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zeb/

Western banks with strong performance in 2013 and narrowing valuation gap with BRICS – 2014 outlook for European banks clouded

zeb/market flash | Scandinavia

Key topics

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

- US and Western European banks continue their strong TSR performance in Q4 2013 with 12.0% and 6.6% respectively leaving BRICS banks with negative performance far behind
- Valuation of BRICS financial institutions further decreased and is now below valuation of US banks for the first time

II. Key banking drivers (p. 6)

- Economic conditions further improved in mature markets, especially in the US with a GDP growth rate of 3.6% in Q3 2013 - emerging markets still at high level with negative trend regarding GDP growth
- Long-term interest rates in the US and Scandinavia increased further resulting in steeper yield curves – yield curve for BRICS remains flat

III. Special topic: Low interest rates and changing regulations – consequences of the double burden for banking stability in Europe (p. 10)

- Double burden of low interest rate and regulation will have massive effect on profitability and the capitalization at European banks
- Holistic actions required to overcome challenging situation

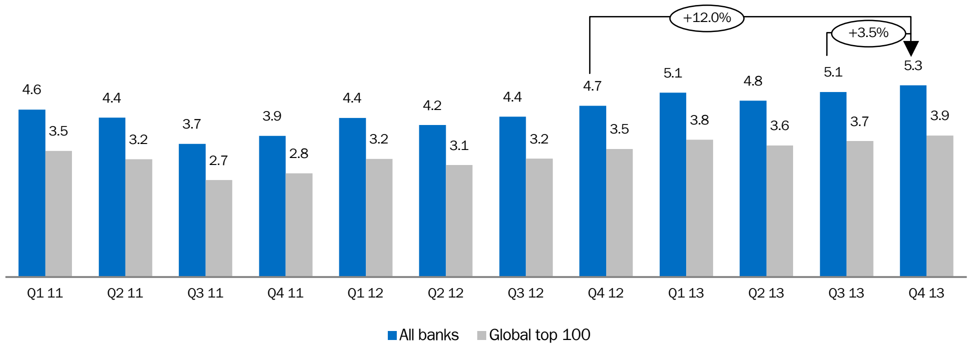
I. State of the banking industry

Market valuation

Globally, the banking industry looks back at a successful quarter as market capitalization increased by 3.5% to over EUR 5.3 bn. However there are regional differences: the valuation of banks from developed markets strongly increased while the valuation in emerging markets decreased again in Q4 leading to a further decline of the former valuation edge.

Global banks' market cap reached new heights in Q4 2013

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



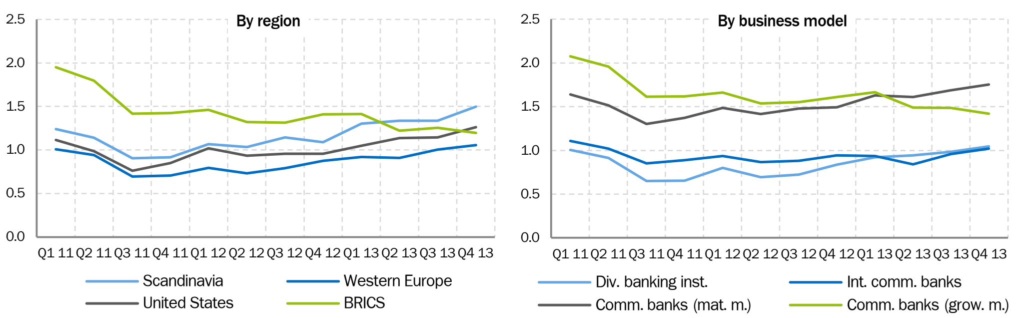
All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on Dec 31, 2012.
Source: Bloomberg, zeb/research

/ Global banking industry continued its long-term recovery path, as market capitalization reached EUR 5.3 bn in Q4 2013: the highest value since the beginning of the financial crisis in 2007

/ However, the valuation increase is mainly driven by banks from developed markets as banks from emerging markets were negatively affected by external factors like clouded economic outlooks e.g. for China or the political turmoil in Turkey or Thailand

Valuation of Scandinavian banks further improved

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

/ After continuously losing valuation over the last years, the average P/B ratio of BRICS banks decreased below the average of US banks in Q4 2013—Scandinavian banks still achieved the highest P/B ratios among the regional clusters with an increase of P/B ratio to 1.5 (+12.2%)

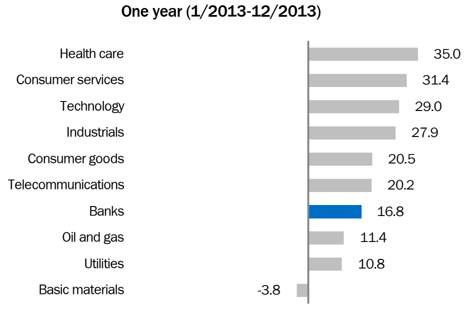
- In terms of business models, the gap between comm. banks from mature and emerging markets widened further, which reflects the general valuation development in mature and growth markets. International comm. banks continue to close gap to div. banks and reach a P/B ratio of 1.0 again

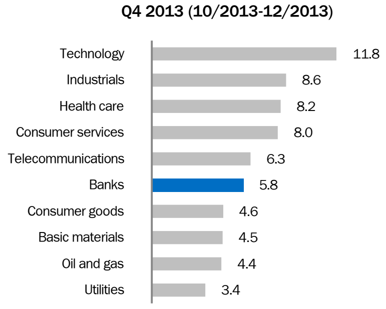
TSR performance

In the fourth quarter, global equity markets achieved good overall performance figures as all industry sectors achieved positive total shareholder returns (TSR). At 5.8%, the banking sector's performance was slightly below industry average. Again, there are strong regional differences: Institutions from emerging markets achieved negative returns for investors, whereas banks from mature markets performed quite well.

Banks' TSR slightly below average compared to other sectors

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



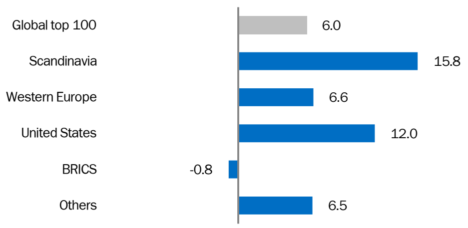


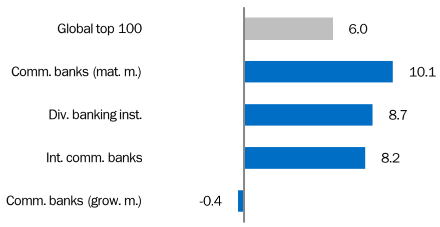
Total shareholder return of industry sectors based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream. Source: Thomson Reuters Datastream, zeb/research

- All industry sectors exhibit positive total returns for investors in Q4 2013 underlining the overall good performance of equity markets
- The global banking industry achieved shareholder returns of +5.8% on a quarterly basis and +16.8% year-over-year resulting in a slightly below average ranking among industry sectors

Scandinavian banks with best performance in Q4 2013—Banks from BRICS with negative TSR

Fig. 4: Total shareholder return of global top 100 banks (10/2013–12/2013, in %)





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

- Banks from BRICS destroyed shareholder value in Q4 2013—a detailed look shows that especially Chinese and Brazilian institutions showed negative returns of -3.6% and -1.7%
- Scandinavian banks exhibit again another strong TSR performance at 15.8% in Q4 2013—ending 2013: Scandinavian banks had a good year with a yearly TSR of 47.8% (compared to the global top 100 23.1%)

Global low performers dominated by banks from emerging markets

Fig. 5: Top/low TSR performers among global top 100 banks (10/2013–12/2013, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
Grupo Financiero Inbursa SA	Mexico	28.8	China Minsheng Banking Corp Ltd	China	-19.2
Skandinaviska Enskilda Banken AB	Sweden	24.5	Yapi ve Kredi Bankasi AS	Turkey	-17.3
ICICI Bank Ltd	India	24.3	Turkiye Is Bankasi	Turkey	-12.9
Charles Schwab Corp/The	United States	23.3	Turkiye Garanti Bankasi AS	Turkey	-12.6
Swedbank AB	Sweden	20.9	Kasikornbank PCL	Thailand	-10.9

Scandinavia

Top performers	Country	TSR	Low performers	Country	TSR
Skandinaviska Enskilda Banken AB	Sweden	24.5	Danske Bank A/S	Denmark	4.8
Swedbank AB	Sweden	20.9	Nordea Bank AB	Sweden	11.8
DNB ASA	Norway	18.8	Svenska Handelsbanken AB	Sweden	15.0

Source: Bloomberg, zeb/research

/ The list of global low performers contains banks from selected emerging markets that were hit hard during the last quarters: China reported a low GDP growth leading to growing concerns about possibly increasing loan loss provisions in the banking industry and general future economic development, whereas Turkey and Thailand saw a massive political turmoil

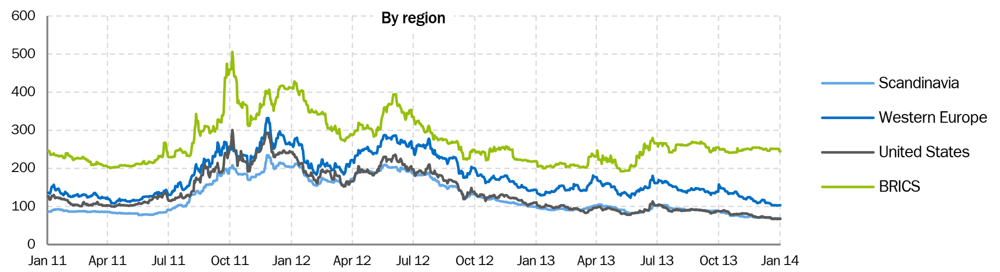
/ All Scandinavian banks from our global top 100 sample created value for their shareholders in Q4 2013: these banks achieved high TSR numbers as nearly all institutions reported very good Q3 results with increasing earnings and very low loan losses—only Danske Bank had single digit TSR growth

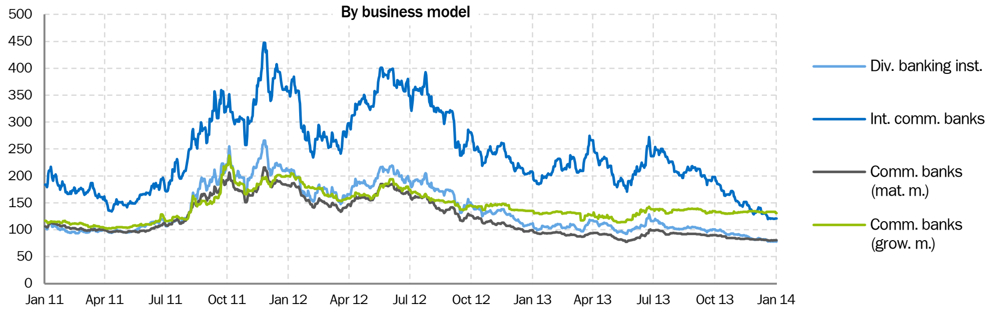
Debt perspective

CDS spreads of several regional and business model clusters further decreased in the fourth quarter. However, due to the mentioned problems especially in China, average spreads of BRICS institutions remained stable and on a significantly higher level compared to US, Western European or Scandinavian banks. The number of rating changes was in line with previous quarters.

Several clusters improve CDS spreads but BRICS remained on high level

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



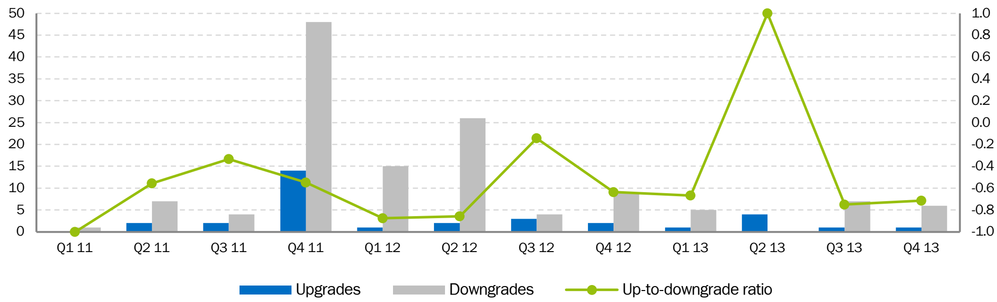


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Bloomberg, zeb/research

- Regionally, CDS spreads of BRICS institutions remained at a high level between 240bp and 254bp; which reflects the developments from the equity perspective
- In contrast, spreads of US, Scandinavian and Western European banks continued their downward trend and declined to 67bp, 69bp and 103bp respectively and are now even lower than in 2011 before the European debt crisis lead to a massive CDS spread increase
- Among business clusters, CDS spreads of international commercial banks decreased further to 121bp—the lowest value since April 2011—and are now below the spreads of commercial banks from emerging markets which remained nearly constant at 131bp in the last quarter

Rating up and downgrades on normal level in Q4 2013

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

- The overall number of rating upgrades and downgrades remained at the same level as the previous quarter
- The last quarter in 2013 had some prominent downgrades in the US though: In November 2013, Moody's collectively downgraded four of the biggest US banks (Morgan Stanley, Goldman Sachs, JPMorgan Chase and Bank of New York Mellon). The rating agency believes that the government is less likely to rescue banks in case of a crisis as bond holders instead of taxpayers should be burdened with the bailout; however, CDS spreads were nearly unaffected by these changes and instead, the average CDS spread of US banks even decreased in Q4 (Fig. 6)
- In Scandinavia there were no changes in ratings–Scandinavian banks are stable

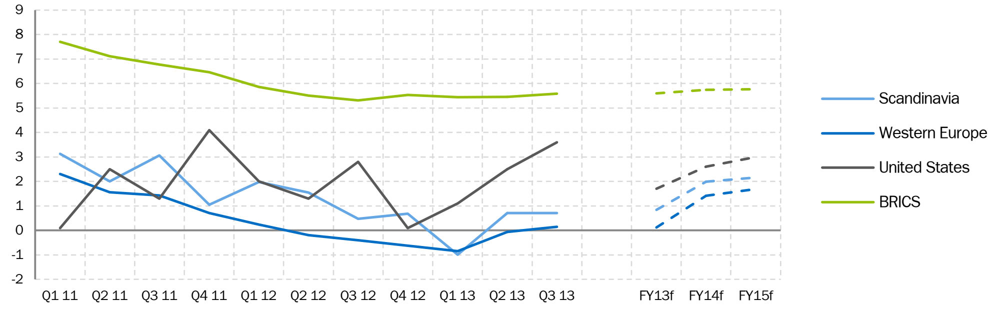
II. Key banking drivers

Economic perspectives

Economic situations by region continued to develop quite differently in the last quarter. While the US economy achieved the highest growth since 2011, BRICS countries continued on a lower growth path. In Western Europe, the economy seems to have achieved a turnaround from the debt crisis and reports positive GDP growth.

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

US economy with another strong quarter



Q4 2013 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

/ The US economy can reflect on another strong quarter of achieving a very high GDP growth rate of 3.6% in Q3—the overall economic situation is still profiting from the US Fed's low interest policy

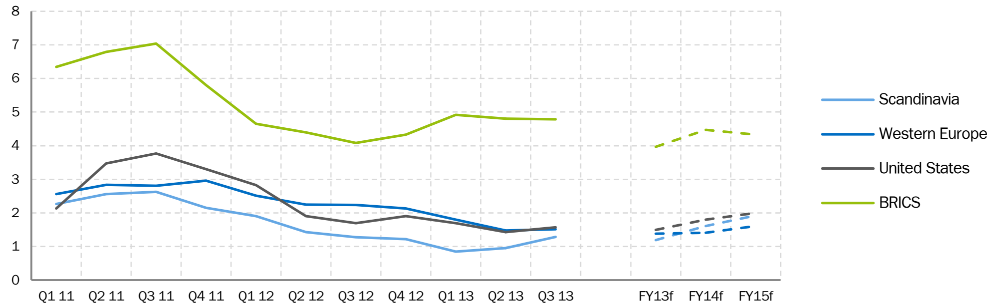
/ Western Europe showed a small but positive GDP growth of 0.2% for the first time since the second quarter of 2012

/ In Scandinavia the average GDP growth is the same as in the previous quarter at 0.7%—Norway (+2.1%), Denmark (+0.5%) and Sweden (+0.3%) still with a positive GDP growth—only in Finland the growth is still negative at -1.0%

/ Regarding BRICS countries, concerns are growing that these countries will not be able to return to growth levels from previous years as GDP growth continues at approx. 5.5% in Q3 2013 and forecasts expect no change to this situation in the next years—BRICS banks are already feeling the consequences from this situation on the equity and debt markets (see Chapter I)

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

Inflation rates remained stable globally



Q4 2013 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

/ Global inflation rates remained at a low level in Q3 2013, with forecasts predicting no significant changes

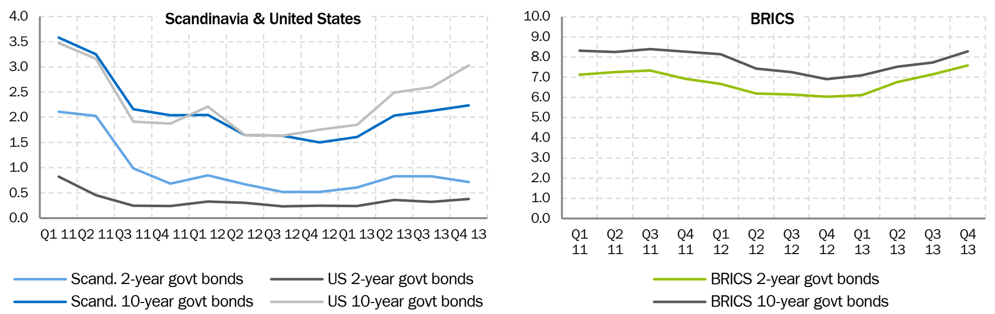
/ Especially in the US, price increases are very low despite the latest growth figures (Fig. 8)—however, the ongoing low interest policy of the ECB and the Fed (the nomination of Janet Yellen indicates continuity of the current loose monetary policy) will put pressure on inflation rates

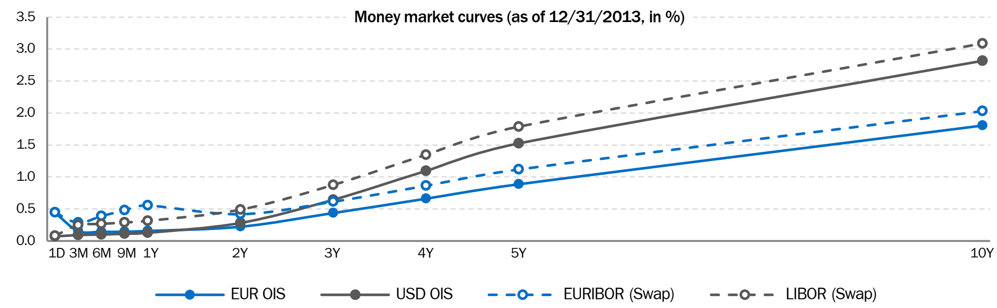
Interest rates

In Q4 2013, government yields in Scandinavia and the US remained stable for 2-year bonds but increased for long-term 10-year bonds, especially in the US. This positively affects the result from maturity transformation due to the slightly steeper yield curves. In BRICS countries, interest rates increased further for both 2-year and 10-year government bonds. As a consequence, the yield curve remains quite flat.

Slightly steeper yield curves in the US and Europe

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





Scandinavian and BRICS bond yields calculated as unweighted average, no forecast data available for BRICS countries. OIS denotes overnight indexed swap.
Source: Bloomberg, zeb/research

/ The Fed's announcement to reduce future bond purchases as a first step of tapering the low interest policy led to increased yields for government bonds

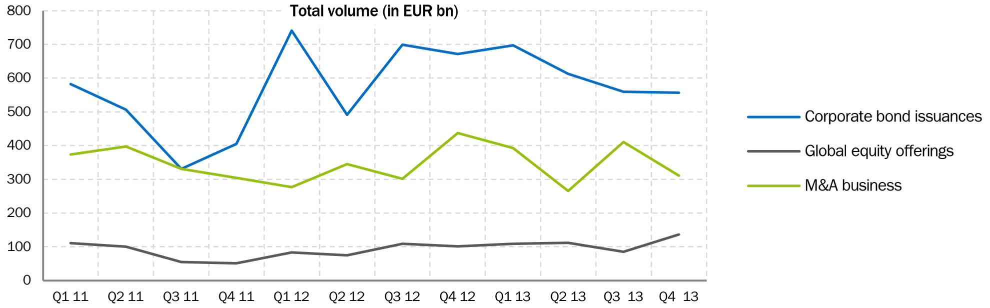
/ The different trends in BRICS and in the US/Scandinavia continue: while the yield curves for BRICS remain flat, the yield curves in the US and Scandinavia continue to become steeper—especially in the US

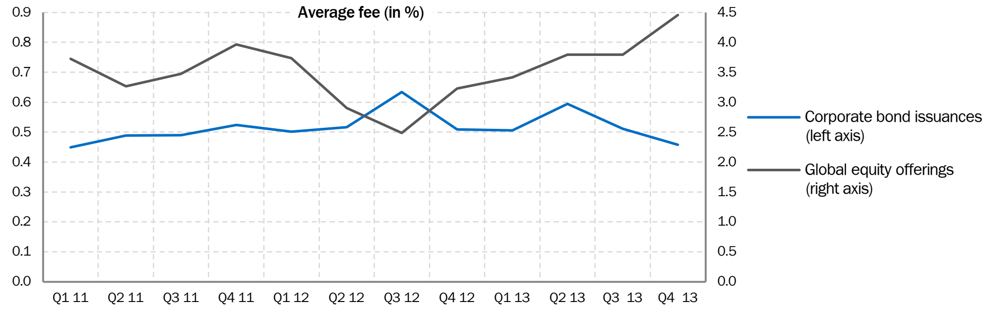
Investment banking activities

Investment banking activities developed quite differently in Q4 2013. While corporate bond issuance business remains on recent quarters' descending path regarding fees, the equity offering business showed a strong performance with both increased volume and fee level. M&A business remains volatile with decreased volume in Q4 2013.

Equity offering business with increased volume and fee level

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

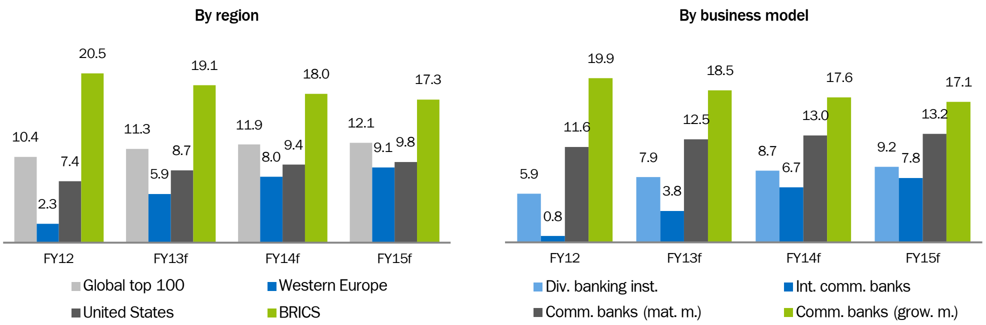
- In Q4 2013, the volume of global bond issuance business remained at the previous quarter's level of approx. EUR 560 bn. However, the average fee rate decreased slightly by a further 5bp, leading to another relatively difficult quarter for corporate bond issuance business
- In contrast, equity offering business performed well in Q4 2013, with volume increasing from EUR 85 bn to EUR 136 bn and a jump of the average fee rate by about 70bp to 4.5%
- M&A transactions decreased strongly by nearly EUR 100 bn to about EUR 310 bn in Q4 2013, continuing the volatile path of 2012 and 2013

Banking profitability

As seen above, from the perspective of equity and debt markets, the former fundamental gaps in valuation and CDS spreads between banks from mature and growing markets disappeared over the last quarters. However, from a profitability perspective, the banking world is still divided into two clusters. US and Western European institutions—despite some recently promising economic growth rates (Fig. 8)—are still expected to achieve RoEs of even below 10%. Instead, forecasts for banks from BRICS still expect RoEs between 17–18% for 2014 and 2015. The decline of the P/B ratio of BRICS and other emerging market banks despite ongoing good profitability and high growth rates is an indication that investors are unsatisfied with the risk dimension (which is reflected in the development of CDS spreads, see Fig. 6).

Fundamental profitability 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

- Profitability of Western European banks is still lacking behind with an estimate of only 5.9% for 2013—despite the improved economic outlook, short-term RoE forecasts especially for 2013 and 2014 were even lowered in Q4 2013
- Generally 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 Chapter III for a short overview of the results of our zeb/ European Banking Study which provides detailed analyses on this topic)
- Due to the lower economic growth rates, profitability of BRICS banks is expected to further decline in 2014 and beyond with forecasts well below 20% for the upcoming years

III. Special topic

Low interest rates and changing regulation – consequences of the double burden for banking stability in Europe

For years ahead, low interest rates and new regulatory requirements regarding capital and liquidity constitute the two major threats to the European banking sector. zeb/ has analyzed both aspects in the European Banking Study 2013/2014 (to be published), which reveals the overall impact on the different business models of the top 50 European banks by total assets[1], using a holistic approach that simultaneously takes into account both the changing regulatory environment and low interest rates in a medium term outlook until 2018. This chapter features a short excerpt of the study.

Retail banking's status as safe haven at risk

After years of crises, the general outlook for banking business models remains rather bleak. Investment banking, wholesale commercial banking and private banking & wealth mgmt. face severe challenges which are broadly documented. The zeb/European Banking Study 2013/2014 shows that low interest rates and the changing regulatory environment compromise even retail banking's status as the sole safe haven. On the one hand, income from customer deposits declines, the transformation result decreases and proprietary investments only have a low profitability. On the other hand, compensation for these negative effects on profitability is limited by regulatory constraints: A low-risk and simple growth strategy, e.g. via the mortgage book, is difficult due to the new leverage ratio which requires a bank to hold Tier-1 capital of at least 3% of total assets. An alternative strategy is to move towards higher risk loan types with higher margins. This is hard to realize, too, as regulatory capital ratios, above all the Common Equity Tier-1 ratio (CET1 ratio), require the banks to back risk-weighted assets with more equity. However, equity is and will become even more a scarce resource due to Basel III. Overall, historically low interest rates and new regulatory requirements are expected to build a double burden even for the formerly "immune" retail banking.

Holistic view more important than ever

To support this hypothesis, holistic simulations with zeb/'s management tool future.grip were conducted. E.g. for international retail banks, zeb/ forecasts show that net interest income will decrease significantly, leading to a reduction of almost 30% in profitability until 2018. Furthermore, Basel III capital deductions and increased risk-weights will result in a significant capital gap in 2018. To avoid this capital gap, massive mgmt. action that eases the decrease of interest income and the increase of costs due to regulatory requirements is inevitable. By additional simulations, the study quantifies the effects of single and combined management actions. The results show that simplistic answers are not adequate to solve the complex problem the financial industry sector is facing in the near future. Instead, a holistic view is more important than ever, because every single decision or non-decision impacts profitability, balance sheet and capital, and affects the bank's position in the impending consolidation process.

For further information on the zeb/European Banking Study 2013/2014 please do not hesitate to contact us:

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[1] Please note that the zeb/European Banking Study and the zeb/market flash are based on different samples. The EBS is based on the 50 largest European banks by total assets, while the zeb/market flash is based on the 100 largest banks globally by market cap. The EBS therefore contains both listed and non-listed banks, while the zeb/market flash sample only contains listed banks. Due to the different sample in the European Banking Study, a different definition of banks' business models was chosen. Universal banks can be compared with diversified banking institutions in the zeb/market flash. International retail banks refer to international commercial banks, and regional retail banks correspond to commercial banks from mature markets of the zeb/market flash sample. Wholesale commercial banks mainly consist of non-listed banks. There is no equivalent business model definition in the zeb/market flash.

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 January 2, 2014. The global top 100 banks cluster contains the largest banks by market capitalization on December 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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