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Capital markets hit by Brexit vote—uncertainties are poisoning market conditions of EU banking industry

zeb.market.flash Q2 2016

Key topics

I. State of the banking industry

- The Brexit decision on June 23rd discontinued the positive trend of the first two months of the second quarter in 2016
- While banks from BRICS and the US showed a positive TSR, European banks ended Q2 with a loss of 8.2% on average

II. Economic environment and key banking drivers

- Persistent low inflation rates and economic uncertainty support the low interest rate policy—money and capital market rates decreased further
- The Brexit decision shows its first impact leading to a decline of the British pound
- Reported figures from Western Europe and BRICS banks showed solid profitability in the first quarter of the year, while US banks reported decreasing results for the fourth time in a row but still remain on a higher level than European banks

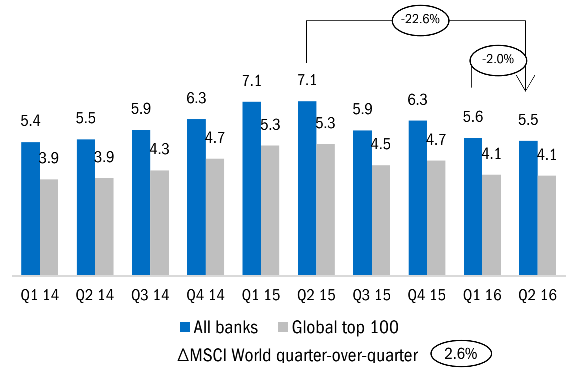
III. Brexit consequences for the European banking industry

- The Brexit decision caught the capital markets on the wrong foot—European banks were hit hard
- Global and large European banks have to deal with market uncertainty and essential issues regarding fundamental changes of legal entity structures and the operating model

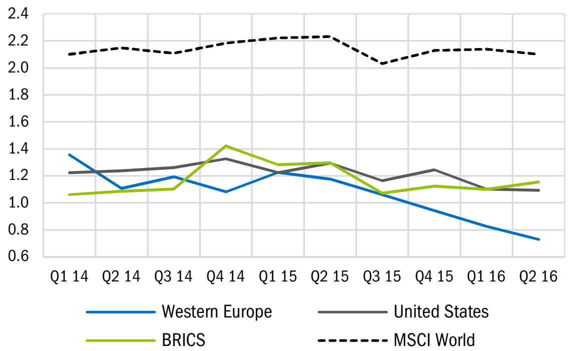
I. State of the banking industry

After a relatively calm and dull development during Q2 2016 the Brexit has dominated the second quarter at the end, leading to a loss of 8.2% on average for European banks. With a P/B ratio of 0.7, the European banking industry is falling further behind.

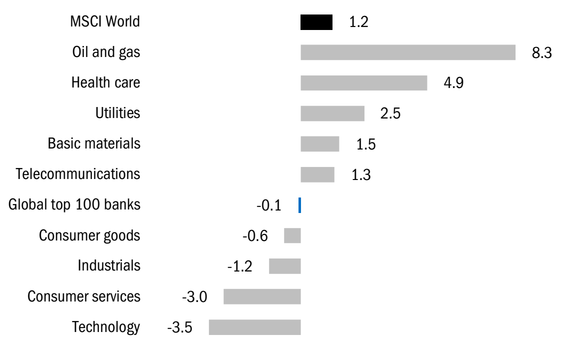
Market capitalization of the banking sector (end of quarter, in EUR trillion)[1]



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



TSR of industry sectors worldwide (4/2016–6/2016, in %)[3]



Top/low TSR performance among global top 100 banks (4/2016–6/2016, in %)

Top performers	Country	TSR
SBERBANK PJSC	Russia	22.8
AXIS BANK LTD	India	20.1
STANDARD CHARTERED	United Kingdom	19.5
SUNTRUST BANKS	United States	14.5
STATE BANK IND	India	14.1
Low performers	**Country**	**TSR**
ALLIED IRISH BK	Ireland	-39.5
UNICREDIT SPA	Italy	-35.2
INTESA SANPAOLO	Italy	-25.6
CAIXABANK S.A	Spain	-23.3
ROYAL BK SCOTLAND	United Kingdom	-22.9

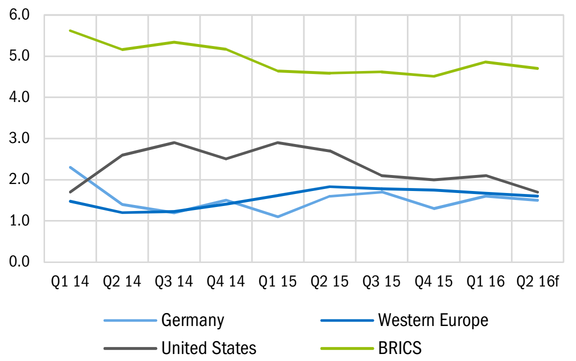
1) All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2015. Figures are aggregated in EUR, without adjustments for foreign currency effects; 2) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, 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

- At the end of Q2, the top 100 banks could more or less sustain their market capitalization which is still far below the peak value one year before (-23.8%).
- Up to the day of the EU referendum, global top 100 banks showed solid performance, but the Brexit vote wiped out most of the TSR performance (-0.1%). European banks were hit extremely hard: while banks from BRICS and the US still show a positive TSR (BRICS: +4.5%, US: +0.6%), European banks ended Q2 with a loss of 8.2% on average. During the first days in July further pressure was put on the market indicating an ongoing “crash at slow pace”.
- Accordingly, the P/B ratios of European banks were still in decline (for the fourth time in a row). UniCredit (0.25), Deutsche Bank (0.27), Credit Agricole and Royal Bank of Scotland (0.37) with the lowest values.
- Standard Chartered, a UK bank with focus on the Asian market, was among the top performers due to high TSR performance within the pre-referendum period of Q2 2016 (+22.3%) and suffered only small losses in final days of Q2.
- Unicredit and Intesa are currently under particular pressure due to high capital gaps and high non-performing loan ratios (17% NPL ratio for the Italian market).

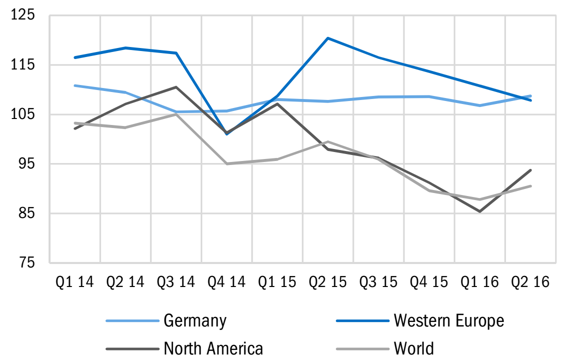
II. Economic environment and key banking drivers

Money and capital market rates decreased further due to persistent low inflation rates and economic uncertainty. In contrast to the rest of Western Europe, the ifo institute expects that the German economy will continue to grow. The Brexit decision had its first impact as the FX rates changed sharply at the end of June. However, a further impact on economic sentiments and GDP growth is to be expected.

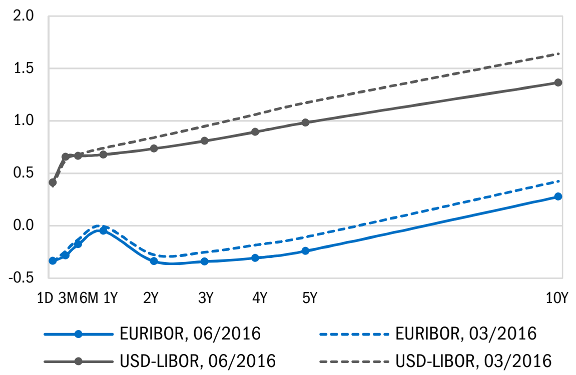
GDP growth and forecasts (real GDP, year-over-year growth rates, in %)[1)]



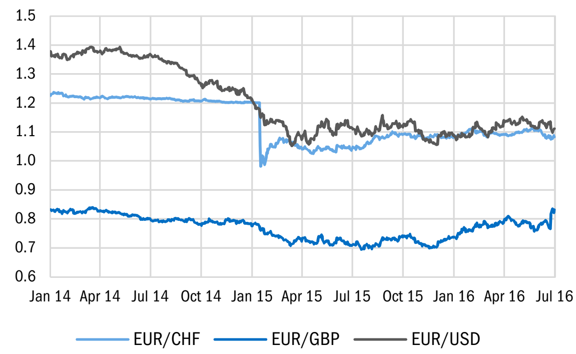
Economic sentiments (ifo Business Climate Index)[2)]



Money and capital market rates



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

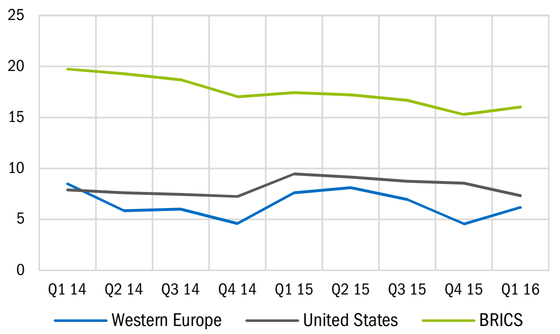


1) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; Q2 16 based on forecasts; 2) The ifo Business Climate Index is an indicator for economic activity based on a survey among companies on their current business situation and outlook 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

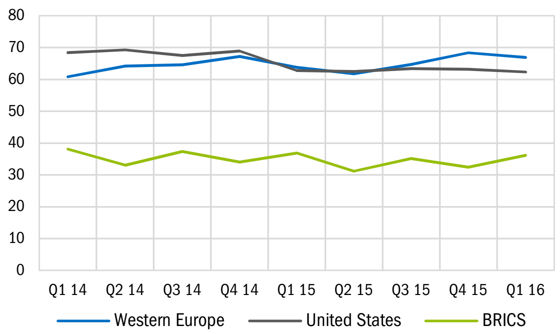
- While the GDP growth of the US dropped by 0.4 percentage points to 1.7%, the other regions remained stable. The economic effects of the Brexit has not been reflected yet.
- Due to the worsened economic figures and the increasing market uncertainties, the Fed has suspended its announced interest rate increase for June. According to J. Yellen, the international uncertainty has put pressure on the US monetary policy. Supported by a re-stabilized oil price, the ifo climate index of the US rose significantly.
- The EURIBOR curve is at a very low level again with now even a negative 7-year EURIBOR. The spread between 2-year and 10-year interest rates is close to 60bp indicating that the yield curve has flattened again. Persistent low inflation rates and economic uncertainty reinforce the low interest rate environment.
- One of the major direct impacts of the Brexit vote was a considerable exchange rate decrease of the British pound, which caused a rise of the EUR/GBP FX rate at the end of the last quarter (+5%). Furthermore, the Swiss franc appreciated slightly due to its status as a safe haven currency.

Looking at reported results, in particular banks from Western Europe and BRICS had a good start in Q1 2016, while US banks reported decreasing RoE figures for the fourth time in a row. However, the RoE level of US banks (7.3%) is still above that of European banks (6.2%). Furthermore, due to a persistent low yield environment, regulatory pressure and possible negative impacts of the Brexit, profitability will remain a major issue for the European banking sector.

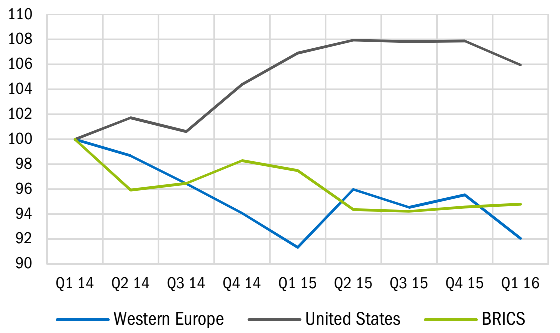
RoE after tax of global top 100 banks (in %)[1)]



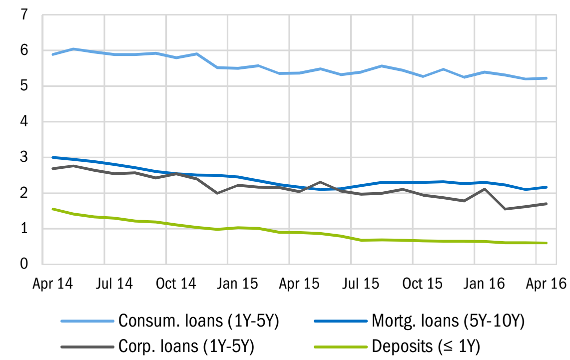
Cost-income ratio of global top 100 banks (in %)[2)]



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



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



Q2 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

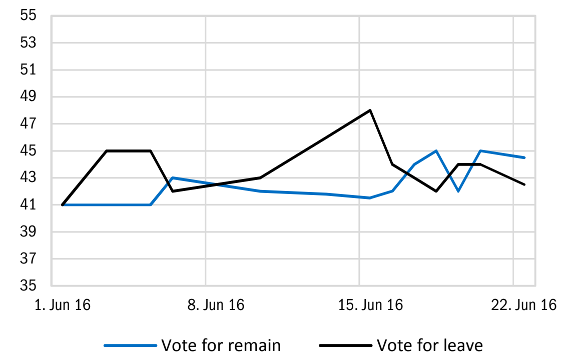
- Especially European banks reported much better results in Q1 2016 than in Q4 2015 because of the absence of extraordinarily high litigation costs (RoE +1.6pp).
- Since Q2 2015, the RoE of US banks has fallen constantly (-2.1pp yoy). The gap between US and European banks' profitability was gradually closing in Q1 2016. However, the positive development of European banks' profitability is unlikely to persist due to impending negative consequences of the Brexit.
- US Banks and European banks both reduced their RWA density in the first quarter of 2016 (US: -1.8%, Western Europe: -3.6%). For US banks, it is the first significant reduction in RWA density since Q3 2014.

III. Special topic

Brexit consequences for the European banking industry

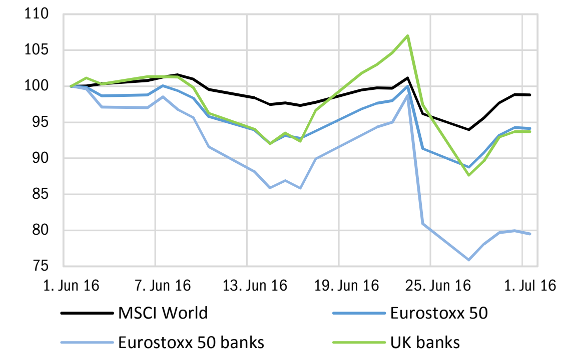
Even though the EU Referendum poll tracker indicated a small lead of the remain proponents, the eligible voters in the UK voted in favor of the British exit from the European Union on June 23rd. Stated in plain figures, the EU's second largest economy (EUR 2.6 tr, 18% of total GDP of the EU), third largest net contributor (EUR 5 bn per year) and largest banking market (EUR 8.9 tr, 21% of total assets) decided by a narrow majority in favor of the so-called "Brexit". At first, the market reactions to the referendum will be analyzed and secondly, an outlook will be given regarding the future for European banks.

EU referendum poll tracker[1)]

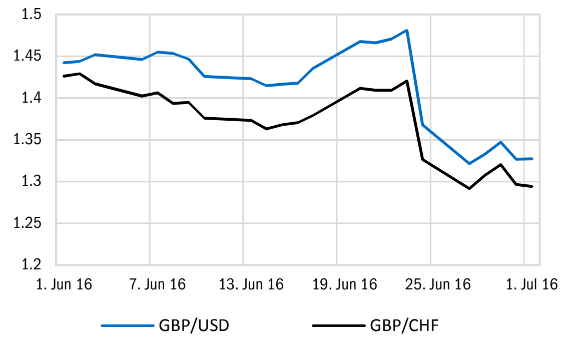


Euro Stoxx 50 Volatility index

Stock market indices and total return index of top UK banks[2)] (indexed to 100)



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



1) Bloomberg composite EU referendum poll tracker: takes the average poll from various surveys, undecided votes are not shown; 2) Total return index of UK banks among the global top 100 banks (based on market capitalization on December 31, 2015); Source: Bloomberg, Thomson Reuters Datastream, zeb.research

The uncertainties regarding the outcome of the referendum resulted in an increasing market uncertainty in Europe in the run-up to June 23rd. This is shown by the Euro Stoxx 50 Volatility index, which hit its second highest value since 2011, when the Greek government debt crisis caused market turmoil. Furthermore, due to the unexpected result of the referendum (poll tracker showed a constant lead for the remain campaign in the final days), the vote for a Brexit triggered a slump of the capital markets to record lows in the first days. The MSCI World Index lost 4.9% and the Euro Stoxx 50 lost 8.6% in just one day.

Even if the real economic effects in the long term are quite uncertain and intensively debated among experts, nonetheless, in the short and medium terms, Britain's leave vote is causing even more uncertainty in the markets. As an indication, estimates say the Brexit has wiped out over two trillion dollars of value in the worldwide capital markets. Furthermore, the British pound experienced a considerable depreciation against the US dollar and the Swiss franc. Falling to $1.32, the British pound hit a 31-year record low against the dollar. Some experts even assume that the pound will be close to parity to the USD in the coming months.

Focusing on the European banking industry, the Euro Stoxx 50 banks index was down by 18.0%, while shares of the Royal Bank of Scotland, Lloyds and Barclays dropped down by around 30%. The total return index of UK banks (among the global 100) suffered a loss of 9.0% and shareholders of European banks lost 11.7%. During the first days of July, further pressure was put on the market indicating an ongoing slow crash.

Brexit poses new challenges to the British and European banking markets. Besides the current challenges of increasing regulations, lasting low interest rates and digitalization initiatives, Brexit brings further uncertainties. Different cooperation models between the European Union and the UK are possible: the Norwegian model, which means to enter the European Economic Area (EEA) and the European Trade Association (EFTA), the Swiss model consisting of numerous bilateral agreements, the Canadian model composed of just free trade agreements or at least the standard WTO model. Currently, the Swiss model as a privileged partnership is the most likely one. However, experts consider it unlikely that all the needed negotiation processes can be finished within the next two years.

Depending on the future cooperation model between the EU and the UK, the European banking industry will face different consequences regarding direct and unrestricted access to markets. Without EU passporting rights, several banks will have to fundamentally change their legal entity structure and operating model. Global as well as European banks that have the UK as their single entry point to the EU market will have to shift activities to another EU country, most likely to cities like Frankfurt, Dublin or Paris. Global or European banks which already have other access to the EU market have to reevaluate the appeal of a detached UK market, maybe resulting in resizing UK activities and/or shifting to existing EU subsidiaries. In anticipation of the UK becoming an offshore market, many professional services, EU regulatory entities, clearing and settlement organizations and exchange facilities will probably soon try to migrate back to an onshore EU location. For instance, the merger of the London Stock Exchange (LSE) and its German counterpart Deutsche Börse is facing further difficulties. Even though the shareholders of the LSE voted with 99.9% in favor of the merger, a discussion of whether or not the legal headquarters can be located in London, as an offshore EU marketplace, has been set off. Besides these direct consequences, indirect effects from other industries (e.g. higher trade barriers cause negative economic prospects, which again reduce investments) may deteriorate the economic outlook for the European Union and European banks respectively. On the other hand, there is some hope that some European banks can benefit from the Brexit with regard to market shares, as the UK has exported around 40% of their financial services to the EU.

Further market turbulence has been observed in recent days. Little by little, the ramifications of Brexit are becoming clear. However, there are still too many unclear issues about the political roadmap of the UK, which in turn is keeping the markets uncertain. Banks that are affected by the Brexit should (1) prepare themselves by analyzing the implications of different scenarios and (2) act carefully by waiting with management decisions and execution until the consequences have been clarified.

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 July 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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