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FINANCIAL SERVICES

Focus on Transparency

Financial reporting of European banks in 2010

The calm between two storms?

July 2011

This is the fifth year of Focus on Transparency, the KPMG European banking survey of banks' annual reports, where we not only look at certain areas of accounting policy and disclosure, but also examine the key issues affecting banks as presented by the banks themselves.

For the first time we have included a chapter on chairmen and chief executive officers' statements. This reflects how chairmen see the main topics presented to shareholders, such as overall performance, the role of banks in society, compensation policy, regulatory reforms and future trends.

We have also added a chapter on emerging risks and issues, which incorporates information on legacy risks from activities linked to the credit crunch, the emergence of sovereign debt (particularly Eurozone debt) as a key risk factor, as well as other issues – such as bank levies – facing the banking sector.

We have continued to comment on key areas of disclosure and accounting policy affecting banks, notably the impact of fair value, capital, funding and liquidity, impairment, and key judgements and estimates.

There were significant movements in foreign exchange markets over the last 12 months making like-for-like, year-on-year comparison across the 15 banks in the report difficult. To eliminate these effects we have used 31 December 2010 exchange rates for both 2010 and 2009 figures. In addition, 2009 figures are based on 2009 comparative figures in the financial statements as at 31 December 2010.

There are 15 banks included in the survey, which reflect a large demographic of European banks reporting under International Financial Reporting Standards (IFRS).

The following people made significant contributions to this publication:

Sophie Sotil-Forgues
Caroline Gallagher
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Key findings

2010 was a less volatile year than 2009…

...but with regulatory change cited as one of the most significant challenges facing the banks in 2011, and the sovereign debt crisis adding significant uncertainty…

…was 2010 the calm between two storms?

- Combined profits hit €85 billion at the leading 15 European banks in 2010, double the previous year's profits…

  …but major reductions in impairment charges flattered the bottom line.

- Chairmen and chief executives believe their banks are well placed for recovery, focusing on core businesses and relationships…

  …but accept need to rebuild trust and confidence while sounding notes of caution over an uncertain future.

- Retail and commercial banking performance improved amid emerging market activity and economic recovery...

  …but investment banking revenues fell 2% to €123 billion, due to lower transaction volumes and increased competition.

- All 15 European banks have Core Tier 1 capital in excess of the minimum 8% prescribed by Basel 2…

  …but proposed regulatory requirements under Basel 3 will be challenging.

- €92.5 billion of deferred tax assets recognised on balance sheets implies approximately €334 billion in future taxable profits…

  …but the figure remained the same as the previous year, suggesting further challenges for the banks.

Banks face a volatile future that will once again place them under severe strain

The calm between two storms

€92.5 billion of deferred tax assets were held on balance sheet at 31 December 2010, representing

around €334bn

of profits that will be taxed in the future

Driving new changes

Europe's leading banks are staring at a financial storm that could wreck their fragile recovery. While some may have hoped that 2010's financial results of the 15 largest European banks signalled a clear road ahead, the growing sovereign debt crisis in the Eurozone could drive that hope away.

Combined with the rising tide of regulation, restricted liquidity and weak confidence, the banks face a volatile future that will once again place them under severe strain.

The 2010 reports showed a greater attention to sovereign debt risk than in previous years, with speculation of government bail-outs for Portugal and Spain, in line with those for Ireland and Greece. All the banks commented on this debt, although not all have a material exposure.

But the speed of developments was not foreseen at the time the annual reports were being written. While government bail-outs were discussed in the 2010 reports – with Greece receiving funding in May 2010, Ireland in November 2010 and Portugal in May 2011 – debt restructuring in the first quarter of 2011, and its potential impact on the banking sector, has become an issue of growing concern. The latest round of European Banking Authority stress tests will require the banks to disclose sovereign debt exposure by accounting portfolios, maturities and countries. This will expose the level of risk facing the banks, and sovereign debt could be the vanguard of another banking crisis.

Lower impairments drive profits

The good news is that profits grew in 2010: the combined profits for the 15 banks hit €85 billion in 2010. That was double 2009's figure of €43 billion, and a vast improvement on 2008's combined losses of €25 billion. Only one bank remained in a loss making position, but even here the losses were substantially reduced.

Despite this, the banks are rightly cautious, seeking to avoid any premature optimism – their chairmen and chief executives acknowledge that the sector is far from out of the woods.

However, a substantial amount of the increased profits came from a significant decrease in loan impairment charges. Impairments fell 29% to €80 billion in 2010. These decreases appeared to offset the effect of reduced revenues, particularly in investment banking.

There were other contributors to the increase in profitability. Some of the banks pointed to strong performances in emerging market activities – those banks that are particularly active in Asia and Latin America benefitted from the continuing growth in these regions.

Somewhat higher derivative fair values were also reported due to restored confidence and improved trading volumes, especially in the second half of the year. At the same time, divesting non-core activities and focusing on client relationships (a key feature of the chairmen's reports) remained key trends for the year.

The deferred tax positions merit particular comment, as on the face of it they reflect growing optimism. In total, €92.5 billion of deferred tax assets were held on balance sheet at 31 December 2010, representing around €334 billion of profits that will be taxed in the future, compared to €90 billion at 31 December 2009. In these uncertain times, the view on availability of future profits could change quickly, resulting in the potential write down of some balances.

A substantial amount of the increased profits came from a significant decrease in loan impairment charges

Basel 2 capital adequacy ratios increased overall with an average rate of

14.83% in 2010

Views from the top

For the first time, our survey looks in detail at what is being said by Europe's banking leaders. We have reviewed the chairman and chief executive statements and found there is a moderate sense of growing, albeit muted, confidence, with references to 'substantial improvement' and 'a time of progress and renewal'.

In these statements, the chairmen and CEOs address a number of varied topics relating to the past and coming years. Common issues include the overall performance of their bank during 2010 in the context of the economic and market conditions, the role of the bank in society, compensation policy, and some of the year's challenges, notably regulatory reforms. As for trends ahead, the main topics are future performance and strategies, the economic outlook and anticipated challenges.

For all the banks, 2010 is reported as a successful year compared to 2009, with all bar one now showing a profit. The statements provide an indication of the key drivers for this success – there has been an improvement in income in some activities, coupled with the decrease of risks and costs through, for example, synergies in the businesses.

Quality capital

All the banks disclosed their Basel 2 capital adequacy ratios, which increased overall with an average rate of 14.83% in 2010 compared with 14.41% in 2009. Most of the banks also calculated and voluntarily disclosed their Core Tier 1 ratio in preparation for Basel 3 standards. All the banks that chose to do so showed an improved ratio compared to 2009, reflecting an increase in the quality of capital held – mainly due to the combined effect of a net increase in 2010 results and a conservative dividend policy. In 2009, by contrast, Core Tier 1 capital increases were more the result of share issuances and state support.

First quarter 2011 statements tend to confirm the ongoing reinforcement of this ratio due to notably strong quarterly results, capital issuances, or management of risk weighted assets.

With the core principles of Basel 3 now mapped out following the November 2010 meeting of the G20, one third of the banks indicated their ability to meet the new requirements in 2013. Seven banks highlighted the areas of detail that need further development and implementation by national supervisors, such as the countercyclical buffer and additional requirements for systemically important financial institutions.

Although supportive of the new regulatory framework, the banks generally consider that the constraint will have a cost.

But a concern for many banks is the disparity of regulation around the world

European alignment of remuneration guidance

in 2011

Ring-fencing retail and investment banking operations remains high on the agenda

Who will bear that cost?

In our view, the new rules will have an impact on profitability and return on equity for the banks.

Change ahead

As in 2009, the pendulum still swings towards tighter and better regulation, shown by the swathe of guidance on topics such as remuneration, more and higher quality capital, diversification of sources of funding, and liquidity. There is a focus on harmonisation across Europe in these areas. Although the banks say they welcome better regulation, they openly acknowledge the challenges it will bring, ranging from staff training and system updates, to driving how the bank conducts its business and ensure returns to shareholders despite increased capital costs.

But a concern for many banks is the disparity of regulation around the world. Some countries are making strident changes to their regulation. Other jurisdictions seem to regard the credit crisis of 2007/2008 as more of a European and US issue, and are making less notable changes to regulation. This disparity is a double-edged sword. On the one hand it seems to provide an opportunity for large global banks to book their business in a less regulated jurisdiction. On the other, a bank continuing to book business in Europe could be subject to various regulations, not all of which are applied harmoniously across the countries.

At the same time, the banks remain under scrutiny over remuneration policies, and the shift towards longer term incentive schemes continues. Ring-fencing retail and investment banking operations remains high on the agenda. Bank levies now affect more than half of the surveyed banks. Dividend policies are now more conservative than in previous years.

It is no surprise that the chairmen and chief executives emphasise their focus on core businesses, the development of high quality relationships and the continuation of cost efficiency policies.

But the road ahead looks far from certain, with further tests on the horizon. The outlook for those in the driving seat looks tough.

Focus on core businesses, the development of high quality relationships and the continuation of cost efficiency policies

1. Insights

Chairmen's and CEO's statements

Highlights

- *2010: "A remarkable year", "substantial progress", "great performance"*
- *Looking ahead: Confidence of the banks in their future success*
- *First quarter 2011 results confirming the trends*

In their statements to shareholders, the chairmen and CEOs addressed various topics related to the past and coming years. Common issues addressed included the overall performance of the bank during 2010 in the context of the economic and market conditions, the role of the bank in society, compensation policy, and some challenges of the year, notably regulatory reforms.

As for trends ahead, the main topics discussed were future performance and strategies, the economic outlook and anticipated challenges the industry has to face in the coming years.

Full year 2010

Overall group performance

The chairman's and chief executive officer's statements are a useful summary of the banks' perspective on the year. Every bank in the sample presented a chairman's report highlighting the results and challenges of the year. Eight banks complemented these statements with ones by their chief executive officers (CEO). In two cases (UBS and BNP Paribas) the chairman and CEO jointly prepared one letter to shareholders. Meanwhile, Barclays, RBS and Standard Chartered presented a detailed report from the chairman of the Audit Committee in their annual report for the first time. This is a trend we expect to see develop in future.

For all the banks 2010 was a successful year compared to 2009, for which the results were viewed more as a return to profitability or a year of progress. Overall performance was characterised by the chairmen as "substantial improvement", "substantial progress", "a good year", "a successful year", "a much improved balance of profits in 2010", "a remarkable year", "a crucial year", "an important milestone", "a time of progress and renewal", "the group's financial rebound" or "a great performance". A summary of the key drivers of the 2010 results was generally provided. The main reasons given were an improvement in income in some activities, coupled with the decrease of risks and costs through, for example, synergies in the businesses. The chairmen generally commented on increased profitability in their core credit businesses such as retail and commercial banking as economic conditions improved, despite lower interest rates tending to tighten interest margins. For those banks more active in Asia and/or Latin America – such as HSBC and Deutsche Bank – there were also higher revenues from retail and commercial banking from those regions. Another important driver of 2010 profitability indicated by six banks (Nordea, UBS, Lloyds Banking Group (LBG), Barclays, BNP Paribas and HSBC) was the reduction of loan impairment charges.

Contribution of investment banking activities to the results was more

Reengineering the business in order to remove inefficiencies

attributed to a decrease of credit losses or impairment charges than to an increase in trading revenues.

Five banks (LBG, ING, UniCredit, RBS and Commerzbank) carried out divestments or balance sheet reduction programmes, principally in order to reduce risk levels.

For almost all banks a prime focus of 2010 was reducing costs. It was expressed in different terms such as "strong attention to efficiency" (RBS), "achievement of cost synergies and savings" (Commerzbank), "discipline over cost base" (UBS), "restructuring the cost base" (UniCredit) and "focus on controlling costs" (Santander). LBG mentioned an improvement of its underlying cost to income ratio of 4.5%, whereas HSBC presented a rise in its ratio of 3.2% due to higher staff costs and investments related to strategic initiatives across the business. The HSBC CEO talked about the need to reengineer the business in order to remove inefficiencies.

Major events of the year, such as acquisitions or the on-going process of integrating new entities for four banks, were noted in successful terms. The chairman of Deutsche Bank referred to three acquisitions: Postbank, the commercial banking activities of ABN AMRO and Sal. Oppenheim/BHF-BANK. Similarly, the chairman of Commerzbank commented on the completed integration of Dresdner Bank and qualified this merger as "one of the biggest projects in the history of German banking". The integration of BNP Paribas Fortis and BGL BNP Paribas was presented as a success, and the chairman of BBVA referred to the acquisition of Garanti Bank in Turkey as a potential source of growth. ING announced the sale of its insurance and investment management activities by two public offerings planned in 2011.

Capital and liquidity were two main themes attracting comment, ahead of the implementation of the Basel 3 requirements, with the chairmen or CEOs saying the capital and liquidity positions of their banks were strengthened in 2010. The chairman and CEO of Société Générale mentioned the "strict management of scarce resources that are capital and liquidity". Five chairmen and all CEOs (UBS, Barclays, BNP Paribas, HSBC and Santander) highlighted the rise of their Tier 1 or Core Tier 1 capital ratio. The chairmen of UBS and HSBC noted the increase of their Tier 1 capital ratios resulted principally from increased profits in 2010, whereas others put their strengthened ratios down to capital issued or a decrease in risk weighted assets. Following its acquisitions during the year, the chairman of Deutsche Bank referred to its "biggest capital increase in the bank"s history' to strengthen its capital base. More conservative dividends policy and retained earnings practices also contributed to reinforcement of Core Tier 1 capital (see chapter 6 on capital).

The chairman of Barclays discussed the stress tests run by the Committee of European Banking Supervisors (CEBS) in 2010 and noted his firm's Tier 1 ratio was among the highest of the European banks. A related issue to stress tests is that of systemic risk, upon which the chairman of HSBC expressed mixed views. Other banks discussed the issue elsewhere in their annual reports, but not as detailed commentary in their statements to shareholders. While the chairman of HSBC agreed with reinforcing supervision on so-called Systemically Important Financial Institutions (SIFIs), he expressed concerns over the additional capital charge being discussed for these institutions and noted the potential unintended consequences that these institutions may become preferred as

A very difficult economic and financial environment

Remuneration policy continues to attract significant public debate

counterparties (due to their incremental capital requirements), potentially leading to further concentration of the industry.

Economic context

Little detailed information was provided on last year's economic context. The environment in 2010 was qualified as "complex" by the chairman of BBVA or "tumultuous" by Société Générale's. The "challenging conditions" in which banks operated in 2010, even if global confidence and stability had started to be rebuilt, were mentioned in three statements. The chairman of Santander referred to "a very difficult economic and financial environment". Also, two chairmen mentioned the global economic recovery with continuing differential growth rates across nations. The chairman of Barclays mentioned a global GDP growth of 5% in 2010 led by emerging markets, whereas growth in most of the developed countries was generally below trend. Furthermore, the chairmen of five banks (Barclays, Société Générale, Deutsche Bank, RBS and Santander) noted the difficulties in the Eurozone without giving any detailed information. Regarding the global economic and financial situation, the chairmen of Barclays and Deutsche Bank expressed the view respectively that "it is too early to say that the financial crisis is over" or "the worst is behind us – but we are not out of the woods yet".

The role of banks in society

The theme of the public role of banks was discussed in almost all reports (13 banks out of 15), which is not surprising in the context of recent political pressure on the industry.

Five chairmen (LBG, Barclays, RBS, Standard Chartered, Société Générale) recognised the major role of banks in financing the economy. For example, among these banks four provided figures on new lending commitments taken in 2010 towards local and worldwide customers (mortgage customers, SME customers, other companies, etc). The fifth gave information on the growth of its lending activity during 2010. One bank provided additional information on its on-going commitments for 2011.

In eight statements (UBS, LBG, Barclays, ING, HSBC, Deutsche Bank, RBS, Santander), the chairmen mentioned the bank's support for communities or the social actions they undertake. For instance, the chairman of Deutsche Bank acknowledged "its commitment towards its corporate social responsibility" illustrated by the financial support of education, community development and art projects. The chairmen of Barclays and ING mentioned their initiatives to demonstrate their behaviour as "good or global citizens".

Compensation policy

Conscious of the public debate surrounding the issue, six chairmen (Standard Chartered, RBS, UniCredit, ING, LBG, Barclays) addressed the topic of remuneration policies, stating notably that they were in line with the regulatory changes (deferrals and clawbacks for variable remuneration, equity instruments instead of cash). Three chairmen referred to their 2010 bonus pool, indicating their variable remuneration policy is no longer directly linked to the year's results and is more aligned with long term shareholders' interests. The chairman of Barclays noted the 2010 bonus pool was down 7% and the chairman of RBS mentioned "a £2,000 cap on immediate cash bonuses". The chairman of LBG said "the payout under our Group bonus schemes for 2010 is a small percentage of overall revenues". The CEO of Barclays referred to a new compensation policy for senior employees, which links future pay-outs to the Group's core capital position (see chapter 8 on remuneration).

Longer maturity funding and less maturity transformation

Regulatory reforms

Regulatory changes were a pervading theme. Most of the chairmen said they support the on-going regulatory reforms. In particular they discussed the publication in December of the final Basel 3 rules, which will impose increased capital and liquidity requirements on the industry. The regulatory changes were viewed as reshaping the banking industry environment. The chairmen of Barclays and Nordea qualified the new business environment as "the New Normal". While the regulatory reforms generally are seen as creating a challenging environment, some chairmen indicated they could also be a source of new opportunities. Specifically regarding the new liquidity requirements under Basel 3, HSBC and Nordea noted the continuing uncertainties around the new rules. The CEO of Nordea also anticipated "longer maturity funding and less maturity transformation".

A first flavour of the impacts of the new regulatory framework was provided in certain cases, but generally without any quantitative data. The chairman of UBS indicated they were in the process of analysing the impacts on the firm of all new regulations and "the effect they may have on the profitability of our businesses". The chairmen of HSBC and Nordea mentioned their banks are meeting the basic capital requirement minimum threshold. The chairmen of Société Générale and Deutsche Bank said their banks expect to meet the new prudential requirements – in particular in terms of capital – in 2013, and two others (ING, UniCredit) plus the CEO of LBG said they are in a relatively good position to meet them. The chairman of Société Générale mentioned a target core Tier 1 ratio of around 8.5% at end 2013. The CEO of Nordea mentioned the negative impact on their return on equity of the Basel 3 capital and liquidity reforms.

Looking ahead

Future performance and strategies

Although they did not provide figures on their future profitability, 12 banks expressed confidence in their future success. Expressions such as "the bank begins 2011 in a solid position", "well positioned for future success", "excellent growth prospects" and "2011 will be a year of improvement" were used. The chairman of Société Générale mentioned a target of "€6 billion of net income by 2012". The chairman of Commerzbank anticipates from 2012 "an operating profit before regulatory effects of approximately €4 billion per year".

Throughout the statements, future strategies of the banks were discussed without any specific details. Three general priorities were defined:

i) A focus on core businesses: some banks stated they prioritised risk reduction through a decrease in non-core assets. The CEO of RBS mentioned that he aims at "building the quality and quantity of Core profits".

ii) The development of high-quality relationships with customers: the chairman of UniCredit characterised the focus on client relationships as "Real-Life Banking". The chairman of UBS referred to its "we will not rest" campaign to focus on clients.

iii) The continuation of cost efficiency policies.

Other strategic intentions were expressed by some banks. HSBC and LBG aimed at maintaining a prudent liquidity position. The CEO of HSBC mentioned the fixing of a maximum advances-to-deposits ratio for the Group of 90% in the risk appetite statement of the Group. Furthermore, some chairmen mentioned the need to strengthen their brand image or reputation (Société Générale, UBS and UniCredit).

Delivering long-term shareholder's value

Based on 2011 Q1 press releases, the trends announced by the chairmen seem to be confirmed. Globally the banks of the sample performed well, comparing favourably to the results of the first quarter of 2010. Core businesses continued to generate growth and disposals of non-core assets seem to continue, with impairment charges remaining at low levels.

Economic outlook

Only a few chairmen gave their view of the economic outlook. Some provided information on forecast growth in certain economic zones, whereas others commented on financial markets.

The chairman of Barclays mentioned global growth down around 4.25% in 2011 due to less rapid growth in Asia and Latin America, where monetary policy has begun to tighten due to higher inflation. In the chairman's statement from Société Générale, growth disparities in developed countries were announced. A forecast of 1.5% growth in the Eurozone and nearly 2.5% growth for the US economy was provided. The resurgence of sovereign risks at the beginning of the year and the preoccupying situation in the Middle East and North Africa affecting the price of oil and confidence was noted by the chairmen of Barclays and the CEO of HSBC. Both expect a positive resolution to the situation in the Middle East and North Africa.

HSBC's CEO and Société Générale referenced the "cyclical volatility" or "erratic movements" in the financial markets in 2011. Two other chairmen (RBS and Santander) expected a rise in interest rates during 2011. Conversely, the CEO of HSBC commented that low interest rates in many developed countries will continue – at least in the near-term.

Shareholder value

"Delivering long-term shareholder's value" was among the main concerns of the chairmen and CEOs. The CEO of HSBC targeted future returns on average shareholders' equity of 12% to 15%. Similarly, the CEO of Barclays stated that the bank "must be in position to deliver at least a 13% return on equity".

At this stage there continues to be a wide range of dividend policies. The chairmen of five banks (BNP Paribas, Société Générale, HSBC, Standard Chartered, Deutsche Bank) recommended the payment of a cash dividend. Three other chairmen (UBS, Barclays, and ING) indicated they wanted to maintain a conservative dividend policy, notably due to coming regulatory reforms.

Strong profit-generation capacity across all the operating divisions

Rebuilding trust and confidence

Following years of financial and economic crisis, seven chairmen (LBG, Barclays, ING, HSBC, Nordea, RBS, UniCredit) recognised there is still a need to rebuild the trust and confidence of stakeholders (customers, employees, shareholders, etc). In the words of LBG's chairman: "we have much work to do as an industry to rebuild trust and understanding".

Even if messages of optimism are dominant in the statements, particularly in relation to results and profitability, there is a cautious and prudent atmosphere given the economic and regulatory uncertainties the banks are facing.

The first quarter results of 2011 seem to confirm the trends of 2010 and expected near term success. The CEO of Barclays declared that the bank "has made a good start in 2011 in a challenging external environment and making good progress on execution in line with strategic priorities". This was mirrored by the sentiments expressed by the chairman of Commerzbank, who said the bank "has got off to a great start in 2011". Meanwhile, the CEO of Nordea referred to "a strong quarter" and the CEO of BNP Paribas to "a very good performance" and "strong profit-generation capacity across all the operating divisions".

Group net income (M€)	1st Quarter 2011	4th Quarter 2010	1st Quarter 2010
HSBC	3,040	2,574	2,122
BNP Paribas	2,616	1,550	2,283
Santander	2,108	2,101	2,215
Deutsche Bank	2,062	601	1,762
UBS	1,405	1,293	1,712
ING	1,381	130	1,230
Barclays	1,186	NP	1,250
BBVA	1,150	939	1,240
Commerzbank	985	257	708
Société Générale	916	874	1,063
UniCredit	810	321	520
Nordea	742	770	643
RBS	- 619	14	- 291
LBG	- 2,858	- 2,177	198
Total	**14,925**	**9,247**	**16,656**

Note: Press releases/interim management statements related to results as at March 31, 2011

NP: not published

Data not available as of March 31, 2011 for Standard Chartered.

Exchange rates used as at 31 March 2011 for all quarters.

Source: KPMG International, July 2011

Banks welcomed successful Q1 2011

2. Performance

Overall performance with focus on investment banking

Highlights

- *Decreased loan impairment charges*
- *Stable asset volumes*
- *Difficult environment for investment banking*

Successful year,
Good performance,
Recovering economic environment

Global economic recovery continued during 2010. However, the level of economic activity remained poor. Two thirds of global GDP growth was attributable to emerging economies, especially Asia and Africa, while growth in the West remained fragile.

Significant decreases in loan impairment charges were reported by all banks, which seemed to offset the effect of reduced revenues, particularly in the investment banking space.

Overall group performance

Income statement

Key drivers to the improved bottom lines reported by banks during 2010 reflected in the graph opposite were identified as significantly lower impairment losses on loans and strong performance from emerging market activities. Somewhat higher derivative fair values were also reported due to restored confidence and improved trading volumes, especially in the second half of 2010. Focusing on strengthening client relationships and divesting non-core activities remained key trends during the year. All banks reported increases in their profit before tax figures, other than Deutsche Bank, UniCredit and LBG. Deutsche Bank ascribed the decrease to the one-time charges relating to IFRS accounting implications to its three acquisitions of Postbank, parts of ABN AMRO and Sal. Oppenheim/BHF-BANK during the year. LBG's decrease in profit before tax was attributed to the gain on acquisition of HBOS included in its 2009 results, while UniCredit's decrease resulted from impairment of goodwill and recognition of deferred taxes.

The largest increases in profits were reported by HSBC, Société Générale, BNP Paribas, ING, UBS and Commerzbank, with the latter three making a comeback to profitability after reporting losses during 2008 and 2009.

ING attributed the improvement to exceptional performance in its banking operations, which more than offset losses suffered in its insurance operations. It also reaped the benefit of divesting a number of non-core activities over the past two years, which generated net gains on sales during the current year and off-set some one-off expenses, such as goodwill write-downs in the Insurance reporting unit in the United States, write-downs of deferred acquisition costs, and expenses relating to various restructuring programmes.

UBS attributed its enhanced profitability primarily to significant improvements in income from trading businesses, especially the investment bank's fixed income, currencies and commodities revenues, coupled with an almost 66% reduction in its credit loss expenses, slightly lower operational expenses due to lower net restructuring costs included in the current year, a significantly larger valuation gain recorded on an option to acquire SNB StabFund's equity, and reported gains on sales of some operations.

Commerzbank also reported improved net trading income, supported by much more favourable financial market conditions,

Overall performance - Profit before tax (Million €)

Source: KPMG International, July 2011

Were balance sheet reductions in 2010 to reduce risk...

...or just to shrink the balance sheets to match available capital?

substantially lower loan loss provisions and the elimination of special charges reported in the prior year, connected largely with the integration of Dresdner Bank.

HSBC's profitability was also attributed to a significant decrease in loan impairment charges and an increased share of associates' profits driven by the strong results in Asia.

BNP Paribas attributed its successful year to the improved economic environment and successful merger of the BNP Paribas Fortis and BGL BNP Paribas entities, where synergies were 30% in excess of the original estimate (€900 million) with marginally higher restructuring costs.

Société Générale referred to its geographically-diverse international retail banking operations, record performance by its insurance operations and growth in vehicle leasing, coupled with improvement in the performance of its legacy assets.

Balance sheet

2010 witnessed frail increases in assets overall. Many of the banks continued their strategies of divesting non-core and legacy assets, while others searched for opportunities presented by emerging markets. The year was marked by continued market and regulatory uncertainty, with banks choosing to follow more conservative policies: focusing on maintaining existing asset balances and strengthening liquidity.

The search for optimum return on assets continued to preoccupy key decision makers within banks. Scarceness of capital made it more costly and, with existing uncertainty around the finality in regulatory reforms, banks have been trying to dispose of lower earning, lower quality assets and replacing them with better quality ones.

Total assets (Million €)

Source: KPMG International, July 2011

Marginal increase in total assets

for 8 of the 15 banks

Deutsche Bank, Santander, Société Générale, Barclays and, to a lesser extent, HSBC, ING, BBVA, Nordea and Standard Chartered reported increases in total assets. The remainder of the banks reported decreases.

The largest asset increases were at Deutsche Bank (27%), Barclays (8%) and Société Générale (11%). Deutsche Bank attributed its large asset increase to acquisitions during the year, particularly Postbank, which contributed a significant increase in its loan book. The remainder of the asset increase was a result of foreign exchange differences, particularly between the US dollar and Euro, which represented about 20% of the total asset increase. Positive market values from derivatives, which fell substantially in the prior year, further contributed to the final increased asset balances.

Société Générale attributed the increase to its strategy of growing its customer base in Europe, including some targeted acquisitions during the year, such as Société Marseillaise de Crédit, Metropolitan West Asset Management and increasing its share in Rosbank.

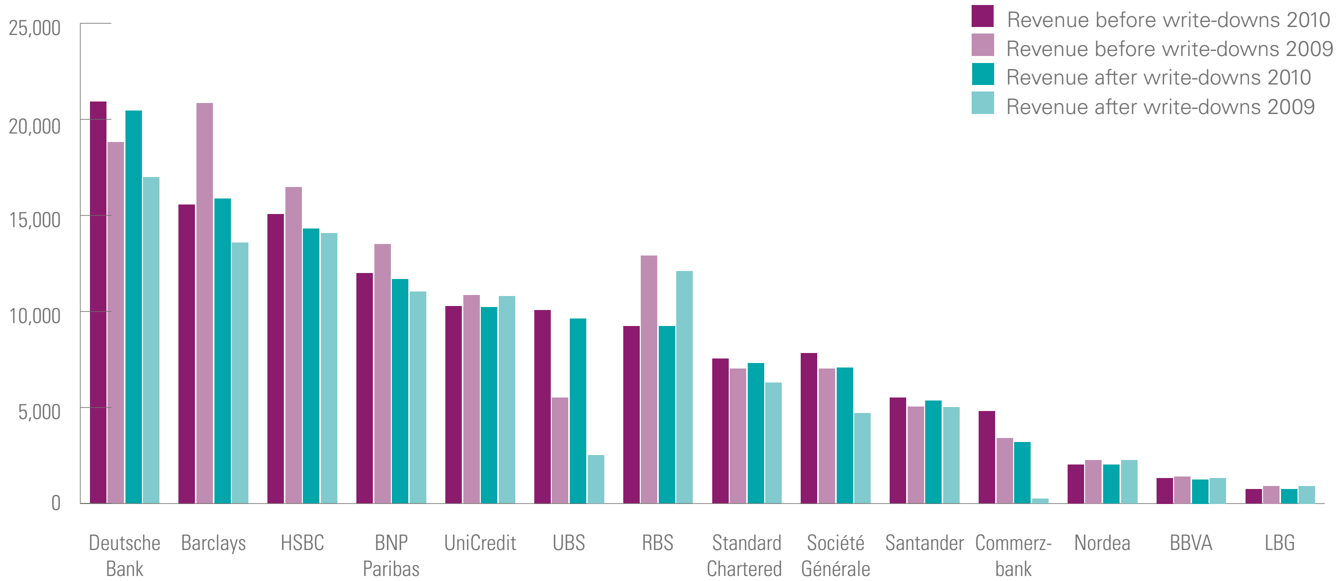
Barclays similarly has increased trading portfolio assets, seen derivative fair values improve and increased loans to customers, in part thanks to its acquisition of Standard Life Bank.

The smaller increases in assets reported by other banks were predominantly attributed to improved derivative asset values and increased lending to customers, with a varying mix between commercial and retail lending.

By contrast, BNP Paribas, RBS, LBG, UBS and Commerzbank reported total asset decreases. They were primarily attributed to divestments, with a realigning of operations and focus on their core businesses, as in the case of RBS, LBG and Commerzbank. For Commerzbank, RBS and LBG, total asset reduction was part of risk reduction measures undertaken to restructure their balance sheets and reduce risk.

BNP Paribas explained its reduction in total assets by various decreases in loans and receivables, offset by increases in the fair value of various financial assets. Meanwhile, UBS described its assets movement as the effects of unfavourable

Revenue after write-downs (Million €)



Note: Write-downs represent impairment charges and allowances for credit losses.
LBG shows net revenue after write-downs in annual report.

Source: KPMG International, July 2011

Defining investment banking

Deutsche Bank	Corporate & Investment Bank
UBS	Investment Bank
BNP Paribas	Corporate & Investment Banking
Société Générale	Corporate & Investment Banking
Royal Bank of Scotland	Global Banking & Markets
Barclays	Barclays Capital
HSBC	Global Banking and Markets
Nordea	Capital Markets
Commerzbank	Corporates & Markets
Standard Chartered	Wholesale Banking
BBVA	Wholesale Banking & Asset Management
Lloyds Banking Group	Treasury and Trading section of Wholesale Division
UniCredit	Corporate & Investment Banking
Santander	Global Wholesale Banking

Note: Where the distinction is not clear in the annual report we have defined it as above for the purposes of this report.

foreign exchange rate movements, especially the weakening of the US dollar and Euro against the Swiss Franc.

Investment banking

Defining investment banking

Investment banking activities are defined differently by the banks, complicating attempts to compare directly between the various divisions. Banks' investment banking activities will also differ with respect to the mix of revenues and geographical spread, and could potentially experience different trends.

Performance during 2010

Revenues from investment banking activities continued to generate significant income during 2010, although for many banks they fell short of the record high performance experienced in 2009. Revenue/operating income reported by some of the banks showed a slight decrease during the year, despite the improvement reflected in the bottom lines. This was predominantly attributed to significantly lower impairment charges reported by all banks.

All banks commented on the difficult economic conditions experienced during 2010 as causes for lower revenues and tight spreads. Other identified drivers were low interest rates, increased competition and decreased transaction volumes, arising from the lack of investor confidence in the capital markets, especially within the Eurozone, after the emerging sovereign debt scares throughout the year.

The graph above shows revenues generated from the investment banking operations of each bank, after taking into account the effects of write-downs for credit losses. All banks recorded net increases compared to the prior year, except RBS, BBVA and LBG. As mentioned, these increases predominantly reflected the significant decrease in impairment losses, reported by all banks, as opposed to core revenue growth.

Deutsche Bank's successful performance was credited to increased market share (via its acquisitions of ABN AMRO, and Sal. Oppenheim / BHF-BANK during the year) and the strengthening of its existing client relationships. It experienced a record year in trading of fixed income products, with its money market and

Significant decrease in impairment reported by all banks

The banks with the top revenues generated from investment banking activities after write-downs are (in order of magnitude):

1. Deutsche Bank – €20.4 billion
   (2009: Barclays – €20.8 billion)
2. Barclays – €15.5 billion
   (2009: Deutsche Bank – €18.8 billion)
3. HSBC – €13.8 billion
   (2009: HSBC – €16.5 billion)
4. BNP Paribas – €11.7 billion
   (2009: BNP Paribas – €13.5 billion)

interest rate business also contributing significantly to revenues. In addition, M&A reported considerable progress, while the acquisition of parts of ABN AMRO in the Netherlands has provided Deutsche Bank with a significant number of new clients.

Barclays reported a 25% decrease in top-line income from the exceptional performance enjoyed in 2009. This was predominantly attributed to the 35% decrease in trading income from fixed income, currency and commodities products, due to lower contribution from rates and commodities, and subdued market activity in European equity derivatives. The fall was partially offset by an increase in fee and commission income, with higher contributions from the Asian markets.

HSBC also reported a decrease in net operating income (before the effects of impairment charges) of 9%, mainly due to lower net interest income from the maturing of higher yielding investments, low interest rates and flattening yield curves. Lower trading income was also attributed to uncertainty in the Eurozone.

BNP Paribas reported an 11% decline in investment banking revenues from the prior year. This was due to a significant decrease in fixed income revenue, stemming from uncertainties from sovereign debt risks in some European countries. However, it was offset by an improvement in advisory and financing incomes.

The banks that experienced the highest growth rate in revenues during the year are (in descending order):

1. Commerzbank
2. UBS
3. Société Générale
4. Deutsche Bank

Commerzbank and UBS attributed their growth in revenues to increased transaction volumes and decreased impairment charges.

RBS showed a significant decrease in revenues from investment banking operations, attributed to increased risk aversion in the market during the second half of 2010.

Market risk

The measurement and monitoring of market risk associated with trading activities continued to be an area of increased interest for banks. In addition, disclosures relating to market risk exposures, objectives, policies and processes for managing market risk, and methods used to measure the risk are compulsory in accordance with IFRS 7 Financial Instruments: Disclosures.

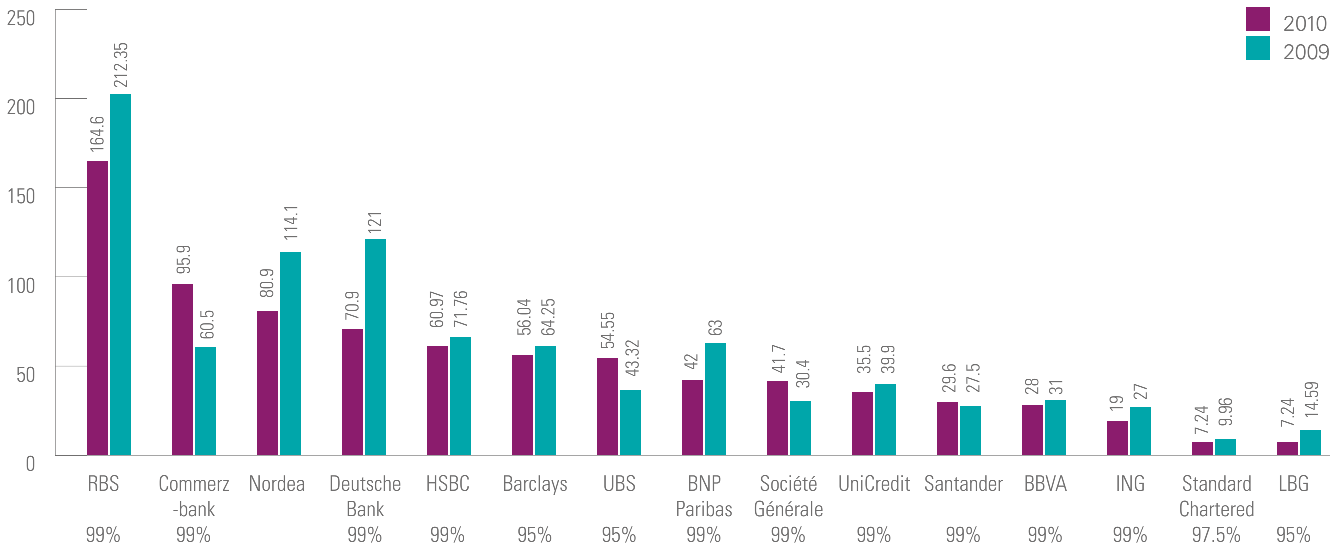
Market risk is the potential for loss of future cash flows or unfavourable changes in fair values of financial instruments due to adverse changes in market rates or prices. The primary categories of market risk identified by all banks as impacting on their business activities are interest rate risk, foreign exchange risk and price risk associated mainly with commodity and equity prices.

Value at Risk (VaR)

VaR is a technique used to estimate the probability of portfolio losses arising from future potential adverse movements in market rates, prices and volatilities, based on the statistical analysis of recent historical market price trends and variances. It is a measure of how much money the bank can lose in one day if some market variables were to change.

The process involves the revaluation of existing positions, by taking into account the effects of historically observed market risk factors on the current portfolio. Thus events that have happened in the past, such as interest rate increase/decrease

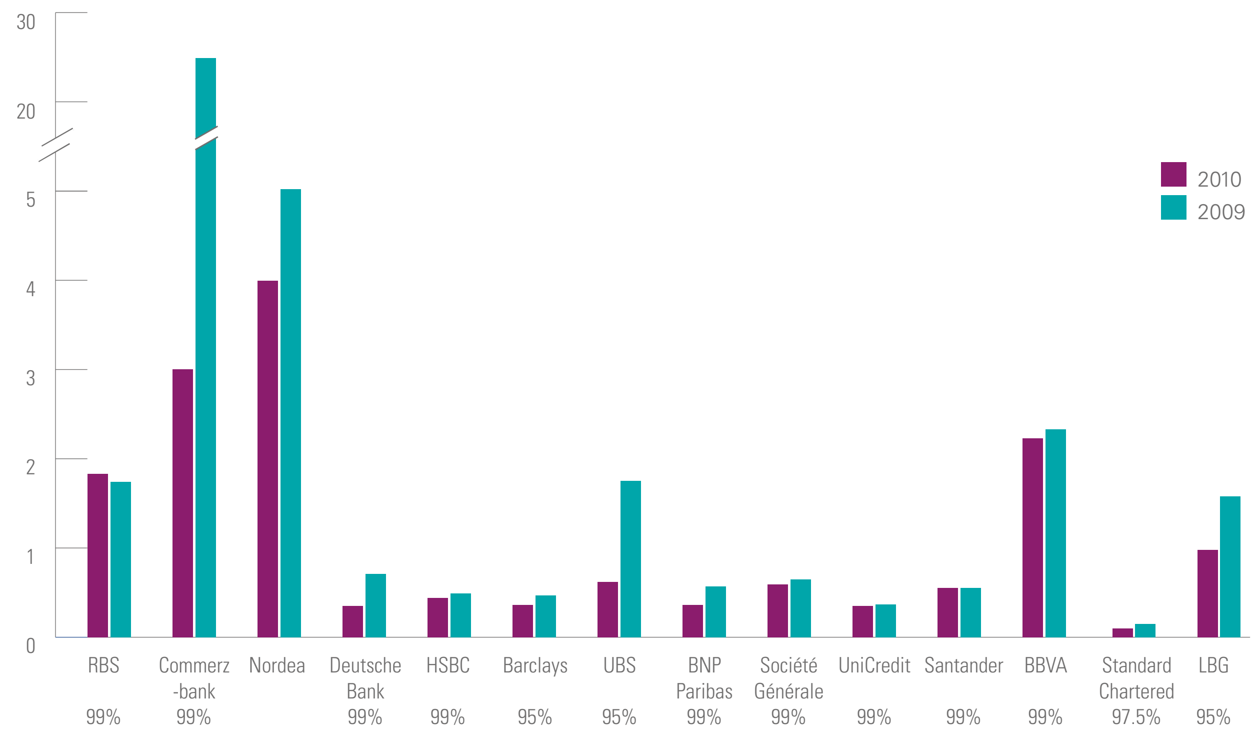
1 Day Trading VaR as disclosed (Million €)



Note: Spot 1 Day VaR was used as at 31 December 2010, except for Société Générale where average VaR was available from the annual report. Deutsche Bank has excluded Postbank from its 1 Day trading VaR. For Nordea, total VaR has been used as trading VaR was not disclosed separately.

Source: KPMG International, July 2011

1 Day Trading VaR as a % of trading revenue (Percentage)



Note: Nordea VaR reflects total VaR as trading VaR was not shown separately.

Source: KPMG International, July 2011

One-day holding period assumes assets can be liquidated within one day...

...yet three days required for a recent liquidation of a significant position...

...is one-day VaR useful?

of x%, are applied to the current portfolio of the bank to calculate a potential loss. Back testing is usually performed in order to assess the reliability and accuracy of the VaR model outcome, by comparing the VaR estimate to the actual losses incurred. The higher the confidence level used in the model, the higher the VaR number and there will be fewer instances of outliers, i.e. when the actual results are not close to the estimates. The Basel Committee on Banking Supervision proposes that institutions use a confidence level of 99%, which would imply that only two to three breaches of the VaR estimate should take place during the year.

Interpreting VaR

VaR output is a single number representing an estimate of the maximum expected loss of a portfolio over the holding period (usually set at one day) at a given confidence level. In practice, VaR cannot be used for comparison between banks, as banks use alternative estimates and assumptions in their models. For example, the use of different confidence levels can either increase or decrease the VaR number, with all other inputs being the same. In addition, it can reasonably be expected that a bank with a higher VaR number would have bigger trading operations, should all the banks' risk appetites be within a similar range. VaR can be used to assess the bank's risk year-on-year and also to assess the potential portfolio loss, but only when looked at against the bank's trading operations size. In other words, a more comparable view for market risk between the banks could be a ratio of the VaR number to trading revenue.

All banks used a one-day holding period. A 99% confidence level was used by the majority of banks, except for LBG, Barclays and UBS, which used a 95% confidence level, and Standard Chartered which used a 97.5% level. The historical observation period applied in the VaR methods varied amongst the banks between one and two years. This implies that market trends having occurred in the last one to two years are used as inputs to estimate future portfolio outcomes. UBS was the only bank to use a different historical observation period (of five years), that implies higher volatility data was included in UBS' calculation.

Most banks disclosed lower daily trading VaR results compared to 2009, predominantly driven by reduced volatility across various asset classes, reduced exposures due to lower client activity and rolling off of highly volatile historical data points. However, Société Générale, UBS and Commerzbank reported slight increases in daily trading VaR. Rationalisation for the increase was, respectively, exposure to the Eurozone, which reflected the risk of debt struggles in peripheral European countries, execution of growth plans in investment banking operations, and change to its internal market risk model.

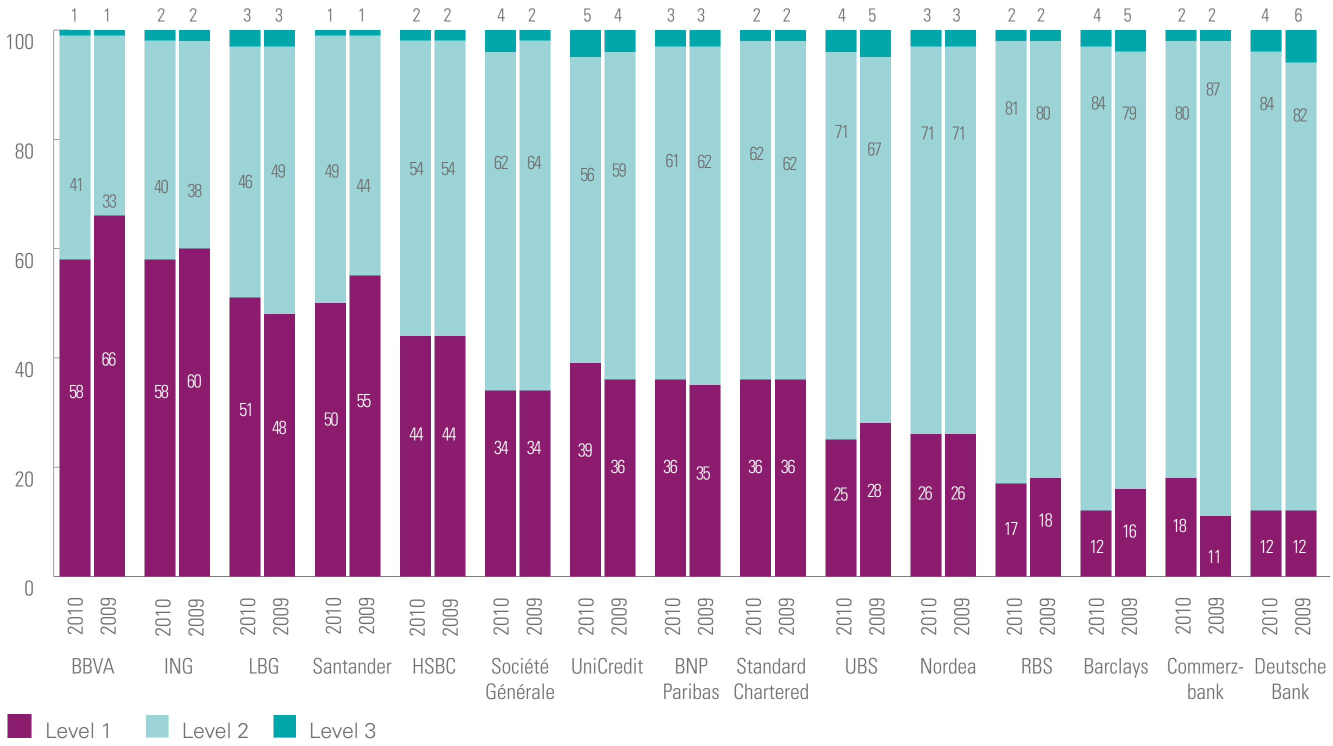
The ratio calculated in the graph on page 16 was calculated in order to create a more comparable picture of market risk between the banks. We took the trading VaR disclosed by all banks as a percentage of their investment banking revenue, after write-downs, to arrive at a potential percentage loss. For the majority of banks, the potential loss from trading activities seems to be around less than 1% of trading income.

VaR limitations

Despite its wide application, the VaR model has a number of shortcomings. These should be considered when relying solely on the VaR output to assess and analyse market risk.

- The use of past market trends to predict the future in VaR methodology implies the past would repeat itself, which does not always hold true.
- All past market trends are equally weighted.

Fair value hierarchy of financial assets (Percent)



Source: KPMG International, July 2011

Rolling off of highly volatile historical data points resulted in **most banks disclosing lower daily trading VaR results** compared to 2009

- The one-day holding period assumes assets can be liquidated within one day, which is not always the case.

Fair value implications

As part of IFRS 7 Financial Instruments: Disclosure, all banks are required to disclose fair value measurement basis, the fair value hierarchy level for all financial instruments measured at fair value on the balance sheet, and details of significant transfers between levels of the hierarchy.

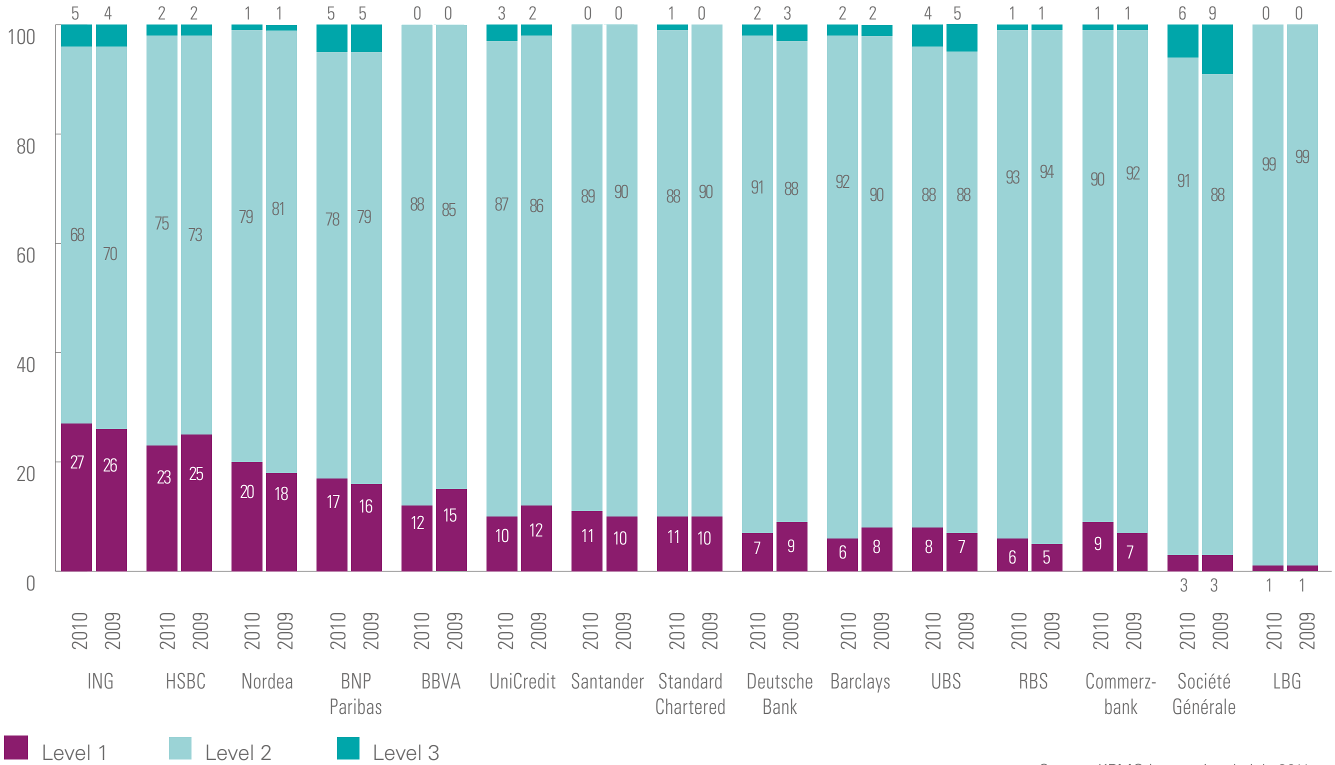
The three levels to the hierarchy, as identified by IFRS 7, are:

- **Level 1:** fair value of the financial instrument reflects unadjusted quoted prices for identical instruments in active markets.
- **Level 2:** fair value is determined by using inputs, other than quoted prices that are observable for the financial instrument, either directly or indirectly.
- **Level 3:** fair value is determined by using inputs for the financial instrument that are not based on observable market data, i.e. it is based on unobservable inputs.

The relative proportion of total financial assets and financial liabilities measured at fair value is a good indicator of each bank's trading activities. A higher proportion of Level 3 instruments could further indicate the bank's involvement in exotic instruments, where market prices are not available. While a general trend of decrease in financial assets and financial liabilities held at fair value was noted, reflecting the general decrease in exposures either through divesting or just general decrease in the fair values of the portfolios, trading books have not diminished significantly.

Derivative assets represented, on average, around a third of the trading portfolio assets. This contrasts with the

Fair value hierarchy of financial liabilities (Percent)



Source: KPMG International, July 2011

The banks with the highest percentage of assets held at fair value, as part of total assets, are:

1. Deutsche Bank (61%)
2. RBS (54%)
3. UBS and BNP Paribas (each with 53%)

previous year, where derivative assets were half of trading assets. This decline comes despite an increase in derivative fair values, reflecting a drop in derivative assets volumes held by the banks due to planned exposure reductions. The largest representations are still being seen by Barclays (60% of total trading portfolio represented by derivative assets), Deutsche Bank (57%) and RBS (54%).

Derivative liabilities, on average, reflect just over half the trading portfolio liabilities, with the highest proportions seen at Barclays, Deutsche Bank, RBS and Standard Chartered.

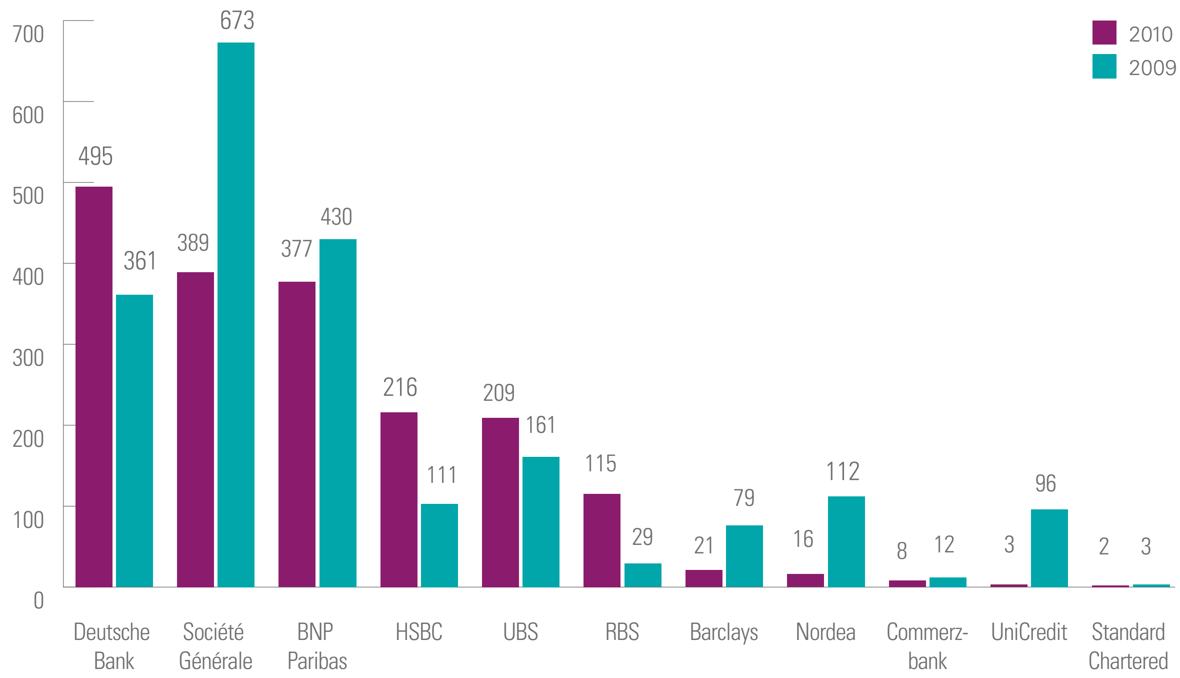
Consistent with previous years, the proportion of Level 1, 2 and 3 financial assets and liabilities varies between the banks. However, the most frequently used categories are Level 1 and 2. Comparison between the banks is difficult as a result of the high degree of subjectivity involved in determining the split between the three categories and how these are applied in practice. Many of the banks have tried to facilitate better understanding by including examples of financial instruments that would typically be classified in a given category.

Financial assets

It can be seen from the graph on page 18 that Level 1 and 2 categories represent on average approximately 98% of total fair value financial assets.

UniCredit has the highest percentage of its financial assets in Level 3, standing at 5%, while Deutsche Bank, Barclays and UBS are following very closely, each with 4% of total financial assets held at fair value. These mainly include collateralised debt obligations, collateralised loan obligations, various bonds trading in illiquid markets and highly customised CDO derivatives. This could indicate the existence of Day 1 P&L reserve, less certainty around balance sheet valuations and on-going profit and loss impacts.

Day 1 P&L reserve released to profit or loss (Million €)



Source: KPMG International, July 2011

The banks with the highest percentage of liabilities held at fair value are:

1. RBS (47%)
2. Deutsche Bank (46%)
3. UBS (45%)
4. Barclays (40%)

Overall, Day 1 P&L releases not as significant as in prior years

Financial liabilities

Consistent with financial asset findings, the largest category in the financial liabilities held at fair value is Level 2, as shown by the graph opposite.

The banks with the highest composition of financial liabilities in the Level 1 category are the leaders from the previous year: ING with 27% (2009: 26%) and HSBC with 23% (2009: 25%) of their financial liabilities being measured using quoted prices. This indicates immediate recognition in the profit or loss of changes in own credit risk.

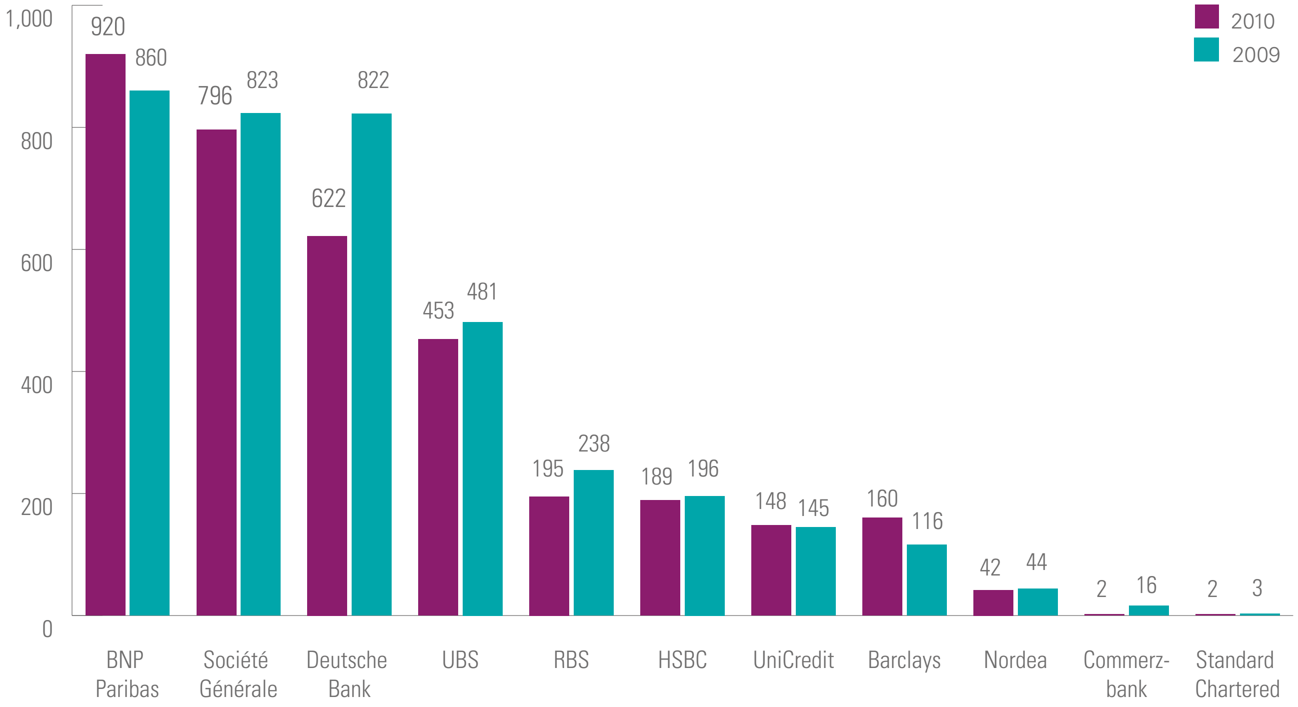
Day 1 P&L

An implication of having financial assets and liabilities categorised into the fair value hierarchy is that of the Day 1 profit and loss effect. For example, if a financial instrument is purchased for a certain price but the bank uses a model to calculate the instrument's value on the purchase date, there could be a difference between the price paid for that instrument and the value calculated using that model. If the model used to calculate the instrument's value applies unobservable inputs, then the difference between the price paid for the instrument and the model value cannot be taken to profit and loss immediately. In accordance with IAS 39 Financial Instruments: Recognition and Measurement, this difference is released to profit and loss over the life of the instrument, when inputs become observable or when the instrument is sold. This could potentially cause volatility in the profit or loss depending on the amount of that difference deferred over time.

Disclosures recommended by IFRS 7 Financial Instruments: Disclosures relating to the Day 1 P&L incorporate issues such as accounting policies, reconciliation of the reserve held at year-end with movements during the year, and transfers to profit and loss during the year.

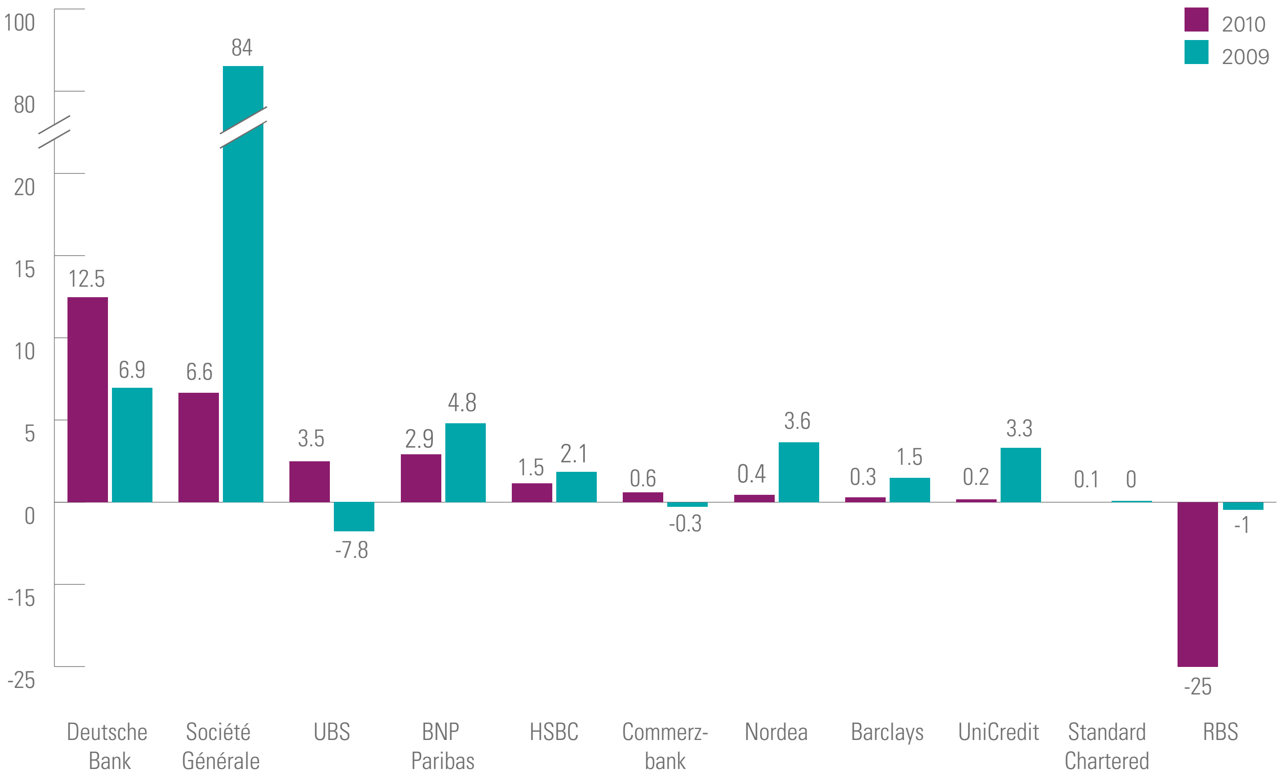
All banks have included some disclosure around Day 1 P&L, except LBG, BBVA and ING.

Day 1 P&L reserve on balance sheet (Million €)



Source: KPMG International, July 2011

Day 1 P&L release as a % of PBT (Percent)



Source: KPMG International, July 2011

BNP Paribas and Société Générale held the highest Day 1 P&L reserve at year-end. Overall, it seems the reserve balances have not increased significantly from the year before, which implies that significant future profit volatility might not be expected.

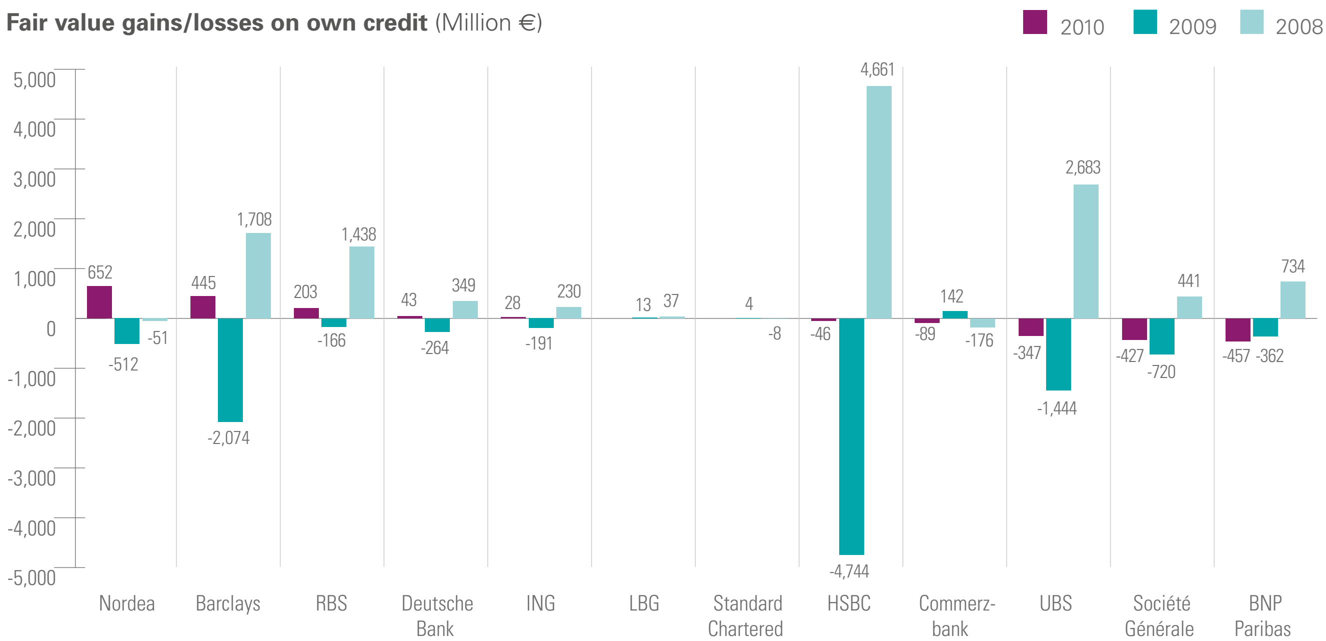
The highest release of this reserve to profit and loss for the year was by Deutsche Bank, followed by Société Générale and BNP Paribas. In terms of volatility profit or loss, the graph opposite shows the percentage release to total profit before tax. It is evident that this release has not affected profit or loss significantly in 2010. This may be due to the fact Day 1 P&L tends to accrete evenly into profit and loss, therefore it is generally less volatile than other fair value movements.

Fair value gains on own credit

The interesting fact about fair value changes on own liabilities is that should a bank's credit rating deteriorate, the fair value of its liabilities decreases, which results in a gain taken to profit and loss. A corresponding loss will be generated should the bank's credit rating improve. This will have a larger effect on banks that hold a larger portion of their liabilities at fair value.

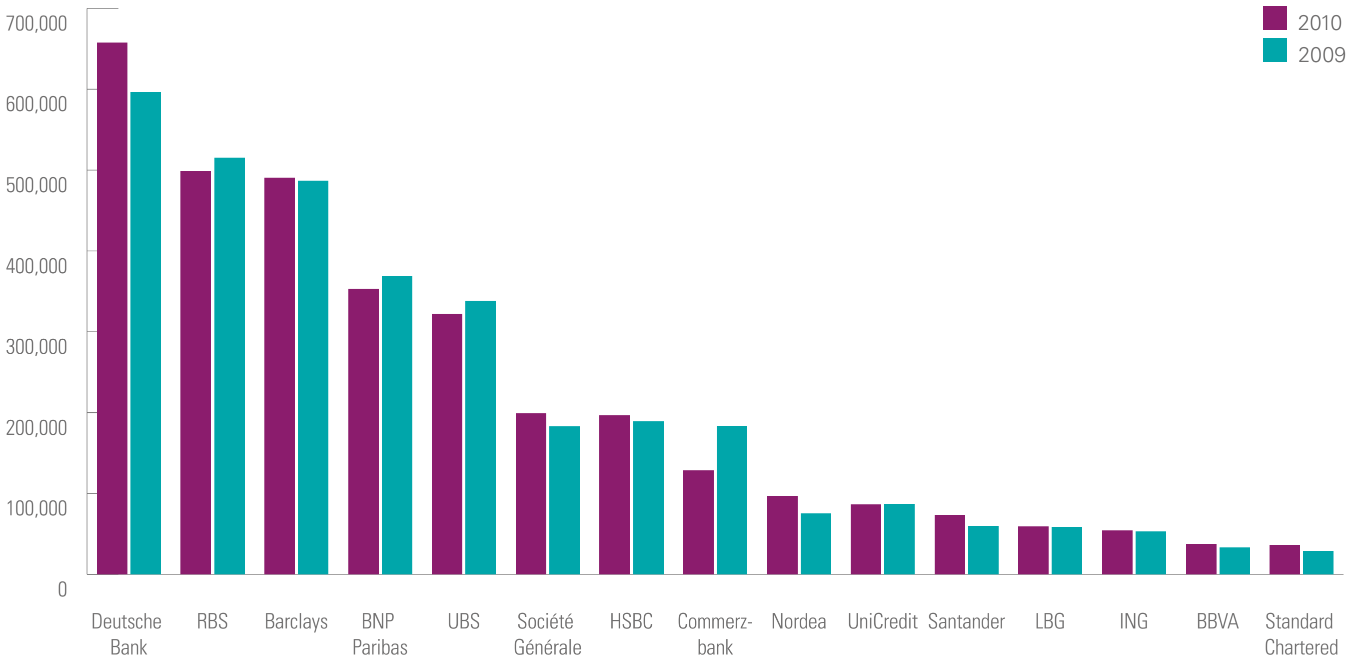
The biggest gains experienced during 2010, and thus decreases in their credit spreads, were by Nordea, Barclays and RBS, while the biggest losses and thus increases in credit spreads were experienced by BNP Paribas, Société Générale and UBS. This causes volatility over the years in the financial statements, as reflected in the graph below, and has always been counterintuitive. IFRS 9 removes this accounting treatment for financial liabilities held under the fair value option, with effect from 1 January 2013. Such debt will be held either at amortised cost or at fair value, with changes in own credit risk being recognised in other comprehensive income and not profit and loss.

Fair value gains/losses on own credit (Million €)



Source: KPMG International, July 2011

Derivative assests (Million €)



Source: KPMG International, July 2011

2010 saw modest increases in derivative market values compared to 2009, which was the year of drastic derivative asset decline across the banks

Derivatives

In accordance with IFRS, derivative contracts are reflected at fair value on the balance sheet, with movements in the fair value being taken to profit or loss. Derivative values, as seen from the balance sheets, give only a broad indication of the risk exposure of the bank, since a derivative's fair value moves in line with an underlying asset or liability or other market variable, and it is further exposed to risks such as counterparty credit risk and wrong way risk.

These contracts are predominantly held as part of the banks' trading portfolios for purposes of client facilitation, arbitrage and/or speculation. The size of the derivative portfolio is often indicative of the bank's business model and investment focus.

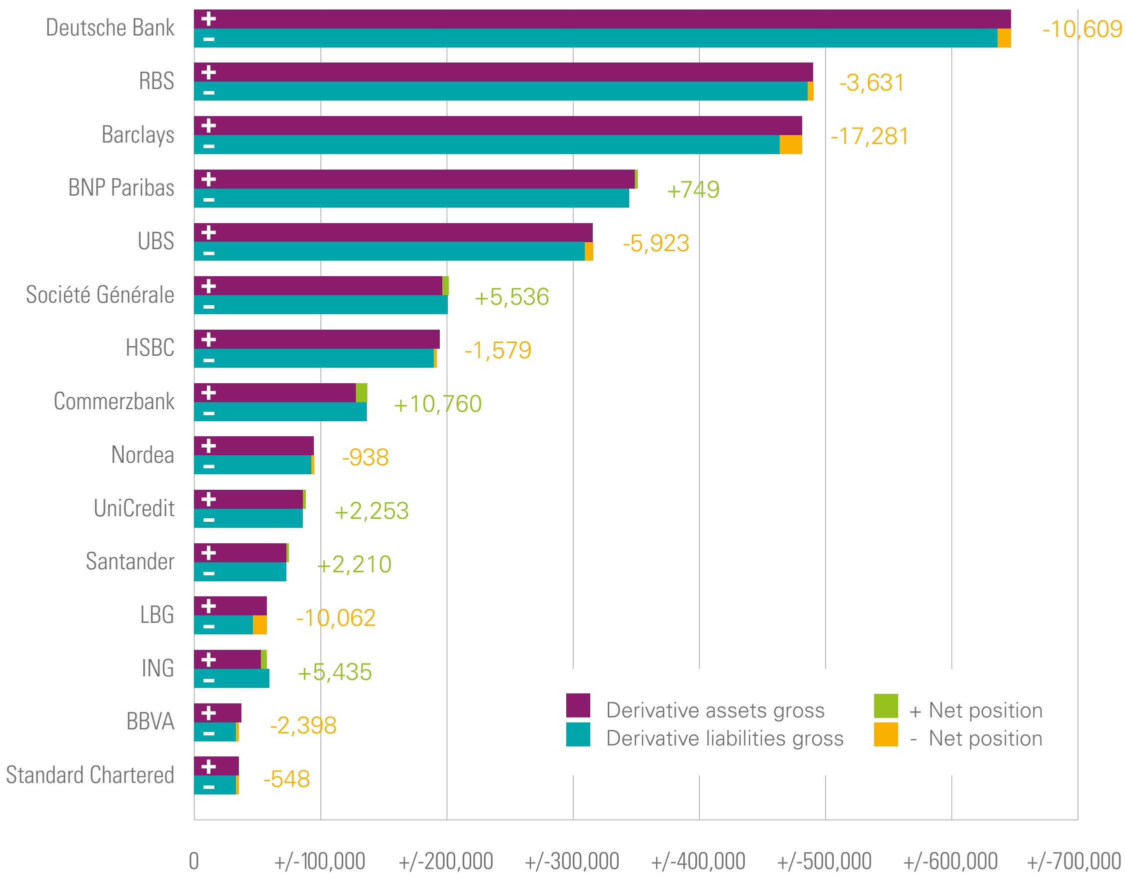
Consistent with previous years, derivative assets largely offset derivative liabilities, as seen from the graph opposite, and very small net effects can be noted.

In contrast to 2009, which was the year of drastic derivative asset decline across the banks, 2010 saw modest increases in derivative market values.

All banks reported an increase in derivative fair values over the past year, with the exception of Commerzbank, BNP Paribas, UBS and RBS. Commerzbank attributed its decrease to expansion in netting, where more derivative assets and liabilities were allowed to be netted off against each other. Overall small decreases are attributed to foreign currency movements and lower transaction volumes. A general improvement was seen in interest rate and foreign exchange derivatives, due to movements in forward interest rate curves and volatility in the foreign exchange market. This improvement was partially offset by the decline in values of equity, credit and commodities derivatives as a result of reduced volatility. The largest increase was noted on Deutsche Bank's balance sheet, which was attributed equally to currency translation effects and acquisitions.

Consistent with the previous year, the largest derivative asset balances were held by Deutsche Bank, RBS, Barclays, BNP Paribas and UBS, each with over €300 billion as at December 2010.

Gross derivative positions as at 31 December 2010 (Million €)



Source: KPMG International, July 2011

Outlook

2010 showed a mild economic improvement after the financial crisis, and even though there were clear signs of recovery, bank leaders were unanimous that the global economy remains fragile. Investment banking performance, which makes up a significant portion of overall banking performance, could not live up to the record revenues witnessed in 2009. The size of the asset portfolio does not directly translate to revenue generating capabilities anymore, and with the proposed conservative new regulatory reforms relating to capital, banks have become selective with regards to what assets they would like to keep on their balance sheets. This was evident from the continued divestment of non-core operations, and by selling lower earning and lower quality assets and replacing them with assets of higher quality and perceived lower risk. That, of course, has not been easy, as many banks blamed low interest rates and flattening yield curves for the lower returns, especially with many maturing investments having had to be re-invested at lower yields. Without doubt, the future will be interesting, although not easy for the banks.

3. Impairments

Analysis of allowances and write-offs

Highlights

- *Increased maximum credit risk exposure*
- *Lower charges for loan impairment*
- *On the horizon: provision for expected losses*

As expected and announced in 2009, impairment charges on loans and advances fell significantly. It reflects improving credit conditions in the main sectors and geographies in which European banks lend, which led to lower charges across the majority of businesses.

However, many of the banks moderate this assessment since some national markets are still in crisis.

In general, the maximum credit risk exposure increased slightly compared to 2009

Maximum credit risk exposure

All banks provided information, including their maximum credit risk exposure as required under IFRS 7. Commerzbank disclosed maximum credit risk exposure net of collateral, probabilities of default and economic factors. For the 14 other banks, the collateral held to reduce the exposures is not taken into account in the disclosed maximum credit risk exposure.

The maximum exposure to credit risk relates to balance sheet and off-balance sheet financial instruments, incorporating the gross carrying amount of financial assets including derivatives, the total amount of committed facilities and the maximum amounts guaranteed.

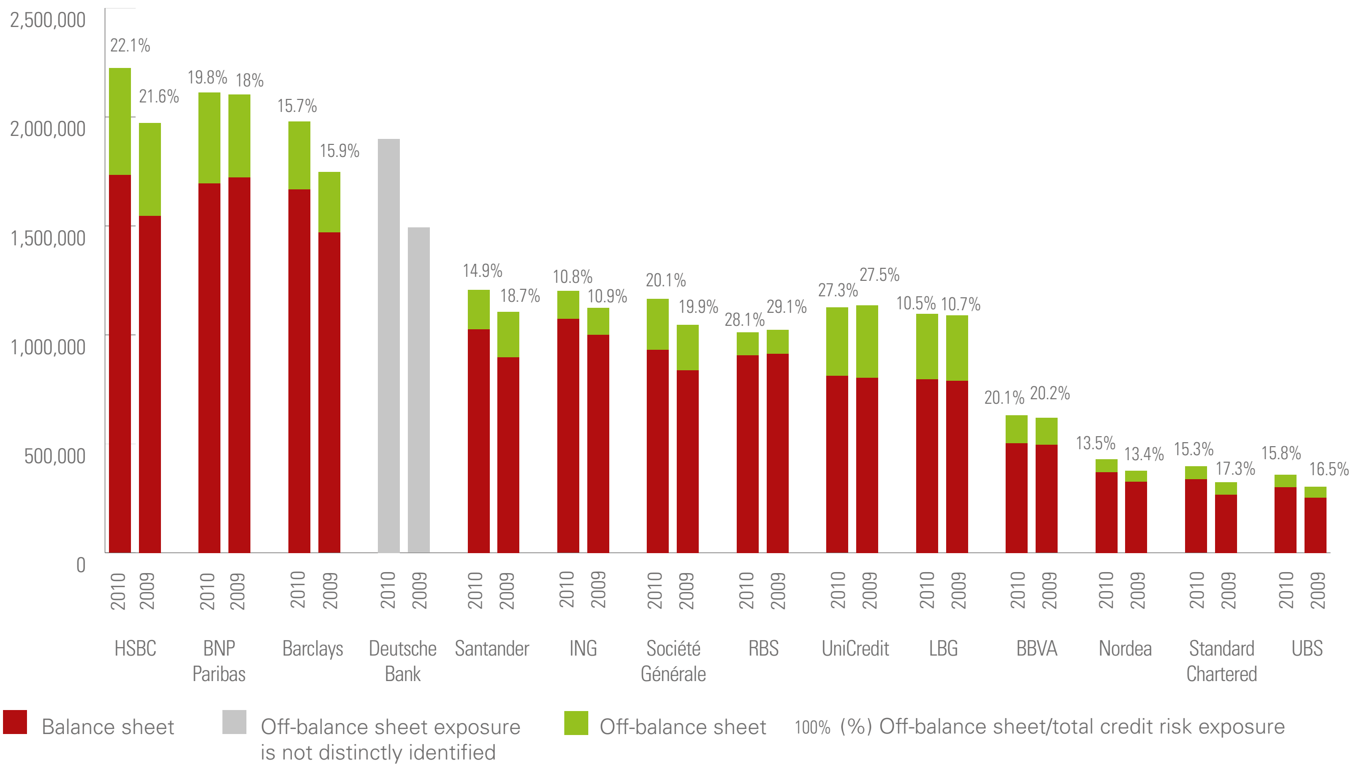
In general, the maximum credit risk exposure increased slightly compared to 2009. Deutsche Bank explains that the increase in credit risk exposures was driven by acquisitions (mainly Postbank), which led to a rise in deposits with banks, financial assets at fair value through profit and loss, and loans. Similarly, Standard Chartered's increased credit risk exposure resulted mainly from the rise of exposure to loans and advances to banks and customers due to growth in the mortgage portfolio and broad-based growth across several industry sectors in Wholesale Banking. HSBC reported an increase in loans and advances to customers, which was driven by focussed growth in Asia in commercial lending and in mortgage lending within Hong Kong and the UK.

Contribution of off-balance sheet items to the maximum credit risk exposure varied significantly from one bank to another, ranging from 28.1% (RBS) to 10.5% (LBG).

The majority of banks disclosed this information in the notes to the financial statements, with five banks presenting the disclosures in the risk management report.

All banks had significant off-balance sheet exposures

Maximum credit exposure (Million €)



Note: Commerzbank is not presented because it discloses maximum credit risk exposure net of collaterals, probabilities of default and economic factors – therefore, it is not comparable.

Source: KPMG International, July 2011

Significant decrease of impairment charges for the majority of banks

Impairment charges

The impairment charge for the year, which comprises the net impairment allowance (after releases) for credit risk on loans to customers and banks, decreased for most banks in 2010.

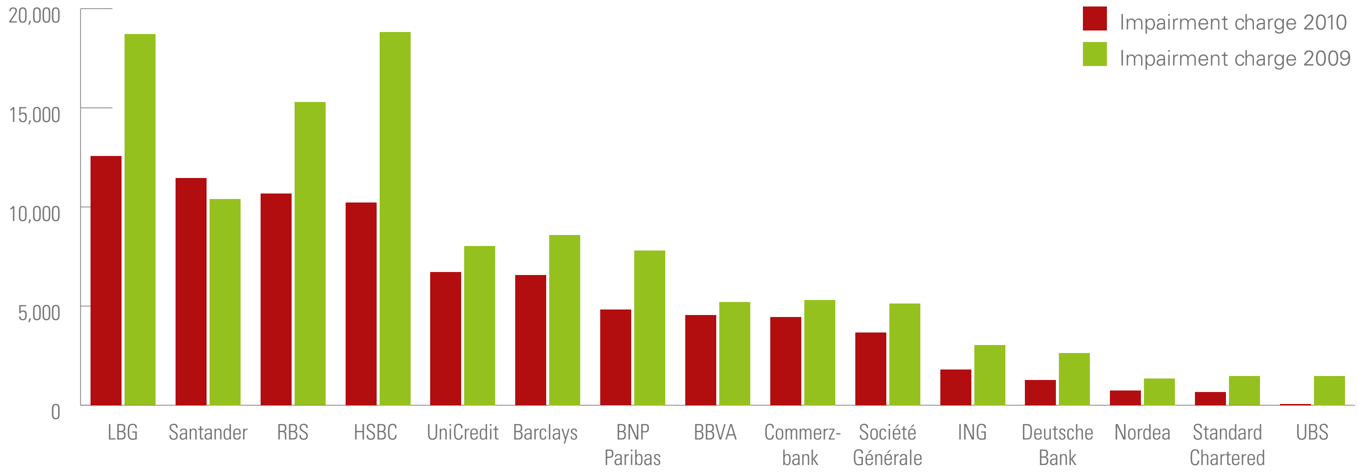
Impairment charges decreased by 29% on average across the survey with the total charge being €80 billion compared to €113 billion in 2009. The charge was reduced at least by 30% for HSBC, BNP Paribas, Deutsche Bank, Nordea, Standard Chartered, ING and UBS.

Only Santander recorded a rise of the impairment charge compared to 2009 due notably to increased bad loans in Spain and Portugal, the acquisition of Santander Consumer Finance and a change in local regulations relating to provisions for loan losses.

The decrease in impairment charges resulted from different factors such as:

- Improved economic conditions in the USA and UK: Loan impairment charges for HSBC were reduced in all regions and all customer groups but particularly in the US (-€7,711 million), driven primarily by HSBC Finance and declining impairment charges in retail and commercial portfolios in the UK, where economic conditions improved and interest rates remained at low levels.
- ING (-€1,248 million) experienced improving portfolio within commercial banking (mainly in the USA), even if it was partly offset by the continuing elevated levels of risk costs in retail in Benelux, since the economic recovery in the Netherlands remains fragile.
- For BNP Paribas, the charge for loan impairment at its retail banking business fell by 22% thanks to an improvement in all the leading countries, especially the USA.

Impairment of loans (Million €)



Source: KPMG International, July 2011

Movements in non-performing loans	Variation (%) 2009/2010	Variation (%) 2008/2009
Barclays	+ 68	+ 29
Standard Chartered	+ 25	+ 31
Commerzbank	+ 17	+ 25
UniCredit	+ 16	+ 36
Santander	+ 16	+ 73
LBG	+ 15	+ 79
ING	+ 15	+ 39
Nordea	+ 14	+ 91
Société Générale	+ 10	+ 62
BBVA	+ 3	+ 78
RBS	+ 2	+ 80
HSBC	- 8	+ 21
UBS	- 27	- 37
Deutsche Bank	- 28	+ 115
Total	**+ 10**	**+ 52**

Note : BNP Paribas had not disclosed its gross NPL in 2008. Therefore, it is not comparable.

Source: KPMG International, July 2011

- Corporate and Investment banking business: the impairment charges recorded by BNP Paribas fell to €314 million (compared to €2,473 million), which includes a 99% decrease in the provision for financing activities.
- Improved risk management processes: for LBG, the fall (€4,866 million) is mainly due to effective portfolio management and improved quality of new business.
- Standard Chartered reduced its charge for loan impairment by 55% (€770 million) as a result of consistently robust risk management processes and underwriting standards, as well as improving economic conditions in most markets.
- Run-off plans: RBS reduced its impairment charges by €4,359 million from management of its non-core book.
- Impact of the impairment charge on the assets reclassified according to revised IAS 39: Deutsche Bank's impairment charge fell €1,357 million due to lower provisions for credit losses related to exposures in leveraged finance that were reclassified in 2009 into the loan category, creating a significant impairment charge in 2009.

The decrease in impairment charges across the survey also results from a significantly smaller increase in identified non-performing loans.

As can be seen from the table on the left, average growth in non-performing loans amounts to 10% in 2010, compared to 52% in 2009.

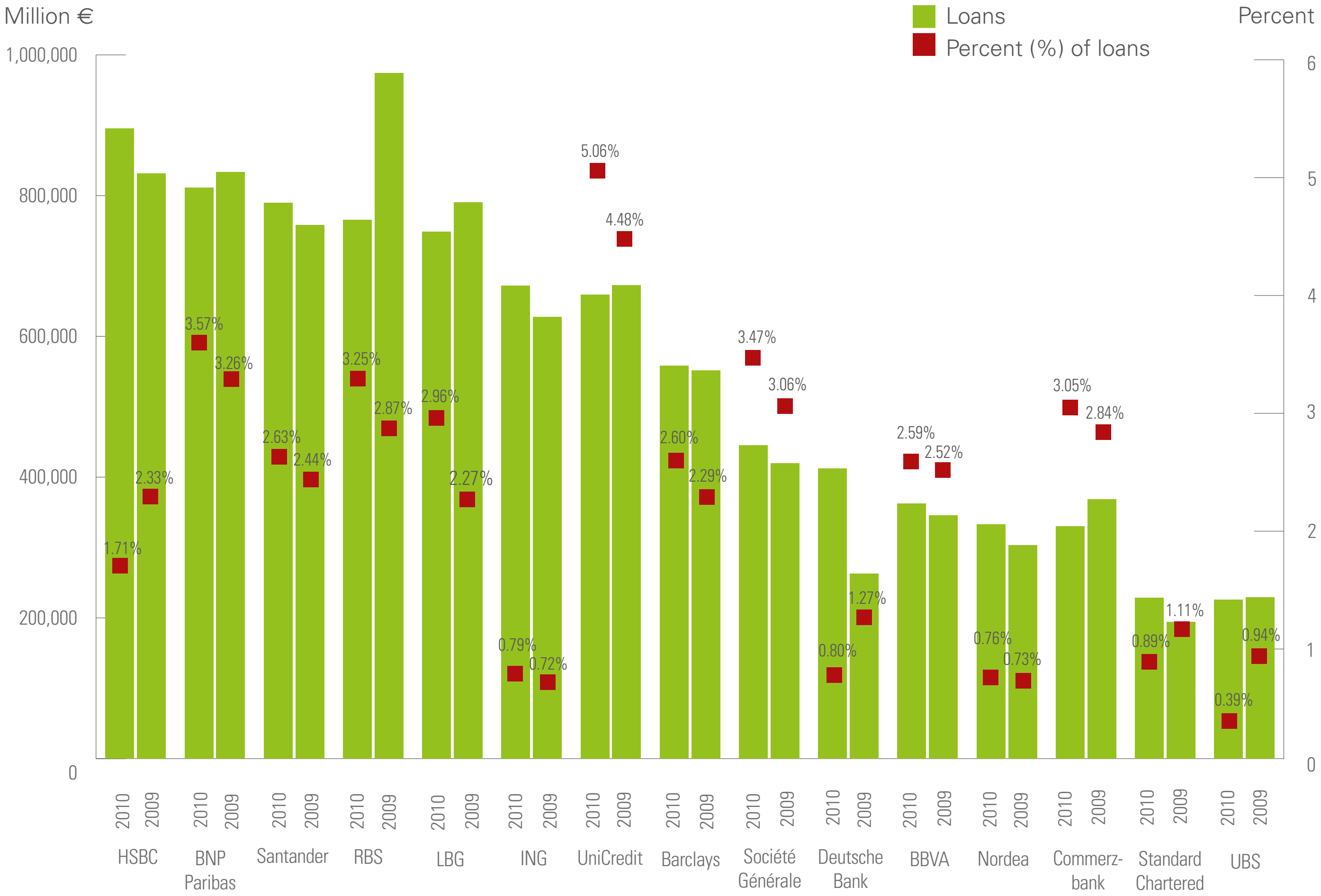
In 2010, the increase of non-performing loans primarily relates to:

- Eurozone exposures, notably for RBS and LBG (Ireland), Barclays (Spain), Standard Chartered (Middle East and Other South Asia region) and Société Générale (Central and Eastern Europe).
- Deterioration of the economic environment in Spain (Santander and BBVA).

Impairment rate (provision as percentage of gross loans and advances)

With the growth rate of non-performing loans generally falling, although the impairment charge is generally decreasing, the resulting year-end provision as a percentage of gross loans and advances has, in fact, improved for the most part.

Impairment rate (Million € / Percent)



Note: The impairment rate presented in the graph above is the provision (individual and collective) compared to the gross loans and advances (banks and customers).

Source: KPMG International, July 2011

Non-performing loans increased at a lower rate than in 2009 and generally represent a small amount of the total credit portfolios

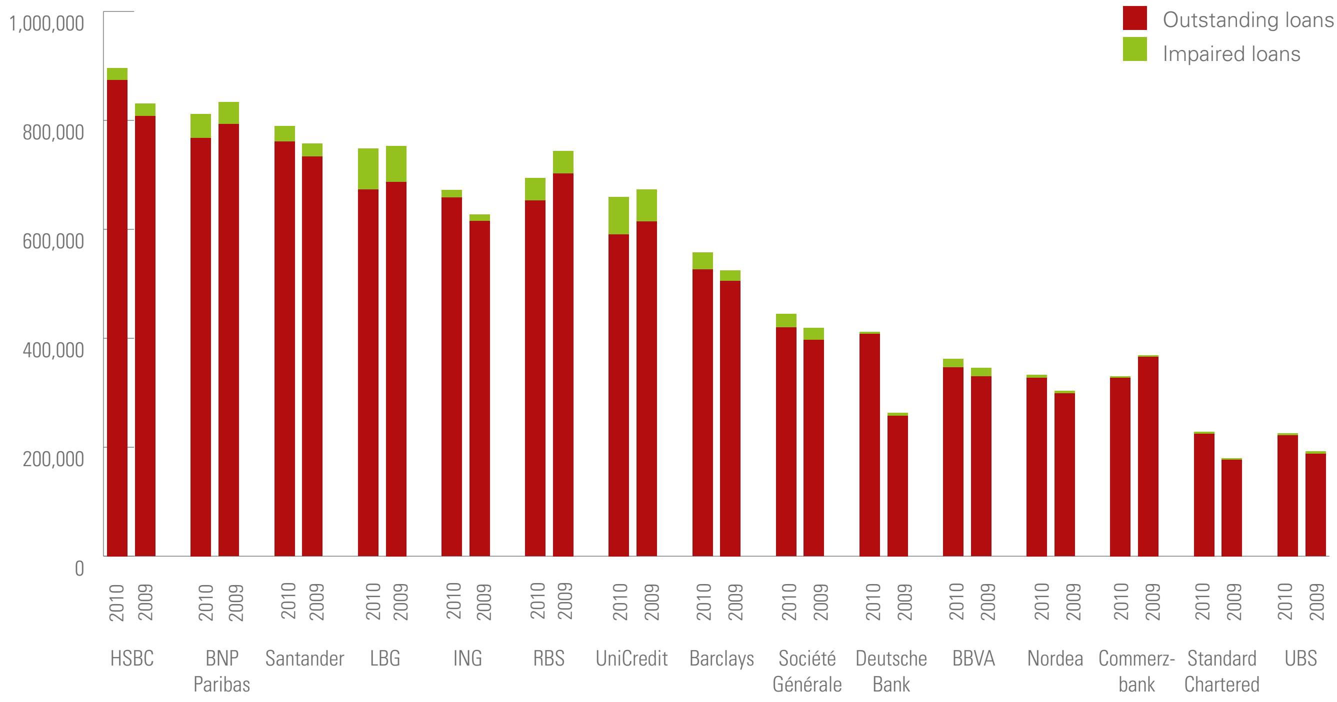
As in 2009, the impairment rates (provision as percentage of gross loans and advances) differ between the banks, ranging from 0.39% (UBS) to 5.06% (UniCredit). On the whole, the impairment rates observed in the sample increased, except for four banks (Deutsche Bank, Standard Chartered, UBS and HSBC). Since the impairment charge in 2010 has generally fallen across the survey, the increased impairment rate (provision as percentage of gross loans and advances) is a result of a stable credit portfolio, and therefore an improved percentage.

Deutsche Bank recorded a fall in its impairment rate from 1.27% in 2009 to 0.80% in 2010 due to the rise of German retail loan and commercial real estate loan portfolios (€150 billion).

The decrease recorded by HSBC is due to the growth of loans and advances to customers in portfolios with historically low loss experience (e.g. Asia) and the run-off of the higher risk US consumer portfolio.

Non-performing loans increased at a lower rate than 2009 and generally represented a small amount of the total credit portfolios, as shown in the graph on the next page.

Impaired versus outstanding loans (Million €)



Source: KPMG International, July 2011

Impaired loans generally a low proportion of total loans

In 2010, the increase of non-performing loans primarily **related to Eurozone exposures**

Individual versus collective charges

There was little change compared to 2009 in respect of the split between collective and individual impairment provisions. Collective allowance as a percentage of total allowances ranged from 4.2% (UBS) to 71% (BBVA). As in 2009, there was significant divergence in practice for how the banks determine loan impairment charges on an individual or collective basis. This leads to a lack of comparability between the banks concerned. However, the methods described are within the standard's definition. In order to improve the comparability, further guidance will be required. Other drivers for this large difference are large retail portfolios, which could lead to future impairment, when assessed by the banks.

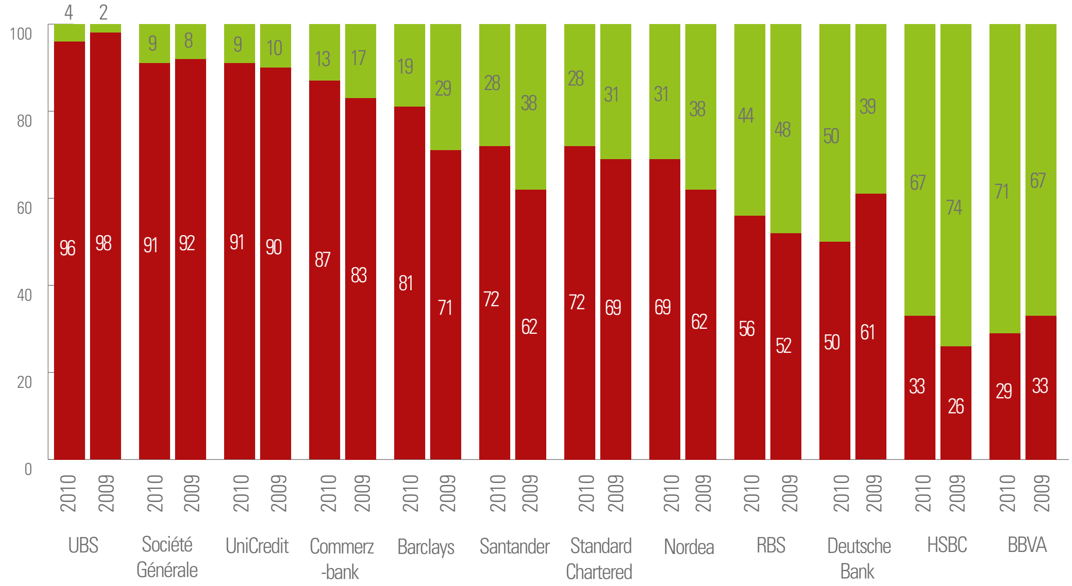
Not all the banks provided a clear distinction between the amount of collective and individual charges for impairment and these banks have therefore been excluded from the graph opposite.

The increase of Deutsche Bank's collective impairment charge (+11%) was driven by increases in its portfolios in Italy and Poland.

On the other hand, the fall in the HSBC collective impairment charge is mainly due to the significant decline in loan impairment charges recorded in the USA, given the geographical area with most exposure to collectively assessed loans and advances is North America.

In Spain, the Bank of Spain, through the Circular 3/2010 of 29 June, revised the parameters for determining allowances and provisions for insolvency risk attributable to the borrower, and the consideration that must be made of guarantees received (building on the experience accumulated over recent years and taking into consideration the current economic situation). To some extent this explains the evolution of the collective impairment of the Spanish banks.

Individual versus collective impairment (Percent)



Note: Data not available for LBG, BNP Paribas and ING

Source: KPMG International, July 2011

Outlook

In light of the economic recovery, 2010 saw a decrease in impairments. Improving credit conditions and a fall in default rates resulted in decreasing loan impairment allowances and write-offs across our survey.

Compared to 2009, more banks disclosed information on the split of their businesses between core and non-core. As in 2009, run-off portfolios (as identified by LBG, RBS, Société Générale, Commerzbank and ING) that have been isolated from core businesses were impaired in 2010 according to the annual reports, although less was provided. These banks continue to manage these types of assets separately from their main businesses.

Some banks commented that they believe the decrease should continue, but they moderated their predictions because economic conditions are still fragile in some markets, such as Ireland, Spain and Greece. They also underlined that sovereign risk could generate future impairment losses (Deutsche Bank, Commerzbank and RBS).

Although coverage rates (provision as a percentage of gross loans and advances) increased due to stable credit portfolios, impairment charges decreased for most banks in 2010 due to the economic recovery.

This prediction of a continuing reduction of impairment charges seems to be confirmed through the first quarter of 2011. Most of the banks announced lower loan impairment charges and even net reversals in their first quarter announcements.

Only one bank mentioned an increase in its impairment charge related to loans in Ireland due to the deterioration of the local economy and a decrease in commercial real estate prices.

Impairment is still on the agenda of standard setters. In January 2011 the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) issued a joint supplementary document on the impairment of financial assets managed in an open portfolio, with a comment period ending 1 April 2011. The common approach proposed is an expected loss model for open portfolios capturing expected losses due to inherent credit risks that have not yet been recognised to replace the current 'incurred loss model. As far as we are aware, the Boards have not carried out an assessment of the quantitative impact the proposals could have on the recognition in practice of loan loss allowances in financial institutions. Without such an assessment it is impossible to conclude whether or to what extent the proposals practically address the criticism of delay in recognition of credit losses.

Our survey has highlighted that the split between collective and individual provisioning is characterised by a lack of comparability between the banks, as there is significant divergence in practice in how banks determine loan impairment charge allowances on an individual or collective basis. To improve the comparability, further guidance will be required.

4. Challenges

Legacy risks and emerging issues

Legacy issues

- *Maturing securitised assets*
- *Continuing government support*
- *Focus on estimates and judgements in financial statements*

Emerging issues

- *Sovereign risk*
- *Changes to regulatory and accounting guidance*
- *Bank levies*

Sovereign debt risk was commented on by the Chairmen and CEOs in 2010, with particular focus on exposures to specific peripheral Eurozone countries. However, sovereign debt risk appears more of a 2011 issue, with further bail-outs for Greece dominating the news and the European Banking Authority stress tests requiring detailed disclosure of exposures to sovereign debt risk, giving rise to speculation around banks' ability to withstand a second crisis.

The CDOs, RMBS, monoline and leveraged finance assets from the 2007/2008 crisis are maturing; the bank levy has superseded the bankers' bonus tax as a government – targeted action to rein-in the banks; and Basel 3 with IFRS Wave 2 are key challenges for the coming years.

Annual reports reflect on what occurred during the year and provide some insight on what is to come. As a result, the annual reports provide information on the banks' risk exposures identified by management, with an indication of key emerging issues. Although the banks in the survey were selected because they are European banks that apply IFRS, they differ in market share – some are more Europe-focused (ING, Nordea, UniCredit), others have significant exposures to Europe and North America (RBS, BBVA), and there are those with a more global exposure (HSBC, Standard Chartered).

IFRS requires disclosure of some risk types, namely credit, liquidity and market risk. These risks are discussed elsewhere in this publication. This chapter focuses on legacy and emerging issues: legacy risks from activities linked primarily to the credit crunch; and emerging issues arising from changes, for example, to regulatory and accounting guidance, which will emerge due to the changing political, financial and economic environment.

Legacy risk

Interests in securitisation vehicles

Despite positive indications that the majority of losses have been incurred and reflected in financial assets, banks remain exposed to 'high-risk' assets such as collateralised debt obligations (CDOs), residential mortgage-backed securities (RMBS), monoline insurers' exposures, and leveraged finance exposures.

These assets are considered together as they share similar risks. The assets (RMBS, CDOs, etc) are either debt or equity issued by a securitisation vehicle and purchased by the banks. Principal and interests on the debt and dividend payments on equity assets are paid from the money collected on the securitised asset (e.g. from the mortgage payments if an RMBS).

Consequently, if, for example, the homeowners default on mortgage payments there is no money to pay the principal, interest, or dividends on the RMBS. In order for the bank to collect the

Legacy 'credit crisis' exposures are decreasing

money due it may be necessary for the house on which the mortgage is secured to be sold, with the sale proceeds used to pay the principal, interest or dividend. These payments generally follow a 'cash waterfall' system, with the senior tranches paid first and the most subordinated tranche paid last. At least, this is the theory. However, given the relatively stagnant real estate industry in Europe and the US, there is no guarantee the house can be sold. As a result, the bank may be left holding real estate, ships or even casinos, which they generally prefer to avoid.

The concern for banks is they will incur further losses on these assets through continued deterioration of the assets underlying the exposures. Therefore, there is a concerted effort to dispose of these types of assets. However, given the potential losses, there are few willing buyers prepared to pay a value acceptable to the banks. This means banks will continue to hold the assets until the markets recover to a greater extent, making the exit strategy much more gradual.

The graphs overleaf show the banks' exposures to these assets are falling as a whole. Net exposures represent the carrying value after taking account of the hedge and other protection purchased.

CDO

For the 13 banks that disclosed their net CDO exposures separately in both 2009 and 2010, overall there was a 2% decrease.

Commerzbank's CDO balance, the largest net CDO exposure, is backed primarily by US and European corporate loans and/or bonds, or US sub-prime exposures. Its exposure to other structured products is noticeably smaller. However, five of the banks show increased exposures, with Barclays and Société Générale the largest. Barclays' balance increased as a result of the dollar appreciating against sterling, whereas Société Générale's exposure increased primarily due to the inclusion of six RMBS CDOs following the substitution of protection acquired from a monoline insurer.

RMBS

Of our survey sample, 12 banks disclosed their net exposure to RMBS in 2009 and 2010. On average, the overall net exposure decreased 10%. This decrease is driven by the reduction of non-US RMBS in LBG's portfolio.

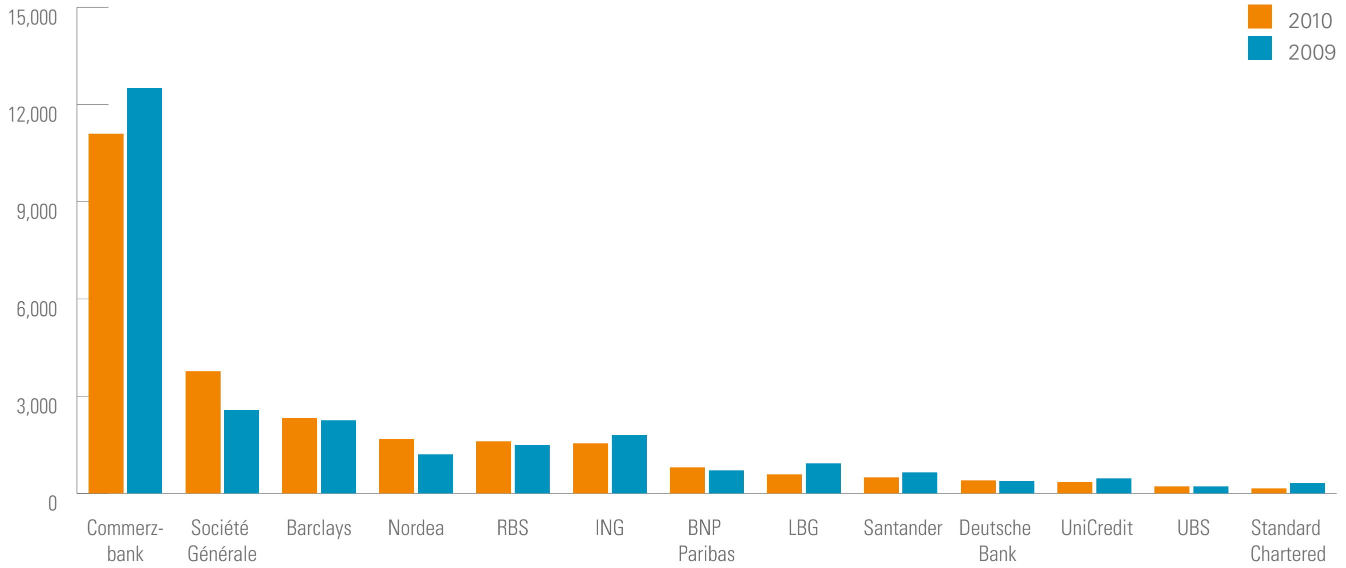
RBS' exposure increased in 2010. However, the majority of these assets are guaranteed or effectively guaranteed by the US government or guaranteed by the Dutch government. Although RBS sold RMBS assets in Q1, the sales were more than offset by purchases in Q2; the latter being driven by perceived market appetite. ING's RMBS exposure increased marginally as a result of lower impairment charges in 2010 compared to 2009.

Monolines

Monolines are entities that specialise in providing credit protection of the principal and interest cash flows due to the holders of debt instruments in the event of default by the debt instrument counterparty. Examples of monoline protection are credit default swaps (CDSs) referencing underlying exposures held directly or synthetically by the group, or other derivatives.

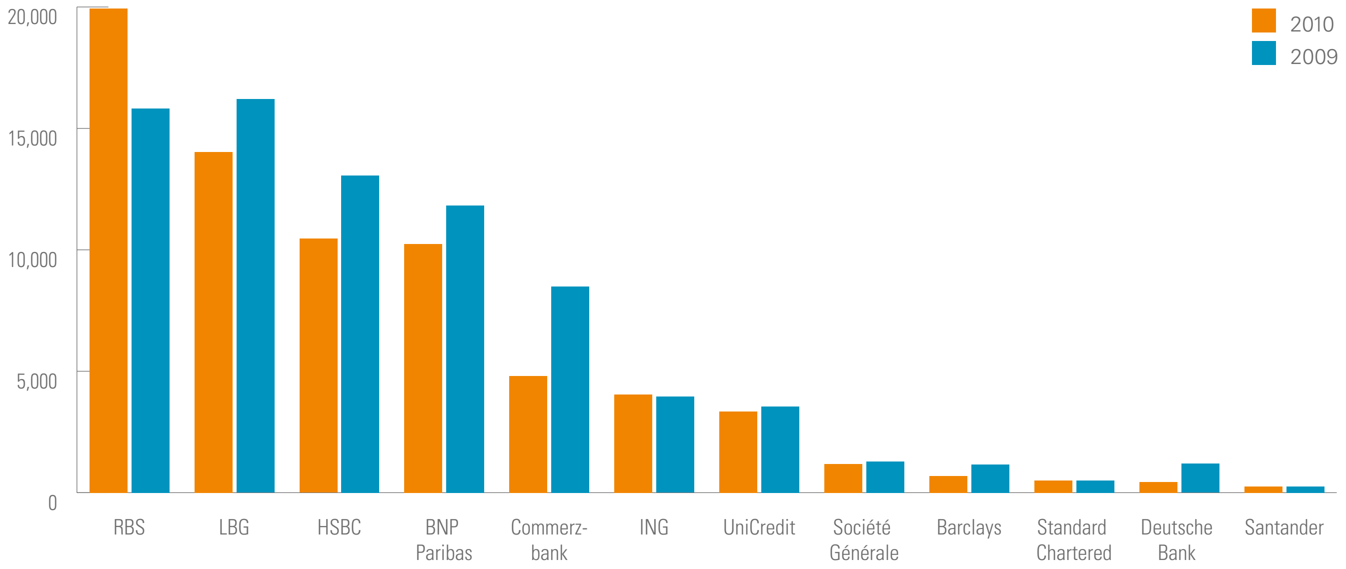
Nine banks disclosed their net monoline exposures in 2010 (UniCredit disclosed its exposure gross), compared with 11 in 2009. All of the banks decreased their monoline exposures.

CDO net exposures (Million €)



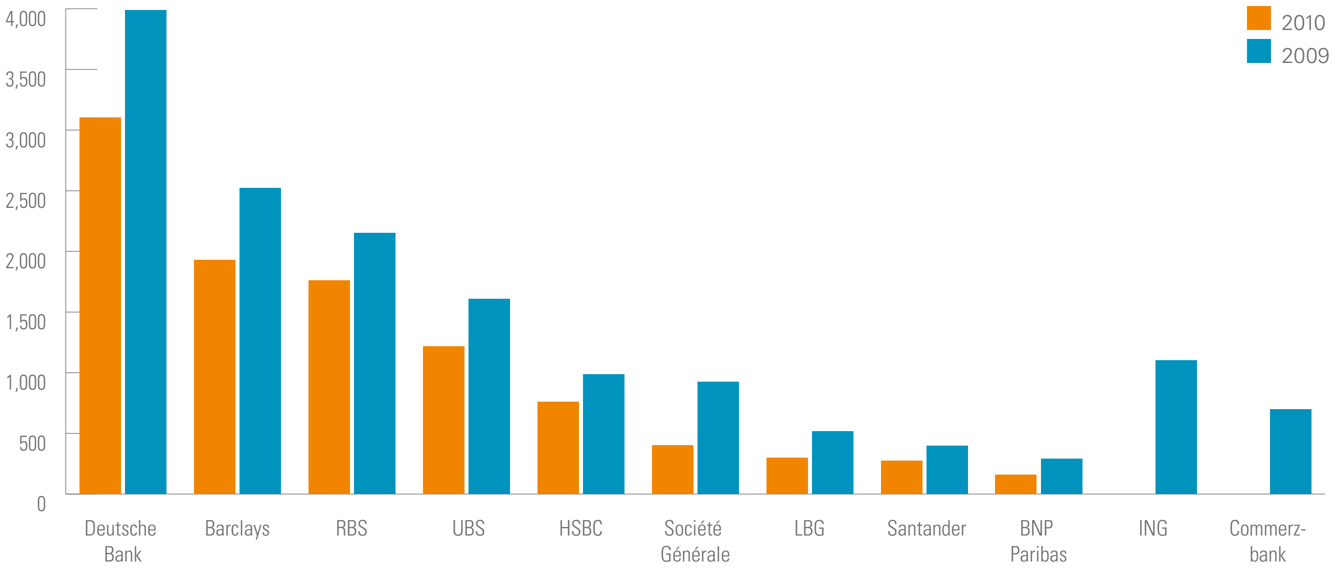
Source: KPMG International, July 2011

RMBS net exposures (Million €)



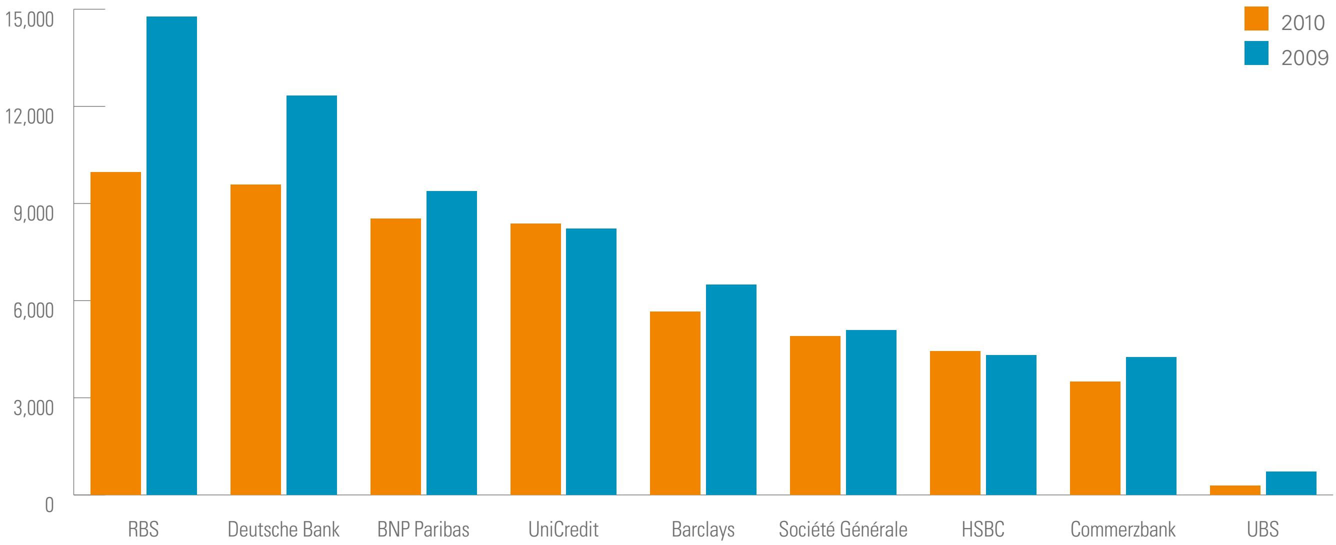
Source: KPMG International, July 2011

Monoline net exposures (Million €)



Source: KPMG International, July 2011

LBO net exposures (Million €)



Source: KPMG International, July 2011

Divergence in accounting treatment of bankers' payroll tax

Some of the reduction can be attributed to currency movements, others to the monoline exposures maturing. In addition, monoline protection acts inversely to the financial instrument it covers. Therefore, when the underlying instrument's value increases the value of the monoline decreases. As such, all else remaining constant, the reduction in monoline balances tends to indicate improving credit market conditions.

Leveraged finance

For the nine banks that disclosed their net leveraged finance exposure in both 2009 and 2010, the overall decrease of leveraged finance exposures was 13%. This decrease is principally driven by RBS, with the reduction in exposures reflecting its Non-Core disposal strategy.

Estimates and judgement

Accounting policies provide a guide on how assets, liabilities, income and expenses are treated by the bank, and form an integral part of the audited financial statements. In many cases, the accounting policy is relatively simple to understand – for example, the accounting for fixed assets, which also tends not to be a significant balance for banks. In other situations, management is required to apply judgement and make estimates. It is for these items where further disclosure is required by IFRS, as these items may have a significant effect on the amounts presented in the financial statements.

The interesting point around the critical estimates and judgements is that they are not prescribed by the market or by the IASB. Rather they are identified by management as being critical to their specific business.

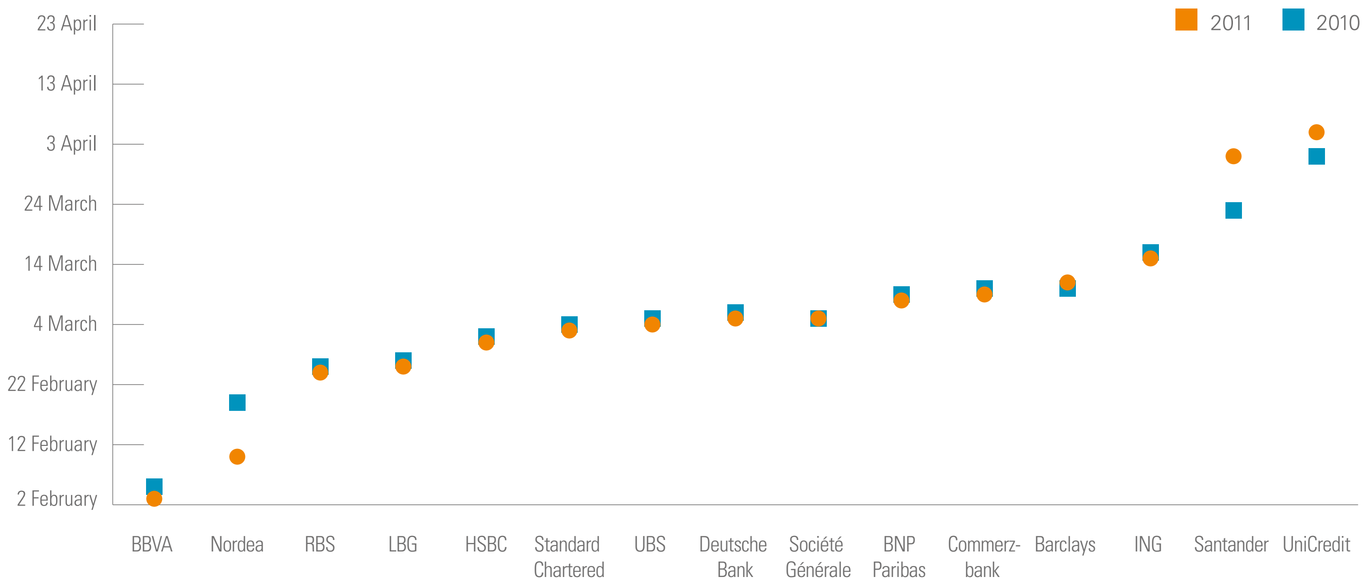
All of the banks cited valuation of financial instruments and impairment of financial assets to be key critical accounting estimates and/or judgements in 2010, an increase from 2009 when a few of the banks did not identify these as key areas.

Goodwill and goodwill impairment, plus pensions remain the most commonly identified non-financial areas of key judgement, although not all banks have these as critical accounting policies. As with deferred tax assets, their valuation depends on estimates of future profitability, so it is understandable that banks have identified these as areas where significant uncertainty could exist. Intangible assets and related impairments, along with deferred tax assets, are quoted by more banks in 2010 as being areas of critical judgement and estimate. This is driven in part by the focus on these assets under Basel 3, and also because future tax profits have historically been driven by investment banking, an area now lacking the certainty of large profits seen in previous years. We have examined these two areas further in Chapter 5.

There was little consistency among the banks in how the information was presented. Most banks include the critical estimates and judgements as the final note within the accounting policy section. Five presented the information elsewhere. Standard Chartered provides its discussion in a separate note outside of accounting policy section, but within the financial statement and notes segment of the annual report. Similarly, HSBC discloses the information separately, placing it in the operating and financial review segment in the front section of the annual report. UBS presents its policy as the first piece of information within the financial information segment of the annual report, even ahead of the financial statements.

While all the banks identified some similar themes (fair value measurement and impairment, for example), the level of detail and discussion on these themes varied, as it is in part predicated by the activities of the bank. A bank with complex, structured products that are not exchange traded would be expected

Attestation dates (date)



Source: KPMG International, July 2011

Press release (date)

Source: KPMG International, July 2011

Sovereign debt exposure varies significantly between the banks

to have more detail about estimates and judgements than a bank holding exchange traded financial instruments. Furthermore, some of the banks provided general information in the critical estimates and judgements section, with more information in the specific notes.

Bankers' tax

In 2009, a key point of debate concerned bonuses paid to bankers. This led to the UK introducing the Bank Payroll Tax, a 50% levy on top of existing Income Tax and National Insurance liabilities that was applied to bank bonuses greater than £25,000 per employee and awarded between 9 December 2009 and 5 April 2010.

Accounting for this tax appeared to differ among the banks. Barclays disclosed it paid a total of £437 million, which will be spread over 2009 to 2013 according to how the cash awards and deferred components are distributed. Similarly, RBS indicated the bonus tax was distributed over a number of years to 2011. HSBC and Standard Chartered, on the other hand, indicated they incurred a one-time expense for the bonus tax.

France also introduced a similar non-recurring tax on bonuses (based on 2009 traders' bonuses, and equal to 50% of the bonus attributed in 2009 above an amount of €27,500).

Emerging issues

Sovereign risk

Sovereign risk is the risk that a government could default on its debt obligations. Most banks defined sovereign risk as exposure to government and central bank obligations.

Sovereign debt was briefly mentioned in some 2009 bank annual reports, usually in relation to the burgeoning unrest in Greece and exposures to Iceland. By 2010, with speculation of government bail-outs for Portugal, Ireland, Spain and Greece, sovereign debt risk merited further mention. All the banks commented on sovereign debt, although not all have a material exposure, with these discussions predominantly embedded in the risk overview section of the annual report and not in the notes to the accounts.

LBG, Standard Chartered, and UniCredit did not provide quantitative disclosures around their sovereign debt exposures due to immateriality. Among the remaining banks there was little consistency in their disclosures. Société Générale and UBS disclosed both net and gross exposures, with UBS providing a comparison to 2009. ING and Nordea provided an aggregate exposure balance, while others provided a breakdown on exposures to selected Eurozone sovereign risk (e.g. BBVA, UBS and HSBC). For banks providing quantitative disclosures, the countries specifically identified tended to be Portugal, Italy, Ireland, Greece and Spain. However, often the countries defined as 'periphery European countries' by the banks were not listed, and thus it was not possible to compare the banks. Overall, the largest exposures tended to be with Spain or Italy and the amounts varied between banks.

Based on the information provided, there does not appear to be a large concentration of exposures by all of the banks in one country. Some banks have concentrated exposures in specific countries (e.g. RBS with its exposure to Ireland). Others had significant exposures to their own government's debt – for example, Spanish bank BBVA had the unfortunate position of being based in one of the countries deemed to have high sovereign risk. Despite being in a similar situation, UniCredit did not have a high exposure to Italian sovereign risk.

Proposed bank levies

	France	Germany	Sweden	UK
Application to bank	Levy applied to local bank, which may include foreign branches or be applied on the global consolidated banking group depending on the bank's structure.			
Tax base	Minimal amount of own fund on a consolidated basis or standalone accounts at 31/12/N-1. Under €500m of minimal funds requirements: not chargeable.	Amount based on specific liabilities of prior year accounts, i.e. 31/12/N-1.	Amount based on specific liabilities (i.e. total debts and provisions at the end of the financial year for the Swedish legal entity).	Amount based on specific liabilities, as at 31/12/N, with a two-tier tax rate depending on duration of liability (i.e. greater or less than one year). Specific liabilities up to £20bn not chargeable.
Tax rate	0.25%	Progressive rates for 'relevant liabilities' ranging from 0.02% to 0.04%. 0.00015% for off-balance sheet derivatives.	0.036%, but a 50% reduced rate for 2009 and 2010.	For 31/12/11 year end 0.075% and 0.0375% for >one year funding. Reduced rates for 2012 0.078% and 0.039% for >one year funding.
Deductible for corporate tax purposes	Yes	No	Possibly	No
Permanent	Yes			

Source: KPMG International, July 2011

Bank levies introduced across Europe in 2010

In the 2010 annual reports the banks acknowledged the growing risk of sovereign debt, and in particular referenced the increasing risk associated with certain European sovereign debt. However, the speed of developments could not be foreseen at the time the annual reports were prepared. While government bail-outs were discussed in 2010 – with Greece receiving funding in May 2010, Ireland in November 2010 and Portugal in 2011 – in the first quarter of 2011 debt restructuring, and its potential impact on the banking sector, became an issue of growing concern. Contagion spread as markets speculated on which country would need the next bail-out.

In March 2011 the European Banking Authority (EBA) issued information on stress tests they would undertake to assess the resilience of financial institutions to adverse market developments. This stress test builds on the information derived from earlier stress tests performed by CEBS, the EBA's predecessor. One of the requirements of the stress test is for banks to disclose their sovereign debt exposure by accounting portfolios (available for sale, held to maturity and held for trading), maturities and countries. Results from the stress test were made public in July 2011 and may drive sovereign debt disclosures for 2011.

Bank levy

In 2011 the banks will be subject to the bank levy, which arose from various Group of 20 (G20) talks and an EU Member State agreement in June 2010. Many governments, including those in France, Germany, Sweden and the UK, have announced and started to implement their plans for bank levies, and inconsistencies between the structures have already been noted. A brief summary is provided in the table above.

In addition to the differing levies proposed, there is the further complication that the accounting treatment for these levies is unclear. For example, for levies based on the current year's balance sheet, there is an argument that the levy is only triggered as an obligation when the balance sheet is measured. Therefore, there should be no accrual and just a one-time charge

IASB timeline for standards and exposure drafts particularly key for banks

2009	Q1 2011	Q2 2011	Q3 2011	Q4 2011	2013
IFRS 9: Financial instruments – classification and measurement		IFRS 10 – Consolidation IFRS 11 – Joint arrangements IFRS 12 – Disclosure of Interests in Other Entities IFRS 13 – Fair value measurement	Proposed issue date: Asset and liability offsetting (currently exposure drafts) IFRS 9: Financial instruments – General hedge accounting.	IFRS 9: Financial instruments – Macro hedge accounting (Exposure draft)	IFRSs 9-13 effective as of 1 January (early adoption permitted) (pending EU endorsement)
			IFRS 9: Financial instruments – Impairment (Re-exposure or Review draft)		

Source: KPMG International, July 2011

The banks welcome better regulation, while acknowledging the challenges it will bring

at year-end when the balance is known. However, others argue the amount could be estimated and, therefore, balances should be accrued over the year to inform the shareholders of the potential charge. Given a bank could incur a charge >€1 billion, it could be significant to the financial statements. Consequently, many constituents have raised the query of how to account for the levy with the International Financial Reporting Interpretations Committee (IFRIC), where it is being deliberated further. It will be interesting to see whether this matter resolves itself by interim, and if so, how the banks present the information.

Changes to regulation

As in 2009, the pendulum still seems to be swinging towards tighter and better regulation – evidenced by the swathe of guidance on topics such as remuneration, more and higher quality capital, diversification of sources of funding, and liquidity – with a focus on harmonisation across Europe in these areas. Overall the banks commented that they welcomed better regulation, while acknowledging the challenges it will bring: ranging from training staff and updating systems, to driving how the bank conducts its business to ensure returns to shareholders despite increased capital costs.

A concern for many banks is the disparity of regulation across the globe. Some countries are making strident changes to their regulation. Other jurisdictions seem to regard the credit crisis of 2007/2008 as more of a European and US issue, and are making less notable changes to regulation. This disparity is a double-edged sword. On the one hand it seems to provide an opportunity for large global banks to book their business in a less regulated jurisdiction. On the other, a bank continuing to book business in Europe could be subject to various regulations, not all of which are applied harmoniously across the countries.

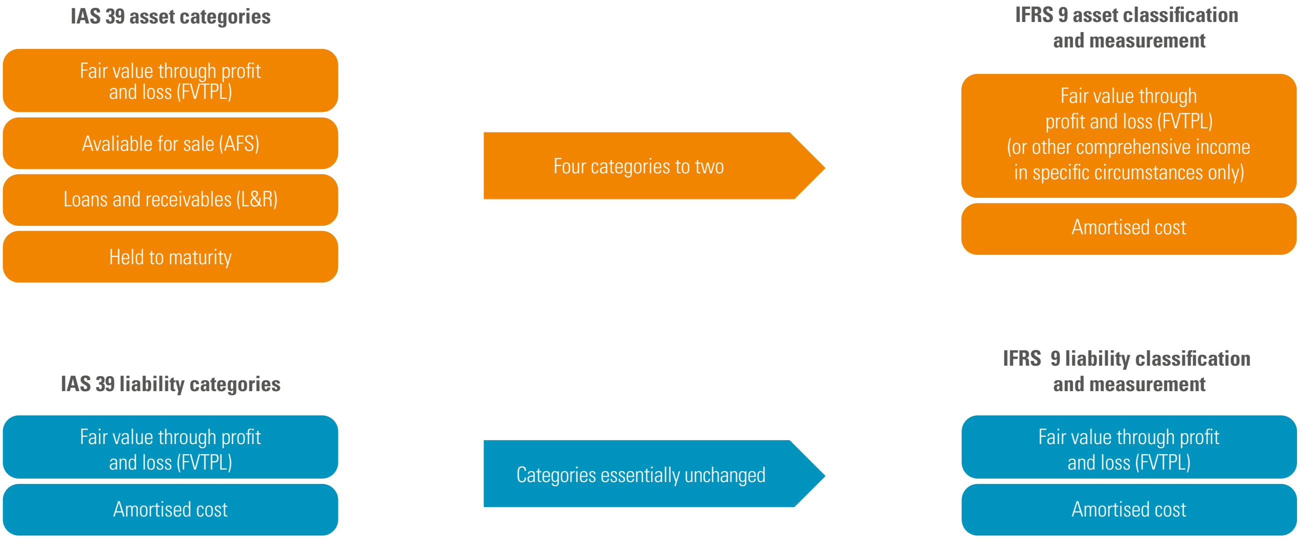
Changes to accounting guidance

Over the last few years the IASB has been assiduously reassessing many of the accounting standards, with 2009-2011 the peak years for issuing proposed and final standards. Assuming the IASB's plan stays on track, 1 January 2013 will see the dawn of 'Wave 2,' with implementation of many of the new standards: for example, IFRS 9 Financial Instruments, a three-pronged project that will replace IAS 39; IFRS 10 and IFRS 12 on Consolidation and related disclosures, superseding IAS 27 and SIC 12.

IFRS 9

IFRS 9 arose primarily from concerns raised from the G20, the FSB and others, to simplify the accounting for financial instruments. Generally, the annual reports only commented on the issuance of IFRS 9: Classification and measurement, as it

Comparison of IAS 39 to IFRS 9: classification and measurement



Source: KPMG International, July 2011

Accounting rules are being rewritten

was the sole phase issued by year-end. This standard, as with all IFRS, cannot be applied to European banks until the standard has been endorsed by the EU, which is still pending and could delay implementation date.

The first phase: Classification and Measurement was completed in November 2009 and moves financial asset classification from a four category model to a two category model; financial liability classification is, to a point, unaltered.

IFRS 9 also introduces a two-step evaluation: firstly, the assets are assessed to determine whether management intends to hold them to collect the contractual cash flows ('held to collect' or 'HTC' model) or to sell in the short term and secondly, for assets within the HTC model, whether the contractual cash flows meet the definition of 'solely principal and interest' ('SPPI' test). Only when both the HTC and SPPI tests are met can the asset be accounted for at amortised cost; otherwise it will be measured at FVTPL. The full impact of this new standard is still to be seen.

However, the general view is there will be more instruments measured at FVTPL under IFRS 9 than under current guidance. As a result, IFRS 9 is expected to give rise to more volatility in net income.

Impairment

Phase 2 focuses on impairment of financial assets held at amortised cost, which is proving to be one of the more challenging standards for the IASB to write and is still in exposure draft pending further deliberations.

Hedge accounting

Phase 3, which is being written contemporaneously with Phase 2, covers hedge accounting for financial and non-financial assets. While there are some fundamental changes to the current guidance, these are intended to make hedge accounting more aligned with risk management and hedge accounting a less onerous practice. For example, the exposure draft proposes eliminating the quantitative threshold and retrospective assessment for hedge effectiveness testing (i.e. the 80–125% test); and allowing entities to rebalance certain existing hedge relationships that

Increased regulatory and accounting constraints and the impact of new accounting standards affecting how management runs the bank

have fallen out of alignment instead of having to restart the hedge in another relationship. However, voluntarily discontinuing certain hedge relationships would be prohibited.

Furthermore, the proposed standard widens the criteria for both hedging instruments and hedged items. Non-derivate financial instruments measured at FVTPL may now be designated as a hedging instrument of FX risk and any other risk, and certain risk components of non-financial items, certain aggregate exposures that are combinations of exposures and derivatives, and certain layer components of defined nominal amounts would be eligible hedged items. The exposure draft has generally been well received by the market, but there are further deliberations planned before the final standard is issued.

Consolidation, Joint Agreements, Disclosures and Fair Value Measurement

In May 2011 the IASB issued four new standards, with the same effective date of 1 January 2013. Fair value measurement is intended to align the definition of 'fair value' within the various standards, and should not present too much of an impact to banks in this survey. The challenges for the banks will likely arise from implementing the other three standards.

IFRS 10 is intended to eliminate the two-model consolidation assessment under IAS 27 and SIC 12, replacing it with a comprehensive model. The general market view is there will be a re-jig of who consolidates; however, the actual number of entities consolidated is unlikely to change. Similarly, IFRS 11 is regarded as a 'manageable' standard by most banks.

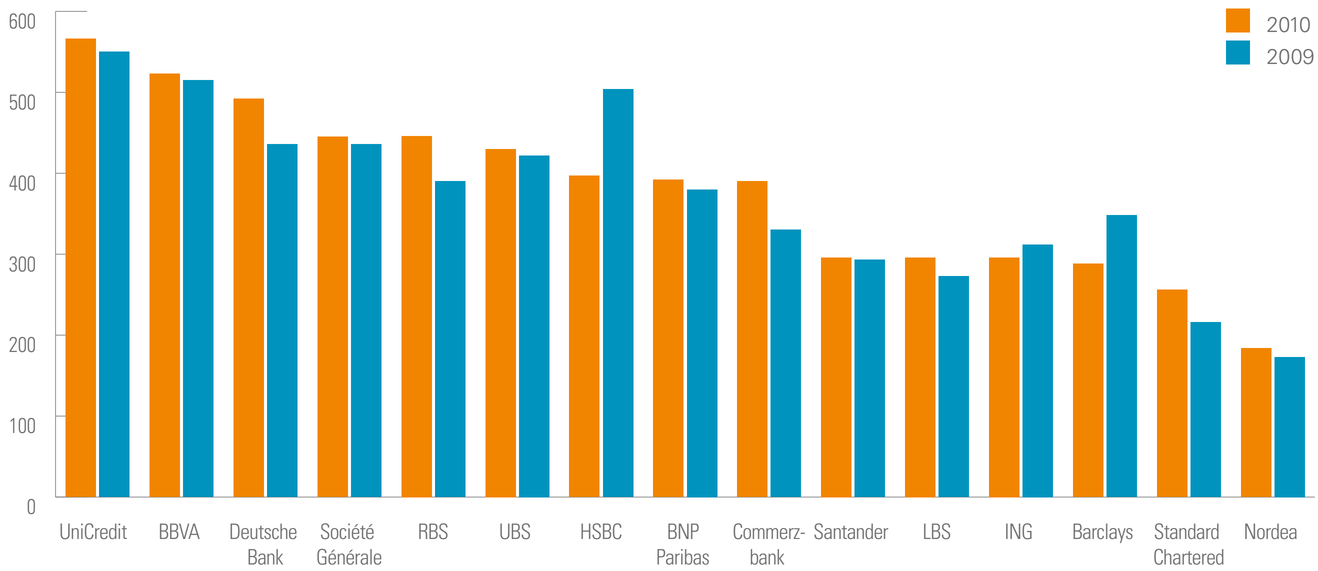
IFRS 12 is the standard that will be the most challenging, as this was not issued as an exposure draft prior to being finalised as a standard. As such the market continues to assess the impact of the new guidance, the requirements of which appear quite onerous and likely will increase the size of the financial statements.

The graph opposite shows the size of the annual reports; 2010 continued the trend from 2009 and 2008 of increasing volumes. Whilst the increases can be explained through additional information requested by regulators and the market (e.g. around impairments, IFRS 7 risk disclosures, the composition of capital), 2008's annual reports were frequently criticised for being too large – was this view still held in 2010? Given the additional proposed disclosure requirements in 'Wave 2' standards, banks may need to reconsider the format and layout of their annual reports, or the average size of the annual reports could be over 500 pages.

The coming challenge for the banks is to assess the impact of adopting all of the standards on 1 January 2013* given the majority require retrospective application.

*Currently indication of initial adoption

Volume of annual reports (Pages)



Source: KPMG International, July 2011

Outlook

We expect the following trends to develop in the following year:

- Legacy assets will continue to decrease primarily through maturity. RMBS, in particular, could incur further losses if the underlying retail mortgages in the US or Europe are subject to further economic shocks.
- Increased disclosures regarding sovereign debt exposures, as European governments are provided support or look for other solutions and provisions for sovereign debt, in particular if Greece restructures its debt or leaves the Euro.
- Increase in interest rates is an emerging risk that could have an impact on the economy.
- Developing economies compared to European economies, and the continuing emphasis on lending away from the mature US and European markets to emerging Asian markets.
- Increased regulatory and accounting constraints and the impact of new accounting standards affecting how management runs the bank.
- A decrease in government support as certain governments, such as the UK's, have indicated they will start withdrawing support from LBG and RBS, as they reduce their reliance on it.
- Payment Protection Insurance (PPI) losses (Q2 2011).

5. Intangibles

Non-financial assets

Highlights

- *Marginal decreases in goodwill with no impairments recorded*
- *Deferred tax asset balances relatively unchanged compared to 2009*

Although financial assets constitute a major part (generally in excess of 90%), of a bank's balance sheet, certain other assets such as goodwill and deferred tax can be key indicators in the banking sector because of the inherent judgement of future profitability used to substantiate them.

Goodwill is already deducted in full from Core Tier 1 capital to obtain regulatory capital. Under the forthcoming Basel 3 requirements, deferred tax assets which rely on future profitability will have to be deducted in the calculation of future Core Tier 1 capital.

Each of the banks in the sample had goodwill amounts on balance sheet

exceeding €2bn

at 31 December 2010

Goodwill

Goodwill is recognised only in business combinations, representing the future economic benefits arising from assets not capable of being separately identified. Goodwill is measured as the difference between the cost of an acquisition and the amount of any non-controlling interest in the acquirer and the fair value of assets and liabilities acquired.

Under IFRS, goodwill is not amortised, but is subject to annual impairment testing. Impairment may arise if the acquired entity is adversely affected by market or economic events, which in turn indicate the carrying value of goodwill is higher than the future economic benefits the acquirer will derive. Goodwill impairment is recorded in profit or loss.

As in 2009, each of the banks in the sample had goodwill amounts on balance sheet exceeding €2 billion at 31 December 2010.

In total, €142 billion of goodwill is held on balance sheet by the 15 banks (compared to €139 billion in 2009).

The carrying amount of goodwill was stable for our sample banks compared to 2009, without the significant impairment charges that have been experienced in recent years. Only two banks recorded a fall in the carrying value of goodwill compared to 2009 (RBS and ING). For RBS the goodwill amount decreased (-€2,174 million) as a result of sales of businesses due to its disposal programme.

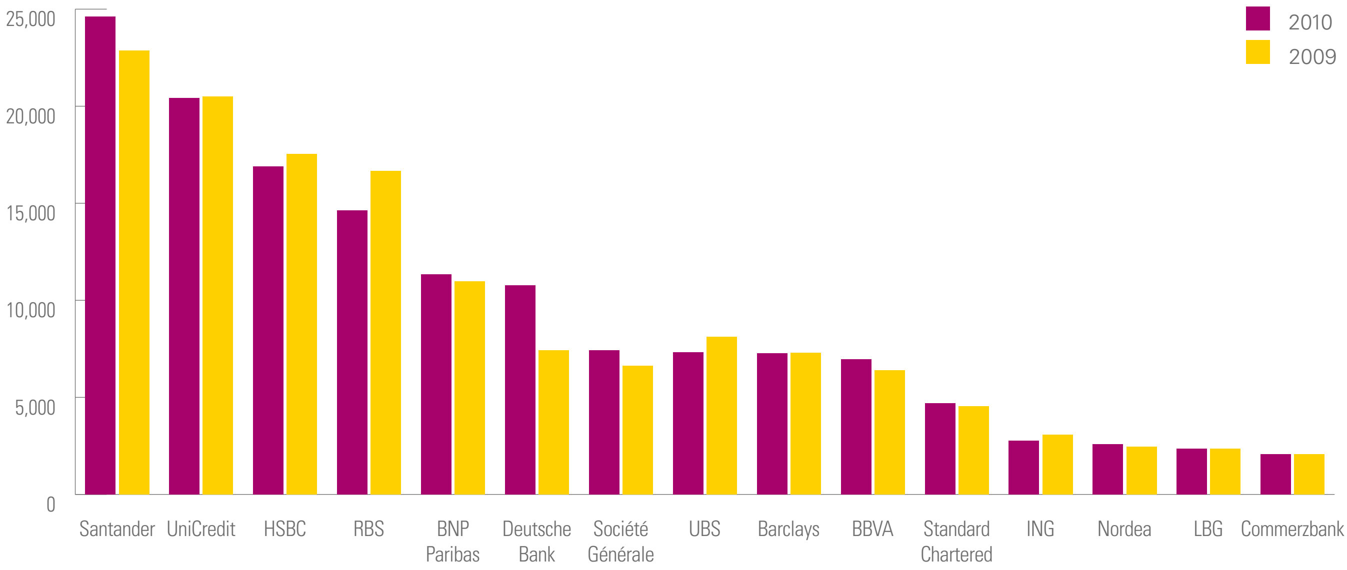
The largest increases were recorded by Deutsche Bank (+€3,342 million) and Société Générale as a result of their acquisitions.

Carrying amount of goodwill and amount of impairment

In 2010, none of the banks in our survey recorded significant goodwill impairment.

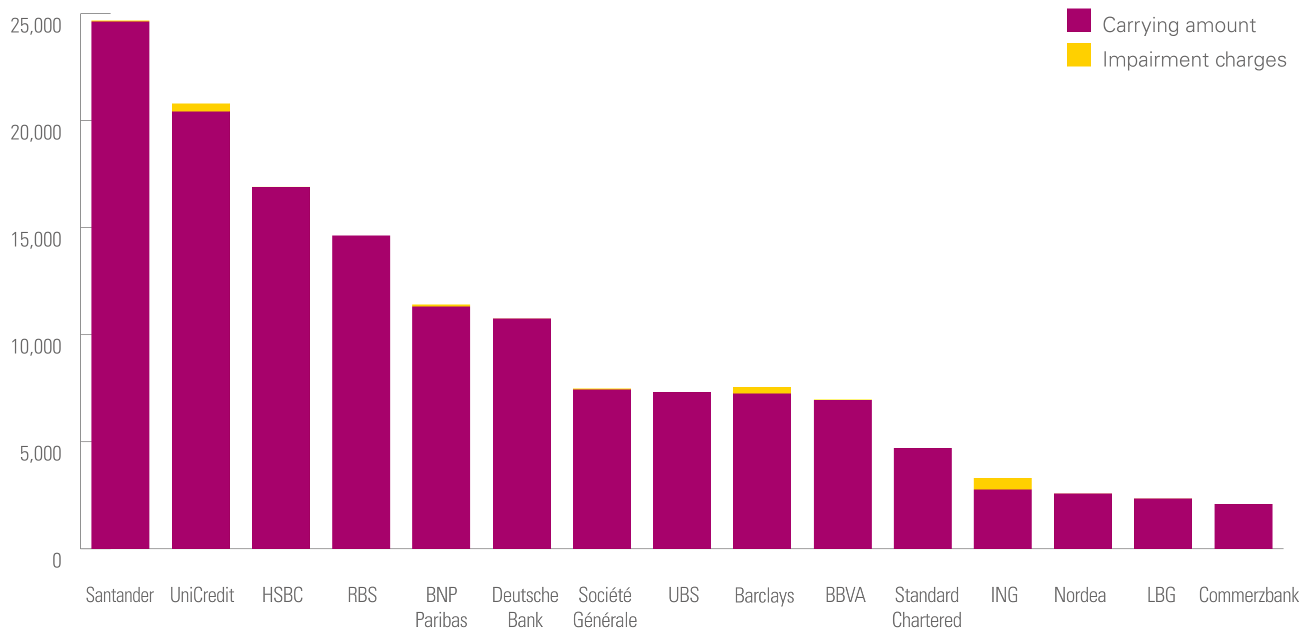
Seven banks recorded a goodwill impairment charge in 2010, the highest charge being €540 million for ING from the reporting unit Insurance US. Unfavourable market circumstances for Insurance, including the low interest rate environment, were mentioned as indicators of a lower recordable amount of the reporting unit Insurance US than book value.

Carrying value of goodwill (Million €)



Source: KPMG International, July 2011

Carrying amount of goodwill and related impairment charges during the year (Million €)



Source: KPMG International, July 2011

Goodwill is deducted from regulatory capital

All other impairments are less than €400 million. Among them, Barclays recognised an impairment charge of €284 million due to the goodwill held by Barclays Corporate in Barclays Bank Russia (BBR). For UniCredit, the impairment charge of goodwill amounted to €362 million, mainly due to its subsidiaries in Kazakhstan, where the continuance of the economic crisis and high local market volatility led to a prudent revision of strategic plans.

Goodwill disclosure

For each cash-generating unit for which the carrying amount of goodwill is significant, entities are required by IAS 36 to disclose information about:

- the carrying amount of goodwill allocated to the unit,
- the basis on which the unit's recoverable amount has been determined (i.e. value in use or fair value less costs to sell),
- for the value in use and the fair value less costs to sell, if it has not been determined using an observable market price the following information shall also be disclosed:
  - a description of each key assumption and management's approach to determining the value assigned to each key assumption,
  - the period over which management has projected cash flows,
  - the growth rate used to extrapolate cash flow projections,
  - the discount rate(s) applied to the cash flow projections.

Disclosures regarding goodwill varied across the survey. Some banks include detailed information about goodwill allocation and impairment regarding:

- Cash generating units: UniCredit, BNP Paribas, Deutsche Bank, RBS, Société Générale, BBVA, Standard Chartered and Santander.
- Geographical regions: HSBC, Santander.
- Sensitivity analysis: Commerzbank, RBS.

Stable deferred tax assets indicate losses still occurring – but where?

Deferred tax

Deferred tax assets under IFRS relate to amounts of income taxes recoverable in future periods in respect of deductible temporary differences, the carry forward of unused tax losses and tax credits. Deferred tax assets can only be recognised to the extent it is probable that sufficient future taxable profits are expected to be available against which these tax losses and credits can be used.

In 2010, 13 out of 15 banks had recognised deferred tax assets exceeding €2 billion each, which was the same in 2009. The highest amounts were held by Santander (€17.1 billion), UniCredit (€11.3 billion), BNP Paribas (€9.2 billion) and Deutsche Bank (€8.3 billion).

Only three banks (Santander, Deutsche Bank and UniCredit) recorded a significant rise in their deferred tax assets (more than €1 billion).

The largest increase of €1.2 billion in Santander deferred tax assets can be explained by the fact that overseas branches and subsidiaries of the Group have deferred tax assets related to tax loss carry-forwards.

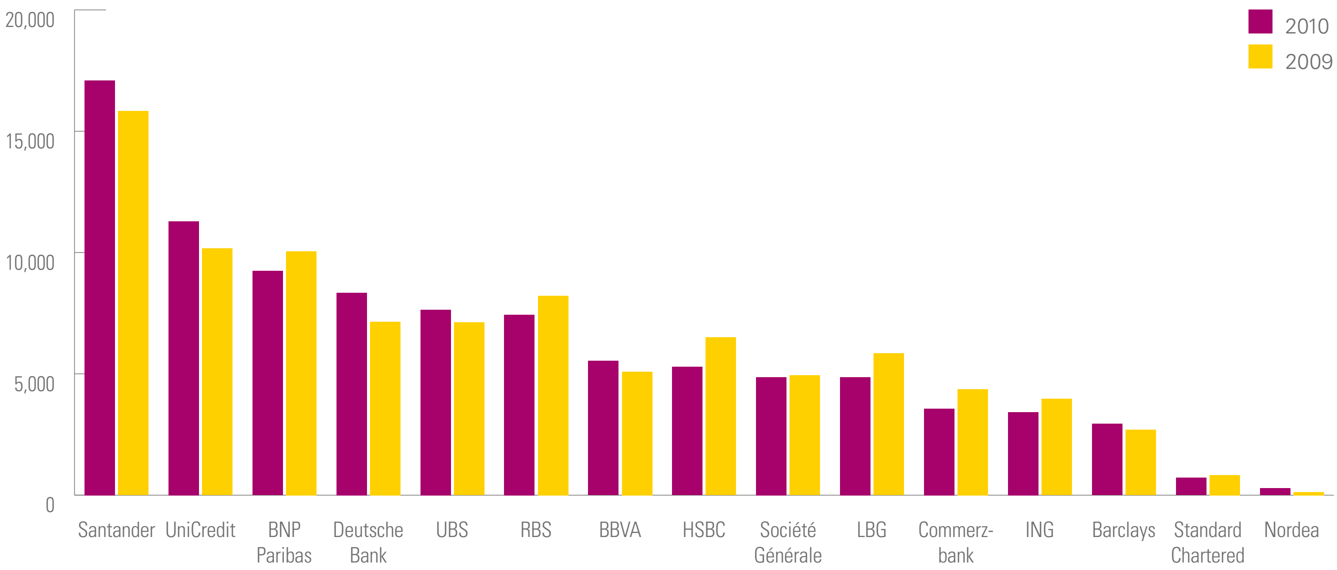
In total for our sample, €92.5 billion of deferred tax assets were held on balance sheet at 31 December 2010, which represents around €334 billion of profits that will be taxed in the future (at an average tax rate of 27.7%), compared to €92.8 billion at 31 December 2009. As in 2009, the banks' optimism for future profits is confirmed.

Deferred tax assets disclosure

Banks are required under IAS 12 to disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

- the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences, and

Deferred tax assets (Million €)



Source: KPMG International, July 2011

Around €10bn of deferred tax assets not recognised... yet?

- the entity has suffered a loss in either the current and preceding period in the tax jurisdiction to which the deferred tax asset relates.

Only two banks (RBS and UBS) disclosed a judgement of how many years of future profits they used to support their deferred tax asset. The period varies from five (UBS) to eight (RBS) years.

Many banks disclosed information about unrecognised deferred tax assets (where predicted future profits are not sufficiently probable to support on balance sheet recognition, for example where the prediction is too far in the future). Four banks did not disclose the amount (BNP Paribas, Société Générale, BBVA and Nordea).

The highest unrecognised deferred tax assets were disclosed by Barclays (€5.9 billion) and HSBC (€2.7 billion). The Barclays amounts relate to losses in the US branch of Barclays Bank plc. For HSBC, unrecognised deferred tax mainly relates to unused state losses and unused federal losses in the US.

Outlook

The €1.4 billion total amount of goodwill impairment recorded in 2010 by the banks fell compared to 2009, when it was €4.3 billion.

The recognition of deferred tax assets varies across the survey, with the largest exposure being over €17 billion. In these uncertain times, the view on availability of future profits could change quickly, resulting in the potential write-down of some balances. Additionally, as deferred tax assets (net of associated deferred tax liabilities) which rely on future profitability of the bank to be realised have to be deducted in the calculation of Common Equity Tier 1 under the forthcoming Basel 3 requirements, the impact on regulatory capital could vary markedly from one bank to another, depending on the amount of deferred tax assets (currently carried on the balance sheet).

6. Capital

Regulatory challenges

Highlights

- *Reinforcing Core Tier 1*
- *Regulatory versus accounting capital*
- *Anticipation constraints of Basel 3*

The core principles of the new Basel 3 framework were endorsed at the G20 Summit in November 2010, imposing a higher level of capital on all banks. Further development and debate are still to come. However, in 2010 banks have sought to demonstrate capital resilience in anticipation of the forthcoming constraints.

As in 2009, organisations extensively communicated on their levels of core capital and most banks chose to disclose their Pillar 3 requirements in a separate report.

Only 10 banks paid dividends

in 2010

Capital disclosure

All banks presented regulatory capital disclosures in the annual report as required by IAS 1. The CEBS issued a paper in April 2010 recommending clarity on whether information presented was audited or unaudited. In the case of our 15 bank sample, capital disclosures are located within various sections of the annual report, as illustrated in the graph opposite. Meanwhile, 13 banks published a separate report regarding Basel 2 Pillar 3 disclosures.

In 2010, information related to capital management policies was disclosed by all banks. Most mentioned the need for adequate and efficient capital management and the benefits of a strong capital base to face potential crises. Nine banks included that part of their ongoing objective is the continuous compliance with minimum regulatory requirements (Barclays, LBG, HSBC, ING, Nordea, RBS, Société Générale, Standard Chartered and UBS), compared to eight banks in 2009.

Eight banks (BBVA, BNP Paribas, Deutsche Bank, Nordea, RBS, Société Générale, UniCredit and UBS) also mentioned that capital management aimed to optimise the return to shareholders. For example, BBVA indicated its intention "to maximise the return on shareholders' funds" and Nordea stated its goal is to "enhance returns to the shareholder while maintaining a prudent capital structure". Moreover, UniCredit underlined the impact of capital management creating value for shareholders.

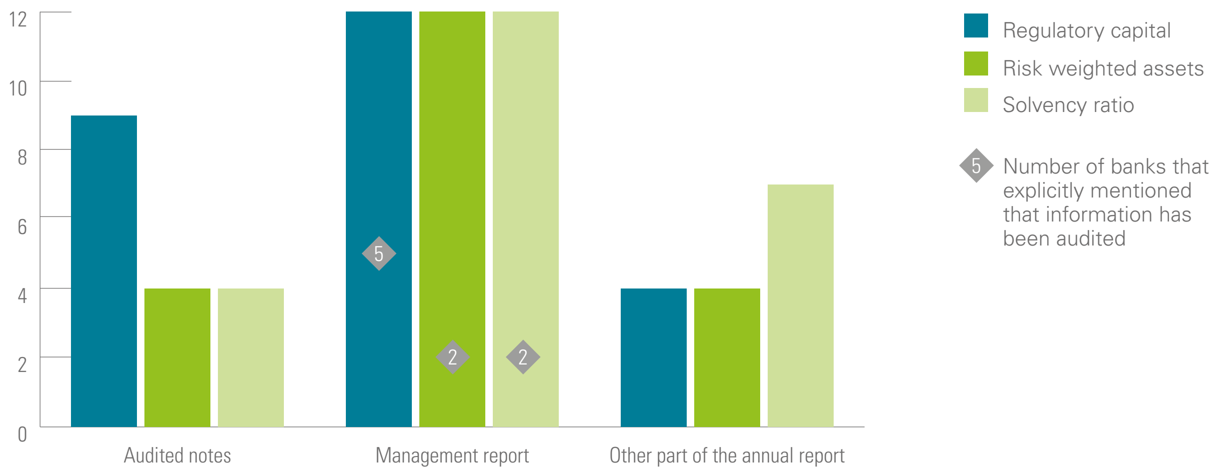
Some banks, for example HSBC, referred to different capital measures such as market capitalisation, invested capital, economic capital and regulatory capital.

Finally, quantitative internal targets were disclosed by three banks (Deutsche Bank, Standard Chartered and Commerzbank). Deutsche Bank confirmed a Tier 1 target of 10% or above, and Standard Chartered said its Tier 1 target is "in a range of 7% to 9%". Commerzbank presented a "target corridor which is between 7% and 8% for the Core Tier 1 ratio".

Regulatory versus accounting capital

Rather than accounting capital, regulatory capital is the area of focus of regulators and politicians.

Location of capital disclosure information (Number of banks)



Source:
KPMG International, July 2011

Accounting capital			
+	Innovative Tier 1	–	Goodwill and other intangibles
	Preferred shares and preferred securities or subordinated debt		Prudential filters (including adjustments to unrealised gains on available-for-sale securities)
	The revaluation of property		Unconsolidated investments in insurance companies
			= Regulatory capital

Source: KPMG International, July 2011

In 2010, as in 2009, all banks presented regulatory capital as part of the IAS 1 disclosure requirements, resulting in more emphasis on regulatory capital compared to accounting capital.

Capital from an accounting perspective consists of all amounts within shareholders' equity, which includes share capital, share premium, retained earnings and reserves. Anything defined as a liability from an IFRS perspective is excluded from accounting capital.

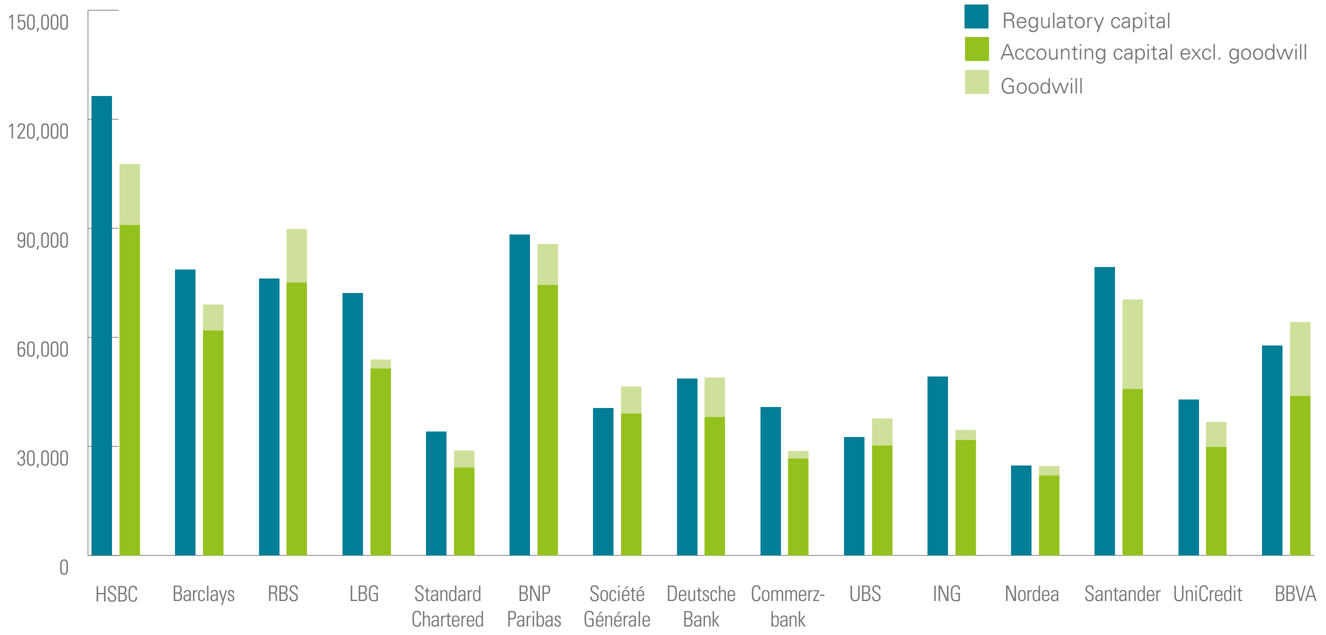
In order to determine regulatory capital calculated under Basel 2 rules, certain adjustments are made to accounting capital, shown above.

Under Basel 3, among the main changes regarding the calculation of regulatory capital are:

- Common equity and retained earnings (rather than debt-like instruments) should be the predominant component of Tier 1 capital, above the current 50% rule[1]. Additional regulatory adjustments should be deducted from the Common or Core Tier 1 capital, such as net deferred tax assets from unused tax losses, non consolidated equity participations in other financial institutions included in both banking and trading books, etc.

Note: [1]Common Equity Tier 1 should be at least 4.5% of risk-weighted assets. Common Equity Tier 1 should be composed of common shares, share premium, retained earnings, accumulated other comprehensive income including reserves, minority interests that meet criteria for inclusion, and regulatory adjustments.

Total regulatory capital versus accounting capital (Million €)



Source: KPMG International, July 2011

Elements of regulatory capital under Basel 2 and 3: minima

Elements of regulatory capital	Basel 2 rules	Basel 3 rules
Core Tier 1 capital	At least 2% of RWA	At least 4.5% of RWA
Tier 1 capital	At least 4% of RWA	At least 6% of RWA
Total capital	Tier 1 + Tier 2 + Tier 3 capital: at least 8% of RWA	Tier 1 + Tier 2 capital: at least 8% of RWA

Source: KPMG International, July 2011

All banks, except Santander and LBG, provided reconciliation between accounting and regulatory capital, compared to 10 in 2009.

The above graph compares 2010 Basel 2 regulatory capital to 2010 accounting capital (issued share capital and reserves including profit for the year), and indicates the level of goodwill deducted from accounting capital.

For 10 of the banks, regulatory capital was greater than accounting capital mainly due to subordinated debt and hybrid instruments included in Tier 1 and Tier 2 capital. For four other banks (RBS, Société Générale, UBS, UniCredit), amounts of prudential deductions, mainly consisting of goodwill and intangible assets, explain levels of regulatory capital that are lower than accounting capital. At Deutsche Bank the levels of regulatory capital and accounting capital are similar.

Solvency

All banks disclosed the Basel 2 capital adequacy ratio (capital as a percentage of risk weighted assets), which ranged from 11.5% to 20.4% for total capital. Tier 1 capital ratios ranged from 9.5% to 17.8% and Core Tier 1 capital ratios from 8.5% to 15.3%.

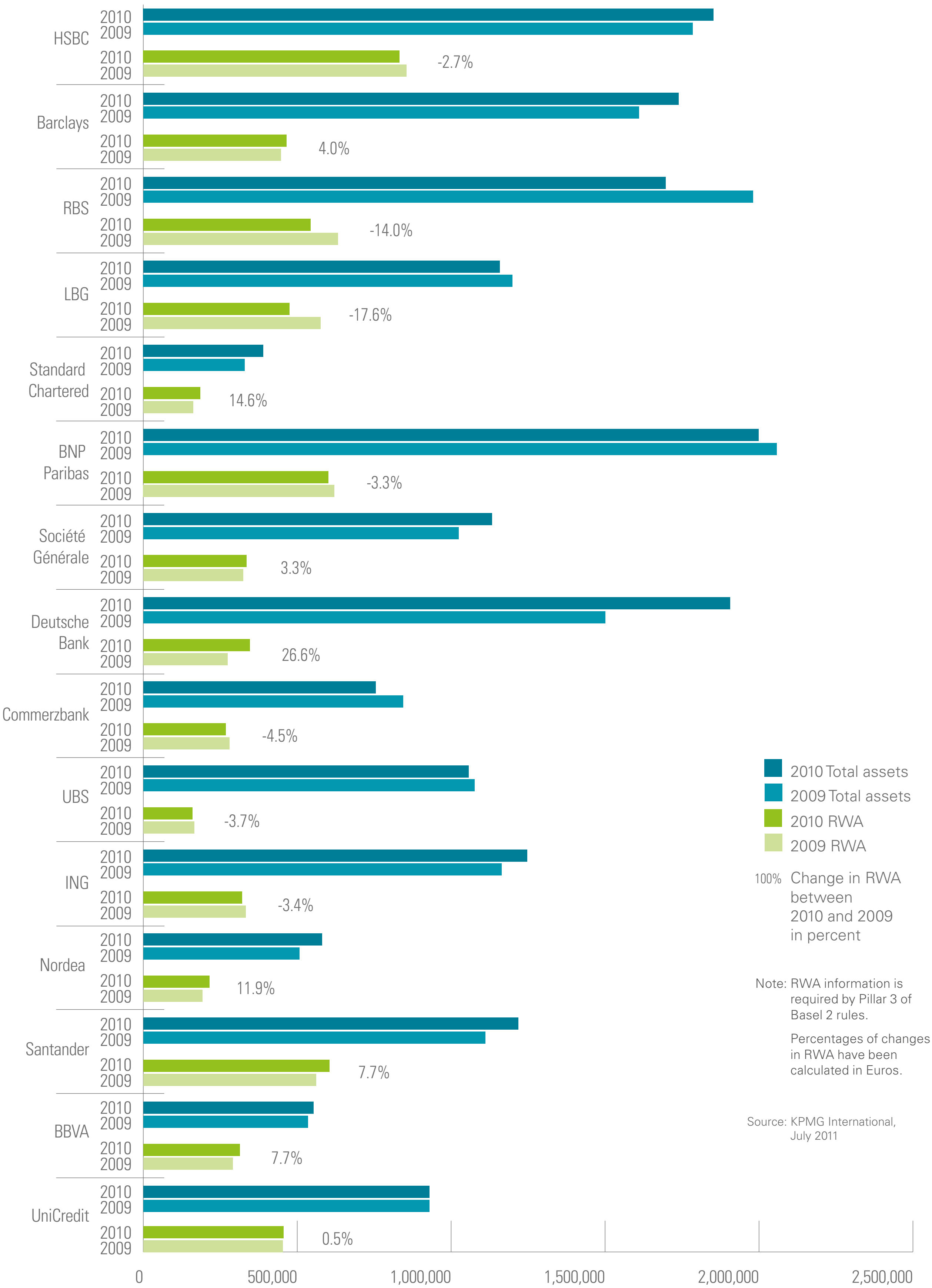
Evolution of the Basel 2 capital adequacy ratio can be explained by movements in regulatory capital – especially in core capital – and/or in risk weighted assets.

Generally, Basel 2 capital adequacy ratio went up, with an average rate of 14.83% in 2010 against 14.41% in 2009.

For eight banks (UBS, Barclays, Commerzbank, BNP Paribas, Deutsche Bank, BBVA, UniCredit) the capital adequacy ratio remained stable or recorded a slight increase.

The increase in the solvency ratio is quite significant for LBG, due to a sharp decrease in risk weighted assets explained by balance sheet reductions across all divisions; and a change in the credit risk measurement methodology to the 'Foundation Internal Ratings-based approach' in the Wholesale division, and an improved credit risk profile in the Retail division.

Risk weighted assets (Million €)



Note: RWA information is required by Pillar 3 of Basel 2 rules.

Percentages of changes in RWA have been calculated in Euros.

Source: KPMG International, July 2011

Banks	Basel 2 capital adequacy ratio 2010 (%)	Basel 2 capital adequacy ratio 2009 (%)
UBS	20.40	19.80
Standard Chartered	18.40	16.50
Barclays	16.90	16.60
Commerzbank	15.30	14.80
ING	15.30	13.46
HSBC	15.20	13.70
LBG	15.20	12.40
BNP Paribas	14.50	14.20
Deutsche Bank	14.10	13.90
RBS	14.00	16.10
BBVA	13.70	13.60
Santander	13.10	14.20
UniCredit	12.68	12.02
Société Générale	12.10	13.00
Nordea	11.50	11.90

Source: KPMG International, July 2011

Banks bolstering their Tier 1 Capital base in preparation for Basel 3

Solvency ratios for HSBC and ING were also higher in 2010 than 2009, due to a fall in their risk weighted assets combined with an increase in their capital during the period. The increase of the Core Tier 1 capital of Standard Chartered mainly explained the rise of its solvency ratio.

Conversely, solvency ratios for Santander, Société Générale and Nordea were lower in 2010, due to increases in their risk weighted assets (as disclosed), accentuated by limited movements in their equity. Finally, RBS significantly lowered its regulatory capital due to reductions in minority interests through disposals. Accordingly its solvency ratio was reduced at year-end 2010.

Risk weighted assets

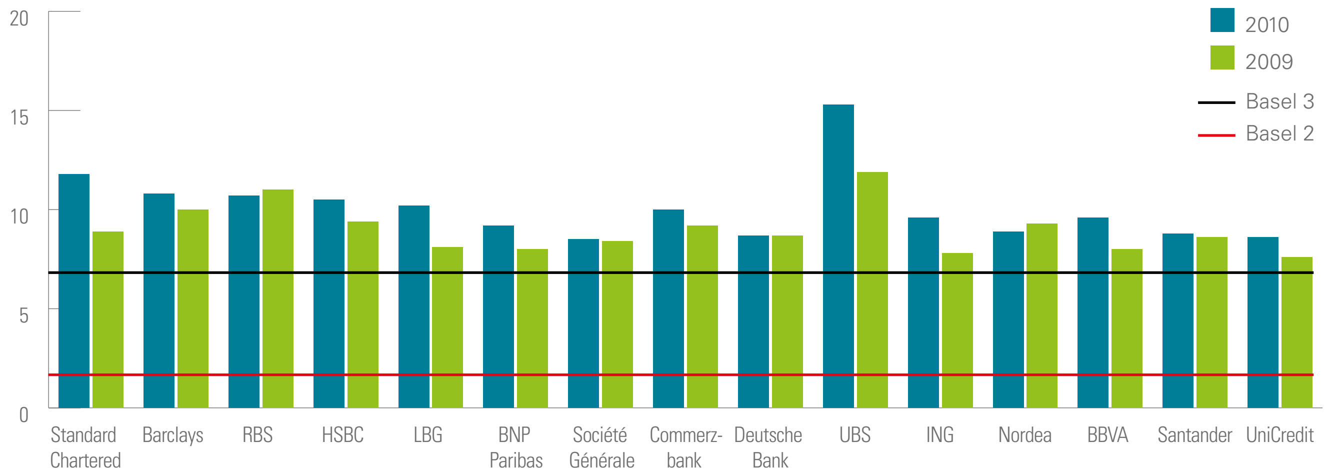
Eight banks (Barclays, Standard Chartered, Société Générale, Deutsche Bank, Nordea, Santander, BBVA, UniCredit) reported an increase in their risk weighted assets. Notable increases were driven by the rise in credit risk of the retail portfolio (Standard Chartered, Nordea, Société Générale) or due to acquisitions for Deutsche Bank.

Other banks saw their risk weighted assets decreasing in 2010. This evolution was principally due to disposals (RBS), or a reduction in the size of the balance sheet plus a change in credit risk measurement methodology (LBG).

The comparison between total assets and risk weighted assets gives an indication of the activities and quality of assets of the banks. High total assets with low risk weighted assets are expected for significant investment banking activity (for which trading book assets are lower risk-weighted than banking book assets) and/or assets with strong security (high quality counterparty or high level of guarantee in event of default). The internal ratings-based approach used for the calculation of capital requirements for credit risk is also a means by which the ratio between total assets and risk weighted assets compared to a standardised approach not specifically tailored to the risk profile of the bank is optimised.

Spanish banks, as well as three of the five British banks (HSBC, LBG and Standard Chartered) and UniCredit showed the highest levels of risk weighted assets compared to the size of their balance sheets. For the other banks, this percentage was around one-third, except for UBS and Deutsche Bank, which remain at low levels.

Core Tier 1 capital (Percent)



Note: The Core Tier 1 ratio has been extracted from 2010 Results Press Release for BNP Paribas. Core Tier 1 definitions are different compared between Basel 2 and Basel 3. The minimum thresholds in the graph are included for high level representation only.

Source: KPMG International, July 2011

Reinforcement of 2010 Core Tier 1 capital (Million €)

Source: KPMG International, July 2011

Banks	Core Tier 1 ratio 2010 (%)	Core Tier 1 ratio 2009 (%)
UBS	15.30	11.90
Standard Chartered	11.80	8.90
Barclays	10.80	10.00
RBS	10.70	11.00
HSBC	10.50	9.40
LBG	10.20	8.10
Commerzbank	10.00	9.20
BBVA	9.60	8.00
ING	9.60	7.80
BNP Paribas	9.20	8.00
Nordea	8.90	9.30
Santander	8.80	8.60
Deutsche Bank	8.70	8.70
UniCredit	8.60	7.60
Société Générale	8.50	8.40

Source: KPMG International, July 2011

Core Tier 1 capital

Most of the banks calculated and voluntarily published their Core Tier 1 ratio, which under Basel 2 does not have a common definition across all jurisdictions.

Core Tier 1 capital is commonly composed of ordinary shares, retained earnings, non-controlling interests and eligible reserves. Captions such as goodwill, intangible assets, some securitisation positions and part of regulatory required expected losses over accounting impairment allowances are also deducted from this basis.

Some banks included other items in their Core Tier 1 specific to their capital structures. For example, mandatory convertible bonds are part of Core Tier 1 for BBVA.

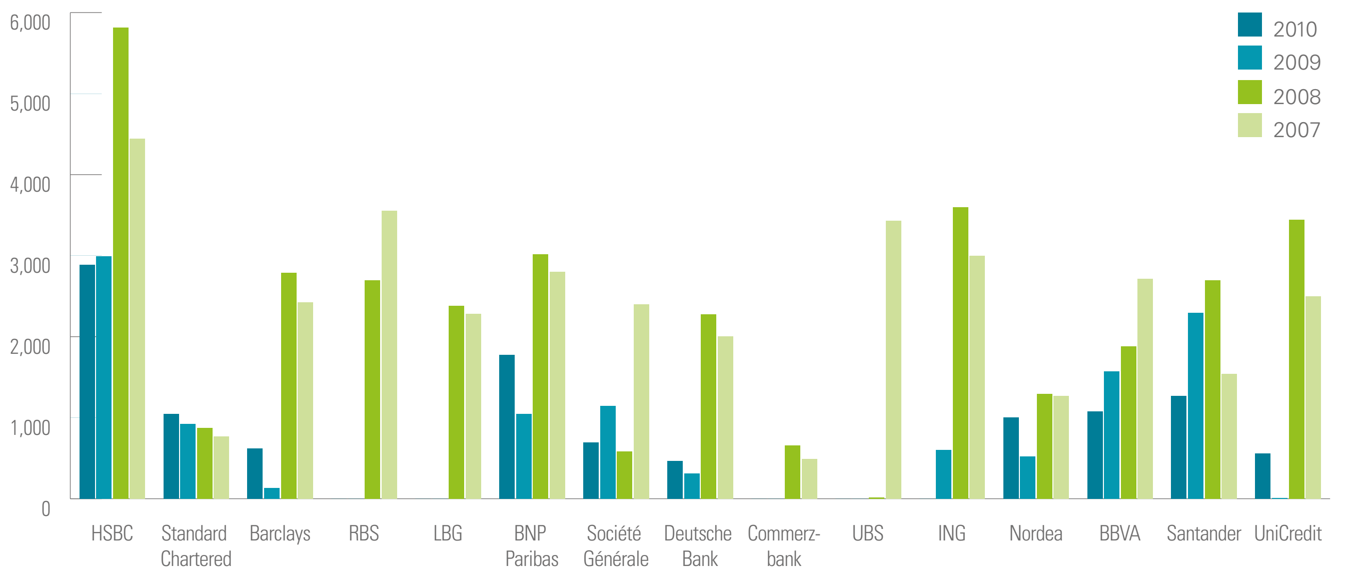
As shown in the graph on page 51, all the banks displayed a Core Tier 1 ratio significantly above 8% and 12 banks increased their ratio compared to 2009. The most significant increase, by UBS, is principally explained by the contribution of positive retained earnings.

Most of the banks in our survey raised their capital in 2009, either through the issuance of ordinary shares or, in the case of five of them (BNP Paribas, ING, Commerzbank, LBG, RBS), due to direct state support. Capital increases were less significant and less numerous in 2010.

Apart from retained earnings, the source of capital increases for the above-mentioned banks was the issuance of ordinary shares:

- BBVA raised capital amounting to €5 billion through issuance of ordinary shares;

Dividends paid (Million €)



Note: The graph represents the total dividends paid each year to group shareholders, regardless of the year in which the related profits were earned.

Source: KPMG International, July 2011

Regulatory capital =
Core Tier 1
+ Other Tier 1
(hybrid instruments)
+ Tier 2 & Tier 3
(debt instruments)

- Barclays and UniCredit issued €1.8 billion and €4 billion of ordinary shares respectively;
- Deutsche Bank's share capital increased by €10.2 billion;
- LBG's capital increase is mainly due to the issuance of ordinary shares (€2.6 billion) largely as consideration for the redemption of certain preference shares.

A common topic for 2009 was the level of government support for banks. This was not focussed upon as much in 2010, although it continues to exist for the following institutions:

- 11.8% of BNP Paribas' capital is held by the Belgian and Luxembourg states.
- Commerzbank has 25% of capital plus one share owned by the German federal government.
- The UK government holds 67% of RBS' ordinary share capital and 40.6% of LBG's ordinary share capital.
- ING repaid 50% of the Dutch State aid (Core Tier 1 securities) in December 2009. In May 2011 the bank intends to repay another 20% and the final 30% by May 2012.

Dividends

Dividend policies remained conservative.

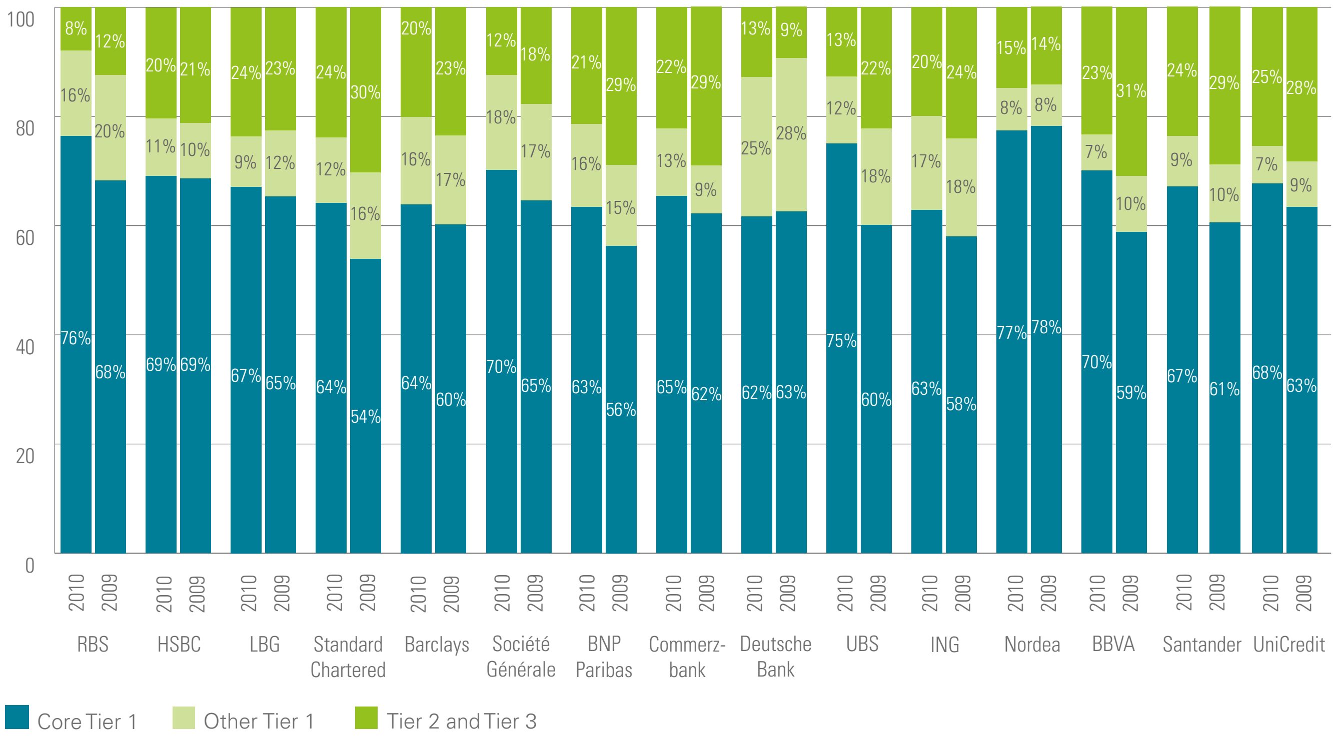
As shown by the graph, most of the banks applied a more prudent dividend policy. Of the 15 banks in our sample, 10 decided to pay dividends in 2010. Amounts paid in 2010 and 2009 remained lower than pre-crisis levels, except for Standard Chartered, where the dividends paid were at low levels.

Total regulatory capital

We discussed above the significance of Core Tier 1 capital and its ratio to risk weighted assets.

The following graph shows the relative weight in total regulatory capital of Core Tier 1, other Tier 1, Tier 2 and Tier 3 capital in 2010.

Capital adequacy ratio structure (Percent)



Note: The Core Tier 1 ratio has been extracted from 2010 Results Press Release for BNP Paribas.

Information extracted from consolidated statement of changes in equity. For ING, UniCredit and Commerzbank the AFS reserve is not published separately from revaluation reserves.

Source: KPMG International, July 2011

A reminder of some major events of the subprime crisis:

August 2007:

- BNP Paribas temporarily closed three funds invested in securitised assets.
- German Finance minister launched a workout plan for IKB.

September 2007:

Northern Rock faced massive withdrawals of cash deposits within a day.

March 2008:

JP Morgan bought Bear Stearns.

July 2008:

US government supported Fannie Mae & Freddie Mac to curb the banking panic.

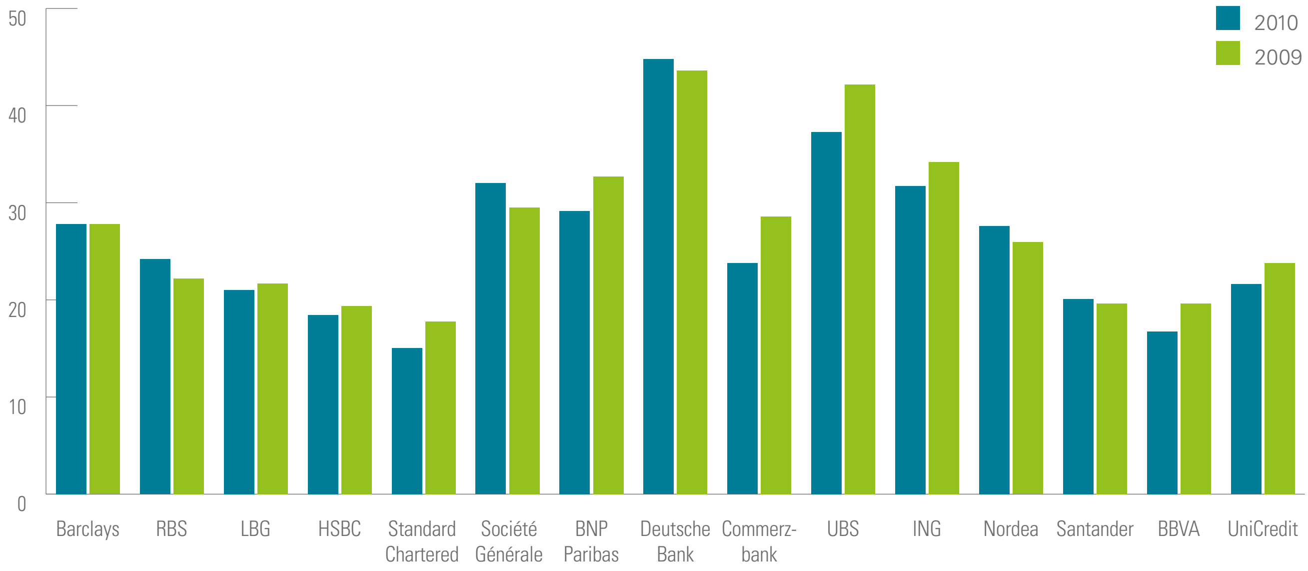
September 2008:

Lehman bankruptcy and US state support for AIG.

Shareholders' funds evolution for the period 2008 – 2010 (Million €)	2010	2009	2008	Total
Movement in shareholders' funds from 1 Jan	**734,484**	**551,495**	**568,055**	
+ Capital increase (ordinary shares)	28,188	89,116	63,403	**180,707**
+ Other capital issued	3,422	-635	10,584	**13,370**
+ Net income (consolidated group share)	57,348	39,084	-10,874	**85,558**
- Dividend distributed	-13,308	-12,811	-36,727	**-62,846**
+ AFS reserve	3,702	33,501	-63,724	**-25,521**
+ Others (Exchange reserve, merger reserve, etc)	5,165	34,735	20,778	**60,678**
Additionnal shareholders' funds as at 31 Dec	**819,001**	**734,484**	**551,494**	

Although capital increases were significant in 2008, shareholders' funds were negatively impacted due to negative results, unrealised losses on AFS investments and dividends distributions which were high because they mainly related to 2007 profits. In 2009, strengthening of the capital base continued, with high levels of issuance of ordinary shares and state support reaching a peak in that year. The positive net results and AFS reserves contributed to the increase of shareholders' funds combined with a more conservative dividend policy. This trend continued in 2010, although increases in capital were less significant compared to previous years.

Calculated leverage ratio (Percent)



Note: Total assets used to derive this ratio also include insurance assets for some banks.

Source: KPMG International, July 2011

Basel 3 driving funding profile

For all banks the weight of Core Tier 1 capital in total regulatory capital was

over 60%

Leverage

Banks are not required to disclose leverage, but five of the banks (LBG, Barclays, RBS, UBS and Deutsche Bank) disclosed this ratio voluntarily. In order to create a consistent comparison between the banks, the graph above shows the calculated leverage ratio by applying the total asset balance, as reported in the balance sheet, and dividing this by total Tier 1 capital. The ratio is indicative of how much of the bank's assets are financed by shareholders' equity, as opposed to by debt, and is useful in assessing the bank's solvency and liquidity positions. Debt, in itself, carries liquidity risk to the bank, but is a cheaper form of finance than equity. Consequently, in the past banks have opted for higher leverage positions in attempts to decrease the overall cost of capital. This has decreased slightly in recent years, mainly as a result of external and regulatory pressure.

On average, leverage ratios fell from the previous year, implying the equity portion in the financing mix has increased in relation to total assets. This trend was consistent with the one witnessed since 2008, where banks have been trying to raise capital and reduce assets.

This also reflects prudent regulatory expectations for the coming years, and it is evident from the annual reports that banks are preparing their balance sheets for compliance with forthcoming Basel 3 proposals. Deutsche Bank, Société Générale and Nordea did show an increase in leverage, but they were small.

Barclays and Nordea indicated their leverage ratio would be within the proposed limit of 33 times if the Basel 3 rules would have applied as at 31 December 2010.

The Basel 3 framework: expected impacts on capital

The G20 endorsed the new 'Basel 3' capital and liquidity requirements at the November 2010 Summit in Seoul. As the core principles were set, one third of the banks (Barclays, Deutsche Bank, HSBC, Nordea and Société Générale) included in our sample indicated their ability to meet the new requirements in 2013. Seven banks highlighted the areas of detail that need further development and implementation by national supervisors, such as the countercyclical buffer and additional requirements for SIFIs.

New regulatory framework likely to have a negative cost impact...

...who will bear this cost?

However, anticipated impacts were disclosed in different ways. Some banks disclosed projected levels of capital ratios based on Basel 3 rules at year-end:

- HSBC estimated the Core Tier 1 capital ratio at 31 December 2010 would be lower by some 250-300 basis points if Basel 3 rules as of 1 January 2019 would have applied at the end of 2010. A future level of Core Tier 1 ratio between 9.5% to 10.5%. When computing the impact of the Basel 3 rules, HSBC did not take into account any management actions to reduce RWAs or any future retained earnings.
- RBS provided a detailed study of expected quantitative changes and notable impacts on risk weighted assets of the market risk and securitisation measures and on its Core Tier 1 ratio (lower by approximately 1.3% assuming RWAs of £600 billion and a Core Tier 1 ratio of 10%).
- LBG expected (with no mitigating action) a reduction in Core Tier 1 capital ratio of 1.2% by 2013.
- Standard Chartered anticipated a reduction of its future Core Tier 1 capital ratio of up to 1%.
- Société Générale anticipated a Core Tier 1 capital ratio of around 8.5% at 31 December 2013.
- Nordea forecasts an increase of its risk weighted assets of 10%, mainly due to modified rules on market risk and credit-value adjustment.

Although supportive of the new regulatory framework, it is generally considered by banks as a constraint which will have a cost: RBS raised the potential adverse impacts on its financial position and UBS said "the Basel 3 revisions will have a negative impact on capital". Banks anticipate increasing issuances of common equity and reorganisation of certain business lines and products, with Deutsche Bank stating the new regulation will "substantially reduce volumes in certain market segments".

Outlook

All banks have tended to report on capital more extensively this year.

Information presented on capital management was disclosed by all the banks within their annual reports, but with varying levels of detail. Disclosure of Pillar 3 information within the financial statements relating to solvency ratio, risk weighted assets and capital is not mandatory. Most of the banks now publish Pillar 3 information outside the annual report.

The Basel 3 framework introduces another set of significant shifts in capital and liquidity standards that were constructed and agreed in a short time. A number of issues remain unfinished, particularly the final implementation by national supervisors. In 2010, the banks exposed qualitative and sometimes quantitative impacts of the proposals. The new regulatory framework is generally considered by banks as a constraint, even if they remained confident in their future results of reaching those new requirements. Indeed 12 banks already disclosed in 2010 an increasing Core Tier 1 ratio compared to 2009 figures. The increase of the Core Tier 1 capital was mainly due to the combined effect of a net increase of 2010 results and a conservative dividend policy, whereas in 2009 Core Tier 1 capital increases were more the result of share issuances and state support. The whole profitability and return on equity of banks might be impacted with those new rules.

The average leverage ratio decreased in 2010 against 2009 figures, implying an increasing weight of equity in the financing mix. Banks seem to have already anticipated compliance to Basel 3 proposals.

7. Liquidity

Maturity and sources of funding

Highlights

- *Predominance of customer deposits*
- *Extended maturities*
- *Innovative liquidity ratios: LCR and NSFR*

Compared to the last quarter of 2009, early 2010 was characterised by much more favourable market conditions. The decisive role taken by central banks and the publication in July 2010 of the stress tests for European banks have contributed to improvements in liquidity conditions on the interbank markets and medium term finance.

However, the crises in Greece and Ireland have generated unusual volatility in the financial markets as a result of an acute perception of sovereign risk in some European countries.

Funding diversification

Diversification of a bank's funding profiles (investor types, regions, products and instruments) is central to its liquidity management strategy, in order to avoid dependency on a particular group of customers or market sectors and minimise risk concentration.

The following chart shows the composition of external funding sources that contributed to the liquidity risk position of each of the banks at December 2010, 2009 and 2008.

Availability of funding

Current bank accounts and savings deposits payable on demand or at short notice constitute the most significant part of banks' funding, and their share of funding continues to grow across our survey.

The main source of funding in 2010 was deposits from customers, which has continued the trend of increases. The rationale for this trend can be explained by a combination of economic and business conditions.

Pursuant to Basel 3 requirements, banks will be expected to increase their proportion of long term resources. Increasing deposits from customers is a cost effective manner to reach this objective, as funding from the interbank market is relatively more expensive.

Consequently, funding from the interbank market, which constitutes a major short term source of funding, generally decreased this year, except for a few banks such as Santander, UBS and UniCredit.

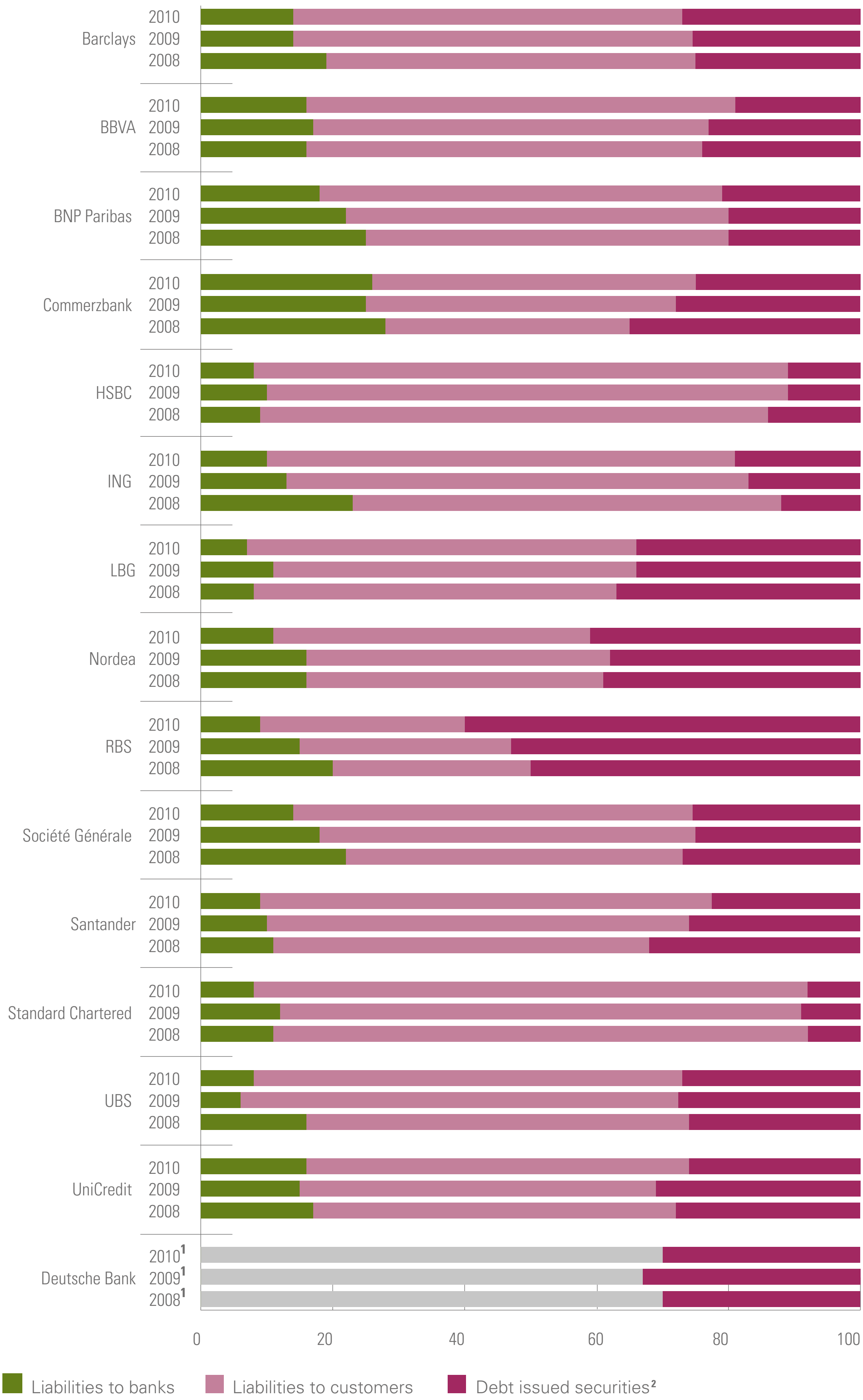
The following graph shows the amount of external funding sources for each bank year-on-year.

Maturity of funding

Diversification of funding profiles in terms of products and instruments is a core element of the liquidity risk management framework. Banks aim at maintaining the stability of their main funding resources, which come from capital market investors, the interbank market and retail customers.

Main source of funding in 2010 was deposits from customers, continuing the trend

Funding diversification (Percent)

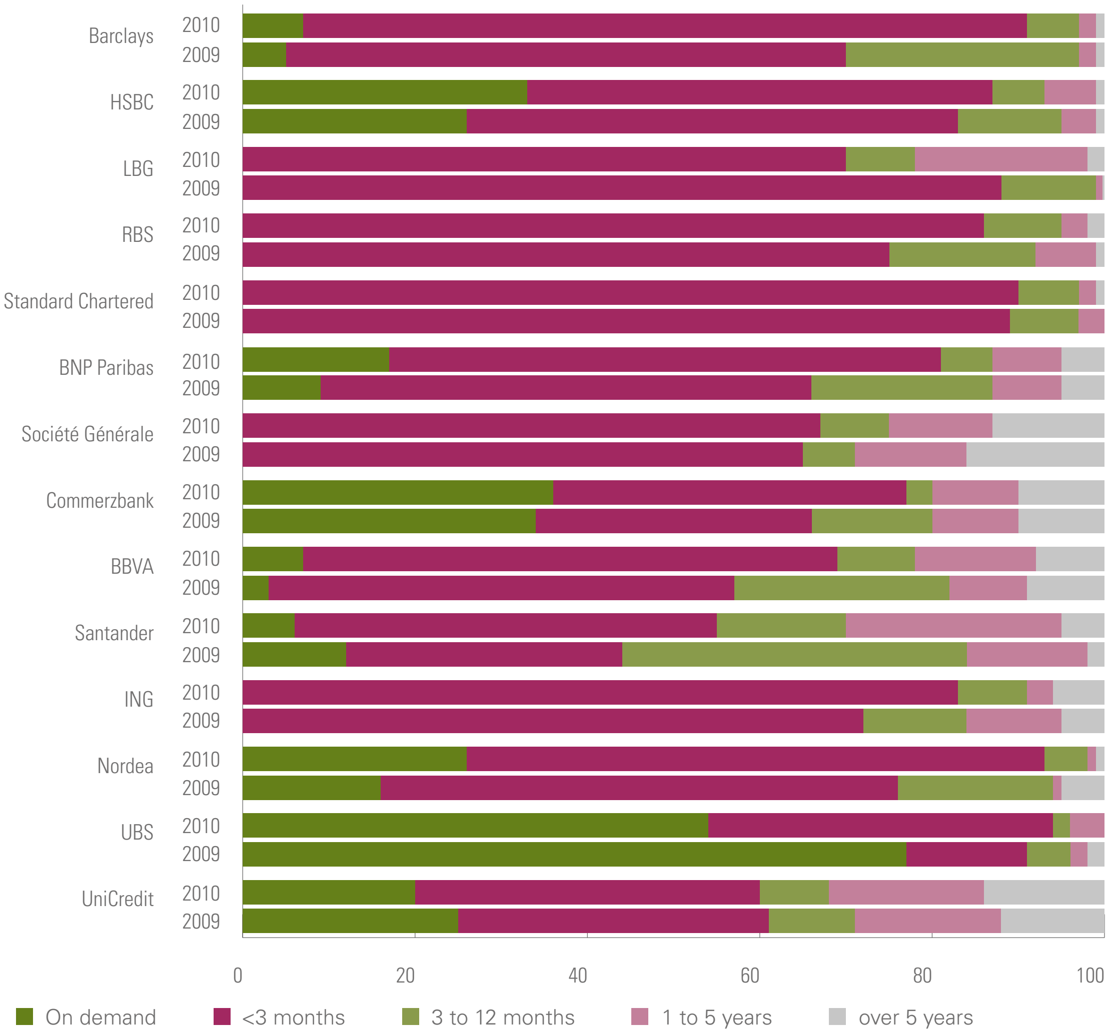


Note: [1]Liabilities to banks and customers are disclosed as one figure in the Deutsche Bank Annual Report.

[2]Issued debt securities consist of certificates of deposit, covered bonds, senior debt and commercial paper.

Source:
KPMG International, July 2011

Maturity analysis of liability to banks (Percent)



Note: Liabilities to banks and customers are disclosed in aggregate in the Deutsche Bank Annual Report

Source:
KPMG International, July 2011

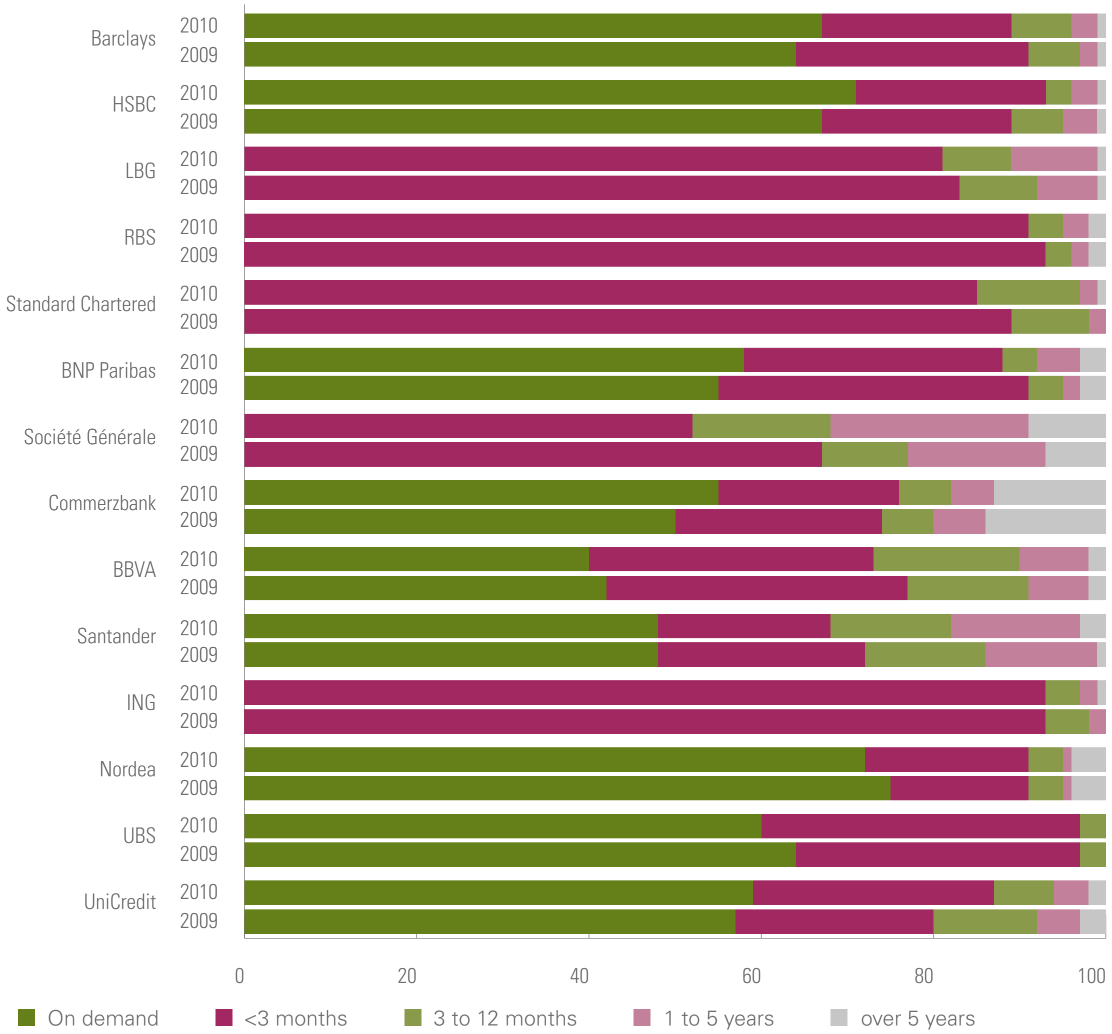
Longer maturity funding tends to be costlier than short term funding

However, the regulatory framework is evolving quickly with implementation of the Basel 3 requirements, and banks have to reinforce their long term funding.

The maturity analysis charts demonstrate the following trends:

- Short term bank liabilities in the one to five year range increased in most cases, indicating banks are managing to obtain slightly longer medium interbank funding.
- Customer liability maturities increased in 2010 compared to 2009 for eight banks, moving from the on-demand and less than three month ranges, to three to 12 months and one to five years, demonstrating they have been able to attract deposits from customers with slightly longer maturities.
- Maturity of issued debt securities has extended for nine out of 14 banks, mainly from on-demand and less than three months, to three to 12 month ranges, illustrating a general trend of obtaining slightly longer maturity deposits and other short term funding.

Maturity analysis of liability to customers (Percent)



Note: Liabilities to banks and customers are disclosed as one figure in the Deutsche Bank Annual Report. Derivatives liabilities are usually included in the 'on-demand' maturity band or in '< three months' maturity band.

Source:
KPMG International, July 2011

Loan to deposit ratio improved for 11 banks

Banks will no doubt try to continue this trend. However, there is a cost in terms of remunerating such funding. Generally, on-demand and less than three months deposits are the cheapest form of funding.

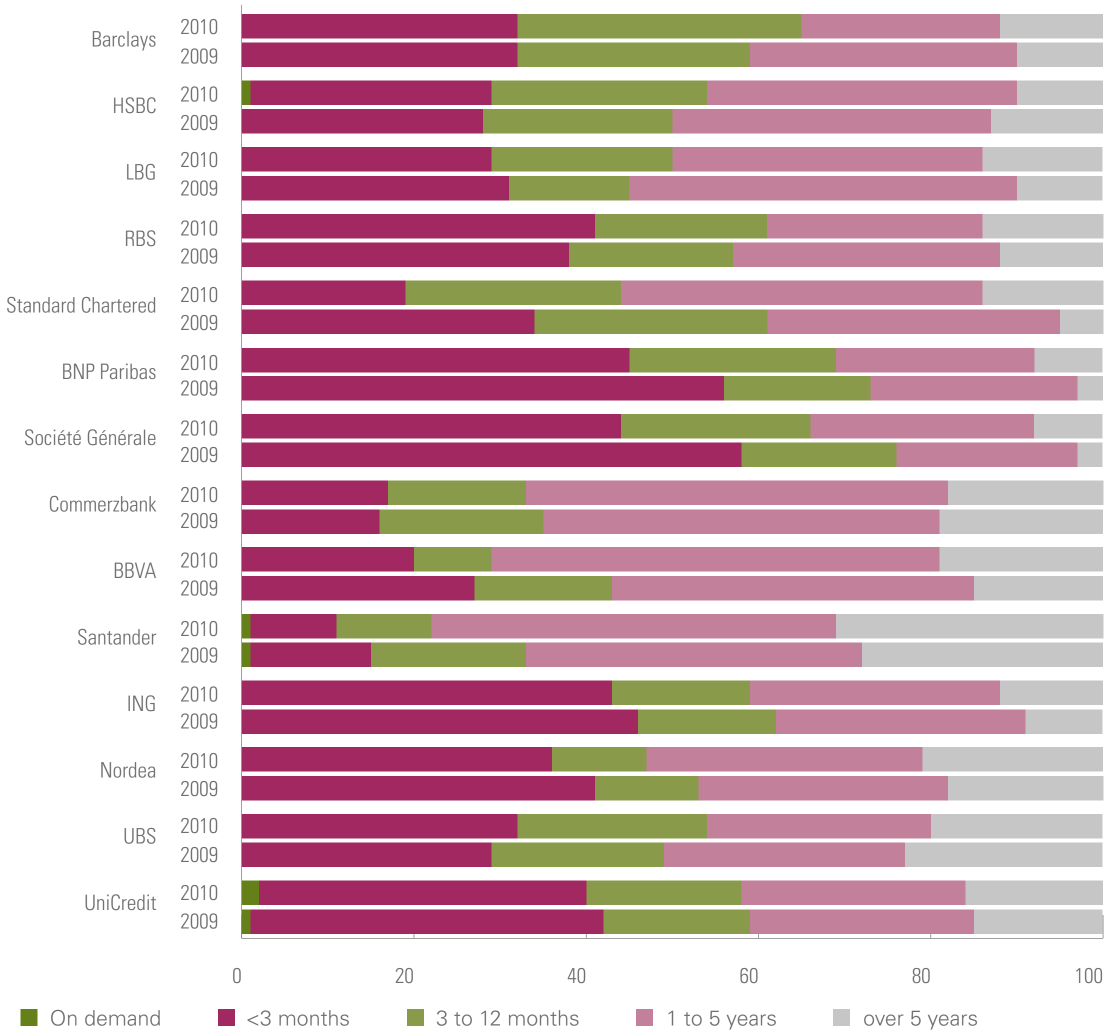
Loan to deposit ratio

This ratio is defined as the total wholesale and retail loans and advances to customers (net of the related impairment allowance) relative to total customer deposits. A low loan to deposits ratio demonstrates that customer deposits exceed customer loans. Banks continue to use this ratio when discussing their performance[1].

As in 2009, the loan to deposit ratio varies considerably from one bank to another, ranging from 178% (Nordea) to 76% (Deutsche Bank).

Note: [1]For the purpose of this report we have calculated the ratio (loans/deposits).

Maturity analysis of debt securities in issue (Percent)



Source:
KPMG International, July 2011

Limited liquidity risk disclosure in annual reports of 2010

Banks' loan to deposit ratios improved for 11 banks thanks to increasing customer deposits, as institutions seek to increase their customer deposits to improve their liquidity. For those banks that still have a high loan to deposit ratio, such as Nordea (178%) and LBG (151%), this indicates that any increase in lending has not been offset by a similar rise of deposits. These banks will depend more on the wholesale market for funding purposes.

Liquidity risk management

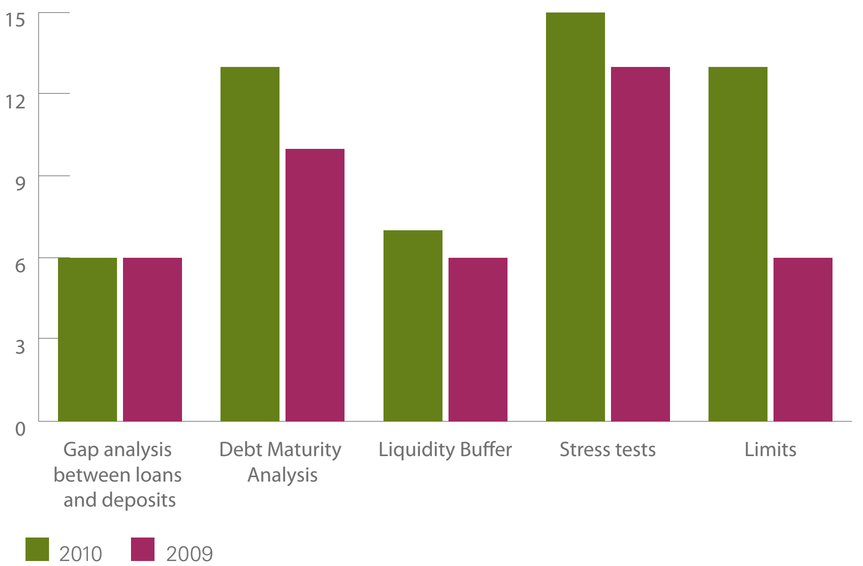
Banks must continuously manage their liquidity and funding to ensure they can successfully adjust to sudden adverse changes in market conditions or their operating environment, whether such changes consist of a general market crisis, a localised difficulty affecting a smaller number of institutions, or a problem unique to an individual bank.

In order to prevent themselves from being unable to meet their obligations when they fall due, banks have developed both organisational measures and indicators to mitigate risk exposure.

Loan to deposit ratio (Percent)

Source: KPMG International, July 2011

Analysis of content of the liquidity risk management report
(Number of banks)



Source: KPMG International, July 2011

Across our survey, we noted that most of the banks use a centralised organisation to manage their liquidity risk (10 out of 15). Our survey also underlines the necessity for banking groups to assess their liquidity risk locally in order to maintain a balance between asset and liability maturities on a local level.

Most of the banks have an Assets and Liabilities Committee (local or group, depending on the management system), which plays a prominent role in leading action such as approving funding models, analysing the impact of the banks' projects on its funding structure, and so on. Such organisational structures also provide support to the treasury and executive committees.

Key performance indicators (KPIs):

The data to the left summarises the KPIs used internally to manage liquidity risk, as disclosed in the banks' 2010 financial statements.

Quantitative information concerning liquidity ratios is only disclosed by BNP Paribas, Commerzbank, HSBC and Santander. Société Générale only indicated that the minimum legal requirement of 100% was met.

All 15 banks perform liquidity stress tests.

The role of banks is to lend long term but fund predominantly by short term liabilities

Maturity of financial assets and liabilities

IFRS 7 does not require an analysis of the maturity of financial assets, but it is essential for understanding banks' liquidity risk. As in 2009, 11 banks (Barclays, BBVA, BNP Paribas, Commerzbank, ING, Nordea, RBS, Société Générale, Santander, Standard Chartered and UniCredit) have chosen to disclose this analysis voluntarily, combined with the required analysis of maturities of financial liabilities.

The maturity of assets and liabilities highlights the maturity transformation which underpins the role of banks to lend long term but fund predominantly by short term liabilities, such as customer deposits.

Regulatory developments

In the aftermath of the crisis, a number of financial institutions have been confronted with new local liquidity requirements, which either have been implemented or are in the course of implementation.

In December 2010, the Basel Committee issued the 'International framework for liquidity risk measurement, standards and monitoring,' which confirmed the introduction of two liquidity ratios: the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR).

The LCR promotes short term resilience of the liquidity profile by ensuring banks have sufficient high quality liquid assets to meet potential funding outflows in a stressed environment within a one month period. The NSFR promotes resilience over a longer time horizon by requiring banks to fund their activities with a more stable source of funding on a going concern basis.

Introduction of the LCR and NSFR aim to enhance the resilience of banks to potential liquidity shocks and provide the basis for a harmonised approach to liquidity risk management. The introduction of both ratios will be subject to an observation period, which includes review clauses to address and identify any unintended consequences.

After an observation period beginning in 2011, the LCR, including any revisions, will be introduced on 1 January 2015. The NSFR, including any revisions, will move to a minimum standard by 1 January 2018.

Three of the banks in our survey estimated the relevant ratios as at 31 December 2010:

	LCR (%)	**NSFR** (%)
Barclays	80	94
LBG	71	88
RBS	N/A	101

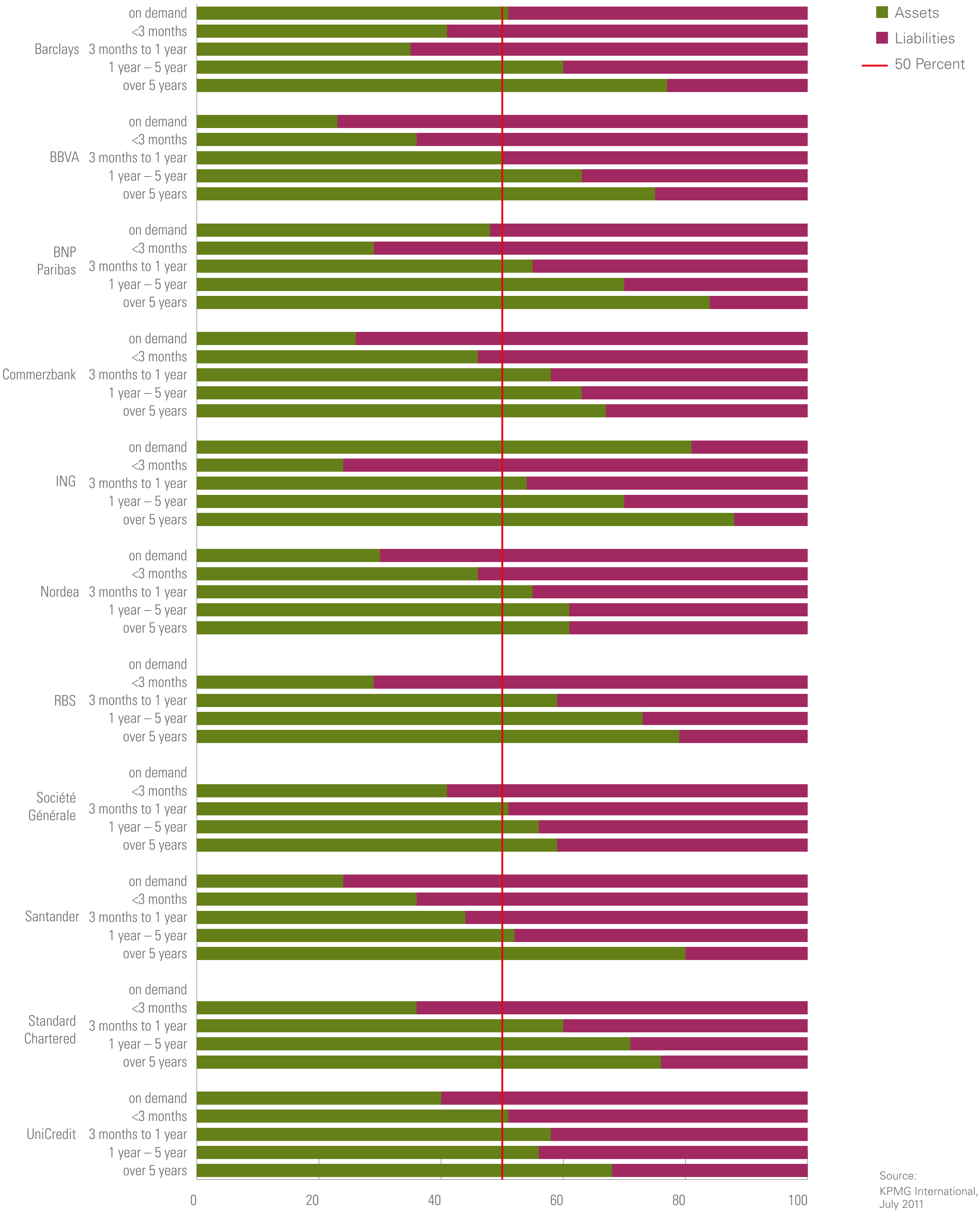
Source: KPMG International, July 2011

Outlook

Most banks expect the combination of continued increases in customer deposits and reductions in assets (primarily from non-core asset reduction plans) over the next few years to deliver further improvements in their liquidity and funding position. As a result, banks expect a steady improvement in the overall loan to deposit ratio, and therefore a reduction in wholesale funding requirements in order to meet the additional liquidity requirements imposed by Basel 3.

Funding and liquidity was a key area of focus for the banks through 2009 and 2010 and this will continue to be a critical area for the foreseeable future, especially as Basel 3 will force banks to work actively to adapt their liquidity management processes in order to comply with the future constraints.

Maturity analysis of financial assets and liabilities (Percent)



Source: KPMG International, July 2011

8. Governance

Executive remuneration and governance

Highlights

- *Audit committee reports disclosed by three banks*
- *No decrease in average salary per employee*
- *CEO pay generally increased*

Over the past few years, remuneration of key management has come under increasing scrutiny. As a result, banks are providing more information on their payment structures. The focus of this chapter is on the trends in executive directors' remuneration. Executive directors are classed as members of the management board in the two tier board-system and executive management in the unitary and mixed board systems.

All the banks in the survey provided information in their annual reports about remuneration, except for UniCredit, Société Générale and BNP Paribas, where the information was contained in separate published reports outside the annual reports.

New remuneration guidance taking effect

from 1 January 2011

Regulatory changes

During 2009 all the banks reassessed their remuneration policies in light of key regulatory changes. These regulatory changes were driven by local regulators:

- In the UK, the Financial Services Authority (FSA) issued its Code on Remuneration, which applies to UK banks.
- The French Banking Supervisor (Autorité de Contrôle Prudentiel) and the French Banking Federation respectively issued remuneration rules and guidance.
- In Germany, the Act on the Appropriateness of Management Board Remuneration and the specific rules of the Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)) apply to banks.
- Swiss banks are governed by the Swiss Financial Market Supervisory Authority (FINMA).
- Swedish banks have to fulfil the requirements of the Swedish Financial Supervisory Authority (SFSA).
- In the Netherlands, banks are required to comply with guidance from the Dutch Central Bank (DNB) as well as the Dutch Banking Code, which was driven by the banking sector.

For banks that received state support, additional conditions may apply. In Germany, for example, these banks would also need to consider the conditions of the Financial Market Stabilisation Fund (Finanzmarktstabilisierungsfonds (SoFFin)).

In December 2010, the European Commission issued its Capital Requirements Directive 3 (CRD 3), which contained significant regulations in relation to remuneration for certain categories of employees in banks and asset managers. CRD 3 is intended to align the remuneration practices across Europe,

CEO remuneration packages generally increased

and the EU member states had until 31 December 2010 to implement the new guidance, which took effect from 1 January 2011.

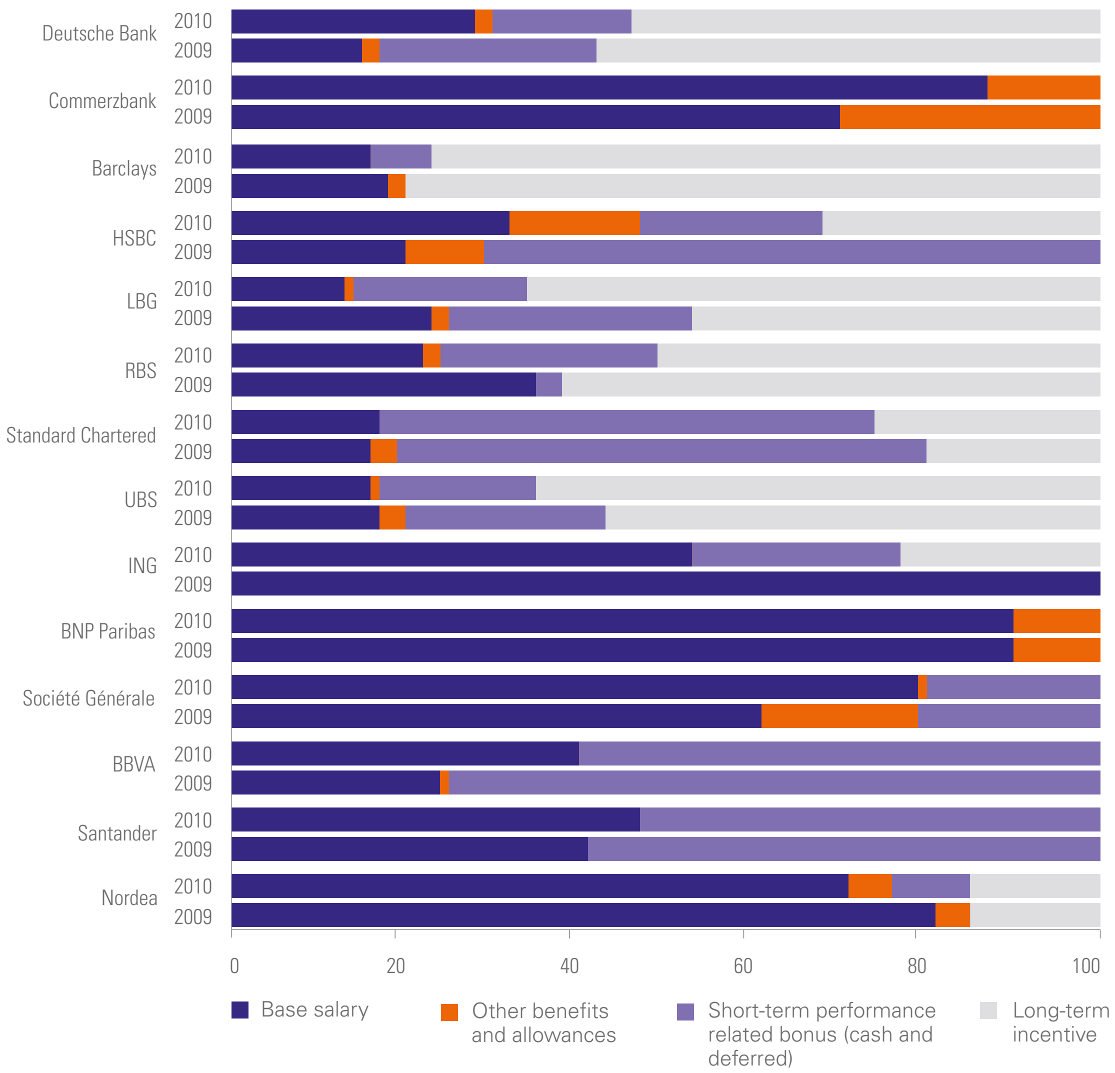
The key aspects of the guidance are:

- **Restrictions on immediate cash bonuses:** The Guidelines require that only a proportion of variable pay can be delivered immediately (40% to 60% must be deferred). Of that proportion, only half can be settled in cash. The other half must be settled in equity, or equity-like instruments. Consequently, for the highest paid staff, only 20% of variable remuneration can be paid in cash up front.
- **Guarantees:** All staff, not only senior executives, should not receive guaranteed bonuses, and sign-on bonuses should be limited to one year's remuneration and only in exceptional circumstances.
- **Fixed to variable pay ratio:** Firms are required to determine the maximum permitted ratio between the fixed and variable elements of remuneration.
- **Retention period:** Variable remuneration paid in shares, whether immediately vested in equity or a deferred bonus, must have a retention period applied. Guidance was provided around the length of retention periods, but there is no firm rule.

Analysis of executive directors' remuneration

Fundamental changes to remuneration policies were enacted by the banks in 2009, primarily driven by the G20 guidelines. These changes saw a shift from short-term incentives (e.g. cash bonuses) to long-term incentives (e.g. share options/equity bonuses). The spirit of the G20 discussions has since been incorporated in CRD 3. As the impact of CRD 3 will not take effect until 2011, the changes to remuneration policies implemented in 2009 are still reflected in 2010.

Analysis of executive directors' remuneration (Percent)



Note: For UniCredit, the information was not available in the annual report. For BNP Paribas and Commerzbank annual bonus information was not available at the time of writing of this report.

Source: KPMG International, July 2011

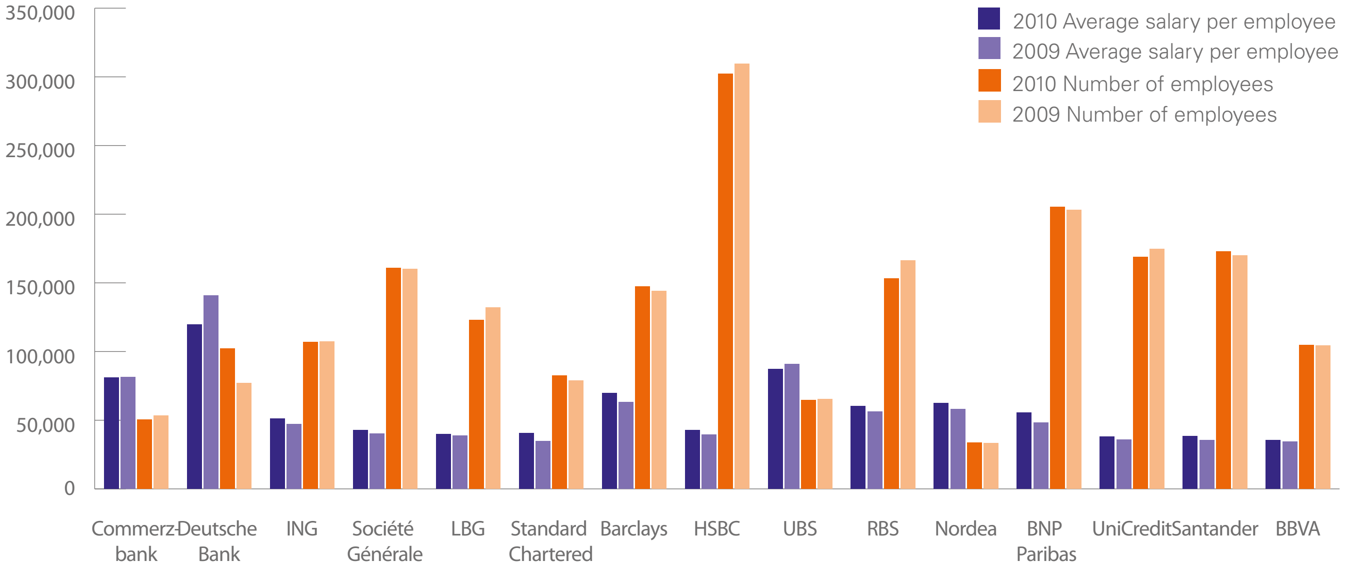
Salary components

The change to remuneration policies in 2009 was primarily driven by the perception that banks were rewarding short-term, high risk activities. By moving from a predominantly cash-based reward package that reflected current, short-term activities to one where remuneration was tied into long term growth, the intention was to incentivise management to focus on long term strategies.

Barclays has developed an innovative structure for a deferred compensation scheme for its most senior employees, linking future pay-outs under the scheme to the Group's core capital position at the time.

Comparing the remuneration structures of 2010 to 2009, the components generally remain in the same ratio, primarily due to the banks retaining the same payment structure from 2009. However, some banks

Average remuneration per employee, and average number of employees (€ / number)



Note: The information presented is as at year-end, and not adjusted to reflect staff increases or decreases during the year (e.g. Deutsche Bank's acquisition of Postbank in December 2010 resulted in one month of contributed expenses yet 30 additional employees).

Source: KPMG International, July 2011

altered their incentive plans, which explains some of the movement in 2010. ING moved from a full cash payment to short and long-term incentives, and HSBC altered the balance between upfront versus deferred awards. All banks have a base salary element, with the remainder of the remuneration being divided between other allowances, short and long-term incentives.

Commerzbank and BNP Paribas indicated they did not have approval for their respective bonuses and long-term incentive plans when their annual reports were published, and so no amounts for these components were disclosed. As a result, the graph does not reflect these components.

An interesting difference is the geographical trend. Aside from Deutsche Bank, banks in continental Europe tend to pay a higher proportion as base salary. By comparison, at UK banks the base salary is <25% of total remuneration.

Average salary per employee

One of the changes with implementation of CRD 3 will be the focus on remuneration for a wider range of employees, not just executive directors. The graph above compares the average salary per employee in 2009 and 2010. Overall, the number of employees has remained constant, reflecting the cost efficiency focus of the banks. The only significant change is the increase at Deutsche Bank, resulting primarily from its acquisition of Postbank.

One aspect that CRD 3 hopes to deliver is an equalising of remuneration between peer groups. Many banks, such as Commerzbank, already provide an analysis of its remuneration compared to its peer group. Looking at the graph above, there seems to be a disparity in the average amounts paid by the banks to their employees. However, this could be linked to geographical position of people and the nature of activities, e.g. the weight of investment banking.

Average salary per employee remained constant despite cost-cutting agenda

An increase in CoCo remuneration

could be seen in 2011

Expected trends from 2009

In last year's report we stated the remuneration trends we expected to see in 2010. One of these was the rise of equity-linked bonus plans, including the rise of contingent convertible instruments ('CoCos'). CoCos are debt instruments that convert into Common Equity Tier 1 instruments upon a certain trigger, such as a reduction in the Tier 1 capital ratio. During 2010 there was increased discussion around the issuance of such instruments, with the conversion trigger linked to capital ratios. However, none of the banks in the survey disclosed whether CoCos formed part of their remuneration in 2010.

Given CoCos can convert from debt instruments into equity instruments they are generally regarded by the market as having a higher associated risk than non-convertible debt instruments. This is primarily due to the conversion trigger being an equity-related ratio. For example, a holder of a CoCo would expect a higher coupon to compensate for the risk the CoCo would convert into equity following a reduction in Tier 1 capital, below a certain level. The reduction may be due to the bank incurring losses, which means the CoCo holder may eventually hold equity with a low market value.

We expect to see an increase in CoCos within long-term incentive plans, where they may be issued with a coupon lower than the same instrument would attract if issued to the market. As a result, these instruments should result in lower costs to banks, while also meeting the objective of tying in compensation to the bank's long term growth.

The development of these instruments in 2011 will be interesting to observe.

Governance

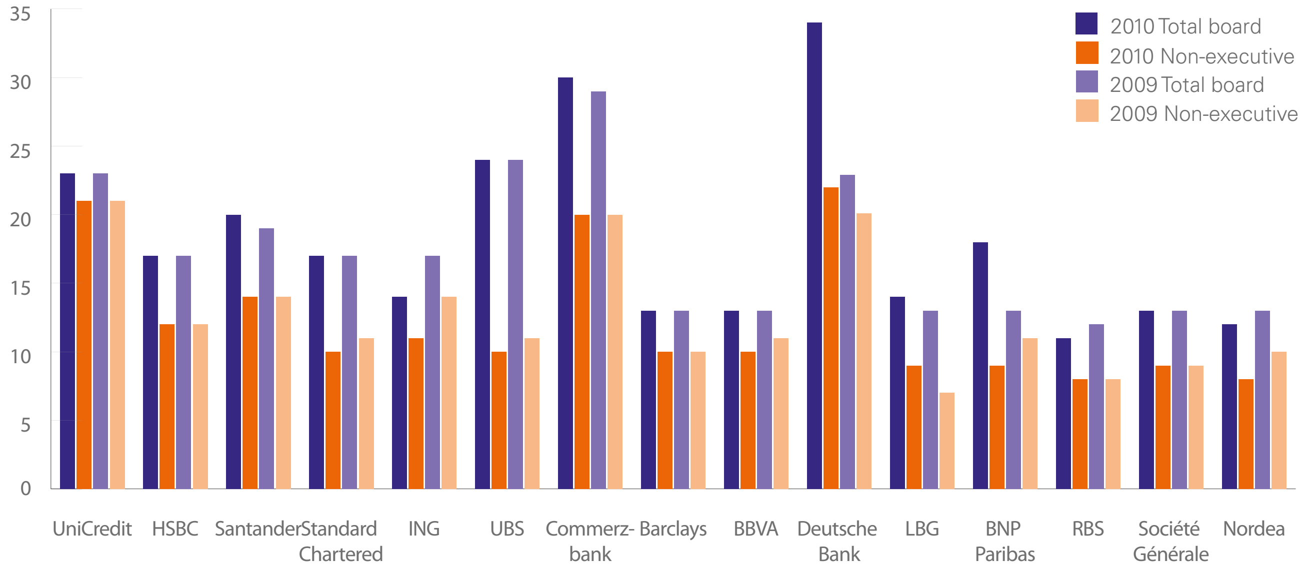
No significant changes to the composition of the board have been seen.

The composition of the Boards of Directors did not change significantly, other than the occasional retirement, except for Deutsche Bank and BNP Paribas that showed a noteable increase in total members. Non-executive, independent directors still accounted for the largest portion of the Boards.

Disclosures relating to corporate governance varied among the banks in terms of content and detail. The general disclosure seen in the annual reports ranges from simple discussions of the duties and composition of the board of directors and remuneration committee (UniCredit), whose detailed information is provided in the Report on Corporate Governance and cross referenced to the annual report; to a more detailed discussion of the boards' composition, remuneration policies and internal controls (Société Générale, BNP Paribas, Commerzbank, Nordea, LBG, Santander, ING, UBS, BBVA, Deutsche Bank, HSBC); to a new innovation in corporate governance, where three banks have included a detailed report from the chairman of the audit committee (Barclays, RBS and Standard Chartered).

Banks have further tried to assure stakeholders about the quality of their senior teams by including a summary of their directors' previous professional experience and educational background (RBS, HSBC, Barclays, BNP Paribas, Standard Chartered, BBVA, Société Générale, LBG, Deutsche Bank and ING), summaries of duties and responsibilities, and involvement in risk management processes. Some banks have even

Board members composition (Number)



Note: All board members have been included. Supervisory boards accounted for non-executive membership.
Non-executive board members include the Chairman of the board,where specifically identified as non-executive.

Source: KPMG International, July 2011

Base salary decreased for UK banks

as a result of FSA's early adoption of CRD 3

included a table of board meetings and attendance by each director. Detailed disclosures of remuneration policies for executive directors also featured in the annual reports, with summaries of various shares/option schemes set up to incentivise executive directors.

The reports from the chairmen of the audit committees of RBS, Barclays and Standard Chartered included a lot of interesting content, such as the duties and responsibilities of the audit committee, the review of key accounting policies and disclosures, especially significant judgements and estimates affecting the financial statements, their role regarding the internal and external control processes, and performance evaluation of the committee.

In particular, the audit committee chairmen mentioned some key accounting issues discussed by the committee relating to the 2010 accounts, such as fair value of credit market exposures and associated disclosures, loans impairment (in particular the impairment situation in Spain for Barclays) and impairment of goodwill.

The audit committee of RBS also reviewed actuarial assumptions related to pensions' obligations and the Group's tax position including deferred tax assets. Barclays' audit committee mentioned the review of outstanding litigation matters.

Regarding oversight of internal controls, the chairmen referred to their role in the assessment of the internal auditors' work, including audit plan and resources.

The chairman of the audit committee of RBS stated that "the Audit Committee oversees the work of Group Internal Audit".

The chairmen also assessed the quality of the internal control framework. The chairman of Barclays' audit committee stated that "much progress has been made in improving the control environment". The work performed by the audit committee of Barclays was notably "the review of controls in the areas of product valuation, the trading businesses and client assets segregation". Due to reorganisation of businesses in 2010, it was also mentioned that "the focus was on ensuring that there was no impact on controls during and after the reorganisation".

More disclosure by the Audit Committees could become a trend in the future

In order to strengthen the monitoring of its audit committee on internal control and audit functions, the chairman of the audit committee of Standard Chartered announced the split of the audit and risk committee into two separate bodies. It permitted the audit committee "to deepen its focus on internal controls, compliance and assurance and internal audit functions".

With the role of external auditors coming under scrutiny on the back of a Green Paper issued by the European Commission, it is interesting to note that two audit committee chairmen (Barclays and RBS) confirmed the independence, objectivity and effectiveness of their external auditors, and referred to a process of evaluation of the work performed by their external auditors. The chairman of the audit committee of Barclays stated "the Committee is fully satisfied with the performance of its external auditors". Furthermore, the policy set up regarding the services external auditors may or may not provide is explained in RBS and Barclays' statements. Authorised and prohibited non-audit services were listed.

These audit committee chairmen reflect the growing role audit committees play within the governance structure of banks. They provide additional assurance on the control environment and financial statements of banks.

Outlook

We expect the trends identified for 2010 to continue in 2011 as CRD 3 is implemented across Europe:

- Focus to be given on the ratio of base salary to incentive components.
- Larger elements of variable remuneration being deferred.
- More emphasis on detailed consideration of risk associated with individual performance in respect to bonuses.
- Deferred annual bonuses, with greater emphasis on equity or equity-linked remuneration.

With CRD 3 applying to all of Europe, we expect the difference in geographic trends to diminish over the coming year as banks align their remuneration policies.

Corporate governance disclosures are useful in that they provide stakeholders with some comfort as to the bank's internal processes and governing structure, and it was evident from the disclosures that banks have tried to present a picture to stakeholders in order to improve transparency.

Innovation is evident in the corporate governance reporting by Barclays, RBS and Standard Chartered, where each bank included a detailed statement from the chairman of the audit committee relating to work undertaken during the year. This initiative might be taken up by other banks in the survey in the future.

On the international scene, the Basel Committee issued principles for enhancing corporate governance in October 2010. The European Commission has also started to examine corporate governance rules and practices within financial institutions, and aims to make recommendations (Green Paper dated June 2010). While the regulators and European Commission want to strengthen corporate governance practices, some changes might be seen within financial institutions in the coming years.

The calm between two storms?

Regulatory change cited as one of the most significant challenges facing the banks in 2011

Changes ahead

- **CRD4 back on…** After announcing a delay until October 2011, the European Commission has now confirmed that the rules implementing Basel 3 in Europe will be released on 20 July. Whether concerns over maximum harmonisation will be addressed, and the significance of any weaknesses found under the European Banking Authority stress test results remains to be seen.

- **EMIR vote delay...** The European Parliament has delayed the plenary vote on the European Market Infrastructure Regulation (EMIR) proposals to reform the OTC derivatives market until September 2011. The European Commission is putting pressure on to finalise ahead of November's G20 meeting but both the Council and Parliament will be using the delay to continue negotiations around scope, exemptions and the role of the European Securities and Markets Authority (ESMA).

- **EC corporate governance consultation ends…** The European Commission's consultation on broad reforms to corporate governance standards across all industries ends in July. Following previous discussions on financial services specific reforms, there are concerns that there will be a shift away from principles towards prescriptive rules and a one-size fits all approach.

- **Credit rating agencies are under pressure…** Credit rating agencies (CRAs) were criticised by the EU for their behaviour in the ongoing European sovereign debt issues. This coincided with the European Commission publishing responses to its consultation to reform CRAs. There is widespread concern over the lack of competition among CRAs, and overreliance on CRAs, with calls for more independent due diligence by banks and investors.

- **IFRS Wave 2...** The debate on new impairment guidance continues in Europe. Despite the reduction in impairment charges in 2010, this remains a hot-topic with sovereign debt and CRAs under scrutiny.

This year s Focus on Transparency questioned whether 2010 was the calm between two storms. Compared to 2009, the year banks saw a return to profitability, 2010 appeared quieter as banks focused on managing the size of their balance sheet and risk exposures.

We saw an improvement in asset values and a decrease in impairment charges; a shift in longer term funding and increased liquidity, resulting in a stronger capital base; the continuation of aligning executive remuneration with good corporate governance and robust risk management; and improved RWAs as legacy credit-crisis assets matured and non-core assets were sold.

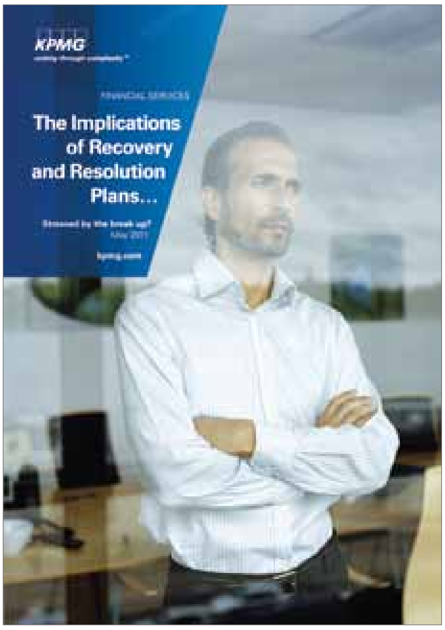
The view that 2011 will bring further changes and challenges is not new. Even so, the extent of the changes increases almost daily, primarily driven by regulatory improvements and political unrest. Debates around sovereign default dominate the news highlighting again the global impact of issues facing banks. How the banks treat their sovereign debt exposures will affect the perception of certain governments' credit status and, potentially the viability of the Euro. But as detailed throughout the report this important issue is not all the banks have to contend with.

Thank you

We would like to extend our gratitude to those banks who reviewed our document, providing many useful insights. While we have, where possible, incorporated your comments and observations, any errors or omissions remain the sole responsibility of the editors.

KPMG publications

In addition to Focus on Transparency, we have a range of publications and newsletters that provide insight into regulatory reforms and accounting changes, including:



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