RISK ASSESSMENT OF THE EUROPEAN BANKING SYSTEM

JUNE 2014

EBA
EUROPEAN BANKING AUTHORITY

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Abbreviations

AQR	asset quality reviews
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BRRD	Bank Recovery and Resolution Directive
CDS	credit default swaps
CET	common equity tier
CoCos	contingent convertibles
CoE	cost of equity
CRD IV-CRR	Capital Requirements Directive and Capital Requirements Regulation
CRE	Commercial Real Estate
CT1	Core Tier 1 ratio
DDos	Distributed denial of service
EBA	European Banking Authority
EDF	expected-default frequencies
ESRB	European Systemic Risk Board
Euribor	Euro interbank offered rate
FICC	fixed-income, currencies and commodities
GC	global charge
IAS	International Accounting Standards
ICAAP	internal capital adequacy assessment process
IOSCO	International Organisation of Securities Commissions
IRB	Internal-rating based
KRI	key risk indicators
LGD	loss given default
LIBOR	London interbank offered rate
LTRO	long-term refinancing operations
NII	net interest income
NPLs	non-performing loans
PD	probability of default
RAQ	risk assessment questionnaire for banks
RAQ for market analysts	risk assessment questionnaire for market analysts
RoE	return on equity
RWA	risk-weighted assets
RW	risk weights
SMEs	small and medium-sized enterprises
SREP	supervisory review and evaluation process
SRM	single resolution mechanism

Executive summary

The EBA's key risk indicators show that a positive market sentiment and confidence are strengthening; however, the signs of recovery remain modest and fragile. Throughout the first half of 2014, following the publication of the EBA's last report on the risks and vulnerabilities of the European Banking System (December 2013), the EBA has continued to observe improvements in market confidence towards the EU banking sector, from both debt and equity investors. Nevertheless, a dislocation between financial markets and the real economy continues to be observed and risks to the EU growth outlook still weigh more heavily on the downside with forward-looking leading indicators pointing to the broad-based weakness of several EU Member States. Financial fragmentation persists, although it is receding, and geopolitical risks are increasing with retrenchment to home markets still a concern. Significant challenges within the EU banking sector continue due to the heavy debt overhang in the public and private sectors, the necessary restructuring of the debt-burned corporate and households sectors, the potential prudential impact of conduct-related issues, persistent asset quality deterioration, likely rising level of provisions, squeezed net interest margins and profitability concerns. Therefore, further challenges lie ahead and the ongoing repair of the individual banks' balance sheets and sector restructuring should remain a key priority for the medium term.

European banks have been taking advantage of favourable market conditions to raise capital ahead of the 2014 EU wide stress test. Following the EBA's recapitalisation exercise, the weighted average tier 1 capital ratio increased to 13.1 % and the weighted average tier 1 ratio excluding hybrid instruments — a good proxy of the core tier 1 ratio — for the largest European banks stood at 11.6 % in December 2013, a level broadly equivalent to the largest US banks. In 2013, for example, the euro area banks raised over EUR 80 billion in capital and in 2014, they will raise over EUR 60 billion, according to some market estimates, with significant amounts already raised during the first half of 2014 as a precursor to the 2014 EU wide stress test. The banks' issuance of equity across the EU, including by larger banks in financially stressed countries, have been able to benefit from a benign market sentiment. At the same time, quality of banks assets and the consistency of the the calculation of banks' risk weighted assets remains an area for close supervision.

Nonetheless, the quality of some banks' loan portfolios continued to decline in 2013 and the first months of 2014 and remains a concern across the EU, pointing to the need for rigorous asset quality reviews. The ratio of impaired and past due (> 90 days) loans to total loans increased slightly from 6.7 % in June 2013 to 6.8 % in December 2013 (the highest since 2009). The 75th percentile continues to present worrisomely high levels of approximately

16 %, which is well above historical levels for this ratio. At the same time, in some cases, provisioning has not increased in conformity with rising credit risks and an increasing dispersion is being observed, with some banks decreasing the coverage ratio levels. The share of banks with a coverage ratio of less than 25 % continues to represent 14 % of total KRI sample assets in December 2013 (from 13.2 % in December 2012). The uncertainties about asset quality have heightened the need for rigorous asset quality reviews (AQRs) and stress test exercises in 2014, with consistent definitions, across the EU. In October 2013, the EBA published recommendations for supervisors to conduct asset quality reviews on major EU banks in order to dispel concerns over the deterioration of asset quality. 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 until the end of 2013. In the last few months, however, EU banks have been actively managing loan exposure and are now more willing to sell both distressed and stressed loans in Europe's secondary market, as distressed investors line up to buy the loans. There are indicators that a downsizing of banks' balance sheets continues to take place in order to complete the repair of balance sheets. Increased transparency and confidence through front-loading of impairments are fundamental factors to reduce the sector risk premium. European banks have accomplished significant adjustments on the asset side by cutting risky assets, front-loading impairments (additional provisioning of EUR 25 billion between June 2013 and December 2013) and shrinking their balance sheets (– EUR 3.4 trillion since 2011). The deleveraging accelerated in the last months of 2013 (AQR cut-off date) and first months of 2014, the sovereign bond holdings were reduced, and long-term refinancing operations (LTRO) repayments accelerated. These are positive developments but there is still no room for complacency. Improvements in the reliability of the EU banks' balance sheets are necessary through a rigorous asset quality review and banks may end up needing additional capital and other additional measures. For this reason, banks and supervisors need to be prepared to take action as a result of these exercises.

EU banks' income and profitability has continued to be faced with significant headwinds, which are unlikely to dissipate in 2014 with the looming redress costs related to conduct issues a key concern. 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. In 2013, the total operating income declined EUR 10 billion (after a decline of EUR 39 billion in 2012) and, in the last quarter of 2013, the annual flow of profits declined by 58 % (EUR 54 billion). The main drivers were fundamental structural issues in terms of sustainability of some business models not adapted to a low interest rate environment, creating pressure on bank net interest margins and profitability concerns. At the same time, the balance-sheet clean-up of EU banks as pre-emptive measures in preparation for the EU wide asset quality

review and stress test exercise, as well as, litigation costs are also impacting economic performance.

A number of detrimental business practices of some EU banks have crystallised and costs have increased markedly. Banks with a return on equity (RoE) less than 4 % represented 39 % of total assets of the sample in December 2013: a worrying situation, which combined with the new regulatory environment and modest growth outlook, will continue to present a challenge for management in terms of sustainability of some banks' business models. Banks will need to adjust expectations and manage risks strictly in accordance with their risk appetite, which also means managing expectations about returns. A process of consolidation and resizing has already been on-going since 2008 (the number of credit institutions has fallen by 9% or around 600 institutions) and fundamental structural issues will make it impossible to maintain business as usual, thus a smooth exit of the weakest and non-profitable banks would contribute to competitive efficiency as part of this cleansing process. Consequently, supervisors will need to assess banks' profit and funding models, risk pricing, business mix, management strength and strategy, and engage with banks management on appropriate action where sustainability is in question.

Geo-political concerns and potential distress in emerging markets may raise risk aversion and affect capital flows. For some EU countries or banks, the exposure to emerging markets is relatively large in terms of total assets and contribution to the banks' profits. In addition, non-performing loans (NPLs) may rise significantly as these emerging economies slow down, some of them due to political turmoil. The uncertainties from either geo-political concerns or a normalisation of monetary conditions, after a prolonged period of monetary accommodation will require close monitoring. The two most important channels through which risk will materialise are the deterioration of asset quality in emerging markets and the possible slowdown of the global economy: these could disturb capital flows and strain the markets' confidence in a still modest economic recovery.

1. Introduction

This is the fifth semi-annual report on risks and vulnerabilities of the European banking sector conducted by the European Banking Authority (EBA). This report describes the main developments and trends that affected the EU banking sector in the first half of 2014 and provides the EBA's outlook on the main micro-prudential risks and vulnerabilities looking ahead.

The EBA considers that the information contained in the report provides the relevant stakeholders with a useful benchmark for analysis[1]. 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 31 December 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 2014 and comparisons with previous responses from a representative sample of 39 European banks (Annex I) is used in this report. In addition, the EBA conducted a survey (RAQ for market analysts) asking market analysts (23 respondents) a number of questions in a multiple-choice format with responses reflecting the degree of agreement with a given statement.

[1] With this report, the EBA discharges its responsibility to monitor and assess market developments and provides in-formation 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 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 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 and the dynamics of asset quality. 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.

Chapter 6 describes banks' income and profitability and the significant headwinds during the first six months of 2014. 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. Finally, Chapter 8 presents policy implications and possible measures to address the prudential issues mentioned in the previous chapters.

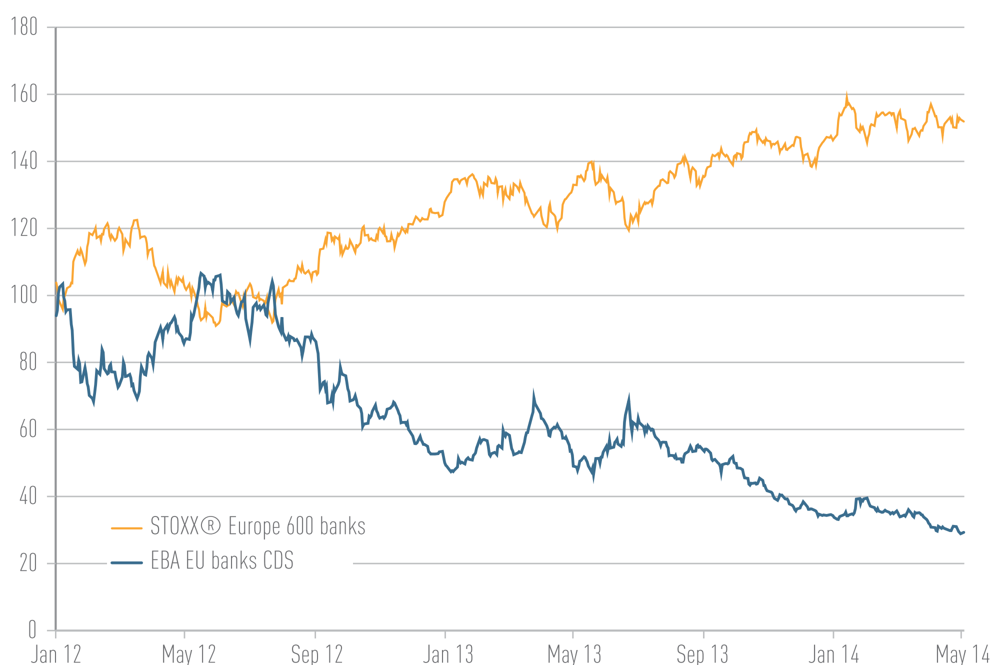
2. External environment

2.1 Market sentiment and macroeconomic environment

Europe has made significant progress in implementing structural reforms, at both national and EU wide levels, and the positive market sentiment is spreading to all EU Member States. Several initiatives have allayed the markets, and policy support and institutional changes have played an important role in this respect. EU banks' capital positions have increased and funding conditions improved during 2013 and in the first half of 2014. Sovereign debt spreads have continued to tighten and bank debt issuance has continued to develop positively in benign funding conditions. Even banks in countries with financially stressed sovereigns have continued to access both the debt and the equity markets. Increased confidence in stating that the worst of EU banking system's woes are over have seen iTraxx Euro Financials Credit Default Swaps (CDS) Index and the EBA EU Bank CDS Index tightened since July 2013 (Figure 1). These views reinforce a positive stance on financials and bank bonds across Europe, including financially stressed countries.

Europe's macroeconomic environment continues to display some signs of improvement;

Figure 1: Stock index — STOXX® Europe 600 banks share price index and CDS Index — EBA EU banks CDS Index, average Dec 2011=100 (*source*: Bloomberg, EBA calculations)



nevertheless, risks towards the global outlook remain conspicuous with the existence of subdued indicators and some ongoing dislocation between the positive market sentiment in financial markets and the still fragile macroeconomic environment.

There is a positive market sentiment and investor demand continues to be high

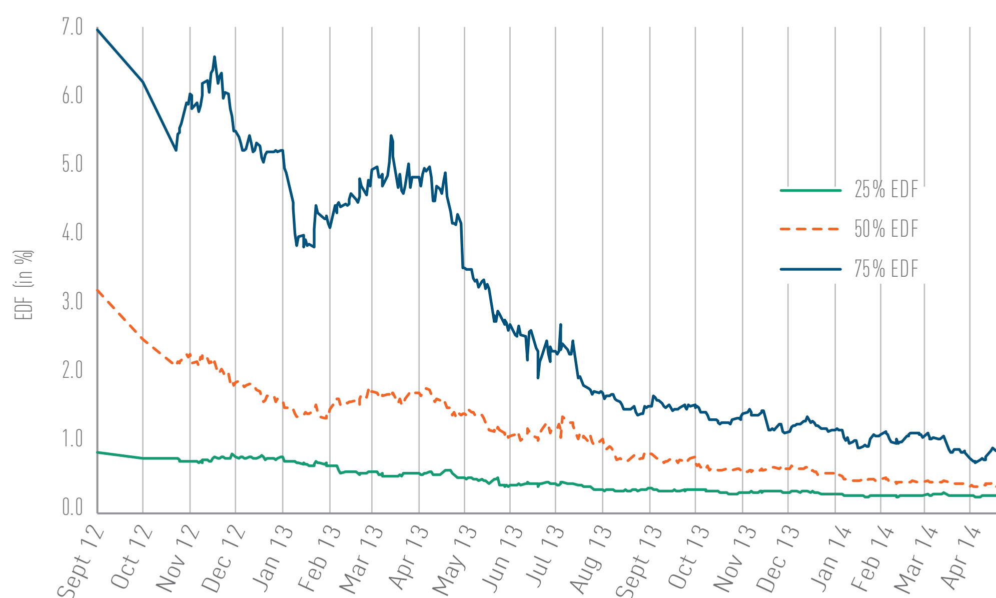
As a consequence of decisive policy measures and regulatory steps, funding conditions have continued to ameliorate in general, and particularly for banks in financially stressed countries, both for large and small banks. Thus, EU banks have continued to be active issuers over the first months of 2014, confirming that banks

in financially stressed countries are returning to the markets and that wholesale funding markets are open to most EU banks.

The largest EU banks are taking advantage of investors' search for yield, in a low interest rate environment, by issuing additional tier 1 bonds (also named contingent convertibles — CoCos) or tier 2 bonds. Market data show a total issuance of additional tier 1 debt (AT1) CoCos by EU banks of approximately EUR 22 billion up until the end of May 2014.

A positive market sentiment is also visible through a declining trend in EU banks' expected-default frequencies([2]) (EDF), in part related to the positive actions that were taken to strengthen EU banks' capital and funding. The tightening of the EDF quartiles and the reduction in the respective volatility are positive signs throughout the first six months of 2014 in comparison to previous years (Figure 2).

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



Moreover, there is an increased confidence in European sovereign debt markets combined with low levels in key interest rates and sovereign yields at historical lows. However, risks of realignment remain and detrimental linkages between banks and sovereigns persist even if less pronounced. High public debt overhang, incomplete reform implementation and a re-heightening of debt sustainability concerns together with significant amounts of domestic sovereign debt on banks' balance sheets may fuel detrimental banks-sovereign linkages. Furthermore, despite some improvements, geographical fragmentation of lending and funding conditions continues, with significant different rates for similar companies in different countries and dispersed funding condition between large cross border banks and smaller banks in financially stressed countries.

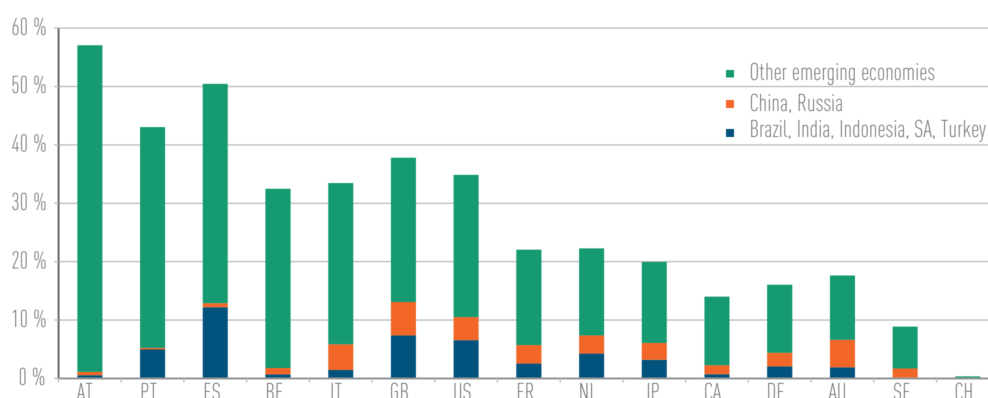
Emerging-market risks need to be closely monitored

Among the emerging markets, the macroeconomic environment is jagged and there are continued signs of weaknesses in China, Russia, Turkey and Ukraine. European credit is showing some resilience to emerging-market risks and seeing inflows of funds as investors switch out of emerging economies into Europe, looking for yield in bond markets, amongst other things. Nevertheless, European funding markets are facing increasing uncertainties after a prolonged period of monetary accommodation and expectations of a subsequent normalisation of monetary conditions. The reassessment of risk premia in global markets and a possible slowdown of recent investment flows or even abrupt reversals may produce some turbu-

([2]) Moody's KMV Expected Default Frequency (EDF) is a measure of the probability that a company will fail to make scheduled debt payments over a specified period — typically one year.

lence and managing these side effects may prove challenging and will consequently need special attention from policymakers. Contagion from emerging markets could spread through several channels such as bank lending and trade links. At the same time, the banking assets in emerging markets are relatively large for some EU countries or banks, for example in terms of foreign claims (Figure 3) or contribution to profits. Uncertainties and risk aversion increases may translate into a repricing in financial markets and higher levels of banks' funding costs. In addition, non-performing loans may rise significantly as these emerging economies slow down — some of them, such as Ukraine and Russia, due to political uncertainty. The possibility of sanctions against banks and other counterparties from states may also create some volatility and tensions; consequently, banks and supervisors will need to monitor external exposures to emerging markets and discuss contingency plans.

Figure 3: Banking-system exposure to emerging markets — percentage of total foreign claims — consolidated data on an ultimate risk basis (*source*: Bank for International Settlements (BIS), EBA calculations)

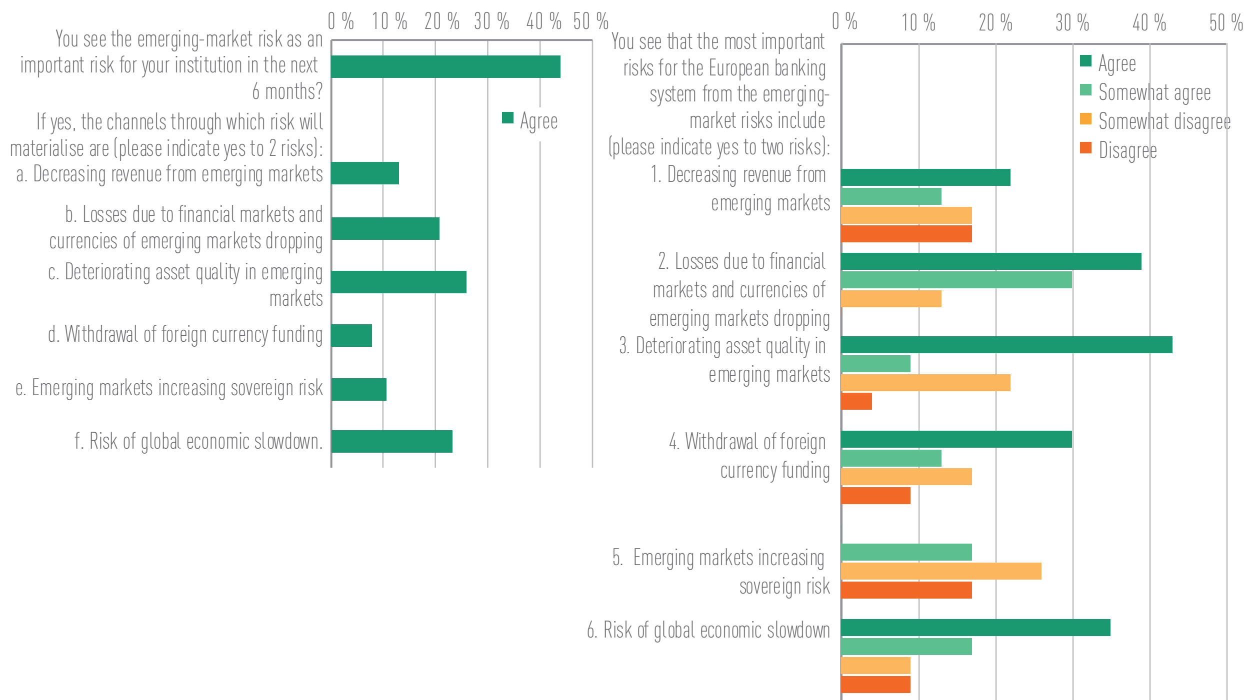


Most RAQ respondents (banks and market analysts) see the emerging-market risk as an important risk for their institutions in the next 6 months. The two most important channels through which risk will materialise are the deterioration of asset quality in emerging markets and the possible slowdown of the global economy.

On the contrary, the withdrawal of foreign currency funding and the possible increasing of sovereign risk of the emerging markets are considered less significant as risk channels in Europe (Figure 4) ([3]).

([3]) The length of the bars shows the percentage of respondents who: agree; somewhat agreed; somewhat disagreed; or disagreed with the statement on they axis.

Figure 4: Emerging-market risk (*source*: RAQ Banks and RAQ market analysts)



The risks of a too-prolonged period of low inflation deserve further attention

Forward-looking macroeconomic indicators show signs that the world economy improved in the second half of 2013 and growth is expected to accelerate for most advanced economies outside the EU. The outlook for EU real GDP development has been raised slightly since autumn 2013 and, in 2014, is expected to increase by 1.5 % (the increase in the euro area is expected to be 1.2 %). While some uncertainty has receded after a 2 year contraction, growth remains modest and fragile as the crisis' legacy of excessive debt, financial fragmentation and economic uncertainty still exists and threatens to remain a dragging on growth.

The outlook for inflation in the EU has been lowered substantially in the last few months and is expected to decrease to 1.2 % in 2014 (the decrease in the euro area is expected to be 1 %, standing at 0.7 % in April, up from 0.5 % in March 2014, the slowest pace in more than 4 years). The potential risks could result from a demand or supply shock, weakening the still fragile economic growth relative to the current forecasts and will significantly influence the levels of monetary accommodation. Subdued pressures are expected to maintain inflation at low levels and inflation expectations have been dropping implying that, in fact, there has been an increase in real interest rates since autumn 2013, with negative effects on growth and on the real debt burden.

2.2 Regulatory developments

The regulatory reform agenda has notched up some significant achievements with the adoption of a slew of landmark reforms and the main bulk of reform is now through. Nevertheless, there is still some way to go to make EU banks safer and financial markets more transparent.

In January 2014, the European Commission proposed a regulation on the reform of the structure of the EU banking system, built on the recommendations of the 'Liikanen report' [4].

The proposal completes the financial regulatory reforms undertaken over the last few years by setting out rules on structural changes for 'too-big-to-fail' banks. In order to ensure the effective and consistent supervision and the development of the single rule book in banking, the EBA would be consulted by competent authorities when taking certain decisions as set out in this proposal and would be required to assess the potential impact of such decisions on the financial stability of the EU and the functioning of the internal market. In addition, the EBA would be required to prepare draft regulatory measures and implementing technical standards, and submit reports to the Commission.

[4] *High-Level Expert Group on reforming the structure of the EU banking sector*, Chaired by Erkki Liikanen, 2 October 2012.

Recovery and resolution legislation is in train

In April 2014, the European Parliament approved the EU's Bank Recovery and Resolution Directive (BRRD) as well as the EU's single resolution mechanism (SRM). The proposed rules include measures dealing with restructuring and winding down stressed lenders together with ensuring banks guarantee deposits under EUR 100 000 (for short-term deposits of up to EUR 200 000) in the event of a run-down. The pooled guarantee funds are expected to amount to EUR 44 billion within the next 10 years. The legislative proposals on recovery and resolution will aid in creating a common framework for European banks going forward with credible procedures for resolving distressed banks. At the same time, the decision of the Basel Committee on Banking Supervision (BCBS) on the definition of the leverage ratio brought light to an important topic.

Following the EBA Recommendation on the development of recovery plans (EBA/REC/2013/02), the vast majority of large European cross-border banking groups now have recovery plans in place. In the context of supervisory colleges, the EBA has noted the engagement of supervisors' colleges in the assessment of the recovery plans of European banking groups. This engagement will become increasingly important following the publication of the BRRD.

In May 2014, a vast majority of Member States signed an intergovernmental agreement on the transfer and mutualisation of contributions to a single resolution fund that will be established as part of Europe's banking union. The agreement will complement the regulation on the creation of a single resolution mechanism (SRM), which establishes the fund and also features a central decision-making board.

The fund will be built up over 8 years, reaching a target level of at least 1 % of the amount of covered deposits of all credit institutions authorised in all the participating Member States. It is estimated that this will amount to about EUR 55 billion.

Efforts to revive the securitisation market continue

Moreover, following two different calls for advice from the Commission, the EBA is currently working on a technical paper to provide advice on the development of a sound, stable, and transparent securitisation market which could help unlock additional funding sources for banks and therefore revive the real economy in Europe and on a report on EU covered bond frameworks and the prudential capital treatment. The aim of this report is to increase convergence of the EU covered bonds market towards common safeguards of robustness and credit quality, which may also be beneficial to the development of a large investor base. In addition, in accordance with the CRR, the EBA published in December 2013 final draft technical standards regarding the securitisation retention rules, due diligence and disclosure requirements and is finalising Guidelines on significant risk transfer for securitised assets.

Regulatory and supervisory efforts across the single market will continue apace

As a result of the completion of significant elements of the legislative programme, RAQ respondents note that regulatory clarity has improved. Nevertheless, significant execution risks remain ahead; for example, concerns on the execution of asset quality review and stress test exercises, IT-related risks, implementing 'bail-in' rules or the near-term delinking of sovereigns and banks. 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, particularly in regard to the timing and respective contents.

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 work on recovery and resolution. Given the concerns on the integrity of the single market, it is fundamental to complete the legislative process with structural and institutional reforms at European level. Meanwhile, the EBA will continue pursuing its objectives in advancing towards a single EU wide rule book and promoting regulatory and supervisory convergence across the Union, in both rules and practices. The unity and integrity of the EU single market will thereby be strengthened through the development of uniform rules in key areas and implemented whilst the EBA will promote and monitor convergence in supervisory practices through the issuance of guidelines, its handbook and through participation in colleges of supervisors for cross border banking groups across the EU as a whole.

3. Assets side

The EBA's KRI demonstrate that the quality of banks' loan portfolios continued to deteriorate throughout 2013. Nonetheless, responses to the RAQ indicate expectations of marginal improvements in asset quality in the first months of 2014 in comparison to the previous months. The expectation of improvements emerges for the first time after several months of negative prospects. At the same time, investor capital is returning to Europe and banks have been able to sell their non-performing loans to external investors.

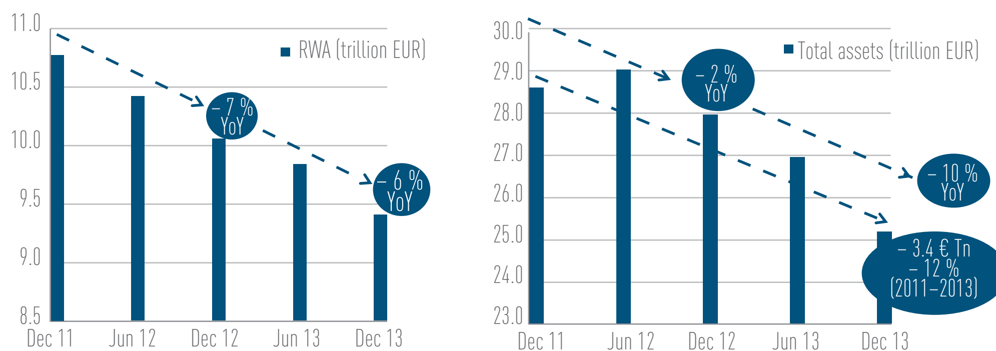
Pre-emptive measures have been taken in the context of EU banks' preparation for both asset quality reviews and stress test exercise

Deleveraging has mostly been achieved through run-off, rather than sales of assets, but there is an increasing evidence of portfolios sales and lines of businesses in the first six months of 2014. As pre-emptive measures, it is now evident that banks are doing their utmost to frontload the adjustments that result from the EU-wide asset quality review and the stress-test of 2014.

EU banks are adapting to the new business environment as a direct result of the financial crisis, economic uncertainty and regulatory reform. The financial crisis has exposed weak business models and business lines, and the wave of global regulatory reform is appreciably altering the risk return dynamics of numerous business lines going forward.

There is a continuing reduction in balance sheets and loan books across the EU (Figure 5); however, 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. Significant challenges persist due to the heavy debt overhang in the public and non-financial private sectors (e.g. households) and the still very high level of indebtedness of non-financial corporations by historical standards. The on-going process of achieving sustainable levels of debt and possible restructuring of the debt-burdened corporate sector will maintain important vulnerabilities within the EU banking sector due to a still fragile economic activity and interest rate developments, in particular in scenarios of higher costs of debt financing. Therefore, further challenges lie ahead and the ongoing repair of the banks' balance sheets should remain a key priority also after the EU-wide asset quality reviews and stress test exercise.

Figure 5: Risk-weighted assets and Total assets — trillion EUR (*source*: KRI data)



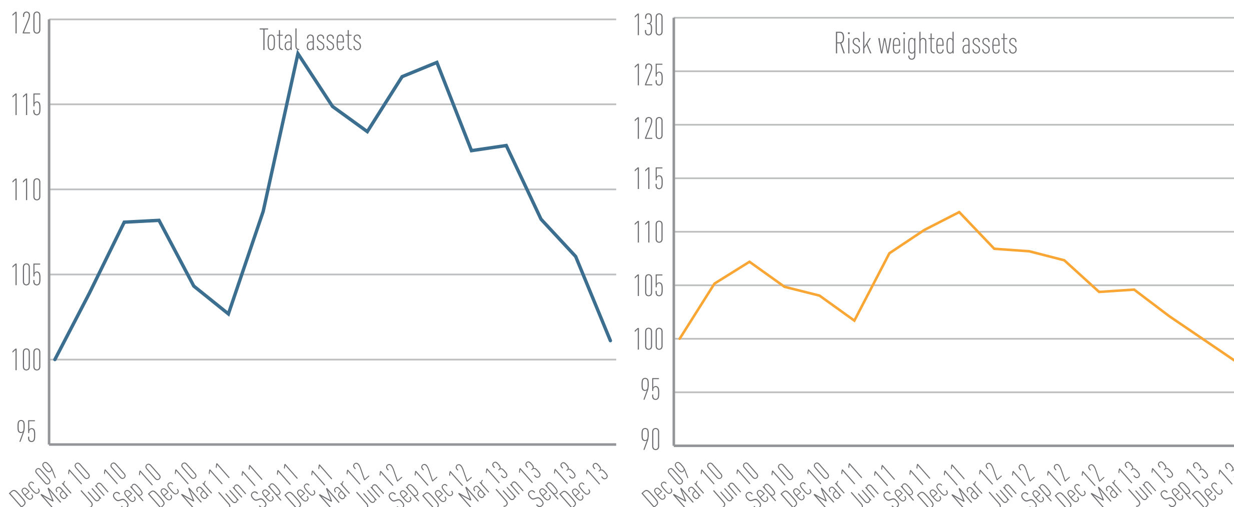
3.1 De-risking

Deleveraging and de-risking continue to be very important components for repairing and strengthening the EU banking sector as well as improvement in the transmission mechanism of monetary policy, so as to allow the real economy to benefit from the current level of interest rates. Stable and long-term solutions for repairing the EU banking sector include more transparency through both the EU wide asset quality review and the stress test exercise in 2014. Therefore, completing the action of balance sheet repair in the EU banking sector, far from hampering growth, is instead a precondition to kick-starting lending in the real economy.

De-risking continues

EU banks are carving out non-performing and non-core assets and these will allow these banks to restart lending to creditworthy clients. Some indicators show that de-risking and downsizing of banks' balance sheets continues to take place with significant changes regarding the total assets and risk weighted assets since 2009 (Figure 6). At the same time, the calculation of banks' risk weighted assets remains an area for close supervision.

Figure 6: Evolution of the Total assets and Risk Weighted Assets — December 2009 = 100 (*source*: KRI)



Comparability of risk-weighted assets

The EBA is developing a wider and deeper analysis on the consistency of risk-weighted assets (RWAs) in the banking book across European banks. The objective is to identify any material difference in banks' assessments of risks and to understand the main drivers of such differences, while the non-risk weighted metrics, such as the leverage ratio, could be used as a backstop.

The analysis is based on benchmarking exercises for the low default portfolios (central governments, credit institutions and large corporate), for small and medium enterprises (SME — classified as retail or as corporate) and residential mortgages portfolios. The fourth interim report was published on 11 June 2014.

The policy responses that the EBA considers as particularly important for addressing concerns about RWA consistency are the following:

(i) enhancing disclosure and transparency of RWA-related information: the analysis demonstrates that enhanced transparency could help market participants understand — and therefore trust — bank risk weighted assets. The EBA is providing appropriate disclosure of RWA-related information and underlines the importance of roll out of IRB models, share of defaulted assets, or different share of asset classes to explain variation in RWA.

(ii) supporting competent authorities (CA) in properly implementing the single rule book with the delivery of existing mandates set out in the CRR and CRD (these include the important benchmarking work on RWA parameters that supervisors can use to assess model outcomes): from 2014 onwards the EBA will perform yearly benchmarking exercises with the objective to inform competent authorities for their assessment of internal models and steer discussion on common issues at European level. For the time being, the EBA is bilaterally engaging with the CA, promoting the use of the outcome of the studies and collecting their assessment about the functioning of the internal approaches.

(iii) developing additional guidance that specifically addresses and facilitates consistency in supervisory and banks' practices, which includes, for example, uniform default defini-

tions and harmonised treatment of defaulted assets under the internal-rating based (IRB) approach, clearer guidance on probability of default (PD), loss given default (LGD) estimations and treatment of low-default assets: the analysis has proven that better harmonisation of supervisory practices are needed, which is also in line with the mandated given to the EBA by the CRR when drafting guidelines or technical standards on credit risk.

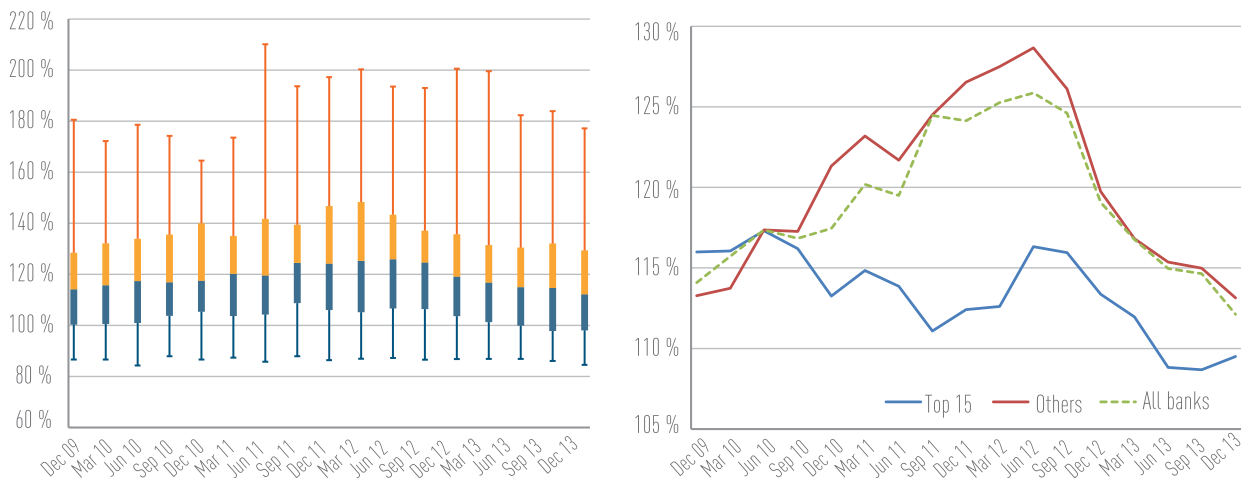
The EBA considers that the understanding, transparency and consistency of risk weighted assets will improve through the policy responses above mentioned and will help to restore market confidence in risk-sensitive measures of capital adequacy.

Several signs of increased deleveraging

Over the last 6 months of 2013, the debt-to-equity ratio decreased from 17.5 to 16.5, the loan-to-deposit ratio declined from 114 % to 113 %, and customer deposits over total liabilities increased from 46 % to 48 %. In the last few years, deleveraging has been significant and EU banks have cut around EUR 4 trillion in total assets. Over the last 6 months of 2013, the sum of total assets decreased by 6.6 %, and further changes to banks' balance sheets are expected as business models still need to adapt to a new environment in order to avoid persistent investor doubts about bank asset valuations.

In parallel, the loan-to-deposit ratio has continued to show a general downward trend since June 2012, 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 112 % in December 2013), but and more importantly so also have the 75th percentile (from 139 % to 129 % in December 2013). The 75th percentile is now 21 percentage points less than its March 2012 maximum value, a significant decrease in just two years (Figure 7). Furthermore, this trend is observed within the EU in different size classes (i.e. Top 15 banks and remaining banks) and with different intensities across geographies.

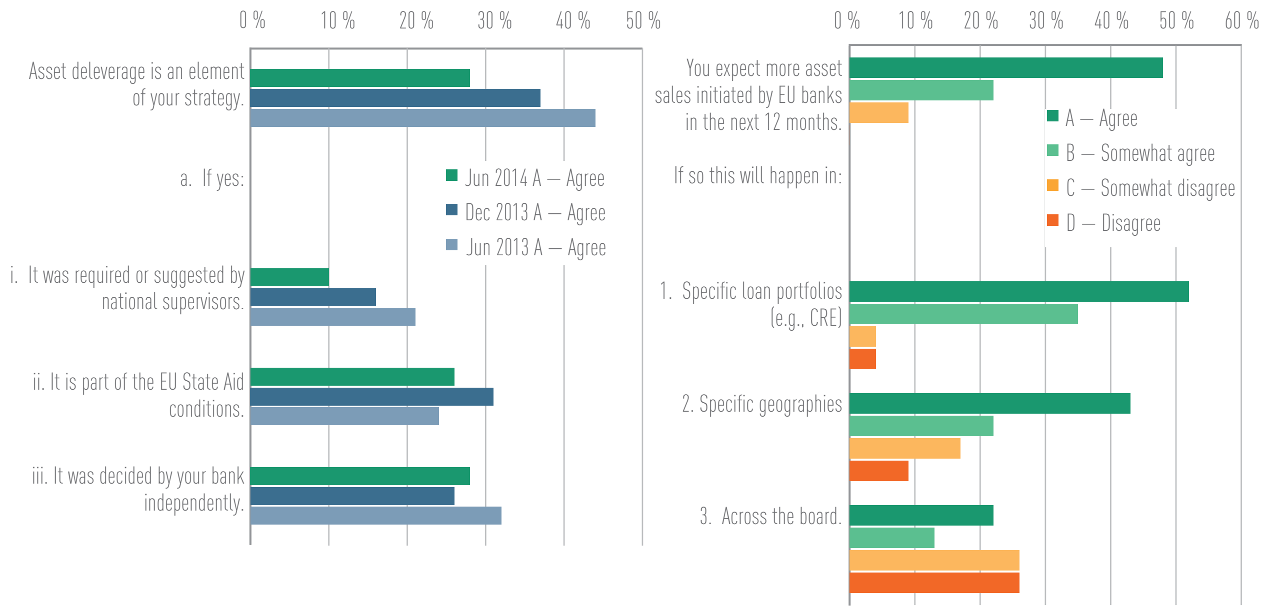
Figure 7: Loan-to-deposit (*source*: EBA KRI) — 5th and 95th percentiles, interquartile range and median, and by size class — medians (as of December 2013); banks are classified in the size class according to the their average total assets between December 2009 and December 2013



Investor appetite for banks' assets rises

This trend also seems to be confirmed when looking at the outcome of the RAQ; however, there are some signals that banks are prepared to reduce the pace of deleveraging. While most of the RAQ respondents continue to agree that the asset deleverage is an element of their strategy, this majority continues to decrease. At the same time, the majority of respondents state that they are deleveraging for both 'private' drivers (i.e. according to their own business strategy reasons which are decided independently), and for 'public' drivers (i.e. according to official requirements as part of the EU State aid conditions). In addition, the importance of possible requests or suggestions by national supervisors is decreasing (Figure 8).

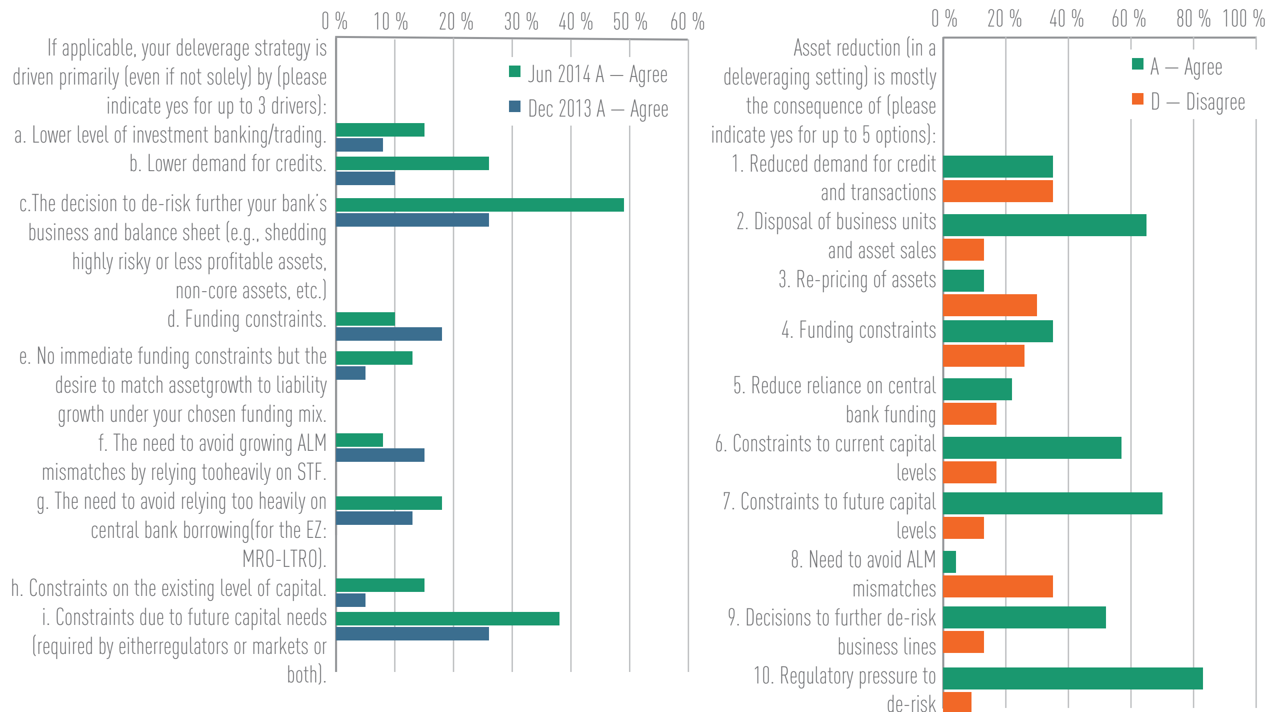
Figure 8: Deleverage (*source*: RAQ)



According to market analysts' views (RAQ for analysts), more asset sales to external investors by EU banks are expected in the next 12 months. Interestingly, the number of respondents that agree with this has increased from 35 % in December 2013 to 48 % in June 2014. The asset sales will be predominantly in specific loan portfolios (e.g. commercial real estate).

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 by, for example, shedding highly risky or less profitable assets. Other important drivers are the potential constraints due to future capital needs and the lower demand for credits. Market analysts also agree that loan deleverage is mostly the consequence of regulatory pressure to de-risk, constraints to future capital levels, disposal of business units and asset sales, and banks' decisions to further de-risk business lines (Figure 9).

Figure 9: Deleverage drivers (*source*: RAQ and RAQ market analysts)



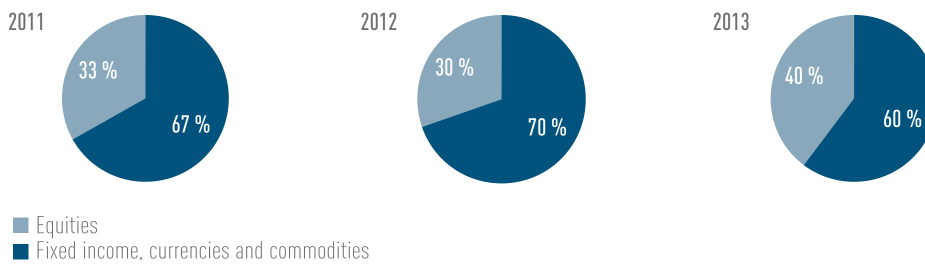
The focus of deleveraging targets remains in wholesale assets

While banks envisage achieving an asset reduction from the current level and over the next 24 months, an increasing majority of RAQ respondents still indicate that the reduction will be below 2 % of total assets. This evolution may indicate that, for several banks, the main objectives of deleveraging were achieved; however, the number of respondents with levels of deleverage above 10 % continued to be stable throughout the last months.

Market analysts also concur that asset deleveraging will continue over the next 12 months, particularly in the financially stressed countries as many banks have still very high loan-to-deposit ratios. The expected areas for deleveraging continue to be in investment banking, trading and cross-border wholesale assets.

Fixed-income, currencies and commodities (FICC) are an important part of European investment banks' trading and profits. During the crisis, FICC generated heavy losses and regulatory and legal reactions, and continues under pressure due to weak markets and ongoing regulatory challenges. The percentage shares of equity and FICC income show shifting signs (Figure 10).

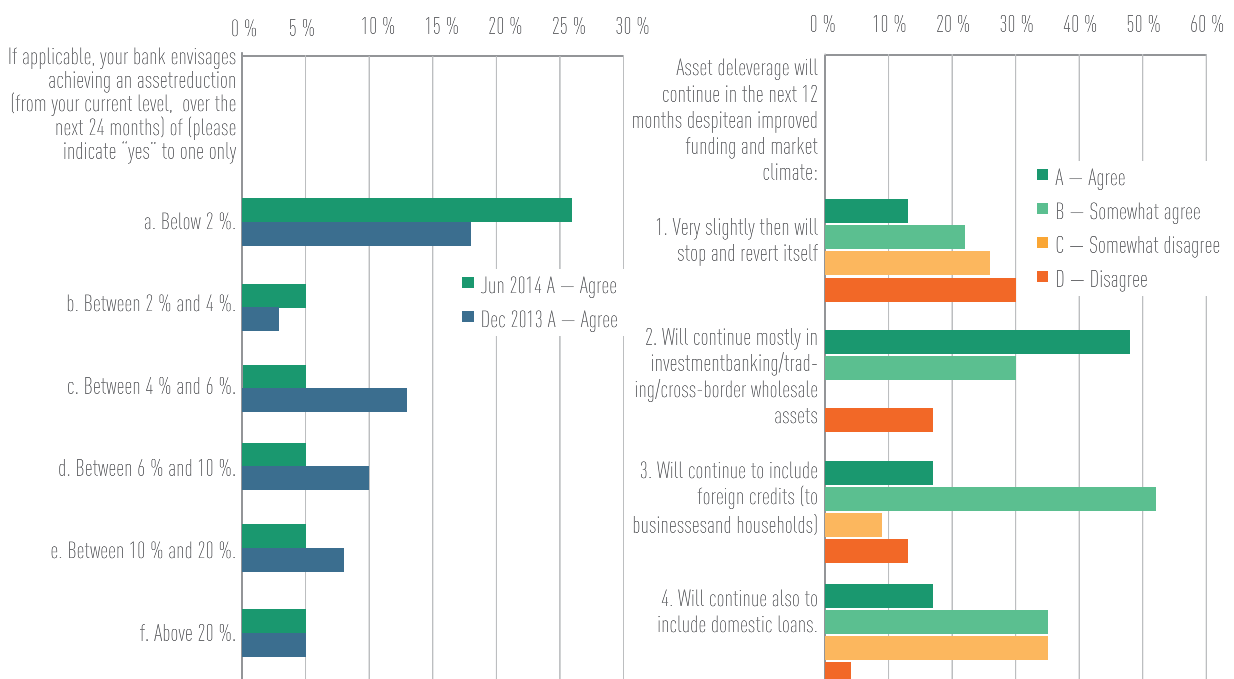
Figure 10: Equity and fixed-income, currencies and commodities income (*source*: SNL, six large European investment banks, as of April 2, 2014)



There is some ambiguity concerning banks' strategy, capital allocations, and a general scepticism about the FICC business model, taking into account profitability, market positioning and litigation risks. The pressure on investment banking continues to increase due to weak FICC revenues, forcing restructuring and cost-cutting among European banks.

The inclusion of foreign credits to businesses and households is also somewhat expected as part of the deleveraging process (Figure 11).

Figure 11: Levels of asset reduction and deleverage drivers (*source*: RAQ and RAQ market analysts)



There are signs of a resurgent risk appetite

In contrast, other riskier financial instruments are increasing in popularity; for example, the issuance of covenant light loans, payment-in-kind bonds, and high-yield bonds from mid-caps. Regarding the growing volumes of covenant light loans, around EUR 8 billion in 2013, this signals that debt investors have a preference for riskier instruments rather than the creditor protection on European leveraged buyout loans. The re-emergence of lending to leveraged clients should increase the interest and close monitoring of the banking supervisors, particularly regarding the lending practices of EU banks and possible repetition of excessive risk-taking. Moreover, the real estate markets are showing divergent valuations within the EU, reflecting a significant heterogeneity in housing markets. Given the fact that, in some countries, property prices have risen significantly, this is raising concerns about possible risks of overvaluation.

EU Banks' preparation for the 2014 EU-wide stress test and the main features of the exercise

As important pre-emptive measures in the context of EU banks' preparation for both asset quality reviews and stress test exercise, banks have been doing their utmost to frontload the adjustments that will result from these exercises. This indicates a proactive reaction from the EU banks, with a steady increase in capital and a reduction in the on-balance-sheet financial sector leverage to lower levels within the EU. Over the last months, more specifically by the end of 2013 and especially during Q1 2014, it was clear that banks have made further efforts in increasing coverage ratios, getting rid of risk assets, and raising fresh capital.

EU banks have taken measures, such as assets sales and share sales and they are expected to sell a record EUR 80 billion of noncore loans in 2014, compared to EUR 64 billion in 2013. Moreover, capital offerings continued in several jurisdictions in Q4 2013 and the first months of 2014, both common equity and hybrids. About EUR 34 billion has either been raised or is to be raised through issues of publicly listed shares and capital gains from asset disposals, as well as EUR 22 billion of contingent capital hybrids and EUR 19 billion of extra provisions.

Consequently, with coordinated policy actions scrutinizing EU banks' balance sheets and testing their strength, the consequent pre-emptive measures show that both the 2014 EU-wide AQR and stress test exercise are posing the right incentives.

The key features of the 2014 EU-wide stress test are also clear, namely (i) a credible tool for supervisors; (ii) an instrument of comparability across banks; and (iii) a high level of transparency within the EU. Among important examples of common treatments across all EU-countries is the common approach for the application of prudential filters for assets in the available-for-sale (AFS) portfolio, including sovereign exposures. That is, 'minimum' transitional requirements apply to all EU-countries independent of national derogations, e.g. including 20 % of unrealised losses in 2014, 40 % in 2015 and 60 % in 2016. Additionally, the impact of the application of prudential filters on the stress test results will be publicly disclosed.

Static balance-sheet assumption prevents unproven mitigation actions from banks

The EBA stress test remains a bottom up exercise, but some methodological safeguards were introduced to avoid overly optimistic and unrealistic outcomes. The common methodology reflects important severe assumptions and constraints throughout the exercise. In addition to the static balance sheet assumption, important constraints are also imposed to reflect possible changes in funding by using asymmetric pass-through minimums to corporate and households deposit rates, as well as caps to residential mortgages and new lending rates. Moreover, several new types of floors and caps were developed for profits and losses (P&L), as well as risk weights (RWs) in order to guarantee the credibility and consistency of the common methodology.

Table 1: Overview of floors and caps in the stress test common methodology (*source*: EBA)

P&L	Floor		Cap	
Net interest income			End 2013	Para 181
Interest expense	End 2013	Para 172		
Net interest income			End 2013	
Net fee and commission income			End 2013	Non interest income/total assets cannot be larger than 2013 (adverse) — Para 197
Net trading income after stress (comprehensive approach)			net trading income before stress	Para 99
Net trading income after stress (simplified approach)			net trading income before stress	Para 110
Administrative and other operating expenses	End 2013	Para 186		
Impairment of financial assets				
Impairment on non financial assets				
Pre-tax profit				
Tax	30 % or pre tax profit per year of exercise	in P&L template		
Net income				
Net income of the year net of estimated dividends			Pay-out ratioaverage 2011/13	in P&L template
RWA	**Floor**		**Cap**	
RWA per regulatory portfolio	End 2013	Para 89		
RWA operational risk	End 2013	Para 211		

3.2 Asset quality

The quality of banks' loan portfolios continued to decline in 2013 and in first months of 2014 and remains a concern, harmfully contributing to the continuation of elevated risk premium levels on European banks. Notwithstanding this, the impairments are showing some signs of stabilisation and the weighted average of the coverage ratio has been increasing since December 2011. At the same time, in some cases, provisioning has not increased in conformity with rising credit risks and an increasing dispersion is being observed and translated into more banks and respective assets with a coverage ratio of less than 25 %.

This mixed picture in terms of coverage ratio continues to raise some questions about the extent to which provisioning is adequate and about the capacity of some banks to cope with rising credit risks. The balance-sheet clean-up of EU banks with significant front-loading provisioning, as pre-emptive measures in preparation for the EU wide asset quality review and stress test exercise, are contributing to profitability pressures.

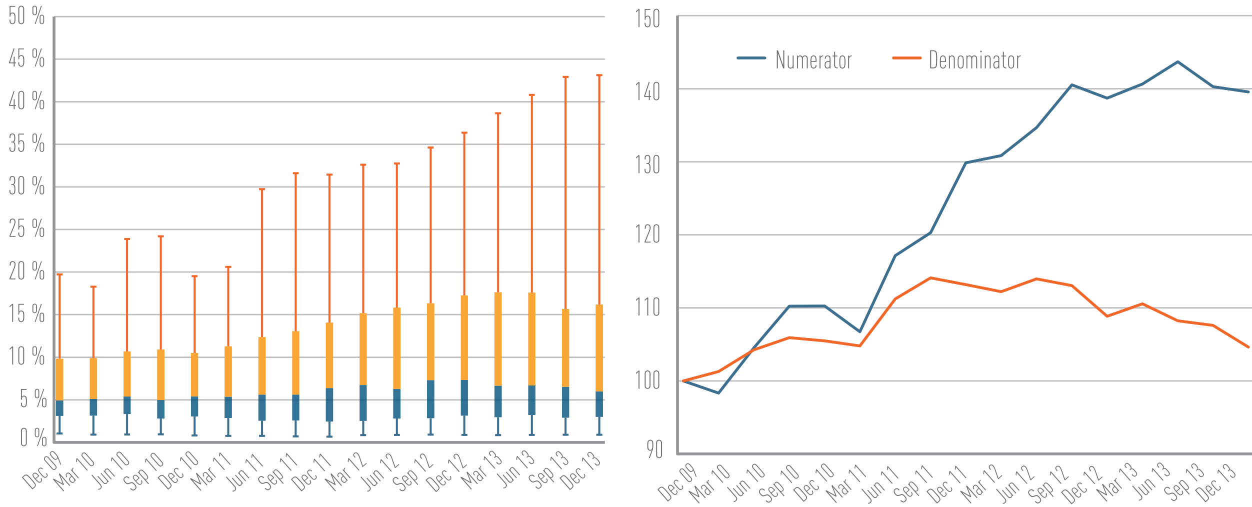
On the other hand, there is evidence that banks have been selling non-performing loans to investors and a composition effect, by refocusing on some activities or improvements in credit risk management, may partly explain lower levels in the coverage ratios for some banks (e.g. mortgage lending instead of commercial lending, more guarantees). Given the belief that mortgage portfolios have generally recognised lower losses, the average provisioning levels for exposure to real estate continue to deserve particular attention and close monitoring. Moreover, the increase in the level of impairment provisioning may pose challenges in maintaining adequate capital levels in some cases.

Asset quality still showing some deterioration

According to the KRI, impaired loans are still showing a deterioration but with some signals of stabilisation (after a significant increasing trend since March 2011). The ratio of impaired and past due (> 90 days) loans to total loans increased slightly from 6.7 % in June 2013 to 6.8 % in December 2013. On the other hand, the 75th percentile continues to present high levels of approximately 16 % despite a decrease in comparison to June 2013 (from 17.6 % to 16.2 %), which is well above historical levels for this ratio. However, this is also influenced by the decrease in the denominator (total loans and advances).

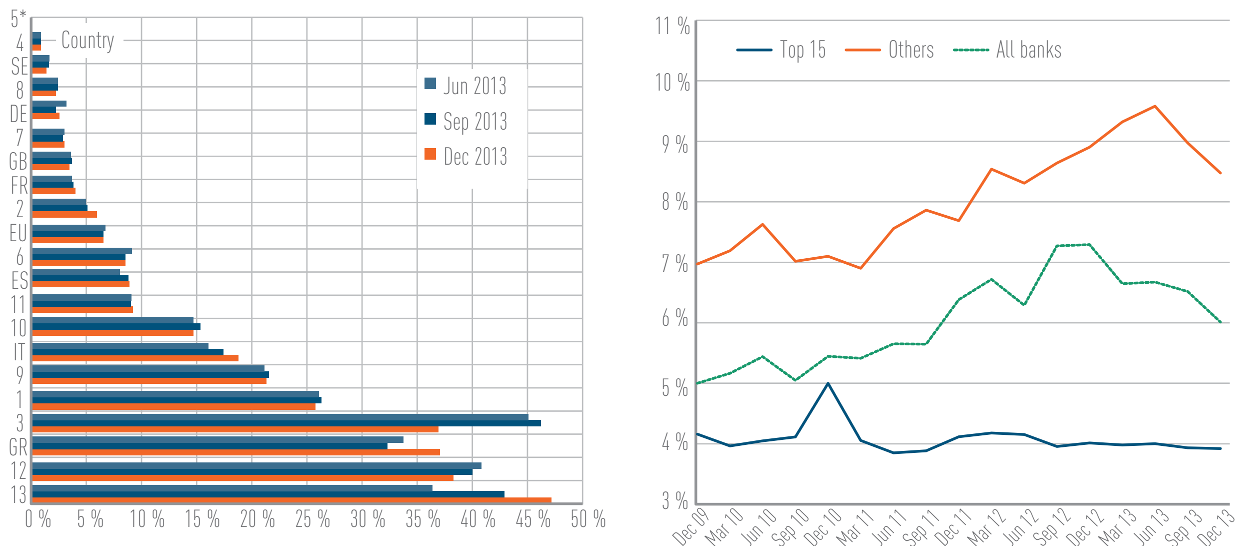
The dispersion also continues to be significant and is still increasing, achieving the highest level since 2009 (Figure 12). Banks with a ratio of impaired and past due (> 90 days) loans to total loans higher than 10 % represented 13 % of total assets in December 2013 (from approximately 14 % in June 2013 and still far from 5 % in December 2009). Moreover, banks with a ratio of impaired and past due (> 90 days) loans to total loans less than 5 % continue to decrease and represented 55 % of total assets in December 2013 (down from approximately 59 % in December 2012 and 57 % in and June 2013).

Figure 12: 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 (December 2009 = 100)



Banks from six countries (one additional country in comparison with June 2013) have median values of impaired loans and past due loans to total loans of more than 20 % (Figure 13).

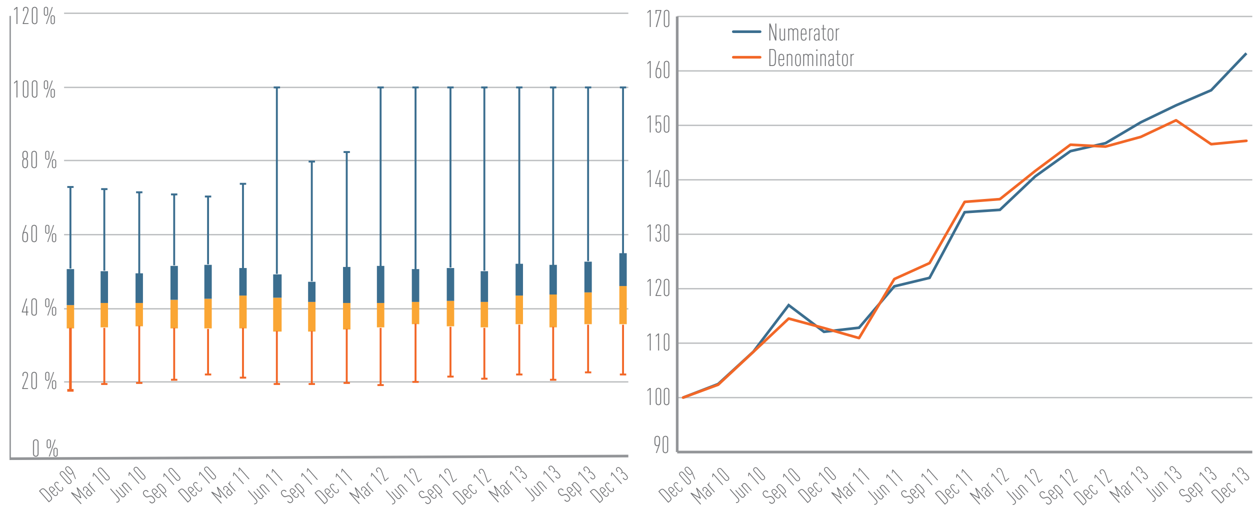
Figure 13: Impaired loans and past due (> 90 days) loans to total loans (*source*: KRI) — country dispersion — medians by country and by size class (as of December 2013); banks are classified in the size class according to the their average total assets between December 2009 and December 2013



Growing divergence between banks with some presenting lower coverage ratios

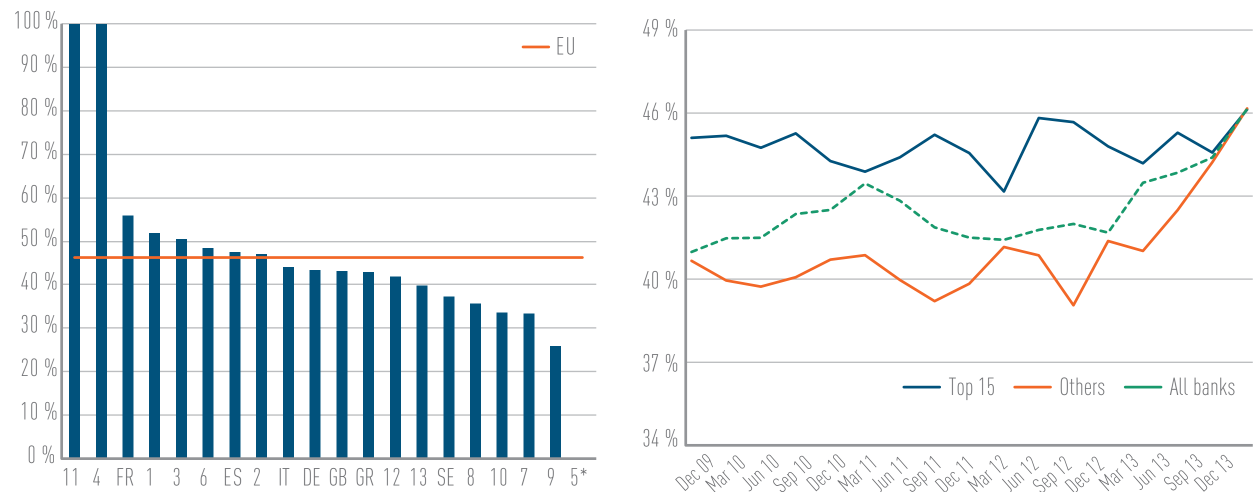
In regard to the coverage ratio (Figure 14), the weighted average has been increasing since December 2011 and shows the highest level since 2009 (47.2 %). In addition, the 25th percentile also increased but only slightly in the last six months of 2013 (from 33.7 % in June 2013 to 34.5 % in December 2013), after a worrying and slow decrease since June 2012. However, the share of banks with a coverage ratio of less than 25 % continue to represent 14 % of total KRI sample assets in December 2013 (from 13.2 % in December 2012, and the highest value since December 2009, at only 1.7 %). The general trend is showing that some banks are diverging from the majority and presenting lower coverage ratios.

Figure 14: Coverage ratio — specific allowances for loans to total gross loans (*source*: KRI) — 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (December 2009 = 100)



The coverage ratio continued to increase particularly in medium-sized banks (in comparison with the top 15 EU banks), augmenting the weighted average of the EU banking system and confirming a trend initiated in December 2012. However, banks from some countries maintain low median values of coverage ratios (Figure 15).

Figure 15: Coverage ratio — specific allowances for loans to total gross loans (*source*: KRI) — country dispersion — medians by country and by size class (as of December 2013)



Only marginal improvements in asset quality are expected in the near term

Looking ahead as much as 12 months, responses to the RAQ indicate expectations of marginal improvements in asset quality in comparison to the previous six months (Figure 16). The expectation of improvement comes into sight for the first time after several months. In fact, currently there are more responses indicating that the general trend in the quality of banks' credit portfolios is marginally improving rather than remaining steady (41 % against 33 %). This is a strong increase in the general trend initiated in December 2013 (an increase from 9 % in June 2013 to 16 % in December 2013 and 41 % in June 2014).

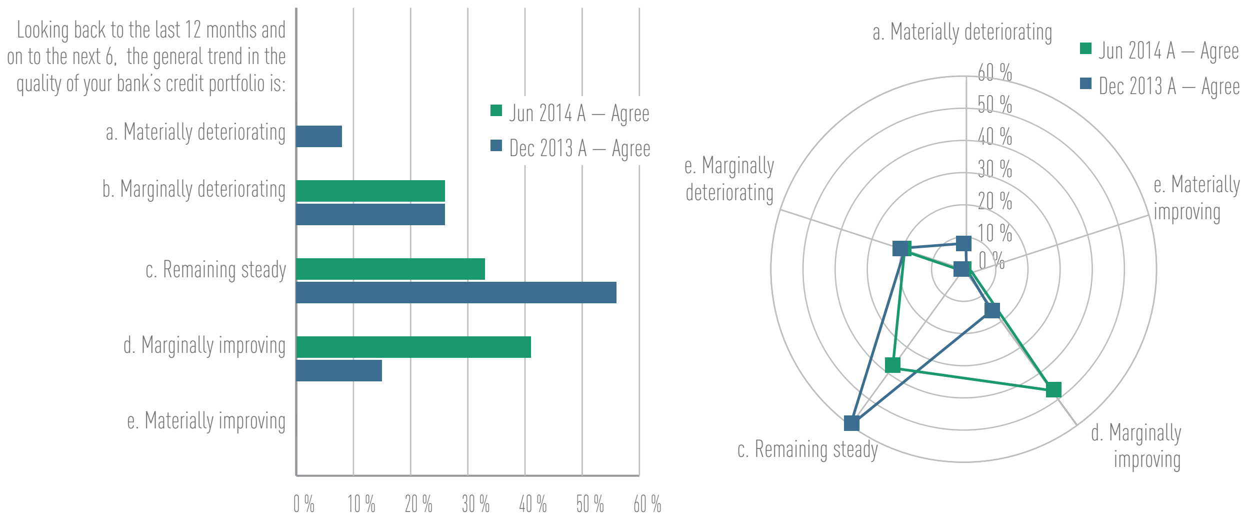
But these should prefigure a general improvement

In addition, the responses regarding the trends in credit quality and impairment levels over the period of the next 12–18 months continue to show expectations that the impairment provisions will remain at roughly the same level (41 % of respondents agree

with the statement). These are strong improvements in the expectations of quality of banks' credit portfolio.

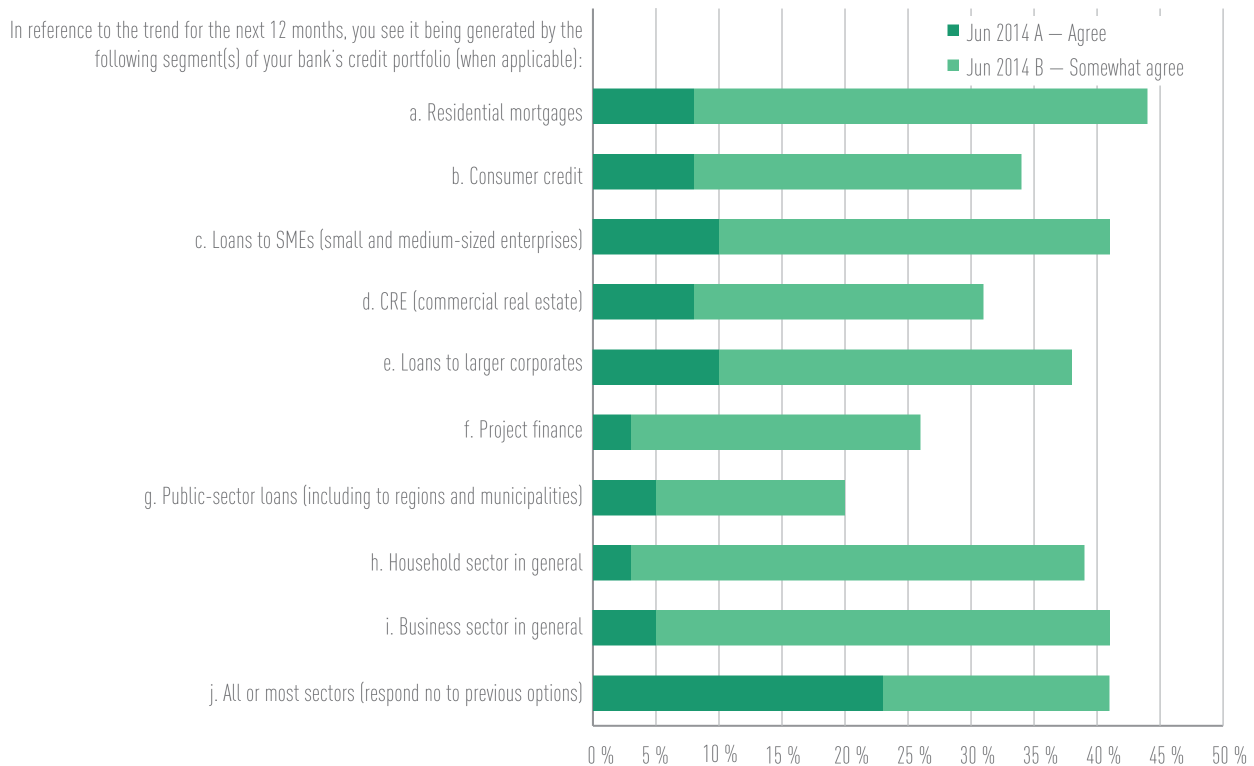
Further reflecting on the expectations of asset quality concerns for the next 12 months (Figure 17), the large majority of RAQ respondents continue to state that the trend of the quality of loan portfolios is being generated by the same segments, in particular in SME lending portfolios and residential mortgages. The commercial mortgages, consumer credit and public sector loans (including to regions and municipalities) are now less mentioned in comparison to previous months.

Figure 16: Quality of loan portfolios (*source*: RAQ)



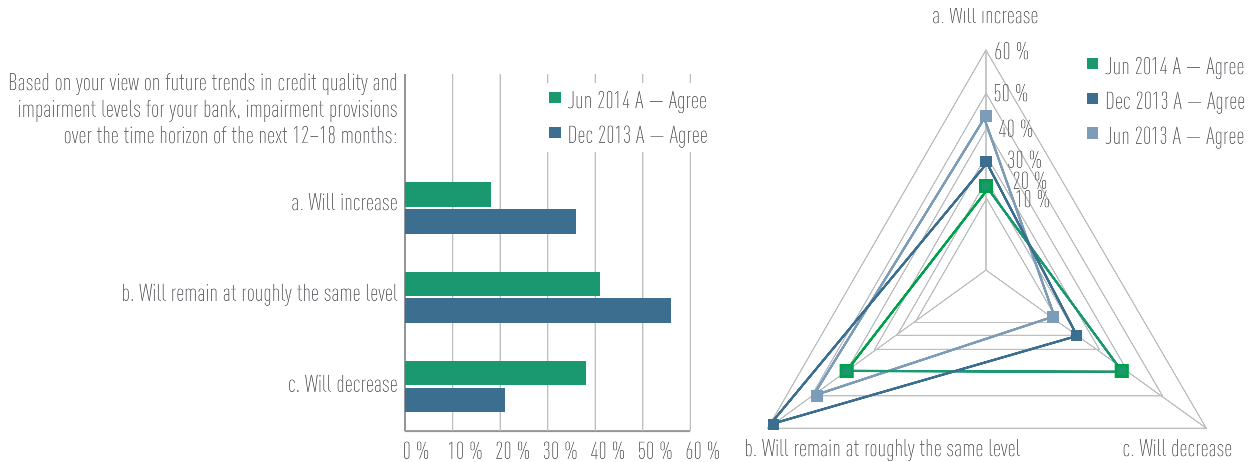
Most RAQ respondents stated that the impairment provisions over the time horizon of the next 12–18 months will remain at roughly the same level. At the same time, there is a strong increase in the expectation that, in fact, the impairment provisions will decrease (the replies that agree with the statement show an increase from 9 % in June 2013 to 21 % in December 2013 and 38 % in June 2014).

Figure 17: Drivers of asset quality trend (*source*: RAQ)



Some RAQ respondents, despite being less numerous and decreasing since December 2012 (from 57 % in December 2012 to 26 % in December 2013 and 18 % in June 2014), still believe and agree that the impairment provisions will increase (Figure 18). Interestingly, the majority of respondents that agree that the impairment provisions will increase are from banks in non-financially stressed countries.

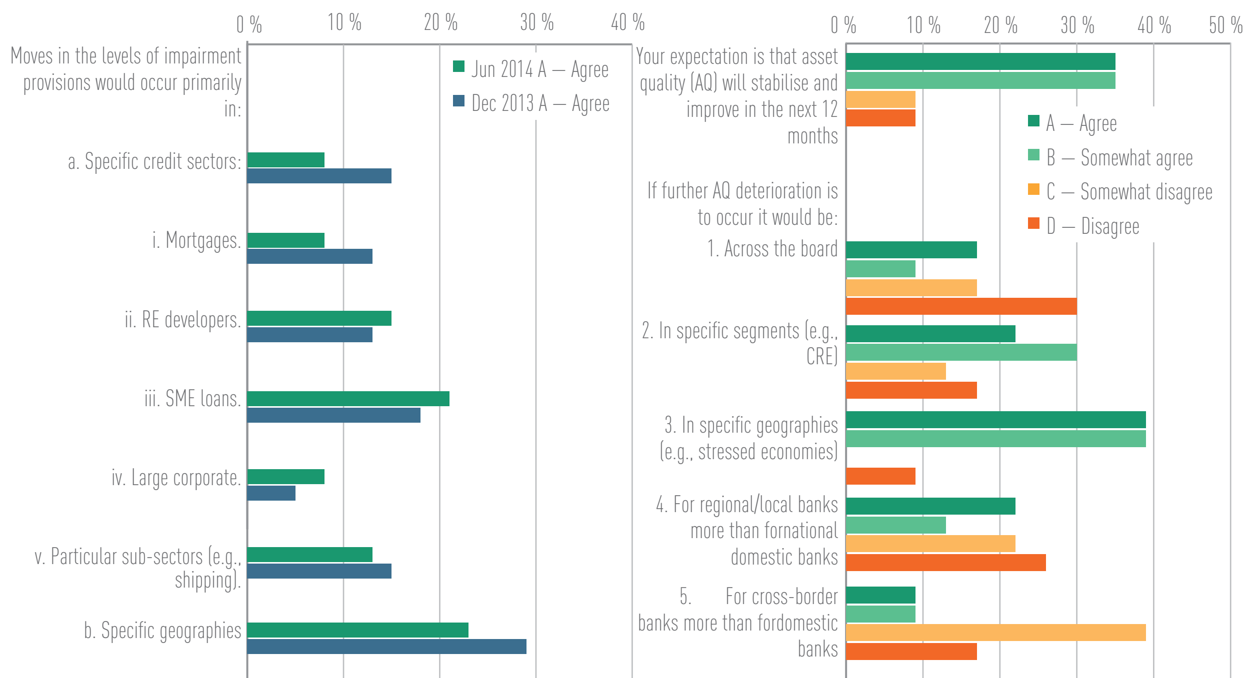
Figure 18: Expectations for impairments (*source*: RAQ)



The majority of RAQ respondents continue to state that the overall composition of loan portfolios is relatively well balanced, with no material sector or exposure concentration. According to RAQ respondents, possible concentration risks are more likely from specific sectors than from several large single-name exposures (lower percentages of replies agreeing with the statement). Almost all RAQ respondents that agree or somewhat agree that possible concentration risks are more likely from specific sectors are from non-financially stressed countries.

From both the RAQ for banks and the RAQ for market 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 occur primarily in specific geographies but with lower importance (Figure 19).

Figure 19: Drivers of impaired loans trends (*source*: RAQ and RAQ market analysts)



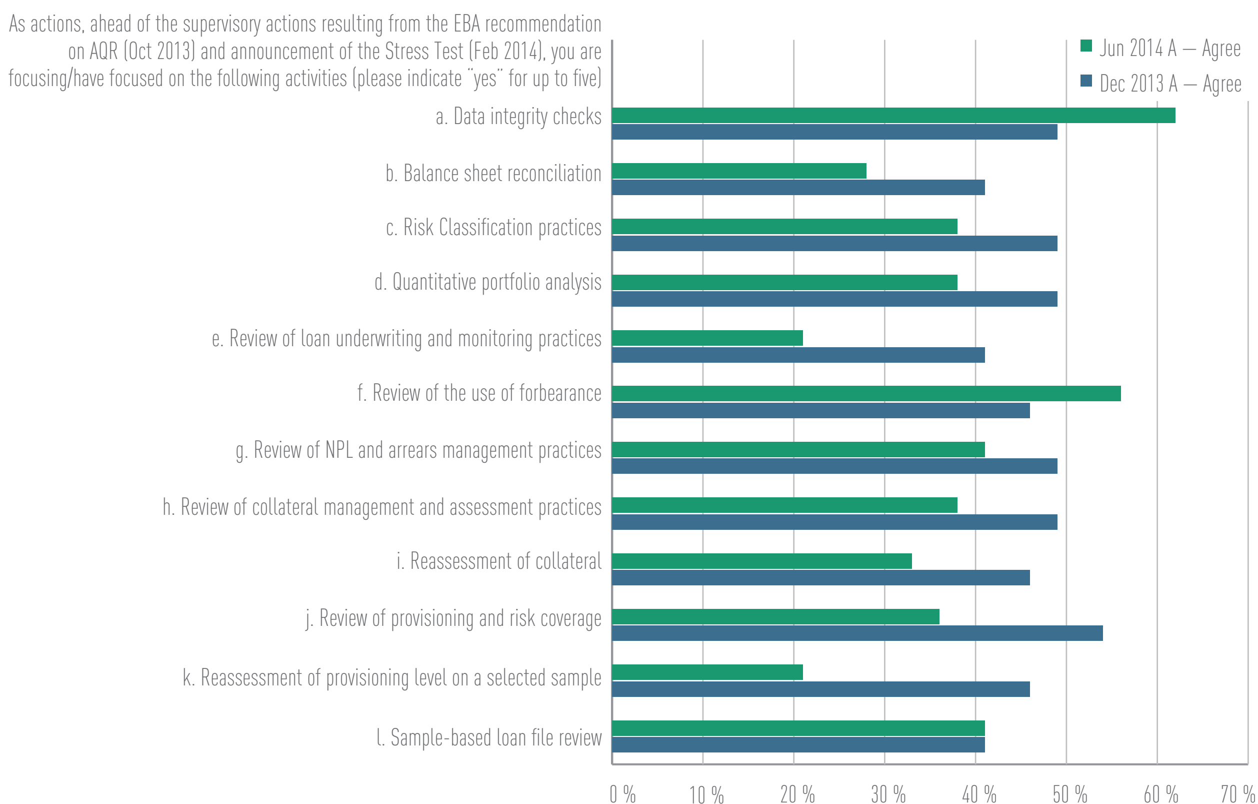
Several actions ahead of AQR and Stress-test for some portfolios and type of activities

As actions, ahead of the supervisory actions resulting from the EBA *Recommendation on asset quality reviews* (EBA/REC/2013/04) and the announcement of the Stress Test (February 2014), the majority of RAQ respondents mentioned that they have focused on commercial real estate, corporate and SMEs. This focus has increased significantly, since December 2013, on corporate and SMEs.

In addition, regarding the type of activities, they have focused on data integrity checks and on reviewing the use of forbearance. Interestingly, in comparison to December 2013, there is a much lower focus on the review of provisioning and risk coverage, the reassessment of provisioning level on a selected sample, and the review of loan underwriting and monitoring practices.

Moreover, the number of RAQ respondents that agree that the number and volume of loans classified as restructured or under restructuring has increased in their institutions

Figure 20: Actions resulting from the EBA *recommendation on AQR* and announcement of the Stress Test and loans classified as restructured or under restructuring (*source*: RAQ)

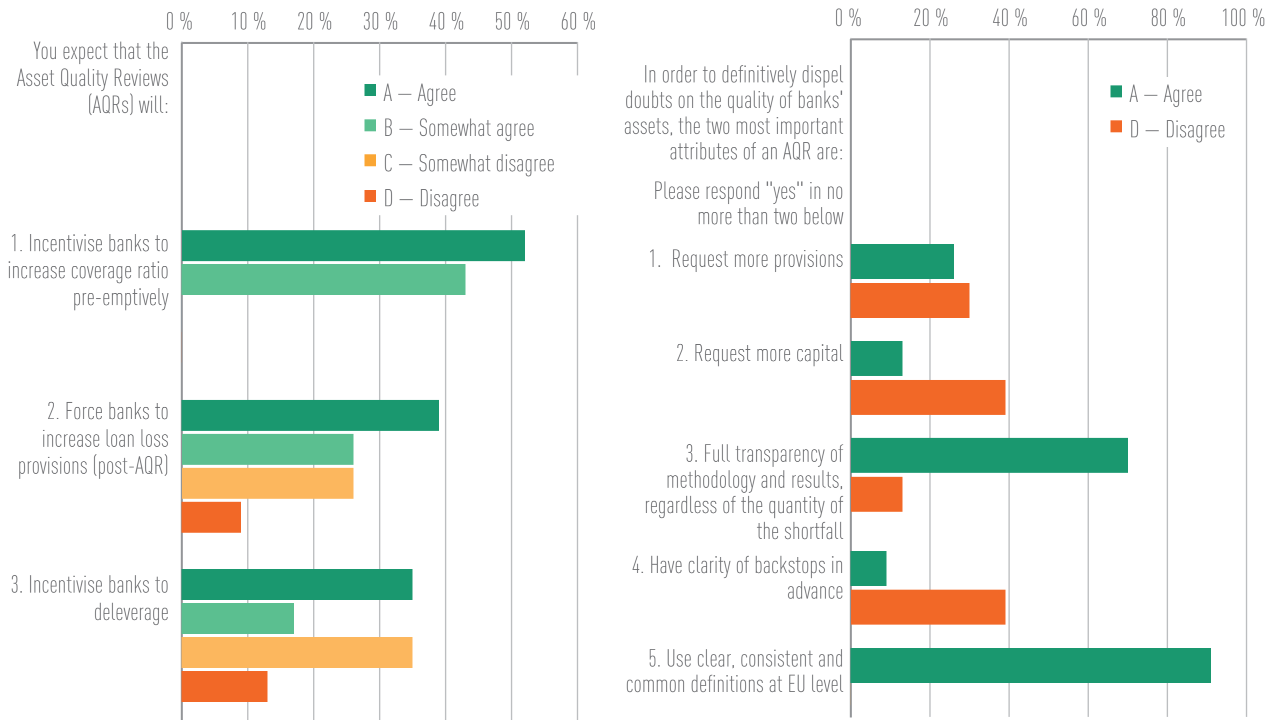


diminished in comparison to December 2013 (Figure 20).

According to market analysts' views (RAQ for market analysts), the AQR is giving banks incentives to increase the coverage ratio pre-emptively, and they somewhat agree that it is also forcing banks to increase loan loss provisions after the AQR. In comparison to the previous six months the incentive to deleverage is now less evident (higher number of disagreements).

Finally, market analysts continue to 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. Interestingly, having clarity of backstops in advance continues to be the less important attribute among the other factors of the AQR to dispel doubts on the quality of banks' assets (Figure 21).

Figure 21: Asset quality reviews (*source*: RAQ market analysts)



Impact of scenarios on default rates and loss rates

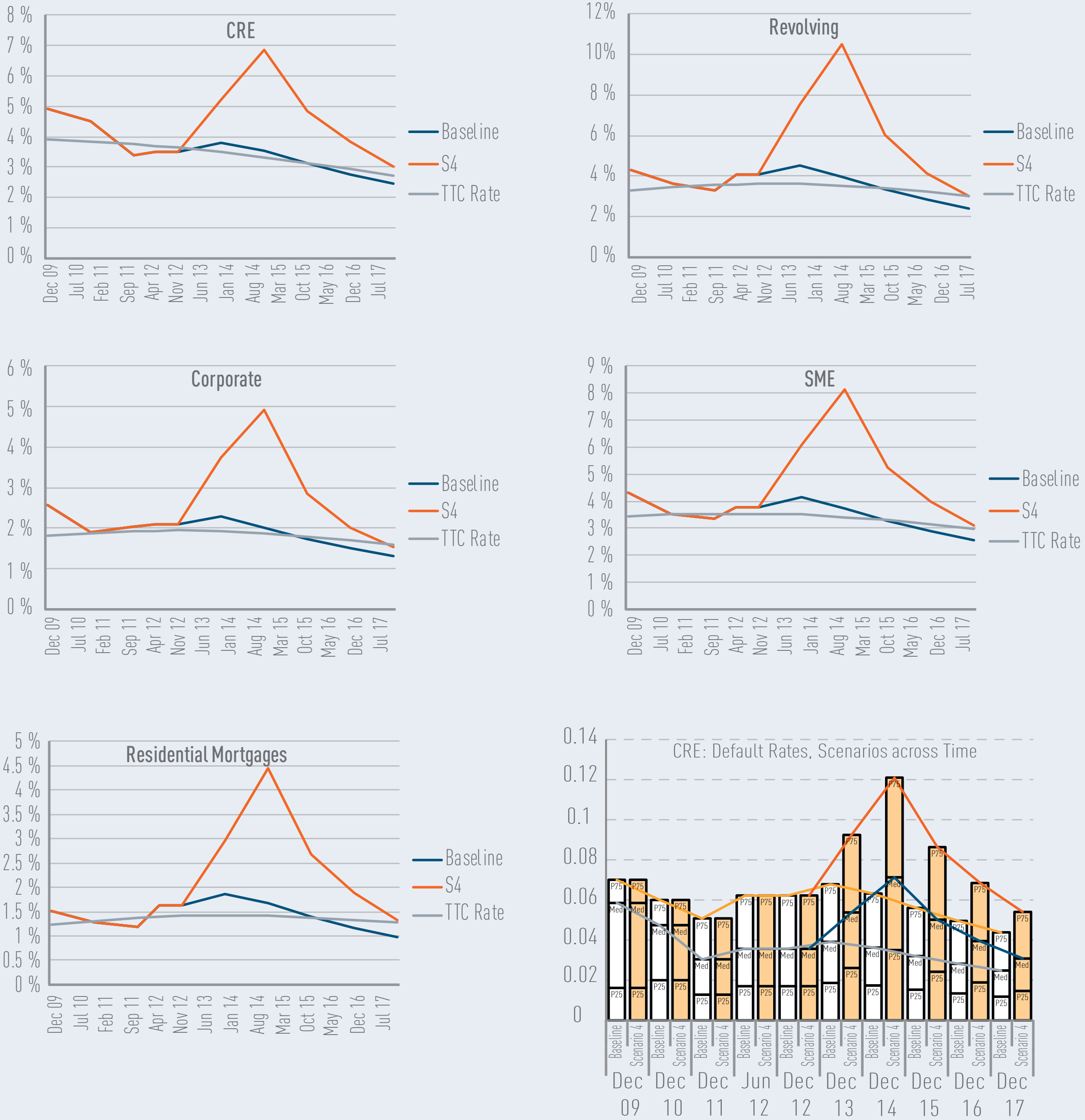
The EBA is required, in cooperation with the European Systemic Risk Board (ESRB), to initiate and coordinate EU-wide stress tests to assess the resilience of financial institutions to adverse market developments. Building on experience of previous EU-wide stress tests, portfolio models were developed to help discussions about simple indicators that facilitate the creation of benchmarks to contrast and compare EU-banks under adverse market conditions.

The portfolios models, the respective assumptions and results for both default rates and loss rates presented below are based on the current common baseline (Baseline) and adverse macro-economic scenario (S4) developed for the 2014 EU-wide stress tests.

Default rates

As expected, the portfolios with higher default rates are revolving, SMEs and Commercial Real Estate (CRE). On average, the default rates during the peak of the adverse scenario (S4) are around 7 % and 10 % for the mentioned portfolios. The 75th percentile presents levels above 14 % and 12 % for revolving and CRE respectively (Figure 22).

Figure 22: Default rates based on the scenarios developed for the stress tests (*source*: EBA)



Loss rates

The portfolios with higher loss rates are also revolving, SMEs and Commercial Real Estate (CRE). On average, the loss rates during the peak of the adverse scenario (S4) are around 35 % and 65 % for the above mentioned portfolios (Figure 23). The revolving portfolio is one of the most affected (together with SMEs) by an adverse development of GDP growth (coefficient = – 0.039). In addition, in the adverse scenario, the CRE portfolios show an increase higher than 15 percentage points in comparison with the baseline.

The EBA will provide competent authorities with statistical benchmarks for the key risk parameters and variables for assisting the quality assurance process. Although some differences are expected in the way the macroeconomic scenarios will be translated by banks into the relevant risk parameters, the results are expected to be substantially consistent for comparable portfolios, institutions and recent historical trends.

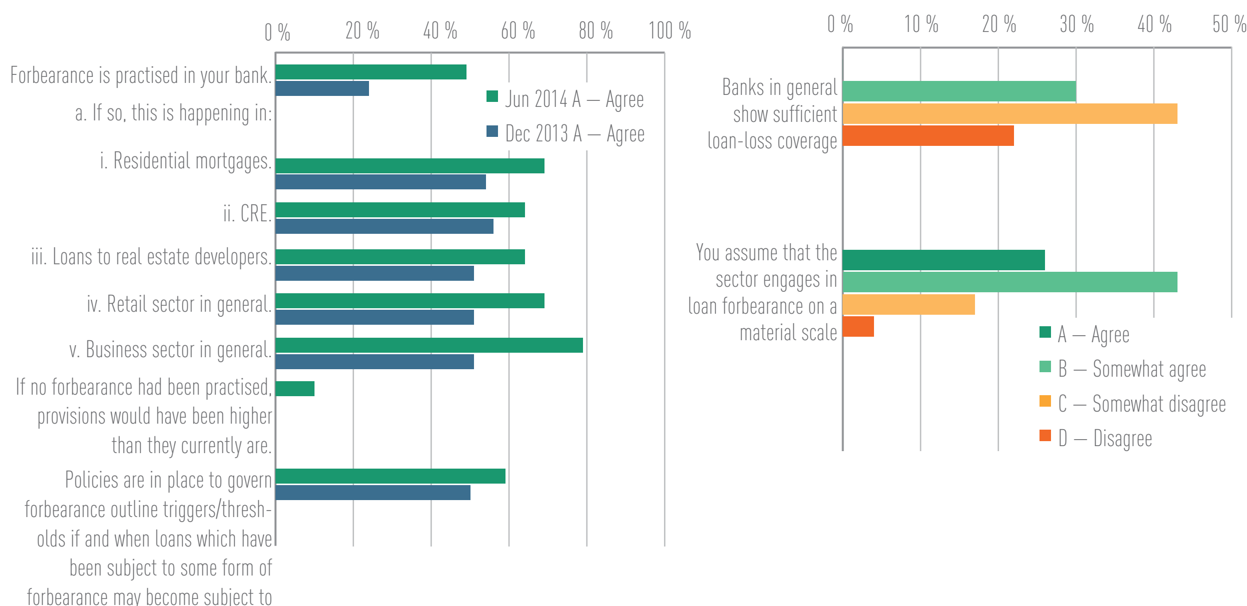
Figure 23: Loss rates and LGDs based on the scenarios developed for the stress tests (*source*: EBA)

Forbearance practice has increased in residential mortgages

Regarding forbearance issues (Figure 24), the majority of RAQ respondents agree (49 % of the replies in comparison with 24 % in December 2013) that forbearance is practised. It is evident that this practice has increased and is happening in general, but is more prevalent in residential mortgages and the rest of the retail sector. At the same time, the extent of forbearance practices may influence the level of impairment provisioning. However, most RAQ respondents disagree that if no forbearance had been practised, provisions would have been higher than they currently are (23 % in disagreement compared to 10 % in agreement). Moreover, the number of replies agreeing that policies are in place to govern forbearance outline triggers and thresholds (if and when loans which have been subject to some form of forbearance become subject to credit workout procedures) has increased.

Market analysts continue also to agree that the sector is engaging in loan forbearance on a material scale; however, the number has decreased significantly (from around 40 % in December 2013 to 26 % in June 2014). At the same time, market analysts continue to highlight potential low coverage ratios and somewhat disagree that banks, in general, show sufficient loan-loss coverage. Nevertheless, and interestingly, the number also decreased (from around 50 % in December 2013 to 43 % in June 2014) and was substituted by respondents that somewhat agree that banks, in general, show sufficient loan-loss coverage (from around 10 % in December 2013 to 30 % in June 2014). This is a clear positive evolution in the perception of market analysts on better levels of provisions and coverage of potential losses.

Figure 24: Forbearance practices (*source*: RAQ and RAQ market analysts)



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 example, the definition of non-performing loans.

Thus, for the purpose of AQRs, the EBA recommends [5] competent authorities to apply, to the extent possible, the common definitions on 'non-performing exposures' and 'debt forbearance' published in October 2013.

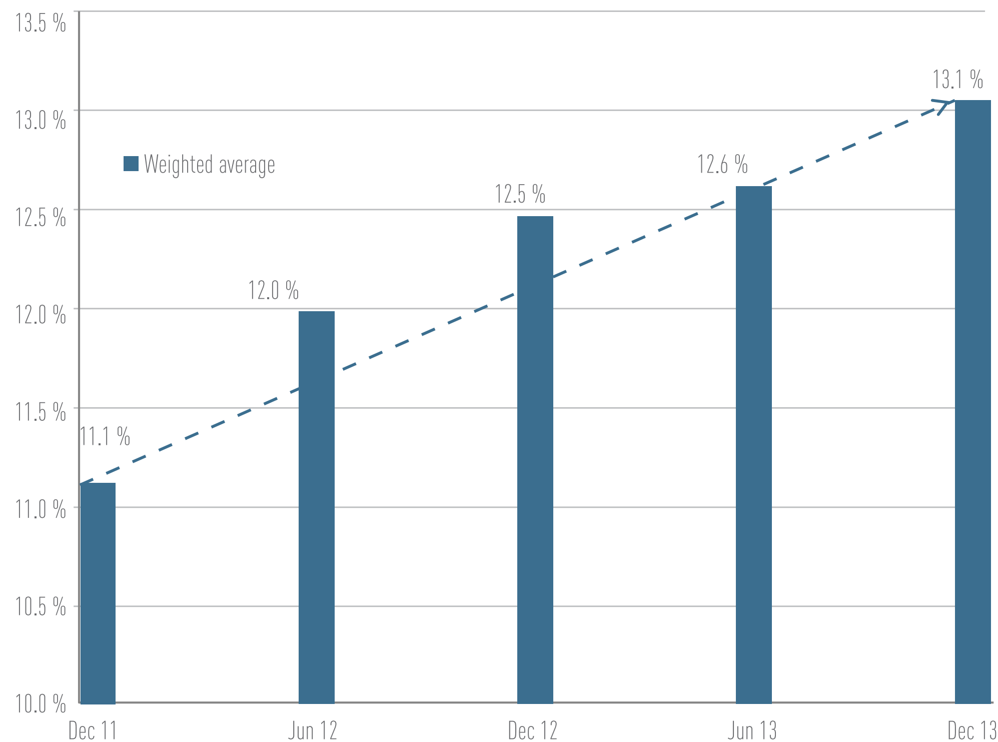
The final standards will be sent to the European Commission to be adopted as EU regulations that will be directly applicable throughout the EU.

[5] 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 2013, for example, the euro area banks raised over EUR 80 billion in capital and, in 2014, they will raise over EUR 60 billion according to some market estimates. In particular, over the second half of 2013, notwithstanding still some challenging conditions in financial markets, the banks' capital position has strengthened once more; however, this was on the back of falling risk weighted assets (Figure 25).

Figure 25: Tier 1 capital ratio — weighted average (*source*: EBA KRI data)



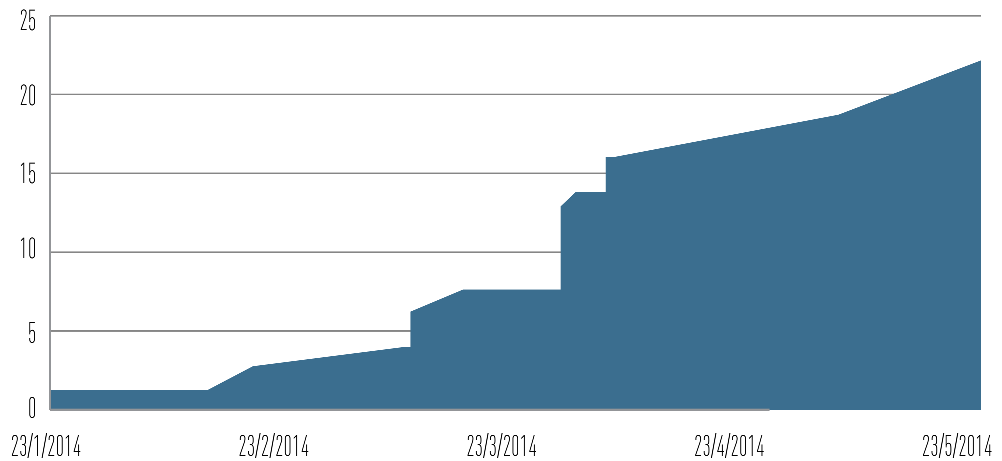
Core tier 1 capital levels have substantially improved

In the EBA's recapitalisation exercise, completed in 2012, as well as the national efforts progressing towards strong capital buffers during 2013, the weighted average tier 1 ratio excluding hybrid instruments for the largest European banks stood at 11.6 % in December 2013 (an increase of 50 basis points in comparison with June 2013). This is strong evidence of substantial infusions of capital into European banks in line with major international peers and also revealing that the 2014 EU wide AQR and stress test exercise have triggered capital increases despite some reductions in risk weighted assets (RWAs).

As banks also issue Additional Tier 1 bonds — contingent convertibles — CoCos

EU banks are issuing additional tier 1 bonds (also named contingent convertibles (CoCos)) or tier 2 bonds. Market data show a total issuance of AT1 CoCos by EU banks of approximately EUR 22 billion up until the end of May 2014 (Figure 26).

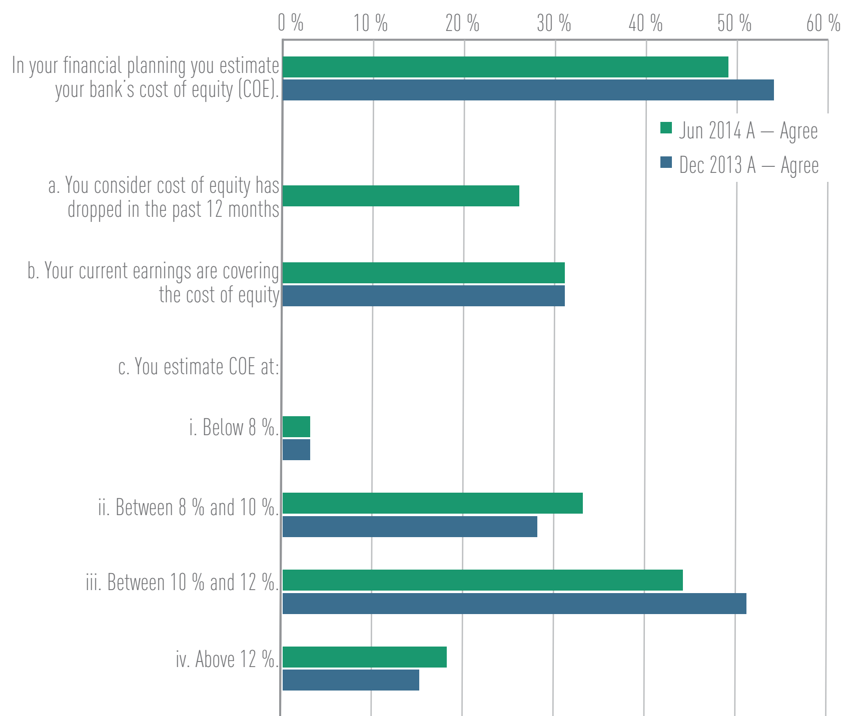
Figure 26: EU banks AT1 CoCos' total issuance (billion EUR) (*source*: SNL Financial, Bloomberg, EBA calculations.)



The regulatory pressure combined with an improving investor confidence and chase for yield in a low interest rate environment is helping banks to strengthen their capital. Under CRD IV, CoCos are loss-absorbing capital, either by conversion into equity or facing write-down, when a certain capital level is breached.

According to RAQ respondents, the cost of equity is currently in the 10–12 % range (Figure 27), while the coupons on additional tier 1 or CoCos might be 6 % (and tax deductible), thus driving tightening spreads.

Figure 27: Cost of equity (*source*: RAQ)

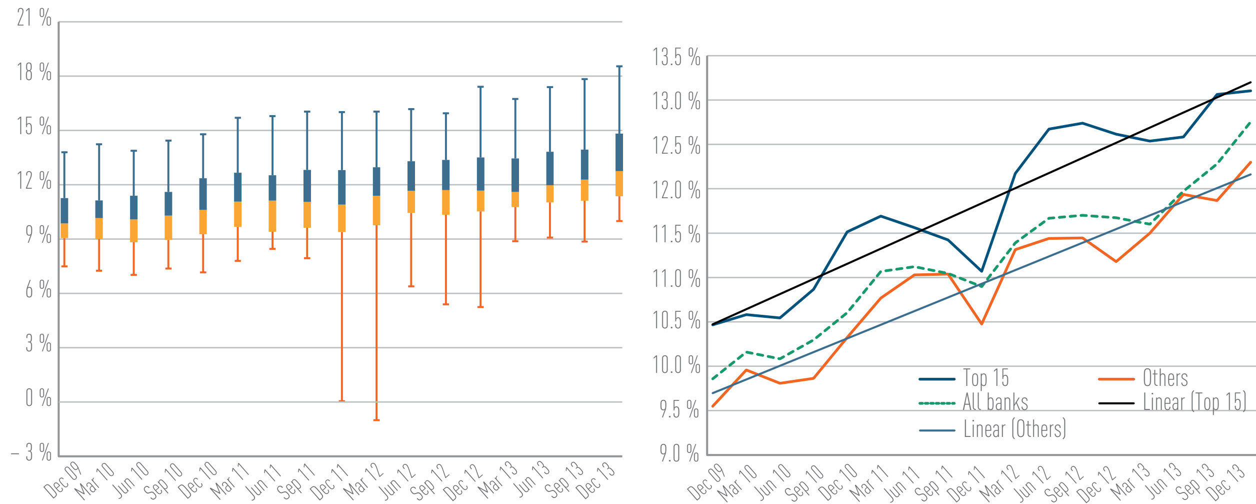


The demand for hybrids is significant despite regulatory uncertainty and the lack of a clear-cut standardised product as well as an undoubted complexity of pricing for these instruments. Among many characteristics to take into account, the additional tier 1 or CoCos can be perpetual or dated, converted or written-down, with significantly different triggers calculated according to Basel III or transitional RWAs temporarily or on a permanent basis, and with possible coupon suspension. Additional tier 1 bonds are usually perpetual and tier 2 CoCos are usually dated. The different factors should be considered, such as the risk of conversion and coupon deferability, demonstrating that additional tier 1 or CoCos remain a deeply complex asset class for supervisors, banks, and investors.

Core Tier 1 ratio improves further

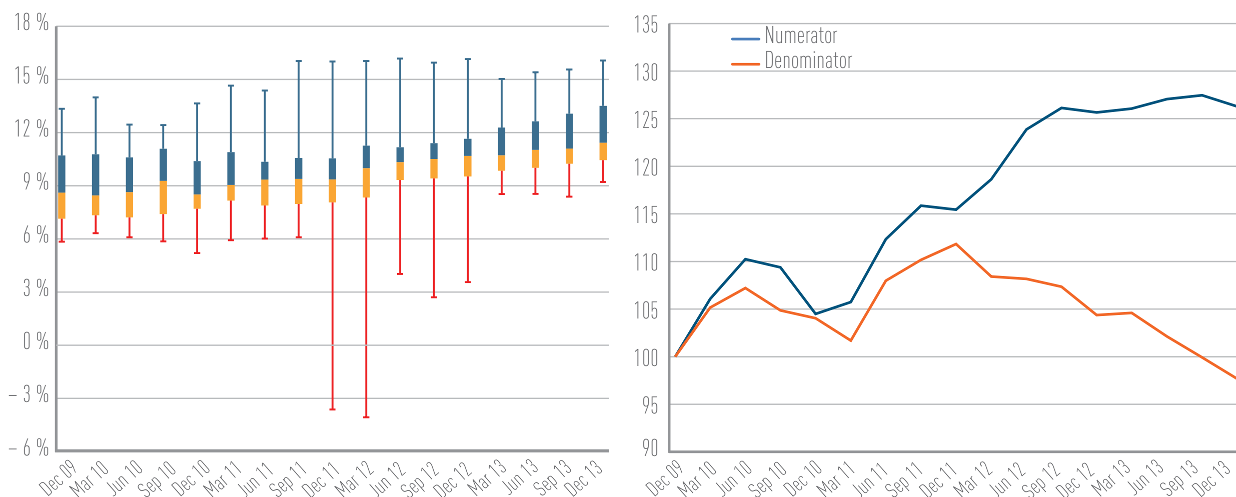
Throughout 2012 and 2013, the KRI confirmed that the EU banks' capital positions continued to maintain an important increasing trend and have improved significantly (Figure 28). In the second part of 2013, the tier 1 capital ratio rose by 50 basis points to 13.1 %. In the same period, the median tier 1 capital ratio increased by 80 basis points (from 12 % in June 2013 to 12.8 % in December 2013), after an increase of almost 1 percentage point, from 10.9 % to 11.7 % in 2012. Banks with tier 1 capital ratio less than 12 % decreased and represented 27.1 % of total assets in December 2013 (from around 42 % in December 2012) and for the first time since December 2009, there are no banks with tier 1 capital ratio below 9 %. The positive evolution of the tier 1 capital ratio is also confirmed when considering the size class of banks (i.e. for the top 15 banks) in terms of total assets, and for the remaining banks of the KRI sample.

Figure 28: Tier 1 capital 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 again from 11.1 % to 11.6 % in the last six months of 2013 (Figure 29). At the same time, banks with tier 1 ratio excluding hybrid instruments higher than 10 % increased once more and represented 88 % of total assets in December 2013 (from 76 % in June 2013). The dispersion of capital indicators decreased markedly during 2013, suggesting that banks in the sample continue converging towards a more conservative solvency base. The tier 1 ratio excluding hybrid instruments is now above 11.5 %.

Figure 29: Tier 1 ratio (excl. hybrid instruments) (*source*: KRI) — 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (December 2009 = 100)

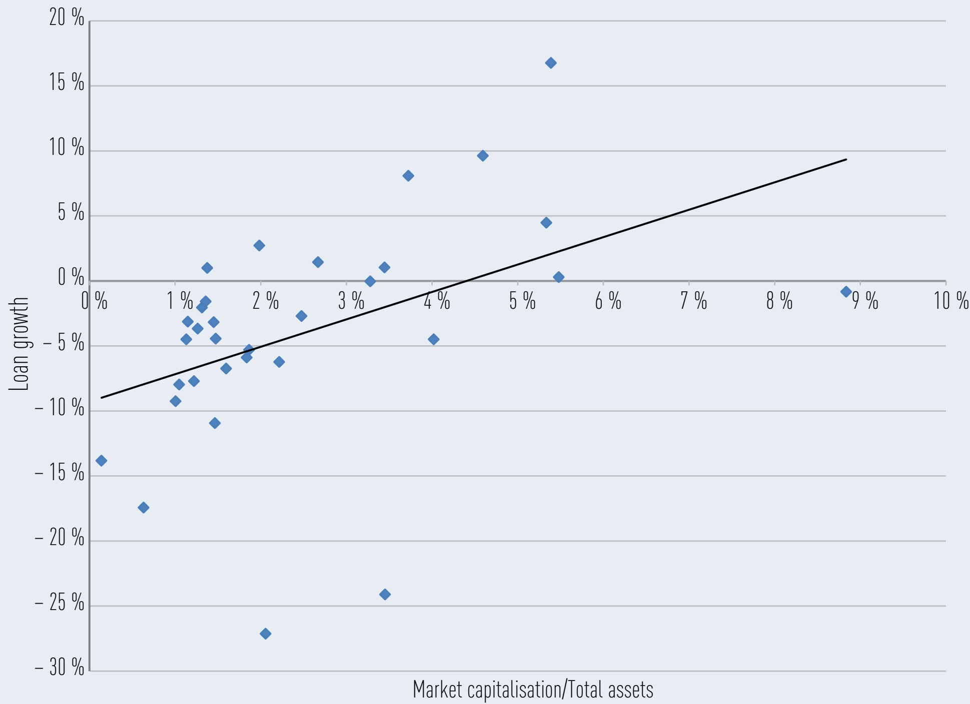


While capital positions for the EU banks are stronger than in the past and are on a comparable basis to those of international peers, it is expected that the level of non-performing loans will continue to require some increasing impairment provisioning. Therefore, there is still no room for complacency due to the fact that, in some cases, the level of non-performing loans may pose challenges to the maintenance of adequate capital levels.

Capital ratios, credit growth and market perceptions

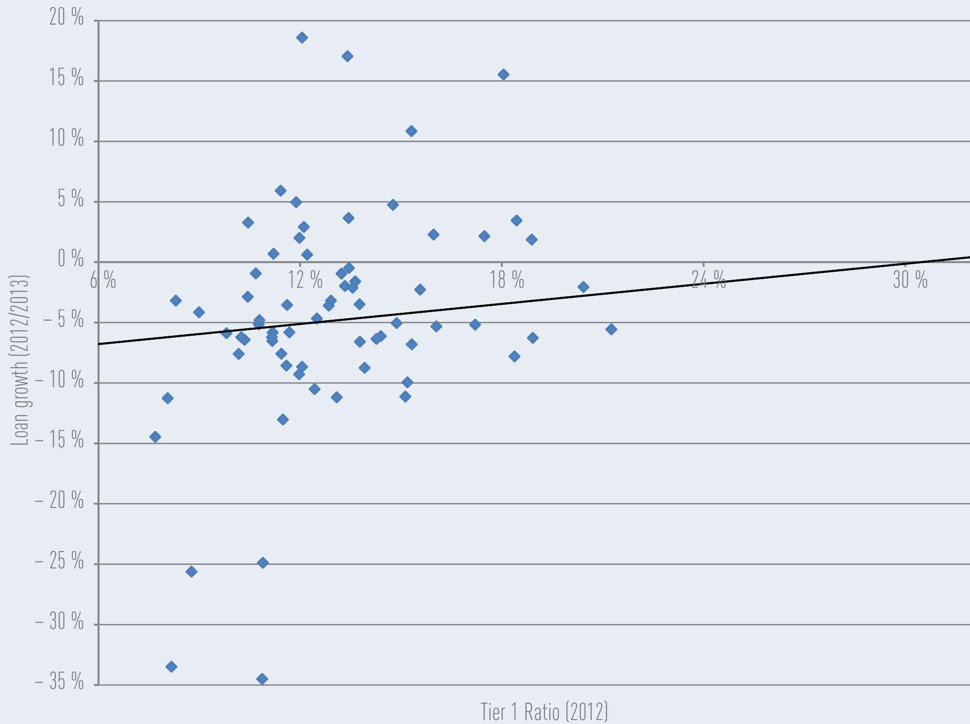
The benefits of a stronger and healthier financial system are being acknowledged and expected to be around for years to come. In addition, market participants' preference for safer and well capitalised banks need not mean slower credit growth and economic recovery. Sound bank balance sheets are fundamental for the recovery of credit following crises by enhancing their ability to withstand financial shocks and continue lending. Only banks with proper and credible capital cushions are able to maintain lending during a financial shock, influencing positively the recovery process. Market participants' preference for well capitalised banks provide evidence that banks that have been most successful over the long run are those that held higher and better quality of capital showing a position of strength in comparison with other banks. For a sample of 32 listed banks, a comparison between the ratio of market capitalisation to total assets per end-2012 and customer loans growth between 2012 and 2013 is presented (Figure 30).

Figure 30: Bank customer loan growth versus market capitalisation as a percentage of the book value (*source*: EBA calculations, Bloomberg)



Banks that have been perceived by the markets to be healthier or with less problems may have been better able to access cheap funding and lend to real economy. For a sample of 72 banks (EUR 29.6 trillion of total assets), a comparison between tier 1 per end-2012 and customer loans growth between 2012 and 2013 is presented and shows the same type of positive relationship (Figure 31).

Figure 31: Tier 1 ratio in 2012 versus bank customer loan growth in 2012 and 2013 (*source*: EBA calculations, Bloomberg)

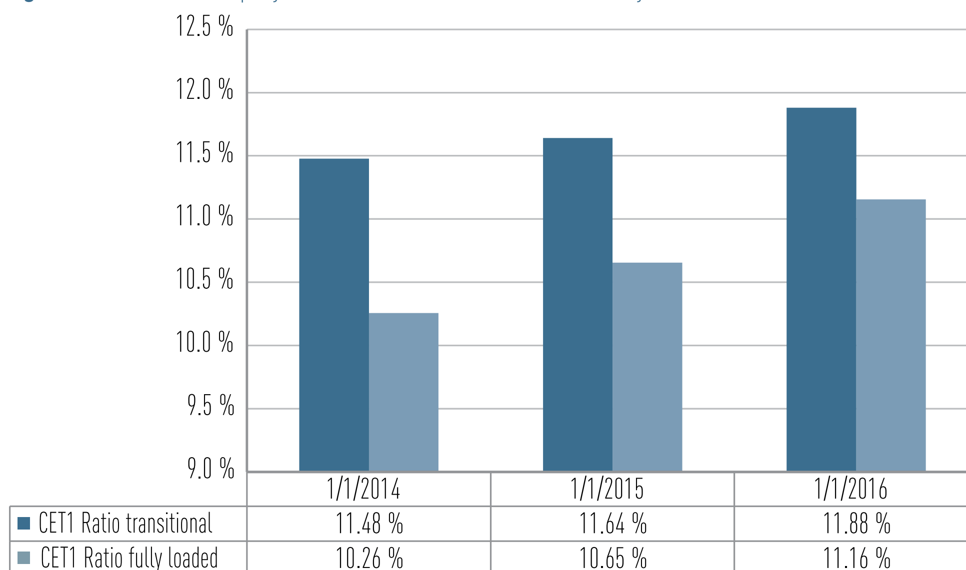


Transition to the CRD IV/Capital Requirements Regulation

In July 2013, the EBA published its *Recommendation on the preservation of core tier 1 capital during the transition to the CRD IV-CRR framework* with the aim of preserving the enhanced capital base and capital buffers that credit institutions had built by June 2012. The evolution of capital and RWAs and the planned evolution of common equity tier 1 capital, tier 1 capital and total capital ratios and RWAs according to the capital plans submitted by the banks provide an interesting overview of the drivers.

The sample of institutions includes 57 banks for which national competent authorities have notified the EBA of their intention to comply with the July 2013 Recommendation. The aggregate common equity tier 1 ratio (CET) shows a positive evolution from January 2014 to January 2016 both on a transitional and fully loaded basis (Figure 32).

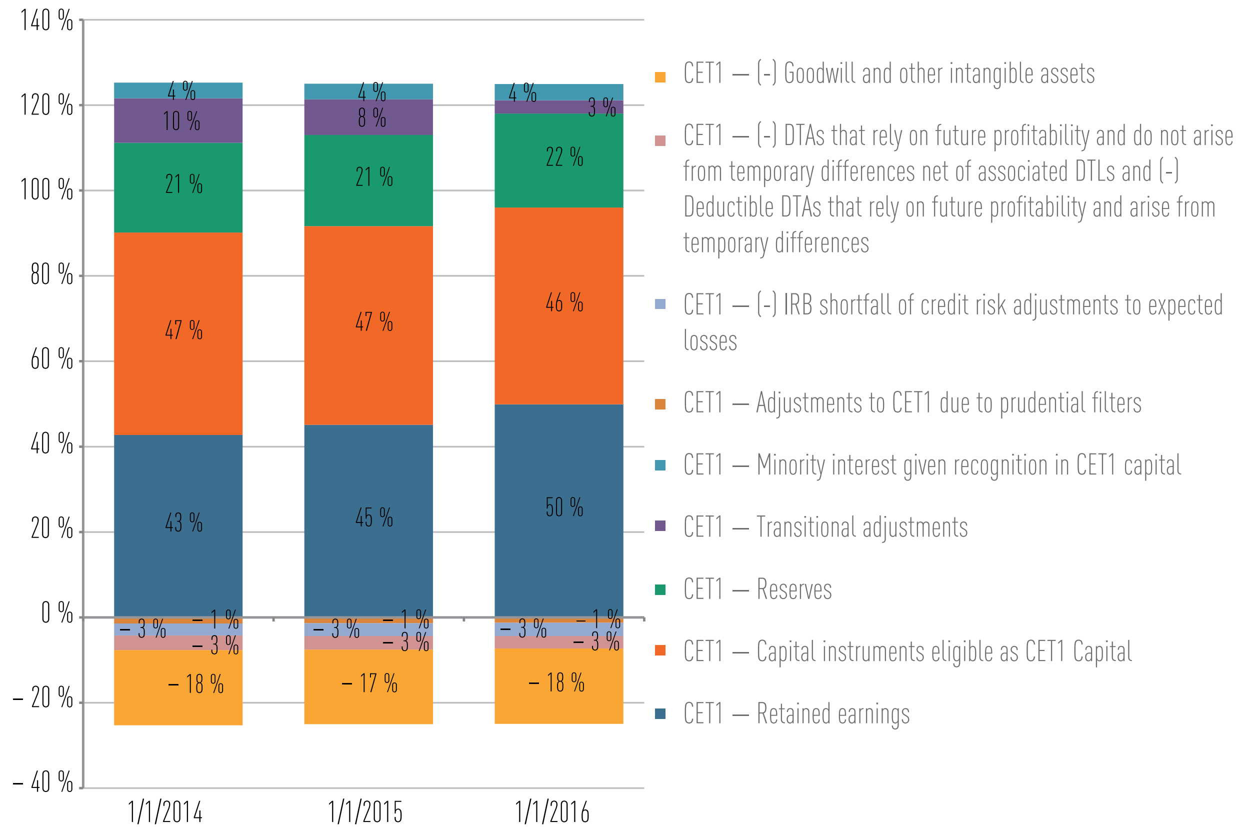
Figure 32: Common equity tier 1 ratio — transitional and fully loaded basis (*source*: EBA)



	1/1/2014	1/1/2015	1/1/2016
CET1 Ratio transitional	11.48 %	11.64 %	11.88 %
CET1 Ratio fully loaded	10.26 %	10.65 %	11.16 %

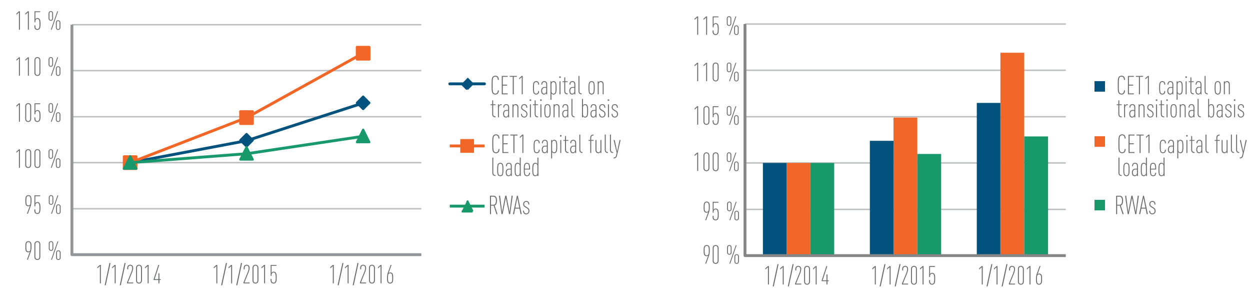
As regards the composition of the common equity tier 1 capital from January 2014 to January 2016, it is possible to observe that, in aggregate terms, it remains steady across the time, with the main elements being: capital instruments (from 47 % to 46 %); retained earnings (from 43 % to 50 %); and reserves (from 21 % to 22 %). It can also be noted that the weight of the transitional adjustments decreases from 10 % as of January 2013 to 3 % as of January 2016 (Figure 33). On the deductions side, the most relevant are goodwill and other intangible assets (around – 18 %).

Figure 33: Common equity tier 1 capital (numerator) — composition (aggregate) (*source*: EBA)



Regarding the evolution of both the numerator and the denominator of the CET1 ratio on transitional and fully loaded basis, the capital plans show that the numerator (i.e. the amount of CET1 capital) increases at a higher rate than the denominator (RWAs). The CET1 capital on a fully loaded basis increases also at a higher rate than on a transitional basis (Figure 34).

Figure 34: Evolution of the numerator and the denominator of the CET1 ratio on transitional and fully loaded basis (*source*: EBA)



5. Liabilities side

Market funding conditions continued the improving trend observed since the second part of 2012 and all banks regained access to market funding. The cost of funding decreased and banks, especially from financially stressed countries, benefited from the strong investor demand for European banks' debt. European banks have started to adapt their funding and capital structure to the new regulatory requirements and issuance of contingent convertible instruments significantly picked up in early 2014. Deposit growth has decelerated during the last months but deposits are forming an increasing part of banks' funding as deleveraging continues.

Market funding continued steadily to replace early repayments of the two 3 year refinancing operations (long-term refinancing operations (LTRO)) provided by the ECB, thus decreasing reliance on official sources of funding. By March 2014, almost half of the funding provided in the two LTROs had been repaid. The pace of repayments has decelerated from early 2013 resulting in some concerns about possible divergence between stronger and weaker institutions. Target 2 imbalances continued decreasing and many banks domiciled in financially stressed sovereigns strengthened their customer deposit bases. Almost all market analysts who responded to the questionnaire believed funding conditions would remain benign or continue to improve in 2014. This was seen mostly stemming from higher demand for bank debt outside the EU and positive impacts from regulatory and policy steps. The majority of market analysts indicated that banks would be able to fund themselves on the market and would not need to use additional long-term funding support measures.

Decisive 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, despite improvements also in fundamentals, some banks still face continued structural funding challenges, in particular in countries having experienced some sovereign stress. Despite benign funding conditions, financial markets remain in an overall fragile state and banks should continue repairing their balance sheets to be able to withstand adverse changes in funding conditions.

5.1 Funding

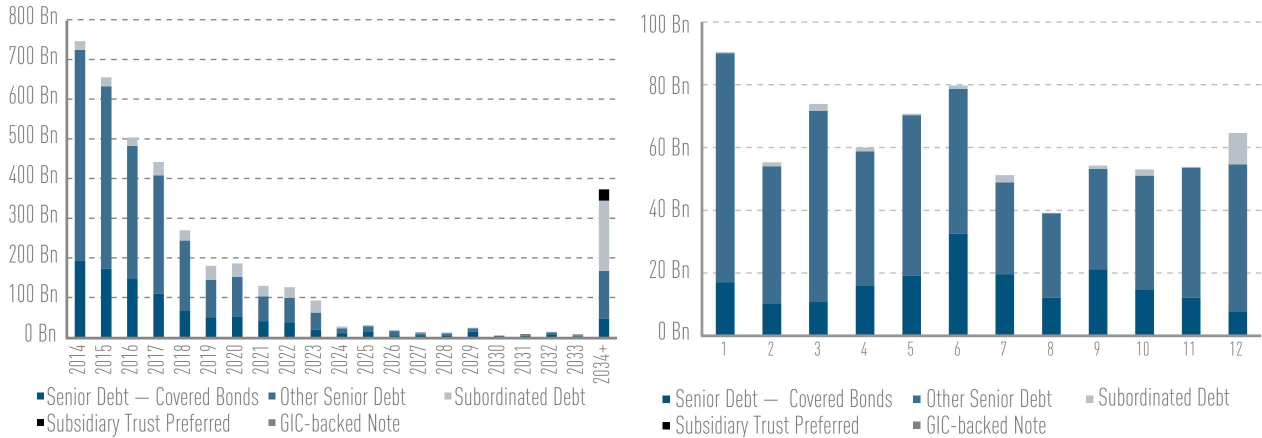
During the first six months of 2014 the pricing of both short-term and long-term funding has continued to improve and all banks now have regained access to market funding. Investors have been intensively looking for yield in the low interest rate environment resulting in high demand, especially for bonds issued by banks domiciled in financially stressed sovereigns. Spreads of some of these banks have reached pre-crisis levels after decreasing sovereign yields reaching 8 year lows. In late 2013 and also in 2014, smaller banks domiciled in financially stressed countries have returned to the unsecured funding markets.

Market funding conditions, including unsecured funding, have continued to improve

The issuance activity has been relatively high in early 2014 but substantial net negative issuance is expected by European banks for 2014. This is due to decreasing funding needs mainly resulting from continued deleveraging and strong deposit bases.

Funding activity in 2014 has been more focused on unsecured funding and volumes of issued covered bonds were lower than in 2012 and 2013. The refinancing rate of unsecured funding was elevated in the first quarter of 2014 following a similar pattern to that in early 2013. Based on the RAQ responses, banks expect unsecured funding to increase and form a significant part of their funding structure (Figure 35).

Figure 35: Bonds — Aggregated debt maturity profile — 20 year breakout and Next 12-month breakout in EUR billion (*source*: SNL data)

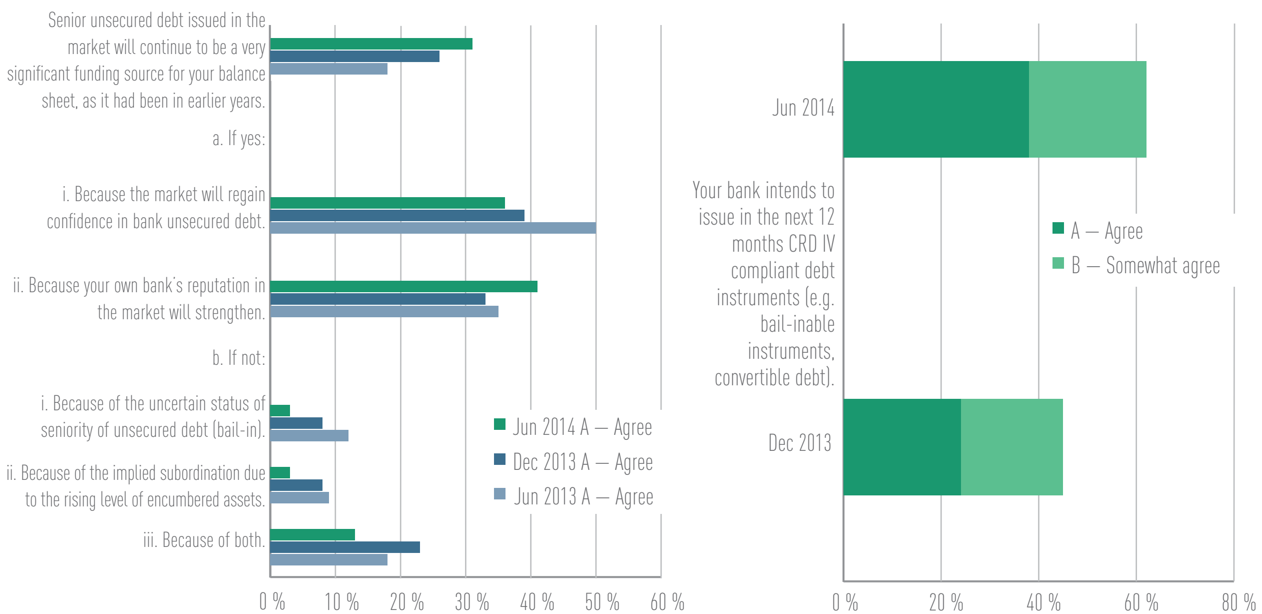


Unsecured funding costs have narrowed across the single market

Funding costs have evolved differently between unsecured and secured financing. The cost of unsecured funding of banks domiciled in financially stressed countries has decreased and converged towards the funding costs of banks domiciled in financially strong countries. A significant difference in costs remains for secured funding.

Banks have started to adapt their funding and capital structures to the new regulatory requirements. Issuances of additional tier 1 instruments have significantly picked up in 2014 and volumes are already reaching the levels of 2013. This development is also seen in the RAQ responses according to which the majority of banks planned to issue convertible debt and bail-inable instruments during 2014 (Figure 36).

Figure 36: Issuance of convertible debt and bail-inable instruments during 2014 (*source*: RAQ)

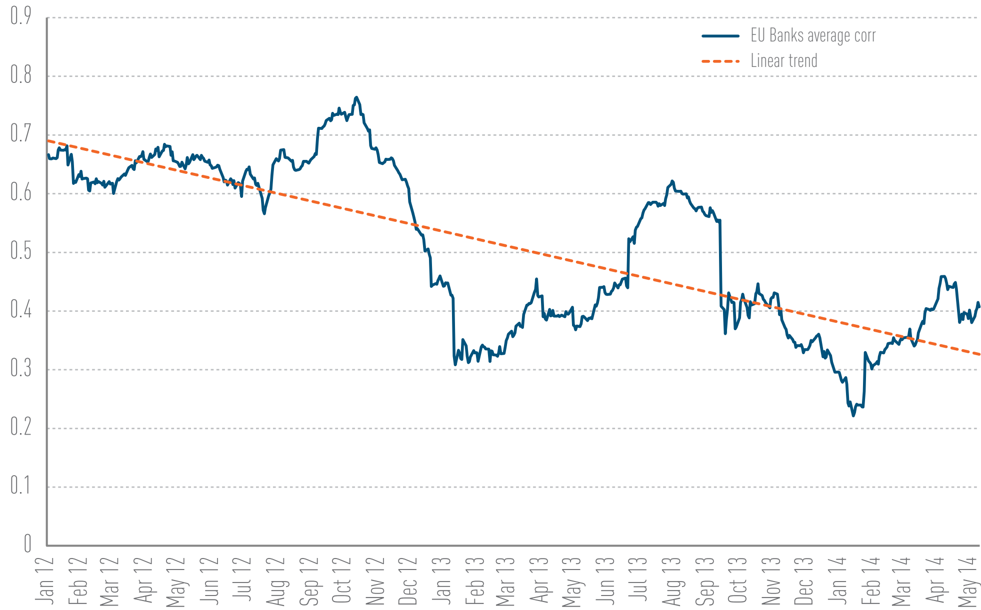


European banks continue to meet, on average, the liquidity coverage ratio requirement of 100 % which will come into force only in 2019. The vast majority of RAQ respondents confirmed their objective is to have ratios above fully phased-in regulatory liquidity ratios.

Sovereign-bank link decreasing and tentative signs of reduced fragmentation

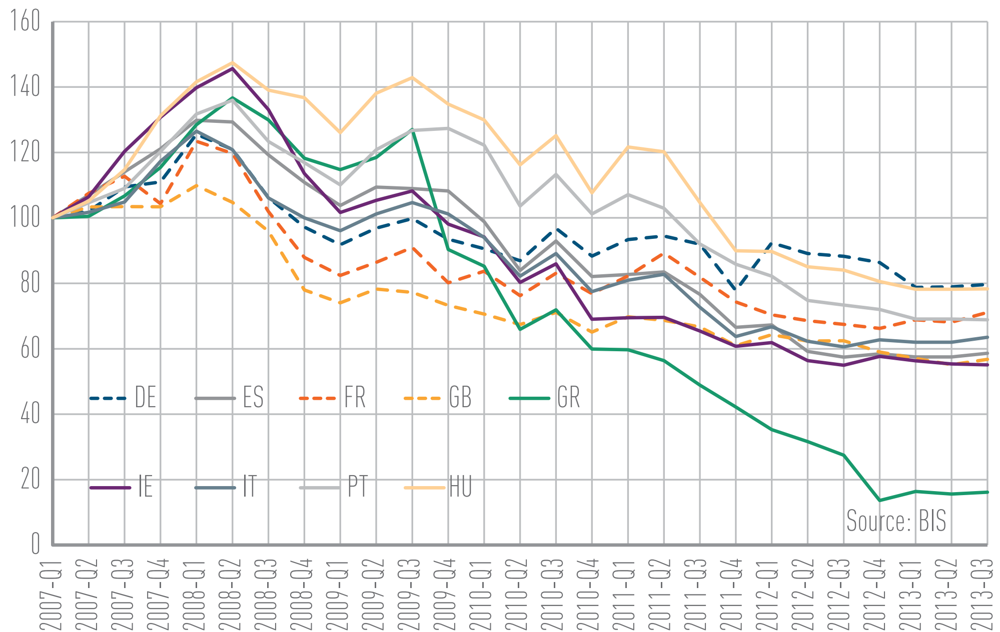
Indications of weakening correlation between sovereign and bank CDS spreads (Figure 37), stabilisation of deposit flows in financially stressed countries, and continued decrease of Target 2 imbalances are first signs of weakening link between banks and sovereigns.

Figure 37: Average correlation of CDSs for 20 major EU banks and respective sovereigns (*source*: EBA, Bloomberg) — 60-day rolling window



Cross-border lending of European banks has stabilised after a falling trend but remains subdued indicating the existence of fragmentation (Figure 38). Despite converging costs of funding, smaller banks domiciled in financially stressed countries in particular, face higher funding costs than their peers in other EU countries. 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.

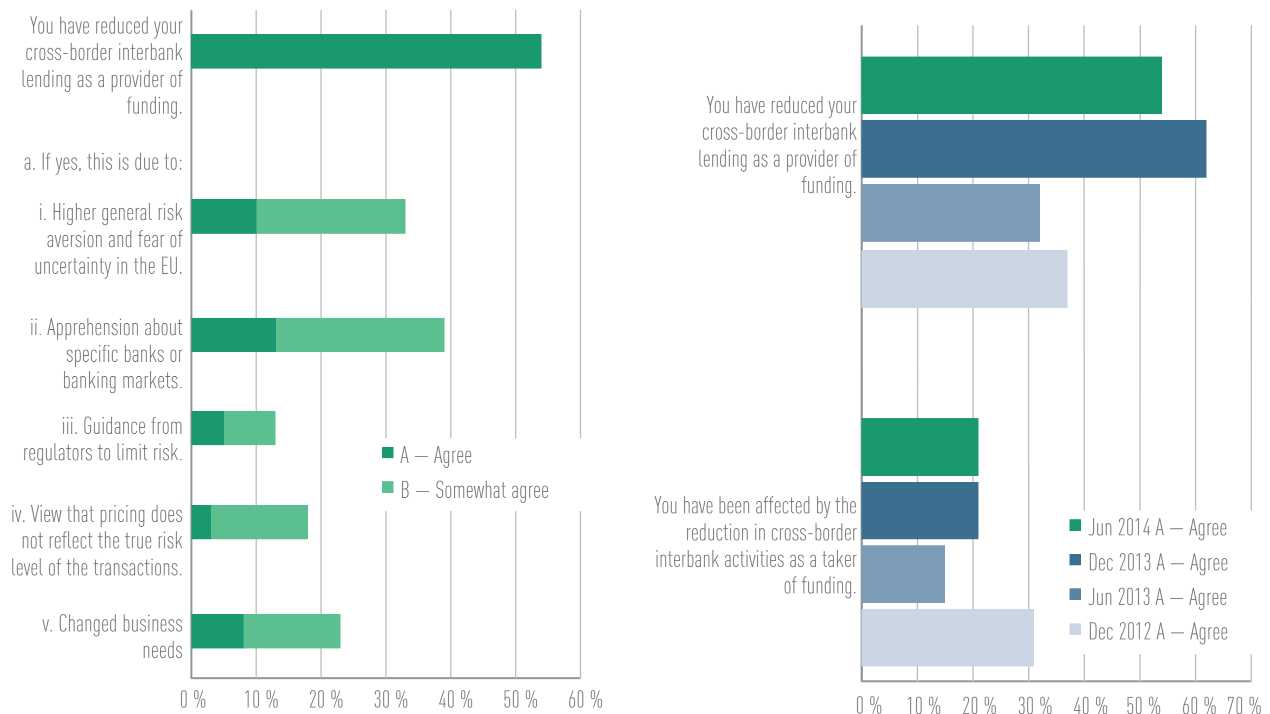
Figure 38: Evidences of fragmentation of the EU single market. Consolidated total foreign claims (ultimate risk basis) of reporting European banks vis-à-vis selected countries, 2007 Q1 = 100 (*source*: BIS, EBA calculations)



The re-emergence of an active cross-border interbank market would be a strong sign of regained confidence. Despite some encouraging signs of stabilisation, the cross-border interbank activities remain low, signalling fragmentation of the single market funding conditions.

In comparison with previous periods, fewer respondents report that they are reducing their cross-border interbank lending. At the same time, the number of respondents affected as inter-bank borrowers by reduced cross-border activity remains the same and one fifth of the banks have been affected (Figure 39). The main reasons for the reduced cross-border interbank activity were higher general risk aversion and fear of uncertainty in the EU, and the apprehension about specific bank or banking markets. In some jurisdictions, supervisory measures have also impacted on cross-border lending.

Figure 39: Cross border borrowing and lending (*source*: RAQ)



5.2 Deposits

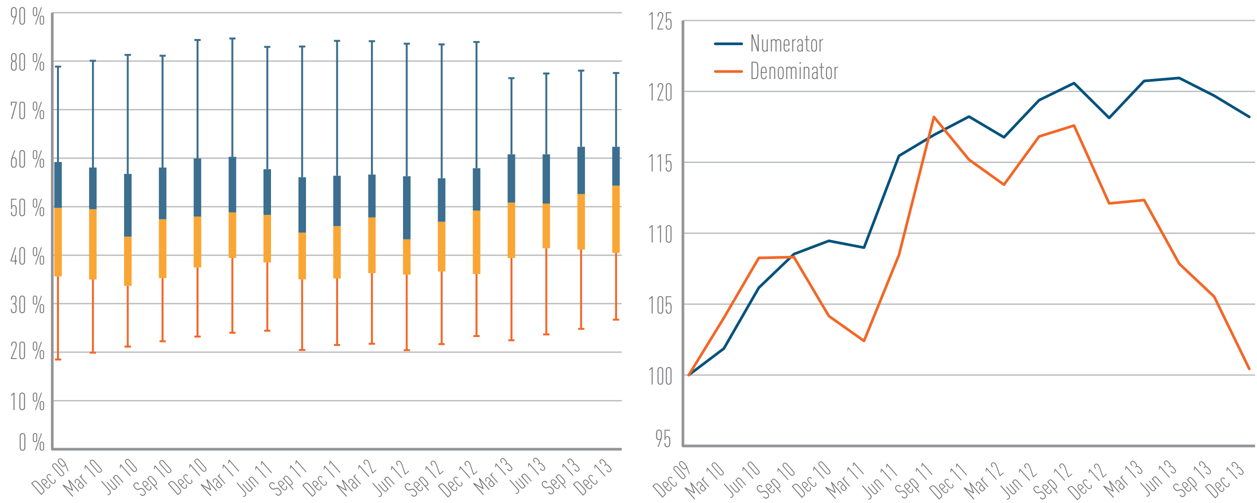
In the last few years, European banks have been under increasing pressure to restructure their balance sheets, de-risk their positions, and align their business models. Consequently, banks have deleveraged assets and paid greater attention to funding structures. The deleveraging process has given banks the opportunity to reduce reliance on short-term funding sources and increase the share of more stable financing despite sometimes very challenging funding conditions and limited market access in the last few years.

Share of deposit funding have continued to increase

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 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 ratio of customer deposits to total liabilities has continued to increase steadily from September 2011 (Figure 40). The deposit position strengthened especially dur-

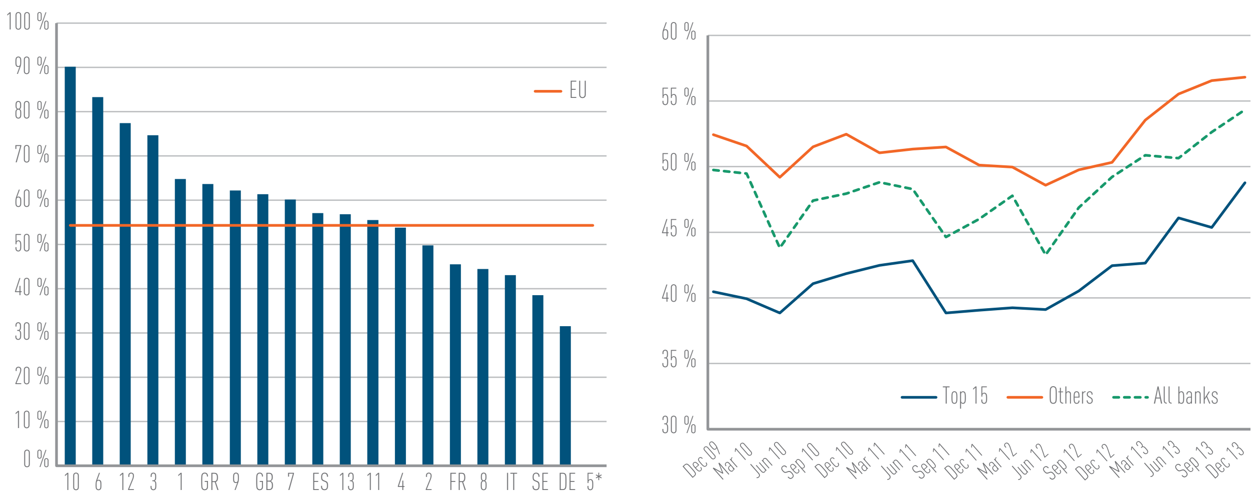
Figure 40: Customer deposits to total liabilities (*source*: KRI) — 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (December 2009 = 100)



ing 2013 and the average ratio increased by 5 percentage points to 47.7 % in December 2013. The increase was mainly driven by the deleveraging process and decreases in other types of funding as deposit volumes and equity remained relatively stable.

The system-wide objective of increasing the deposit base will result in market competition and may result in excessive deposit price competition to attract term deposits. While flows of retail deposits have stabilised across countries, some concerns remain on the behaviour of large depositors not covered

Figure 41: Customer deposits to total liabilities (*source*: KRI) — country dispersion and by size class (medians)

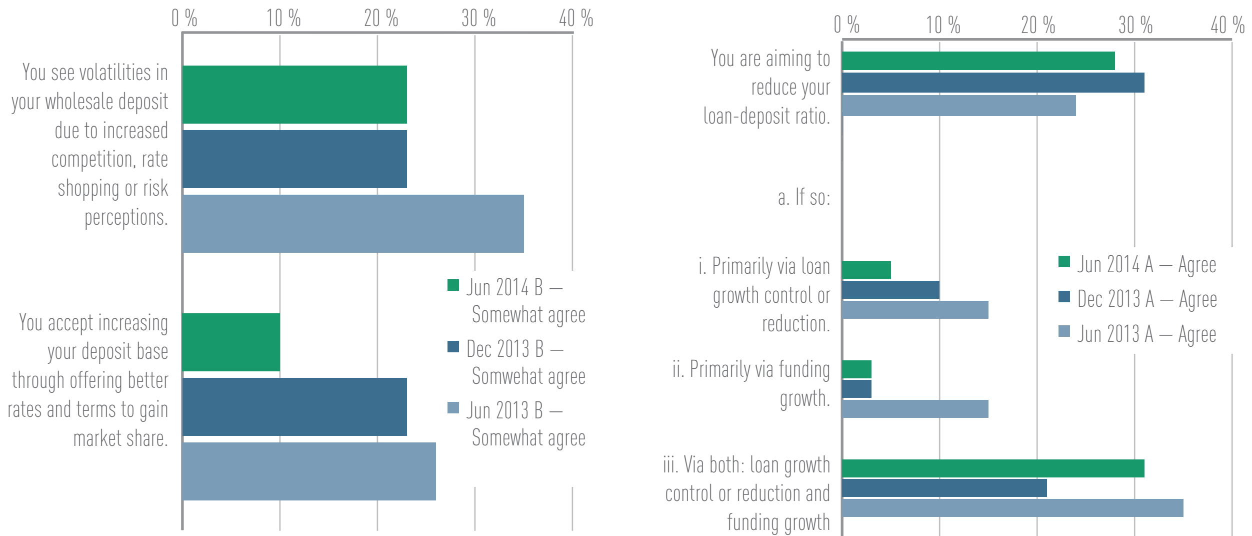


by deposit guarantee schemes, especially when new resolution and bail-in requirements come into force. Reliance on deposit funding continues to vary between geographies but the difference between largest banks and other major banks decreased in 2013 (Figure 41).

Banks are less willing to attract deposits by pricing

The number of RAQ respondents aiming to reduce the loan-deposit ratio has significantly decreased from 2012, potentially indicating that banks are achieving a more balanced funding mix (Figure 42). RAQ re-

Figure 42: Deposits (*source*: RAQ)



spondents have also reduced their apprehension of increased market competition in retail deposits and wholesale deposits.

Simultaneously, RAQ respondents also reported a decreased appetite for increasing deposit bases through offering better rates and terms to gain market share, consequently reducing competition for deposits. Further improved funding conditions and wider market access have also contributed to deposit pricing and, on average, the cost of deposit funding has decreased slightly during 2013.

5.3 Asset encumbrance and collateral

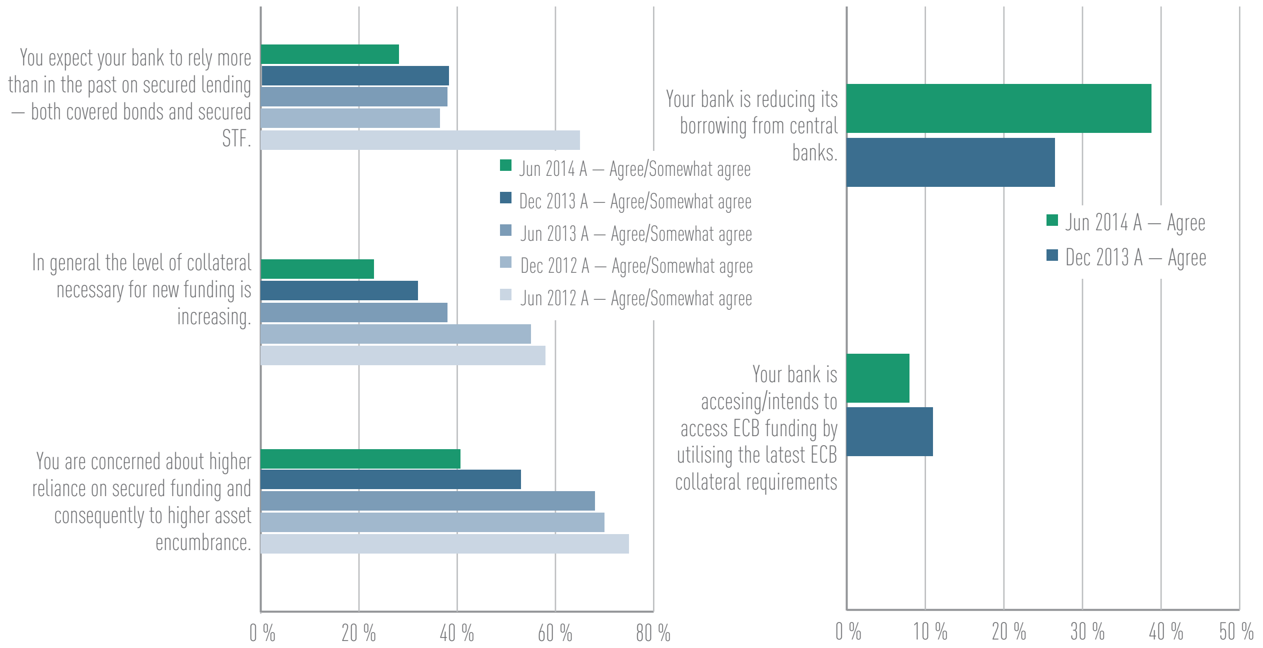
The reliance on secured funding in the last few years has increased the amount of encumbered collateral. When the market funding conditions were most challenging, banks needed to rely to secured funding from markets and also increasingly from central banks earmarking significant amounts of collateral in their balance sheets. New liquidity and capital regulations will also put increasing emphasis on collateralisation. However, high levels of asset encumbrance can be harmful and self-reinforcing.

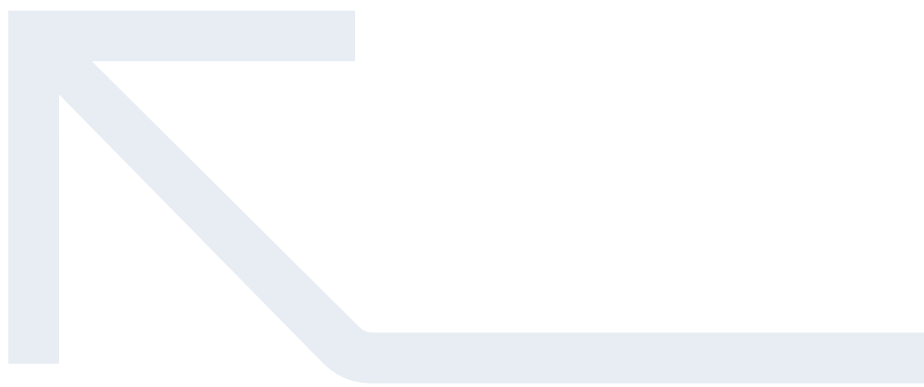
Increase of unsecured funding reducing pressure on collateral use

Looking ahead, 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 some of them.

Another positive indication is the increasing number of RAQ respondents who plan to reduce the use of central bank funding (Figure 43). Two thirds of respondents are not accessing, or are not intending to utilise, central bank funding by utilising the changed ECB collateral requirements from June 2013. The number of banks expecting to rely more than in the past on secured funding has further decreased; consequently, a minority of banks are also concerned about higher asset encumbrance. On the other, an increased number of respondents said that the level of collateral necessary for new funding is increasing.

Figure 43: Central bank and secured funding (*source*: RAQ)





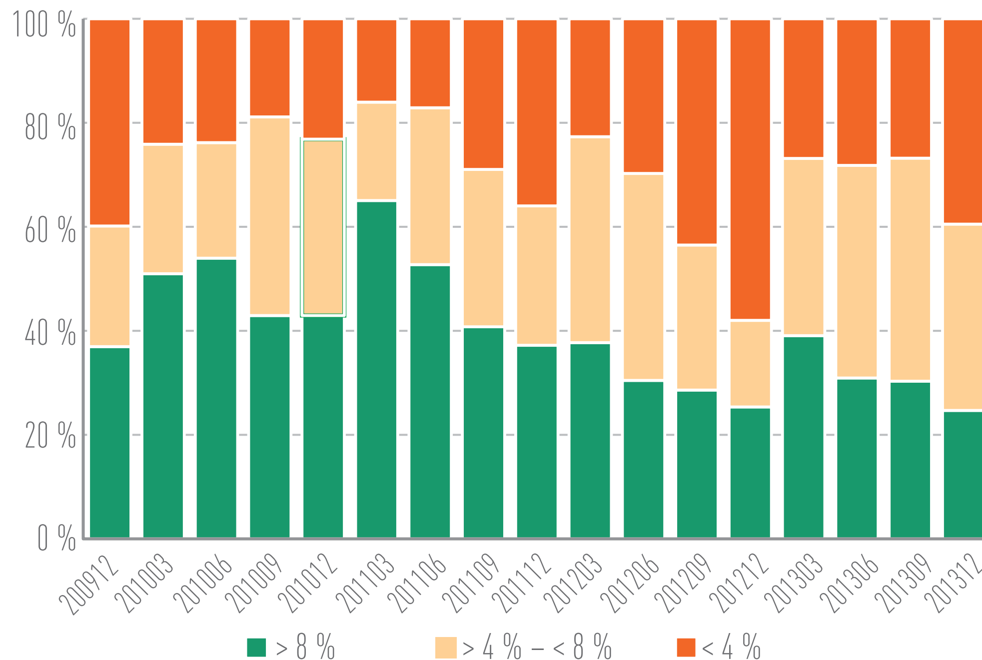
6. Income and profitability

During 2013 and the first months of 2014, EU banks' income and profitability levels have continued to face significant headwinds which are not likely to disappear in the near term. In the last quarter of 2013, the total profits (after tax and discontinued operations) declined EUR 54 billion (– 29 % compared to June 2013). The main drivers were the balance-sheet clean-up of EU banks as pre-emptive measures in preparation for the EU wide asset quality review and stress test exercise, as well as, litigation costs.

Some question marks over some institutions' future profitability and viability

In 2013, the specific allowances for loans increased by EUR 43 billion (11 % in comparison with December 2012). At the same time, EU banks have seen their net interest margins compressed while the fragile economic environment continues to provide limited new lending opportunities. The low interest rate environment is also putting pressure on the business model sustainability of banks which find overall net interest margins squeezed, contributing to profitability pressures. In some cases, earnings may not be sufficient to cover rising bad loans, and the asset quality reviews continue to add some uncertainty, therefore leaving some question marks over some institutions' future profitability and viability. Moreover, banks with a return on equity (RoE) of less than 8 % continue to increase and represented 75 % of total assets in the sample in December 2013 (up from approximately 69 % in June 2013). More specifically, banks with a RoE of less than 4 % represented 39 % of total assets in December 2013, a perturbing situation that is recurrent in the last few years (Figure 44).

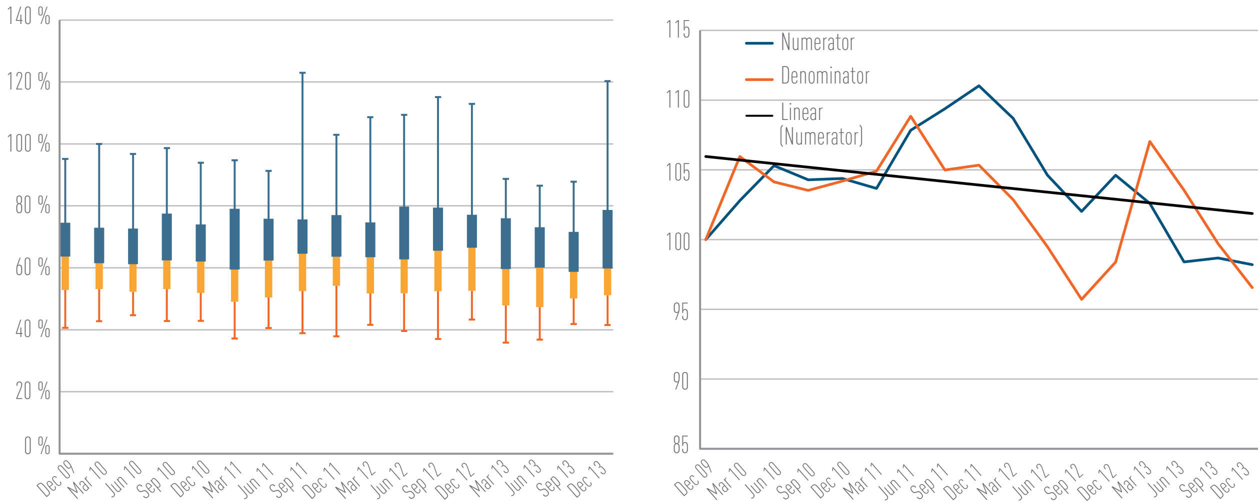
Figure 44: RoE by bucket and percentage of banks' total assets (*source*: EBA KRI data)



Net interest margins continue under pressure and on a downward trajectory (Figure 45). Net interest income has continued to decrease since December 2011 and is less than in 2009 (– 12 % and – 6 % in comparison with December 2011 and December 2012 respectively). The banks' possible attempts to increase lending rates and achieve and full repricing of assets may prove not possible, and even insufficient, to address the current

low interest rate environment. Customer capacity to bear higher lending rates and potential full repricing of assets is affected by the economic downturn, limiting banks' possible actions and, in some cases, coupled with increases in funding costs.

Figure 45: Net interest income to total operating income (*source*: KRI) — 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (December 2009 = 100)

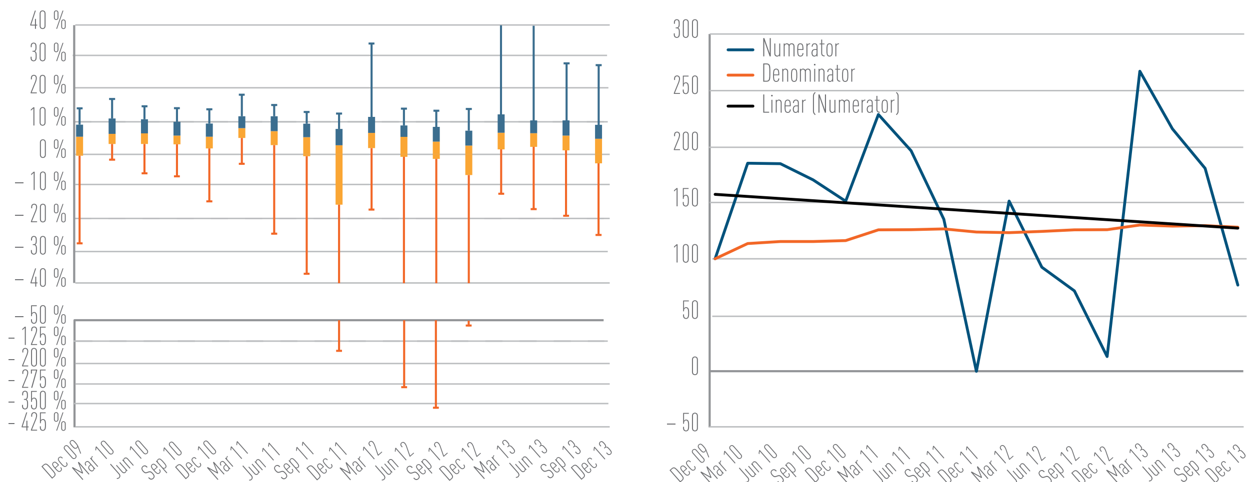


The first-quarter earnings season points to improved capital positions owing to run-offs of non-core assets and cost-containing efforts flowing through. Nevertheless, it is necessary to maintain a cautious outlook on revenues in light of the weak macroeconomic environment and expected generally weak business generation towards the next months.

The return on equity (RoE) continues to decrease

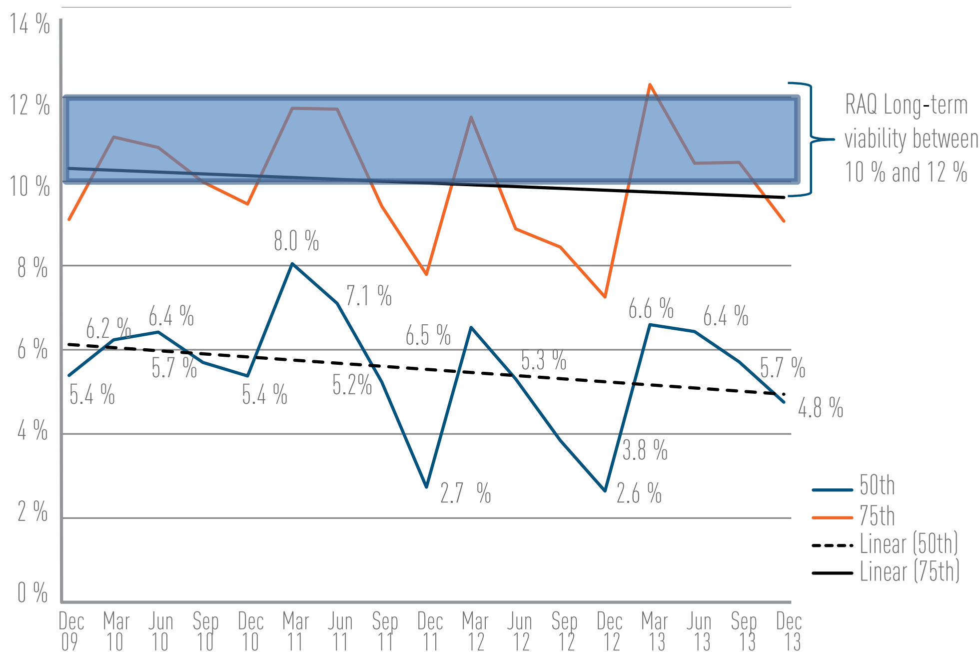
The return on equity (RoE) decreased in 2013 (Figure 46). The weighted average RoE and the 25th percentile have decreased (down from 7.6 % and 2.2 % respectively in June 2013 to only 2.7 % and – 2.9 % in December 2013). The median and the 75th percentile have also decreased since June 2013 (from 6.4 % and 10.4 % to 4.8 % and 9.1 % respectively in December 2013). The total profit or loss after tax and discontinued operations (annualised) shows strong volatility together with a declining trend since 2009. In addition, the dispersion has decreased; however, banks from 10 countries present median values of RoE less than 5 %, without significant differences per banks' size class.

Figure 46: Return on equity (*source*: KRI) — 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (December 2009 = 100)



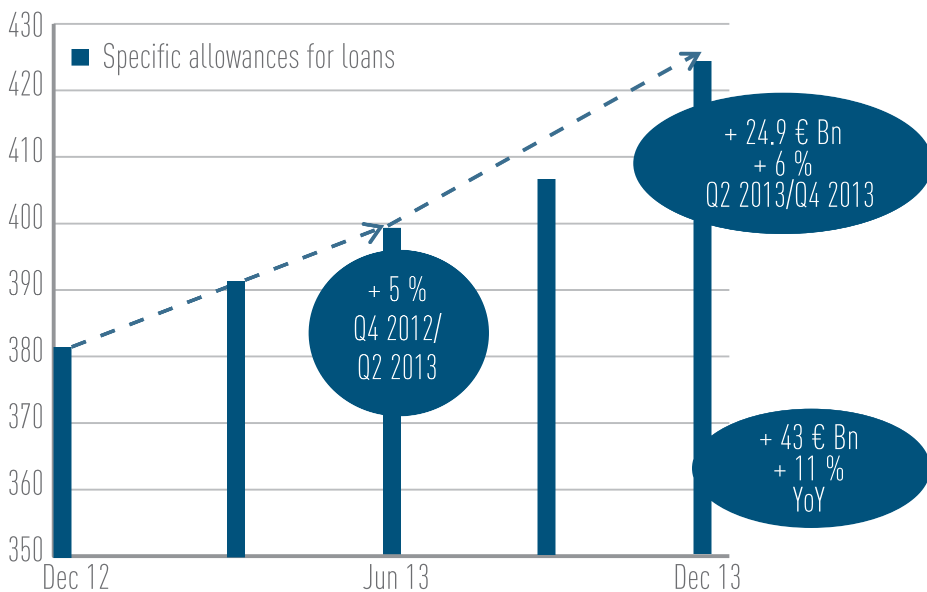
In comparison with the median and the 75th percentile (4.8 % and 9.1 % respectively in December 2013), the majority of RAQ respondents continue to consider a RoE value in the range of 10 % to 12 % as the target for the long-term viability of their businesses. In the last few years, the median presents a RoE of around 5.5 %, significant lower than the target for the long-term viability mentioned by RAQ respondents (Figure 47). In addition, the number of respondents that agree to consider a RoE value below 10 % has increased and in the range of 12–14 % has reduced. This provides strong evidence of a significant reduction in terms of RoE expectations.

Figure 47: Return on equity (*source*: EBA KRI and RAQ data) — 50th and 75th percentiles



For RAQ respondents, the main factors that will influence the RoE in coming months are operating expenses, net interest income and the level of impairments (an increase in comparison with the previous semester). The increased cleaning of balance sheets, ahead of the AQR and EU wide stress test exercise, shows significant front-loading impairments with additional provisioning of EUR 25 billion between June 2013 and December 2013. Also, the recent increase in non-performing loans may, to some extent, reflect the new EBA definitions, contributing to more reliable and comparable figures (Figure 48).

Figure 48: Evolution of specific allowances for loans (*source*: EBA KRI data)



Increased efforts to cut costs

In addition, the vast majority of respondents agree that they are reducing costs through both successfully established cost-cutting plans and reductions in overheads and staff costs. The cutting of non-profitable units is also another factor mentioned, whereas the outsourcing of some the administrative and development departments are not expected. These responses confirm some market estimates that mention that Europe's largest banks cut their staff by another 3.5 % in 2013. In the mentioned cost-cutting plans, and from a supervisory perspective, banks will need to take into account possible problems created by previous cutbacks due to the growing need for some specific and definable skills in certain areas such as anti-money laundering, internal audit, cyber security, and risk management areas.

In a clear contrast, the majority of RAQ responses from market analysts (RAQ for market analysts) continue to somewhat disagree that total revenues will increase. On the other hand, many respondents somewhat agree that the overall profitability will improve, mostly due to overall cost-efficiency improvements, confirming RAQ responses from banks.

With limited options to increase income, many banks are now involved in change initiatives aiming at reducing their cost base. By this we mean outright reductions in operating cost levels, but also improvements in cost-efficiency metrics such as the cost-to-income ratio.

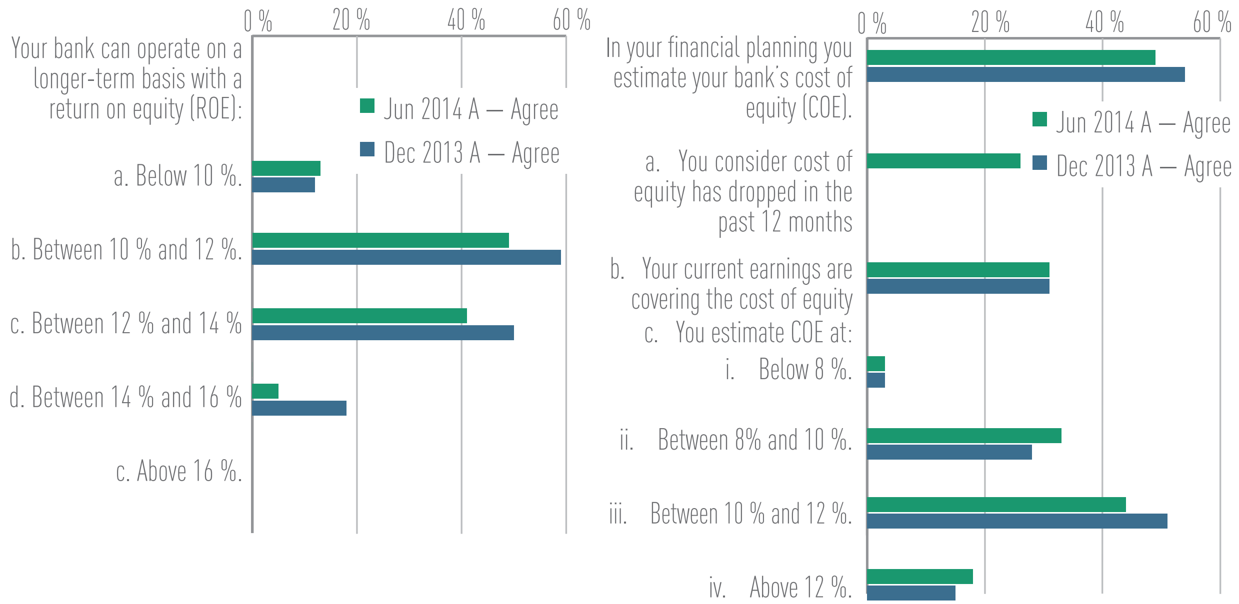
While acknowledging that well-implemented change initiatives can have positive medium-term and long-term implications for a bank's value and capital generation, cost-reducing measures can be highly complex and can require material changes to a bank's business model. This may affect the organisational structure, resources, processes, culture and, ultimately, the client. Not surprisingly, given this complexity, a significant amount of organisational change efforts fail. As a result, there are prudential risks — primarily operational and strategic risks — which require supervisors' attention.

The simplest changes (but not necessarily the least risky) with a limited impact on existing business practices are driven by front-loaded cuts, for example in real estate or staff expenses. More fundamental actions change the operating model and processes of banks, which should ultimately drive a lower staff requirement in the medium to longer term.

Any possible cost-reduction measure creates risk. The consequences of operational and strategic risks from cost-reduction measures may be directly measurable in monetary terms, but they may also be less tangible. For example, an ill-executed cost-reduction programme may lead to legal penalties, the size of which may be easy to measure. On the other hand, the outcome of cost-reduction programmes will be more uncertain when the risks do not only stretch to the current income statement but also to future income-generating capacity in the form of strategic risk.

In regard to the cost of equity (CoE), most RAQ respondents believe this to also be in the 10–12 % range; however, the dispersion increased, with more respondents answering both additional possibilities (i.e. CoE between 8 % and 10 % and CoE between 10 % and 12 %) (Figure 49).

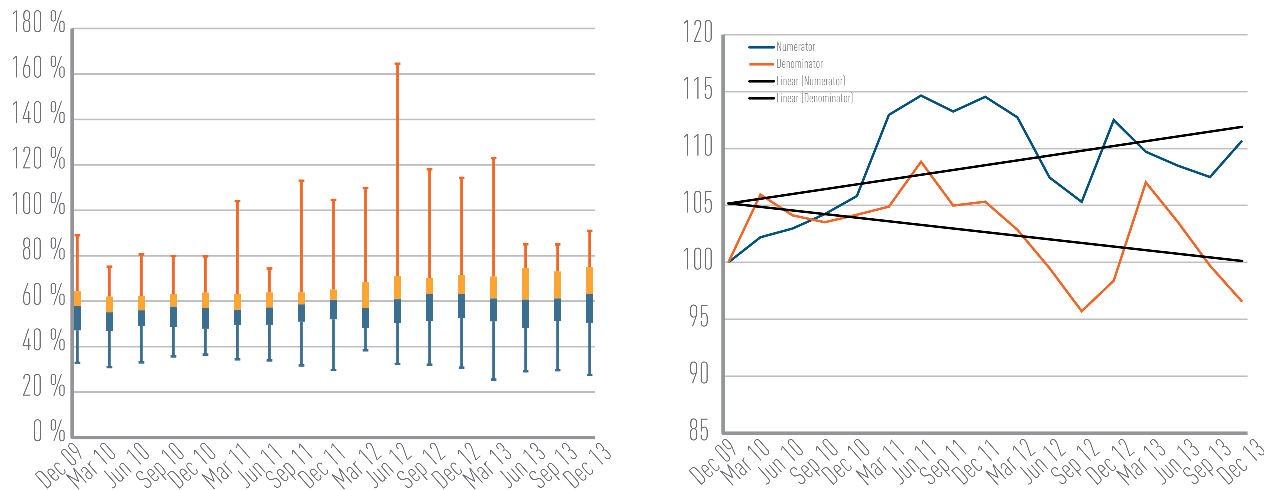
Figure 49: Return on equity and cost of equity (*source*: RAQ)



There are limited and less flexible levers available to meet minimum returns in the context of a general slowdown in economic activity. At the same time, banks need to provide a return to investors at, or above, their cost of equity which may make some business models unviable.

The cost-to-income ratio increased from 57.9 % in June 2013 to 63.3 % in December 2013 (Figure 50), maintaining similar values to December 2012 (weighted average of around 63 %, the highest values since December 2009). On the contrary, the 25th percentile has decreased from 52.5 % in December 2012 to 50.5 % in December 2013. However, the 75th percentile has continued to increase since March 2010 (from 62.1 % to 71.6 % in December 2012 and 75 % in December 2013). For a significant number of banks, the reduction in administration costs has not been sufficient to compensate the decrease of total operating income.

Figure 50: Cost-to-income ratio (*source*: KRI) — 5th and 95th percentiles, interquartile range and median, numerator and denominator trends (December 2009 = 100)



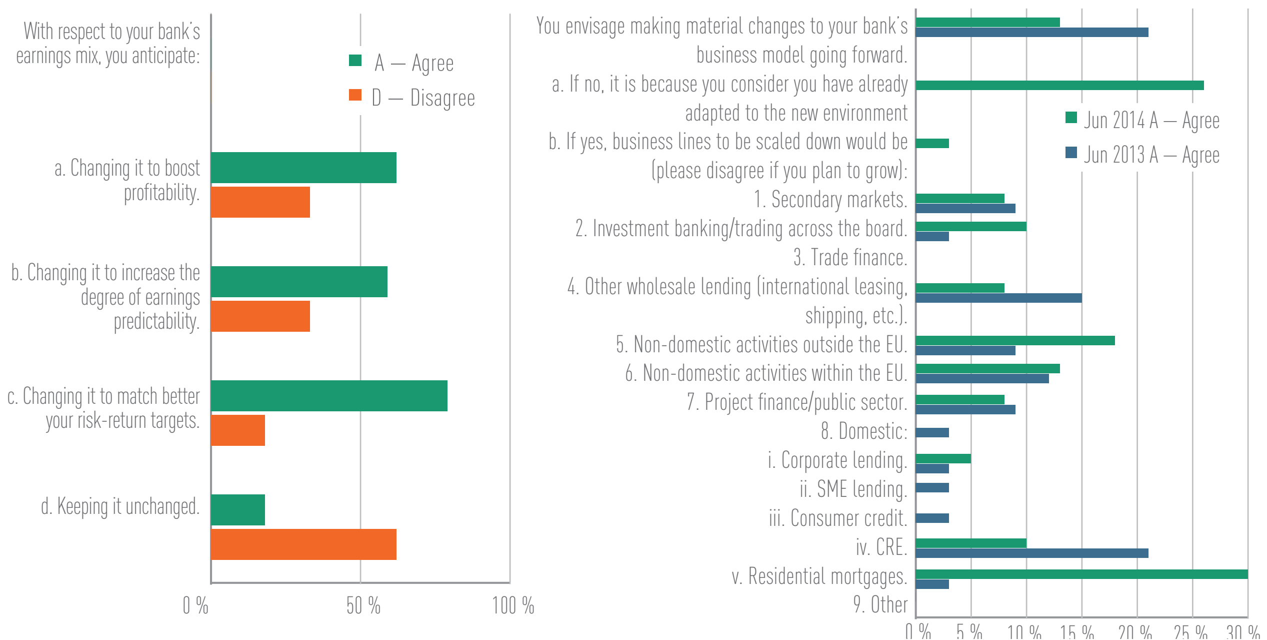
Changes to business models in search for solid profitability

Some banks continue to show signs of exiting 'crisis mode' in response to a wider environment that contains some signs of improvement. Despite improvements, challenges, nevertheless, remain. The issue of profitability is a cause of concern due to a number of factors.

The fragile macroeconomic environment in some areas does not allow for growth of revenues. The low interest rate environment supports repayments by borrowers by reducing interest costs, but negatively impacts the net interest margin generation by banks, as banks' loans are also suppressed. The increased capital which has bolstered the European banking system and rendered it safer has led to pressures on return on equity. In addition, 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. 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 responses to the RAQ present some general trends. RAQ respondents' views on changes to business models show that banks continue to reduce their intention of making material changes because banks consider that they have already implemented change programmes and (more than 25 % of respondents agree) have adapted to the new environment. For the minority that envisage making changes, the business lines to be scaled down reflect, to some extent, the refocusing on core activities and markets, as non-domestic activities, both within the EU (which has fragmentation as a side-effect) and especially outside the EU, are a popular choice for scaling-down. Reflecting a propensity to deleverage, commercial real estate (CRE) has reduced in popularity as a scaling-down target, possibly because of the reduction that has already been achieved (Figure 51).

Figure 51: Changes to the business model (*source*: RAQ)

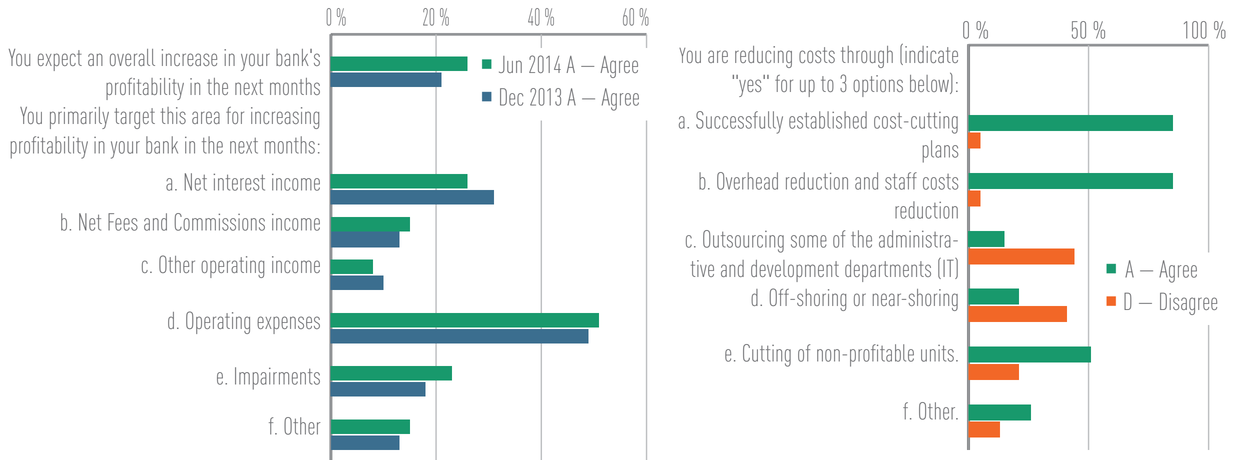


As regards respondents' expectations of higher profitability, there is an increase in comparison with the previous six months. RAQ responses exhibit some dispersion but the majority considers that profitability will increase. The most popular areas that banks target in order to achieve higher levels of profitability continue to be: (i) operating expenses; (ii) net interest income (NII); and (iii) impairments. This indicates an increase in the optimism about future prospects that started in the previous six months.

With regard to the question whether cost-cutting will be achievable, the most important drivers are both successfully established cost-cutting plans and reductions in overheads and staff costs. The cutting of non-profitable units is also mentioned as an important driver. The reference to net interest income as an area to achieve higher levels of profitability points to a realignment of revenue streams since net interest income is under pressure in the current low interest rate environment due to the tightening margin between deposits and loans (Figure 52).[6]

[6] When interest rates fall, deposit rates have to remain non-negative, while loan rates are compressed. A floor on deposit rates imposes a tightening margin to a deposit-funded bank that has floating rate loans.

Figure 52: Drivers of profitability (*source*: RAQ)



7. Consumer issues, reputational concerns and IT related operational risks

Detrimental business practices of EU banks continue to affect consumer confidence in banks and have an increasingly adverse impact on institutions involved. Related risks remain elevated while further risks related to banks' business practices have materialised, and the number and types of alleged detrimental practices continue to grow. Some banks are coping with further rising materialised and potential redress costs, and conduct concerns therefore remain high on the supervisory agenda. In addition, there are growing concerns over the increasing persistence, intensity and sophistication of information technology-related operational risks.

7.1 Consumer issues and reputational concerns

Inappropriate conduct such as mis-selling of banking and other products to consumers, failures with regard to rate benchmark setting processes, and alleged manipulation of markets for credit default swaps has already been mentioned in previous reports. However, the scope of alleged inappropriate practices is widening, and the magnitude of previously identified detrimental practices, for example related to foreign exchange trading business, is increasing. Additional types of alleged inappropriate conduct are coming to the fore, for example inappropriate hiring of relatives of family members of well-connected business and public partners.

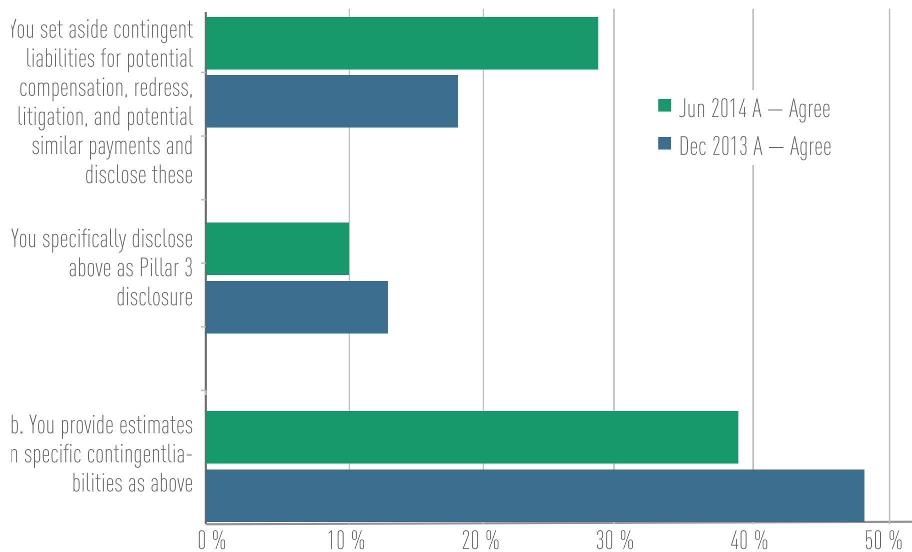
Increased concerns on widening scope and magnitude of in-appropriate practices

The RAQ provides indications of an ongoing aggravation of reputational risks. Around 43 % of respondents identified a further increase in the reputation/legal risk for the banking sector in general and a negative trend in banks' public perceptions — an increase compared to the December 2013 RAQ (33 % of respondents), and an indication of a need to keep conduct risks high on the supervisory agenda. The RAQ also provides an indication of rising redress costs. A growing number of respondents have paid out in the form of compensation, redress, litigation and similar payments aggregate amounts of over EUR 1 billion, both in the reporting year and also since the financial year 2007/08. Around 21 % of respondents have paid out such amounts since 2007/08. Such rising conduct costs in some cases substantially affect profitability of institutions concerned.

It is also noteworthy that in the previous RAQ, some respondents did not need to render some compensation, redress, litigation and similar payments in the ongoing financial year: all respondents to this RAQ now need to render such payments. On the one hand 49 % of respondents provided related payments of less than EUR 10 million, on the other hand around 11 % of respondents needed to provide substantial amounts of over EUR 1 billion.

Previous risk reports have indicated that conduct risks are not sufficiently provisioned for and that there is room for improvement in disclosure on details of redress costs. However, this RAQ indicates some modest improvement in provisioning of conduct risk. Since the last RAQ, the share of respondents indicating that they set aside and disclose contingent liabilities for potential compensation, redress, litigation and similar payments has increased (28 % of respondents compared to 18 %). However, at the same time, the level of disclosure appears to have deteriorated and only 10 % of respondents indicate that they provide specific pillar 3 disclosure (13 % in the previous RAQ). Also, only 38 % of respondents now provide estimates on specific contingent liabilities (47 % in the previous RAQ), in spite of stipulations in International Accounting Standards (IAS) 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 therefore provisions cannot be recognised (Figure 53).

Figure 53: Contingent liabilities (*source*: RAQ)



In line with heightened risks, an increasing number of RAQ respondents indicate that they aim to adjust their risk culture and conduct governance (46 % in this RAQ compared to 33 % in the previous RAQ). However, many fewer institutions now consider it necessary to build up contingency reserves (5 % now compared to 21 % in the previous RAQ). Whereas redress payments are rising at the same time, a reduced build-up of contingency reserves should be an issue of increased supervisory scrutiny. Further educational efforts to improve the financial literacy of consumers are also important, especially since the majority of RAQ respondents consider lack of knowledge to be the most important risk for retail investors.

Risk cultures should be adjusted, and institutions should better integrate conduct of business concerns in their governance and risk management arrangements. These arrangements often fall short of identifying conduct of business concerns. There often is no internal institutional definition of conduct risks, and most risk models applied in institutions fail to capture conduct risks.

Following the manipulation scandal of interest rate benchmark setting, benchmark administrators have carried out major reforms on the governance of both LIBOR and Euribor to decrease incentives and risk for manipulation. The panel of banks submitting the daily quotes have stepped up the internal governance of their quote submission and the quotes are now better anchored on real transactions. However, several panel banks took different courses of action and decided to leave the Euribor panel jeopardising the representativeness and credibility of the benchmark. Interest rate benchmark and foreign exchange benchmarks, which are also currently under investigation of potential misconduct, are crucial for preserving financial stability and all stakeholders should work together to preserve the reliability of financial benchmarks.

7.2 Information and communications technology-related operational risks

The importance of information and communications technology (IT) for institutions has grown substantially. While IT systems are becoming increasingly complex and the volume of data are growing, challenges to safely control these systems are rising and concerns are rising and their vulnerability is increasing. There are growing concerns over the increasing persistence, intensity and sophistication of information technology-related operational risks. This includes concerns related to dependency on the Internet, as well as to cyber-attacks and other malicious attacks on IT systems. Banks are reported to have been hit by such attacks more frequently and have seen an increase in high-profile distributed denial of service (DDoS) and of outages.

Increased attention to IT related operational risks

IT-related risks are increasing while profitability often remains subdued and pressure to reduce costs persists. It is important in such an environment to ensure that IT systems and related internal controls are safeguarded against budgetary pressures and remain robust. While consolidation in the banking sector continues interaction of legacy or heterogeneous IT systems deserves heightened attention, as particular weaknesses has been identified here. At the same time, market pressure to swiftly launch new IT-related and mobile technology products is an additional source of risk, as sufficient time to testing prior to product launching may be compromised. In addition, companies are using new approaches which involve testing as an integral part of the design and development process. Updating legacy IT systems while simultaneously adopting new technologies can be a major challenge for banks and create substantial risk exposure.

The RAQ indicates that almost all institutions are responding to growing IT-related operational risks. Actions taken are such as increased spending on IT security- and resilience, strengthening of governance and business continuity plans. Two thirds of RAQ respondents cover IT risks as part of their general operational risk management. Supervisors should caution whether this general treatment is capturing IT risks adequately.

8. Policy implications and possible measures

A clear picture of the quality of European banks' assets is necessary in order to dispel persistent concerns and reassure potential investors about the robustness of the EU financial system. The EBA issued recommendations, in October 2013, to competent authorities for their existing and/or planned work on asset quality reviews (AQRs)(7) across the European Union. There is existing strong evidence that the EU wide AQRs are an important catalyst for addressing uncertainties surrounding EU banks' asset quality in the current context and will support future monitoring changes in asset quality after the 2014 EU wide stress test exercise. The competent authorities are completing their respective AQRs during the first six months of 2014 and will be reporting to the EBA the preliminary outcomes in order to be taken into account and support the EU wide stress test in the second half of 2014.

Supervisors need to develop a more coordinated analysis of banks' business models across the EU to assess banks' profits and funding models, business mix, management strength and strategy, among other issues. The EU banks' income and profitability levels and the sustainability of some business models remain a cause for concern. Some EU banks are facing strong challenges in adapting to the many changes derived from the emerging new economic, regulatory and financial landscape, and it is still unclear where their future profitability drivers will originate from. Existing EU banks' business models are experiencing pressure through stronger competition and supervisors are required to have an accurate assessment of core banking risks and challenge banks' business plans.

The EBA will continue to foster and promote convergence in European banking regarding the development of recovery plans by institutions, provide guidance and assist competent authorities in the assessment of such recovery plans, and develop a comprehensive library of recovery best practices in European banking. The resolution and recovery plans will help the respective bank and the supervisory authorities in preparing for crisis situations and potential resolution of the bank. The resolution and recovery plans will be also instrumental in assessing the viability of current business models and will provide an opportunity to tackle issues such as banks' profits and funding models, business mix, management strength and strategy. In reference to the content of the recovery plans actually developed by major European cross-border banking groups, the EBA has analysed them and seen that institutions should: (i) have a sufficient number of recovery plan indicators that adequately capture the risk profile, size and complexity of each institution in order to identify the point at which it has suffered a significant deterioration of its financial conditions; (ii) contain a full description of the possible recovery options, having analysed their impact and feasibility and the assumptions considered for their potential use; (iii) when developing scenarios, consider a range that covers idiosyncratic events, system-wide events and a combination of both that should be severe enough to threaten to cause the failure of the institution, unless recovery measures are implemented in a timely manner; and (iv) have in place appropriate escalation procedures to ensure the adequate governance of each recovery plan.

The EBA will also foster resolution planning and will be actively involved in the establishment and monitoring of resolution colleges that will be created under the BRRD mandate. Resolution colleges will provide a forum to exchange information and for the coordination of resolution measures, in order to ensure coordination at cross-border or EU level between all the national authorities involved in the resolution of institutions. In the event of disagreement between national authorities on decisions to be taken with regard to institutions, the EBA will have a role of mediation similar to that which it plays in supervisory colleges.

(7) EBA recommends supervisors to conduct asset quality reviews (http://www.eba.europa.eu/documents/10180/449802/EBA-Rec-2013-04+Recommendations+on+asset+quality+reviews.pdf/1eb0b843-0c2c-4b05-995e-f2887edb2981).

A more general reassessment of the relationship between banks and their customers remains a priority. The EU banks' reputational and legal risks remain a concern due to potential prudential impact of conduct-related issues. A number of detrimental business practices of some European banks have significantly affected consumer confidence and had an adverse impact on the respective banks involved.

In light of indications of insufficient and decreasing disclosure of conduct risks, auditors and supervisors should pay additional attention to monitoring if adequate provisioning for related risks has been made, and if contingency reserves are being built. Supervisors should maintain appropriate supervisory vigilance in business conduct-related issues, and 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 provisioning is adequate. Further educational efforts to improve the financial literacy of consumers are also important. While a lack of financial literacy seems to be the main concern, the level of information institutions provide to retail investors appears to differ significantly across Europe, in particular on certain more complex products. Better internal governance should be an issue of supervisory concern; therefore, continued heightened supervisory attention to risk culture and governance is necessary. 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).

Supervisors should factor mitigation of IT-related risks into regular risk assessments. This includes IT inspections with a necessary scope and depth, while institutions should give increased priority to related risks. IT controls and audits should be reinforced, and institutions should strive to integrate IT security and resilience into the risk models they apply. The evolving nature of IT-related risks and rapid technological advances highlights the need for sound management practices and a strong, professional risk culture which can swiftly react to new threats and deliver appropriate levels of employee awareness about evolving risks.

A coordinated policy action remains fundamental for the coherence of the single market. Initiatives such as the asset quality reviews (AQR), common definitions on 'non-performing exposures' and 'debt forbearance' form part of broader policy actions aimed at addressing the current situation in the EU by restoring stability and confidence in the markets. Moreover, new regulatory requirements for banks (e.g. the CRD IV-CRR and the (BRRD) are fundamental for the ongoing repair of the EU banking system. 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. The sovereign-bank linkage persists and there is evidence of disparities in funding conditions and funding costs between banks domiciled in financially strong and financially stressed sovereigns. The institutional reforms at EU level are crucial in breaking this pernicious linkage, more specifically in the establishment of the banking union, including the implementation of a more integrated framework for bank resolution and an appropriate single deposit guarantee system scheme.

Annex I — Samples

Below a list of the banks that made up the sample population for the Risk Assessment Questionnaire (RAQ) and the Key Risk Indicators (KRI).

Risk Assessment Questionnaire

Bank name	Home country
Erste Group Bank AG	AT
Raiffeisen Zentralbank	AT
KBC Group	BE
Bank of Cyprus Public Company Ltd	CY
Bayerische Landesbank	DE
Commerzbank AG	DE
Deutsche Bank AG	DE
DZ BANK AG	DE
Hypo Real Estate Holding	DE
Norddeutsche Landesbank Girozentrale NORD/LB	DE
Danske Bank A/S	DK
Alpha Bank AE	EL
Eurobank Ergasias	EL
National Bank of Greece	EL
Piraeus Bank	EL
Banco Bilbao Vizcaya Argentaria SA	ES
Banco Santander SA	ES
BNP Paribas	FR
Crédit Agricole Group-Crédit Agricole	FR
Société Générale	FR
OTP Bank NYRT	HU
Allied Irish Banks plc	IE
Bank of Ireland	IE
Gruppo Bancario Intesa Sanpaolo	IT
Gruppo UniCredit	IT
ABN Amro	NL
ING Groep NV	NL
Rabobank Group-Rabobank Nederland	NL
DNB Bank	NO
Banco Comercial Português	PT
Nordea Bank AB (publ)	SE
Skandinaviska Enskilda Banken AB	SE
Svenska Handelsbanken AB	SE
SWEDBANK AB	SE
Barclays Plc	UK
HSBC Holdings Plc	UK
Lloyds Banking Group Plc	UK
Royal Bank of Scotland Group Plc (The)	UK
Standard Chartered Plc	UK

Key Risk Indicators (KRI)

	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	CY
8	DZ BANK AG	DE
9	WestLB AG	DE
10	Landesbank Baden-Wuerttemberg	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	Banco Santander SA	ES
18	Banco Bilbao Vizcaya Argentaria SA	ES
19	La Caixa	ES
20	Banco Financiero y de Ahorro	ES
21	OP-Pohjola Group	FI
22	BNP Paribas	FR
23	Crédit Agricole Group-Crédit Agricole	FR
24	Société Générale	FR
25	Credit Mutuel	FR
26	Group BPCE	FR
27	Barclays Plc	GB
28	Lloyds Banking Group Plc	GB
29	Standard Chartered Plc	GB
30	HSBC Holdings Plc	GB
31	Royal Bank of Scotland Group Plc (The)	GB
32	Nationwide Building Society	GB
33	National Bank of Greece	GR
34	Alpha Bank AE	GR
35	Piraeus Bank	GR
36	EFG Eurobank Ergasias	GR
37	OTP Bank NYRT	HU
38	Bank of Ireland	IE
39	Allied Irish Banks plc	IE
40	Gruppo UniCredit	IT
41	Gruppo Monte dei Paschi di Siena	IT
42	Gruppo Bancario Intesa Sanpaolo	IT
43	Gruppo Banco Popolare	IT
44	Bank of Valletta (BOV)	MT
45	ABN Amro	NL
46	ING Groep NV	NL
47	Rabobank Group-Rabobank Nederland	NL
48	DnB NOR	NO
49	PKO Bank Polski	PL
50	Banco Comercial Portugues	PT
51	Caixa Geral de Depositos	PT
52	Espirito Santo Financial Group (ESFG)	PT
53	Skandinaviska Enskilda Banken AB	SE
54	Nordea Bank AB (publ)	SE
55	SWEDBANK AB	SE
56	Svenska Handelsbanken	SE
57	Nova Ljubljanska Bank (NLB)	SI

Notes:
WestLB is not considered for the KRI calculation since June 2011.
Marfin Popular Bank is not considered for the KRI calculation since March 2013.

Annex II — Descriptive statistics from the EBA key risk indicators

Descriptive statistics from the EBA key risk indicators with data to Q4 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	Sep 13	Dec 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 %	n.1 %	11.6 %	12.0 %	12.3 %	12.5 %	12.4 %	12.6 %	12.9 %	13.1 %
		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 %	11.0 %	11.1 %	11.4 %
		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 %	12.3 %	12.8 %
		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 %	13.9 %	14.8 %
	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 %	15.4 %	15.7 %
		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 %	13.1 %	13.0 %	13.4 %
		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 %	14.4 %	14.4 %	14.6 %	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 %	17.1 %	17.4 %
	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 %	11.4 %	11.6 %
		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 %	10.2 %	10.4 %
		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 %	11.0 %	11.1 %	11.4 %
		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 %	13.1 %	13.5 %

	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	Sep 13	Dec 13
Credit risk and Asset Quality	13 — Impaired loans and Past due (>90 days) loans to total loans	Weighted average	5.1 %	4.9 %	5.1 %	5.3 %	5.3 %	5.2 %	5.4 %	5.4 %	5.8 %	5.9 %	6.0 %	6.3 %	6.5 %	6.5 %	6.7 %	6.6 %	6.8 %
		25th percentile	3.1 %	3.1 %	3.3 %	2.8 %	3.0 %	2.9 %	2.5 %	2.6 %	2.5 %	2.5 %	2.8 %	2.8 %	3.1 %	3.0 %	3.2 %	2.9 %	3.0 %
		50th percentile	4.9 %	5.1 %	5.4 %	5.0 %	5.4 %	5.4 %	5.6 %	5.6 %	6.4 %	6.7 %	6.3 %	7.3 %	7.3 %	6.7 %	6.7 %	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 %	17.6 %	17.6 %	15.7 %	16.2 %
	14 — Coverage ratio (specific allowances for loans to total gross impaired loans)	Weighted average	41.6 %	41.7 %	41.6 %	42.5 %	41.4 %	42.3 %	41.2 %	40.7 %	41.0 %	41.0 %	41.3 %	41.3 %	41.8 %	42.4 %	42.4 %	44.4 %	45.9 %
		25th percentile	34.5 %	34.8 %	35.2 %	34.6 %	34.5 %	34.6 %	33.8 %	33.8 %	34.3 %	34.8 %	35.8 %	35.1 %	34.7 %	35.6 %	34.9 %	35.6 %	35.6 %
		50th percentile	41.0 %	41.5 %	41.5 %	42.4 %	42.5 %	43.5 %	42.8 %	41.9 %	41.5 %	41.4 %	41.8 %	42.0 %	41.7 %	43.5 %	43.8 %	44.4 %	46.1 %
		75th percentile	50.7 %	50.1 %	49.4 %	51.5 %	51.9 %	50.9 %	49.3 %	47.2 %	51.1 %	51.4 %	50.6 %	50.9 %	50.1 %	52.0 %	51.7 %	52.8 %	55.0 %
	18 — Impaired financial assets to total assets	Weighted average	1.6 %	1.6 %	1.6 %	1.6 %	1.7 %	1.7 %	1.8 %	1.7 %	1.9 %	1.9 %	1.9 %	1.9 %	2.0 %	2.0 %	2.1 %	2.0 %	2.0 %
		25th percentile	1.0 %	1.1 %	1.1 %	1.2 %	1.2 %	1.2 %	1.1 %	1.0 %	1.0 %	1.2 %	1.2 %	1.1 %	1.2 %	1.2 %	1.2 %	1.3 %	1.3 %
		50th percentile	1.9 %	1.9 %	1.8 %	1.9 %	2.0 %	1.9 %	2.0 %	2.1 %	2.2 %	2.1 %	2.1 %	2.2 %	2.4 %	2.4 %	2.6 %	2.5 %	2.4 %
		75th percentile	3.5 %	3.5 %	3.6 %	3.9 %	3.9 %	4.1 %	5.3 %	5.3 %	5.6 %	6.6 %	6.9 %	7.8 %	7.8 %	8.7 %	8.9 %	7.9 %	7.1 %
	20 — Accumulated impairments on financial assets to total (gross) assets	weighted average	1.3 %	1.3 %	1.3 %	1.4 %	1.4 %	1.4 %	1.4 %	1.3 %	1.6 %	1.5 %	1.5 %	1.5 %	1.6 %	1.6 %	1.7 %	1.8 %	1.9 %
		25th percentile	0.9 %	0.9 %	0.9 %	0.8 %	0.9 %	0.8 %	0.8 %	0.7 %	0.8 %	0.8 %	0.7 %	0.7 %	0.7 %	0.7 %	0.8 %	0.8 %	0.8 %
		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 %	1.8 %	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 %	4.2 %	4.3 %
	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 %	16.9 %	18.6 %	18.6 %	22.8 %
		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 %	9.8 %	10.4 %	11.0 %
		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 %	19.4 %	19.2 %	20.0 %	21.4 %
		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 %	34.2 %	30.8 %	31.9 %	43.3 %

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	Sep 13	Dec 13
Profitability	22 — Return on equity	Weighted average	4.5 %	7.4 %	7.3 %	6.7 %	5.9 %	8.3 %	7.1 %	4.9 %	0.0 %	5.6 %	3.4 %	2.6 %	0.5 %	9.3 %	7.6 %	6.4 %	2.7 %
		25th percentile	-0.5 %	3.1 %	3.1 %	3.0 %	1.7 %	5.0 %	2.8 %	-0.7 %	-15.7 %	1.8 %	-0.9 %	-1.5 %	-6.5 %	1.4 %	2.2 %	1.5 %	-2.9 %
		50th percentile	5.4 %	6.2 %	6.4 %	5.7 %	5.4 %	8.0 %	7.1 %	5.2 %	2.7 %	6.5 %	5.3 %	3.8 %	2.6 %	6.6 %	6.4 %	5.7 %	4.8 %
		75th percentile	9.1 %	11.1 %	10.8 %	10.0 %	9.5 %	11.7 %	11.7 %	9.4 %	7.8 %	11.5 %	8.9 %	8.4 %	7.2 %	12.3 %	10.4 %	10.4 %	3.1 %
	24 — Cost-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 %	56.6 %	57.9 %	59.6 %	63.3 %
		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 %	51.2 %	50.5 %
		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 %	61.2 %	60.8 %	61.3 %	63.1 %
		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 %	73.1 %	75.0 %
	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 %	61.1 %	61.2 %	60.9 %	61.7 %	61.6 %	55.5 %	55.1 %	57.3 %	58.9 %
		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 %	50.1 %	51.1 %
		50th percentile	64.1 %	61.9 %	61.6 %	62.8 %	62.5 %	59.9 %	62.8 %	65.0 %	64.0 %	63.9 %	63.2 %	65.9 %	66.9 %	60.0 %	60.5 %	59.1 %	60.2 %
		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 %	75.6 %	72.7 %	71.1 %	78.2 %
	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 %	25.8 %	26.7 %	27.7 %	23.5 %
		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 %	15.3 %	15.4 %
		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 %	24.6 %	23.6 %	23.5 %	24.8 %
		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 %	32.6 %	31.2 %
	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 %	1.2 %	23.1 %	19.3 %	16.8 %	7.4 %
		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 %	7.2 %	6.1 %	-16.0 %
		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 %	15.9 %	16.6 %	16.5 %	13.6 %
		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 %	29.5 %	30.9 %

	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	Sep 13	Dec 13
Balance sheet structure	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 %	117.4 %	114.1 %	114.7 %	112.8 %
		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 %	101.3 %	99.9 %	97.8 %	98.0 %
		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 %	116.8 %	115.0 %	114.6 %	112.1 %
		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 %	131.5 %	130.5 %	132.1 %	129.4 %
	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 %	45.5 %	46.0 %	47.7 %
		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 %	41.2 %	43.5 %
		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 %	50.9 %	50.6 %	52.6 %	54.3 %
		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 %	62.4 %	62.3 %
	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 %	5.0 %	5.1 %
		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 %	4.5 %	4.6 %
		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 %	5.4 %	5.4 %	5.5 %	5.5 %
		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 %	6.7 %	6.8 %	6.6 %	6.7 %
	45 – Debt-to-equity ratio	Weighted average	18.7	19.2	19.4	19.2	18.2	17.8	17.9	19.4	19.6	19.1	19.4	19.1	18.1	17.9	17.5	17.0	16.5
		25th percentile	12.0	12.6	13.1	12.8	12.3	12.0	12.7	13.1	13.6	13.2	13.6	13.5	13.3	12.7	12.5	12.6	12.1
		50th percentile	14.9	15.3	16.0	16.1	16.6	16.0	17.2	17.2	18.4	18.1	18.1	17.7	16.2	15.9	16.0	15.6	15.9
		75th percentile	22.6	23.0	24.4	22.8	22.9	22.5	21.7	25.1	27.5	25.0	24.1	24.1	22.7	22.1	22.3	21.4	19.6
	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 %	18.1 %	18.6 %	19.0 %
		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 %	7.8 %	7.7 %
		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 %	14.5 %	14.7 %	14.9 %	15.2 %
		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 %	21.7 %	22.2 %

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