Issue 3 | October 9, 2012

zeb/

Short-term recovery of Western banks –
However, outlook still negative

zeb/market flash

Key topics

I. Global economic climate (p. 2)

- The global economic environment got worse as GDP growth rates and forecasts declined around the globe
- ECB support promote Western European sovereign CDS spreads significantly – decline of 50% within one quarter only

II. Key banking drivers (p. 5)

- In Q3 2012, market volatilities and uncertainties clearly calmed down – the euro recovered moderately
- The interbank funding situation improved considerably with positive effects on the banks' margins

III. State of the banking industry (p. 9)

- Central bank support in Europe and the US boosts banks' equity performances in these regions with double-digit TSR figures outperforming BRICS countries in Q3 2012
- Impact also visible on debt side as average CDS spreads of banks declined significantly and series of rating downgrades was brought to an end despite weaker economic conditions

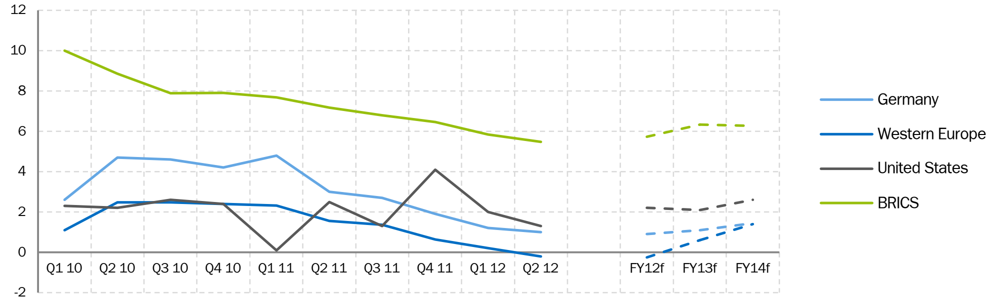
I. Global economic climate

Economic growth perspectives

In Q2 2012, the economic environment got worse as GDP growth rates fell all around the globe. Based on current forecasts, the general economic climate will not change in the short term as expectations for 2012 and 2013 were mostly adjusted downwards in the last quarter.

Another challenging quarter for the global economy

Fig. 1: GDP growth and forecasts (real GDP, year-over-year growth rates, in %)



Western Europe includes the euro area, Denmark, Norway, Sweden, Switzerland, United Kingdom. BRICS: Brazil, Russia, India, China, South Africa.
Q3 2012 data not yet available at the time of writing.
Source: Bloomberg, zeb/research

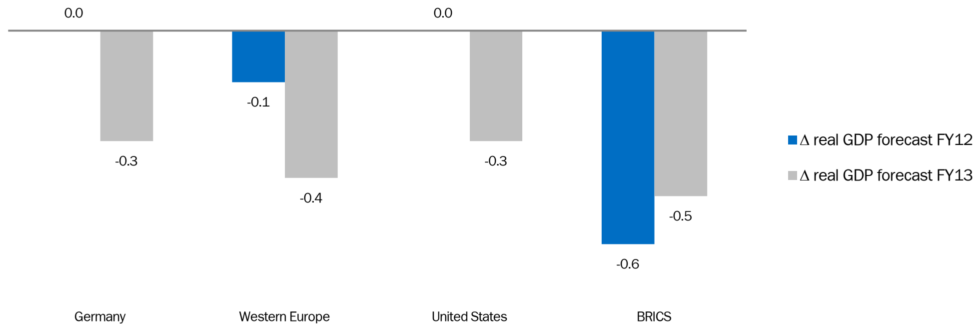
/ The global economic downturn continues in Q2 2012: in Western Europe, GDP growth declined for the seventh quarter in a row, falling to a negative value of -0.2%

/ BRICS countries grew by less than 6% – the second lowest growth rate of the last 10 years – mainly due to an economic downturn in Brazil and India

/ Forecasts predict improvements for 2013/14, especially in Western Europe, but fundamental changes in the current global economic environment are not anticipated for the next 1-2 years

GDP outlook for 2013 substantially reduced

Fig. 2: Change of GDP outlook (difference between GDP forecasts Q3 12 to Q2 12, in %p)



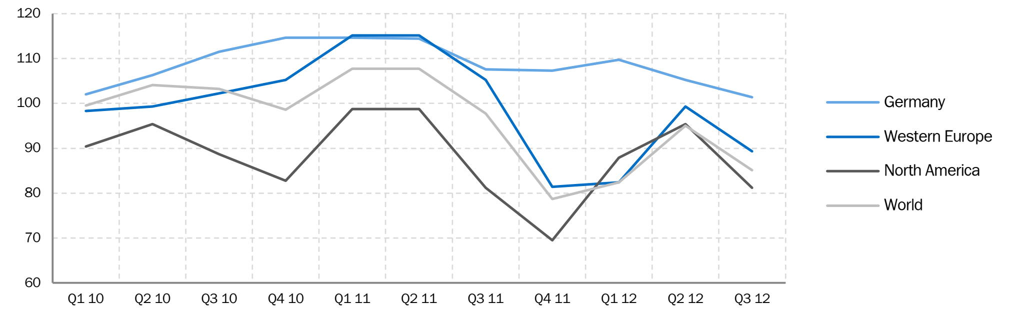
Source: Bloomberg, zeb/research

/ Most recent economic expectations prove previous hopes for a global economic turnaround in late 2012/early 2013 premature as all forecasts for 2013 were significantly reduced

/ Among the BRICS countries, Brazil and India in particular showed only modest economic dynamics in the recent past, which leads to downward adjustments of the regions' GDP growth rates by -0.6%p, from 6.3% (forecast Q2 2012) to currently 5.7% for 2012, and by -0.5%p, from 6.8% to 6.3% for 2013

Fig. 3: Economic sentiments (ifo Business Climate Index – ifo Geschäftsklimaindex)

Sentiments in line with GDP downturn



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: ifo Institute for Economic Research, zeb/research

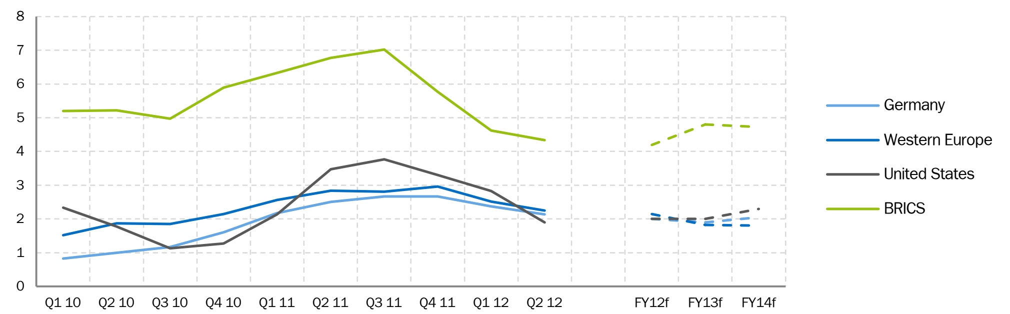
/ After a brief recovery in the first half of 2012, economic sentiments declined again substantially all around the globe in Q3 2012, which is in line with the pessimistic global economic outlook shown in figures 1 and 2
/ Germany's business climate index is still ahead of other regions but decreased for the second quarter in a row, which underlines that the German economy is more and more affected by a difficult global and Western European environment

Inflation and interest rates

Global inflation rates decreased in Q2 2012 and are now almost at 2% in Germany, Western Europe and the US. Interest rates, which had reached historic lows in previous quarters already, further declined.

Fig. 4: Inflation rates and forecasts (annual change of average consumer prices, in %)

Global inflation rates further declined

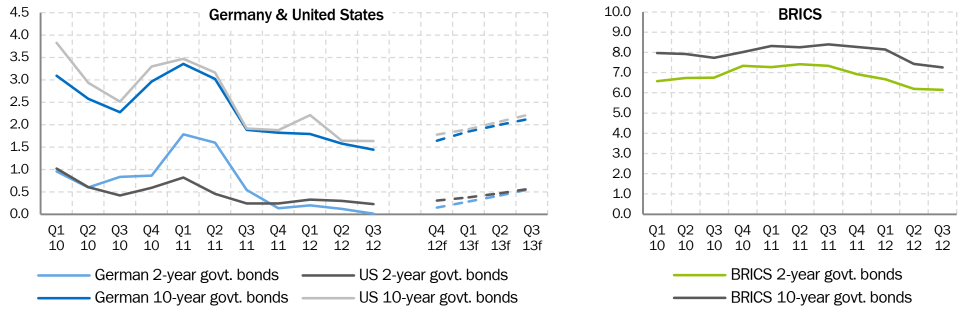


Q3 2012 data not yet available at the time of writing.
Source: Bloomberg, zeb/research

/ Global inflation rates are still widely affected by currently very low economic growth dynamics and therefore further declined in Q2 2012
/ In Germany, Western Europe and the US, inflation rates are under control at levels of around 2%
/ Central bank support does not have an effect on inflationary expectations so far as forecasts remain stable at around 2% for the two upcoming years

Fig. 5: Government bond yields (2/10-year bond yields p.a., in %)

Interest rates still historically low



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

/ ECB decision to lower interest rate of main refinancing operations to 0.75% at the beginning of July led to further declining interest rates – the yield for German 2-year government bonds is now virtually 0.0% and below 1.5% for 10-year bonds

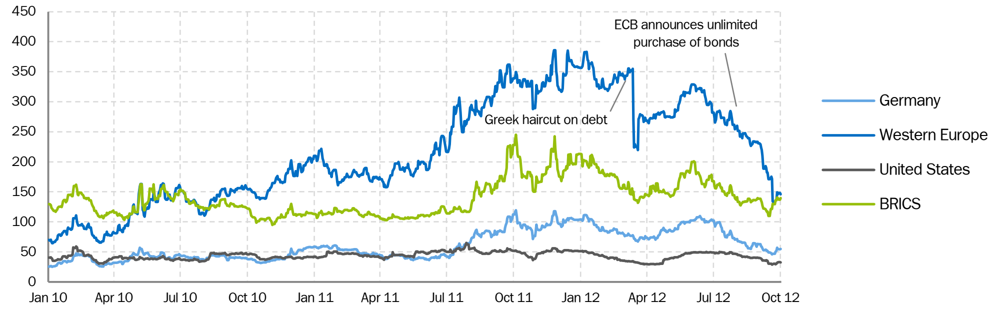
/ Nevertheless, forecasts expect an increase of interest rates in the upcoming months despite a negative economic outlook and unchanged ECB interest rates – as pointed out in our previous issue, an explanation may lie in debt investors who could leave Germany as a safe haven once the European debt crisis improves

Special focus: The sovereign debt crisis

After a year of elevated sovereign CDS spreads, Q3 2012 finally brought about a major turnaround in Western Europe. The ECB support led to a decline of CDS spreads back to the level of October 2010.

Fig. 6: Sovereign CDS spreads (5-year CDS spreads, in bp)

Western European CDS spreads improved substantially



Average of Western European countries as composed by Bloomberg. BRICS 5-year sovereign CDS spreads calculated as unweighted average, no data available for India.
Source: Bloomberg, zeb/research

/ In Q3 2012, the ECB announced unlimited purchase of Western European countries government bonds if a country fails to obtain new money via capital markets

/ The ECB announcement led to a massive improvement of the refinancing situation in Western European countries, including Germany, as CDS spreads declined by 50% in just one quarter

/ Taken as a whole, the announcement is no final solution to the European debt crisis as refinancing needs remain high in certain countries but certainly provided some "breathing space"

Fig. 7: Sovereign refinancing needs (bonds and loans outstanding with maturity 2012/13, in % of nominal GDP)

Italy still with high refinancing needs in 2012

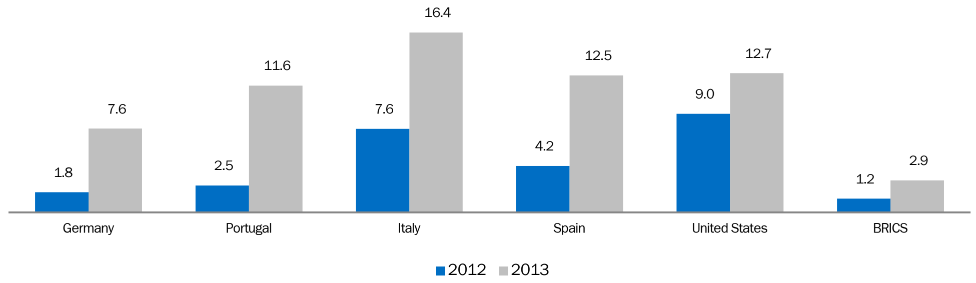


Figure contains only currently outstanding bonds and loans, without net new borrowings.
Source: Bloomberg, zeb/research

/ As of September 30, 2012, Italy still faces remaining refinancing needs of EUR 120 bn (7.6% of nominal GDP) for bonds and loans maturing in the last quarter of 2012

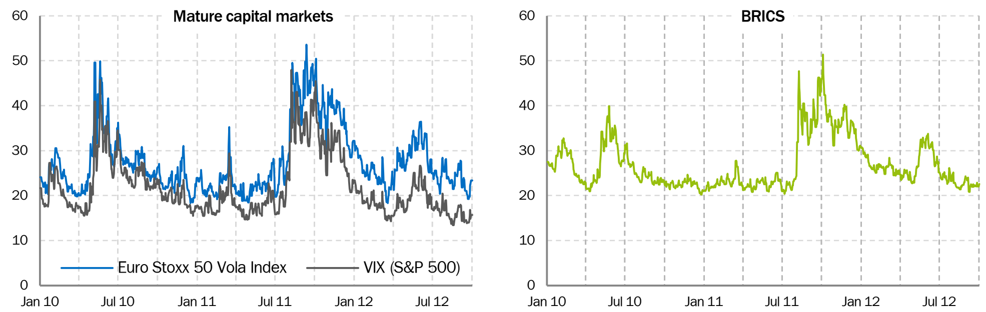
II. Key banking drivers

Selected capital market indicators

In Q3 2012, the uncertainty of investors, which contributed to volatilities of stock and currency markets in the last quarters, was significantly reduced.

Fig. 8: Stock market volatilities (in bp)

Decreased uncertainty in capital markets

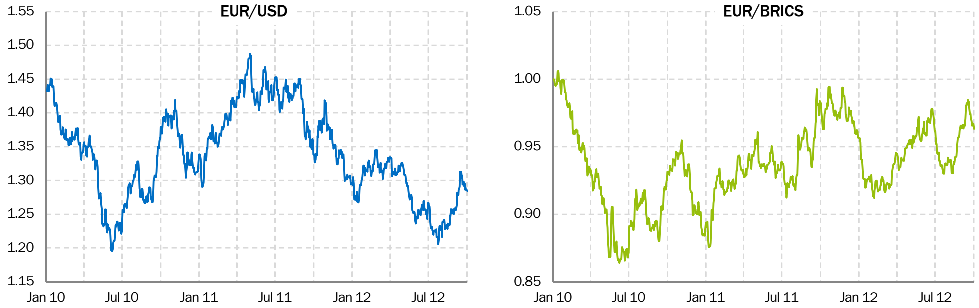


The BRICS volatility index is calculated as unweighted average of CBOE Brazil Volatility Index, Russian Volatility Index, India NSE Volatility Index, AlphaShares Chinese Volatility Index, JSE Securities South African Volatility Index.
Source: Bloomberg, zeb/research

/ In Q3 2012, market volatilities in Europe and the US declined, which is reflected in a reduced uncertainty of investors similar to CDS spreads in figure 6
/ BRICS' volatility more steadily decreased, too, to its lowest level since the Greek haircut on debt in October 2011

Fig. 9: FX rates (EUR/USD, EUR/BRICS basket)

Euro recovered moderately



EUR/BRICS basket represents a custom index of EUR/BRL, EUR/RUB, EUR/INR, EUR/CNY and EUR/ZAR exchange rates. Individual exchange rates are indexed by 1/1/2010. The basket is then calculated as an unweighted average of individual exchange rate indices.
Source: Bloomberg, zeb/research

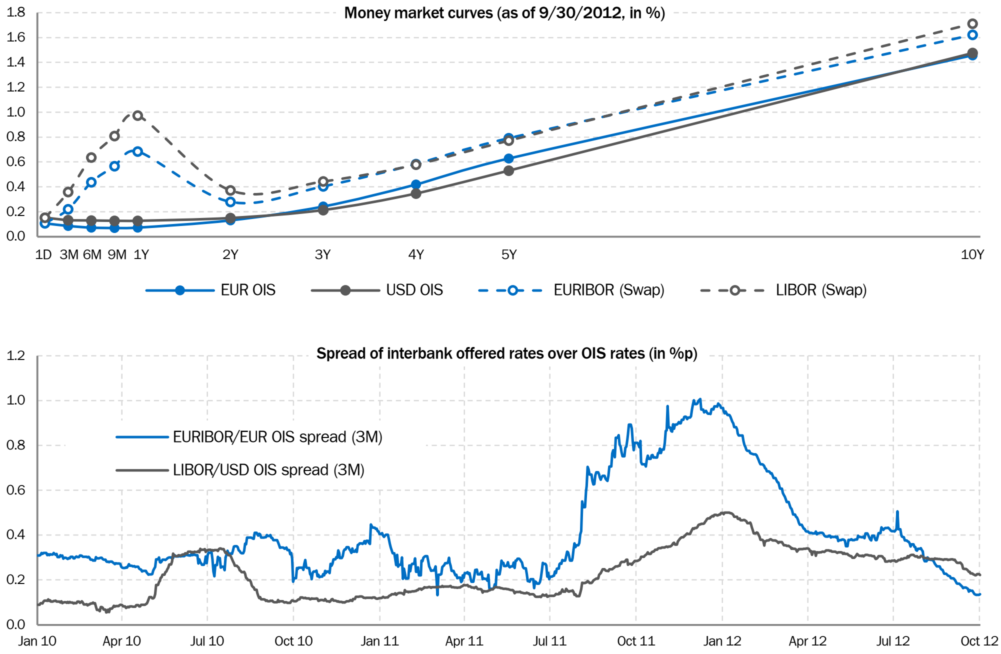
- Against the USD and BRICS currency basket, the euro gained in value in the second half of Q3 after losing in the first half
- Upcoming quarters will show if this quarter's development indicated a strengthened investors' trust in the euro area or rather a short-term reaction to recent ECB support

Funding costs and margins

Q3 2012 was characterized by a substantial improvement of the interbank funding situation in the euro area with positive effects on the banks' margins.

Fig. 10: Interbank market rates (interbank offered rates and overnight indexed swaps)

Improved interbank funding situation in the euro area

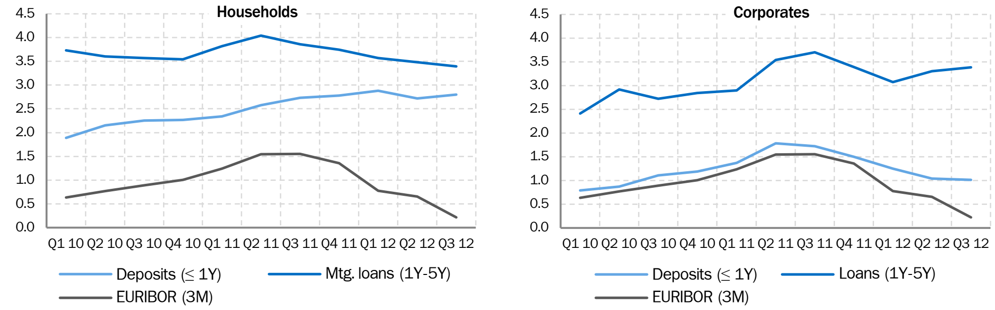


Source: Bloomberg, zeb/research

- On September 30, 2012, the EURIBOR (swap) and the EUR OIS rates were well below the rates at the end of the previous quarter for all maturities, while USD-LIBOR (swap) and USD OIS rates declined only slightly
- Apparently, banks see a much lower probability of default in the euro area interbank market compared to previous quarters as the spread between the 3-month EURIBOR and the corresponding EUR OIS rate, the interest rate swap without credit risk, declined substantially by 68% or 28bp during the last quarter

Sharp drop in EURIBOR not reflected in lending rates

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



Source: European Central Bank, zeb/research

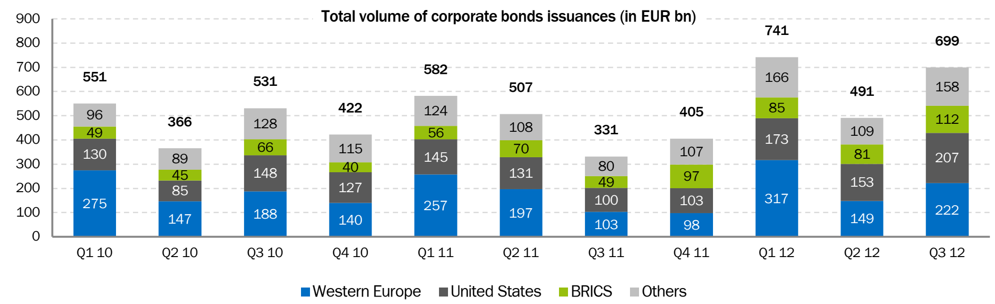
- The competition for customer deposits as a cheap and stable funding base remains a major issue – in Q3 2012, deposit rates increased marginally for households and remained unchanged for corporate customers despite a sharp drop in EURIBOR rates
- Similarly, the 43bp drop of the 3-month EURIBOR did not have a significant effect on the lending rates either, resulting in improved business margins

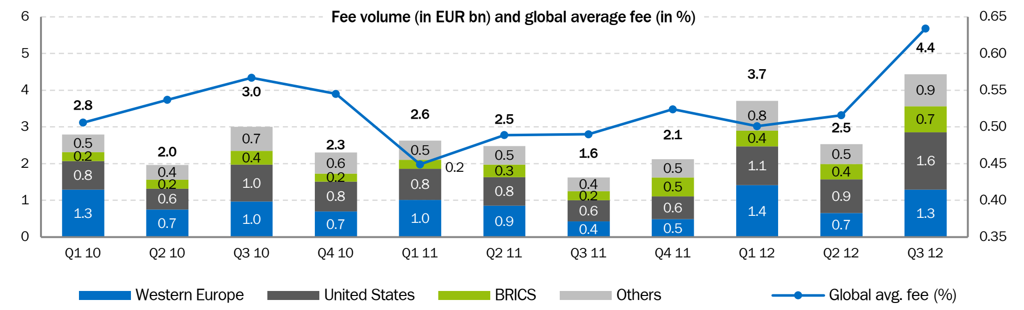
Investment banking activities

Q3 2012 showed a mixed picture of the global investment banking business. Whereas the bond issuance business denoted a jump in volume and average fee rates, the equity offering business' positive development in volume is partially offset by a reduced average fee. M&A advisory was subject to declining deal volumes with the exception of deals with US targets. All in all, Q3 2012 did not compensate for the first two quarters; therefore investment banking activities could not generate the same revenues within the first nine months of 2012 as in the first nine months of 2011.

Jump in bond issuances volume and fee rate

Fig. 12: Corporate bond issuance business by home region of issuing company



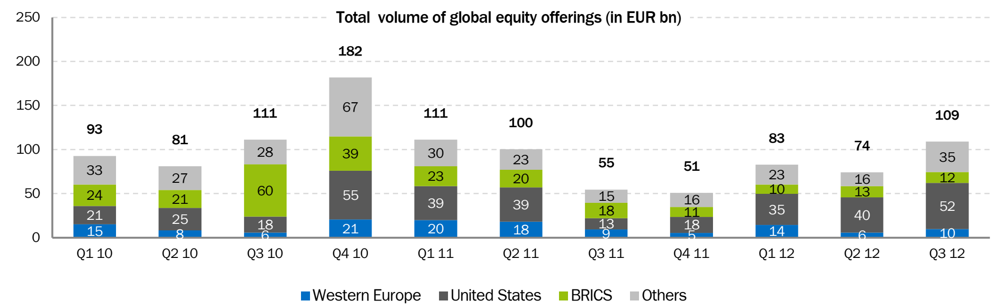


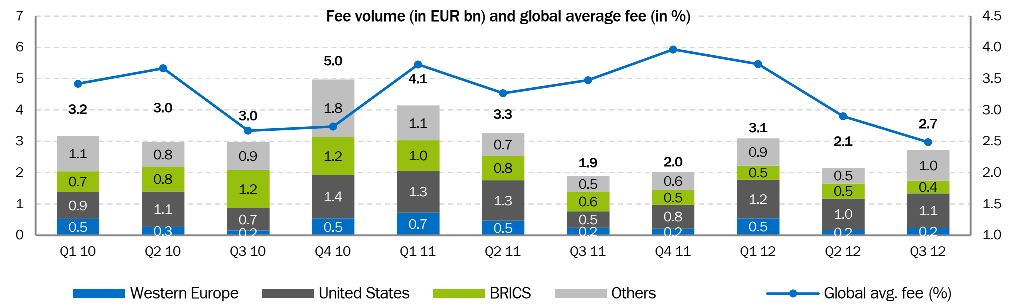
Fee volume (left-hand axis) and global average fee rate (right-hand axis) are estimated based on offering volume and volume-weighted average of all available fees.
Source: Bloomberg, zeb/research

/ In Q3 2012, the global volume of corporate bond issuances increased by 42% to EUR 699 bn
/ Especially Western European companies (+49% issuance volume) raised liquidity directly via capital markets as a cost-saving alternative to long-term bank loans
/ The volume effect was enhanced by a 12bp higher fee rate, resulting in a global fee volume grown by 75% to EUR 4.4 bn

Fig. 13: Equity offering business by home region of issuing company

Increased equity offering volume but lower fee rate



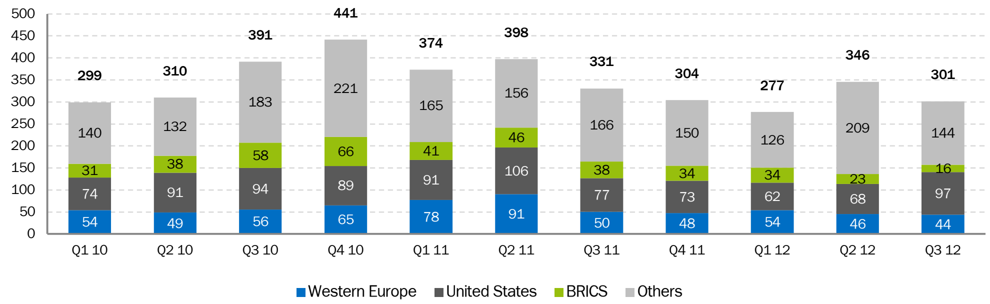


Equity offering business includes initial public offerings and additional equity listings. Fee volume (left-hand axis) and global average fee rate (right-hand axis) are estimated based on offering volume and volume-weighted average of all available fees.
Source: Bloomberg, zeb/research

/ Compared to bond issuances, global equity offering volumes increased to an even larger extent (+47%) in Q3 2012 – the US government placed stocks of AIG insurance, which was rescued after the Lehman crash, in two tranches with a total volume of EUR 21 bn
/ However, this positive effect was partly offset by a further declining fee rate (-0.4%p), which led to a fee volume of "just" EUR 2.7 bn (+26%)

Fig. 14: Deal volume of M&A business by home region of acquired company (in EUR bn)

Only M&A deals with US targets developed positively



Category "Others" includes all M&A transactions with target companies from regions different than those specified and deals with targets in multiple regions not further specified. All transactions classified by announcement date.
Source: Bloomberg, zeb/research

/ After a temporarily higher deal volume in Q2 2012, the third quarter exhibited a lower M&A volume of EUR 301 bn, 13% less than in Q2 2012

/ In contrast, M&A deals with US targets showed a substantial increase in volume to EUR 97 bn (+43%), including the sale of Citigroup's remaining shares in the joint venture Morgan Stanley Smith Barney, specialized in wealth management, to Morgan Stanley for EUR 5 bn

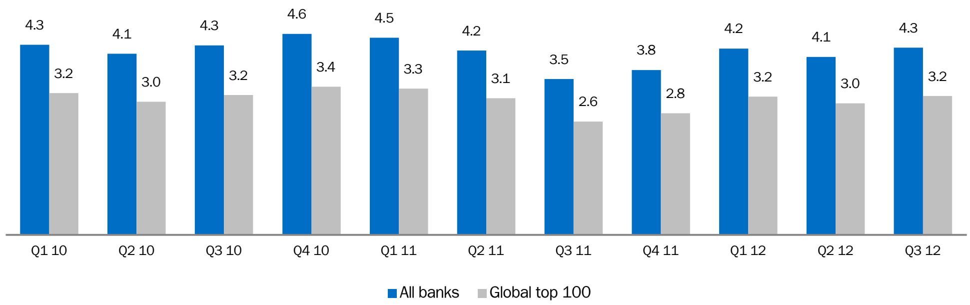
III. State of the banking industry

Market valuation

Q3 2012 was a strong quarter for the global banking industry. The banking sector regained value which it had lost in the previous quarter, mainly due to an increased market capitalization of the global top 100 institutions.

Fig. 15: Market capitalization of the banking sector (end of quarter, in EUR tr)

Top institutions regained value lost in Q2 2012

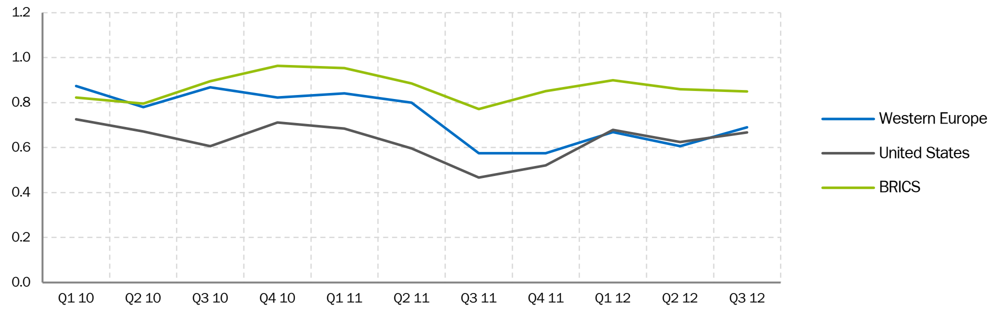


All banks include all banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization.
Source: Bloomberg, zeb/research

/ After a temporary drop in Q2 2012, the global banking industry continues to recover from its losses in the second half of 2011

/ The global top 100 institutions account for the essential part of the increase in market capitalization (+EUR 0.2 tr) of the banking sector (all banks)

Fig. 16: Market capitalization of global top 100 banks by region (in EUR tr)



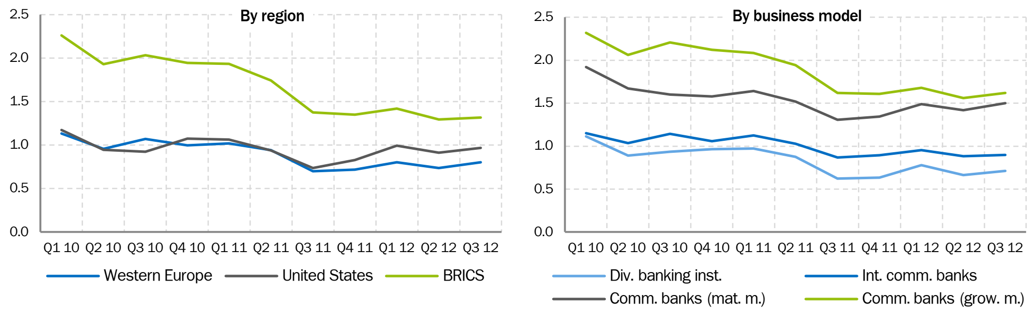
Source: Bloomberg, zeb/research

Western European banks achieve strongest growth in market capitalization

/ Despite a deteriorating economic outlook and ongoing sovereign debt issues, the market capitalization of US and Western European top institutions improved in Q3 2012 thanks to central bank support

/ The aggregated market capitalization of BRICS institutions further decreased by 1.1%, reflecting the reduced growth outlook in figure 2

Fig. 17: Price-to-book ratio of global top 100 banks



Regional commercial banks still achieve highest price-to-book ratios

Diversified banking institutions generate more than 30% of their earnings from investment banking / trading / non-classic banking activities, international commercial banks generate more than 70% of their earnings from classic banking in culturally different types of international markets, commercial banks from mature/growing markets generate more than 70% of their earnings from classic banking activities in their respective market type.
Source: Bloomberg, zeb/research

/ With regard to regional distribution, the average price-to-book ratio of Western European institutions increased most by 9.1% in Q3 2012, while at the same time remaining the region with the lowest price-to-book valuation

/ Considering the business model of the top 100 institutions, investors still prefer national commercial banks over diversified banking institutions and international commercial banks

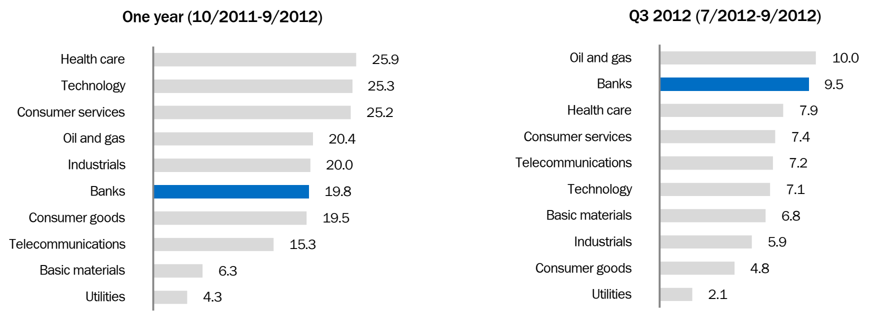
/ Within the group of national commercial banks the valuation difference between mature and growth markets declined due to GDP growth and outlook in the latter regions slowing down (see fig. 1 and 2)

Equity performance

Across all sectors, the global equity performance was positive in the third quarter of 2012. Banks in particular performed well in the recent quarter, the average total shareholder return (TSR) of the banking industry ranks second among all sectors.

Banks performed well in Q3 2012

Fig. 18: Total shareholder return of industry sectors worldwide (in %)

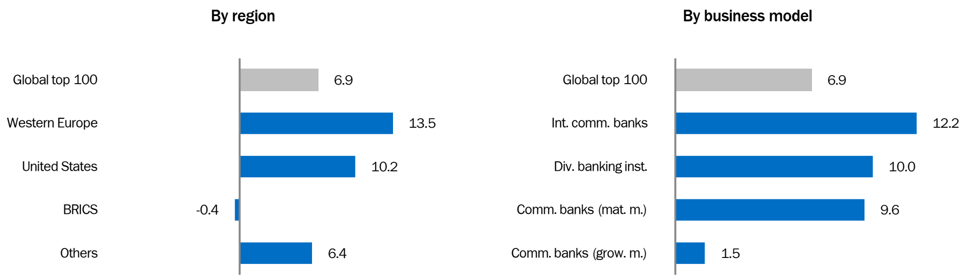


Total shareholder return of industry sectors based on global sector total return indices, aggregated and provided by Datastream.
Source: Datastream, zeb/research

- In Q3 2012, all industry sectors provided positive returns to their investors – with a TSR performance of 9.5% in the last quarter, banking ranks second
- During the last 12 months, the banking sector performed moderately compared to other industries with a TSR of 19.8%

Central bank support in Western Europe and the US boosts TSR performance

Fig. 19: Total shareholder return of global top 100 banks (07/2012-9/2012, in %)



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

- Central bank support in the US and Western Europe pushed the TSR performance in these regions in Q3 2012
- This also explains the performance of business models as most international commercial banks and diversified banking institutions are from Western Europe and the US

TSRs in Europe very heterogeneous despite ECB support

Fig. 20: Top/low TSR performers among global top 100 banks (7/2012-9/2012, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
Credit Agricole SA	France	54.7	Huaxia Bank Co Ltd	China	-15.1
Barclays PLC	Britain	32.8	Bank of Beijing Co Ltd	China	-13.8
Banco do Brasil SA	Brazil	29.1	Shenzhen Development Bank Co	China	-13.4
Danske Bank A/S	Denmark	28.6	Shanghai Pudong Development Bank	China	-9.2
Lloyds Banking Group PLC	Britain	24.9	VTB Bank OJSC	Russia	-7.5

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
Credit Agricole SA	France	54.7	Standard Chartered PLC	Britain	2.6
Barclays PLC	Britain	32.8	HSBC Holdings PLC	Britain	3.3
Danske Bank A/S	Denmark	28.6	UBS AG	Switzerland	3.6
Lloyds Banking Group PLC	Britain	24.9	Intesa Sanpaolo SpA	Italy	5.8
Skandinaviska Enskilda Banken AB	Sweden	22.9	UniCredit SpA	Italy	8.5

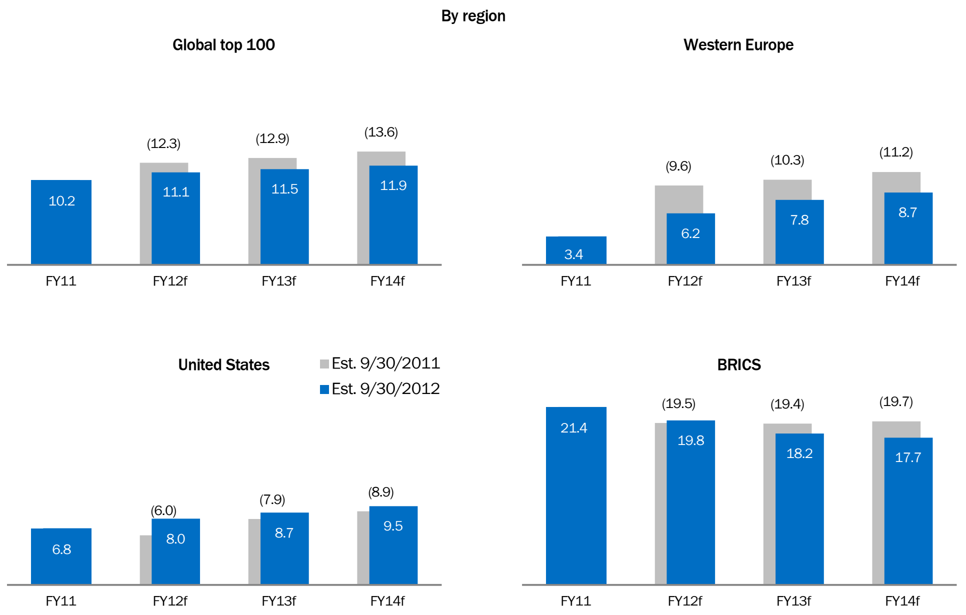
Source: Bloomberg, zeb/research

/ The top 100 banks ranking shows that the global banking sector developed quite heterogeneously – top performers achieved a TSR of more than 50% over the last quarter, while low performers from BRICS lost up to 15%

/ Despite ECB support, the Western European TSR performance was very heterogeneous, too – however, all banks presented a positive TSR in the last quarter

Only US RoE forecasts revised upwards

Fig. 21: RoE after taxes and yearly RoE forecast changes of global top 100 banks (in %)



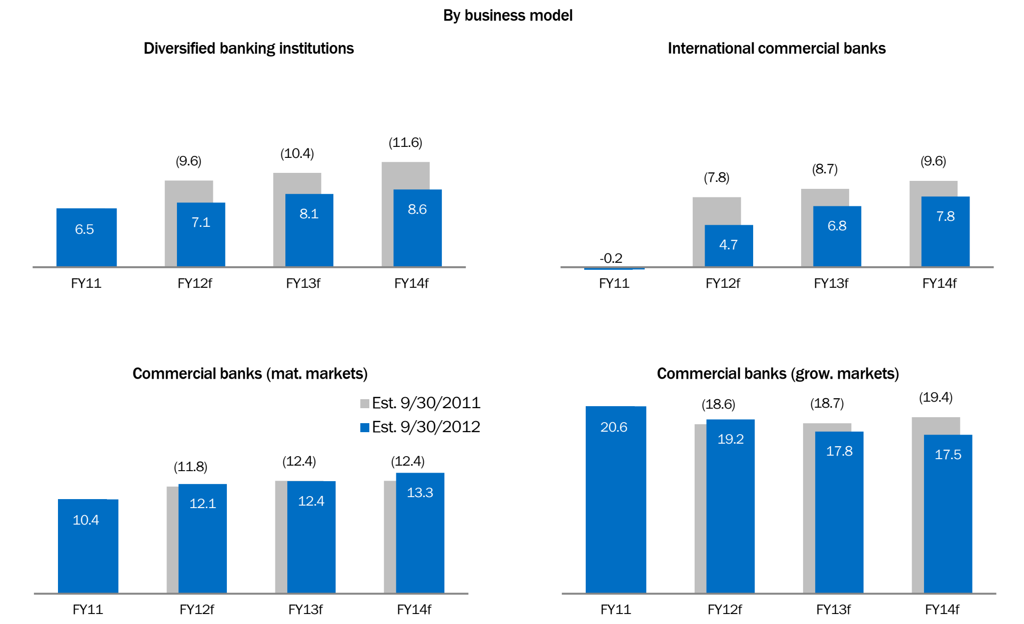


Figure compares different consensus forecasts of return on equity of global top 100 banks based on market capitalization. Forecasts are calculated as equity-weighted averages of analysts' consensus forecasts as available in Bloomberg.
Source: Bloomberg, zeb/research

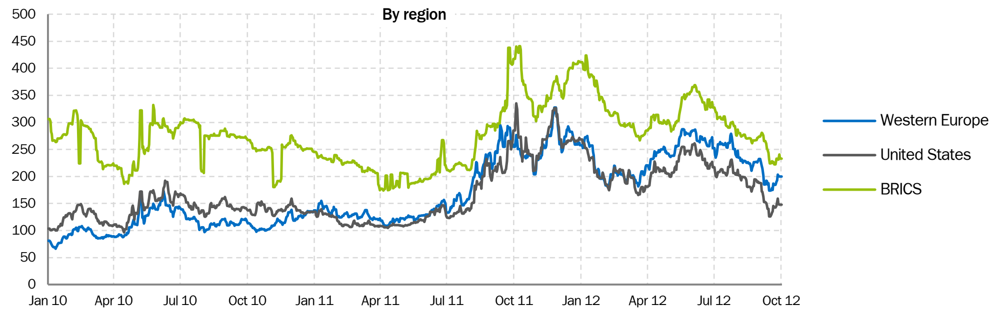
- In general, RoE forecasts were revised downwards over the course of the last year, with the exception of banks in the US and commercial banks in mature markets
- The RoE of Western European and US institutions is currently expected to grow from a very low level of 3.4% and 6.8% in 2011 to 8.7% and 9.5% in 2014, which is still low when compared to the RoE of BRICS institutions, which is expected to decrease by 3.1%p from 2011 to 2014
- The low valuation of diversified banks and international commercial banks in figure 17 was underlined by lower RoE forecasts
- Regional commercial banks are expected to have by far the highest profitability level in the near future while the difference between mature and growth markets is shrinking

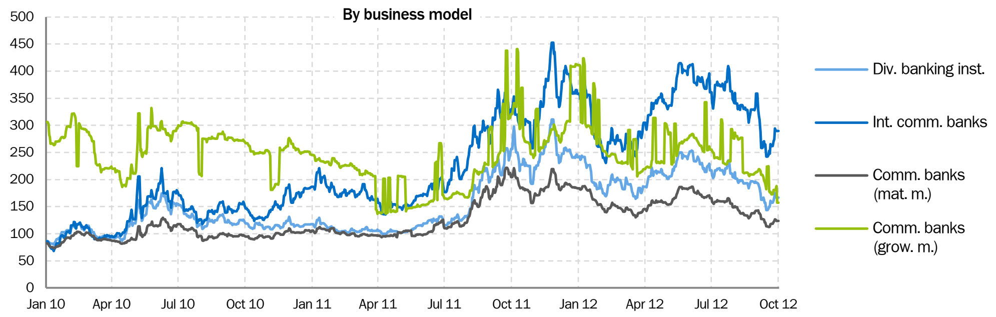
Debt perspective

The third quarter of 2012 was characterized by a cautious return of trust in the banking sector: Banks' CDS spreads dropped significantly and the series of rating downgrades was stopped.

Banks' CDS spreads reached one-year low

Fig. 22: CDS spreads of global top 100 banks (avg. 5-year CDS spreads, in bp)



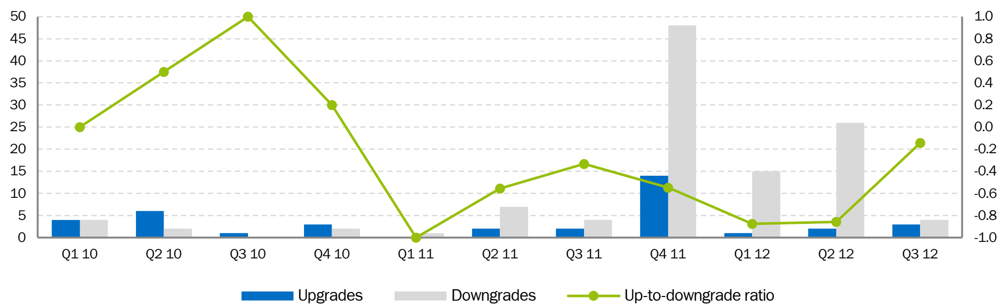


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Bloomberg, zeb/research

- In Q3 2012, CDS spreads of top 100 banks fell regardless of region or business model
- Regionally, CDS spreads of US institutions are at the lowest with 148bp at the end of Q3 2012 but even the average spread of institutions from Western Europe, which are generally vulnerable due to the ongoing debt crisis and a bad economic outlook, dropped to 200bp (-21%)
- With regard to business models, the strongest quarterly decline can be denoted for commercial banks from growing markets with -38% from 255 to 158bp; but even the spreads of international commercial banks dropped by 20% to 290bp
- The combination of relatively high CDS spreads and low RoE forecasts explains the lower price-to-book valuation of international commercial banks and diversified banking institutions – recent TSR recovery is most likely just a one-time high due to central banks support

Fig. 23: Rating changes of global top 100 banks

Series of rating down-grades brought to an end for now



Rating changes consider number of upward and downward revisions of 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

- After three quarters of several rating downgrades due to the sovereign debt and Spanish banking crises, only four downgrades are accompanied by three upgrades in Q3 2012 – as a consequence, the up-to-downgrade ratio improved from below -0.8 to -0.2
- Although some institutions were still downgraded in Q3 2012, the overall funding situation for banks improved, taking declined CDS spreads (fig. 22) and a further eased interbank funding situation (fig. 10) into account

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 October 1, 2012. 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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For more information: **www.zeb.de**

Contact

Dr. Dirk Holländer
Partner
Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.182
Fax +49.251.97128.101
E-mail dhollaender@zeb.de

Volker Abel
Senior Manager
Taunusanlage 19
60325 Frankfurt am Main | Germany

Phone +49.69.719153.453
Fax +49.69.719153.410
E-mail vabel@zeb.de

Oliver Rosenthal
Head of Research
Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.135
Fax +49.251.97128.101
E-mail orosenthal@zeb.de