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zeb/

Global banking industry with a groggy start in 2014—BRICS even destroying value

zeb/market flash | Scandinavia

Key topics

I. State of the banking industry (p. 2)

- Market capitalization of global banking industry almost unchanged
- Scandinavian banks still with leading position regarding valuation
- BRICS institutions with negative TSR performance, increased CDS spreads and rating downgrades (e.g. uncertainty about Crimea crisis in Russia)

II. Key banking drivers (p. 6)

- Scandinavian and Western European economic recovery continued in Q4 2013, but rising concerns about possible deflation
- Scandinavian and US long-term yields decreased in Q1 2014, leading to flatter yield curves and reduced maturity transformation
- Major Western European banks reported low results for Q4 2013

III. Special topic: Asset Quality Review (AQR) challenges largest European institutions (p. 10)

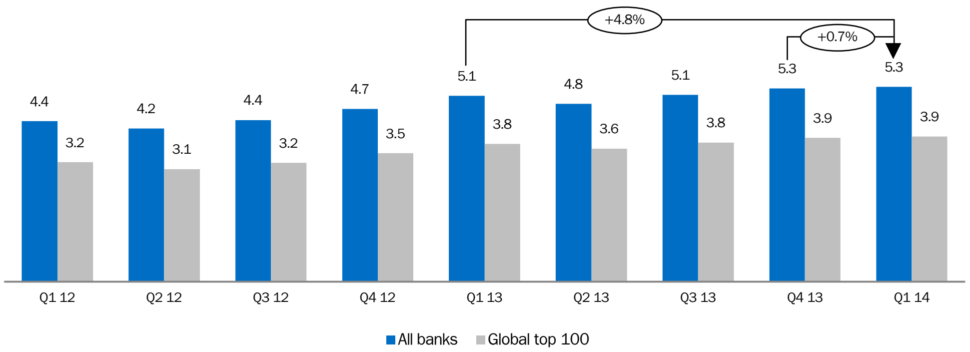
- AQR as core element of the ECB's comprehensive assessment running since end of February
- Capital gap expected only for few institutions by most market participants
- Not fully disclosed framework for stress testing causes high uncertainty

I. State of the banking industry

Market valuation

The market capitalization of the global banking industry increased slightly in Q1 2014 and reached EUR 5.3 bn. However, there are differences regarding regions and business models: market cap of Scandinavian banks increased again above average, whereas US institutions showed the highest P/B increase and regional commercial banking remained investors' favorite business model.

Fig. 1: Market capitalization of the banking sector (end of quarter, in EUR tr)

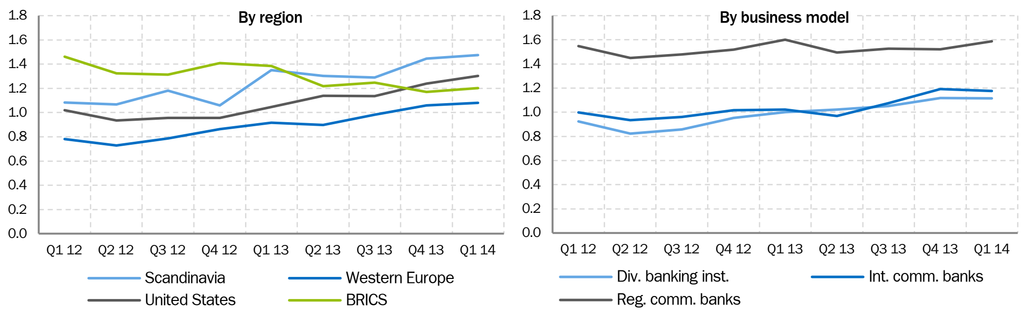


All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on Dec 31, 2013.
Source: Bloomberg, zeb/research

Global banks' market capitalization almost unchanged in Q1 2014

/ Recovery of global banking industry slowed down in Q1 2014: market capitalization increased slightly and amounted to EUR 5.3 bn for all banks and EUR 3.9 bn for global top 100 banks
/ Scandinavian banks showed again an above-average growth of 3.7% to EUR 150 m
/ Banks from emerging markets were negatively affected by external factors like clouded economic outlooks e.g. for Russia and China, whereas Western banks were able to improve their market capitalization

Fig. 2: Price-to-book ratio of global top 100 banks



Commercial banks generate at least 2/3 of their earnings from retail business or wholesale banking, international commercial banks generate 20% or more in non-domestic and culturally different markets, diversified banking institutions generate at least 1/3 from investment banking activities.
Scandinavia: Denmark, Finland, Norway, Sweden. Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa.
Source: Bloomberg, zeb/research

Scandinavia remained on top of regional clusters

/ Scandinavian banks remained on top among regional clusters achieving an average P/B ratio of 1.5, an increase of 2.0% compared to Q4 2013

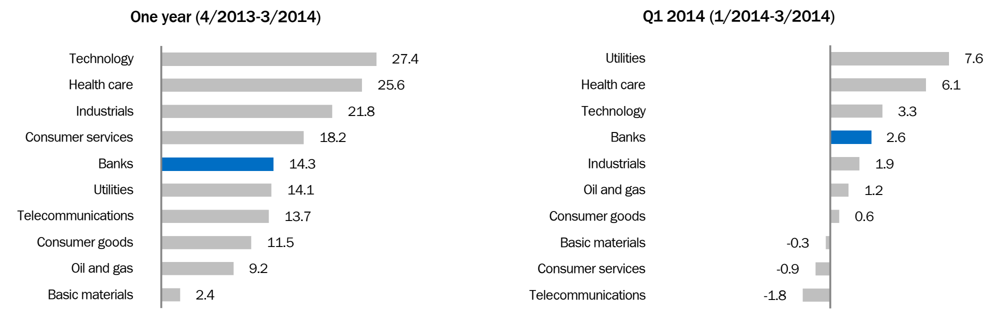
/ Average P/B ratio of US banks increased by 5% to 1.3, while the valuation of BRICS banks and Western European institutions remained almost unchanged in Q1 2014
/ In terms of business models, the gap between regional commercial banks and internationally active commercial banks or diversified banking institutions widened further

TSR performance

In the first quarter of 2014, global equity markets showed a mixed picture with several well-performing industries on the one hand, but some sectors actually destroying shareholder value on the other hand. With 2.6%, the performance of the banking sector was slightly above the average of all industries. Again, strong regional differences can be noticed: institutions from emerging markets achieved negative returns for investors, whereas banks from mature markets performed quite well.

Banks rank mid-table in a performance comparison of industry sectors

Fig. 3: Total shareholder return of industry sectors worldwide (in %)

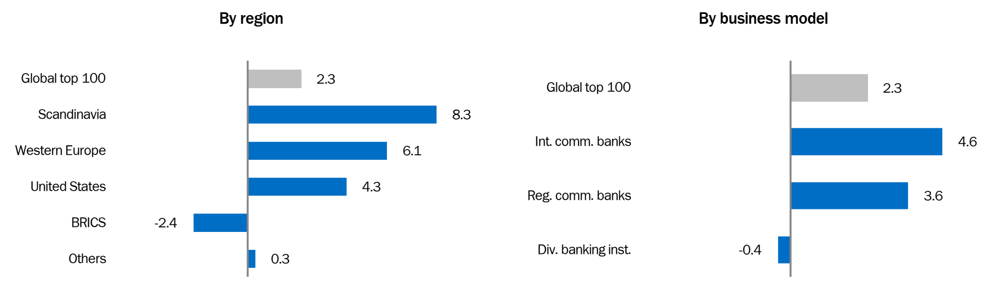


Total shareholder return of industry sectors based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream.
Source: Thomson Reuters Datastream, zeb/research

/ Year-over-year, all industry sectors show a positive development of total returns for investors, but some industries suffered from decreasing shareholder value in Q1 2014
/ The global banking industry achieved shareholder returns of +2.6% on a quarterly basis and +14.3% year-over-year, resulting in a mid-table ranking among industry sectors

BRICS institutions showed negative TSR in Q1 2014

Fig. 4: Total shareholder return of global top 100 banks (1/2014–3/2014, in %)



Average total shareholder returns are weighted by the market capitalization of each bank. Source: Bloomberg, zeb/research

/ As in Q4 2013, banks from BRICS destroyed shareholder value in Q1 2014, whereas Western European banks showed a TSR of 6.1%, achieving a return above the average of top 100 institutions for the fourth quarter in a row
/ Scandinavian institutions had another good quarter leading regional markets with a TSR of 8.3%

/ Regarding business models, the TSR of diversified banking institutions was slightly negative. Main reasons: weak results announced by some large banking groups from this cluster for the financial year 2013 (e.g. Deutsche Bank) and the weak start of the investment banking business in Q1 2014 (see Fig. 11)

Russian and Japanese banks occupy top ranks of global low performers

Fig. 5: Top/low TSR performers among global top 100 banks (1/2014–3/2014, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
Intesa Sanpaolo	Italy	37.1	VTB Bank	Russia	-20.2
Allied Irish Banks	Ireland	26.8	Mitsubishi UFJ Financial Group	Japan	-19.7
Natixis	France	24.7	Haitong Securities	China	-18.4
CaixaBank	Spain	24.6	Sumitomo Mitsui Financial Group	Japan	-17.5
Bank Mandiri Persero	Indonesia	24.5	Sberbank	Russia	-17.1

Scandinavia

Top performers	Country	TSR	Low performers	Country	TSR
Danske Bank	Denmark	23.0	DNB	Norway	-4.1
Nordea Bank A	Sweden	10.3	Swedbank	Sweden	1.5
Skandinaviska Enskilda Banken	Sweden	9.5	Svenska Handelsbanken	Sweden	8.0

Source: Bloomberg, zeb/research

/ The list of global low performers is dominated by banks from Russia, which suffer from sanctions in the context of the Crimea crises and a generally weak economic outlook, as well as Japanese institutions, which face a potential economic slowdown due to a VAT increase in April 2014

/ Western European banks showed a diversified picture: institutions that were hit hard by the sovereign debt crises continued their strong recovery with TSRs of at least 24%, whereas banks from stable European economies, primarily the UK, clearly lost shareholder value in Q1 2014 due to weak results for the financial year 2013. For example, Barclays reacted with the announcement of a job-cutting program in the investment banking division and RBS plans a comprehensive restructuring to become a regional commercial bank focused on the UK

/ Most Scandinavian banks showed a very good TSR performance in Q1 2014. DNB and Swedbank showed lower performances but given the good TSR figures in the past, this is more a stabilization on a high level and should not be interpreted as the beginning of a downswing due to fundamental reasons

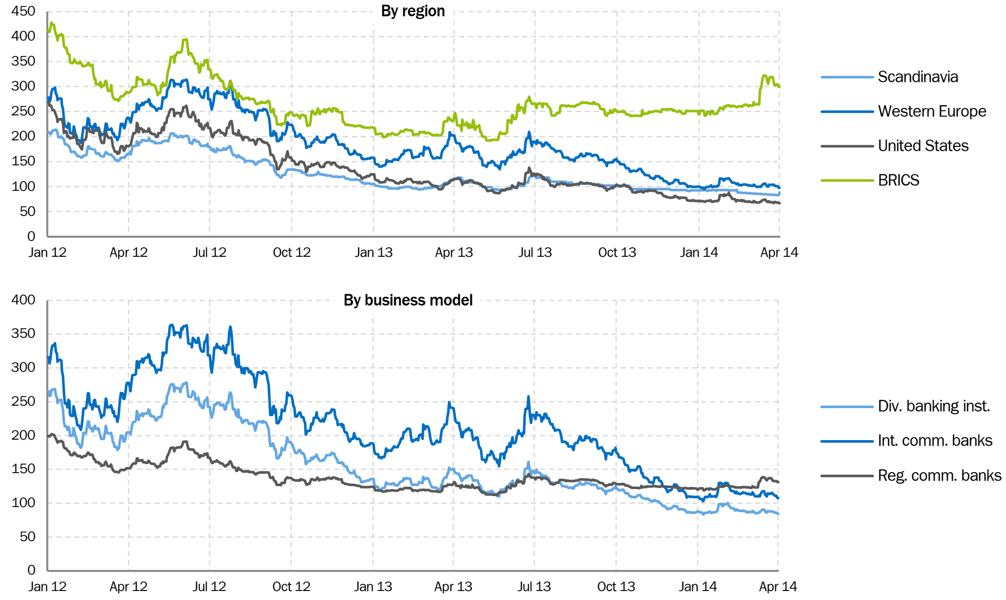
/ The results for Western Europe also reflect the bad performance of the diversified banking sector, as three of the five banks with the lowest performances banks are from this cluster

Debt perspective

CDS spreads remained almost unchanged for regional and business model clusters in Q1 2014, with one exception: BRICS banks had to face deteriorating spreads. In line with the development of CDS spreads, rating downgrades applied solely to BRICS institutions from Brazil and Russia. Overall, the number of rating changes remained at a constant level compared to the previous quarters.

CDS spreads of BRCIS banks significantly worsened

Fig. 6: CDS spreads of global top 100 banks (avg. 5-year CDS spreads, in bp)



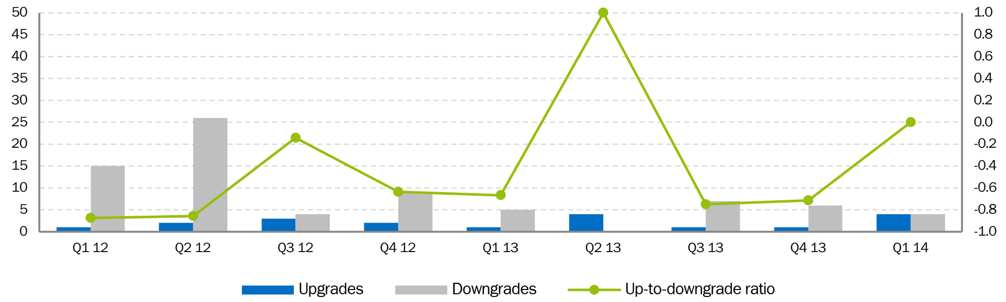
5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Bloomberg, zeb/research

/ Regionally, CDS spreads of BRICS institutions jumped up by 50bp to 300bp in Q1 2014, while the average spreads of Scandinavian, Western European and US banks remained unchanged at low levels between 70bp to 100bp

/ There are no substantial changes from a business model perspective

Rating downgrades of BRICS institutions in Q1 2014

Fig. 7: Rating changes of global top 100 banks



Rating changes consider the number of upward and downward revisions of the long-term rating of global top 100 banks as provided by Standard & Poor's, Moody's, Fitch Ratings. Outlook revisions are excluded. Up-to-downgrade ratio (right-hand axis) is a harmonized index calculated as (number of upgrades – number of downgrades)/sum of upgrades and downgrades.
Source: Standard & Poor's, Moody's, Fitch Ratings, zeb/research

/ Overall, few rating upgrades and downgrades balanced out each other in Q1 2014

/ Downgrades exclusively affected BRICS institutions, namely Itau Unibanco, Banco Bradesco, Banco do Brasil (all Brazilian) and Russian VTB Bank, which is in line with the deteriorating CDS spreads of BRICS banks (Fig. 6)

/ In contrast, Banco Santander and BBVA were subject to rating upgrades, which can be referred to a slowly recovering Spanish and Western European economy (see Fig. 8)

/ Ratings of Scandinavian banks remained unchanged in Q1 2014

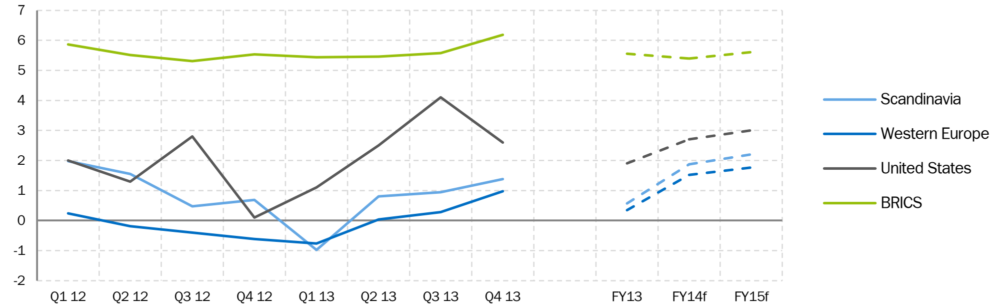
II. Key banking drivers

Economic perspectives

The general economic environment in Scandinavia and Western Europe improved further in Q4 2013 and economic outlooks, with the exception of BRICS, show a clear upward trend. With regard to consumer prices, continuously decreasing inflation rates raised concerns about an emerging deflation in Western Europe in the upcoming quarters.

Ongoing recovery in Western Europe, higher growth in Scandinavia

Fig. 8: GDP growth and forecasts (real GDP, year-over-year growth rates, in %)



Q1 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

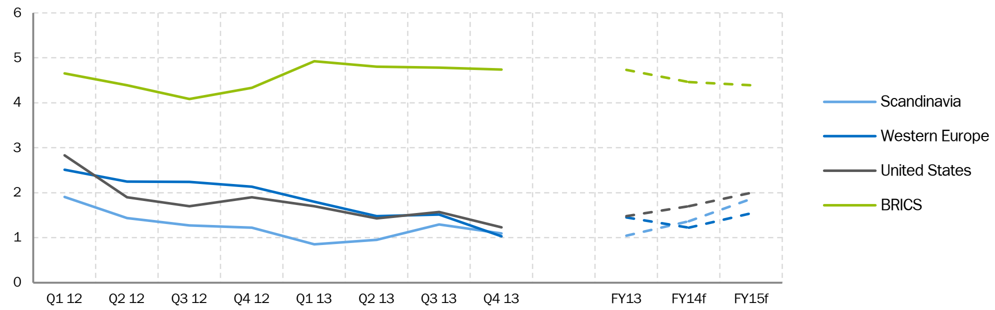
/ Western Europe continued its economic recovery as average GDP growth improved for the third quarter in a row to 1% in Q4 2013; main drivers are better economic conditions in crisis states like Spain or Greece, but also the GDP growth of Scandinavia, which is continuously above that of Western European as a whole

/ The US growth rate dropped sharply again in Q4 2013, but the general growth trend still continues

/ GDP growth in BRICS increased in Q4 2013. However, growth rates in Brazil and Russia stayed at a very low level with 1.9% and 1.3% in Q4 2013, and long-term forecasts remain below 6% for the upcoming years

Rising concerns about possible deflation in Western Europe

Fig. 9: Inflation rates and forecasts (annual change of average consumer prices, in %)



Q1 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

/ Despite the current loose monetary policy by ECB and Fed, which should actually put pressure on inflations rates, the increase of consumer prices slowed down again in Q4 2013

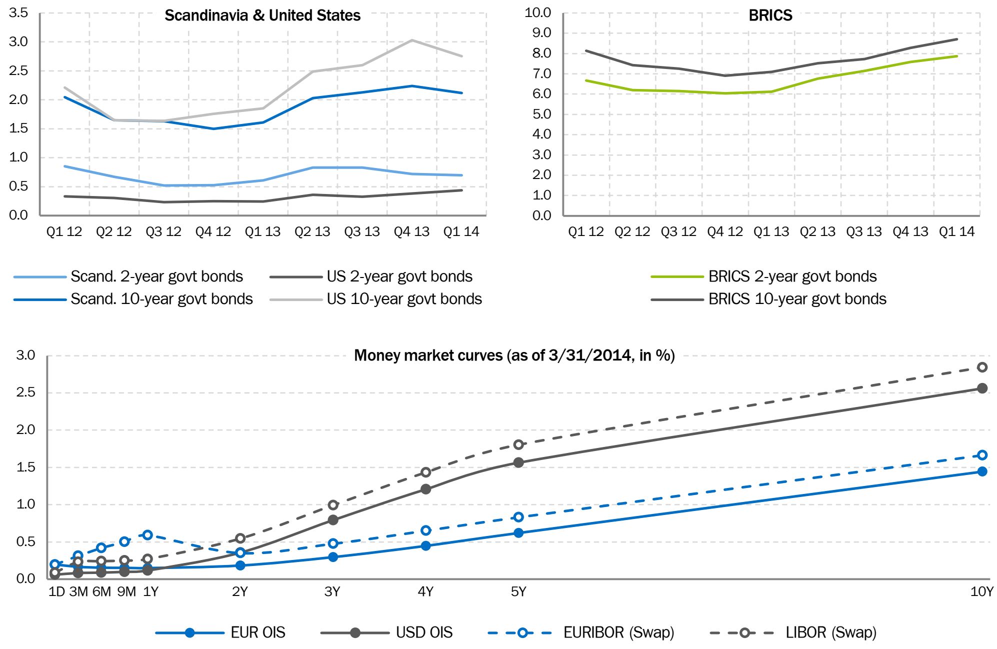
- In Scandinavia and Western Europe, there are rising concerns about a possible deflation in Europe (Spain already reported a small decline of consumer prices of 0.2% in March). Such a deflation would have negative effects on corporate investments, consumption and thus on the fragile economic recovery that began a few quarters ago, and would entail clear negative consequences for banks
- In the recent conference by the ECB, president Draghi announced a “wait and see” approach by keeping the interest rate constant and discussed the implementation of quantitative easing if necessary

Interest rates

The first quarter of 2014 brought a drop of long-term yields in Scandinavia and the US. Average Scandinavian 10-year rates decreased from nearly 2.3% in Q4 2013 to 2.1%, while yields of US 10-year government bonds declined from 3.0% to 2.8%—the first decrease of long-term yield rates since the beginning of the economic recovery one year ago. In BRICS countries, interest rates increased further for both 2-year and 10-year government bonds but the yield curve remains quite flat.

Fig. 10: Government bond yields (in %) and interbank market rates

Drop of long-term yields in Scandinavia and the US



Scandinavian and BRICS bond yields calculated as unweighted average. OIS denotes overnight indexed swap.
Source: Bloomberg, zeb/research

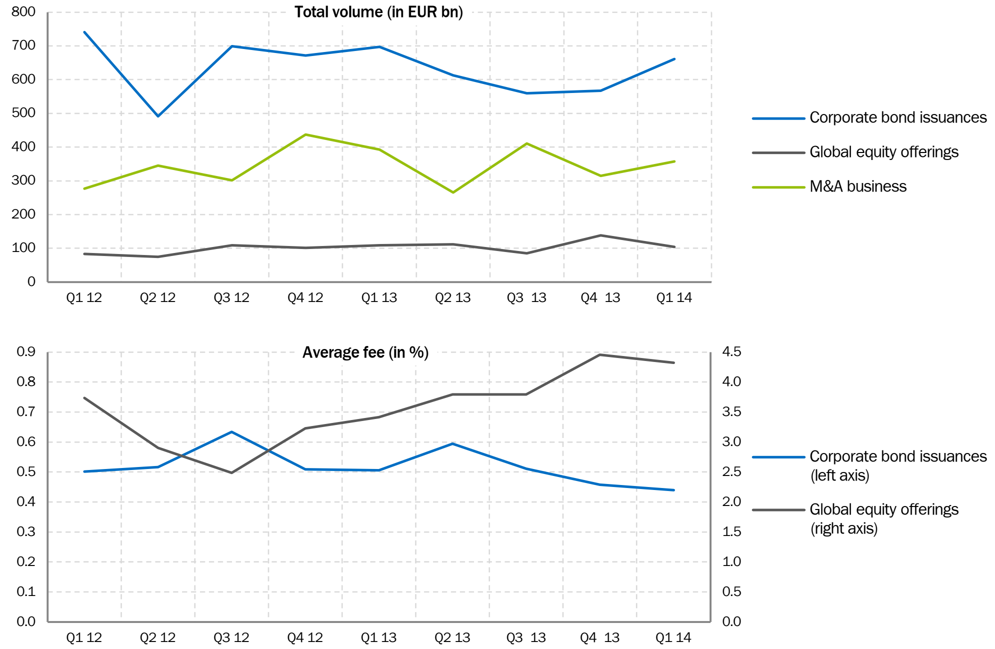
- Scandinavian and US long-term government bond yields dropped in Q1 2014—as a result, the slope of Scandinavian and US yield curves, which had increased more and more during the previous quarters, decreased again in Q1 2014, disappointing the banks’ hopes for higher maturity transformation results
- BRICS countries saw another nearly parallel increase of short-term and long-term interest rates, keeping the yield curve rather flat

Investment banking activities

Investment banking activities developed quite differently in Q1 2014. Total volumes of corporate bond issuances and M&As increased, but still reached only average levels compared to previous years. Equity offering fees remained relatively high at above 80bp, but the decline of bond market fees continued in 2014. Aside from these numbers, database provider Dealogic reported that total investment banking earnings (bonds, equities and M&As) declined by 18% at a global level and by 9% in Europe in Q1 2014 compared to the previous year, underlining that the investment banking market environment remains difficult for banks.

Investment banking remains difficult despite increasing volumes

Fig. 11: Global issuance business and deal volume of global M&A business



All M&A transactions classified by announcement date. No fee rates available for M&A transactions.
Source: Bloomberg, zeb/research

/ Volume of corporate bond issuances increased in Q1 2014 but remained below previous peaks; however, the average fee rate decreased by another 2bp, so that overall revenues in the bond issuance business remained at a relatively low level

/ In the equity offering business, volumes and fees decreased slightly but remained at a relatively high level. The M&A business profited from some larger deals such as the takeover of WhatsApp by Facebook, but the overall volume of EUR 357 bn in Q1 2014 only translated to an average level compared to previous years

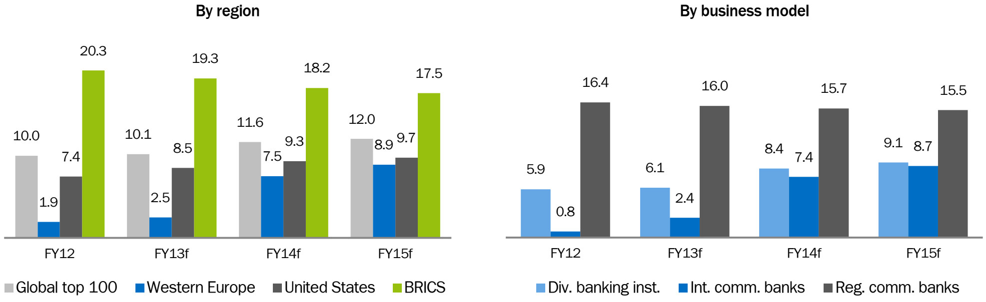
/ The overall situation of investment banking remained difficult, as underlined by several recent announcements of market leading banks like JP Morgan, Citigroup and Deutsche Bank, which all reported a slow start of their investment banking business in Q1 2014

Banking profitability

Some major Western European institutions reported very weak results for Q4 2013. With only 2.5%, profitability fell significantly behind the returns achieved by US and BRICS institutions. Current forecasts expect improved returns of Western European and international commercial banks in 2014/15, but profitability levels of more than 10% are not in sight for Western European and US banks.

Sharp RoE decrease of Western European banks and international institutions

Fig. 12: RoE after tax and annual RoE forecasts of global top 100 banks (in %)



Forecasts are calculated as equity-weighted averages of analysts' consensus forecasts as available from Bloomberg.
Source: Bloomberg, zeb/research

- Some major Western European banks look back at a devastating last quarter of 2013: UniCredit for example wrote off goodwill in Italy, Austria and Central Eastern Europe and significantly increased loan loss provisions, leading to an overall loss of nearly EUR 15 bn in Q4 2013. Other major players also reported profits well below market expectations. In total, the expected RoE of Western European banks for the full year 2013 is currently only 2.5%—a rather slight recovery compared to 2012. In the previous quarter, the initial RoE expectation had been 5.9% for 2013. Forecasts for 2014/15 were also adjusted downwards
- Scandinavian institutions are significantly above the Western European average with a post-tax return on equity of 10.6% in 2013 and an expected profitability of 11.7% in 2014 and even 12.3% in 2015
- US institutions remain clearly ahead of Western European banks, but forecasts still expect RoEs below 10% in 2013 and even in 2014/15
- For BRICS institutions, current forecasts expect lower total earnings and further increasing loan loss provisions in the upcoming years, leading to a further decline of the profitability in 2014 and beyond with returns well below 20% in the upcoming years

III. Special topic

Asset quality review (AQR) poses challenges to the largest European institutions—one step closer to the supervision of European banks by the ECB

Supervision in Europe showed major deficits in the past

The recent crises revealed certain deficits in the supervision of European banks. Strong interdependencies between the institutions led to delayed recognition of systemic risks and national interests biased the local supervision. Furthermore, single governments had to pay for the rescue or resolution of banks that got into trouble due to transnational crises. The solution for these problems is presented as the European Banking Union, which comprises a single rulebook (CRR/CRD IV), the single resolution mechanism (SRM), collective deposit protection (in the long run) and the single supervisory mechanism (SSM). The SSM is assigned to the ECB and addresses 128 European institutions that are defined as "significant".[1] The implementation of the SSM has already begun with the comprehensive assessment (CA) of the institutions directly supervised by the ECB. The ECB is authorized to provide access to the European stability mechanism (ESM) in case of a crisis, and therefore demands a high degree of transparency from supervised institutions.

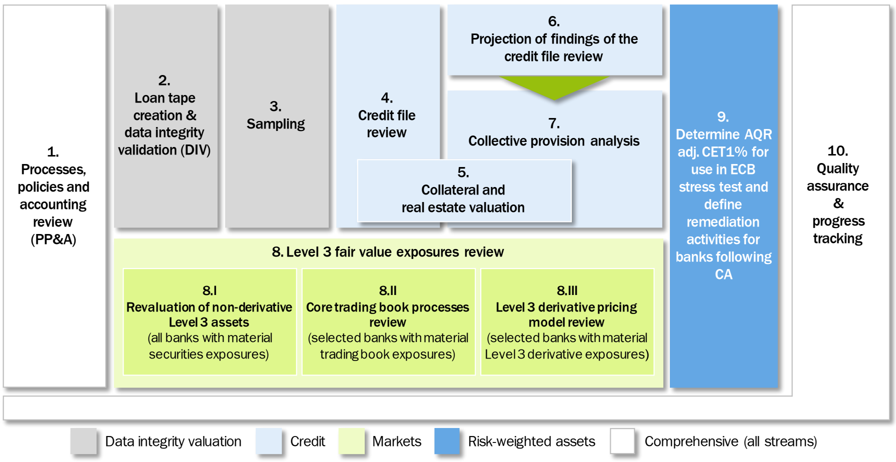
ECB's comprehensive assessment should return trust to banking

The CA is conducted to increase the quality of data with respect to a bank's financial strength. Issues regarding capital will be outlined and institutions will be forced to counteract identified capital gaps. Finally, the CA should send a signal of confidence to stakeholders, creating a picture of a banking sector that is healthy in terms of fundamentals and that deserves credibility. As a consequence, the evaluation of risks in these fundamentals, namely the AQR, represents the core element of the CA.

Majority of experts expect an only moderate impact from AQR

But what do experts and market participants expect from the AQR? Overall, the only majority sees a low or moderate impact. Analysts from JPMorgan[2] see a positive sign in their analysis for those banks that were seen as at risk in the AQR, e.g. Deutsche Bank, Commerzbank, Italian banks and domestic Spanish banks. And even the ECB does not expect to find new issues unknown to the market. However, the supervisors underlined that they are not willing to make compromises.

Fig. 13: Work blocks of AQR as defined by the ECB and major streams



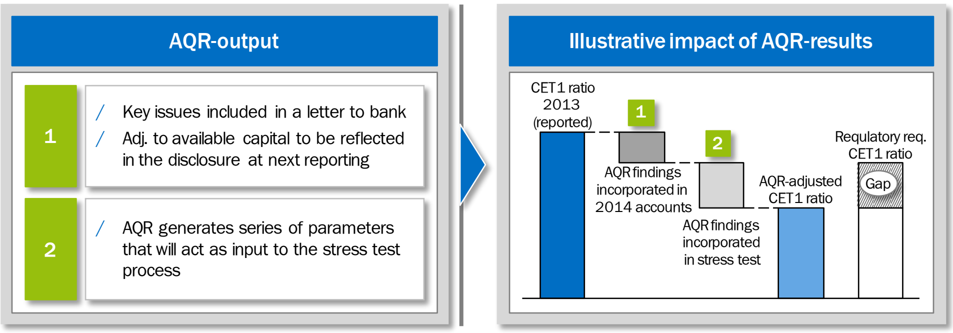
Source: ECB, zeb/

[1] ECB determines "significance" of an institution and for this purpose refers to several criteria, e.g. total assets larger than EUR 30 bn or 20% of GDP, direct support by European Financial Stability Facility (EFSF) or European Stability Mechanism (ESM).
[2] Analyst report: European Banks – ECB Stress Test

The ECB defined ten AQR work blocks that can be assigned to four major streams (see Fig. 13). First, a data integration valuation (DIV) has to be conducted, which examines the quality of data delivered to supervision and includes corrections where necessary. Second, the loan book will be assessed in the credit stream: the organizational and IT structure is subject to a process review, receivables and collaterals are evaluated regarding their recoverability. Furthermore, the adequacy of provisions for risks is tested. The third stream (markets) represents an assessment of the market portfolios. Here, the adequacy of methods and models used for the asset valuation as well as the categorization into level 1, 2 or 3 assets are under review. The fourth stream is an evaluation of risk-weighted assets (RWA), where findings from the preceding credit and market streams are included to recalculate RWA and dependent capital ratios with adjusted parameters.

AQR addresses data quality, credit and market risk

Fig. 14: AQR output and illustrative impact on capital base



Source: zeb/

The AQR has two outputs: First, the national competent authority (NCA) sends a letter to the bank that outlines any areas where the bank is found to be outside of accounting principles and the required remediation actions the bank is expected to take. The letter further includes an expected effective adjustment regarding available capital that has to be reflected within the next reporting period. Second, the AQR generates a series of parameters that will act as input to the stress test process. The parameter set includes adjustments to the data segmentation highlighted in the data integrity valuation, adjustments regarding the common equity tier 1 ratio (CET1 ratio) and parameters for probabilities of impairment (PI) and loss given impairment (LGI).

Findings are outlined in letter to bank and will be input for the following stress test

Fig. 14 illustrates the potential impact of the AQR on a bank's capital base. The reported CET1 ratio is negatively affected by the findings from the AQR and requires an immediate reaction by the bank. As the findings from the AQR are incorporated in the following stress test, further deductions of capital could be the result. Overall, an AQR-adjusted CET1 ratio is calculated, which might be below the regulatory minimum requirement for some of the 128 banks. These banks then would have to increase their capital base or reduce RWA to meet the regulatory requirements.

The current AQR phase is scheduled until the end of September 2014 and is followed by the highly expected stress test, which will show the ultimate condition of the European banking sector's foundations. As banks face great uncertainty about the stress test, preparations and simulations are an issue for top management.

zeb/ is closely following the ongoing assessment process and is assisting the NCAs as well as providing support for banks in context of the AQR. The next issues of the zeb/market flash will continue to cover the ECB's CA as it could significantly impact value creation.

About zeb/market flash

zeb/market flash is a quarterly compilation of market data, putting the total shareholder return (TSR) performance of the global banking industry, economic fundamentals and key value drivers into perspective. It is published by zeb/rolfes.schierenbeck.associates. All data and calculations of this issue are based on the date April 1, 2014. The global top 100 banks cluster contains the largest banks by market capitalization on December 31, 2013 and is updated on a yearly basis. Data is subject to ongoing quality assessment. As a consequence, minor adjustments could be applied to historical data as well as forecasts shown in previous issues of zeb/market flash.

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