

September 2005



Inside this issue

- 03 Is the future for unsecured credit as bleak as this year's interim results would imply?
- 05 The mortgage customer experience post-regulation – still consistently inconsistent?
- 08 Payment Protection Insurance ('PPI') – The balloon is inflating
- 11 IFRS: Is your financial reporting sustainable?
- 15 Financial Services M&A
Review of and outlook for mergers and acquisitions in the European financial services market

Editor: Harjeet Baura, Senior Manager,
Retail Banking Group Tel: 020 7804 7687
Email: harjeet.baura@uk.pwc.com

Distribution: If you would like to receive this newsletter by email or you would like add your colleagues to the mailing list, please contact Carly Taylor on carly.taylor@uk.pwc.com

UK Retail Banking Newsletter

I would like to take this opportunity to welcome you to the inaugural edition of the PricewaterhouseCoopers UK Retail Banking Newsletter.

This regular newsletter is aimed at providing insights and updates on the key issues and current developments facing the retail banking industry. In this edition we have five articles covering an interesting mix of industry-wide topics.

I hope that you find this newsletter informative and insightful. As with all of our publications your feedback is invaluable and we would welcome your comments and suggestion on this, and future editions of the newsletters.

Copies of this newsletter, and other related publications, are available on our global banking and capital markets website, www.pwc.com/banking. If you would like to discuss any of the issues raised in more detail, I would be happy to hear from you.

John Hitchins, UK Banking Leader
020 7804 2497
john.hitchins@uk.pwc.com

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Is the future for unsecured credit as bleak as this year's interim results would imply?

By John Hitchins and Harjeet Baura

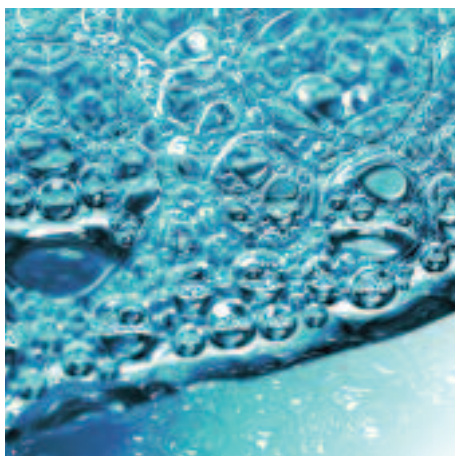
The introduction of IFRS can present significant problems in understanding the underlying trends of a business as, in a number of instances, the basis of measurement has changed significantly from previous accounting practice. In particular, the recent interim results announcements by the UK high street banks highlight one example of this – the method by which IFRS requires loan loss, or impairment, provisions to be calculated.

In the past few months, the UK unsecured credit market has without doubt seen a downturn in terms of credit quality. During this year's interim reporting season, nearly all UK high street banks released good results tinged with disappointing accounts of increased delinquencies and non-payments on credit cards and consumer loans. The press has painted a dismal picture of the situation with headlines predicting doom and gloom for the UK economy. Some commentators have pointed to the detrimental effects of new laws making bankruptcy a more favourable option for borrowers in difficulty and a general tightening of the credit market making loan

refinancing harder for those who borrowed from elsewhere once difficult questions started to be asked.

However, the introduction of IFRS has also contributed to the uncertainty as implementing the more detailed requirements relating to provisioning for bad debts will generally mean an increase for impairment provisions on unsecured loans. While Lloyds TSB was the only major bank to quantify the effect of IFRS (£111m of a total impairment charge of £511m) all banks with significant unsecured lending would have felt similar impacts. Whereas under UK GAAP,

The introduction of IFRS has also contributed to the uncertainty as implementing the more detailed requirements relating to provisioning for bad debts will generally mean an increase for impairment provisions on unsecured loans.



banks had to make an assessment of how much they would lose on defaulted loans, IAS 39 requires credit risk teams to estimate the cash flows expected to be received from loans showing signs of difficulty and also requires these cash flows to be discounted by the rate that is used to recognise interest on these loans, the “effective interest rate”. For some unsecured products, such as credit cards, this could mean a discount factor of up to 30%, therefore increasing the amount to be provided for regardless of whether recovery expectations have changed or not.

The unwind of the discount then flows back through the net interest income line leaving the impression that bad debt losses have risen sharply when in fact there has been no change to the underlying economics.

Consequently, focusing solely on impairment charges will not enable analysts and other users of financial information to understand all the underlying factors causing the increased charges to the income statement. It was clear from published commentaries that while some analysts appreciated that the basis of measurement has moved, other commentators did not and had not therefore revised their expectations surrounding reported provision numbers.

This is just one example of many where users and analysts need to proceed with caution in interpreting IFRS results. Banks face a tough task in separating the effects of IFRS reporting from the underlying trends. Transparency regarding the trend is the only way banks are going to avoid feeding the self sustaining danger of results being used incorrectly to expose a ‘debt crisis’ when actual trends point to merely a moderate worsening of credit quality.

Contact Us

[John Hitchins](#)

UK Banking Leader

Tel: 020 7804 2497

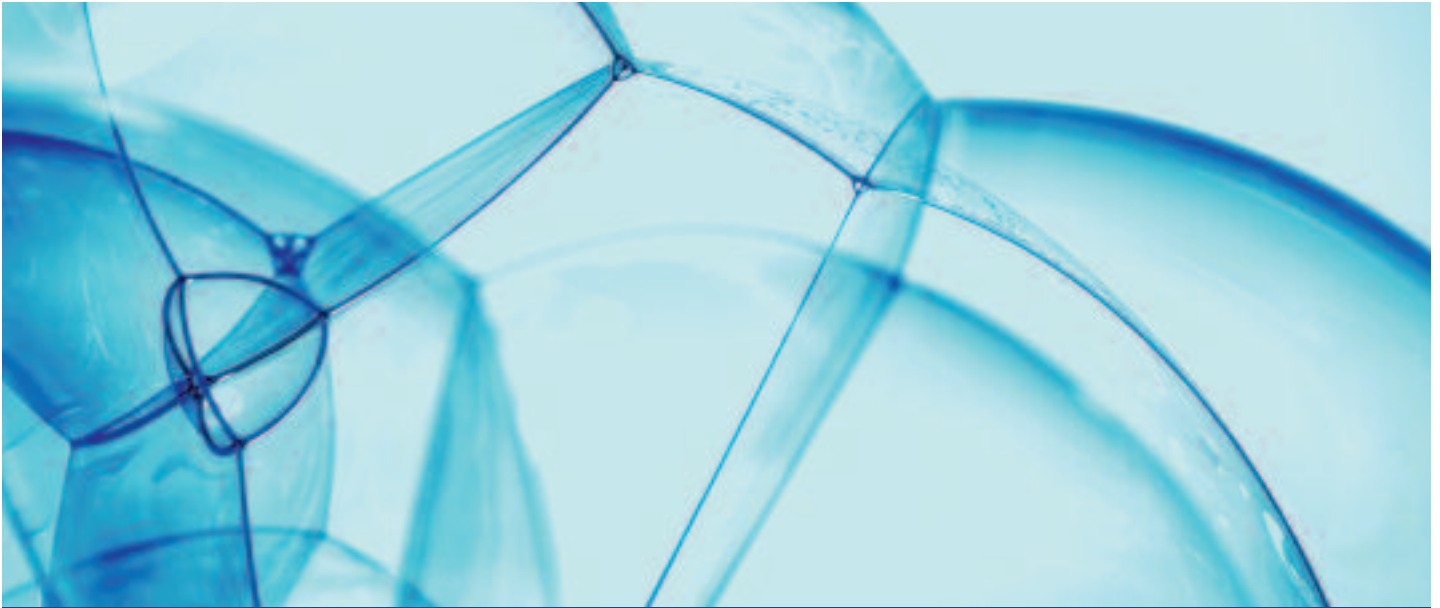
Email: john.hitchins@uk.pwc.com

[Harjeet Baura](#)

Senior Manager, Retail Banking Group

Tel: 020 7804 7687

Email: harjeet.baura@uk.pwc.com



The mortgage customer experience post-regulation – still consistently inconsistent?

By David McWhir

Within the mortgage market, there has been much debate as to how the Treating Customers Fairly principle can be reconciled with operating profitably whilst ensuring that new regulatory and legislative requirements are met.

The provision of the new Key Facts Illustration is indicative of the tension across these three elements. A primary reason for issuing such personalised illustrations is to enable customers shopping around for a mortgage to compare mortgage figures and conditions provided by different providers. From a Treating Customers Fairly perspective, customers should be in a position to make such comparisons prior to selection; however, such documentation is not always made available, possibly due to reasons of cost. When it is made available, the varying size of the documentation, ranging in our experience from 4 to 12 pages, does not make comparison easy from a customer perspective.

Towards the end of 2004, soon after mortgage regulation came into force,

PricewaterhouseCoopers undertook a mystery shopper survey of a number of leading mortgage providers, looking at key implementation and customer experience issues. The results of the survey, albeit in the early days of regulation, indicate that in many cases operational improvements will be necessary to meet the Treating Customers Fairly principle.

100 branches of leading mortgage banks and building societies together with 100 calls to providers of telephone based services were surveyed. The findings show that a number fell short in providing a consistent and well signposted approach for their customers and also issued a lower level of follow-up documentation than had been expected.

The results of the survey, albeit in the early days of regulation, indicate that in many cases operational improvements will be necessary to meet the Treating Customers Fairly principle.



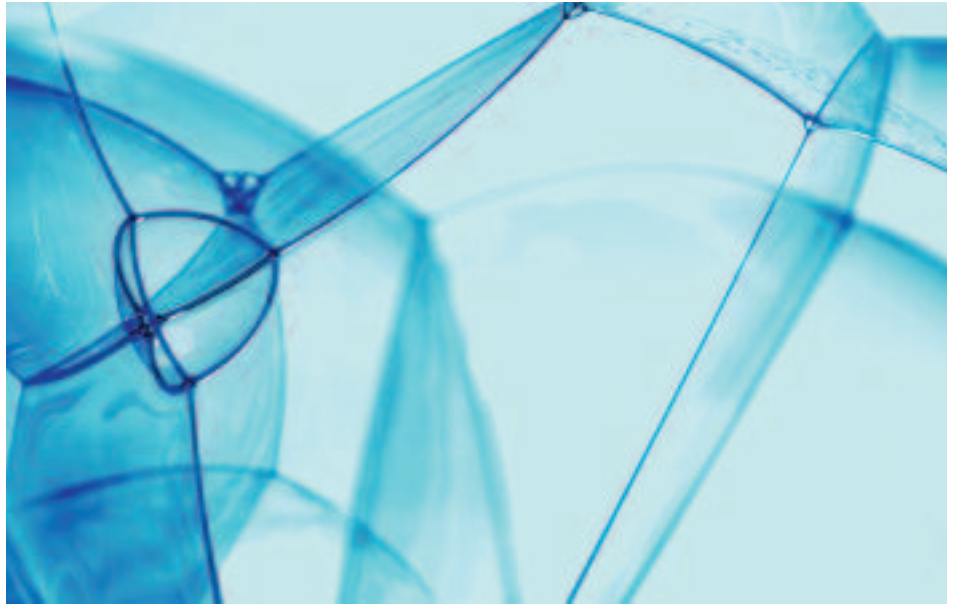
The survey was designed to provide early feedback to mortgage providers on customers' experiences of the newly regulated mortgage process and examined commercial aspects of their sales operation, such as ratings on 'likelihood of buying a mortgage' in relation to experience of various parts of the interview process.

Findings from the survey include:

- Early signs that whilst providers have made good progress in meeting the new regulatory requirements applying to the UK mortgage market, there is some evidence of inconsistency in providers following their own processes.
- Customer feedback suggests that there remains confusion as to what type of service they are being offered – “information only” or advice – and the range of products available to them.
- Of the telephone shoppers, 14% were unable to distinguish whether they were receiving advice or being provided with information only, such a distinction being a key requirement under the new regulations. More effective signposting throughout the interview may address this point.
- In 37% of branch information only interviews, the customer felt that the provider did not explain whether they were tied or independent. This figure fell to 24% of branch based visits in which the advice route was followed,

possibly due to the more participative experience. It may well be that the correct form of words was used by the adviser but it is possible that such information, again, is not being sufficiently signposted and/or being lost alongside the other information provided.

- The research also found that key documentation to support customers in their decision-making process, namely the Initial Disclosure Document and the Key Features Illustration, was not received in a number of cases.
- The Key Features Illustration (KFI) is designed to provide customers with confirmation of personalised information or recommendations provided to them. There was variation in the provision of such documentation, even within the same provider. This variation was particularly interesting, given that the mystery shoppers all offered the same scenario.
- Of those branch visiting shoppers who did receive a KFI, only 6% following the advice route claimed not to understand the documentation. However, this rose to 38% of those who went via the information only route professing not to understand the documentation.
- There was dissatisfaction with the length of the interview, although not in the way the sector might have expected. Prior to regulation, providers



expressed concern that customers would be put off by the increased length of interviews due to the requirements to follow a regulated process. However, a significant proportion of customers were dissatisfied when the interview was too short. Of customers who were unlikely to buy as a result of the experience (rather than price or product features), 35% of callers and 47% in branches rated the interviews as far too short.

- Of those who had meetings at branches and were given advice, half rated themselves as extremely likely to buy compared with 17% who went down the information only route.
- In 19% of cases, shoppers were unable to obtain a branch based interview within the three week period of the survey, suggesting that at the time insufficient numbers of trained representatives were available to meet demand. The period of the survey coincided with the lowest level of mortgage approvals for nine years.

Conclusion

Whilst the research was undertaken in the early days of the regulation of mortgage business, there were emerging trends on customer experiences and the impact of certain parts of the process on their perceptions. It will be interesting to see whether “bedding down” leads to an increase in customer satisfaction as well

as an improvement in the consistency and effectiveness of processes over time. PricewaterhouseCoopers is undertaking further research with a number of providers to establish how well the new mortgage processes have now settled in and areas for potential improvement. The FSA will continue to monitor how providers apply the Treating Customers Fairly principle to the mortgage process, undoubtedly paying particular attention to documentation, including the contents and length of the KFI, as well as comparability across lenders. Aspects of the process such as positioning and depth of credit referencing will also have an impact on how attractive lenders’ propositions to customers will be when shopping around.

Mortgage regulation ‘M day’ is now well behind us. However it would appear that there is still some way to go before it is fully and consistently delivering the experience the customer – and the FSA – is seeking.

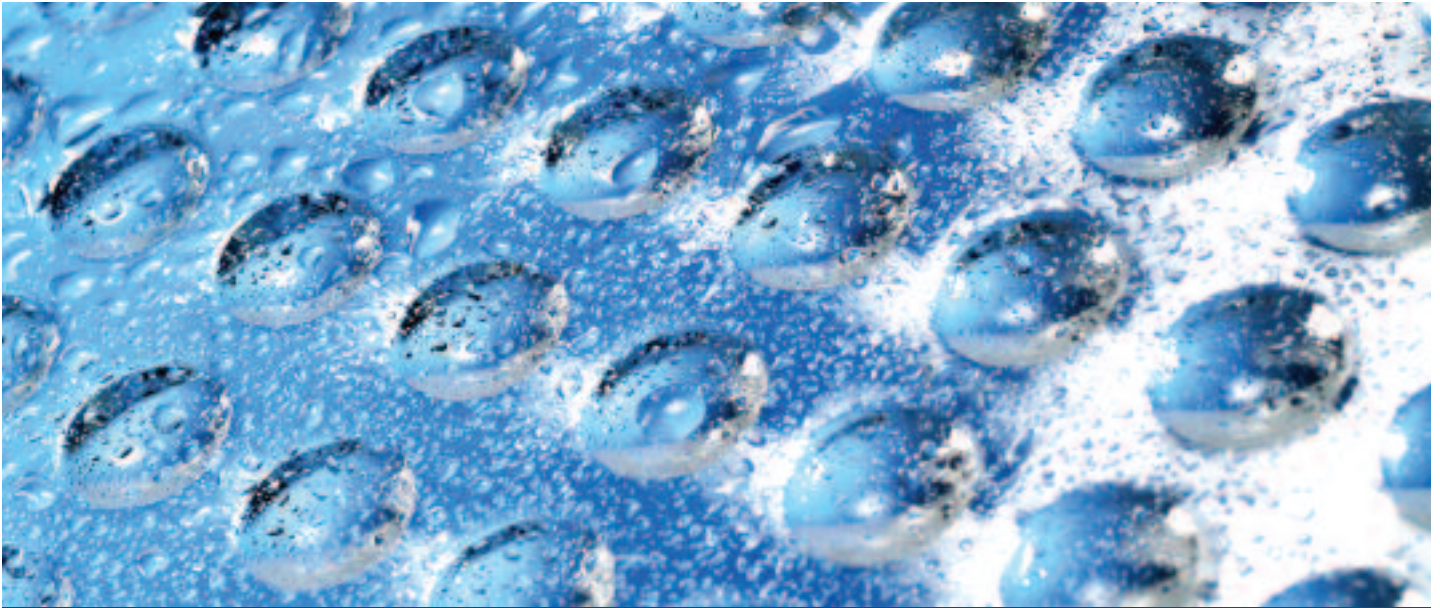
Contact Us

David McWhir

Senior Manager, Governance,
Risk and Compliance

Tel: 0161 245 2519

Email: david.w.mcwhir@uk.pwc.com



Payment Protection Insurance ('PPI') – The balloon is inflating

By David Morey and Vincent Branch

“We recommend that once the transfer of responsibilities for insurance regulation to the FSA has been completed the FSA should begin an investigation into the selling of Payment Protection Insurance. This should include the safeguards in place to prevent the mis-selling of PPI to customers who would not be able to benefit from it due to exclusions, how more competition could be introduced into the market, and how the provision of information to consumers could be improved to allow better informed choices about whether to take out PPI and about which policy is appropriate for individual circumstances.”

(Source: The Treasury Select Committee Report, 5 April 2005).

The publication of the above report is an example of the unprecedented scrutiny that PPI has attracted in the last six months. To put this into context PPI is being debated by all the industry stakeholders including consumer groups, regulators, trade bodies, the Competition Commission, the media and investment analysts. The media comments on PPI are increasing month-on-month.

What is PPI?

PPI, also known as Creditor Insurance, is an insurance product typically sold as a package with unsecured loans, mortgages or credit/store cards. In a number of situations, for example, where the borrower becomes sick, unemployed or has incurred an accident that prevents the claimant from working, the insurance will make repayments towards the loan up to a pre-specified amount over a pre-specified period.

If the current scrutiny from the various stakeholders is short term in nature and the current regulatory threats are successfully rebutted by both PPI product providers and distributors without any significant operational change, then the status quo would be maintained.

Why is PPI in the spotlight?

Despite the benefits of PPI, there are three main areas under scrutiny:

- Potential mis-selling;
- Treating Customers Fairly; and
- Competition, product margins and commissions.

An interesting theme that runs through all of these issues is disclosure and transparency, which for obvious reasons would improve consumer awareness about what coverage they are buying and its cost. A secondary impact of this greater transparency, disclosure and more informed consumer buying would be an increase in the propensity for consumers to shop around to purchase the best value product, possibly unbundled from the underlying credit sale.

The short-term focus appears to be on potential mis-selling and fair treatment. Pressure from various stakeholders, including politicians, has prompted the FSA to put the selling of PPI to the top of its list of emerging financial services market risks. In addition, PPI has been under increasing scrutiny from the national press for being overpriced and the Competition Commission has extended the review of store cards to include PPI. Many companies are grappling with understanding what

Treating Customer Fairly means in the context of PPI. However, as TCF principles are likely to impact how PPI is sold, marketed, priced and how claims are handled, they cannot be ignored.

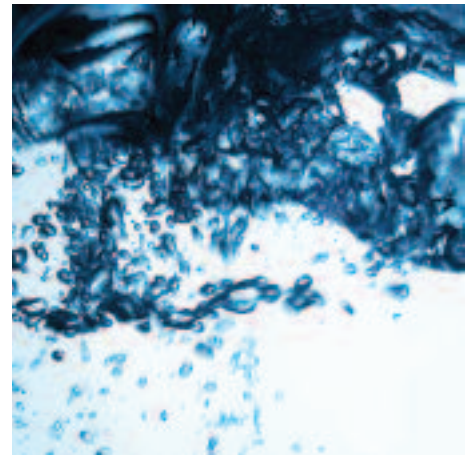
What is the potential impact on the PPI industry?

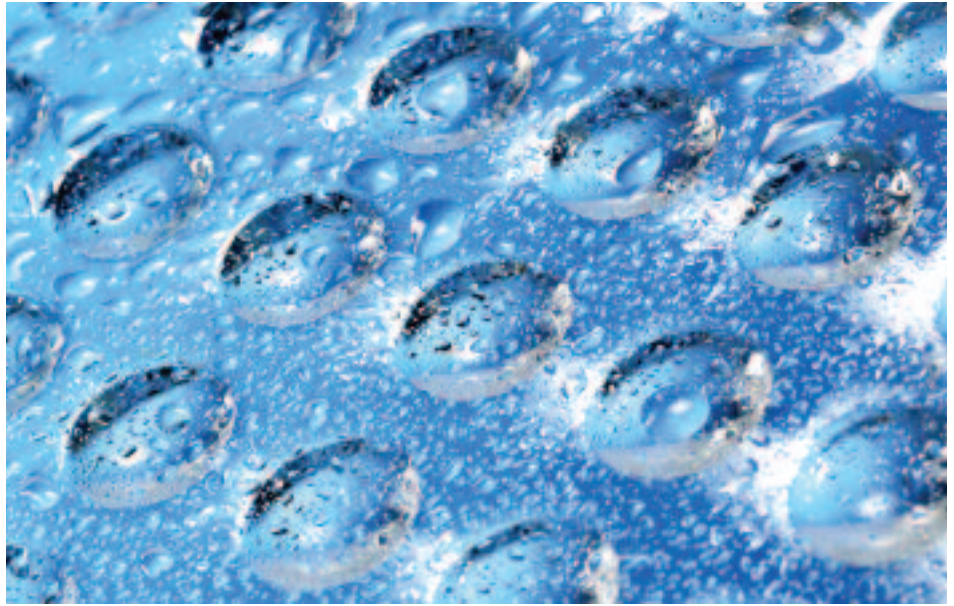
To put into context the potential impact on the PPI industry, we believe that there are three possible industry scenarios:

- a) Status quo;
- b) Product decline; or
- c) Product overhaul.

If the current scrutiny from the various stakeholders is short-term in nature and the current regulatory threats are successfully rebutted by both PPI product providers and distributors without any significant operational change, then the status quo would be maintained.

The product decline scenario could occur if there is a significant loss in consumer appetite for PPI as a result of sustained adverse media and consumer group coverage. This may at first appear sensational, but interesting parallels can be drawn with endowment sales which have fallen dramatically over the last four to five years causing a fundamental shift in the life assurance market. In the event of this scenario, we would expect the





sales of legacy PPI products to fall sharply, possibly accompanied by a shift in consumer behaviour to buying new 'substitute' untied protection products and the emergence of new 'substitute' channels of sale. Alternatively, customers might decide to forgo insurance altogether.

Product overhaul would be required if the current regulatory and consumer environment requires remediation and significant change in all, or part, of the following areas: product design, pricing, marketing, sales process, claims handling, remuneration or disclosure. As a result this may lead to lower PPI volumes and more pressure on margins as consumers are making more informed decisions and greater transparency increases competition. We would also expect a degree of migration from the legacy PPI products to new substitute protection products and channels of sale.

In addition to the regulatory and consumer environment, any challenges arising from the above scenarios may be further compounded by any deterioration in the economy and the subsequent impact on unemployment. Recent announcements by UK lenders indicate that consumer bad debt is on the increase, which may be an early indication that claims ratios are on the rise. Recent unemployment figures have also shown a small upturn.

What are companies doing to respond?

The eventual outcome of the PPI industry is, of course, all conjecture, but what are companies doing to prepare and respond to the current environment? There are three emerging positions being taken:

- a) Continuing to reap the margins and worry about the adverse scenarios if they arise;
- b) Preparing a robust defence and addressing gaps relative to best practice; or
- c) Researching the development of new business models and strategies for radically different PPI and alternative protection products.

Companies are now taking action; a CEO of a UK banking group advised us recently that for them the regulatory risk and bad publicity from PPI is considered the number one risk to group profits. To this end, most companies have done some risk assessment on the potential impact on their PPI profits, but few have included the product decline scenario which, for most distributors, would elevate the issue to the board agenda. However, the recent interest in PPI from the city analysts and the potential knock-on impact for share prices is likely to keep PPI on the radar of the senior executives.

As a general rule, the product providers are being more proactive and are

considering the latter two options, whilst the distributors are naturally more resistant to change that may threaten the existing PPI profit stream.

Firms should now be fully analysing these risks, and understanding the profitability of the product across the entire economic cycle, both from the perspective of the insurer and distributor. They should also be looking to design solutions to increase profitability of the current book as well as the profitability of any new business given the changed environment. They also have to consider the impact on unsecured lending pricing should the percentage of customers declining PPI start to rise. In addition, management information should be designed to monitor and control the risk and performance of your creditor insurance business, including the critical controls over potential mis-selling.

The balloon is inflating, but there is plenty that can be done to avoid a nasty bang!

Contact Us

David Morey

Director, Financial Services
Regulatory Practice
Tel: 020 7804 2684
Email: david.morey@uk.pwc.com

Vincent Branch

Director, Actuarial and Insurance
Management Solutions
Tel: 020 7804 3218
Email: vincent.branch@uk.pwc.com



IFRS: Is your financial reporting sustainable?

By Simon D Gealy and James Hewer

The banking industry has crossed the IFRS starting line. It has not been an easy journey to get there; the financial services industry, more than any other, has faced the greatest number of IFRS dilemmas, potentially due to the complexities of financial instrument accounting and disclosure. At least for banks (in contrast to insurers), most technical issues have now been resolved.

Any bank tempted to rest on its laurels, however, should first consider whether it has merely changed the numbers or whether they have managed to embed sustainable reporting, able to weather the challenges ahead. IFRS financial reporting needs to be core to how banks look at and think about their operations, not just an adjunct to the finance function. It is also of crucial importance when considering regulatory compliance and the impact of Basel II. Together with IFRS, these represent the most profound change in business economics and operating dynamics for the past 20 years. If IFRS does not yet permeate the decision-making and financial reporting of the organisation, banks may find themselves on the defensive in the coming weeks and months.

Banks should never underestimate the sheer difficulty, from a technical viewpoint, of getting the numbers and the process right, particularly with regard to hedge accounting. There will be ongoing interpretative difficulties of the present rules, and these rules will continue to undergo future changes. IFRS is a journey, not a step change. Banks, regulators, and industry associations need to work closely together to manage this change to avoid further uncertainty and damage to the corporate reputation. Changes in reporting need to be properly disclosed to ensure full transparency. After years of familiarity with legacy GAAP, companies, analysts and investors are looking at the numbers afresh (without the benefit of trend data) under IFRS. As companies struggle



complex new standards, some changes of interpretation are inevitable as the rules are embedded.

It is not yet widely recognised in the market that under IFRS the threshold requiring restatement is lower; that is, while under UK GAAP only fundamental errors need to be restated, under IFRS any material error necessitates a restatement. Given that restatements were a rare occurrence under UK GAAP and usually accompanied by negative connotations, will the market be able to suspend traditional prejudices when restatements occur because of these IFRS policy or interpretation differences?

Could a flurry of restatements even precipitate a wider crisis in confidence in financial reporting? Recent market experience of restatements in the US shows that these have created uncertainty and shareholder concern.

Thus there is no room for complacency. The management of market expectations by banks needs to be ongoing, and those responsible for the finance function and financial reporting should anticipate that confusion over IFRS may put them under significant scrutiny. To establish credibility and demonstrate resilience, banks must have sustainable IFRS reporting embedded in their organisations, with the finance function demonstrating effective leadership, in relation to both internal and external reporting.

From tactical to sustainable to flexible

To the outside world, the image of a swan gliding serenely across troubled waters may be how the organisation appears to be coping with IFRS. In reality, many organisations are paddling frantically under the surface to cope with current IFRS challenges, let alone those that lie ahead, not only in financial reporting but also in regulation. In truth, IFRS has been approached tactically by many organisations, albeit out of necessity due to the uncertainty surrounding the final form of the set of IFRS standards, particularly IAS 39. This is particularly relevant with regards to cashflow hedging – easy to designate relationships but proving very hard to run in practice on a day-to-day basis. The short-term tactical fixes may prove unsuitable in the long run.

Going back to the IFRS swan, it's not just paddling furiously under the surface, but it is also actually having stones thrown at it from the shore. These stones represent several extra challenges, including the complex regulatory and compliance framework being introduced over the next few years through Basel II and Sarbanes-Oxley, as well as a host of International Accounting Standards Board (IASB) financial reporting improvements and research projects.

The IASB has an ambitious agenda and many of the present solutions are

short-term interim fixes that arose from the improvement projects. Companies must have the flexibility to change their IFRS approach to accommodate both minor and major future changes.

For an organisation to cope, it will need to be moving toward a flexible approach where it is not just embedding reporting, but also embedding the ability to change. Under this scenario the necessary organisational structure, systems, data capabilities and people will need to be in place so that future changes can be factored into the activities of the finance function without undue stress. But this is easier said than done. This is a huge task for any organisation – requiring a highly effective and integrated change and development plan. It may be enough in the short-term to embed the requirements of IFRS and Basel II, moving on to more structural and systems changes in due course.

Operational risk looms large

The price some organisations have paid to meet IFRS deadlines has been a deterioration in the overall robustness of the control environment, underlying processes and systems, experience of people, as well as a reduction in overall efficiency. There has been heavy reliance on manual intervention, spreadsheets, and 'back of the envelope' responses. There has been a single-minded emphasis on external reporting with less emphasis

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on the less visible. For instance, the operational risk created by business practices, management accounting and incentivisation arrangements not being properly aligned with the new external reporting requirements is potentially significant.

Furthermore, and especially for financial institutions, the knowledge and understanding of IFRS must go deeper than just the finance function.

Customer relationship managers and credit analysts are now revisiting the way they interpret financial statements, and analyse ratios and covenants of customers. M&A teams and equity analysts are using the new rules to assess targets and proposed business combinations differently pre- and post-deal as the changes in relation to goodwill and intangibles take effect. Recent conversion experience has shown that the impact on distributable reserves, for example at British Airways, can be significant. The skills shortage will be particularly acute in the front office, where the understanding of the accounting implications for their customers of their proposed transactions, particularly in relation to derivatives and structured products, will be key.

Some examples of where effective IFRS change can or should be facilitated include:

1. Reporting needs to be timely and accurate, with a minimum of human

intervention. Reporting disciplines need to be able to cope with increased data collection analysis and disclosure. Technologies like XBRL may be useful to eliminate communication difficulties and duplication between systems.

2. Controls and procedures need to be reviewed to ensure they remain appropriate, with the right policies and procedures in place. These need to be seen to be supported by management. Accounting manuals throughout the organisation are needed to help IFRS be understood and implemented in a consistent way. These should also be Sarbanes-Oxley compliant, a process much easier to do whilst the controls are being put in place. This is good business practice for all banks, not just SEC registrants.

3. Certain areas of IFRS, for example effective interest rate calculations, fair valuation of derivatives and hedging, create new balance sheet intangible assets and liabilities. Therefore companies need to ensure they have rigorous and robust validation procedures in place to establish balances. In addition, controls over the balances must be developed given that as they do not easily lend themselves to traditional controls, such as reconciliation to third party information. They must also be able to explain their volatility, particularly if they use cashflow hedging. Skilled resources are in short





supply in the market – a good training regime is a way to mitigate some of this risk.

4. On the people side, specific work needs to be done to motivate personnel to embrace, instead of feel excluded by or from, IFRS. This needs to be built into training, development and reward structures. Critically, resources must be made available for change implementation. Training and updates are the norm, but IFRS needs to form part of the language of the business. For example, IFRS needs to be used when and where business is booked, not in a remote central finance function. All of management, not just those in finance, need to be aware of the requirements of IFRS and their associated implications.

It goes without saying that a thorough understanding of, and preparation for the requirements of IFRS and its implications needs to be in place to avoid undue

disruption to the business, and the risk of market confusion regarding the consequences of IFRS for the institution's financial performance. Furthermore, as IFRS is amended and re-interpreted, the finance function must have the flexibility and capability to take this in its stride, and exude confidence to the organisation and the market.

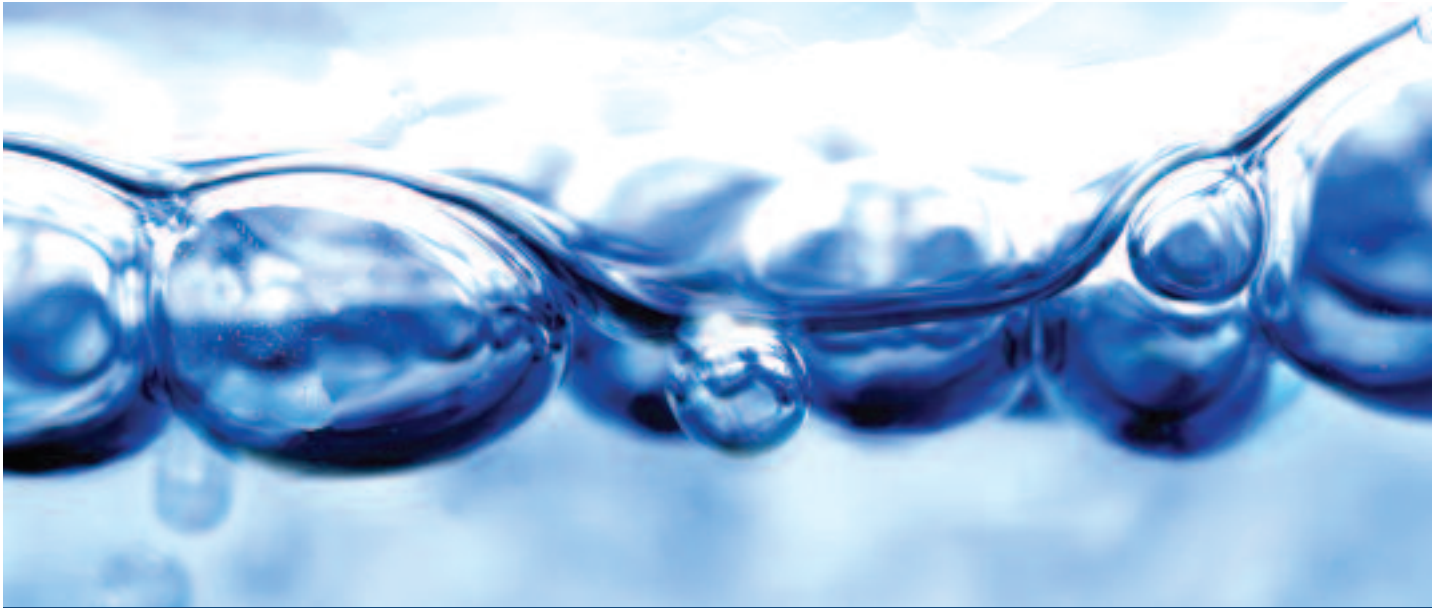
Contact Us

[Simon D Gealy](#)

Global Partner, Capital Markets Group
Telephone: 020 7212 3513
Email: simon.d.gealy@uk.pwc.com

[James Hewer](#)

Director, Banking and Capital Markets
Telephone: 020 7804 9605
Email: james.hewer@uk.pwc.com



Financial Services M&A

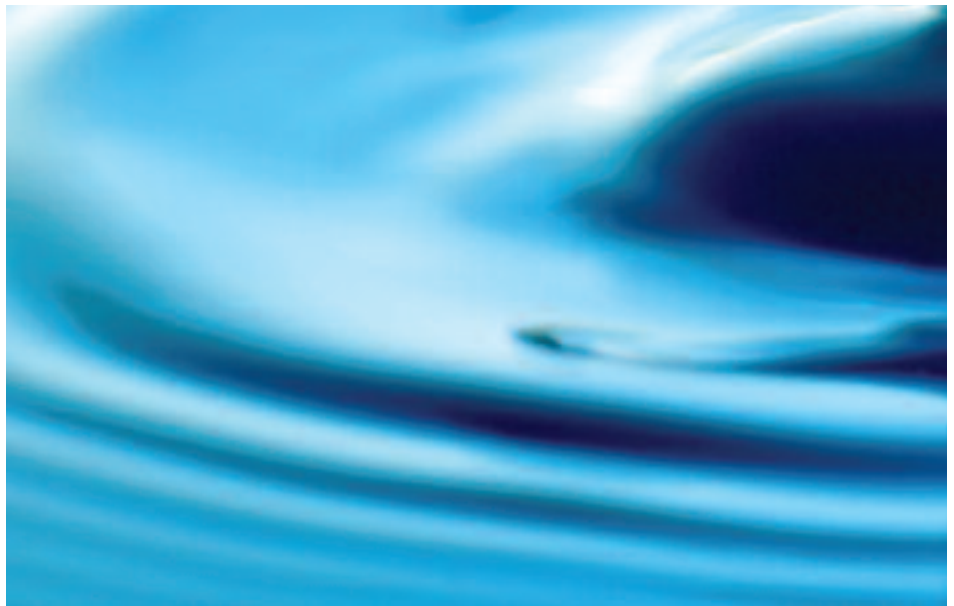
Review of and outlook for mergers and acquisitions in the European financial services market

By Nick Page and Shamshad Ali

Compared with 2003, in 2004 there was a significant increase in the proportion of cross-border deals, representing 61% of all financial services activity (measured by value). Banking was again the most active financial services sector accounting for over half of all deals (measured by value), dominated by Santander Central Hispano's €12.3 billion acquisition of Abbey National.

In 2004, the UK and Ireland was the most popular place for FS M&A by far, accounting for nearly two thirds of all deal activity (measured by value). Only three other territories in Europe saw a deal over €1 billion in 2004; these were the Netherlands, Sweden and Denmark. Other themes that we have seen in 2004 financial services M&A are:

- The top 10 FS deals in 2004 had a combined value of €26.8 billion (2003: €15.2 billion) which was c. 60% of all FS deals (2003: c. 45%) by value;
- Increased appetite from private equity investors with four €1-billion-plus deals in the insurance sector;
- A continued focus on divestments of non-core businesses;
- A focus on M&A in local and neighbouring markets, enabling mid-sized institutions to achieve critical mass; and
- A number of niche market acquisitions, highlighted by the UK closed life fund sector.



UK & Ireland

In 2004 the UK & Ireland was the most active territory in Europe with eight deals in excess of €1 billion, dominated by the acquisition of Abbey by Spain's Santander. This deal created the world's 10th largest bank by market capitalisation. The transaction is part of Santander's plans to expand in Europe and it expects the combination to generate annual cost and revenue synergies of €560 million by the third year after the completion of the acquisition. It remains to be seen if synergies of this magnitude can be delivered or even surpassed.

In total in the UK & Ireland, there were over €28 billion of deals being announced in 2004 (2003: €10 billion). The significant €18 billion increase in total deal value from 2003 to 2004 was largely due to the following:

- The acquisition of Abbey by Santander for €12.3 billion (the largest deal announced in 2003 was the €1.7 billion acquisition of Churchill Insurance by RBS);
- The number and scale of deals was greater:
 - 90 deals announced in 2004 vs 64 in 2003; and
 - In 2004 eight deals in excess of €1 billion were announced compared with four in 2003.

Interestingly, in 2004 two of the top five deals were cross-border compared with three in 2003. Danske Banking Group, the Danish bank, in its first cross-border transaction, acquired Northern Bank and National Irish Bank, the Irish retail banks, from National Australia Bank, for a total consideration of €1.4 billion. The acquisition is in line with Danske Bank's strategy to enhance its presence in retail banking and consolidate its position in Irish markets. The transaction is expected to allow National Australia to focus on its UK operations.

Looking ahead

The European banking sector reported improved overall profitability in 2004, with some of the major banks delivering record-breaking profits. These results were earned in the context of an improved operating environment and recovered equity markets in addition to the realisation of cost-cutting plans initiated in prior years.

This general banking good health is owed in part to the demand for credit from consumers and businesses alike. However, while there is limited risk of a drop in demand in a low interest rate environment, any rate increase could begin to hurt European bank profits from an increase in defaults.

The European banking sector reported improved overall profitability in 2004, with some of the major banks delivering record-breaking profits. These results were earned in the context of an improved operating environment and recovered equity markets in addition to the realisation of cost-cutting plans initiated in prior years.

That said, the large European banks are now leaner and may look to counter any increase in risk in their home territories through cross-border acquisitions. Furthermore, with ambitious targets for growth set by institutions, it would appear that M&A will play a key role in achieving that target alongside further organic growth.

Domestic and neighbouring market consolidation expected to continue

A typical European country has a handful of major banks which, in general, dominate their local market but are now beginning to look outside their home territories and in some cases Europe for growth opportunities (such as Barclays' move towards South Africa). Where banks have looked to expand in Europe, it has been in neighbouring and/or similar territories to their own. This was a key trend in Scandinavia in 2004, with institutions such as Kaupthing Bank of Iceland acquiring FIH in Denmark.

In order to achieve a footing in Europe, mid-tier European banks are likely to seek domestic consolidation before branching out into similar local territories, potentially driving cross-border activity once they have achieved the desired critical mass. In Germany and Italy, where the banking industry is particularly fragmented, significant domestic consolidation is required to produce a new major European player, or the

mid-tier banks run the risk of being subject to a bid themselves, as we have seen with Banca Antonveneta in Italy.

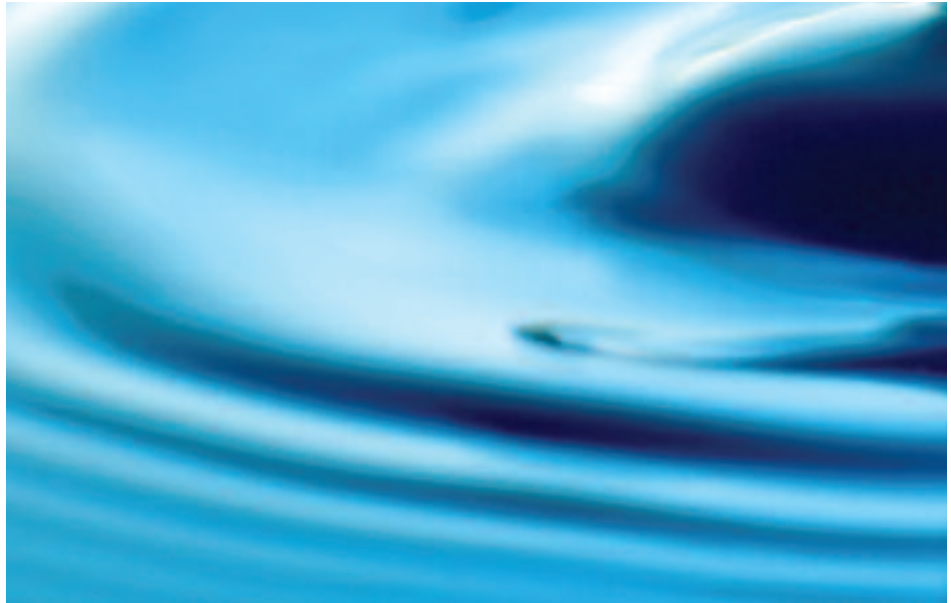
In Germany in particular, the successful withdrawal of the state guarantees for the German Landesbanks is likely to generate consolidation, even though there are no early indications that private sector banks will play a significant role in this process.

Further local consolidation is likely to be seen in the next 12 - 24 months as the mid-tier European banks look to increase their size domestically and in the European market as a whole.

Limited significant European cross-border M&A (i.e. the Santander acquisition of Abbey is unlikely, in our view, to be a prelude to major European banking consolidation).

Santander's €12.3 billion acquisition of Abbey at the end of 2004 is unlikely to be a prelude to large cross-border deals, as the majority of banks will likely stay clear of significant headline European acquisitions. To a degree this is illustrated by the muted response of other European banks to Santander's bid; in the case of UK banks, fears of the reaction of the UK competition authorities played a role. Nevertheless, Santander's bid went uncontested, for an institution that in recent years had seen off advances from Lloyds TSB and Bank of Ireland.





The drivers for large cross-border deals are generally market driven. The same problems still remain in terms of realising synergy benefits on cross-border acquisitions, in terms of limited duplicate costs, different tax regimes and regulatory structures and challenging revenue synergy opportunities.

US banking predators are looking to acquire in the UK or possibly Europe. But buying in the UK or Germany is not necessarily the acquisition of a European platform.

It is believed that the three major banks in the US (Citigroup, Bank of America and JP Morgan) are close to their maximum size in their home territory. So it is natural to assume that, with their respective business integrations now considered largely complete, they are looking for new targets and have the capital to buy almost any bank in Europe.

While the European banks remain a target, their own M&A strategies could be stepped up in order to move themselves 'off the radar'. This may in turn drive further acquisitions by the major banks both in Europe and the rest of the world, including the US.

In conclusion, we anticipate that 2005 and 2006 will continue to see a greater level of M&A activity in the European FS sector with the Banking sector again leading the way. Likely characteristics of this will be continued private equity interest in the sector, continued neighbouring market acquisitions, ongoing wider cross-border activity possibly punctuated with a large deal such as the recently announced Unicredito acquisition of HVB.

The full version of this report was released in July 2005 and can be found on www.pwc.com/financialservices

Contact Us

Shamshad Ali

Director, Transaction Services
Financial Services Group
Telephone: 020 7804 9600
Email: shamshad.ali@uk.pwc.com

Nick Page

Partner, Transaction Services
Financial Services Group
Telephone: 020 7213 1442
Email: nick.r.page@uk.pwc.com

