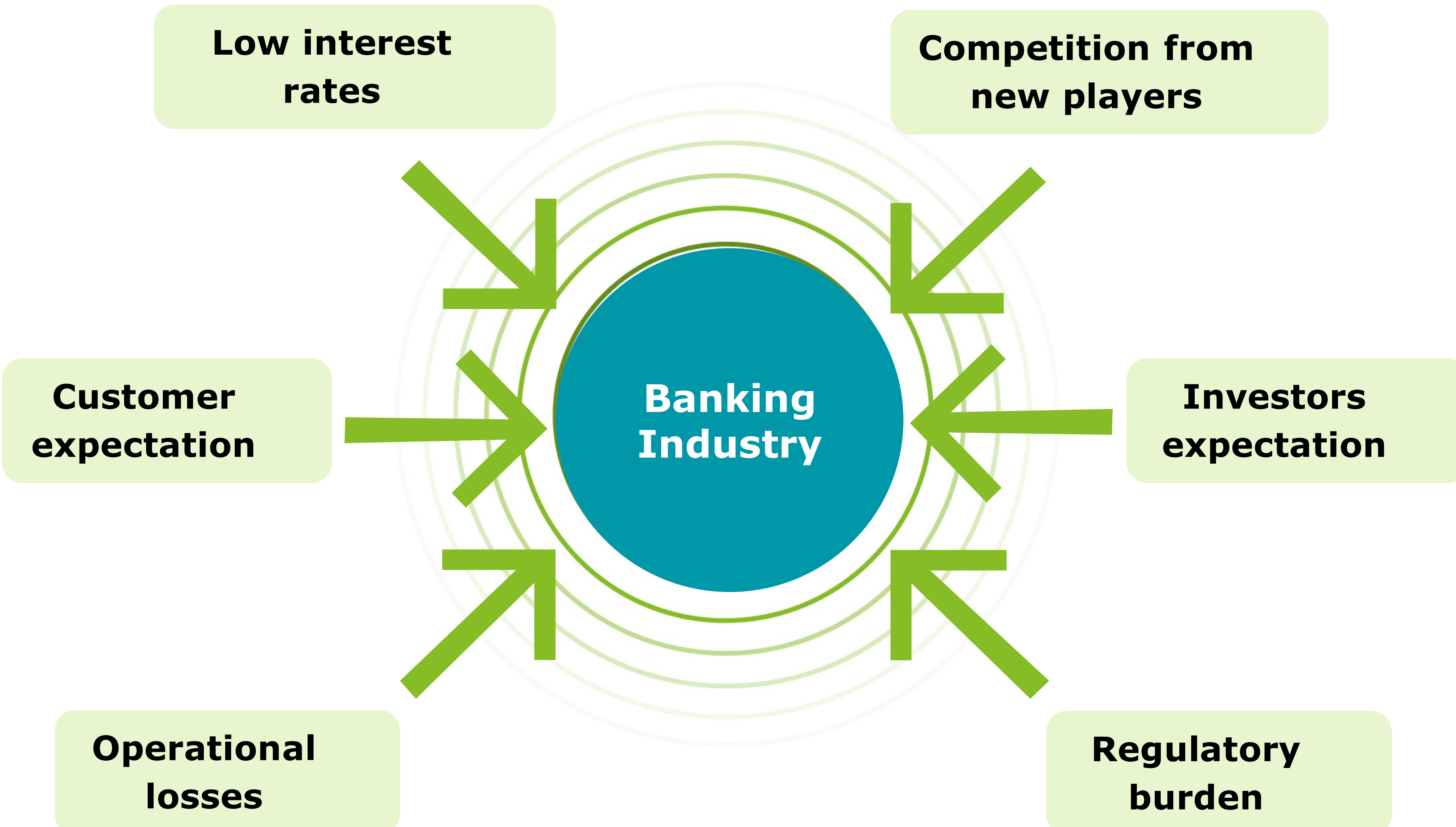
Deloitte.

Sustainability of the banking profitability model

October 2019

Risk Advisory

Banking industry is facing an unprecedented pressure



IFRS 9 impact on products

Banks need to review their portfolio strategy at a much more granular level

IFRS 9 made some products and business lines less profitable:

Industry

The forward-looking nature of credit provision under IFRS 9 means that banks need to reconsider their allocation of lending to economic sectors with greater sensitivity to the economic cycle, also to evaluate whet is phase of the cycle.

Maturity

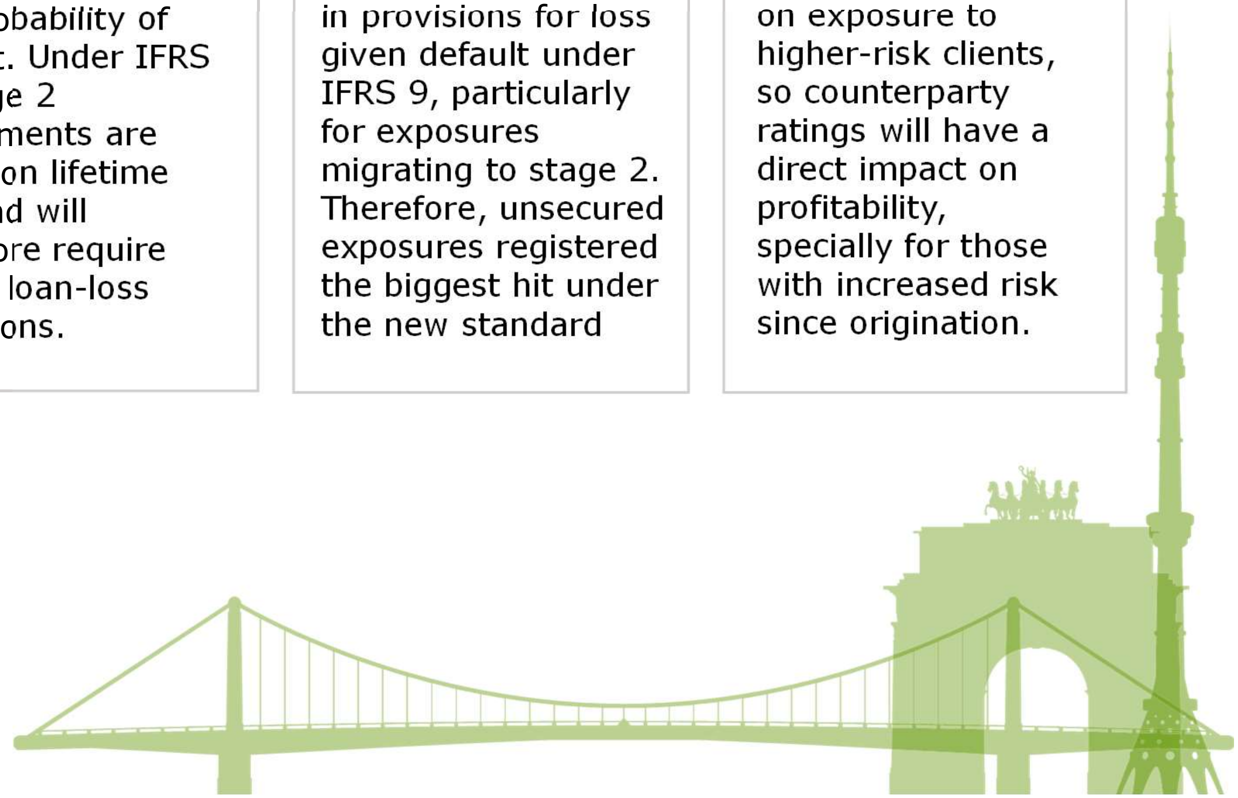
The longer the time frame, the higher the probability of default. Under IFRS 9, stage 2 impairments are based on lifetime ECL and will therefore require higher loan-loss provisions.

Collateral

Guarantees help mitigate the increase in provisions for loss given default under IFRS 9, particularly for exposures migrating to stage 2. Therefore, unsecured exposures registered the biggest hit under the new standard

Counterparty Ratings

IFRS 9 imposes heavier provisions on exposure to higher-risk clients, so counterparty ratings will have a direct impact on profitability, specially for those with increased risk since origination.



IFRS 9 impact on provisions

IFRS 9 had a direct, quantifiable impact on provisions feeding into the P&L.

Introduction of **stage 2** forces banks to maintain higher provisions **generating opportunity costs**.
The impact is different, depending on products.

Impact on provisions

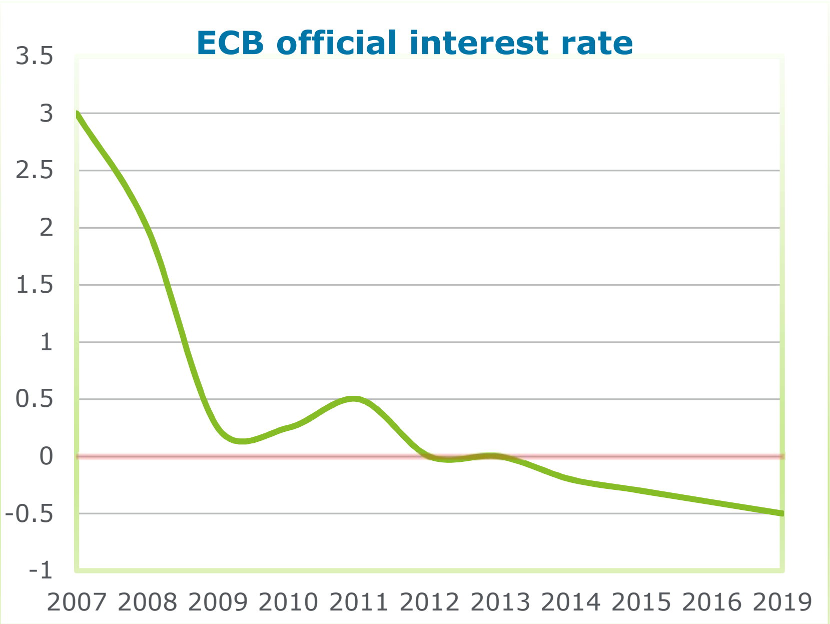
Unsecured loans	Secured loans	Corporate loans
Short maturities have less impact even if a loan enters stage 2. A significant part of credit portfolio may enter stage 2 (due to lifetime PD comparison if the assumption is that the remaining lifetime is in recession, while at origination boom prediction was considered).	Long maturities generate very high lifetime ECL when assigned to stage 2. Projection of real estate market decline increases ECL estimation. Due to lifetime comparison potentially smaller part of portfolio should enter Stage 2 (as recession is only a small part of product's lifetime and at origination recession is already considered).	Danger of unbalanced portfolio: • Sensitive to new technologies • Hotels • Construction There is a risk that whole business sectors may enter stage 2 at once.

- Can banks **predict** that a certain portfolio enters **stage 2** in the future?
- Can banks **assess** such customers adequately **at the moment of application**? How is this recorded/historized in lifetime PD at origination?

Low interest rates squeeze deposit margins

ECB monetary policy had a significant impact on banks profitability

In July 2012 the ECB set its deposit facility rate to 0%. A series of further cuts pushed the deposit facility rate into negative territory, **reaching -0.5% in September 2019.**



Most of the European banks have so far chosen not to expose households and companies to a negative deposit rate.

This means in turn that banks' **"deposit margins" are squeezed, thus having a negative impact on profitability.**

Source: Key ECB interest rates
https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

Operational Risk causes huge losses to banks

Persistent cybersecurity threats is a key driver for operational risk

Cyber-attacks costed nearly $360 billion per year in losses every year, for the past three years*

User awareness training and testing

This will help to reduce the risk of unauthorized access and prevent breaches.

Strong authentication mechanisms

To prevent malicious actors from gaining access to banking systems or information.

Identify key responsible

Designation by bank management of appropriate personnel for key responses, including personnel from operations, business units, public affairs, and legal, as well as personnel for coordination with service providers, law enforcement, and other government entities.

Periodic independent auditing

Conduct periodic independent auditing will help to establish a proper risk control and monitoring.

A strong system development lifecycle

This requires regular maintenance, patching, timely updates, and disposition at end-of-life.

Control over vendors

Identification of vendors that may have access to data and control systems, and who perform key operations.

*The Global Banking and Finance Review

Increasing cost of compliance

Regulatory environments globally are becoming increasingly complex

January 2018

IFRS 9

June 2018

Internal Governance

The EBA's Guidelines on internal governance apply across the EU

July 2018

MiFID II / MiFIR

Firms will be subject to the Legal Entity Identifier (LEI) requirement ("no LEI, no trade" requirement)

January 2019

TLAC

Total Loss Absorbency Capacity (TLAC) requirements set the minimum for G-SIBs at 16% of risk-weighted assets or 6% on a leverage ratio basis. This will rise to 18% of RWAs in 2022

September 2019

Outsourcing

EBA Guidelines become applicable

September 2019

PSD2

Delegated acts on strong customer authentication and common secure communication, under the Revised Directive on Payment Services (PSD2), become applicable in its entirety from 14 September 2019

January 2020

AML

The 5th Anti-Money laundering directive has been adopted and entered into force on 9 July 2018. Member States will have to implement these new rules into their national legislation by 10 January 2020.

July 2020

MiFID II / MiFIR

The open-access requirements for exchange traded derivatives to apply fully. MiFID II's open access rules aim to give traders a choice on where to clear listed derivatives contracts.

January 2021

NPLs

EBA new default definition

January 2022 +

Revised Basel Framework

Globally, banks are spending more than **$270 billion a year on compliance and regulatory obligations**, having on average 10–15% of their staff dedicated to compliance.

300+ million pages of regulatory documents will be published by 2020 and 600+ legislative initiatives need to be cataloged by a medium-sized, sell-side institution to have a holistic view of their rulebook.

FinTechs lead innovation in the banking industry…

… but failed yet to disrupt the competitive landscape

FinTechs have undeniably made their mark on the banking industry, as they:

- shaped and paced **innovation** across financial services;
- set higher standards for **customer expectations** and user experience.

FinTechs will likely be more successful servicing and partnering with banks, especially in the area of data sourcing, data analytics, and cognitive technologies.

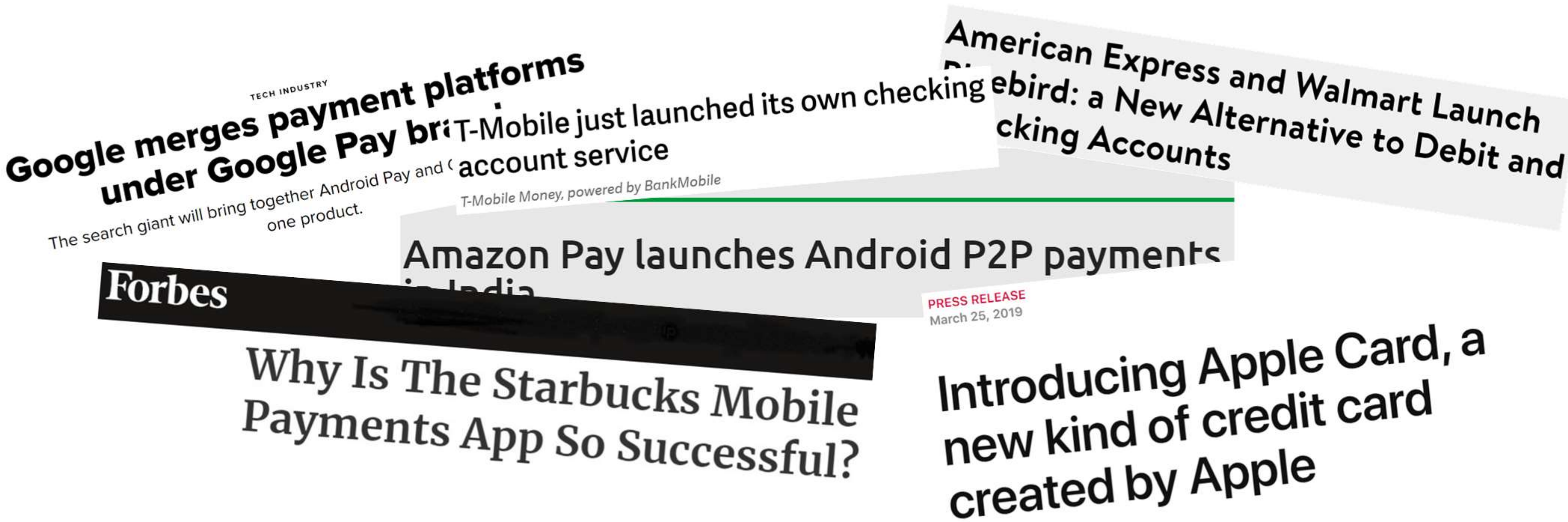
Banks will likely remain dominant, but teaming with the extended ecosystem will become a key source of competitive advantage.

Banks will likely maintain market leadership due to certain factors that work in their favour:

- **regulatory barriers to entry -** Banks are essential intermediaries between stakeholders and FinTechs are not taking over this essential role in the economy;
- **convincing customers to switch -** FinTechs have underestimated customer willingness to switch from incumbents;
- **the capital to absorb, partner with, or replicate FinTechs -** FinTechs have struggled to create new infrastructures.

New Competitors for Banks

Payments, a source of up to one-quarter of traditional bank revenues, is one of the most threatened areas



- ✓ **PayPal** is now **the number one online payment method** in many countries;
- ✓ nearly 1/3 of US **Starbucks** revenues are paid through its **own loyalty cards;**
- ✓ **Google** and **Apple introduced they payment app** for mobile phones;
- ✓ **T-Mobile** launched a new checking service with a smartphone app and ATM card;
- ✓ In just four years, **Alibaba**’s repository for leftover cash from online spending became the **largest money market fund in the world**, through its Ant Financial Unit.
- ✓ **Walmart** teamed up with **American Express** to launch a **prepaid card that functions like a debit account**.

The bank of the future?

Banks need to transform to stay competitive

- **Adapt to a new generation of customers and technologies**
- **Become faster**
- **Be more efficient**
- **Tackle with regularly pressures in a smarter way**
- **Manage emerging risks**
- **Optimize capital**