RISK ASSESSMENT OF THE EUROPEAN BANKING SYSTEM

JULY 2013

EBA
EUROPEAN
BANKING
AUTHORITY

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Executive summary

Throughout the first semester of 2013, following the publication of the EBA's last risk assessment report (*Report on risks and vulnerabilities of the European Banking System*, January 2013), the EU banking sector has continued to observe some limited improvements in market confidence, from both debt and equity investors. Conversely, a clear dislocation between financial markets and the real economy is being observed, with macroeconomic data and forward looking leading indicators displaying signs of a general weak macroeconomic environment. Given the continued disappointing economic activity and some deep recessions in parts of the EU, the outlook for the near future remains subdued. Consequently, significant challenges within the EU banking sector continue to persist due to probable rising provisions and continuing asset quality deterioration along with this trend showing no sign of reversal.

Market sentiment has improved in comparison to last year as a consequence of decisive policy measures and regulatory steps since the summer of 2012, perceived as very positive moves to reduce the risks of both EMU break-up and outright sovereign defaults. The recapitalisation of EU banks through 2012 on the back of the EBA's recapitalisation recommendation has combined with ample central bank liquidity such that the secondary market is showing that investor demand is substantial and exceeds supply from new issuances. At the same time, spreads of bank benchmark bonds of different durations have continued to decline in both 'core' and 'peripheral' countries. However, a sudden reassessment of expectations regarding liquidity programmes of major central banks may trigger significant corrections in markets. Whilst the return of calmer conditions paved the way for a gradual return of market confidence, **financial markets still remain fragile and susceptible to a sudden switch of market sentiment**.

With regard to regulatory developments and structural reforms, the EU parliament approval of the CRD IV, the legislation implementing Basel III within the EU, and publications of the CRR/CRD, were likewise positive steps forward in reducing uncertainties. Withal, despite some clarity on the technical details, significant implementation challenges remain ahead. The numerous regulatory reforms still underway continue to be of concern for investors and other market participants in particular in regard to the timing and respective contents. **Moreover, there continues to be evidence of a fragmented European financial sector** with regard to bank lending. In parallel, the sovereign-bank linkage still persists, smaller banks are facing relatively higher funding costs, and cross-border interbank markets continue to be very subdued and fragile in many jurisdictions. To bring fragmentation to a halt and strengthen the single market, it is fundamental to press ahead with structural and institutional reforms at the European level, in particular the establishment of the banking union, including a Single Supervisory Mechanism (SSM) and bank resolution schemes. Meanwhile, the EBA will continue to pursue its objectives in advancing towards an EU-wide single rule-

book and promoting regulatory convergence across the Union, in both rules and practices.

With regard to capital levels, over the last months, EU banks and respective capital positions continued to maintain a noteworthy increasing trend, notwithstanding the challenging conditions in financial markets. Nonetheless, the continued deterioration of both the quality of banks' loan portfolios and profitability may also pose challenges in some cases to the maintenance of adequate capital levels. Therefore, European supervisors will need to continue monitoring the increasing credit risks and the smooth and timely transition to the CRR/CRD framework.

On the asset side of the EU banks, there is an ongoing and limited de-risking process through the reduction of balance sheets and loan books across the EU, and the optimal pace of deleveraging justifies close attention. **There is evidence of a continuing deterioration of the quality of banks' loan portfolios** throughout 2012 and the first months of 2013. The increasing credit risks and the deterioration in asset quality are spread across the EU. The ratio of impaired loans and past due (> 90 days), in terms of weighted average, has increased from 6 % in June 2012 to 6.3 % in December 2012 (the highest since 2009). Loans in arrears, and impaired assets in particular, continue to increase and provisioning, in some cases, has not increased in conformity with rising credit risks, which continues to raise questions on the extent to which provisioning is adequate. Banks with a coverage ratio of less than 25 % increased and represented approximately 14 % of total key risk indicator (KRI) sample assets in December 2012. At the same time, there is a general market view that forbearance is practised, particularly, in residential mortgages, commercial real estate, and real estate developer loans. In addition, banks active efforts to deal with problem assets have been to some extent hampered by the absence of a lively secondary market in banks assets in the EU. The EBA agreed, in May 2013, on recommendations to supervisors to conduct asset quality reviews on major EU banks in order to dispel concerns over the deterioration of asset quality [1]. In addition, the EBA proposed harmonised definitions on forbearance and non-performing exposures [2]. These consistent EU-wide definitions are a key step in the early identification of risks to the financial stability at EU level and will facilitate further actions, such as asset quality assessments.

With reference to the EU banks' liability side, the funding conditions have improved with some consistent banks' issuance of unsecured debt. There has also been some evidence of deposit inflows from both retail and corporate customers, including into banks in countries with financially stressed sover-

[1] EBA recommends supervisors to conduct asset quality reviews and adjusts the next EU-wide stress test timeline. http://www.eba.europa.eu/-/eba-recommends-supervisors-to-conduct-asset-quality-reviews-and-adjusts-the-next-eu-wide-stress-test-timeline

[2] EBA Consultation Paper on supervisory reporting on forbearance and non-performing exposures. http://www.eba.europa.eu/-/eba-consultation-paper-on-supervisory-reporting-on-forbearance-and-non-performing-exposures

eigns, and the average cost of equity of banks in the EU has decreased. With regard to deposits, their importance for bank funding has been steadily increasing. Not only the weighted average of the loan-to-deposit ratio has been decreasing since September 2011 (from 147 % to 139 %, in December 2012), but also the median (from 152 % to 140 % in December 2012). Nonetheless, some behavioural changes could be expected for deposits not covered by deposit guarantee schemes, and heightened supervisory attention is necessary. A sustainable development also needs to take into consideration the necessity to restore market access for banks and a move away from central bank support.

The EU banks' income and profitability has continued to be faced with significant headwinds which are not likely to dissipate in 2013. The low interest rates environment creates some pressure on bank net interest margins, especially for banks with exposure to tracker type mortgages, and increases the risk of hidden forbearance with build-up of latent credit risk and inefficient market allocation of available credit resources. At the same time, net interest margins are pressured by high funding costs, official funding notwithstanding, which are not being matched by a full re-pricing of assets. The cost-to-income ratio and similar indicators also point to some deterioration of banks' ability to keep relative costs under control whereas the credit costs are on the rise, leading to higher levels of loan-loss provisions. In a context of economic downturn and sector deleveraging there are limited and less flexible levers available to meet minimum returns, making some business models unviable. There is limited evidence of banks grasping the need for fundamental restructuring and adapting business models to cope with the changing environment. Moreover, sustainable profit generation is necessary for some banks to satisfy Basel III requirements.

With reference to reputational concerns linked to the relationship between banks and consumers, a number of detrimental business practices of European banks have affected consumer confidence. These incidents concern detrimental behaviour and inappropriate conduct of various types, namely mis-selling of products, failures with regard to rate benchmark setting processes and taxation issues. These prudential risks have crystallised in some EU members and are significant, therefore other jurisdictions should pay heightened attention to potential risks, especially in geographies where innovative instruments have been sold to retail customers.

Table 1: Main risks facing the EU banking sector

		Bank risk	Risk drivers	Level of risk	Trend	Contributing factors/interactions
CAPITAL	Pillar 1	Credit risk (includes asset quality, provisions, indebtedness, etc.)	Asset quality	■ High	⇧	Uncertainty on timely recognition of problem loans, loan restructuring and modifications, level of impairments, real estate dynamics
CAPITAL	Pillar 1	Market risk	Volatility, hedge effectiveness	■ Medium	⇔	Geopolitical uncertainty, monetary policy stance of the different world central banks
CAPITAL	Pillar 1	Operational risk	Pressure for changes and weak operational resilience, indiscriminate cost cutting	■ Medium	⇔	Degradation of controls, increased risk of fraud in downturn, IT service continuity
CAPITAL	Pillar 2	Concentration risk, interest rate risk in the banking book-IRRBB and other	Interest rates	■ Medium	⇔	Low interest rates improve affordability, but squeeze down profitability due to increased margin pressures
CAPITAL	Pillar 2	Reputational and legal	Libor/Euribor investigations, mis-selling	■ Medium	⇧	Banks face endogenous confidence pressures due to failures in practices, but also exogenous from possibility of bail-in of non-insured deposits. Prudential implications from fines and redress costs, and consequent impact on profitability
CAPITAL	Pillar 2	Profitability	Margins, asset quality, provisions workout, business model changes	■ High	⇧	Low interest margins, increased cost of funding, non-performing loans on the rise, limited room for cost cutting
Liquidity and funding		Access to funding and maturity distribution	Market confidence, pricing	■ Medium	⇧	High reliance on public sources of funding, though decreasing. National compartmentalisation and ring fencing, increasing reliance on deposit funding but unsecured markets are now open and functioning. Bail-in uncertainty increases funding prices
Liquidity and funding		Funding structure (encumbrance, loan to deposit, official vs private sector)	Leverage	■ High	⇔	Business model changes, macroeconomic condition, fragmentation, ongoing de-risking
Environment		Regulatory environment	Timing and scope of implementing regulatory initiatives	■ High	⇔	Perceived lack of clarity on convergence of regulatory initiatives, implications on business models, but increased clarity with vote on CRD/CRR package, implementation risk of SSM
Environment		Fragmentation	Continued lack of confidence, sovereign/bank link, national-only regulatory/policy initiatives	■ High	⇔	Increasing home bias and requirements to match asset and liabilities at country level; cross-border interbank markets remain very subdued. Rates for comparable companies divergent in different countries.
Environment		Sovereign risk	Fiscal policy and effectiveness, budgets imbalances	■ High	⇔	Implementation delays of the banking union

■ High ⇧ Increasing
■ Medium ⇔ Stable
■ Low ⇩ Decreasing

The level of risk summarises, in a judgmental fashion, the probability of the materialisation of the risk factors and the likely impact on banks. The assessment takes into consideration the evolution of market and prudential indicators, NSAs and banks' own assessments as well as analysts' views.

1. Introduction

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

With this report and those published in July 2012 and January 2013, the EBA discharges its responsibility pursuant to recital 43 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 to monitor and assess market developments as well as to provide information to other EU institutions and general public. The EBA believes that the information contained in the report provides the relevant stakeholders with a useful benchmark for analysis.

The report draws on the views of banks and national supervisors to construct a forward-looking view of risks that are becoming 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;
(b) EBA risk assessment questionnaire for banks;
(c) EBA risk assessment questionnaire for market analysts; and
(d) Micro prudential expertise and college information gathering.

The EBA key risk indicators (KRIs) 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 2012. Information about the sample and descriptive statistics of the latest KRIs can be found in both the appendix and annex.

Since KRIs 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 surveys.

The EBA conducts semi-annual surveys, the risk assessment questionnaire (RAQ), asking banks and/or their financial supervisors a number of multiple choice questions. Information from the questionnaire completed in April 2013 and comparisons with previous answers from a representative sample of 35 banks, listed in the appendix, was used for this report. In addition, the EBA conducted a survey (RAQ for market analysts) asking market analysts (nine respondents) a number of questions in a five-way multiple choice format with responses reflecting the degree of agreement to the statement made. Conclusions should be treated with caution due to the fact that questionnaires are sampling only the large EU groups (RAQ for banks)

and only some market analysts (first attempt and for future increase). The main findings of both RAQs are reported through the report and have contributed to the overall risk assessment.

The report also analyses information gathered by the EBA from the European colleges of supervisors and from informal discussions as part of the regular risk assessments and ongoing dialogue on risks and vulnerabilities of the EU banking sector.

The report views EU banks as a set of balance sheets and is organised as follows.

Chapter 2 looks at the external environment and processes by which EU banks' balance 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 the European level.

Chapter 3 presents the assets in the banking system, explaining the ongoing de-risking process, the respective influence in banks' business models and risk appetite, the asset quality and evolution of banks' loan portfolios, loans in arrears and impaired assets, as well as policy implications and possible measures to address these prudential issues.

Chapter 4 provides an overview of the banks' capital positions and respective positive trends, taking into account the challenging conditions in financial markets and the national efforts progressing towards strong capital buffers, as well as the EBA recapitalisation exercise and the smooth and timely transition to the CRR/CRD framework.

Chapter 5 switches to the liabilities side, presenting the general positive evolution of funding conditions, the rethinking of dependence on less stable funding sources, the higher reliance on deposit funding and potential in-market competition for new deposits. It also discusses the development of asset encumbrance and highlights remaining structural fragilities and challenges, in particular in countries having experienced some sovereign stress.

Chapter 6 describes banks' income and profitability and the significant headwinds during the end of 2012 and the first semester of 2013, taking into account the weak economic environment and ongoing net interest margins compression, as well as banks' ability to keep relative costs under control, the sustainability of their respective business models, policy implications and possible measures.

Finally, Chapter 7 touches upon aspects of banks' consumer issues and reputational concerns, business conduct, effective and potential financial costs stemming from mis-selling and other unfair past business practices, policy implications and possible measures to address these prudential issues.

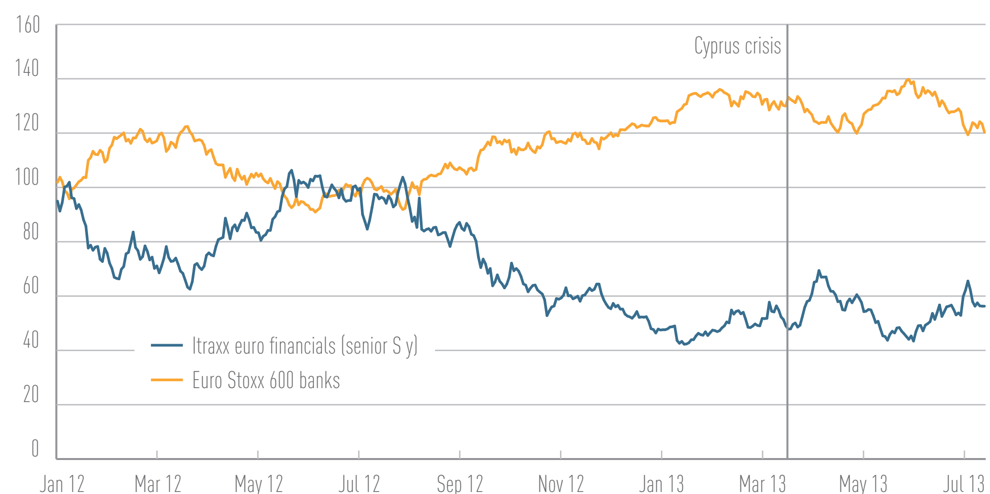
2. External environment

Market sentiment and macroeconomic environment

There is a comprehensive consensus that funding conditions have improved compared to last year. Examining various aspects of banks issuance, it is visible that the situation in bank funding is healthier. Bank debt issuance is being relatively strong in the favourable spread environment and even banks in countries with financially stressed sovereigns have re-accessed the markets. However, a weak macroeconomic environment and respective data and indicators continue to show signs of retreatment and risks to the global outlook remain evident, in a clear dislocation between financial markets and the real economy.

Funding conditions are particularly improving for peripheral banks — both large and small — and they have been active issuers in the last couple of months, suggesting that wholesale funding markets remain open. Issuance is still not very large, but it seems that it has more to do with the lack of need rather than the lack of ability to issue. Concurrently, banks have more funding avenues including increased deposits and central bank access. Maturities are similar to last year's level, but banks are continuing to deleverage, deposit growth remains positive in most countries, and banks still benefit from ample central bank liquidity.

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



Moreover, the secondary market is showing that investor demand is substantial and exceeds supply from new issues. Benign funding conditions, in particular in 'peripheral' countries, are not only supported by improved market sentiments but also by bank debt investors being prepared to go down the credit curve in search for yield. In parallel, spreads of bank benchmark bonds of different durations have continued to decline in both 'core' and 'peripheral' countries. At the same time, banks are also taking advantage of the renewed USD investors' confidence, seeming to have little problem in accessing USD funding. The increasing USD funding of European banks could be considered a sign of regaining trust from the US investors.

In addition, unsecured funding has grown in terms of share from 60 % to 65 %, collateralised funding decreased from 31 % to 27 %, and government-guaranteed funding, which was largely absent in the first months of the year, has returned in the second quarter of 2013. Even the sovereign developments in March did not lead to a lasting reversal of the benign trend but only to some temporary deterioration. The secured issuance falling, as an overall percentage, confirms the improvement of the unsecured market.

The first-quarter earnings season points to improved capital positions owing to run-offs of non-core assets, organic capital generation and cost-containing efforts flowing through. In addition, notwithstanding con-

tinued impairments associated with international subsidiaries, goodwill impairments diminished in 2012 when compared to the large impairments registered in 2011 as a sign of optimism of the European banks. Nevertheless, it is necessary to maintain a cautious outlook on revenues in light of the macro-backdrop and expected generally weak business generation towards the next months. Forward-looking macroeconomic indicators continue to show signs of retreatment, and risks to the global outlook remain tilted towards the downside.

A weak macroeconomic environment and weaker-than-expected economic data have extended into the first semester of 2013 and loan dynamics remain subdued and subject to downside risks, translated into non-performing loans. The EU outcome for real GDP continues to be weak and with signs of contraction. Recent indicators confirm that the decline reflects not only a significant fall in demand but also a decrease in exports. The subdued loan dynamics are a result of the current stage of the business cycle, characterised by heightened credit risk and the ongoing adjustment of financial and non-financial-sector balance sheets.

Attainable information on non-financial corporates' access to financing indicates tighter credit conditions in comparison to previous semesters, in particular for SMEs, in several EU countries. SME lending has significantly contracted and among some reasons for weak SME lending a low average profitability for SMEs is pointed as well as a further deteriorating business confidence. Therefore, the resulting deterioration in creditworthiness is one of the key reasons for weak SME lending. In parallel, a growing number of banks also identify demand-driven factors and register a lower demand from SMEs in a context of a preference for de-leveraging and compression in investment. As policy responses, actions involving funding, risk-reduction guarantees and increased disintermediation may be necessary for a significant shift in confidence in SMEs in order to result in improved lending volumes.

Regulatory developments

The current environment is characterised by regulatory measures that are both significant in their impact and many in quantity. Some of the regulations are shaping the environment for financial services and will significantly influence and impact on the form of intermediation as well as the scale and the functioning of the EU banking sector.

In April 2013, the European Parliament approved the CRD IV/CRR, the legislation implementing Basel III within the EU. In June 2013, the CRD IV and CRR were published [3]. This new framework will influence banking activities as it requires banks to hold more and higher quality of capital and increases capital charges on certain banking activities. In addition, it will discourage trading activities using balance sheet and certain business structures. With reference to the future liquidity framework, banks are now strongly encouraged to increase stable funding such as customer deposits. The leverage ratio should also limit balance sheet expansion and the harmonised definition of capital and liquidity standards engendering an easier and more effective comparison among banks, hence enhancing transparency (the regulation on liquidity and leverage is not binding and requirements are there only in terms of reporting requirements for the CRR). This approval was a positive step forward in reducing uncertainties and reinforcing market confidence in the EU banking sector and has provided some clarity on the regulatory process, technical details and implementation for CRD IV/CRR on capital, liquidity and funding. Previously, in early January 2013, the announcement of implementation details by the Basel Committee on Banking Supervision (BCBS) on the liquidity coverage ratio (LCR) was also an important step towards global liquidity standards. In Basel III, the LCR will be instilled as planned in 2015, with a minimum requirement set at 60 % and will rise in equal annual steps to reach 100 % in 2019. Given the important role liquidity mismatches played in the financial crisis, the EU legislators

[3] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

Table 2: Key EU regulatory measures

Items already adopted or about to be adopted	Timeline
Basel 2.5 (Securitisation and market risks)	2011
Recovery & resolution	2012
CRD IV/CRR	2013–18
CRD IV/CRR (liquidity coverage ratio-LCR)	2015-18
Basel III (liquidity coverage ratio-LCR)	2015–19
G-SIFI	2016

Items under consideration	Timeline
CRD IV CVA implementation	2013
BCBS proposal on securitisations	2013
Financial transaction tax	2013
MiFID II	2013
Banking union	2013
European market infrastructure regulation	2013
Fundamental review of the trading book	2014
Crisis management directive	2014
Basel III (NSFR/leverage ratio)	2013-18
Liikanen report recommendations	-

considered it more appropriate to have a faster implementation schedule than Basel and the 100% LCR implementation will be reached in 2018 (one year earlier than Basel III). These publications and communications reduced some uncertainties and concerns for investors in bank instruments, allowing the markets to price the risk premium demanded for investment and expeditiously moving capital and credit more efficiently.

Simultaneously, other measures are about to be implemented or are being discussed and therefore becoming increasingly clear as concepts and that may also result in further regulation. The numerous regulatory reforms still under way continue to be of concern for investors and other market participants, well acknowledged in the RAQ responses, in particular in regard to the timing and respective contents.

The new regulatory environment is creating significant strategic challenges, forcing banks' business models and a range of activities to adjust given the new capital and liquidity levels. There are significant implementation challenges ahead and several procedures and policies need to be aligned with the new rules, creating particular difficulties for banks.

Fragmentation of the EU single market

The last Risk Assessment Report published in January 2013 presented some evidence of fragmentation in the EU single market. There was evidence of a material scaling back of global activities such as trade and commodity finance, international cross-border lending and leasing, trading and investment banking, in particular intra-EU cross-border lending into economies experiencing stress or recession. Risks of further fragmentation of the EU single market were also evident through the increasing national retrenchment of assets and liabilities, home bias and reduced banks' cross-border financial activity. This trend was mainly driven by banks' revised business strategies, changes in risk appetite, higher funding costs and the challenging macro environment, but it was also exacerbated by uncoordinated national policy measures, including ring-fencing of local bank capital and liquidity. This evidence of fragmentation and retrenchment has been hindering the free movement of capital and funding, increasing funding costs, signalling supervisory divergence, rolling back integration gains and risking further safeguard measures.

Throughout the first semester of 2013, there have been some positive signs of deceleration of the detrimental trend towards market fragmentation. Fundamentally, the interbank flows across borders and the foreign claims have stabilised after the significant

Figure 2: Consolidated total foreign claims (ultimate risk basis) of reporting european banks vis-à-vis selected countries, 2010 Q4 = 100 (*source*: BIS)

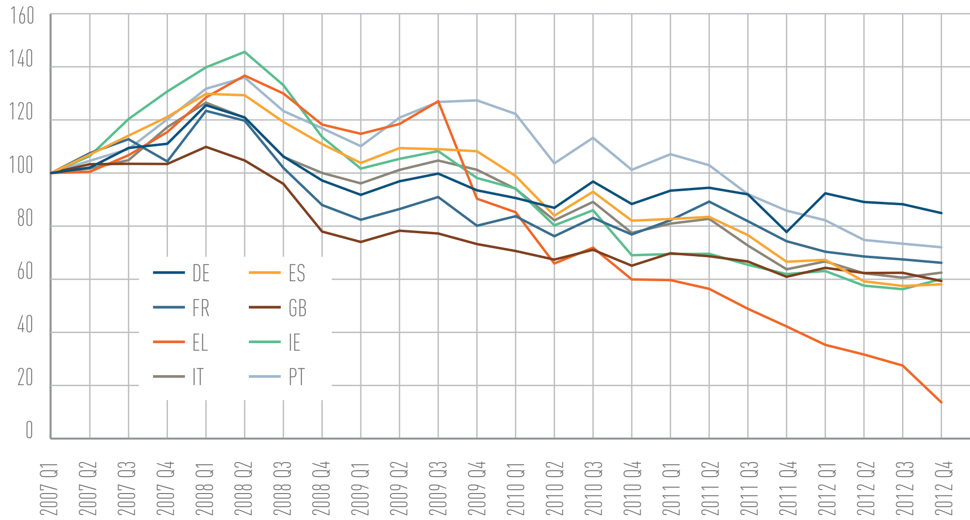
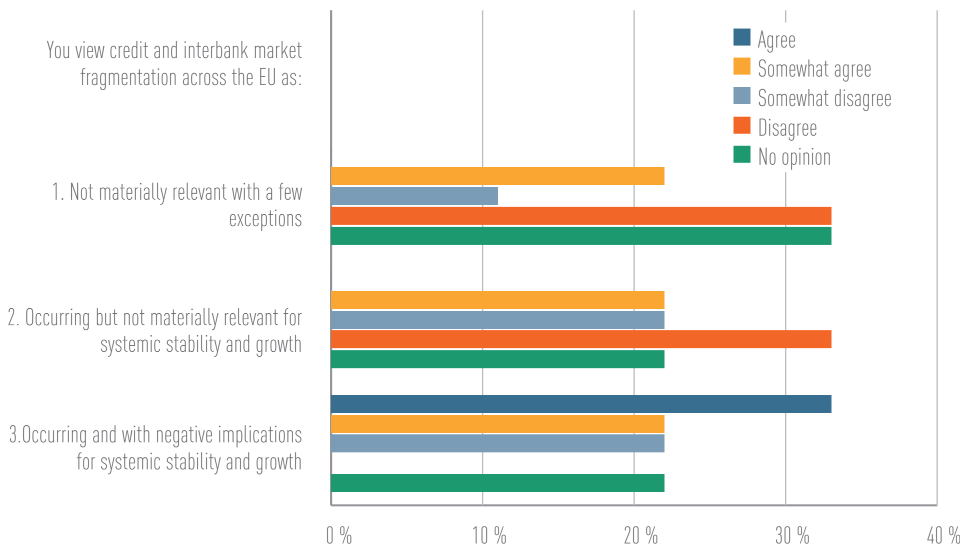


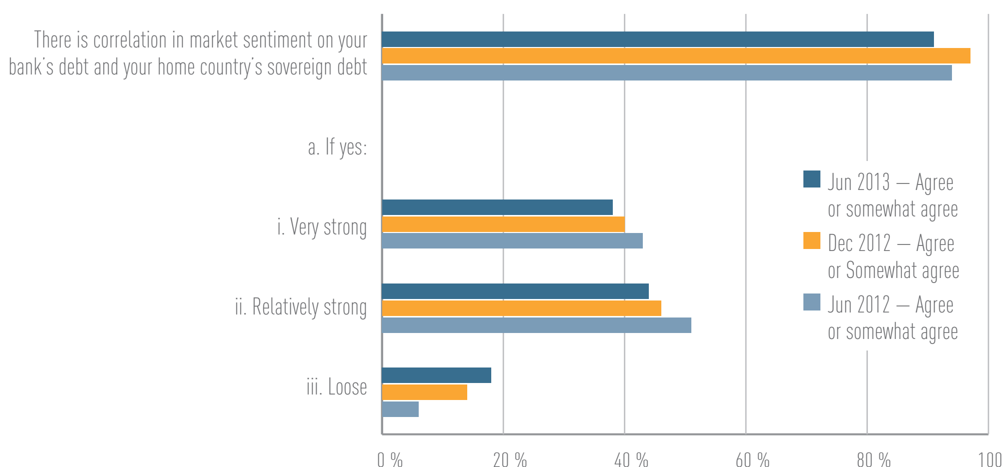
Figure 3: Evidence of fragmentation of the EU single market (*source:* RAQ market analysts)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis. The y-axis carries the distribution ABCDE, i.e. answers to all closed questions, namely: 'A' — agree; 'B' — somewhat/mostly agree; 'C' — somewhat/mostly disagree; 'D' — disagree; and 'E' — not applicable or no opinion.

decreases of the previous semester. At the same time, there are two main factors proving divergent evolutions, namely bank funding and bank lending. On the one hand, with regard to bank funding, some observed rebalancing of funding flows amongst EU countries and the recent deposit inflows evidence, including into banks in countries with financially stressed sovereigns, are positive signs of retreating fragmentation. On the other hand, with regard to bank lending, indications of a substantial widening of cross-border lending rates and contracting new bank lending in countries with financially stressed sovereigns provide further evidence of increasing retrenchment preventing the extension of credit in sectors and geographies where it may be used most effectively. The same is being acknowledged in the RAQ market analysts' responses, with recognised implications for systemic stability and growth.

Figure 4: Evidences of sovereign-bank linkage (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

This divergent evolution between bank funding and lending is perturbing. Amongst other inefficiencies, an increased cross-country dispersion of lending rates has substantially weakened capital allocation. Consequently, firms face increasingly different credit supply and pricing conditions across countries irrespective of their own profitability and risk. Therefore, an immediate consequence of market fragmentation has led to a shortage of new lending to small and medium-sized enterprises (SMEs), which in many European countries are the main engine for economic growth. These are clear signs of significant inefficiencies across the EU single market that need to be rectified.

Overall, the sovereign-bank linkage still persists, despite the peripheral deposit flows stabilisation as well as decreasing Target 2 imbalances and all the efforts developed so far to decrease this linkage, with spreads within the EU widening, including divergent rates to real-economy comparable firms. In addition, smaller banks are facing relatively higher funding costs, cross-border lending is still decreasing, and cross-border interbank markets continue to be very subdued and fragile in many jurisdictions, also contributing among other reasons to a continuing dependency of some banks on the central banks' liquidity providing operations.

Structural and institutional reforms at European level

To bring fragmentation into a halt and strengthen the single market, it is fundamental to press ahead with structural and institutional reforms at European level, in particular the banking union establishment, including a Single Supervisory Mechanism (SSM) and bank resolution schemes. In June 2012, the European Council decided that euro area countries, and other Member States that may wish to opt in, would create an SSM mainly as a response to the banking and sovereign crisis, and in December 2012 Ecofin made specific progress in this direction. More recently, in April 2013, the Council of the European Union approved a compromise agreed with the European Parliament on the establishment of an SSM for the oversight of credit institutions. The SSM, coupled with other measures to drive further integration such as the European Stability Mechanism (ESM) and harmonised deposit guarantee scheme(s) will be instrumental in breaking the adverse bank–sovereign link and a major step to promote the unity and integrity of the EU single market.

Simultaneously, it is necessary to foster supervisory convergence through a strong role in supervisory colleges and through the development of both the EU-wide Single Rulebook and Supervisory Handbooks. The EBA continues to strongly support colleges of supervisors as the proper forum for discussion and agreement on appropriate supervisory measures for cross-border banking groups. At the same time, the EBA will continue pursuing its objectives in advancing towards an EU-wide Single Rulebook and promoting regulatory convergence across the Union, in both rules and practices. The unity and integrity of the EU single market could be achieved through uniform rules in key areas — the Single Rulebook — and effective convergence in supervisory practices within the EU as a whole.

3. Assets side

There is an ongoing reduction of balance sheets and loan books across the EU and it is still necessary to reduce further and strengthen European banks' balance sheets. Many examples in financial history emphasise the importance of bank deleveraging to overcome banking crises and restore stability in a banking sector. However, the optimal pace of deleveraging is a difficult process and warrants close attention.

As a direct result of the financial crisis, economic uncertainty and regulatory reform, banks need to adapt to the new business environment. The financial crisis has exposed weak business models and business lines, and the wave of global regulatory reform is considerably altering the risk return dynamics of numerous business lines going forward.

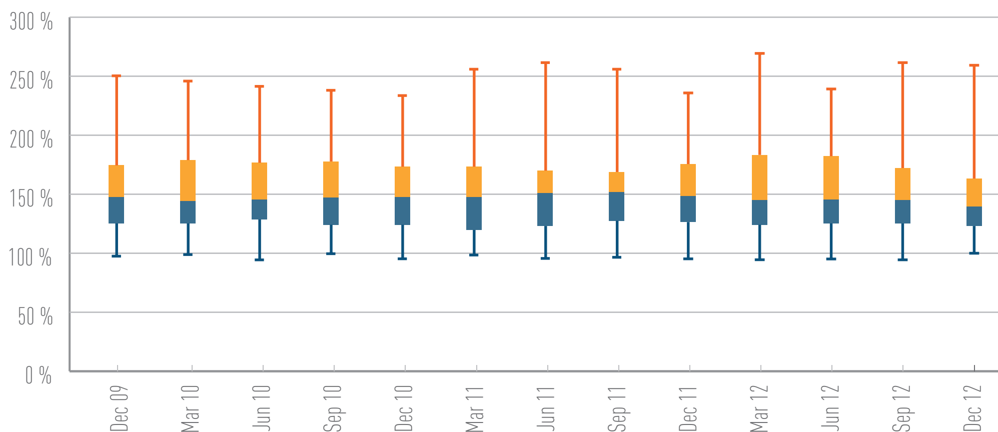
The quality of banks' loan portfolios continued to deteriorate throughout 2012 and the first months of 2013. The September and December 2012 KRIs, and the responses to the RAQ on asset quality both point to a continued deterioration of asset quality in the last few months.

De-risking

Across the EU banking sector there is a need for de-risking, bringing leverage to more conservative levels and a number of European banks have not yet completed the clean-up of their balance sheets and shedding of legacy assets.

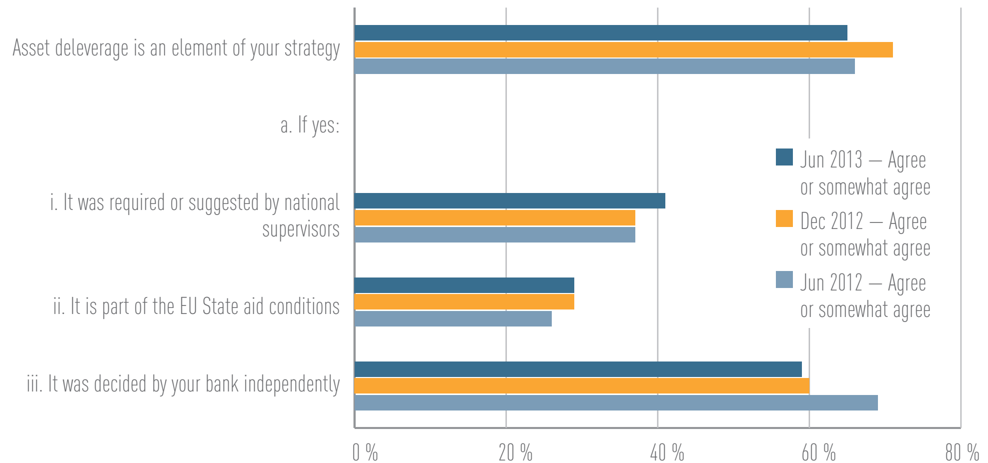
In EU countries there is no evidence that an excessive or disorderly asset deleveraging has occurred, especially insofar as assets related to the real economy (loans to businesses and households) are concerned. This is an important element taking into account that if deleveraging happens, disorderly banks can sharply restrict bank credits, inducing a credit crunch. Nevertheless, European banks have been systematically tightening credit conditions, underscoring the risks of a disproportionate lending retrenchment. On the other hand, a slow and not convincing process of deleveraging can raise questions whether assets still remain overvalued, undermining market confidence and normal funding for growth. More severe deleverag-

Figure 5: Loan-to-deposit (*source:* KRI) — 5th and 95th percentiles, interquartile range and median



Total loans advances (Loans and advances held for trading, designated at fair value through profit or loss, AFS, Loans and receivables, HTM). Total deposits (other than from credit institutions: Deposits held for trading, designated at fair value through profit or loss, measured at amortised cost).

Figure 6: Deleverage (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

ing has been occurring in financially stressed countries and this trend is set to continue, partly due to their ongoing macroeconomic and financial adjustment programmes. For this reason, completing the action of balance sheet repair in the banking sector, far from hampering growth is instead a precondition for kick-start lending into the real economy. There is still a need for adjustments to remove excess capacity and to restructure balance sheets, and to set the basis for a more stable and sound banking sector. There are indicators that a downsizing of banks' balance sheets has started and continues to take place to complete the repair of their balance sheets.

Over the last 12 months while total assets remained fairly stable, risk-weighted assets decreased by 6.3 %, approximately EUR 673 billion. In parallel, the loan-to-deposit ratio has shown a general downward trend in the last few years, indicating a steady reduction in the on-balance-sheet financial sector leverage to sustainable levels.

According to the KRIs, the loan-to-deposit ratio continues to decrease markedly. Not only

Figure 7: Deleverage drivers (*source:* RAQ)

The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

has the weighted average of the loan-to-deposit ratio been decreasing since September 2011 (from 147 % to 139 % in December 2012), but also the median (from 152 % to 140 % in December 2012). Moreover, a decreasing dispersion is being seen since March 2012, with the 75th percentile decreasing from 184 % to 163 % in December 2012. The weighted average loan-to-deposit ratio declined to 139 %, 10 percentage points less than 3 years before and this trend is observed within the EU, with different intensities across geographies.

The majority of the RAQ respondents agree or somewhat agree that the asset deleverage is an element of their strategy. The majority refer they were deleveraging for both 'private' drivers as described earlier, i.e. according to their own business strategy reasons, and in some cases 'public' drivers according to official requirements or suggested by national supervisors.

Most RAQ respondents continue to consider that their deleverage strategy is mainly driven by the decision to de-risk a bank's business and balance sheet, for instance, shedding highly risky or less profitable assets, followed by constraints due to future capital needs.

Business models

EU banks continue to rebalance their willingness to take risk and to embrace risk-averse strategies across products and geographies, systematically avoiding material risk-taking both in credit and market activities. The most impacted business lines are investment banking and trading, reflecting a disinterest from high-risk high-return activities and moving towards a more balanced approach with an emphasis on retail activities. In parallel, cross-border activities have also reduced across non-core and emerging markets, provoking a significant withdrawal of large EU banks from global finance, on aggregate by far the largest participants, with impact on international trade finance.

Banks are also seeking to increase efficiency of low-margin businesses, either through lower cost income ratios, increasing asset/inventory turnover or regulatory optimisation. In parallel, banks continue to consolidate on areas where they have a natural advantage or economies of scale — both on the retail and the trading side — and where the emergence of banks with significant transaction volumes is apparent. These trends point towards further consolidation of the sector as banks with strong information technology (IT), infrastructure, risk management and trading platforms stand to benefit from the increasing automation of banking services, while the emergence of regional niche players is also a theme that is gaining momentum. This structural transformation process occurring across the banking sector presents considerable execution risk, and heightens the risk that banks will be less able to rely on organic capital generation to meet the new regulatory requirements.

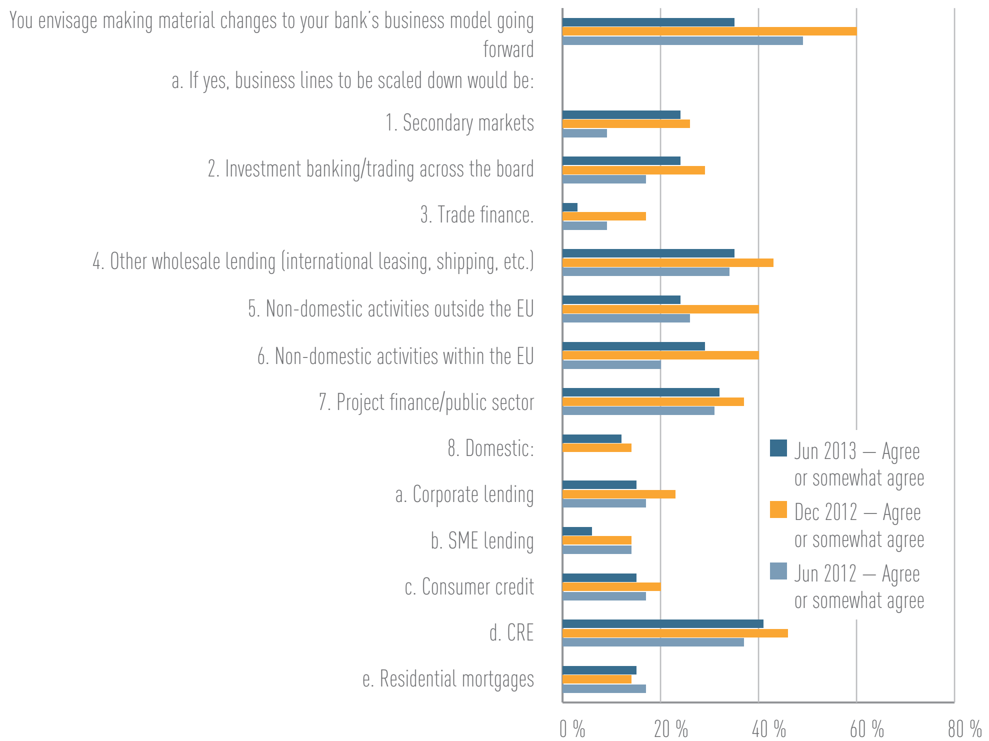
In addition, some inability of many banks to adjust their balance sheets and their reduced risk appetite has also led to an increase in banking activities being undertaken by the non-bank sector (disintermediation) or in some instances by other banks operating under a more favorable regulatory regime. Overall though, the risks in the banking system are now better understood and addressed than prior to the crisis; however, there is still considerable uncertainty as banks are sometimes slow to adapt to the new reality and the transition is costly.

The responses from the RAQ present some general trends. With regard to the main drivers, while for banks there are several references to market structures and dynamics as well as earnings pressure as reasons for changes, market analysts regard regulatory initiatives as a main reason. There is a growing trend for banks to also agree or somewhat agree that they have already achieved the right earnings-risk mix; nevertheless, a strong majority anticipate changing it further in order to better match their risk-return targets.

RAQ respondents' views on changes to business models and on the scaling down of business lines show that banks have reduced the intention in making material changes, possibly due to the fact they have already started implementing changing programmes. Nevertheless, the business lines to be scaled down continue to be similar to those in previous questionnaires, that is, commercial real estate (CRE), wholesale lending (including international leasing, and shipping), and project finance.

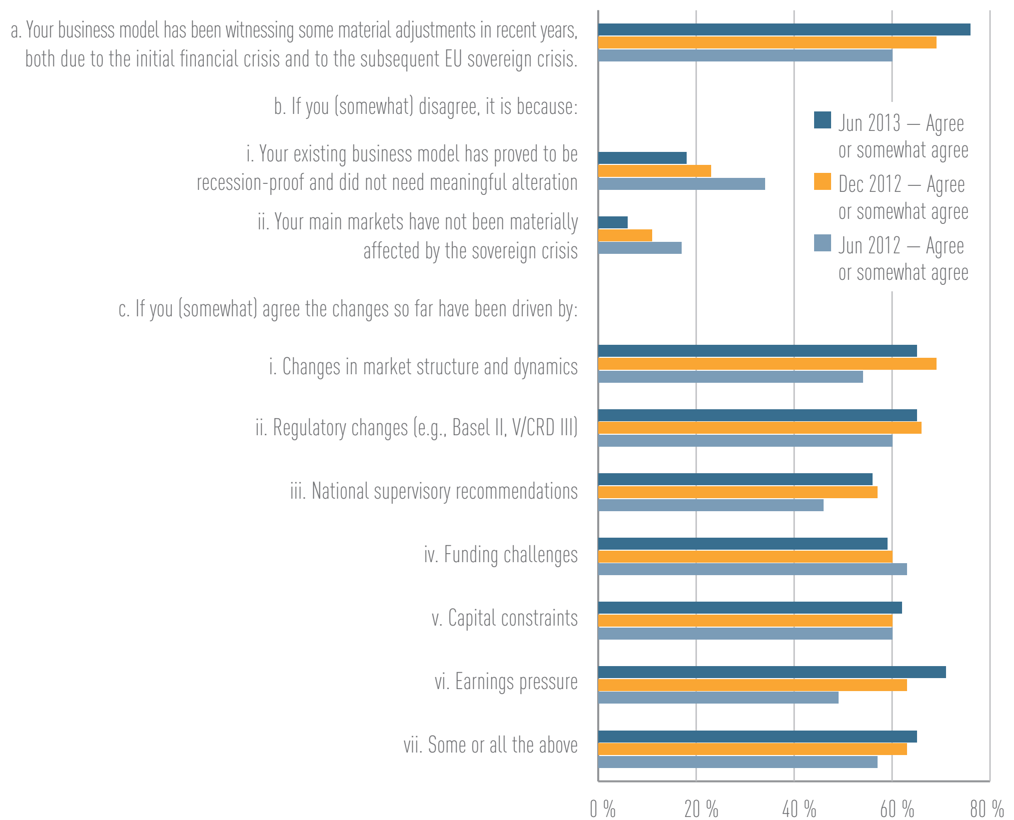
RAQ respondents show an increasing trend referring that their banks' business models have been making adjustments in recent

Figure 8: Changes to business model (*source:* RAQ)



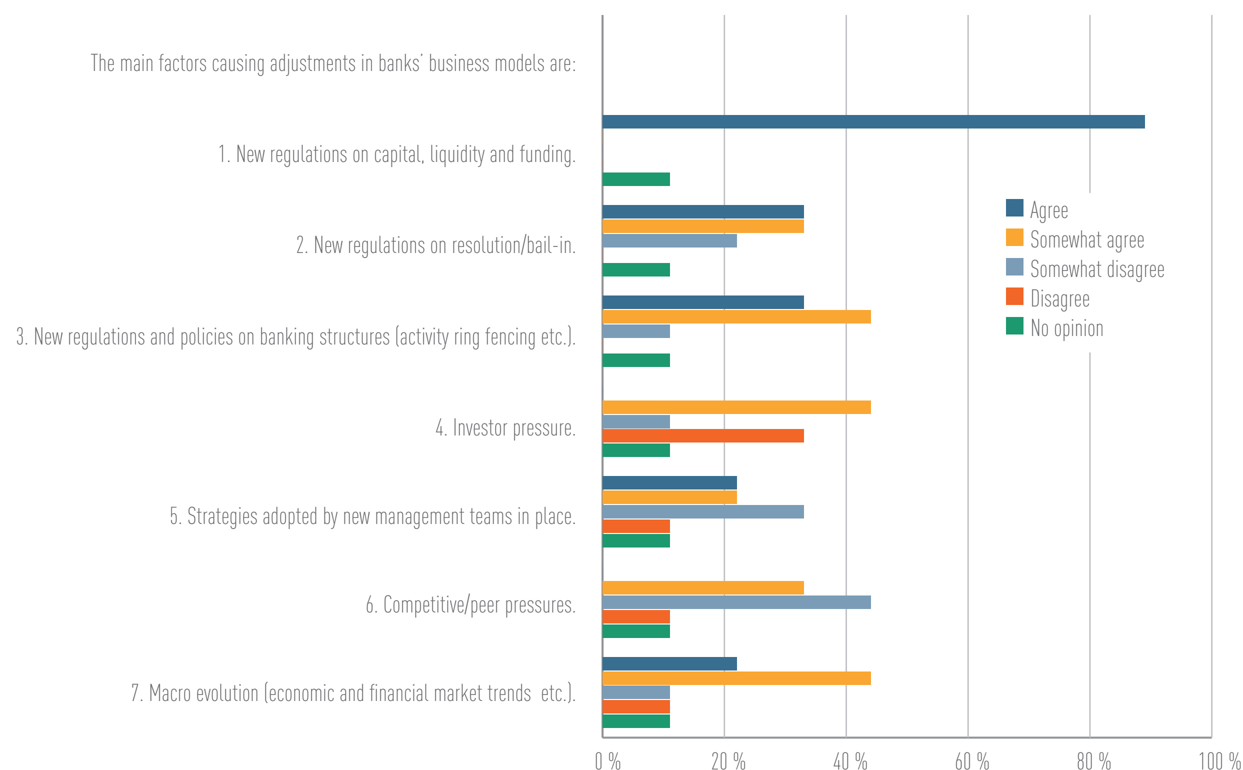
The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Figure 9: Business model adjustments (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Figure 10: Business model adjustments (*source:* RAQ market analysts)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.
The y-axis carries the distribution ABCDE, i.e. answers to all closed questions, namely: 'A' — agree; 'B' — somewhat/mostly agree; 'C' — somewhat/mostly disagree; 'D' — disagree; and 'E' — not applicable or no opinion.

years. In addition, there are fewer respondents affirming that their bank's business model has proved to be recession-proof and that their main markets have not been materially affected by the sovereign crisis. There are several drivers underpinning this trend, such as: (i) earnings pressure, with a noticeable augmentation in positive responses and possibly signalling an increasing scepticism in regard to the quality and sustainability of earnings; (ii) regulatory changes (e.g. CRR/CRD framework, transition towards Basel III); (iii) reforms on market structure; and (iv) increased capital charges and funding/liquidity constraints, with possible impacts on the intermediation form and on the scale and functioning of the banking sector.

A strong majority of the RAQ market analysts respondents also agree that the main factors causing adjustments in banks' business models are the new regulations on capital, liquidity, funding, resolution, bail-in, and on banking structures. In addition, the economic and financial market trends are also mentioned as main factors.

Regarding the new regulations, the EU is closer to resolving some of the regulatory uncertainty through the agreement on the CRD IV/CRR legislative package. Furthermore, regulatory discussions on the bail-in framework also need to be finalised in order to continue to reduce uncertainties and establish a clear framework for adjustments in banks' business models, consequently reducing creditors' and investors' concerns.

At the same time, EU banks' home markets and businesses — in particular SMEs — have tightened their credit conditions further, as shown by more recent statistics and lending surveys at EU level. There is also evidence of significant differences in lending conditions and very low numbers in new lending within EU countries. Looking forward, European banks expect further tightening of lending conditions and weaker demand in the next few months. Therefore, this trend is unlikely to reverse itself in the immediate future — at least not while domestic economies do not show signs of recovery.

Asset quality

The quality of banks' loan portfolios continued to deteriorate throughout 2012 and the first months of 2013. The September and December 2012 KRIs, and the responses to the RAQ on asset quality both point to a continued deterioration of asset quality in the last few months. The deterioration in asset quality is spread across the EU; however, the declining intensity varies considerably across portfolios and geographies.

According to the KRIs, loans in arrears, and impaired assets in particular continue to increase showing that asset quality is still declining. On the other hand, provisioning in some cases has not increased in conformity with rising credit risks. While the weighted average of the coverage ratio has been increasing since December 2011, an increasing dispersion is being observed and translated into more banks and respective assets with a coverage ratio of less than 25 %. Thus, there is a mixed picture in terms of coverage ratio, which continues to raise several questions about the extent to which provisioning is adequate. Refocusing on some activities such as mortgage lending instead of commercial lending might partly explain a reduction in the coverage ratios (composition effect). However, whereas it is known that mortgage portfolios have generally recognised lower losses, the average provisions for exposures to real estate continues to raise some doubts.

The RAQ respondents also expect the level of non-performing loans to remain high. Such deterioration would require increasing impairment provisioning, in line with deteriorating asset quality and increasing residual credit risk throughout loan portfolios. This trend would not only adversely affect already subdued earnings, but in some cases may also pose challenges to the maintenance of adequate capital levels. In addition, both different national approaches and banks' widely differing practices at EU level to address not only asset quality concerns, but also debt forbearance, creates significant uncertainties; therefore, coordinated supervisory actions would be crucial to restore market confidence.

Loans in arrears and impaired assets

The most recent evolution set of KRIs continue to reflect increasing credit risks and declining asset quality, as both the ratio of impaired loans and past due loans to total loans and the ratio of accumulated impairments on financial assets to total assets once again increased within the last semester. Also the ratio of impairments on financial assets to total operating income increased markedly in the last quarter.

Impaired loans continue to show an increasing trend. The ratio of impaired loans and past due (> 90 days), in terms of weighted average, increased from 6 % in June 2012 to 6.3 % in December 2012 (the highest since 2009). Interestingly, the median and the 75th percentile decreased in the last quarter, after significant increases in September 2012. Nevertheless, the 75th percentile continues to present concerning levels of approximately 14 %, well above historical levels for this ratio. The dispersion also continues to be significant, achieving the highest level in September 2012 (since 2009). Banks with a ratio of more than 10 % represented 12.5 % of total assets in December 2012 (from approximately 11.6 % and 12 % in December 2011 and June 2012, respectively).

A trend in growing geographical dispersion of asset quality indicators across Europe can also be identified. Impairments continued to increase particularly in banks in financially stressed countries, but they have also increased in other regions. Real estate portfolios have been particularly affected and deserve attention. Banks from five countries have values of impaired loans and past due loans to total loans of more than 16 %, while the figure is less than 2 % only for two banks from other countries (there were four countries in June 2012, confirming the increase of the 25th percentile from 2.8 % to 3 %).

In regard to the coverage ratio, an increasing dispersion is being observed (the difference between the 25th and the 75th percentile is the highest since December 2010). Whereas the weighted average has been increasing since December 2011 and shows one of the largest levels since 2009, the median (and the 75th percentile) continues to decrease. Banks with a coverage ratio of less than 25 %

Figure 11: Impaired loans and past due (> 90 days) loans to total loans (*source:* KRI) — 5th and 95th percentiles, interquartile range and median

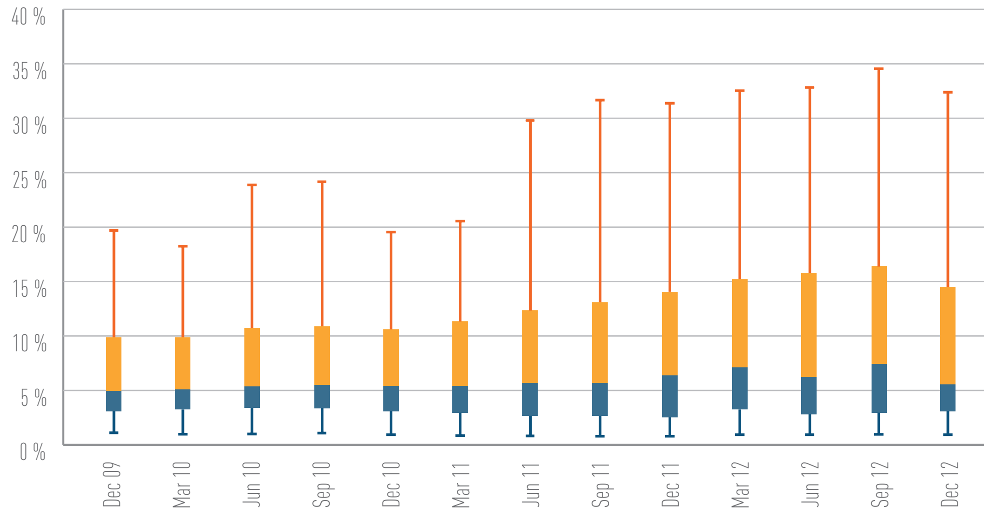
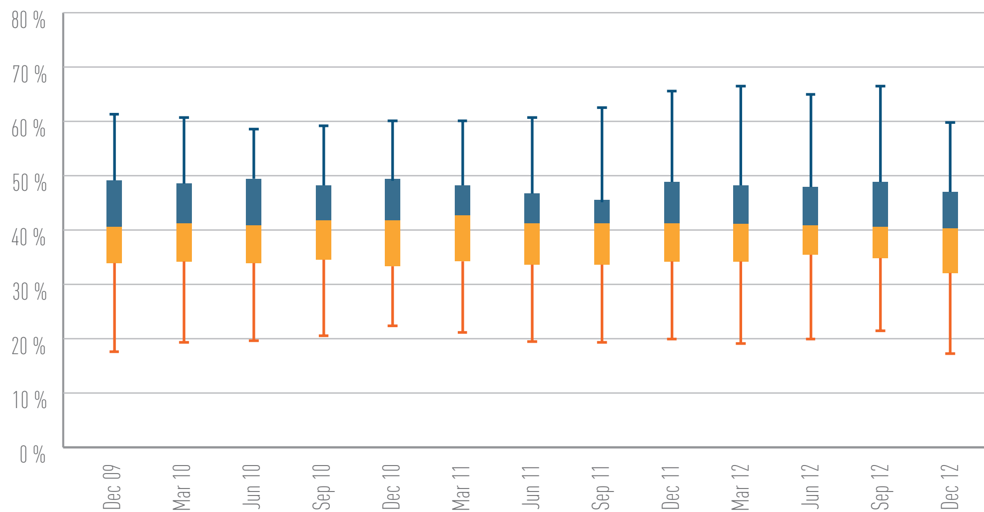


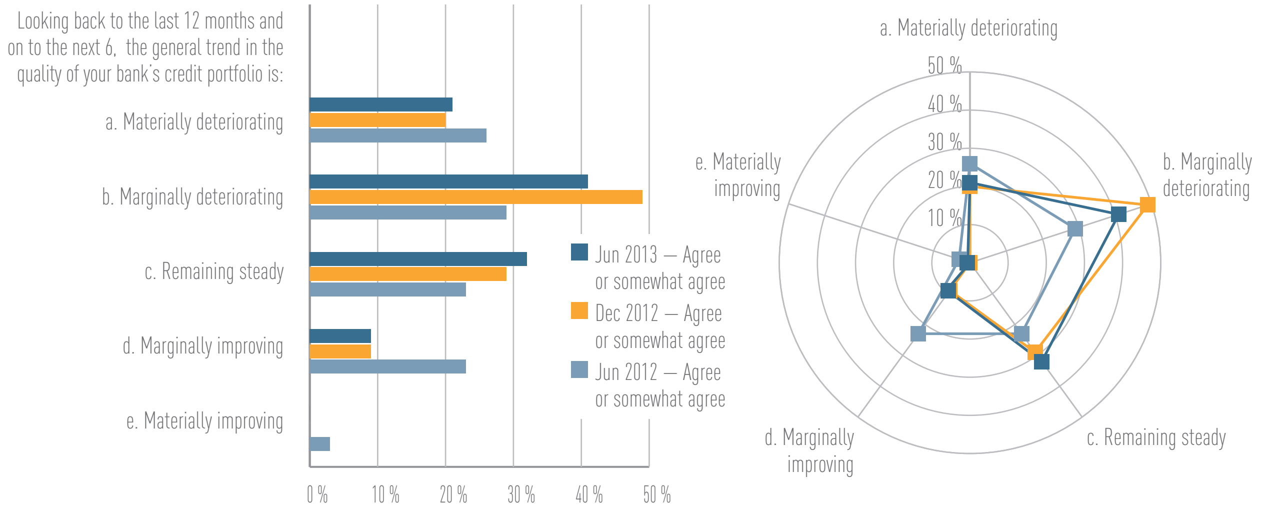
Figure 12: Coverage ratio (specific allowances for loans to total gross loans; *source:* KRI) — 5th and 95th percentiles, interquartile range and median



increased and represented around 14 % of total KRI sample assets in December 2012. Similarly, banks with a coverage ratio higher than 50 % also increased and represented 29 % of total assets in December 2012 (from approximately 24 % in June 2012).

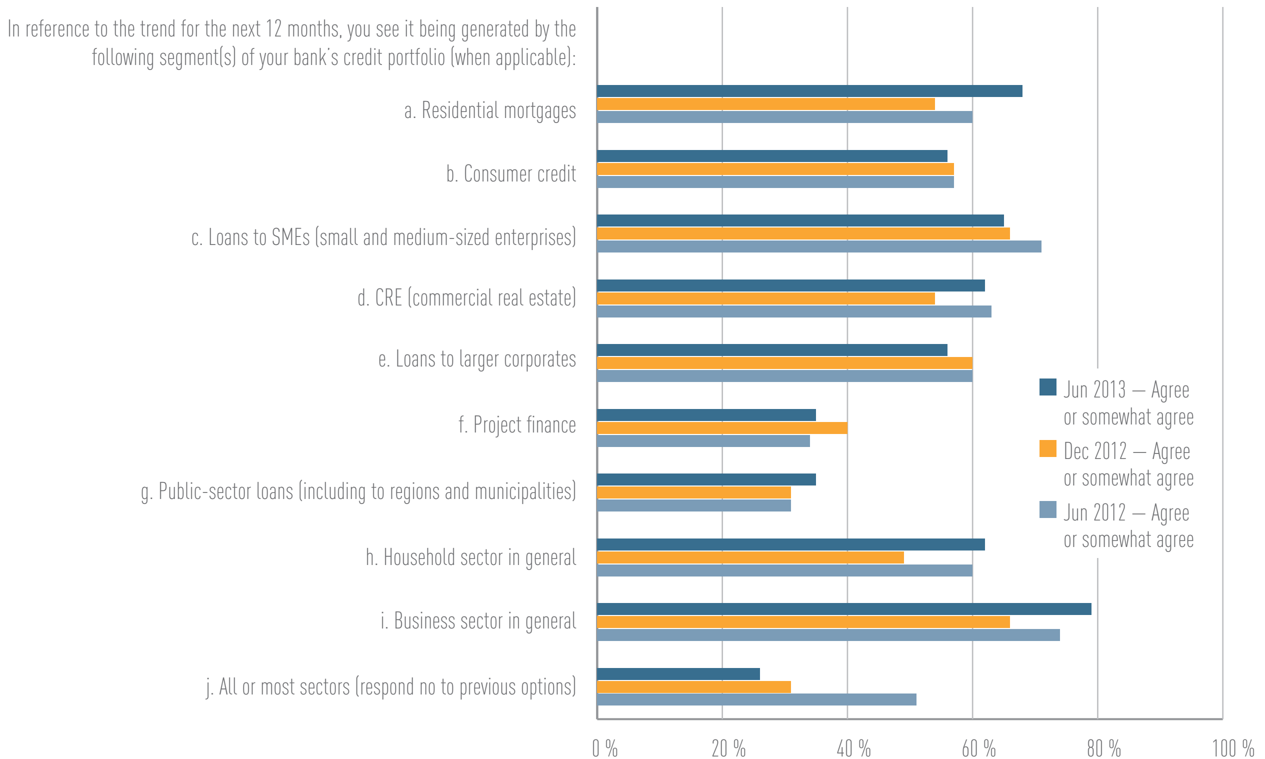
Responses to the RAQ indicate expectations of further marginal deterioration in asset quality and of further increasing impairment levels for a majority of banks. Nevertheless, currently there are more responses that the general trend in the quality of banks' credit portfolios is remaining steady (32 % in June 2013 against only 23 % in June 2012). On the other hand, there is a strong response decrease in saying that the general trend is marginally improving (a decrease from 23 % in June 2012 to 9 % in June 2013). In addition, the responses show expectations of further increasing impairments from banks in financially stressed countries, but also in countries with significant recent asset price increases.

Figure 13: Quality of loan portfolios (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Figure 14: Drivers of asset quality trend (*source:* RAQ)



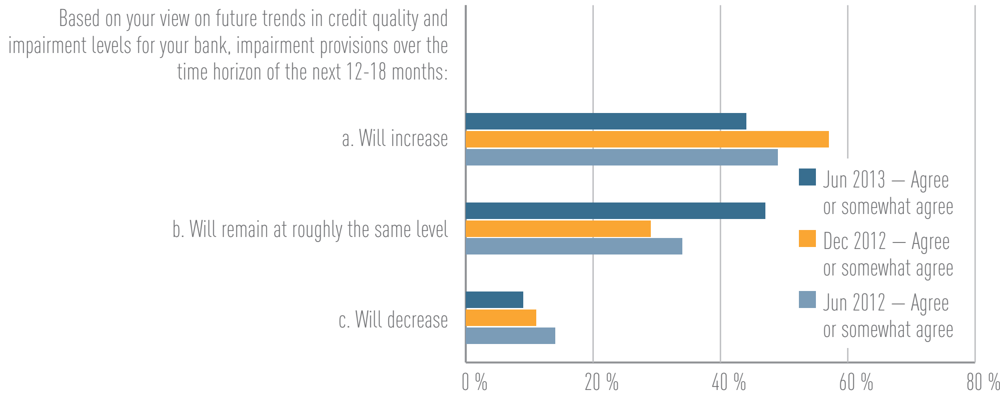
The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Further reflecting on the expectations of exacerbated asset quality concerns for the next 12 months, in the light of a deteriorating economic environment, a large majority of the RAQ respondents expect deteriorating quality of loan portfolios across most segments, but in particular in SME lending portfolios, despite a slight decrease since June 2012, residential mortgages and commercial mortgages.

In line with deteriorating asset quality, most of the RAQ respondents referred that the impairment provisions over the time horizon of the next 12–18 months will remain at roughly the same level (there was an increase from 29 % to 47 % who agreed or somewhat agreed, from December 2012 to June 2013, respectively). A significant level of RAQ respondents, despite being less, still believe the impairment provisions will increase (there was a small decrease in the percentage of answers from 57 % in December 2012 to 44 % in June 2013). The number of RAQ respondents who believe the impairment provisions will decrease, has fallen considerably reaching only 9 % in June 2013, compared to 14 % in June 2012.

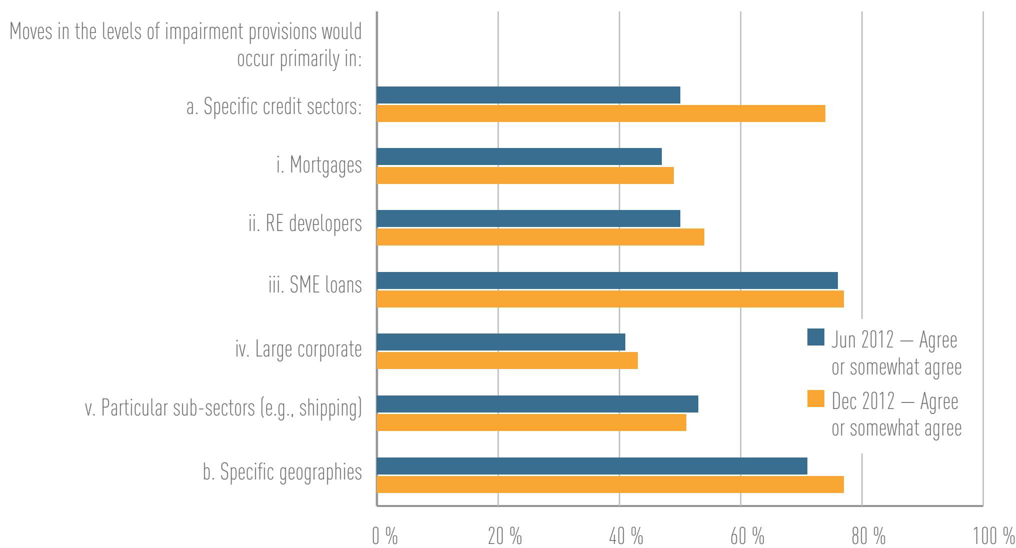
The majority of the RAQ respondents mentioned that the overall composition of their loan portfolios is relatively well balanced with no material sector or exposure concentration. The trends in impaired loans are driven

Figure 15: Expectations for impairments (*source:* RAQ)



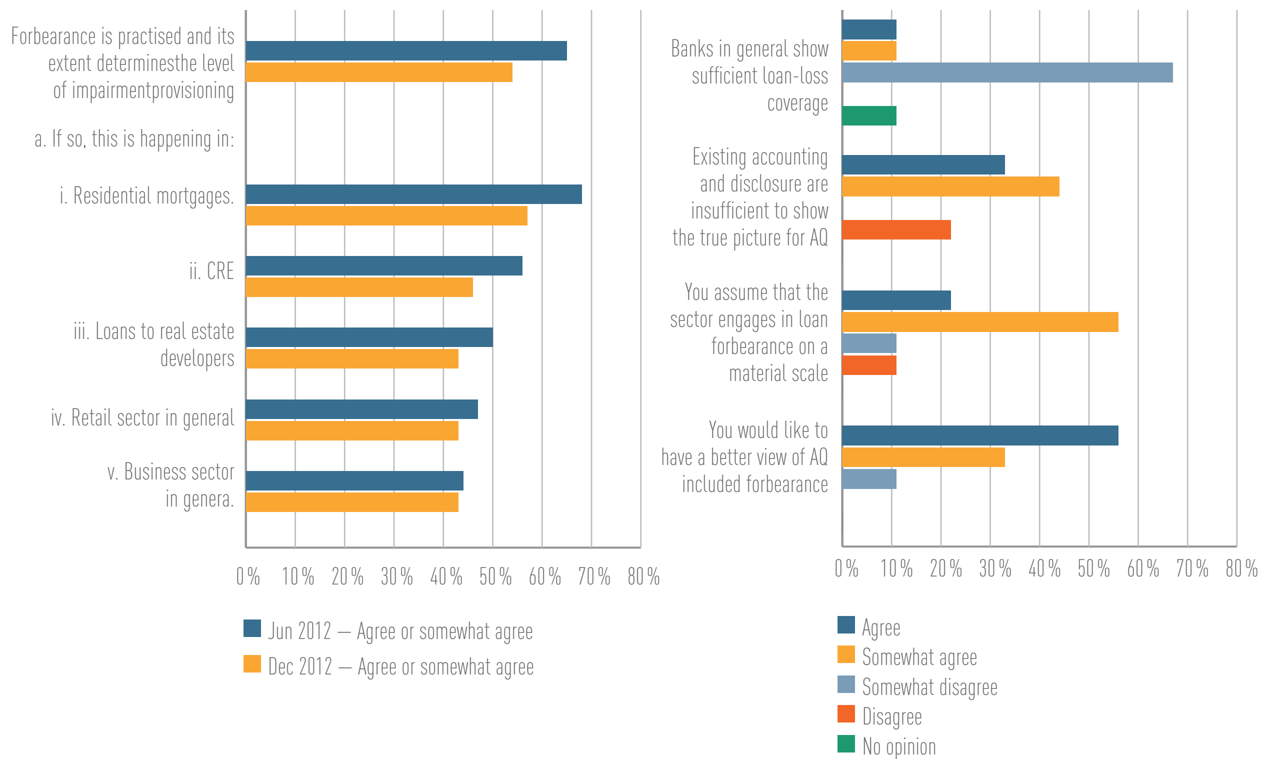
The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Figure 16: Drivers of impaired loans trends (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Figure 17: Forbearance practices (*source:* RAQ and RAQ market analysts)



For the left-hand side figure, the length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis. For the right-hand side figure, the length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis. The y-axis carries the distribution ABCDE, i.e. answers to all closed questions, namely: 'A' — agree; 'B' — somewhat/mostly agree; 'C' — somewhat/mostly disagree; 'D' — disagree; and 'E' — not applicable or no opinion.

primarily by SME loans, mortgages and real estate developer loans and would occur primarily in specific geographies. The relevant variables to explain potential impairments in the real estate developer loans are the debt coverage ratio and the respective collateral. Moreover, the RAQ respondents consider that the current levels of impairment provisions adequately protect their bank against loan impairment losses.

A large majority of RAQ respondents continued to step up efforts to monitor institutions' asset quality. They have introduced or strengthened regular reviews of different loan portfolios conducted to assess their current quality, and they have introduced or strengthened reviews of existing policies for arrears management. At the same time, there was a reduction in the percentage of RAQ respondents who agreed or somewhat agreed that the number and volume of loans classified as restructured or under restructuring has increased.

Regarding forbearance issues, the majority of the RAQ respondents agreed or somewhat agreed that forbearance is practised and its extent influences the level of impairment provisioning. There was a significant increase from 54 % in December 2012 to 65 % in June 2013 in the percentage of RAQ respondents who agreed or somewhat agreed on what is happening, particularly, in residential mortgages, commercial real estate, and real estate developer loans. The market analysts' expectation is that asset quality (AQ) will decrease in the next 12 months, believing that banks in general continue to show insufficient loan–loss coverage. In addition, they somewhat agree that the sector is engaging in loan forbearance on a material scale and they would like to have a better view of asset quality.

Consequently, further coordinated supervisory actions and commitments to reduce uncertainties surroundig practices and the valuation of bank assets would be beneficial in restoring market confidence in regard to the reliability and comparability of reported asset values and of the banks' status.

Policy implications and possible measures

While many supervisors have stepped up efforts to monitor asset quality, a variety of different national approaches continues to make it difficult to obtain a clear picture of the extent of asset quality problems across the EU in a transparent way. The vast majority of the RAQ respondents agree or somewhat agree that policies are in place to govern forbearance and to outline triggers/thresholds if and when loans, which have been subject to some form of forbearance, may become subject to credit workout procedures. However, differing practices across jurisdictions to address not only asset quality concerns, but also debt forbearance, continue to create uncertainties about the actual level of credit risk in banks' balance sheets and the valuation of bank assets. At EU level there are differences in loan classifications (e.g. performing loans, non-performing loans (NPLs), 'doubtful' loans, 'watch list'). There are also differences in the way forbearance is defined, assessed, classified and reported. In addition, uncertainties also arise through accounting practices for loans in arrears, or the status of restructured loans, and through different practices of reclassifying performing loans which can substantially distort information on reported NPLs.

The level increase of non-performing loans would require increasing impairment provisioning, in line with deteriorating asset quality. In some cases this may pose challenges to the maintenance of adequate capital levels. In addition, different national approaches and banks' widely differing practices at an EU level to address asset quality concerns and debt forbearance creates significant uncertainties. The doubts related to banks' asset quality and forbearance, and the uncertainty on timely recognition of problem loans, loan restructuring, level of impairments, and real estate market dynamics need to be undoubtedly addressed in order to rebuild confidence in banks' balance sheets. The EBA's work on harmonised definitions and data collection aims to provide the supervisory authorities with the tools to monitor asset quality developments in a coordinated fashion and on a comparable basis across the EU. Therefore, coordinated supervisory actions would be crucial to restore market confidence. Consequently, it is extremely important that EU supervisors conduct comprehensive asset quality reviews on major EU banks in order to dispel concerns over asset quality deterioration. Importantly, in order to ensure transparency and comparability over the years, appropriate disclosure on the actual exposures of the EU banking sector is also a fundamental measure to address concerns on asset quality.

4. Capital and recapitalisation results

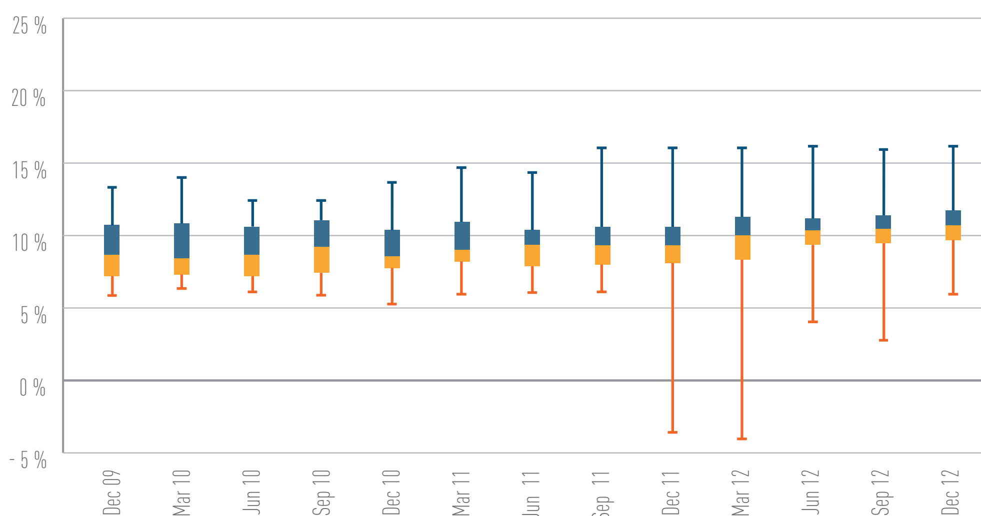
Over the 12 months ending in December 2012, EU banks and respective capital positions continued to maintain a noteworthy increasing trend. In particular, over the second half of 2012, notwithstanding the challenging conditions in financial markets, the banks' capital position once more has strengthened further.

This evolution reflects the national efforts progressing towards strong capital buffers as well as the EBA recapitalisation exercise, leading to substantial infusions of capital into EU banks and establishing new standards for the quantity and quality of banks' capital. European supervisors, nonetheless, will need to continue to monitor the smooth and timely transition to the CRR/CRD framework.

The KRIs confirm this positive evolution. The median Tier 1 ratio increased by 10 basis points (from 11.7 % to 11.8 %), after an increase of almost 1 percentage point, from 10.9 % to 11.7 % in the previous semester. Banks with a Tier 1 capital ratio above 12 % significantly increased and represented approximately 72 % of the total assets of the KRI sample in December 2012 (in comparison with 63 % in June 2012 and more than three times than the December 2009 value). This positive trend is also confirmed when looking at the median of Tier 1 ratio excluding hybrid instruments (a rough proxy of the Core Tier 1 ratio (CT1)) which increased from 10.3 % to 10.5 %. Both, the 25th percentile and the weighted average also increased from 9.3 % and 10.2 % to 9.6 % and 10.8 %, respectively. Equivalently, banks with Tier 1 ratio excluding hybrid instruments lower than 5 % decreased and represented only 1 % of total assets in December 2012 (from around 2 % in June 2012). At the same time, banks with Tier 1 ratio excluding hybrid instruments higher than 10 % increased and represented more than 80 % of total assets in December 2012 (from 73 % in June 2012). The dispersion of the indicators decreased markedly, suggesting that banks in the sample are converging towards a more conservative solvency base.

This evolution partly reflects European banks' significant progress in boosting their capital positions and in strengthening the overall resilience of the EU banking system as a result of the EBA recapitalisation exercise. The recapitalisation recommendations have brought the common equity capital ratios of EU banks in line with those of major international competitors. EU bank capital levels are aligning business models to both markets' expectations and to forthcoming regulatory requirements and the capital strengthening is also a result of measures taken by EU banks to comply with the 2011 EBA recommendation which asked EU banks to raise their CT1 ratio to 9 %, after accounting for an additional buffer against sovereign risk holdings. The capital exercise

Figure 18: Tier 1 ratio (excluding hybrid instruments) (*source:* KRI) — 5th and 95th percentiles, interquartile range and median



led to an increase in banks' capital positions of more than EUR 200 billion. For the 27 banks which were requested to submit capital plans, due to a capital shortfall of EUR 76 billion, the exercise resulted in an aggregate recapitalisation in the amount of EUR 116 billion. Overall, the cumulative impact on capital levels of the measures put in place by banks in 2011 and 2012 in relation to the EBA initiatives is about EUR 250 billion.

Despite the challenging conditions in financial markets and little investor appetite for new equity, banks' capital position and respective compliance with the EBA recommendation has been achieved mainly via new capital measures such as retained earnings, new equity, and liability management, and, to a lesser extent, by releasing capital through measures impacting risk-weighted assets (RWAs) (e.g. by reduced lending and sales of assets). Banks have been increasing capital relative to assets even if total asset reduction has been less pronounced than risk-weighted declines might suggest. In this respect, aggregate data shows that these new capital measures have been more than enough to cover shortfalls.

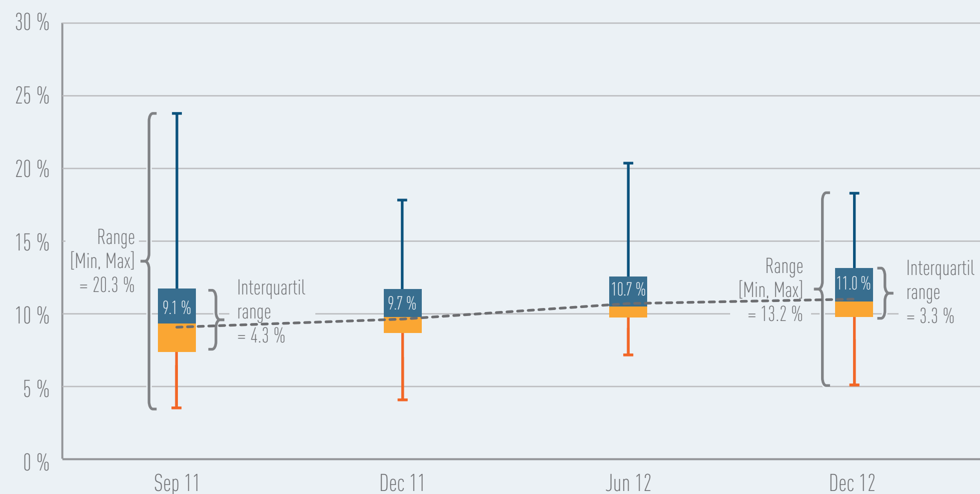
Nonetheless, measures to strengthen capital directly may be vulnerable to the risk of weaker earnings. While the banks' capital positions have improved, European supervisors will continue to monitor the smooth and timely transition from the new EBA standards to the CRR/CRD framework for banks.

COMPLIANCE WITH THE EBA DECEMBER 2011 RECOMMENDATION (EBA/REC/2011/1)

As of December 2012, the banks involved in the data collection reached a Core Tier 1 ratio of 11 %, taking into account Sovereign Capital Buffer (EUR 31.5 billion and 0.3 % of RWAs) and including other instruments eligible and existing government support measures. The same ratio was equal to 10.7 % in June 2012 and to 9.1 % in September 2011. The overall surplus of capital in excess of 9 % increased by EUR 175 billion from September 2011 to December 2012. At the same time bank dispersion has narrowed during the same period with the range between minimum and maximum declining from 20.3 % to 13.2 % and the interquartile ranging from 4.3 % to 3.3 %.

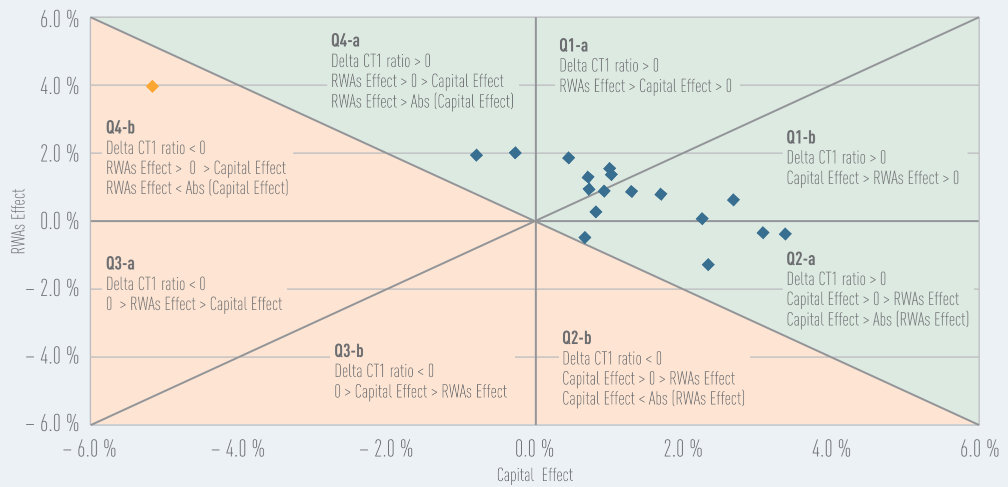
An analysis has been carried out to identify the main drivers of the CT1 ratio trend and to decompose its variation into capital and RWAs components. Chart below illustrates the relative importance of the CET1 (numerator) and RWA (denominator) effects on the CET1 ratio by jurisdiction. The green areas represent a positive variation of the CT1 ratio between September 2011 and December 2012. In contrast, the red areas show a negative variation of the CT1 ratio between September 2011 and December 2012. In one country (area Q4/b) there has been a reduction of CT1 ratio, due to a reduction of capital, partially offset by a reduction of RWAs. In

Figure 19: CT1 ratio after including sovereign capital buffer and additional impairments on sovereign exposures



The figures represent the CT1 ratio and respective minimum (orange line) and maximum (blue line), interquartile range (25th and 75th) and weighted average (based on risk-weighted assets per institution).

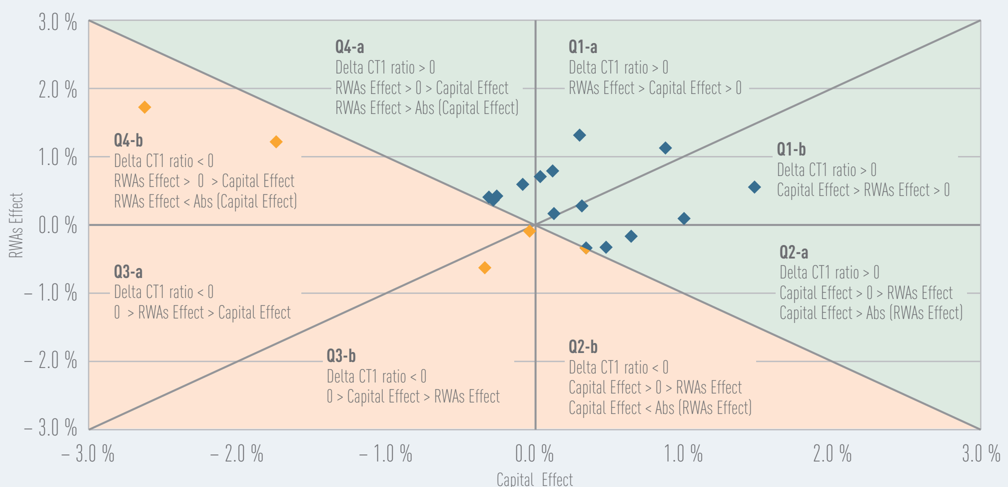
Figure 20: Trend of CT1 ratio (Sept 11 - Dec 2012) by country of the banks:decomposition of Capital effect and RWAs Effect



6 countries (area Q1/b) the impact of higher CT1 has been larger than the impact of the decline in RWAs. On the other hand, for 6 countries (area Q1/a), the improvement in the CT1 ratio has been largely driven by a reduction of RWAs. In 4 countries (area Q2-a) the increase in the CT1 has been partially offset by an increase of RWAs while for two countries along with a reduction of RWAs there has been a reduction of capital.

Therefore, improvement has been achieved by acting on both numerator and denominator; however recent trends show growing importance of the RWAs effect. Focussing on the 6 months ending in December 2012, for most EU countries in which there has been an increase in the Core Tier 1 ratio, this has been achieved mainly by combining both an increase in capital and a reduction in RWAs (areas Q1/a and Q1/b of the chart below). The green areas represent a positive variation of the CT1 ratio between June 2012 and December 2012. In contrast, the red areas show a negative variation of the CT1 ratio between June 2012 and December 2012. In 4 countries, the RWAs reduction has been partially offset by a reduction of capital. Vice-versa, in three EU countries, along with an expansion in RWAs banks have increased their capital levels (areas Q4/a and Q2/a of the chart below). In the 4 countries where there has been a reduction of the Core Tier 1 ratio, this has been the result of the contraction of capital which in two cases has been partially offset by a decrease of RWAs (area Q4/b of the chart below).

Figure 21: Trend of CT1 ratio (Jun - Dec 2012) by country of the banks: decomposition of Capital effect and RWAs Effect



5. Liabilities side

Subsequent to the last December 2012 report, the funding conditions seem to have improved with some consistent banks' issuance of unsecured debt, particularly in the beginning of 2013, and market funding slowly replacing early repayments of the two 3-year refinancing operations (long-term refinancing operations (LTROs)), and thus decreasing reliance on official sources of funding. There is also some evidence of deposit inflows from both retail and corporate customers, including into banks in countries with financially stressed sovereigns. At the same time, the average cost of equity of banks in the EU has decreased and there has been a compression in bank equity prices when comparing core and peripheral banks.

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

Funding

Market funding conditions have been relatively benign during the first semester of 2013. Large banks, including financially stronger banks domiciled in financially stressed sovereigns, have been issuing unsecured debt, particularly in the first quarter of the year. Sovereign developments in March did not lead to a lasting reversal of the benign trend but only to some temporary deterioration. Nevertheless, the absence of fundamental improvements is demonstrated by the negative reaction of the financial markets during May and June 2013 to suggestions of tightening liquidity by central banks.

Looking ahead, based on RAQ answers, banks expect an increasing importance of unsecured debt as a significant source of funding, consequently paving the way for reducing concerns regarding the levels of asset encumbrance, i.e. assets earmarked as collateral for specific secured funding. Whilst events related to Cyprus led to a temporary deterioration of market funding sentiment in March, they did not lead to a lasting reversal of the benign trend started months earlier. Nevertheless, persistent evidence of increasing differences in funding conditions and funding costs can be identified between banks domiciled in financially strong sovereigns and those domiciled in financially stressed sovereigns. In addition, several banks remain reliant on central bank support and future withdrawals of public funding sources are still a challenge for many of them.

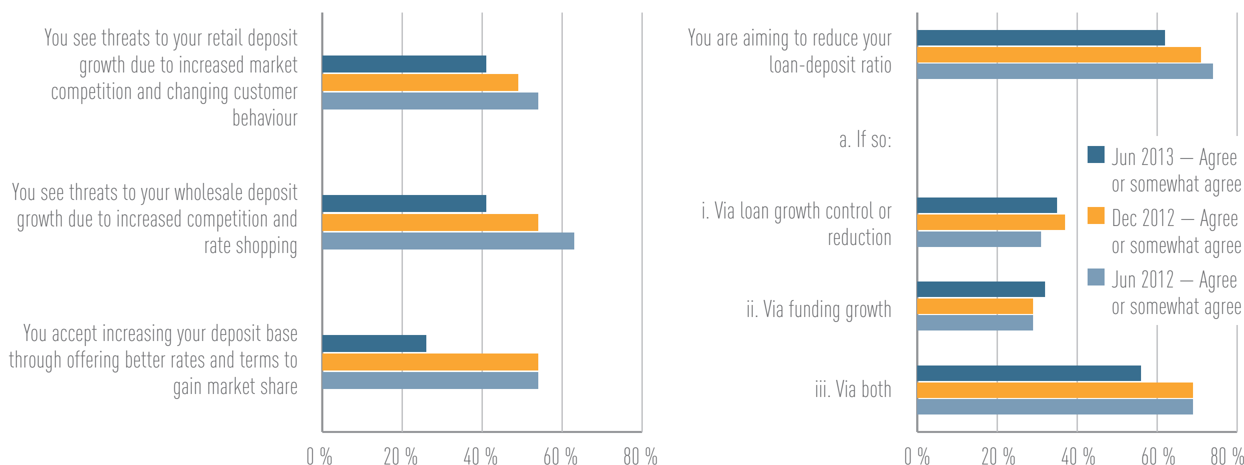
In parallel, there are indicators that a downsizing of banks' balance sheets has started and more severe deleveraging has been occurring in financially stressed countries, partly due to their ongoing macroeconomic and financial adjustment programmes.

With regard to deposits, their importance for bank funding has been steadily increasing. While March events led to a heightened attention on deposits, they have to date not had a material impact on deposit flows. Be that as it may, some behavioural changes could be expected for deposits not covered by deposit guarantee schemes, and heightened supervisory attention is warranted.

Competition for deposits

Strong pressure for deleveraging emerged in Europe during the final quarter of 2011 and will continue throughout 2013. With a need for de-risking and aligning the business models to the market's expectations, EU banks are bringing their leverage to more conservative levels and rethinking their dependence on less stable funding sources, such as short-term wholesale financing, which have also become more expensive in the new market environment. As part of the deleveraging process, banks could strengthen their liquidity and funding positions by attracting more deposits. In this respect, EU banks have been able to attain their funding needs not only via refinancing operations, but also by reducing their overall balance sheet and diminishing the need to attract new funding, as well as through the strengthening of their

Figure 22: Deposits (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

deposit base in order to target lower loan-deposit ratios.

Therefore, aiming for higher reliance on deposit funding is leading to more balance sheet stability and a better funding mix, but at the same time may result in an increase of in-market competition among banks for new deposits in some geographies, raising overall funding costs and thus potentially challenging bank profitability.

Moreover, increasing reliance on deposits could also pose vulnerabilities as deposits might become more volatile as new resolution and bail-in requirements emerge. As a result, continued funding challenges continue to exist, particularly in distressed countries.

RAQ respondents reduced their apprehension for increased market competition in retail deposits and wholesale deposits. At the same time, they also reduced their acceptance to increase deposit base through offering better rates and terms to gain market share, consequently reducing competition for deposits. The majority of the RAQ respondents are still aiming to reduce their loan-to-deposit ratio via both loan growth control or reduction and funding growth.

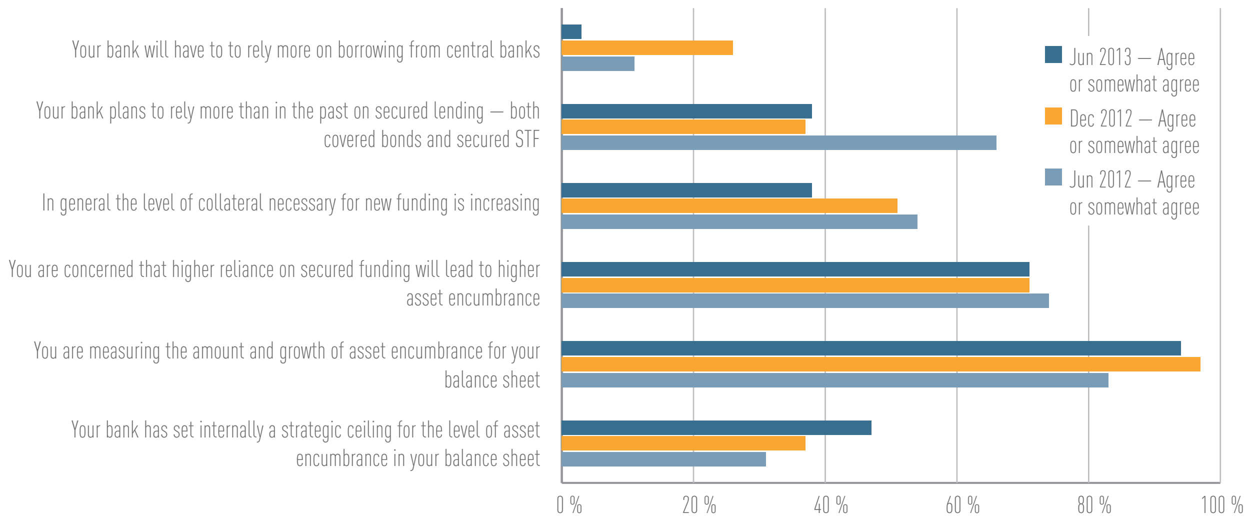
Asset encumbrance and collateral

In 2012, the reliance on secured funding has created a substantial amount of asset encumbrance. In cases where it exceeds certain thresholds the asset encumbrance could be harmful and self-reinforcing. Amongst many reasons, the excessive reliance on central bank borrowing required banks to earmark significant amounts of collateral in their balance sheets. At the same time, forthcoming regulations are likely to lead to an increase in the demand for collateral. A sustainable development needs to consider the necessity to restore market access for banks, both in terms of costs and availability, and a move away from central bank support towards the increasing use of unsecured funding on private markets.

Looking ahead, there are some positive signs. A majority of RAQ respondents continue to consider that there will be less need for central bank borrowing and do not intend to rely more on secured lending. At the same time, there is a strong response decrease in saying that the level of collateral necessary for new lending is increasing. In addition, the majority of RAQ respondents are measuring the amount and growth of asset encumbrance and an increasing number of respondents have internally set a strategic ceiling for the level of asset encumbrance in their balance sheets.

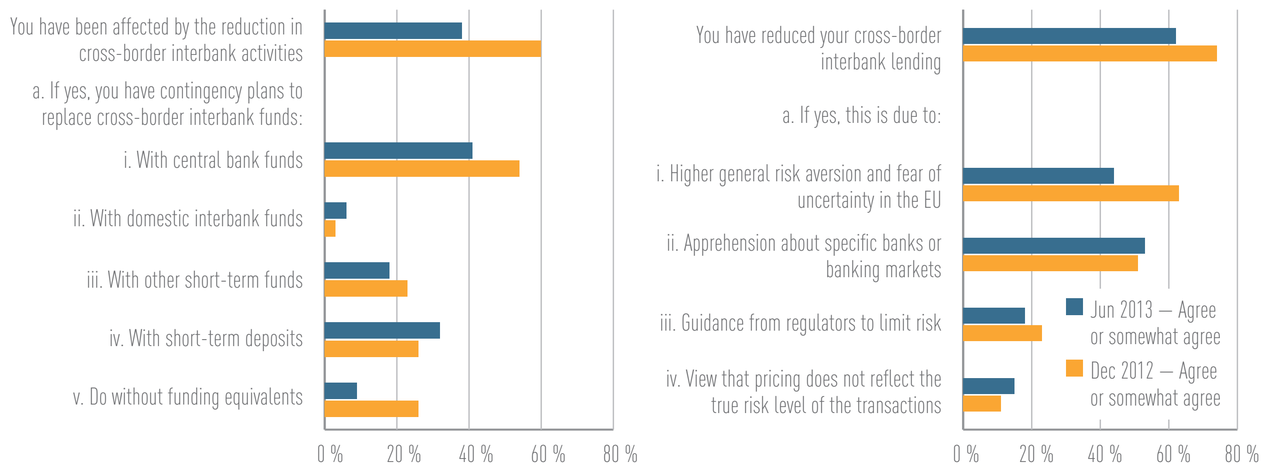
A regain in confidence within the banking system would be the re-emergence of an active cross-border interbank market. Signs of fragmentation of the single market can be identified in funding conditions, also evidenced by a strong reduction in cross-border interbank activities. Despite a benign funding environment, banks remain susceptible to a sudden switch of market sentiment, and the sustainability of benign conditions remains fragile. Nevertheless, the RAQ respondents provide some signs of improvement (in comparison to December 2012) with both a significant decrease in the number of banks affected by the reduction in cross-border activity and also with fewer banks agreeing to a reduction on their cross-border interbank lending.

Figure 23: Central bank and secured funding (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Figure 24: Cross-border borrowing and lending (source: RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

6. Income and profitability

During the end of 2012, EU banks' income and profitability levels have continued to be faced with significant headwinds which are not likely to dissipate in 2013. EU banks have seen their net interest margins compressed while the weak economic environment provides limited new lending opportunities, with banks scrapping for the few quality credits that exist and leaving some question marks over some institutions' future profitability and viability.

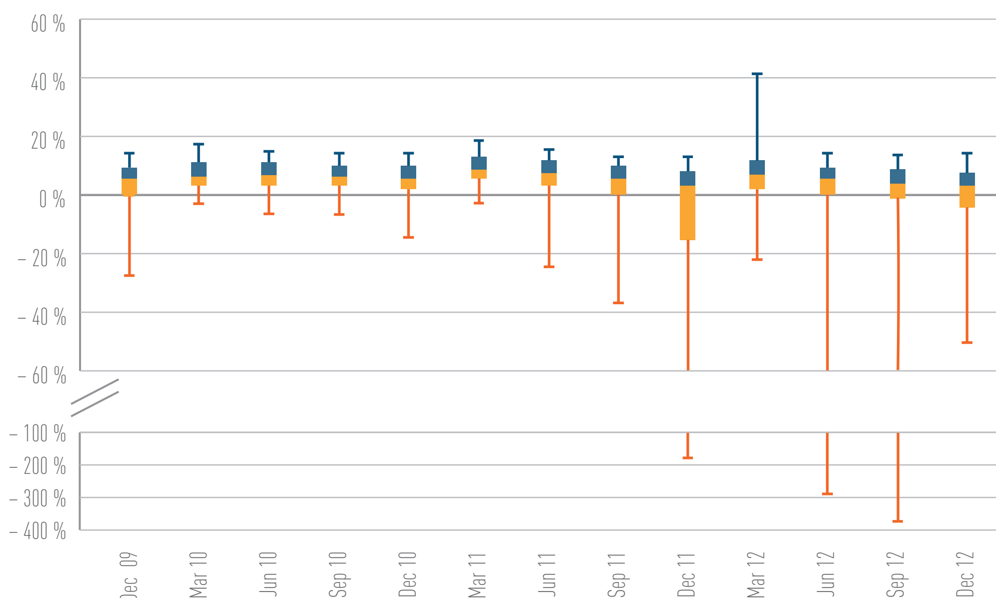
Persistent low interest rates are also putting pressure on the business model sustainability of banks which find overall net interest margins squeezed, contributing to profitability pressures. Given the fact that customer capacity to bear higher lending rates is affected by the economic downturn, banks' attempts to increase lending rates may prove not possible and even insufficient to address a low interest rates environment and increases in funding costs in some cases. Thus, net interest margins are pressured and are not being matched by a full re-pricing of assets.

Fee and commission incomes, which have traditionally been an important source of earnings for banks, are also under pressure due to low economic growth. The reduced demand for banking products and services blunts growth-generated earnings hikes. In order to reduce expenses and improve efficiency controls, banks are also trying to cut costs, mostly staff-related through lay-offs and re-adjusting the remuneration structures as well as utilising economies of scale and innovations. However, the cost-to-income ratio and similar indicators point also to some deterioration of banks' ability to keep relative costs under control.

Reflecting the continued macro-deterioration and some deep recessions in parts of the EU, the credit costs are rising and this trend shows no sign of reversal. Concurrently, more transparency on impairments and potential losses are leading to higher levels of loan–loss provisions. When benchmarked against low growth and flat or declining volumes of loans, higher credit costs are an important driver for weaker earnings, putting bank profitability at risk and removing an important source of capital growth and banks' performance.

The KRIs show that the return on equity (RoE) in December 2012 decreased. The weighted RoE and the 25th percentile have significantly decreased (from 1.7 % and – 0.9 % in June 2012, to 0.6 % and – 4.6 % in December 2012, respectively). The median and the 75th percentile have also eroded since March 2012 (from 6.5 % and 11.6 % to 3.2 % and 7.4 % in December 2012, respectively).

Figure 25: Return on Equity (*source:* KRI) — 5th and 95th percentiles, interquartile range and median

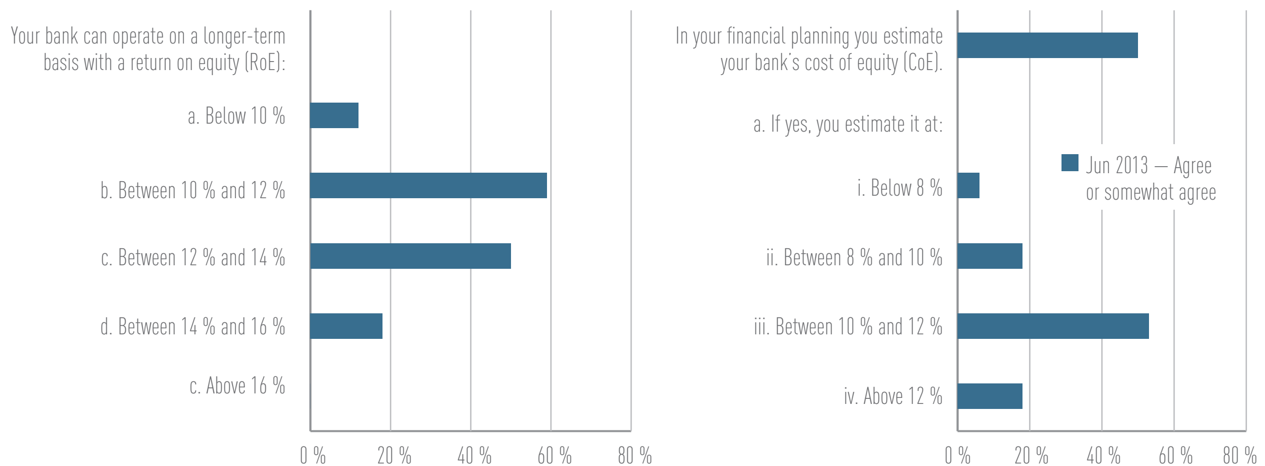


The majority of the RAQ respondents consider an RoE value in the range of 10 % to 12 % as the target for the long-term viability of their businesses. For the RAQ respondents, the main factors that will influence the RoE in the next months are both the operating margins and the pre-tax profit margins. In addition, a vast majority agree or somewhat agree that the current earnings levels are within market expectations. In contrast, some RAQ responses from market analysts (RAQ for market analysts) refer that the current earnings levels are moderately below market expectations. In regard to the cost of equity (CoE), most respondents believe it to be also in the 10 % to 12 % range. Given the fact that banks need to provide a return to investors at or above their cost of equity, in a context of economic downturn and sector deleveraging there are limited and less flexible levers available to meet minimum returns, turning some business models unviable.

According to many respondents, the CoE has subsided significantly since August 2012, and this is widely attributed to the European Central Bank's outright monetary transactions (OMT) announcement. The rise in banks' share prices over this period is attributed to the falling CoE, as it has happened despite a drop in the banks' earnings.

At the same time, the KRIs show that the cost-to-income ratio in December 2012 increased. For instance, the weighted cost-to-income ratio has significantly increased from 59.7 % in June 2012 to 63.2 % in December 2012. The median and the 75th percentile have also eroded since March 2011 (from 56.3 % and 63.2 % to 63.1 % and 71.6 % in December 2012, respectively).

Figure 26: Return on equity and cost of equity (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

Figure 27: Cost-to-income ratio (*source:* KRI) — 5th and 95th percentiles, interquartile range and median

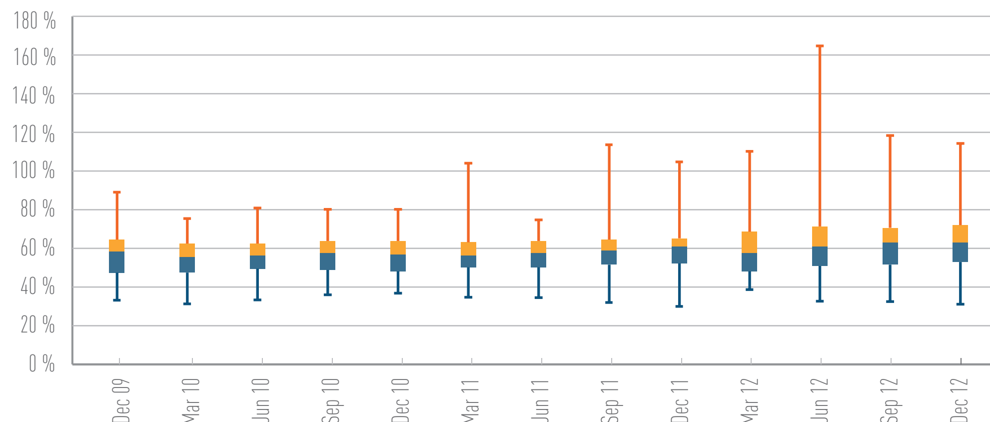
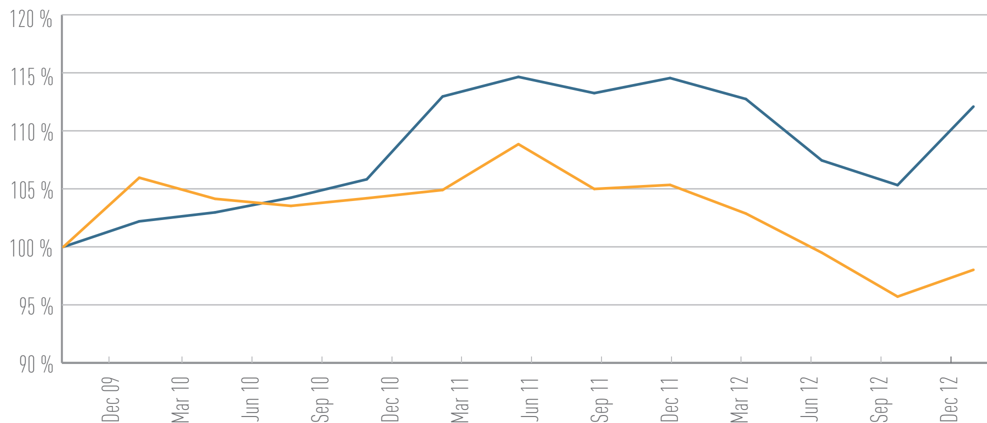


Figure 28: Cost-to-income ratio (*source:* KRI) — numerator and denominator trends (Dec 2009 = 100)



The indicators point to some deterioration of banks' ability to keep relative costs under control. The numerator of the cost-to-income ratio shows an increasing trend since December 2009.

Policy implications and possible measures

EU banks face strong challenges in adapting to the many changes derived from the emerging new economic, regulatory and financial landscape and the sustainability of their respective business models remains a motive for concern. All these changes have led some banks to be confronted with a situation where their current business model proves to be unviable. Overall, existing business models will experience pressure by stronger competition and banks will need to adjust their business models by finding additional sources of income and cost efficiency, whilst it is still unclear from where their future profitability drivers will originate from.

Hence, supervisors need to create a more coordinated analysis of banks' business models across the EU to assess banks' profit and funding model, business mix, management strength and strategy. The current methodologies and the monitoring intensity are substantially different for each European supervisor; therefore a coherent understanding of the commonalities and differences of approaches could be beneficial, as would be the development of best practices and harmonisation of assessments. To this end, the EBA is devoting part of the Single Supervisory Handbook to be written to the assessment of banks' business models. Supervisors are required to have an accurate assessment of core banking risks and challenge banks' business plans. This should in turn facilitate the joint decision processes and business model risk could be an explicit part of the joint risk assessment decision discussion.

7. Consumer issues and reputational concerns

A number of detrimental business practices of European banks have recently come to light and affect consumer confidence, leading to adverse implications not only on the banks involved, but also on the banking sector as a whole. These incidents concern detrimental behaviour and inappropriate conduct of various types, including mis-selling of products, failures with regard to rate benchmark setting processes, to taxation and further issues. The list of regulatory investigations and litigation cases is long and has already been costly for the banks concerned.

Incidences of detrimental business practices have raised wide public attention. A related increase of reputational risks has also been identified by the respondents of the RAQ. Growingly negative public perception of banks has several undesirable affects, including decreasing public willingness to support banks in distress, and may affect public support for banks in potential future distress situations, as recent discussions surrounding bank resolution indicated.

Supervisors and banks should therefore turn their attention to increasing legal and reputational risks with potential consequences for affected banks beyond direct losses. Potential shortcomings in institutions' risk management functions and compliance procedures need to be addressed, appropriate contingency reserves should be made, and disclosure on risks should be transparent. Related risks should also be adequately reflected in the supervisory review process.

Business conduct of banks and prudential risk

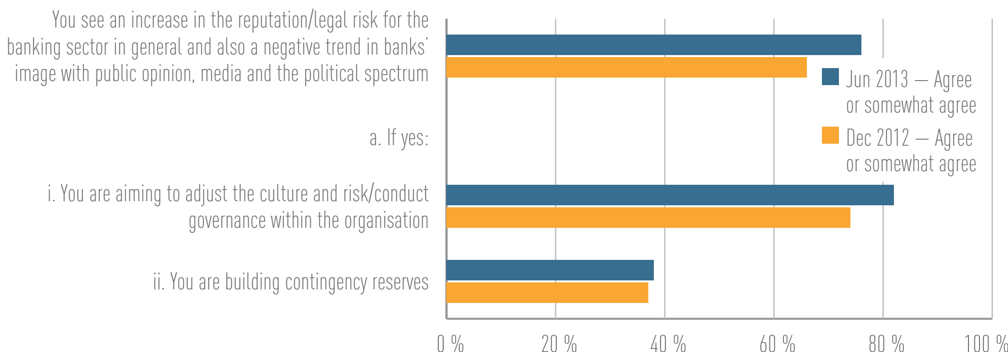
There are indications for an ongoing aggravation of reputational risks. In the responses to the RAQ, 76 % of respondents identified an increase in the reputation/legal risk for the banking sector in general and a negative trend in banks' public perceptions. This is an increase compared to the December 2012 RAQ, and an indication that risks should be carefully considered.

Business practices with a potential detrimental impact on the European banking sector can be related to mis-selling of unwanted products, to fraudulent behaviour, and/or to poor risk management. Some recent examples illustrate the issue.

The mis-selling of unwanted or unrequested credit insurance (payment protection insurance (PPI)) and other financial products made it necessary for some banks to set aside substantial compensatory provisions that have an impact on the profitability of these banks.

Financial market reference rates and respective calculation procedures have been under closer public and regulatory scrutiny in recent years. Since June 2012 three large European financial institutions have been found liable for attempted manipulation of Libor, and Euribor by the UK and US authorities. Several authorities around the world have investigated cases of alleged misconduct regarding the Libor rate-setting, Euribor and other

Figure 29: Trends in reputational risk (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed or somewhat agreed with the statement on the y-axis.

THE EBA AND ESMA TAKE ACTION TO STRENGTHEN EURIBOR AND THE BENCHMARK RATE-SETTING PROCESSES

In January 2013, the EBA and ESMA published the results of their joint work on Euribor and proposed principles for benchmark rate-setting processes, namely:

- a review of Euribor's administration and management and clear recommendations to the Euribor-European Banking Federation (EEBF) to improve the governance and transparency of the rate-setting process;
- formal EBA Recommendations to national authorities on the oversight of banks participating in the Euribor panel; and
- a joint ESMA–EBA consultation on principles for benchmark setting processes in the EU which establish a framework for the conduct of benchmark rate setting and the activities of participants in the process.

The proposed principles, which are aligned with ongoing EU and international work, will provide clarity to benchmark providers and users, and are an immediate step to be taken in advance of potential wider changes in the supervisory and regulatory framework for financial benchmarks. The prompt and full implementation of these recommendations is an important step towards ensuring that Euribor represents a transparent and reliable benchmark for financial transactions within the EU.

reference rates. Besides, the Commission is currently investigating several antitrust cases which concern benchmark rates including Libor/Tibor and Euribor and in relation to a number of currencies including inter alia the yen, the euro and the Swiss franc. The EBA and the European Securities and Markets Authority (ESMA) have carried out joint work that has identified significant weaknesses and insufficiencies in the governance of the Euribor rate-setting mechanism and European competent national authorities are also conducting legal investigations. The first outcomes of the investigations at national levels as well as a mounting number of private litigation cases have highlighted the scope and scale of possible manipulations of reference rate-setting mechanisms. Consequently, a number of initiatives to reform reference rate-setting mechanisms have been launched across wide parts of the regulatory and supervisory communities as well as the financial markets.

These recommendations are made within the current legislative setting, while the need for broader structural changes is being assessed by the European Commission.

In other cases European banks violated US sanctions and regulatory law by handling transactions involving companies in countries under US sanctions and allegedly manipulating the US electricity market. Further investigations are currently going on, in several countries, of banks having allegedly facilitated clients to evade taxation. Products of the Madoff Ponzi scheme were being held and sold by many banks to their clients. When the fraudulent nature of these products became evident, write-downs and compensation payments had to be made.

Recent major disruptions of IT-systems of several banks occurred, where in some cases customers did not have access to their bank account up to several days.

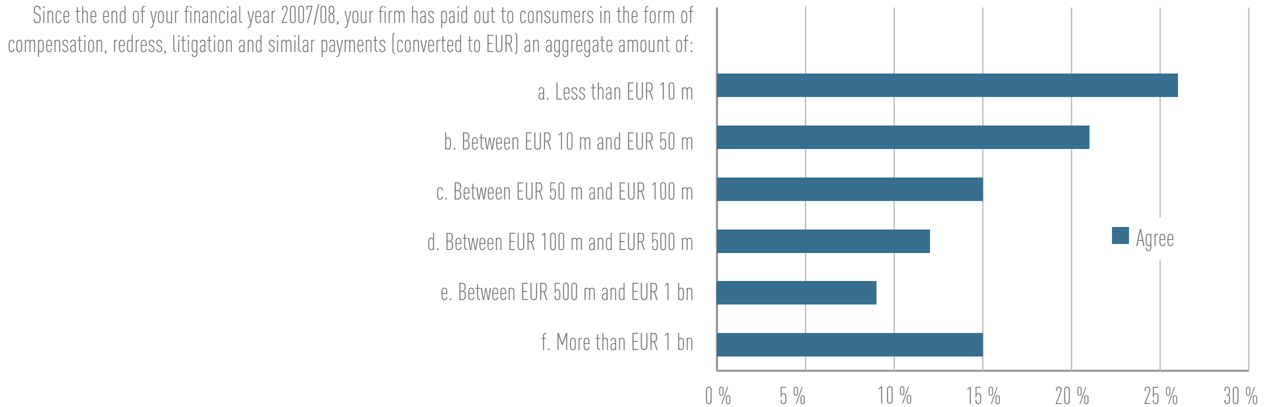
Costs and prudential implications of banks' business conduct

As for aggregated costs stemming from misselling and other unfair past business practices towards bank customers, 15 % of the banks responding to the RAQ have each paid to their customers amounts exceeding EUR 1 billion since the end of the financial year 2007/08. At the same time, 57 % of the responding banks have each paid to their customers amounts between EUR 10 million and EUR 1 billion in the form of compensation, redress, litigation and similar payments.

The provisions in the ongoing financial year set aside for costs of compensation, redress, litigation and similar payments to consumers amount to between EUR 10 million and EUR 100 million in 38 % of banks in the RAQ sample; in 12 % the amount is higher than EUR 1 billion.

There are some challenges to quantify the aggregated financial impact for European banks stemming from already materialised redress costs and further contingent liabilities, not least since accounting treatment of actual and potential redress costs is not always consistent between institutions even when they face similar risks: according to International Accounting Standards (IAS) 37 provisions have to meet certain criteria in order to be recognised and thus have an impact on the income statement, notably that a reliable estimate can be made of the amount of the obligations. If this is not the case, a contingent liability is set aside, with no effect on the income statement. However, information on contingent liabilities disclosed often lacks detail. Both the classification of a potential financial obligation (provisions or contingent

Figure 30: Payments to consumers since 2007 (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed with the statement on the y-axis.

liabilities) as well as the level of disclosure often leaves room for interpretation.

Even though legal risk is covered by the operational risk framework, Pillar 3 disclosures on this topic appear not very well developed. As for costs stemming from reputational risks, explanations should mostly be found in Pillar 3 reports. However, the level of disclosure differs significantly between institutions and information tends to be rather unspecific or high level only. Risks are often generally acknowledged, but attempts to quantify associated costs are rare.

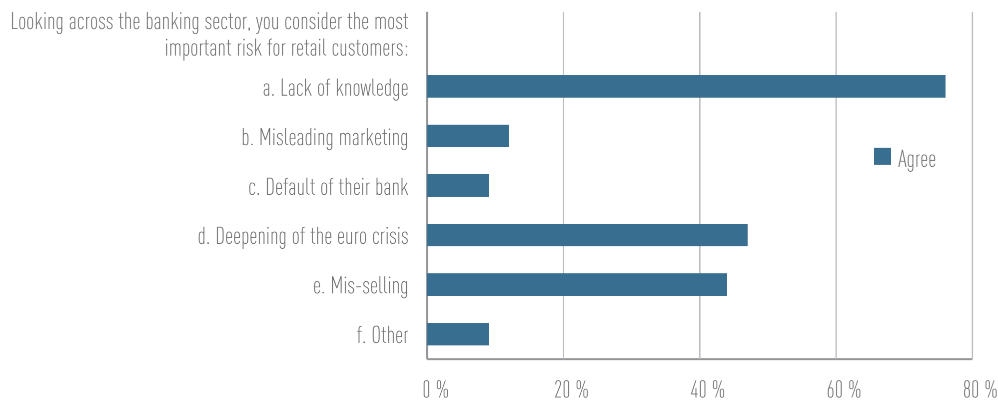
While fines and other redress costs related to past business practices which have arisen to date affect banks' profitability, they do not substantially affect their capital positions. However, reputational damage coupled with ongoing uncertainties stemming from lengthy legal proceedings and potential additional substantial redress costs is detrimental for banks' ability to raise capital.

Policy implications and possible measures

All these detrimental incidents indicate that there is room for improvement in many institutions' risk management functions and compliance procedures regarding business conduct issues, and point to the need of further improvements in risk cultures and risk appetites. Compliance with internal and external rules for risk management and compliance functions needs to be ensured and warrants increased supervisory attention in light of rising risks.

Even though most banks recognise that reputational risks are becoming an issue, only 38 % of the responses in the RAQ sample indicated that contingency reserves are being

Figure 31: Important risks for retail customers (*source:* RAQ)



The length of the bars shows the percentage of respondents who agreed with the statement on the y-axis.

built in order to meet increased reputational and/or legal risk.

Supervisors should therefore assess if prudential risks stemming from banks' business practices are adequately reflected in an institution's Internal Capital Adequacy Assessment Process (ICAAP), given their institution-specific and potential wider prudential implications. Likewise, supervisors should ensure that risks stemming from potentially detrimental business practices of banks are adequately reflected in their supervisory review and evaluation process (SREP). While an appropriate quantification of institution-specific reputational risks might be difficult to attain, further approaches of taking into account reputational risks should be explored.

In order to get a more accurate picture of legal and reputational risk, auditors and supervisors should challenge situations where non-provisioning for related risks is poorly substantiated and where contingency reserves for legal or reputational risks are lacking.

Further, a more general reassessment of the relationship between banks and their customers should be considered: when asked about most important risks for retail consumers, 76 % of the RAQ respondents specified lack of knowledge, 47 % mentioned the deepening of the euro crisis, and 44 % thought mis-selling to be the most important risk for consumers. Thus a lack of knowledge is considered being the predominant reason for materialisation of risks for consumers. With respect to existing markets in financial instruments directive (MiFID) provisions aimed to protect customers from buying products they do not understand, the conclusion could be drawn that the relationship between banks and retail customers needs further improvement. In particular, further needs for educational efforts for both banks and the public sector can be identified, as well as the need for simpler and more transparent products offered to retail customers. In addition, other conditions such as comprehensive disclosure and products, conflict-of-interest-free advice, measures against mis-selling, alternative dispute resolution and a pro-active supervision of business conduct are key to improve the functioning of the retail financial markets for consumers.

Appendix: Samples

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

Risk assessment questionnaire

	Bank name	Home country
1	Erste Group Bank AG	AT
2	Raiffeisen Zentralbank	AT
3	KBC Group	BE
4	Marfin Popular Bank Public Company Limited	CY
5	DZ BANK AG	DE
6	Deutsche Bank AG	DE
7	Commerzbank AG	DE
8	Bayerische Landesbank	DE
9	Danske Bank A/S	DK
10	National Bank of Greece	EL
11	Alpha Bank AE	EL
12	Piraeus Bank	EL
13	Eurobank Ergasias	EL
14	Banco Santander SA	ES
15	BNP Paribas	FR
16	Crédit Agricole Group — Crédit Agricole	FR
17	Société Générale	FR
18	OTP Bank NYRT	HU
19	Bank of Ireland	IE
20	Allied Irish Banks plc	IE
21	Gruppo UniCredit	IT
22	Gruppo Bancario Intesa Sanpaolo	IT
23	ABN Amro	NL
24	ING Groep NV	NL
25	Rabobank Group — Rabobank Nederland	NL
26	DNB Bank ASA	NO
27	Banco Comercial Portugues	PT
28	Skandinaviska Enskilda Banken AB	SE
29	Nordea Bank AB (publ)	SE
30	Swedbank AB	SE
31	Svenska Handelsbanken AB	SE
32	Barclays plc	UK
33	Lloyds Banking Group plc	UK
34	HSBC Holdings plc	UK
35	Royal Bank of Scotland Group plc (The)	UK

Key risk indicators

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

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

Annex

Descriptive statistics from the EBA key risk indicators with data to Q4 2012.
The charts of KRIs 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
SOLVENCY	1 — Tier 1 capital ratio	Weighted average	10.2 %	10.2 %	10.4 %	10.6 %	11.0 %	11.3 %	11.4 %	11.4 %	11.2 %	11.6 %	12.0 %	12.3 %	12.5 %
		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 %	10.7 %
		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 %	11.8 %
		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 %	13.6 %
	2 — Total capital ratio	Weighted average	13.0 %	12.9 %	12.9 %	13.1 %	13.5 %	13.7 %	13.6 %	13.5 %	13.2 %	13.6 %	13.9 %	14.1 %	14.5 %
		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 %	12.5 %
		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 %
		75th percentile	14.0 %	13.9 %	14.0 %	14.6 %	14.9 %	15.0 %	15.1 %	15.1 %	15.1 %	15.5 %	15.8 %	15.8 %	16.6 %
	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 %	9.3 %	9.8 %	10.2 %	10.5 %	10.8 %
		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 %	9.6 %
		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 %
		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 %	11.7 %

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
13 — Impaired loans and past due (> 90 days) loans to total loans	Weighted average	5.1 %	5.0 %	5.1 %	5.3 %	5.3 %	5.2 %	5.4 %	5.4 %	5.9 %	5.8 %	6.0 %	6.3 %	6.3 %
	25th percentile	3.1 %	3.1 %	3.3 %	3.4 %	3.0 %	2.9 %	2.5 %	2.6 %	2.5 %	3.3 %	2.8 %	2.9 %	3.0 %
	50th percentile	4.9 %	5.1 %	5.4 %	5.5 %	5.4 %	5.4 %	5.6 %	5.6 %	6.4 %	7.0 %	6.3 %	7.3 %	5.5 %
	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 %	14.4 %
14 — Coverage ratio (specific allowances for loans to total gross impaired loans)	Weighted average	42.0 %	41.8 %	42.0 %	42.9 %	41.7 %	42.7 %	41.4 %	40.9 %	41.2 %	40.9 %	41.5 %	41.5 %	42.8 %
	25th percentile	34.0 %	34.4 %	34.0 %	34.5 %	33.5 %	34.2 %	33.7 %	33.7 %	34.3 %	34.4 %	35.6 %	34.8 %	32.3 %
	50th percentile	40.7 %	41.3 %	40.9 %	41.7 %	41.8 %	42.8 %	41.2 %	41.4 %	41.2 %	41.2 %	40.9 %	40.7 %	40.3 %
	75th percentile	49.0 %	48.5 %	49.4 %	48.3 %	49.5 %	48.3 %	46.6 %	45.6 %	48.7 %	48.1 %	47.9 %	48.9 %	47.1 %
18 — Impaired financial assets to total assets	Weighted average	1.6 %	1.4 %	1.5 %	1.4 %	1.7 %	1.6 %	1.7 %	1.7 %	1.9 %	1.8 %	1.8 %	1.9 %	1.9 %
	25th percentile	0.9 %	1.0 %	1.0 %	1.1 %	1.2 %	1.1 %	0.6 %	1.0 %	1.0 %	1.1 %	1.2 %	1.1 %	0.7 %
	50th percentile	1.8 %	1.7 %	1.8 %	1.8 %	2.0 %	1.9 %	1.9 %	2.0 %	2.2 %	2.1 %	2.1 %	2.2 %	1.9 %
	75th percentile	3.4 %	3.4 %	3.6 %	3.8 %	3.9 %	3.9 %	4.6 %	5.3 %	5.6 %	6.2 %	6.6 %	7.2 %	7.0 %
20 — Accumulated impairments on financial assets to total (gross) assets	Weighted average	1.3 %	1.2 %	1.3 %	1.3 %	1.4 %	1.3 %	1.4 %	1.3 %	1.6 %	1.4 %	1.5 %	1.5 %	1.6 %
	25th percentile	0.9 %	0.9 %	0.9 %	0.9 %	0.9 %	0.8 %	0.8 %	0.7 %	0.8 %	0.8 %	0.7 %	0.7 %	0.7 %
	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 %	1.7 %
	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 %	3.8 %
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 %	26.3 %
	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 %
	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 %	22.2 %
	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 %	42.7 %

	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
PROFITABILITY	22 — Return on equity	Weighted average	4.5 %	1.9 %	3.6 %	5.0 %	5.9 %	2.1 %	3.5 %	3.6 %	0.0 %	1.4 %	1.7 %	1.9 %	0.6 %
		25th percentile	– 0.5 %	3.0 %	3.0 %	3.0 %	1.7 %	5.2 %	2.8 %	– 0.7 %	– 15.7 %	1.7 %	– 0.9 %	– 1.5 %	– 4.6 %
		50th percentile	5.4 %	6.2 %	6.3 %	5.7 %	5.4 %	8.3 %	7.1 %	5.2 %	2.7 %	6.5 %	5.3 %	3.8 %	3.2 %
		75th percentile	9.1 %	11.1 %	10.8 %	10.0 %	9.5 %	12.6 %	11.7 %	9.4 %	7.8 %	11.6 %	8.9 %	8.4 %	7.4 %
	24 — Cost-to-income ratio	Weighted average	55.2 %	53.3 %	54.6 %	55.6 %	56.1 %	59.5 %	58.2 %	59.6 %	60.1 %	60.6 %	59.7 %	60.8 %	63.2 %
		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 %	52.6 %
		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 %
		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 %
	26 — Net interest income to total operating income	Weighted average	57.9 %	56.2 %	58.6 %	58.3 %	58.0 %	57.2 %	57.4 %	60.3 %	61.0 %	61.2 %	60.9 %	61.7 %	61.5 %
		25th percentile	52.8 %	53.2 %	52.3 %	53.2 %	51.9 %	49.0 %	50.4 %	52.5 %	54.2 %	51.7 %	51.8 %	52.5 %	51.5 %
		50th percentile	64.1 %	61.9 %	61.6 %	62.8 %	62.5 %	59.9 %	62.8 %	65.0 %	63.5 %	63.9 %	63.2 %	65.9 %	65.5 %
		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 %	76.6 %
	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 %
		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 %	17.7 %
		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 %	26.0 %
		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 %	30.9 %
	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 %	2.0 %
		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 %	– 11.8 %
		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 %	9.5 %
		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 %	18.7 %

BALANCE SHEET STRUCTURE

KRI	Descriptive statistics	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12
34 — Loan-to-deposit ratio	Weighted average	148.9 %	148.9 %	147.4 %	146.4 %	144.2 %	144.4 %	145.2 %	147.0 %	142.7 %	144.2 %	143.6 %	141.4 %	139.1 %
	25th percentile	125.2 %	125.2 %	128.6 %	123.8 %	124.5 %	119.7 %	122.4 %	127.8 %	126.7 %	123.9 %	125.4 %	125.5 %	122.7 %
	50th percentile	147.4 %	144.6 %	145.3 %	148.0 %	147.7 %	147.4 %	151.1 %	152.0 %	148.5 %	146.0 %	145.9 %	146.0 %	139.5 %
	75th percentile	174.6 %	179.7 %	177.9 %	178.4 %	174.5 %	173.9 %	170.5 %	169.5 %	176.8 %	184.4 %	182.8 %	173.1 %	163.7 %
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 %
	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 %
	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 %	45.2 %
	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 %	57.0 %
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 %
	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 %	4.4 %
	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 %	5.3 %
	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 %
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
	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	13.1
	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	16.0
	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	22.3
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 %	18.2 %	17.4 %	17.3 %	16.4 %	16.9 %
	25th percentile	8.9 %	8.5 %	8.2 %	8.2 %	8.3 %	7.8 %	8.0 %	7.7 %	8.5 %	7.8 %	8.1 %	7.4 %	7.3 %
	50th percentile	14.7 %	14.4 %	14.2 %	14.2 %	14.0 %	14.1 %	13.8 %	13.4 %	14.5 %	14.2 %	14.3 %	14.2 %	14.7 %
	75th percentile	20.8 %	20.0 %	19.8 %	20.3 %	19.1 %	19.0 %	18.5 %	17.4 %	19.0 %	19.5 %	18.5 %	18.0 %	18.4 %

The KRI database

The definitions used are consistent with the supervisory common reporting (COREP) and financial reporting framework (FINREP).

Nr	Kri Code	KRI name	Numerator	Denominator
1	1	Tier 1 capital ratio	TOTAL ORIGINAL OWN FUNDS FOR GENERAL SOLVENCY PURPOSES	TOTAL CAPITAL REQUIREMENTS *12.5
2	2	Total capital ratio	TOTAL OWN FUNDS FOR SOLVENCY PURPOSES	TOTAL CAPITAL REQUIREMENTS * 12.5
3	3	Tier 1 ratio (excluding hybrid instruments)	TOTAL ORIGINAL OWN FUNDS FOR GENERAL SOLVENCY PURPOSES -Hybrid instruments in Minority interests - Hybrid instruments in 1.1.4.1a Hybrid instruments - (-) Excess on the limits for hybrid instruments	TOTAL CAPITAL REQUIREMENTS * 12.5
4	13	Impaired loans and Past due (>90 days) loans to total loans	Row: Loans and advances Column: Net carrying amount of the impaired assets Row: Loan and advances Specific allowances for individually assessed financial assets and Specific allowances for collectively assessed financial assets Column: Closing balance Row: Loans & advances Columns: > 90 days ≤ 180days; > 180 days ≤ 1year; > 1year	Total loans advances (Rows: Loans and advances AFS, Loans and receivables, HTM) Row: Loan and advances Specific allowances for individually assessed financial assets and Specific allowances for collectively assessed financial assets Allowances for incurred but not reported losses on financial assets Column: Closing balance
5	14	Coverage ratio (specific allowances for loans to total gross impaired loans)	Row: Loan and advances Specific allowances for individually assessed financial assets and Specific allowances for collectively assessed financial assets Column: Closing balance	Row: Loans and advances Column: Net carrying amount of the impaired assets Row: Loan and advances Specific allowances for individually assessed financial assets and Specific allowances for collectively assessed financial assets Column: Closing balance
6	18	Impaired financial assets to total assets	Row: Total Column: Net carrying amount of the impaired assets	Total assets
7	20	Accumulated impairments on financial assets to total (gross) assets	Row: Loan and advances, Debt instruments and Equity instruments Specific allowances for individually assessed financial assets and Specific allowances for collectively assessed financial assets Allowances for incurred but not reported losses on financial assets Column: Closing balance	Total assets Row: Loan and advances, Debt instruments and Equity instruments Specific allowances for individually assessed financial assets and Specific allowances for collectively assessed financial assets Allowances for incurred but not reported losses on financial assets Column: Closing balance
8	21	Impairments on financial assets to total operating income	Impairment on financial assets not measured at fair value through profit or loss	Total operating income: rows: Interest income; Interest expenses; Expenses on Share capital repayable on Demand; Dividend income; Fee and commission income; Fee and commission expenses; Realised gains (losses) on financial assets & liabilities not measured at fair value through profit or loss, net; Gains (losses) on financial assets and liabilities held for trading, net; Gains (losses) on financial assets and liabilities designated at fair value through profit or loss, net; Gains (losses) from hedge accounting, net; Exchange differences, net; Gains (losses) on derecognition of assets other than held for sale, net; Other operating income; Other operating expenses
9	22	Return on equity	Total profit or loss after tax and discontinued operations (annualised)	Total equity (period average)

Nr	Kri Code	KRI name	Numerator	Denominator
10	24	Cost-income ratio	Rows: Administration costs; Depreciation	Total operating income: rows: Interest income; Interest expenses; Expenses on Share capital repayable on Demand; Dividend income; Fee and commission income; Fee and commission expenses; Realised gains (losses) on financial assets & liabilities not measured at fair value through profit or loss, net; Gains (losses) on financial assets and liabilities held for trading, net; Gains (losses) on financial assets and liabilities designated at fair value through profit or loss, net; Gains (losses) from hedge accounting, net; Exchange differences, net; Gains (losses) on derecognition of assets other than held for sale, net; Other operating income; Other operating expenses
11	26	Net interest income to total operating income	Rows: Interest income; interest expenses	Total operating income as above.
12	27	Net fee and commission income to total operating income	Rows: Fee and commission income; fee and commission expense	Total operating income as above.
13	33	Net income to total operating income	Total profit or loss after tax and discontinued operations	Total operating income as above.
14	34	Loan-to-deposit ratio	Total loans advances (Rows: Loans and advances held for trading, designated at fair value through profit or loss, AFS, Loans and receivables, HTM)	Total deposits (other than from credit institutions) (Rows: Deposits held for trading, designated at fair value through profit or loss, measured at amortised cost)
15	35	Customer deposits to total liabilities	Total deposits (other than from credit institutions) (Rows: deposits (other than from credit institutions) held for trading, designated fair value through profit or loss, measured at amortised cost)	Total liabilities
16	36	Tier 1 capital to (total assets - intangible assets)	Original own funds	Total assets - Intangible assets
17	45	Debt-to-equity ratio	Total liabilities	Total equity
18	46	Off-balance sheet items to total assets	Loan commitments given, financial guarantees given, other commitments given to other counterparties	Total assets

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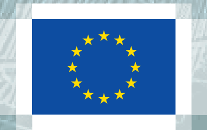

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