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zeb/

Banking sector remains on recovery track driven by overall market momentum – however, economic and business challenges persist

zeb/market flash

Key topics

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

- In Q1 2013, the upward trend of recent quarters continued as market capitalization reached highest value since 2010
- Investors continue to favor commercial banks; gap between mature and growth markets narrows
- CDS spreads of Western European banks again increased significantly in March 2013 due to the recent market turmoil in Cyprus

II. Key banking drivers (p. 6)

- Interest rates remain at historic lows, but are not yet fully reflected in business margins
- Banks' RoE forecasts predict increasing RoEs despite weak economic fundamentals

III. Special topic: Succeeding in a low interest rate environment (p. 9)

- A detailed analysis shows that the current low interest rate level may reduce net interest income of banks by up to 14%, thus threatening banks' profitability
- Only a differentiated and effective set of strategic initiatives will help banks to limit the losses occurring from low interest rates

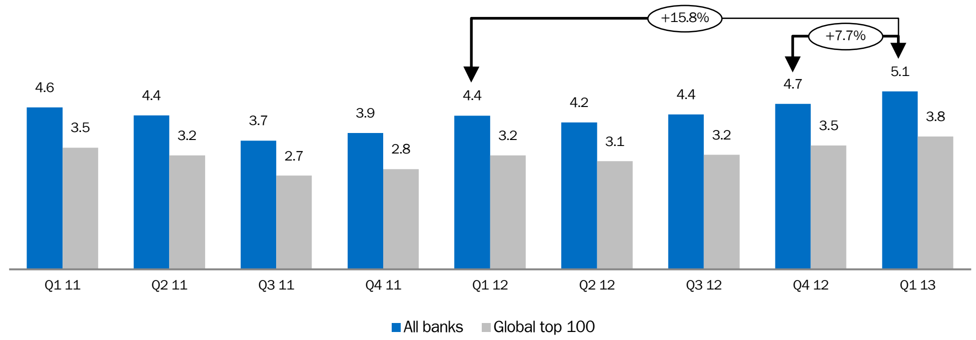
I. State of the banking industry

Market valuation

In Q1 2013, the global banking sector remained on its growth path in terms of market valuation. Market capitalization of banks rose the third quarter in a row and reached EUR 5.1 bn, the highest value since the beginning of the European debt crisis. Especially commercial banks from mature markets showed significantly improved price-to-book ratios.

Banks continued upward trend in Q1 2013

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



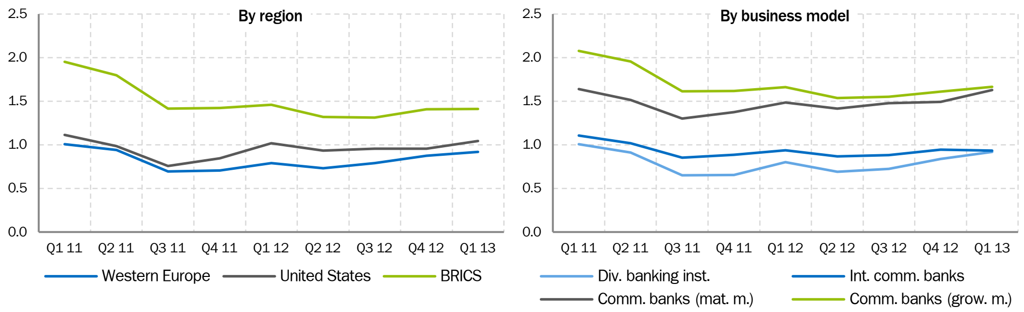
All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on 12/31/2012.
Source: Bloomberg, zeb/research

/ The market capitalization of all banks increased to a new two-year high with EUR 5.1 bn in Q1 2013, an overall growth of 7.7% in the last quarter and 15.8% compared to Q1 2012

/ In Q1 2013, the market capitalization of the entire sector and the global top 100 banks increased almost in parallel; the share of the largest 100 banks remained unchanged at 75%

Regionally focused commercial banks kept highest valuation

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. Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa.
Source: Bloomberg, zeb/research

/ With regard to regional distribution, banks from BRICS remained investors' favorites with a stable average price-to-book ratio around 1.4, US banks' valuation slightly improved and Western European banks' average P/B ratio remained below 1.0 for the eighth quarter in a row

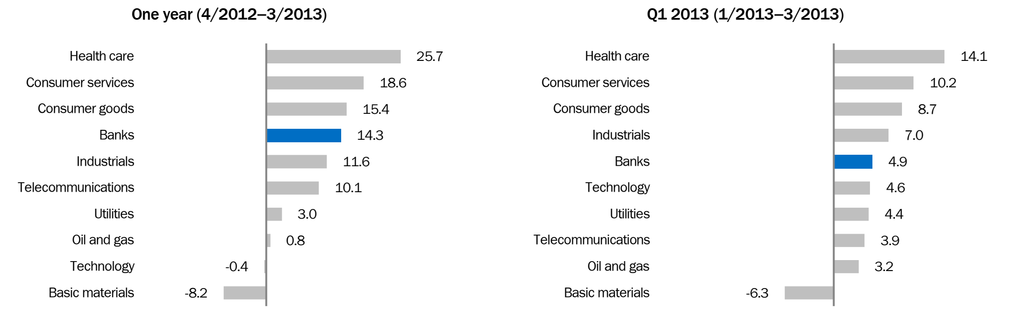
/ In view of business models, the P/B ratios of diversified banking institutions and international commercial banks remained below 1.0, while national commercial banks from mature markets caught up to their peers in growth markets with a P/B ratio around 1.7

Equity performance

After a strong recovery in 2012, the value creation of the global banking sector slowed down in Q1 2013. Regional and business model differences continued to exist and global top performers continued to generate value for their shareholders, while low performers had negative TSR performances.

Recovery of the banking sector slowed down

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

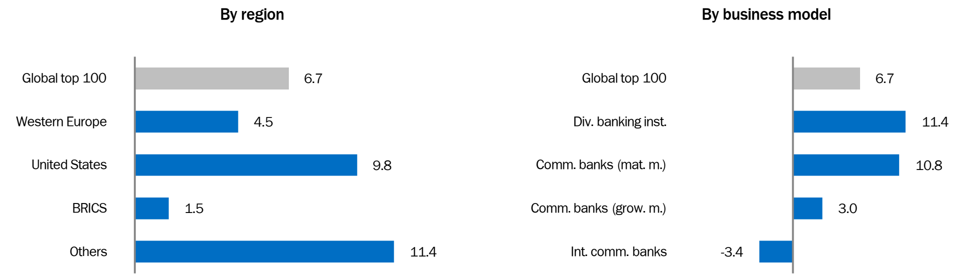


Total shareholder return of industry sectors based on global sector total return indices, aggregated and provided by Datastream.
Source: Datastream, zeb/research

- With total shareholder returns (TSR) of 4.9% in Q1 2013 and 14.3% year-over-year, banks showed a solid growth in recent past
- Especially health care and consumer goods and services outperformed the banking sector on a quarterly and year-over-year basis

Significant TSR differences across regions and business models

Fig. 4: Total shareholder return of global top 100 banks (1/2013–3/2013, in %)



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

- After a strong TSR development in Q4 2012, BRICS institutions generated almost no value for their investors in Q1 2013 in contrast to the other regions considered
- In line with increasing price-to-book ratios (Fig. 2), diversified banking institutions and commercial banks with a focus on mature markets showed the best TSR performance in Q1 2013; in contrast, international commercial banks, on average, even destroyed shareholder value

Fig. 5: Top/low TSR performers among global top 100 banks (1/2013–3/2013, in %)

Mixed regional pattern for top and low TSR performers

Global

Top performers	Country	TSR	Low performers	Country	TSR
Bank Rakyat Indonesia Persero Tbk PT	Indonesia	29.1	Royal Bank of Scotland Group PLC	Britain	-15.1
Mizuho Financial Group Inc	Japan	28.3	State Bank of India	India	-13.1
State Street Corp	United States	26.2	Intesa Sanpaolo SpA	Italy	-12.2
Bank Central Asia Tbk PT	Indonesia	25.3	Banco Santander SA	Spain	-12.0
Ping An Bank Co Ltd	China	25.0	China Merchants Bank Co Ltd	China	-11.8

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
Swedbank AB	Sweden	24.5	Royal Bank of Scotland Group PLC	Britain	-15.1
Svenska Handelsbanken AB	Sweden	24.5	Intesa Sanpaolo SpA	Italy	-12.2
Nordea Bank AB	Sweden	23.3	Banco Santander SA	Spain	-12.0
Skandinaviska Enskilda Banken AB	Sweden	23.3	UniCredit SpA	Italy	-10.1
DNB ASA	Norway	21.7	Société Générale SA	France	-9.6

Source: Bloomberg, zeb/research

/ Q1 2013 top and low performer rankings show no clear regional pattern, but the gap between top and low performers remains large: while global top performers generated > 25% of TSR, global low performers destroyed more than 10% in value

/ In Western Europe, Scandinavian banks clearly dominate the ranking with TSR rates above 20% due to their still very positive overall position with high profits, low risks and minor challenges compared to many of their European counterparts, and in addition, all mentioned Scandinavian banks were able to provide higher dividends to investors in Q1 2013

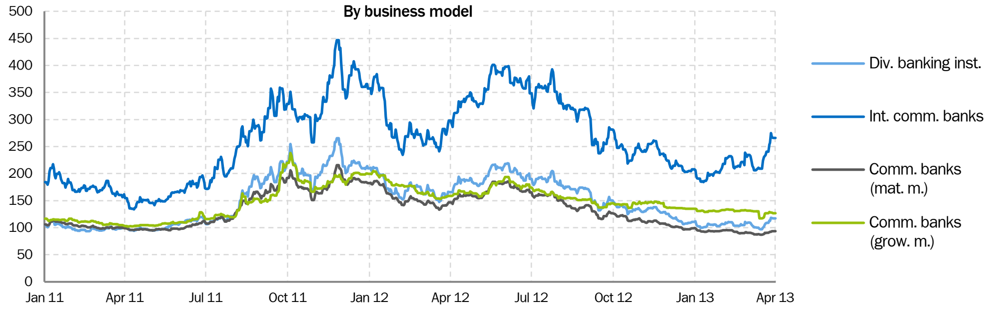
/ On the low performer side, Royal Bank of Scotland's stock price strongly decreased due to a negative earnings announcement (profit before tax 2012: EUR -6.4 bn)

Debt perspective

From a debt perspective, Q1 2013 showed slightly increased CDS spreads for Western European institutions and almost unchanged spreads for US and BRICS banks. The total number of rating changes remained on a normal level.

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

CDS spreads of international commercial banks increased noticeably

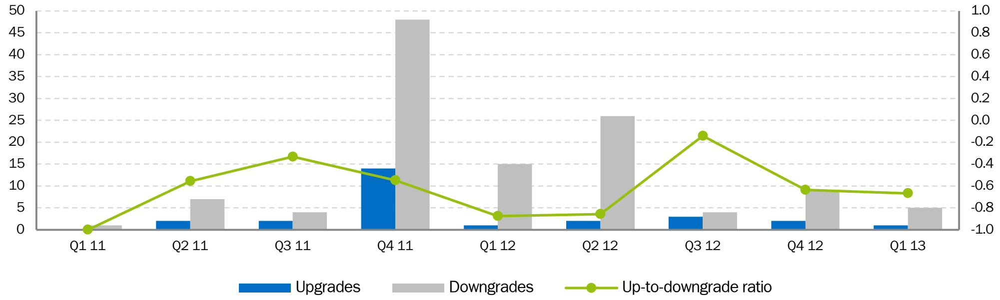


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Bloomberg, zeb/research

- In Q1 2013, CDS spreads of Western European banks increased noticeably by 34bp to 177bp, which can probably be explained by the exposure of Western European banks to the struggling Cypriot banking sector and the general fear that the European debt crisis might heat up again
- In contrast, the average CDS spread of US institutions continued to decrease and reached 94bp at the end of March 2013
- Among our business model clusters, CDS spreads of international commercial banks remained the highest and even increased by 58bp to 266bp, whereas the spreads of commercial banks with regional focus and diversified banking institutions moved sideways on lower levels between 90bp and 130bp

Fig. 7: Rating changes of global top 100 banks

Number of rating downgrades decreased



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: Bloomberg, zeb/research

- The number of rating downgrades of the global top 100 institutions decreased: After nine downgrades in Q4 2012, Q1 2013 brought only five, affecting two Italian institutions, namely Intesa Sanpaolo and Unicredit, two banks from the so far stable Canadian banking sector (Bank of Nova Scotia and Toronto-Dominion Bank) and the Standard Bank Group from South Africa
- As these downgrades were accompanied by only one upgrade, the up-to-downgrade ratio remained almost constant at -0.7

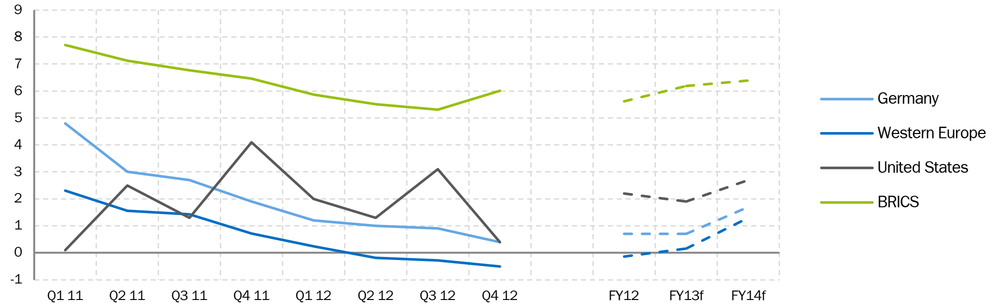
II. Key banking drivers

Economic perspectives

As banking performance is often highly correlated with general economic conditions, we will next investigate the general economic climate before we turn to more specific banking drivers.

Global economy cooled down in Q4 2012

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

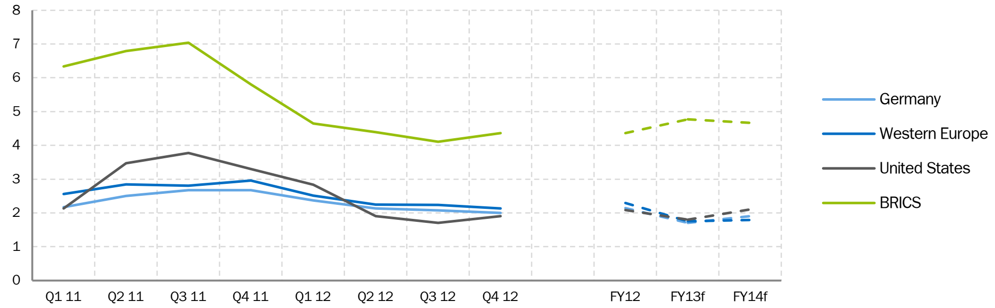


Q1 2013 data not yet available at the time of writing.
Source: Bloomberg, zeb/research

- The Western European economic recession continued for the third quarter in a row, while forecasts predict a return to modest growth by the end of 2013/beginning of 2014
- After a positive development in Q3 2012, even the US economy was hit hard in Q4 2012, as the growth rate significantly decreased to 0.4%; looking ahead, the unsolved fiscal cliff might further hamper the economic recovery in the upcoming quarters
- In BRICS countries, the average GDP growth has stabilized around 6.0%, which is well below the Q1 2011 value of 8.0%

Inflation rates remain relatively stable

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



Q1 2013 data not yet available at the time of writing.
Source: Bloomberg, zeb/research

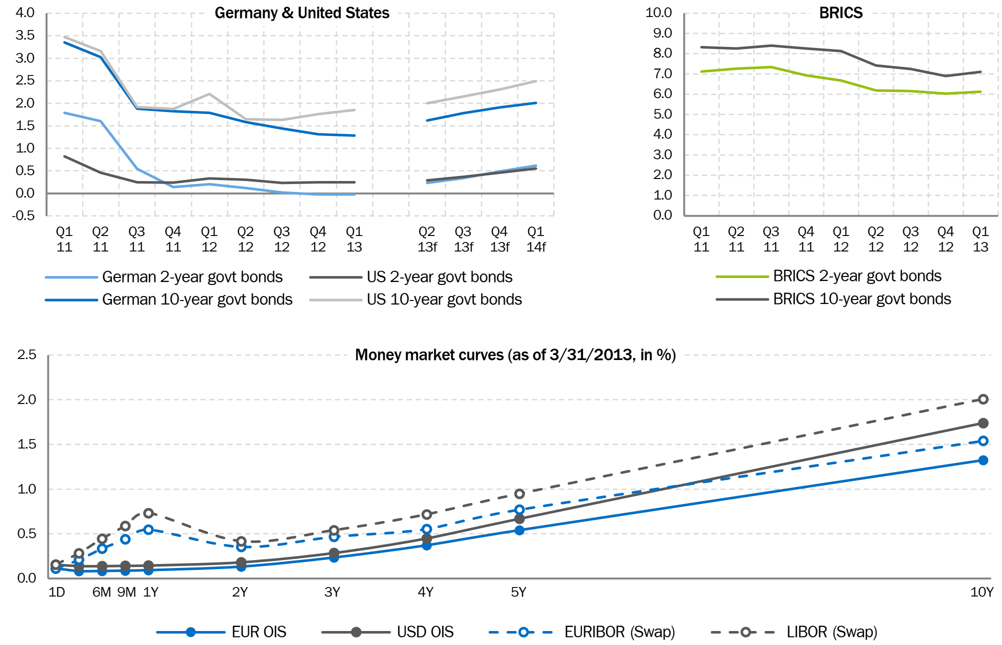
- In Q4 2012, inflation rates in Western Europe and Germany remained nearly unchanged, with forecasts predicting no significant changes
- In BRICS, consumer prices increased slightly due to the improved economic performance, but the average inflation is still under control and on a reasonable level for growing markets

Interest rates

German short-term government bond yields remained below zero in Q1 2013, whereas 2-year US bonds provided at least a small return for investors. In the customer business, the historically low EURIBOR rates are still not reflected in deposit and corporate lending rates.

Interest rates remained at historic lows

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

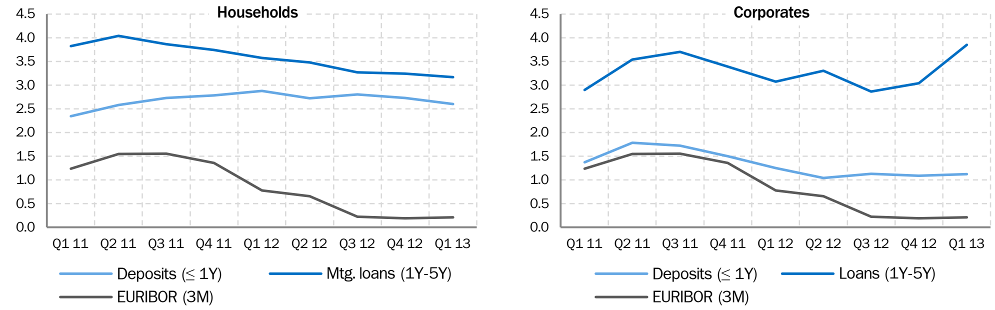


BRICS bond yields calculated as unweighted average, no forecast data available for BRICS countries. OIS denotes overnight indexed swap.
Source: Bloomberg, zeb/research

- In the current economic environment, Germany continued to profit from its safe haven status, as German 2-year bonds again exhibited slightly negative average interest rates in Q1 2013
- In the US, 2-year bond yields remained at their historic low, but 10-year bond yields rose again in the last quarter, which could be the result of higher uncertainties related to the future path of the US economy

EURIBOR only slightly above zero for third quarter in a row

Fig. 11: Deposit and lending interest rates in the euro area (new business rates) and EURIBOR (in %)



Source: European Central Bank, zeb/research

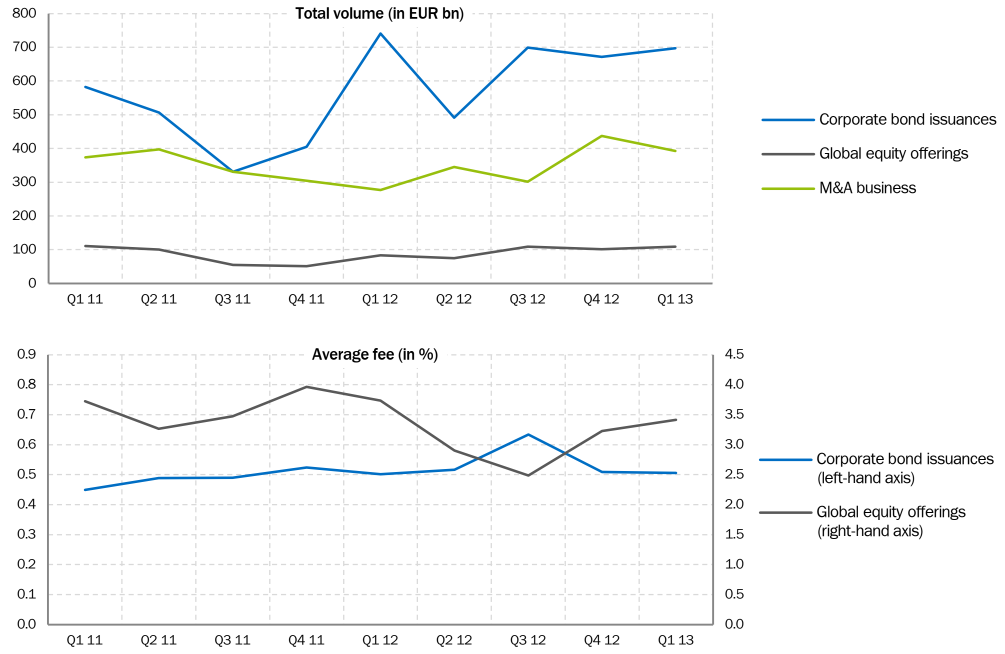
- In the last quarter, the 3-month EURIBOR remained nearly unchanged at 0.2%, but especially deposit rates are still not affected by this historic low interest level, thus reflecting the continued perception of deposits as a relatively cheap and stable funding base for banks
- In the lending business, corporate lending rates increased substantially by 0.8bp, thus raising the already high margins in this business area; the declining credit quality, especially in some European countries, might explain this observation

Investment banking activities

The global investment banking business exhibited decent results in Q1 2013. Volumes of corporate bond issuances and equity offerings improved slightly and remained on a relatively high level compared to previous quarters. In line with previous years, M&A deal volumes declined seasonally in the first quarter of the year.

Global investment banking with decent results in Q1 2013

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

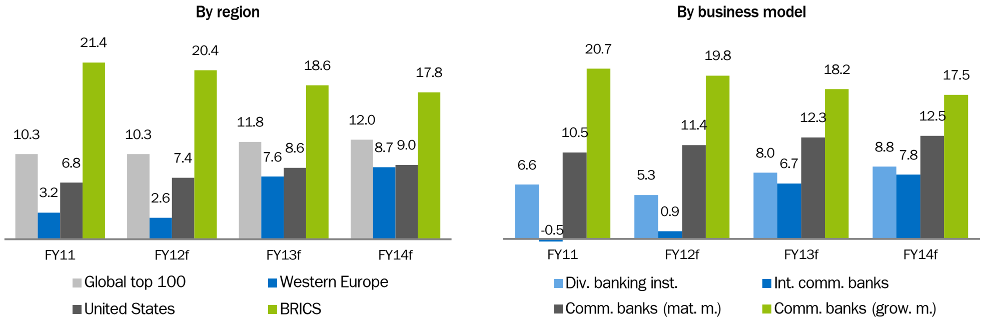
- In Q1 2013, global bond issuances again reached last quarters' high levels, indicating that companies and firms still heavily rely on bonds as a major refinancing source
- The global equity offering volume improved by 7.4% to nearly EUR 109 bn, continuing the long-term positive trend that started in early 2012; in combination with an improved average fee rate, the total fee volume rose to more than EUR 3.7 bn (+13.5%)
- The volume of M&A transactions decreased in Q1 2013, which is in line with the seasonal pattern of previous years

Banking profitability

After two difficult years, analysts' consensus forecasts expect improving Return on Equity (RoE) figures in 2013. Nevertheless, the overall profitability of Western European and US banks will remain significantly below 10% even in 2014, implying that many banks will not be able to earn their cost-of-capital. This situation might not change fundamentally as long as the economy lacks growth dynamics in most regions and interest rates remain at low levels.

Improving but still low RoE figures for 2013 expected

Fig. 13: 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

/ Based on current forecasts, the RoE of Western European institutions is expected to grow from a very low level of 2.6% in 2012 to 7.6% in 2013 and 8.7% in 2014

/ However, given current indicators for weaker economic fundamentals, these RoE forecasts have been significantly reduced in the last quarters and further reductions have to be expected

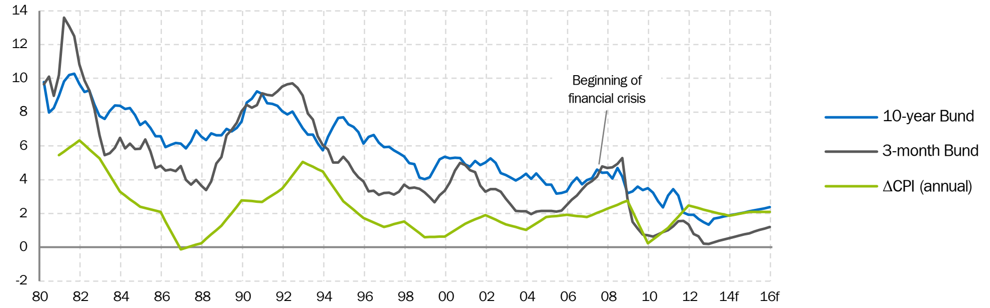
III. Special topic

Succeeding in a low interest rate environment

As already discussed in Chapter 2, currently, the interest rates in stable European economies are at historically low levels. For example, German 10-year Bunds and 3-month Bunds are as low as 1.4% and 0.0%, respectively. In this chapter, we briefly investigate the reasons underlying this interest rate environment and likely future developments and give some insights into banks' strategic responses.

Historically low interest rates in the euro area

Fig. 14: Long-term development of German interest and inflation rates (in %)



curves represent return rates of German government bonds. ΔCPI (annual) represents annual change of German consumer price index.
Source: Reinhart/Rogoff: "This Time is Different", IMF World Economic Outlook, Deutsche Bundesbank, Bloomberg, zeb/research

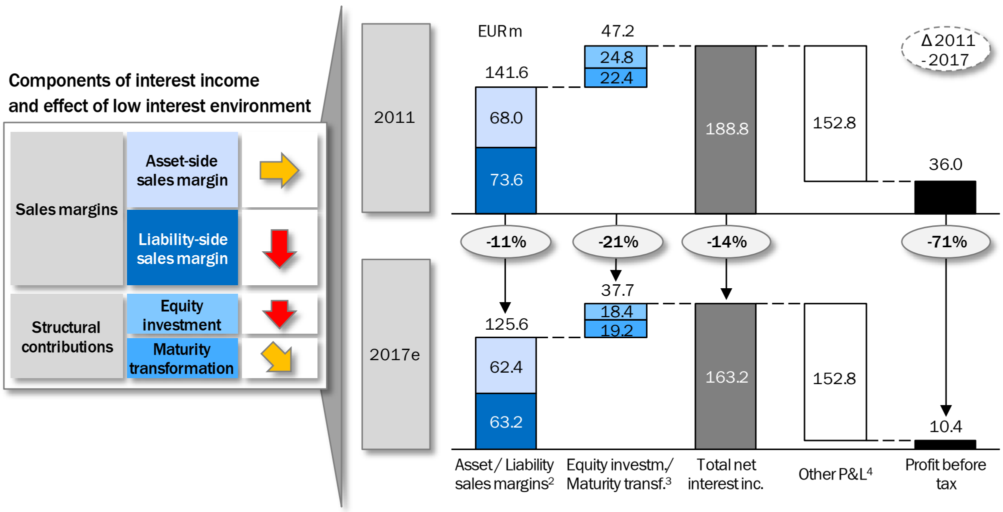
Financial repression likely to continue

Many economists agree that today's low interest rates are signs of a financial repression, which, from a historical perspective, is the most effective measure to overcome financial and/or sovereign debt crises. Low real interest rates, together with a relatively high inflation, allow sovereigns to slowly clear off their debt simply by loss of value. To do so, monetary policy and macroprudential regulation may be forced to keep interest rates low. As the euro area is only at the beginning of sovereign de-leveraging, it is to be assumed that financial repression and low interest rates will continue for quite some time.

Retail revenues, in particular, under strong pressure

For the banking industry, this economic scenario is a considerable challenge, as in a low interest rate environment, margins tend to be squeezed. Particularly retail banks are likely to experience a sharp decline in net interest income, especially if they are highly dependent on variable deposit products. With the strong competition in the market, deposit rates can hardly be lowered any further. Average opportunity interest rates available for such products, however, become lower with each high-yield tranche being replaced by a new low-yield tranche. Banks thus experience a significant loss in margin. Model calculations for a typical retail bank show that net interest income may be reduced by nearly 14% until 2017: with all other P&L positions constant, this translates into a loss of more than 70% in profit before tax.

Fig. 15: zeb/ model calculation for retail banking[1]



1) zeb/ model calculation for average retail bank on the basis of carrying forward the 2011 business structure and the 2012 interest rate level
2) Total net interest income of private and corporate clients 3) Total net interest income of Treasury 4) Total fee income, risk costs, G&A costs, etc.
Source: zeb/

Other business models face similar challenges to their revenue pools. The following figure shows simulation results for three additional types of banks.

Fig. 16: zeb/ model calculation for different business models[1]

Simulation of change in results by 2017	Retail	Landesbank	Building Society	Pfandbrief-bank
Sales margins	-11%	-9%	-18%	-7%
Structural contributions	-21%	-22%	-8%	-24%
Net interest income	-14%	-12%	-23%	-11%
Other P&L[2]	+/- 0%			
Profit before tax	-71%	-30%	-47%	-32%

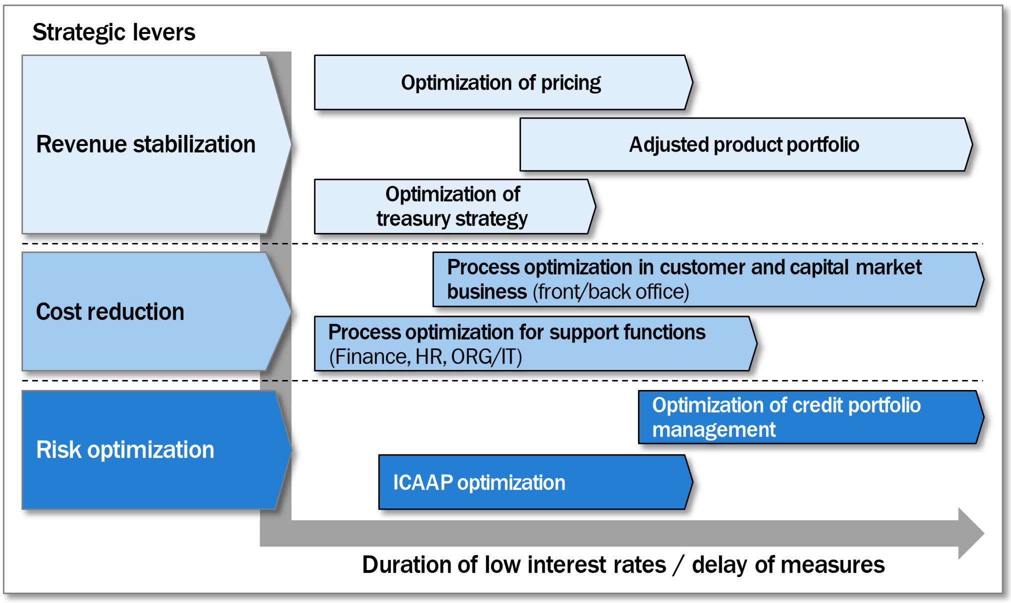
1) zeb/ model calculation for typical institutions on the basis of carrying forward the 2011 business structure and the 2012 interest rate level
2) Assumed constant
Source: zeb/

Response to low interest rate environment needed

With future profits severely under pressure, banks should consider a broad portfolio of strategic measures to act on the low interest rate environment. On the revenue side, pricing and portfolio optimization projects can help to stabilize revenues from customer business. Similarly, banks should review their current maturity transformation strategy and evaluate whether there are strategies that promise a better risk-return relationship given the expected interest rate development. Cost reduction seems a must, particularly for institutions that face heavy competition in the market. Here, both front and back-office processes as well as support functions such as Finance and HR should be examined. Finally, an optimization of the risk situation could become part of the interest rate response scenario.

Fig. 17: Strategic initiatives in a low interest rate environment (exemplary)

Strategic initiatives to address revenue, cost and risk dimensions



Source: zeb/

In order to define a set of measures adapted to the specific needs of the institution, banks should think about the optimization potential associated with each individual measure, the required implementation effort and its robustness in a changing interest rate environment. However, best-practice experience shows that banks which rely on joint expertise from multiple functions, e.g. via the setup of an interest rate "task force", are likely to come up with the most differentiated and effective set of strategic initiatives to act on the low interest rate environment.

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 due date April 2, 2013. The global top 100 banks cluster contains the largest banks by market capitalization on 12/31/2012 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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