

THE GOOD, THE BAD, AND THE UGLY

The impact of inflation on European banking
and what to do about it



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CONTEXT AND THE CHALLENGE AHEAD

In the first quarter of 2022, economies across Europe recorded the highest levels of inflation in a decade, and economists started acknowledging that inflationary pressure might not be temporary.

Inflation was widely expected to be a temporary consequence of extraordinary fiscal stimulus and pandemic-induced supply chain disruptions. Economists are now acknowledging that inflation is evolving from being transient and mostly technical, to being driven by persistent demand-side and supply-side factors as well by structural changes in the way value is allocated within the economy. The recent rise in energy prices, exacerbated by the war in Ukraine, is the latest and likely the biggest inflation driver in the short term. In the medium to long term, structural factors, such as the shift to greener (and more expensive) energy, and the investment backlog, as well as demographic changes in Europe and key supply markets, are likely to stoke inflationary pressure.

Different economies are exposed to diverse combinations of supply and demand-side shocks, meaning central banks face complex trade-offs when formulating policy responses. This is increasing uncertainty as to how the economic scenario will unfold and whether the chosen policy instruments will be effective:

- Within the Eurozone, for example, labor market tightness and increasing demand are driving inflation in Germany. Meanwhile, supply chain pressures are the primary cause of inflation in Italy and France. This heterogeneity could lead to some back and forth in the appropriate monetary policy strategies
- Different dynamics across the Eurozone, the US and the UK could also lead to a possible divergence of monetary policy and could create asymmetry in resource allocation, with foreign exchange implications that could have broader inflationary and economic implications
- While tighter monetary policy is expected across regions (as proven by recent central bank declarations), the effectiveness of these measures in combatting inflation remains uncertain given persistent supply chain issues driven by the war in Ukraine and COVID-19-related disruptions. This could lead to real inflation remaining high

Furthermore, the ultra-loose monetary environment of the past decade has contributed to historically high debt levels. In the Eurozone in particular these have built up in the periphery in the aftermath of the Euro crisis, although the expansion of public debt occurred in all Eurozone economies as result of Covid-19-related backstop and recovery measures. Central banks were able to focus on yield control in absence of any related cost. But as these costs now drive inflation, leaders will need to balance their primary mandate of price stability with the need to prevent fragmentation and consider the potential impact on economic growth.

This note is structured around three sections:

1. Exploring possible inflationary scenarios
2. Breaking down the implications of these scenarios on the European banking system
3. Recommending actions for European banks and policymakers

The banking system will face this evolving environment after having addressed legacy issues (better capitalization, more resilient business models, solid governance practices) and with a newfound centrality in its role in society. However, this does not necessarily imply that the system is prepared for this kind of disruption, particularly since most current bank executives have yet to lead through an inflationary period.

Steering through this time of high inflation, whilst supporting the real economy in this period of uncertainty and efficiently facilitating the reallocation of resources, will be the measure of success for the banking sector. The central role of banks as an enabler of economic growth will be emphasized yet again.

POSSIBLE INFLATIONARY SCENARIOS

To highlight the impacts of inflation on the banking sector, we have built three possible scenarios intended to outline at a high-level how the macroeconomic situation might evolve over the next couple of years.

Whilst the likelihood of the “soft landing” scenario is decreasing, only time will tell which of these scenarios is most likely to occur, and these scenarios (or variations of these scenarios) should serve a reference point for bank executives as they simulate possible implications for the industry and prepare their response.

Exhibit 1: Three likely inflationary scenarios for Europe

Soft landing	Hard landing	Stagflation
<p>Central banks succeed in containing inflation in the single low digits, without compromising post-pandemic GDP growth, avoiding substantial spikes in unemployment and excessive supply chain pressures. Government yields remain sustainable for peripheral countries, while credit spreads and core economies remain contained. The divergence in the speed and intensity of the monetary policy responses between Europe and the US is limited and FX effectively compensates any differences, with no disruptions to international trade patterns</p>	<p>Inflation spirals out of control in the short-term (high single digits), forcing central banks to adopt a more vigorous monetary response. Ultimately, the monetary tools succeed in normalizing inflation, at the price of slowing down economic growth in 2023–24, inducing volatility in FX and straining international trade patterns. Credit spreads in peripheral countries diverge significantly from core ones, requiring measures to prevent fragmentation and a program to accompany the path of policy normalization</p>	<p>The global economy experiences sustained high inflation despite the severe tightening of monetary policy, slowing down economic growth for several years and triggering a price spiral that is complex to break. Fragmentation between countries is significant, with a deterioration of the credit spreads on peripheral bonds that triggers a new credit crunch and weakens public debt sustainability. The possible divergence of monetary policy between Europe and the US could further deteriorate this scenario with negative effects on trade, which is already under significant strain due to the war in Ukraine and supply chain issues</p>

IMPLICATIONS FOR BANKS

Inflation impacts banks’ financial performance via multiple mechanisms as detailed in Exhibit 2:

- **Net Interest Margin (NIM):** Higher rates increase interest income on the lending book but put pressure on cost of funding of banks (deposits and wholesale funding). Severe economic slowdown reduces the total financing need for corporate and retail clients negatively impacting the net interest margin
- **Cost of risk:** Balance sheet quality deteriorates, driven by higher default rates of highly leveraged firms and households that are sensitive to inflation and interest rates
- **Fees:** Asset management and return on assets under management (AuM) slow down; less favorable markets and trade volume dynamics drive down transaction banking and asset management fees. M&A and Equity Capital Markets (ECM) fees are likely to be negatively hit driven by uncertain economic outlook — although this can vary by sectors as this might trigger market consolidation
- **Securities portfolio:** Possible mark-to-market losses on certain credit instruments and government debt held in bank’s securities portfolio. Increase in bond coupons on newly issued debt
- **Operating costs:** Increasing wages and cost of third-party service providers with limited ability to pass on these costs to bank customers in the short term.

Exhibit 2: Mechanisms of the inflationary impact on bank profitability

P&I item	Channel	Description	Main drivers determining the exposure to inflation
NIM	Repricing of the lending book	Increasing contribution of interest income on lending book driven by rates hike and volume dynamics	<ul style="list-style-type: none"> • Average maturity of the back-book and incidence of floating rate component • Growth of new loans and pace of renegotiation of existing lending • Evolution of the real estate valuation
	Elasticity of the customer deposits	Surging interest rate expenses driven by the renegotiation of rates on deposits to preserve liquidity and relationship	<ul style="list-style-type: none"> • Deposits mix: Retail vs. non-financial institution • Level of price competition in the market (e.g., liquidity fees)
	Wholesales funding spread	Raising cost of funding, driven by hike of risk-free rates and widening credit and government spreads	<ul style="list-style-type: none"> • Domestic government spread and idiosyncratic credit quality of the bank • Share of institutional funding and MREL obligation
Cost of risk	Default rates on lending	Surge of default on family and corporates due to increasing cost of liquidity and prices	<ul style="list-style-type: none"> • Magnitude of the impact specific to certain industrial sectors and countries • Incidence of variable rate loans (higher leverage and cash sensitivity) • Exposure to leverage finance
	Real estate price	Tightening liquidity and inflation could have opposing impacts on real estate price and collateral valuation	<ul style="list-style-type: none"> • Quality and level of coverage of secured NPL • Incidence of structured financed and HLVT business
Fees	Wealth management	Slowdown of the AuM business as a mix of decline in asset price and reduce saving capability	<ul style="list-style-type: none"> • Fee structure (upfront vs. running) and ability to rollover the existing funds • Evolution of new inflows and saving capability
	Renegotiation of the other services	Repricing of the services offered to clients to match the surge of price levels	<ul style="list-style-type: none"> • Incidence of the fee from services • Level of competition in the market (e.g., fintech or low C/I players)
Securities portfolio	Bond coupons	Raising coupons collected by the reinvestment of bonds at maturity in instruments with equal risk but wider credit spreads	<ul style="list-style-type: none"> • Ability to rollover bond portfolio: duration, accounting (i.e., HTC versus HFT) • Exposure to idiosyncratic shocks: Relative size, concentration, credit quality
	Capital gains and market valuation	Depreciation of the market value of bonds held in the portfolio due to widening of market credit spreads	<ul style="list-style-type: none"> • Size, issuer type, and country concentration (e.g., peripheral “govies” vs. core) • Sensitivity of the portfolio valuation to credit spread (duration/DV01)
Operating costs	Internal costs	Increasing administrative cost (utility, rent, ...) and personnel cost	<ul style="list-style-type: none"> • Efficiency of the cost base (cost-income ratio) • National legal labor framework and wage stickiness
	Renegotiation of the outsourcing	Surging cost on the services in outsourcing at contract maturity	<ul style="list-style-type: none"> • Cost structure: Insourced vs. outsourced • Contracts impacted by inflation in plan horizon to be renegotiated

Source: Oliver Wyman analysis

Exhibit 3: Summary of impact on European banks

Consolidated average of EU banks, recognizing that impact on individual banks will depend on structure of balance sheet, funding profile and exposure to specific sectors and labor markets

Item	Contribution to ROA 2021	Δ Impact on ROA in 2024			Which drivers will increase the risk of inflation for a specific bank?
		Soft	Hard	Stagflation	
NIM	60	+	++	+/=	<p>Lending book: High duration, low sensitivity (prevalence of fix rates loans, existing floor) and elevate IR gap between back/front book</p> <p>Funding: Incidence of institutional funding (versus customer deposits), in particular for Tier II/low rating banks in peripheral countries</p> <p>Deposits: Share of corporate deposits (versus retail and terms deposits) and those with regulated deposits</p>
Cost of risk	-25	=	=/-	--	<p>Idiosyncratic concentration of the loan book to industries highly sensitive to inflationary shocks and relevance of pandemic guarantee</p> <p>Leveraged buyout: Level of exposure to leveraged finance and LBO portfolio (especially during recession) and share of book to most exposed sectors</p>
Fees	60	+	=	-	<p>Wealth management: Relevance of upfront fees and low specialization of the WM offer (risk of outflows towards specialist/financial advisors)</p> <p>IB: Tier II players likely to be the most impacted with a further concentration of the market towards globals</p> <p>Services: Competition and price sensitivity in the market</p>
Securities portfolio	20	=	=	=/-	<p>Diversification: Holding of government bonds issued by peripheral/high indebted countries (in particular in case of recession)</p> <p>Sensitivity: Elevate maturity of bonds and predominance of fix coupons</p> <p>Accounting: Incidence of HTC portfolio (vs. HTCS/ FVTPL)</p>
Operating costs	-80	=	=/-	--	<p>Operating efficiency: Low efficient banks (high C/I) more impacted</p> <p>Labor market: Flexibility of local labor framework and market dynamics (for banks operating in market with risk of labor shortage)</p> <p>Cost structure: Incidence of cost outsourced to third parties</p>
Total ROA (bps)	35	[-5;15]	[-15;15]	[-50;-5]	
Total ROE (average)	7%	[-1;+3%]	[-3;+3%]	[-10;-1%]	

Note: Figures are an indication of the average impact at the end of 2024 and exclude any management actions that could be taken today to tackle the effects of inflation

Source: Oliver Wyman analysis

With the likelihood of the soft-landing scenario decreasing, it will be very likely that bank profitability will be hit over the next cycle, bearing in mind that the impact of the economic scenario on individual banks will depend on the business and geography mix. It will also depend on how sensitive each banks' performance components are to the various shocks that may occur and how significant the economic shock is to the performance of each individual component.

To provide further detail to support these assertions, we have represented the two extreme scenarios (soft landing and stagflation) and insights into each of the components:

Scenario 1 ("soft landing") — The controlled inflation scenario would be the most favorable scenario for banks

Thanks to timely intervention by central banks, inflation is contained without stifling growth, as interest rates are increased slightly and in an orderly fashion. This scenario is likely to be aided by a relaxation of global tensions, no further COVID-19 related issues and a fast adaptation of supply chains. The foreign exchange will absorb the temporary divergence of monetary policies with limited volatility.

NIM is expected to increase as interest rates rise and demand for new financing remains strong. This will more than compensate growth in the cost of deposits (more relevant for the corporate segment), which we deem to be delayed, of smaller magnitude, and without friction. The cost of wholesale funding will also increase because of increases in credit spreads but without large differences between countries or institutions. The growth in the volume of the new book will generally be strong and able to further support the improvement of interest margin.

Cost of risk is not expected to spiral out of control. Inflation will put pressure on households and margins for corporates, but defaults will remain limited. Households have exited the pandemic with stronger balance sheets and greater savings. Furthermore, the increase in value of real estate will help reduce banks' risk exposure. Overall, the corporate sector is largely expected to maintain a strong credit quality as post-pandemic demand remains strong. However, the ripple effects of the war have a specific impact on certain industries.

Wealth management remains a profitable business (but less so than in 2021), whereas other services will experience a gradual repricing. While the overperformance of 2021 is unlikely to be repeated, the repositioning of portfolio assets to cope with new market trends and consistent new flows will help sustain sales volumes in this channel. Overall, banks will be able to relay some of the inflationary pressure to consumers via an increase in fees.

Securities valuation will be impacted by widening of credit spreads while coupons will increase, compensating for the impact overall. The valuation of debt securities held in banks' investment portfolio and increasing interest paid on new investments create opposing forces. Their magnitude will depend on the relative size of the investment portfolio and on the relevance of capital gains in each bank's profits (banks operating in peripheral

countries with a high concentration in domestic government bonds are likely to see these revenues disappear).

Inflation will put a strain on banks' cost base, with salaries, overheads, and outsourcing costs progressively increasing. Banks that outsourced more may suffer more significant consequences, while those that have more scope for improving efficiency will likely cope better. Banks manage to contain costs through management actions.

Scenario 3 ("stagflation") — Should central banks fail to control inflation, and should recessionary forces persist, the banking sector will face a more complex outlook

Our stagflation scenario is characterized by high inflation (reaching and remaining in high single digits) together with a recession. The severity of this extreme scenario will also depend on the possible divergence of monetary policies across countries and regions that will impact trade patterns and foreign exchange markets, further worsening the scenario. As the scenarios become more severe, the impact on different banks becomes more varied in severity based on their business models, country of operation, and their relative size. Further, stagflationary periods tend to last several years, exacerbating the aggregate negative effect.

NIM is subject to both strong tailwinds and headwinds, whose net impact could vary across different institutions. The benefits of rising rates will be deflated by the increase of wholesale funding costs and friction on deposits. While in a moderate economic downturn the need of bank financing from corporate will be broadly stable due to raising need of liquidity and less favorable debt markets, in the stagflation scenario the NIM will be severely penalized by the reduction of the lending book both to corporate and retail clients (in particular, unsecured loans are likely to be the first impacted). Banks operating in weaker economies, especially those without monetary sovereignty, are likely to be penalized. Reduced economic growth will also severely impact the ability of banks to grow their loan book and other business, which in turn affects their P&L and valuation.

Cost of risk will significantly increase as household and corporate finances are damaged by poor growth and rising operating costs. Many corporations that are very sensitive to the inflationary shocks are likely to see their viability and solvency deteriorating. Households are likely to increase their spend on essential goods, negatively impacting their credit quality. Leveraging of finance and LBO portfolios could be severely strained. Corporates that have accumulated cushions from COVID-19 support measures will use those but it is likely that this will not be sufficient to weather the crisis.

Banks' fee income will suffer, as wealth management faces significant headwinds. Clients' saving capabilities will be negatively impacted and valuations will fall in multiple asset classes (especially equities). This will compress the value of the AuM and the willingness of clients to reshuffle their portfolio, compressing the profitability of the asset management business. In response to this, banks will be tempted to transfer these costs to clients, increasing the fees on other services (payments, transactions, and so on etc.). However, this may harm business volumes.

Stress on government credit spread will reduce the capital gains for banks operating in countries with high public debt and possibly induce the write down on low yielding debt as new high-yielding debt is issued. Rising rates and widening government yields will impact banks' ability to monetize their bond portfolio. In order to compensate for this instant loss, banks will have to replace their investments, reshuffling their portfolios to newer and higher yielding coupon bonds, but this will take years to be achieved. The increase of the duration of banks' portfolios, which took place during previous years due to low yields, has further increased this issue. Possible divergence between the United States and the European Union could lead to a flight of institutional money out of Europe, straining EU debt and possibly leading to diverging yields across EU countries and a renewed EU sovereign debt crisis, forcing central banks to be buyers of last resort of EU debt in a context where they need to reduce the size of their balance sheet to absorb liquidity.

Fiscal action to cushion impact of the recession might increase public debt levels further. This limits the ability of central banks to fight inflation and might lead to a strategy of "financial repression" that negatively impacts returns on all credit assets.

As in the previous scenario, operating costs will increase. The magnitude of this issue is wholly dependent on how much inflation rises. As previously mentioned, banks with additional scope for efficiency improvements will fare better than those tied to multiple outsourcing contracts, and hence with less control over their cost base.

RECOMMENDED RESPONSE FOR BANKS AND POLICYMAKERS

Commercial and central banks must equip themselves with a new toolkit to help them navigate this period of high inflation different from the one that characterized the last decade of declining interest rates.

For commercial banks, the obvious challenge will be to manage the potential pressure on their bottom line during the inflationary regime (increased credit losses, operating expenses, wipe-out of capital gains on securities) and ensure they are protecting their relationships with customers in the medium to long run.

The new toolkit to manage the impact of inflation will require banks to:

Increase managerial and exco focus on planning and simulation to ensure that strategic decisions are taken in a timely manner and are informed by clear data.

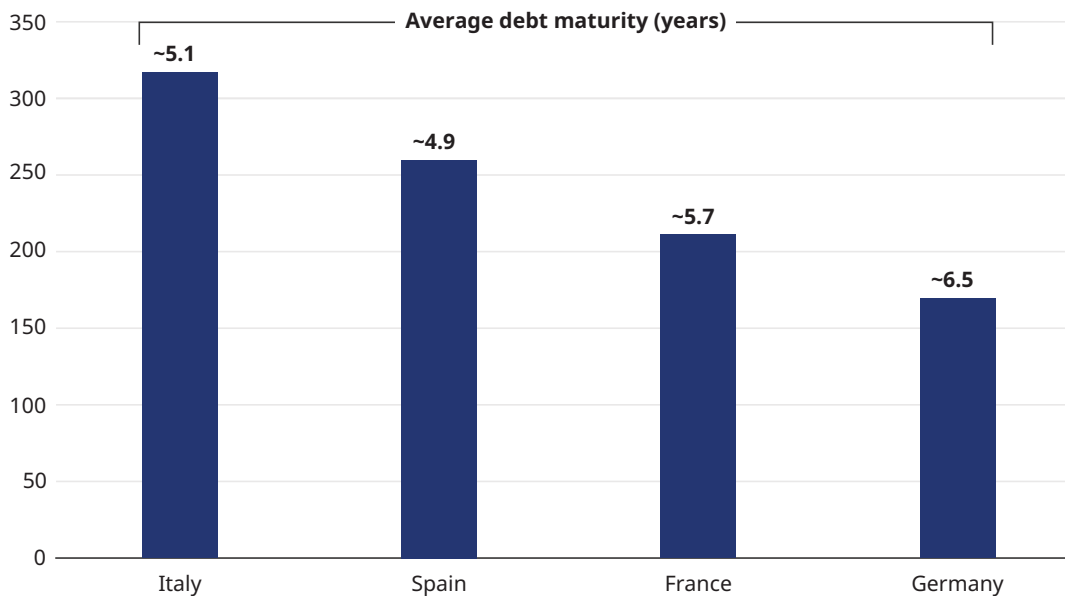
Planning models have historically been a patchwork of fragmented processes and often are slow. The complexity and the speed of the changes in this new context means banks must improve their planning processes and consider projections for revenues, expenses, balance

sheets, and financial resources within them. Planning processes must be more insightful for managers in explaining the factors that could influence these projections. The scenario analysis and the discussion on the potential response strategies should be prioritized in the agenda of senior executives serving as a compass to help them navigate the current turmoil.

Enhance the asset and liability management (ALM) to gain a more realistic and comprehensive understanding of the impacts of the macro economic scenario on banks' interest margins (and deposit behaviors), financial profits, and liquidity, and define the most appropriate response strategy (playbook). Today the analytics and the processes used to oversee financial resources and other profitability drivers (e.g., interest rate risk in the banking book (IRBBB) measurement, FTP framework, liquidity ratios, deposit pricing) are often overlapping and siloed, which makes them an imperfect suite of tools to support strategic decision-making in a new and ever-changing macroeconomic environment. They are also very tactical as opposed to being strategic. To navigate the new economic context, banks need to better understand their structure of funding and how it will evolve under all scenarios. Banks will be called to adopt an integrated framework to dynamically simulate the interdependencies between the various aspects of bank operations and support the definition of managerial responses.

Exhibit 4: Sovereign bond exposure in banking industry (as percent of CET1 Capital)

In percent, 2021H1



Source: EBA Transparency Exercise, BankFocus, TradingEconomics, Banks' financial reports, Oliver Wyman analysis

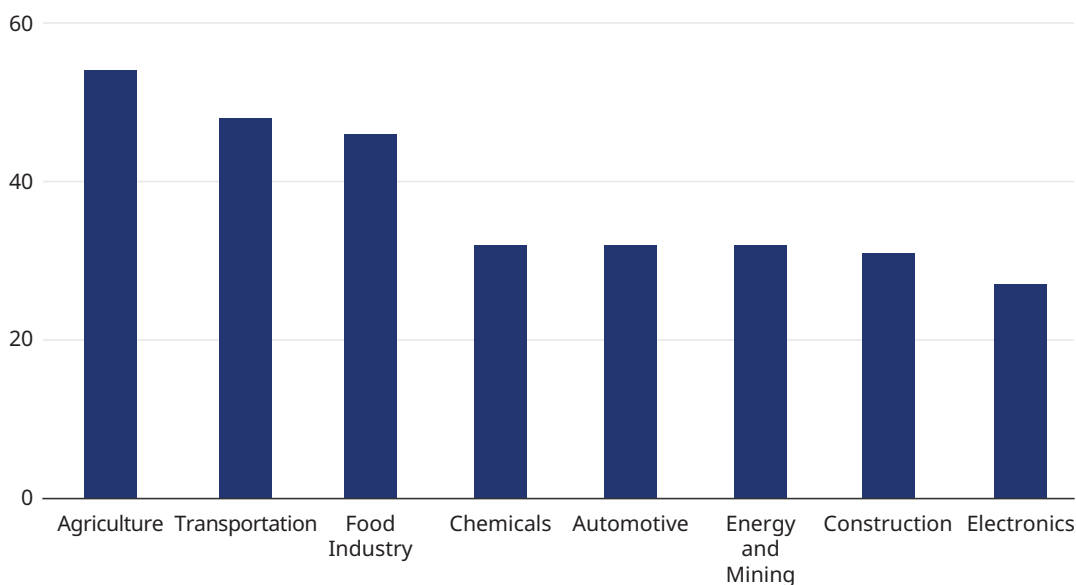
Manage credit through asset quality rating (AQR) and stress tests of the balance sheet to highlight where banks are most exposed across geographies and sectors and develop proper resource reallocation response and adjustment to risk appetite frameworks.

Management must have an accurate understanding of the bank’s quality of credit in the context of the inflationary period and be able to quantify their cost of risk. Unlike the COVID-19 shock that severely hit specific economic sectors, in this case, measuring the impact of this crisis might be challenging but will need to be modelled. In particular, banks need to get a clear and updated view on the income and debt situation of their borrowers and understand how these will react to a changing economic environment. If prolonged, the current economic instability will affect several items of companies’ profit and cash available for debt service: weaker revenues (reduction of international trade, sanctions, and borders closures), higher cost of goods (more expensive raw materials and semi-finished products), rising operating costs (inflationary pressure on wages and rent), higher interest expenses, and less liquidity. While export shocks can be more easily mapped to industries, the other shocks are sector-agnostic and require a more thorough analysis of each counterparty and its interconnection with its supplies and customers. Banks’ lending strategy and risk appetite will need to be adapted accordingly, also taking into consideration the opportunities that will arise as a consequence of the reallocation of resources within the real economy given the dislocation of supply chains.

Exhibit 5: Sectors most exposed to inflationary pressure

Percentage of corporate with deteriorating net financial performance in a prolonged stagflation scenario

In percent



Note: Preliminary estimates to be refined to take into account the characteristics of each local industrial district
 Source: Oliver Wyman analysis

Seize the opportunity to support their clients throughout this inflationary period and proactively reallocate resources to growth areas.

Banks will need to determine their credit strategies for hard-hit sectors, paying particular attention not to accelerate or deepen the recession. They also need credit strategies for sectors that will benefit from new investment due to the implementation of the National Recovery and Resilience Plan and the post-war resilience plan (tourism, etc.). First movers will be advantaged by developing strong views and sectorial plays in these areas and will be central to helping accompany the new EU economic structure and competitiveness.

Banks need to also ensure they share the impact of interest rates fairly with customers while also insulating them from some of the inflation-induced increases in the costs of service. Banks will be well served to review end-to-end customer journeys and associated operational capacity for customers in financial difficulty, given the importance in both regulatory terms and how the overall brand is perceived at a time of heightened customer need. As an illustration, we have listed action items and levers that could be pulled:

- Treating customers fairly in relation to interest rate increases across asset and liability products
- Helping customers — retail and corporate — to understand the impact of inflation and interest rate increases on their cashflow based on analysis of transaction data
- Where appropriate, providing customers — particularly retail — with insights that prompt them to adjust expenditure to fit the new context
- Where appropriate, offering customers — particularly corporate — credit to increase liquidity and working capital, e.g., supply chain finance; asset-backed finance
- Re-structuring loans to make payments affordable, e.g., lengthening term of secured loans; switch to interest only on mortgages

Immediate focus on reining in costs without jeopardizing the much-needed transformation and modernization of banking infrastructure of processes. This will require a laser sharp review of spending portfolio to prioritize strategic investments and innovation in the renegotiation of third-party contracts to tackle (vs. prolong) accumulated technology debt.

Centrals banks, policy makers and supervisors, will also be called upon to help support a smooth migration of the financial system into this new economic phase. In general, we believe the magnitude and unpredictability of the context demands better collaboration between institutions and the banking system as a whole. In particular, we recommend that attention should be paid to the below considerations.

Jointly defining the best mitigation strategy for the potential deterioration of the quality of credit alongside commercial banks. Fast and accurate communication between banks and central institutions regarding the evolution of credit quality and the weaknesses in the lending portfolio could help create a deeper and a more coordinated “cost of risk” and NPL strategy at European and country level, helping contain defaults and inform the right policy responses.

Scale up the ambition on European debt mutualization to help avoid divergences between different countries and a repeat of the sovereign debt crisis. The European Union has proven to be particularly effective in managing the pandemic crisis by overcoming previous divisions and launching a eurobond to back the recovery and the resilience program (like the recent ECB 750 billion program). If stagflation materializes in Europe, the risk is that the widening of credit spreads could worsen the condition of weaker economies, inducing rifts between core and peripheral countries, like in 2012. To avoid this scenario, the mutualization of debt would be necessary to launch an anti-fragmentation asset purchase program to accompany the path of policy normalization.

Tackle core inflationary issues. The establishment of a partial embargo on Russian oil appears to further reinforce the need for an energy independence plan, potentially with the help of development finance institutions. Alternative energy policies could be enacted, and funds can be rerouted. Beyond energy, specific strategies for most disrupted supply chains (e.g., microchips) will need to be developed, taking a short but also a longer-term view to tackle inflationary pressure while thinking of reducing EU dependence on core essentials in the long term. Some of these actions might not yield immediate relief, but can help solidify the foundations of the EU economy supported system governed by the central bank for years to come.

CLOSING REMARKS

The goodwill that banks and the financial services sector managed to build during the pandemic crisis will only increase if, in the inevitable reallocation of resources, they are putting “social responsibility” at the center of their actions. By supporting the recovery from the pandemic and helping to tackle the biggest issue facing Europe’s economy today, the sector can gain a stronger sense of purpose, increase profits, and ensure its ongoing relevance.

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