Issue 17 | April 13, 2016

Banking industry shocked by financial market eruptions—new banking crisis imminent?

zeb.market.flash Q1 2016

Key topics

I. State of the banking industry

- Global capital markets were massively distressed during the first quarter of 2016—significant loss of market cap. (global top 100 banks: -12.1%), decline in P/B ratios of around 9% on average and the lowest TSR performance of all industry sectors
- Among global top 100 banks, especially shareholders of Western European banks had a very rough quarter losing 15.2% on average

II. Economic environment and key banking drivers

- Worsening economic figures for China and the ECB's decision to further expand its ultra-loose monetary policy (rate on main refinancing operations reduced by 5bp to 0.0%, new series of targeted longer-term refinancing operations, TLTRO II) dominated the economic environment in Q1 2016
- Business climate deteriorated again with figures declining for at least the third consecutive month
- In Q1 2016, Western European banks once again reported massive bottom line issues for the second half of 2015—full year post-tax return on equity of just 6.0%

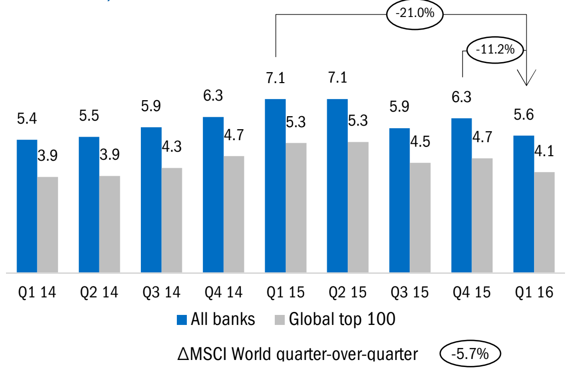
III. Special topic: Sell-off in European banking industry—fundamental reasons or exaggerated fear?

- Negative TSR performance goes along with a significant reduction in the profitability outlook for respective banks
- Pessimistic profitability outlook combined with bad news from the Chinese economy created toxic sentiment leading to a strong reaction in the capital market

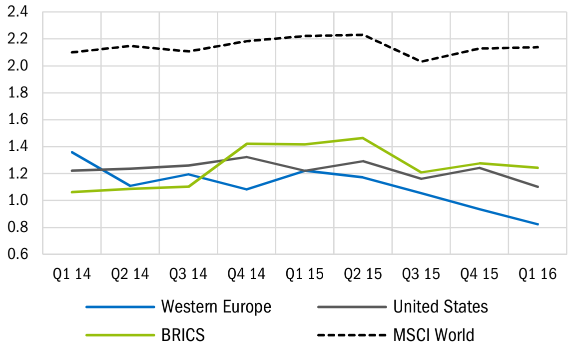
I. State of the banking industry

Global capital markets were massively distressed during Q1 2016. Starting with bad news from the Chinese economy, uncertainty increased among market participants leading to a strong downturn in stock prices in January. While other industry sectors recovered in the course of the first quarter, the valuation of the banking sector (and especially Western European banks) remained in a slump. Global top 100 banks ended Q1 2016 with a total shareholder return of -8.6%.

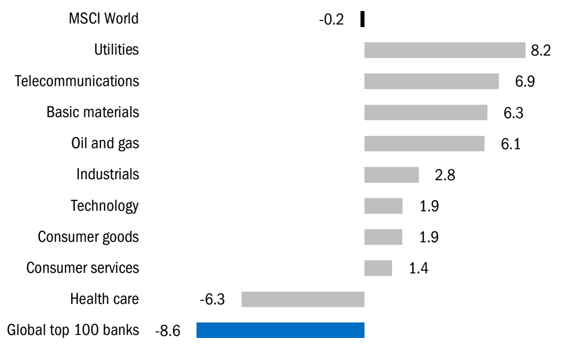
Market capitalization of the banking sector (end of quarter, in EUR trillion)[1)]



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



TSR of industry sectors worldwide (1/2016-3/2016, in %)[3)]



Top/low TSR performance among global top 100 banks (1/2016-3/2016, in %)

Top performers	Country	TSR
Banco Bradesco SA	Brazil	40.7
Allied Irish Banks	Ireland	36.6
Itau Unibanco	Brazil	21.9
FirstRand Bank	South Africa	16.9
Bank Mandiri	Indonesia	14.2
Low performers	**Country**	**TSR**
UniCredit	Italy	-38.3
Credit Suisse	Switzerland	-37.3
Deutsche Bank	Germany	-33.8
Barclays PLC	United Kingdom	-30.0
Mitsubishi	Japan	-29.9

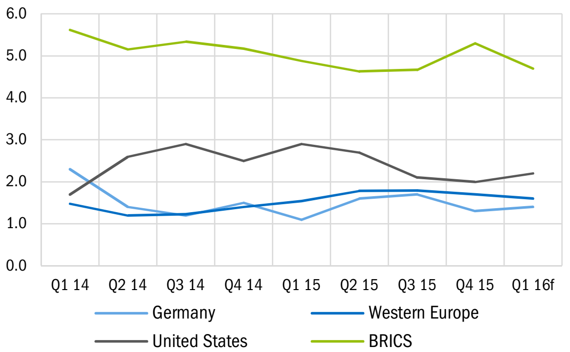
1) All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2015. Figures are aggregated in EUR, without adjustments for foreign currency effects; 2) Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland,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

- Significant loss of market cap. (global top 100 banks: -12.1%), decline of P/B ratios by around 9% on average and the lowest TSR performance of all industry sectors characterize the global banks' capital market performance in Q1.
- At the end of Q1, several large European players showed disastrous P/B ratios, for example Deutsche Bank (0.31), UniCredit (0.40), Barclays (0.42) or Société Générale (0.44).
- Among global top 100 banks, especially shareholders of European banks had a very rough quarter losing 15.2% on average. Main reasons: several large players reported weak full year results (well below market expectations) accompanied by increasing market doubts regarding the sustainability and the future course of European banks.
- Two Brazilian banks, Banco Bradesco and Itau Unibanco, are among the top performers in Q1 2016. Market participants were positively surprised by the banks' Q4 results and analysts consider the looming political impeachment of the Brazilian president as a possibility to start stabilizing the struggling Brazilian economy again.

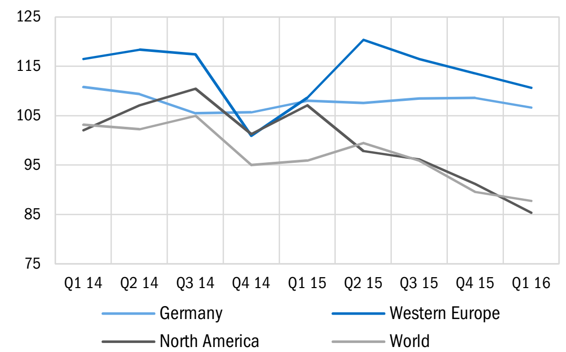
II. Economic environment and key banking drivers

Looking back at the first months of 2016, two topics dominated the global economy: First, China once again reported lower growth rates for its economy. GDP growth was noticeably below the state-prescribed hurdle of 7%, imports shrunk by 25% and the government even lowered its outlook for the upcoming quarters. Second, the European Central Bank extended its ultra-loose monetary policy by lowering the rate on the main refinancing operations by 5bp to 0.0%.

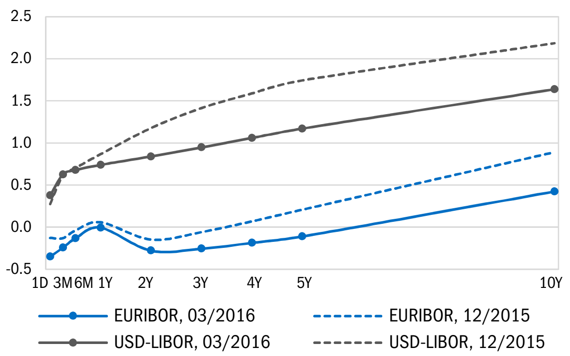
GDP growth and forecasts (real GDP, year-over-year growth rates, in %)[1)]



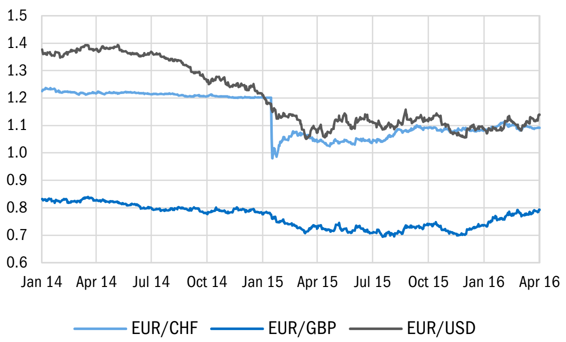
Economic sentiments (ifo Business Climate Index)[2)]



Money and capital market rates



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

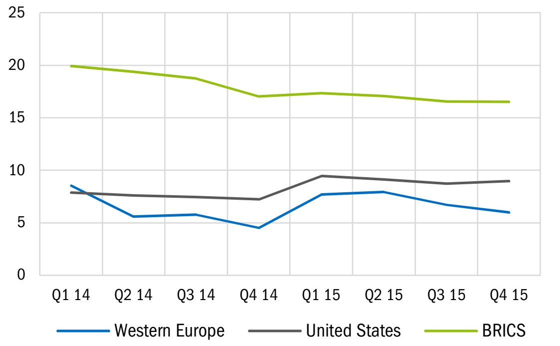


1) Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; Q1 16 based on forecasts; 2) The ifo Business Climate Index is an indicator for economic activity based on a survey among companies on their current business situation and outlook 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

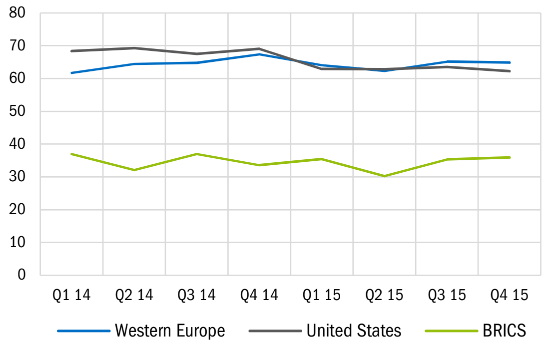
- Bad news from the Chinese economy once again fueled the worldwide fear of a looming global recession. Current GDP rates are still stable (or even slightly increasing in the US and Germany), but the business climate is causing concerns. Sentiment in Western Europe, North America and even worldwide deteriorated for the third time in a row (US: four times).
- The ECB's decision in March to expand its quantitative easing program (lower central rates, new series of targeted longer-term refinancing operations, TLTRO II) still has not had the intended impact on the real economy (either through higher GDP forecasts or improved business climate). European interest rates declined significantly compared to the end of 2015. Currently, even the 5-year EURIBOR is negative (for the first time ever). The spread between 2-year and 10-year interest rates is only 70bp leading to the flattest yield curve since March 2015.

The low levels of profitability and efficiency remain major issues in the banking sector. Especially Western European banks, which had a strong start in the first half of 2015, reported disappointing full year figures. In contrast to this, US banks seem to be in much better shape: post-tax return on equity remained just under 10% for 2015 but clearly increased compared to 2014.

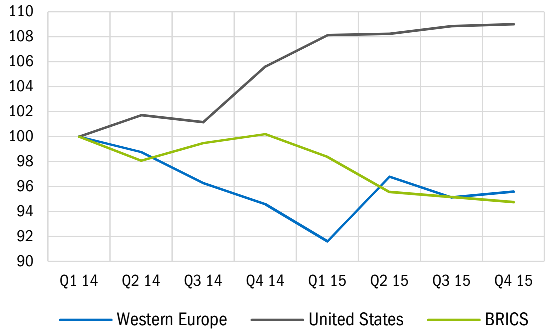
RoE after tax of global top 100 banks (in %)[1)]



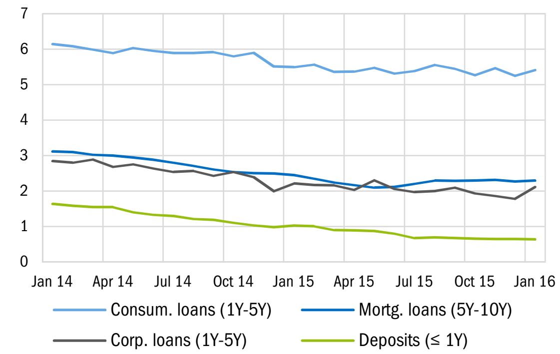
Cost-income ratio of global top 100 banks (in %)[2)]



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



Customer interest rates in the euro area (new business, in %)[4)]



Q1 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, 2014; Source: Bankscope, ECB, zeb.research

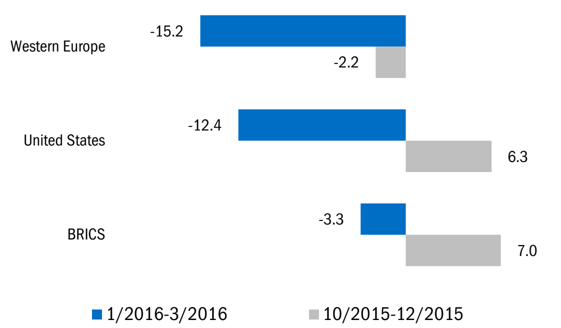
- In the first half of 2015, the European Banking sector seemed to be back on track with several large institutions reporting their best quarters in recent years. However, after reaching a post-tax RoE of 8.0% in mid 2015, the sector stumbled again in Q3 and Q4 due to new litigation costs and new depreciations on securities and investments, especially because of a weak investment banking business. Overall, for the full year 2015, profitability of European banks was just 6.0% and therefore once again below costs of equity of around 9-10% requested by investors.
- The overall outlook is not promising: The ECB even expanded its ultra-loose monetary policy leading to a continuous decline in deposit rates. From today's perspective, Western European banks' P&L will definitely remain under pressure in the quarters to come.
- US banks showed a better development in 2015: profitability improved noticeably from 7.2% in 2014 to 9.0% at the end of 2015 despite negative effects of new litigation costs for selected large players. In contrast to Western European banks that have reduced their risk-weighted assets since 2014, US banks continued to continuously increase their RWA density.

III. Special topic

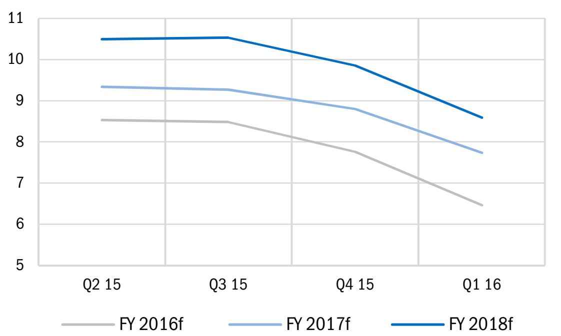
Sell-off in European banking industry—fundamental reasons or exaggerated fear?

The European banking industry has been severely affected by the global stock market turmoil since the beginning of 2016. A slump in stocks of European banks and increasing CDS spreads of bank bonds imply a significant loss of confidence in the European banking industry. More than in other regions, the profitability of the European banking industry has suffered from low interest rates and high regulatory pressure for years. Due to further intended regulatory initiatives and the ECB's expanded QE program, there is no improvement to be expected. The special topic in this issue focuses on the question whether this market behavior is fundamentally justified or simply an overreaction.

TSR of global top 100 banks by regions (10/2015–12/2015 and 1/2016-3/2016, in %)



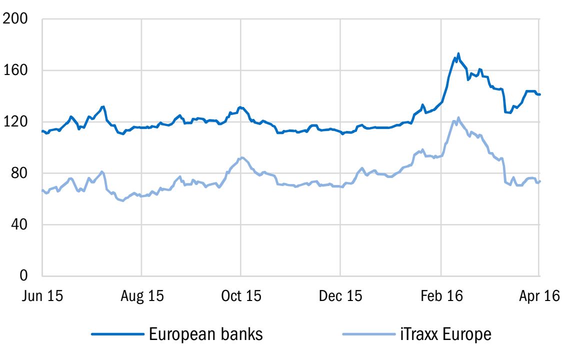
Analysts' consensus forecast on RoE after tax of European top banks (in %)[1)]



Performance and profitability forecast of European top/low performers (as measured by TSR 1/2016-3/2016)[2)]

Top performers	TSR 1/2016-3/2016, in %	RoE after tax FY 2016f Q4 2015, in %	RoE after tax FY 2016f Q1 2016, in %
Allied Irish Bank	36.6	10.4	10.8
Danske	4.2	10.8	11.2
Svenska	-3.4	12.3	12.1
Swedbank	-6.5	14.4	14.3
Lloyds Bank	-6.9	12.1	12.5
Low performers			
Unicredit	-38.3	5.6	4.8
Credit Suisse	-37.3	7.2	2.0
Deutsche Bank	-33.8	4.1	0.6
Barclays PLC	-30.0	7.3	4.3
Royal Bank Scotland	-26.3	1.1	0.1
European market			
EURO STOXX	-6.5		

CDS spreads of European top banks and corporates (avg. 5-year CDS spreads, in bp)[3)]



1) Average value of individual forecast of 27 European banks, weighted by total equity; consensus forecasts are based on estimates from economists at major banks and brokerages;
2) Profitability forecasts: consensus forecasts based on estimates from economists at major banks and brokerages; 3) European top banks' 5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank; Source: Bloomberg, Thomson Reuters Datastream, zeb.research

Many of the largest European banks reported very good bottom line results for the first six months of 2015, however full year results were quite disappointing. Whereas US and BRICS institutions stabilized or even improved their results, European banks once again showed decreasing profitability (see chapter II). Consequently, it is the second quarter in a row that European banks show a negative TSR performance. Furthermore, analysts' forecasts on post-tax RoE of European banks were adjusted downwards to a considerable extent. Since October 2015, not only short term but also long term forecasts have been corrected by around -2pp. As a result, market uncertainty and CDS spreads increased significantly. After the current market turmoil, the gap between European banking spreads and corporates rose by 29bp.

European banking spreads are now roughly double the corporate average which indicates a decreasing confidence in the banking sector.

A closer look at the low and high performers among European institutions reveals the fundamental problems of this industry. The high performing banks exhibit constant profitability forecasts and their TSR performance (between -6.9% and +36.6%) seems to be driven by the overall market performance (see EURO STOXX performance of -6.5% in Q1 2016). The low performing banks show a disastrous TSR performance between -26.3% and -38.3%. The bad capital market performance in Q1 2016 goes along with a significant reduction in the profitability outlook for these banks and indicates structural problems. The reasons for this are manifold. Several big European players are dealing with restructuring measures and have announced new strategies. The execution of these restructuring measures is tough and the desired effects will take a long time to materialize. For example, the post-tax RoE forecasts of Deutsche Bank and Royal Bank of Scotland are just slightly above zero. This bearish perspective is also confirmed by the new European Banking Study 2016 by zeb which analyses the situation and developments of European top 50 banks. The results show that by 2020, alarming 33 of the top 50 European institutions will be below the required capital and profitability hurdles.

The results indicate that the capital market performance of banks in Q1 2016 is to a large extent driven by structural problems. In addition to the pessimistic profitability outlook, bad news from the Chinese economy have increased investors' fears of a prolonged recovery path of the European banking sector. These factors in combination have created a toxic sentiment leading to a strong reaction in the capital market. Overall, the combination of persistent fundamental problems of the European banking industry and the bearish economic perspective have led to the sudden turmoil in European stock markets and a further loss of confidence in European banks.

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, 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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