Association of British Insurers

Investibility of UK Banks

December 2012

Contents

Section A – Introduction

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 30% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £200 million to customers, including motorists, householders, pension annuity payments, businesses and investors.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has almost 350 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

Background to the report

The purpose of the report is to reflect UK investors' views in the continuing debate on UK banks' capital structure, funding, liquidity and balance sheet risk weighting.

So far, the public debate on banks' capitalisation has reflected the views of regulators, politicians and policy makers, e.g. The Independent Commission on Banking (ICB), but not the providers of the Capital – the investors. If more capital is indeed required in the UK banking system, as recently highlighted in the Bank of England's Financial Stability Report (Issue no.32, November 2012), then investors need to understand first, why this is the case and, secondly, what is the likely return on the capital invested and associated risks. We hope the ABI report will go some way to representing investors' questions and concerns.

Section B – Summary and Conclusions

Profitability

Sustainable profitability (i.e. the ability to earn a Return on Equity ("ROE") in excess of the Cost of Equity ("COE")) across the cycle is critical to investibility.

"When banks are profitable, they are stable. When banks succeed, the economies and communities prosper…Profits also expand the capital base of banks, which in turn maintains the stability of the system, ensuring the safety and security of [Canadians'] deposits". Canadian Bankers' Association, May 2012.

Benefits of profitability

- A robust banking ROE is beneficial for the wider economy and not just equity shareholders.
- Sustainable ROE must be based on a sustainable business model, which investors can assess and value. Attaining regulatory clarity is a key component of this process, for both investors and banks' management.
- A robust ROE boosts internal capital generation, which in turn supports loan capacity, augments core tier 1 capital, i.e. loss absorbing capacity, and creates dividend distribution capacity.
- In a 'normal' cycle, pre-tax profits would be divided into three components (i) corporation tax; (ii) retained capital to support loan growth and increase loss absorbing capacity; and finally (iii) shareholder dividends.
- Failure to achieve at least cost of capital across the cycle is likely to lead to banks' businesses being unsustainable in the longer term and will inevitably constrain asset growth and lending to the wider economy.

Difficulties and risks of calculating Return on Equity (ROE)

- ROE is the product of return on assets ("ROA") and asset gearing (or leverage). The consequences of driving up profitability, by driving up leverage, remain all too fresh in investors' minds from the financial crisis.
- Investors recognise the need to focus on the fundamental drivers of a bank's ROA, i.e. net interest margins (asset yields and blended funding costs), efficiency ratios, the credit cycle and capital structure, whilst also looking at assets on a risk adjusted basis.
- An attempt to 'maximise' ROE, particularly in the short-term, can create excessive risk taking, under-investment, or short term uncompetitive pricing. If a bank appears to be generating an ROE that is out of line with the banking cycle or with its peer group, investors will need to understand why.
- We believe these risks are recognised by both banks' management and investors, with management teams attempting to focus on medium term sustainable ROE targets, although lack of clarity on capital levels makes this particularly challenging.

Cost of Equity (COE)

- Cost of equity will be influenced by (i) capital levels (ii) earnings volatility (ii) business mix.
- Levels of core tier 1 capital and degree of separation or ring-fencing are therefore pivotal in assessing cost of equity.
- Banks are inherently more highly geared, with greater earnings cyclicality, compared with non-financial companies. It therefore follows that investors should be compensated for the increased risk in the investment and a bank's COE will reflect this.
- Discussions suggest that cost of equity for a Retail Banking business is in the range of 8%-10%, with Investment Banking around 15%. Thus a blended Universal Banking cost of equity might initially be in the 11%-12% range.
- Investors are keen for management to articulate their cost of equity, since management is allocating shareholders' capital across a variety of businesses with differing risks/returns. Moreover, it would be difficult to formulate an ROE target without having some notion of cost of equity. Investors in parallel will have their own views on COE.

Regulatory Risks

Investor appetite is significantly adversely affected by lack of regulatory clarity, as well as by concerns that the UK may impose more stringent requirements than other jurisdictions. Investors are also looking for an integrated approach, as opposed to piecemeal reform.

Continuing uncertainty over the structure of the industry and the regulatory environment impairs the ability of the sector to help finance growth.

General

- Asset value uncertainty, Eurozone risks and mis-selling investigation are all weighing on investor confidence, reflected in very low share price: tangible net asset values.
- However, regulatory 'opacity' also remains a significant investment risk for investors.

Required holdings of Core Tier 1 Capital

- Lack of clarity regarding capital levels, and the apparent conflict between resilience and recovery, are muddying the investment case for UK banks.
- Investors need to understand if the change of emphasis from core tier 1 ratio to absolute levels of capital is permanent or part of a more temporary mechanism to facilitate asset growth.

- Investors are seeking a deeper understanding of the ICB's 10% core tier 1 guidance. Some investors believe the stock market, rather than regulators' prudential risk analysis, may have led to the conclusion that 10% was the "right" core tier 1 ratio, taking into account a counter-cyclical buffer or G-SIFI/SIFI layer above the Basel 3 minimum of 7%.
- Investors need to understand to what extent UK banks will be subject to additional requirements, particularly given (i) the scope within Basel 3, CRD IV, for higher minima to be imposed nationally and (ii) for a 2.5% counter-cyclical buffer to be applied. UK banks that participated in the European Banking Authority (EBA) stress tests remained adequately capitalised under the stress scenarios specified, and were not required to increase core tier 1 capital in order to meet the EBA's 9% target level, unlike a number of European banks.
- Investors need confidence that a bank is operating with a core tier 1 ratio above the regulatory minimum. However, explicit publication of locally agreed capital buffers (referred to in one meeting as 'concrete buffers') may only serve to heighten investor anxiety during the down-leg of a cycle. A locally agreed capital buffer should provide banks' management and regulators with time to take the necessary action as credit or broader market conditions deteriorate. Recent history tells us that this time may not be available once markets perceive problems; debt markets effectively anticipate and discount the likely impact of the credit cycle on a bank's capital base, almost immediately, through shifts in yield curves, risk premiums above government bond yields, and credit default swap rates.
- Banks must be correctly capitalised but not over-capitalised. It is accepted by investors that the price of increased capital and regulation will reduce ROEs. However, investors need to be equipped with the information to assess the likely scale of ROE contraction.
- Investors are also seeking a better understanding of Pillar 2 capital and its allocation across banks' business sectors.

Risk-weightings

- The Basel 2 IRB approach to risk-weighting has become too complex and susceptible to individual bank interpretation, which distorts inter-bank comparison by investors.
- The European Banking Federation (EBF) has highlighted the disparity in risk weightings of mortgage portfolios in Europe. Risk weightings on total assets range from 17% to 84% across the 66 banks surveyed.
- We highlight similar disparities in UK portfolios, which, together with average low risk weightings, are undermining investor confidence in the mortgage risk weighting methodology.
- There are similar inconsistencies in corporate loan portfolio risk weightings.

- We consider in detail four potential solutions:
  - Returning to a Basel 2 standardised approach – this would be regressive and potentially damaging.
  - Adopting simple leverage – used alone, this could encourage banks to pursue a higher margin/higher risk strategy and so would need to be used in conjunction with a risk-weighted approach.
  - Modifying mortgage risk weightings – this could lead to significantly increased Core Tier 1 capital requirements. We doubt fresh equity would be available and increasing capital organically could choke off growth.
  - Improved disclosure, providing a 'bridge' from gross assets to RWA – this could be of significant assistance to investors.
- The ABI would therefore be supportive of an IRB methodology (or an improved standardised approach for those who have not adopted IRB) together with a simple leverage approach, augmented with significantly enhanced risk disclosures, reconciling accounting balance sheets with regulatory balance sheets. Abandoning IRB would be highly regressive.
- Investors also need the assurance of prudent asset valuations. Current accounting rules limit potential credit loss recognition. We therefore support the Enhanced Disclosure's Task Force (EDTF) recommendations for banks to provide a reconciliation of the accounting balance sheet to the regulatory balance sheet. We would also encourage additional disclosures on Expected Loss calculations in the banks' regulatory returns.

Loss-absorbing capital in addition to Equity: Bail-in Capital and Cocos

Investors emphasise that, for banks to operate well and support the economy, they need to be financed by stable long-term capital. Stable financing comes from equity and long-term debt.

General

- Investors are supportive of the progress by financial regulators to improve the strength of financial regulation and minimise the risk of systemic contagion presented by the prospect of failing financial institutions.
- Investors need to have a clear understanding of what constitutes Primary Loss Absorbing Capacity ("PLAC"). In particular, investors need further clarification on the logic of 17% PLAC.
- The risk-return of additional loss absorbency or bail-in capital is confusing the market and requires clarification.
- Investors highlight the importance that the investment risk faced is well defined, unambiguous and maintains the current creditor hierarchy with respect to senior secured, senior unsecured, subordinated and equity claims in a resolution scenario.

- Investors are seeking clarity on the depositor preference mechanism and, in particular, whether this would really create additional 'market discipline' on investors sub-ordinated to depositors.

- Investors acknowledge the need for governments and regulators to retain flexibility around which tools are employed to resolve an institution. However, the higher the uncertainty attached to a security's potential value in a crisis management scenario, the higher the risk premium that will be demanded by investors.

Bail-in

- Introducing a separate bail-in layer, with specified instruments effectively constituting a 'Tier 3' capital layer, may serve only to confuse, particularly as it is widely believed that, at the point of resolution, all unsecured funding will be effectively be 'bail-inable'.

- For debt investors:

  – there has been a significant move towards secured funding rather than unsecured

  – the longer-term implications of this for the costs of unsecured debt funding and the effectiveness of bail-in remain unclear.

- Investor demand for bail-in debt has not been assessed and we are concerned that the risk-return characteristics of bail-in versus the secured debt market may not be sufficiently compelling to provide substantial amounts of bail-in debt. A possible unforeseen consequence of bail-in may be that only the larger (SIFI and G-SIFI status) banks will be seen as sufficiently robust to issue investible bail-in debt.

- There are some concerns that a requirement to maintain a certain level of bail-inable debt (effectively 'Tier 3 capital') could cause difficulties if the average tenor is, say, 5 years and so an amount needs to be 'rolled over' each year. A failure to roll over, or roll over on unattractive terms, could itself undermine confidence in the bank.

Cocos

- In the absence of significant incremental demand for bank equity, instruments such as Cocos, which offer 'near-equity' returns on a fixed income basis, are attractive to some investors.

- However, differentiation in terms of cost relative to equity – and so maintaining a viable capital structure – means that tax deductibility is viewed as essential. In addition, Cocos do not account as Core Tier 1 and 'gear' the equity further, and so may have a longer-term impact on equity demand.

- Fixed income securities that are mandatorily convertible into equity would not currently qualify for many of the benchmarks currently tracked or replicated by investors on behalf of their clients.

"Ring-fencing": ICB approach; Liikanen; Volcker

- Investors recognise the potential pitfalls of universal banking, in particular, the risk of 'cultural clash' between the investment bank and the retail/commercial bank and the potential for investment banking activities to be funded with retail/commercial deposits. However, the management of risk, which encompasses maturity transformation, managing liquidity, interest rate risk and credit risk is at the heart of a universal banking model.
- However, whilst accepting that it will happen, many investors are unconvinced about the real benefits of ring-fencing and/or separation and are sceptical about the benefits relative to the operational costs and disruption. Other investors welcome the perceived benefits of ring-fencing.
- It is vital that derivative activities supporting SME and commercial banking be carried out within the ring-fence. Not allowing such activities may make the ring-fenced activities more, rather than less, risky.
- Isolation of higher risk trading books may be better achieved via a Liikanen/Volcker approach rather than an ICB approach. Higher risk trading books are already being unwound in response to Basel 3 and ahead of any ring-fencing legislation.
- Ease of resolution may be better achieved by marginally higher core tier 1 ratios determined by portfolio mix.

Balance between Resilience and Competition

- A robust banking system necessitates capital and liquidity requirements, which of themselves will form barriers to entry.
- The relative failure of the larger building societies which demutualised in 1997-2000, indicates the difficulties of establishing new challengers.
- This is reinforced by the challenges facing the remaining building societies.
- Nonetheless, the market for retail deposits appears structurally quite competitive.
- The market in retail and wholesale banking may develop to a structure where (i) four or five banks have sufficient scale to achieve economies of scale, from which all stakeholders can benefit, plus (ii) a number of more focused 'niche' businesses that offer specialist services, through smaller branch networks, or online, or via intermediaries.

Financial Impact of Regulation

The cost of revised regulation is potentially significant and is likely to increase pressure on banks to improve asset margins.

- Analysis of the impact on the 2011 ROEs of three banks of the effects of regulation indicates a reduction of between 3.1% and 4.1% – a significant headwind. This takes no account of potential future additional equity requirements, potential additional funding costs arising from ring-fencing or conduct-related charges, e.g. PPI.
- Current average Return on Tangible Assets ("ROTA") across the banks is around 0.20% – 0.25%. We estimate that this needs to reach around 0.50% on average in order for banks to be able to meet their COE.
- Some potential mitigants are, however, available to the banks, for example:
  - Cost reduction – operating efficiency may well be the key differentiator for banks as profitability remains under pressure
  - Asset pricing – sector resilience may well be partly funded by customers as well as shareholders
  - Capital efficiency – banks' continued focus on ROA and ROE may well lead to further asset deleveraging
  - Strategic change – sale of businesses.

Dividends

Investors place weight on a clear distribution policy, to understand how a bank determines the balance between dividends, incentive payments and retention of earnings to bolster the capital base. In this respect, a clear dividend policy is vital.

- Dividends remain a key signal of management confidence in sustainable profitability and will be interpreted as an indicator of regulatory rehabilitation.
- Banks' management across the entire sector need to articulate a dividend policy to investors with the confidence and backing of regulators.

Section C – Principal findings: What investors require to gain confidence in UK banks

Overview

Investors want a secure and properly capitalised banking system and are supportive of regulatory reform, although banks' crucial social role in liquidity and maturity transformation means a truly "safe" system is unrealistic. Moreover, some investors expressed caution about imposing ever increasing layers of regulation formulaically, which are likely to affect adversely pricing and profitability. Investors require, above all:

- **Confidence in the future ability of the sector to achieve sustainable returns above the cost of equity and to re-establish dividend payments across the whole sector.**
- **Confidence in both the future operating and regulatory environment.** A subdued macro-economic outlook and anxieties regarding the Eurozone have undoubtedly affected investor confidence. However, it is clear that, at present, investor confidence continues to be affected not only by a number of operational matters and legacy issues, but also by apparent indecision around capital levels, capital structure and structural change e.g. ring-fencing.
- **Consistency in regulation with other jurisdictions.** Investors are concerned that, for example, the way in which bancassurers could be treated in the UK, compared with other European jurisdictions, may create an uneven playing field.

  The evolving global nature of capital markets heightens the need for a level international regulatory playing field, including strong international cooperation which reflects the international nature of most UK banks. Approximately 40% of the UK stock market is owned by overseas institutions. Since 2009, the value of ABI members' overseas equity investments has exceeded the value of domestic investments.

Profitability

The ability to forecast sustainable post tax ROE in excess of COE

Importance of ROE

Investors need a framework in which they can assess the potential post-tax ROE of the banks, both at any given point in time and through the cycle. Basic financial economics dictates that, if ROE remains structurally below COE, the equity of banks will remain essentially uninvestible.

It is the responsibility of a bank's board and management, on behalf of investors, to invest only in businesses where ROE exceeds COE, ensuring COE for the whole group is exceeded. If a bank continues to generate a low ROE, future asset growth will be naturally constrained, unless the bank can gear up on its core tier 1 by issuing additional tier 1 debt. This, of itself, is unlikely to be sustainable in the longer term.

A robust, sustainable post-tax ROE means a bank will internally generate sufficient capital to support future asset growth, whilst bolstering capital ratios, i.e. loss absorbing capacity, and enabling it to distribute a dividend. The biggest protection equity holders have against recapitalisation in bad times is a bank's ability to replace equity (when impaired) via retained earnings.

The apparent regulatory conflict between resilience and recovery is then effectively removed, as a robust ROE enables both of these objectives to be achieved, under the control of a bank's management team. Consequently, a robust sector ROE will have a significant beneficial effect on the broader economy, through enhanced direct lending and income distribution to pension funds and other investors, whilst improving capital ratios and loss absorbing capacity, counter-cyclically. If a bank can consistently deliver an ROE above COE, equity investors will be more prepared to invest and recapitalise the bank if and when required. A strong ROE across the sector is also required to attract new entrants to the UK banking sector.

Investors will also focus on estimating the level of impaired ROE in a company in a downturn and whether that is sufficient to limit the risk of dilution. Dilution becomes much more painful for shareholders once a company raises equity from a valuation lower than its book value (since it starts to have to raise a larger percentage of market cap for every percentage by which it needs to increase its regulatory capital), in what can become a negative spiral if distress is extreme. Investors' propensity to own shares in a bank must take account of the cost of dilution as well as the risk of dilution – and of the alternatives available elsewhere (other countries, other sectors). ROE therefore effectively regulates all of these factors.

In summary, adequate ROE is important to shareholders and regulators alike. In faster growth periods, the rate of capital generation regulates the speed at which a bank can grow its loan book to support the economy.

ROE, in isolation, without considering risk adjusted returns and leverage can be mis-leading (as discussed further in *Difficulties and Risks in Calculating ROE* below). However, equity investors ultimately value a bank by reference to the sustainable earnings power of its tangible net assets and that must start with ROE. Alternative measures of profitability are useful in understanding the quality of profitability, but are not strong enough to be alternative main measures.

Difficulties and Risks in Calculating ROE

Whilst underlining the importance of ROE, we recognise the difficulties and risks in calculating it, and of the behavioural risks of capital allocation decisions in a bank run solely or primarily on the basis of ROE. Specific difficulties include:

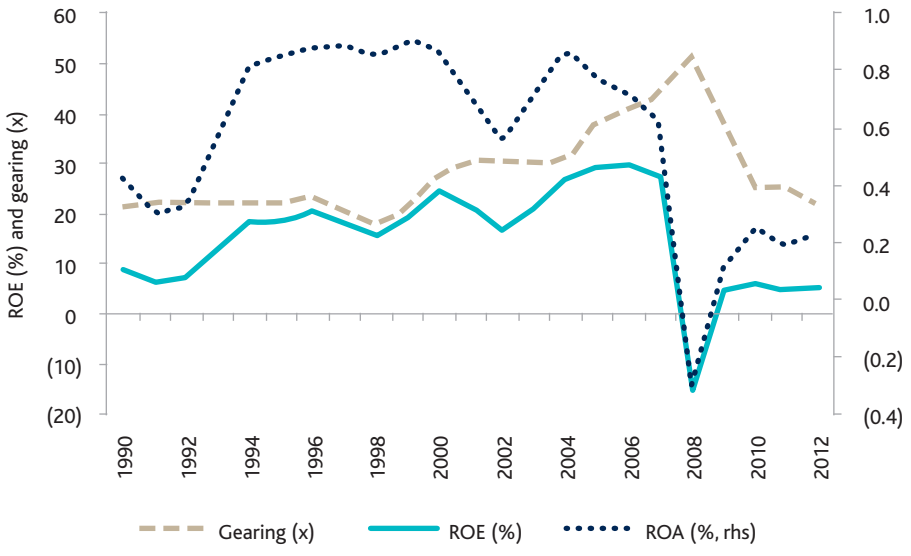
- the ROE numerator will contain some profit or loss from trading activities, part of which will be struck on a 'mark-to-model' basis. The financial crisis highlighted the limitations of many of these models. Investors are mindful of this and seek to assess the extent to which profitability is being driven by trading revenues and the basis on which those revenues are being accounted for
- accounting convention dictates that potential future losses on larger ticket loans cannot be recognised as a provision in current reporting. Therefore assets may, to some extent, be overstated at the point of 'fair valuation' in any period's accounts. Investors need to consider 'through-the-cycle' provisions when analysing a bank's profitability. Under UK GAAP, general provisions went some way to addressing this issue, enabling a management team to strike provisions based on their own assumptions around economic cycles, interest rates and unemployment.

Critically, however, ROE is the product of return on assets ("ROA") and asset leverage. The consequences of driving up profitability, by driving up leverage, remain all too fresh in investors' minds from the financial crisis.

That said, it would be wrong to assume that leverage is always a bad thing. For example, securitisation, properly regulated and monitored, provides a stable source of funding for mortgages, with matched maturities, lower interest rate risk and far lower liquidity risk than funding with retail deposits. However, securitisation will optically increase balance sheet leverage.

Investors recognise the need to focus on the fundamental drivers of a bank's ROA, i.e. net interest margins (asset yields and blended funding costs), efficiency ratios, the credit cycle and capital structure, whilst also looking at assets on a risk-adjusted basis:

Figure 1. UK Banks – ROA, gearing and ROE (1990-2012)



Source: Company data, Barclays research

- As the chart above illustrates, during the 1990s gearing (defined as gross assets: tangible equity, with assets including derivatives) was in the 18x-23x range (averaging 21x), with return on assets in the early half of the decade heavily affected by high impairments associated with a collapse in commercial and residential real estate values, combined with high levels of unemployment and therefore increasing loan arrears. However, by the end of the decade, return on assets had more than doubled, driving return on equity back up to 18%-20%. Almost immediately, in the post dot.com boom, gearing expanded to 30x, with profitability stabilising in 2003-04 at the levels seen in the second half of the 1990s. Gearing however, continued to climb through 2004-06, with return on assets averaging around 0.80%, resulting in a sector ROE of some 29%. The pattern since 2008 shows the impact of write-downs in asset values (and so significantly lower ROA), accompanied by rapid deleveraging, with sector gearing slowly returning to the levels seen in the first half of the 1990s.

Figure 2. UK Banks – ROA, gearing and ROE

	1990–2012		
	ROA (%)	**Gearing (x)**	**ROE (%)**
Max	0.91	51	29.5
Min	(0.30)	18	(15.3)
Avge	0.57	28	15.0
1990's			
Max	0.91	23	20.2
Min	0.29	18	6.4
Avge	0.68	21	14.4
2000-07			
Max	0.87	44	29.5
Min	0.55	28	16.5
Avge	0.73	34	24.6
2009-12			
Max	0.24	39	6.0
Min	0.12	22	4.7
Avge	0.20	28	5.1

Source: Company data, ABI analysis

- Quite miraculously, despite a brutal early 1990s recession, a post dot.com slump and a near-fatal (fatal for some) financial crisis, the sector has delivered an average ROE (see table above) since 1990, of 15%. Gearing has averaged 28x since 1990, with ROA averaging 0.57%. However, ROA and gearing have varied significantly along the way, with the last decade's pattern, for reasons now widely understood, being quite different from the 1990s' pattern. With hindsight, a 14% return on equity in the 1990s, based on 21x gearing, appears to be a not unreasonable balance between gearing and profitability, although the first half was very different from the second half. The 2000-07 period of high gearing delivered, arguably, excess profitability. In the table above, we have excluded the sector's heavy losses in 2008. Since then, gearing has been reducing rapidly and ROA is a shadow of its former self. If gearing of 25-30x, i.e. an equity: gross assets ratio of 3.3%-4.0%, turns out to be acceptable to regulators, then management need to drive ROA back up to the 0.40-0.48% range, more than doubling the recent run-rate, in a low interest rate environment with high liquidity buffers.

- Longer run historical data for the sector shows that the average ROE from the 1920's through to the late 1960's averaged 7.0%. We have not examined the reasons for such low profitability, but would highlight that the liquid asset ratio appeared to be 30% in the late 1960's, reducing steadily to around 5% by the late 1970's.

An attempt to 'maximise' ROE, particularly in the short-term, can create excessive risk-taking, under-investment, or short-term uncompetitive pricing. If a bank appears to be generating an ROE that is out of line with the banking cycle or with its peer group, investors will need to understand why.

We believe these risks are recognised by both banks' management and investors, with management teams attempting to focus on medium-term sustainable ROE targets, although lack of clarity on capital levels makes this particularly challenging.

We recognise that public perception of the banking industry is such that the very notion of a bank making a profit may, for many, be quite abhorrent. We would therefore stress that:

- a profitable banking system can self-fund loan growth, increase resilience through internally generating loss-absorbing capacity and pay dividends to shareholders. A healthy banking system, with sustainable profitability, is beneficial to the broader economy

- arguably, shareholder value (one measure of which is the profitability generated above cost of equity) can only be based on successfully creating customer value i.e. the combination of attractive products, competitively priced, backed up with superior service. Under-investing or over-pricing is unlikely to deliver sustainable growth and profitability.

Assessment of sustainable ROE

ROE is, as stated above, the product of (i) return on assets and (ii) leverage. Certainty around acceptable regulatory leverage levels, whether a simple assets: equity ratio or risk weighted, will determine appropriate capital levels and is therefore a vital first step in determining a sustainable ROE.

Ring-fencing or separation, once complete, should enable investors to assess risk and return both within and outside the ring-fence. Different considerations arise for Retail Banking and Investment Banking.

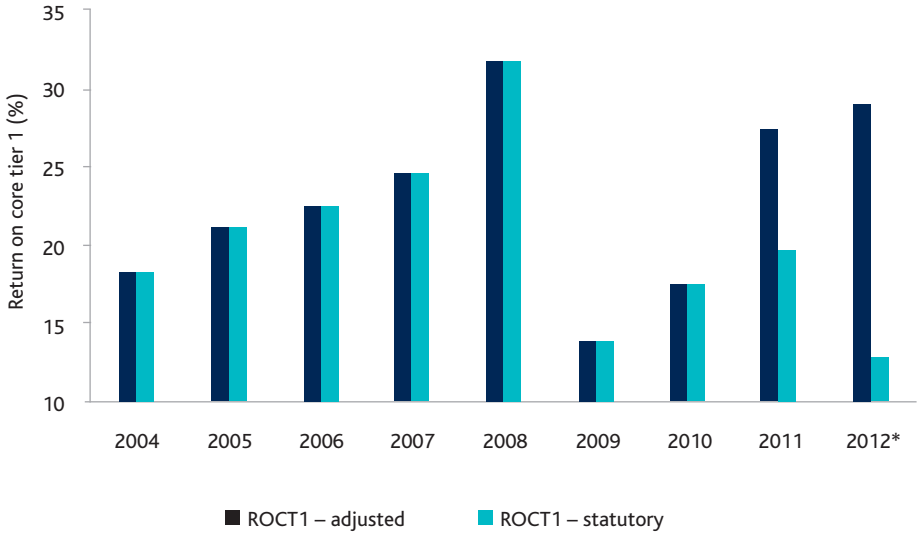
Retail Banking profitability

Retail banking profitability is a function of (i) product mix, including the secured nature of mortgage lending versus the unsecured nature of credit card lending, (ii) efficiency ratios, and (iii) charges and provisions relating to prior year practices e.g. PPI claims, interest rate swap mis-selling.

Charges and provisions are having an increasing impact. We illustrate below the profitability of Barclays' Retail Banking business from 2004-2012, both at the statutory level (including PPI provisions) and adjusted (excluding PPI provisions). From 2004-09, the division was named UK Retail Banking but, since 2009, has been renamed UK Retail and Business Banking, so there may be some data continuity

issues. However, subject to this, between 2004 and 2008, return on core tier 1 (assuming 10% core tier 1, 2004-09, and then reported group core tier 1 ratio thereafter) averaged 24%, with a peak of 32% and a trough of 18%. This compares with a return on core tier 1 averaging 16% in the 2009-Q3/2012 period, heavily affected by PPI provisions of £1,250m for the Retail Banking business (excluding Barclaycard) in 2011 and 2012. The adjusted return on average core tier 1 (pre-PPI provisions) averaged 22% in the 2009-Q3/2012 period.

Figure 3. Barclays Retail Banking, Return on Core Tier 1 (ROCT1) 2004-Q3/2012



Source: Company data, ABI analysis, *2012 = 9M,2012 annualised

Whilst it is of course appropriate for prior mis-selling processes to be addressed, investors are mindful of both:

- the profound impact that conduct authority charges may have on the prospective profitability (and capital levels) of Retail Banking businesses, with, for example, interest only mortgages and bundled current account charges now likely to come under investigation; and
- the longer-term risk that strong headline ROEs may be capped through further regulatory scrutiny in the form of, for example, price controls.

Investment banking profitability

Profitability will vary significantly according to business mix and the broader macro-economic cycle. As Basel 3/CRD IV is implemented, we would expect ROEs to come under further pressure with management seeking to exit higher capital intensity businesses and develop lower capital intensity (fee based) businesses. UBS's announcement (30th October 2012) on reshaping its investment banking business may provide a useful template of how restructuring could happen. Investors will want assurance that ring-fencing will not require 'fast-forwarding' of Basel 3, with businesses outside the ring-fence immediately funded and capitalised on a standalone basis.

Cost of Equity

Cost of equity will in turn be influenced by (i) capital levels (ii) earnings volatility (ii) business mix. Levels of core tier 1 capital and degree of separation or ring-fencing are therefore pivotal in assessing cost of equity. Discussions would suggest that cost of equity for a Retail Banking business might be in the range of 8%-10%, with Investment Banking around 15%. Thus a blended Universal Banking cost of equity might initially be in the 11%-12% range.

Investors broadly agree that a better capitalised, more liquid bank should have a reduced cost of equity over time. Investors are keen for management to articulate their cost of equity, since management is allocating shareholders' capital across a variety of businesses with differing risks/returns. Moreover, it would be difficult to formulate an ROE target without having some notion of cost of equity. Investors in parallel will have their own views re COE.

Deleveraging of investment banking and restructuring into less capital intensive activities should, in theory, reduce the blended cost of equity for a universal bank, as should an increase in core tier 1 capital. However, a bank's leverage and inherent earnings volatility will continue to be reflected in a relatively high beta, creating a structural limitation to any reduction in cost of equity.

Regulatory Risks

Confidence in the regulatory environment

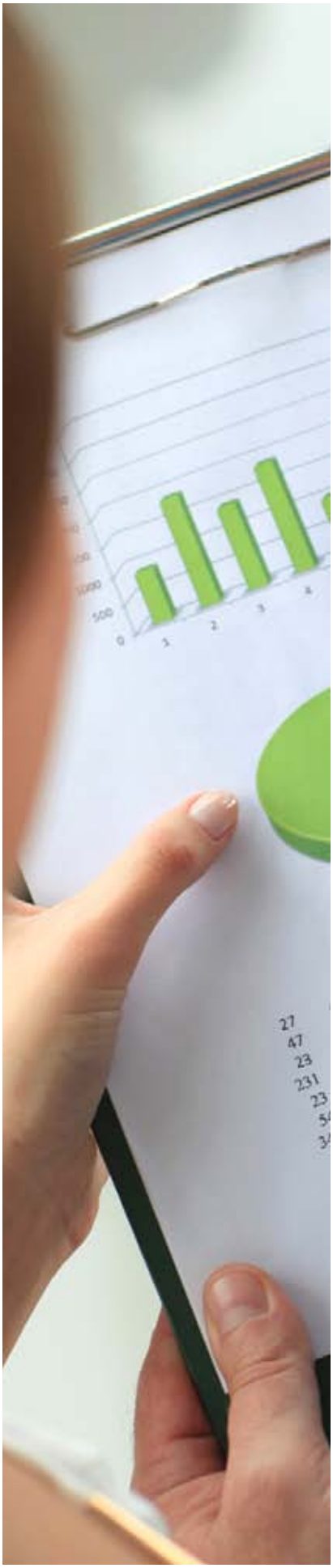
Economic environment and legacy issues

Andrew Bailey (Managing Director, Prudential Business Unit, FSA and Executive Director, Bank of England) suggested in a recent speech (BBA Annual Banking Conference) that UK banks' low price: tangible net asset values were indicative of investor concerns regarding banks' capital ratios, with capital levels likely to be impacted by (i) further asset write-downs, exacerbated by the current accounting regulations which do not allow recognition of future loans losses (ii) tail risks, e.g. a disorderly Eurozone break-up, (iii) higher funding costs with limited asset re-pricing potential (iv) structural uncertainty and costs e.g. ring-fencing.

It is clear that UK banks' valuations are also weighed down by a range of legacy issues, including: PPI mis-selling provisions, Ireland real estate exposure, UK commercial real estate exposure, potential LIBOR litigation, interest swap mis-selling and, now, the prospect of investigations into interest-only mortgages and 'bundled' current account charges. In order to contain uncertainty around 'conduct charges' we would support the CBI's recent suggestion that the government considers introducing a statute of limitations for all PPI claims, capping the time period during which legal proceedings can be initiated.

Whilst these factors, by their very nature, are difficult to forecast, the equity market tends to stress-test net tangible asset values by deducting a likely 'worst case' net provision, i.e. treating it as a "one-timer" and so, in effect, applying a P/E of 1.0x.

UK banks' share prices have enjoyed a recent rerating, effectively following the tightening of 5-year credit default swap (CDS) spreads, in turn reflecting improved



confidence in Eurozone resolution, Relaxation in liquidity requirements has also recently helped UK banks' share prices. Five year CDS spreads have tightened by 10-20% during the last three months and by around 25% during the last six months. Share prices of the three domestic banks, Barclays, Lloyds Banking Group and RBS Group, have increased around 25% in three months, with more muted share price rises for HSBC and Standard Chartered.

Notwithstanding the recent domestic bank share price rally, Barclays, Lloyds Banking Group and RBS Group are still only trading on price to forecast 2012 tangible net asset values averaging 0.6x, with HSBC and Standard Chartered trading on 1.12x and 1.35x respectively. Following this rally, we note a more cautious tone to recent sell-side broker reports, with some trimming of recommendations, reflecting essentially continued regulatory uncertainty, as discussed further below.

Regulatory uncertainty and inconsistency are, however, themselves a significant investor concern. Lack of clarity regarding capital levels, and the apparent conflict between resilience and recovery, are muddying the investment case for UK banks, limiting a further rerating of share prices relative to earnings and tangible net asset values.

Investor appetite is significantly adversely affected by lack of regulatory clarity, as well as by concerns that the UK may impose more stringent requirements than other jurisdictions. Investors are also looking for an integrated approach, as opposed to piecemeal reform. Continuing uncertainty over the structure of the industry and the regulatory environment impairs the ability of the sector to help finance growth.

Confidence that the banks hold sufficient core tier 1 capital

Concerns in relation to Core Tier I capital levels arise in a number of areas:

- investors need to understand if the change of emphasis from core tier 1 ratio to absolute levels of capital is permanent or part of a more temporary mechanism to facilitate asset growth
- investors are seeking a deeper understanding of the ICB's 10% core tier 1 guidance. In fact, some investors believe the stock market, rather than regulators' prudential risk analysis, may have led the debate to the conclusion that 10% was the "right" core tier 1 ratio, taking into account a counter-cyclical buffer or G-SIFI/ SIFI layer above the Basel 3 minimum 7%.

Banks must be correctly capitalised but not over-capitalised. Downward pressure on ROE (through expansion of the denominator) can even – paradoxically – increase risk as management teams may be tempted into investing in higher return (and therefore higher risk) activities in order to meet cost of equity. Excess capital and low ROEs are also likely to result in upward asset re-pricing, with the customer picking up part of the cost for increased regulation. This trend is already apparent in mortgage pricing where spreads above the 5-year GBP swap rate have widened by around 200 basis points since the end of 2010.

It is accepted by investors that the price of increased capital and regulation will reduce ROEs. However, investors need to be equipped with the information to assess the likely scale of ROE contraction. Only then can investors assess what

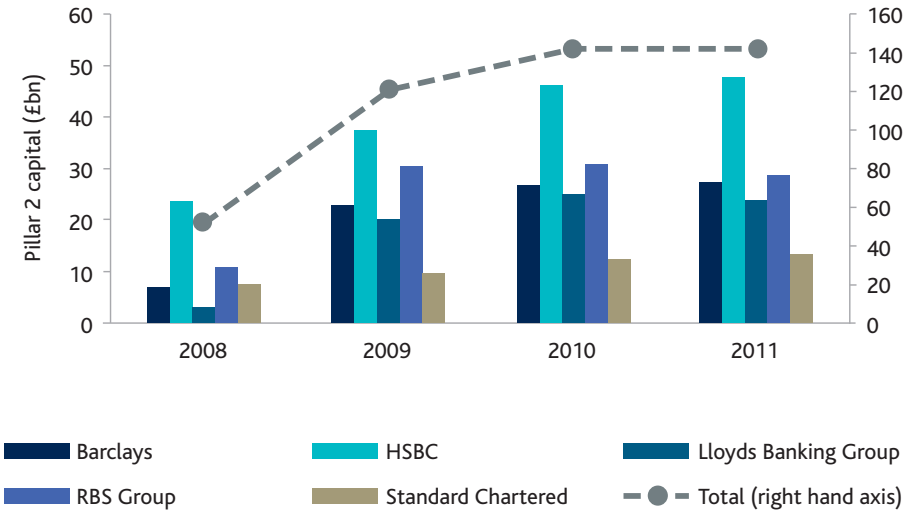
can be done to mitigate the ROE impact through cost reduction and/or asset re-pricing. Conversations with banks' management indicate that successful operating costs' reduction will be key and perhaps the primary differentiator among banks in the near-term, where the revenue outlook remains subdued.

- investors need the confidence that a bank is operating with a core tier 1 ratio above the regulatory minimum. However, explicit publication of locally agreed capital buffers (referred to in one meeting as 'concrete buffers') may only serve to heighten investor anxiety during the down-leg of a cycle. A locally agreed capital buffer should provide banks' management and regulators with time to take the necessary action as credit or broader market conditions deteriorate. Recent history tells us that this time may not be available once markets perceive problems; debt markets effectively anticipate and discount the likely impact of the credit cycle on a bank's capital base, almost immediately, through shifts in yield curves, risk premiums above government bond yields, and credit default swap rates

- investors are also seeking a better understanding of Pillar 2 capital, its allocation across banks' business sectors and how Pillar 2 capital requirements will be integrated with Basel 3. Pillar 2 is where supervisory judgement is applied to overlay the capital applied to risk assets under Pillar 1. As Andrew Bailey highlighted in his BBA speech, Pillar 2 capital has increased from just under £20bn to £150bn, of which £100bn is held across the sector in 'Capital Planning Buffers'

The chart below illustrates growth in Pillar 2 capital since 2008. Since it is unclear how Pillar 2 capital is allocated, we have assumed that 50% of the Pillar 1 capital (note: Basel 2 requires Pillar 1 capital: RWAs to be 8%) is core tier 1. Therefore we treat all core tier 1 capital above 4% as Pillar 2. The bars depict Pillar 2 capital growth for each bank (left-hand axis) and the line indicates, based on our estimates, growth in sector Pillar 2 capital to above £140bn in 2011 (right-hand axis).

Figure 4. UK banks – Pillar 2 capital growth (2008-11)



Source: Company data, ABI estimates

- investors are concerned that, for example, the way in which bancassurers could be treated in the UK, compared with other European jurisdictions, may create an uneven playing field. For example, Article 46 of CRD IV allows greater recognition of bancassurers' insurance assets, compared with Article 45. Interpretation of the ruling is left to national regulators and the concern is the FSA may take the more stringent approach, absorbing capital that could be deployed commercially.

Other areas of potential inconsistency include; liquidity, treatment of sovereign exposures risk weightings, Primary Loss Absorbing Capacity (PLAC), ring-fencing, the solo capital regime and the UK bank levy.

- clarification is also needed on whether ratios will be viewed by regulators under transitional rules or on a 'fully-loaded' basis.

Confidence in measuring and comparing asset risk

Background

Investors require consistency across the sector in calibrating risk weightings on banks' asset portfolios and therefore in estimating capital requirements. It is apparent from investor meetings that confidence in Basel 2 Internal Ratings Basis (IRB) as a basis for making these comparisons is low. Cross-sector risk comparisons are therefore distorted and international comparisons become extremely challenging.

At the recent Prudential Regulation Authority (PRA) launch conference (October 22nd), David Rule (Director, International Banks Division, Prudential Business Unit, FSA) emphasised, during Q&A, that the PRA's prime objective was to ensure banks are adequately capitalised and will use a combination of Basel-standardised, Basel-IRB, simple leverage and banks' internal models to assess risk and capital requirements. From a regulatory perspective, this is a pragmatic approach. However, it is likely to increase, rather than reduce, opacity for investors in understanding and comparing capital requirements across the sector.

Investors' views on risk-weighting methodology

Barclays' European Banks Equity research team conducted a detailed survey of investors earlier this year (Bye-Bye Basel? May 2012) specifically to understand investors' views on RWA calculations. The survey covered 130 equity investors, representing 100 institutions, with approximately $6trn of equities under management. The investor base surveyed was 41% UK, 26% European and 30% US based. Long-only investors represented 72% of responses, with hedge funds representing 28%.

The charts over-page set out the results of the investor survey. The key conclusions were:

- around half the investors surveyed had a very high level of distrust in RWAs, with hedge funds more sceptical than long-only funds, and US investors more sceptical than European investors

- confidence in RWAs reduced dramatically during the year leading up to the survey

- an overwhelming majority of investors believe that the RWA calculation should be simplified with the model discretion currently enjoyed by the banks removed.

Figure 5. How much do you trust risk weightings?

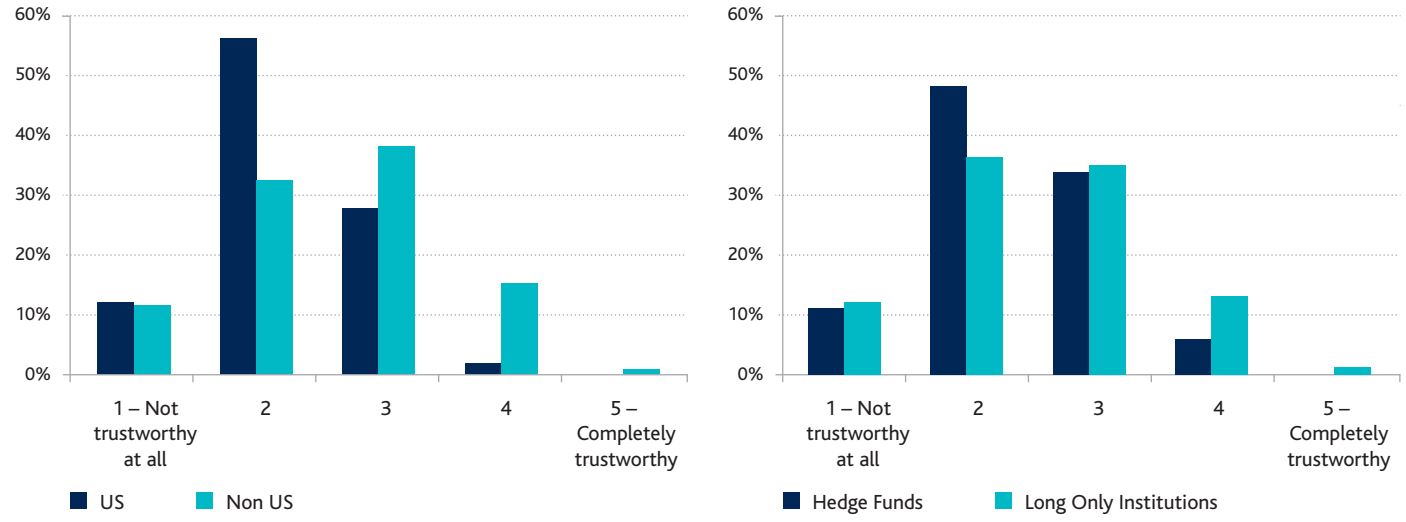


Figure 6. Has your confidence level in RWAs gone up or down over the past year?

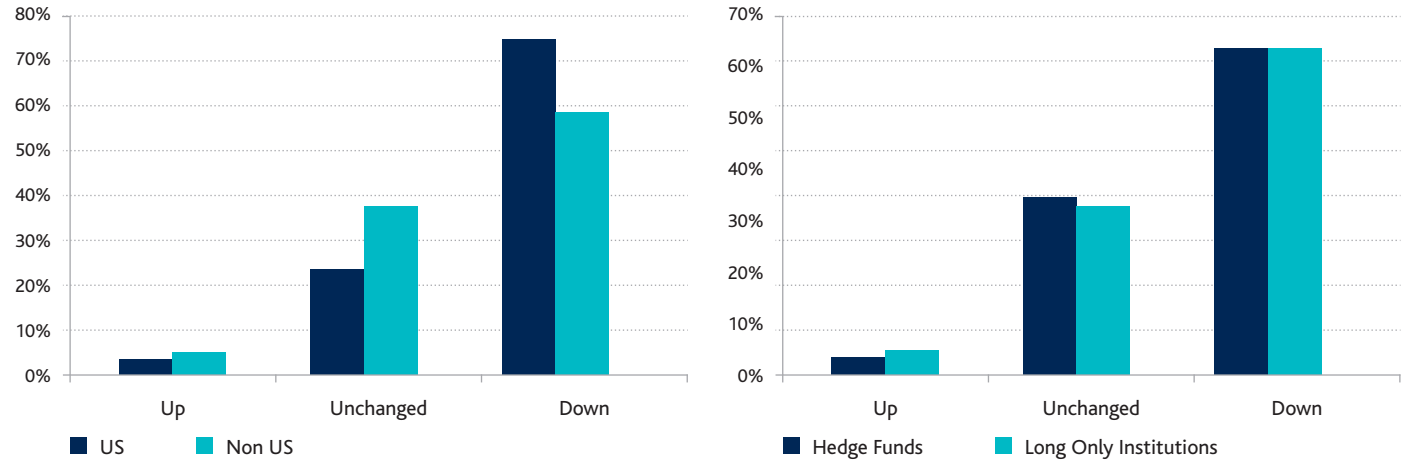
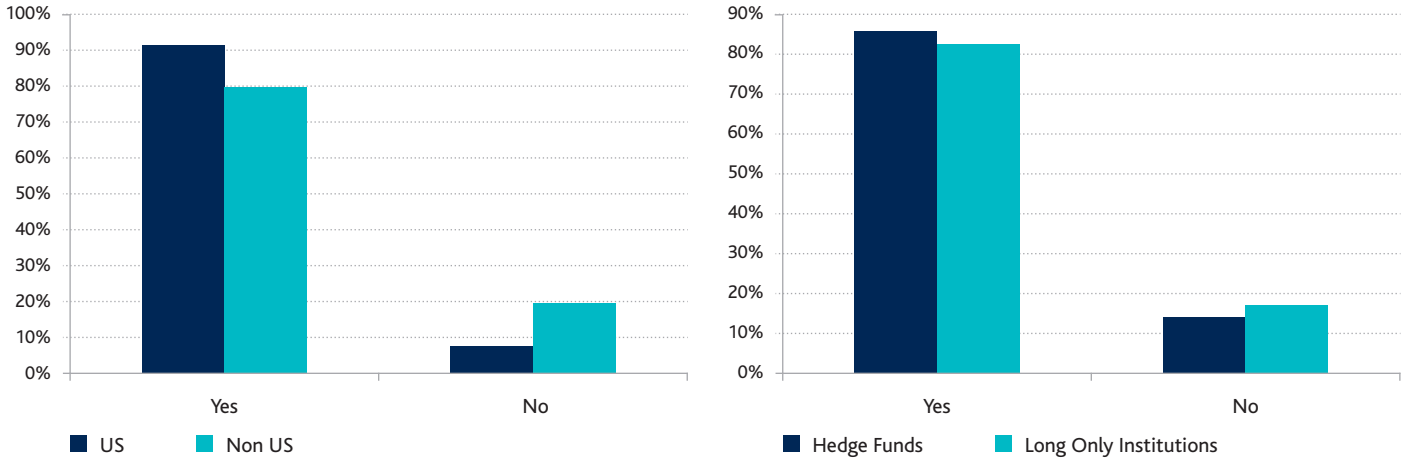


Figure 7. Should the risk weighting calculations be simplified/made more transparent?



Source: Barclays research; RWAs Investor Survey (Bye-Bye Basel? May 2012)

Observations and conclusions

- The European Banking Federation (EBF) has highlighted the disparity in risk weightings of mortgage portfolios in Europe, with risk weightings ranging from 17% to 84%.
- We highlight similar disparities on UK portfolios, which, together with the apparent low risk weighting, are undermining investor confidence in the mortgage risk weighting methodology.
- There are similar inconsistencies on corporate loan portfolio risk weightings.

The potential solutions are:

Returning to a Basel 2 standardised approach

We believe this would be:

- regressive, primarily because the IRB approach is firmly entrenched in UK banks' capital allocation models
- potentially damaging, as the additional core tier 1 capital requirements would be substantial. Barclays' European Banks equity research team estimate that, across Europe, reversion to a standardised approach would reduce estimated 2013 core tier 1 to 7.6% from 9.9%. For the UK banks, the core tier 1 impact of returning to a standardised model would range from 1.4% for Barclays (based on consensus forecasts) to 1.6% for HSBC, 1.8% for RBS Group and 2.7% for Lloyds Banking Group.

Adopting simple leverage

Whilst a gross leverage ratio (core tier 1: assets) offers simplicity, it encourages banks to originate and retain higher margin assets. It will therefore benefit banks pursuing a strategy of securitising lower-margin assets, in conjunction with an originate/hold strategy for higher margin, higher risk assets. Moreover, banks regulated purely on this basis are likely to pursue such a strategy. A regulatory regime based on simple leverage will generate different 'banking behaviour' compared with a risk-based regime.

We estimate that the UK banks have core tier 1: tangible assets (excluding derivatives) ranging from 3.85% to 5.95%, compared with 2.61% to 5.30% based on gross assets (including derivatives). Investors are supportive of using a backstop leverage ratio, in conjunction with a risk weighted approach, however it is important that regulators recognise that whatever is agreed for simple leverage will have immediate implications for a risked approach, since both approaches will use the same numerator.

Modifying mortgage risk weightings

Recent research by the Morgan Stanley UK Banks' equity research team considers three scenarios for improving and narrowing the range of risk weights on UK mortgage portfolios:

- applying a 20% risk weighting floor would increase the aggregate core tier 1 requirement for the UK quoted banks, plus Santander UK and Nationwide, by around £9.5bn
- returning to a standardised approach on mortgage risk weighting would increase core tier 1 capital requirements by £17bn for the same group
- applying a 4% gross leverage ratio to the mortgage portfolio would increase the core tier 1 requirement by more than £20bn.

We doubt fresh equity is readily available to improve the capital backing of UK mortgages and increasing capital allocations organically would completely choke off credit growth.

Improved disclosure.

The Enhanced Disclosure Task Force (EDTF) which was established by the Financial Stability Board in May 2012, recently published its first report 'Enhancing the Risk Disclosure of Banks', 29th October 2012. In its recommendations on capital adequacy and risk weighted assets, the EDTF specifically recommended that:

- banks provide a reconciliation of the accounting balance sheet to the regulatory balance sheet i.e. effectively a bridge which would explain the assumptions behind the risk weighting of the gross assets on the balance sheet
- banks provide detailed information to explain how risk-weighted assets relate to business activities and related risks
- there should be standardisation in presentation of information in the banking books showing average Probability of Defaults (PD), Loss Given Default (LGD) and Exposure at Default (EAD), RWAs and RWA density for each Basel asset class and major portfolios within the Basel asset classes.

In summary, abandoning IRB appears highly regressive. Moreover, a return to a standardised approach, whether on the entire portfolio or just on the mortgage portfolio would increase core tier 1 requirements substantially at a time when new equity is unavailable and when organically increasing capital ratios would have a significant impact on credit formation.

The ABI would be supportive of an IRB methodology, together with a simple leverage approach, augmented with significantly enhanced risk disclosures, reconciling accounting balance sheets with regulatory balance sheets.

Investors also need reassurances on asset quality. Credit risk disclosure in banks' annual results releases has expanded significantly in recent years. However, IFRS accounting convention disallows anticipated loss recognition, which, by definition, may result in some overstatement of assets. We also acknowledge the Bank of England's recent concerns regarding forbearance and its potential to understate impairments. However, banks' forbearance disclosure and impairment policy is

made quite clear in their annual reports and accounts. Whilst there may be a risk of under-stated impairments, we note from regulatory capital disclosures that the excess of aggregate calculated expected losses, above balance sheet impairment provisions, was £12bn at the end of 2011, 50% of which is treated as a core tier 1 haircut (and 50% from tier 2 capital). The deduction from core tier 1 capital was therefore £6bn, reducing the aggregate core tier 1 ratio from 11% (including Nationwide and Santander's UK business) to 10.7%. To the best of our knowledge, this regulatory deduction is not made in other banking jurisdictions.

Additional disclosure behind the Expected Loss calculation, together with enhanced disclosure on Pillar 2 capital buffers, would go some way to providing investor assurances on asset quality, in the absence under IFRS of a UK GAAP style general provision.

The remainder of this section considers these risk weighting issues in more detail.

Inconsistent mortgage risk weightings

The European Banking Federation (EBF) published (July 2012, 'Study on Internal Rating Based models in Europe') the results of a survey on the mortgages and mortgage risk weighting of 66 banks in Europe. The European residential mortgage market at the time of the survey accounted for 23% of loans and 75% of loans to households.

The survey highlighted that the ratio of risk weighted assets to total assets (RWA density), according to Pillar 3 disclosures ranged from 17% to 84% across the 66 banks. At the aggregated country level, the risk density ranges from 20% (Switzerland) to 64% (Portugal), with the UK at 38%. Differences between the jurisdictions should not be a complete surprise given differing economic outlooks, loan to value distributions, home ownership levels etc.

However, the survey also highlighted significant differences among the banks within individual jurisdictions. The EBF highlighted that RWA comparability and transparency are affected by the inconsistency of approaches to 'model add-ons' and layers of conservatism related to model uncertainty, model risk, data issues, cyclicality adjustments and other issues.

The EBF survey also highlighted that only half of the banks applied a through-the-cycle adjustment and, for those that did, the methodology used varied significantly. Some of the survey respondents adopted their own methodology, with other following regulators' requirements. Some of the European regulators had not published guidelines on rating philosophy, with many not requiring a cycle adjustment. The survey also highlighted that the banks' loss given default (LGD) modelling differed across a range of individual components e.g. use of empirical data (time periods, lack of defaults), use of discount rates, application and allowed number of loan-to-value (LTV) bands. Often this variation was the result of supervisory guidance and not bank-specific.

Banks highlighted in the survey that the LGD regulatory floor was interpreted in different ways i.e. at portfolio, segment or individual asset level or a combination of all of these. This, in conjunction with variances in default definition (number of past-due days), could create significant distortions.

Finally, the EBF identified divergences between banks, sometimes operating in the same jurisdiction. Differences in the definition of default, based on either EU definitions or the treatment of forbearance can significantly impact probability of default (PD) and LGD. Supervisors appear to be applying different criteria of default to banks in the same country, significantly affecting comparability.

The survey revealed differences in the historical data series, with time spans ranging from 5 to 27 years for PD and LGD calculations, with the longest track record covering two complete cycles, and the shorter series covering just the recent crisis.

Corporate risk weightings

Recent research from the Barclays European Banks equity research team ('The dog that dug' September 2012) highlighted a number of limitations in comparing risk-weightings:

- US versus European risk weighting comparisons are affected by the US's limited take-up of Basel 2 and the US regulatory regime historically based more on simple balance sheet leverage
- inter-bank comparisons across Europe are affected by differences in asset mix
- comparing the risk weightings of individual portfolios will be affected by the credit rating distribution within those portfolios.

However, the Barclays' team pointed out that there should be greater comparability in comparing risk weightings on sub-sets of portfolios e.g. the AAA-tranche, single A-tranche, or BBB tranche of different banks' corporate loan books. However, even this comparison highlights significant diversity in risk-weights. The table below illustrates the range of risk weighting across the team's European coverage list for sub-sets of loan portfolios.

Figure 8. Corporate risk weightings by ratings (%)

	AA rated	A rated	BBB rated
Simple average risk weight	14	23	45
High risk weight	27	31	66
Low risk weight	6	13	29
Risk weight range	21	18	37
Range as a multiple of average (X)	1.5	0.8	0.8

Source: Barclays research

To some extent, a broad risk-weighting range is understandable on the lower-quality tranches. The risk weight on the BBB tranches ranges from a high of 66% to a low of 29%, with the risk weight range (37%) being 0.8x the simple average of the range (45%). However, intuitively, the range of risk weighting on the better-rated tranches should be tighter, yet this is not the case. For the AA-rated portfolio, the range of ratings is 1.5x the simple average risk weighting (14%) with the range spanning from a high of 27% to a low of 6% i.e. a risk weight range of 21%.

There are two potential reasons why the RWA density may differ between portfolios with identical credit ratings:

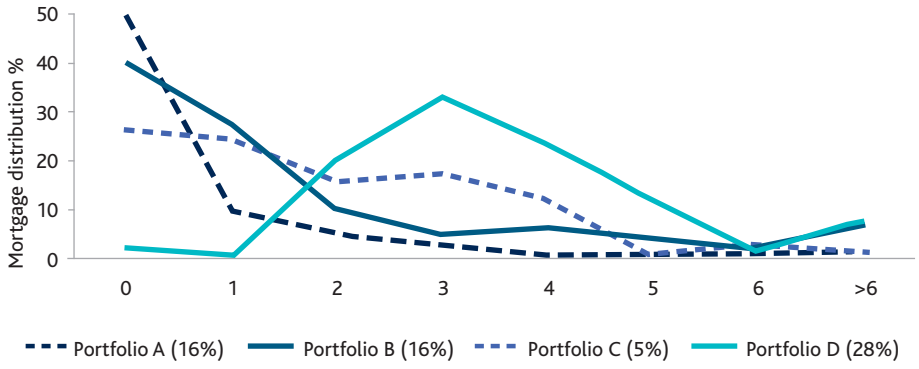
- collateral, which would therefore impact loss given default percentages
- risk weighting of the exposures at the very top, or very bottom, of an individual credit rating tranche

As the Barclays team points out, neither of these factors is observable in Basel 2, Pillar 3 disclosures and, in any case, neither is likely to distort portfolio risk weightings to the extent illustrated in this analysis.

Confidence in UK banks' risk weightings

As the EBF highlighted, mortgage risk weighting disparities do exist between banks within individual countries and Barclays' research has also highlighted the range of risk-weightings across individual corporate loan tranches. Against this background, we reviewed in more detail (i) mortgage portfolio risk weightings in the UK banks and (ii) risk weighting on higher rated UK corporate portfolios.

Figure 9. Mortgage distribution by PD band and RWA density (Basel 2, IRB basis)

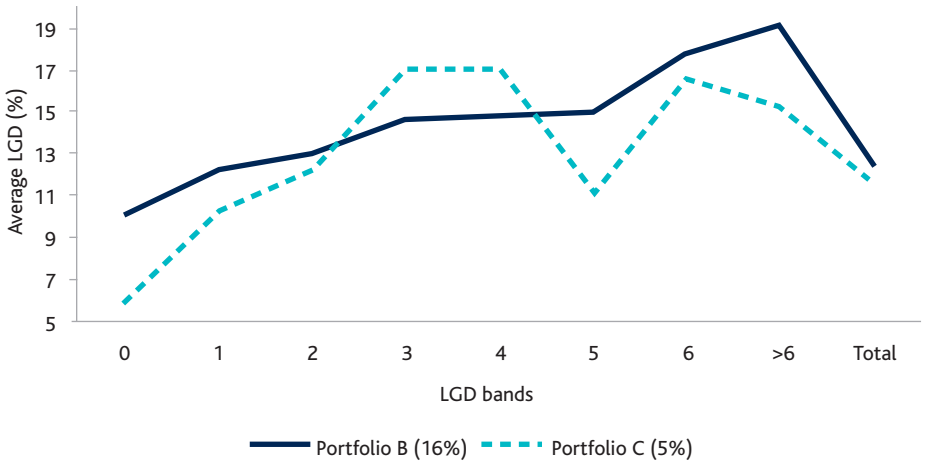


Source: Company Pillar 3 disclosures and ABI analysis

The chart above compares mortgage portfolio distribution by probability of default (PD) band for four mortgage portfolios on an IRB basis. The PD bands categorise the risk of default from low probability of default (band zero or one) through to high probability of default. Different banks will have varying numbers of bands and varying 'band-width' according to their own internal credit risk management approach. The legend highlights the RWA density for each portfolio i.e. the ratio of RWAs to total assets. To ease comparison, PD bands above band no.6 (including the default category) have been consolidated – hence in certain cases there is an increase in weightings at the lower end of the credit quality scale.

Portfolio A appears to be of a very high quality, with exposure skewed to the low PD bands, reducing rapidly to low exposure in the high PD bands. Optically, Portfolio A appears to be of a better quality than the other three portfolios, yet, at 16%, it has the second highest RWA density. Portfolio C appears to be of lower quality compared with Portfolio A and, arguably, with Portfolio B, yet its risk density is just 5%.

Figure 10. Mortgage distribution by LGD band and RWA density

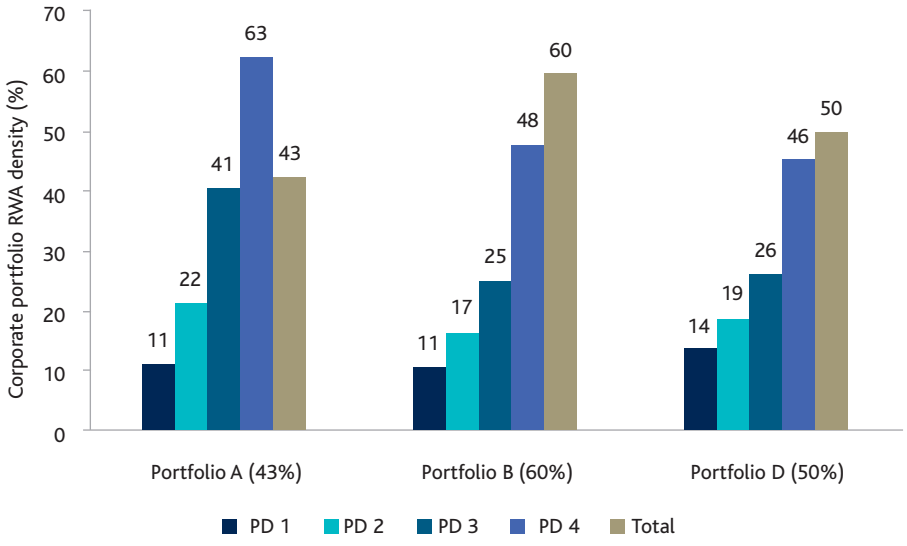


Source: Company Pillar 3 disclosures and Association of British Insurers analysis

Since probability of default is just one part of the Expected Loss equation (Loss Given Default and Exposure at Default being the other two parts), we have also looked at the distribution of mortgage assets across a range of loss given default bands. This information is only available on Portfolios B and C. Portfolio C appears to have lower loss given default rates (LGD) in most of the PD bands, apart from the mid-range bands 3 and 4. However, the weighted total loss given default of the two portfolios is broadly the same at around 12%. Whilst Portfolio C perhaps should have a lower risk density, it is not clear why it should be so much lower than Portfolio B's risk density, particularly when Portfolio B's risk density already looks low compared with the other portfolios.

The chart below illustrates the extent to which risk weightings vary across expected loss bands on three UK corporate loan portfolios. There is reasonable consistency for the first band (with RWA densities ranging from 11% to 14%).

Figure 11. Corporate loan portfolio RWA density, by PD bands



Source: Company data, Association of British Insurers analysis

The second band shows a deepening of the RWA range from 17% on Portfolio B to 22% on Portfolio A. However, the third and fourth bands have RWA density ranges of around 15% each with the lower bands (not shown here) RWA ranges increasing further.

This comparison suggests that really to understand and compare portfolio risk and to understand the variations in RWA density, Pillar 3 disclosures require additional data on collateral and industry/geographic exposures.

Potential solutions for improving risk weight clarity

Recent speeches and presentations from the FSA and the Bank of England would indicate that regulators will want to use a combination of risk-based measures and simple leverage. From a regulatory perspective this is pragmatic, but it is clear from the ABI's discussions with investors that there is little confidence in the Basel 2 IRB risk weighting framework. Yet the IRB approach, by definition, is the basis on which banks are calculating risk weighted assets and allocating capital. Abandoning IRB would therefore be a regressive step in UK banks' risk management. It would also have a substantial impact on the UK sector's core tier 1 ratios.

Reverting to a standardised approach

Barclays' European Banks team estimated that moving to Basel 2 standardised would reduce "fully loaded" core tier 1% ratios across the European sector by 2.3% from 9.9% to 7.6%. The estimate naturally assumes no change in core equity as this is calculated on a fully loaded 2013 basis i.e. as if the transition to Basel 3 was collapsed into one year. Therefore the core tier 1 reduction would be entirely attributable to a 30% increase in risk weighted assets, with 60% of the increase attributable to an increase in corporate portfolio risk weighted assets. The increase also assumes that the average risk weighting on mortgages increases from 19% under the IRB approach to 35% under the standardised approach.

For the UK banks, the core tier 1 impact would range from 1.4% for Barclays (based on consensus forecasts), to 1.6% for HSBC, 1.8% for RBS Group and 2.7% for Lloyds Banking Group. Standard Chartered was not included in the analysis.

Figure 12. Estimated European banks sector impact of moving to Standardised Approach

	Risk weights (%)		RWAs		Core tier 1
	IRB	Standardised	€m	€m	%
Current Basel 3 forecast 2013			6,992,094	693,104	9.9
Revisions:					
Sovereign	6.0	7.0	16,305		
Financial Institutions	18.0	45.0	338,647		
Corporates	48.0	86.0	1,276,857		
Mortgages	19.0	35.0	271,776		
Revolving credit	46.0	75.0	133,858		
Other	36.0	57.0	98,748		
Revised Basel 3 forecast 2013			9,128,285	693,104	7.6
% change in RWAs			31		

Source: Barclays research

Simple leverage

Whilst a leverage ratio (core tier 1: assets) offers simplicity, it can encourage banks to originate and retain higher margin assets. It will therefore benefit banks pursuing a strategy of securitising lower margin assets, in conjunction with an originate/hold strategy for higher margin, higher risk assets. Moreover, banks regulated purely on this basis are likely to pursue such a strategy. A regulatory regime based on simple leverage will generate different 'banking behaviour' compared with a risk based regime.

The table below compares core tier 1 leverage ratios for the UK banks, based on assets (net of derivatives) and gross assets, with core tier 1 capital to RWA ratios at H112. Net of derivatives, the UK banks would comfortably meet the Basel 3 backstop leverage ratio of 3%. However, the Basel 3 requirements actually require the ratio to be applied at the gross asset level and including undrawn commitments. This appears punitive, particularly since, under US GAAP, US banks would net derivative assets and derivative liabilities.

Figure 13. UK banks – core tier 1 capital measures at H112 (%)

	Barclays	HSBC	Lloyds	RBS Group	Stan Chart	Total
Core tier 1: assets, net of derivatives	3.85	5.76	4.17	5.30	5.95	4.94
Core tier 1: gross assets	2.61	4.93	3.90	3.40	5.30	3.82
Core tier : risk weighted assets	10.9	11.3	11.3	11.1	11.6	11.2

Source: Company data, ABI estimates

Expanding the mortgage risk weights

Morgan Stanley's banks and economics team, in a recent note ('Increasing UK mortgage risk weights, October 4th 2012') examined three scenarios for mortgage risk weights:

- Scenario 1: Imposing a floor on risk weights of 20%
- Scenario 2: Reverting to Basel 2 standardised approach
- Scenario 3: Applying a gross leverage ratio of 4

Figure 14. Mortgage risk weighting scenarios (£m)

		Scenarios		
	Base case	**1**	**2**	**3**
	2013e	RWA floor=20%	B2-standardised	4% leverage ratio
UK mortgage RWAs	144,417	241,506	317,998	363,426
Additional mortgage RWAs	-	97,089	173,581	219,009
Group RWAs	2,642,449	2,739,538	2,816,030	2,861,458
Group RWAs increase from base	-	4	7	8
Group CT 1 capital	257,615	257,615	257,615	257,615
Group CT 1%	9.7	9.4	9.1	9.0
Capital requirement	-	267,080	274,538	278,966
Capital shortfall	-	9,465	16,923	21,351

Source: Morgan Stanley research

The Morgan Stanley base case for 2013 is an aggregate core tier 1 ratio of 9.7% for the five quoted large capitalisation banks plus Nationwide and Santander UK. The risk weighted asset and capital impact of alternative risk weightings is summarised below:

- Scenario 1 – imposing a 20% floor to risk weightings would increase aggregate mortgage portfolio risk weighted assets by around £97bn (from a £144bn current base case for mortgages), increasing group RWAs by 4%. The group core tier 1 ratio would reduce to 9.4% (from 9.7% base case), so the core tier 1 capital shortfall under this scenario would be approximately £9.5bn.
- Scenario 2 – returning to a Basel 2 standardised approach would increase mortgage portfolio RWAs by £174bn, or 7% of group RWAs. The group core tier 1 ratio under scenario 2 would be 9.1% i.e. a capital shortfall of almost £17bn compared with the base case.
- Scenario 3 – applying a 4% backstop leverage ratio (i.e. tangible equity: tangible assets) to the aggregate mortgage book would create a £21bn capital shortfall. RWAs do not actually increase under this scenario – the RWA increase in the above table is used to calculate the additional core tier 1 requirement.

The Morgan Stanley scenarios are illustrative only, but effectively highlight the 'resilience versus recovery' conflict. It is highly unlikely that equity shareholders would be prepared to invest up to a further £20bn in the UK sector simply to enable UK banks to comply with revised leverage regulation. The alternative therefore would be for banks to deleverage further, starving the housing market of credit, working in the opposite direction to the Bank of England's Funding for Lending scheme.

Bridging the gap between assets and risk weighted assets

The Enhanced Disclosure Task Force (EDTF, established by the Financial Stability Board in May 2012) recently presented its recommendations and findings ('Enhancing the Risk Disclosure of Banks', 29th October 2012) to Mark Carney, Chairman of the Financial Stability Board. The report was compiled by private sector stakeholders as a joint initiative representing both preparers and users of financial reports. The primary objectives of EDTF are to:

- develop fundamental principles for enhanced risk disclosures
- recommend improvements to current risk disclosures, including ways to enhance their comparability
- identify examples of best or leading practice risk disclosures presented by global financial institutions.

Resulting from its initial meetings the EDTF established seven principles for risk disclosure. Specifically, risk disclosures should:

1. be clear, balanced and understandable
2. be comprehensive and include all of the bank's key activities and risks
3. present relevant information
4. reflect how the bank manages its risks
5. be consistent over time
6. be comparable among banks
7. be provided on a timely basis

In its recommendations on capital adequacy and risk weighted assets, the EDTF specifically recommends that banks provide a reconciliation of the accounting balance sheet to the regulatory balance sheet, i.e. effectively a bridge which would explain the assumptions behind the risk weighting of the gross assets on the balance sheet. The task force also recommended that banks provide detailed information to explain how risk-weighted assets relate to business activities and related risks. It also highlights the need for standardisation in presentation of information in the banking books showing average probability of defaults (PD), Loss Given Default (LGD) and Exposure at Default (EAD), RWAs and RWA density for each Basel asset class and major portfolios within the Basel asset classes.

Investors also need reassurances on asset quality. Credit risk disclosure in banks' annual results releases has expanded significantly in recent years. However, IFRS accounting convention disallows anticipated loss recognition, which, by definition, may result in some overstatement of assets. We also acknowledge the Bank of England's recent concerns regarding forbearance and its potential to understate impairments. However, banks' forbearance disclosure and impairment policy is made quite clear in their annual reports and accounts. Whilst there may be a risk of under-stated impairments, we note from regulatory capital disclosures that the excess of aggregate calculated expected losses, above balance sheet impairment provisions, was £12bn at the end of 2011, 50% of which is treated as a core tier 1 haircut (and 50% from tier 2 capital). The deduction from core tier 1 capital was therefore £6bn, reducing the aggregate core tier 1 ratio from 11% (including Nationwide and Santander's UK business) to 10.7%.

Additional disclosure behind the Expected Loss calculation, together with enhanced disclosure on Pillar 2 capital buffers, would go some way to providing investor assurances on asset quality, in the absence under IFRS of a UK GAAP style general provision.

A clear understanding of Loss Absorbing Capacity in addition to Equity

Overview

Investors are supportive of the progress by financial regulators to improve the strength of financial regulation and minimise the risk of systemic contagion presented by the prospect of failing financial institutions. One investor highlighted the benefit within the EU Framework for Crisis Management for loss absorption mechanisms beyond those that are currently available through the existing bankruptcy code in resolving failed or non-viable banks.

However, investors need to judge the risk/return (yield/coupon) for each layer of the capital structure and have a clear understanding of what constitutes Primary Loss Absorbing Capacity (PLAC), as covered in the ICB submission, particularly, clarification on the logic of 17% PLAC.

General investor concerns

Equity investors need full visibility on the cost of each type of debt instrument, as this will have a significant impact ultimately on ROE.

Debt investors have less immediate interest in COE/ROE, but ultimately need the comfort of knowing the bank is capable of achieving an ROE greater than its cost of equity: if a bank is generating insufficient equity internally, it will only be able to fulfil growth plans through the fixed income/convertibles market via issuance of non-equity tier 1 capital, which itself is unlikely to be sustainable in the longer term.

As governments seek to minimise the losses to taxpayers of resolving failing banks, the potential likelihood and severity of losses to investors could increase. The riskiness of new types of bank securities or changes to the risk profile of current securities may not suit all investors. Detrimental changes in the recovery assumptions of bank securities in a resolution scenario, or the likelihood of encountering such losses, may not suit the existing investment objectives for investors, and the changes being proposed could constrain or prohibit the eligibility of certain bank securities for some investor mandates.

Whilst the proposals under consideration may present new investment opportunities for some investor mandates, this capacity is not yet known with certainty. A clear understanding of how bank securities, existing or new, may be affected under a resolution or bail-in scenario will enable investment managers to better evaluate the investment risk and their suitability for investor portfolios.

Investors highlight the importance that the investment risk faced is well defined, unambiguous and maintains the current creditor hierarchy with respect to senior secured, senior unsecured, subordinated and equity claims in a resolution scenario.

Investors acknowledge the need for governments and regulators to retain flexibility around which tools are employed to resolve an institution. However, the higher the uncertainty attached to a security's potential value in a crisis management scenario, the higher the risk premium will be demanded by investors. Increased uncertainty around securities' valuation will likely also limit the suitability of the securities for many investors. A 'presumptive path' of how financial institutions may most likely be resolved would be highly beneficial.

Unsecured debt/bail-in

Investors would generally be supportive of a broader, more inclusive range of bail-in capital, as proposed by the European Commission. Restricting the range through, for instance, depositor preference, or by specifying certain layers of senior unsecured debt as bail-inable, will increase the loss given default and perceived risk of the bail-inable capital layers Paradoxically, this loss concentration risk might be heightened within the ring-fence, where unsecured creditors will be subordinate to a potentially deep layer of secured creditors (where mortgages are the collateral) and preferred depositors. Even though the businesses within the ring-fence should be of lower risk, investors are concerned that they remain susceptible to conduct authority risk.

Discussions suggest that introducing a separate bail-in layer, with specified instruments effectively constituting a 'Tier 3' capital layer, may serve only to confuse, particularly as it is widely believed that, at the point of resolution, all unsecured funding will be effectively be 'bail-inable.' One investor commented that the pricing of debt is significantly a function of perceptions of how regulators are likely to behave and what their attitude to the overall capital structure, at the time of resolution, is likely to be. Bail-in capital would potentially work in the event of smaller idiosyncratic risk event, but, for larger/systemic risk, it is likely that central bank support would still be called on.

Clarification is required in the areas of:

- bail-in by contract or statute
- grandfathering of existing and soon to be issued debt instruments
- destination of new funding i.e. within or outside the ring-fence, and in particular would banks need to be raising debt capital under two separate names in the market, with separate contracts, separate pricing structures and separate credit ratings. It remains to be determined what the supply of bail-in bonds outside the ring-fence really would be, and whether there would be a market for parallel bail-in bonds under two different issuing names
- definition of point of non-viability (PONV)
- regulators' views on secured (securitisation, covered bonds) versus unsecured funding and in particular how much asset encumbrance regulators will tolerate. The European debt market is moving further towards covered bonds. At the end

of September, covered bonds accounted for around half the Euro-denominated investment grade financial supply, broadly in line with 2011, but above the trend rate seen in earlier years. As the secured layers of funding increase within the debt capital structure, then the unsecured, potentially bail-inable, debt layers would be subject to greater loss absorption at the point of resolution. This will have implications both for the cost of unsecured debt and, potentially, the effectiveness of bail-in

- appropriate investor base. Mr. Liikanen's report suggests that bail-in bonds should not be held by banks, as doing so would heighten bank sector contagion risk. However, we are not convinced that life companies and pension funds would be natural investors in bail-bonds particularly given the sensitivity of pension funds being seen to provide bail-in capital to the banking sector. It seems likely that the more natural bail-in bond investor would have a higher risk appetite i.e. hedge funds or high net worth individual investors.

One potential unforeseen consequence of bail-in capital stems from its shorter tenor and the requirement for frequent roll-over and refinancing. A deterioration in market conditions could affect a bank's ability to refinance effectively, which would potentially reduce the availability of bail-in capital during refinancing periods and reduce a bank's loss-absorbing layers. This in turn could undermine confidence in the bank.

Depositor preference

Investors are not convinced that depositor preference would empower unsecured creditors to exert 'market discipline' on banks. Depositor preference would also compress the bail-in capital layer, increasing the loss given default, thereby raising the risk premium demanded by investors on bail-in capital.

Cocos

Whilst contingent convertible bonds ("Cocos") may offer (in a market where ordinary equity is difficult/ impossible to raise) attractive yields (currently c.9%, and historically, significantly higher) to investors and, assuming tax deductibility, represent reasonable terms to issuers, our meetings have highlighted a number of concerns:

- the 'death-spiral' arguments around Cocos are now well rehearsed – as core tier 1 approaches the trigger ratio, equity holders fearing dilution through conversion will sell, share prices will fall, in turn creating concern among depositors and money market funds who will withdraw funds i.e. potentially a 'run' on the bank. The key is therefore to set the coupon at a level which compensates bond investors for the risk at a core tier 1 trigger level which is unlikely to be breached in the normal course of events, but at a rate which is not seen as punitive for equity investors

- a potential risk for Cocos is the extent to which a core tier 1 trigger level could be breached through regulatory action e.g. further mis-selling charges or provisions

- logically, if a 'Coco' coupon is, for example, 9% gross, or 7% net, cost of equity cannot be less than 7% and it may be materially higher
- Coco's are ineligible for core tier 1 (until converted) and therefore do not increase loss absorption until point of conversion.

At present, therefore, Cocos are attractive to a number of investors as they offer near equity returns on a fixed income basis at a time when the equity of banks is difficult/ impossible to value and in a period when interest rates are likely to stay lower for longer. However, to maintain a longer-term viable capital structure:

- it is important that the required yield on Cocos is materially less than the cost of equity. Investors see tax deductibility of the coupon as a critical factor here
- care should be taken in the extent of use of Cocos as they do not count as core tier 1 and, of themselves, further gear the equity. Regulatory persistence on the issue of increased loss absorbing capacity, in conjunction with difficulties/an inability to raise pure equity, may result in the forced issuance of Cocos – and so in turn make the market for bank equity more difficult for longer.

Index eligibility

Fixed income securities that are mandatorily convertible into equity would not currently qualify for many of the benchmarks are currently tracked or replicated by investors on behalf of their clients.

Summary

In summary, investors need visibility on the risk-return characteristics of each layer of the capital structure. The degree to which capital instruments are 'bail-inable' is clouding that judgement and may well drive debt investors further to secured funding.

To the best of our knowledge, investor demand for bail-in debt has not been assessed and we are concerned that the risk-return characteristics of bail-in versus the secured debt market may not be sufficiently compelling to provide substantial amounts of bail-in debt. A possible unforeseen consequence of bail-in may be that only the larger (SIFI and G-SIFI status) banks will be seen as sufficiently robust to issue investible bail-in debt.

Clarity on legislation for ring-fencing and/or full separation

There are effectively three schools of thought regarding ring-fencing:

- the first school of thought would be that there is no clear evidence of a particular banking business model being more susceptible to pressure during a financial crisis, other than to observe that many 'narrow banks' failed. So, the approach of this school of thought could be not to establish a ring-fence or have full separation, but to address riskiness of businesses and assets through risk weightings and capital

- the second school of thought would be to ring-fence, but not legally separate, the higher risk trading activities from the mainstream Retail/SME banking activities. The UK's ICB proposes a flexible ring-fence between the vital Retail/SME banking businesses and other parts of the group. Mr.Liikanen's High Level Expert Group recommends assigning proprietary trading and other significant trading activities to a separate legal entity
- the third approach is the Dodd-Frank/Volcker approach which highlights the risk of permeability in any ring-fence construction and therefore recommends full legal separation of higher-risk proprietary trading, whilst retaining the advantages of a universal banking model, including the client facing activities within the investment bank.

Most investors are broadly of the view that the universal banking model was not the root cause of the financial crisis, although internal capital allocation to investment banking businesses was far too low, encouraging excessive growth. Moreover, many banks that failed during the crisis were 'narrow' banks and indeed would be inside the ring-fence rather than outside. This would be true in the UK of all of Northern Rock, Bradford & Bingley and Alliance & Leicester and, arguably, most of HBOS, although excess leverage, and reliance on wholesale funding would not be allowed inside the ring-fence in the proposed new regime. Within the UK, banking cycles have been closely correlated to real estate valuations and 'bubbles', rather than to investment banking cycles or structural limitations or weaknesses within universal banks. For some investors, the uncertainty of the practicalities in ring-fencing and the likely costs of separation lead, by default, to supporting the universal banking model.

Investors nonetheless recognise the potential pitfalls of universal banking, in particular the risk of 'cultural clash' between the investment bank and the retail/commercial bank and the potential for investment banking activities to be funded with retail/commercial deposits and to leverage up on the implicit too big to fail guarantee of the retail bank more generally. However, the management of risk, which encompasses maturity transformation, managing liquidity, interest rate risk and credit risk is at the heart of a universal banking model. The role of a bank's Asset & Liability Management team is to fund a bank's lending and investment activities, using a variety of funding, recognising the risk/return on each of those activities.

Many investors have been sceptical on the cost-benefits of ring-fencing and most have shown little appetite for full separation, particularly if the demerged investment bank was required to be immediately Basel 3 compliant, which would almost certainly require additional equity to be issued immediately. Whilst both investors and the banks appear to accept that some degree of ring-fencing is inevitable, the costs and operational complexity plus disruption to clients and employees should not be under-estimated. In this respect, if isolation of trading activity is the heart of the issue, the cost benefits of a Liikanen/Volcker approach may be more appealing, possibly augmented by additional core tier 1 capital to reflect portfolio mix. Other investors, however, welcome the perceived benefits of ring-fencing.

Investors have raised the question as to what is the fundamental purpose of a ring-fence. Is it to facilitate resolvability in the event of a repeat crisis or to protect the provision of Retail/SME banking services? If it is to protect the provision of Retail/SME services, from what is it being protected? A volatile, capital-hungry, non-client facing business, consistently earning sub-cost of equity returns has no place in a bank, whether inside or outside the ring-fence.

Some investors have suggested, for example, that:

- resolvability might be better addressed through increased capital requirements, rather than the cost and customer disruption associated with ring-fencing. The Bank for International Settlements (BIS – 'An assessment of the long-term economic impact of stronger capital and liquidity requirements', August 2010) illustrated that an increase in tangible common equity (TCE) to risk weighted assets (RWA) from 6% to 10% would reduce the probability of a systemic banking crisis from 4.8% to 1.2%, assuming banks could meet their net stable funding ratio requirements. An increase from 10% to 11% in the TCE/RWA ratio would still reduce the probability of a systemic banking crisis from 1.2% to 0.9%
- protection of vital Retail/SME services may be better achieved through isolation (Liikanen), or suppression (Volcker), of proprietary trading.

In assessing this, other factors need to be addressed, including:

- the distinction between proprietary trading and market-making or client facilitation. At one extreme, proprietary trading is the commitment of a bank's capital and funding to trading positions, from which only the bank itself will benefit i.e. a non-client initiated trade. This type of business should, in the ABI's view, remain firmly inside any separate legal entity proposed by the Liikanen committee. However, market-makers take positions in order to facilitate, and in anticipation of, client business. The extent to which a bank may hold positions will be determined predominantly by the bank's risk appetite (inventory risk) and capital. Market-making is an intrinsic part of an investment bank's client facing activities and therefore should not be isolated. However, by its very nature, market-making will display higher volatility than many businesses within the bank
- whilst funding inside the ring-fence theoretically presents a lower risk investment, the bond-holder will be subordinate to customer deposits and secured finance. The businesses outside the ring-fence might be more attractive in terms of diversification
- the location of corporate deposits and the potential for switching from in-ring fence to outside the ring-fence is an issue and source of potential confusion for investors
- the location of derivatives to facilitate customer hedging contracts in or outside the ring-fence
- the location of Treasury and Balance Sheet Management teams to manage the deployment of liquidity and retail deposits

- the distinction between prudent bank balance sheet management and proprietary trading, i.e. would creating a short position in Eurozone sovereign debt, in order to reduce a bank's net long position in its primary liquidity pool, in the face of a Eurozone crisis, be regarded as proprietary trading or prudent management?

In evaluating alternative banking models, it is important to take a forward-looking view, based on the Basel 3 regime, to be implemented start 2013, as opposed to a business model originally based on the Basel 1 or Basel 2 regime. Put another way, current regulatory change is already influencing banks' strategy and capital allocation decisions. UBS's recent announcement (30th October 2012) on restructuring its investment banking business provides a template for a "capital-light Basel 3 compliant bank." In fact, UBS believes its investment banking business will be the first "capital-light Basel 3 compliant bank." UBS will concentrate on its traditional strengths in advisory, research, equities, FX and precious metals and will exit business lines, predominantly in fixed income, rendered uneconomic by changes in regulation and market developments. The UBS Investment Bank is expected to make a return well in excess of its cost of capital and will consist of two key businesses:

- Corporate Client Solutions – includes all advisory and solutions businesses plus execution that involves corporate, financial institutions and sponsor clients. The business is expected to generate one-third of the Investment Bank's revenues and utilise around 15% of its Basel 3 RWAs.

- Investor Client Services – includes execution, distribution and trading for institutional investors and will provide support to UBS's wealth management business. The business will comprise UBS's equities, FX, precious metals businesses. The flow rates and credit business will be more closely aligned to its Debt Capital Markets and Wealth Management businesses. This business is expected to generate two-thirds of the Investment Bank's revenues and utilise around 85% of Basel 3 RWAs.

Achieving the appropriate balance between resilience and competition

Investors do not consider that concentration issues led to instability or that there is a particular link between size and likelihood of failure. Indeed, Australia and Canada, whose banking systems proved relatively robust in the crisis, have essentially oligopolistic and protected market structures. However, it is understood that there may be a wider desirability in promoting competition.

Tougher regulation may raise barriers to entry

A robust banking system necessitates capital and liquidity requirements, which of themselves may form barriers to entry. The shortage of potential buyers for the EC mandated disposal of the Lloyds Banking Group and RBS Group branches may in part be attributable to demanding capital and liquidity requirements, together with regulatory uncertainty, rendering it near impossible for any potential acquirer to assess accurately future capital requirements and therefore forecast return on capital.

The track record of challengers has been poor

In 1997, Northern Rock, Halifax, Woolwich and Alliance & Leicester demutualised, followed by Bradford & Bingley in 2000. They all converted to PLC status, attracted by the ability to compete on a level playing field, having the same access to wholesale funding and capital markets as the listed UK banks. None remains independent. Woolwich was acquired by Barclays in 2000. Alliance & Leicester management recommended to its shareholders a £1.26bn offer by Santander in 2008, having reportedly rejected a £5.8bn bid from BNP in 2006. Halifax merged with Bank of Scotland in 2001 to form HBOS, proclaiming itself a 'challenger' to the main four domestic banks (Barclays, HSBC, Lloyds TSB and RBS Group). HBOS was acquired by Lloyds TSB in a 2009 rescue operation (announced in 2008) to form Lloyds Banking Group. Both HBOS and Lloyds TSB were individually recapitalised by the UK Government in 2008. Northern Rock was nationalised in 2008. Bradford & Bingley was effectively split into two parts in 2008, with the mortgage business nationalised and the saving business and branches acquired by Santander.

The success rate of the 1997/2000 demutualisations was therefore poor and, in particular, unsuccessful in increasing competition amongst retail banks. One common feature of the outright failures (Northern Rock, HBOS and Bradford & Bingley) was a high dependence on wholesale funding, the very feature which attracted the former building societies to demutualisation in the first place. A second common feature was, arguably, a relatively inexperienced management team, focused on growth through gaining market share from the established banks, without fully appreciating the risks attached to such an aggressive strategy.

The outlook for the building society sector is challenging

For the remaining building societies, the outlook appears challenging. According to the Building Society Association website, there were 1,723 building societies in 1910. Today there are 47, having contracted from 71 in 1997 (excluding the three demutualisations) and 60 as recently as 2006. Since 2006, 13 building societies have disappeared through merger or rescue acquisitions. Today, the building societies account for just 20% of the mortgage market, with the largest five societies accounting for almost 88% of the total building society sector (and one, Nationwide, accounting for more than 60% of the building society sector and 10% of the total UK mortgage market).

These five societies, most recently, in aggregate reported a return on general reserves of just 4%. The very nature of a 'mutual' means members are perhaps benefitting through competitive pricing on loans and deposits. However, the current difficulties of the building society sector may indicate that increased competition may be hard to achieve given so many building societies are sub-scale and the top five, which dominate the sub-sector, are making such a low return on their reserves.

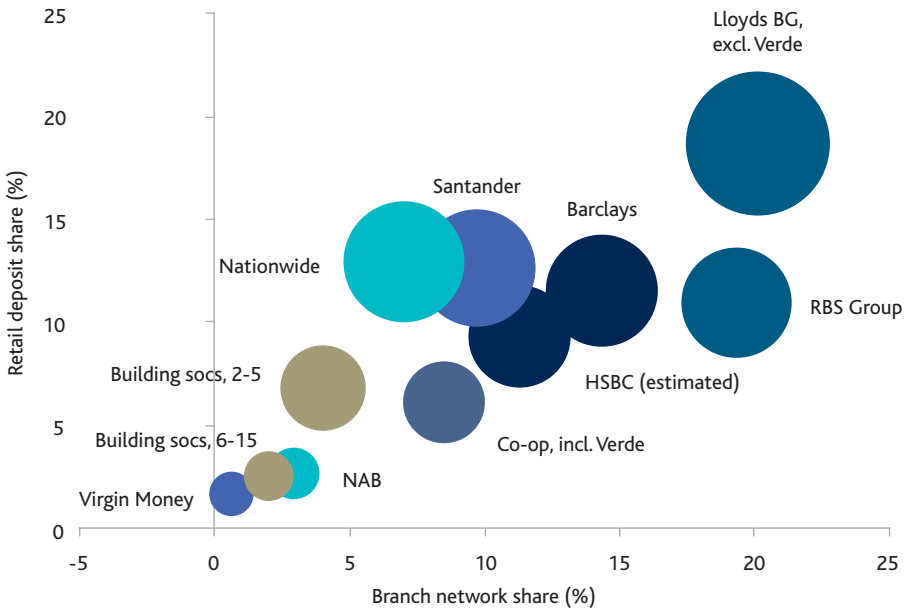
Nevertheless, the UK bank sector is structurally competitive

Despite the recent history of bank failures and the challenges in the building society sector, we believe the UK banking market is competitive. New entrants are able to provide a range of financial services via internet, telephone, intermediaries and mobile phone banking, without traditional branch infrastructure. At the time of writing, MoneySupermarket.com listed more than 25 current account offerings (excluding multiple accounts from one provider). We would support the ICB's recommendations to ensure that current account switching mechanisms are made as simple and streamlined as possible. However, banks stress that detailed knowledge of customer transactions and financial behaviour, built up over a long period of time, makes for a more effective banking relationship.

Deposit gathering has traditionally required a branch network and, for this reason, might be deemed less competitive than the markets where direct distribution can be used. This may change going forward and we understand that already internet and mobile are becoming increasingly important channels for deposit gathering for some banks.

However, we have analysed the retail deposit market as it stands today (adjusting for the planned Lloyds Banking Group Verde disposal to the Co-operative Bank). The chart below sets out the market share of retail deposits (vertical axis) compared with the market share of the branch networks (horizontal axis) of the UK banks' and building societies.

Figure 15. Retail deposit and branch network market shares (%)



Source; Company data, Bank of England, ABI estimates. Note; bubble size depicts size of retail deposit base (£billion)

We would make several observations:

- five banks/building societies with an average 14% market share of branch distribution and retail deposits, followed by HSBC UK, with an estimated 9-10% share do not suggest this is an uncompetitive market The banks and building societies are employing their branch networks for deposit gathering (measured by market share) at broadly similar utilisation rates

- non-banks, with branch access to retail customers, i.e. retailers and supermarkets, are clearly potential challengers to the banks. Tesco and Marks & Spencer, as examples, have well developed financial services businesses, aimed at existing customers, potentially increasing value per footfall of their branch networks

- Co-operative bank (including the 632 planned Verde branches) plus Virgin Money (that acquired Northern Rock in January 2012) are positioned as strong potential challengers in the UK market, with National Australia Bank's Clydesdale and Yorkshire Bank businesses continuing to serve its customers through a combined 334 branch network

- Nationwide Building Society has a strong position in the retail deposit and mortgage market. However, as disclosed in it 2011-12 report and accounts, maintaining its Base Mortgage Rate (BMR) pledge, ensuring the majority of its customers have access to a mortgage rate capped at 2% above Bank of England base rate is benefitting its members by around £750m per annum. Excluding this, Nationwide's 2011-12 statutory pre-tax profit would have been almost £1bn, producing an estimated 11% post-tax return on reserves, compared with approximately 3.0% achieved. What is effectively a forced 80% pay-out ratio to members may affect its ability to grow, let alone increase market share

- together, the second largest building society, down to the fifth largest building society are collectively punching above their weight, with a 7% share of the deposit market, compared with a 4% share of the branch network. Again, however, their collective ability to grow remains uncertain

- if retail deposits are deemed to be the firm bedrock on which to lend into the retail and SME market, then one conclusion might be that increasing competition in this market requires either (i) new entrants to build physical branch networks or (ii) new banks need to be created through further branch 'carve-outs'. Investing in branch networks, whilst complying with onerous capital and liquidity requirements, may just be too high a barrier for potential new entrants. Equally, carving-out branches from existing networks is complex, disruptive to customers and employees, and is very costly. Purchasers of the EU mandated branch disposals of Lloyds Banking Group and RBS Group have proved to be scarce. However we would not see either of these factors as structurally limiting competition in UK financial services, particularly given the increasing significance of non-branch distribution.

In summary:

- regulators and policy-makers need to consider the extent to which capital and liquidity requirements may raise barriers to entry

- the record of challengers to the larger banks is patchy and the outlook for the remaining building societies appears challenging
- financial services competition is strong
- the retail deposit market, traditionally the preserve of the branch network, appears to be structurally competitive
- competition might be increased if policies to incentivise savings were improved, thereby increasing savings net inflows
- retail deposits tend to be inelastic in a low interest rate environment and competition should intensify as and when base rates increase.

The market in retail and wholesale banking is perhaps likely to develop to a structure where (i) five or six banks have sufficient scale to achieve economies of scale, from which all stakeholders can benefit, plus (ii) a number of more focused 'niche' businesses that offer specialist services, through smaller branch networks, or online, or via intermediaries.

Assessing the financial impact of regulation

It is impossible to attribute the financial crisis to one particular cause. Mr.Liikanen made this point very eloquently when recently presenting evidence to the Parliamentary Commission on Banking Standards (PCBS), commenting that any single explanation of the crisis he offered would be wrong, since there was more than one cause.

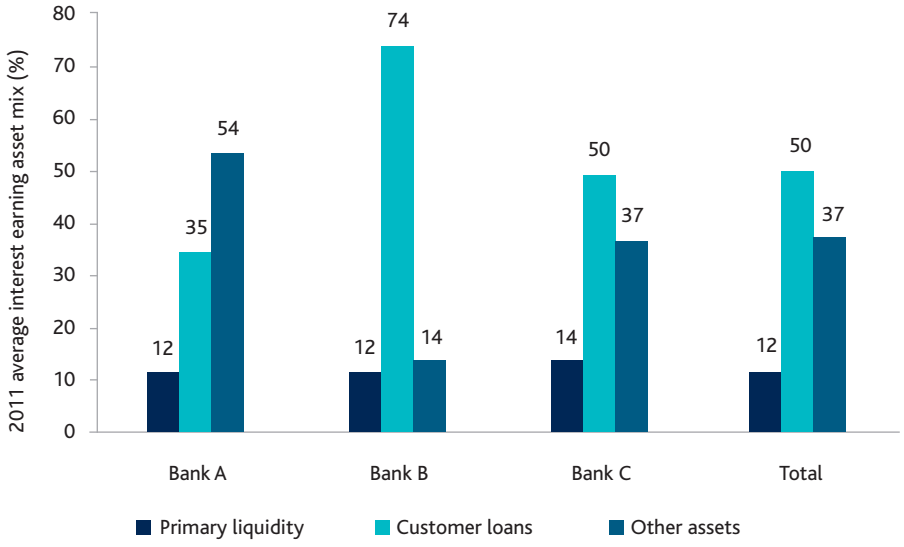
In assessing the investibility of banks, investors have questioned whether regulators are recognising this and taking a sufficiently holistic view of the banking sector and regulatory reform. The aggregate financial effects of ring-fencing, bail-in, UK banks levy, liquidity ratios, plus the continued flow of conduct related charges, are already having a significant impact on profitability. This is before factoring in additional equity requirements (under Basel 3, FSB SIFI and G-SIFI requirements) and potential risk weight recalibration.

Subject to this continuing uncertainty, we have sought to assess the impact on 2011 adjusted (underlying) return on equity for three banks in two areas:

Liquidity

The BIS liquidity requirements for (i) Liquidity Coverage Ratio (LCR) and (ii) Net Stable Funding Ratio become effective in January 2015 and January 2018 respectively. Establishing more robust liquidity guidelines was a clear and necessary requirement following the crisis. However, the impact of holding substantial levels of liquid assets is having a significant impact on both credit growth and profitability. The average primary liquidity balances (cash at central banks plus government bonds) accounted for between 12% and 14% of average assets in 2011, with customer loans averaging 50% across the three banks. We have estimated this using the year end liquidity pool disclosure and the average balance sheets presented in the Annual Report & Accounts and/or 20-F filings.

Figure 16. 2011 – average interest earning asset mix (%)



Source: Company data, ABI analysis

Using the same average balance sheet disclosure, we illustrate in the chart below the yield differential between the primary liquidity pool and average customer loans. Yields on the primary liquidity pool range from 1.34% up to 1.50%, compared with the customer loan portfolios ranging from 3.85% up to 4.34% – a yield differential of between 2.40% and 3.0%.

Figure 17. 2011 – estimated average asset yields (%)

Source: Company data, ABI analysis

For the purposes of calculating the financial impact of regulation, as summarised below, we have estimated, the opportunity cost of holding half the primary liquidity pool. Across the three banks, the ROE impact is between 1.9% and 2.8%.

Broader financial impact of regulation

We have also taken into account a range of other issues, also summarised below:

- the marginal cost of holding additional Primary Loss Absorbing Capacity (PLAC) is based on 1% of year-end risk weighted assets, assuming a 9% gross coupon

(7% net), which we believe is a reasonable assumption for the perceived risks. An additional 1% PLAC reduces ROE by around 0.5%

- the Financial Services Compensation Scheme levy shaves between 0.1% and 0.3% off ROE and the UK banks' levy removes a further 0.4%-0.5%
- the operational costs of ring-fencing, according to some broker estimates, will reduce ROE by a further 0.2%-0.4%.

Figure 18. Potential regulatory impact on return on equity (%)

	Bank A	Bank B	Bank C
Liquidity pool	(2.8)	(2.3)	(1.9)
Marginal cost of additional 1% PLAC (9% coupon)	(0.5)	(0.6)	(0.5)
FSCS levy	(0.1)	(0.3)	(0.1)
UK bank levy	(0.4)	(0.5)	(0.4)
Ring-fencing operational cost	(0.3)	(0.4)	(0.2)
Potential regulatory impact	**(4.1)**	**(3.9)**	**(3.1)**

Source: ABI analysis

The cumulative impact on return on equity ranges between 3.1% and 4.1%. Whilst the liquidity cost is the biggest drag on profitability, it should be emphasised that this summary assumes (i) no additional equity required (ii) just 1% additional PLAC (iii) no additional marginal funding costs outside the ring-fence (iv) conduct related charges e.g. PPI, are reported as statutory adjustments and not in the underlying ROE.

Arguably (as stated above), a more resilient, better capitalised bank, with strong liquidity should be accorded a lower cost of equity. However, the impact on profitability of regulation should not be under-estimated.

There are several channels available to banks to mitigate the impact on profitability of financial regulation. Some analysts estimate that UK banks could mitigate 50% of regulatory reform costs through balance sheet shrinkage, loan re-pricing and cost cutting. We summarise below four key areas of potential mitigation:

1. Cost mitigation – arguably the key differentiator of banks' operating performance in the coming years.
2. Re-pricing – UK banks are likely to raise the cost of credit to offset some of the additional regulatory costs. We observe that lending rates to non-financial corporations relative to households have widened recently.
3. Capital efficiency – banks are already examining RWA efficiency in advance of transitioning to Basel 3, particularly; deleveraging, reducing RWA-consumptive lines, collateral backing and reviewing the originate/distribute risk model. In the case of investment banking activities, there is a risk of shrinking to a point of non-viability for the customer. Investment banking activities need to be de-risked, but be of sufficient scale and profitability to remain relevant to corporate clients.
4. Strategic change – sale of subsidiaries and businesses, particularly given the treatment under Basel 3 of insurance subsidiaries and non-controlling interests.

Future dividend payments

Investors place weight on a clear distribution policy, to understand how a bank determines the balance between dividends, incentive payments and retention of earnings to bolster the capital base. In this respect, a clear dividend policy is vital.

There is broad agreement that the UKFI's ability to reduce its stakes in Lloyds Banking Group and RBS Group is likely to be contingent on re-establishing a clear path to meaningful and sustainable dividend payments.

Dividends remain a key signal of management confidence and will be interpreted as an indicator of regulatory rehabilitation. Banks' management across the entire sector need to have a very clearly defined dividend policy for investors with the confidence and backing of regulators. Banks once accounted for over 20% of the FTSE 100's dividend income – a valuable income source to UK investors. Whilst lower pay-out ratios will prevail for the foreseeable future, the positive message that a restored dividend policy will convey, together with increased investment funds, should not be under-estimated.

For more information, contact:

Association of British Insurers,
51 Gresham Street,
London EC2V 7HQ

020 7600 3333
www.abi.org.uk