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zeb/

Western European banks show strong performance – institutions in China and India under pressure

zeb/market flash | Scandinavia

Key topics

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

- In Q3 2013, the global banking industry and especially Western European institutions achieved excellent TSR performances of nearly 15%
- Again, BRICS financial institutions and commercial banks from growing markets lost some of their previously existing valuation edge

II. Key banking drivers (p. 6)

- Economic conditions improved in mature markets like Scandinavia, Western Europe and the US in Q2 2013 – growth in emerging markets stabilized
- Low interest rate regime persists in Scandinavia and the US – yield curves in BRICS countries flattening

III. Special topic: Separation of banks ("Liikanen report") as strategic and operational challenge for European banks (p. 10)

- 37 of the 50 largest European banks hit by Liikanen proposals
- The implementation of the Liikanen model would lead to an increased market share of European top players

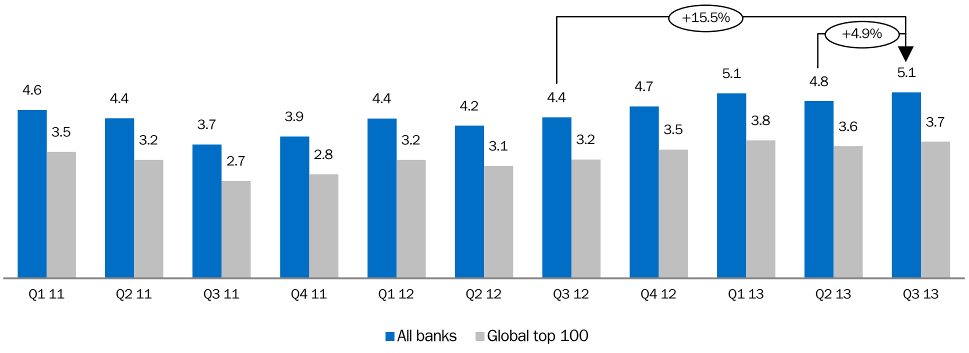
I. State of the banking industry

Market valuation

The global banking industry seems to be back on its long-term upward trend as total market capitalization is again above EUR 5.1 trillion in Q3 2013 for only the second time since 2007. However, the valuation of banks from emerging markets is still significantly lower than in 2012 due to uncertainties of the economic development in major growing markets like China, India and Brazil.

Global banks back on upward trend

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

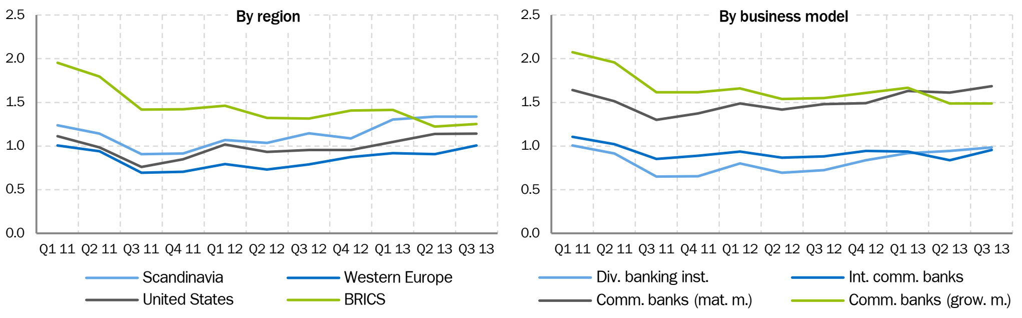


All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on Dec 31, 2012.
Source: Thomson Reuters Datastream, zeb/research

- In Q3 2013, global banking industry was back on its recovery path originally started at the end of 2011: market capitalization increased by 4.9% on a quarterly basis and 15.5% year-over-year
- However, current controversies in the US regarding the US budget and government shutdown cause some uncertainties in the market and could stress market caps in Q4

Scandinavian banks still with highest price-to-book ratio

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



International commercial banks generate more than 70% of their earnings from classic banking activities in different international markets, commercial banks from mature/growing markets more than 70% in their respective market types, diversified banking institutions more than 30% from investment/ non-classic banking. Scandinavia: Denmark, Finland, Norway, Sweden. Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa.
Source: Thomson Reuters Datastream, zeb/research

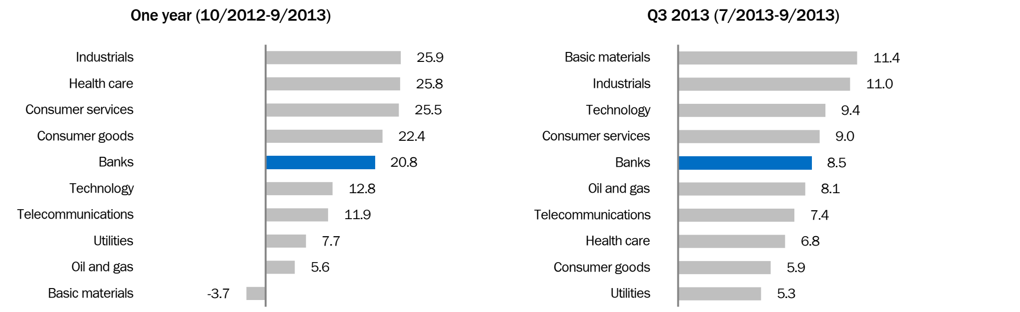
- In Q3 2013, Scandinavian banks' price-to-book ratio remained nearly unchanged at 1.3 but they still achieved the highest price-to-book ratios among regional clusters ahead of BRICS and the US
- Price-to-book ratio of Western European banks continued to increase in Q3 2013 and is now back at 1.0 for the first time since the debt crisis led to a significant devaluation in mid 2011

TSR performance

In Q3 2013, global equity markets had a generally positive performance in terms of total shareholder return (TSR). The banking sector showed an average performance, both in terms of quarterly performance and from a year-over-year perspective. Among the largest 100 banking institutions, especially banks from Western Europe outperformed. Scandinavian institutions achieved a lower but still positive return in the last quarter which is not distressing given their very good performance in the past.

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

Medium performance of banks among industry sectors

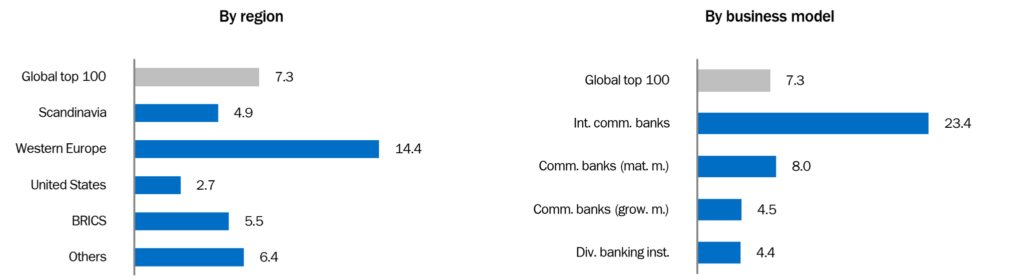


Total shareholder return of industry sectors based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream.
Source: Thomson Reuters Datastream, zeb/research

- All industry sectors exhibit a positive return in the previous quarter underlining the overall good performance of equity markets
- Banking industry achieved total shareholder returns of +8.5% in Q3 2013 and +20.8% year-over-year resulting in an average ranking among industry sectors

Fig. 4: Total shareholder return of global top 100 banks (7/2013–9/2013, in %)

Western European banks with best performance – Scandinavia achieved relatively low TSR



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

- In Q3 2013, Western European banks achieved the highest returns as risks from the European debt crisis continued to decline and economic indicators such as GDP growth improved; however, recent political turmoil, e.g. in Italy, showed that the European crisis is not over yet
- TSR of Scandinavian banks was among the lowest in the last quarter but based on the very good performances in the past, the long-term return is still ahead of most banking regions
- Overall, all regional and business model clusters created value in the last quarter but figures do not include the consequences of the current government shutdown in the US, which could lead to some negative impacts in the upcoming quarter

Fig. 5: Top/low TSR performers among global top 100 banks (7/2013–9/2013, in %)

Western European and international commercial banks dominate top performers

Global

Top performers	Country	TSR	Low performers	Country	TSR
CaixaBank	Spain	39.9	ICICI Bank Ltd	India	-17.5
Societe Generale SA	France	39.5	State Bank of India	India	-17.3
Banco Bilbao Vizcaya Argentaria SA	Spain	31.7	Siam Commercial Bank PCL	Thailand	-13.0
Royal Bank of Scotland Group PLC	Britain	31.6	Bank Mandiri Persero Tbk PT	Indonesia	-11.7
UniCredit SpA	Italy	31.0	HDFC Bank Ltd	India	-11.4

Scandinavia

Top performers	Country	TSR	Low performers	Country	TSR
Danske Bank A/S	Denmark	21.1	Swedbank AB	Sweden	-2.7
Skandinaviska Enskilda Banken AB	Sweden	6.2	Svenska Handelsbanken AB	Sweden	2.1
DNB ASA	Norway	3.8	Nordea Bank AB	Sweden	3.3

Source: Thomson Reuters Datastream, zeb/research

/ Despite the downgrade of some major European financial institutions in July 2013 (Fig. 7), the five best-performing institutions are solely from Western European markets with a quarterly TSR of above 30% due to an improved sentiment in the Euro markets and promising P&L results for the first half of 2013

/ In Q3 2013, especially Indian banks were hit hard as the GDP growth in India was down to a ten year low; in addition, the national bank of India massively restricted the monetary policy in July to fight the very high inflation rate leading to a strongly decreased liquidity in the Indian banking sector and capital outflows to other emerging countries

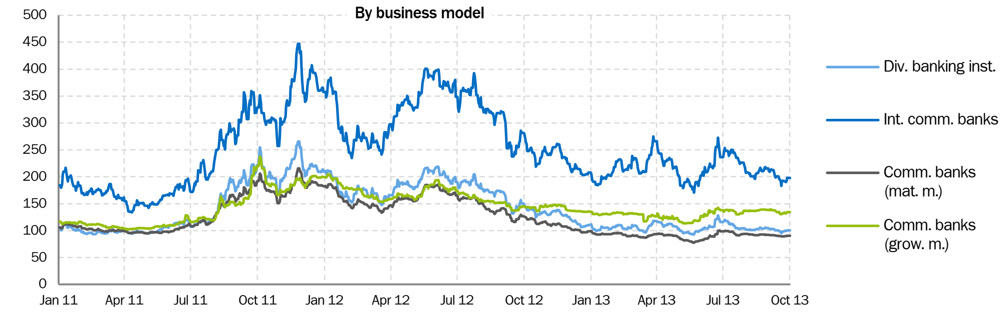
/ Among Scandinavian banks, Danske Bank and SEB announced very good results for the first six months of 2013 leading to good TSR performances above the Scandinavian average (Fig. 4)

Debt perspective

The third quarter started with several rating downgrades of major Western European banks in July 2013 due to increased uncertainty at the end of Q2 2013. However, despite these downgrades, CDS spreads of financial institutions slightly decreased in the course of Q3 2013 regardless of regions and business model clusters. Scandinavian banks' CDS spreads also improved.

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

Decreasing CDS spreads among regions and business models

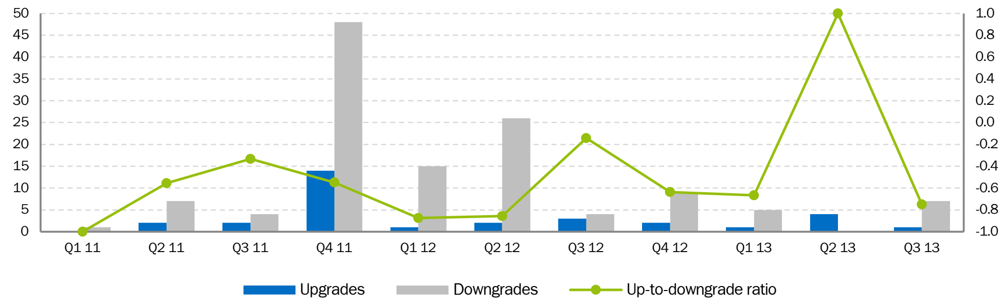


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Thomson Reuters Datastream, zeb/research

- CDS spreads of global top 100 banks decreased again, regardless of region and business model
- Regionally, US and Scandinavian banks' CDS spreads remain the lowest with 87bp and 88bp, down 15bp and 14bp respectively compared to the end of Q2 2013; Western European institution's spreads also developed relatively well and are now down to 138bp, a decrease of 23bp
- Among business clusters, CDS spreads of international commercial banks are still the highest and most volatile; they decreased by 39bp to 198bp in the last quarter after a sharp increase in June 2013

Fig. 7: Rating changes of global top 100 banks

Seven rating downgrades of European 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

- In Q3 2013, the number of rating downgrades of global top 100 banks increased: after zero downgrades in Q2 2013, seven institutions had negative rating revisions in the last quarter, while the up-to-downgrade ratio decreased from +1.0 to -0.8
- The most notable rating changes were the downgrades of several European institutions like Barclays, Credit Suisse, Deutsche Bank, Intesa Sanpaolo and UniCredit by S&P
- According to S&P, the downgrades of Barclays, Deutsche Bank and Credit Suisse were mainly the result of negative effects from the investment banking business, which suffers from strong supervisory regulation and became riskier due to a more volatile market environment while markets were not affected by the downgrades
- Among Scandinavian banks, Svenska Handelsbanken's rating outlook was lowered from stable to negative by S&P in July but this was returned to stable in September; however, ratings of other Scandinavian banks remained unchanged in Q3 2013

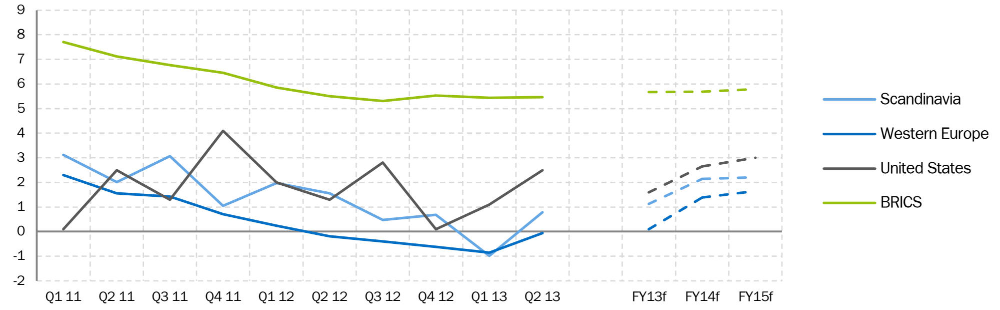
II. Key banking drivers

Economic perspectives

In Q2 2013, the economic environment improved in mature markets like Scandinavia, Western Europe or the US. However, the situation remains challenging for banks as forecasts still predict low overall growth rates in these markets for the full year 2013. BRICS' growth remained relatively stable.

Improved conditions in mature markets

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

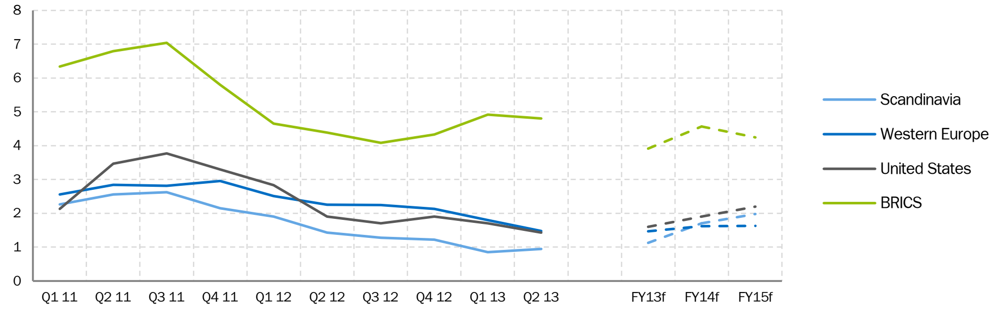


Q3 2013 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

- In Western Europe, the economic condition improved significantly in Q2 2013 as the growth rate improved compared to the previous quarter for the first time in three years, however current forecasts still expect a stagnation of the Western European economy in 2013
- In Scandinavia, the economic condition in Norway improved significantly as GDP growth increased to 2.6% after -2.6% in Q1 2013; however, GDP growth in Finland is still negative at -1.2%
- The US economy showed reasonable growth in Q2 2013, however the mentioned current political controversy regarding the US budget could negatively affect the future situation
- Growth of BRICS countries remained stable above 5% which corresponds to the expectations for the years 2014/15 but is significantly lower than growth rates in the past

Inflation rates decreased in most regions in Q2 2013

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



Q3 2013 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

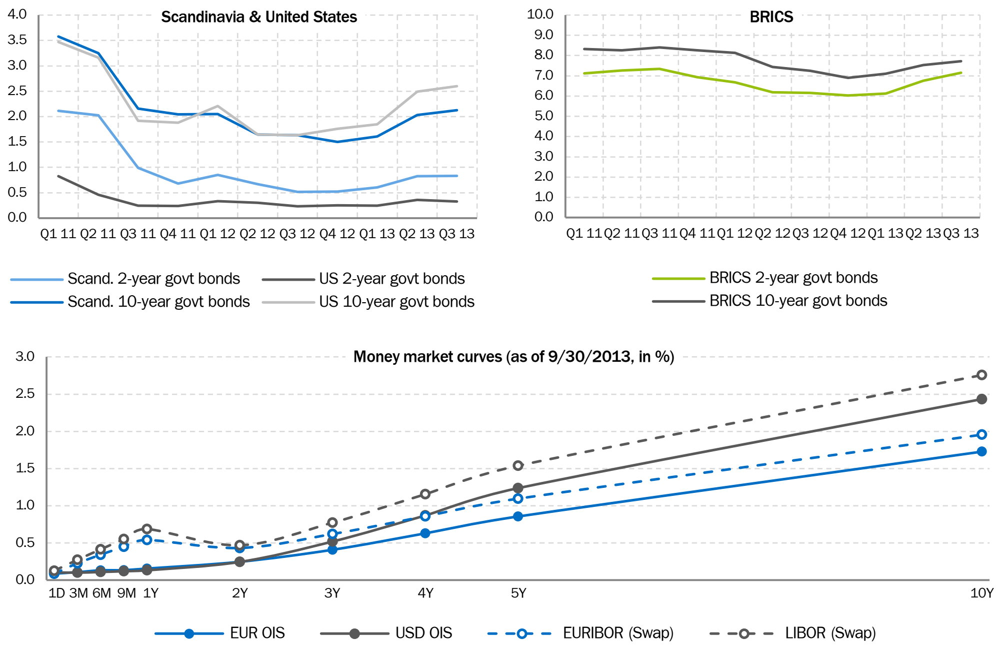
- Despite a better economic development, global inflation rates continued to decline in Q2 2013
- In Scandinavia, consumer price changes increased slightly but remained below 1.0%, whereas inflation in the BRICS countries stopped to increase

Interest rates

After a strong increase in Q2 2013, government yields in Scandinavia and the US stabilized in Q3 2013. In BRICS countries, interest rates increased further and the yield curve became even flatter in Q3 2013 as short-term government bond yields rose more than long-term yields, making maturity transformation for banks more difficult, especially compared to the years 2011 and 2012 where the yield curve was clearly steeper.

US and Scandinavian interest rates stabilized; BRICS yields increased

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



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

/ The increase of interest rates in Scandinavia and in the US came to an end in Q3 2013 as government yields stabilized and short-term yields even slightly decreased due to the latest announcement from the Fed

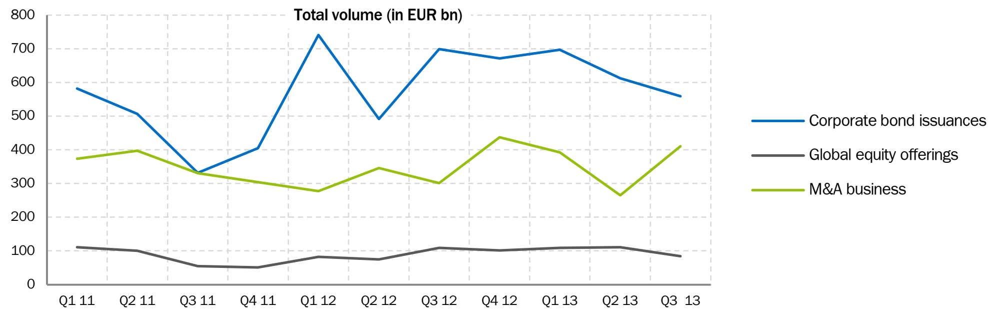
/ Overall, the yield curves in BRICS, the US and Scandinavia developed in different directions: whereas the yield curves in BRICS countries became more flat over the last quarters, the yield curve slightly steepened in Scandinavia and the US

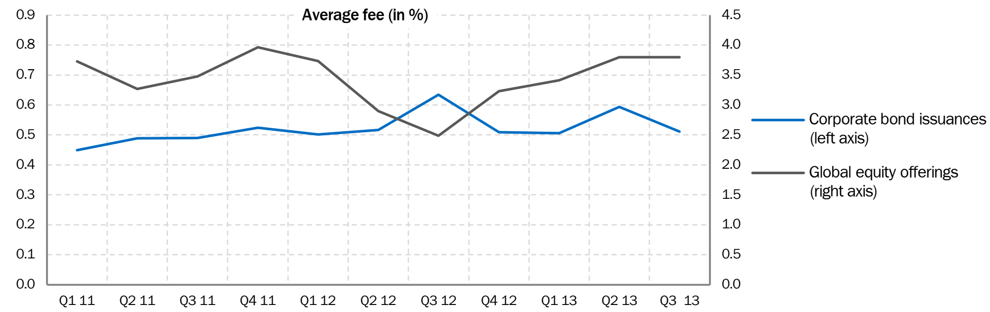
Investment banking activities

Overall investment banking activities achieved a solid performance in Q3. Although bond issuance business looks back at a quarter with a low overall performance in terms of volumes and margins, M&A transactions increased significantly resulting in one of the best quarters since 2011. Volume of equity business declined slightly but margins remained at a relatively high level compared to previous quarters.

Bond issuance business hit by decreasing volumes and margins

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

/ In Q3 2013, global bond issuances declined further to below EUR 600 bn, the lowest issuance volume since Q2 2012. In addition, the average fee rate declined to 0.5% resulting in a relatively difficult quarter for corporate bond issuance

/ M&A transactions increased strongly by nearly EUR 150 bn to more than EUR 500 bn (+55%) in Q3 2013 compensating the decline in previous quarters and reaching one of the highest volumes in the last three years

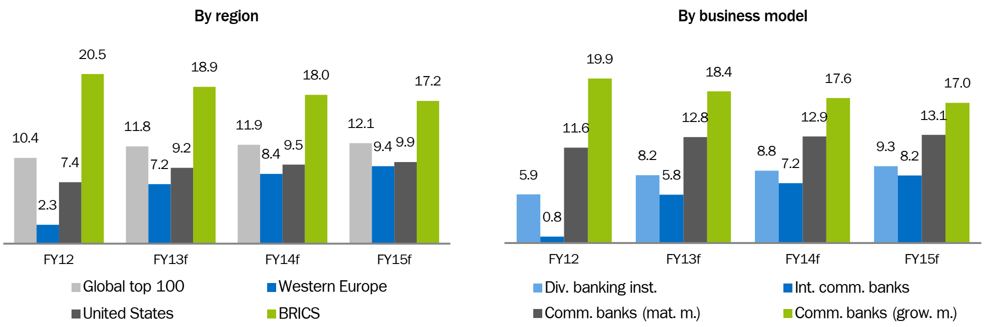
/ Despite a slight decrease in deal volume, the equity offering business saw no fundamental changes in Q3 2013 – margins stabilized at a relatively high level

Banking profitability

According to current analysts' forecasts, the gap between BRICS banks and mature markets will slightly decrease but not fundamentally change. The profitability of financial institutions from mature markets like Western Europe or the US will continuously increase but will remain below 10% in the mid-term future.

Fundamental gaps will further persist

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



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

- After achieving low RoE figures in 2012, analysts expect a rise in profitability for US and Western European banks until 2015 but profitability will remain below or around 10%
- Especially in Western Europe, the future profitability of banks is heavily affected by the negative impact of the current low interest rate level and the new regulatory requirements from Basel III; see the upcoming zeb/ European Banking Study for a further discussion on this topic
- The future profitability of BRICS banks should further decline in 2013, 2014 and 2015 which is mainly the effect of significantly lower economic growth rates in these countries in the future; however, the fundamental gap between banks from mature markets and BRICS institutions and commercial banks from growing markets will not change in the upcoming years

III. Special topic

Separation of banks ("Liikanen report") as strategic and operational challenge for European banks

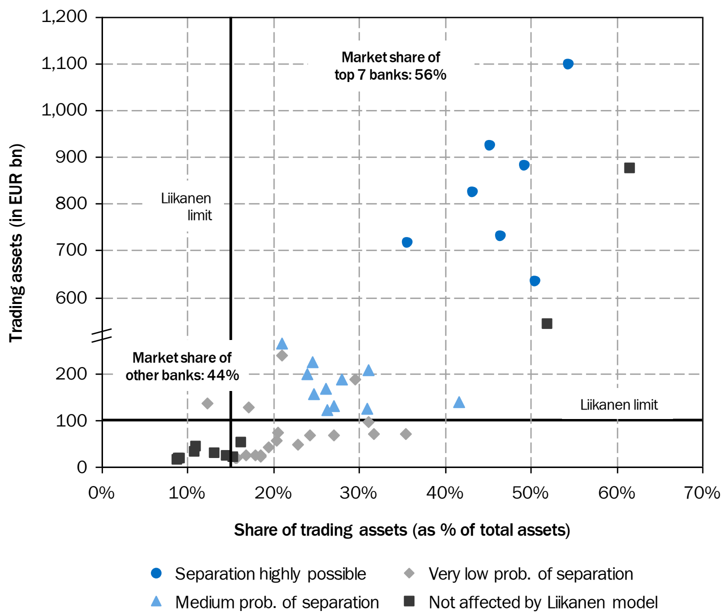
The Liikanen model for a separation of banks

When the Liikanen Group, on the initiative of EU Commissioner Michel Barnier, presented its recommendations for a more stable and efficient banking system within the European Union in October 2012, the fundamental changes that resulted from the designed set of measures could hardly be foreseen. However, it is undisputable that introducing a separated banking system, i.e. a functional separation of traditional lending/deposit-taking business and trading business, strongly impacts business strategies and operational processes of banks. Despite strong resistance from banks and banking associations and ambiguous opinions from economists, several countries have already launched initiatives for introducing such models. The parliaments in Germany and France have enacted partially modified versions from Liikanen. The UK is generally moving in the same direction with its "ring-fencing" approach.

High relevance for European banks

From today's perspective, the political dynamics indicate that the introduction of a separate banking system within the EU or at least in several member states is quite likely. And yet these plans are not only relevant for institutions based in the EU. Banking groups from other countries can also be affected by these plans, for example due to subsidiaries based in the European financial centers such as Frankfurt, London or Paris. Since institutions may partly cease or significantly reduce their trading business, a separate banking system would also impact the corresponding market segment and market structure outside of the EU.

Fig. 13: Volume and share of trading business of top 50 European banks



Trading assets include trading securities, derivatives and available-for-sale assets. Liikanen limits: trading assets above EUR 100 bn or a share of trading assets of at least 15%. Institutions not affected by Liikanen include banks below the Liikanen limits and institutions from non-EU countries such as Norway, Russia and Switzerland.
Source: Bankscope, zeb/research

Figure 13 illustrates an overview of the current situation based on the volume of trading assets and their share in the balance sheet total. Based on zeb/'s initial evaluation, 37 of the 50 largest European financial institutions are currently directly affected by the Liikanen recommendations. These banks are located in an EU member state and their trading business exceeds the volume limits proposed by the Liikanen Commission.

Affected institutions face enormous consequences in terms of business policy aspects. These banks have to decide whether to separate their business or to reduce their trading activities to such an extent that it will not exceed the specified limits. Three different groups can be distinguished: Cluster 1 contains top players in European trading business. These institutions are well above the Liikanen limits as shown in Figure 13. Separation into a trading and a non-trading institution within a banking group is highly possible because their trading business is simply too large and too important for the total banking group. Cluster 1 contains Deutsche Bank, Société Générale, BNP Paribas, Crédit Agricole and the four largest UK banks. Furthermore, Credit Suisse and UBS would fall into cluster 1, however, they are not directly affected by the Liikanen model as they are based in a non-EU country.

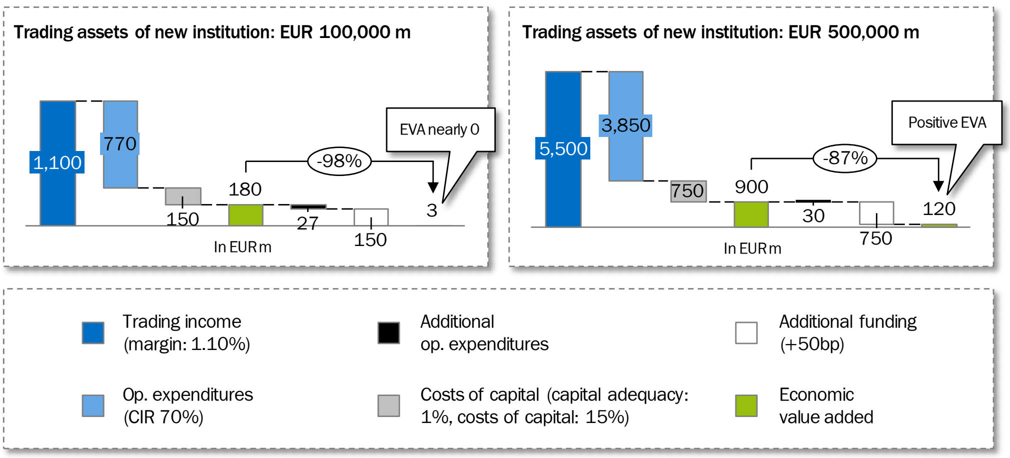
Key question: separation or reduction of trading business?

Cluster 2 includes banks with a considerably lower but still significant share of trading business. These banks would exceed the Liikanen limits. In our opinion, these institutions are free to decide whether to separate the two business areas or to reduce the trading business. This cluster contains approx. ten institutions, including Nordea and Danske Bank from the Nordic countries, and the Spanish market leaders Banco Santander and BBVA. In contrast, Cluster 3 institutions exceed the limits set by the Liikanen model, but, from today's perspective, given their trading business volume and its relevance for their total assets, establishing a separate trading institution does not seem to be a reasonable option. From the Nordics, SEB belongs to this group with trading assets slightly above the Liikanen limits. Other banks from Nordic EU countries like Svenska Handelsbanken or Swedbank are currently below the limits based on this first outside-in analysis.

From an economic perspective, the decision whether to separate or cease the trading business should be based on the expected economic value added (EVA) of the newly emerging trading institution. Banking groups will only separate the trading business if a positive EVA can be expected for the new entity in the long term. To provide a first impression on this problem, zeb/ conducted an initial evaluation of this issue.

EVA of trading entity contingent on size of trading business

Fig. 14: Estimated economic value added of trading entities based on trading assets



Source: zeb/research

In an approximative approach, the EVA can be estimated as follows. In addition to the expected trading business income, the newly established institution faces non-recurrent expenses for the separation process and additional recurring expenses depending on the volume of their trading activities. Besides administrative expenses, e.g. for additional IT systems or the setting up of duplicate internal divisions, the new entity has to face higher costs of capital and funding. We have to assume that the new trading institution's rating will be several notches below the holding company's rating due to the riskier business model. On the basis of a simplified model (see Fig. 14), a minimum volume can thus be derived for the "new" trading institution to achieve a positive economic value added. Assuming an increase of funding costs, e.g. by 50 basis points, the critical volume of transferable trading assets amounts to a minimum of approximately EUR 100 bn.

First estimates indicate that the market structure will undergo significant changes once a separate banking system is introduced. Depending on the number of institutions that opt for a separation, the top players' market share might increase from currently 56% to 70–80% according to zeb/ estimates. It remains to be seen how the trading business margins and also the customers' access to related services in this area will change.

The first national initiatives in European states, e.g. the German "*Trennbankengesetz*", demonstrate the commitment of European policy makers to introduce a separate banking system. Since bank separation is not simply a regulatory requirement but affects the whole business model, banks should carefully consider their strategic options first. From a zeb/ perspective, institutions need to conduct a thorough impact analysis based on a robust analytical framework to allow for different scenario analyses (e.g. reduce trading business or separate businesses). Based on the strategic impact analysis, a target picture for the bank in a separate bank system either as a holding model or with a reduced / ceased trading business needs to be developed. Finally the required operational changes need to be addressed. The implementation roadmap needs to cover almost all banking areas: e.g. from sales to IT, from legal / compliance to communication.

From a zeb/ perspective, the banking sector's preparation is currently at a very early stage given the tremendous impact and the high probability of a separate banking system in Europe. Bank management is advised to put this topic on its agenda.

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 October 1, 2013. The global top 100 banks cluster contains the largest banks by market capitalization on Dec 31, 2012 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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