KPMG

Focus on transparency

Financial reporting of European banks in uncertain times

FINANCIAL SERVICES

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This is the fourth year of Focus on transparency; KPMG s European banking survey. The publication includes chapters on the key issues that affected banks in 2009. For the first time we have included chapters on corporate governance and remuneration, reflecting the increased focus on these areas by the banks in response to the financial crisis and the ensuing public scrutiny into banking risk management. New chapters have also been added on deleveraging and investment banking which incorporate commentary on balance sheet risk reduction measures taken by the banks and investment banking performance respectively. 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 are 15 banks included in the survey, one fewer than in 2009 due to the merger of HBOS with Lloyds TSB to form Lloyds Banking Group. The banks reflect a large demographic of European banks reporting under IFRS:

Note: Comparatives for Lloyds Banking Group are based on statutory rather than proforma results. Comparatives for UBS are based on the Bank's restated results.

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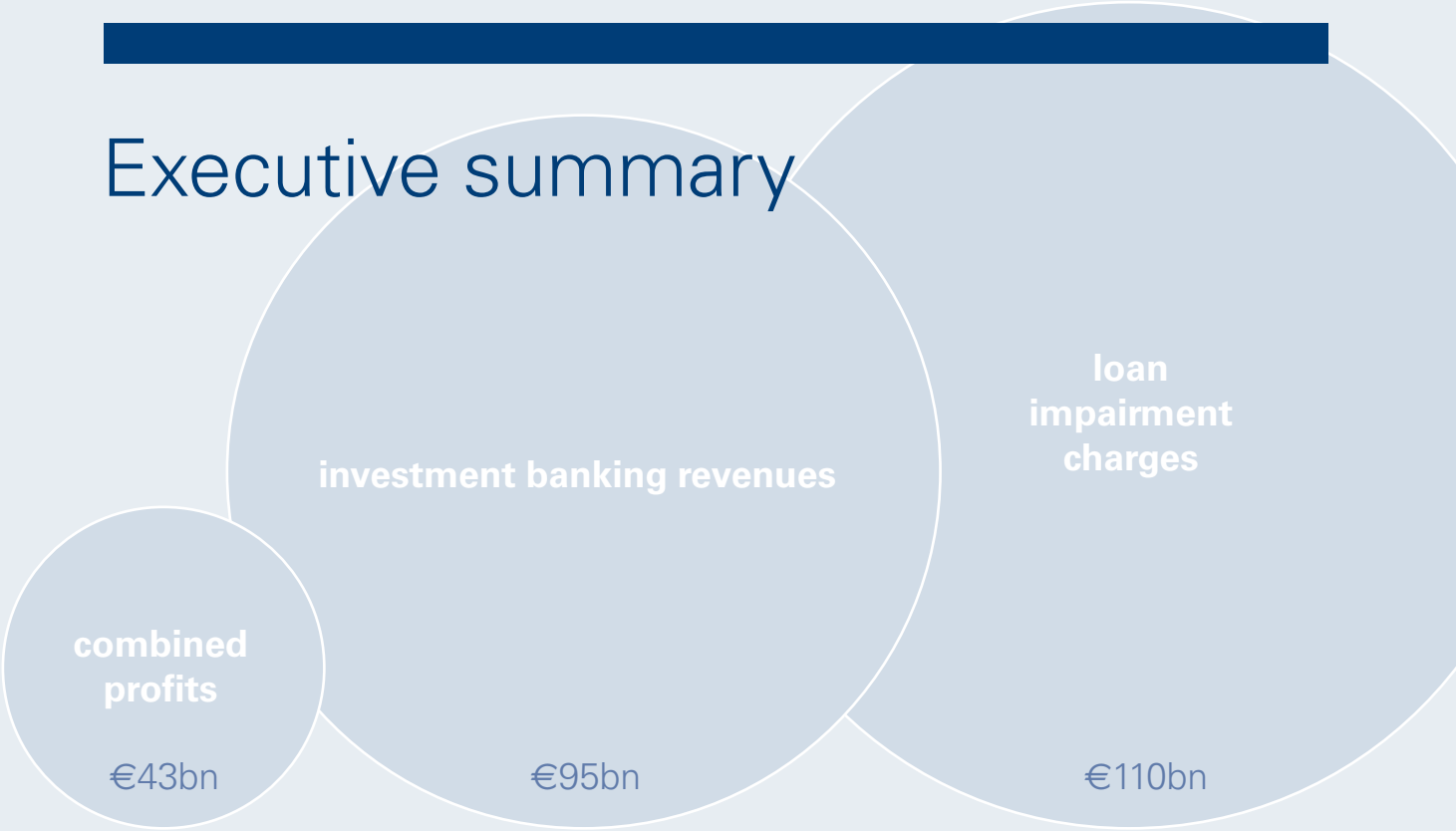

Key findings:

Klaus Becker

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KPMG in Germany

Combined profits of €43 billion from the leading European banks in 2009 turn around the previous year's losses of €25 billion...

...but many financial markets remain fragile and we expect continued volatility in the future.

Greater than expected improvement in investment banking performance - combined revenues nearly quadruple to reach €95 billion in 2009...

...but retail banking under pressure with total loan impairment charges hitting **€110 billion**, an average increase of 83%.

Balance sheets reduce...

...but most of the reductions relate to movement in the fair value of derivatives.

Capital quality transforms as 12 of the banks now have more than 60% of capital in core tier 1...

...but further regulation could see increasing capital requirements squeezing profitability.

Predictions of widespread clearances in boardrooms failed to materialise...

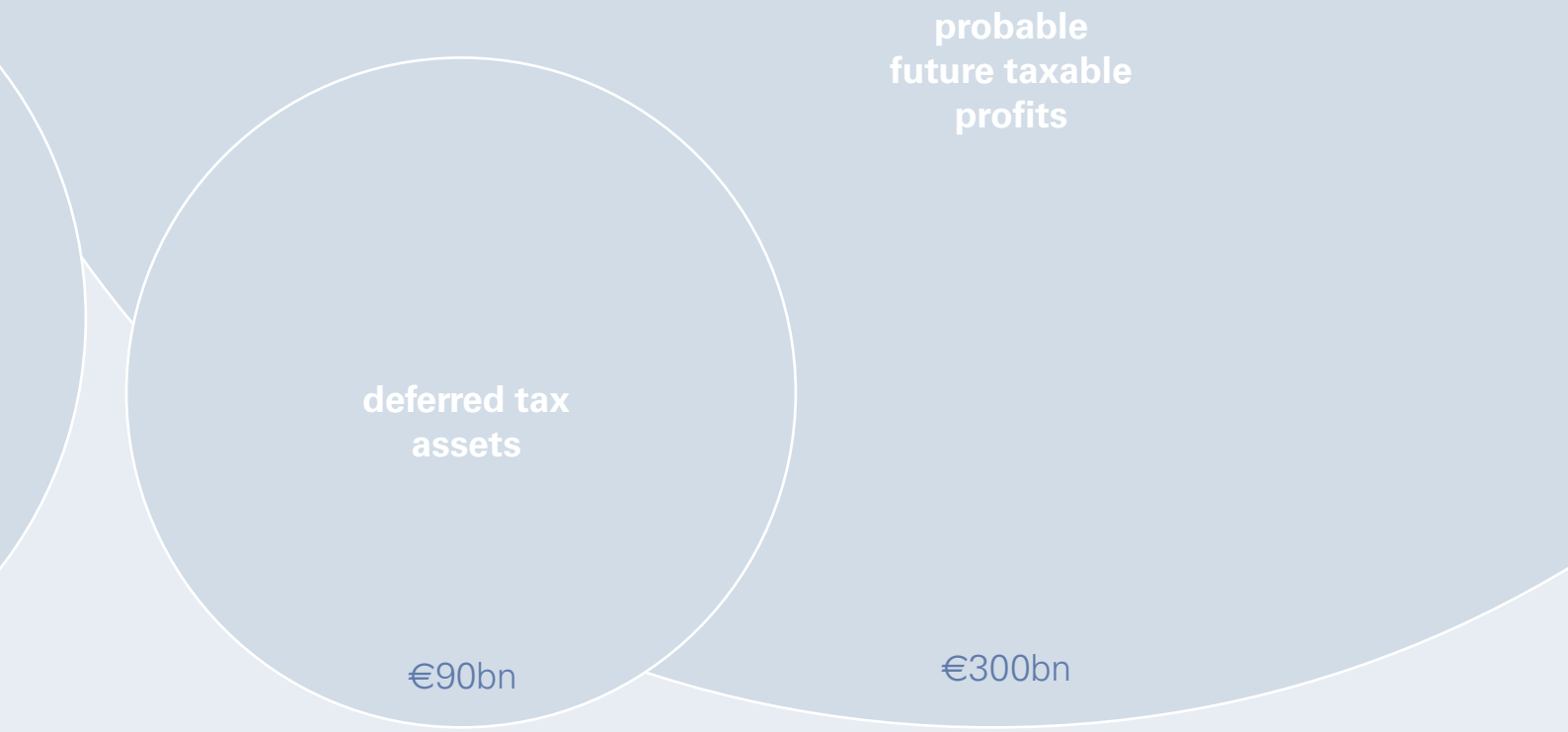
...but there were significant changes to corporate governance and remuneration policies.

Executive pay frozen at 2008 levels...

...but few banks reduce pay of highest paid director.

€90 billion of deferred tax assets recognised on balance sheets equates to around €300 billion of probable future taxable profits...

...but recent profit history suggests recovering those profits will be a challenge for the banks.



A story of recovery?

Uncertainty and volatility are the key watchwords for Europe's senior bankers. While our survey of the leading 15 European banks finds a return to collective profitability in 2009, it is clear that with the threat of a 'double dip' recession and growing regulatory pressure, balance sheet management will remain the banks' primary focus.

For boards and their senior executives, the objectives of profitability and growth have been replaced with the management of scarce resource - how do they manage liquidity and make the best use of limited capital resources and funding availability?

At the same time, the boards have found that dealing with regulation has become their new strategic focus.

Some banks started 2009 on life support, with European governments providing the intensive care needed, including aggressive fiscal policies, liquidity support mechanisms and direct majority shareholdings to prevent the collapse of individual institutions.

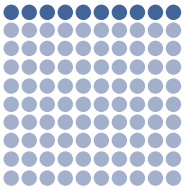
A better than expected 2009 has led many commentators to predict the worst is over. Less than two years since the collapse of Lehman Brothers, the resurgence in investment banking performance is beyond most people's expectations. Total investment banking revenues across our survey are €95 billion for 2009 (2008: €25 billion), representing record investment banking returns for many.

However, our survey finds the performance of universal banks to be more mixed. The retail banking model remains under pressure and loan impairment charges are up for 2009 by an average of 83% across the survey, with eight of the banks seeing double or more the impairment charges of 2008. Total impairment for 2009 is €110 billion, although there is widespread comment that this will be the peak in impairment charges. For some, the impact of 'bad bank' type legacy assets is a significant factor in recorded impairment charges.

Total investment banking revenues of €95 billion in 2009 represented record investment banking returns for many

2009 impairment charges of €110 billion, up 83% on average across the survey

Total assets on balance sheet are down 10%



Most balance sheet reduction seen in 2009 was derived from falls in derivative values as a result of market parameters

… but how are balance sheets reducing?

The majority of banks in our survey have seen their balance sheets reduce significantly over 2009. Total assets are down an average of 10%, with the banks having combined total assets of more than €17 trillion at the year end. But with many banks beginning to actively manage down their assets, a surprising amount of balance sheet reduction is derived from falls in derivative values as a result of market parameters. The notional volumes of derivative portfolios themselves, where disclosed, have not reduced significantly.

At the same time, loans and advances have increased across the survey by 8% (due to acquisition activity). The total on balance sheet is nearly €7 trillion at the year end.

As an indicator of the risk faced by an organisation, these measures of gross balance sheet size have inherent limitations. Market risk can be offset using off and on balance sheet liabilities, significantly reducing risk without reducing balance sheets. However, with no clear downward trend in risk weighted assets across our survey, the banks still have much to do to achieve real deleverage and balance sheet risk reduction, and 2010 will doubtless see balance sheet reduction programmes continue. But the emphasis will be on achieving the best long term outcome through the most appropriate timing of disposals.

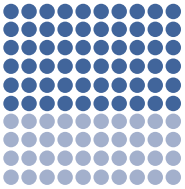
Significant merger activity during 2009 - vital to prevent the failure of some of the largest financial institutions - also means that the restructuring and management of legacy portfolios will be a major focus for the affected banks. By definition, legacy assets contain unwanted risk and with funding and liquidity still at a premium, divestment is not easy. Coupled with a market reluctance to use complex structuring, there is often a considerable difference between willing buyer and willing seller prices. In our view, all but the most urgent of divestment will take significant time to meet this expectation gap.

… and will quality capital squeeze profits?

Five banks in the survey (RBS, LBG, BNP Paribas, ING and Commerzbank) benefit from governments taking significant shareholdings and the capital positions of eight of the remaining ten banks are now stronger through successful ordinary share issues. With upcoming changes to European regulation, the quality of capital has also been transformed with all 15 of the banks surveyed now having a tier 1 ratio of at least 8% compared to only two banks in 2008. Recognising the importance of these actions, there is increased disclosure on the measures the banks have taken to increase capital and on key capital ratios and measures such as core tier 1.

But the longer term questions are whether investor expectations can be maintained when servicing this level of capital and whether the withdrawal of government stimulus packages and further regulation will see increasing capital requirements squeezing profitability.

12 of the banks surveyed now have in excess of 60% of total capital in core tier 1



Most of the banks froze executive pay at 2008 levels, but few reduced pay in the wake of the financial crisis

Who is paying the price?

Rightly or wrongly, the senior management at the banks continue to face the blame for the financial crisis. Issues of governance, risk appetite and remuneration are all under scrutiny, forcing the banks to make significant changes to their corporate governance and remuneration practices. Reacting to this, the banks are showing how they are taking steps to strengthen their governance through structural changes, new forums and new board members.

RBS comments explicitly on wholesale changes to the executive in the wake of the banking crisis. Conversely there does not appear to have been the widespread change in personnel in many other banks that some media commentators predicted.

All the banks have revisited their remuneration structures in 2009, with a shift away from short-term cash incentives towards fixed and longer-term remuneration for executives. Many banks froze executive pay at 2008 levels with this being expected to continue into 2010. Only UBS, Nordea and RBS actually reduced the pay of their highest paid director in 2009.

… and what challenges lie ahead?

Our survey shows there are some major challenges ahead for the European banking sector. Take the surprisingly large figure for recognised deferred tax assets. The 2009 annual reports reveal that, collectively, the banks in the survey have some €90 billion of deferred tax assets recognised on their balance sheets. That equates to some €300 billion of probable future taxable profits that need to be generated to recover them. Against a backdrop of combined profits of only €43 billion in 2009 and a loss of €25 billion in 2008, the implication is that the sector expects a sustained improvement in profitability.

Other challenges include: the likely introduction of living wills; continued public and political scrutiny of corporate governance and risk management; the huge and volatile impact that fair value reporting has on profits.

And as coping with regulation critically impacts strategy, governments and regulators are set to change many aspects of banking that would have been extremely difficult a decade ago.

We all may be hoping for a rapid return to stability as banks learn from the crisis, but it is clear that, as this survey demonstrates, we are only seeing the opening salvoes in what is set to be a long struggle where the future of banking will look very different.

Throughout this year's survey we have sought to provide insight to the banks' annual reporting and give a flavour of not only the results themselves, but also what they mean in terms of underlying performance, financial health and capital position within the sector. We hope these results are a helpful commentary on the position of European banking and we welcome your feedback.

1. Governance

Governance and risk management remain high on banks' agendas as they seek to enhance internal processes in light of the financial crisis and external pressures.

Overview

In response to significant governmental and regulatory pressures, corporate governance and risk management have been a key focus area in 2009. The financial crisis has led many banks to re-examine their governance structures and consider whether enhancements could be made.

2009 has seen regulatory pressure applied across Europe to improve corporate governance practices in the banking sector

The de Larosiere report on EU financial market supervision identified weaknesses in the current, largely national based, regulatory supervision of financial institutions in the European Union. The key recommendations of the report were:

- **Market wide supervision of risk:** Establishing a European Systemic Risk Council to provide an effective risk warning system with the power to take action if individual supervisory intervention is thought inadequate
- **Macro-prudential supervision:** The introduction of a European System of Financial Supervisors with existing national supervisors of individual EU countries continuing to implement day to day supervision
- **Capital adequacy:** A macro approach to capital adequacy to counter the pro-cyclical nature of the existing rules

Across Europe, governments and regulators have put pressure on banks to improve corporate governance and remuneration practices. In the UK, the government published the final recommendations arising from the Walker Review of corporate governance in UK banks and other financial industry entities. Although the review concluded that the Combined Code remained fit for purpose, the following key themes were identified as requiring consideration by financial institutions:

- The need for banks to ensure there is effective challenge at board level and that the board is of an appropriate size with a mix of skills and qualifications
- Boards need to have sufficient involvement and reassert their responsibility for strategic direction, risk appetite and business plan risk management
- The creation and enhancement of board risk committees with the chief risk officer reporting directly to the committee to ensure there is effective flow of risk information to the board

In Germany, the main initiatives have been similar with reforming remuneration policies, improving professionalism of supervisory boards and introducing minimum requirements for risk management being key objectives. Changes have been made to the German Corporate Governance Code with effect from June 2009, strengthening corporate governance in the following areas:

- Mandatory reporting of corporate governance in the annual report including reporting of areas of possible non-compliance
- Remuneration for management board members (executive directors) to be determined by the full supervisory board with the compensation structure being orientated towards sustainable growth of the entity. Mandatory reporting by individual of management board members' remuneration
- Nominations to the supervisory board to be considered in the context of the overall need to ensure there is the required knowledge, ability and expertise on the board

In France, there are ongoing improvements to risk management requirements being looked at by the government and the regulator. Changes to date include:

- Introduction of an independent executive risk officer that identifies and monitors risks and who reports to the executive committee and to the board or audit committee
- Aligning risk management and compensation policies
- Deeper focus on risk analysis of new or complex transactions
- Emphasis on the responsibility of the executive and audit committee for internal controls

The French banking regulator has also recently insisted that responsibility for defining a bank's risk appetite and monitoring approved risk policies should lie with the board. The board and senior management should also be more involved in the identification of risks and day-to-day risk management (through the implementation of a risk committee for example).

In light of general criticism of banks' governance structures, several of the banks in our survey have commented on the steps they have taken to enhance or amend their governance policies and practices. HSBC commented that a review of non-executives' time commitment has been undertaken and the terms of reference of the remuneration committee broadened in response to the Walker Review. Both

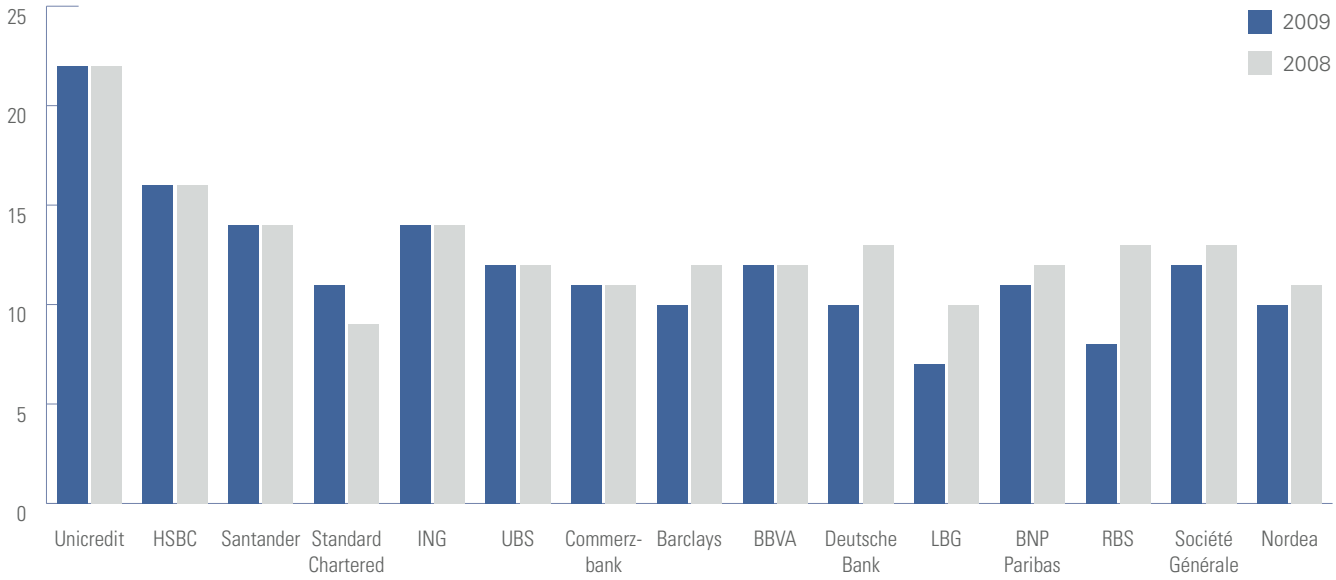
Board stability and appropriate skill mix have been key themes in the wake of the financial crisis

HSBC and Nordea have established separate board risk committees and Commerzbank has reorganised its risk function in response to the crisis. Barclays has increased the frequency of reporting of risk, capital and liquidity to the board and allocated additional time to board strategy discussions.

Board composition

The majority of the banks made extensive disclosure regarding board structure, function and composition. Many comment on the board's involvement in overall strategy, risk appetite setting and risk management. The graphs below illustrate non-executive and full board membership numbers across the survey.

Non-executive board members (Number of members)

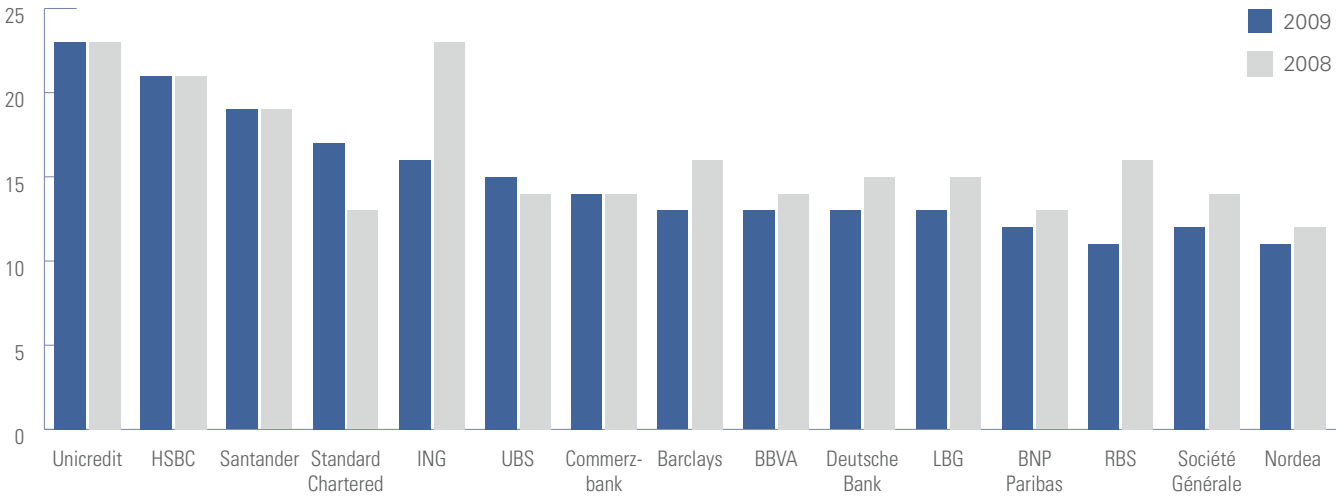


Note: Non-shareholder nominated members of supervisory boards (e.g. employee representatives) have been excluded as have executive board members in countries such as the UK where a unitary/mixed board system is in place.

Source: KPMG International, June 2010

Non-executive board member numbers include the Chairman of the board.

Membership of full board (Number of members)



Note: In countries where there are two tier board structures board member numbers are those of the supervisory board (excluding non-shareholder elected members) together with the Chairman, CEO, COO and CFO on the management board.

Source: KPMG International, June 2010

In countries where there is a unitary board system, full board member numbers include both executive and non-executive directors.

In some jurisdictions there is a two tier board system where it is a legal requirement to have a supervisory board consisting entirely of non-executive directors and a separate management or executive board reporting into this body. In others, there is a single unitary board of directors consisting of both executive and non-executive directors. The composition of boards therefore varies considerably across the survey, but all boards had a majority of independent non-executives and a chairman/CEO and COO or equivalents on either the unitary board or the management board. There is a focus on emphasising the independence of board members and most banks have also included director biographies which demonstrate the depth and breadth of experience across the board as a whole.

There has been little change in board composition, only RBS comment explicitly on changes to the board and executive in the wake of the banking crisis

There has been a high degree of stability across board membership. For example, 12 of the 15 banks had continuity of the CEO and eight had the same chairman for both 2008 and 2009. Both RBS and Deutsche Bank comment that they have actively strengthened their boards in 2009 by bringing in new directors with specific skill sets. For example, Deutsche Bank doubled the size of its management board, adding four new members who strengthened the business and regional expertise of the board. RBS added four new full board members in 2009 with the objective of bringing further sector skills and experience to help rebuild the bank. Additionally, a new executive committee was formed. ING commented on the reduction in the number of directors due to the restructuring programme implemented as a requirement for state support.

State support

Indirect support

In the wake of the financial crisis, banks globally have been supported by state action to boost overall liquidity in the markets. Central banks and individual governments have implemented specific schemes to aid liquidity for individual banks. Quantitative easing measures taken by the European Central Bank and the Bank of England have eased liquidity pressures generally for banks and specific schemes have helped individual banks improve their liquidity by exchanging illiquid assets such as mortgage backed securities for government bonds. These include the Special Liquidity Scheme in the UK, the Société de Prise de Particitation de l'Etat (SPPE) and Special Fund for Financial Market Stabilization (SoFFin) schemes in France and Germany respectively.

Direct support

All the banks in the survey have benefited indirectly from state support in 2009 and five now have significant public stakeholdings

A number of banks in the survey benefited from direct state support in 2009 and five banks (RBS, LBG, ING, BNP Paribas and Commerzbank) currently have significant public stakeholdings.

The German federal state took a 25% stake in Commerzbank via SoFFin during 2009, helping to strengthen the Bank's capital base. As part of the conditions attached, the Bank has sold a number of non-core subsidiaries including Dresdner Bank (Switzerland). The Bank has reorganised its activities and separately manages troubled assets within its 'cutback' portfolio together with those it no longer wishes to retain for strategic reasons.

RBS joined the UK Government's Asset Protection Scheme in December 2009, putting the bank in a position of greater confidence to rebuild going forward, having insured and therefore limited its losses on a large proportion of its loans and other financial assets through the Scheme. The Bank has also significantly strengthened its capital position through the B shares issued as part of the Scheme. RBS has stated that the divestments it is required to make under the state aid requirements of the European Commission (EC) represent under 15% of the Group. Divestments will include the RBS branch network in England and Wales, NatWest branches in Scotland and the sale of RBS's insurance business.

The capital position of LBG has been strengthened this year through a significant public shareholding and successful rights issue. As a result of the acquisition of HBOS at the start of the year, management of HBOS' legacy book and integration of the two businesses has been a significant feature of 2009. In the latter part of 2009 the Bank has agreed a restructuring plan with the European Commission as part of the state aid requirements which will see the Bank dispose of parts of its retail banking business.

ING received direct government support via the Dutch State in 2008. As part of the restructuring plan submitted to the EC, the Bank is to separate its banking and insurance businesses. The divestment of ING Direct US by 2013 was also required as part of the EC's approval for state support.

Both Société Générale and BNP Paribas benefited from the French economic support plan in 2009.

Board representation has not generally been a requirement of state support. However, banks such as RBS have been required to make lending commitments as part of the Asset Protection Scheme negotiations and significant divestments and restructuring are required for the individual banks affected as noted above.

Summary

In response to government and regulatory pressure, banks have made some significant changes to corporate governance practices this year.

The banks have commented extensively on the steps they are taking to reduce and manage risk. The importance of good corporate governance and the need for strength and experience on boards has been a key focus area in these challenging times. Looking forward, we can expect increasing regulatory scrutiny of banking business models and appropriate governance frameworks to drive continued cultural change throughout the sector.

2. Remuneration

With the public, political and regulatory focus on remuneration practices in the financial sector, one of the biggest challenges banks throughout Europe faced in 2009 was reforming remuneration policies.

All the banks have revisited their remuneration policy in light of regulatory and political pressure

Remuneration policy

All the banks in the survey, although to a varying extent, disclosed information on remuneration. This information was usually included in banks' annual reports or, as in the case of UniCredit, was provided in a separate document. The information on remuneration generally comprised:

- Overall principles of remuneration policy
- Application of policies to executive and non-executive directors
- Detailed information on structure and amount of executive directors' remuneration for the respective financial year, in total and by individual
- Information on non-executive directors' remuneration
- Remuneration decisions for the following financial year

This chapter focuses on executive directors' remuneration. Executive directors in this respect are the members of the management board in the two tier board-system and of executive management in the unitary and mixed board systems.

All banks in the survey disclosed details explaining the principles applied in determining the remuneration of executive directors and all the annual reports also disclose the remuneration structure and amounts in respect of the individual directors (with the exception of UniCredit). Remuneration of executive directors comprised fixed, non-performance and variable performance related components. All the banks have revisited their remuneration frameworks in light of regulatory and political pressures which have included targeted bonus taxes (for example in the UK and France).

Regulatory changes

Bankers' pay is widely seen as being a contributory factor in the financial crisis because remuneration practices in the banking sector have appeared to reward short-term profit and encourage excessive risk taking.

Executive pay has generally moved away from variable cash bonuses with greater emphasis on fixed remuneration and longer term reward schemes

Regulators and financial authorities worldwide responded by issuing new regulations and guidelines on remuneration. As a result, banks have to comply not only with the Financial Stability Board (FSB) Implementation Standards agreed at the G-20 meeting in September 2009, but also with emerging and increasingly complex national legislation and regulation. British banks have committed to implementing the Financial Services Authority (FSA) Code on Remuneration and German banks have to consider the requirements of the Act on the Appropriateness of Management Board Remuneration as well as the specific rules of the Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin). French banks are subject to the regulations of the French Banking Federation and the French Banking Supervisor, Swiss banks have to comply with the requirements of the Swiss Financial Market Supervisory Authority (FINMA) and Swedish banks have to fulfil the requirements of the Swedish Financial Supervisory Authority (SFSA). In the Netherlands a new Dutch Banking Code has been developed by the banking sector itself.

Additionally, banks that received state support are tied to special conditions, as in Germany, for example, to those of the Financial Market Stabilisation Fund (Finanzmarktstabilisierungsfonds – SoFFin).

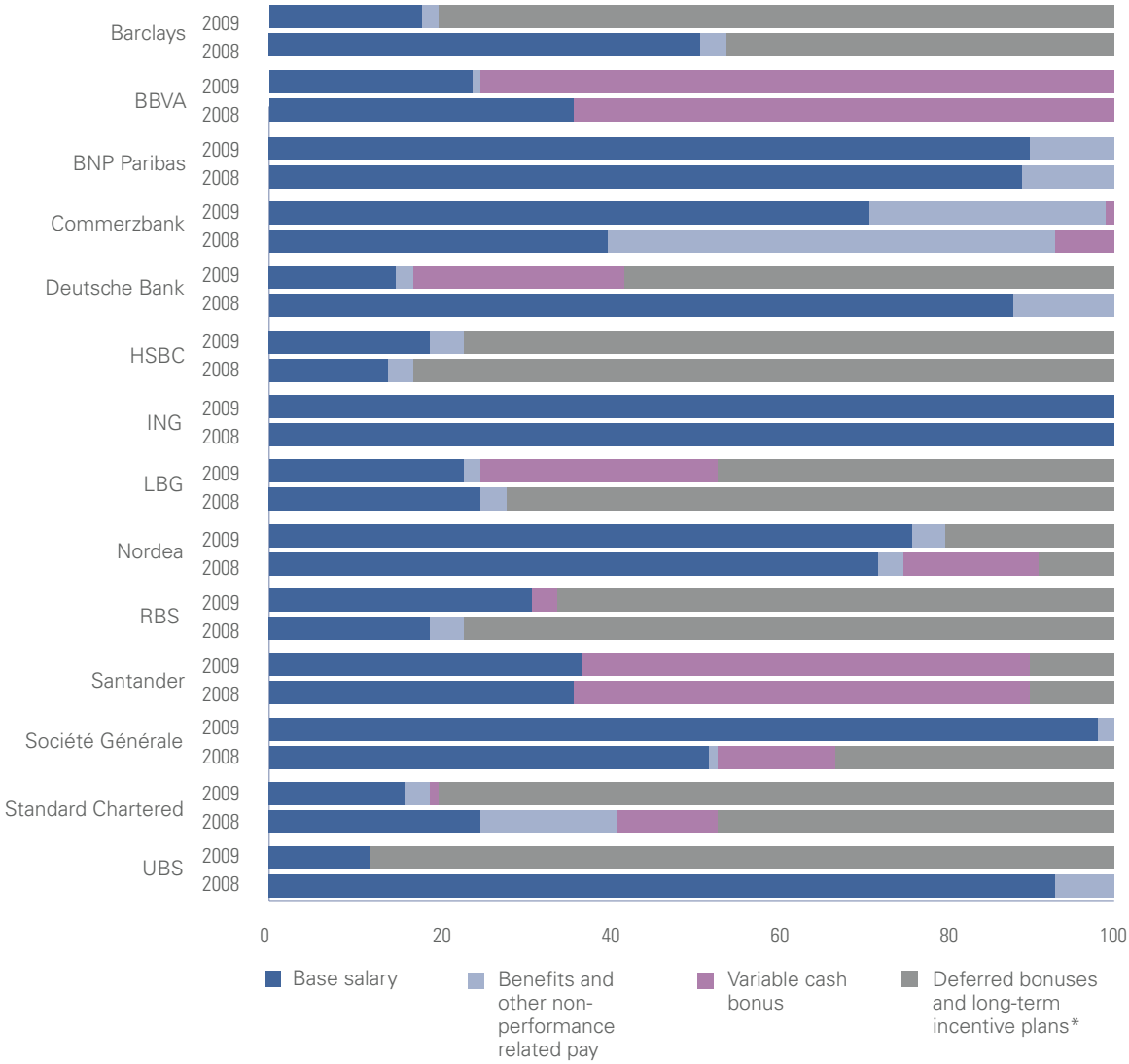
Further legal and regulatory changes are still in discussion across the European Union.[1]

Executive directors' remuneration

Given the revised legal and regulatory requirements which have been implemented in 2009, all the banks have revisited their remuneration practices. The key changes are analysed below by the main remuneration elements; base salary, benefits, annual bonuses and long-term incentive awards. The following graph shows a breakdown of the remuneration of executive directors awarded in 2008 and 2009.

[1] The European Commission recommendations of 14 December 2004 (2004/913/EC) and 30 April 2009 (2009/385/EC) foster an appropriate regime for the remuneration of directors of listed companies and the recommendation of 30 April 2009 on remuneration policies in the financial services sector (2009/384/EC) set out guidelines for national legislation and regulation.

Analysis of executive directors' remuneration (Percent)



*The underlying data for deferred bonuses and long-term incentive plans have been calculated on the basis of the fair value on grant date. As all relevant information was not always disclosed, approximations for the fair value on grant date have been used.

Note: Data not available for UniCredit.

Source: KPMG International, June 2010

Base salaries were frozen for most of the banks' executive directors in 2009, only UBS significantly reduced the base pay of the highest paid director

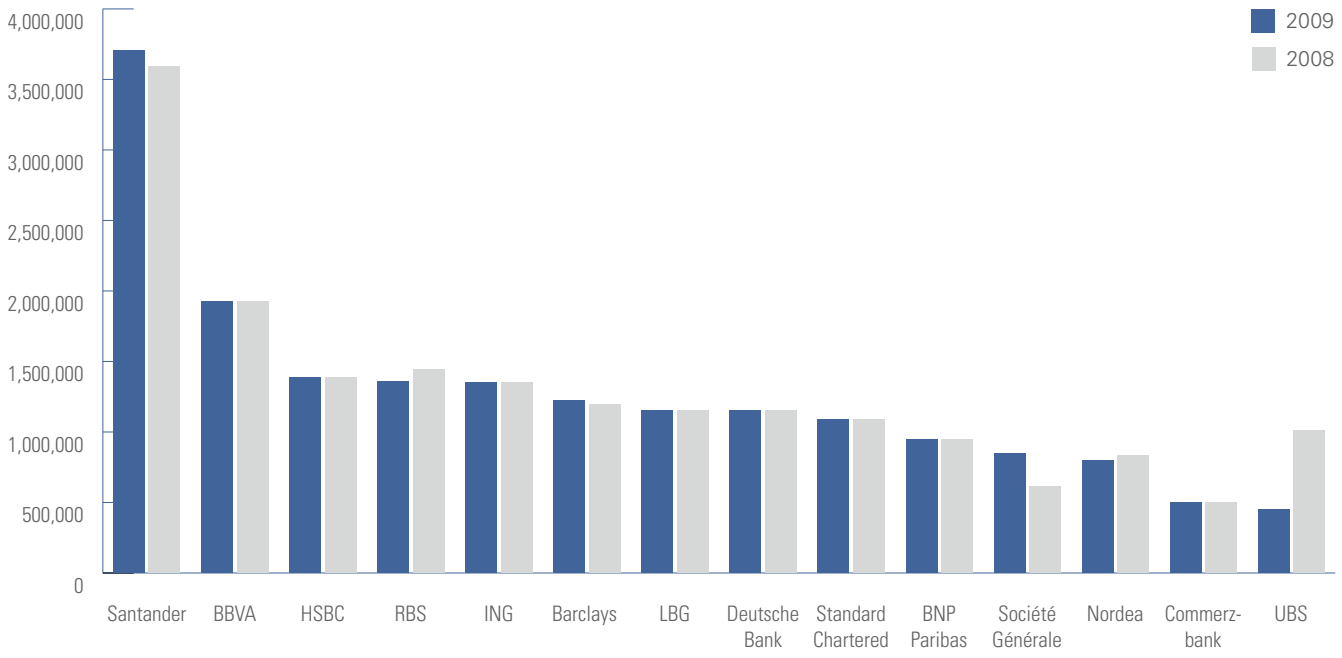
Base salary

Regulators are encouraging new remuneration systems, with less focus on short-term bonuses. The rationale is that then the incentive to engage in excessive risk-taking diminishes.

The majority of banks in the survey disclosed a change in the ratio between fixed and variable remuneration elements as one of the core components of their new remuneration structures. In this respect, some banks plan to increase base salaries in the longer term. However, with the exception of Santander and Standard Chartered, no base salary increases were made in 2009.

The graph overleaf illustrates the highest director base salary for each bank.

Highest director base salary (€)



Note: The director with the highest base salary was the CEO for most of the banks.
The absolute amounts shown in the graph is influenced by factors such as the appointment date of the director.

Source: KPMG International, June 2010

Data not available for UniCredit.

Annual bonuses

Annual bonuses remain an integral component of variable pay and all the banks operate annual bonus plans for their executive directors. Awarded annual bonuses decreased in 2008 and 2009 relative to 2007 reflecting the financial crisis and also the fact that a high number of executive directors waived either their annual bonuses or all variable pay.

Annual cash bonuses

Seven banks awarded annual cash bonuses for 2009 (BBVA, BNP Paribas, Commerzbank, Deutsche Bank, LBG, Santander, Standard Chartered) and six banks (BBVA, Commerzbank, Nordea, Santander, Société Générale, Standard Chartered) for 2008.

The receipt of a cash bonus is usually dependant on one or a combination of performance measures such as return on equity, cost/income ratio or operating earnings before tax. For 2009, and encouraged by regulators, more emphasis was placed on detailed consideration of risk associated with individual performance.

Deferred annual bonuses

In accordance with regulatory requirements and recommendations deferred annual bonus plans were an established component of executive directors' pay in 2008 and 2009.

A high proportion of deferrals were granted in equity to align interests of executives with shareholders. The most common performance measures were economic profit, earnings per share, the ratio of total shareholder return and the corresponding average figure for a selected peer group (or a combination of these and different measures). Deferral periods ranged from two to five years.

Deferred bonuses were generally subject to claw back, mostly for a three year period. Common claw back clauses were the non-achievement of defined parameters, policy breaches and financial impairment.

Long-term incentives

Performance share plans and share option plans are the typical types of long-term incentive remuneration in use. Performance share plans are long-term incentive plans that deliver free shares to executives at the end of a specific performance period, whereas a share option is the right to buy a certain number of shares at the price fixed on the date the option is granted.

Ten banks (Deutsche Bank, Commerzbank, Barclays, HSBC, Standard Chartered, UBS, ING, BBVA, Santander and Nordea) have performance share plans in place for their executive directors. Five banks granted awards in 2009 (Deutsche Bank, Barclays, Standard Chartered, BBVA and Nordea) and three in 2008 (Barclays, Standard Chartered and Nordea). Total shareholder return was the most common performance measure in respect of performance share plans.

Six banks (LBG, RBS, ING, BNP Paribas, Société Générale and Santander) operate share option plans as part of the compensation of their executive directors. Three banks (LBG, RBS and Santander) granted awards in 2009 and 2008. The most common performance conditions used were earnings per share and total shareholder return.

Executive salaries are expected to remain frozen for many of the banks in 2010 with increased emphasis on deferral of bonuses

Outlook

All the banks implemented revised remuneration structures for executive directors during 2008 and 2009. Some of the banks commented that further changes will be implemented in 2010. Ten banks (Deutsche Bank, Barclays, HSBC, LBG, RBS, UBS, ING, Santander, Nordea and Standard Chartered) disclosed information about their remuneration policy for 2010.

Some of the banks disclosed base salaries for 2010 in their 2009 reports. For example, Deutsche Bank's new remuneration structure will strengthen the importance of base salary compared to variable remuneration components for all executive directors. In contrast, the base salaries of some other banks will continue to be frozen at 2009 levels (LBG, RBS and ING) or with increases for certain individual executive directors only (Barclays, HSBC and Standard Chartered).

The highest director base salary is set to remain the same in 2010 for the 9 banks which disclosed this information, with the exception of Deutsche Bank.

We expect to see the following trends continuing for 2010 remuneration:

- Base salaries being a significant proportion of total remuneration packages
- Larger elements of variable remuneration being deferred
- More emphasis on detailed consideration of risk associated with individual performance in respect to bonuses
- Claw back arrangements for deferred variable remuneration
- Deferred annual bonuses with greater emphasis on equity or equity-linked remuneration
- New long-term incentive plans

3. Deleveraging

Reducing leverage has been a key trend in 2009 as banks have sought to de-risk their balance sheets. Progress overall has been modest and has been assisted by a pronounced decrease in derivative valuations arising from market conditions.

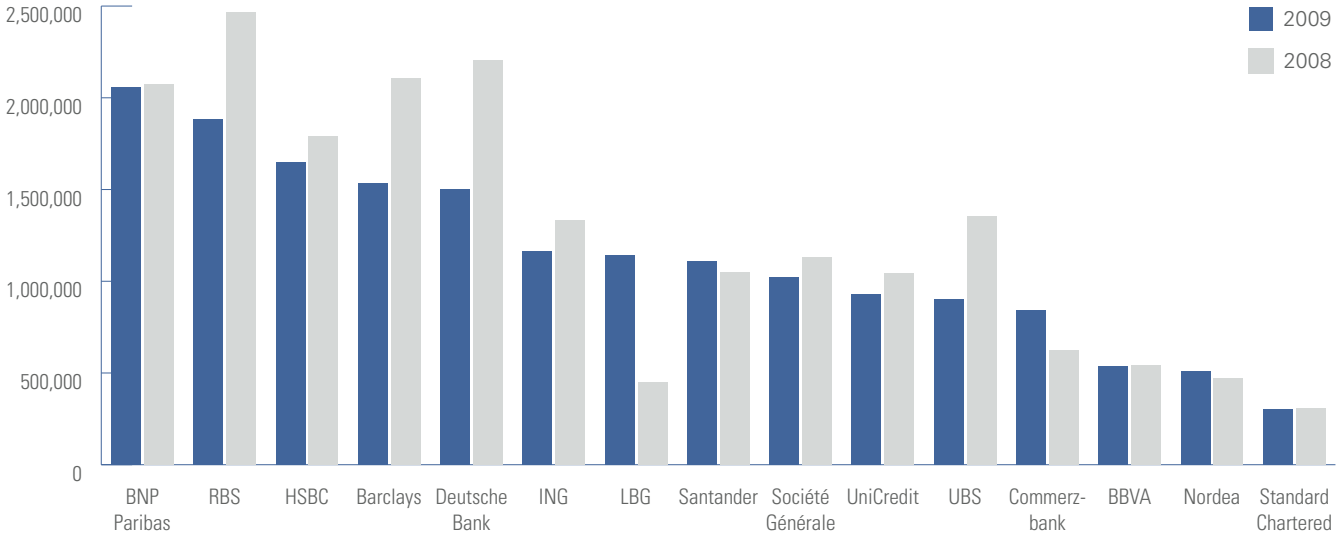
The need for deleveraging in 2009 has been tempered by a market where capital for buyers and sellers remains scarce. Banks have been seeking to obtain the best return possible from assets within a reasonable risk profile and divesting where possible. 2008 was a year that saw enormous market volatility with some market parameters such as credit spreads starting the year at abnormally high levels.

An average reduction in total assets of 10% was seen across the survey, the banks having combined total assets of €17,087 billion as at 31 December 2009

Total assets

Total assets for all but four banks (LBG, Commerzbank, Santander and Nordea) have trended downwards in 2009. In previous years, the trend has been unilaterally increasing with balance sheet growth traditionally being a key performance indicator and strategic objective. Clearly, strategic priorities have changed in the current market as banks have sought to reduce balance sheet assets and leverage ratios.

Total assets (Million €)



Source: KPMG International, June 2010

On average total assets reduced by 10%, although there were wide variations within individual banks. Most banks saw total assets decrease, the biggest decreases being seen by Barclays, RBS, UBS and Deutsche Bank, each of whom saw their balance sheets shrink by over 20%. In all cases, the primary driver was the reduction in derivative assets on balance sheet.

Deutsche Bank commented that the reduction in derivative values was driven by their rates, credit trading and FX businesses as a result of rising interest rate curves, exposure reduction activity and tightening credit spreads during 2009. Similarly, the total asset reduction for both Barclays and RBS primarily reflects movements in market rates together with active derivative reduction programmes with market factors being the most significant contributor to the reductions seen.

At UBS, the decline in total assets of 33% was again due to significant market driven reductions in derivatives. UBS also incurred losses on their holdings of securities related to the US residential mortgage market and on other assets carried at fair value.

The exceptions were LBG, Commerzbank, Santander and Nordea each of whom recorded a growth in total assets. LBG and Commerzbank had the largest increases (155% and 35%) following the acquisitions of HBOS and Dresdner Bank respectively.

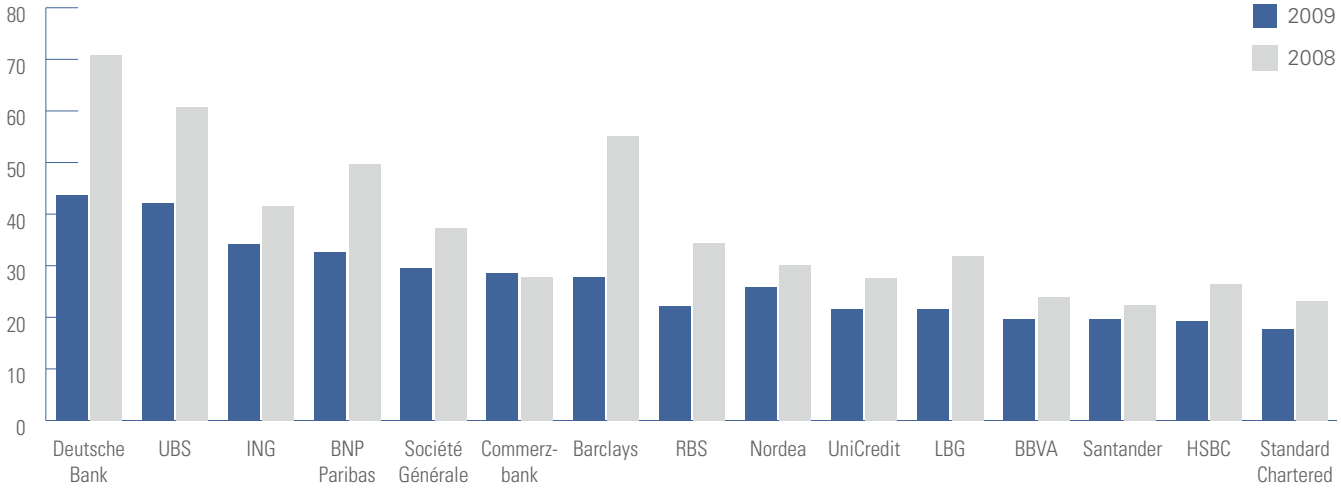
BNP Paribas experienced a very low overall total asset reduction of 1%. The acquisition of Fortis Bank in 2009 increased loans to customers and available for sale assets substantially, but these increases were offset by reduced holdings of trading book derivatives and repurchase agreements held at fair value.

Leverage

Banks are not required to disclose leverage but seven of the banks in the survey (LBG, Barclays, RBS, UBS, Deutsche Bank, ING and Commerzbank) disclosed the information voluntarily.

The definitions used varied considerably from bank to bank, illustrating the difficulty in agreeing a common calculation. For consistency, the commentary below is based on leverage calculated as total assets divided by total tier 1 capital.[1] On average, using this measure, leverage ratios fell in 2009, most notably for Deutsche Bank, UBS, RBS, BNP Paribas, Barclays and LBG, each of whom saw a reduction of over 10% in the ratio. In general the reduction in leverage reflected reduced total asset positions as well as capital raising activity for a number of banks.

Calculated leverage (Total assets / Total tier 1 capital)



Source: KPMG International, June 2010

Leverage reduced for most of the banks in 2009 as a result of capital raising activity and reduced balance sheet assets, however, much of the reduction in balance sheet assets came from falling derivative valuations and, in underlying asset terms, balance sheet risk reduction has been limited

LBG, RBS, UBS and BNP Paribas all issued additional capital in 2009 and this was a major factor in the improvement seen in the leverage ratios of these banks. The most notable was LBG which increased tier 1 capital from €15.2 billion to €52.8 billion through capital raising activity including a £13.1 billion (€14.6 billion) rights issue in December 2009. BNP Paribas's capital benefited following a €11.7 billion share issue and RBS's capital was increased through the issue of £25.5 billion (€28.3 billion) B shares to the UK government as part of state support provided to the Bank.

Barclays' and Deutsche Bank's ratios improved largely due to balance sheet reduction of over 25%, mainly due to falls in derivative assets. Both of these large investment banks saw their derivative assets on balance sheet halve in 2009 as a result of the impact of the return of more normal market conditions on derivative fair values.

[1] The appropriateness of differing leverage ratios is not discussed in this document and the method selected here is solely for simplicity. For clarity, derivative asset values per face of the balance sheet are included in this calculation.

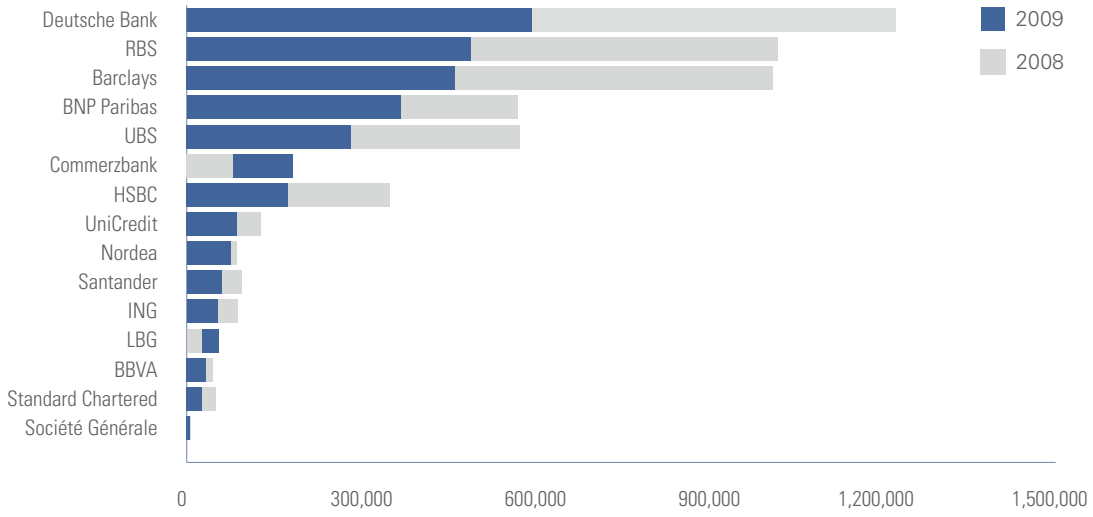
Derivative assets fell on average by 45% across the survey, but reductions in values due to market conditions, rather than reduced derivative portfolio size, was the principal driver

Derivatives

A decrease in derivative assets was the principal driver for the reduction seen in the banks' balance sheets this year. The fall in derivative balances was attributable to reduced market volatility, narrowing credit spreads, steepening yield curves and active book reductions by some banks. Under IFRS, derivatives are marked to market and are included on balance sheet at fair value. For all the banks, the movement in market values was the main factor in the fall in derivative assets seen in 2009. Nominal values have fluctuated with many of the merged banks seeing an increase and others showing relatively stable levels, indicating that derivative portfolios have not reduced significantly, other than due to market value movements.

All but two of the banks in the survey saw a significant reduction in derivative assets in 2009. LBG and Commerzbank bucked the trend, the acquisitions of HBOS and Dresdner Bank in 2009 having impacted on the LBG and Commerzbank figures respectively.

Derivative asset movement (Million €)



Source: KPMG International, June 2010

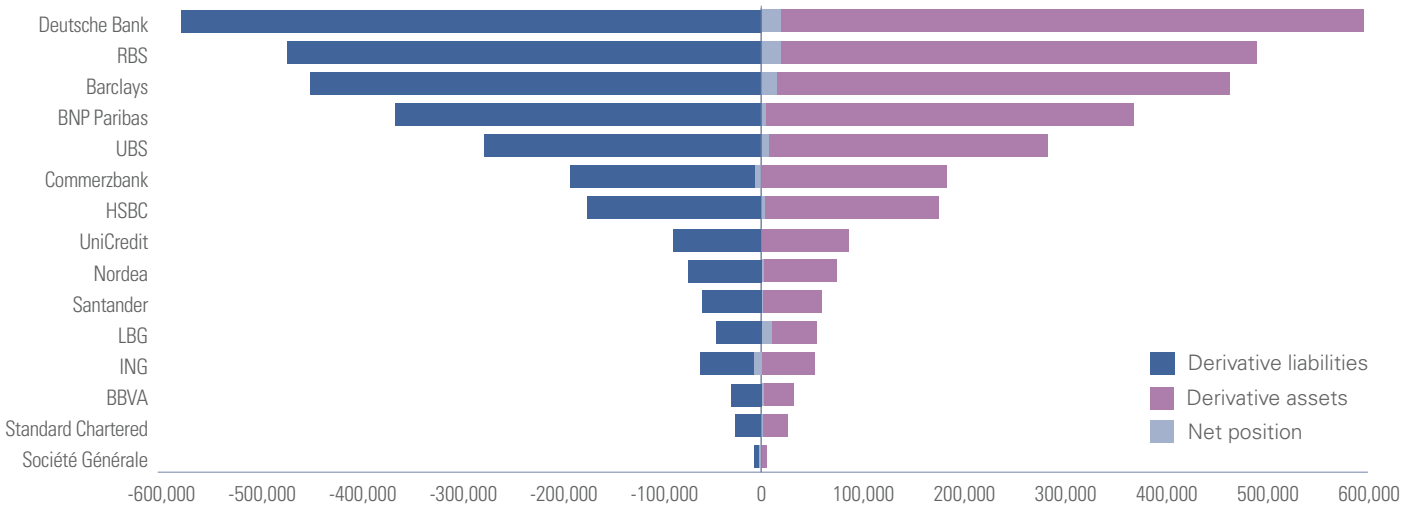
The largest derivative portfolios were held by Deutsche Bank, Barclays, RBS and BNP Paribas each of whom had derivative assets of over €300 billion at December 2009. This reflects the banks' business models and their investment banking focus. These four banks saw an average reduction of 50% in derivative asset balances compared to 2008.

There is a wide variation in the use of derivatives by the banks, largely correlating to the size of the banks' trading derivative portfolios and their investment banking operations.

In all the banks, the reduction in derivative assets was matched by a similar reduction in derivative liabilities. Derivative assets and liabilities largely offset each other with net positions being relatively small as indicated by the graph overleaf.

2008 saw unprecedented volatility in the markets which drove derivative values to record highs. With a return to more normal market conditions, reductions in 2009 were inevitable irrespective of whether banks actively managed down their portfolios. However, the magnitude of derivative values gives only a broad indication of risk exposure and it is important to consider the underlying counterparty credit risk in the banks' derivatives businesses, the impact of unfunded derivative asset positions and wrong way risk exposures.

Gross derivative position at 31 December 2009 (Million €)



Source: KPMG International, June 2010

Loans and advances increased by 8% on average, mainly due to acquisition activity. A total of €6,991 billion were held on balance sheet by the banks at 31 December 2009

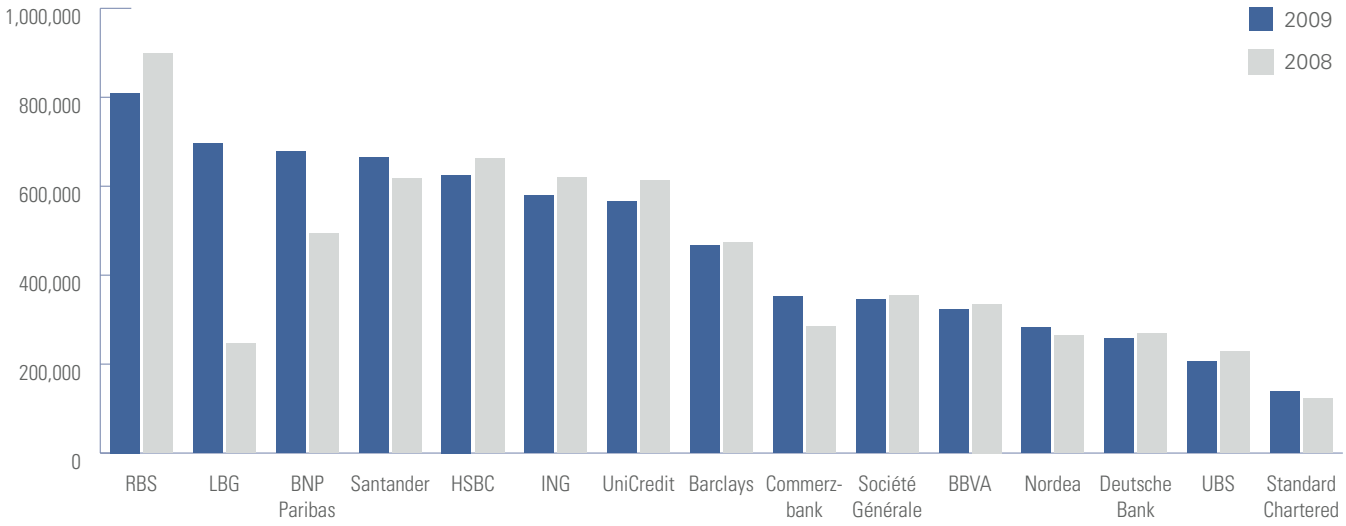
Loans and advances

Loans and advances to customers fluctuated across the banks. LBG, BNP Paribas and Commerzbank all reported increases in excess of 20%; Standard Chartered, Santander and Nordea disclosed modest increases of up to 12% whilst the remaining nine banks reported modest portfolio reductions.

At LBG, loans and advances to customers increased by 182% due to the impact of the HBOS acquisition in January 2009. LBG began implementing a long-term strategy in the second half of 2009 to reduce assets associated with non-relationship lending and investments, including business which is outside their current risk appetite.

The increase for both BNP Paribas and Commerzbank is directly attributable to the acquisition activity of the two banks during the year.

Loans and advances to customers (Million €)



Source: KPMG International, June 2010

The increase for Standard Chartered is attributed to their strategy of de-risking the balance sheet by increasing the proportion of secured advances. Standard Chartered have benefited from a diversified portfolio across emerging markets, particularly Hong Kong, Singapore, Korea and Other Asia Pacific, where market conditions have been relatively benign. At Nordea, the increase is attributable to the Bank's overall growth strategy.

The largest reduction was reported by RBS (10%) driven by the Global Banking & Markets division (€79 billion) and reductions of non-core assets (€33 billion).

Legacy and non-core assets

The financial crisis has seen the banks focus on their mainstream banking businesses and divest areas which do not fit with their risk appetite or core banking activities.

RBS, LBG and ING have all implemented significant long-term restructuring programmes in 2009. RBS comments extensively on the management of its non-core division and action to reduce balance sheet risk through divestment, asset run-off, sales and the Asset Protection Scheme. RBS is the only one of the banks to report separately on the non-core division as part of its divisional performance review.

LBG has a balance sheet reduction programme for non-relationship lending and investments including business outside the bank's current risk appetite. There is extensive comment on management of HBOS legacy assets within the annual report.

ING implemented its 'Back to Basics' programme during the year, the objective being to de-risk the balance sheet, reduce complexity of the business and sell non-core businesses. Commerzbank comment on their 'Roadmap 2012' strategy which will see a focus on customer orientated core business in the core bank. A 'Portfolio Restructuring Unit' has been set up to enable portfolios the bank no longer wants to be separately identified and managed.

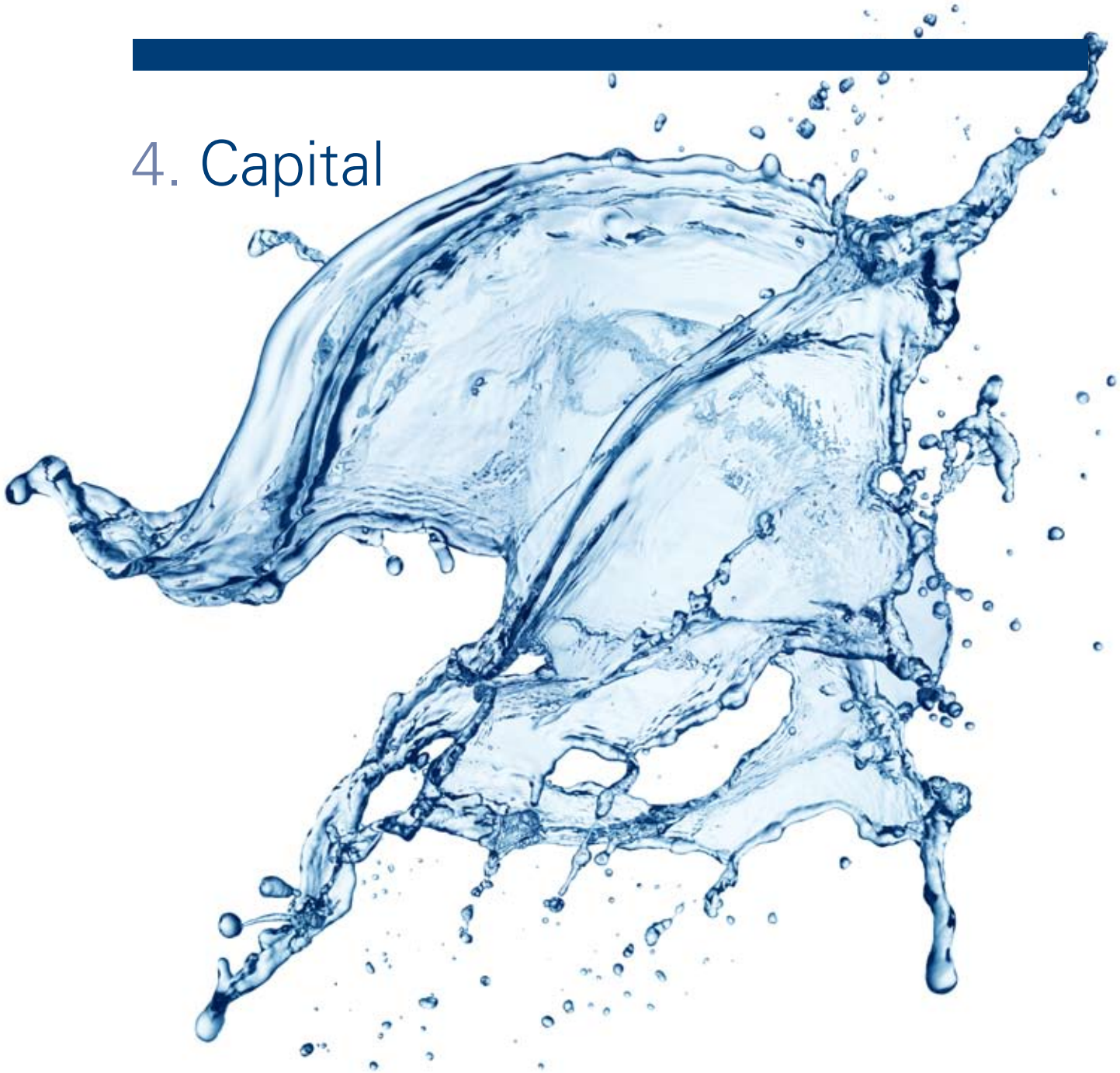
Additionally, many banks commented on sales they have implemented in 2009. For example, Barclays sold Barclays Global Investors and some other businesses and Commerzbank disclosed information regarding the sale of Dresdner Bank subsidiaries.

Summary and outlook

Deleveraging has been a key trend in 2009, arising from both asset reduction and capital raising activity. Whilst many banks' balance sheets have shrunk, much of the reduction in assets seen in the year has been derived from falls in derivative values as a result of less volatile market conditions and tightening credit spreads. Loans and advances balances have increased in total across the survey, although this is driven by acquisitions, leading to the conclusion that deleveraging has only been modest in 2009.

There continues to be governmental and economic pressure on the banks to lend and merger activity in the year has been a significant factor in maintaining balance sheet asset levels for some. However, all the banks are now shifting their focus to managing down non-core and higher risk assets. Given the number and scale of expected disposals in the near future, it is possible that there will be increased pricing pressure on asset disposals. We are likely to see further deleveraging in 2010 as the banks seek to continue to de-risk their balance sheets and focus on core activities.

4. Capital



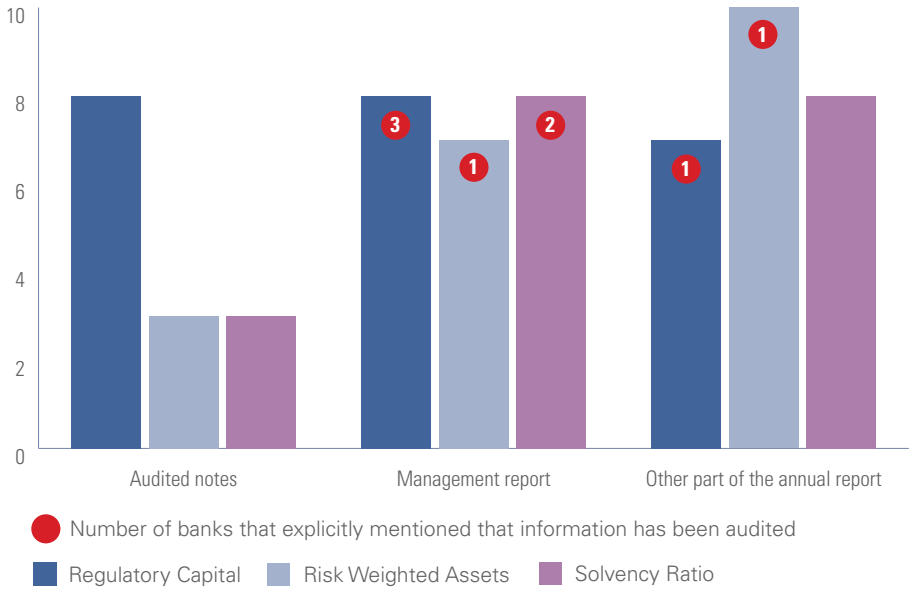
The recent market turbulence has highlighted the need for banks to hold capital to protect against sudden increases in risk, particularly relating to investment banking activities or in periods of severe stress. In anticipation of new regulatory rules, banks have increased their level of core capital in 2009 and simultaneously been more transparent about measures taken to raise capital levels.

Capital disclosure

In 2009, information related to capital management policy was disclosed by all banks. Nine banks (Barclays, BNP Paribas, RBS, Commerzbank, Société Générale, Deutsche Bank, HSBC, ING, UBS) compared to seven in 2008, disclosed information including their objectives (e.g. capital ratio target for HSBC, Deutsche Bank, RBS and Commerzbank), strategy and allocation process for regulatory capital. For example, Barclays aims at "optimising return on economic and regulatory capital through the planning process", whereas Deutsche Bank indicated that their tier 1 target was a minimum of 10% since October 2008 and Commerzbank disclosed a core tier 1 target of 7% to 9%. HSBC indicated a tier 1 target ratio of 7.5% to 10% in 2009 compared to 7.5% to 9% in 2008 following their rights issue.

All banks presented regulatory capital disclosures in the annual report as required by IAS 1. It should be noted that there is no requirement to audit risk weighted assets in most jurisdictions. The CEBS (Committee of European Banking Supervisors) issued a paper in April 2009 recommending clarity on whether information presented was audited or unaudited. Across the 15 banks in our survey, capital disclosures were located within various sections of the annual report as illustrated in the graph below.

Location of capital disclosure information (Number of banks)



Source: KPMG International, June 2010

Regulatory versus accounting capital

In 2009, as in 2008, many banks presented regulatory capital as part of the IAS 1 disclosure requirements, resulting in more emphasis on regulatory capital as 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, certain adjustments are made to accounting capital. It is increased through the addition of:

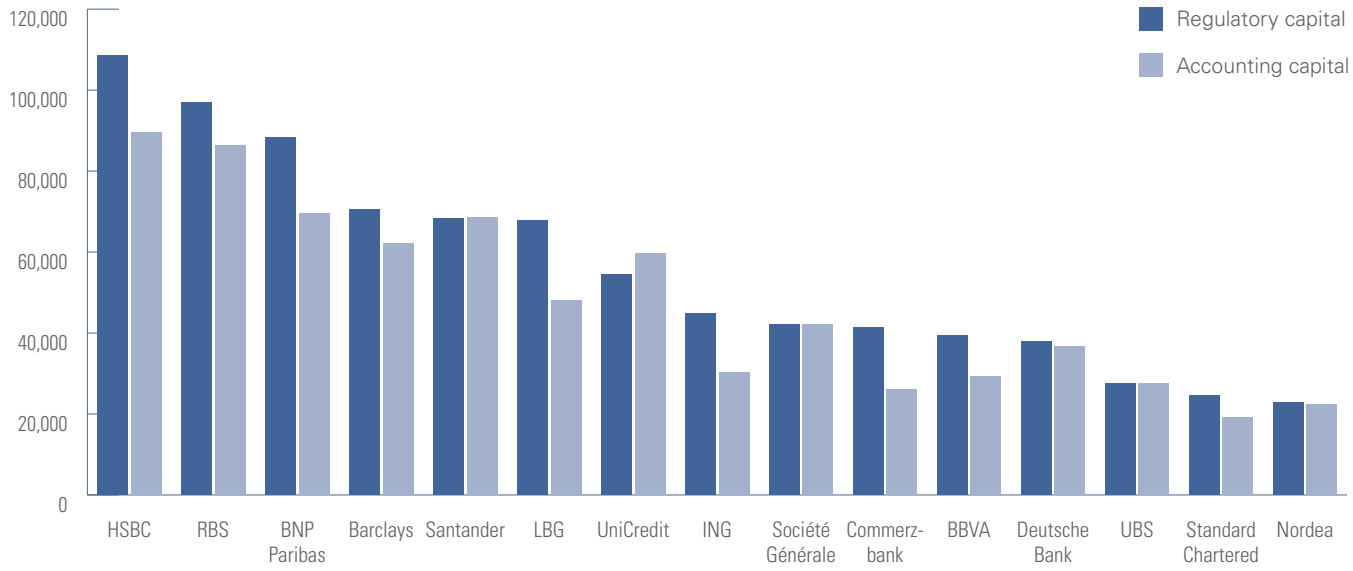
- Innovative tier 1 capital
- Preferred shares and preferred securities or subordinated debt
- The revaluation of property

The most significant deductions are:

- Goodwill and other intangible assets
- Prudential filters (including adjustments to unrealised gains on available for sale securities)
- Unconsolidated investments in insurance companies

The following graph compares 2009 Basel II regulatory capital to 2009 accounting capital.

Total regulatory capital versus accounting capital (Million €)



Source: KPMG International, June 2010

For most of the banks regulatory capital was greater than accounting capital mainly due to subordinated debt instruments included in tier 1 and tier 2 capital.

There were significant movements in capital between 2008 and 2009. These movements are largely due to capital raising activity during the year.

Ten banks (BNP Paribas, Commerzbank, Deutsche Bank, HSBC, ING, Nordea, Société Générale, Standard Chartered, UBS, UniCredit) provided a reconciliation between accounting and regulatory capital, compared to seven in 2008.

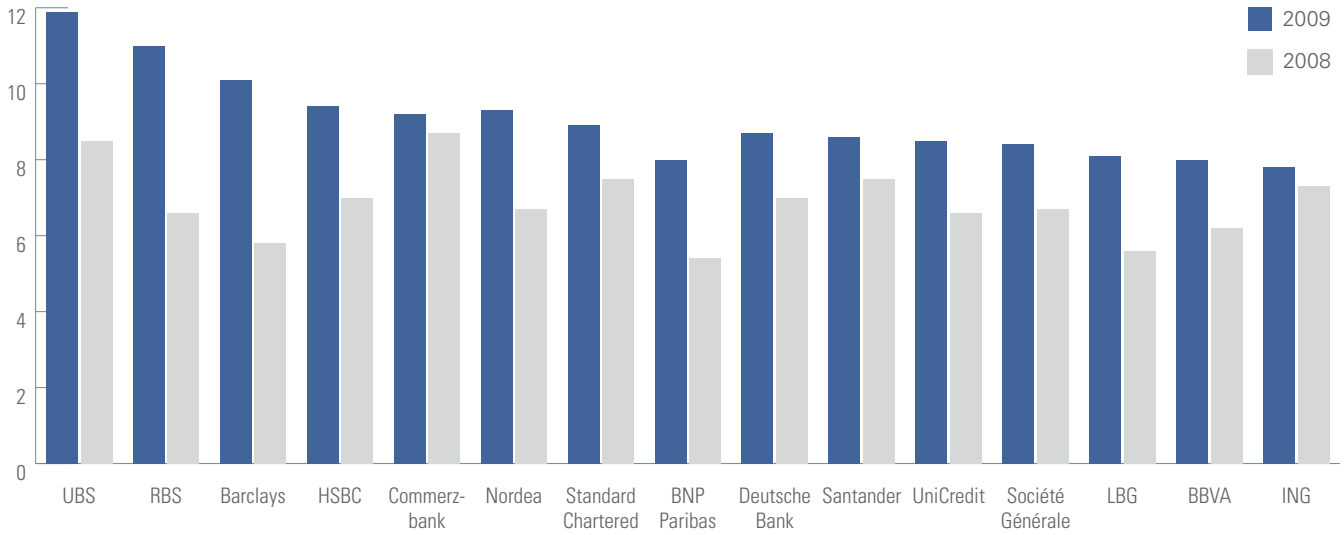
Solvency

Core tier 1 capital ratio increased by 32% from 6.9% to 9.1% on average during the year

Core tier 1 capital

Most of the banks (with the exception of UBS and Commerzbank for which core tier 1 ratio can be deduced from data published in the accounts) calculated and voluntarily disclosed their core tier 1 ratio which as yet does not have a common definition across all jurisdictions. Being the best quality capital, core tier 1 and associated ratios often get the most attention from analysts. Core tier 1 commonly consists of ordinary shares and retained earnings.

Core tier 1 ratio evolution 2008-2009 (Percent)



Note: The core tier 1 ratio has been calculated for UBS and Commerzbank (tier 1 capital minus hybrid capital divided by risk weighted assets).

Source: KPMG International, June 2010

Solvency ratio 2009 as disclosed by banks

UBS	19.8%	Deutsche Bank	13.9%
RBS	16.1%	Santander	14.2%
Barclays	16.6%	UniCredit	12.7%
HSBC	13.7%	Société Générale	13.0%
Commerzbank	14.8%	LBG	12.4%
Nordea	11.9%	BBVA	13.6%
Standard Chartered	16.5%	ING	13.5%
BNP Paribas	14.2%		

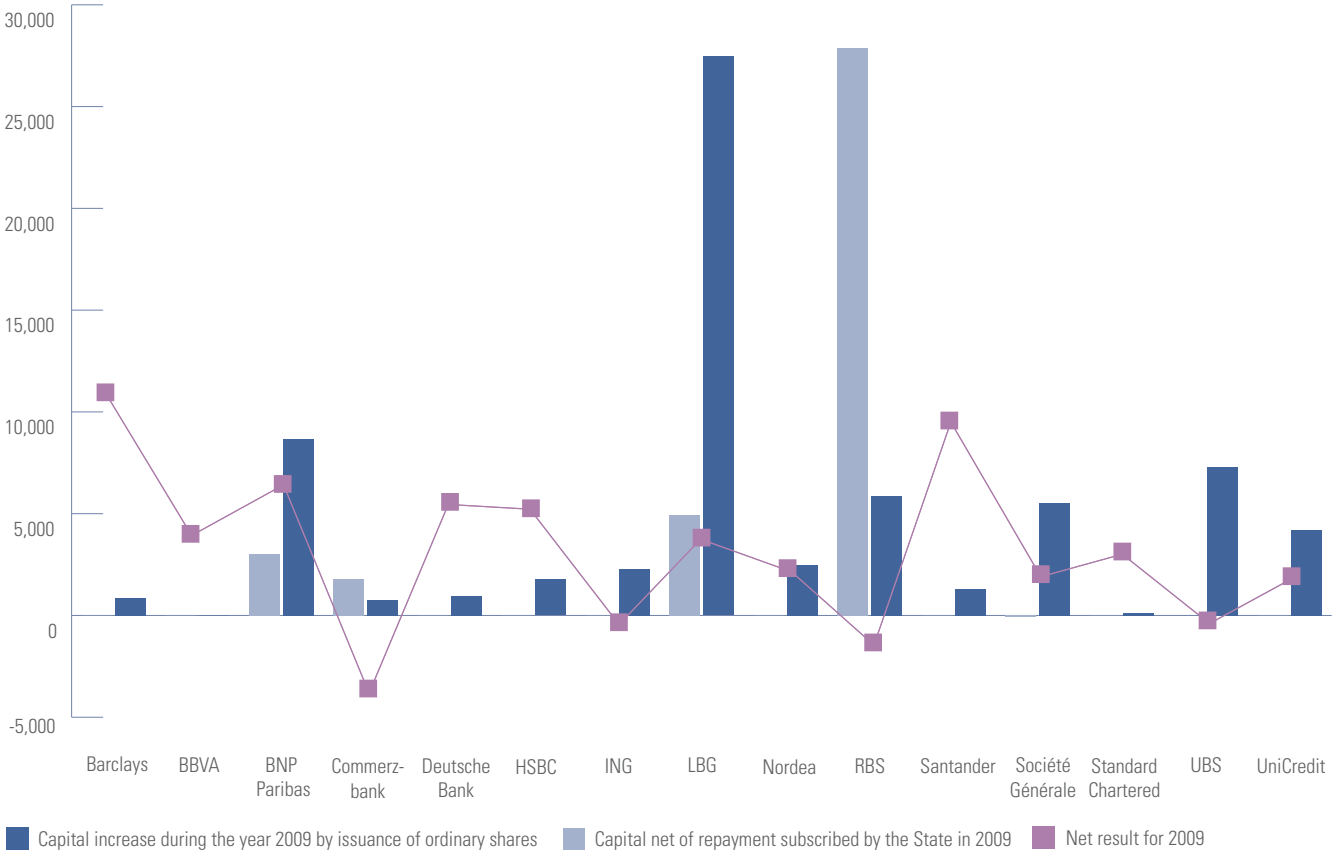
Note: The solvency ratios disclosed by banks cannot be compared due to differences in the definitions applied.

Source: KPMG International, June 2010

All the banks included in the survey have significantly increased their core tier 1 ratio. In 2009 all the banks had a core tier 1 ratio of at least 8% compared to only two banks in 2008.

The following graph illustrates the source of capital increases in 2009 for each of the banks.

Summary of capital increases in 2009 including state support and net result for the year (Million €)



Note: The RBS ordinary share issuance was fully underwritten by the UK Government.

Source: KPMG International, June 2010

Most banks raised capital through share issues in 2009 with five banks issuing new capital via direct government support

All banks disclosed the Basel II capital adequacy ratio, ranging from 11.9% to 19.8% for total capital, tier 1 capital ratios ranged from 9.4% to 15.4% and core tier 1 capital ratios from 7.8% to 11.9%

Most banks raised capital in 2009 through issuance of ordinary shares. Five banks (BNP Paribas, Société Générale, Commerzbank, LBG, RBS) received direct state support in 2009, Société Générale repaying the amount before the year end.

RBS significantly strengthened its capital position through the B shares issued as part of the UK Government's Asset Protection Scheme. RBS also entered into a contingent capital agreement with the UK government that permits conversion of B shares into ordinary shares at the option of the holder and under certain conditions. The UK government held 70.3% of the ordinary shares of the bank at 31 December 2009.

LBG had a 43% government shareholding at 31 December 2009.

Société Générale issued preferred shares for €1.7 billion to the SPPE as part of the French economic support plan in 2009. These shares were bought back and cancelled before the year end.

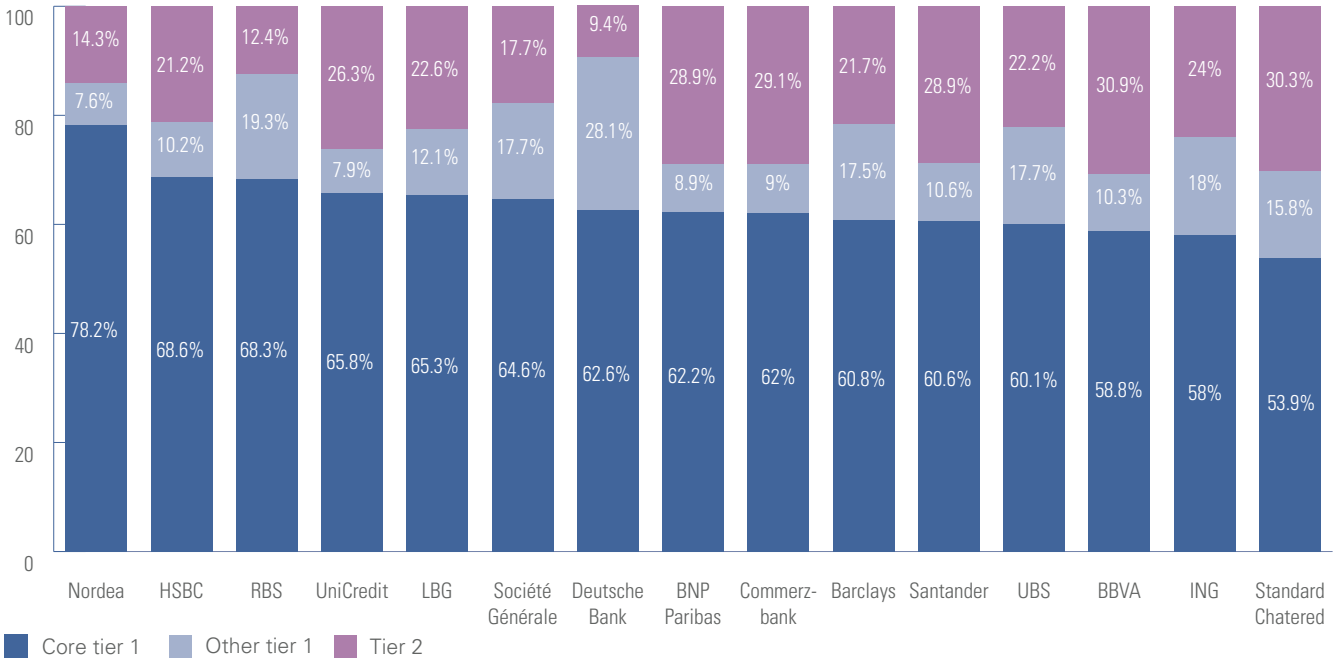
Similarly, BNP Paribas issued €5.1 billion of non-voting preferred shares to the SPPE which were redeemed at the year end with the proceeds of a rights issue. Following the merger of Fortis group, the Société Fedérale de Particitations et d'Investissement (SFPI) acting on behalf of the Belgian government owns 10.8% of BNP Paribas.

All banks disclosed the Basel II capital adequacy ratio, ranging from 11.9% to 19.8% for total capital. Tier 1 capital ratios ranged from 9.4% to 15.4% and core tier 1 capital ratios from 7.8% to 11.9%.

Total regulatory capital

The following graph shows the relative weight in total solvency ratio of core tier 1, other tier 1 and tier 2 capital in 2009.

Capital adequacy ratio structure (Percent)



Source: KPMG International, June 2010

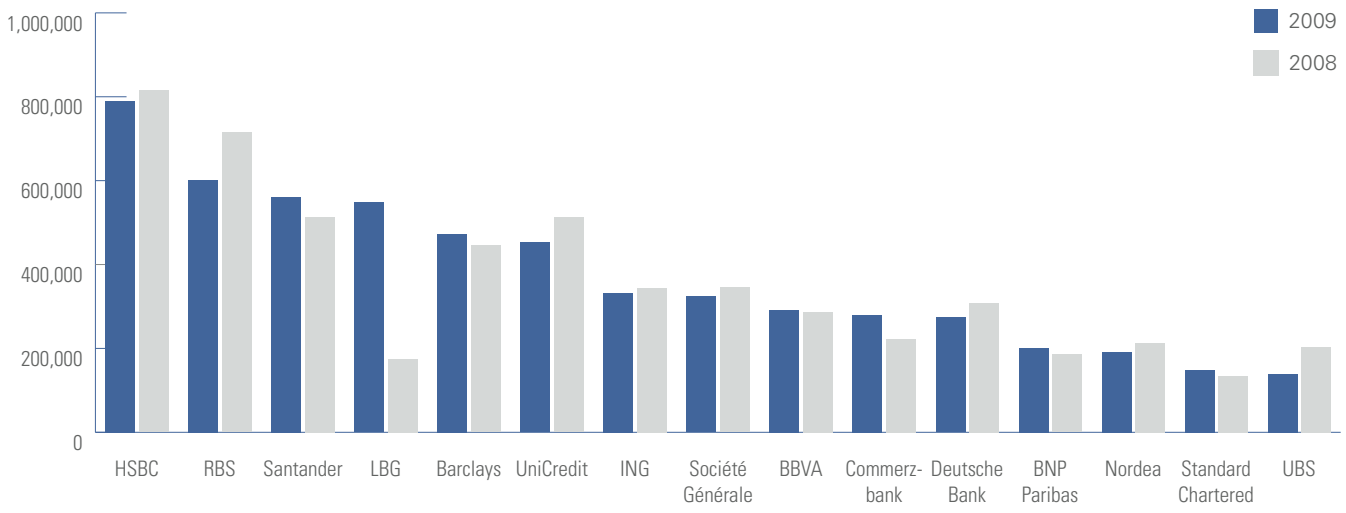
All the banks favoured increasing the core tier 1 ratio in 2009 compared to 2008 with a relative weight of more than 60% of core tier 1 capital in total regulatory capital for twelve of the banks (2008: two banks).

Most of the banks referred to the Basel II Pillar 2 requirements in their annual reports. The information provided varied significantly. For example, Commerzbank gave information on their ICAAP (Internal Capital Adequacy Assessment Process) and in particular on the management of unquantifiable risks.

Risk weighted assets

Seven banks (HSBC, ING, Société Générale, Deutsche Bank, Nordea, UBS and UniCredit) reported a slight reduction of risk weighted assets. This reduction is mainly the result of the fall in lending to customers during the year. The eight other banks reported an increase of risk weighted assets driven by a significant increase of credit risk due to the impact of deteriorating economic conditions on credit quality or acquired portfolios. Commerzbank's risk weighted assets increased by more than 26% due to a significant increase in balance sheet size (35%) following the acquisition of Dresdner Bank.

Risk weighted assets (Million €)



Source: KPMG International, June 2010

Summary

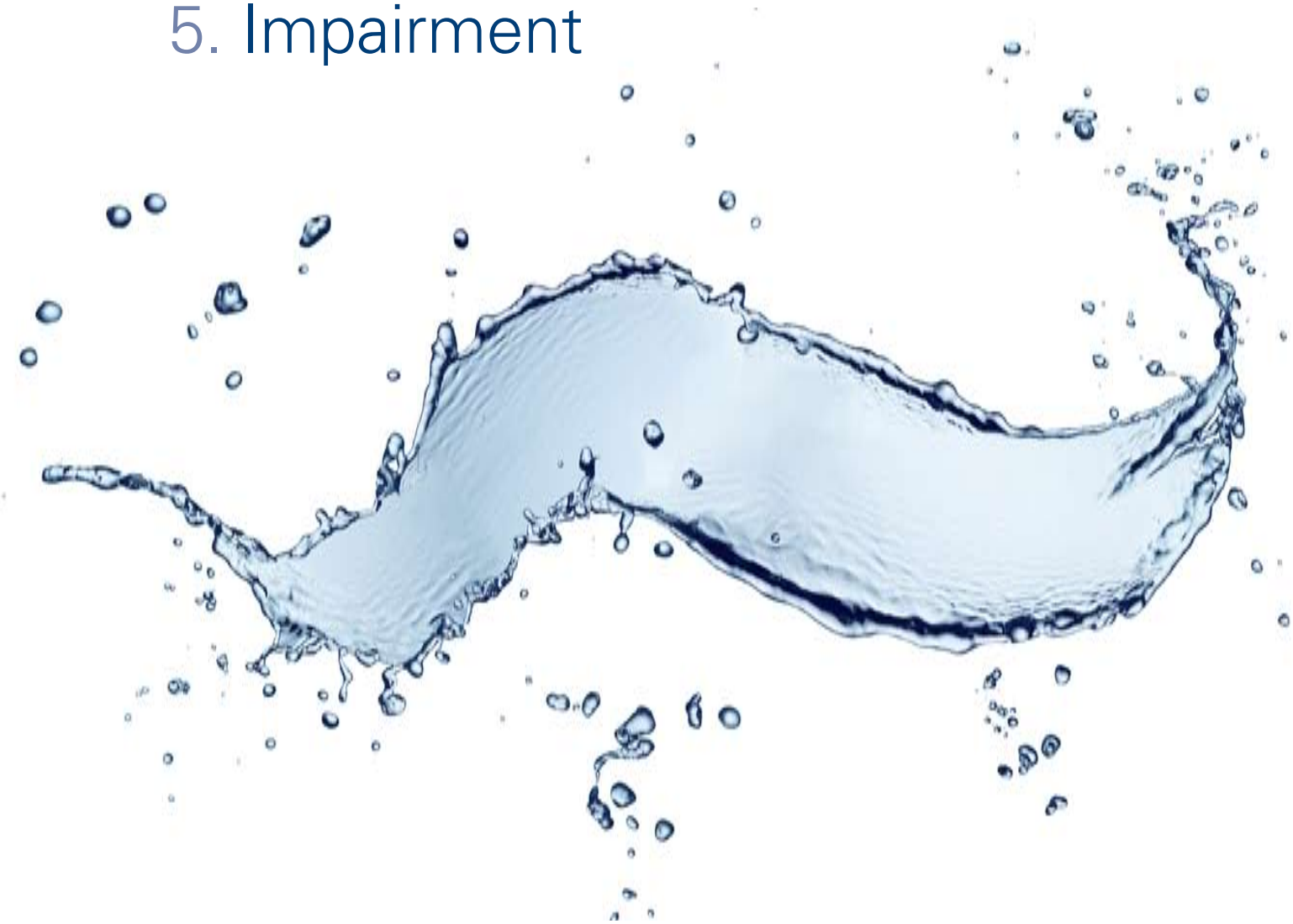
All banks have tended to report on capital more extensively this year as capital initiatives have been launched. It continues to be an area of focus, especially in 2009 when banks sought to improve their core tier 1 capital ratios in anticipation of the greater importance given by Basel III to core capital and in response to regulatory and investor concerns.

Information presented on capital management was disclosed by all the banks within the annual report but with different levels of detail. Although all the banks disclosed capital information this information did not always form part of the audited financial statements.

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 published Pillar 3 information outside of the annual report.

As the resilience of the banking sector depends on a strengthening of the regulatory capital framework, we expect the reinforcement of the quality of core capital to continue in the coming years. In addition, as future rule changes become clearer, we can expect an increase in the issuance of new types of loss absorbing capital (such as the contingent capital issued by LBG). Improvements in market credit conditions and the ongoing processes of deleveraging and de-risking should help to reduce risk weighted assets, but this is likely to be tempered by increasing requirements to hold capital as new regulatory requirements become applicable in the near future.

5. Impairment



High impairment has continued to be a feature in 2009 with many banks reporting an increase in impairment charges. However, many of the banks also comment they believe impairment charges have now peaked and should therefore see a reduction from 2010.

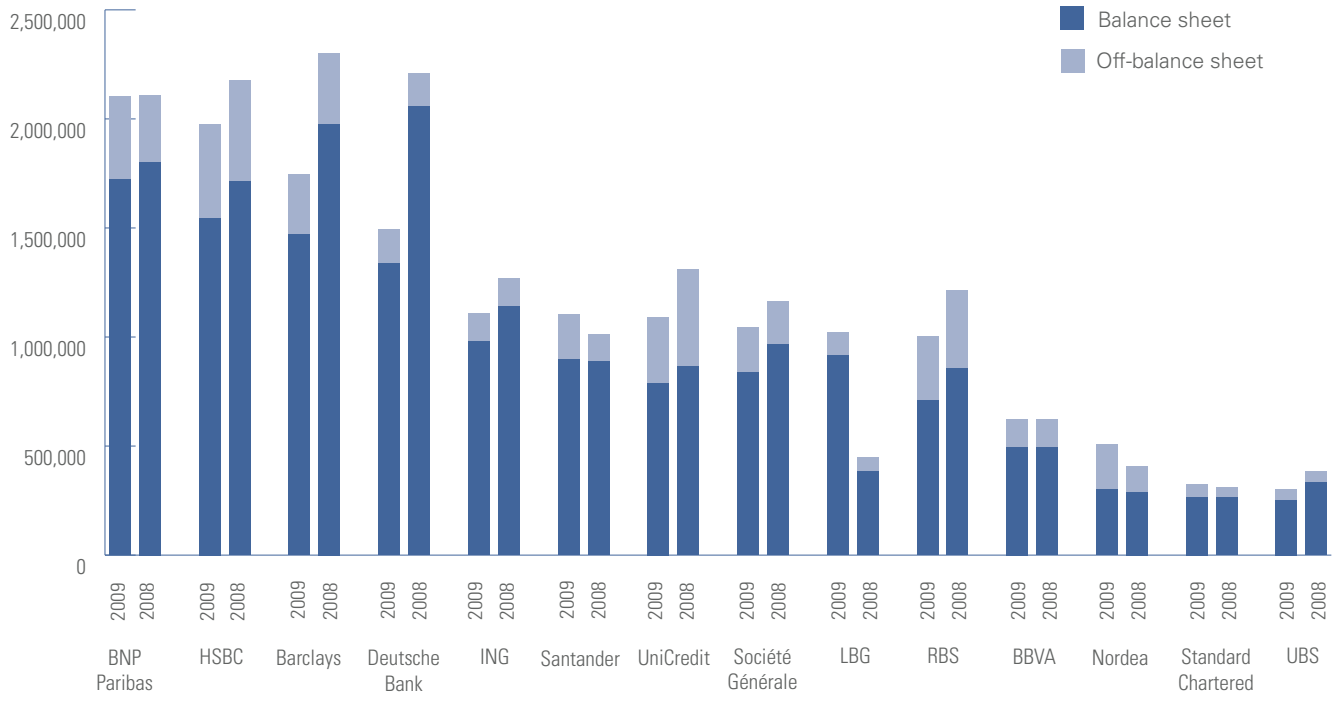
In light of the financial crisis a continued increase in impairment was observed in 2009. Deterioration in payment patterns and default rates resulted in increasing loan impairment allowances or write-offs. Banks (such as RBS, LBG, Société Générale, Commerzbank) have commented extensively in 2009 on troubled asset portfolios and non-core businesses that they no longer wish to retain.

Maximum credit risk exposure

All the banks disclosed information about their maximum credit risk exposure, including off-balance sheet items and their contribution to credit risk as required under IFRS 7. The maximum exposure to credit risk relates mainly 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. The collateral held to reduce the exposures is generally not taken into account in the disclosed maximum credit risk exposure.

The maximum credit risk exposure generally decreased slightly compared to 2008. For example, Deutsche Bank indicates that the reduction of credit risk exposures were primarily in OTC derivatives (mainly in Western Europe and North America) and loans. Those reductions were mainly related to a reduction in loans granted in certain regions while the derivative decrease was driven largely by a reduction of derivative activities, rising interest rate curves as well as tightening credit spreads during 2009. Similarly the decrease of the credit risk exposure of Barclays resulted mainly from the reduction by more than 50% of derivative assets and by a decline in loans to customers.

Maximum credit risk exposure (Million €)



Note: Data not clearly disclosed between balance sheet and off-balance sheet exposure for Commerzbank.

Source: KPMG International, June 2010

Additional information provided on the maximum credit risk exposure predominantly focused on off-balance sheet items. Contribution of off-balance sheet items to the maximum credit risk exposure varied significantly from one bank to another ranging from 40.9% (Nordea) to 10.5% (Deutsche Bank).

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

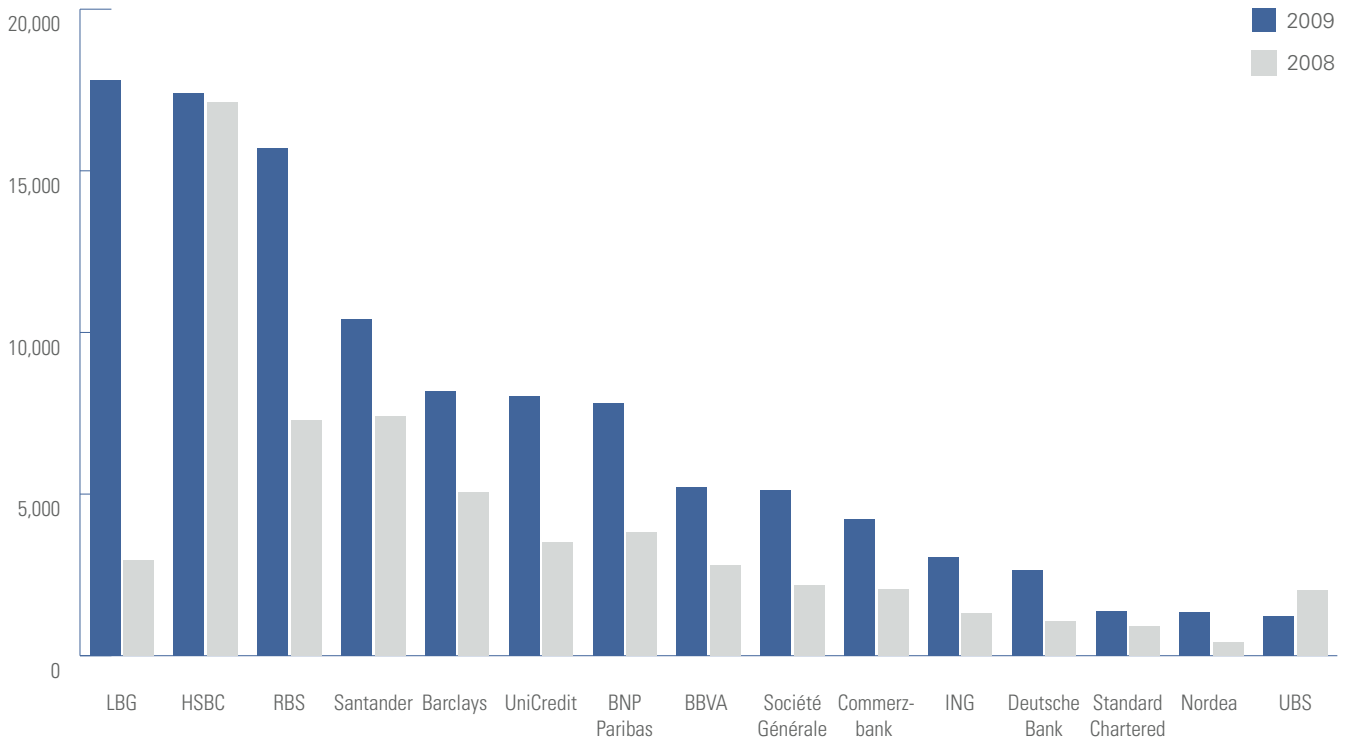
Impairment

Impairment charge

Impairment charges rose by 83% on average across the survey with the total charge being €110 billion

The impairment charge for the year, which comprises the net impairment allowance (after releases) for credit risk on loans to customers and banks, increased for most banks in 2009. The largest increase in impairment charge was recorded by LBG. In presentation currency terms, the charge more than doubled for UniCredit, BNP Paribas, Société Générale, Commerzbank, Deutsche Bank, ING and Nordea compared to 2008. Only UBS recorded a reduction of the impairment charge compared to 2008 (in the fourth quarter of 2008 UBS recorded high impairment charges on reclassified instruments of which the majority related to leveraged finance commitments).

Impairment charge (Million €)



Source: KPMG International, June 2010

The significant rise in impairment for LBG is principally due to the impact of HBOS portfolios acquired on merger, mainly comprising of commercial real estate exposures. Management of this legacy book has been a major feature of 2009 for LBG. The resulting decrease in quality of the LBG book in 2009 is reflected in the increased ratio of impairment to maximum exposure (see impairment rate section on page 31).

RBS has transferred some assets such as trading assets (including credit derivatives and asset-backed security exposures) and certain retail and commercial businesses to a non-core division. This division will manage separately the assets the Group intends to run-off or to sell. The principal reason for the increase in RBS's impairment level in 2009 relates to non-core businesses; in particular across the corporate and property sectors.

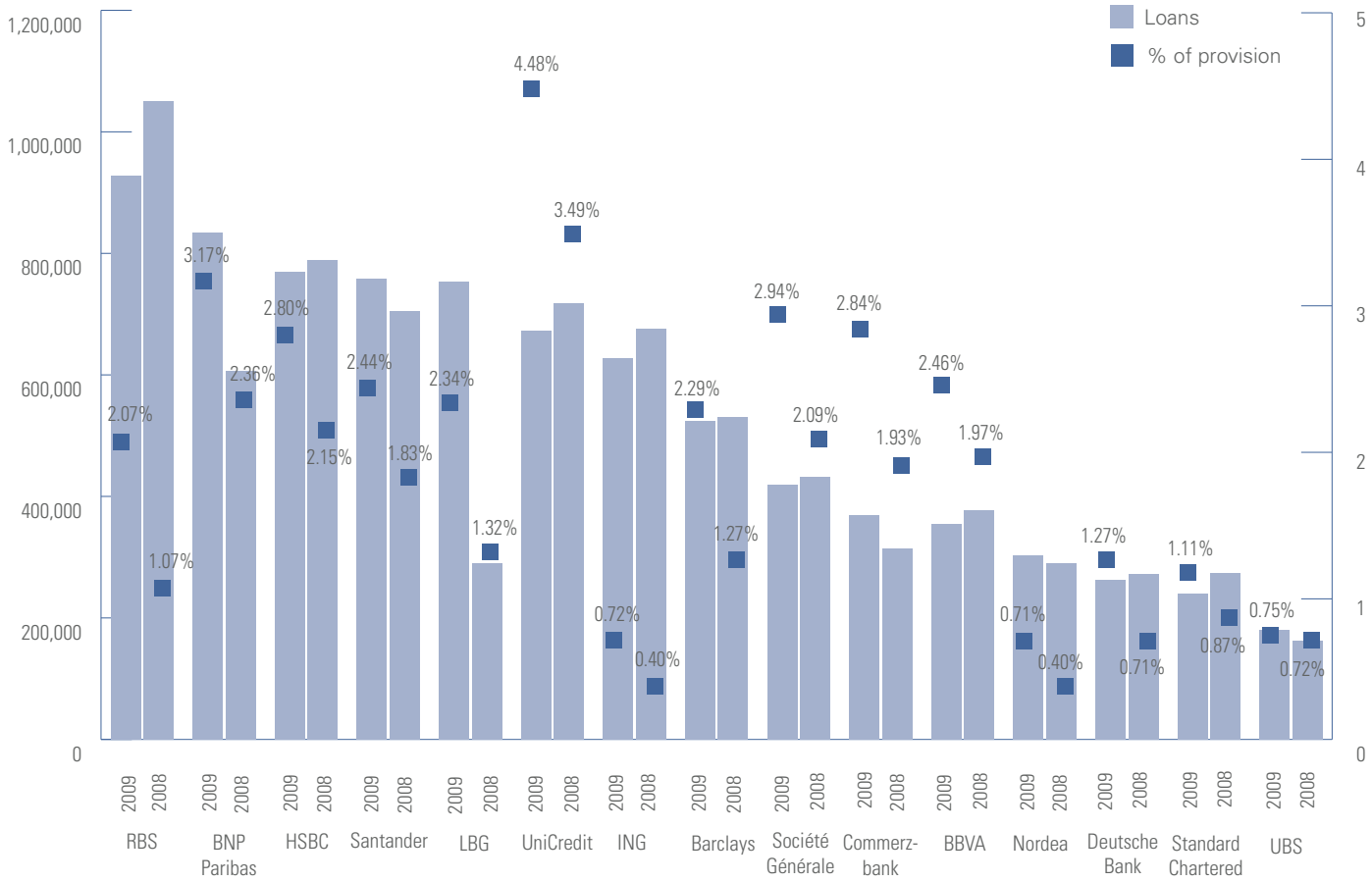
For Société Générale, a significant part of the increase of the impairment charge resulted from the deterioration of the quality of corporate and investment banking legacy assets (i.e. assets that became illiquid during the crisis such as CDOs, RMBS, CMBS). Those assets have been isolated in a specific structure separate from the core business in order to optimise exit strategies. Additionally the rise in delinquency rates on French and International retail loan counterparties contributed to the increase in the impairment charge. BNP Paribas recorded higher impairment charges in 2009 due to an increase in risk in the global retail banking sector.

The 'cutback' portfolio of Commerzbank which consists of troubled assets as well as exposures that no longer fit the business model of the bank was particularly affected by the increase of credit risk impairment. For Deutsche Bank, the increase in impairment mainly related to exposures in leveraged finance that have been reclassified in accordance with IAS 39 into the loans category. Additional provisions were the result of the deteriorating credit environment, predominantly in Europe and the Americas.

Impairment rate

As in 2008, the impairment rates differ between the banks, ranging from 0.71% (Nordea) to 4.48% (UniCredit). On the whole, the impairment rates observed in the sample have increased.

Impairment rate (Million € / Percent)

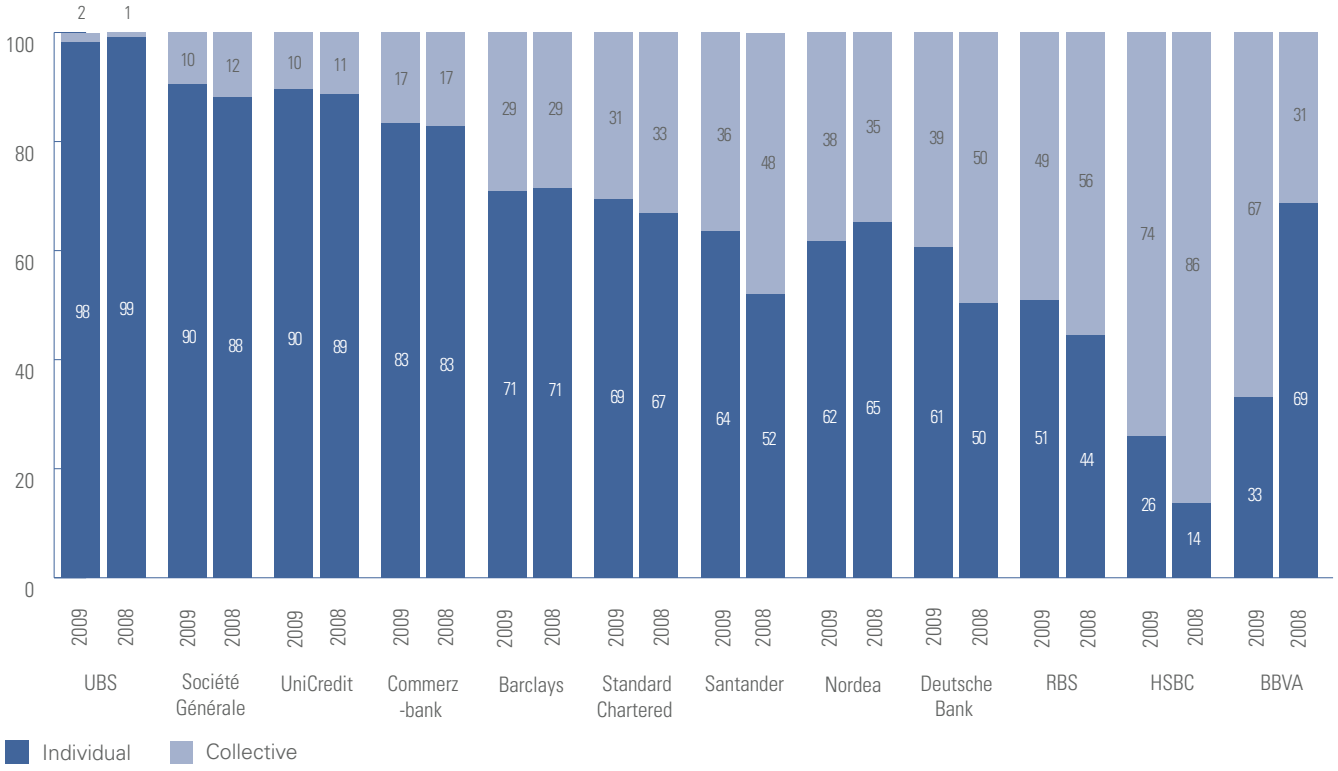


Source: KPMG International, June 2010

Individual versus collective assessment

As in 2008, there was significant divergence in practice for how the banks disclose loan impairment allowances on an individual or a collective basis. However there was little change compared to 2008, with the exception of HSBC and BBVA, in respect of the split between collective and individual impairment provisions. Collective allowance as a percentage of total allowances ranged from 1.8% (UBS) to 67% (BBVA). Not all the banks provided a clear breakdown between the amount of collective and individual impairment and these have therefore been excluded from the graph below.

Individual versus collective assessment (Percent)



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

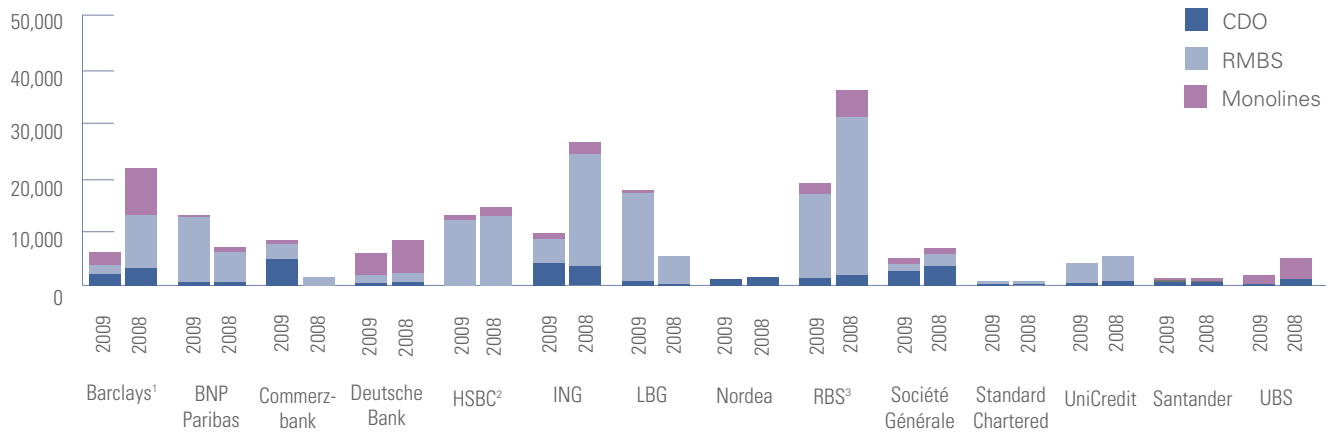
Source: KPMG International, June 2010

Only HSBC reported a significant increase regarding the proportion of individual impairment versus collective impairment (+12 percentage points). The increase of BBVA collective impairment (+36 percentage points) was notably related to the application of revised metrics to calculate the internal expected loss models for retail banking businesses as required by the Spanish banking regulator.

Mortgage-backed, CDO and monoline exposures

As in 2008, certain banks opted to disclose more quantitative and qualitative information on their exposures affected by the financial crisis (e.g. collateralised debt obligations, monoline insurers' exposures, residential mortgage-backed securities) in accordance with recommendations of supervisory bodies such as the Financial Stability Board (FSB). In 2009, most banks reduced their net exposure compared to 2008. This decrease is explained by either an overall decrease of banks' exposures or an increase of write-downs or a combination of both.

CDO / RMBS / Monolines net exposures (Million €)



Note: Data not available for BBVA.

Source: KPMG International, June 2010

1. On 16 September 2009 Barclays sold assets of €8,284 million, including €5,653 million in credit market assets, to Protium Finance LP, a newly established fund. As part of the transaction, Barclays extended a €8,523 million loan to the fund.

2. CDO exposures are not disclosed separately for HSBC. US Government agency and sponsored enterprises mortgage-related assets of €11,191 million (2008: €16,958 million) have been excluded from the graph.

3. €10,416 million of RBS RMBS exposures are disclosed as prime. €48,403 million (2008: €42,209 million) of RBS RMBS exposures are government or quasi-government backed by the US, Dutch and Spanish governments and have been excluded from the graph.

For the twelve banks which disclosed their net CDO exposure in both 2008 and 2009, an overall decrease of CDO exposures of 17% was observed.

Twelve banks disclosed their net exposure to RMBS in 2008 and 2009. On average, the overall net exposure decreased by 34%. This decrease is driven by fair value mark downs and portfolio sales of RMBS which was particularly the case for Barclays.

Eleven banks disclosed their net exposure to monolines in 2009 compared to nine in 2008. On average, the significant decrease of the net exposure levels (of 54%) was driven by the reduction of exposures through commuting trades (in the case of UBS) and a decrease in fair value of exposures. The increase of credit valuation adjustments to reflect the impact of counterparty risk tended to significantly reduce fair value amounts.

Outlook

The impairment rates and impairment charges increased for most banks in 2009 due to deteriorated economic conditions. Some banks such as RBS, LBG, HSBC and Commerzbank commented that they believe they may have seen the peak of impairments in 2009 with the expectation of reductions in the coming year.

More banks have disclosed information on the split of their business between core and non-core. Run-off portfolios (as identified by LBG, RBS, Société Générale, Commerzbank and ING) that have been isolated from core businesses have been significantly impaired. These banks plan to manage these types of assets separately from their main businesses.

Impairment is currently high on the agenda of standard setters and included in the project to replace IAS 39 with IFRS 9. In November 2009, the International Accounting Standards Board (IASB) issued an exposure draft related to the impairment of financial assets. This paper proposes a new expected loss model capturing expected losses due to inherent credit risks that have not yet been recognised to replace the current 'incurred loss' model. The effect of this new impairment methodology on the income statement is difficult to assess as the approach is still being discussed. Overall, the standard setter is attempting to address criticism that the financial statements reflected impairments that were too little, too late. It seems certain that a new model for impairment will result in an increase of impairment provisions during good times rather than waiting for default or trigger events before providing.

6. Investment banking

With the return of liquidity into many markets, investment banking performance has been one of the largest drivers of profit growth across Europe.

Overall profitability of the banks improved in 2009, the key driver being the marked recovery in investment banking returns

Overall group performance

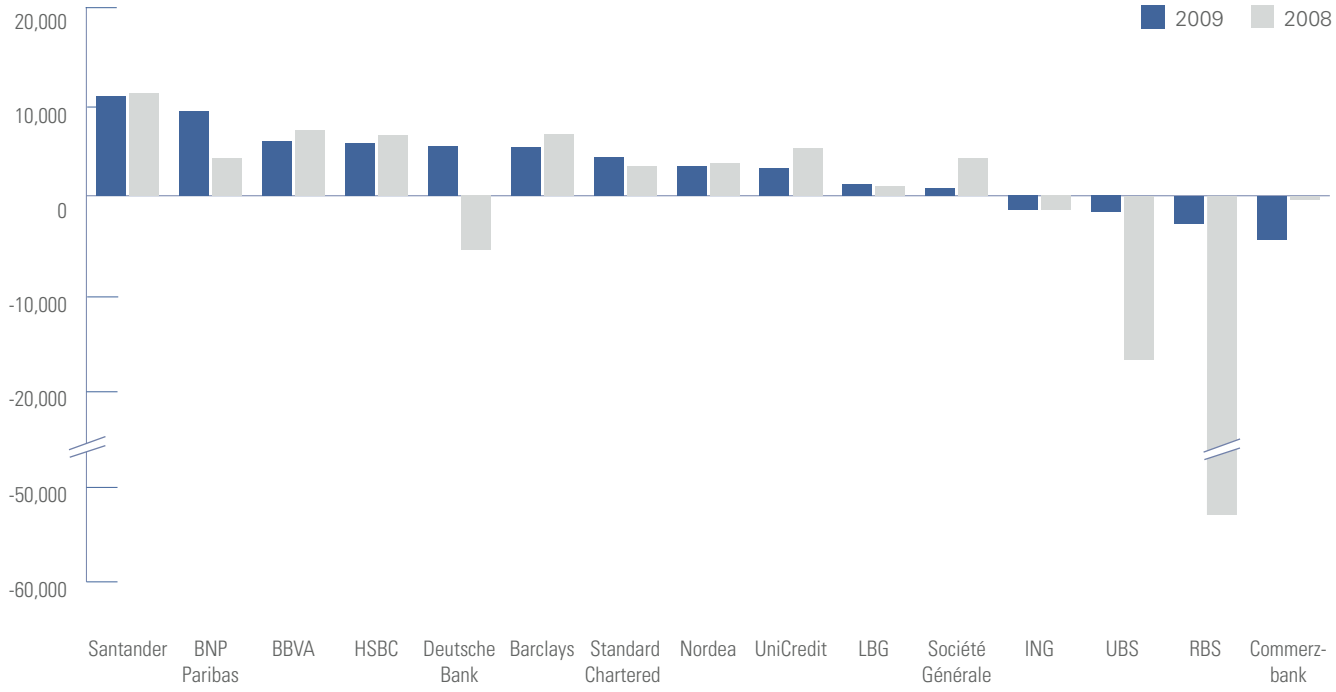
The key drivers of profits and improved performance for the year were the marked recovery in investment banking returns offset by a continued increase in impairment provisions. Although most of the banks made profits in 2009, a number recorded significant exceptional items and one-off adjustments which had a negative impact on performance as compared to the previous year. These items include negative fair value movements on the revaluation of own debt and increases in goodwill impairment.

Santander reported the highest profit before tax for 2009, attributing this performance to their management model, strict control of risk and investment banking activity within their wholesale banking division.

Significant one-off goodwill impairment adversely affected RBS's 2008 results, but the bank recorded significantly improved results in 2009 due to performance in its Global Banking & Markets division.

Commerzbank attributes the costs incurred during the integration of Dresdner Bank and ongoing difficult market conditions as key drivers behind the loss reported in 2009.

Overall group performance - Profit before tax (Million €)



Source: KPMG International, June 2010

Investment banking

Defining investment banking

Investment banking activities are defined differently by the banks, complicating attempts at direct comparisons between the businesses. Furthermore, the respective investment banking activities of each bank will differ in terms of mix of revenues (i.e. client flow versus proprietary position taking) and geographical spread. In Appendix 1 to this chapter we have set out which divisions of each bank comprise investment banking.

Investment banks reported record levels of revenue in 2009 as market conditions improved, total investment banking revenue after write downs reached €95 billion in 2009 compared to €25 billion in 2008

2009 performance

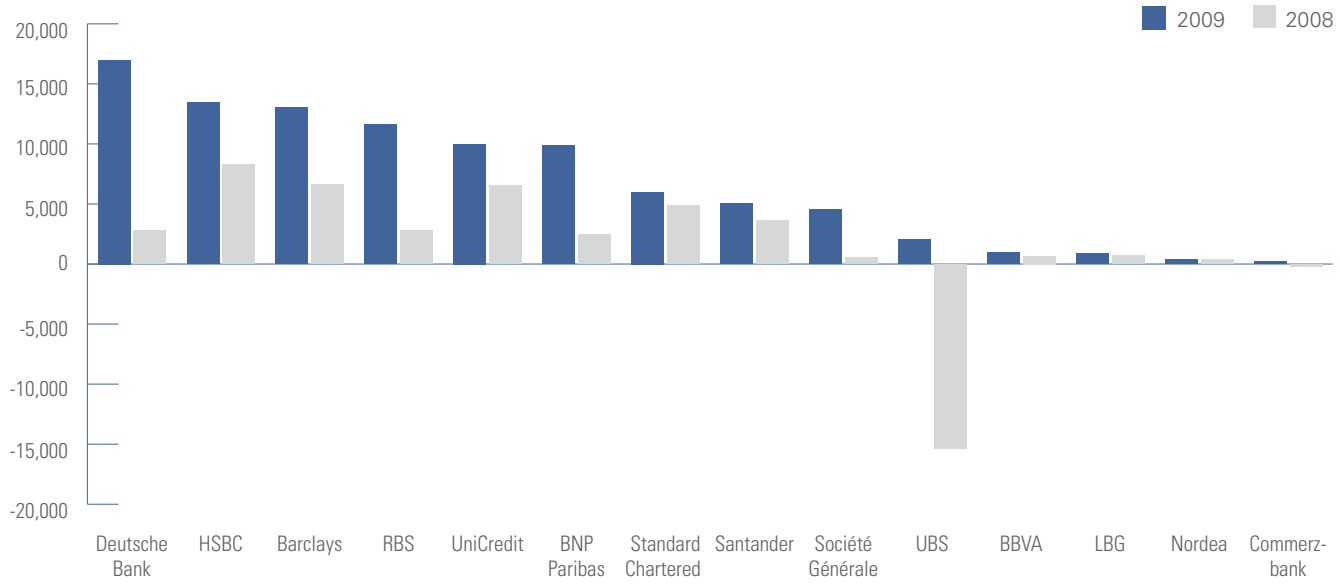
2009 has seen a significant upward trend and rebound in the fortunes of banks with investment banking operations.

The surge in revenue performance can be linked with common strategies shared amongst the banks:

- A focus on client transaction volume as opposed to proprietary trading – increasing hedging activity in an attempt to avoid the volatility caused by the collapse of Lehman Brothers
- Management of legacy positions – deleveraging and managing down legacy portfolios of credit market related assets – with many banks having attributed improved investment banking performance as a result of lower credit-related writedowns

The graph overleaf shows year on year investment banking revenue after writedowns for each of the banks.

Revenue after writedowns (Million €)



Note: No investment banking segment disclosed for ING.

Source: KPMG International, June 2010

The banks with the largest investment banking operations are Deutsche Bank, HSBC, Barclays, RBS, BNP Paribas and UBS.

Deutsche Bank reported the highest level of net revenue at €17.0 billion. The key contributory factors were significantly lower mark-downs on credit-related exposures in 2009, and the non-recurrence of losses in credit trading, equity derivatives and equity proprietary trading incurred in 2008.

HSBC reported an increase in revenues from €8.3 billion in 2008 to €13.4 billion in 2009 driven by increased revenues in the Rates and Balance Sheet Management division and as a result of higher net interest margins together with lower credit market-related writedowns in the credit trading business.

Barclays reported record performance with revenues increasing to €13.1 billion in 2009 from €6.6 billion in 2008. This performance is mainly attributable to the expansion of the trading business combined with origination and advisory activities, lower credit market related write-downs, and the Lehman Brothers acquisition.

RBS revenues increased by €8.9 billion as a result of strong performance from the Rates and Equities businesses. RBS also experienced lower credit market-related write-downs. Many of the assets that incurred significant write-downs during 2009 were transferred to the non-core division, which is now reported as a separate business segment.

The turnaround for UBS in 2009 is attributable to substantially reduced losses on risk positions within the fixed income, currencies and commodities business area.

Market risk reporting

The market risk associated with investment banking activity remains a key focus area for banks and we comment below on the main reporting of market risk measures.

Despite its limitations, VaR remains the key measure of market risk reported by the banks with the majority reporting a reduction in 2009, key to the reduction were reduced credit spread volatility and a reduction in underlying exposures

Defining value at risk (VaR)

Value at risk (VaR) is defined as a single number (currency amount) which estimates the maximum expected loss of a portfolio over a given time horizon (the holding period) and at a given confidence level. VaR estimates the potential loss arising from unfavourable market movements, if the current positions were to be held unchanged for a specified time frame.

The holding period used depends on the underlying assets and the underlying activities. For example, foreign exchange dealers are often interested in calculating the amount they might lose in a 1-day period. Therefore, in measuring the VaR of an active trading portfolio of liquid instruments, 1-day VaR is usually appropriate. The longer the holding period, the higher the VaR.

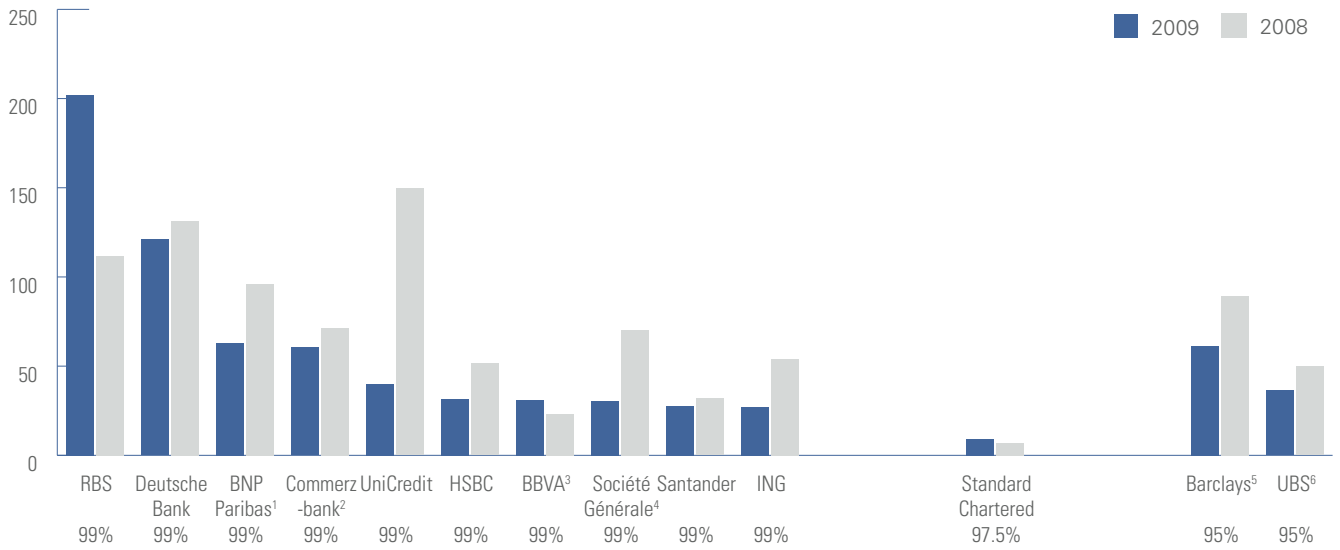
The higher the confidence level, the higher the VaR amount will be. A 95% confidence level implies that the VaR estimate will be exceeded about 5% of the time. The Basel Committee on Banking Supervision proposes that institutions use a confidence level of 99%, which implies that only two to three breaches of the VaR estimate occur during the year.

VaR analysis

Not all banks have disclosed VaR information. The underlying assumptions for VaR calculations and the methods of calculation also vary between the banks, meaning it is not possible to make direct comparison of the values disclosed.

All banks that disclosed VaR analysis for 2009 have used a 1-day holding period. Most used a 99% confidence interval, the exceptions being Standard Chartered who used 97.5%, and Barclays and UBS who both used 95%.

Day 1 Trading VaR as disclosed* (Million €)



Source: KPMG International, June 2010

Notes:

* These results are not comparable due to differences in calculation and confidence interval used. The graph is intended to illustrate the relative movement in VaR for each bank. Percentages relate to the relative confidence interval used by the banks.

1. Estimated using graph disclosed on page 159 of 2009 Annual Report.
2. Comparative figure calculated at 31 March 2009 due to acquisition of Dresdner Bank in 2009.
3. Trading and non-trading figure used as trading VaR not separately disclosed.
4. Average figures used as year end result not disclosed.
5. Trading and non-trading figure used as at 31 December 2009 sourced from Results Announcement, trading VaR not separately disclosed.
6. Results for Investment Bank segment as total trading VaR not disclosed.
7. LBG does not disclose comparative consolidated VaR results.
8. Nordea does not disclose VaR results.

Most banks disclosed lower daily trading VaR results as compared to 2008 driven by reduced volatility in interest rates (both general interest rates and credit spreads) and reduced levels of underlying exposure in trading books which is consistent with deleveraging balance sheet positions.

The increase for RBS was attributed to increased market volatility experienced since the credit crunch began in late 2007 being increasingly incorporated into the two year time series used by their VaR model.

UniCredit reports a "generalised reduction" in market risk, primarily in response to a reduction in credit spread volatility combined with a gradual reduction of exposure to "non-core" businesses.

VaR limitations

It is important to note that the VaR model has a number of limitations including the fact that each bank's VaR is not directly comparable as the underlying assumptions and the method of calculation vary. This variation is attributable to a number of factors, some of which are listed below;

- The accounting treatment and designation of trading book positions and non-trading book positions and whether VaR is calculated individually for both books and/or on a consolidated basis
- The impact of the IAS 39 reclassifications, transferring risk from the trading book to the non-trading book

VaR limitations have become more evident during the past two years, resulting in a high number of outliers. The major drawback to VaR analysis is the assumption that portfolio returns are normally distributed. All market participants understand that from time to time there are unusual or extreme events in the market that are not captured by a normal distribution. When such events occur, VaR calculations may underestimate the true value at risk. Therefore, relying on the assumption of normally distributed returns alone is insufficient when there are extreme movements in the market.

HSBC, Société Générale, Standard Chartered, RBS, UBS, Deutsche Bank, ING and Santander all disclose the use of trading book VaR stress testing as an additional market risk assessment tool, but it is only Société Générale and Santander that actually disclose the results of this testing. Whilst not disclosing the results of their stress testing, UBS presented the results of their VaR back testing.

Fair value hierarchy

Disclosure of fair value measurement hierarchy became mandatory in 2009 under the amended IFRS 7

The percentage of total financial assets and financial liabilities measured at fair value provides a good measure of the relative size of each bank's investment banking activities. Deutsche Bank measures almost 70% of financial assets at fair value and over 50% of their financial liabilities at fair value. In terms of financial assets, UBS and BNP Paribas follow closely recording 57% and 56% at fair value respectively.

For all but two banks, trading derivative liabilities represent the largest group of liabilities at fair value, which is consistent with 2008. HSBC and ING were the only banks to report liabilities designated at fair value through profit or loss as their largest financial liabilities category.

All banks are required to disclose their fair value measurement basis, specifically the hierarchy level for all financial instruments measured at fair value on the balance sheet.

There are 3 levels to the hierarchy:

- **Level 1:** fair value is determined as the unadjusted quoted price for an identical instrument in an active market
- **Level 2:** fair value is determined using observable inputs other than unadjusted quoted prices for an identical instrument, and does not use significant unobservable inputs
- **Level 3:** fair value measurement uses significant unobservable inputs, including observable inputs that require significant adjustments based on unobservable inputs

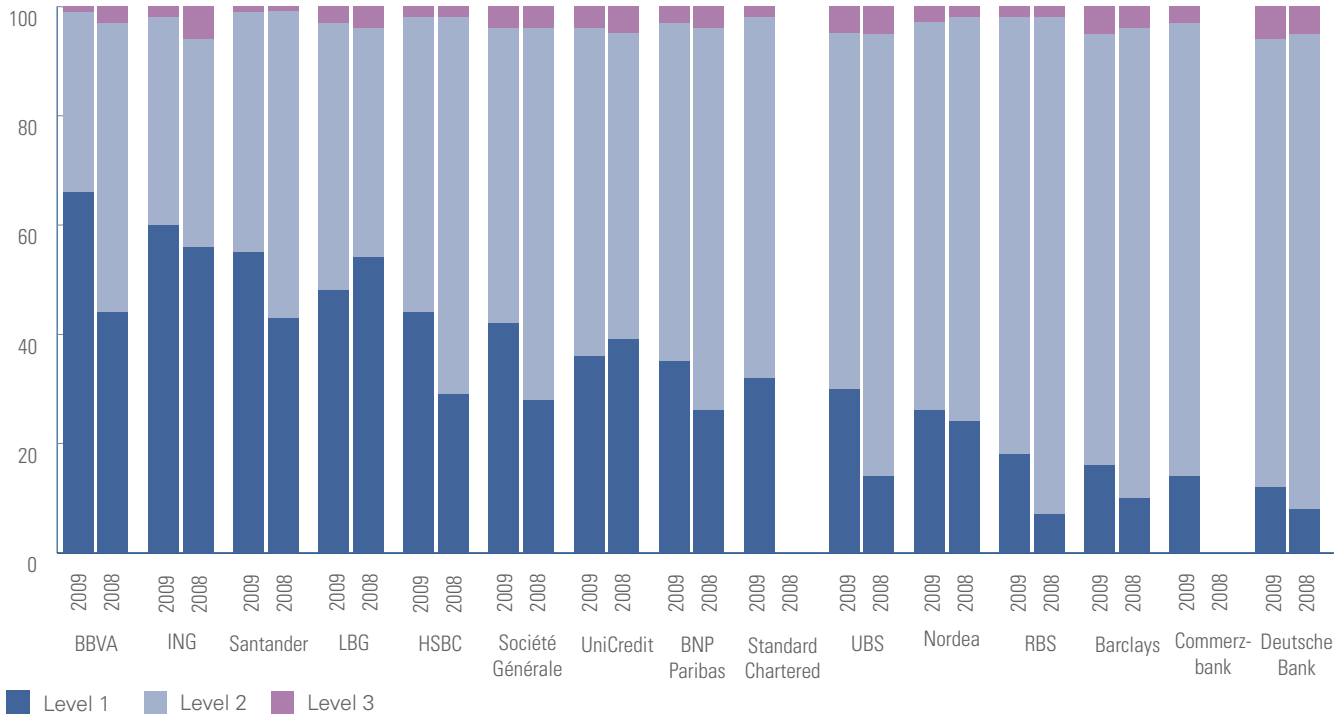
The proportion of Level 1, 2 and 3 financial assets and liabilities varies significantly among the banks. Level 1 and 2 are by far the most widely adopted measurement categories.

It is not clear how each bank applies the definitions above to classify their financial instruments. Whilst each bank provides the above definitions within their fair value hierarchy disclosures, there is little detail as to how the definitions are applied in practice. There is a great deal of subjectivity concerning the dividing lines between Level 1, 2 and 3 which reduces the level of comparability between the banks.

Financial assets

On average, Level 1 and 2 combined account for 97% of total fair valued financial assets. It is interesting to observe the significance of Level 2 classification across all the banks and the potentially vulnerable position if there was a return to a financial crisis, re-introducing the levels of illiquidity and un-observability experienced in the past two years. This shift could see a considerable reclassification from Level 2 to Level 3, significantly impacting profit or loss volatility.

Fair value hierarchy of financial assets (Percent)



Note: Fair value hierarchy data for 2008 not available for Standard Chartered and Commerzbank.

Source: KPMG International, June 2010

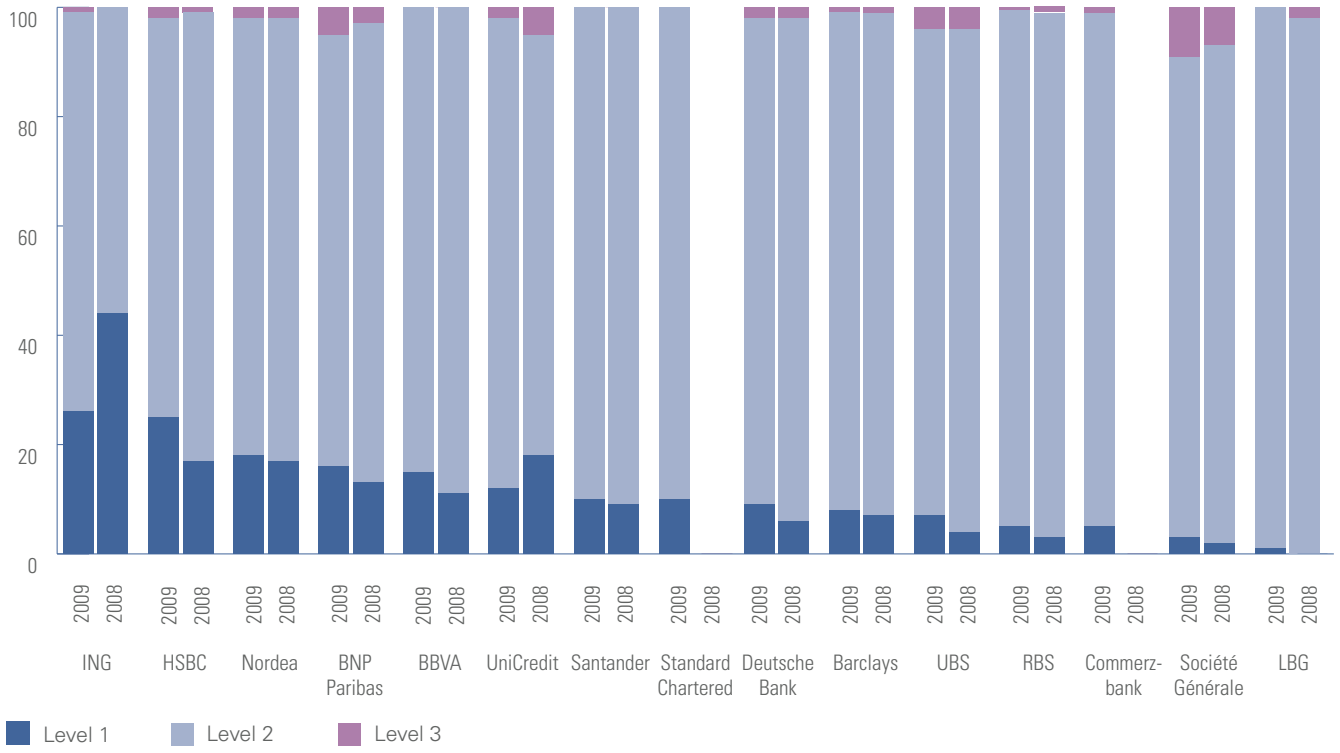
Deutsche Bank, UBS and Barclays have the highest proportion of Level 3 valued financial assets, with up to 6% classified as Level 3. The Level 3 instruments for these banks consist mainly of derivative financial assets and non-derivative trading assets.

Financial liabilities

As with financial assets, Level 2 is the most significant hierarchy category for financial liabilities, further highlighting the vulnerability to adverse market conditions and the potential bottom line volatility due to Day 1 P&L releases.

ING and HSBC measured just over 20% of their financial liabilities using Level 1 of the fair value hierarchy, an increase compared to 2008 where only one bank (ING) measured more than 20% of their liabilities using quoted prices.

Fair value hierarchy of financial liabilities (Percent)



Note: Fair value hierarchy data for 2008 not available for Standard Chartered and Commerzbank.

Source: KPMG International, June 2010

Day 1 P&L

If the fair value of a financial instrument is derived using a valuation model with non-observable market parameters (Level 3), there might be a difference between the initial transaction price and the valuation using a valuation model on day 1. This 'Day 1 P&L' cannot be taken to P&L immediately and must be deferred, being recognised in P&L either:

1) Over the life of the transaction

2) When the market data becomes observable

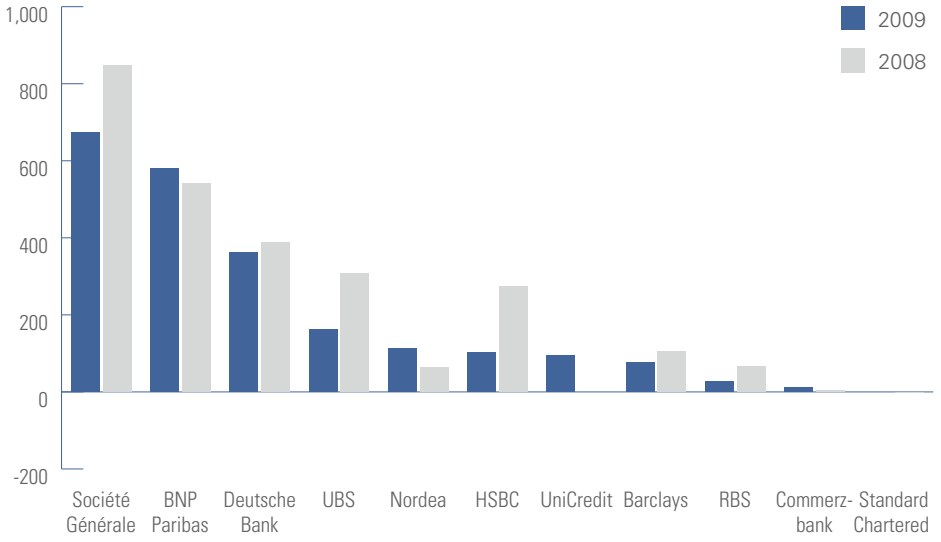
3) When the transaction matures or is closed out

4) When the bank enters into an offsetting transaction

Day 1 profit can have a significant impact on profitability, representing between 1% and 84% of the banks' profit before tax

Société Générale and BNP Paribas have recorded the greatest Day 1 P&L release during the year. The P&L release represents 84% of Société Générale's profit before tax for 2009 and 6% for BNP Paribas.

Day 1 P&L release during the year (Million €)

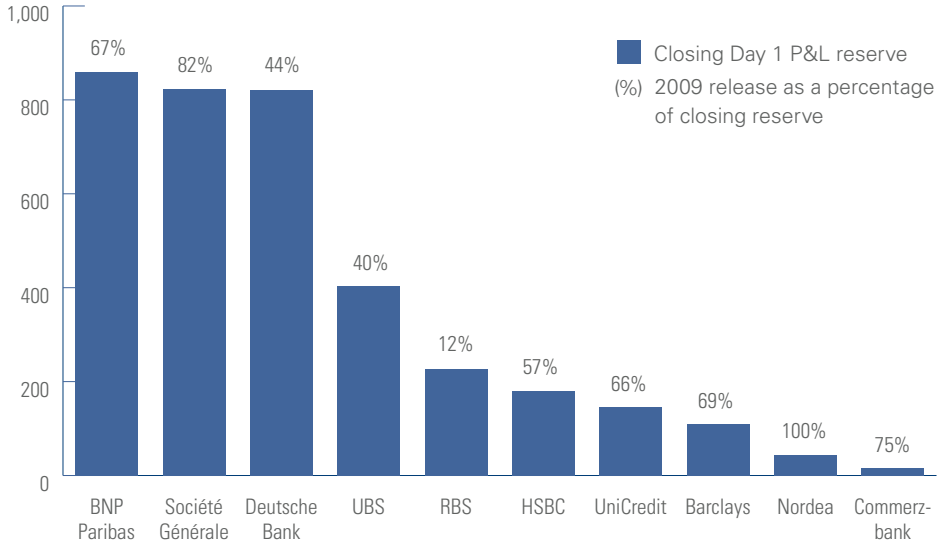


Note: Data not available for LBG, BBVA, ING and Santander.

Source: KPMG International, June 2010

The graph below illustrates the impact on closing Day 1 P&L reserves if the 2009 P&L releases are repeated in 2010.

2009 Day 1 P&L release as a % of closing Day 1 P&L reserve
(Million € / Percent of closing Day 1 P&L reserve)



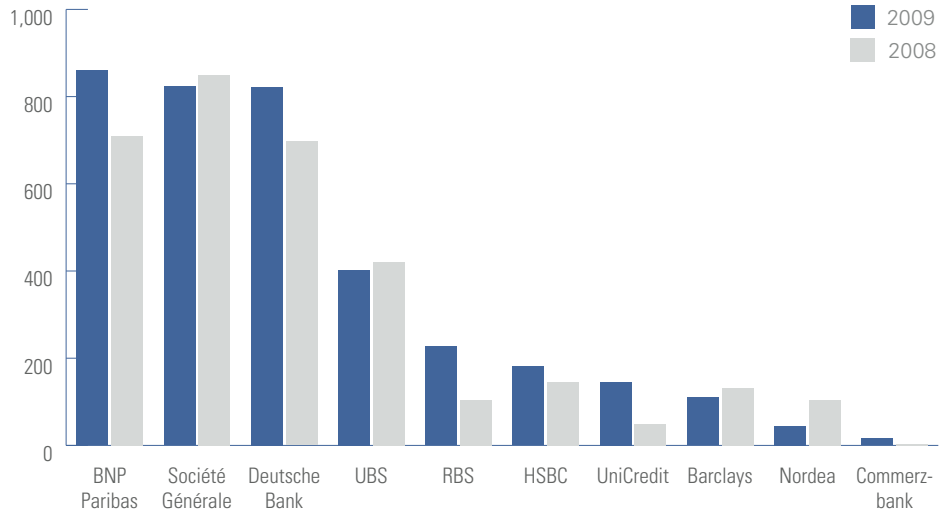
Note: Data not available for LBG, BBVA, Standard Chartered, ING and Santander.

Source: KPMG International, June 2010

Movements in the level of Day 1 P&L reserves reflect the activity in financial instruments eligible for Level 3 fair value classification. The level of Day 1 P&L reserve represents potential future revenues which can have a significant impact on profit.

Société Générale, BNP Paribas and Deutsche Bank had the largest Day 1 P&L reserves as at 31 December 2009.

Day 1 P&L reserves (Million €)



Note: Data not available for LBG, BBVA, Standard Chartered, ING and Santander.

Source: KPMG International, June 2010

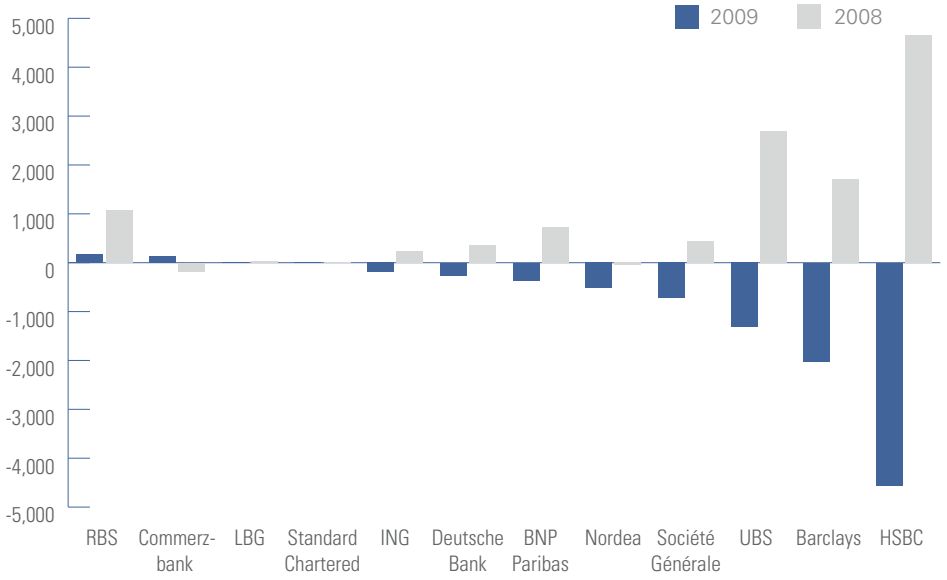
Gains on own credit seen in 2008 have largely been reversed in 2009

Fair value gains on own credit

All the banks designated some financial liabilities at fair value through profit or loss. Twelve have separately disclosed the proportion of the total gain or loss due to movements in own credit risk.

Most of the banks reported significant gains on own debt in 2008 due to widening credit spreads. These gains have largely been reversed in 2009.

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



Note: Data not available for UniCredit, BBVA and Santander.

Source: KPMG International, June 2010

HSBC reports that a significant tightening in credit spread on their own long-term debt in 2009 reversed the movement in 2008. UBS and Barclays also report that their own credit loss is attributable to the market's perception of improved creditworthiness (i.e. tightening of credit spreads).

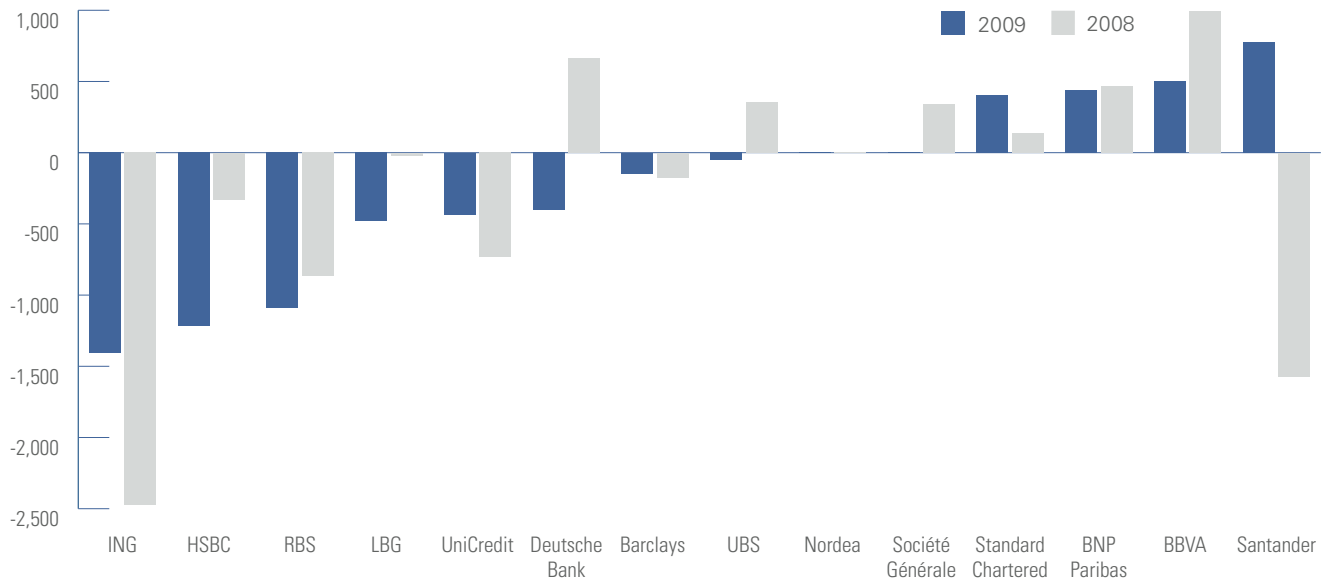
This has been a trend in 2009 where many of the banks have experienced tightening of credit spreads and are experiencing improved credit ratings as stability returns following the after-math of the Lehman's crash.

Release of available for sale reserve through profit or loss

The release of the available for sale (AFS) reserve is another impact of fair value measurement on profit or loss. In accordance with IAS 39, fair value gains and losses on available for sale financial assets are initially recognised in other comprehensive income and are released to profit or loss when there is objective evidence of impairment or when the asset is derecognised.

ING have recorded an improvement in the impairment charges on AFS debt and equity securities, reducing by 43% since 2008, driven by the improved outlook (compared to 2008) and the reclassification of €22.8 billion of AFS exposure to loans and receivables. This improvement is partially offset by losses on the disposal of AFS securities linked to the illiquid assets back up facility with the Dutch State.

Net gains/losses transferred to the income statement from AFS reserve (Million €)



Note: Commerzbank data not clearly disclosed

Source: KPMG International, June 2010

HSBC report a significantly increased AFS debt security impairment charge in respect of certain asset backed debt securities within the Global Banking and Markets division, reflecting mark to market losses which HSBC judged to be significantly in excess of the likely ultimate cash losses.

Santander disclose a positive AFS reserve release for 2009 driven by a reduction in impairment charges as compared to 2008 and a gain on sale of AFS debt and equity securities.

Outlook

2009 saw a marked recovery in investment banking following on the back of the global financial crisis of late 2007 and 2008. Even though there has been strong growth, it is important to consider the sustainability of such growth and the challenges that lie ahead in managing the inherent risks of investment banking in an inherently uncertain market. Some commentators have cited the end of the investment banking 'bubble' and it certainly seems that the results of the first half of 2009 are unlikely to be repeated. However the investment banking market has been shown to be a resilient one and it is likely that as the landscape changes, the market will change with it.

Appendix 1: 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
Financial Institutions

Commerzbank
Corporates & Markets

Standard Chartered
Wholesale Banking

BBVA
Wholesale Banking & Asset Management

Lloyds Banking Group
Wholesale Division

UniCredit
Corporate & Investment Banking

Santander
Global Wholesale Banking

7. Funding and liquidity

The financial crisis has demonstrated how quickly liquidity can become a scarce resource as certain types of funding, notably interbank funding, dried up. In this context banks were called upon by G-20 leaders and regulators to reinforce their liquidity risk management procedures including the diversification of their funding sources.

The fundamental role of banks in the transformation of short-term deposits into long-term loans makes a bank inherently vulnerable to liquidity risk either due to the nature of its own business or due to general market liquidity conditions.

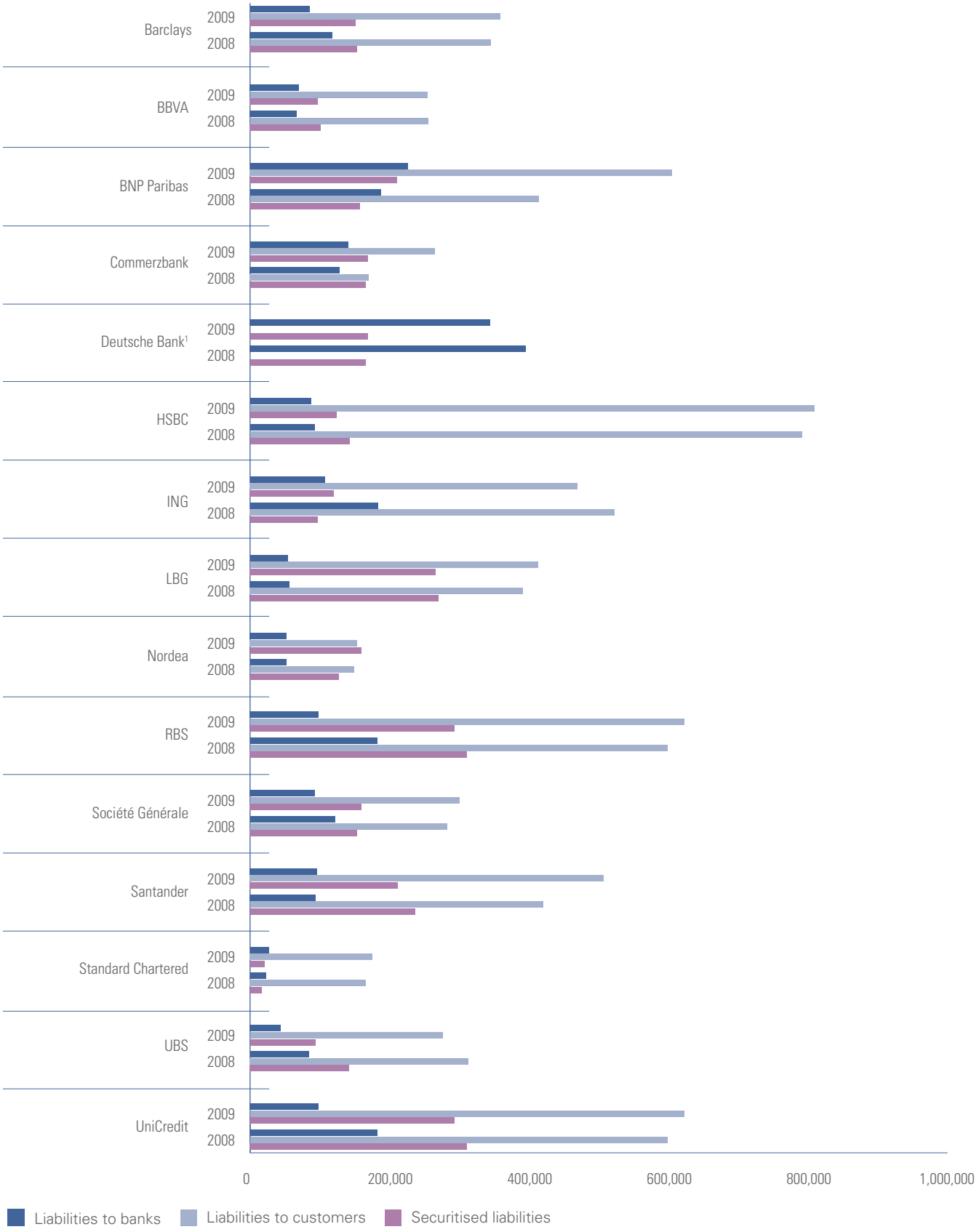
Funding

Availability of funding

The main source of funding in 2009 was deposits from customers, which tended to increase in 2009 (see graphs on pages 46 and 47). In comparison, funding from the interbank market, which constitutes a major short-term source of funding globally, decreased this year.

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

External funding sources (Million €)



[1] Liabilities to banks and customers are disclosed as a whole in the Deutsche Bank Annual Report (i.e. cannot be separately identified).

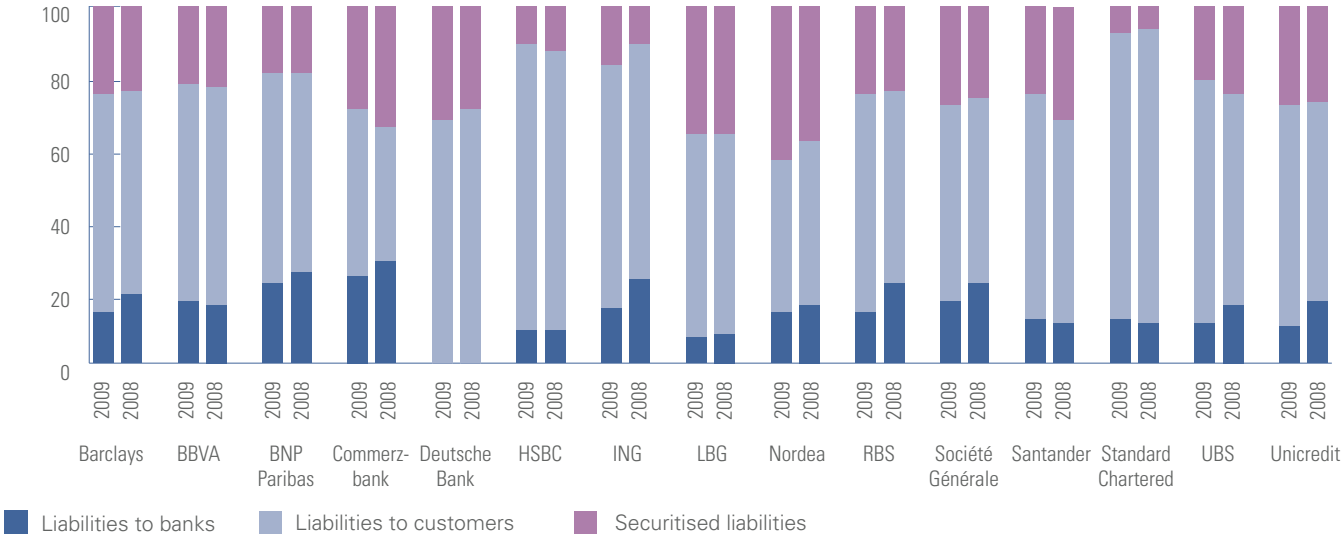
Source: KPMG International, June 2010

Funding diversification

Diversification in funding profile with different investor types, regions, products and instruments is indicative of the liquidity risk management framework for each bank. To avoid dependency on a particular group of customers or market sectors, the distribution of sources and the maturity profile of deposits have to be carefully managed.

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

Funding diversification (Percent)



[1] Liabilities to banks and customers are disclosed as a whole in the Deutsche Bank Annual Report (i.e. cannot be separately identified).

Source: KPMG International, June 2010

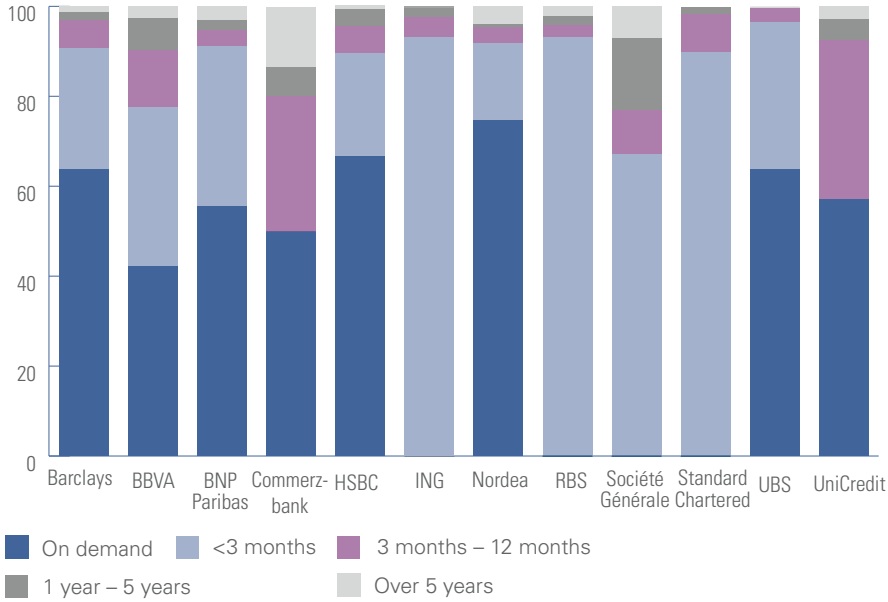
Securitised liabilities have increased steadily for several years. These consist of:

- Certificates of deposit
- Covered bonds
- Senior debt
- Commercial paper

In relation to customer deposits it should be noted that to mitigate the risks present as a result of the financial crisis as well as to satisfy the public demand for protected investments, a number of emergency policy actions were taken to expand retail deposit insurance, for instance in Germany and the UK.

Maturity of funding

Maturity of funding - Liabilities to customers (Percent)



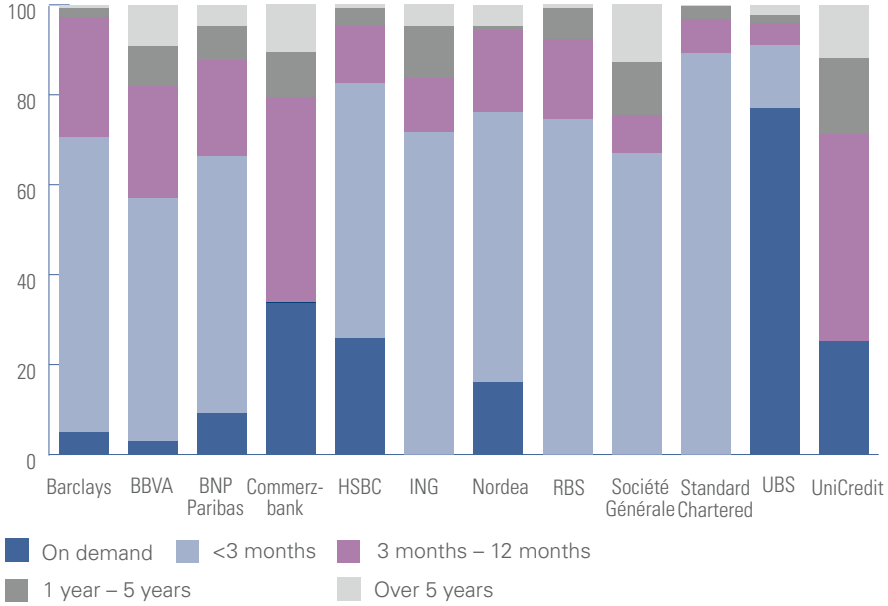
Source: KPMG International, June 2010

Note: Data not available for LBG and Santander.

Liabilities to banks and customers are disclosed as a whole in the Deutsche Bank Annual Report (i.e. cannot be separately identified).

Standard Chartered, Société Générale, RBS and ING did not disclose separately on demand financial liabilities from those that are due in 3 months.

Maturity of funding - Liabilities to banks (Percent)



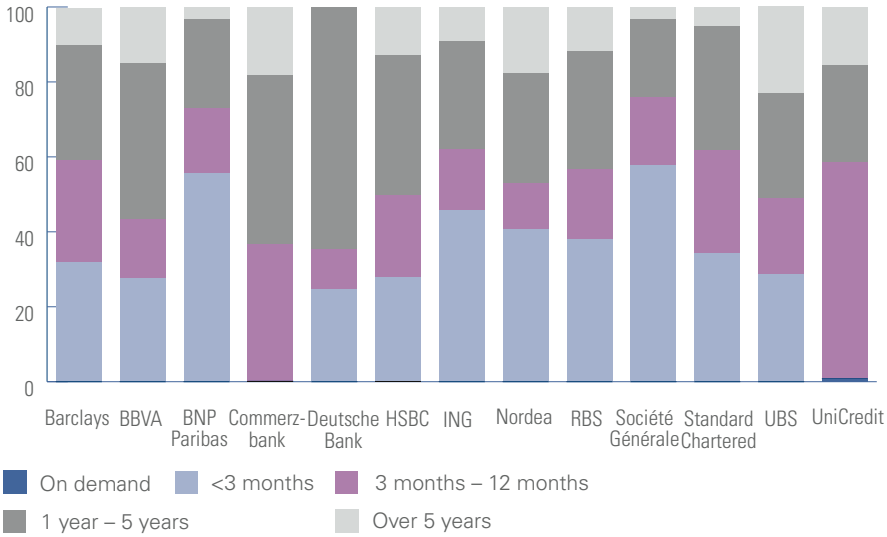
Source: KPMG International, June 2010

Note: Data not available for LBG and Santander.

Liabilities to banks and customers are disclosed as a whole in the Deutsche Bank Annual Report (i.e. cannot be separately identified).

Standard Chartered, Société Générale, RBS and ING did not disclose separately on demand financial liabilities from those that are due in 3 months.

Maturity of funding - Securitised liabilities (Percent)



Note: Data not available for LBG and Santander.

Source: KPMG International, June 2010

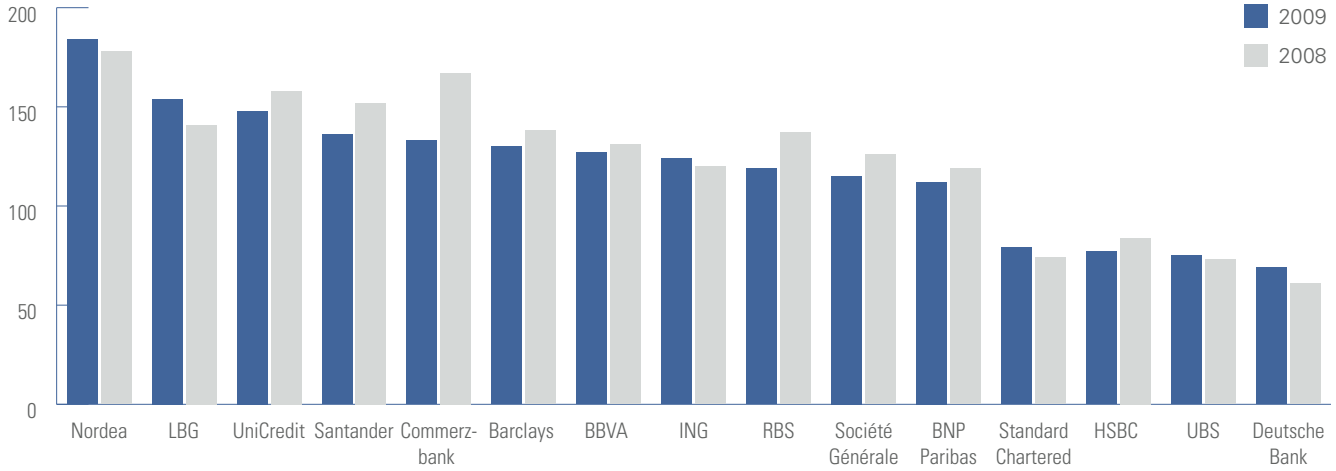
Compared to 2008, the maturity of funding remained stable for most of the banks.

A comparison of funding maturity as disclosed in annual reports highlights the importance of customer deposits and interbank market funding.

Some banks were still benefitting from governmental liquidity support as at 31 December 2009 (see chapter 4 for analysis of state capital support). Recourse to liquidity facilities sponsored by central banks is discussed only by LBG who indicated that overall funding support totaled € 141 billion as at 31 December 2009 maturing over the course of the next two years.

Loan to deposit ratio

Loan to deposit ratio (Percent)



Note: Calculation of loan to deposit ratio is based on balance sheet amounts. Consequently, the impact of repos has not been excluded.

Source: KPMG International, June 2010

The loan to deposit ratio is the ratio of wholesale and retail loans and advances to customers net of the related impairment allowance as a percentage of customer deposits. As in 2008, the loan to deposit ratio differs considerably from one bank to another ranging from 184% (Nordea) to 69% (Deutsche Bank).

Banks continued to utilise this ratio when discussing their performance and emphasize the importance of core current accounts and savings accounts as a source of funds to finance lending to customers reflecting their fundamental role as intermediaries between depositors and borrowers.

The increasing proportion of deposits funding lending has led to a majority of the banks showing a decrease in this ratio. For the banks that remain with still high loan to deposit ratios such as Nordea and LBG this indicates that any increase in lending has not been offset by a similar rise of deposits, although in the case of LBG the picture is complicated by a mix of impacts attributable to the acquisition of HBOS.

Liquidity risk management

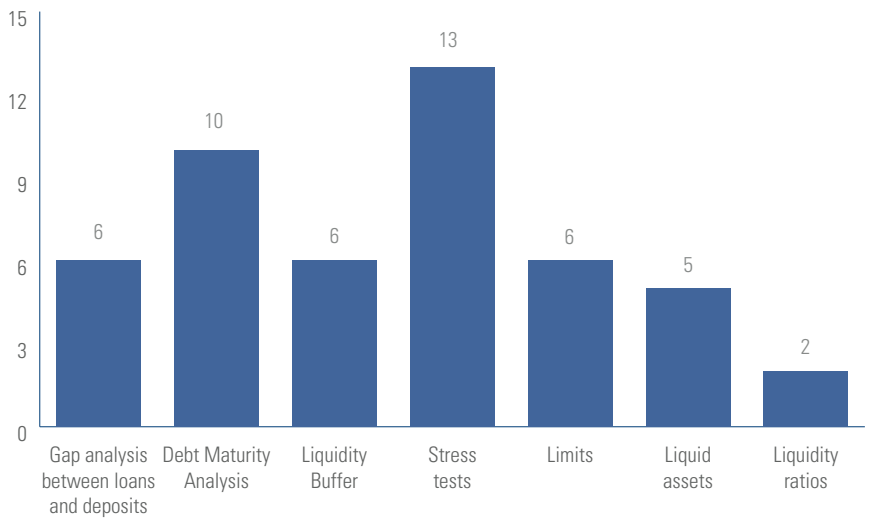
IFRS 7 requires a qualitative description of liquidity risk management. Across our survey:

- Seven banks have centralised management of liquidity (RBS, Deutsche Bank, LBG, Nordea, BNP Paribas, Commerzbank, UBS)
- Two have decentralised management (BBVA and HSBC)
- The remainder opt for a mixed management with centralised decisions and decentralised execution - liquidity is managed by the local committee within the pre-defined liquidity limits set by the group

Most of the banks have an Asset and Liabilities Committee – ALCO (local or group depending on the management system), which plays a predominant role in liquidity management. The ALCO often assists the executive committee or the treasury committee. The CFO and/or CEO are generally involved in all decisions made.

The banks disclose a number of tools used to manage liquidity risk as illustrated by the chart below. They all give qualitative indications about their measurement methods but rarely quantitative information. For example, BNP and Commerzbank presented their liquidity ratios of 131% and 120% respectively. Société Générale and Deutsche Bank explain that they were in compliance with all applicable liquidity regulations without disclosing quantitative information on their liquidity ratio.

Liquidity risk management methods (number of banks)



Source: KPMG International, June 2010

An understanding of the maturity profile of financial assets and liabilities is essential for an understanding of the liquidity risk of banks – ten banks in our survey chose to disclose this information voluntarily

Maturity of financial assets and liabilities

An analysis of the maturity of financial assets is not required by IFRS 7, but it is essential for understanding the liquidity risk of banks. Ten banks have chosen to disclose this analysis combined with the required analysis of maturities of financial liabilities being: Barclays, BBVA, BNP Paribas, Commerzbank, ING, Nordea, RBS, Société Générale, Standard Chartered and UniCredit.

The maturity analysis of financial assets versus financial liabilities reflects the general view of the banks that demand deposits are a stable source of funding even though they could be withdrawn on demand. Proposals of the Basel Committee to strengthen and harmonise liquidity risk management encourage banks to diversify their sources of stable funding by, for instance, reducing the portion of retail deposits (demand and up to one year) included in the stable resources. The Basel Committee recommends assumptions for retail deposit run-off of 7.5% per year for stable (as defined) deposits and 15% per year for less stable (as defined) deposits or higher. Certain banks have expressed concern about the proposals as such deposit run-off rates have not actually been experienced during the financial crisis.

Summary

As information on liquidity is considered particularly sensitive by both banks and regulators, banks presented general information – either in the risk report or in the notes to the financial statements – on their liquidity risk management. Banks have generally concentrated more on general procedures and processes than on the assumptions used in their cash flow analysis. In the context of the liquidity crisis, banks presented more qualitative information about tools and indicators used to manage their liquidity risk. From the information presented banks seem to have started to reinforce their liquidity risk management procedures including the diversification of their funding sources.

Banks are aware of the recent regulatory consultation papers relating to liquidity requirements which will introduce new and consistent metrics to measure and monitor liquidity risk. If implemented, this will force banks to more closely align their funding and liquidity policies which could change their liquidity management processes.

Most of the banks are actively participating in the industry-wide consultation and calibration exercises taking place in 2010, relating to two liquidity metrics proposed by the Basel Committee and the European Commission:

- The liquidity coverage ratio which identifies the amount of unencumbered, high quality liquid assets a bank holds that can be used to offset the net cash outflows it would encounter under a short-term stress scenario specified by regulators. The specified scenario entails both institution-specific and systemic shocks built upon actual circumstances experienced in the global financial crisis. This ratio introduces a restrictive definition of high quality liquid assets
- The net stable funding ratio which measures the amount of longer-term, stable sources of funding used by a bank relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet exposures and obligations. This ratio is intended to promote longer-term structural funding of banks' balance sheets and off-balance sheets

8. Non-financial assets

Although financial assets constitute the majority (generally in excess of 90%) of a bank's balance sheet, certain other assets such as goodwill and deferred tax have been significantly affected by the financial crisis.

In total, €135 billion of goodwill is held on balance sheet by the 15 banks

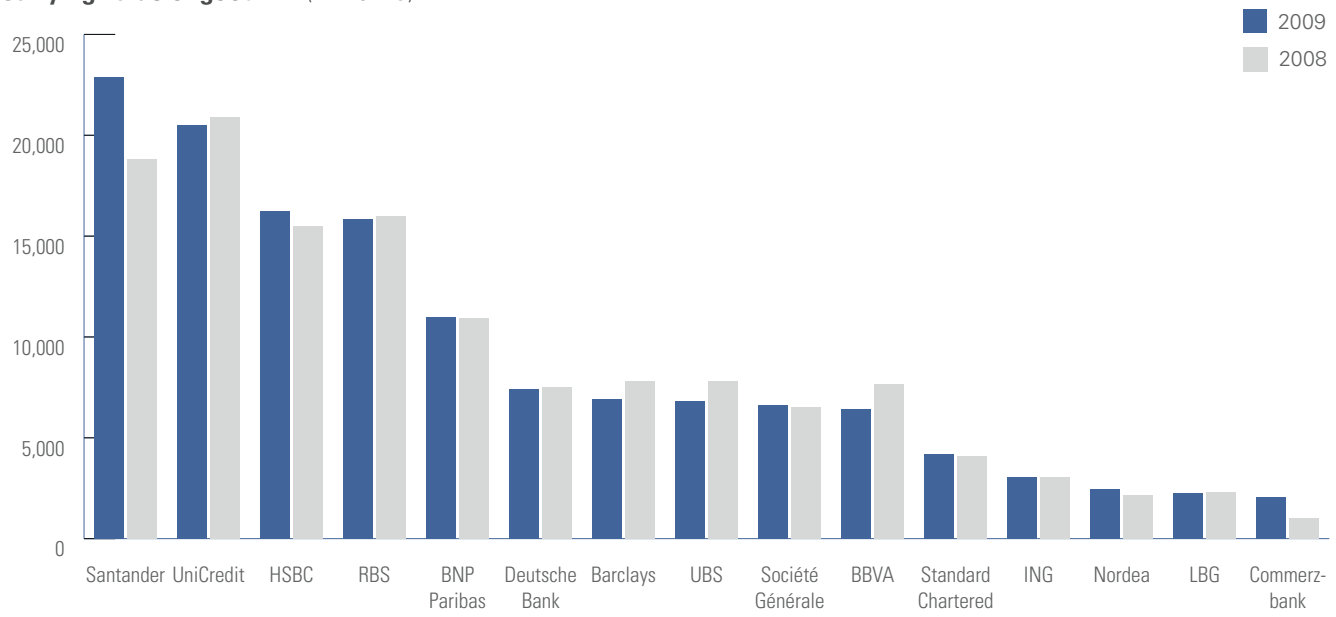
Goodwill

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 the business combination 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 a bank 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 bank will derive. Goodwill impairment is recorded in profit or loss.

All 15 banks had goodwill amounts on balance sheet exceeding €2 billion at 31 December 2009.

Carrying value of goodwill (Million €)



Source: KPMG International, June 2010

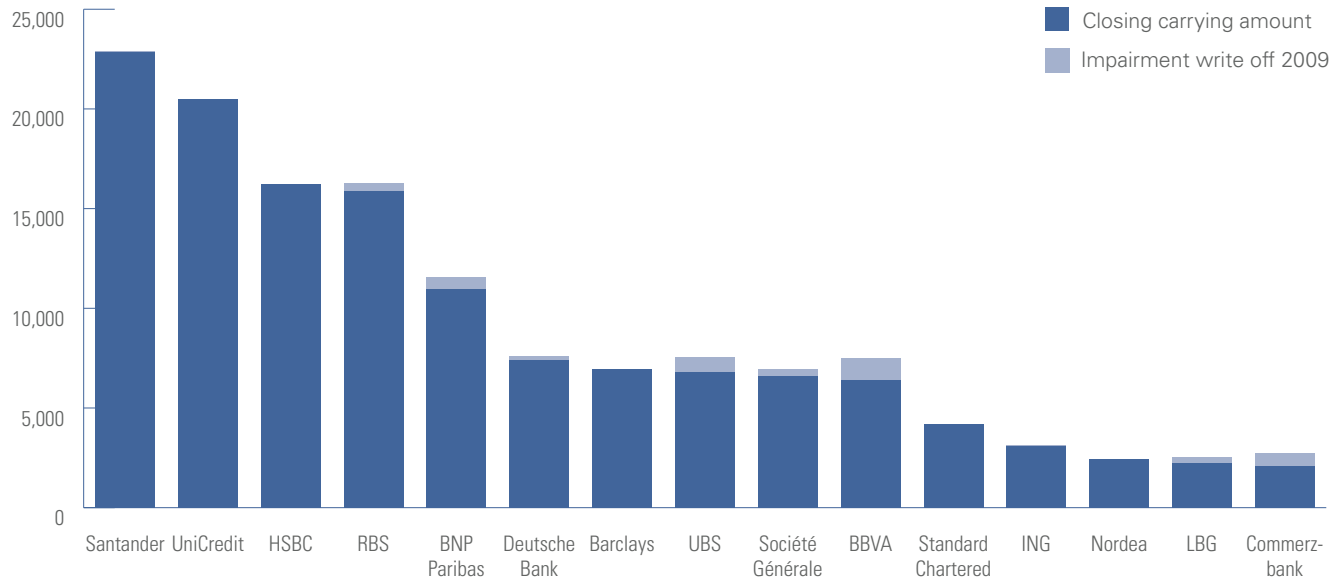
In contrast to 2008, none of the banks in our survey recorded significant goodwill impairment in 2009, the highest charge being €1.1 billion at BBVA

In 2009 most banks had decreases in goodwill as a result of impairments or sales of business. Only two banks (Santander and Commerzbank) recorded an increase in goodwill of over €1 billion. The carrying amount of goodwill recognised by Santander increased by more than €4 billion due to a number of acquisitions. The goodwill at Commerzbank increased by €1.1 billion as a result of the acquisition of Dresdner Bank.

In 2008, 2 banks (RBS and HSBC) incurred significant goodwill impairment charges of €30.9 billion and €7.5 billion respectively. RBS impairment related mainly to the acquisition of ABN AMRO, and also to Citizens/Charter One and NatWest goodwill. At HSBC, the impairment charge wrote off any remaining goodwill in the Personal Financial Services division in North America.

In 2009, none of the banks recorded goodwill impairment on the same scale as 2008, indicating a general stabilisation of future cash flow streams that support the carrying value.

Carrying amount and goodwill impairment 2009 (Million €)



Source: KPMG International, June 2010

Goodwill impairment was recorded by 11 of the 15 banks. BBVA had the highest amount of impairment (€1.1 billion) attributed to the decline in economic and credit conditions in the United States. All other impairments are less than €1.0 billion.

Goodwill disclosure

Disclosures regarding goodwill varied considerably across the survey. Some banks include detailed information about goodwill allocation to cash generating units and calculation of impairments. For example:

- BNP Paribas discloses sensitivities regarding goodwill impairment in terms of the impact on the cost/income ratio and other parameters
- Deutsche Bank disclosed the changes in the carrying amount of goodwill and information at a business segment level
- HSBC provided detailed information about goodwill in all geographical regions whilst RBS disclosed it by division
- HSBC and UBS disclose key assumptions for all cash generating units (discount rate, nominal growth rate beyond initial cash flow projections) and how the key assumptions were assessed

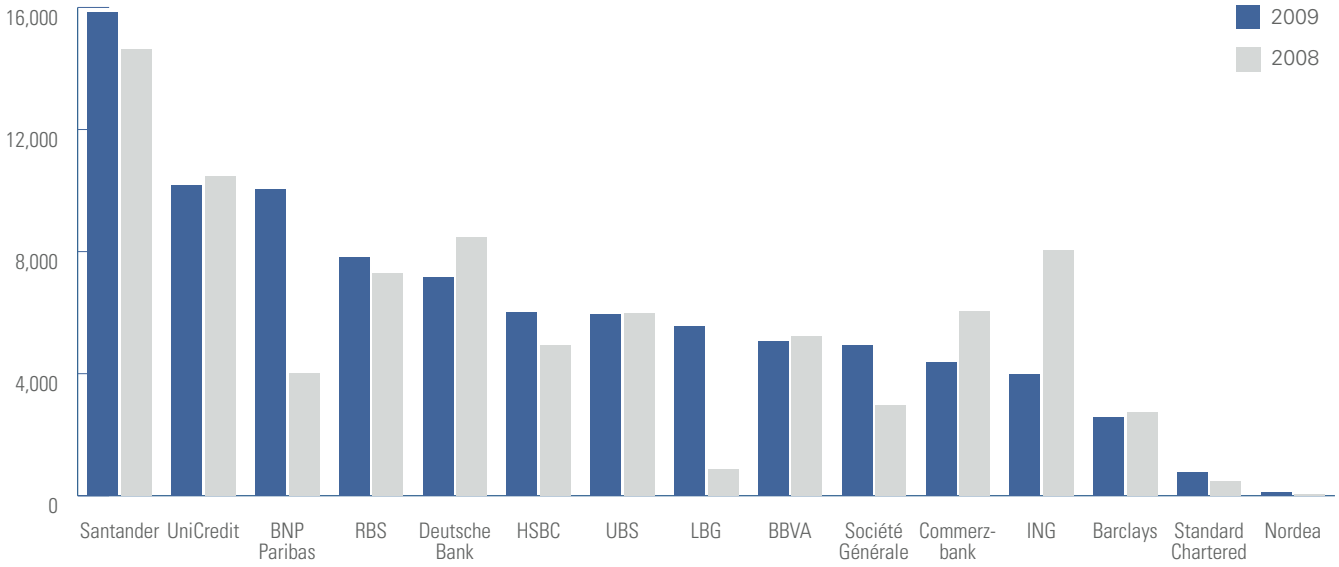
€90 billion of deferred tax assets were held on balance sheet at 31 December 2009, equating to around €300 billion of future taxable profits

Deferred Tax

Deferred tax assets under IFRS relate to temporary differences whereby there is a potential future tax benefit. For example, unused tax losses and tax credits. Deferred tax assets can only be recognised to the extent it is probable that sufficient taxable future profits are expected to be available to utilise these temporary differences.

In 2009 13 of the banks had recognised deferred tax assets exceeding €2 billion. The highest amounts were held by Santander, UniCredit and BNP Paribas who had recognised deferred tax assets of €15.8 billion, €10.2 billion and €10.1 billion respectively. The large increase of 150% in BNP's deferred tax assets is due to the first time consolidation of Fortis and related to impairment provisions and tax losses carried forward.

Deferred tax assets (Million €)



Source: KPMG International, June 2010

Only three banks (Commerzbank, RBS and UBS) disclosed the judgement of how many years of future profits they used to support this deferred tax asset. The period varies from five to eight years among these banks.

Most of the 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.

The highest unrecognised deferred assets were disclosed by Barclays and UniCredit, being €9.5 billion and €7.5 billion respectively. The Barclays amounts relate to losses in non-UK branches. UniCredit's unrecognised amounts relate to foreign branches and UniCredit and Bank of Austria subsidiaries.

Summary

The total amount of goodwill impairment recorded in 2009 by the banks decreased significantly compared to 2008 (€4.3 billion versus €40.3 billion in 2008). However, with total capitalised goodwill across the survey of over €130 billion, there is significant risk of impairments having a major impact on profit or loss in future years should global markets suffer a double dip recession.

The level of deferred tax assets (aggregating to €90 billion) varies considerably across the survey with the largest exposure being over €15 billion. In these uncertain times, the view on availability of future profits could change very quickly resulting in the potential write down of some significant balances. Additionally, as deferred tax assets may no longer be recognised for capital purposes under the forthcoming Basel III requirements, the impact on regulatory capital could be very significant for some banks.

9. Transparency

Annual reports continue to grow, with structure remaining broadly the same. The quality and quantity of critical accounting judgements and estimates disclosure remains mixed.

The volume and structure of annual reports in 2009 has remained similar to 2008, with the average volume increasing from 325 to 350 pages. Critical judgements and estimates are key disclosures for banks as they provide important information about subjectivity in the accounts and the risk of adjustment in future years.

Volume and structure

The structure of annual reports has remained largely unchanged. Under the revised IAS 1, a statement of changes in equity was required to be presented as a primary statement for the first time in 2009. There was an option this year to revise the primary statement names, for example, referring to the balance sheet as the statement of financial position, but many reporters chose to stay with the traditional titles. Also in 2009, there was an option to present either a single statement of comprehensive income or an income statement and separate statement of other comprehensive income.

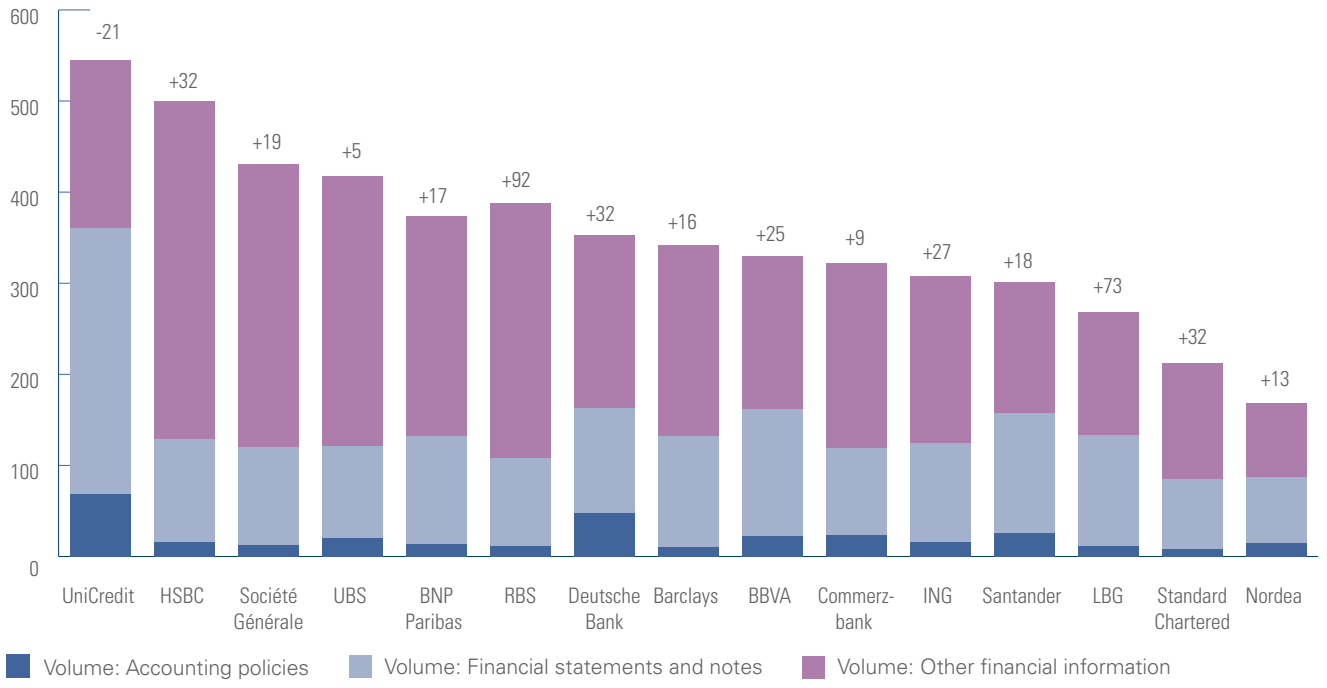
The structure of annual reports has remained largely unchanged in 2009, with an average length of 350 pages

BNP Paribas eliminated the section 'Extension of the financial crisis' which was part of the notes in 2008. Some banks added new notes. For example:

- BBVA included a new note on valuation adjustments explaining which balance sheet items had been adjusted
- Commerzbank included two new notes concerning 'Impairments of goodwill and brand names' and 'Adjustment to fair value attributable to portfolio fair value hedges'
- Deutsche Bank added two new chapters on 'Critical Accounting Estimates' and 'Recently Adopted and New Accounting Pronouncements'
- ING included a new 'Subsequent events' section in the notes
- Nordea added information about credit risk, disclosing the exposure at default
- UBS included further details about compensation principles in 2009 and beyond for senior executives

The length of the annual reports varied significantly across the survey which was to some degree a reflection of the regulatory and oversight requirements in different countries. The volume of annual reports ranged from 168 to 545 pages. As in previous years UniCredit had the highest volume of pages.

Volume and structure of financial reporting 2009 (Number of pages / Change in no. pages from 2008)



Note: Some of the banks have included audited information, such as IFRS 7 disclosures, within other financial information.

Source: KPMG International, June 2010

The volume of the annual reports increased slightly, the continued high volume of reporting reflecting the banks' complex business models and the extensive disclosures required thereon under IFRS. Fourteen banks extended their annual reports, UniCredit being the exception. LBG's annual report 2009 was significantly longer (by 37%) than in 2008, mainly due to disclosures associated with the acquisition of HBOS.

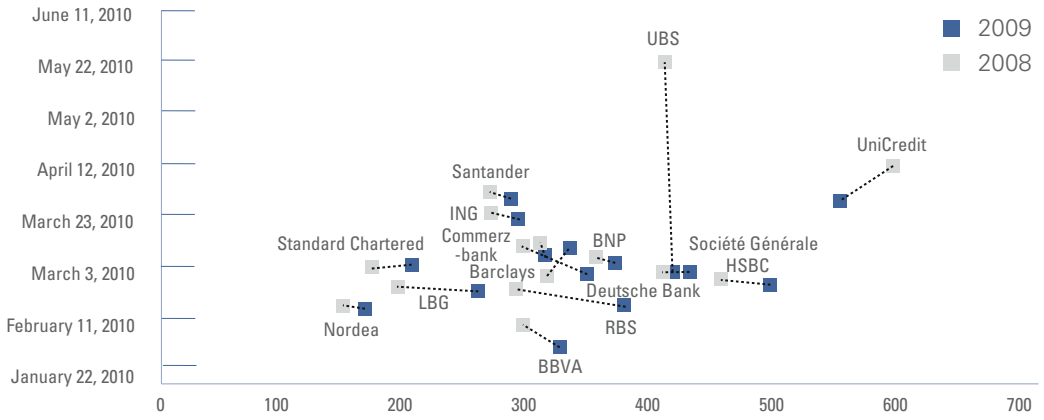
The 'other financial information' section also increased. This section includes diverse information about the banks' business, risk, corporate governance and remuneration reports, business reviews, management discussions and information about business segments. The average volume of this section increased by 6% in 2009.

Attestation dates

The average period from balance sheet date to attestation date decreased slightly from 70 days in 2008 to 63 days in 2009.

The graph illustrates the period from balance sheet date to attestation date as well as the volume of the annual reports. It has to be considered that some banks make preliminary announcement of their results before the publication of their annual report. In some cases the announcement or publication date may differ from the attestation date, being the date on which the accounts are signed.

Attestation (Date and no. of pages)



Source: KPMG International, June 2010

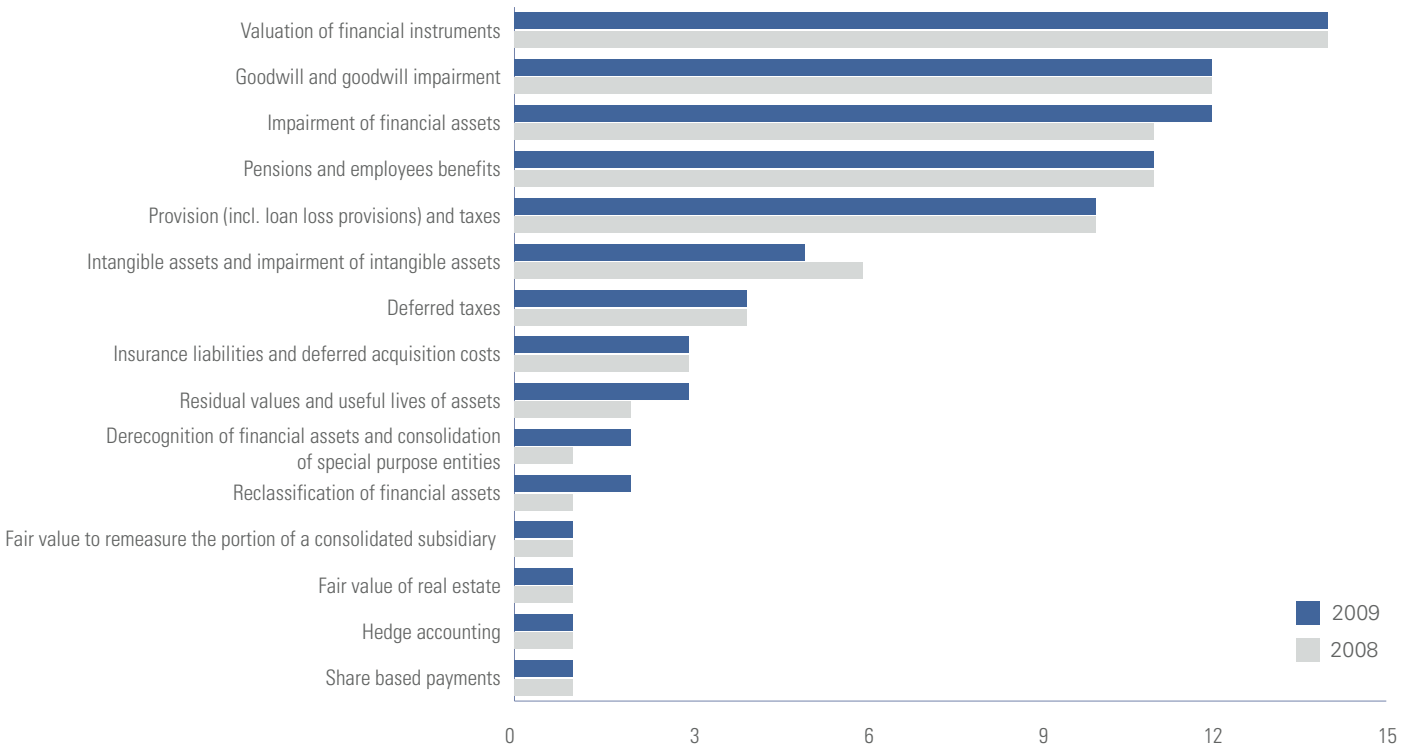
BBVA took the shortest period with only 35 days. UniCredit took the longest time (90 days) but its annual report was also the longest. The annual report of UBS was restated last year. Therefore this year's attestation date is significantly earlier than in 2008.

Judgements and estimates

IFRS requires entities to disclose the judgements that management has made in applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Entities are also required to disclose assumptions about estimates that may result in a material adjustment to the carrying amounts of assets and liabilities in the future.

The critical accounting policies identified by the banks are similar to last year. Most banks considered the valuation of financial instruments as critical. The impairment of financial assets, pensions, provisions (including loan loss provisions) and goodwill impairment were also considered critical by the majority of the banks.

Critical accounting policies (Number of banks)



Source: KPMG International, June 2010

The quantity and quality of information about judgements and estimates varied considerably with some banks providing very detailed information of up to ten pages and others disclosing only a few paragraphs and more general statements. We expect this to be an area of focus for regulatory bodies in the future.

Only two banks, Deutsche Bank and HSBC, presented five or more pages of disclosures. Deutsche Bank significantly increased the information about accounting judgements and estimates (ten pages in 2009 compared to one page in 2008); identifying the following significant accounting policies that involve critical accounting estimates: fair value estimates, reclassification of assets, impairment of loans and provision for off-balance sheet positions, impairment of other financial and non-financial assets, deferred tax assets and tax risks. For all of these accounting policies the bank describes the accounting estimates and judgements and disclosed the amount of the items concerned.

Summary

The volume of annual reports remained consistently high across the banks in 2009, reflecting the complexity of the banks' operations and the high level of disclosure requirements under IFRS. Quality and quantity of disclosures of judgements and estimates continues to vary between the banks although most provided general information thereon.

Due to forthcoming regulatory requirements we may see the information published both in annual reports and outside (e.g. in a separate report, as Pillar III information) increase further.

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