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Solid performance of the banking sector in Q3 2014, despite increasing global uncertainties

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Key topics

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

- Global banking industry with significant increase in market cap and solid TSR performance—global top 100 banks are best-performing industry in Q3 2014
- Stable CDS spreads—AQR and stress test uncertainties not yet reflected

II. Key banking drivers (p. 7)

- Strong GDP growth in the US accompanied by a rise of inflation and interest rates and improving loan quality
- Interest and inflation rates further decreased in Germany
- Shrinking global investment banking revenues—volumes down by more than 20%

III. Special topic: Bank separation and RRP—The end of universal banking? (p. 12)

- Structural separation and recovery & resolution initiated to solve the "too big to fail" problem
- Structural reforms will significantly affect profitability of universal banks (RoE cost of 1.5-3.4pp)—strategic response required

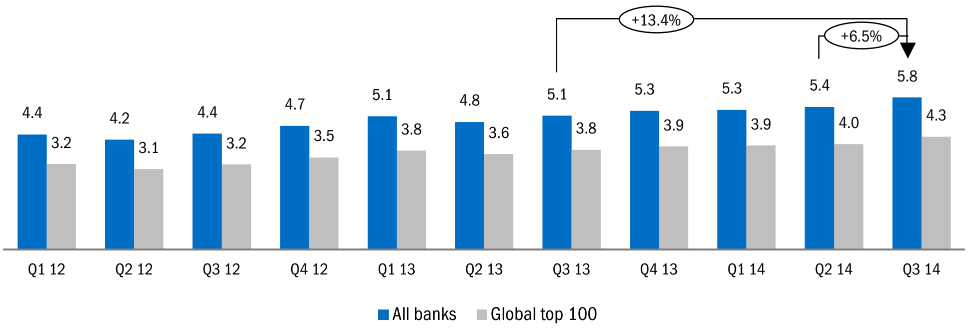
I. State of the banking industry

Market valuation

Market capitalization of the global banking industry improved significantly by 6.5% in Q3 2014 (13.4% year-over-year), reaching EUR 5.8 trillion. The remarkable increase in valuation of investment banking institutions continued. As a result, investment banks reached the highest average P/B ratio of all business models for the first time (outperforming retail banks).

Banking sector's market cap with a significant increase in Q3 2014

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

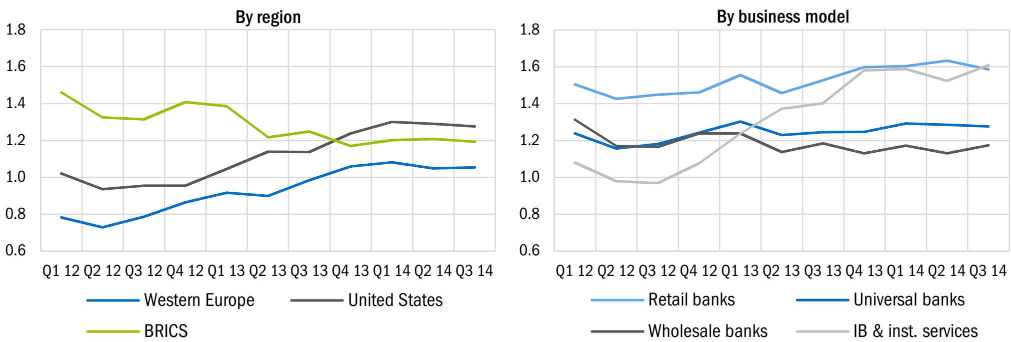


All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2013.
Source: Bloomberg, zeb.research

- Market capitalization of the global banking sector jumped by 6.5% in the third quarter of 2014, continuing the growth trend that began at the start of 2012
- The market cap of the global top 100 banks increased even stronger by 7.0% in Q3 2014

Investment banking institutions with highest P/B ratio among business models since the financial crisis

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



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

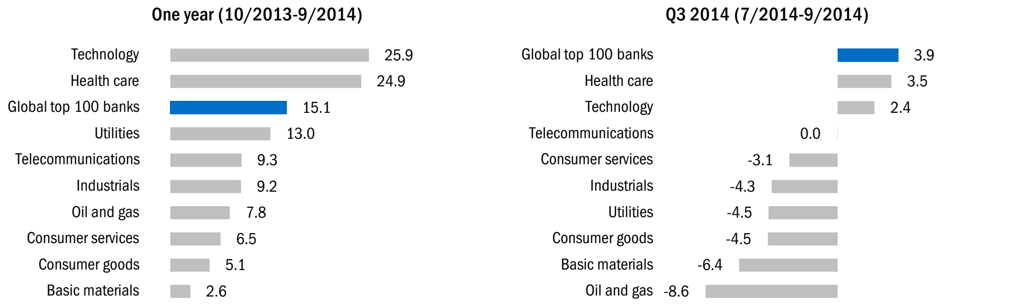
- Investment banking institutions continued their growth in valuation, for the first time reaching the highest P/B ratio of all banking business models at 1.6 (+5.6% qoq), whereas retail banks decreased below 1.6 (-2.9% qoq) after having been on top since the financial crisis
- Fundamental gaps persisted in Q3 2014 from a regional perspective, with US institutions still ahead of banks from BRICS and Western Europe

TSR performance

Global equity markets look back on a tough third quarter 2014, as most industry sectors destroyed shareholder value. However, after achieving the lowest TSR in Q2 2014, global top 100 banks jumped to the top of the industry ranking, showing the best performance of all sectors with 3.9% in Q3 2014. This is also reflected in a solid year-over-year performance of 15.1%.

Banks on top of industry sectors in a difficult market environment

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

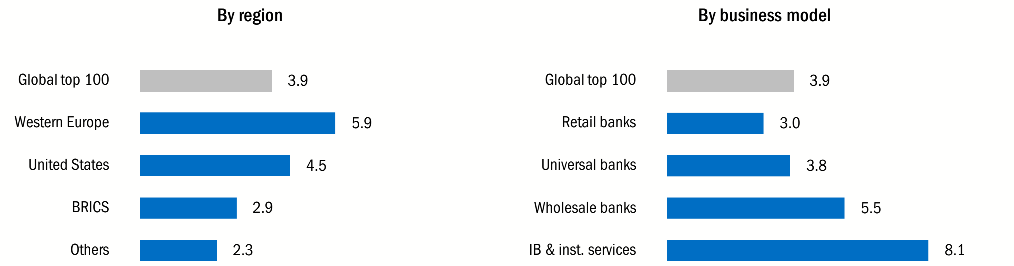


Total shareholder return of industry sectors other than banking are based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream.
Average total shareholder returns of global top 100 banks are weighted by the market capitalization of each bank.
Source: Bloomberg,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

- After solid performances in the last quarters, global equity markets were hit by the ongoing political crisis hotspots in Q3 2014
- Global top 100 banks are on top of all industry sectors in the last quarter and among the best year–over–year

All banking clusters with a positive TSR performance in Q3 2014

Fig. 4: Total shareholder return of global top 100 banks (7/2014–9/2014, in %)



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

- Western European institutions recovered from TSR losses in Q2 2014 by increasing TSR by 5.9% in Q3, followed by US banks with 4.5% TSR; however, uncertainty remains within the Western European banking sector due to the eagerly awaited AQR and stress test results that will be published by the end of October 2014
- In terms of business models, investment banking & institutional services institutions showed the best performance with 8.1%—especially French Natixis (16.4%), Chinese Haitong Securities (12.8%) and US Goldman Sachs (10.0%) performed well, despite lower total revenues in the global investment banking business (fig. 11) and growing uncertainties on the capital markets (fig. 3)

Two Russian banks among global low performers

Fig. 5: Top/low TSR performers among global top 100 banks (7/2014–9/2014, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
Qatar National Bank	Qatar	24.2	Erste Group Bank	Austria	-23.2
Allied Irish Banks	Ireland	19.2	Sberbank	Russia	-10.6
Bank Central Asia	Indonesia	18.9	State Bank Of India	India	-9.0
First Gulf Bank	UAE	17.9	Standard Bank Group	South Africa	-8.1
Natixis	France	16.4	VTB Bank	Russia	-7.5

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
Allied Irish Banks	Ireland	19.2	Erste Group Bank	Austria	-23.2
Natixis	France	16.4	Standard Chartered	UK	-3.0
Credit Agricole	France	16.0	Nordea Bank	Sweden	-0.4
Royal Bank Of Scotland Group	UK	12.1	Banco Santander	Spain	1.8
Caixabank	Spain	8.1	Unicredit	Italy	2.4

Source: Bloomberg, zeb.research

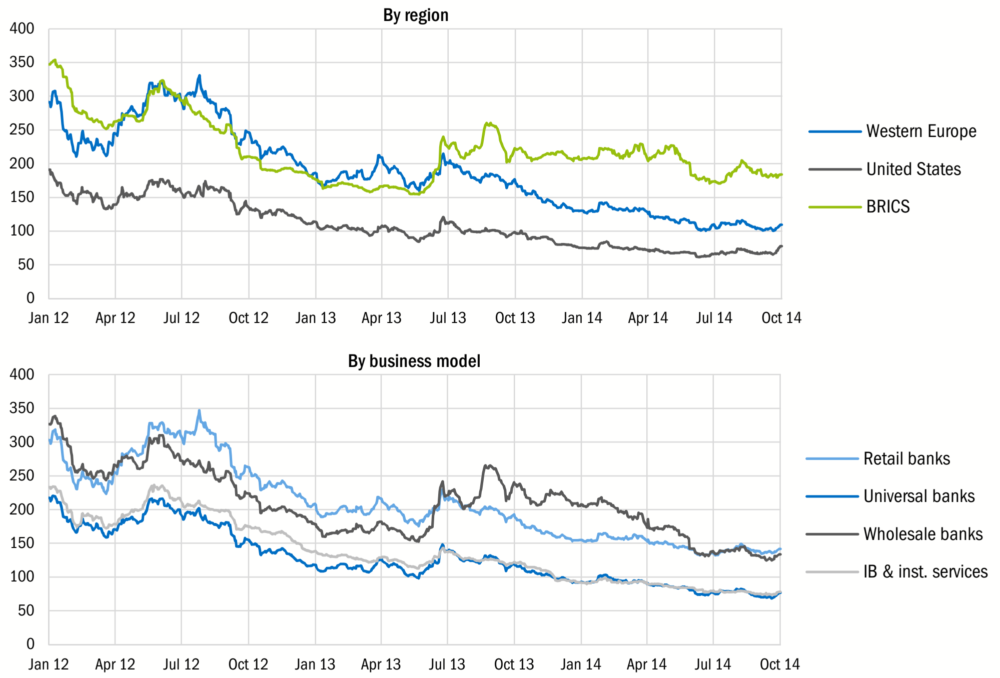
- Sberbank and VTB Bank suffer from the ongoing political tensions and appear among the low performers in Q3 2014; especially VTB is affected by the US' and EU's sanctions as the group's profit of the first six months 2014 dropped by more than 80% and full-year profit is expected to be even negative
- List of top performers in Western Europe contains several institutions that were hit hard by the crises over the last years, e.g. Allied Irish Banks, Natixis or Royal Bank of Scotland
- Top performer Allied Irish Banks continues its highly volatile path in 2014 (+26.8% in Q1 and -36.6% in Q2)
- Among low performers, the TSR of Erste Group Bank (-23.2%) was affected by reported losses, high NPL ratios in CEE countries and rating downgrades by Moody's and S&P (fig. 7)

Debt perspective

From a debt perspective, the situation of global top 100 banks did not show any fundamental changes in the last quarter. CDS spreads remained more or less steady for regional and business model clusters and the rating agencies' view on the banking sector also remained unchanged.

CDS spreads almost unchanged

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

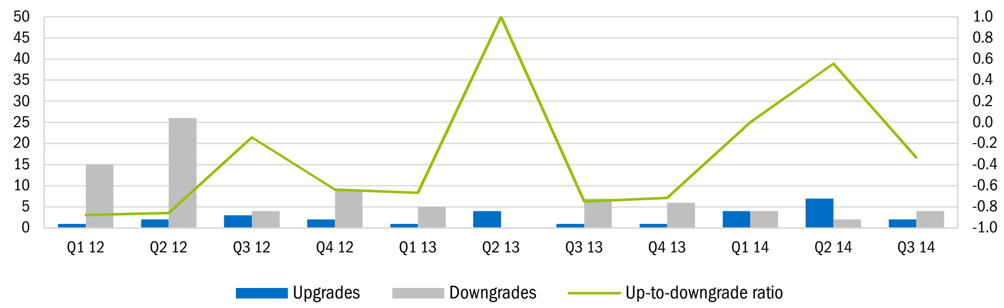


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Thomson Reuters Datastream, zeb.research

- CDS spreads remained steady in Q3 2014
- Overall, the spread level for US and Western European institutions remained at a low level, especially in the US, with an average spread of less than 80bp
- The general differences between business models still persist, as the spreads of retail and wholesale institutions are approximately 60bp above the average spread of universal and investment banks

Few rating changes in Q3 2014

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



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

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 Q3 2014, among the global top 100 banks only five were affected by rating changes: ratings improved for State Street (US) and Bank of Nova Scotia (Canada), downgrades applied to Deutsche Bank (Germany), Standard Bank and (South Africa) and Erste Group Bank (Austria)
- Investors' reaction to Erste Group Bank's downgrade can be seen in the bad TSR performance (fig. 5), which was the lowest among all global top 100 banks (-23.2%) in Q3 2014
- The average rating of 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

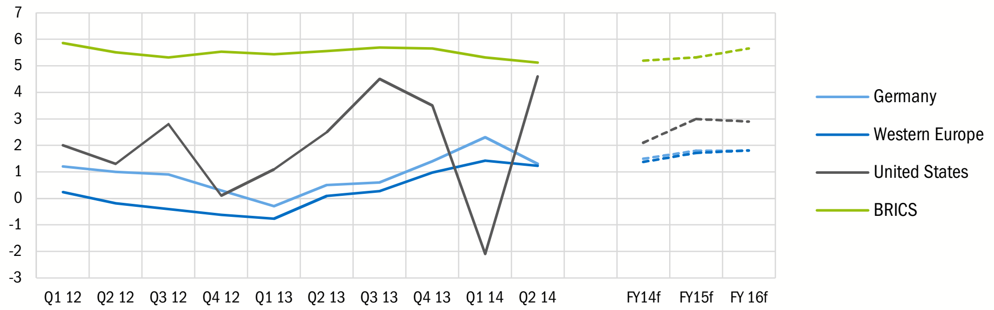
II. Key banking drivers

Economic perspectives

The global economic development saw a sharp increase of the US GDP growth from -2.9% to 4.6%, reaching growth levels of BRICS countries. Consumer prices in the US and BRICS countries also increased, while inflation rates in Germany and Western Europe continued to decrease.

Strong GDP growth in the US

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

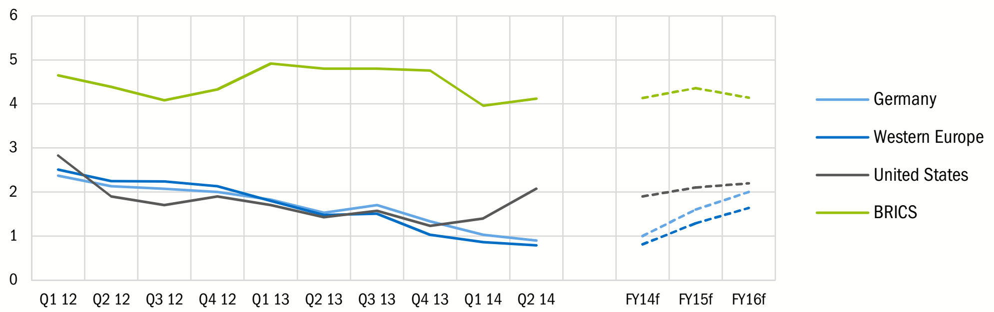


Q3 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb.research

- After shrinking in Q1 2014, the US GDP grew by 4.6% in Q2 2014, reaching growth levels of BRICS countries
- Germany's GDP growth dropped by 1.0 pp to 1.3% and is now at the same level as the average GDP growth rate of Western Europe—Western Europe's GDP growth suffers from France's weak economic development (GDP growth dropped by 0.7 pp to almost zero (0.1%) in Q2 2014)

Inflation rates increase in US and BRICS—Germany's inflation rate further decreasing

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



Q3 2014 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb.research

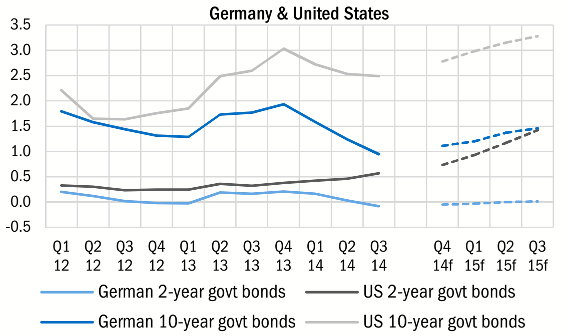
- Germany's inflation rate declined further to 0.9% in Q2 2014—the same can be observed for the whole Western European area
- Inflation stabilized in BRICS countries after a drop in the previous quarter and slightly increased to 4.1% in Q2 2014—US consumer prices increased by almost 2.1%, which is the Fed's target inflation rate for upcoming years

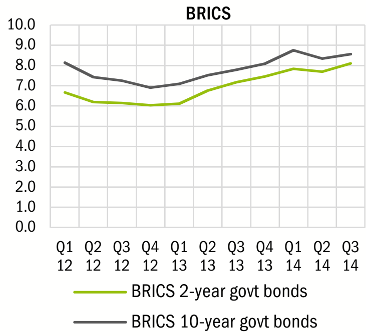
Interest rates

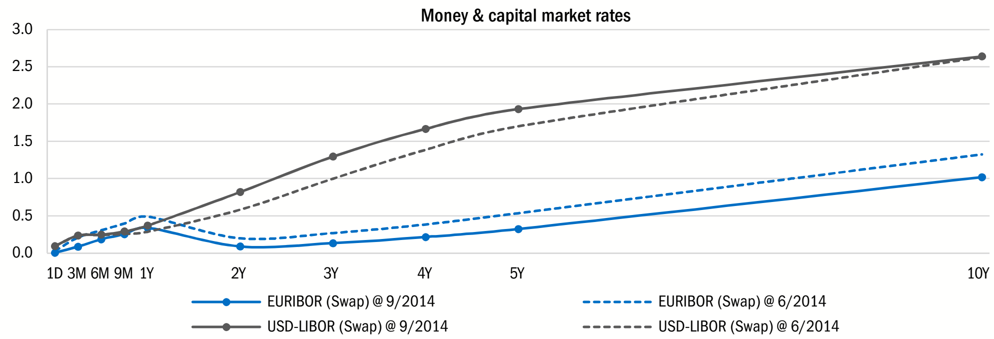
In September 2014, the ECB further reduced the central rate for the euro area once more to 0.05%. The deposit facility rate decreased to -0.2% and remains a "penalty rate". In this monetary environment, yields on German government bonds dropped to a historical low. In contrast, increased US short-term government bond interest rates led to a flatter yield curve.

German interest rates reach historical low

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

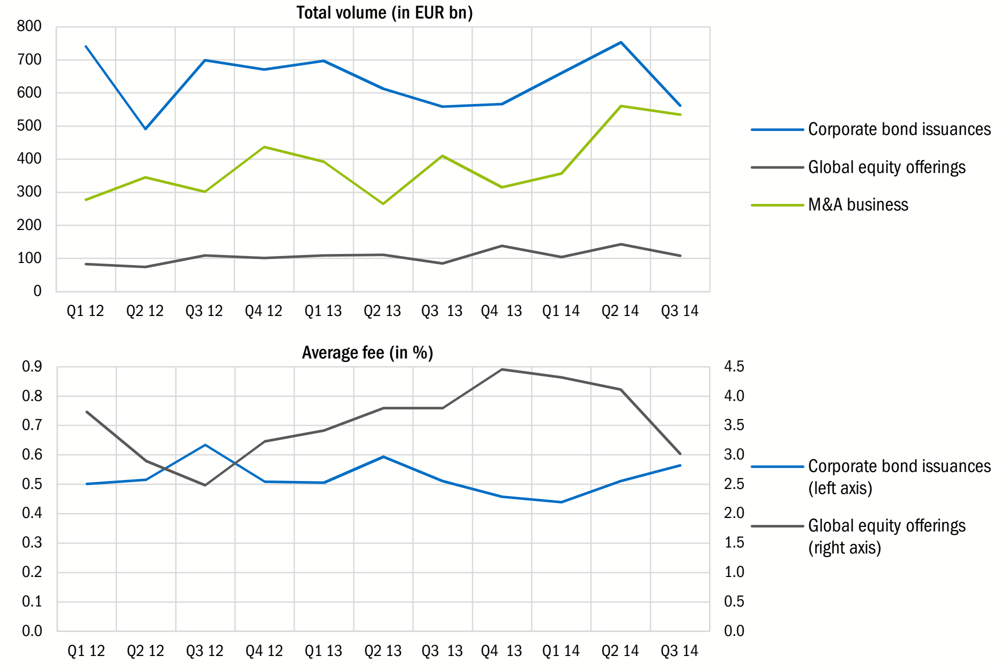
- Interest rates in the US start to increase, while recent ECB decisions lead to a historic low of German interest rates
- Yield curves further flattened, but drivers differ for the US and Germany: while the US yield curve flattened due to the strong increase of short-term interest rates, the German yield curve flattened due to the decreased long-term interest rates
- While the low interest rate environment in the euro area is expected to continue in the medium term, the US Fed is about to end its asset purchase program and is expected to increase interest rates in the middle of 2015—this is reflected in strongly increasing US yields forecasts for the upcoming quarters

Investment banking activities

Overall, the past quarter showed a negative development in all fields of the traditional investment banking business. Whether on debt, equity or M&A markets, deal volumes decreased in Q3 2014. Only the average fee on bond issuances showed a positive development.

Investment banking revenues decreasde in Q3 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

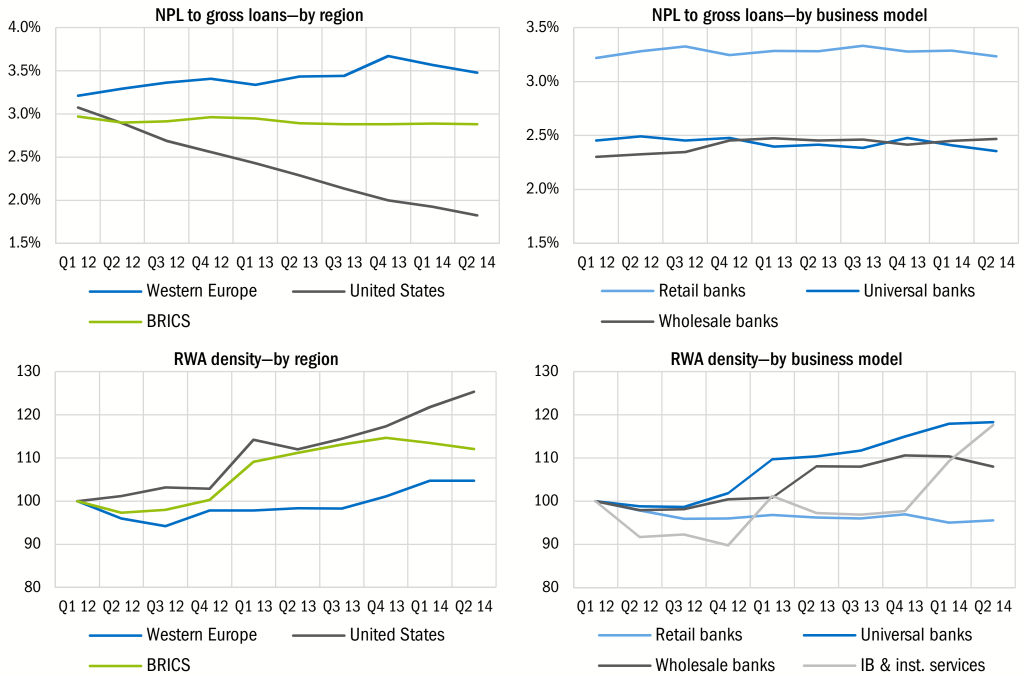
- The global bond issuance volume fell by 25% compared to the previous quarter—however, with increasing average fees (+11% qoq)
- Equity offerings suffered the most, with a 24% drop in volume and a decrease of the average fee by 27%—however, prominent offerings like Alibaba in the US and Zalando and Rocket Internet in Germany give a positive signal

Risk indicators

Balance sheet-based risk indicators of global top 100 banks show structural differences between regional clusters and business models. The non-performing loans (NPL) to gross loans ratio of US banks decreased at an almost constant rate since 2012 and is well below 2%, based on 2014 semi-annual reports data. The share of NPL in their loan book decreased for another quarter.

Loan quality improved in the US – stable in Western Europe and BRICS

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. Q3 2014 data not yet available at the time of writing.
Source: Bankscope, zeb.research

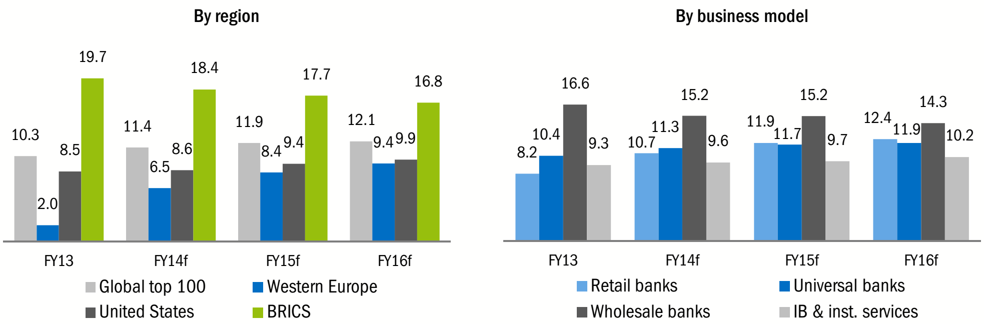
- US institutions continue to improve their NPL to gross loans ratio, mainly thanks to favorable economic conditions over the past quarters that have led to a decline of non-performing loans by 37% since the beginning of 2012; at the same time, US banks' gross loans remained stable, while Western European institutions showed a significantly higher NPL to gross loans ratio (about 3.5%)
- The increase in US loan quality is accompanied by an increasing risk appetite, as RWA density further increases in the US: US institutions increased their RWAs over the last 2 years (+17.8% since Q1 2012) despite a decreasing NPL ratio and only low balance sheet growth (+2.1%)—in the same period, Western European banks cut both RWAs (-4.8%) and especially total assets (-9.3%), resulting in only a slight increase of the RWA density

Banking profitability

For Western European banks, analysts' expect a clearly better performance in upcoming years. However, Western Europe will remain the least profitable market among regions, but is expected to catch up with the US until 2016 in terms of RoE. 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. It will remain on top of other business models despite a decreasing performance until 2016. The retail banking business is expected to improve its profitability until 2016 and will outperform universal banking as well as investment banking.

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

Forecasts expect moderate profitability growth – only retail banking with positive growth outlook



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 2013, current forecasts expect a better performance in 2014—however, the "double burden" of the low interest environment and regulatory requirements still challenge the recovery of profits in European banking
- With the exception of retail banking, forecasts expect only moderate profitability growth—the retail banking sector is expected to exceed 10% RoE in 2014 and will thus outperform universal banks and investment banking by 2016

III. Special topic

Bank separation and RRP—the end of universal banking?

Structural reforms to end Too Big To Fail problem

Since the financial crisis 2007, the G-20 have initiated several measures for a reform of the financial markets, e.g. higher capital requirements, the new leverage ratio, convergence of accounting standards and the definition of G-SIBs (global systemically important banks). In the context of the "too big to fail" (TBTF) problem, which forced several sovereigns to rescue banks from collapsing, a discussion about "structural separation" and "recovery & resolution plans" (RRP) evolved.

Separation plans for stable and adverse conditions

Both measures are part of the structural reform but differ in their main principles. The basic principle of structural separation is to protect retail banking services from risks in trading units by permanently separating the two activities in separate legal entities. The structural separation reduces complexity, which is a prerequisite for a cost-efficient resolution in case of a bank failure. RRP's primary target is to avoid failures of systemically important banks to maintain financial stability and minimize losses for society if the recovery plan is not successful. Both measures, structural separation and RRP, have the common objective to solve the "too big to fail" problem.

Fig. 15: Overview of structural separation approaches

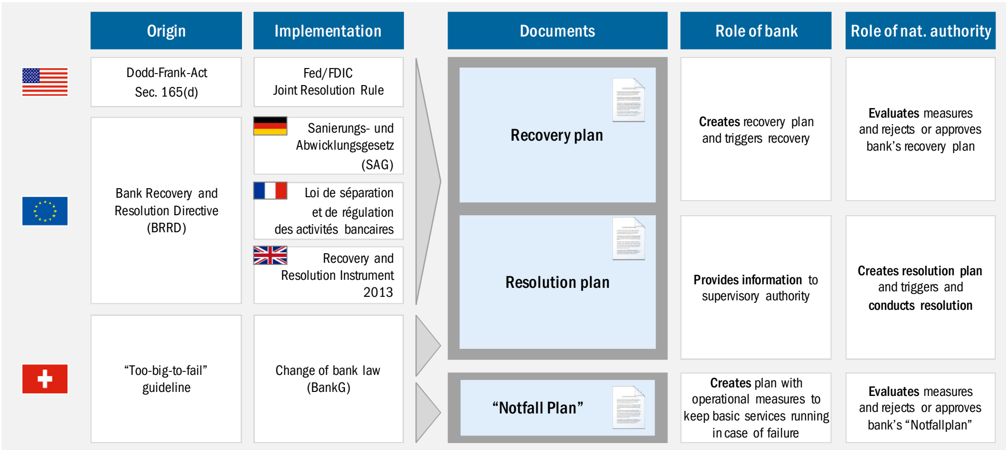
	EU	GER	FR	UK	US
Current status	Proposal for regulation	Regulation (implementation ongoing)		Proposal for regulation	Regulation (implemented)
Type of separation	Prohibition + trading entity in bank holding	Trading entity in bank holding		Ring-fencing of retail bank	Prohibition/exclusion from bank (holding)
Separated activities	Prop. trading & hedge-fund inv. prohibited; market-making under assessment	Proprietary trading, investments into & services for hedge funds transferred to trading entity; market-making under assessment		Like GER and FR but market-making also transferred to trading entity	Prop. trading & hedge-fund investments prohibited
Thresholds	Trading portfolio ≥ EUR 70 bn or 10% of B/S	Trading portfolio ≥ EUR 100 bn or 20% of B/S	To be defined	Core deposits (retail) ≥ GBP 25 bn	–

Source: zeb

Different structural separation approaches in Europe and the US

Different approaches for structural separation exist in Europe and the US. They differ in the scope of activities, the degree of separation and the size of banks that will be affected. The current EU proposal prohibits proprietary trading, but softens the original Liikanen proposal as the principle of a general separation of market-making is no longer included. However, the final EU regulation will not be finalized before 2016. French and German governments surged ahead with national laws. Compared to the EU proposal, German law allows proprietary trading in an independent trading entity and defines higher thresholds. At the moment, only Deutsche Bank and UniCredit are expected to be affected by the German law. The French approach is very similar to the German one, but thresholds are not yet defined—however, all large French universal banks should be affected. Within Europe, UK regulators follow the most extensive approach of separation by defining a broad scope of activities to be transferred out of the ring-fenced retail bank. However, due to the focus on customer deposits upon defining the thresholds, only domestic UK banks seem to be affected at the moment. In the US, the Volcker-Rule prohibits proprietary trading and applies to any deposit-taking US bank and US-related business of non-domestic institutions. Switzerland currently does not have an initiative to separate banks, after the structural separation initiatives were dismissed by the Swiss council of states in March 2014.

Fig. 16: Overview of RRP approaches



Source: zeb

RRP-approaches more convergent

Regarding RRP, regulators across the globe follow more convergent approaches with two central documents. Banks have to define triggers and measures within a recovery plan for adverse circumstances, which is evaluated by national authorities regarding its feasibility. In contrast, the resolution plan is created by national authorities. Banks only provide necessary information requested by the supervisors.

Structural reform will affect profitability of universal banks

Overall, large European banking groups expect that structural reform requirements will increase costs and ultimately reduce profitability. A directional estimation by zeb confirms the presumption that especially universal banks will suffer strongly in terms of RoE performance due to their significant investment banking activities. They have to face one-time reorganization and separation efforts, permanent costs for running separated legal entities, increased funding costs due to limited intra-group funding and decreased revenues due to the prohibition of proprietary trading and investments in hedge-funds. An initial analysis by zeb.research estimates that, altogether, these costs will reduce profitability in terms of RoE by 1.5-3.4 percentage points.[1] It seems that these costs are not fully reflected in the forecasts (see fig. 13).

Structural reforms with strategic dimension

The structural reforms demand fundamental organizational changes, which affect many aspects and dimensions of a large and complex banking group (i.e. capital allocation, bank management, IT infrastructure, legal/tax issues, liquidity management, etc). It is important for bank managements to realize that the structural reforms are not just "regulatory requirements" that need to be implemented. The planned initiatives and resulting dissynergies have a strategic dimension that can lead to a realignment of the bank's business model and/or geographic scope.

[1] Details are provided on request.

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 October 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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