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European banks achieve a surprising TSR of 15% in Q3 2016—however, structural problems remain

zeb.market.flash Q3 2016

Key topics

I. State of the banking industry

- Global top 100 banks increased their market capitalization by +6.5% and achieved the second highest TSR performance among all industry sectors (+9.9%) in Q3 2016
- European banking sector with strong quarter-over-quarter performance (+15%) after a weak first half of 2016—several large European institutions still with disastrous P/B ratios far below 1.0x

II. Economic environment and key banking drivers

- Economic environment for Western Europe still mainly influenced by economic uncertainty due to Brexit vote as well as persistent structural problems of the European banking sector
- ECB's expansive monetary policy pushed down the long end of the European money and capital market rates
- Profitability of global and European banks improved in Q2 2016, but with huge differences across the sector

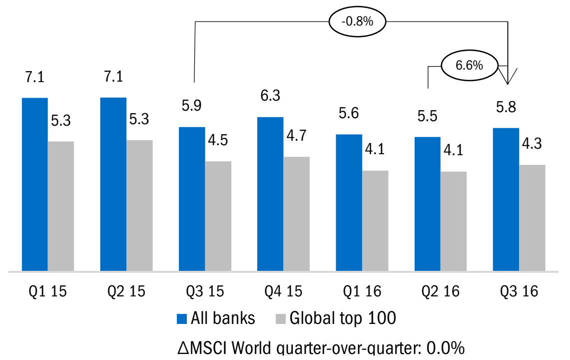
III. Special topic: analysis of the ECB's asset purchasing program

- Between October 2014 and September 2016, the ECB purchased a total of EUR 1.29 tr of marketable assets leading to an increase in its balance sheet by +63% to over EUR 3.3 tr
- Decreasing yields, lower market liquidity as well as negative impacts on the banking sector are becoming more and more observable

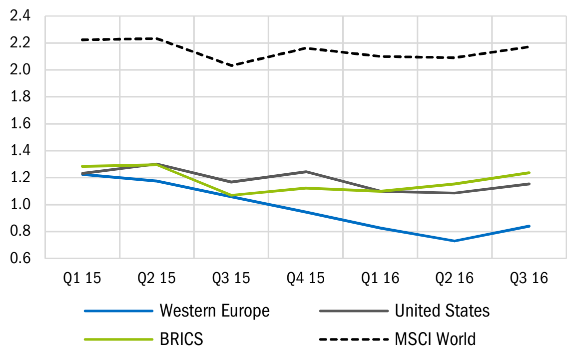
I. State of the banking industry

The banking industry has recovered from the rough first half of 2016. At the end of the third quarter, global top 100 banks showed an increasing market capitalization (+6.5%) and the second largest TSR performance (+9.9%) among all industry sectors. Especially several European banks boasted a very strong market performance. However, with an average P/B ratio still far below 1.0x, the European banking industry is not yet out of the woods.

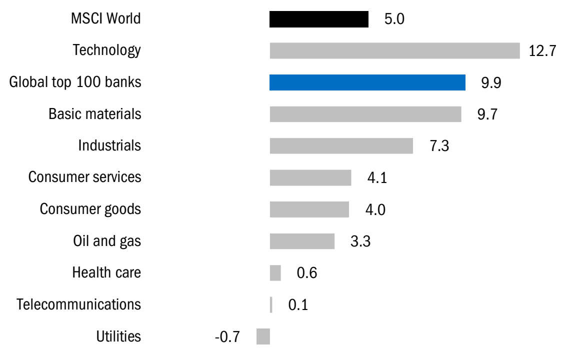
Market capitalization of the banking sector (end of quarter, in EUR trillion)[1]



Price-to-book ratio of global top 100 banks and MSCI World[2]



TSR of industry sectors worldwide (7/2016–9/2016, in %)[3]



Top/lowest TSR performance among global top 100 banks (7/2016–9/2016, in %)

Top performers	Country	TSR
STATE STREET CORP	United States	29.9
ERSTE GROUP BANK	Austria	29.8
HSBC HLDGS PLC	United Kingdom	26.0
SCHWAB (CHARLES)	United States	25.0
CITIZENS FINANCIAL	United States	24.3

Lowest performers	Country	TSR
NATIONAL COMM	Saudi Arabia	-16.1
AL RAJHI BANK	Saudi Arabia	-11.9
FIRST GULF BANK	United Arab Emirates	-6.3
DEUTSCHE BANK-AG	Germany	-6.3
WELLS FARGO & CO	United States	-5.7

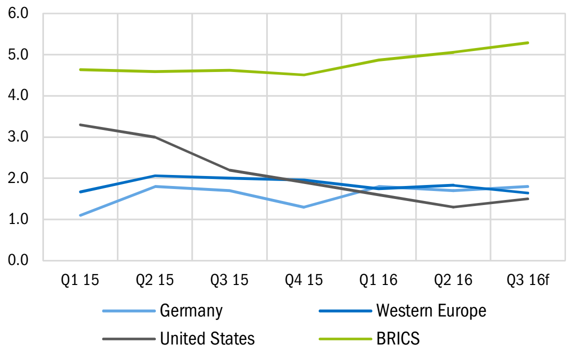
1) All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2015. Figures are aggregated in EUR, without adjustments for foreign currency effects; 2) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; 3) Total shareholder return (TSR) of industry sectors other than banking 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

- In Q3, the banking sector recovered from the market turmoil during the first half of 2016. Top 100 banks increased their market capitalization by 6.5% and showed the second highest TSR performance among all industry sectors.
- Especially European banks made up for the large losses in connection with the Brexit vote. European banks ended Q3 with an exceptionally strong TSR performance of 15% on average (US: +9.3%, BRICS: +9.1%).
- For the first time since Q1 2015 European banks also showed increasing P/B ratios. However, the P/B ratios of several large European institutions are still disastrous with values far below 1.0x (Deutsche Bank: 0.26, Unicredit: 0.27, Royal Bank of Scotland: 0.39) indicating a persistent lack of confidence in the sector.
- Erste Group is European top performer due to repeatedly strong quarterly results and increasing capitalization. HSBC convinced the market by share buyback and a commitment to sustain dividends at current levels for the foreseeable future.
- Deutsche Bank is the only European bank with losses in Q3. Higher expected litigation costs in the US and speculations about required government aid or a capital increase led to a massive distrust in the banks' resilience.

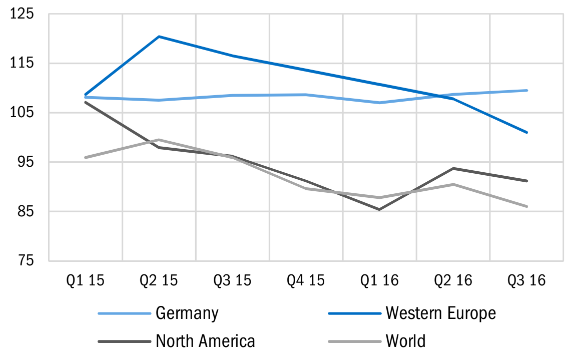
II. Economic environment and key banking drivers

In the third quarter of 2016, the economic environment in Western Europe was still mainly influenced by rising economic uncertainty due to the Brexit vote as well as persistent structural problems of the European banking sector. The EURIBOR yield curve has flattened further due to the ECB's continuing QE policy. The EUR/GBP exchange rate reached a new three year high whereas other FX rates stabilized in Q3.

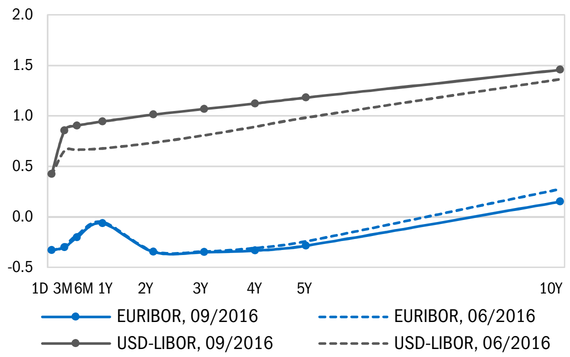
GDP growth and forecasts (real GDP, year-over-year growth rates, in %)[1)]



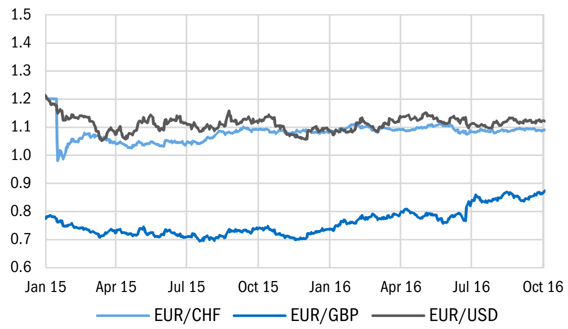
Economic sentiments (ifo Business Climate Index)[2)]



Money and capital market rates



FX rates (EUR/CHF, EUR/GBP, EUR/USD)

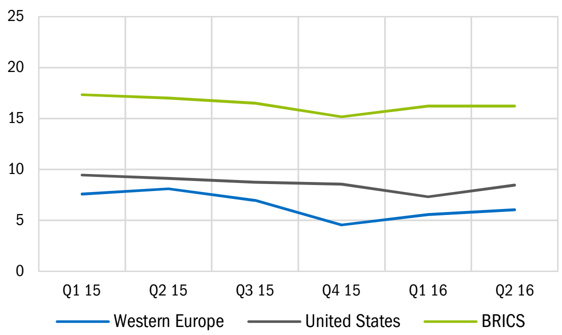


1) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; Q3 16 based on forecasts; 2) The ifo Business Climate Index is an indicator for economic activity based on a survey among companies on their current business situation and outlook for the upcoming six months (2005 = 100). The ifo Institute only provides data for selected countries and regions. North America includes Canada and the US, no separate data for BRICS countries available; Source: Bloomberg, ifo Institute for Economic Research, Thomson Reuters Datastream, zeb.research

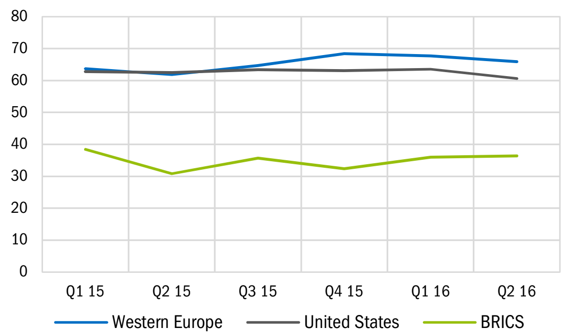
- Whilst the GDP growth rates of Germany (+0.1pp), the US (+0.2pp) and BRICS countries (+0.2pp) increased, the GDP growth rate of Western Europe decreased by 0.2pp in the third quarter of 2016.
- Influenced by increasing uncertainty about the future cooperation between the EU and the UK, the economic climate in Western Europe darkened noticeably.
- The EURIBOR yield curve has flattened further since the long end of the EURIBOR curve was pushed down. This is because of the latest decision of the ECB to leave interest rates unchanged and to run the Quantitative Easing (QE) policy until at least March 2017. In contrast, the USD-LIBOR curve shifted upward slightly.
- As a direct consequence of the Brexit vote and the ensuing interest rate cuts of the Bank of England in August, the British pound continued to lose value. At the end of September, the EUR/GBP exchange rate reached a new three-year high of 0.87 (+4.1% qoq) and the USD/GBP FX rate even achieved the highest value since 1985 (0.77).

The profitability of US and European banks slightly improved in Q2 2016 driven by some strong performing top players (Swedbank: 17.05%, Synchrony Financial: 16.61%, Svenska Handelsbanken: 14.24%). Although regional differences regarding RoE and CIR remained constant, a further reduction and alignment of the RWA densities among global top 100 banks is evident.

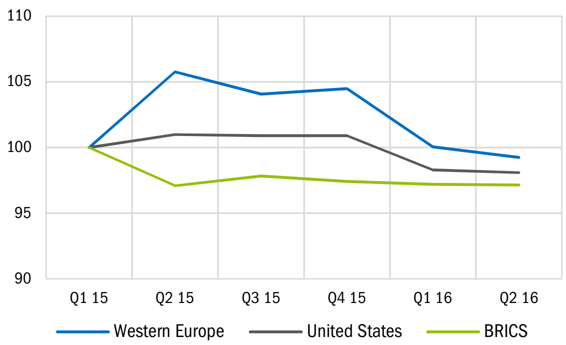
RoE after tax of global top 100 banks (in %)[1)]



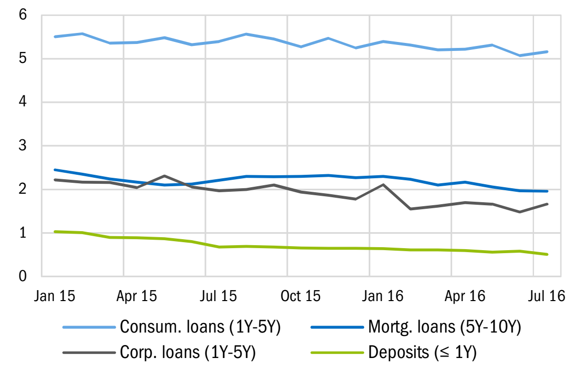
Cost-income ratio of global top 100 banks (in %)[2)]



RWA density development of global top 100 banks (in %)[3)]



Customer interest rates in the euro area (new business, in %)



Q3 16 data not yet available at the time of writing; 1) Post-tax RoE (return on equity): post-tax profit to average total equity; 2) Cost-income ratio: operating expenses to total income; 3) RWA density: risk-weighted assets (RWA) to total assets; RWA density indexed to 100 at March 31, 2015; Source: Bankscope, ECB, zeb.research

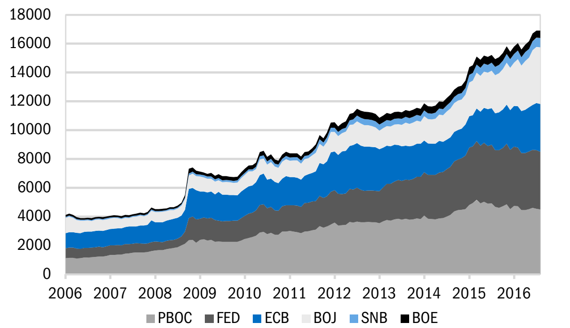
- Overall, global top 100 banks reported increasing profitability in Q2 2016. For the first time since Q1 2015, US banks could increase their RoE on average (+1.1pp) and widen the gap to European banks again, even though European banks' profitability improved for the second time in a row.
- Compared to other regions, the development of profitability among European banks is much more heterogeneous. While a few banks like the Nordic banks reached RoEs above 10%, several banks showed a value close to or even below zero (Royal Bank of Scotland: -3.31%, Credit Suisse: -0.42%, Deutsche Bank: 0.86%). Other EU banks (Commerzbank, ING) announced massive restructuring plans with a reduction of 10-20% of staff underlining the persistent structural problems of the European banking sector.
- Moreover, the continuing decrease of customer interest rates in Europe due to the ECB's low interest rate policy puts further pressure on European banks' profitability making it more difficult to sustain the current positive trend.
- US and European banks' CIR decreased slightly in Q2, but remains far above BRICS banks.
- Over the last year, European banks significantly reduced their RWAs leading to further alignment of the RWA densities among global top 100 banks.

III. Special topic

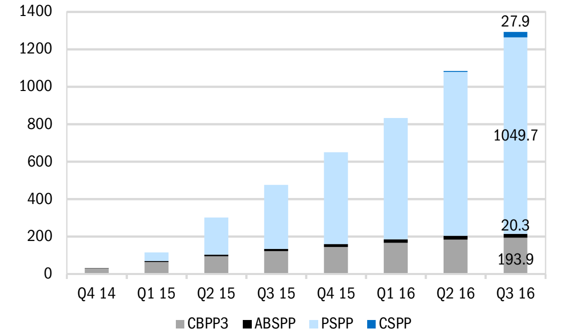
Spending spree of the European Central Bank—analysis of the ECB's asset purchasing program

In the last decade, the six largest central banks in the world increased their balance sheets (in total) to EUR 16.9 tr. The largest players on the market are the People's Bank of China, the Federal Reserve Bank, the European Central Bank (ECB) and Bank of Japan. Especially the ECB inflated its balance sheet by using its massively criticized expanded asset purchasing program (APP)—also called Quantitative Easing (QE)—which started in October 2014. The special topic in this issue analyzes the extent of the ECB's APP and the consequences on respective capital and banking markets.

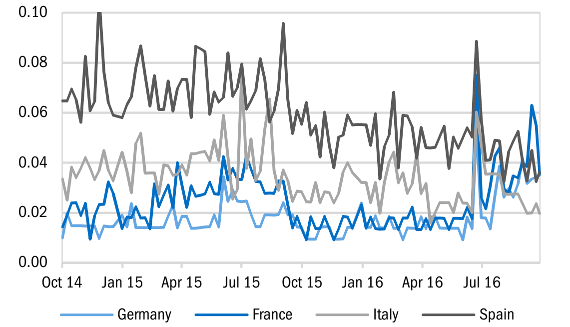
Balance sheet of most important central banks, in EUR bn[1)]



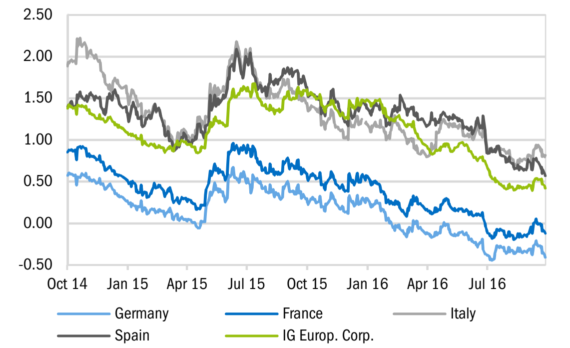
ECB's expanded asset purchasing program, in EUR bn[2)]



Bid-ask spreads of European government bonds (8 years maturity, in %)[3)]



Yields of government bonds and European corporates with investment grade (8 years maturity, in %)



1) PBOC: People's Bank of China, Fed: Federal Reserve Bank, ECB: European Central Bank, BOJ: Bank of Japan, SNB: Swiss National Bank, BOE: Bank of England; 2) At amortized cost, at month end. Figures from Q3 are based on the latest available data on September 26, 2016; CBPP3: third covered bond purchase program, ABSPP: asset-backed securities purchase program, PSPP: public sector purchase program, CSPP: corporate sector purchase program; 3) Bid-ask spreads are calculated on a weekly basis by: (ask price – bid price)/ask price x 100; Source: Bloomberg, European Central Bank, Bank of England, zeb.research.

The APP of the ECB includes four individual packages which consecutively extended the purchasing program in recent years: the third covered bond purchase program (CBPP3), the asset-backed securities purchase program (ABSPP), the public sector purchase program (PSPP) and the corporate sector purchase program (CSPP). Between October 2014 and September 2016, the ECB purchased EUR 1.29 tr of marketable assets in total, leading to an increase in its balance sheet by +63% to over EUR 3.3 tr. Only the Bank of Japan was more active by almost doubling its balance sheet in the same period (+97%). Overall, up to March 2017, the ECB will purchase further public as well as private sector securities amounting to EUR 80 bn each month which will end up in the total amount of the APP of around EUR 1.7 tr.

In March 2015, the ECB started by far the largest program (PSPP) of the whole purchasing program including purchases of public sector securities issued by euro area governments, agencies and European institutions, whereby almost 90%

of these purchases are allocated to government bonds. At the end of September 2016, the holdings comprised a volume of nearly EUR 1.05 tr (81% of the total APP). By now, the ECB holds approx. 18% of the total outstanding amount of government bonds in the euro area, where the largest shares are allocated to German, French, Italian and Spanish bonds with an average maturity of 8 years. More precisely, due to specified purchasing criteria (only bonds with a yield above the deposit facility rate of -0.4% and a maturity of 2 to 30 years) the share of the ECB holdings of eligible bonds even equals nearly 38%. The large and increasing market share of the ECB has direct impacts on the bond market liquidity. On the one hand, the ECB's demand for government bonds from economically weaker European countries leads to an increasing market liquidity. For instance, the bid-ask spreads of Italian and Spanish bonds slightly decreased over the period of the APP indicating an increasing market liquidity. On the other hand, especially since the announcement of a further expansion of the APP by an increase of the monthly purchases from EUR 60 to 80 bn from April 2016 on, the demand of the ECB for so called "safe haven" bonds from strong European countries like Germany or France has led to a decreasing market liquidity. These developments result in an alignment and in a lower total liquidity in European government bond markets which makes a drying up of these markets more likely in the next months.

On June 8th 2016, the last extension of the APP was introduced by the purchase of corporate sector bonds with investment grade (IG) in the secondary as well as the primary markets issued by non-banks domiciled in the euro area (CSPP). Regarding IG corporate bonds which are eligible for ECB purchases, the market share of the ECB increased in just four months to a value estimated at 3.5%. However, bond issuance has increased ahead of the release of the CSPP so that between March and June 2016 the number of issued IG bonds grade rose by over 10%.[1]

In line with the latest two programs, the ECB acts as a significant participant on the government and corporate bonds market. The consequential effect of this additional strong buyer is a considerable decrease in fixed income yields. Since the beginning of the APP, the yields of the primarily purchased European government bonds have decreased by almost 1pp. However, hopes for an earlier end of the QE program due to better economic figures and the ECB decision in April 2015 to hold the ECB rates on a constant level led to an overall short recovery in Q3 2015. Nevertheless, the negative trend has been further strengthened. In particular yields of EU corporate bonds with investment grade slipped by 0.7pp within the first months of the CSPP and German government bond yields are only slightly above the deposit facility rate.

From a European bank's perspective, there are several direct and indirect effects of the APP. First of all, decreasing market liquidity and low fixed income yields for all rating classes entail distortions in bond markets making the trading business much more difficult. Furthermore, the ECB now also negatively influences the long end of the interest rate curve leading to decreasing income resulting from maturity transformation. In addition, the CSPP impacts the banks' corporate lending business—examples of the multilayered effects are increasing bond issuance and pressure on credit spreads. To summarize, as long as the QE program stabilizes the European economy, the banking sector benefits from an improving credit environment including lower loan loss provisions and more new business. However, in the long run, the expansive monetary policy leads to increasing distortions in capital markets and the risk of speculative bubbles.

With the APP, the ECB is a strong player with a significant and still increasing market share in the European bond market. As a result, decreasing yields in European government and corporate bonds as well as decreasing market liquidity are observable. All in all, concerns about negative impacts of the QE program on the financial markets as well as the banking sector are increasing. However, with the latest decision on September 8th 2016, the ECB reaffirmed its plans to run quantitative easing until March 2017 or beyond if required—with all its consequences.

[1] Eligible corporate bonds include investment grade bonds of corporates located in the euro area with a maturity greater than 18 months and an outstanding amount of EUR 200 bn. Source: Bloomberg

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 4, 2016. The global top 100 banks cluster contains the largest banks by market capitalization on December 31, 2015 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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