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COVID-19 economic impact on Expected Credit Losses

An analysis of the economic consequences of the COVID-19 pandemic on the performance and expected credit losses of major UK banks

May 2021

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Introduction

Before 2020, major UK banks were already facing a number of challenges: a complex regulatory environment, reducing interest rate margins, cost pressures, and the need for digitalisation to remain competitive. The economic fallout from the COVID-19 pandemic has exacerbated some of these challenges as well as added new ones.

Although governments have implemented unprecedented relief measures in order to minimise the economic impact of COVID-19 on businesses and individuals, the pandemic has had a clear impact on the key performance metrics of the banking sector: a decline in income due to interest rate cuts and reduced economic activity, incremental operating costs due to COVID-19 and a sharp increase in impairment for financial assets. Nevertheless, banks have thus far proven resilient and remain well-capitalised despite these challenges.

While the speed of vaccine rollout will drive the expected economic recovery, banks will still be faced with pressures from slower growth and lower interest rates. Banks are making strategic changes such as a shift to more profitable geographic and business segments, and withdrawal from other markets.

COVID-19 has also challenged the traditional ways of working and banking. The new flexible ways of working, while reducing property-related expenses, serve as impetus for digitalisation within the banking sector. There is a growing need for banks to focus on the ESG agenda by offering green financing and undertaking sustainability initiatives.

In this document, we have analysed the financial performance of six major UK banks for the first quarter ended 31 March 2021 by comparison to the year ended 31 December 2020 to provide insights into broader trends within the UK banking sector. For some of the key metrics, we have compared the performance of UK Banks against peers in the European Union (EU) for financial year 2020, albeit as an average across the selected banks.

UK Banks Performance – Q1 21

NIM	RoTE	Cost to income
1.9%	11.2%	60%
Q4 20: 1.8% 🟩↑	Q4 20: 1.1% 🟩↑	Q4 20: 78% 🟩↓
Q1 20: 2.2% 🟦↓	Q1 20: 4.6% 🟩↑	Q1 20: 56% 🟦↑

CET1	ECL Charge	ECL Coverage
🟦↓	🟩↓	🟩↓
15.8%	-132%	86bps
Q4 20: 15.9%	compared to Q4 20	Q4 20: 98bps

🟩 Favourable change 🟦 Unfavourable change 🟪 Neutral

UK Banks Performance - FY20

NIM	RoTE	Cost to income
🟦↓	🟦↓	🟪↔
1.9%	2.5%	65%
FY19: 2.1%	FY19: 8.1%	FY19: 65%

CET1	ECL Charge	ECL Coverage
🟩↑	🟦↑	🟦↑
15.9%	+209%	98 bps
FY19: 14.4%	compared to FY19	FY19: 70bps

Note: Represents simple averages of key metrics across selected UK banks, except for coverage ratio which is a weighted average ratio across various banks.

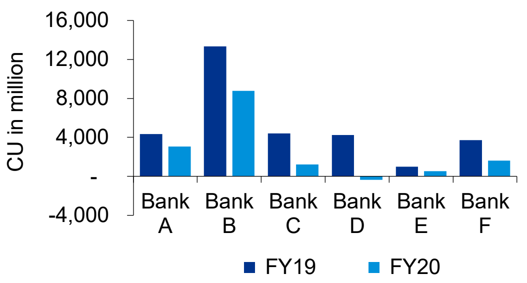
Snapshot of performance results

Profitability down in FY20 compared to FY19, but stronger performance reported in Q1 21

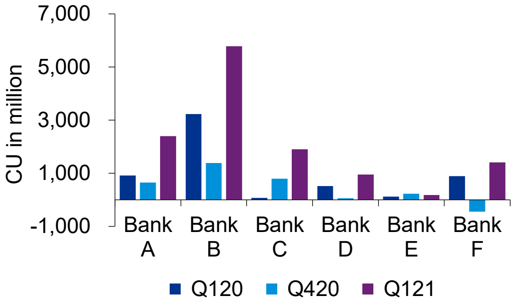
— Banks reported an overall decline in profitability in FY20 due to the COVID-19 outbreak and the challenging macroeconomic environment, including lower interest rates and higher expected credit losses. Banks have remained resilient however, with only one in the six banks reporting a loss for FY20.

— Q1 21 results show better performance in comparison to Q4 20, mainly driven by reductions in ECL charges reflecting improvements in macroeconomic outlook.

Profit before tax for FY20



Profit before tax for Q1 21



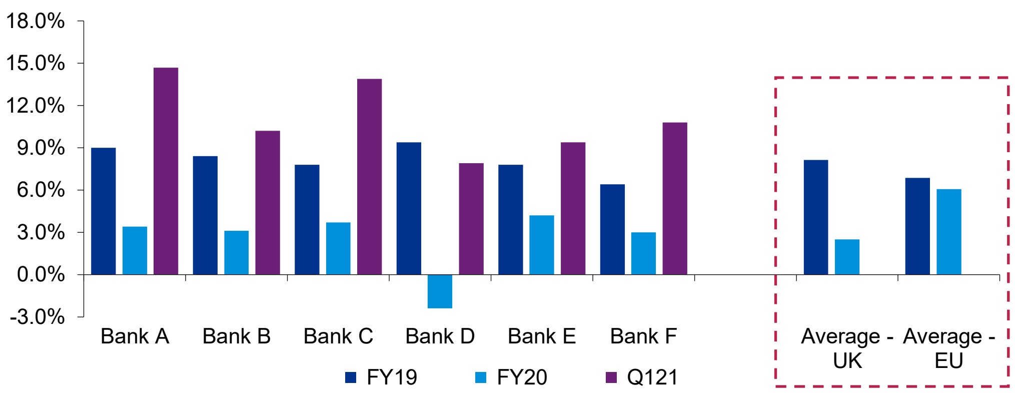
> Banks are seeking to overcome twin pressures on revenue and costs by pivoting to fee-based business and cutting overheads through digitalisation. CFOs should focus on building capital strength to support sustainable dividends to shareholders, especially as relief for loan-loss provisions tapers off and capital deduction for software assets is reintroduced.
>
> **Karim Haji**
> Head of UK Financial Services, KPMG UK

Return on Tangible Equity (RoTE) declined to 2.5% for FY20, down from 8.1% in FY19, improving significantly to 11.2% for Q1 21

— The decline in RoTE in FY20 was consistent with EU banks, although the rate of decline was higher for UK Banks due to NIM contraction this year, which was already experienced by EU banks in previous years.

— For Q1 21, RoTE increased significantly, mainly driven by decline in ECL charge from improved macroeconomic outlook. Despite the uncertainty around the economic impact of the pandemic, banks expect improvements in the RoTE over time, driven by improved asset quality, growth in lending, better funding mix, cost efficiencies and better macroeconomic outlook.

Return on Tangible Equity – RoTE



Note:
The ratios in the graph are based on simple averages of the selected banks' results. Similarly, average results for UK and EU are based on simple averages of selected banks.

RoTE declined in FY20 due to the economic fallout of the pandemic, but most banks continued to report a net profit. With declining NIM, banks are focusing on fee-based businesses while adjusting their funding mix. In Q1 21, banks saw solid improvement in profit due to ECL release or lower ECL charges, reflecting an improvement in macroeconomic outlook.

Snapshot of performance results (cont.)

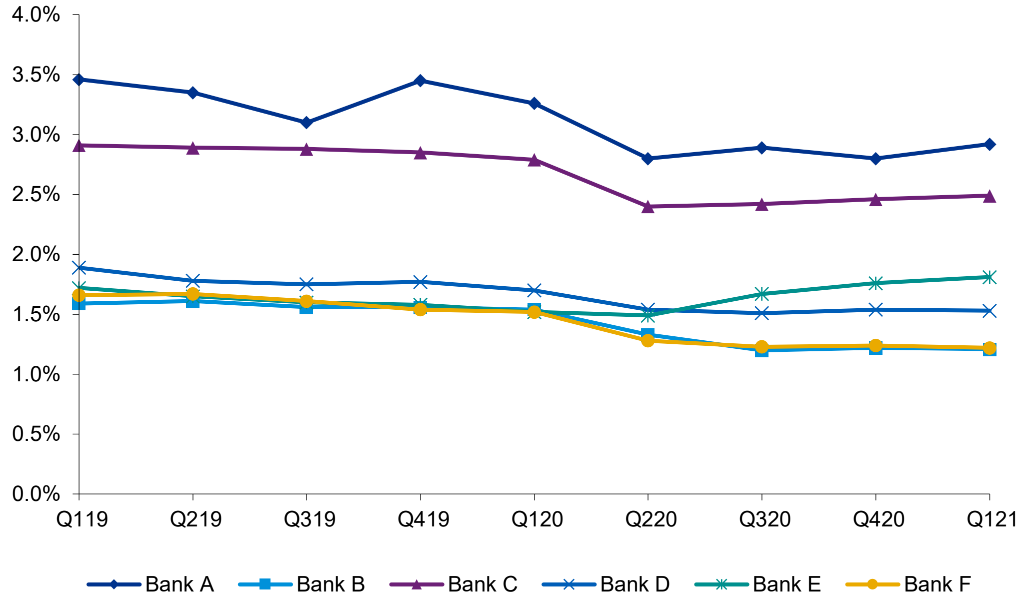
Net Interest Margin (NIM) for FY20 averaged 1.9%, down from 2.1% in FY19. Generally, NIM was showing a downward trend from Q1 19 to Q4 20, largely attributable to rate cuts by central banks

— Banks are adjusting their funding mix and turning towards fee-based businesses to improve profitability.

NIM improved slightly in Q1 21 to 1.86% in comparison to 1.84% for Q4 20

— Banks saw NIM improve in Q1 21, driven by an increase in lending from mortgage and government backed loans coupled with changes in funding mix and deposit repricing.

Net Interest Margin (NIM)



No clear trend in cost-to-income ratio

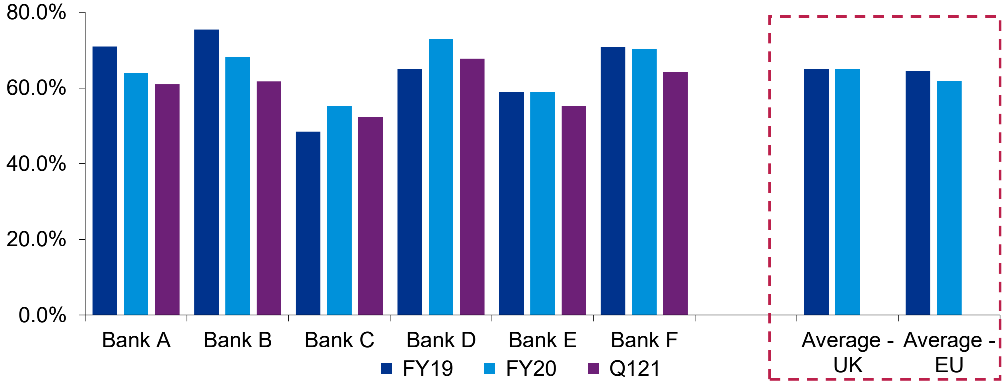
— While the pandemic partially impacted banks' ability to reduce costs through delays in restructuring and increased costs from the direct impact of COVID-19, certain banks were able to deliver their cost reduction targets through process improvements and digitalisation and reducing performance-related pay in FY20. In the coming years, we expect banks to focus on digital delivery of services and remote working, driving down property-related expenses which can be redirected towards digital innovation.

— Despite cost reduction efforts, we see mixed results in cost-to-income ratio, depending on whether the proportionate decline in operating costs for a bank were in line with, more than, or less than the proportionate decline in operating income for the bank.

— **This contrasts with EU banks, where we see an average of 2bps decline** in the cost-to-income ratio in FY20 as cost efficiencies outweighed the decline in revenue.

— **Cost-to-income ratio has decreased to an average of 60% in Q1 21 relative to 65% in FY20 but is still higher than 56% in Q1 20.** This is due to increased variable compensation for Q1 21, COVID-19 related costs that continued in Q1 21 and strategic investments, which were partially offset by a decline in expenses through restructuring and headcount reductions.

Cost-to-income



Note: The average ratios in the commentary are based on simple averages of ratios for selected banks' results.

Snapshot of performance results (cont.)

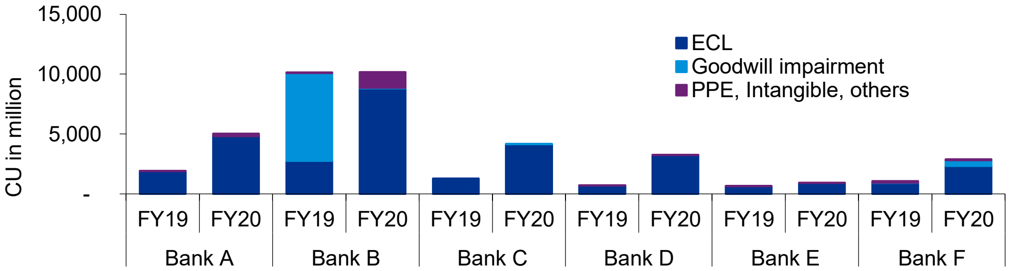
Increased focus on non-interest income

- With declining NIM, banks, particularly the corporate segment, focused on fee-based business such as corporate advisory to drive future growth. Despite these efforts, fee income remained stable for FY20, due to the offsetting reduction in fee income from retail businesses driven by lower customer spending.
- The decline in other income was driven by lower volumes of trading activity in FY20 as the securities markets were significantly affected by the pandemic.
- In FY20, as a percentage of operating income, the average net interest income increased to 61% (FY19:56%), fee income reduced slightly to 19% (FY19:20%) while the proportion of other income reduced to 20% (FY19: 24%)
- In general, banks recorded a higher operating income in Q1 21 as compared to Q4 20 due to favourable performance in fee-based businesses and improvement in funding mix.

ECL charges in FY20 surged by 209% compared to FY19, but Q1 21 saw some ECL releases

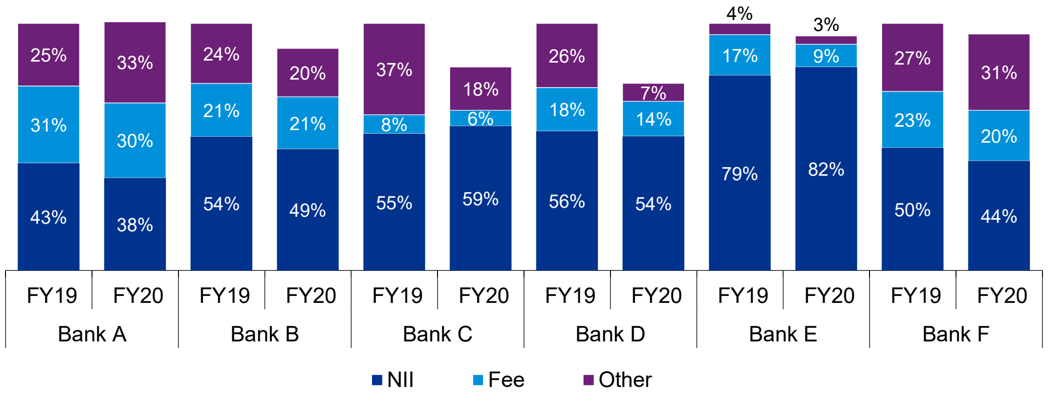
- The negative economic outlook as a result of the pandemic drove significant increases in ECL provisions across all UK banks in FY20. In Q1 21, there were some ECL releases reflecting improvement in macroeconomic outlook. This is discussed in detail on page 13 to 20.
- Some banks also reported impairments on intangible and tangible assets including right-of-use assets relating to leases in FY20. No material impairment was recognised in respect of these assets in Q1 21.

Impairment charge for FY20

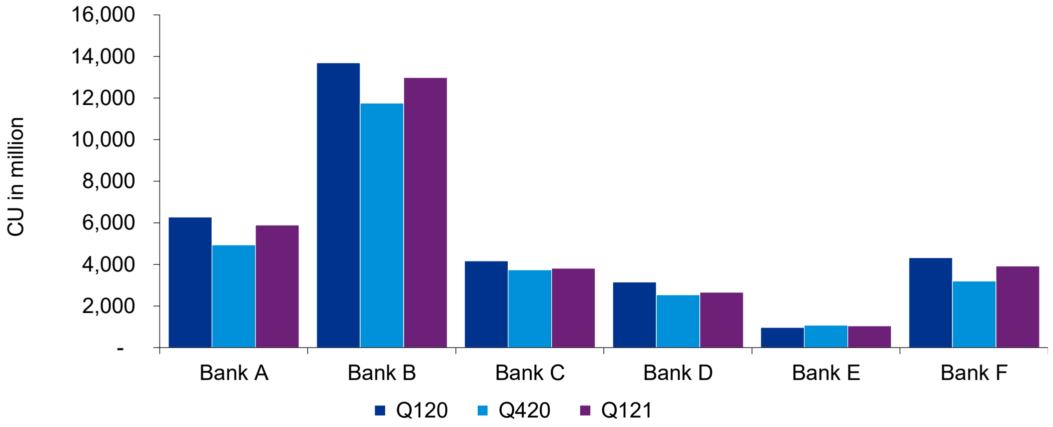


Components of operating income for FY20

Computed as a % of FY19



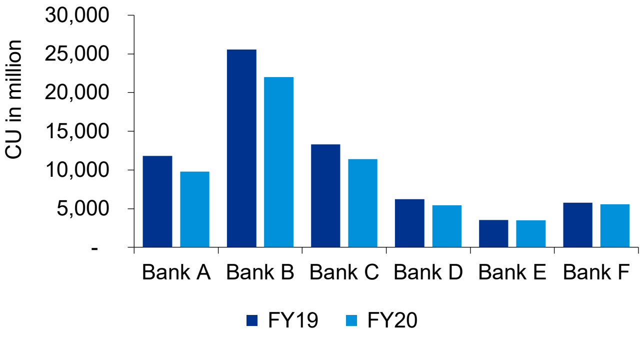
Operating income for Q1 21



Note: The average ratios in the commentary are based on simple averages of ratios for selected banks' results

Segmental analysis - Retail, private and wealth

Operating income – FY20



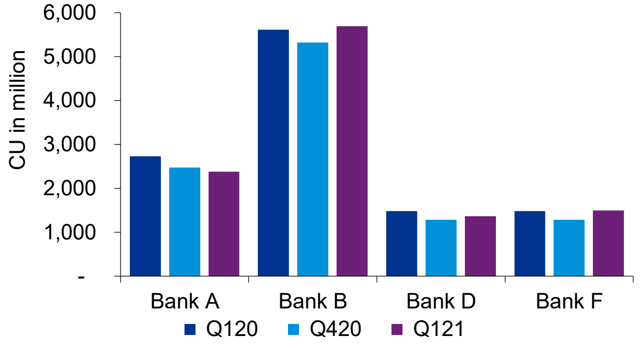
Operating income fell by circa 10% in FY20 compared to FY19

For the selected banks, retail lending contributed circa 57% of the operating income in FY20. The operating income for retail lending declined on average by 10% in comparison to FY19, attributable to lower interest income driven by interest rate cuts, and reduced fee income from lower card spend and reduction in account services.

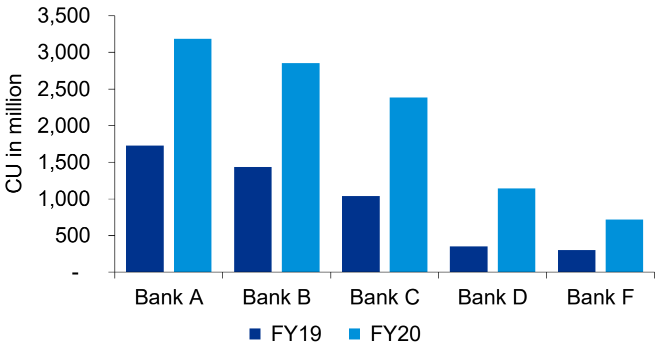
Operating income levels improved in Q1 21 but remains below pre-COVID levels

Operating income in Q1 21 improved slightly from the previous quarter Q4 20 primarily due to growth in consumer lending such as mortgages and better deposit pricing, offset by lower unsecured loan balances. Nonetheless, Q1 21 operating income remained below the corresponding Q1 20 levels due to reduction in fee charges in light of customer relief measures provided on consumer lending.

Operating income - Q1 21



Expected credit losses – FY20

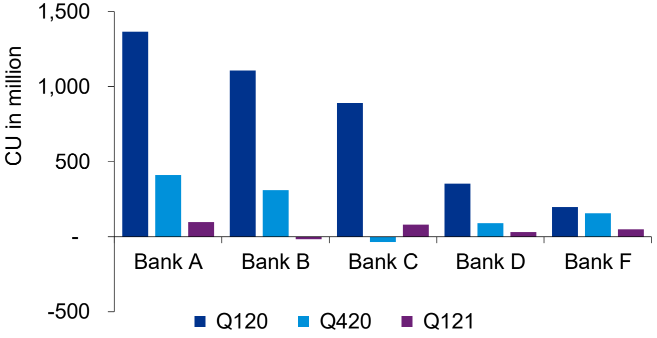


ECL charge in FY20 rose by 134% compared to FY19 but fell significantly in Q1 21

Loan impairment charges increased substantially in FY20, particularly in non-defaulted exposure stages 1 and 2, reflective of the credit losses expected from the economic downturn and increase in weighting for downside and severe downside scenarios. Government support measures such as payment holidays and furlough schemes prevented a significant increase in defaults during the year.

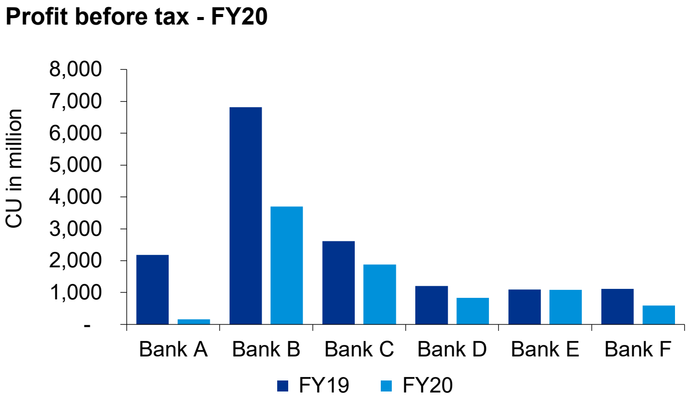
In Q1 21, we saw a significant decline in ECL charge and in some cases even reversals, driven by improvement in macroeconomic variables, particularly HPI and unemployment rates.

Expected credit losses - Q1 21



Notes: The reporting currency (CU) for Bank A, C, D and E is GBP while Bank B and F is USD
Segmental split of ECL for Bank E was not available
The quarterly results for Bank C and E did not provide segmental breakdown for operating income and profit before tax.
The average ratios in the commentary are based on simple averages of ratios for selected banks' results.
Segmental information aggregated by KPMG based on published information of the banks. Terminology, amount, and ratios may differ from banks' own disclosures.

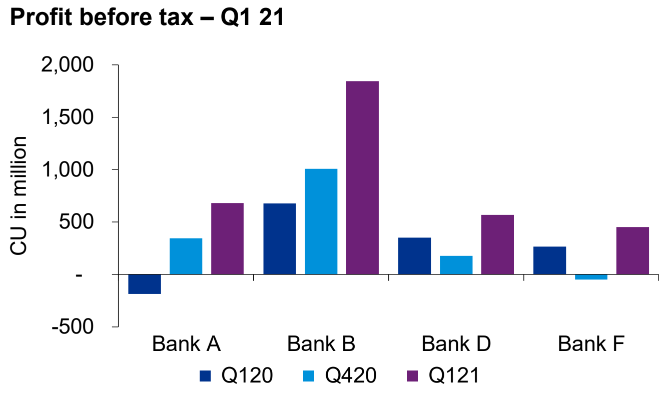
Segmental analysis - Retail, private and wealth (cont.)



Overall reduction in profitability for FY20 while Q1 21 recorded better performance

Some banks reported a sharp decline in profit before tax in FY20 for retail segments, driven by lower operating income and higher ECL charges. While banks managed to reduce operating costs by achieving efficiencies and reducing discretionary spend, additional operating expenses due to COVID-19 partially offset such benefit.

Banks recorded higher profitability in Q1 21 due to significantly lower ECL charges, and in some cases releases of ECL.



Profitability in retail lending decreased in FY20 due to a surge in expected credit losses and reduction in operating income. Q1 21 shows improvement in profitability with markedly lower ECL charges.

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Segmental split of ECL for Bank E was not available

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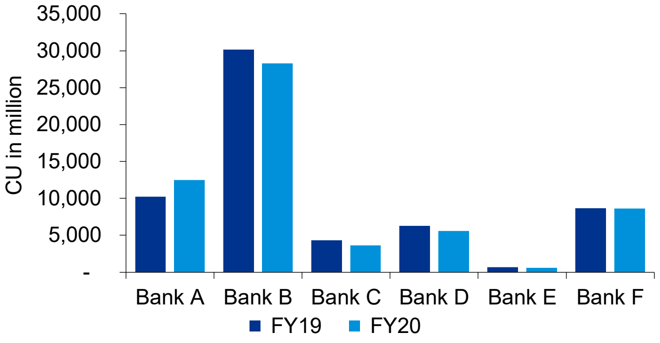
> Investment in digital propositions is vital to compete against digital lenders, mobile payments, and open banking platforms. We see banks pivoting to wealth management to compensate for persistently low net interest margins. Mortgage lending is being buoyed by rising house prices and government-led incentives, whereas unsecured loans and credit card balances are down – although there could be a spending spree as restrictions on travel and hospitality are lifted.

Lisa Fernihough
Head of UK Financial Services Consulting
KPMG UK

Segmental analysis - Corporate, commercial, and wholesale

Operating income – FY20



Operating income decreased by 4% for FY20 in comparison to FY19

Overall, there were mixed results in relation to operating income. In FY20, there was a decline in operating income from:

— reduced lending income driven by interest rate cuts; and

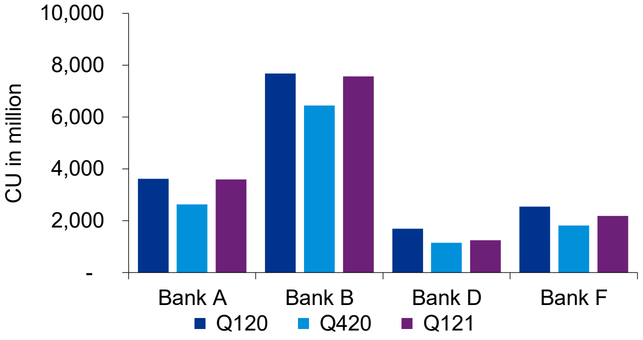
— reduced fee income from decline in trade activity.

This was partially offset by increase in operating income from change in funding mix and advisory income from increased advisory services.

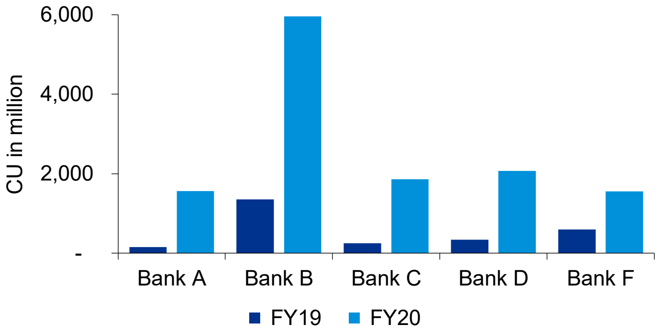
Better performance in operating income for Q1 21 relative to Q4 20

Operating income for Q1 21 improved in comparison to Q4 20, although operating income levels remained below Q1 20 levels due to lower fee income and trade finances.

Operating income – Q1 21



Expected credit losses – FY20



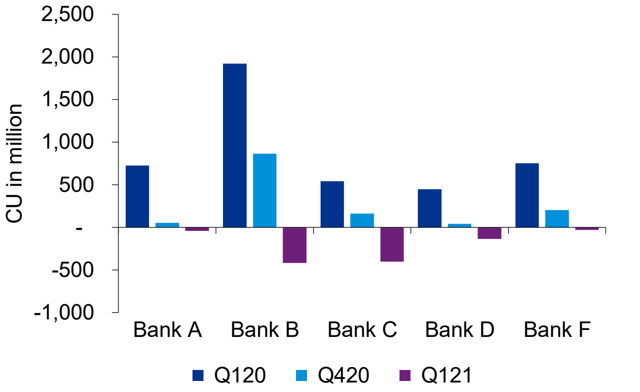
ECL charges soared by 508% for FY20 compared to FY19

Significantly higher full year ECL charges in FY20 predominantly due to the deterioration of economic outlook as a result of the pandemic. This led to higher ECL charges for stage 1 and 2, particularly against exposures in sectors severely impacted by the pandemic such as aviation, hospitality, and commercial real estate.

ECL releases in corporate, commercial, and wholesale lending across UK banks in Q1 21

UK banks reversed some ECLs in Q1 21 due to improvement in macroeconomic outlook, coupled with the fact that significant ECL charges were already recognised in FY20 to reflect the negative impact of COVID-19.

Expected credit losses – Q1 21



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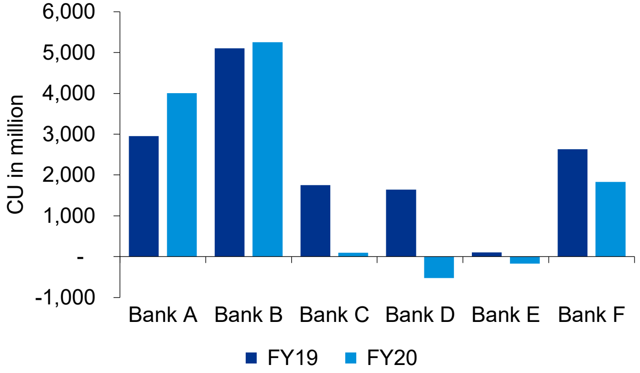
Segmental analysis - Corporate, commercial and wholesale (cont.)

Profit before tax – FY20



Mixed results for segmental profitability for FY20 when compared to FY19

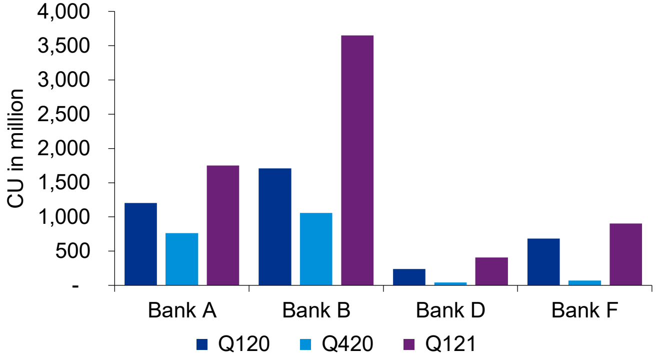
In FY20, we saw a decline in profitability from reduced income and higher ECL charges as noted above. However, banks were able to manage operating costs through cost reduction initiatives.

Some banks saw favourable performance in FY20 profitability in their wholesale business, primarily driven by global market operations, higher spreads on fixed income and gains on derivatives from increased volatility.

Corporate, commercial, and wholesale business saw favourable profitability performance in Q1 21 relative to Q4 20

In Q1 21, profitability improved due to decreases in, and in some cases reversals of, ECL charges. Costs generally increased in comparison to Q1 20 due to increases in variable compensation and other COVID-19 related costs.

Profit before tax – Q1 21



Significant increase in ECL on corporate, commercial, and wholesale exposures but some banks were able to maintain profitability in FY20. Q1 21 recorded stronger results due to ECL releases.

Notes: The reporting currency (CU) for Bank A, C, D and E is GBP while Bank B and F is USD

Segmental split of ECL for Bank E was not available

The quarterly results for Bank C and E did not provide segmental breakdown for operating income and profit before tax.

The average ratios in the commentary are based on simple averages of ratios for selected banks' results.

Segmental information aggregated by KPMG based on published information of the banks. Terminology, amount, and ratios may differ from banks' own disclosures.

> Profits from corporate portfolios are recovering, though still subdued. Trading volumes, capital markets and advisory activities are on the up, but interest income remains sluggish due to low rates and reduced lending. Reductions in loan loss provisions are giving a boost.

Paula Smith
Head of UK Banking
KPMG UK

COVID-19 – Impact on regulatory capital

Despite the effect of the pandemic resulting in declining profits in FY20, we saw an improvement (on average 150 bps) in common equity tier 1 (CET1) ratio for the major UK banks. This is consistent with the better CET1 ratio for EU banks. In Q1 21, CET1 ratios were down marginally, as improved profitability was offset by share buybacks and cessation of certain regulatory reliefs.

Primarily, regulatory relief measures have contributed to the higher overall capital ratio for the UK banks for FY20.

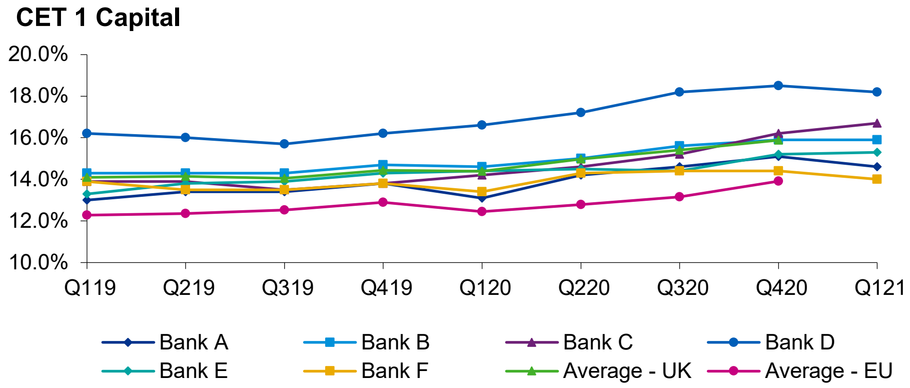
FY20:

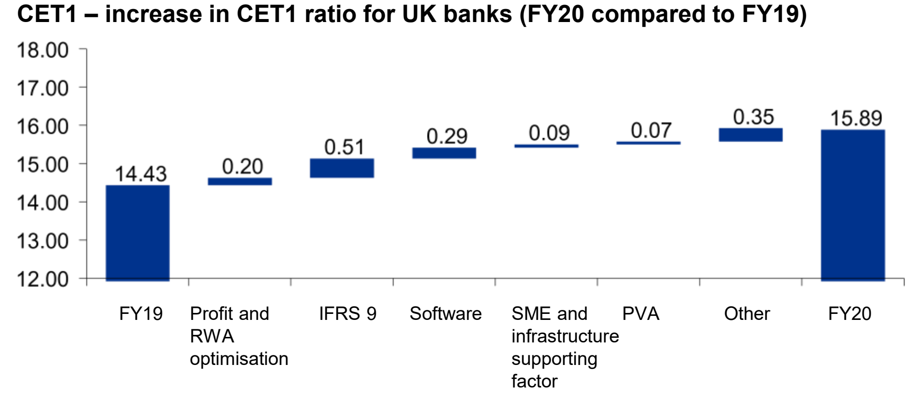
- **Profit and RWA (20 bps):** Better CET1 ratio in FY20 through RWA optimisation and addition of profits to CET1 capital, although the latter impact was limited due to decreased profitability.
- **Regulatory support** in the form of the following quick fixes adopted by the EBA and PRA:
  - **IFRS 9:** ECL relief of 51bps, ranging up to 83 bps for certain banks in FY20. For banks adopting the IFRS 9 transitional relief, the dynamic portion of Stage 1/2 ECL raised from 1 January 2020 to 31 December 2021 is added back to CET 1 capital at the following percentages: 100% in 2020 and 2021, 75% in 2022, 50% in 2023, and 25% in 2024.
  - **Software:** Circa 30bps increase in CET1 ratio from the revised regulatory treatment of software assets that was promulgated in December 2020. This benefit is likely to be temporary as the PRA is undertaking consultation on this change with a view to reverting to a full deduction of software assets from CET1 capital.
  - **SME and infrastructure supporting factor:** This represents advanced application of both the SME and infrastructure supporting factor, which resulted in a more favourable prudential treatment of certain exposures, leading to an increase in capital ratios.
  - **PVA (Prudent Valuation Adjustment):** This represents revisions to the RTS on prudent valuation under CRR, allowing for aggregation factor for additional valuation adjustment to be increased from 50% to 66%, resulting in decrease in PVA charge deducted from CET1 capital in FY20. However, this relief ceased to apply from 1 January 2021.
- **Other factors** include cancellation of dividends for 2019 due to COVID-19, and FX adjustments.

Q1 21:

- On average, CET1 ratio in Q1 21 declined slightly as compared to Q4 20, given that the impact of profitability and RWA optimisation were offset by share buybacks and cessation of PVA relief.

The tapering of ECL capital relief and the expected reversion to full capital deduction for software assets put additional downward pressure on CET1 ratios.





The data in the above chart represents a simple average for selected banks of CET1 ratio and the various contributing factors.

Average CET1 for UK and EU banks are based on a simple average of selected UK and EU banks.

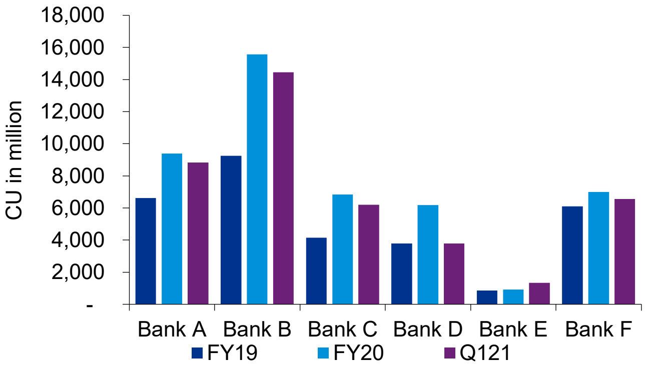
Expected Credit Losses on financial assets

Significant government support measures have helped to alleviate the recessionary impact of the pandemic on the economy, however the unprecedented nature of the current macroeconomic conditions introduced by COVID-19 has led to substantial increase in ECL charges for banks in FY20 relative to FY19. Most of the ECL charges for FY20 were recognised in the first and second quarters of the year.

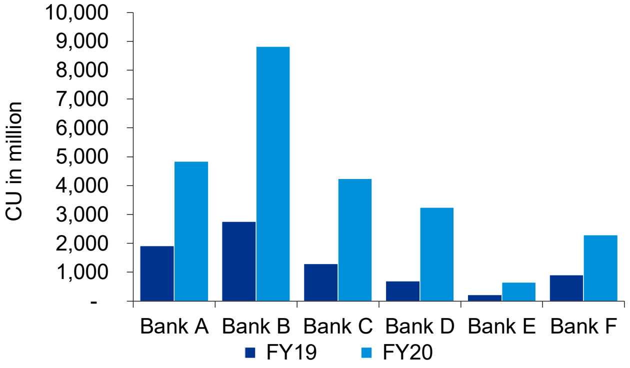
The trend in FY20 has since reversed as banks recognised significantly lower ECL charges in Q1 21, with three of the six banks recognising an ECL release. The reduction or reversal in ECL charge were primarily driven by improvement in macroeconomic forecasts and lower level of defaults in Q1 21.

> The economic outlook is rosier but there remain headwinds. High uncertainty coupled with default deferrals mean banks must continue to exercise significant judgement to set appropriate loan loss provisions. Most foresee materially lower ECL charges in 2021.
>
> **May Tiem Gillen**
> Head of Banking Accounting Advisory
> KPMG UK

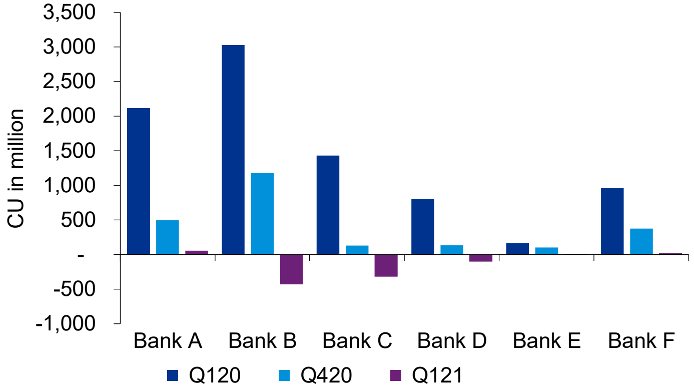
ECL allowance as at Q1 21



ECL charge for FY20



ECL charge for Q1 21



In the next pages, we discuss how various ECL elements contributed to the higher ECL charge in FY20 and the subsequent ECL release in Q1 21.

Notes: The reporting currency (CU) for Bank A, C, D and E is GBP while Bank B and F is USD

Transition of exposure across stages

Stage 2 on-balance sheet exposures increased by circa 39% for retail products and 101% for wholesale products in FY20 relative to FY19, before decreasing in Q1 21

— A significant portion of loans and advances moved to stage 2 in FY20 as compared to FY19 due to the deterioration of macroeconomic variables.

— The increase in stage 2 exposures is most evident in the wholesale portfolio where stage 2 exposure almost doubled in FY20. The sharp increase is mainly attributable to negative macroeconomic outlook coupled with credit deterioration of customers, particularly in high risk sectors most impacted by the pandemic such as hospitality, transportation and retail – the latter is discussed in more detail in the section "Sectors most impacted by Covid-19".

— We observe a 30% to 40% increase in stage 2 exposures for retail lending in FY20. This increase was predominantly driven by economic variables supplemented, where available, by information obtained when providing tailored relief to the customers. Some banks also performed collective assessments to identify the portion of loans that experienced a significant increase in credit risk to be transferred to stage 2.

— Overall, the higher stage 2 exposures recognised by the major UK banks is consistent with the results of selected EU banks in FY20, although the magnitude of increase is greater for the UK banks.

— In Q1 21, there was a reduction in stage 2 exposures, although the proportion of exposure was still higher than pre-pandemic levels. Stage 2 wholesale exposures decreased due to improvement in underlying credit risk metrics. Similarly, for retail exposures, stage 2 balances decreased due to improvement in PDs reflecting better economic outlook, moving some exposures back to stage 1. A small proportion of stage 2 retail exposures deteriorated further to stage 3.

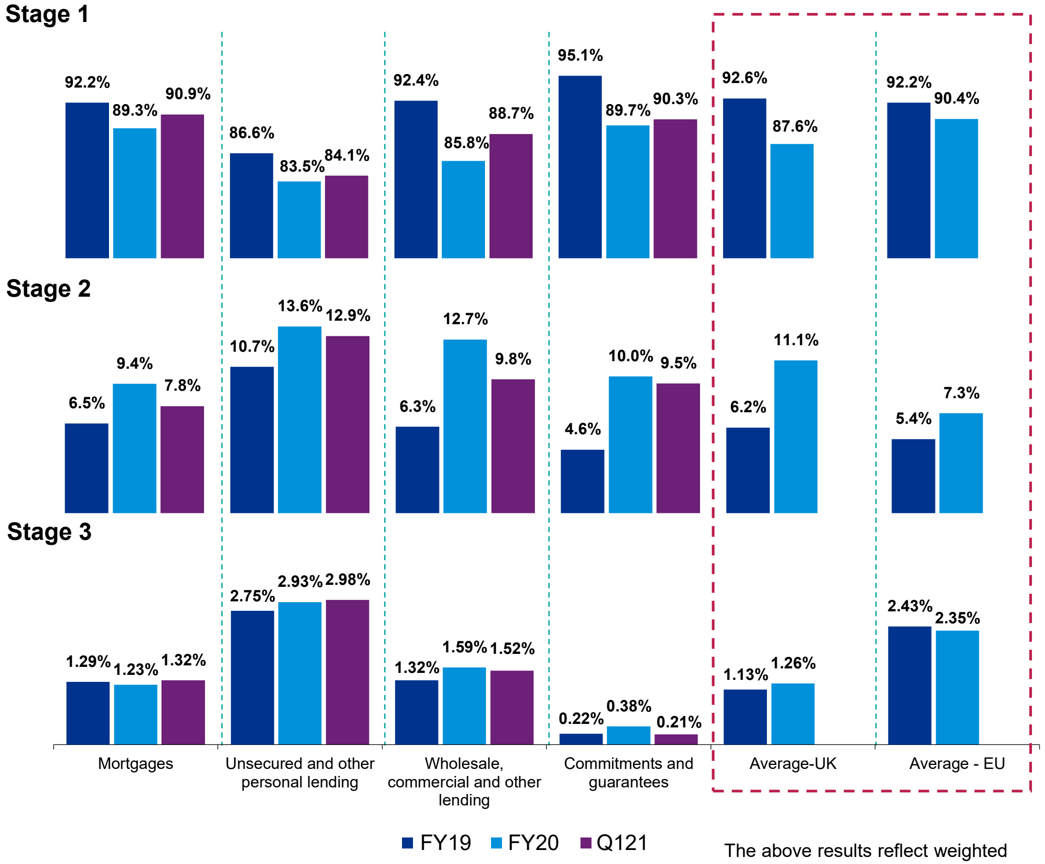
Modest increase in stage 3 exposures for FY20, with the trend continuing in Q1 21

— UK banks have reported a modest increase in stage 3 exposures in FY20 as compared to FY19. Conversely, EU banks saw a small decline in stage 3 exposures driven primarily by write-offs.

— In Q1 21, we saw a slight increase in stage 3 exposures, driven by movement of customers to delinquent status, offset in part by loan write-offs.

— We anticipate that the proportion of stage 3 loans will begin to increase as we move through 2021 as government support measures are withdrawn.

Higher default rates may emerge over the course of 2021 as government relief schemes end.



The above results reflect weighted average exposure transition across various product segments for the selected banks. The average results for UK and EU banks are based on weighted average exposure transition across selected UK and EU banks.

Notes:
Stage 1 is where credit risk has not increased significantly since initial recognition
Stage 2 is where credit risk has increased significantly since initial recognition
Stage 3 is where the financial asset is credit impaired

Expected Credit Losses on financial assets

ECL coverage ratios

FY20

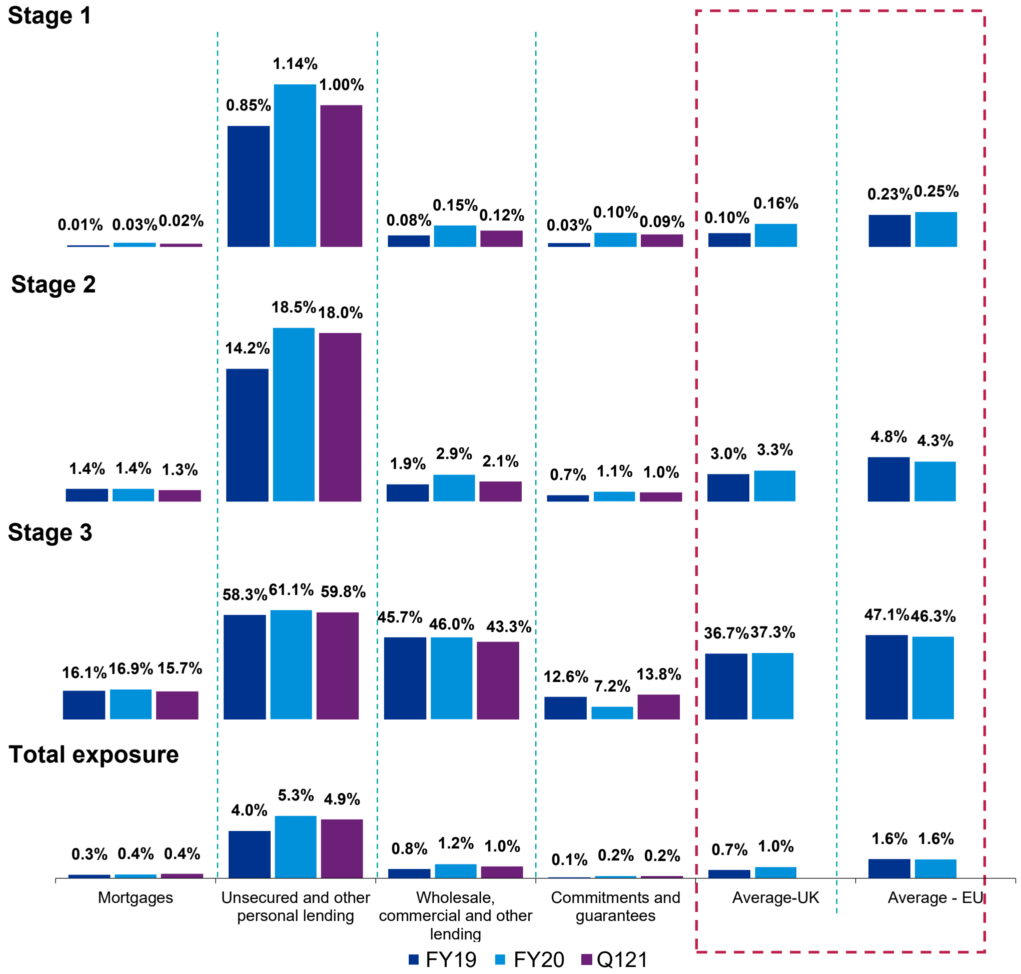
- ECL coverage ratios increased across the three ECL stages in FY20.
- At product segment level, we observe that the coverage ratio on:
  - secured loans such as mortgages remained low as banks maintain a low loan-to-value ratio and HPI has not been severely impacted by the pandemic. HPI forecast has also improved in part due to the government stamp duty relief.
  - unsecured personal lending, especially credit cards, has increased significantly as a result of increased unemployment rate and other macroeconomic variables.
  - wholesale and commercial portfolio has increased due to severe adverse shift in macroeconomic scenarios related to COVID-19 and reduction in collateral value.
- Both 12-month and lifetime PDs have increased in FY20, predominantly driven by downside economic forecasts.
- Government guarantees on new CBILs and BBLs issued to corporate and commercial customers have been incorporated in the calculation of loss given default on affected loans – thus reducing the ECL impact substantially.
- The UK banks' results in FY20 are in contrast to EU banks', where overall ECL coverage ratios (average) remained flat year on year. Specifically, the ECL coverage ratio for stage 2 has fallen despite higher stage 2 exposures in EU banks.

Q1 21

- As we move into FY21, we saw a decline in the ECL coverage ratios in Q1 21, although they remained higher than pre-pandemic levels, particular against stage 1 and 2. As noted previously, the reduction in coverage ratio is attributed to improvement in PDs reflecting more positive economic forecasts.

High ECL coverage ratios in FY20 driven by a bigger proportion of assets in stage 2 and 3 and deterioration in economic outlook. Conversely, ECL coverage ratios are down in Q1 21 due to improvements in economic outlook, but are still higher than pre-COVID levels.

Notes:
Stage 1 is where credit risk has not increased significantly since initial recognition
Stage 2 is where credit risk has increased significantly since initial recognition
Stage 3 is where the financial asset is credit impaired

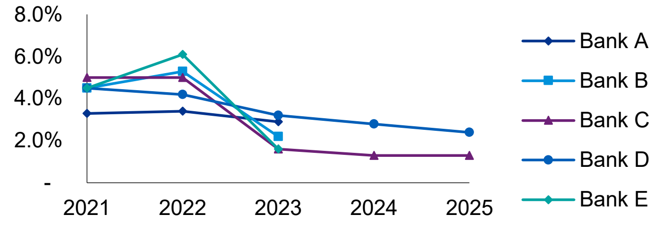


The above results reflect weighted average coverage ratios across various product segments for the selected UK banks.

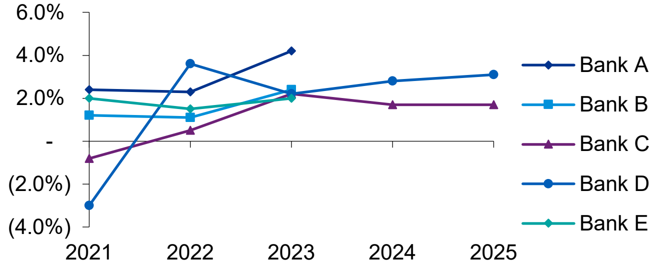
KPMG

Macroeconomic forecasts

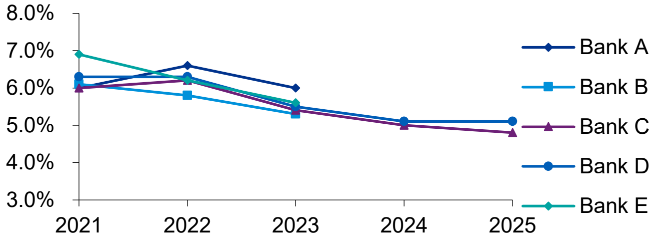
**Macroeconomic variable –
UK GDP forecast (Q1 21)**



Macroeconomic variable – UK HPI (Q1 21)



**Macroeconomic variable –
UK Unemployment rates (Q1 21)**



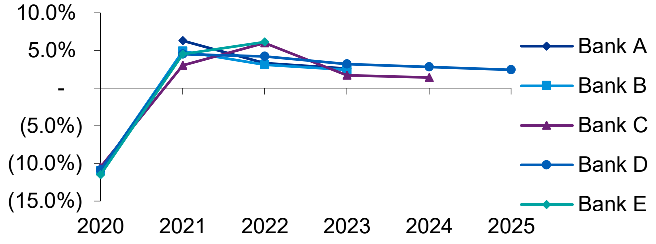
- UK banks disclosed a wide range of UK macroeconomic forecasts incorporated in their ECL measurement for FY20. While some banks expect macroeconomic variables to return to a long-term stable trend from 2022, others believe that it will only happen after 2022.
- For baseline scenarios, we see convergence on GDP and unemployment rates across banks. However, there is wide disparity in HPI forecasts across the banks.
- In Q1 21, we continued to see some divergence in the UK macroeconomic forecasts amongst UK banks - consistent with FY20. Nevertheless, there were improvements in forward economic outlook as reflected in the growth in macroeconomic variables such as GDP and HPI during the first two years of forecasts due to the extension of government support and efficiency of the vaccination programme in the UK. While the UK managed to secure a deal with the EU, avoiding significant disruptions to trade, the realities of the new trading relationship will dampen economic growth for a while.
- Given the extensive government support measures, the full economic impact of the COVID-19 pandemic on ECL has not manifested in FY20. UK Government intervention, in particular the Job Retention Scheme, helped to control unemployment levels in 2020. Unemployment could peak in 2021 and 2022 when government support schemes end, driving higher level of defaults in retail exposures.
- The speed of COVID-19 vaccine rollout will be pivotal to economic recovery. Although the macroeconomic forecasts at the end of FY20 saw some improvement relative to the first half of the year, banks have in general maintained their ECL provision levels due to the high uncertainty of economic outlook and deferral of defaults.

The uncertainties around economic conditions in 2021 and beyond mean that it is likely that there will continue to be divergence in the forecasts used by banks during 2021.

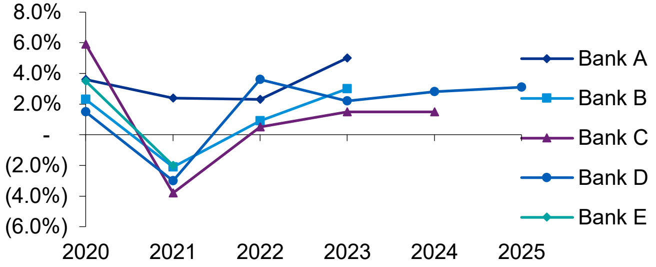
Notes

- The macroeconomic variables are for baseline scenarios.
- Bank F did not provide details of its macroeconomic variables.

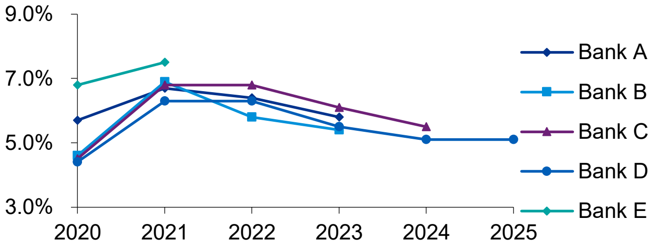
**Macroeconomic variable –
UK GDP forecast FY20**



Macroeconomic variable – UK HPI FY20

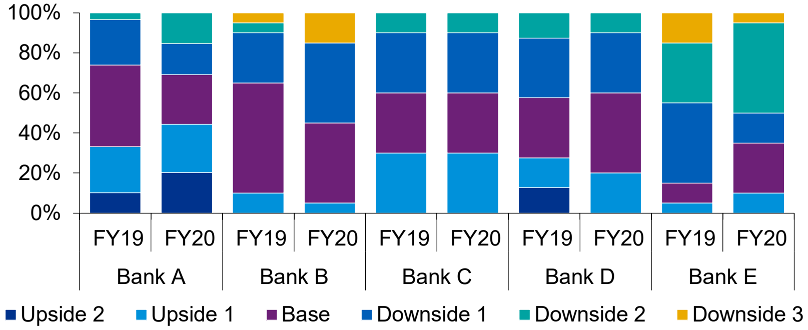


**Macroeconomic variable –
UK Unemployment rates FY20**

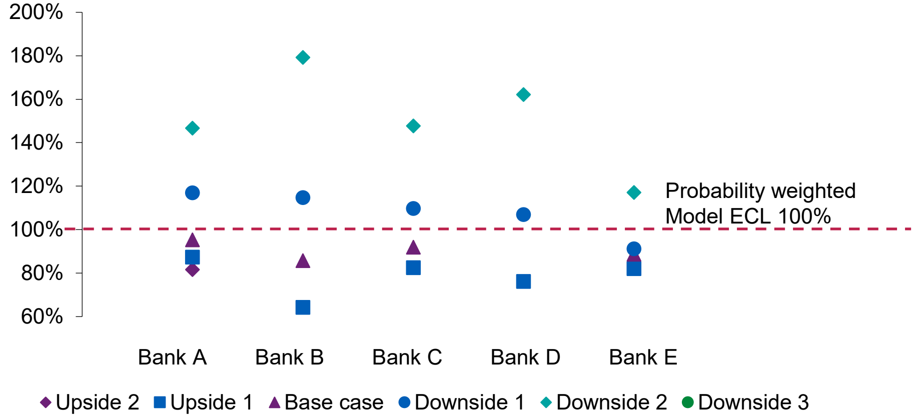


Sensitivity analysis

Probability weighting of scenarios – comparison between FY20 and FY19



ECL under different scenarios as a % of Model ECL as at 31 December 2020 (based on 100% weighting of scenarios)



Notes:
Bank F did not provide details of its macroeconomic variables.

Banks incorporated the economic uncertainty related to COVID-19 into their models for FY20 by:

— Updating their macroeconomic variables and weightings of their existing scenarios;

— Adding additional economic scenarios for the impact of COVID-19; or

— Applying an overlay to modelled ECL to capture economic uncertainty.

As can be seen from the chart 'Probability weighting of scenarios – comparison between FY20 and FY19', banks have attached higher probability weightings to downside scenarios in FY20 to reflect the negative economic outlook, as compared to FY19.

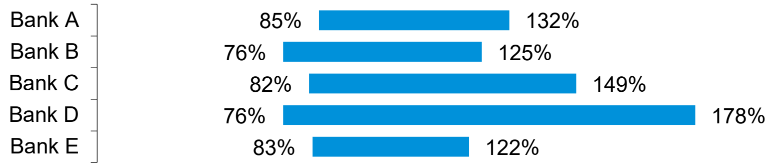
There is a wide range in the ECL results under various scenarios ranging from 64% in an upside scenario to approximately 179% for a downside scenario when compared to the modelled probability weighted ECL. The range is even broader specifically for wholesale exposures where one bank indicated that in the event of an extreme downside scenario, the ECL could increase to 231% (see split of wholesale and retail below).

Q1 21:

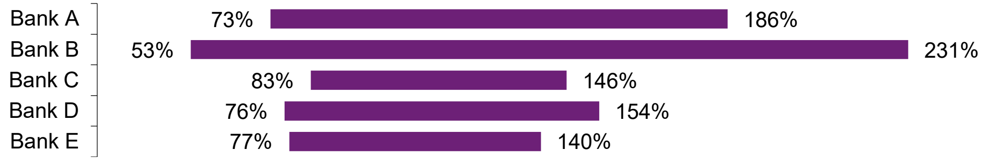
In general, banks have maintained the probability weightings of scenarios in Q1 21 the same as Q4 20, except one bank has increased its base case scenario weighting by 5% with corresponding reduction in its consensus downside scenario weighting.

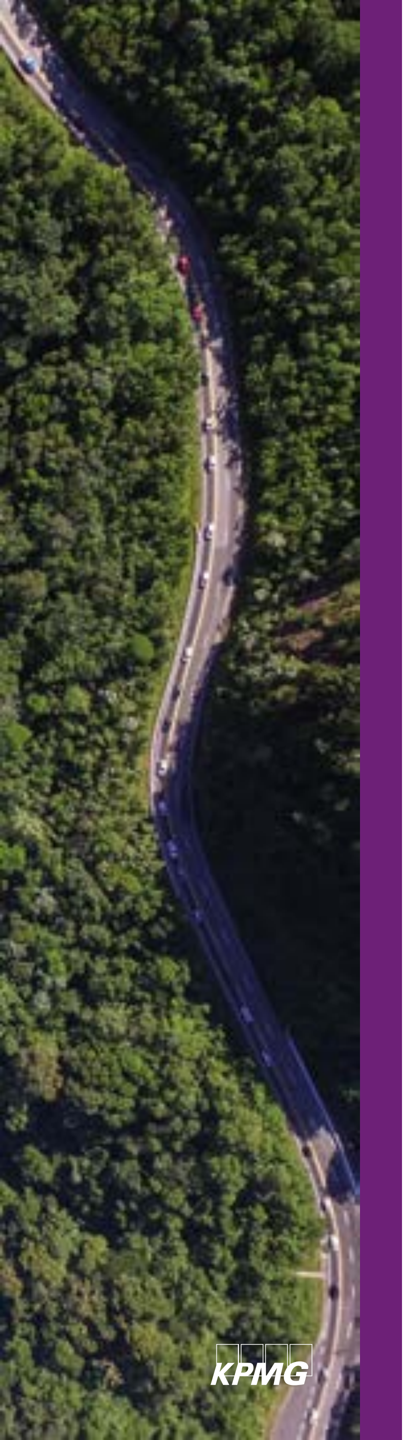
Only two of the six banks provided sensitivity analysis in Q1 21. The range of results for these two banks under the various scenarios is in line with FY20, albeit slightly narrower.

Modelled ECL Range for FY20 – Retail



Modelled ECL Range for FY20 - Wholesale





Post-model adjustments (PMA)

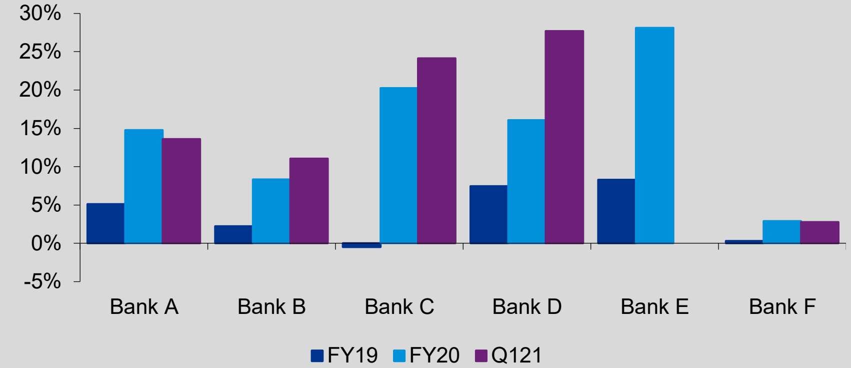
FY20:

- ECL models used by banks were not calibrated to the unprecedented economic conditions caused by COVID-19 and did not take into account the significant government support measures. Most banks have therefore made significant adjustments to their modelled ECL.
- The level of PMA booked as a percentage of total ECL allowance ranged vastly amongst banks, ranging from 3% to 28% for UK banks in FY20, which is significantly higher than FY19.
- Corporate and wholesale exposures
  - PMA applied to wholesale exposures in FY20 principally reflected expert credit judgements applied in high-risk and vulnerable sectors.
  - These were offset by downward adjustments for low risk counterparties such as banks/sovereign exposures. The modelled ECL output for these exposures were inflated due to the ECL models being oversensitive towards downside scenarios.
- Retail exposures
  - In general, PMA against retail exposures were made to account for delays to the timing of defaults as a result of government support schemes. This has been further supplemented by increases in ECL or deferrals of ECL releases due to customer relief and data limitations.
  - Retail PMA in FY20 were offset in some banks by decreases in ECL for unintuitive model responses, primarily where economic forecasts were beyond the bounds of the model development period.

Q1 21:

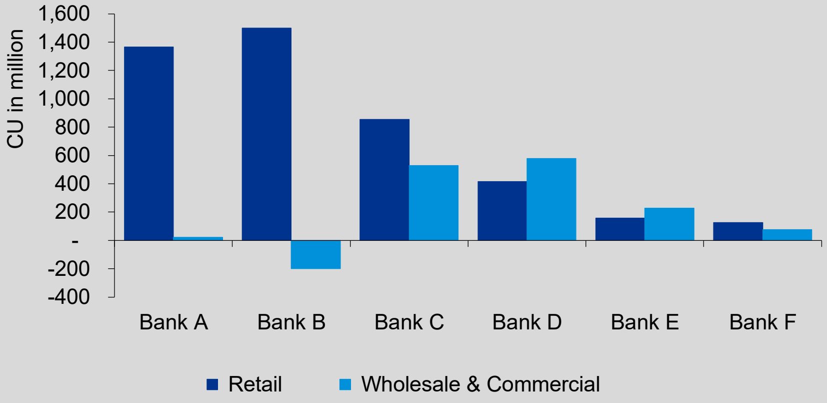
- UK banks have mainly carried forward the PMA applied at Q4 20, making marginal adjustments to the overlay amount in Q1 21. PMA as a percentage of total ECL allowance in Q1 21 is higher than FY20 because of the lower ECL allowance in Q1 21.

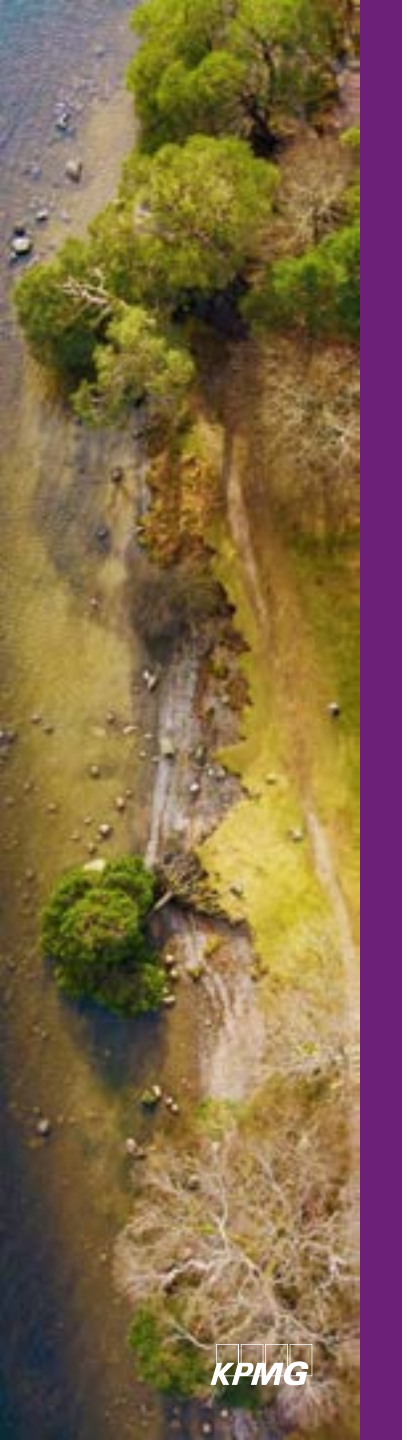
PMA as % of total ECL allowance



Note: Bank E did not provide PMA for Q1 21.

Split of PMA - Retail vs wholesale and commercial for FY20





Sectors most impacted by COVID-19

Industry sectors significantly affected by the pandemic include:

FY20:

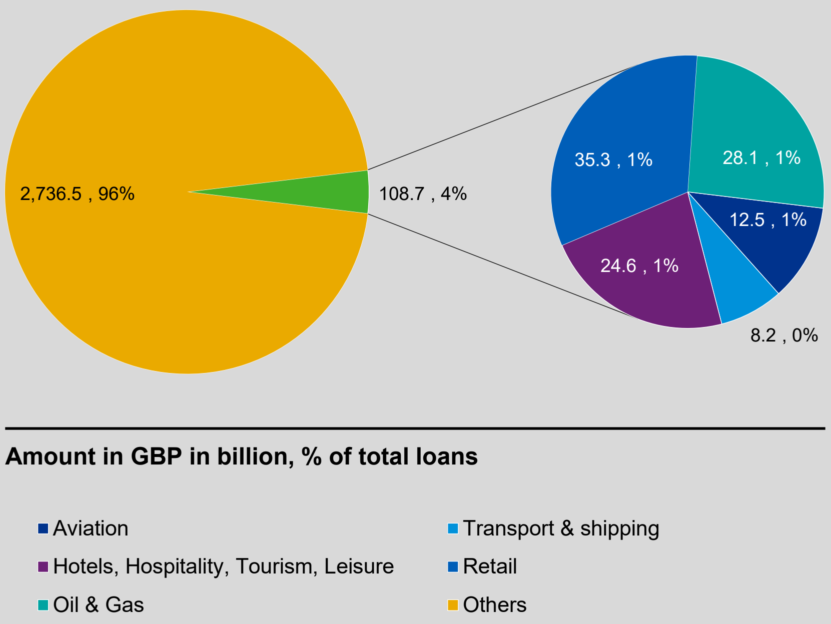
	Across selected UK banks		
Industry	Average percentage of stage 2 exposure	Average ECL coverage ratio for stage 2	Average ECL coverage ratio across stages
Aviation	50.4%	4.0%	5.0%
Hospitality	46.8%	4.5%	4.2%
Transport and shipping	33.3%	5.8%	4.1%
Retail	23.2%	4.7%	3.5%
Oil and Gas	22.6%	4.8%	5.1%

Banks have been prudent in identifying and incorporating the impact of the pandemic in their financial performance. As illustrated above, a significant portion of exposures has been moved to stage 2 in FY20, particularly in the aviation and hospitality industry which saw their businesses shrink markedly during 2020 due to lockdowns and strict measures to curtail the effects of the pandemic.

Q1 21:

The exposures in sectors most impacted by COVID-19 have reduced marginally in Q1 21 as compared to FY20. Of the two banks that provided further information, stage 2 exposures in high risk sectors and associated ECL coverage ratios were down slightly due to better macroeconomic outlook.

Sectors significantly affected as at 31 December 2020



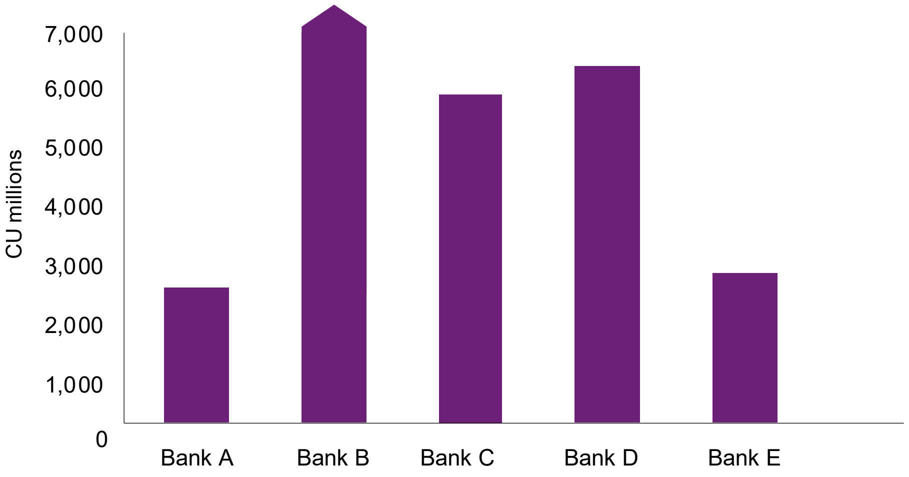
Amount in GBP in billion, % of total loans

Payment holidays and Government support measures

Payment holidays were provided to customers during 2020 to reduce the economic impact of the pandemic. For retail lending such as mortgages, payment holidays were mandated by the regulators, while for other lending such as commercial loans, banks voluntarily provided customer relief or concessions.

The introduction of payment holidays has delayed delinquency and migration of exposures to stage 2 or stage 3. Banks applied a combination of individual assessments, using available information, and collective assessments to determine whether loans have suffered a significant increase in credit risk.

Gross carrying value of loans with payment holidays still in place as at 31 December 2020



Note

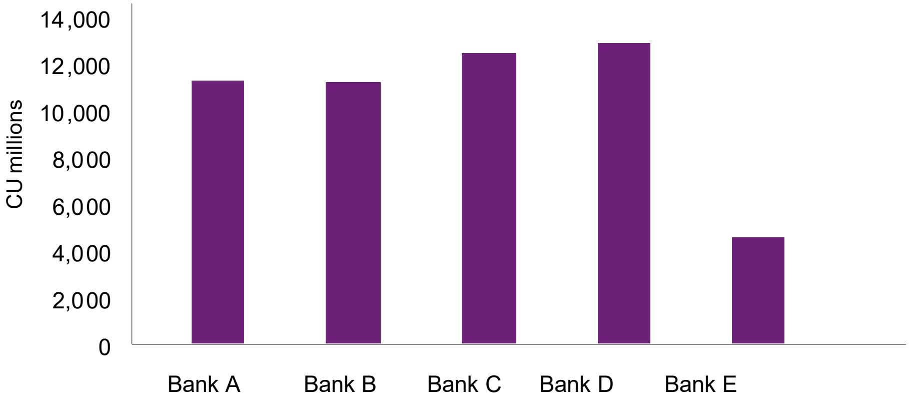
- The total balance of payment holidays granted by Banks B was in excess of $9,000m as at year end. Y-axis has been cut off for clearer comparison to the other banks.
- Data provided by Bank C was as at 16 February 2021.
- Bank F did not disclose detailed information related to payment holidays granted.

In addition, the UK government has introduced various government support schemes such as CBILS and BBLs to mitigate the economic impact of the pandemic.

Under the scheme, banks issued government backed lending to its customers, particular small and medium enterprises to help with temporary liquidity constraints. The increase in UK government backed loans is one of the drivers for the growth in commercial lending for some banks. Minimal ECL was recognised on these loans in FY20 given they are either 80% or 100% guaranteed by the UK government.

The graph below summarises the approved loan balances position as at 31 December 2020. The government support schemes continued in Q1 21 as new loans and top-ups were approved. New applications are closed from 31 March 2021.

Total approved loan balances under UK government lending schemes as at 31 December 2020



Note

- Data provided by Bank C was as at 12 February 2021.
- Bank F did not participate in the UK government lending schemes.

Summary

Banks have remained resilient with a strong capital base despite the challenges posed by the pandemic, declining market interest rates and subdued economic growth.

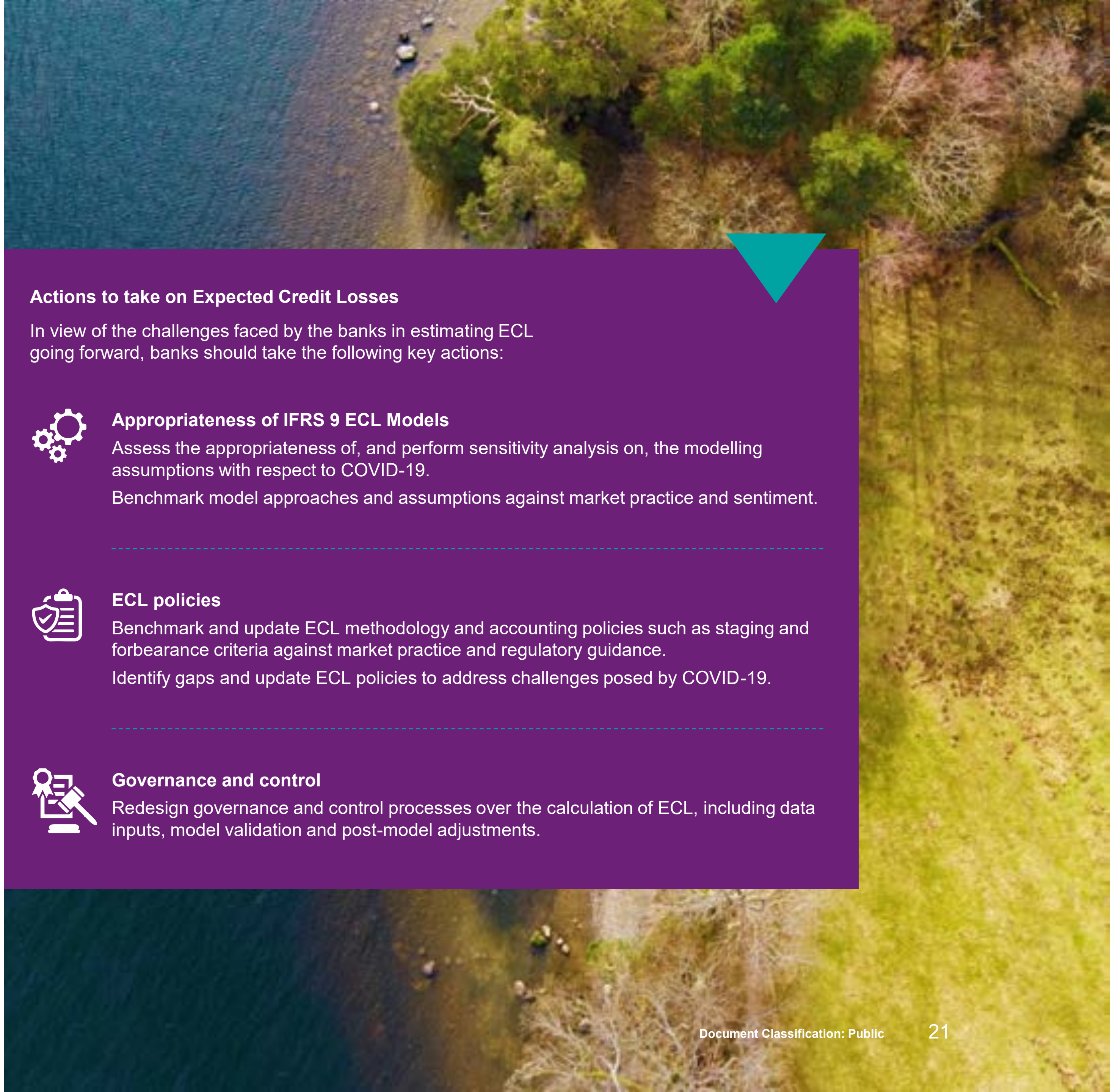
Five of the six UK banks reported profit for FY20, and all banks recorded strong improvements in Q1 21 results, although overall profitability remained below pre-pandemic levels. To mitigate the low interest rate environment, banks have amended their funding mix and prioritised focus on fee-based businesses.

UK banks have reported higher CET1 capital ratios in Q1 21 and Q4 20 primarily due to RWA optimisation and adoption of regulatory capital relief measures. Banks will need to continue to manage the downward pressure on CET1 ratios as these relief measures phase out.

From an ECL perspective, the consensus is that adequate loan loss provisioning has already been recognised against lending exposures. With the improving macroeconomic outlook, UK banks expect a materially lower ECL charge in FY21 than FY20, although there is uncertainty around the timing and actual default rates given ongoing government support. This is reflected in the Q1 21 results of UK banks where we saw significantly lower ECL charges or ECL releases for some banks due to low levels of defaults in the quarter. In Q1 21, UK banks have carried forward the post-model adjustments applied at Q4 20 given the continuing economic uncertainty.

On the UK's economic outlook, the rapid rollout of vaccines will drive strong UK GDP growth from Q2 21 onwards, with Brexit-related trade frictions expected to ease from the second half of this year. The prolonged lockdown in the first quarter of 2021 will inevitably see GDP contract, although to a much lesser extent than Q2 last year. Government intervention, in particular the Job Retention Scheme, should help to keep unemployment relatively low, while the pace of inflation is expected to accelerate.

Although the full economic impact of the pandemic will only become clear once government support measures are withdrawn, indicators show that the economy in general is on the road to recovery, with successful vaccination rollout in the UK as the driving force.



Actions to take on Expected Credit Losses

In view of the challenges faced by the banks in estimating ECL going forward, banks should take the following key actions:

Appropriateness of IFRS 9 ECL Models

Assess the appropriateness of, and perform sensitivity analysis on, the modelling assumptions with respect to COVID-19.

Benchmark model approaches and assumptions against market practice and sentiment.

ECL policies

Benchmark and update ECL methodology and accounting policies such as staging and forbearance criteria against market practice and regulatory guidance.

Identify gaps and update ECL policies to address challenges posed by COVID-19.

Governance and control

Redesign governance and control processes over the calculation of ECL, including data inputs, model validation and post-model adjustments.

Other accounting issues to look out for

IBOR transition

The deadline for cessation of LIBOR is fast approaching. While the IASB has provided relief in relation to accounting for IBOR transition, the impact of the transition is pervasive on the banking industry as multiple areas are affected ranging from customer contract modification, legal and regulatory aspects, treasury, and funding costs. Within the domain of accounting and reporting, such a transition could result in modification or derecognition of cash products and impact on hedge accounting. Banks should proactively manage the transition.

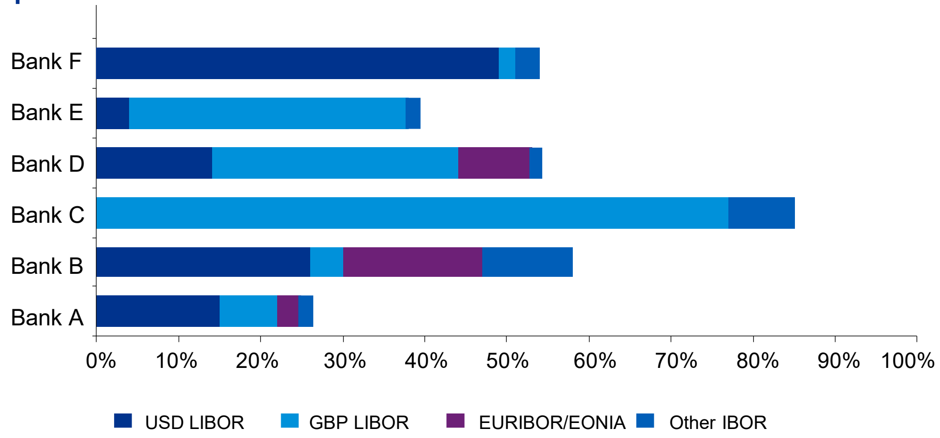
ESG and climate focus

The pandemic has brought ESG into the limelight with a focus on climate-related disclosures. Many regulations are coming into force requiring the incorporation of climate risk as part of risk management process and requiring adequate disclosures (such as those aligned with TCFD recommendations). Although climate is the first of the factors required to be considered, it is not the only one. Other components of ESG reporting are also coming into focus with EBA, for example, planning to incorporate ESG risks as part of Pillar 3 disclosures. Banks will need to streamline their processes for identifying and reporting key metrics for ESG reporting. Banks will also need to consider incorporating the effect of climate risk in their financial statements.

Accounting considerations from climate risk and ESG products

- SPPI assessment for investments in green products (where the interest rate is linked to borrower's performance related to green initiatives)
- Accounting for borrowings / funds raised through green bonds / ESG products
- Incorporating ESG risks (including climate risk) in assessing Expected Credit Losses
- Accounting for carbon credits
- Assessing impact of climate risk on impairment of non-financial assets
- Hedge accounting for derivatives converting "brown" to "green"
- Accounting for derivatives used for economic hedging
- Risk disclosures under IFRS 7

Percentage of hedging instruments impacted by IBOR reform, reported as at 31 December 2020



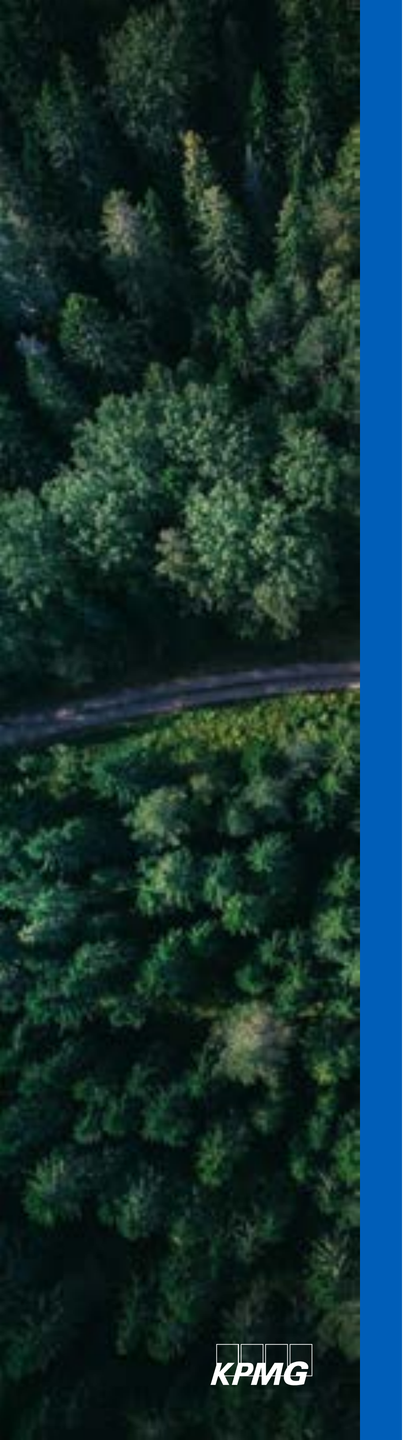
Negative interest rates

Although common in European countries for a number of years, the PRA have asked UK banks to prepare for the possibility of negative interest rates in the UK for the first time. Banks will need to consider the impact of negative interest rates both on their business strategy and operations, ensuring that their systems are able to accurately deal with negative interest rates. Negative interest rates will also have an implication on the accounting and reporting by banks. Some of these implications include:

- Impact on ECL computation
- Hedge accounting
- Presentation of negative interest payments in financial statements
- Determination of relevant discount rates under multiple IFRS Standards.

Glossary

BBLs	Bounce Back Loans
CBILs	Coronavirus Business Interruption Loans
CET1	Common Equity Tier 1 Regulatory Capital
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECL	Expected Credit Losses
ESG	Environmental, social and corporate governance
GDP	Gross Domestic Product
HPI	House Price Index
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
LIBOR	London Inter-bank Offered Rate
MEVs	Macroeconomic variables
NII	Net Interest Income
NIM	Net Interest Margin
PD	Probability of Default
PRA	Prudential Regulation Authority
PVA	Prudential Valuation Adjustment
RoTE	Return on Tangible Equity
RTS	Regulatory Technical Standards
RWA	Risk-Weighted Assets
SME	Small and Medium Enterprises
SPPI	Solely Payments of Principal and Interest
Stage 1	Stage 1 is where credit risk has not increased significantly since initial recognition
Stage 2	Stage 2 is where credit risk has increased significantly since initial recognition
Stage 3	Stage 3 is where the financial asset is credit impaired
TCFD	Task Force on Climate-related Financial Disclosures



Key contacts

Karim Haji

Partner

Head of UK Financial Services,
KPMG UK

karim.haji@kpmg.co.uk

Paula Smith

Partner

Head of UK Banking,
KPMG UK

paula.smith@kpmg.co.uk

Lisa Fernihough

Partner

Head of UK Financial
Services Consulting,
KPMG UK

lisa.fernihough@kpmg.co.uk

May Tiem Gillen

Director

Head of UK Banking
Accounting Advisory
KPMG UK

maytiem.gillen@kpmg.co.uk

Jaco Jordaan

Senior Manager

Banking Accounting Advisory
KPMG UK

jaco.jordaan@kpmg.co.uk

Fahad Rahman

Manager

Banking Accounting Advisory
KPMG UK

fahad.rahman@kpmg.co.uk

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