



Strong finish of the global banking sector in Q4 2014 despite Russian banking crisis

zeb.market.flash

Key topics

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

- Global banking industry with a strong finish in 2014, as market valuation increased by 9.6% in Q4—surprisingly, the banking industry thus outperformed all other industry sectors in terms of TSR in both Q4 2014 and the full year 2014
- CDS spreads remain stable in Western Europe and in the US, but uncertainties about Russia increase BRICS CDS spreads, putting pressure on performance

II. Key banking drivers (p. 7)

- GDP growth unchanged in Q3 2014
- Inflation rates further decreased in all regions
- Interest rates decreased to a new historic low in Germany
- Loan quality further improving globally

III. Special topic: The EBA stress test—starting point for a new era of bank supervision in Europe (p. 12)

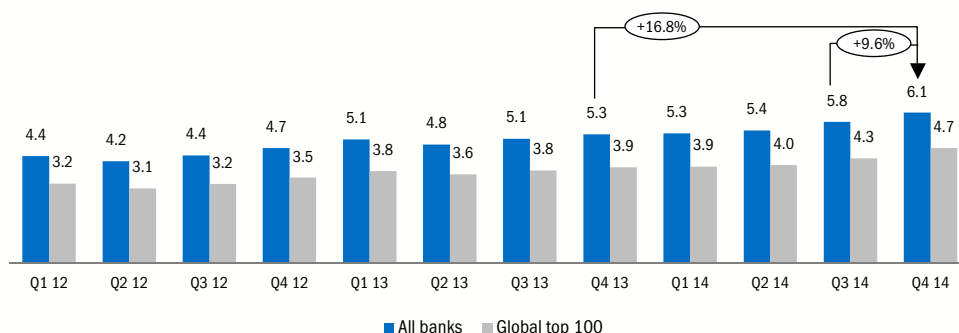
- Reactions of capital markets to stress test results indicate disappointment
- Regulators focus on increasing transparency in the bank business

I. State of the banking industry

Market valuation

In the last quarter of 2014, the global banking industry experienced a growth boost and market capitalization increased by 9.6%, reaching EUR 6.1 trillion on December 31. The P/B ratio of banks located in the BRICS states increased by more than 20% to an average above 1.4, while the P/B ratio of Western European banks decreased slightly to below 1.0. Regarding business models, the P/B ratio of investment banks rose by a remarkable 17% in Q4 2014.

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

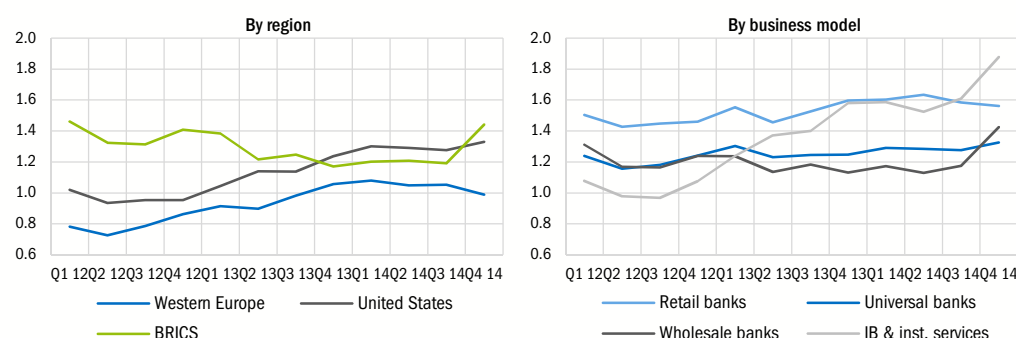


Banking sector with market cap. growth boost

All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2014. Source: Bloomberg, zeb.research

- The market capitalization of the global banking sector rose for the sixth consecutive quarter, closing 2014 with a plus of 16.8% compared to end of 2013
- The global top 100 banks increased their market capitalization by 9.6% in Q4 2014 and by 19.9% year-over-year

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



Investment banks and BRICS institutions with strongly improved valuation

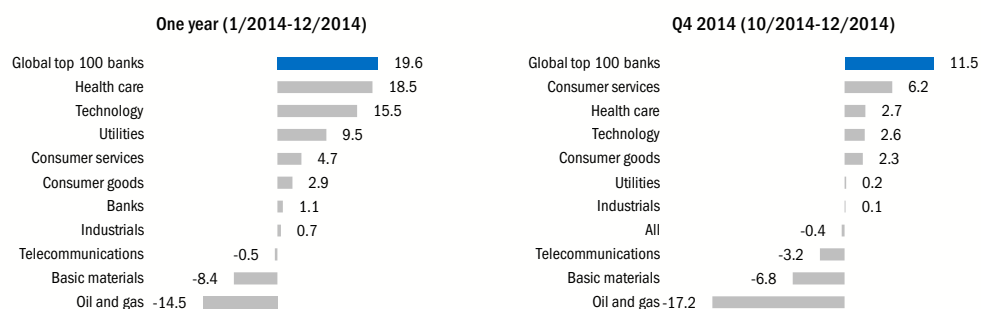
Retail banks / wholesale banks / investment banking (IB) & institutional services institutions generate at least 2/3 of their earnings in respective business segments (based on stated segment reports); universal banks are all other institutions. Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland,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

- The average P/B ratio of Western European banks fell to below 1.0 in Q4 2014, whereas the higher valuation of US and BRICS institutions (primarily Chinese banks), improved further—Russian VTB’s P/B ratio recovered from 0.6 to 1.0, whereas Sberbank dropped from 0.9 to 0.6.
- With respect to business models, P/B ratios of investment and wholesale banks increased at high rates—improved valuation of IB & inst. services institutions was mainly driven by US-based Bank of NY Mellon and some Chinese institutions such as Haitong Securities

TSR performance

In Q4 2014, global top 100 banks retain their top position among industries on yearly as well as on quarterly basis. Due to the significant decrease of oil and gas prices the sector ends up as worst performing.

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

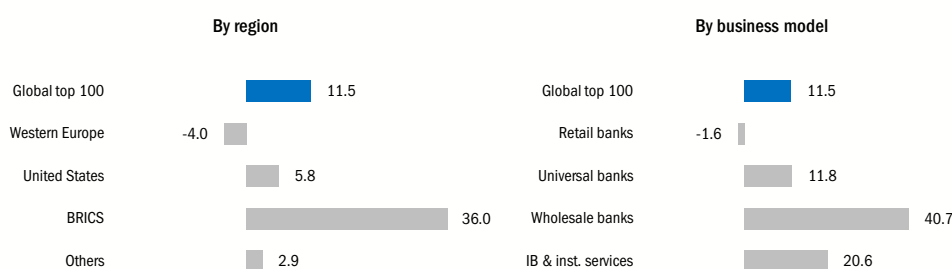


Banking once again with best quarterly TSR-performance among industry sectors

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: Bloomberg, Thomson Reuters Datastream, zeb.research

- Oil and gas industry suffers significantly from the deteriorating oil price and thus lost shareholder value
- Global top 100 banks reached a TSR of almost 20% and lead both the yearly and the quarterly ranking—they were able to increase their year-over-year TSR by 4.5 pp in the last quarter while all other sectors reported lower TSRs in Q4 than in Q3 2014

Fig. 4: Total shareholder return of global top 100 banks (10/2014-12/2014, in %)



Western European banks destroyed shareholder value

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

- Western European institutions on average could not retain positive TSRs in Q4 2014—possibly in response to the disappointing results from AQR and stress test (see chapter 3 for further discussion)
- In contrast, Chinese institutions performed extraordinarily well, pushing the average BRICS TSR to 36% (despite the crisis in the Russian banking sector) and the global top 100 average to 11.5%
- Looking at business models, the strong performance of Chinese banks lifted the wholesale sector average to an astonishing 40.7%

Fig. 5: Top/low TSR performers among global top 100 banks (10/2014–12/2014, in %)

*Chinese banks dominate
global performance ranking*

Global					
Top performers	Country	TSR	Low performers	Country	TSR
Haitong Securities	China	133.1	Al Rajhi Bank	Saudi Arabia	-27.8
China Everbright Bank	China	76.2	Sberbank	Russia	-27.3
VTB Bank	Russia	76.1	Allied Irish Banks	Ireland	-25.5
China Minsheng Banking	China	74.4	CIMB Group Holdings	Malaysia	-20.9
Industrial Bank	China	61.4	BBVA	Spain	-16.9
Western Europe					
Top performers	Country	TSR	Low performers	Country	TSR
KBC Groep	Belgium	10.3	Allied Irish Banks	Ireland	-25.5
Svenska Handelsbanken	Sweden	8.0	BBVA	Spain	-16.9
Swedbank	Sweden	7.6	Bankia	Spain	-16.2
Barclays	UK	7.5	Standard Chartered	UK	-15.6
Royal Bank of Scotland Group	UK	7.1	UniCredit	Italy	-14.8

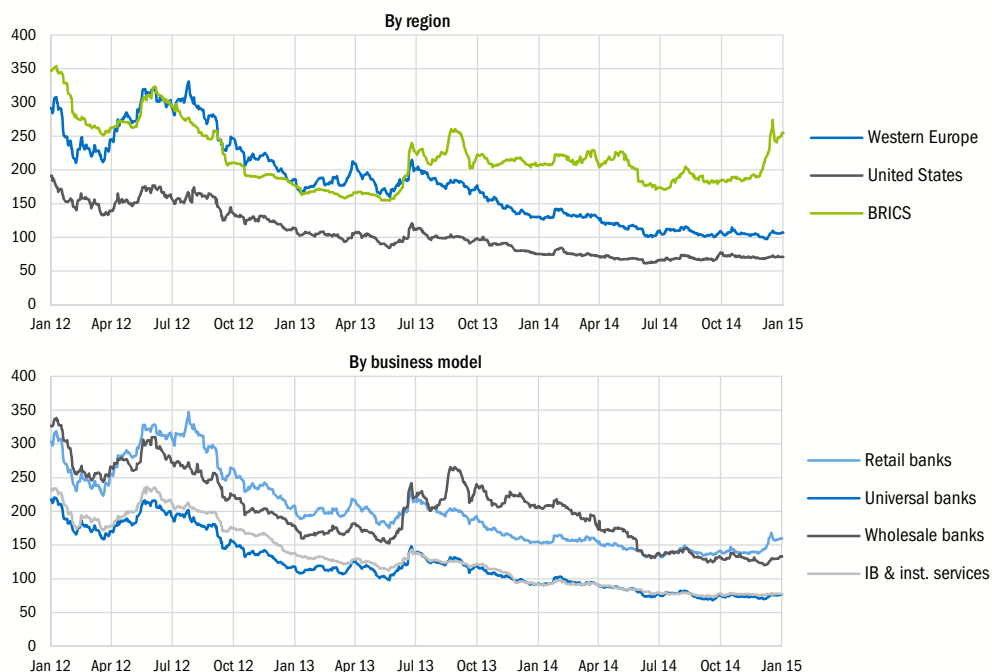
Source: Bloomberg, zeb.research

- Chinese banks dominate the global top performers: as the Chinese inflation rate reached a 5-year low (fig. 9), interest rates are expected to decrease in Q1 2015 in order to match the government's five-year plan—in addition, Chinese top performers benefit from restructuring processes and government interventions
- The high TSR score of Russian VTB Bank comes as a surprise—government support and guarantees were required to stabilize Russia's second-largest credit institution after it was hit hard by European and US sanctions, which led to a decrease in solvency (see debt perspective)
- Royal Bank of Scotland was able to prove skeptics wrong by passing the EBA stress test, and speculations about a sale of Coutts International further promoted the (mostly government-owned) bank's TSR performance

Debt perspective

From a debt perspective, no fundamental changes occurred during the last quarter, except with a view to BRICS institutions, whose CDS spreads jumped upwards considerably in contrast to the a very good TSR performance. This development is mainly driven by the political situation in Russia and resulting uncertainties about Russian-based institutions.

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

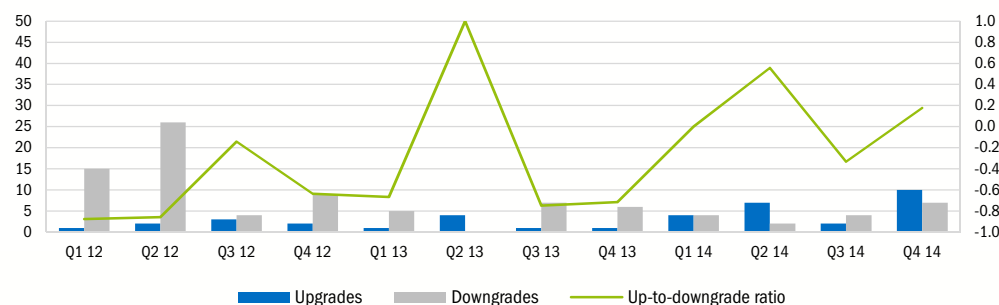


Russian banks push CDS spreads of BRICS institutions

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

- Russia pushed the BRICS average upwards: Sberbank’s CDS spread increased by 250% in the past quarter—in contrast to the development in the equity market, where BRICS banks are among the top performers
- The increase of retail banks’ average CDS spread is also mainly attributable to the extreme increases of spreads of a few Russian and Asian banks
- In Q1 2015, Western European spreads are likely to increase as well, because discussions about Greece leaving the Euro area (“GREXIT”) have resurfaced and uncertainties about the future of the Euro will put pressure on CDS spreads

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



More upgrades than downgrades in Q4 2014

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

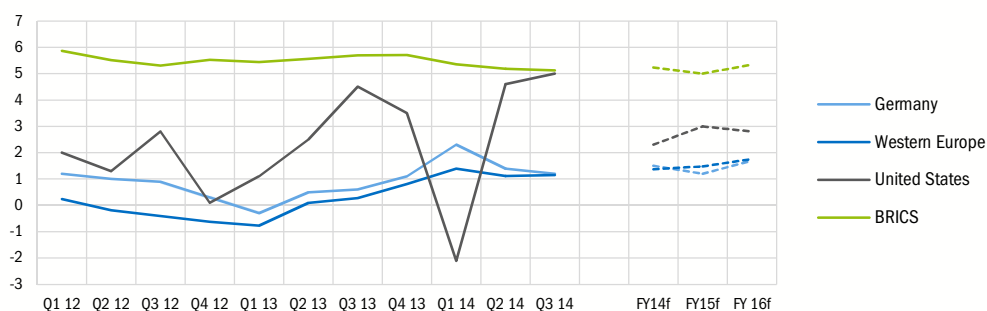
- In the last quarter of 2014, 17 out of the global top 100 banks were affected by rating changes—ten of these changes were upgrades
- Two major European banks, Standard Chartered and UniCredit, were downgraded by S&P from A+ to A and BBB to BBB- respectively
- The largest Russian institutions, VTB and Sberbank, were also downgraded by Moody's, which reflects increasing uncertainties resulting from the political and monetary situation in the country
- The average rating of the global top 100 banks remained stable at A-; from a regional point of view, US institutions (average rating of A) are still rated higher than Western European (A-) and BRICS banks (BBB), while wholesale institutions are on average still one notch below the other clusters with regard to business models

II. Key banking drivers

Economic perspectives

After the sharp increase of the US GDP in the second quarter of 2014, the economic development of all regions remained stable in Q3 2014 and forecasts predict only minor changes for the upcoming years. The German inflation rate declined for the fourth quarter in a row and other regions reported decreasing inflation rates as well. However, the low oil price and the weak EUR to USD exchange rate are supporting growth prospects in Germany and other Western European countries.

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

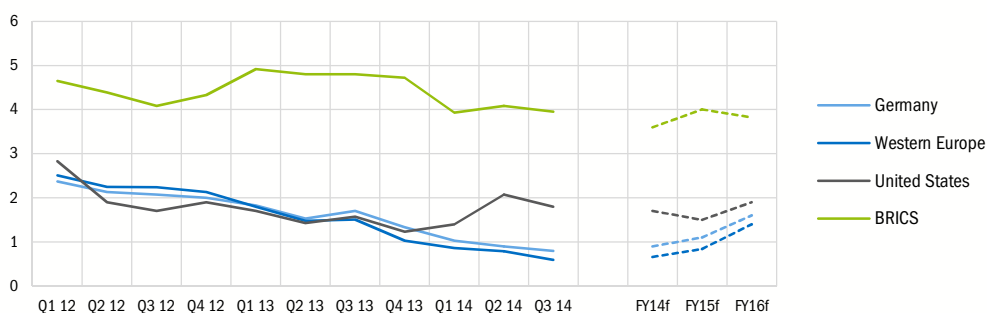


GDP growth remained unchanged in Q3 2014

Q4 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb.research

- The US economy confirmed its strength by increasing its GDP growth rate further to 5% (+0.4 pp), almost reaching the BRICS average of 5.1%
- German GDP growth dropped slightly by 0.2 pp and is now level with the Western European average—however, the low oil price and the decreasing EUR/USD exchange rate could stimulate growth in Western Europe

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



Inflation rates continued sloping downwards

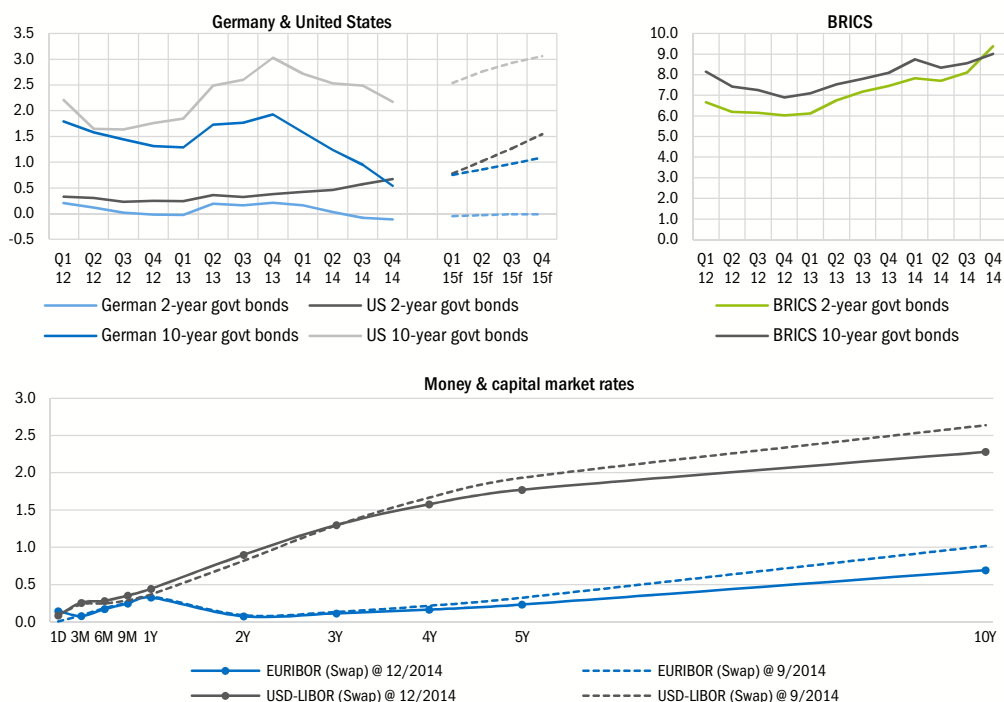
Q4 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb.research

- In Q3 2014, Germany's and Western Europe's inflation rate declined further to 0.8% and 0.6% respectively
- Inflation in the United States dropped by 0.3 pp, below the Fed's target rate of 2.1%

Interest rates

The ECB's fixed rate tenders and deposit facility remained at historic lows of 0.05% and -0.2% respectively. In this monetary environment, yields on German government bonds dropped again to a new all-time low of -0.1% for 2-year bonds and 0.5% for 10-year bonds. Yields of 10-year US government bonds continued to drop as well, reaching 2.2% on December 31. In contrast, yields of 2-year US government bonds rose for the seventh consecutive quarter to now 0.7%.

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



New all-time low yields for German government bonds

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.

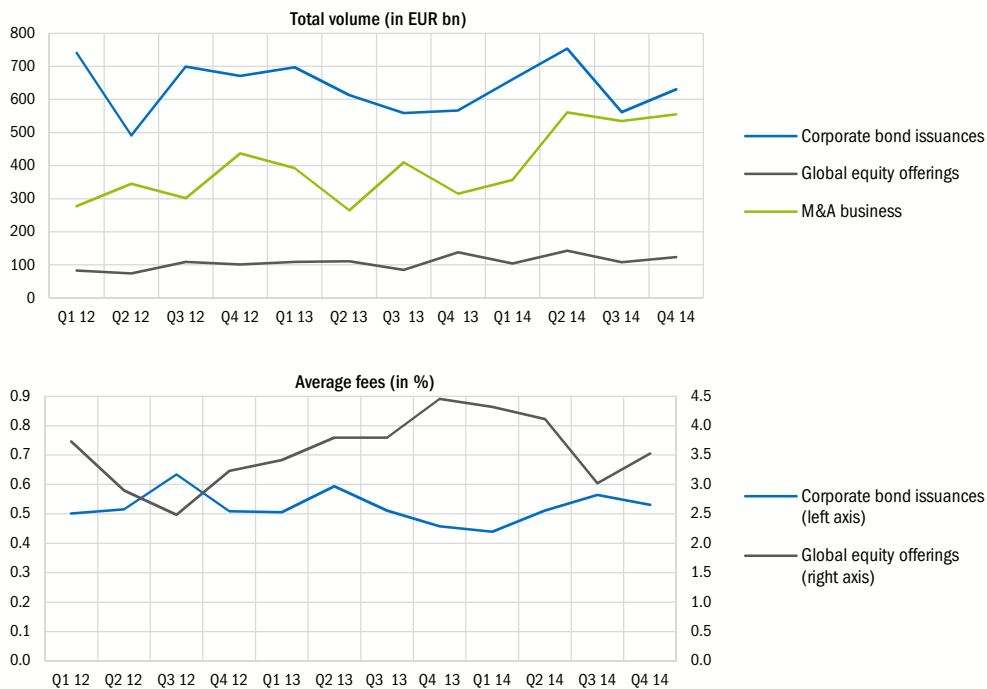
Source: Bloomberg, zeb.research

- Yield curves further flattened, but drivers differ for the US and Germany: while the US yield curve flattened due to the increase of short-term interest rates, the German yield curve flattened due to the stronger decrease of long-term interest rates, which indicates that the low interest environment is going to persist
- Forecasts for central bank policies in the US and Europe also differ: While the low interest rate environment in the Euro area is expected to continue in the medium term, e.g. supported by asset purchases by the ECB, the US Fed finished its quantitative easing program, having spent USD 4.5 tr since 2008, and is expected to increase interest rates in Q1 2015—this is reflected in strongly increasing US yield forecasts for the upcoming quarters
- The notable rise of 2-year BRICS government bonds is mainly driven by a 6.9 pp jump of Russian 2-year bonds due to the strong devaluation of the Ruble, whereas yields of other BRICS countries remained at a comparatively stable level: Brazil +0.7 pp, India -0.5 pp, China -0.4 pp and South Africa -0.3 pp

Capital market environment

After reduced volumes in Q3 2014, all fields of traditional investment banking—debt (+12%), equity (+14%) and M&A business (4%)—recorded positive growth rates in Q4 2014. As in the previous quarters, fees for corporate bond issuances and global equity offerings developed contrarily. While the average fees for corporate bond issuances decreased slightly to about 0.5%, fees for global equity offerings rose by 0.5 pp to 3.5%.

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



Investment banking revenues increased in Q4 2014

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

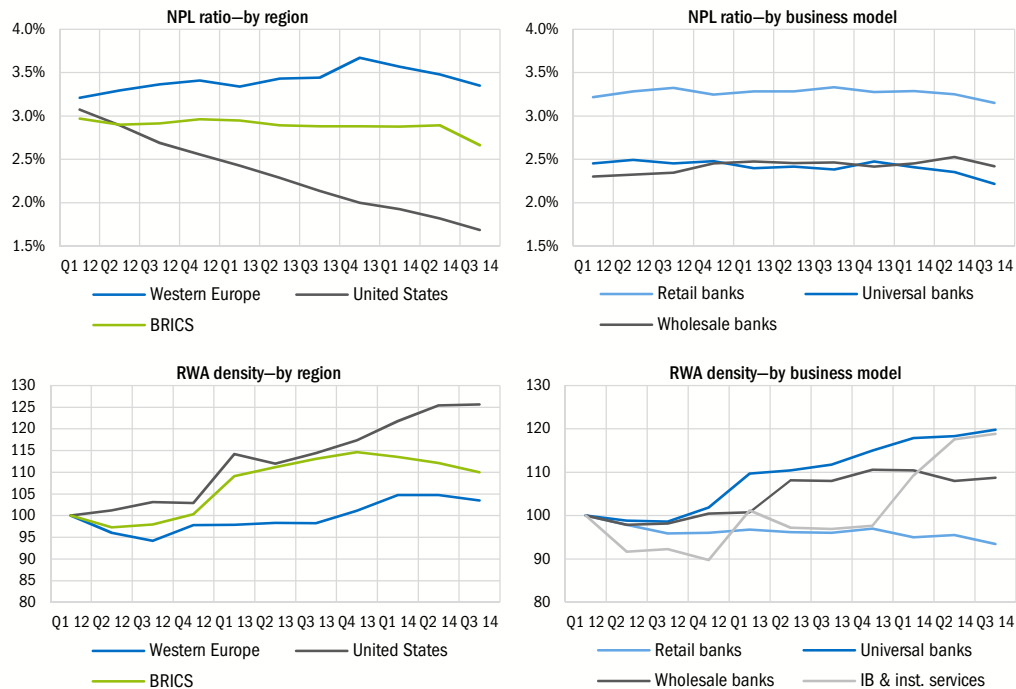
- The corporate bond issuance volume rose by 11% compared to Q4 2013 and average fees increased by 16% year-over-year
- Equity offerings declined in terms of volume (-11%) and fees (-21%) in 2014.
- M&A business grew strongly in 2014: compared to the previous year-end values, market volume increased by 76%

Risk indicators

Balance sheet-based risk indicators of global top 100 banks have improved in Q3 2014. The non-performing loans (NPL) ratio of US banks continued to decrease at a nearly constant rate since 2012 and heads for the 1.5% mark in 2015. Overall, the loan quality improved globally.

Fig. 12: NPL ratio and RWA density of global top 100 banks

Loan quality improved notably in all regions



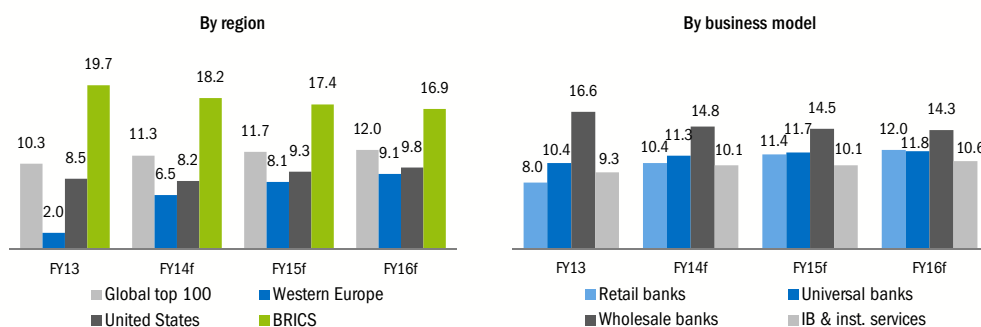
NPL ratio as ratio of non-performing loans (NPL) to gross loans. Investment banking (IB) & inst. services institutions without reasonable data for NPL. RWA density defined as risk-weighted assets (RWA) to total assets. RWA density indexed to 100 at March 31, 2012. Q4 2014 data not yet available at the time of writing. Source: Bankscope, zeb.research

- US institutions continue to improve their NPL to gross loans ratio, which declined steadily over the last three years and by 1.7% in the last quarter
- Western European and BRICS banks decreased their ratios at even higher rates (3.4% and 2.7%, respectively)
- NPL to gross loans ratios decreased throughout all business models by about 2.5%
- The US RWA density stopped increasing in Q4 2014 and remained at a stable level—in contrast, Western European and BRICS RWA density further decreased by 0.4 pp and 1.2 pp respectively
- RWA density of investment banking and institutional services, universal banks and wholesale banks increased by about 1%, while risk density for the retail banking segment decreased by 2%

Banking profitability

Western European banks still suffer from the persisting low interest environment and stricter regulatory requirements. However, analysts expect Western European banks to catch up with US institutions by 2016. The RoE of the wholesale banking sample—which includes a large number of highly profitable institutions from China—is currently ahead of other clusters. Retail banking business is expected to improve its profitability by 2016 and will outperform universal banking as well as investment banking and institutional services.

Fig. 13: 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

Western European banks are expected to catch up with US institutions by 2016

- Western European banks' profitability is still troubled by the "double burden" of the low interest environment and stricter regulatory requirements, which further challenges growth prospects
- Concerning business models, analysts expect a moderate growth of profitability for all models except retail banking—the wholesale banking sample, which include a large number of highly profitable Chinese banks, remains the most profitable business segment

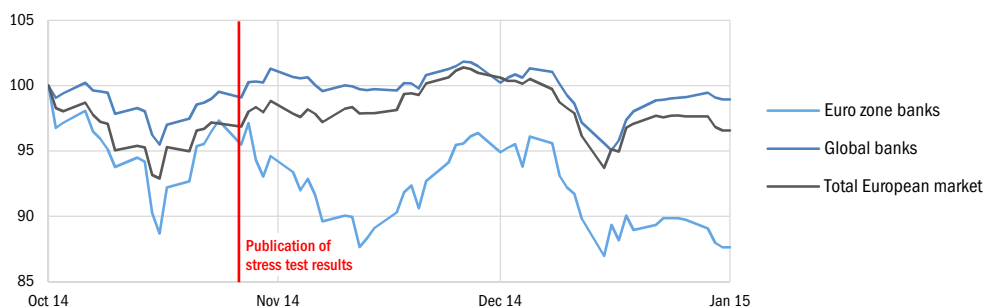
III. Special topic

The EBA stress test—starting point for a new era of bank supervision in Europe

Nearly two months after the results of the EBA stress test were published at the end of October 2014, it is time for a review. How did the markets react? What are the implications for bank management? The stress test has been the last core element of the ECB’s Comprehensive Assessment of banks of systemic importance in the Euro zone and concludes the full implementation of the Single Supervisory Mechanism (SSM). From now on, Europe’s major banks are under direct supervision of the ECB. Of the 25 banks that failed the stress test, 12 banks have already taken measures to close the capital gap. With 9 banks failing, Italy was hit hardest by the stress test. However, this have not been surprising overall.

EBA stress test concludes setting up the Single Supervisory Mechanism

Fig. 14: Stock market reactions to the publication of EBA stress test results—shareholder return

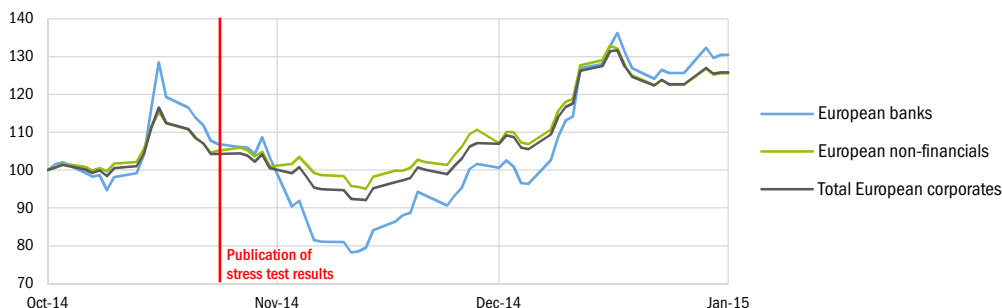


Reaction of capital markets' indicates disappointment of stress test results

Total shareholder return index, weighted by the market capitalization, aggregated and provided by Thomson Reuters Datastream. Indexed to 100 at October 1, 2014. Source: Thomson Reuters Datastream, zeb.research

Equity investors reacted to the publication of the results with a clear response. Compared to their global counterparts, banks in the Euro zone suffered a significant decline in valuation. A comparison with the total European market reveals that this is not a regional issue, as all European industries combined performed better than the banking sector. This is contrary to the signal of confidence intended by central bankers and indicates that investors are not that optimistic about the outcome. As the results have not been surprising, the market reaction is more likely a sign that market participants were disappointed by the relevance of the stress test. It is questionable whether investors interpret the results as credible with regard to the stability of the European banking sector.

Fig. 15: Debt market reaction to publication of EBA stress test results—credit spreads

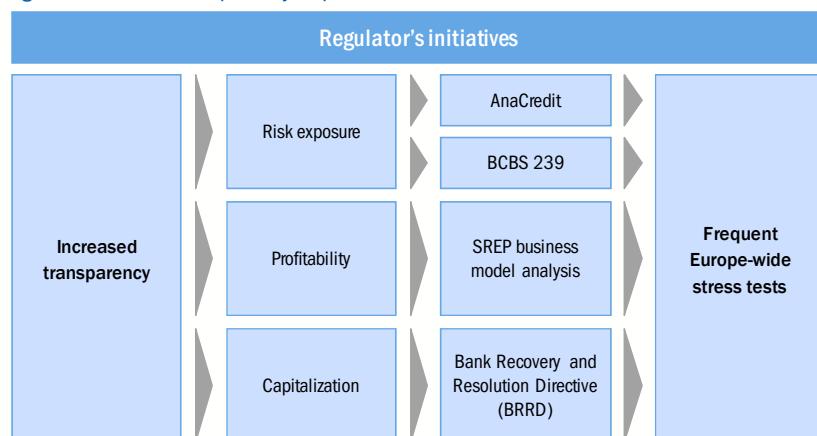


Credit spreads decreased after the publication of the results

iBoxx EUR corporates all maturities indices, yield to indexed to 100 at October 1, 2014. Source: Thomson Reuters Datastream, zeb.research

This conclusion is further supported when looking at the debt perspective. Spreads of European banks' debt instruments show a positive, however short-term, reaction to the publication of the results, which has already vanished by now. All in all, the reactions indicate that capital markets have not been surprised by the stress test results, but are rather disappointed by the significance of the stress test.

Fig. 16: Increased transparency requirements



Source: zeb.research

Regulators focus on increasing transparency in bank business

Markets were not impressed by the stress test. However, for bank management, the EBA stress test has ushered in a new era of regulation in the Euro zone. Alongside the implementation of the Single Supervisory Mechanism, the regulators have introduced a variety of initiatives focusing on increasing transparency regarding banks' risk exposure, profitability and capitalization.

- **Risk exposure:** The “Analytical Credit Dataset” initiative (AnaCredit) demands detailed information about credit contracts with a very low reporting threshold. The BCBS 239 initiative follows that direction by setting minimum standards for risk data quality and availability. As a consequence, banks need to get used to reporting credit risk exposures with the same level of detail as during the Asset Quality Review.
- **Profitability:** The introduction of the business model analysis in the Supervisory Review and Evaluation Process (SREP) is going to intensify regulatory supervision. In addition to well-known supervision areas such as governance, internal control, ICAAP and ILAAP, SREP now also focuses on the bank's business model and assesses their profitability. This is a new step in bank supervision as banks now have to provide resilient proof of the viability and sustainability of their business model.
- **Capitalization:** In addition to the capital requirements from Basel III, banks have to provide loss-absorbing capital in order to be able to continue critical functions in case of a resolution. In the context of the EU's Bank Recovery and Resolution Directive (BRRD), the EBA introduces Minimum Requirements for Own Funds and Eligible Equity (MREL). Under these capital requirements, banks have to develop individual resolution plans and provide detailed data so that the supervisor is able to assess the resolution plan. Again, the granularity of demanded data exceeds the current practice of bank supervision.
- **Frequent Europe-wide stress tests:** The abovementioned transparency requirements are used to improve the significance of further Europe-wide stress tests which, stress all dimensions (risk exposure, profitability and capitalization) comprehensively. This extensive form of stress testing is expected to be implemented on a regular (e.g. yearly) basis.

As a consequence, bank management needs to get accustomed to this new form of transparency requirements. The requirements demand enormous efforts from banks, in terms of pure man power as well as in terms of adjustment efforts for ensuring the availability and quality of the required data. This requires a significant investment in the banks' infrastructure (especially IT). However, since these measures are focused on providing transparency, the regulatory requirements can also be seen as a chance for bank management, because the banking supervisors will not be the only ones benefitting from improved transparency.

New transparency requirements as a management opportunity

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 December 31, 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.

zeb.rolfes.schierenbeck.associates is a management consultancy specializing in the financial services sector with 18 offices in Germany, Austria, the Czech Republic, Denmark, Hungary, Italy, Luxembourg, Norway, Poland, Russia, Sweden, Switzerland and Ukraine. With more than 900 employees and several subsidiaries, zeb is among the leading consulting firms for banks, insurance companies and other financial services providers.

For more information: www.zeb.de

Contact

Dr. Dirk Holländer

Partner

Taunusanlage 19
60325 Frankfurt am Main | Germany

Phone +49.69.719153.597
E-Mail dhollaender@zeb.de

Volker Abel

Senior Manager

Taunusanlage 19
60325 Frankfurt am Main | Germany

Phone +49.69.719153.453
E-mail vabel@zeb.de

Dr. Ekkehardt Bauer

Manager Analysis & Studies

Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.225
E-mail ebauer@zeb.de