Consumer banks 2Q20: Heightened provisions and muted customer activity impact profits

EY Banking & Capital Markets benchmark report

August 2020

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Contents

About this report

The EY Global Banking & Capital Markets benchmark report analyzes the financial performance of banks at a subsector level.

This consumer banking 2Q20 report compares the performance of consumer banking divisions of leading banks across the US, the UK and Europe. While consumer banking may be primarily a regional or local business, this perspective helps identify some global trends on how the subsector is performing.

The report is based on a proprietary EY database of detailed financial information, including balance sheets, income statements and critical pieces of company intelligence.

All information is sourced from publicly available banks' financial statements.

Performance snapshot

2Q20 key performance indicators: a selection of median Year-over-Year (YoY) percentage change of figures, ratios and industry margins

Return on equity (ROE)

5.7%

Industry median – post-tax profit on equity allocated to division

2Q19 = 15.9%

Revenues

-11.7%

The median YoY percentage change in consumer banking (CB) revenues

2Q19 = 0.9%

Operating expenses

-4.2%

The median YoY percentage change in CB operating expenses

2Q19 = 0.3%

Loans

+1.1%

The median YoY percentage change in consumer loans

2Q19 = 1.1%

Non-performing loans (NPLs)

2.7%

The median YoY percentage change in consumer NPLs

2Q19 = -1.5%

Cost-to-income ratio (CIR)

62.8%

Ratio of operating expenses to operating income

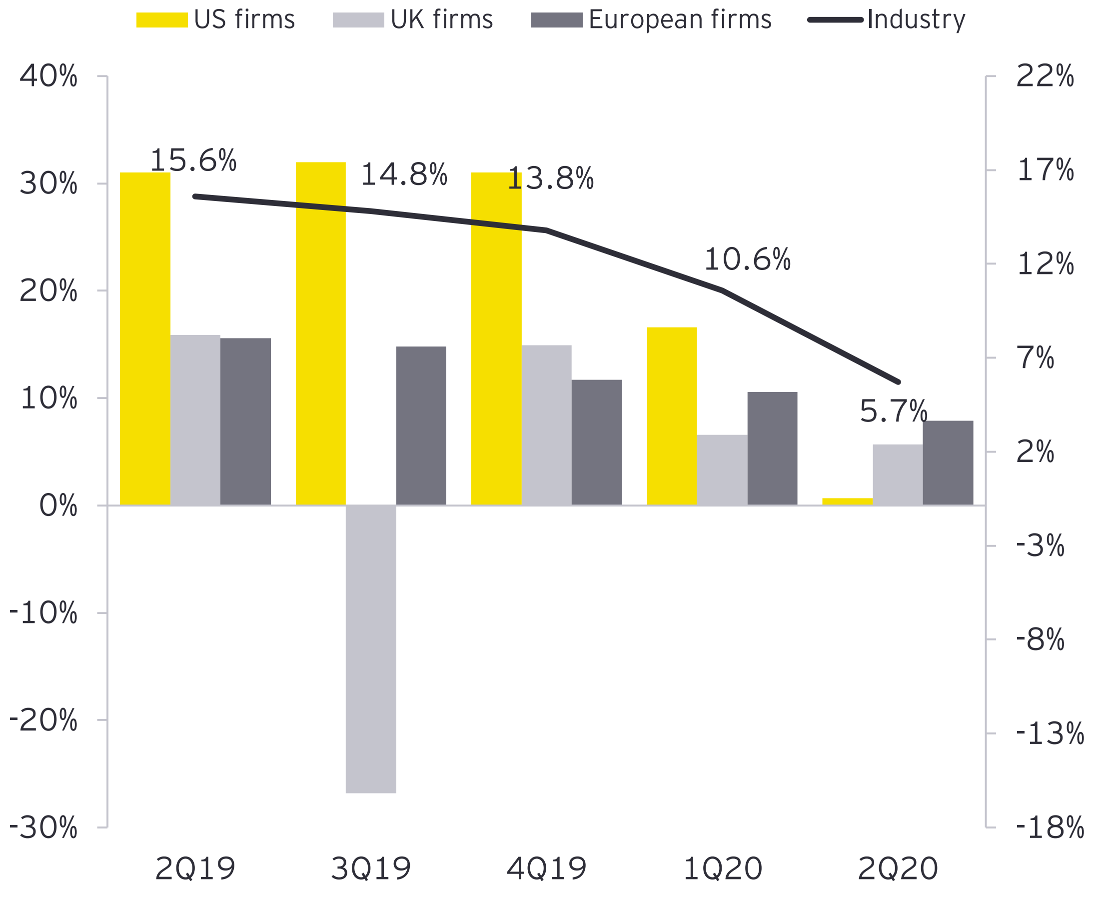
2Q19 = 60.0%

- COVID-19 continued to test the sector's financial strength, resilience, digital readiness, and customer engagement.
- Return on equity (ROE) further declined in 2Q20 largely due to the rise in provisions coupled with the fall in revenues by banks.
- Revenue growth deteriorated due to margin compression and muted customer activity across all regions.
- Expenses declined due to efficiency measures and reduction in discretionary expenditure across the UK and Europe.
- The positive impact from improved underwriting was offset by COVID-19 effects and the adoption of new credit loss accounting standards.

Source for all slides (unless otherwise noted): EY Global Consumer Banking Database – 2Q20; company filings.
Industry reporting of income statement data is subject to transparency and availability of public data.
Note: the use of the median over the mean is to help negate possible outliers in the data and reduce the influence of outliers across a relatively small dataset.

Return on Equity (ROE)

ROE; median values; 2Q19 – 2Q20



Industry profitability fell drastically in 2Q20

- In 2Q20, median industry ROE declined by 9.9 percentage points (pps) YoY to 5.7%. The decrease was driven by a lower profit before tax (PBT) partially offset by a marginal decline in the allocated capital to consumer banking divisions.
- Overall, the most profitable banks generated favorable jaws (i.e., revenue growth exceeded expense growth) that contributed to high ROE. On the other hand, the least profitable banks suffered from higher loan-loss provisions, and subdued revenues in the challenging market environment.
- For the US banks, the median ROE slumped by 30.3 pps YoY, reflecting increased provisions for credit losses, low rate environment and lower contribution from the cards category.
- Among the UK banks, the median ROE fell from 15.9% in 2Q19 to 5.7% in 2Q20 due to the unusual growth in expected credit losses, margin pressures (resulting from COVID-19 customer support actions) and rise in pandemic-related expenses.
- For the European banks, the median ROE fell by 7.7pps YoY, as the rise in credit costs and fall in revenues were partially offset by the banks’ cost containment initiatives.

1 Operating performance

Operating performance

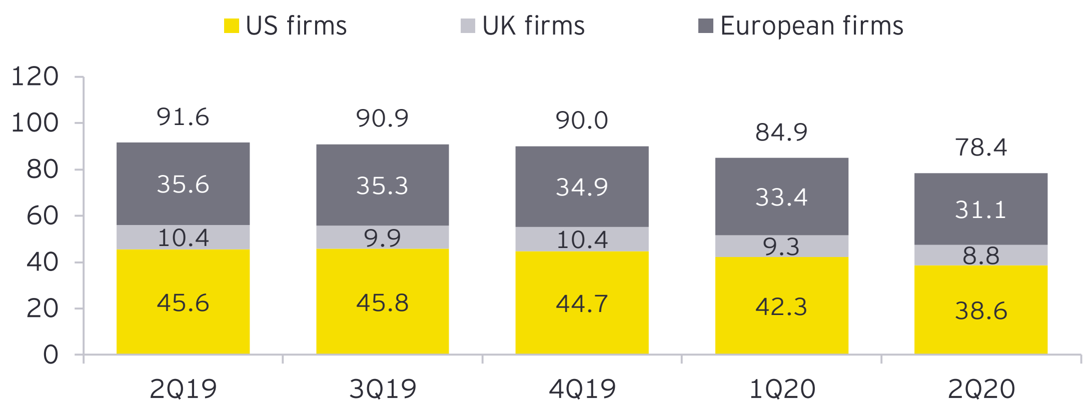
Operating revenue and expenses growth; 2Q20 and 2Q19

Efficiency control remains critical to banks' operating performance in this difficult environment

- Historically, consumer banking businesses have not been able to grow revenues in conjunction with cost-control measures. The majority of banks in the peer set were focused on controlling costs; however, only four banks generated positive jaws in 2Q20.
- COVID-19 and the prolonged lockdowns created uncertainty in the banks' revenue growth, as consumers spent cautiously and largely only on necessities. Thus, efficiency control should be focused, as revenues are unlikely to grow in the near-term at least.
- Additionally, consumer banks need to concentrate on reducing their loan origination costs by enhancing the use of digital channels, deepening client relationships and rationalizing their existing processes to reduce redundancies.
- An emphasis on reducing marginal costs, rationalizing the branch network, outsourcing or divesting from non-critical activities, and addressing legacy issues would enable consumer banking divisions to deliver sustainable performance.

Revenue growth

Industry operating revenues (US$b); 2Q19 – 2Q20



Operating revenue by region; median YoY percentage change; 2Q19 and 2Q20

	2Q19	2Q20
Operating revenue	**0.9%**	**-11.7%**
US firms	0.9%	-11.7%
UK firms	-3.5%	-14.1%
European firms	1.3%	-5.5%

Aggregate revenues fell to a five-quarter low

- Aggregate CB revenues declined substantially by 14.4% YoY to US$78.4b in 2Q20, the lowest level in the past five quarters – driven by a weak performance of consumer divisions across all regions.
- Net interest income (NII) was largely impacted by the low interest rate environment prevalent across most countries. As a result, aggregate NII declined 13.3% YoY in 2Q20 (*slide 8*).
- Aggregate noninterest income fell by a substantial 19.6% YoY in 2Q20, largely due to muted customer transaction activity and the introduction of various fee waivers (*slide 9*).
- Only one bank in the peer set reported an increase in revenue in 2Q20, reflecting greater mortgage banking revenues (higher production and gain on sale margins) that more than offset the impact of low rates on deposit spreads.
- Meanwhile, other banks witnessed revenue decline due to the interest-rate-driven margin compression, falling card fees and a structurally weak mortgage market.

Net interest income (NII)

NII; aggregate YoY industry change; 2Q20

-13.3%

The industry NII grew by 1.1% in 2Q19

NII by region; median YoY percentage change; 2Q19 and 2Q20

	2Q19	2Q20
NII	1.1%	-7.2%
US firms	2.7%	-13.8%
UK firms	-3.6%	-14.8%
Europe firms	1.1%	-4.6%

NII fell to a five-quarter low

- Aggregate consumer banking NII decreased by 13.3% YoY from US$55.3b in 2Q19 to US$48.0b in 2Q20. None of the banks in the peer set recorded growth in NII in 2Q20.
- In the US, NII fell by 13.8% in 2Q20, primarily reflecting the impact of lower rates and lower volume in card loans. However, the decline was partially offset by the resilient balance sheet growth from other categories (such as paycheck protection program loans, etc).
- NII in the UK was impacted by deposit margin compression, mortgage margin pressures and low overdraft income that were partly offset by lower funding costs.
- Meanwhile in Europe, NII realized a moderate decline of 4.6% YoY, as margin compressions and lower deposit income were considerably offset by the strong lending volume growth.
- Going forward, the weak economic outlook and maintenance of low interest rates by central banks will continue to impact the loan growth and interest margins of banks.

Noninterest income

Noninterest income; aggregate YoY industry change; 2Q20

-19.6%

The industry non interest income grew by 4.5% in 2Q19

Noninterest income; median YoY percentage change; 2Q19 and 2Q20

	2Q19	2Q20
Noninterest income	**-3.2%**	**-14.3%**
US firms	0.4%	-28.5%
UK firms	-2.9%	-27.3%
European firms	-4.5%	-9.3%

Noninterest income fell considerably from 2Q19

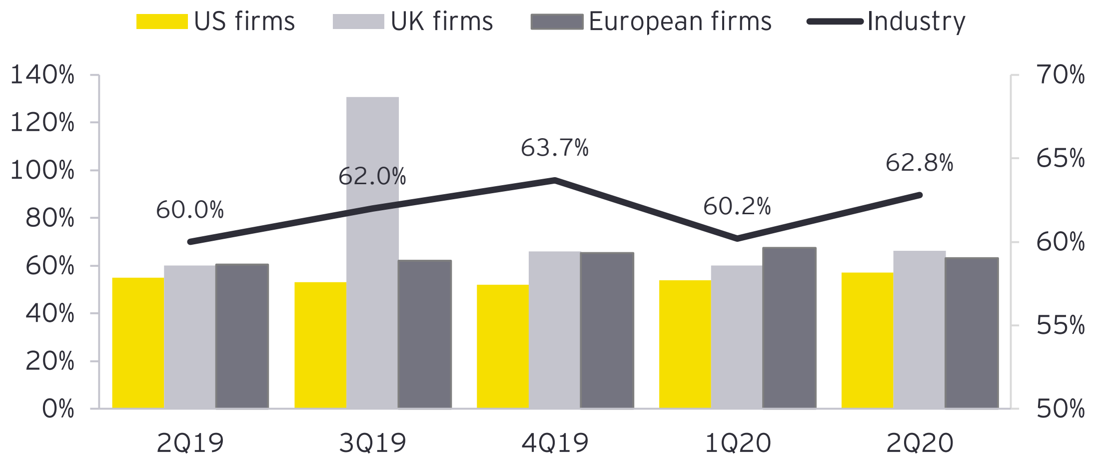
- Aggregate consumer banking divisions' noninterest income decreased 19.6% YoY from US$22.6b in 2Q19 to US$18.2b in 2Q20. Only two banks in the peer set reported higher noninterest income in 2Q20, compared to 2Q19.
- In the US, noninterest income was impacted by lower transaction activity, decline in service charges and fall in card income resulting from the reduced consumer spending. In the UK, removal of certain fees and lower income from unsecured lending products continued to impact banks in 2Q20.
- European banks reported a moderate fall in noninterest income, as reduced consumer spending was partially offset by fee income from investment and securities products.
- Best performing banks realized strong mortgage banking revenues (due to higher production and related gain-on-sale margins), and resilient commission income in a volatile capital market environment.
- Amid the pandemic, further slowdown in consumer spending, except for the necessities, is likely to continue to impact banks' noninterest income in the coming few quarters.

2 Business efficiency

EY

Cost-to-income ratio (CIR)

CIR; median values; 2Q19 – 2Q20



Cost-to-assets ratio; median values; 2Q20

+2.8%

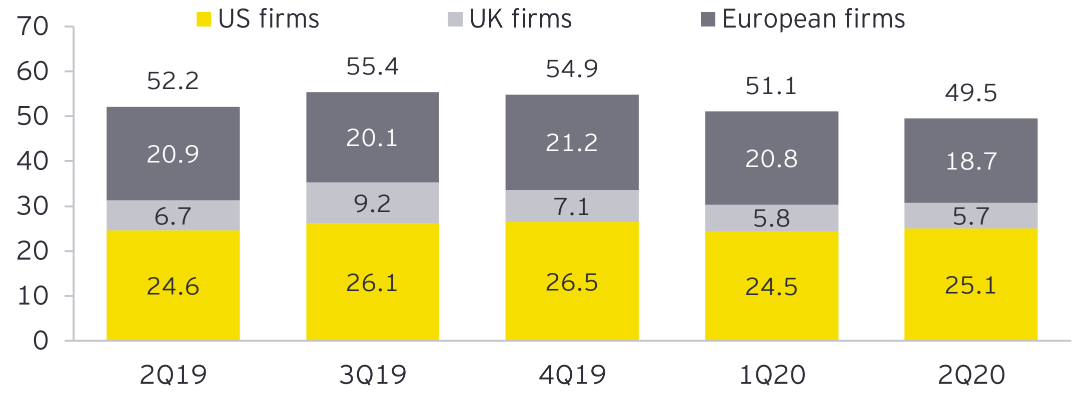
The industry cost-to-assets ratio was 2.8% in 2Q19.

Industry efficiency remained adversely impacted by the negative operating leverage

- The median industry CIR deteriorated from 60.0% in 2Q19 to 62.8% in 2Q20.
- The least efficient banks suffered from increased transformation charges, higher severance costs and heightened customer remediation accruals.
- In contrast, the most efficient banks benefited from cost savings from synergies in various units, results from the restructuring programs and positive impact from cost reduction programs.
- Meanwhile, the median cost-to-assets ratio remained around its lowest levels at 2.8% in 2Q20, highlighting banks' initiatives to rethink their cost structures.
- Prolonged lockdowns have amplified the need for banks to reduce dependence on branches and accelerate the shift to digital channels. They have focused on branch rationalization in the past quarters. However, the need to control costs in this highly challenging environment demands even more radical changes to their channel strategy.

Operating expenses growth

Industry operating expenses (US$b); 2Q19 – 2Q20



Operating expense by region; median YoY percentage change; 2Q19 and 2Q20

	2Q19	2Q20
Operating expense	**0.3%**	**-4.2%**
US firms	-1.1%	3.9%
UK firms	9.5%	-8.1%
European firms	0.5%	-4.2%

Expenses declined to a five-quarter low

- Aggregate consumer banking expenses decreased by 5.2% YoY from US$52.2b in 2Q19 to US$49.5b in 2Q20.
- Region-wise, median change in aggregate expenses stood at +3.9% YoY in the US (COVID-19 related employee costs and continued business investments), -8.1% YoY in the UK (lower staff costs, efficiency saving measures and reduced discretionary expenses) and -4.2% in Europe (positive impact of bank's cost containment plans and absence of one-off charges, such as goodwill impairments).
- Decline in both compensation and non-compensation costs led to banks' reduced operating expenses. Compensation costs declined, reflecting reduced headcount and fall in deferred compensation expenses at most banks. Non-compensation expenses declined largely from reduced marketing and advertising spend in light of the pandemic situation.
- Best performing banks took cost control measures and lowered personnel costs, while the banks with inflated cost bases were impacted from COVID-19 related costs to front line staff, and higher customer remediation accruals (at one bank).

3 Loans and asset quality

Consumer loans and mortgages (1/2)

Consumer loans

US$5.1t in 2Q20

1Q20: $5.1t 4Q19: $5.2t

Mortgage loans

US$2.7t in 2Q20

1Q20: $2.8t 4Q19: $2.8t

Consumer loans, mortgage growth by region; median percentage change; 2Q19 and 2Q20

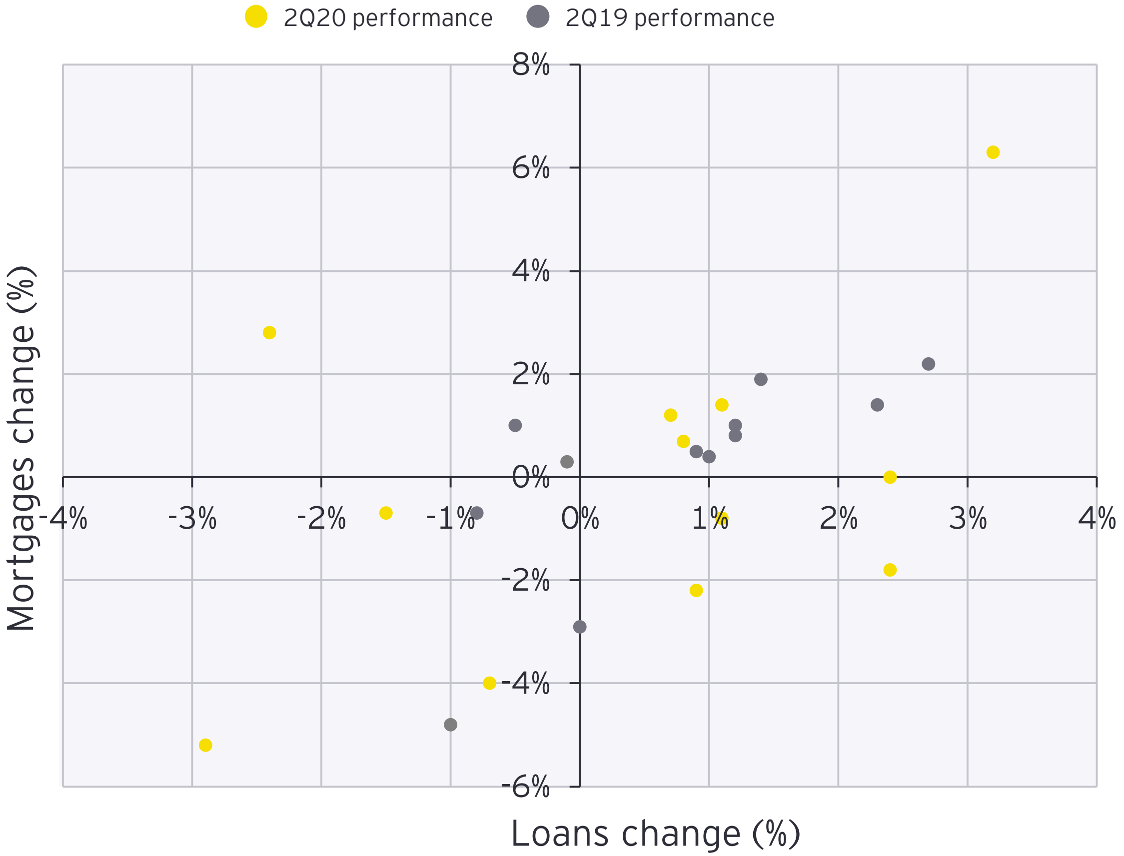
	2Q19	2Q20
Consumer loans	**1.1%**	**1.1%**
US firms	1.4%	-0.7%
UK firms	0.9%	0.9%
European firms	1.1%	1.1%
Mortgage loans	**0.8%**	**-0.3%**
US firms	1.4%	-1.8%
UK firms	1.1%	-0.5%
European firms	0.6%	0.7%

Consumer lending declined to the lowest level since 1Q19

- Aggregate consumer banking loans remained flat quarter-over-quarter at US$5.1t in 2Q20.
- Banks that realized strong growth in consumer loans benefited from strong growth in gross new residential mortgages and COVID-specific lending schemes.
- Banks with the most decline in consumer loans suffered largely due to the magnitude of reduction in credit card balances and a decline in junior-lien mortgages (second mortgages).
- Meanwhile, aggregate mortgage loans registered a marginal decline from US$2.8t in 1Q20 to US$2.7t in 2Q20.
- Going forward, uncertain economic conditions, structurally low growth and limited policy space are likely to impact banks' loan growth.
- According to *EY's Future Consumer Survey*, 63% of respondents say that they would spend less on luxury items and focus on necessities over the next one to two years. This consumer aversion toward spending is likely to hurt loan growth expectations further.

Consumer loans and mortgages (2/2)

Mortgage growth vs loan growth: average change; 2Q20 and 2Q19

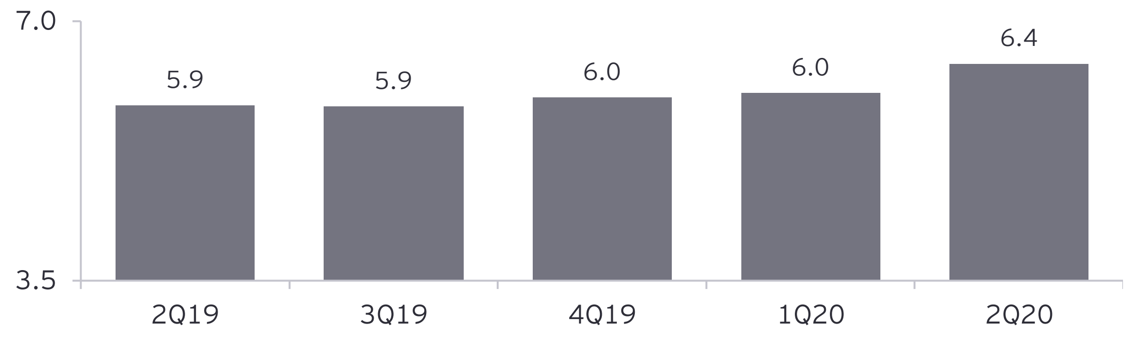


Mortgages showed resilience despite uncertainties

- Over the past few years, the mortgage market continued to be sluggish but stable, primarily due to growing house prices that held back the demand from many potential buyers.
- The banks that witnessed mortgage growth saw increased gross new residential mortgage lending (driven by low interest rate environment) and lower redemptions.
- However, the banks that reported a decline in mortgages suffered due to lower consumer loans in the residential real estate portfolio, predominantly driven by loan sales as well as paydowns in the home lending segment.
- Going forward, the soaring real estate prices, aversion to owning physical assets (as highlighted in the EY's Future Consumer Survey), possible unemployment situations and wage losses related to COVID-19 pandemic will impact the mortgage markets.
- Overall, COVID-19 presents the biggest challenge to mortgage markets since the financial crisis, and banks need to take decisive actions to adapt.

Deposits

Consumer banking deposits (US$t)



Consumer banking deposits growth by region; median percentage change

	2Q19	2Q20
Consumer deposits	**+1.3%**	**+5.3%**
US firms	+1.3%	+10.6%
UK firms	+1.8%	+5.4%
European firms	+1.2%	+4.3%

Consumer deposits at the highest in five quarters

- Aggregate consumer banking deposits increased to US$6.4t in 2Q20, from US$5.9t in 2Q19 and US$6.0t in 1Q20 – the highest level in five quarters.
- All of the consumer banks of the peer set reported higher consumer deposits in 2Q20, compared to 2Q19. Region-wise, median growth in consumer deposits stood at 10.6% in the US, 5.4% in the UK, and 4.3% in Europe.
- Banks leveraged adoption of digital channels and digital account opening processes to drive growth in deposit volumes. Additionally, customers' aversion to risk and the preference to maintain higher levels of liquidity (as a result of uncertain market conditions) boosted deposits.
- The pandemic and extended lockdown has intensified consumer acceptance and use of online and digital banking alternatives. Thus, banks with agile digital solutions are likely to benefit from this behavioral shift.
- Despite the growth, the data suggests intensifying fight for deposits as big digital lenders gain traction. Many large banks are losing deposit market share to digital-only banks providing above-market rates.

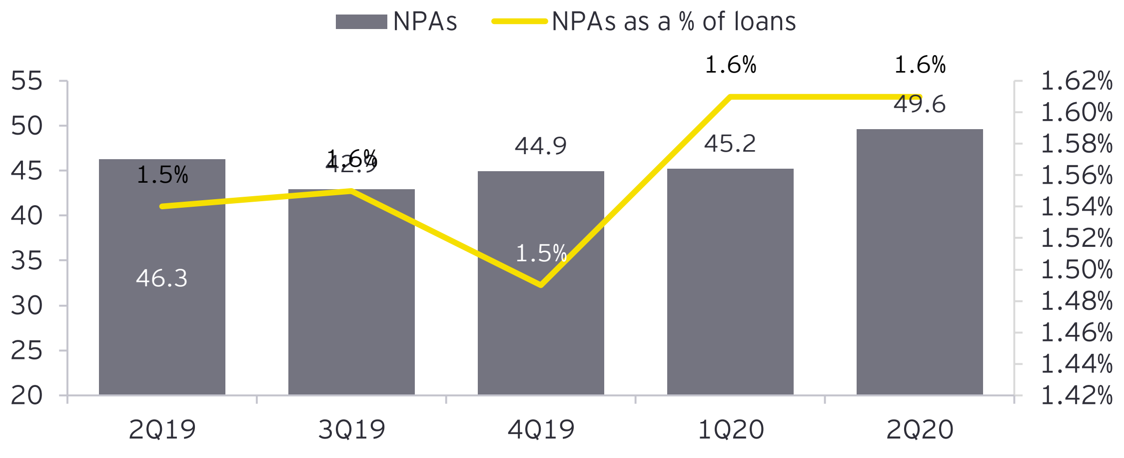
Non-performing assets (NPAs)

NPAs; aggregate industry change; 2Q20

+7.1%

The industry's NPAs declined by 2.8% in 2Q19

Consumer banking NPAs (US$b)



Asset quality showed a fluctuating trend over quarters

- Aggregate consumer banking NPAs stood at US$49.6b in 2Q20, compared to US$46.3b in 2Q19 and US$45.2b in 1Q20 – the highest level in the past five quarters.
- Continued focus on de-risking, coupled with robust underwriting practices, helped banks improve their asset quality over the past few years. But, the recent rise in NPA levels indicate the adoption of new accounting standards.
- Few banks that showed reduction in non-performing loans benefited from improved underwriting and charge-offs.
- However, the banks that witnessed the highest increase in NPAs in 2Q20 either had portfolios with rapidly deteriorating mortgage credits or recorded consumer delinquencies due to the impact from the COVID-19 pandemic.
- Going forward, accommodative monetary policies and payment deferrals will support the overall loan quality and funding of banks. However, the continuation of challenges to global growth from geopolitical risks and COVID-19 would continue to have a detrimental impact on loan quality.

Appendix

Database overview

Size of database (for quarter ending June '20)

US$5.1t

The combined sum of loans advanced by the consumer banking divisions of the banks in the peer group

Institutional coverage (for quarter ending June '20)

17

The database tracks the performance of the consumer banking divisions of the largest banks; reported data is subject to availability of public data

Geographic coverage (by headquarters)

Data points (2014-2Q20)

5,000+

The quantity of historical data points monitored in the database, covering 1QFY14 through to 2QFY20 results

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