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Western European banks' strong performance driven by ECB—US and BRICS banks destroying value

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Key topics

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

- Global banking industry with moderate TSR performance in Q1 2015 (3.1%)—still top performer on a year-over-year basis
- Western European banks heavily benefiting from ECB's quantitative easing
- CDS spreads for BRICS banks decreased slightly due to calming of markets in Russia—but negative outlook for profitability

II. Key banking drivers (p. 8)

- BRICS GDP growth under pressure—drop by 1 pp expected for Q1 2015 and forecast adjusted downwards
- Western Europe and US with inflation rates slightly above zero and partially negative for Q1 2015
- ECB's quantitative easing further decreases yield curves in Germany

III. Special topic: The power of central banks (p. 12)

- ECB and SNB with historic decisions driving European markets
- Besides direct effects, banks also have to deal with uncertain second-round effects

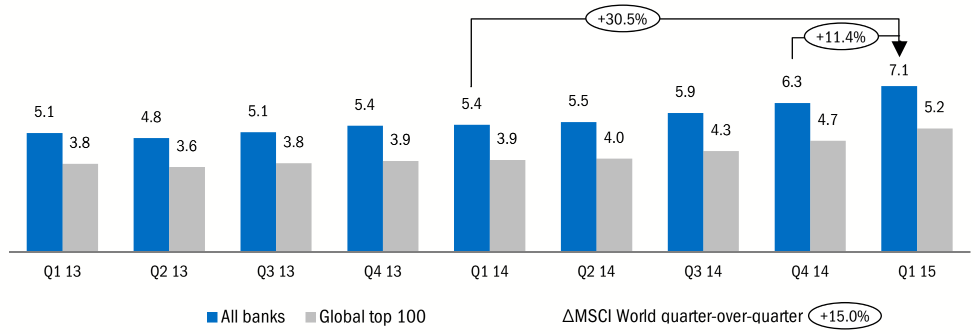
I. State of the banking industry

Market valuation

Continuing the growth in recent quarters, market capitalization of global banks increased further by 11.4% in Q1 2015. However, the total market (as measured by the MSCI world) grew by 15.0%, inter alia, due to the appreciation of foreign currencies in the same period. Global banks reached a market cap. of EUR 7.1 trillion. Regarding market valuation, price-to-book ratios of global top 100 banks converged to a corridor of 1.2 to 1.4.

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

Banking sector showed ongoing market cap. boost

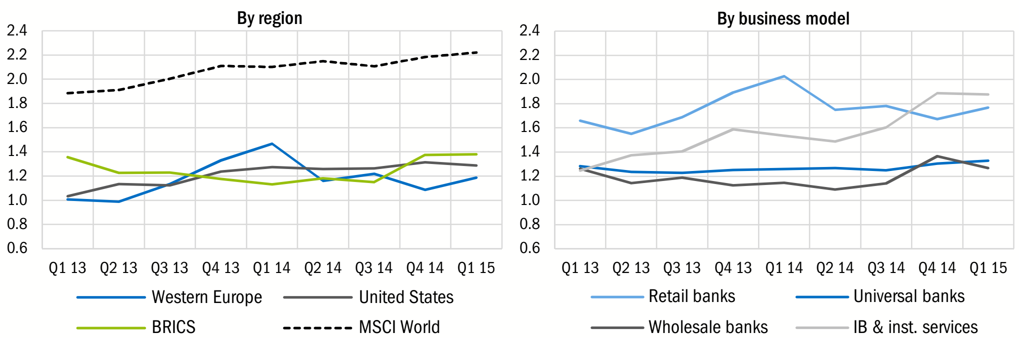


All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2014.
Source: Bloomberg, zeb.research

- The strong increase of market capitalization of the global banking sector continued in Q1 2015—a plus of 30.5% year-over-year for all banks and even 33.7% for global top 100 banks
- Despite strong performance, the banking sector is lacking behind the global market (MSCI world): +11.4% quarter-over-quarter for banks vs. +15% quarter-over-quarter for the global economy

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

Retail and IB & inst. services banks still ahead of universal and wholesale 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

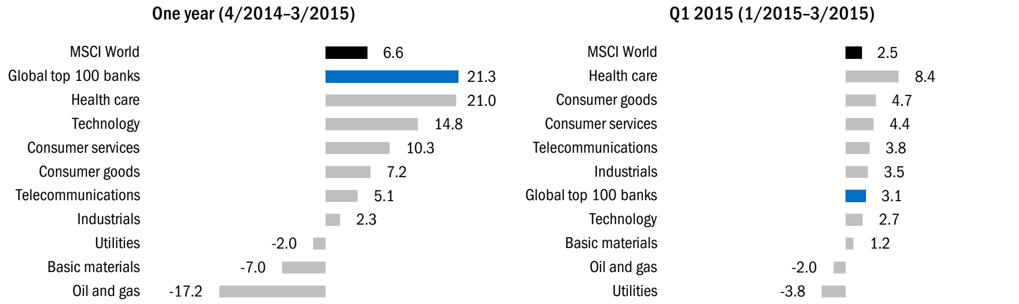
- The average price-to-book ratio of Western European banks recovered to 1.2 in Q1 2015 mainly due to relatively good reported figures for 2014 and ECB's EAPP
- Overall, the P/B ratios of global top 100 banks are still well below MSCI World

TSR performance

In Q1 2015, total shareholder return of global top 100 banks remained on top among industry sectors on a yearly basis. However, quarter-over-quarter banking fell back to a level just above the average of all sectors. Regionally, Western European institutions showed the best performance as the US lost value in the last quarter.

Banking still top TSR performer 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 year-over-year performance—however, they got off to a very moderate start in 2015 with only 3.1% in Q1 2015, an only slightly better performance than that of the MSCI World (2.5%)

US banks destroyed shareholder value in Q1 2015

Fig. 4: TSR of global top 100 banks by regions and business models (1/2015–3/2015, in %)

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

- After negative shareholder value growth in Q4 2014, Western European institutions show strong positive TSR performance for Q1 2015—as the ECB started its quantitative easing program (see chapter III), the market is flooded with liquidity
- In contrast, US institutions showed negative performance which was driven by Bank of America (-13.8% in Q1 2015) and some investment banking institutions, such as Morgan Stanley that reported lower results for 2014 and missed analysts' expectations
- Performance of BRICS institutions suffer from the crisis in Russia and economic problems in India
- Looking at business models, the strong performance of Chinese banks lifts the wholesale sector average to a still high 11.9%, even though the TSR was nearly 30 pp lower than in Q4 2014—investment banking & institutional services, mainly driven by US institutions, had negative TSR in Q1 2015 (-3.5%)

After disastrous Q4 2014, Western Europe banks are top performers in Q1 2015

Fig. 5: Top/low TSR performers among global top 100 banks (1/2015–3/2015, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
Intesa Sanpaolo	Italy	30.7	State Bank of India	India	-14.4
Deutsche Bank	Germany	29.1	Royal Bank of Scotland	UK	-13.8
Societe Generale	France	28.5	Bank of America	United States	-13.7
Credit Agricole	France	27.1	ICICI Bank	India	-10.6
Natixis	France	26.9	VTB Bank	Russia	-10.4

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
Intesa Sanpaolo	Italy	30.7	Royal Bank of Scotland	UK	-13.8
Deutsche Bank	Germany	29.1	HSBC	UK	-3.3
Societe Generale	France	28.5	Barclays	UK	1.2
Credit Agricole	France	27.1	CaixaBank	Spain	2.2
Natixis	France	26.9	Banco Santander	Spain	2.8

Source: Bloomberg, zeb.research

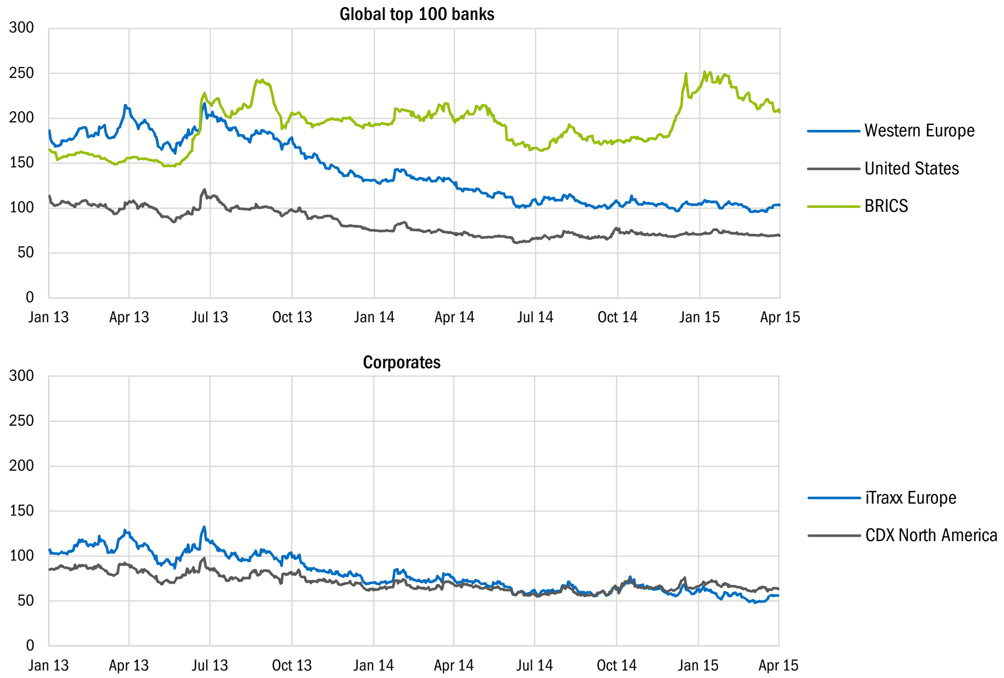
- After losses in shareholder value in Q4 2014, Western Europe banks dominate the global top performers in Q1 2015, which is in line with observations made in fig. 4
- The stock of Deutsche Bank benefits significantly from discussions about the new strategy which might contain a split up or another major strategic shift leading to a TSR increase of 29.1% in the first quarter of 2015—the P/B ratio jumped from 0.47 at December 31, 2014 to 0.61 at March 31, 2015
- Royal Bank of Scotland is caught up by its US business and a foreign currency affair as write-offs and provisions of around GBP 14.0 bn effect the bank's TSR performance—however, the bank followed its transformation path to a national focused retail bank as several divestments regarding private banking (e.g. there are additional rumors that subsidiary Coutts & Co will be sold to an investor) and investment banking were announced
- In India, the whole economy and especially banks are suffering from major increases to non-performing loans resulting in a very bad capital market performance of the two market leaders State Bank of India and ICICI Bank

Debt perspective

After the strong increase of BRICS banks' CDS spreads in Q4 2014, the average spread decreased to around 200 bp in Q1 2015, which might be due to the slightly improved situation in the still unresolved conflict between Ukraine and Russia. For global top 100 banks in the US and Western Europe, no fundamental changes occurred during the last quarter from a debt perspective.

Slight decrease of BRICS' CDS spreads in Q1 2015

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

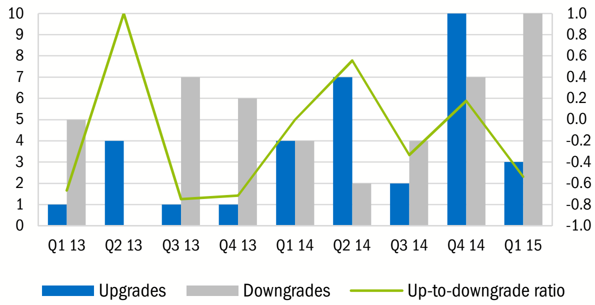


Global top 100 banks' 5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Thomson Reuters Datastream, zeb.research

- After CDS spreads of BRICS banks jumped up in the last months of 2014, spreads decreased slowly as a result of the Minsk II agreement in February to a current average of around 200 bp which is still clearly higher than the average before the political turmoil in mid 2013
- Despite discussions about Greece leaving the Euro area ("GREXIT"), CDS spreads for Western European banks remain stable with a surcharge of around 30 bp compared to US institutions
- Average CDS spread of European corporates decreased slightly in Q1 2015, now showing a discount of around 10 bp compared to North American corporates, after moving on the same level in the second half of 2014

Relatively high number of rating downgrades in Q1 2015

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



	Q4 13	Q4 14	Q1 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

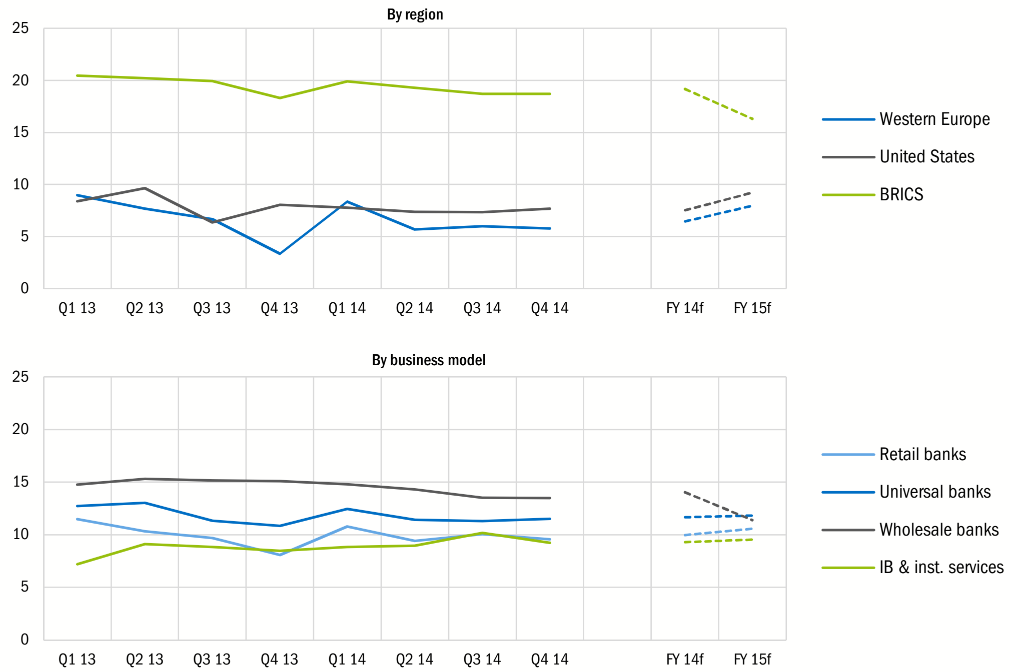
- With the beginning of 2015, 11 out of the global top 100 banks were affected by 13 rating changes—10 changes were downgrades and there were 3 upgrades
- Due to the difficulties mentioned above, Royal Bank of Scotland was downgraded by S&P from BBB+ to BBB- in Q1 2015
- Lasting uncertainties regarding the Russian institutions, VTB and Sberbank, are reflected by further downgrades—Moody's downgraded both banks from Ba1 to Ba2 and S&P downgraded VTB from BBB- to BB+
- The average rating of global top 100 banks remained stable at A-; from a regional point of view, US and Western European institutions (A-) are still ahead of the BRICS (BBB)

Banking profitability

From a profitability perspective, no fundamental changes occurred in Q4 2014 reported figures—all regional clusters remained constant and BRICS banks are still well ahead of other clusters. However, the forecasts for 2015 show contrary developments—while there are improving forecasts for Western European and US institutions, BRICS banks are expected to record a drop of 3 pp of RoE in 2015 as especially Russian banks face some tough upcoming quarters. A similar negative outlook for wholesale banks suggests decreasing profitability for the currently very profitable Chinese wholesale institutions.

Decreasing RoE expected for BRICS banks in 2015

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



Historic data according to quarterly reports from Bankscope. Q1 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

- Western European banks' profitability is still under pressure and remained just above 5% due to the lasting low interest environment and additional regulatory requirements, which further challenges growth prospects
- BRICS are about to experience a decline of RoE of around 3 pp in 2015 as analysts' forecasts especially for major Russian institutions where significantly lowered due to expected very negative impacts of the Western sanctions on the Russian economy and banking sector
- Concerning business models, analysts expect a moderate growth of profitability for all models except wholesale banking, whose profitability is expected to drop by 3.5 pp due to lower expectations regarding economic growth in China—however, up to now, the wholesale banking sample, which includes a large number of highly profitable Chinese banks, is the most profitable business model cluster

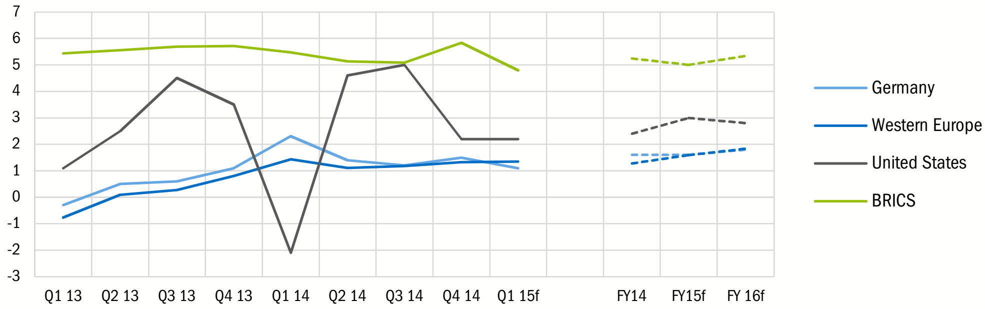
II. Key banking drivers

Economic perspectives

After a good development in Q2/Q3 2014, US GDP growth remained just above 2% in Q4 2014 and Q1 2015. Most noticeably, economic growth in BRICS dropped by 1 pp in the last quarter to below 5.0% as especially Russian GDP fell by -2.8%. For the full year 2015, current forecasts expect a GDP decline of 4.0% in Russia. Regarding consumer prices, German and Western Europe's inflation rates declined further and even showed a deflation for Q1 2015 but forecasts expect moderate inflation.

Drop of BRICS GDP growth to below 5.0% for first time

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

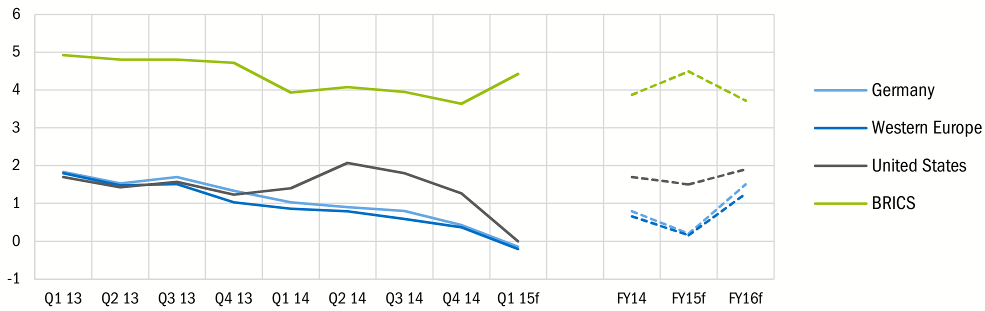


Source: Thomson Reuters Datastream, zeb.research

- The lasting high GDP growth rate of the BRICS declined—based on current forecasts—significantly in the first quarter of 2015 due to negative developments in Russia. In addition, the Brazilian economy is also in a very difficult situation as GDP growth is negative for the last four quarters
- After a strong third quarter 2014, the US' GDP growth rate dropped to 2.2% in Q4 2014 and Q1 2015 but overall forecasts expect a steady growth of above 3% for the full year 2015
- German and Western European GDP growth remained comparatively constant—forecasts imply further but slowly ongoing recovery in the medium term

Inflation rates continue to slope downwards, except for BRICS

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



Source: Thomson Reuters Datastream, zeb.research

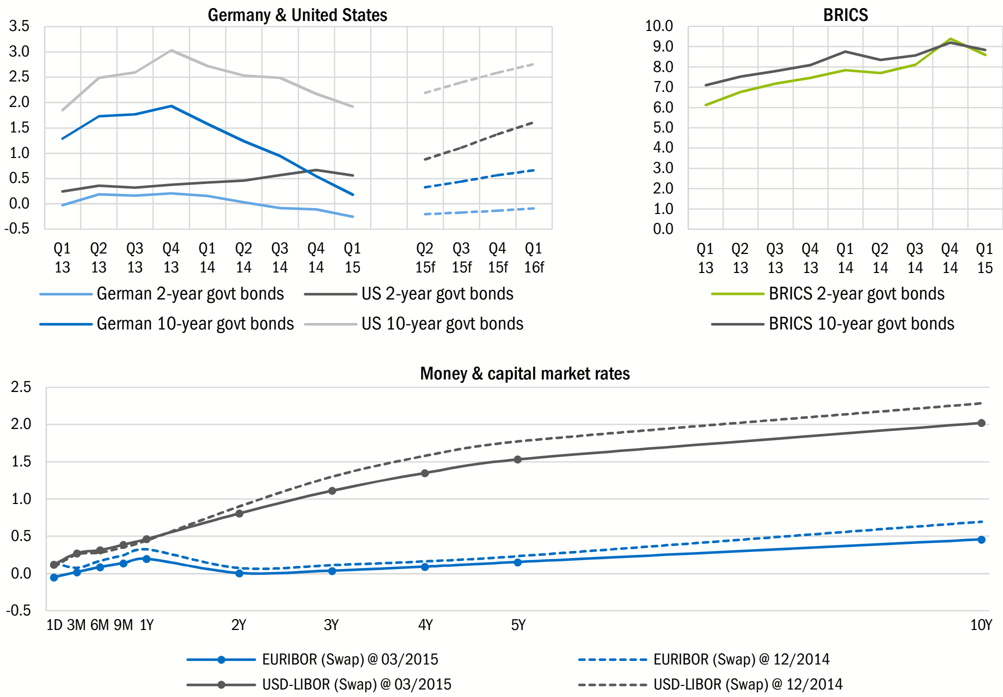
- In the last quarter, consumer prices in Germany and Western Europe shrank, indicating a deflation. However, for the FY 2015, a slight positive inflation of 0.2% is expected
- US inflation rates are also expected to drop close to zero for Q1 2015 and inflation is expected to remain below 2%
- After a further drop of 0.3 pp, BRICS inflation rate is expected to increase by 0.8 pp in Q1 2015

Interest rates

The ECB's fixed rate tenders and deposit facility remained at historic lows of 0.05% and -0.20% respectively. Additionally, ECB started its massive quantitative easing program in March 2015 (see chapter III), which led to a further drop of yields on German government bonds (-0.25% for 2-year bonds and 0.18% for 10-year bonds). After rising yields on 2-year US government bonds for seven consecutive quarters, yields on US government bonds have now dropped to 1.92% and 0.56% for 10-year and 2-year US government bonds respectively.

Again new historic low yields for German government bonds

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

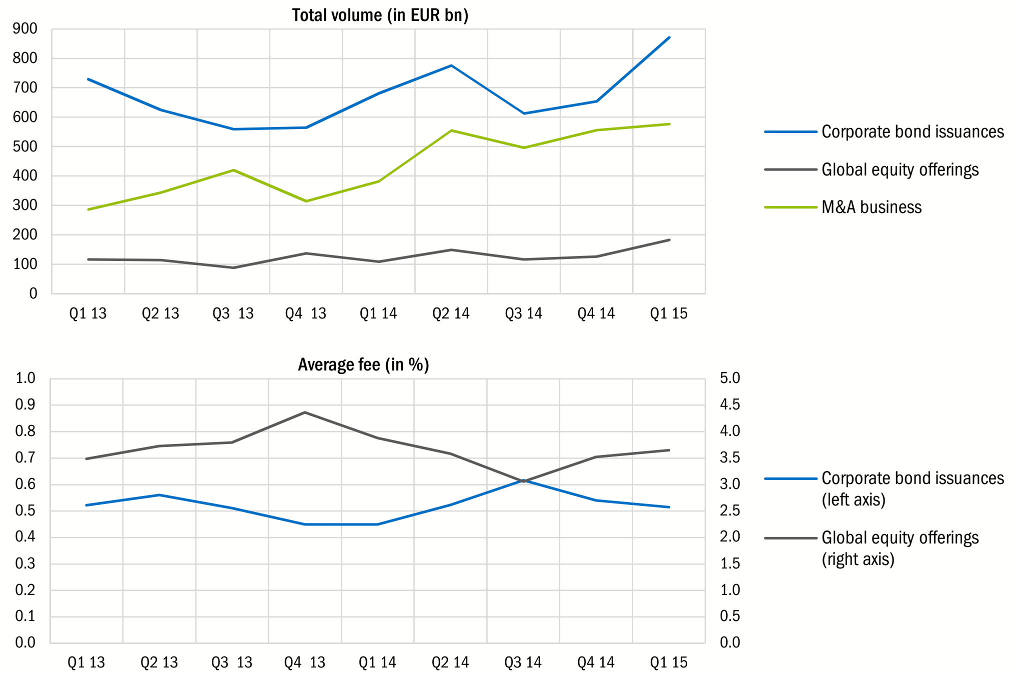
- Yield curves further flattened due to the stronger decrease of long-term interest rates, which is, at least for Europe, initiated by the massive quantitative easing program of the ECB
- Forecasts for central bank policies in the US and Europe also differ: while the low interest rate environment in the Euro area will continue in the medium term, e.g. supported by quantitative easing program of the ECB, the US Fed finished its own quantitative easing program and is expected to increase interest rates in 2015—this is reflected in strongly increasing US yield forecasts for the upcoming quarters
- Yield of German 10-year government bonds declined in the fifth consecutive quarter to only 0.18%, ranging clearly below US 2-year government bonds (0.56%)
- After a notable rise of 2-year BRICS government bonds in the recent quarters, the yield decreased by 0.6 pp, ranging again just below the yield of BRICS 10-year government bonds—this development is mainly driven by a calming of the situation in the Russian market, which is accompanied by a slight appreciation of the Ruble

Capital market environment

Q1 2015 was characterized by increased activity in all fields of traditional investment banking—debt and equity underwriting as well as M&A advisory. Both the corporate bond and equity issuance volume jumped to two-year highs, whereas the average fee on corporate bonds decreased only slightly and improved for equity underwriting.

Investment banking revenues increased in Q1 2015

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

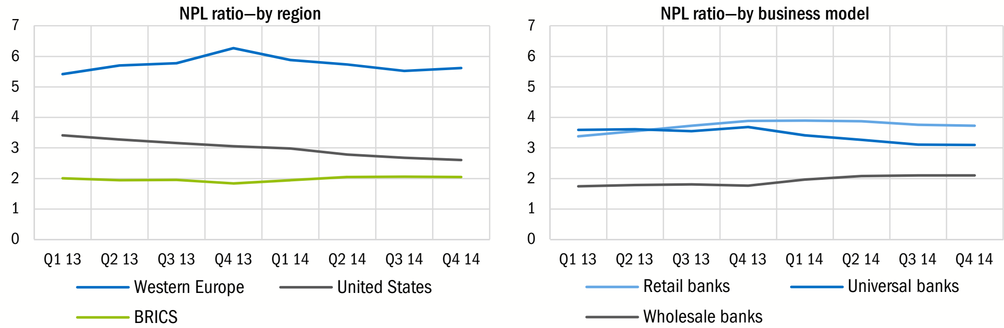
- The corporate bond issuance volume jumped up one third in Q1 2015, which in combination with only slightly decreased average fees (-2 bp) led to strongly improved revenues in debt underwriting business
- Equity offerings volume growth was even stronger: deal volume increased by 45%, the average fee improved by 12 bp
- M&A deal volume grew slightly (+3.7%) in Q1 2015 and thus remained at a high level, especially compared to the first quarters of 2013 and 2014: major deals comprise the acquisition of Kraft Foods by Heinz Co. in the US (EUR 50.5 bn), the acquisition of Pharmacyclics by AbbVie in the US bio-pharmaceutical industry (EUR 17.9 bn) and in Europe, the sale of Spanish Telefónica's UK business to Hong Kong-based conglomerate Hutchison Whampoa (EUR 13.9 bn)

Risk indicators

In this issue of zeb.market.flash, we take a closer look at the ratio of non-performing loans to gross loans (NPL ratio) as a major risk indicator. Upcoming issues will cover additional topics regarding the risk structure. While the loan quality of US banks further improved for the seventh consecutive quarter, Western European banks recorded a slight increase of their non-performing loans (NPL) to gross loan ratio in the last quarter and showed the highest regional average mainly due to high NPLs at Italian and Spanish banks.

Slight increase of NPL ratio for Western Europe banks

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. Q1 2015 data not yet available at the time of writing.
Source: Bankscope, zeb.research

- US institutions continued to improve their NPL ratio, which declined steadily over the last three years to only 2.6% at the end of 2014
- Western European banks, however, increased their ratio slightly in the last quarter to 5.6%. The main drivers for this relatively high overall share in Western Europe—especially compared to other regions—were banks from Spain and Italy that showed an average NPL ratio of above 10% in 2014, while the average ratio of Scandinavian institutions is constantly at around 2%
- A detailed look at BRICS banks' NPL ratio shows huge regional differences: Chinese banks reported NPLs of about 1.5% of their gross loans whereas Russian, Indian and selected Brazilian banks have to deal with significantly higher shares of 3.5% and even above 5.0% in recent quarters
- From a business model perspective, there are no fundamental changes to NPL ratios in the last quarter

III. Special topic

The power of central banks

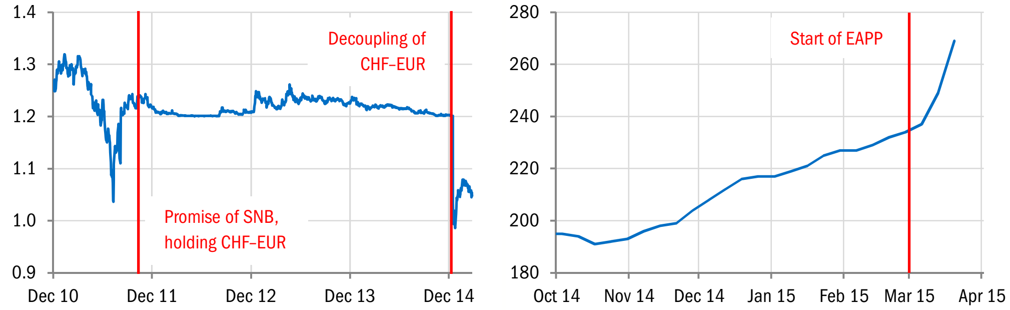
At the beginning of this year, two central banks made fundamental decisions. In January, the Swiss National Bank (SNB) removed the fixed minimum EUR/CHF exchange rate of 1.20 CHF to EUR. In March, the European Central Bank (ECB) started its tremendous quantitative easing program EAPP.

Due to the ongoing depreciation of the Euro in the last year, the SNB promise to hold the exchange rate above 1.20 CHF to EUR was put under pressure. They then stopped intervening and put the CHF exchange rate into a free-floating system. The exchange rate appreciated significantly and climbed by nearly 40% against the euro in a peak. Furthermore, the SNB implemented negative interest rates for high deposits (see article with further information on BankingHub[1]) with the aim to counteract the appreciation of the CHF.

The European Central Bank, however, has to fight with very low, and partly negative, inflation rates. To fulfill the ECB's price stability mandate and to stimulate the lending business of banks, the ECB started its highly controversial 'Expand Asset Purchase Programme' (EAPP). EAPP[2] provides purchases of sovereign bonds and private sector assets for a combined monthly amount of EUR 60 bn.[3] These purchases become apparent in the ECB's balance sheet item 'Securities Held for monetary Policy Purposes', which increased tremendously. As a consequence, interest rates in the Euro zone are expected to remain at a historically low level.

Fig. 14: Development of the CHF-EUR exchange rate and of Securities Held for monetary Policy Purposes by ECB (in EUR bn)

The central banks' decisions have tremendous effects



Source: Bloomberg, ECB, zeb.research

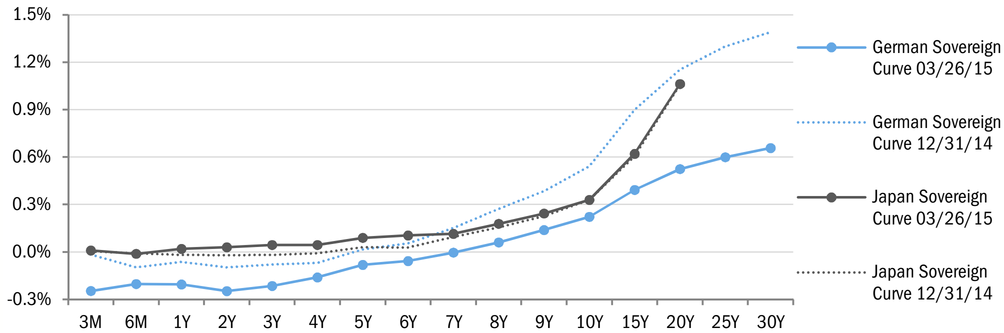
Not only Swiss credit institutions were hit hard by the CHF appreciation, but also banks which maintain large-scale lending activities denominated in CHF. This applies especially to institutions in Central and Eastern Europe and Russia. The CHF appreciation made not only loans denominated in CHF dearer, but Swiss financial products in general increased in prices by around 20%. Thus, banks have to check the accountability of their Swiss products in Euro and if the processing of these products in Switzerland is still profitable. In addition, it can be assumed that the loan loss provisions for loans denominated in CHF, which were concluded before the CHF appreciation, will increase in the mid-term.

[1] Link to article: https://bankinghub.de/banking/steuerung/negativzinsen-der-schweiz-teil-1.
[2] EAPP combines the Asset-Backed Securities Purchase Programme (ABSPP), the Covered Bond Purchase Programme 3 (CBPP3) and the Public Sector Purchase Programme (PSPP).
[3] Cf. ECB – Open market operations: http://www.ecb.europa.eu/mopo/implement/omo/html/index.en.html.

The first consequences of ECB's EAPP become evident when looking at the current yield curves of sovereign bonds in comparison to the year end of 2014. While the German sovereign bond curve was just partly below the Japanese yield curve at year end 2014, it is currently far below the Japanese one.

Fig. 15: Selected yield curves of sovereign bonds, current and at end of 2014

EAPP has already led to significantly lower sovereign bond yields



Source: Bloomberg, zeb.research

The effects of these central bank actions on financial institutions are not straightforward: on the one hand, the further flattened yield curves reduce banks' interest income and puts enormous pressure on banks' profitability[4]. In addition, the CHF appreciation possibly increases loan loss provisions for foreign currency exposures which further reduce profitability and the increased foreign currency exposures burden the available regulatory capital resources. Looking ahead, markets flooded with liquidity due to quantitative easing programs may provoke price bubbles and foster a decrease in credit quality which results in further provision increases. On the other hand, banks can benefit indirectly as the Euro depreciation generally improves the business environment, because of fostered economic growth in the Euro-area due to a better competitive position regarding exports.

Against this background, it is becoming ever more important to be able to analyze the impact of macroeconomic decisions in a holistic way. For bank management, it is crucial to simulate the effect of management actions in this context to fully understand the interdependences of effects and the banks' sensitivities to specific factors. Even though many banks extend their capabilities of carrying out integrated analyses and scenario simulations, the majority of credit institutions are currently struggling to analyze all effects holistically. However, also due to the increasing requirements of stress testing in the course of the ECB's Single Supervisory Mechanism, the ability of integrated simulations will move up on the management agenda.

[4] See for further details also the European Banking Study by zeb.

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 April 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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