Issue 14 | July 8, 2015

zeb

US and BRICS banks with strong performance in Q2—European banks lagging behind due to Greek crisis and weak growth expectations

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Key topics

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

- Banks showed best TSR performance of all industry sectors both in Q2 2015 and year-over-year, but Western European banks lost value as the Greek crisis heated up again
- Market capitalization of global Top 100 banks remained constant quarter-over-quarter
- Several Western European banks were downgraded significantly in Q2 2015 as rating agencies started to include the lower possibility of government support of banks due to regulatory changes

II. Key banking drivers (p. 8)

- Global economic environment improved in the last quarter—reflected by significant increase to inflation rates reducing the fear of deflation
- Long-term interest rates jumped up significantly in Western Europe and the US, leading to steeper yield curves
- Equity offerings and M&A business achieved very good results

III. Special topic: The Greek crisis and a turning European credit cycle (p. 12)

- The situation in Greece shows that the European debt crisis is far from over
- ECB is single guarantor for economic stability, but policy of ultra low yields increases possibility of credit bubbles
- Turning credit cycle creates massive new risks but also opportunities for banks

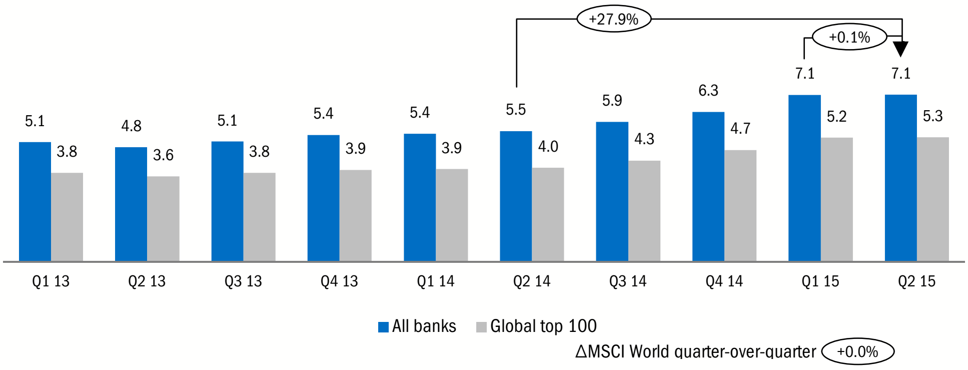
I. State of the banking industry

Market valuation

Banks' market cap remained nearly unchanged in the last quarter with all banks showing a growth of just 0.1% and global top 100 institutions of 0.4%. However, this development is in line with global capital markets which also moved sideways in terms of market capitalization.

Boost of banks' market cap took a break but yearly performance still very good

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

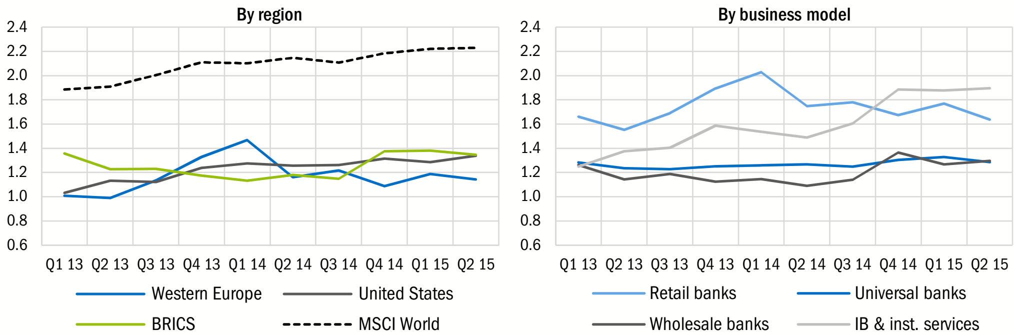


All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2014. Figures are aggregated in EUR, without adjustments for foreign currency effects.
Source: Bloomberg, zeb.research

- After some very good previous quarters (market cap of all banks grew by 27.9% year-over-year), banks' market cap increase slowed down in the last quarter which is in line with the overall market development as MSCI World also just showed a parallel movement

Retail banks' P/B advantage diminished further but gap to universal and wholesale banks still exists

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



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

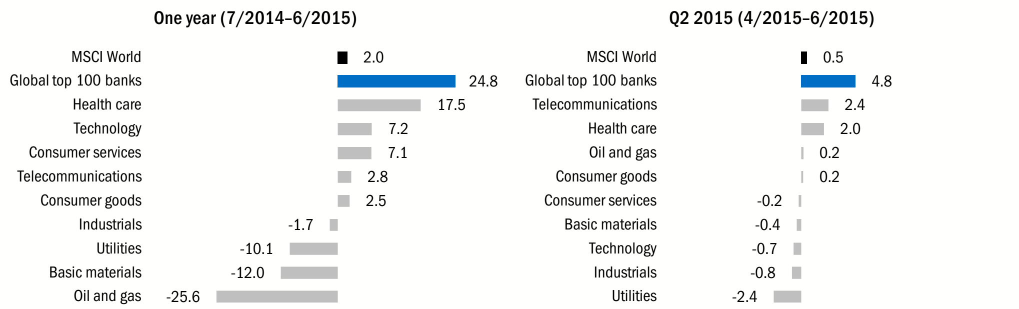
- Average price-to-book ratios of retail banks declined further from above 2.0 in Q1 2014 to now just above 1.6—the latest decrease from 1.8 to 1.6 in Q2 2015 is mainly driven by losses of European retail banks like Santander, Bankia or Credit Agricole
- Overall, the P/B ratios of global top 100 banks are almost unaltered and still significantly below the MSCI World

TSR performance

In Q1 2015, total shareholder return of global top 100 banks remained on top among industry sectors both on a quarterly and yearly basis. Regionally, the US and BRICS showed the best performances as Western Europe lost value due the recent turmoil in Greece and the dispute between the Greek government and other euro area members as well as the IMF during the last days of June.

Banking top TSR performer in Q2 2015 and even year-over-year

Fig. 3: TSR of industry sectors worldwide (in %)

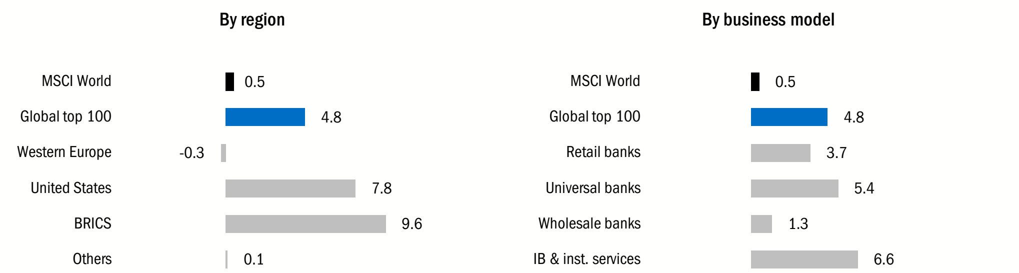


Total shareholder return of industry sectors other than banking are based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream. Average total shareholder returns of global top 100 banks are weighted by the market capitalization of each bank.
Source: Bloomberg,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

- Global top 100 banks still show the best average year-over-year performance with 24.8% and even top all industry sectors with a TSR of 4.8% in the last quarter as high dividend payouts by some large players improved the shareholder value—clearly ahead of MSCI World which achieved 0.5% in Q2 2015

US and BRICS banks driving banks' performance in Q2 2015

Fig. 4: TSR of global top 100 banks by regions and business models (4/2015–6/2015, in %)



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

- At the end of June, the recent Greek turmoil resulted in Western European banks' value slipping by -4.1% (only in the last week of June) and therefore by -0.3% in the total second quarter
- After some lower performances in the past, BRICS institutions improved and achieved a TSR of 9.6% mainly driven by solid figures from Chinese banks (see fig. 5)
- In the US, especially some large players such as JPMorgan (12.6%), Bank of America (10.9%) and Goldman Sachs (11.4%) achieved very good results in Q2 2015

BRICS dominates top performers—Asian-Pacific banks suffer from weaker economy

Fig. 5: Top/low TSR performers among global top 100 banks (4/2015–6/2015, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
VTB Bank	Russia	31.7	Bank Rakyat	Indonesia	-22.0
Bank of Communications	China	26.9	Bank Mandiri	Indonesia	-19.4
Mizuho Financial	Japan	25.5	Kasikornbank	Thailand	-16.2
China Merchant Bank	China	20.2	Westpac Banking	Australia	-15.1
Sumitomo Mitsui FG	Japan	18.6	Deutsche Bank	Germany	-13.8

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
UBS Group	Switzerland	11.1	Deutsche Bank	Germany	-13.8
Lloyds TSB	UK	10.0	Bankia	Spain	-12.3
Barclays Plc	UK	7.9	Allied Irish Bank	Ireland	-11.6
KBC Group	Belgium	7.7	Commerzbank	Germany	-9.8
Danske Bank	Denmark	7.2	Banco Santander	Spain	-8.8

Source: Bloomberg, zeb.research

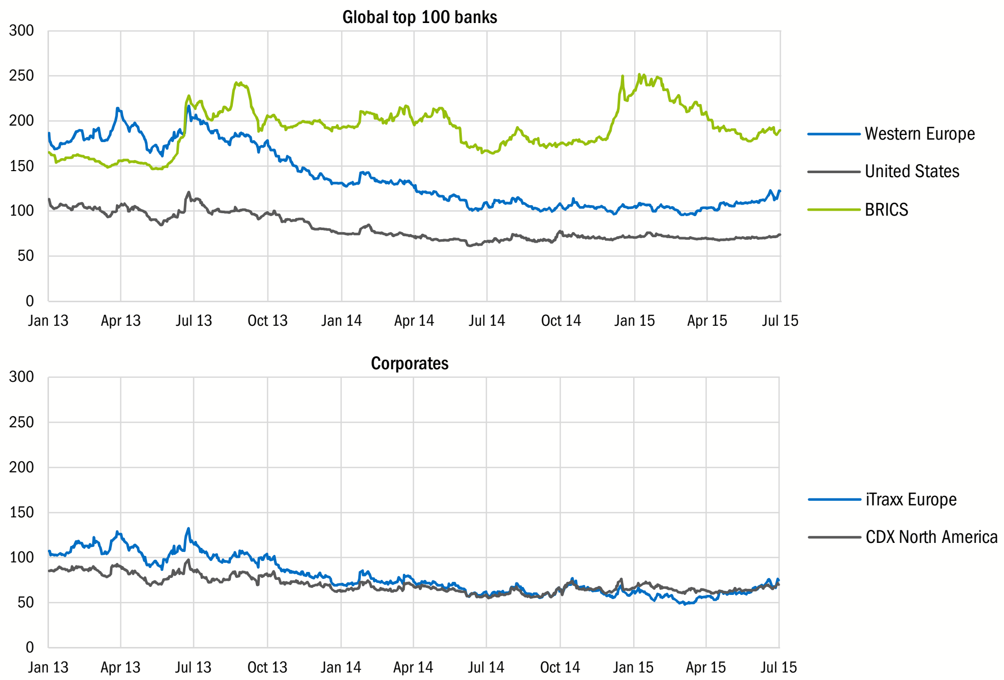
- This quarter's top performers are mainly from BRICS countries as Chinese banks in general performed well with an average TSR of (11.1%) and VTB Bank bounced back by improving its shareholder value by 31.7% after losing 10.4% in the first quarter of 2015
- Japanese banks also gained significant value as Mizuho and Sumitomo Mitsui announced the sale of several non-core investments as a reaction to new Japanese corporate governance rules
- Among low performers, banks from the Asian-Pacific region (especially Indonesia) suffered due to lower economic growth forecasts for upcoming quarters, weak loan growth, deteriorating asset quality and likely higher loan loss provisions in the future—however, some analysts already expect that the worst might be over for the region recommending some of our current low performers as potential future purchases
- The stock of Deutsche Bank decreased significantly by -13.8% in Q2 2015 after announcing details of the new strategy and changes in the executive board

Debt perspective

CDS spreads of global top 100 banks showed different developments in Q2 2015. The average spread of Western European banks grew steadily from the beginning of the quarter at 20bp to 123bp at end of June. In the US, CDS spreads remained a constantly low level. In Q2 2015 a significant number of rating changes took place mainly due to a revision of the bank rating methodology. Furthermore, rating agencies started to reflect the new rules regarding bail-in and resolution instruments and therefore the lower possibility for government support in their ratings.

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

Western European CDS spreads increased as Greek crisis heated up

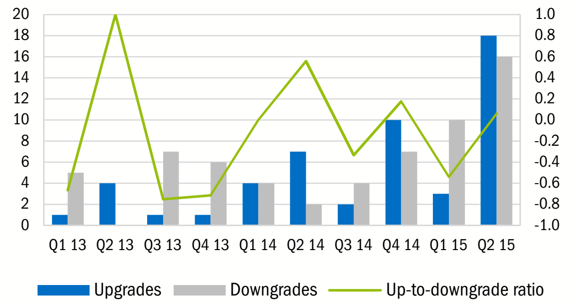


Global top 100 banks' 5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Thomson Reuters Datastream, zeb.research

- Because of the worsened situation in Greece, European banks' CDS spreads started rising at the end of Q2 15, after one year of stability—at this particular time, it is not possible to predict whether recent turmoil will be temporary or the beginning of the next period of increasing CDS spreads in Europe (see this issue's special topic in chapter III for a closer look at the crisis, the European credit cycle and specific opportunities and risks for banks in this environment)
- Compared to corporates, the fundamental gap to the average of Western European banks further persists as average banking CDS spreads are still around 47bp above corporates
- In the US, the situation is still different compared to Western Europe as US' average corporate and banking CDS spreads stayed on the same level at around 70bp
- Spreads in BRICS continued to decline during the second quarter and despite an increase in June current values stayed below 200bp

Significant number of rating changes in Q2 2015 driven by methodological review

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



	Q4 13	Q4 14	Q2 15
Global top 100	A-	A-	A-
Western Europe	A-	A-	A-
United States	A-	A-	A-
BRICS	BBB	BBB	BBB
Retail banks	A-	A-	A-
Universal banks	A-	A-	A-
Wholesale banks	BBB	BBB+	BBB+
IB & inst. services	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. The 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

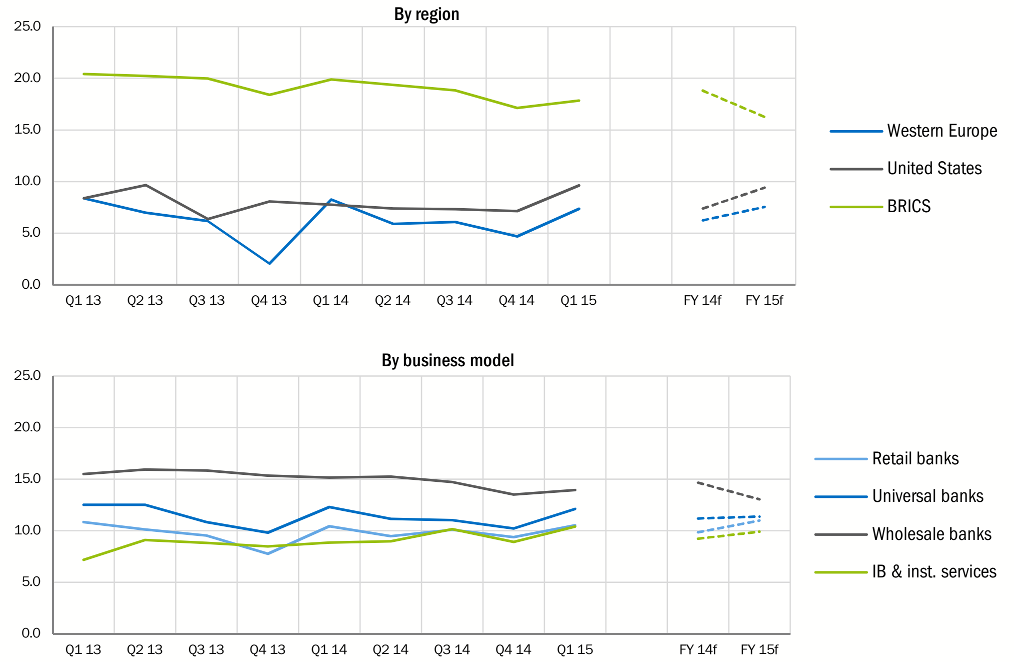
- In Q2 2015, the number of rating changes among global top 100 banks jumped up resulting in an uncharacteristically high number of 34 rating changes with 16 downgrades and 18 upgrades, inter alia, due to a review of the bank rating methodology and assumed government support—revision was provoked by the "too-big-to-fail" regulation and recovery and resolution
- Most rating downgrades are related to Western European banks as rating agencies are now incorporating the decreasing possibility of governmental support for some major banks into their rating
- This different view on Western European banks brought some major chances: Fitch downgraded Commerzbank by four notches from A+ to BBB, Allied Irish Banks by three notches to BB and Royal Bank of Scotland (which already suffered downgrades in Q1 2015) by two notches to BBB+. Among others, Deutsche Bank lost two notches in its S&P rating (A to BBB+) and Moody's downgraded Credit Suisse and Barclays each by three notches to Baa2 and Baa3 respectively
- Regarding upgrades, Moody's upgraded a total number of 16 institutions also mainly from Western Europe such as Santander, UBS, BBVA and three Nordic banks equally due to methodology related reviews
- Overall, most of the rating changes in the second quarter of 2015 were not the result of a changed financial situation of global banks but due to methodological and regulatory considerations

Banking profitability

After some weak quarters, especially in mid/end 2014, profitability of global top 100 banks increased significantly in the first quarter of 2015. However, this increase should not be interpreted as a major turning point as the first quarter's performance is traditionally strong. Nevertheless, US banks still well ahead of European banks, reaching nearly the benchmark of a post-tax RoE of 10%.

Typical profitability increase in first quarter of 2015

Fig. 8: RoE after tax and annual RoE forecasts of global top 100 banks (in %)



Historic data according to quarterly reports from Bankscope. Q2 2015 data not yet available at the time of writing. Forecasts calculated as equity-weighted averages of analysts' consensus forecasts from Bloomberg.
Source: Bankscope, Bloomberg, zeb.research

- Profitability improved in all regions in Q1 2015, which is a seasonal effect in the first quarter of a year
- Western European Banks achieved a post-tax RoE of 7.4% which is far better than in the fourth quarter of 2014, but still behind the very good first quarter of 2014 (8.3%)—current forecasts expect a return on equity of 7.6% for the total year 2015
- US banks' RoE jumped by 2.5pp nearly reaching the important level of 10% post-tax return on equity as several major institutions as JPMorgan, Goldman Sachs and other investment banks profited from the very positive development in the M&A and equity business over the last year (see fig. 12)
- In BRICS, despite a slight profitability increase, the overall trend is negative as current figures are well below last year's Q1 results—however still remaining on a very high level

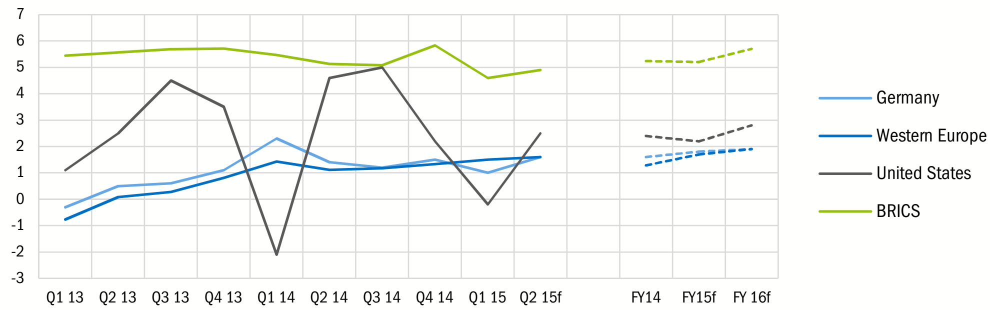
II. Key banking drivers

Economic perspectives

The global economic environment improved in the last quarter. After mostly shrinking GDP growth rates in recent quarters, especially the US showed a positive development. In Western Europe, the long-term trend of economic recovery continued. Regarding consumer prices, the steady decline of inflation rates finally came to an end in Western Europe and the US with almost constant prices in Q2 2015.

Improved GDP growth in all regions

Fig. 9: GDP growth and forecasts (real GDP, year-over-year growth rates, in %)

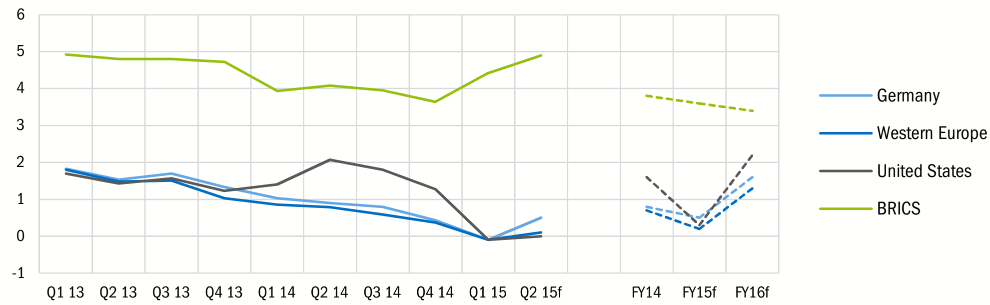


Source: Thomson Reuters Datastream, zeb.research

- The US GDP growth rate rose to 2.5% after being negative in Q1 und BRICS reached almost 5% due to an improved situation in India and Brazil, though Russian GDP growth dropped even further in the last quarter from -2.1% to -4.2%
- In Western Europe, the economy continued its long-term recovery achieving a GDP growth rate of 1.6% and reaching the level of Germany that was mostly ahead in previous years

Inflation rates increased in all regions for first time in almost a year

Fig. 10: Inflation rates and forecasts (annual change of average consumer prices, in %)



Source: Thomson Reuters Datastream, zeb.research

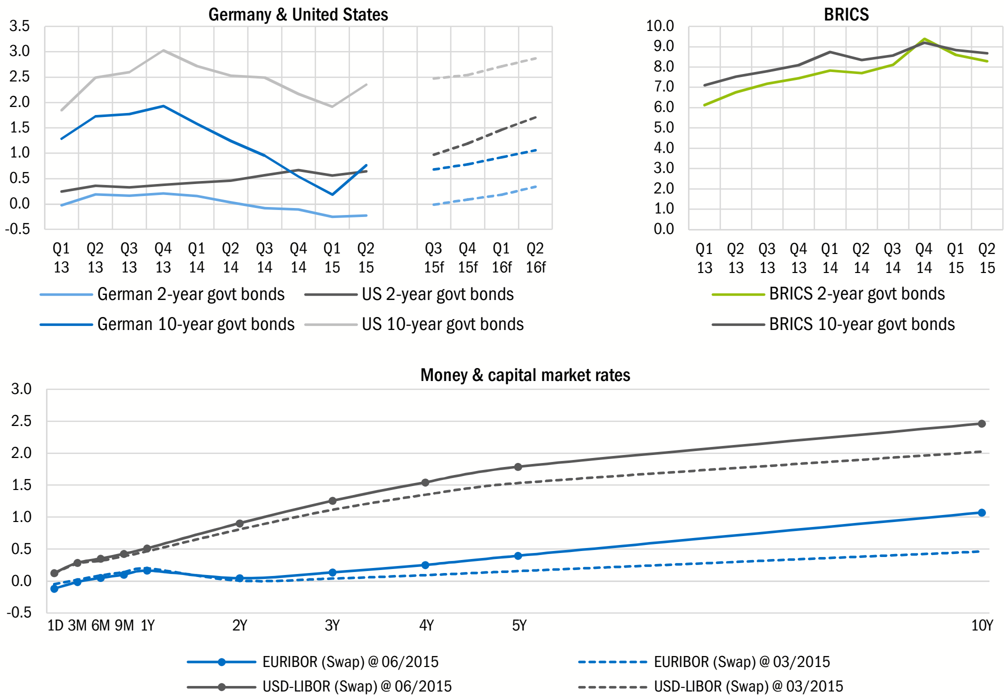
- Western Europe, incl. Germany, and the US have finished deflation (all -0.1%) and showed at least stable and in Western Europe slightly increasing prices—thus the measures of the central banks (e.g. quantitative ease) appear to be effective
- In BRICS, the inflation rate increased again mainly due to higher consumer price changes in Brazil (from 7.7% to 8.5%) and the persisting high inflation rate in Russia at 15.8%

Interest rates

In the last quarter, long-term interest rates increased in Germany and the US significantly for the first time since the end of 2013. As the global economy further recovers (see fig. 9) and a deflation in the upcoming months seems to be less likely (fig. 10), Western European markets hope for an earlier end to the ECB's quantitative easing program resulting in higher expected yields. The USD-Libor and especially the Euribor curves became significantly steeper compared to the end of March 2015.

Long-term yields from Germany and USA increased significantly

Fig. 11: 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

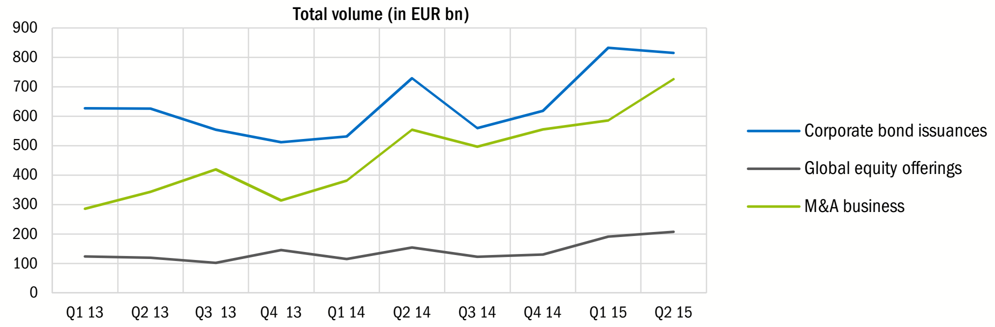
- Hopes for an earlier end of the quantitative easing program of the ECB and better economic figures in the US lead to a strong increase of long-term interest rates in Western Europe and the US resulting in clearly steeper yield curves: German 10-year government bond yield increased by 58bp from 0.18% to 0.76% (after even exceeding 1.0% during the quarter) and US 10-year bonds by 43bp to 2.35%
- In Russia, the interest rate situation improved over the last quarters as short-term yields are now at 10.89% (after 15.96% in Q4 2014) and long-term rates at 11.00% (after 14.01%), but the overall condition is still problematic especially with regard to the overall economy

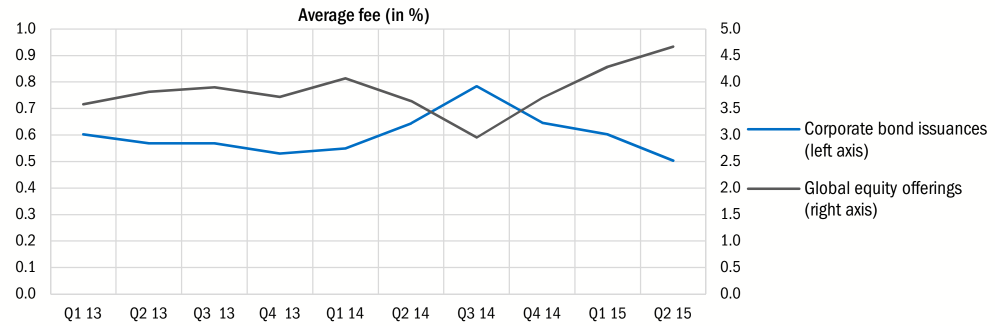
Capital market environment

Global equity offerings and M&A deals showed good results with increasing equity fees and strongly improving deal volumes—especially US banks benefit from this market trend, showing strong performance. Volume of corporate bond issuance is still on a high level, but pressure on fees continued.

Equity and M&A business with very good results

Fig. 12: 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

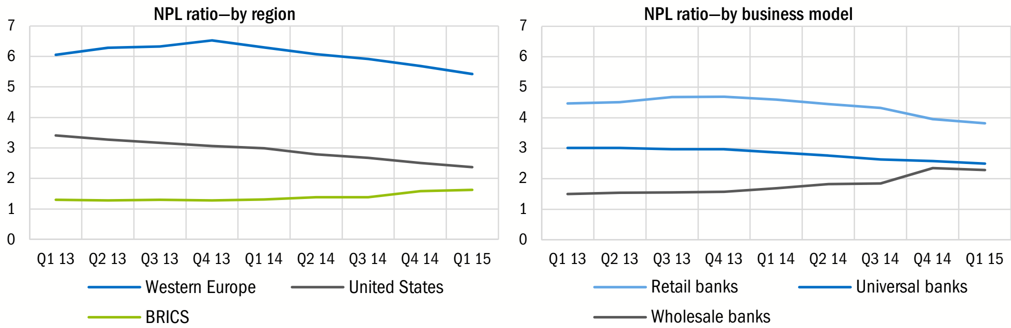
- Regarding deal volume, especially M&A business performed quite well growing by 24% to EUR 725.5 bn compared to last quarter reaching the highest volume for a single quarter since the global economic crisis started in 2007—one major M&A deal was the acquisition of BG Group (gas industry) by Royal Dutch Shell for EUR 73 bn
- In the equity offerings business, not only fees increased again by 38bp to 4.67%, but also the deal volume continued its upward trend by reaching EUR 207.3 bn (+8.2%). It is very positive that this increase is not the result of one large single deal, but more of a higher total number of deals which increased from around 1.100 in Q1 2015 to approx. 1.700 in the last quarter
- In the banks' corporate bond segment, average fees declined again to only 0.50% (-10bp) in Q2 2015 and in the same time total deal volume was reduced by 3% leading to lower total revenues

Risk figures

NPL ratios, which are a central risk measure in banking, declined in most regions and business models. The loan quality of US banks further improved for the ninth consecutive quarter and Western European banks recorded a slight decrease of their non-performing loans (NPL) to gross loan ratio again. However, mainly due to high NPLs at Italian and French banks, European banks showed the highest regional average. In addition, the fear for a turn in the credit cycle in Europe increases and is not yet reflected in reported NPL ratios (see chapter 3).

Further decreasing NPL ratios in Western Europe and the US

Fig. 13: NPL ratio (in %)



NPL ratio as ratio of non-performing loans (NPL) to gross loans. Investment banking (IB) & inst. services institutions without reasonable data for NPL. Q2 2015 data not yet available at the time of writing.
Source: Bankscope, zeb.research

- With the ongoing economic recovery, average NPL ratios of Western European banks declined for the fifth consecutive quarter from 6.5% at the end of 2013 to 5.4% in the first quarter of 2015
- US institutions continued to improve their NPL ratio, which declined steadily over the last three years to only 2.4% at the end of Q1 15
- The differences among BRICS banks and NPL ratios continued: Chinese banks reported NPLs of about 1.3% of their gross loans whereas Russian, Indian and selected Brazilian banks have to deal with significantly higher shares of 3.5% and even above 6.0% in recent quarters

III. Special topic

The Greek crisis and a turning European credit cycle[1]

Seven years after the global financial crisis and five years past the eruption of the European debt crisis, another series of shock waves is sent through financial markets. The escalation of the Greek crisis serves as a powerful reminder that there is little room for complacency as far as lending standards and asset quality is concerned. Fighting the post-2008 corrosive effects of asset devaluations, refinancing impairments and a confidence crisis, the ECB has undoubtedly become the single most-important guarantor of economic stability in the Euro zone. By becoming a lender of last resort and pushing interest rates all the way to zero, the ECB not only enabled, but in actuality mandated banks to reliquify the economy, also by potentially applying generous standards to the credit processes. However, when money becomes easy for an extended period of time, the risk of irrational exuberance, to borrow a term coined by Alain Greenspan, in the credit cycle is becoming very real: "*Bubbles go up very slowly as euphoria builds. Then fear hits, and it comes down very sharply. When I started to look at that, I was sort of intellectually shocked.*" (Alan Greenspan, former Federal Reserve chairman, October 2013)

While the ECB is buying policymakers more time to tackle structural problems in the European economy, the mix of fiscal austerity and economic growth policy creates an inherent risk of sparking the "next" credit bubble. In simplified terms, the following dynamics may take place: In a regime of fiscal austerity, consumers lack purchasing power and overextend themselves with consumer loans; firms react to the slack in the economy by offering interest-free loans to finance consumer goods; banks underestimate risks and rely on credit business to make up for otherwise lower bank profitability in a zero interest-rate environment. In a growth-regime, in which the government stimulates demand by deficit spending, consumers come to rely on a fiscal growth-package, overestimate their long-run sustainable income and spend too much; corporates issue more debt, based on a low-yield environment and a (false) hope for growth; banks once again underestimate risks and overly rely on credit business.

There is a broad body of literature concerning itself the propagation mechanism of credit shocks to the economy. In fact, credit frictions are often referred to as a "financial accelerator", believed to amplify and accelerate macroeconomic fluctuations. But credit shocks are often the result of exogenous factors themselves, triggered by events such as a risk shock (increase of uncertainty, e.g. about ECB policy), an equity/net-worth shock (destroying collateral value) or an increase in interest rates (e.g. through a change of forward-guidance by the ECB). Looking at forward rates, such an increase in interest rates appears to have started already.

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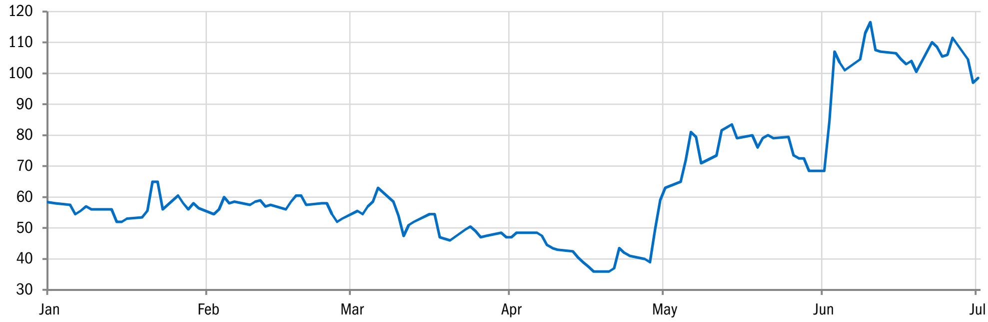
[1] The following text is a shorter version of the article „*Getting banks ready for a turn in the European credit cycle*", originally published in June on zeb BankingHub. For further information please do not hesitate to contact the authors of this article: Jens Kuttig (Partner, jkuttig@zeb.de) and Dr. Fidelio Tata (Manager, ftata@zeb.de)

Fig. 14: September 2019 3-month Euribor futures (1/2015–7/2015, in bps)

Implied yields show an increase in forward rates from around 40 to 100+ bp within the last two months

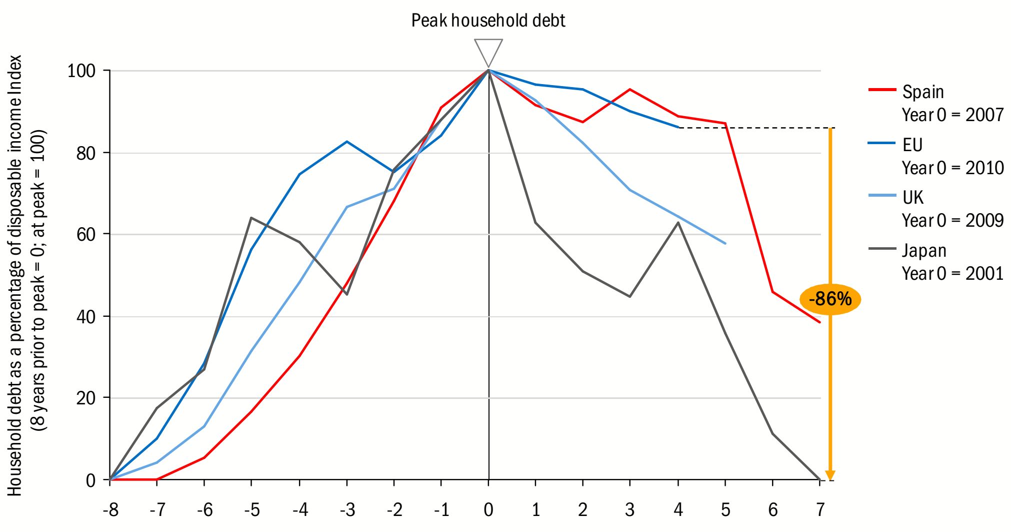


Source: Bloomberg, zeb

Most countries in the Eurozone, with the notable exception of Germany, are plagued by high unemployment, elevated household debts and initial signs of increasing non-performance of bank loans. By reacting to attractive financing opportunities offered by banks, producers and retailers, households, on average, have extended themselves. To us, it is far from obvious that the worst of the European crisis is yet behind us. From a consumer credit perspective, the cycle of household debt reduction has not been completed and much of the pain following the 2007–2010 crisis may still be ahead of ourselves. Benchmarked to the Japanese crisis of 2001, the Eurozone has some 86% household deleveraging to come!

Fig. 15: Houshold debt as a percentage of disposable income—before and after a credit crisis

A look at Japan shows that the worst of the European crisis not yet behind us—most of the pain still ahead



Source: International Monetary Fund, Worldbank, countries' National Statistical Offices, OECD, zeb

Making things worse, there are fewer market participants other than the ECB able and willing to act as shock-absorbers in case of a credit crisis. Corporates by following the value-chain are now capturing larger parts of the end-user financing business, have essentially turned into bank-like institutions themselves. In case of a credit event-triggered liquidity crisis, they will be heading for the (same) exit as banks do. Banks, on the other hand, are focused on repairing their own balance sheet, restoring profitability and curbing financing risks, leaving less and less room for becoming a liquidity provider during a crisis. This leaves the financial system vulnerable to credit shocks and places more importance on prudent risk-management and self-reliability.

While the looming danger of a turning credit cycle creates risks for the financial markets, it also creates new opportunities for market participants nimble enough to adapt to the new situation. For example, banks may reduce their role as a liquidity provider and become more of a trusted advisor on macro-hedging, risk-management and business model adoption to their clients. This requires shifting the focus from transaction banking to fee-based advisory.

A turning credit cycle creates risks, but also new opportunities for banks

Fig. 16: Threats and opportunities for banks

Hypothesis	Threat	Opportunity
Corporate customers have become more like banks themselves	Bank-adverse shocks impact corporates more than ever, amplifying the effect of the shock	Banks to advise corporate customers on how to protect themselves against financial shocks, just like banks are doing
Banks are no longer shock-absorbers as they run lean inventories	Corporates will not easily find (re-)financing opportunities from banks during a crisis	Banks to advise corporates on creating their own (re-)financing channels as a risk measure
Households outside Germany are stretched	Corporates depending on export may suffer from non-German credit write-downs and export declines	Banks to advise corporates on hedging non-German macro risk

Source: zeb

Instead of waiting until the regulator requests it, or hoping that the ECB will dampen any possible dislocation resulting from a turning credit cycle, banks need to become proactive now and immunize themselves as far as possible against such adverse scenarios. In our view, evaluating the right kind of scenarios should be the first step. Thus, instead of just meeting the stress testing requirements of ECB/EBA, banks should assess their vulnerability in case of a credit downturn using their own views and parameters.

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, 2015. The global top 100 banks cluster contains the largest banks by market capitalization on December 31, 2014 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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