Peer Analysis: Predicting Supervisory Challenges

Making the right decision
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Introduction

The banking industry faces challenging times. It is a mature industry vulnerable to newer, sometimes unregulated entrants eager to take profitable segments of business. Simultaneously, the industry is more closely regulated than previously and the costs of being a bank are escalating. Combined with a low interest rate environment, at least in several cases non-performing loan legacies from the financial crisis, as well as challenging economic environments, it is an industry under pressure and forced to innovate.

The European Central Bank (ECB) as a supervisor has been quick to identify this and Danièle Nouy, Chair of the Single Supervisory Mechanism (SSM) is consistent in pointing out to banks that they need to build and demonstrate to the SSM that their business model is viable and sustainable. Recently, in presenting the ECB's annual supervisory report to the European Parliament Ms Nouy commented that 'Low profitability is a concern for supervisors because it may impact the medium-term sustainability of some business models. Certain institutions might struggle to generate capital while having limited access to financial markets. The ECB will carefully assess the sustainability of banks' business models in the coming quarters, with a view to ensuring that they are able to withstand cyclical developments and structural challenges.'

Supervisors want to see safe and profitable banks. The ECB is clear about this as its goal, however, it does not prescribe actions to attain it. Banks must engage extensively with the ECB to present and defend their strategies and business models. For banks, then, understanding where one stands vis a vis its competitors is crucial to preparing for this dialogue with the ECB. In this publication, we aim to show how banks, using publicly available data, can easily, proactively identify questions that supervisors may likely ask.

"Low profitability is a concern for supervisors because it may impact the medium-term sustainability of some business models."

Danièle Nouy, Chair of the SSM

Peer Analysis

One of the innovations made by the SSM is greater use of peer comparisons as a supervisory tool. This is driven by the ECB's goal of ensuring a harmonized supervisory approach across Europe and facilitating the availability of data on larger numbers of banks which makes this level of peer comparisons possible.

The ECB assigns banks to peer groups based on similar business models and balance sheet structure. Using a universe of business model types with a certain constellation of attributes (e.g. refinancing structure, asset mix, P&L structure, ownership, etc.) banks are allocated to one of the following business model types:

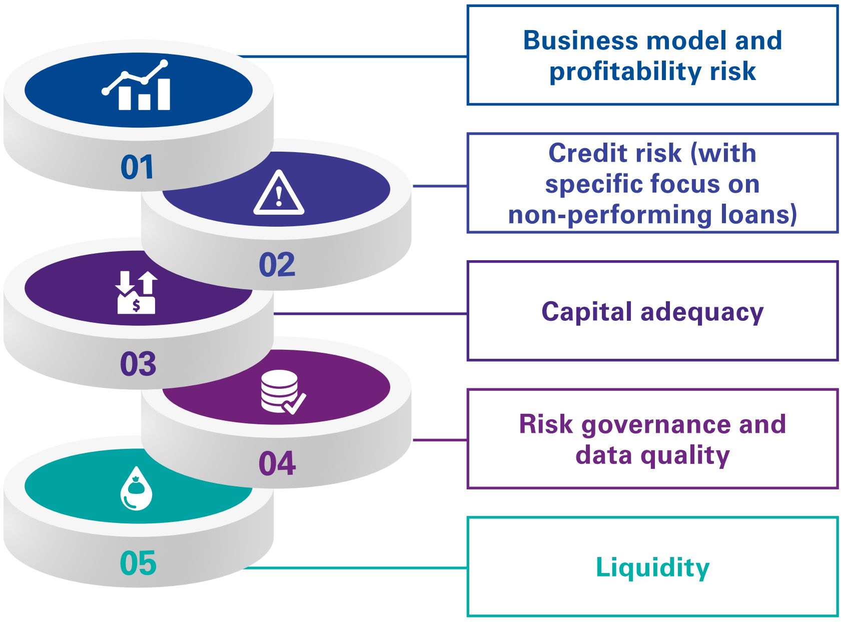
Naturally, banks across Europe want to know which peer group they have been assigned to and where they stand among their peers. To help answer this key question, KPMG's ECB Office[1] in Frankfurt has developed KPMG Peer Bank, a new benchmarking tool that is designed to go beyond transparency to deliver comparative peer-to-peer insights for banks.

In November 2015, the European Banking Authority (EBA) published the outcome of its 2015 EU-wide transparency exercise, providing detailed bank-by-bank data on capital positions, risk exposure amounts and asset quality on 105 banks from 21 countries of the European Economic Area, yielding over 100,000 different data points.

The KPMG Peer Bank tool uses this data to give banks an opportunity to see where they stand against their peers: regionally, nationally, and by peer groups.

Peer Analysis and Supervisory Priorities

The SSM has adopted five high-level priorities to guide its supervision throughout 2016. These are:



It is possible to examine banks against these supervisory priorities using KPMG Peer Bank. The peer groups in the tool are based on the size of banks and their business model – similar to the ECB's methodology for assigning peer groupings. Using these peer groups, member firm professionals have examined a few key metrics that reflect the supervisory priorities and consider which supervisory insights arise. For this, we have downloaded peer group averages from the tool as well as measures of the range of observations for each group. When applied to an individual bank, such data analysis helps to identify which questions supervisors may ask.

This analysis is focused on the five main business model peer groups excluding custodian and small universal banks which are too small in number to justify inclusion in this peer focused analysis.

1. www.kpmg.com/peerbank

Supervisory focus on business model and profitability

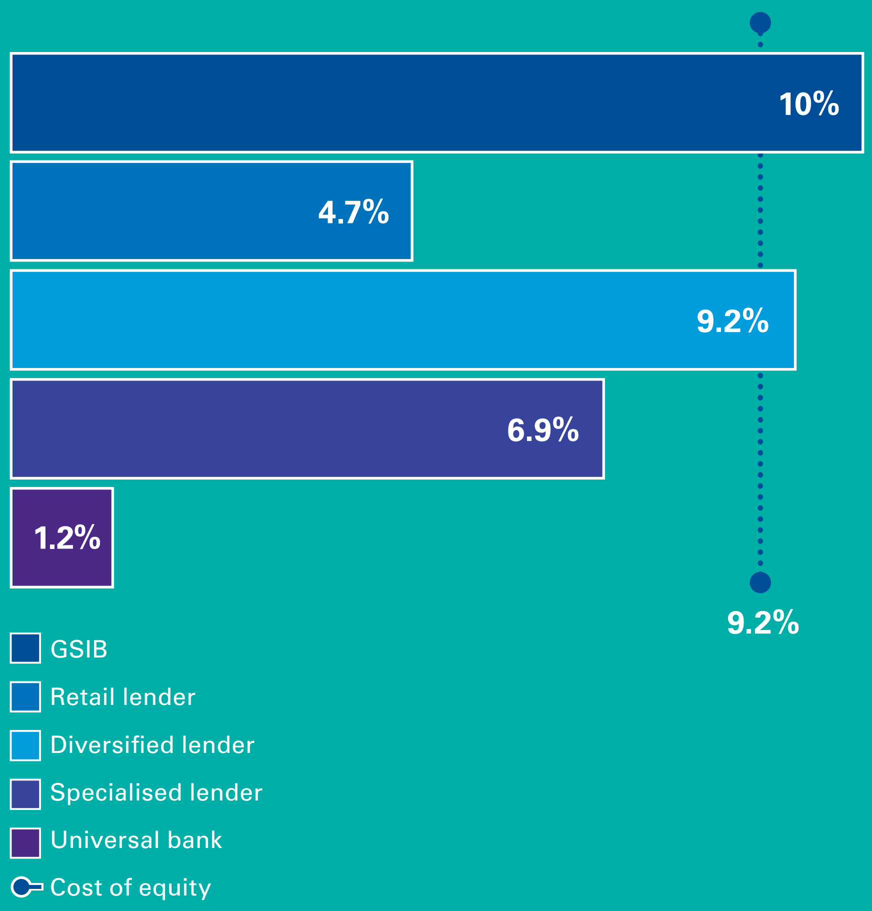
In the context of the supervisory focus on business model and profitability, we looked at three key metrics: Return on Assets (RoA), Return on Regulatory Capital (RoRC)[2] and Cost Income Ratio (see tables 1, 2, 3). The tables show the mean value for the metric for the peer group as well as the range of observations within the group.

In terms of profitability, global systemically important banks (GSIBs) and diversified and specialized lenders show the highest average returns, and GSIBs show the lowest range of variability between highest and lowest observations. Conversely, universal banks show an especially weak average for profitability metrics and a very wide range of outcomes. Looking at RoRC suggests that many banks are not meeting their cost of capital. The EBA's most recent estimate of EU banks' cost of equity was 9.15%[3]. The average returns on regulatory capital of retail banks, specialized lenders and universal banks are all significantly below this figure, (please see Figure 1 opposite).

It would be easy for a supervisor to conclude that this situation is not sustainable and that banks need to develop and implement successful business strategies to push their returns upwards. Interestingly, the recent ECB euro area bank lending survey[4] mentions the negative impact on bank's margins from the ECB's negative deposit facility as well as a narrowing of margins on loans to enterprises indicating that banks will struggle to increase net interest margin in the current interest rate environment. In countries like Germany where most retail and mortgage loans are based on 5 year fixed rates, the low rate environment will be locked in and impact the bank's profitability for longer than anticipated by the monetary policy decision makers. For countries with variable rate lending, a rise in rates may also foreshadow credit risk delinquencies as borrowers struggle to meet increased repayments

Moving our focus from profitability to cost management, we see that the average cost income ratio across the industry is also reasonably high (approximately 60%) for all peer groups with the exception of diversified lenders. There are also banks within four of the peer groups with ratios above 85%. This will undoubtedly draw a supervisory focus on the ability of such institutions to manage their cost base and raise questions about their strategy. The combination of the low interest rate environment and potential customer resistance to fees puts

Figure 1: Return on regulatory capital vs. cost of equity



2. Net Profit (annualized) / Tier 1 Capital (net of deductions and after applying transitional adjustments)
3. Risk assessment of the European Banking System, December 2015, EBA publication
4. The euro area bank lending survey, ECB, April 2016

the industry in a difficult spot. Furthermore, the continuing demand from supervisors for timely and consistent reporting of a wide range of key figures to the supervisors is forcing banks to increase costs to achieve compliance.

One of the ways to help maintain customer service while managing costs will be the success of digitization within banks. It is also possible for industry consolidation to play a role – especially within individual countries.

Table 1: Return on assets

	Mean	High	Low	25th percentile	75th percentile
GSIB	0.5%	0.8%	0.1%	0.4%	0.6%
Retail lender	0.3%	1.5%	-2.2%	0.2%	0.7%
Diversified lender	0.5%	1.3%	-1.3%	0.4%	0.7%
Specialised lender	0.5%	1.4%	-0.1%	0.2%	0.8%
Universal bank	0.2%	1.8%	-5.6%	0.3%	0.7%

Table 2: Return on regulatory capital

	Mean	High	Low	25th percentile	75th percentile
GSIB	10.0%	14.5%	1.5%	7.6%	13.4%
Retail lender	4.7%	16.0%	-37.1%	3.9%	11.6%
Diversified lender	9.2%	22.4%	-21.4%	6.9%	12.0%
Specialised lender	6.9%	18.3%	-3.6%	4.5%	10.4%
Universal bank	1.2%	35.8%	-149.7%	4.4%	12.2%

Table 3: Cost income ratio

	Mean	High	Low	25th percentile	75th percentile
GSIB	60.7%	85.2%	45.9%	50.6%	67.6%
Retail lender	62.7%	85.2%	39.4%	52.3%	70.3%
Diversified lender	51.2%	76.2%	26.0%	44.1%	59.3%
Specialised lender	64.7%	275.8%	10.5%	32.3%	58.4%
Universal bank	57.7%	91.8%	25.3%	48.9%	62.5%

'In countries like Germany where most retail and mortgage loans are based on 5 year fixed rates, the low rate environment will be locked in and impact the bank's profitability for longer than anticipated by the monetary policy decision makers.'

In assessing business models, it is important for institutions to manage the risk that is most prevalent in their balance sheet – that is, credit risk. European banks suffer the drag from substantial portfolios of non-performing loans (NPLs) and forborne exposures. Despite some deleveraging within the industry, the ECB acknowledges that NPLs is perhaps the most significant risk facing the banking sector in Europe. Table 4 shows NPLs by peer group and the subsequent table shows the level of provision coverage of NPL-portfolios. Much of NPL loan stock is already “processed” in the profit and loss (coverage ratio), the amount of “unexpected risk” should be limited, therefore. However, forborne exposure may pop up as “new” NPL in the future and burden future profits (this is especially true of performing loans with forbearance). It can act as an early warning indicator of more credit risk problems on the horizon. Table 6 shows the forbearance ratio, which is the percentage of total loans and advances subject to forbearance. This ratio can act as an indicator of future credit problems.

Table 4: Non-performing loans

	Mean	High	Low	25th percentile	75th percentile
GSIB	4.5%	13.3%	1.5%	2.2%	6.0%
Retail lender	11.8%	28.7%	0.6%	6.6%	14.9%
Diversified lender	10.8%	48.8%	0.6%	3.8%	12.5%
Specialised lender	4.8%	25.6%	0.0%	1.6%	5.2%
Universal bank	12.4%	54.5%	0.5%	3.0%	19.9%

Table 5: Coverage ratio NPLs

	Mean	High	Low	25th percentile	75th percentile
GSIB	43.7%	56.4%	28.0%	34.5%	51.0%
Retail lender	38.8%	48.5%	15.7%	38.9%	43.8%
Diversified lender	41.1%	58.5%	18.2%	33.6%	48.9%
Specialised lender	33.7%	96.7%	2.5%	23.8%	43.6%
Universal bank	42.8%	62.4%	19.6%	37.9%	48.4%

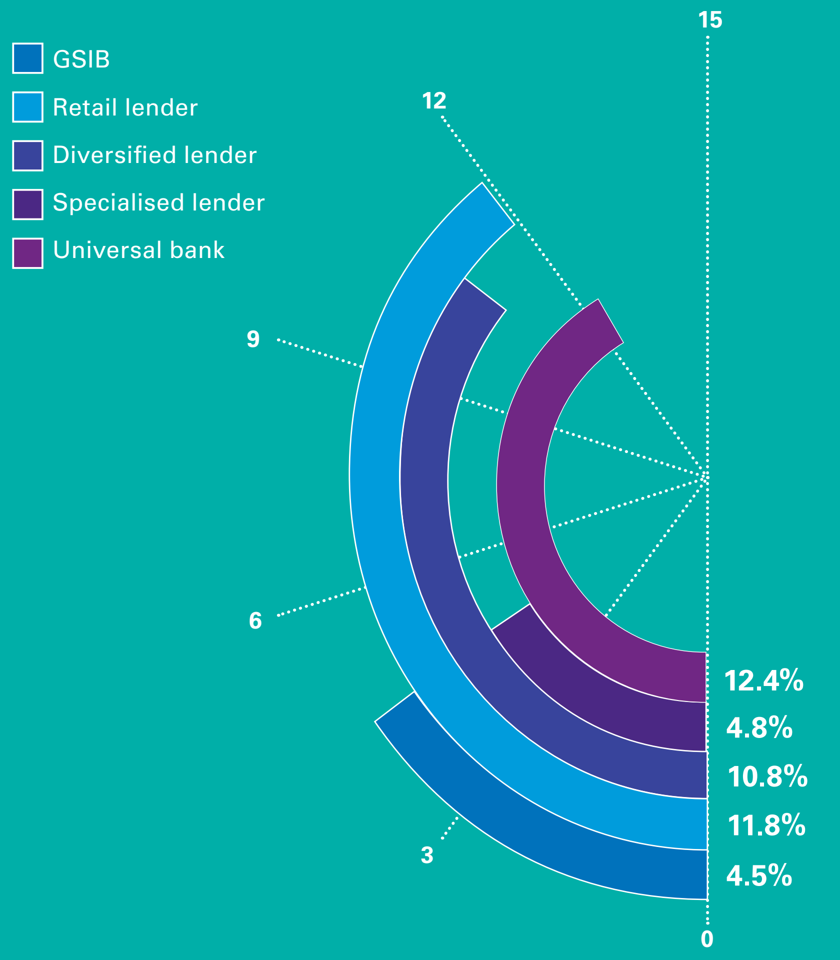
Table 6: Forbearance ratio

	Mean	High	Low	25th percentile	75th percentile
GSIB	2.7%	7.6%	0.8%	1.3%	3.5%
Retail lender	10.4%	23.8%	0.1%	2.6%	17.6%
Diversified lender	6.1%	20.0%	0.4%	1.6%	8.9%
Specialised lender	3.7%	26.4%	0.0%	0.2%	2.9%
Universal bank	6.2%	36.2%	0.4%	2.1%	7.6%

“Despite some deleveraging within the industry, the ECB acknowledges that NPLs is perhaps the most significant risk facing the banking sector in Europe.”

Three of the five peer groups have average NPL levels above 10%, (please see figure 2 opposite). The ECB has publicly mentioned that 12% NPLs is a trigger point for more intensive supervision of a bank's NPLs. For diversified lenders and universal banks, there are individual banks where approximately 50% of their loan portfolio is made up of non-performing loans. This level of NPLs raises questions as to the viability of such banks. One could start asking questions of the operational capacities of a bank to grant new loans even well below ratios such as these. The coverage ratio for NPLs across the groups lies around 40%. Once again, the range of values for coverage ratios between high and low is considerable and those banks with ratios below 30% are certain to receive greater supervisory scrutiny of their approach to provisioning. Interestingly, the three peer groups with highest stock of NPL (Retail, diversified-lenders, and Universal Banks) show the highest forbearance ratios. This combination of high NPL and high forbearance ratio could lead to further supervisory scrutiny.

Figure 2: Non-performing loans by peer group



Finally, related to the issue of capital adequacy, we look at the CET1 ratios of the peer groups and we also look at the percentage of total credit risk exposure accounted for by IRB models.[5] The average CET1 ratios for all peer groups are converging around 13%, with the exception of specialized lenders that hold an average above 20%, although there is a significant range of ratios within individual peer groups (see Figure 3). It is clear that the regulatory push to increase the level of high quality capital at banks has been successful, although the higher capital levels have also increased the cost base of the bank. Nevertheless, institutions with ratios below 10% will surely be questioned by supervisors on their proposed capital planning. Forcing such banks to raise further capital then places additional strain on profitability targets, risking a potential vicious cycle. Solving this problem is the core challenge facing both banks and supervisors in Europe.

If we consider IRB/Total Exposure (Table 8), we can see that there are institutions that may be more vulnerable to the current regulatory initiatives to restrict IRB modelling discretion that may move to a more standardized approach to measuring credit risk. The clear outlier here is the GSIB peer group that unsurprisingly is a bigger user of IRB modelling. Such banks may be subject to the risk of having to hold more capital for existing portfolios as RWA credit modelling discretion is lessened. Obviously, this may negatively tie back to the capital position in Table 7 in the future.

Figure 3: Variance of CET1 by peer group

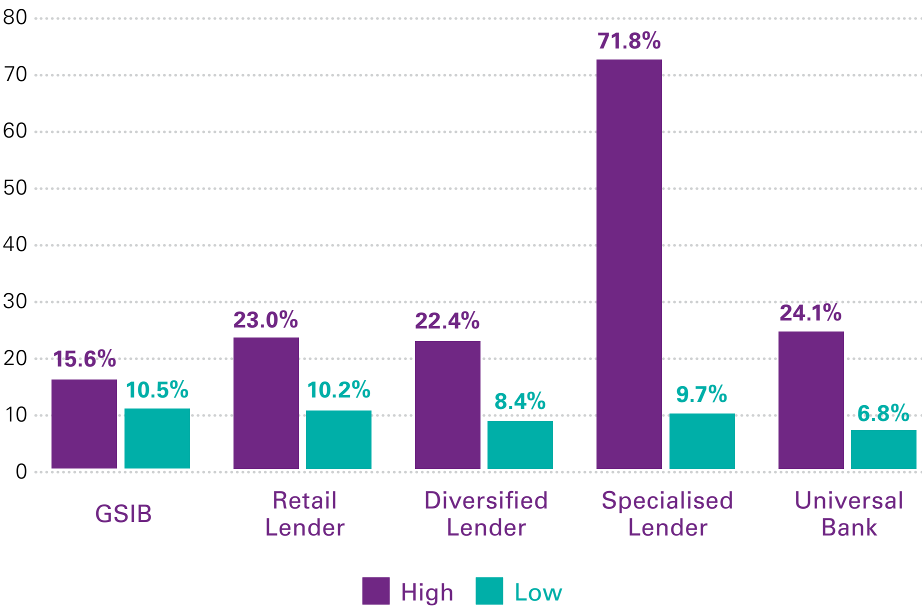


Table 7: CET1

	Mean	High	Low	25th percentile	75th percentile
GSIB	12.3%	15.6%	10.5%	11.2%	12.6%
Retail lender	14.5%	23.0%	10.2%	11.5%	15.9%
Diversified lender	13.6%	22.4%	8.4%	11.8%	16.7%
Specialised lender	21.4%	71.8%	9.7%	11.3%	23.8%
Universal bank	13.6%	24.1%	6.8%	12.0%	14.3%

Table 8: IRB/total exposure

	Mean	High	Low	25th percentile	75th percentile
GSIB	63.5%	91.1%	40.6%	54.5%	78.5%
Retail lender	40.0%	97.8%	0.0%	0.0%	74.2%
Diversified lender	40.0%	98.4%	0.0%	0.0%	82.3%
Specialised lender	42.7%	98.7%	0.0%	0.0%	81.7%
Universal bank	43.9%	93.6%	0.0%	0.0%	79.6%

5. Capital positions still reflect some differences in the capital definition linked to the national discretions allowed in the context of the phase-in period of deductions and the grandfathering of capital instruments. This can arise for items such as DTAs and minority interest.

Conclusion

In summary, peer group analysis offers identifiable supervisory signals. Peer analysis is more interesting, and even more valuable to banks, when done on an individual bank basis. Where a bank finds itself as an outlier in a particular area, it should be ready to explain to the ECB why it is an outlier relative to its peers. Likewise, on a sector level, a bank should be able to justify why certain business model types may be showing more or less strength compared to other peer groups.

As the industry faces challenging times stemming from the historical overhang of NPLs and also the future challenges to protect net interest income in the low interest rate environment, banks should start looking at their figures through a supervisory lens. Banks should innovate and prepare themselves to articulate to the supervisor how they will progress towards a sustainable and viable business model.

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