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Western European banks fall behind in Q2 2014—results from AQR and stress test awaited

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Key topics

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

- Global banking industry with solid increase in market cap and positive TSR—but global top 100 banks worst among all industry sectors
- Western European banks with negative TSR

II. Key banking drivers (p. 7)

- Surprisingly sharp drop of US GDP, but Western Europe continued its recovery
- ECB and Fed's monetary policy lowered long-term interest rates again in Q2 2014, leading to even flatter yield curves—German interest rates back at their level of 2012
- Investment banking clearly improved with higher volumes in all segments

III. Special topic: The EBA stress test—challenging the European banking sector's substance (p. 12)

- EBA stress test is the next core element in ECB's Comprehensive Assessment
- EBA currently analyzes delivered results and refines methodology and calibration
- Results are expected at end of October

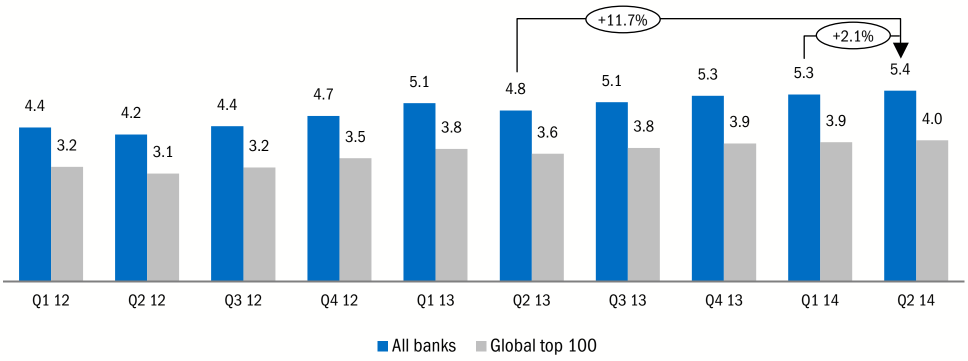
I. State of the banking industry

Market valuation

In the second quarter of 2014, the global banking industry increased its market capitalization by 2.1% and reached EUR 5.4 trillion. From a regional perspective, banks from BRICS countries stabilized their price-to-book ratio at 1.2 after continuously losing valuation over the last years, whereas retail banks still remain investors' favorite among business models.

Banking industry shows solid growth in Q2 2014

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

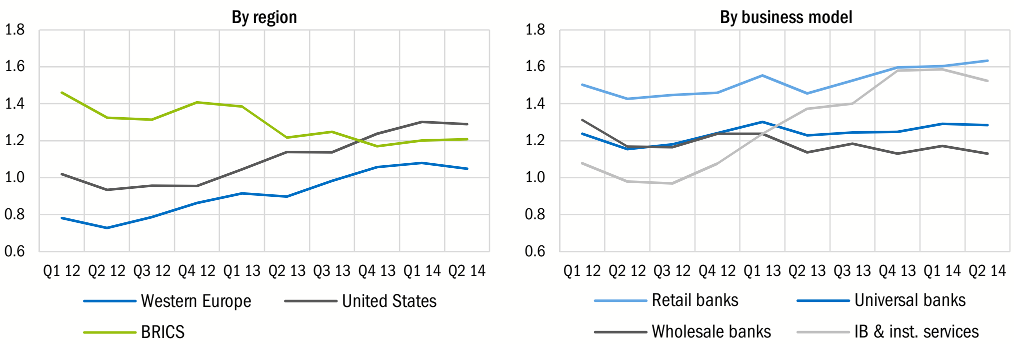


All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2013.
Source: Bloomberg, zeb.research

- In Q2 2014, global banking industry continued its growth path, as market capitalization increased for the fourth successive quarter to EUR 5.4 tr—the second quarter of 2014 showed solid growth with 2.1% in the last quarter and 11.7% year-over-year
- With 1.4%, the growth of global top 100 banks was lower in Q2, as especially Western European banks lost market cap

Retail banks remained in leading position among business models

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



Retail banks / wholesale banks / investment banking (IB) & inst. services institutions generate at least 2/3 of their earnings in respective business segments (based on stated segment reports); universal banks are all other institutions. Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa.
Source: Bloomberg, zeb.research

- Although slightly decreasing average P/B ratios for both US and Western European banks—BRICS only region with increasing valuation

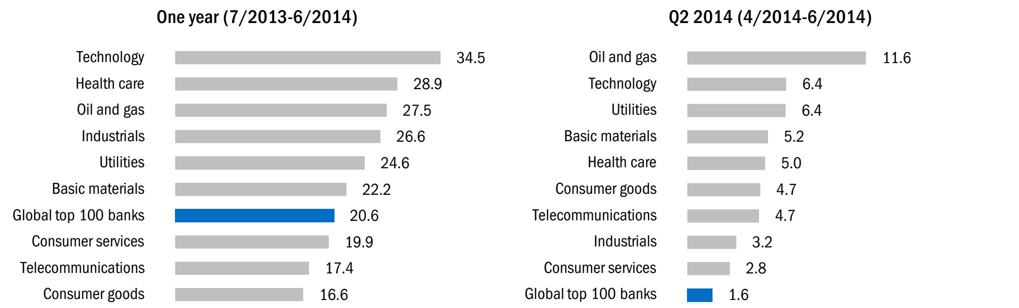
- Among business models, retail banks remain on top with a continuously increasing valuation advantage over universal and wholesale banking—the remarkable valuation growth of investment banking & institutional services institutions in the last quarters came to a (temporary) halt

TSR performance

In the second quarter of 2014, global equity markets show a strong overall performance, as all industry sectors achieved positive returns for shareholders. However, with only 1.6%, the global top 100 banks constitute the industry with the weakest performance in Q2, mainly influenced by Western European banks.

Banks with low performance despite good overall equity market environment

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

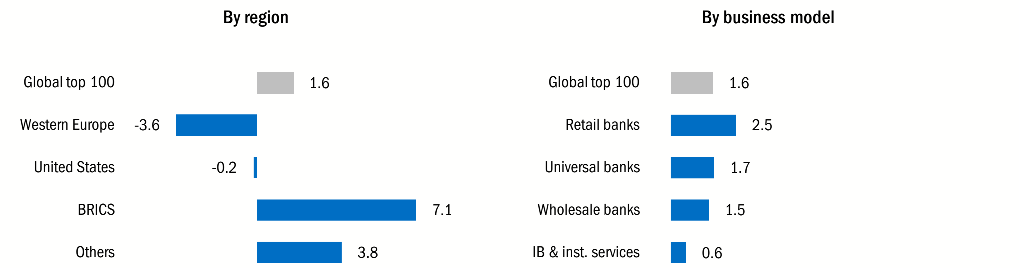


Total shareholder return of industry sectors other than banking are based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream.
Average total shareholder returns of global top 100 banks are weighted by the market capitalization of each bank.
Source: Thomson Reuters Datastream, zeb.research

- Year-over-year, all industry sectors achieved high returns for their shareholders, underlining the still very good overall condition of equity markets
- After good performances in the last quarters, the TSR of global top 100 banks was once again the lowest among all industries in Q2 2014, mainly driven by negative returns of Western European banks

Turning picture: Western European banks destroying value, BRICS back on top

Fig. 4: Total shareholder return of global top 100 banks (4/2014–6/2014, in %)



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

- Value creation in Q2 2014 clearly turned around: winners of Q1 (US and Western Europe) now exhibit negative TSR performance, whereas BRICS institutions achieved a positive return of 7.1% after negative performances in Q1 2014 (TSR: -2.4%) and Q4 2013 (-0.8%)

- Regarding business models, all models generated value in the last quarter—retail banks are the best performers and substantiate their valuation edge with a TSR performance of 2.5% in Q2

BRICS lead top performers—Western Europe dominates low performers

Fig. 5: Top/low TSR performers among global top 100 banks (4/2014–6/2014, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
State Bank Of India	India	40.9	Allied Irish Banks Plc	Ireland	-36.6
ICICI Bank Ltd	India	15.8	Deutsche Bank AG	Germany	-15.0
Grupo Financiero Inbursa	Mexico	14.1	Commerzbank AG	Germany	-13.8
Firstrand Ltd	South Africa	12.9	Qatar National Bank	Qatar	-13.0
China Citic Bank Corp Ltd	China	12.4	Société Générale SA	France	-12.4

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
Banco Santander SA	Spain	12.4	Allied Irish Banks Plc	Ireland	-36.6
DNB ASA	Norway	10.5	Deutsche Bank AG	Germany	-15.0
Banco Bilbao Vizcaya Argenta	Spain	7.0	Commerzbank AG	Germany	-13.8
Royal Bank Of Scotland Group	UK	5.8	Société Générale SA	France	-12.4
Nordea Bank AB	Sweden	2.7	KBC Groep NV	Belgium	-11.0

Source: Bloomberg, zeb.research

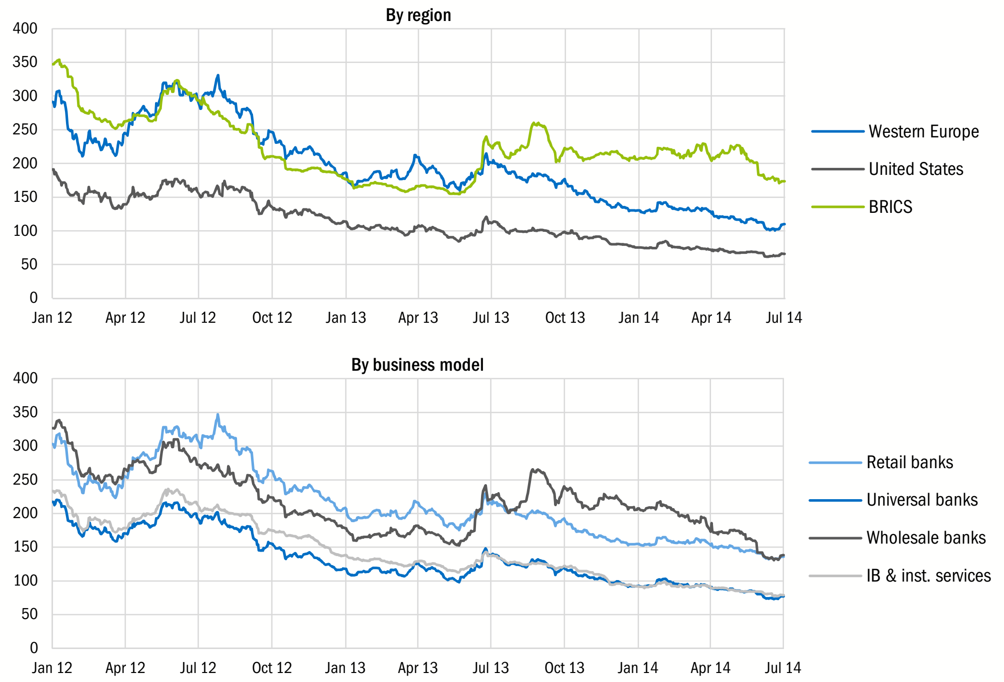
- The list of global top performers is dominated by banks from BRICS countries, which recovered from the TSR losses of previous quarters—list of low performers is dominated by Western European banks
- Top-performing Western European banks include Banco Santander and BBVA, which profited from recent rating upgrades (fig. 7) as well as Scandinavian banks (once again), which already achieved good performances in the past due to a comfortable capitalization and a good overall economic environment in their main markets
- Among low performers, TSR of Deutsche Bank (-15%) was stressed by the third capital increase within four years and ongoing uncertainties regarding selected legal issues whereas BNP Paribas—facing a fine of USD 8.9 bn in the US—narrowly evaded a rank on the low performers list (TSR: -9.0%)

Debt perspective

From a debt perspective, the situation of global top 100 banks clearly improved in the last quarter. CDS spreads decreased for all regional clusters (especially BRICS institutions) and business models. In addition, rating agencies upgraded the ratings of some major Western European institutions so that, in total, upgrades outnumbered downgrades.

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

CDS spreads' development underlines improving debt perspective of banks

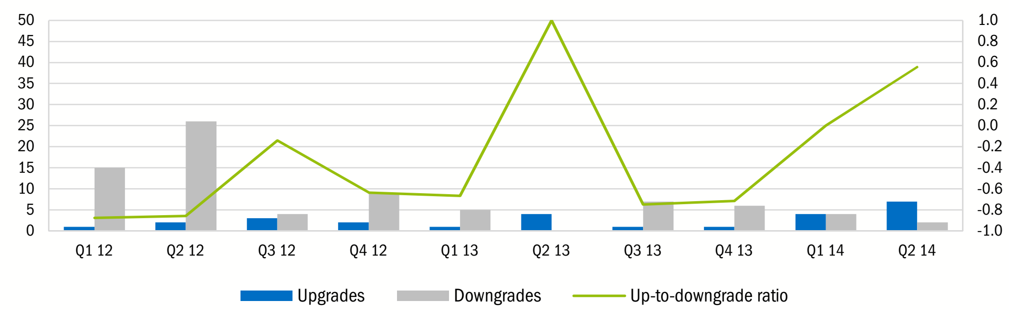


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Thomson Reuters Datastream, zeb.research

- Looking at CDS spreads, the banking environment improved further in Q2 2014
- CDS spreads of BRICS institutions declined significantly by 32bp and even spreads of US and Western European banks decreased slightly further to the lowest level since the beginning of the European debt crisis
- In terms of business models, CDS spreads improved further in Q2 2014, but general differences between banking clusters still persist, as retail and wholesale institutions' spreads are approx. 60bp above the average spread of universal and investment banks

Fig. 7: Rating changes and average ratings of global top 100 banks

Rating upgrades outnumbered downgrades in Q2 2014



	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
Global top 100	A-	A-	A-	A-	A-	A-	A-	A-	A-	A-
Western Europe	A+	A	A	A	A	A	A	A	A-	A-
United States	A	A	A	A	A	A	A	A	A	A
BRICS	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB
Retail banks	A	A	A	A	A-	A-	A-	A-	A-	A-
Universal banks	A-	A-	A-	A-	A-	A-	A-	A-	A-	A-
Wholesale banks	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB+	BBB+
IB & inst. services	A+	A+	A+	A+	A+	A+	A+	A	A-	A-

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. Average ratings calculated by zeb.
Source: Standard & Poor's, Moody's, Fitch Ratings, zeb.research

- In Q2 2014, ratings of selected top banks clearly improved as rating upgrades outnumbered downgrades for only the second time since the end of 2010
- Upgrades exclusively affected Western European institutions, namely Banco Santander, BBVA, BNP Paribas, KBC and Danske
- In contrast, South African First Rand Bank and VTB were the only institutions subject to rating downgrades
- Despite these rating improvements, the average rating of global top 100 banks remained stable at A- in Q2 2014; from a regional point of view, US institutions (average rating of A) are still rated higher than Western European (A-) and BRICS banks (BBB), whereas—in terms of business models—wholesale institutions are on average still one notch below the other clusters

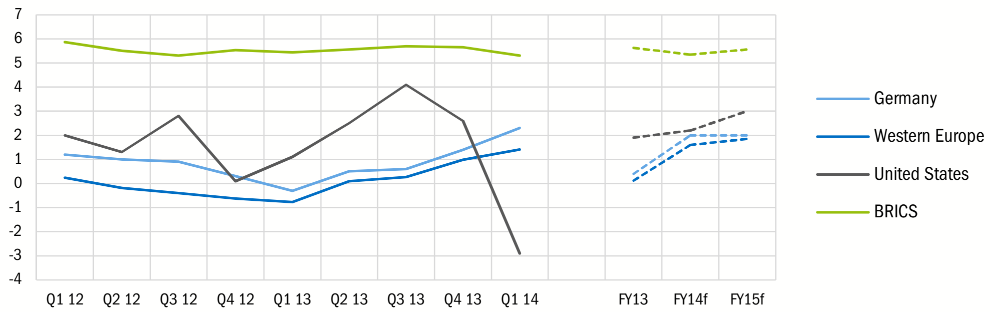
II. Key banking drivers

Economic perspectives

The global economic development was dominated by a sharp drop of the US GDP growth rate, that fell to -2.9%, but at the same time, the economic environment in other regions improved further as GDP growth increased to 1.4% in Western Europe and even 2.3% in Germany. Western European inflation rates continued to decline, driven by the recent interest rate reduction by the ECB.

Strong GDP decline in the US

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

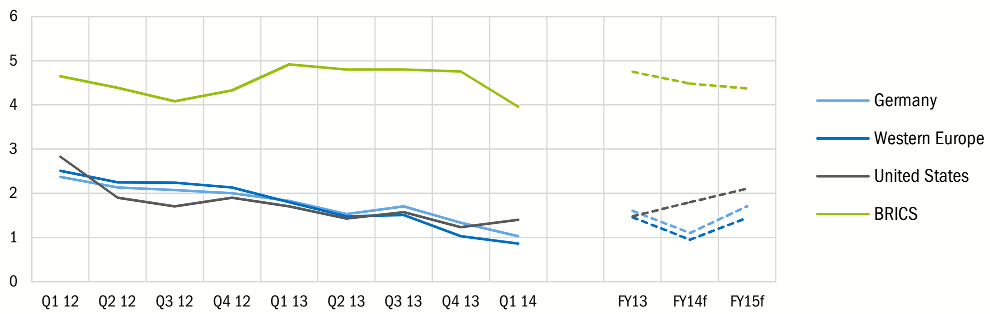


Q2 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb.research

- GDP growth in the US dropped sharply to -2.9% in Q1 2014—the lowest rate in the last five years—affected by the long period of extremely cold weather at the beginning of 2014, which hurt the construction sector in most regions significantly
- Despite this recent decline in the US, which was clearly higher than expected by capital market players, current forecasts still expect a US GDP growth of approx. 2% for 2014; however, there is no noticeable effect on US banks so far, as full-year forecasts remain promising
- Western Europe continued its economic recovery, with the average GDP growth improving to 1.4%—the highest rate since mid 2011—and especially Germany showing a strong growth of 2.3%

No turnaround—inflation rates still declining in most regions

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



Q2 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb.research

- Inflation rates in Western Europe and Germany further declined to only approx. 1% in Q1 2014, continuing the long-term trend of declining rates that initially arose at the end of 2011

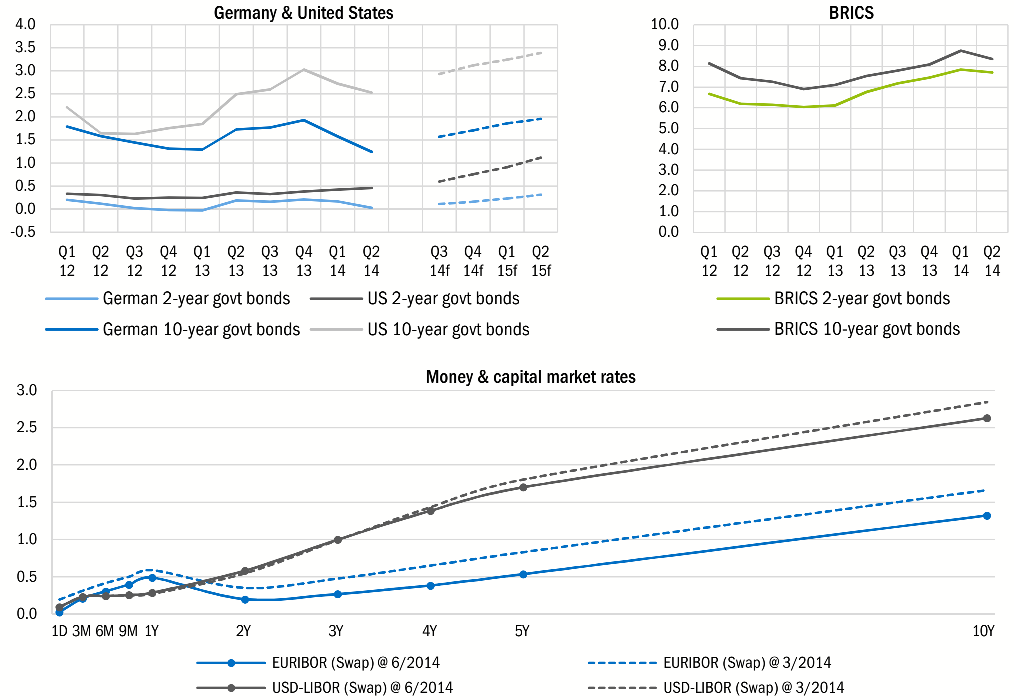
- Despite another interest rate reduction by the ECB in June, current forecasts expect no short-term change to the consumer price environment in Western Europe

Interest rates

In June 2014, the ECB further reduced the central rate for the euro area to a historic low of 0.15% and the deposit facility rate even dropped to a negative value (-0.1%) for the first time. In the US, short-term and long-term interest rates developed in opposite directions resulting in a flatter US yield curve.

German interest rates decline to their level of the end of 2012

Fig. 10: Government bond yields (in %) and money & capital market rates



BRICS bond yields calculated as unweighted average, no forecast data available for BRICS countries, insufficient data to build adequate BRICS basket for money & capital market rates.
Source: Bloomberg, zeb.research

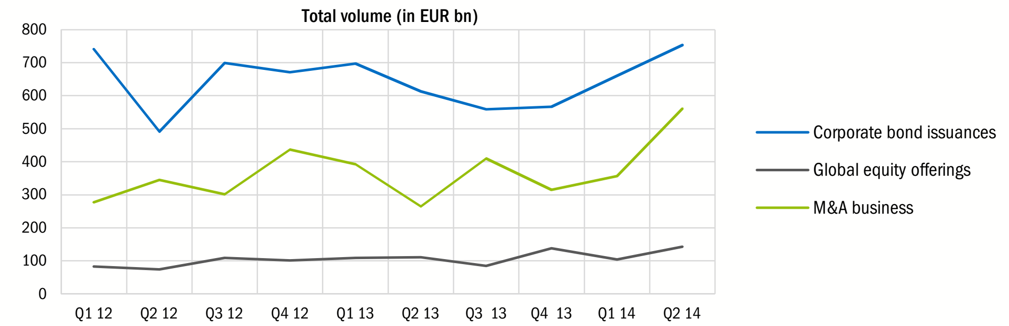
- After another cut down of the central rate to only 0.15% by the ECB in June 2014, president Draghi announced that the current low interest rate environment in Western Europe will persist for another 2.5 years (until the end of 2016) and that the ECB will increase the interest rates only in the first half of 2017—significantly later than the US Fed or the Bank of England, which are expected to increase the interest rates in 2015

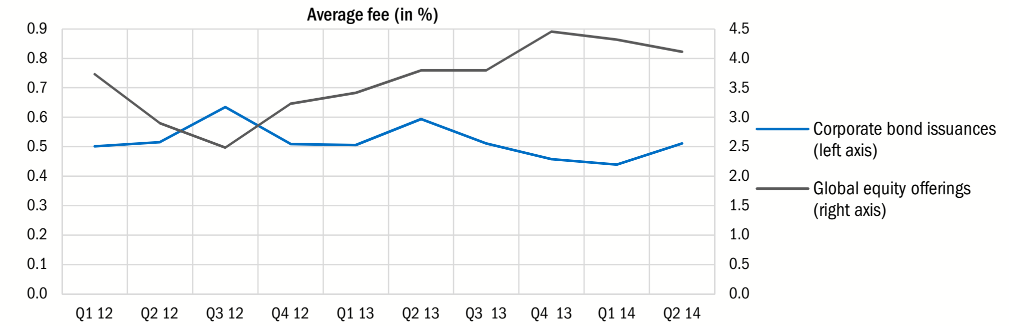
Investment banking activities

After a groggy start into 2014, investment banking business clearly picked up speed in Q2 2014, leading to the highest transaction volumes in a year's first 6 months since 2007. The volume of corporate bond issuances increased by 14.0% in the last quarter, equity offerings rose by 37.6% and the M&A deal volume jumped up by as much as 57.2%. The fee of corporate bond issuances increased for the first time since Q2 2013 and reached the long-term average fee of approx. 0.5%, whereas fees in the equity offerings segment declined by approx. 20bp but remained noticeable above the long-term average of 3.5%.

Investment banking bounced back in Q2 2014

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

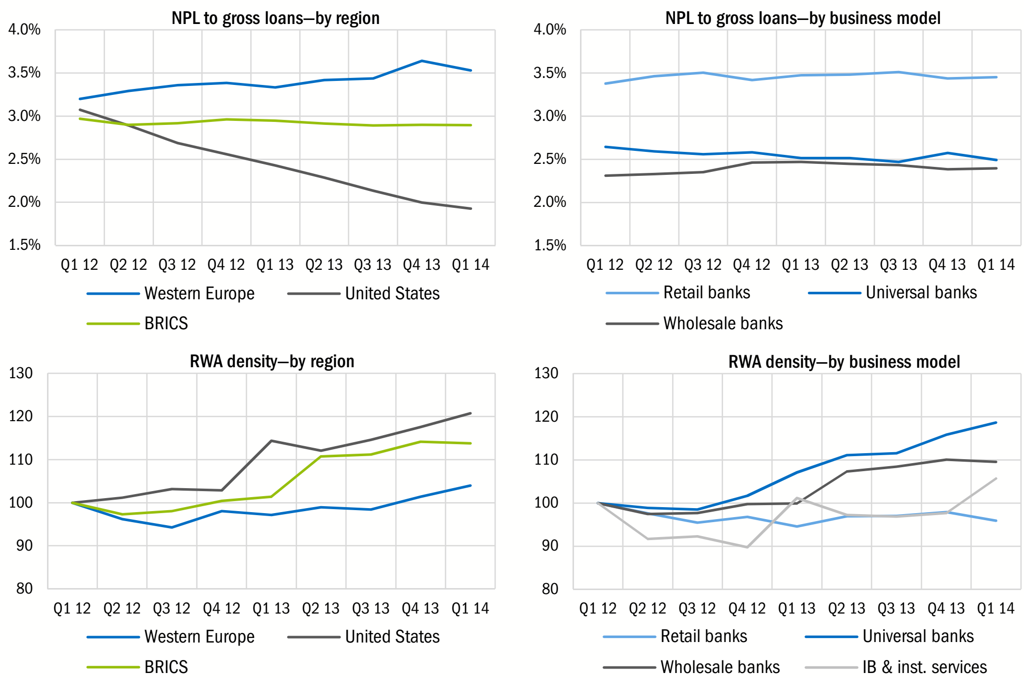
- In the bond issuance business, the global volume as well as fees increased (fees reached a long-term average of approx. 0.5%), but overall earnings remained below previous heights, especially below the record setting quarters of Q3 2012 to Q1 2013, which profited strongly from the calming of the European debt crisis
- M&A business increased the most reaching the highest volume since 2007, with transactions profiting from low interest rates and low refinancing costs; noticeable transactions in the banking sector have been Banco Santander's acquisition of the Swedish subsidiary of GE Money Bank, Industrial & Commercial Bank of China's takeover of the majority stake of Turkish Tekstil Bankasi and Citibank's sale of its Spanish credit card business to Banco Popular

Risk indicators

Balance sheet based risk indicators of global top 100 banks show structural differences between regional and business model clusters. The non-performing loans (NPL) to gross loans ratio of US institutions improved to below 2% in Q1 2014, whereas Western European institutions still have to deal with a high NPL volume. In addition, the total loan book of these Western European banks decreased over the last quarters, underlining that the low interest rate policy of the ECB still does not have the desired effects on the European loan business.

Risk perspective underlines still existing regional differences

Fig. 12: Non-performing loans to gross loans and RWA density of global top 100 banks



Investment banking (IB) & inst. services institutions without reasonable data for non-performing loans (NPL). RWA density defined as risk-weighted assets (RWA) to total assets. RWA density indexed to 100 at March 31, 2012. Q2 2014 data not yet available at the time of writing.
Source: Bankscope, zeb.research

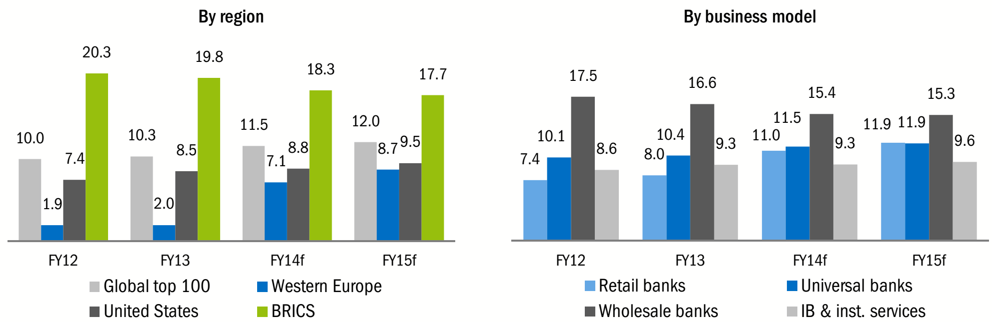
- Over the last two years, US institutions clearly improved their NPL to gross loans ratio, mainly due to reasonable economic conditions over the past quarters that have led to a decline of non-performing loans by more than 36% since the beginning of 2012; US banks' gross loans remained stable at the same time
- Instead, Western European institutions are still affected by the economic downturn during the European debt crisis: non-performing loans increased by 4% since Q1 2012, but Western European banks particularly reduced their total gross loans by nearly 6% in the same period, leading to a steadily increasing NPL to gross loans ratio
- A look at the RWA density, that is defined as banks' risk-weighted assets to total assets, underlines additional differences: US institutions increased their RWAs over the last 2 years (+9.6% since Q1 2012) despite a decreasing NPL ratio and simultaneously reduced total assets by 9.2%, whereas Western European banks strongly cut both RWAs (-6.1%) and total assets (-9.7%) during the European debt crisis, leading to only a slight increase of the RWA density

Banking profitability

Following very weak results reported by some major Western European banks for Q4 2013, current forecasts expect a clearly better performance in 2014/15, with an expected RoE of 7.1% and 8.7% respectively. Western Europe will remain the least profitable market among our regional clusters. With regard to business models, the RoE of the wholesale banking sample—which includes a large number of highly profitable institutions from China and Russia—is currently ahead of other clusters and will remain above 15% over the next years. The relatively low profitability of the investment banking & institutional services sample, which seems to be a contradiction to the very positive development of the P/B ratio (fig. 2), is mainly the result of low RoE figures of two large institutions, Bank of New York Mellon and Natixis.

Fig. 13: RoE after tax and annual RoE forecasts of global top 100 banks (in %)

Forecasts expect increasing returns especially for retail and universal banks



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

- After weak results of Western European banks in 2012 and 2013, current forecasts expect a better performance in 2014, but the low interest environment and regulatory challenges will still slow down the recovery of profits in European banking
- US institutions' forecasts still predict an average profitability of under 10% for 2014 and 2015
- Profitability of investment banking & institutional services banks is expected to remain below 10% in the future and it will be interesting to see if the P/B ratio can be maintained at its currently high level (fig. 2)

III. Special topic

The EBA stress test—challenging the European banking sector’s substance

The EBA stress test is the next core element in ECB’s Comprehensive Assessment

Starting in Q2, the stress test is succeeding the Asset Quality Review (AQR). In the course of the implementation of the Single Supervisory Mechanism (SSM) by the ECB, the stress test is the next core element of the Comprehensive Assessment (CA). Its purpose is to identify the capability of financial institutions of systemic importance to withstand turmoil in their relevant markets. Results are urgently awaited due to their regulatory relevance and their impact on the whole banking sector. Together with the AQR, the EBA stress test should send a signal of confidence to stakeholders, creating a picture of a banking sector that is fundamentally healthy and deserves credibility.

Fig. 14: Components and methodology of the EBA stress test

	Credit risk	Market risk	Sovereign risk	Funding costs and net interest income
EBA input	Macroeconomic scenario ▪ GDP ▪ Unemployment rate ▪ Inflation ▪ Real estate prices ▪ etc.	Parameter shifts: ▪ Interest rates ▪ Credit spreads ▪ FX rates ▪ Equities ▪ Commodities ▪ Haircuts (funds) ▪ Counterparty credit risk ▪ etc.	▪ Haircuts on financial instruments of EU sovereigns (direct positions) ▪ Market risk stress of other sovereign risk positions ▪ Banking book positions: see credit risk	Parameter shifts: ▪ Interest rates
	Application of EBA input to calculate internal risk positions			
Internal risk positions	Point-in-time parameters: ▪ PD ▪ LGD ▪ EL	▪ Trading result ▪ Fair value valuation ▪ Default of counterparties	▪ Fair value valuation ▪ Trading result ▪ Rating migration	▪ Funding costs ▪ Sales contribution ▪ Maturity contribution
	Application of internal risk positions to calculate RWA and capital effects			
RWA/ capital effects	▪ Impairments / write-offs ▪ RWA	▪ Capital/P&L effects from fair value losses (from AfS & FVO positions) ▪ RWA ▪ Trading result	▪ Capital/P&L effects from fair value losses (from AfS & FVO positions) ▪ Impairments / write-offs ▪ RWA	▪ Interest income ▪ Interest expenses

Source: zeb

Credit, market and sovereign risk as well as net interest income are in the focus of the stress test

The EBA stress test is designed to focus on the four dimensions credit risk, market risk, sovereign risk and net interest income (funding cost and interest income). For each dimension, the EBA provides methodological guidelines and scenario parameters. The scenarios are developed collaboratively by the national competent authorities (NCA), the European Commission, the European Systematic Risk Board (ESRB) and the ECB. The institutions have to project their positions in a baseline scenario and an adverse scenario for the years 2014–2016 using the framework provided by the EBA. Both scenarios use the static balance sheet assumption, i.e. the volumes of 2013 are held constant for the whole projection period and maturing positions need to be replaced by similar financial instruments in terms of type, credit quality at date of maturity and residual maturity as at the start of the stresstest. The baseline scenario reflects the expected economic development in the EU according to the common opinion of the above stated organizations. The adverse scenario simulates a severly more negative macroeconomic development. Triggered by a capital market shock, in which bond yields as well as interest rates, credit spreads and FX volatilities increase, macroeconomic indicators such as GDP growth, unemployment rates, real estate prices and default rates deteriorate as well. In both scnearios, the stress test results for all four dimensions affect RWA and capital, which ultimately determines the Common Equity Tier-1 ratio (CET1-ratio). The EBA has set a minimum hurdle rate of a CET1 ration of 8% for the baseline scenario and a CET1 ratio of 5.5% for the adverse scenario. However, the relevant NCA may set higher hurdle rates based on a ladder of intervention points arising from the stress test.

Stress test results are expected end of October 2014

Banks have to submit their (preliminary) stress test results to the EBA in Q3 2014 at the latest (e.g. June 23 for German banks), which is then going to conduct quality assurance, benchmarking and challenges the submitted results. Banks need to prepare for enquiries by the EBA, i.e. to defend assumptions and applied models (defence cases). In this phase, results from the AQR are included in the stress test assessment. Final results are expected at the end of October 2014 and will be disclosed on a bank-by-bank basis with a similar granularity as results of the EU-wide stress test in 2011, including the capital positions of banks, risk exposures and sovereign holdings. For banks that are not able to meet the required hurdle rates or which exhibit other breaches, the EBA will require an action plan to comply with the regulatory requirements.

Banks are faced with severe challenges concerning data availability, methodology and time pressure

Similar to the last European stress test in 2011, conducting the EBA stress test in 2014 constitutes a great challenge for banks. zeb supports several stress test projects in European banks, which all face similar challenges. One major difficulty has been the availability of data. The EBA demands the completion of given structured templates at a highly granular level. This requires a considerable amount of manual work, because generally, multiple data sources within the bank need to be involved. In turn, these manual processes increase the required quality assurance effort. To provide the correct data in keeping with the EBA definition, a time-consuming coordination process with the EBA is necessary. Moreover, banks have to integrate the detailed and qualitative scenario specifications into their own simulation models, which necessitates the development of a new or and adaptation of the existing stress test methodology. The very tight schedule adds further to the difficulties of conducting the EBA stresstest.

The question arises how the specifications of the EBA stress test should affect internal bank stress testing concepts

For bank management, the current EBA stress test has certain implications. Firstly, banks need to address the findings from the AQR and stress test. Remedial actions to avoid increased capital requirements and measures to fulfill the required capital hurdles (e.g. capital increases or asset sales) are at top of the agenda. After fixing the most pressing issues, banks can focus on how to respond in the long-term. Banks need to evaluate how the EBA stress test should affect bank-individual stress test concepts. The EBA has set certain benchmarks with the stress test in 2014 concerning scope, qualitative assumptions, macro scenarios, time horizon and methodology. Banks should adapt these standards in their concepts in order to be prepared for possible further EBA stress tests. Furthermore, adapting the standards helps to meet the regulatory requirements for stress tests. It can be expected that the EBA will benchmark bank-individual stress test concepts with its own design, at least for banks of systemic importance. Adapting to the EBA design also enables banks to consistently monitor the effectiveness of taken capital measures in case hurdle rates are missed. Additionally, the challenges and problems identified during the stress test call for action. Data availability needs to be improved by optimizing data quality and processes.

With the stress test, the EBA has clearly emphasized the importance of stress testing in the evaluation of a bank's sustainability. However, the goal of the stress test—providing confidence in the banking sector—cannot be achieved by a single measure. The EBA stress test 2014 is a good step towards achieving stability and confidence in the banking sector. Nevertheless, it would be a fallacy to assume that this exercise will reveal all existing risks and prevent future crises. The stress test is a snap-shot and ultimately it will be a matter of calibration how many banks will fail the test. Market expectations about what failure rate would make for a credible result of the test are varied. Given that some market members expect up to 30% of all participating banks to fail, the consequences for the stability of the European Banking sector remain to be seen.

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. All data and calculations of this issue are based on the date of July 1, 2014. The global top 100 banks cluster contains the largest banks by market capitalization on December 31, 2013 and is updated on an annual 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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