordance with the international standards agreed under the auspices of the Financial Stability Board and consistently with the template attached to the recommendation. The template covers the key elements that should be addressed in a recovery plan, namely: general but comprehensive information on the institution and its governance structure; a list and description of available options in a crisis situation and an assessment of their execution and impact; and the measures that the institution plans to implement to facilitate, in the future, the update of the recovery plan or its implementation in a time of crisis. During 2014, the process will continue through consistency checks and the identification of good practices.

Moreover, a more EU-wide process, and a truly integrated approach to resolution in the euro area and other countries participating in the SSM, could repair one of the main structural ambiguities that have led to the shortage of restructuring activities, namely the lack of a single market perspective. The creation of a more integrated framework for resolution could be the real event that provokes a significant shift in the current way of thinking.

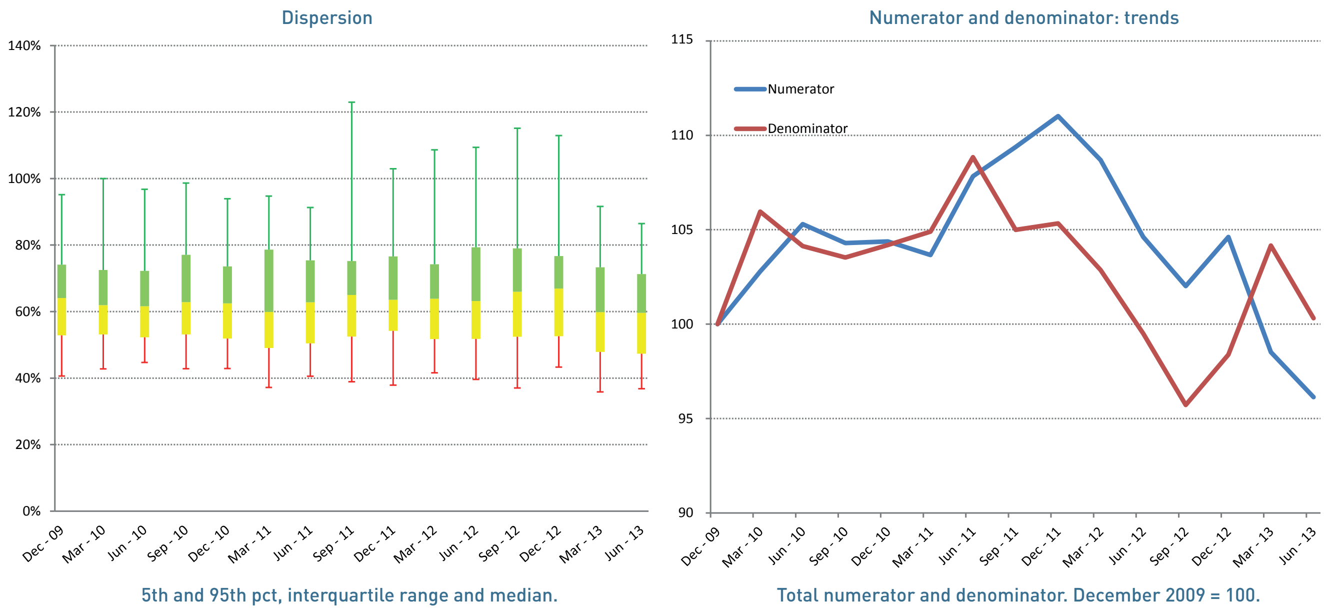
Although the legislative proposals that are being finalised are undoubtedly a major step forward, some concerns on the integrity of the single market need to be considered. The joint decisions on recovery and resolution plans are of crucial importance as, in their absence, authorities may easily tend to ring fence local establishments in order to deal with potential non-cooperative solutions in a moment of crisis. For this reason, and following the Financial Stability Board's (FSB) principles, it is useful that the EU legislation makes it compulsory for competent authorities to achieve such agreements. In the euro area, the SRM will provide for a completely integrated set up. However, there are potential risks arising from the lack of cooperation with authorities from non-participating Member States, thus introducing consequently a possible split within the single market.

# 6. Income and profitability

During 2013, EU banks' income and profitability levels have continued to face significant headwinds which are not likely to dissipate in 2014. EU banks have seen their net interest margins compressed while the weak economic environment continues to provide limited new lending opportunities. The risk premium on EU banks remains heightened not least because of profitability concerns. Earnings may not be sufficient to cover rising bad loans, and the asset quality review adds some uncertainty, therefore leaving some question marks over some institutions' future profitability and viability. In addition, declining deposit costs due to the availability of deposits returning to the system have been a reason for a rebound in most banks' net interest margins and a potential positive indicator in the near future. A reversal in this trend would be negative for the European banking sector. Persistent low interest rates are also putting pressure on the business model sustainability of banks which find overall net interest margins squeezed, contributing to profitability pressures.

Net interest margins are under pressure and are not being matched by a full repricing of assets (see figure 29). The banks' attempts to increase lending rates may prove not possible and even insufficient for addressing a low interest rates environment (in some cases coupled with increases in funding costs), given the fact that customer capacity to bear higher lending rates is affected by the economic downturn.

**Figure 29:** Net interest income to total operating income (source: KRI) – 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (Dec 2009 = 100)




The third-quarter earnings season in 2013 points to a continuation of improved capital positions owing to run-offs of non-core assets, organic capital generation and cost-containing efforts. Nevertheless, it is necessary to maintain a cautious outlook on revenues in light of the macro backdrop, major transitions towards a normalisation of monetary conditions, and the expected generally weak business generation towards 2014.

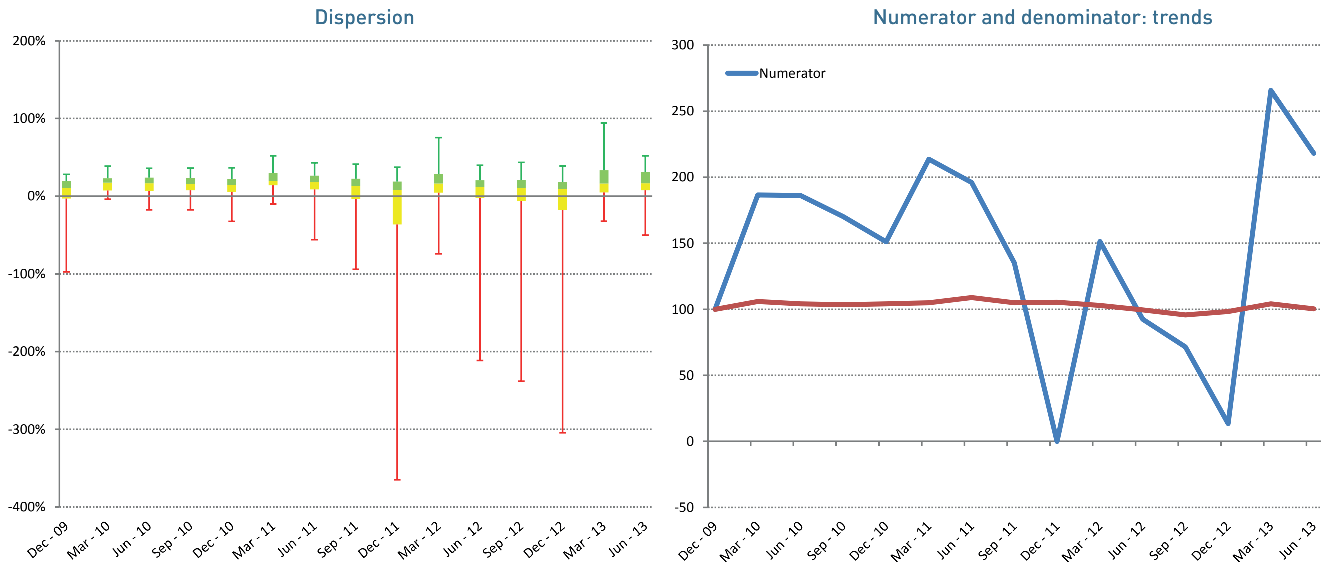
The reduced demand for banking products and services thwarts expectations of growth-generated earnings increases. Thus, fee and commission income, which have traditionally been an important source of earnings for banks, are also under pressure due to low economic growth. In order to reduce expenses and improve efficiency controls, banks have been trying to cut costs, mostly staff-related through lay-offs and readjusting the remuneration structures, as well as utilising economies of scale and innovations. Nevertheless, the cost-to-income ratio and similar indicators continue to point to some difficulty in the banks' ability to keep relative costs under control.

Reflecting the continued macro-deterioration and some economic recessions in parts of the EU during 2013, the credit costs are increasing and this trend continues to show no sign of reversal. Simultaneously, more transparency on impairments and potential losses are leading to higher levels of loan-loss provisions. In a context of low growth and declining volumes of loans, higher credit costs are an important driver for weaker earnings. This situation is putting bank profitability at risk and removing an important source of capital growth, with negative consequences on the banks' performance.

The return on equity (RoE) increased in the first half of 2013 (see figure 30). The weighted average RoE and the 25th percentile have increased (from 0.5% and -6.5% in December 2012, to 3.8% and 2.2% in June 2013, respectively). The median and the 75th percentile have also increased since December 2012 (from 2.6% and 7.2% to 6.6% and 10.4% in June 2013, respectively).

The majority of the RAQ respondents continue to consider a RoE value in the range of 10% to 12% as the target for the long-

**Figure 30:** Return on equity (source: KRI) – 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (Dec 2009 = 100)

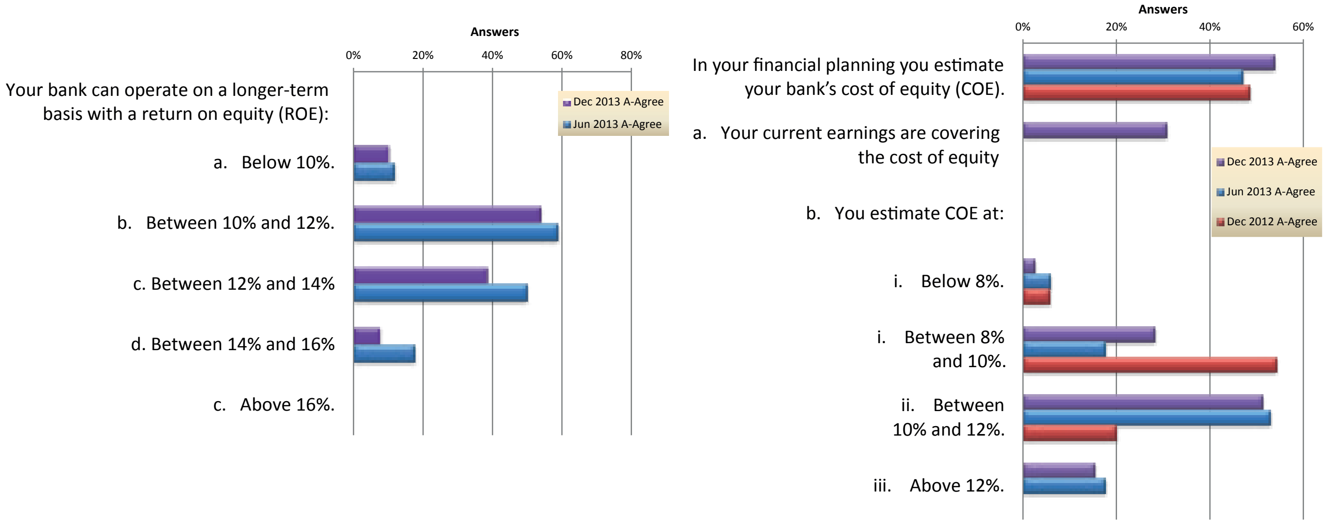



term viability of their businesses. In addition, the number of respondents that agree to consider a RoE value in the range of 12% to 14% has reduced. For the RAQ respondents, the main factors that will influence the RoE in coming months are both the operating expenses and the net interest income. In addition, the vast majority of respondents continue to agree that the current earnings levels are within market expectations, although the number of respondents with such a view reduced in comparison with the previous questionnaire in June 2013. In contrast, the majority of RAQ responses from market analysts (RAQ for market analysts) somewhat disagree that total revenues will increase. On the other hand, many respondents agree that the overall profitability will improve, mostly due to overall cost-efficiency improvements.

In regard to the cost of equity (CoE), most respondents believe this to also be in the 10% to 12% range (see figure 31).

At the same time, the cost-to-income ratio in June 2013 decreased from 63.2% in December 2012 to 57.5% in June 2013

**Figure 31:** Return on equity and cost of equity (source: RAQ)



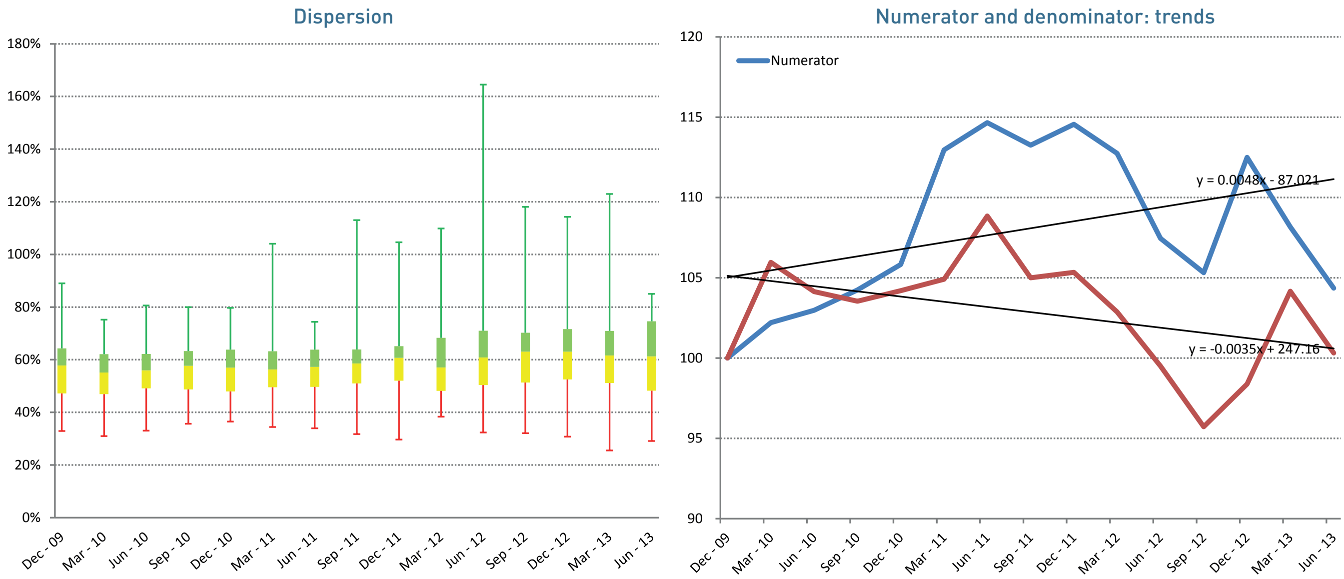

(see figure 32). The 25th percentile and the median have also decreased from 52.5% and 63.1% in December 2012 to 48.2% and 61.2% in June 2013, respectively. However, the 75th percentile has continued to increase since March 2010 (from 62.1% to 63.1% and 74.6% in June 2013).

In a context of economic downturn and sector deleveraging, and given the fact that banks need to provide a return to investors at or above their cost of equity, there are limited and less flexible levers available to meet minimum returns, which may turn some business models unviable.

Some banks are showing signs of exiting 'crisis mode' in response to a wider environment that contains some signs of improvement, though it is still fragile. Despite improvements, challenges nevertheless remain. While most banks were profitable for the 1st half of 2013, the issue of profitability is a cause of concern for both banks and their supervisors, due to a number of factors.

The weak macroeconomic environment in some areas does not allow for growth of revenues. The low interest rate environment, both in the euro area and in the Union more generally, aids repayments by borrowers by reduc-

**Figure 32:** Cost-to-income ratio (source: KRI) – 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (Dec 2009 = 100)




5th and 95th pct, interquartile range and median.

Total numerator and denominator. December 2009 = 100.

ing interest costs, but negatively impacts the net interest margin generation by banks, as banks' loans are also suppressed while deposits still have to earn a non-negative rate of interest, with the result that the margin between deposits and assets is reduced.

There are signs of financial disintermediation that may point to the need for a wider realignment of access to funds for the real economy. It has long been a feature of the US market that corporate tap capital markets directly while EU corporate have traditionally relied on bank lending. European corporates are now increasingly eschewing the traditional route by directly issuing bonds. The search for yield by investors may lead them away from bank bonds towards other asset classes, and sectors such as insurance or shadow banking. Cross-border lending remains very weak as banks still focus on their core markets. This phenomenon hampers the free movement of capital leading to inefficiencies between capital supply and demand. The changing regulatory environment is applying additional pressure that changes the parameters within which banks have been operating, prompting a paradigm shift in some metrics and asset/liability structures.

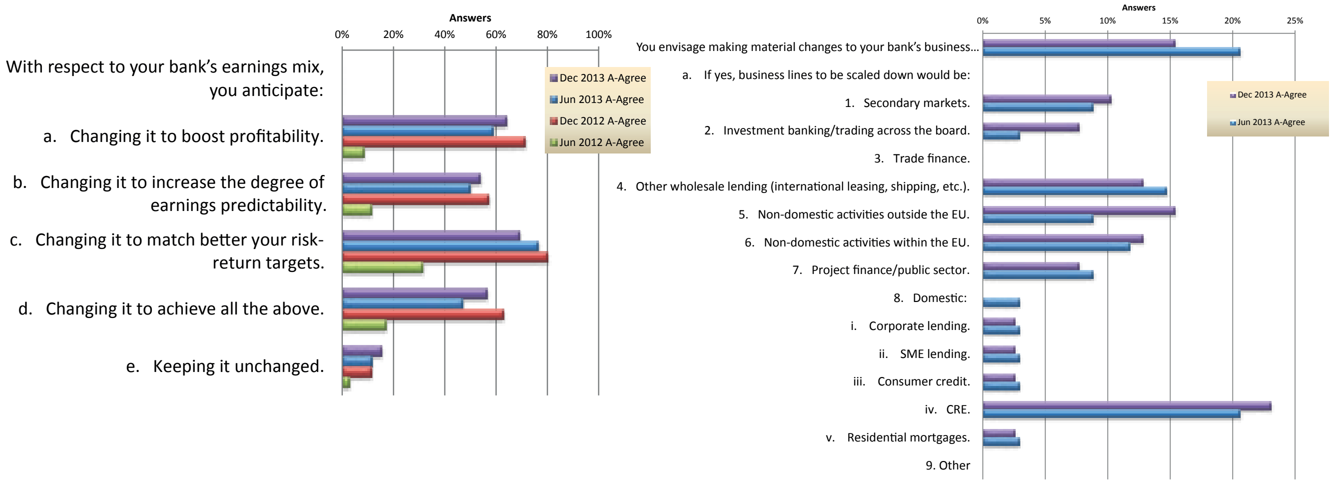
The increased capital which has bolstered the European banking system and rendered it safer has led to pressures on return on equity. The liquidity regulations that are coming in incentivise holdings of long-maturity, low-yield, high quality sovereign bonds, retail deposit bases and lengthening maturities in liabilities, applying pressure on the profitability which is generated as a result of maturity transformation business by banks matching short maturity rolling funding (such as 3 month commercial paper) to long maturity assets (such as 25-year mortgages). Leverage ratio proposals will become a biting constraint for business lines with a very low risk weighting (such as investment banking or prime mortgages).

The responses from the RAQ present some general trends. The banks identified market structures and dynamics as well as earnings pressure as drivers of change, while market analysts regard regulatory initiatives as the main reason. An increased majority of respondents anticipates changing the earning mix in order to better match risk-return targets and to boost profitability (see figure 33).

The RAQ respondents' views on changes to business models and on the scaling-down of business lines show that banks have further reduced their intention of making material changes lending some credence to the hypothesis that they have already been implementing change programmes. The business lines to be scaled-down reflect to some extent the refocusing on core activities and markets, as non-domestic activities, both within and outside the EU are a popular choice for scaling-down (which has fragmentation as a side-effect). Other areas identified are (domestic) commercial real estate (CRE); and wholesale lending. Reflecting a propensity to deleverage, investment banking has reduced its popularity as a scaling-down target, possibly because of both the reduction of investment banking that has already been achieved, as well as business model refocusing results in the desirability of fees and commission income as a revenue stream.

The RAQ responses exhibit some dispersion as to the respondents' expectations of increased profitability; the slight majority considering that the profitability will increase. The most popular areas they target in order to achieve this are (i) operating expenses; (ii) net interest income; (iii) net fees and commis-

**Figure 33:** Changes to the business model (source: RAQ)



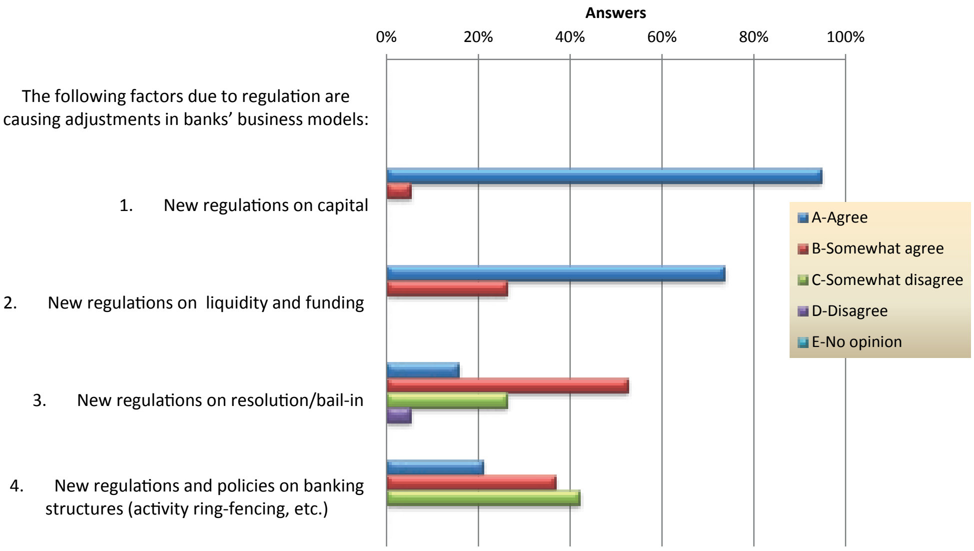
sions income; and (iv) impairments. This indicates some optimism about future prospects, though it does raise the question whether cost-cutting will be achievable, and points to a realignment of revenue streams since net interest income (NII) is under pressure in the current low-interest rate environment([4]).

Reinforcing the idea that there is an improvement in banking conditions and/or the business models of respondents, in this RAQ, and contrary to the previous one, there are more respondents affirming that their bank's business model has proved to be recession-proof and that their main markets have not been materially affected by the sovereign crisis. Of those that materially adjusted their business models, various drivers are cited with the most popular ones being earnings pressure (which fuels the 'search for yield') and regulatory changes.

([4]) The NII frequently suffers in a low interest rate environment due to the tightening margin between deposits and loans: when interest rates fall, deposit rates have to remain non-negative, while loan rates are compressed. The floor on deposit rates imposes a tightening margin to a deposit-funded bank that has floating rate loans.

Almost unanimously, the RAQ market analyst respondents also agree that the new regulations on capital are causing adjustments in banks' business models, and (slightly less forcefully) the new regulations on liquidity. There is more doubt on the effect of bail-in/resolution regulations and/or regulations on banking structures as these areas have not been finalised yet (see figure 34).

**Figure 34:** Business model adjustments (source: RAQ market analysts)




## Policy implications and possible measures

The sustainability of some EU banks' business models remains a cause for concern, whilst it is still unclear from where their future profitability drivers will originate. EU banks are facing strong challenges in adapting to the many changes derived from the emerging new economic, regulatory and financial landscape, and all these changes have led some banks to be confronted with a situation in which their current business model is proving to be unviable. For the above reasons, EU banks need to adjust their business models by finding additional sources of income and cost efficiency.

Therefore, it is fundamental that supervisors create a more coordinated analysis of banks' business models across the EU to assess banks' profit and funding model, business mix, management strength and strategy, among other issues. It is well known that the current methodologies and the monitoring intensity are substantially different for each European supervisor; and therefore a coherent understanding of the commonalities and differences of approaches could be beneficial, as well as the development of best practices and harmonisation of assessments. Consequently, the EBA is devoting part of the Single Supervisory Handbook to the assessment of banks' business models. Overall, in this emerging new economic, regulatory and financial landscape, existing EU banks' business models are experiencing pressure by stronger competition and supervisors are required to have an accurate assessment of core banking risks and challenge banks' business plans. This should in turn facilitate the joint decision processes, and business model risk could be an explicit part of the joint risk assessment decision discussion.

# 7. Consumer issues and reputational concerns

A number of detrimental business practices of EU have in the recent past not only affected consumer confidence in banks and in the financial system, but also have also adversely impacted the banks involved. While detrimental practices and related risks were already featured in the previous risk report, reputational and conduct concerns have lately increased further and some risks have materialised.

The list of alleged misconduct is long, and the nature, types and extent of identified or alleged misconduct have expanded recently. Amounts of materialised and potential redress costs and settlement payments are increasing, substantially affecting balance sheet provisions and the profitability of the banks concerned. In some cases, large redress costs and payouts may also have an adverse impact on a bank's capital position. More recently, the European Commission has published the outcome of its investigations so far on cartels in the interest-rate derivatives industry and has levied total fines of EUR 1.71 bn.

In addition, several cyber risk incidents have raised the profile of the operational risks of cyber attacks and further information technology related risks. Banks are required to hold capital against such risks but it is important that they do not see supervisory capital requirements as a substitute for sound management of operational risk.

## Business conduct of banks and prudential risk

Detrimental business practices include inappropriate conduct of a growing number of different types, such as failures with regard to rate benchmark setting processes, taxation issues, as well as retail conduct, such as mis-selling of banking and other products to consumers, inadequate complaints handling, inadequate oversight arrangements by manufacturers when bringing products to the market; alleged mis-selling of US mortgage bonds, alleged manipulation of markets for credit default swaps, legal probes against bank senior management, and most recently alleged inappropriate practices in foreign exchange trading business.

Regarding the benchmark rate setting process, in September 2013 the European Commission has proposed a draft legislation to help restore confidence in the integrity of benchmarks, following the EBA's and ESMA's proposal the preceding January setting principles to strengthen benchmark rate-setting processes.

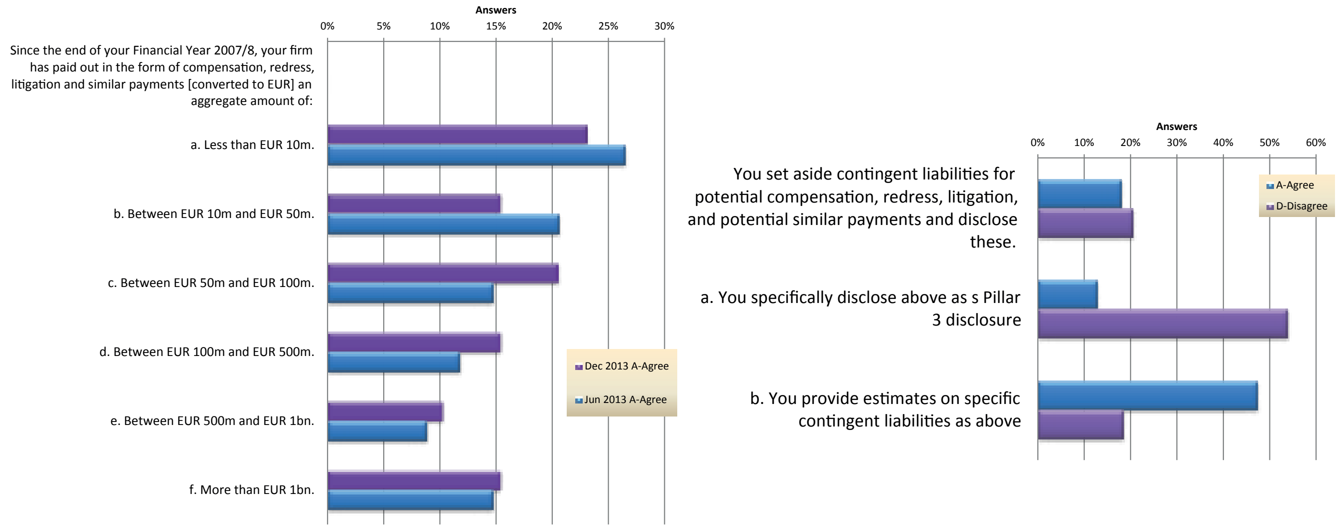
Corresponding to increasing scrutiny of alleged misconduct, the RAQ respondents have identified a high level of conduct and reputational risks. Around 70% of respondents identify a further increase in such risks for the banking sector and a negative trend in public perceptions, after a significant majority of respondents had already identified increasing risks in the previous RAQ. Related risks should therefore be carefully considered and monitored.

## Costs and prudential implications of banks' business conduct

Costs such as redress payments and settlement payments for banks from conduct-related business practices have increased markedly. As for aggregated costs stemming from past unfair business practices, 40% of the RAQ respondents have since 2007/8 paid out in the form of compensation, redress and similar payments of over EUR 100 million: of this, 16% of respondents have paid over EUR 1 billion. This is a general increase compared to the previous RAQ, in which 36% of respondents had paid out compensation payments of over EUR 100 million. Compensation payments in the category between EUR 50 million and EUR 500 million increased in particular. The most recent financial reporting indicates a further increase of such payments. It should be noted that substantial legal fees in addition to redress payments were also paid (see figure 35).

Responses to the RAQ show that provisions set aside in the ongoing financial year for costs of compensation, redress, litigation and similar payments to consumers have increased to a wider scope of banks compared to the previous RAQ, in line with rising risks. Rising costs not only affect the profitability of banks, but also causes additional challenges for attaining higher capital levels, both

**Figure 35:** Payments to consumers since 2007 and contingent liabilities (source: RAQ)




through decreasing retained earnings and because ongoing uncertainties stemming from lengthy legal proceedings and potential further redress costs are detrimental for banks' ability to raise capital.

Claims have nevertheless often been made that there are challenges to quantify aggregated redress costs. While expenses provided for compensation and redress payments have increased, rising and increasingly materialising conduct risks raises the questions as to whether risks are sufficiently provisioned for, and whether provisioning is adequately disclosed. Claims have been made that there is a lack of disclosure on details of redress costs, and responses to the RAQ provide indications that some of these claims could be justified. Only 18% of the RAQ respondents indicated that they set aside and disclose contingent liabilities for potential compensation, redress, litigation and similar payments, and disclose them. Pillar 3 disclosure on conduct risk appears not well developed either, as only 13% of respondents indicate that they provide specific Pillar 3 disclosure, even though legal risk is covered in the operational risk framework.

A lack of disclosure is often associated with challenges to quantify aggregated redress costs. Such challenges are mainly associated with the accounting treatment of actual and potential redress costs, which is not always consistent between institutions even when facing similar risks. Both the classification for related risks (provisions or contingent liabilities) as well as the level of disclosure often leaves room for interpretation. Responses to the RAQ reflect differing treatment of contingent liabilities and show that disclosure on conduct risks is only limited. The majority of RAQ respondents do not disclose in their Pillar 3 disclosure contingent liabilities set aside for potential compensation, redress, and litigation payments. Also, only 46% provide estimates on specific contingent liabilities. This is in spite of the International Accounting Standards (IAS) stipulations that contingent liabilities with no impact on the income statement should be set aside if reliable estimates of actual and potential redress costs cannot be made and provisions cannot be recognised.

## Policy implications and possible measures

The rising scope and the number of detrimental incidents indicate that there is room for improvement in many institutions' risk management functions and compliance proceedings regarding business conduct issues. They also point to the need to further improve risk appetites and risk cultures. In line with heightened risks, the majority of RAQ respondents aim to adjust their culture and risk/conduct governance within their organisations. However, compared to the previous RAQ a decreasing number of respondents identified a need for such adjustments. An indication of an identified decreasing need to improve risk/conduct governance while risks are rising should be an issue of supervisory concern, and continued heightened supervisory attention to risk culture and governance is warranted.

In particular, supervisors will need to maintain appropriate pressure for improvements to be made in banks' management of conduct-related issues and better understand potential redress issues, in order to assess whether adequate contingency reserves for legal or reputational risk are being made. Also, supervisors and auditors should challenge situations where non-provisioning for related risks is poorly substantiated. Supervisors should also assess whether prudential risks stemming from banks' business practices are adequately reflected in an institution's internal capital adequacy assessment process (ICAAP). Likewise, assessment of such risks should be increasingly reflected in the supervisory review and evaluation process (SREP).

A more general reassessment of the relationship between banks and their customers remains warranted. When asked about the most prevalent risks for retail customers, the majority of the RAQ respondents specified a lack of knowledge. With respect to the existing Markets in Financial Instruments Directive (MiFID), provisions aimed at protecting customers from buying products they do not understand, a conclusion remains valid that the relationship between banks and retail customers needs further improvements.

# Appendix: Samples

Below we list the banks that made up the sample population for the risk assessment questionnaire (RAQ) and the key risk indicators (KRIs).

## Risk Assessment Questionnaire

| | Bank name | Home country |
|---|---|---|
| 1 | Erste Group Bank AG | AT |
| 2 | Raiffeisen Zentralbank | AT |
| 3 | KBC Group | BE |
| 4 | Bank of Cyprus Public Company Ltd | CY |
| 5 | Bayerische Landesbank | DE |
| 6 | Commerzbank AG | DE |
| 7 | Deutsche Bank AG | DE |
| 8 | DZ BANK AG | DE |
| 9 | Hypo Real Estate Holding | DE |
| 10 | Norddeutsche Landesbank Girozentrale NORD/LB | DE |
| 11 | Danske Bank A/S | DK |
| 12 | Alpha Bank AE | EL |
| 13 | Eurobank Ergasias | EL |
| 14 | National Bank of Greece | EL |
| 15 | Piraeus Bank | EL |
| 16 | Banco Bilbao Vizcaya Argentaria SA | ES |
| 17 | Banco Santander SA | ES |
| 18 | BNP Paribas | FR |
| 19 | Crédit Agricole Group-Crédit Agricole | FR |
| 20 | Société Générale | FR |
| 21 | OTP Bank NYRT | HU |
| 22 | Allied Irish Banks plc | IE |
| 23 | Bank of Ireland | IE |
| 24 | Gruppo Bancario Intesa Sanpaolo | IT |
| 25 | Gruppo UniCredit | IT |
| 26 | ABN Amro | NL |
| 27 | ING Groep NV | NL |
| 28 | Rabobank Group-Rabobank Nederland | NL |
| 29 | DnB NOR | NO |
| 30 | Banco Comercial Português | PT |
| 31 | Nordea Bank AB (publ) | SE |
| 32 | Skandinaviska Enskilda Banken AB | SE |
| 33 | Svenska Handelsbanken AB | SE |
| 34 | SWEDBANK AB | SE |
| 35 | Barclays Plc | UK |
| 36 | HSBC Holdings Plc | UK |
| 37 | Lloyds Banking Group Plc | UK |
| 38 | Royal Bank of Scotland Group Plc (The) | UK |
| 39 | Standard Chartered Plc | UK |

## Key risk indicators

| | Bank name | Home country |
|---|---|---|
| 1 | Erste Group Bank AG | AT |
| 2 | Oesterreich Volksbanken | AT |
| 3 | Raiffeisen Zentralbank | AT |
| 4 | KBC Group | BE |
| 5 | Dexia | BE |
| 6 | Bank of Cyprus | CY |
| 7 | Marfin Popular Bank Public Company Limited | CY |
| 8 | DZ BANK AG | DE |
| 9 | WestLB AG | DE |
| 10 | Landesbank Baden-Württemberg | DE |
| 11 | Deutsche Bank AG | DE |
| 12 | Commerzbank AG | DE |
| 13 | Norddeutsche Landesbank GZ | DE |
| 14 | Bayerische Landesbank | DE |
| 15 | Hypo Real Estate | DE |
| 16 | Danske Bank A/S | DK |
| 17 | National Bank of Greece | EL |
| 18 | Alpha Bank AE | EL |
| 19 | Piraeus Bank | EL |
| 20 | Eurobank Ergasias | EL |
| 21 | Banco Santander SA | ES |
| 22 | Banco Bilbao Vizcaya Argentaria SA | ES |
| 23 | La Caixa | ES |
| 24 | Banco Financiero y de Ahorro | ES |
| 25 | OP-Pohjola Group | FI |
| 26 | BNP Paribas | FR |
| 27 | Crédit Agricole Group — Crédit Agricole | FR |
| 28 | Société Générale | FR |
| 29 | Crédit Mutuel | FR |
| 30 | Group BPCE | FR |
| 31 | OTP Bank NYRT | HU |
| 32 | Bank of Ireland | IE |
| 33 | Allied Irish Banks plc | IE |

| | Bank name | Home country |
|---|---|---|
| 34 | Gruppo UniCredit | IT |
| 35 | Gruppo Monte dei Paschi di Siena | IT |
| 36 | Gruppo Bancario Intesa Sanpaolo | IT |
| 37 | Gruppo Banco Popolare | IT |
| 38 | Bank of Valletta (BOV) | MT |
| 39 | ABN Amro | NL |
| 40 | ING Groep NV | NL |
| 41 | Rabobank Group — Rabobank Nederland | NL |
| 42 | DNB Bank ASA | NO |
| 43 | PKO Bank Polski | PL |
| 44 | Banco Comercial Portugues | PT |
| 45 | Caixa Geral de Depositos | PT |
| 46 | Espirito Santo Financial Group (ESFG) | PT |
| 47 | Skandinaviska Enskilda Banken AB | SE |
| 48 | Nordea Bank AB (publ) | SE |
| 49 | Swedbank AB | SE |
| 50 | Svenska Handelsbanken AB | SE |
| 51 | Nova Ljubljanska Bank (NLB) | SI |
| 52 | Barclays plc | UK |
| 53 | Lloyds Banking Group plc | UK |
| 54 | Standard Chartered plc | UK |
| 55 | HSBC Holdings plc | UK |
| 56 | Royal Bank of Scotland Group plc (The) | UK |
| 57 | Nationwide Building Society | UK |

Note: WestLB is not considered for the KRI calculation since June 2011.

# Annex

Descriptive statistics from the EBA key risk indicators with data to Q2 2013.
The charts of KRI show the dispersion of data points for the relevant KRI over time, with 5th, 25th, 50th (median), 75th and 95th percentiles.

| | KRI | Descriptive statistics | Dec 09 | Mar 10 | Jun 10 | Sep 10 | Dec 10 | Mar 11 | Jun 11 | Sep 11 | Dec 11 | Mar 12 | Jun 12 | Sep 12 | Dec 12 | Mar 13 | Jun 13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| SOLVENCY | 1 — Tier 1 capital ratio | Weighted average | 10.2 % | 10.2 % | 10.4 % | 10.6 % | 11.0 % | 11.3 % | 11.4 % | 11.4 % | 11.1 % | 11.6 % | 12.0 % | 12.3 % | 12.5 % | 12.4 % | 12.6 % |
| | | 25th percentile | 9.1 % | 9.0 % | 8.8 % | 8.9 % | 9.3 % | 9.7 % | 9.4 % | 9.6 % | 9.4 % | 9.8 % | 10.4 % | 10.3 % | 10.5 % | 10.8 % | 11.1 % |
| | | 50th percentile | 9.9 % | 10.2 % | 10.1 % | 10.3 % | 10.6 % | 11.1 % | 11.1 % | 11.0 % | 10.9 % | 11.4 % | 11.7 % | 11.7 % | 11.7 % | 11.6 % | 12.0 % |
| | | 75th percentile | 11.3 % | 11.1 % | 11.4 % | 11.6 % | 12.4 % | 12.7 % | 12.5 % | 12.8 % | 12.8 % | 13.0 % | 13.3 % | 13.4 % | 13.5 % | 13.4 % | 13.8 % |
| | 2 — Total capital ratio | Weighted average | 13.0 % | 12.9 % | 12.9 % | 13.1 % | 13.5 % | 13.7 % | 13.6 % | 13.5 % | 13.1 % | 13.6 % | 13.9 % | 14.1 % | 14.4 % | 14.8 % | 15.1 % |
| | | 25th percentile | 11.5 % | 11.2 % | 11.4 % | 11.5 % | 11.7 % | 11.8 % | 11.6 % | 11.4 % | 11.3 % | 11.5 % | 12.0 % | 12.0 % | 12.1 % | 12.6 % | 13.3 % |
| | | 50th percentile | 12.5 % | 12.6 % | 12.2 % | 12.4 % | 12.8 % | 13.3 % | 13.0 % | 12.8 % | 12.8 % | 13.9 % | 14.1 % | 14.0 % | 13.9 % | 14.5 % | 14.8 % |
| | | 75th percentile | 14.0 % | 13.9 % | 14.0 % | 14.6 % | 14.9 % | 15.0 % | 15.1 % | 15.1 % | 15.0 % | 15.4 % | 15.8 % | 15.8 % | 16.2 % | 16.3 % | 16.8 % |
| | 3 — Tier 1 ratio (excluding hybrid instruments) | Weighted average | 9.0 % | 9.0 % | 9.2 % | 9.3 % | 9.0 % | 9.3 % | 9.3 % | 9.4 % | 9.2 % | 9.8 % | 10.2 % | 10.5 % | 10.8 % | 10.8 % | 11.1 % |
| | | 25th percentile | 7.1 % | 7.3 % | 7.2 % | 7.4 % | 7.7 % | 8.2 % | 7.9 % | 8.0 % | 8.1 % | 8.3 % | 9.3 % | 9.4 % | 9.5 % | 9.8 % | 10.0 % |
| | | 50th percentile | 8.6 % | 8.5 % | 8.6 % | 9.3 % | 8.5 % | 9.0 % | 9.3 % | 9.4 % | 9.4 % | 10.0 % | 10.3 % | 10.5 % | 10.7 % | 10.7 % | 11.1 % |
| | | 75th percentile | 10.7 % | 10.8 % | 10.6 % | 11.1 % | 10.4 % | 10.9 % | 10.3 % | 10.6 % | 10.5 % | 11.3 % | 11.2 % | 11.4 % | 11.6 % | 12.3 % | 12.6 % |

| KRI | Descriptive statistics | Dec 09 | Mar 10 | Jun 10 | Sep 10 | Dec 10 | Mar 11 | Jun 11 | Sep 11 | Dec 11 | Mar 12 | Jun 12 | Sep 12 | Dec 12 | Mar 13 | Jun 13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 13 — Impaired loans and past due (> 90 days) loans to total loans | Weighted average | 5.1 % | 5.0 % | 5.1 % | 5.3 % | 5.3 % | 5.2 % | 5.4 % | 5.4 % | 5.8 % | 5.9 % | 6.0 % | 6.3 % | 6.4 % | 6.4 % | 6.7 % |
| | 25th percentile | 3.1 % | 3.1 % | 3.3 % | 3.4 % | 3.0 % | 2.9 % | 2.5 % | 2.6 % | 2.5 % | 2.5 % | 2.8 % | 2.9 % | 3.1 % | 3.0 % | 3.0 % |
| | 50th percentile | 4.9 % | 5.1 % | 5.4 % | 5.5 % | 5.4 % | 5.4 % | 5.6 % | 5.6 % | 6.4 % | 6.7 % | 6.3 % | 7.3 % | 5.8 % | 6.5 % | 6.5 % |
| | 75th percentile | 9.8 % | 9.9 % | 10.7 % | 10.9 % | 10.5 % | 11.3 % | 12.4 % | 13.1 % | 14.1 % | 15.2 % | 15.8 % | 16.3 % | 17.3 % | 14.1 % | 14.7 % |
| 14 — Coverage ratio (specific allowances for loans to total gross impaired loans) | Weighted average | 42.0 % | 41.8 % | 42.0 % | 42.9 % | 41.7 % | 42.6 % | 41.4 % | 40.9 % | 41.2 % | 41.2 % | 41.5 % | 41.5 % | 42.0 % | 42.8 % | 42.8 % |
| | 25th percentile | 34.0 % | 34.4 % | 34.0 % | 34.5 % | 33.5 % | 34.2 % | 33.7 % | 33.7 % | 34.3 % | 34.5 % | 35.6 % | 34.8 % | 34.5 % | 34.2 % | 33.7 % |
| | 50th percentile | 40.7 % | 41.3 % | 40.9 % | 41.7 % | 41.8 % | 42.4 % | 41.2 % | 41.4 % | 41.2 % | 41.2 % | 40.9 % | 40.7 % | 41.4 % | 43.4 % | 43.6 % |
| | 75th percentile | 49.0 % | 48.5 % | 49.4 % | 48.3 % | 49.5 % | 48.3 % | 46.6 % | 45.6 % | 48.7 % | 48.0 % | 47.9 % | 48.9 % | 48.8 % | 51.1 % | 50.7 % |
| 18 — Impaired financial assets to total assets | Weighted average | 1.6 % | 1.4 % | 1.5 % | 1.4 % | 1.7 % | 1.6 % | 1.7 % | 1.7 % | 1.9 % | 1.8 % | 1.8 % | 1.9 % | 1.9 % | 2.0 % | 2.1 % |
| | 25th percentile | 0.9 % | 1.0 % | 1.0 % | 1.1 % | 1.2 % | 1.1 % | 0.6 % | 1.0 % | 1.0 % | 1.1 % | 1.2 % | 1.1 % | 0.7 % | 0.7 % | 1.2 % |
| | 50th percentile | 1.8 % | 1.7 % | 1.8 % | 1.8 % | 2.0 % | 1.9 % | 1.9 % | 2.0 % | 2.2 % | 2.1 % | 2.1 % | 2.2 % | 2.2 % | 2.3 % | 2.4 % |
| | 75th percentile | 3.4 % | 3.4 % | 3.6 % | 3.8 % | 3.9 % | 3.9 % | 4.6 % | 5.3 % | 5.6 % | 6.2 % | 6.6 % | 7.2 % | 7.4 % | 7.7 % | 7.8 % |
| 20 — Accumulated impairments on financial assets to total (gross) assets | Weighted average | 1.3 % | 1.2 % | 1.3 % | 1.3 % | 1.4 % | 1.4 % | 1.4 % | 1.3 % | 1.6 % | 1.5 % | 1.5 % | 1.5 % | 1.6 % | 1.6 % | 1.7 % |
| | 25th percentile | 0.9 % | 0.9 % | 0.9 % | 0.9 % | 0.9 % | 0.8 % | 0.8 % | 0.7 % | 0.8 % | 0.8 % | 0.7 % | 0.7 % | 0.7 % | 0.7 % | 0.7 % |
| | 50th percentile | 1.5 % | 1.5 % | 1.5 % | 1.6 % | 1.7 % | 1.6 % | 1.5 % | 1.5 % | 1.6 % | 1.6 % | 1.7 % | 1.7 % | 1.8 % | 1.7 % | 1.8 % |
| | 75th percentile | 2.2 % | 2.3 % | 2.3 % | 2.8 % | 2.7 % | 2.9 % | 2.9 % | 3.1 % | 3.7 % | 3.7 % | 3.7 % | 3.8 % | 3.9 % | 4.0 % | 4.1 % |
| 21 — Impairments on financial assets to total operating income | Weighted average | 26.6 % | 17.2 % | 20.1 % | 18.2 % | 19.4 % | 13.8 % | 17.9 % | 20.3 % | 26.7 % | 17.9 % | 24.6 % | 24.9 % | 27.0 % | 17.2 % | 18.7 % |
| | 25th percentile | 21.0 % | 15.5 % | 17.5 % | 14.5 % | 15.5 % | 7.4 % | 10.0 % | 14.7 % | 14.8 % | 8.4 % | 9.9 % | 10.4 % | 10.8 % | 9.0 % | 10.0 % |
| | 50th percentile | 27.4 % | 20.4 % | 23.3 % | 21.1 % | 23.9 % | 15.7 % | 20.2 % | 21.6 % | 26.2 % | 19.7 % | 18.7 % | 20.9 % | 22.4 % | 19.2 % | 19.0 % |
| | 75th percentile | 41.0 % | 28.1 % | 33.5 % | 31.6 % | 31.3 % | 25.9 % | 32.0 % | 36.9 % | 56.8 % | 32.1 % | 39.8 % | 44.4 % | 56.0 % | 29.0 % | 30.0 % |

The charts of KRI show the dispersion of data points for the relevant KRI over time, with 5th, 25th, 50th (median), 75th and 95th percentiles.

| | KRI | Descriptive statistics | Dec 09 | Mar 10 | Jun 10 | Sep 10 | Dec 10 | Mar 11 | Jun 11 | Sep 11 | Dec 11 | Mar 12 | Jun 12 | Sep 12 | Dec 12 | Mar 13 | Jun 13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| PROFITABILITY | 22 — Return on equity | Weighted average | 4.5 % | 1.9 % | 3.6 % | 5.0 % | 5.9 % | 2.1 % | 3.5 % | 3.6 % | 0.0 % | 1.4 % | 1.7 % | 1.9 % | 0.5 % | 2.3 % | 3.8 % |
| | | 25th percentile | -0.5 % | 3.0 % | 3.0 % | 3.0 % | 1.7 % | 5.2 % | 2.8 % | -0.7 % | -15.7 % | 1.8 % | -0.9 % | -1.5 % | -6.5 % | 2.4 % | 2.2 % |
| | | 50th percentile | 5.4 % | 6.2 % | 6.3 % | 5.7 % | 5.4 % | 8.3 % | 7.1 % | 5.2 % | 2.7 % | 6.5 % | 5.3 % | 3.8 % | 2.6 % | 6.6 % | 6.6 % |
| | | 75th percentile | 9.1 % | 11.1 % | 10.8 % | 10.0 % | 9.5 % | 12.6 % | 11.7 % | 9.4 % | 7.8 % | 11.5 % | 8.9 % | 8.4 % | 7.2 % | 12.0 % | 10.4 % |
| | 24 — Cost-to-income ratio | Weighted average | 55.2 % | 53.3 % | 54.6 % | 55.6 % | 56.1 % | 59.5 % | 58.2 % | 59.6 % | 60.1 % | 60.6 % | 59.7 % | 60.8 % | 63.2 % | 57.4 % | 57.5 % |
| | | 25th percentile | 47.2 % | 46.9 % | 49.1 % | 48.7 % | 47.9 % | 49.6 % | 49.7 % | 51.0 % | 52.0 % | 48.1 % | 50.4 % | 51.4 % | 52.5 % | 51.2 % | 48.2 % |
| | | 50th percentile | 57.8 % | 55.1 % | 56.0 % | 57.7 % | 57.0 % | 56.3 % | 57.3 % | 58.6 % | 60.7 % | 57.1 % | 60.9 % | 63.0 % | 63.1 % | 61.6 % | 61.2 % |
| | | 75th percentile | 64.3 % | 62.1 % | 62.2 % | 63.3 % | 63.8 % | 63.2 % | 63.8 % | 63.9 % | 65.2 % | 68.3 % | 71.0 % | 70.3 % | 71.6 % | 70.9 % | 74.6 % |
| | 26 — Net interest income to total operating income | Weighted average | 57.9 % | 56.2 % | 58.6 % | 58.3 % | 58.0 % | 57.2 % | 57.4 % | 60.3 % | 61.0 % | 61.2 % | 60.9 % | 61.7 % | 61.6 % | 54.8 % | 55.5 % |
| | | 25th percentile | 52.8 % | 53.2 % | 52.3 % | 53.2 % | 51.9 % | 49.0 % | 50.4 % | 52.5 % | 54.2 % | 51.7 % | 51.8 % | 52.5 % | 52.6 % | 47.8 % | 47.4 % |
| | | 50th percentile | 64.1 % | 61.9 % | 61.6 % | 62.8 % | 62.5 % | 59.9 % | 62.8 % | 65.0 % | 63.5 % | 63.9 % | 63.2 % | 65.9 % | 66.9 % | 59.8 % | 59.6 % |
| | | 75th percentile | 74.1 % | 72.5 % | 72.2 % | 77.1 % | 73.6 % | 78.6 % | 75.4 % | 75.2 % | 76.6 % | 74.2 % | 79.3 % | 79.0 % | 76.7 % | 73.3 % | 71.3 % |
| | 27 — Net fee and commission income to total operating income | Weighted average | 26.0 % | 25.8 % | 26.7 % | 26.7 % | 26.8 % | 26.9 % | 27.0 % | 27.6 % | 27.6 % | 27.3 % | 27.1 % | 27.7 % | 27.9 % | 26.2 % | 26.7 % |
| | | 25th percentile | 16.7 % | 14.9 % | 15.6 % | 15.1 % | 15.8 % | 13.3 % | 16.1 % | 16.7 % | 16.5 % | 18.1 % | 17.9 % | 17.6 % | 17.9 % | 16.0 % | 15.3 % |
| | | 50th percentile | 22.6 % | 23.5 % | 24.0 % | 24.0 % | 24.1 % | 24.1 % | 24.4 % | 25.8 % | 24.1 % | 22.8 % | 24.4 % | 24.2 % | 25.7 % | 24.9 % | 24.2 % |
| | | 75th percentile | 29.0 % | 30.6 % | 31.5 % | 30.8 % | 30.6 % | 30.4 % | 29.2 % | 30.5 % | 30.9 % | 28.2 % | 29.1 % | 29.9 % | 30.6 % | 31.2 % | 31.4 % |
| | 33 — Net income to total operating income | Weighted average | 9.3 % | 16.3 % | 16.6 % | 15.2 % | 13.4 % | 18.9 % | 16.7 % | 11.9 % | 0.0 % | 13.6 % | 8.6 % | 6.9 % | 1.3 % | 23.6 % | 20.1 % |
| | | 25th percentile | -3.1 % | 7.3 % | 7.0 % | 7.5 % | 5.6 % | 14.0 % | 8.7 % | -3.6 % | -36.3 % | 4.6 % | -2.5 % | -6.3 % | -17.7 % | 4.9 % | 7.6 % |
| | | 50th percentile | 10.9 % | 17.4 % | 16.6 % | 15.4 % | 14.6 % | 19.3 % | 17.8 % | 13.2 % | 7.7 % | 16.3 % | 12.0 % | 10.7 % | 9.0 % | 16.4 % | 16.6 % |
| | | 75th percentile | 19.3 % | 23.0 % | 24.0 % | 23.4 % | 22.3 % | 29.7 % | 26.4 % | 22.6 % | 18.8 % | 28.6 % | 20.5 % | 21.1 % | 18.5 % | 33.4 % | 30.9 % |

BALANCE SHEET STRUCTURE

| KRI | Descriptive statistics | Dec 09 | Mar 10 | Jun 10 | Sep 10 | Dec 10 | Mar 11 | Jun 11 | Sep 11 | Dec 11 | Mar 12 | Jun 12 | Sep 12 | Dec 12 | Mar 13 | Jun 13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 34 — Loan-to-deposit ratio | Weighted average | 117.1 % | 117.0 % | 116.6 % | 117.6 % | 117.8 % | 118.3 % | 119.8 % | 119.6 % | 117.7 % | 118.0 % | 117.7 % | 116.2 % | 115.7 % | 117.1 % | 114.2 % |
| | 25th percentile | 100.3 % | 100.6 % | 100.9 % | 103.7 % | 105.3 % | 103.7 % | 104.2 % | 108.7 % | 106.0 % | 105.1 % | 106.6 % | 106.4 % | 103.6 % | 100.7 % | 99.9 % |
| | 50th percentile | 114.1 % | 115.7 % | 117.4 % | 116.8 % | 117.5 % | 120.2 % | 119.5 % | 124.5 % | 124.1 % | 125.3 % | 125.9 % | 124.6 % | 119.1 % | 115.6 % | 114.6 % |
| | 75th percentile | 128.4 % | 132.2 % | 133.9 % | 135.6 % | 140.0 % | 135.0 % | 141.7 % | 139.4 % | 146.7 % | 148.3 % | 143.4 % | 137.1 % | 135.7 % | 131.1 % | 130.5 % |
| 35 — Customer deposits to total liabilities | Weighted average | 40.6 % | 39.7 % | 39.8 % | 40.6 % | 42.6 % | 43.2 % | 43.2 % | 40.1 % | 41.6 % | 41.8 % | 41.5 % | 41.6 % | 42.7 % | 43.6 % | 45.4 % |
| | 25th percentile | 35.6 % | 35.0 % | 33.7 % | 35.3 % | 37.5 % | 39.4 % | 38.5 % | 35.0 % | 35.2 % | 36.3 % | 36.0 % | 36.6 % | 36.1 % | 39.4 % | 41.4 % |
| | 50th percentile | 49.7 % | 49.5 % | 43.8 % | 47.4 % | 47.9 % | 48.8 % | 48.3 % | 44.6 % | 46.0 % | 47.8 % | 43.3 % | 46.9 % | 49.2 % | 50.2 % | 49.1 % |
| | 75th percentile | 59.2 % | 58.1 % | 56.8 % | 58.1 % | 59.9 % | 60.3 % | 57.7 % | 56.1 % | 56.4 % | 56.6 % | 56.3 % | 55.9 % | 57.9 % | 60.8 % | 60.8 % |
| 36 — Tier 1 capital to (total assets – intangible assets) | Weighted average | 4.2 % | 4.3 % | 4.3 % | 4.2 % | 4.5 % | 4.6 % | 4.6 % | 4.4 % | 4.4 % | 4.5 % | 4.5 % | 4.5 % | 4.7 % | 4.7 % | 4.9 % |
| | 25th percentile | 3.9 % | 4.0 % | 4.0 % | 3.9 % | 4.1 % | 4.1 % | 4.1 % | 3.9 % | 3.8 % | 3.9 % | 4.1 % | 4.1 % | 4.2 % | 4.3 % | 4.5 % |
| | 50th percentile | 5.5 % | 5.2 % | 5.1 % | 5.0 % | 5.3 % | 5.2 % | 5.2 % | 5.0 % | 4.6 % | 4.8 % | 5.1 % | 4.9 % | 5.1 % | 5.3 % | 5.4 % |
| | 75th percentile | 5.9 % | 6.1 % | 5.9 % | 5.9 % | 6.2 % | 6.3 % | 6.1 % | 6.2 % | 5.9 % | 6.0 % | 6.2 % | 6.3 % | 6.3 % | 6.6 % | 6.5 % |
| 45 — Debt-to-equity ratio | Weighted average | 1870.6 % | 1916.7 % | 1936.6 % | 1920.5 % | 1818.8 % | 1777.2 % | 1794.6 % | 1940.7 % | 1962.5 % | 1911.9 % | 1935.5 % | 1907.8 % | 1812.1 % | 1796.6 % | 1746.7 % |
| | 25th percentile | 1205.0 % | 1262.2 % | 1305.2 % | 1284.3 % | 1229.1 % | 1202.9 % | 1265.8 % | 1309.8 % | 1360.1 % | 1322.3 % | 1363.3 % | 1350.6 % | 1318.3 % | 1284.0 % | 1259.5 % |
| | 50th percentile | 1494.5 % | 1534.7 % | 1604.6 % | 1611.9 % | 1656.1 % | 1603.9 % | 1722.9 % | 1716.9 % | 1835.6 % | 1806.8 % | 1806.9 % | 1769.6 % | 1621.4 % | 1696.3 % | 1610.5 % |
| | 75th percentile | 22581 % | 2297.7 % | 2440.6 % | 2280.0 % | 2292.6 % | 2247.5 % | 2174.6 % | 2514.9 % | 2750.8 % | 2500.0 % | 2412.9 % | 2411.9 % | 2265.2 % | 2212.9 % | 2231.1 % |
| 46 — Off-balance sheet items to total assets | Weighted average | 18.1 % | 17.7 % | 17.6 % | 17.3 % | 17.7 % | 17.4 % | 17.3 % | 16.3 % | 18.6 % | 17.8 % | 17.7 % | 16.8 % | 17.4 % | 17.6 % | 18.2 % |
| | 25th percentile | 8.9 % | 8.5 % | 8.2 % | 8.2 % | 8.3 % | 7.8 % | 8.0 % | 7.7 % | 8.8 % | 8.3 % | 8.3 % | 7.7 % | 7.4 % | 8.0 % | 7.6 % |
| | 50th percentile | 14.7 % | 14.4 % | 14.2 % | 14.2 % | 14.0 % | 14.1 % | 13.8 % | 13.4 % | 15.1 % | 14.6 % | 14.7 % | 14.6 % | 14.7 % | 14.6 % | 14.8 % |
| | 75th percentile | 20.8 % | 20.0 % | 19.8 % | 20.3 % | 19.1 % | 19.0 % | 18.5 % | 17.4 % | 19.1 % | 19.9 % | 19.7 % | 19.1 % | 18.5 % | 19.5 % | 20.4 % |

European Banking Authority
Risk Assessment of the European Banking System

Luxembourg: Publications Office of the European Union

2013 — 46 pp. — 21 × 29.7 cm

ISBN 978-92-95086-52-4
doi:10.2853/58292

DZ-AC-13-002-EN-C


EUROPEAN BANKING AUTHORITY

Tower 42
25 Old Broad Street
London
EC2N 1HQ

Tel. +44 2073821770
Fax: +44 207382177-1/2
E-mail: info@eba.europa.eu

http://www.eba.europa.eu



ISBN 978-92-95086-52-4

Publications Office

doi:10.2853/58292