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Banking industry lost some momentum in Q2 2017—end of rally or short break?

zeb.market.flash Q2 2017

Key topics

I. State of the banking industry

- The global banking industry lost pace in the second quarter of 2017 with slightly decreasing market capitalization and a relatively weak TSR performance
- On average, global banks' market cap decreased by 2.4% reaching EUR 6.9 tr and a TSR of +3.7%.
- Moreover, global top 100 banks again with relatively low qoq performance in Q2 2017 (+3.7%).

II. Economic environment and key banking drivers

- The economic climate globally and in the euro area continued its positive trend in Q2 2017.
- Fed decision to increase interest rates for the second time this year further flattened USD LIBOR curve. Meanwhile, ECB decided to keep interest rates unchanged leading to a slightly steeper EURIBOR curve.
- Profitability of banks worldwide improved in Q1 2017— European banks in particular were able to increase their RoE by 4.0pp to 7.5% on average, mainly driven by extraordinary effects, reducing the gap to their US peers considerably.

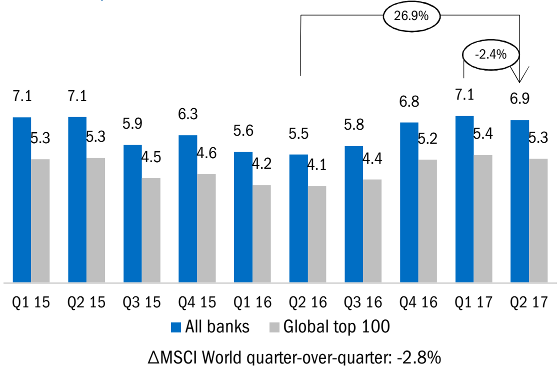
III. Brexit—first observations in year one after the referendum

- 12 months ago, the UK voted for Brexit. After strong market reactions in the days after the referendum, the situation stabilized over the last year. However, a negative outlook for the long-term remains as the market does not expect any winners in the banking industry.
- UK banks with significant EU business showed weaker TSR performance than their peers without business in the euro area
- In June 2017, the official Brexit negotiations between the UK and the EU started. As the outcome of these negotiations is still unclear and the PRA requests contingency plans, affected banks need to prepare themselves for possible Brexit scenarios.

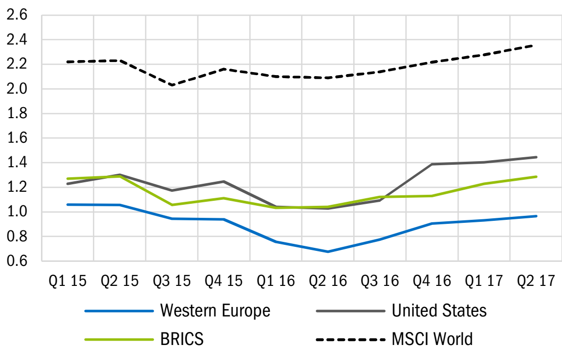
I. State of the banking industry

After the rally in Q4 2016 and a solid capital market performance in Q1 2017, the global banking sector showed slightly decreasing capital market performance in Q2 2017. The total shareholder return of the global top 100 banks was in the middle of the field of industry sectors worldwide—oil and gas as the only industry sector with negative TSR performance.

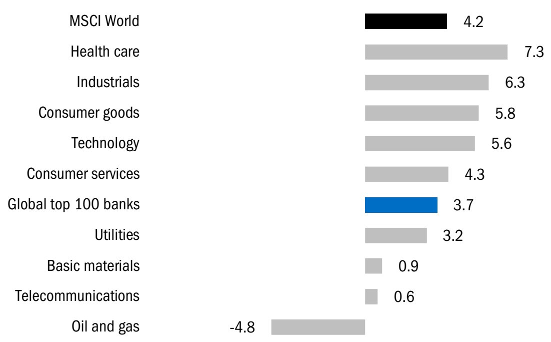
Market capitalization of the banking sector (end of quarter, in EUR trillion)[1)]



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



TSR of industry sectors worldwide (4/2017–6/2017, in %)[3)]



Top/lowest TSR performance among global top 100 banks (4/2017–6/2017, in %)

Top performers	Country	TSR
NATIONAL COMMERCIAL	Saudi Arabia	49.8
CHINA MERCHANTS BANK	China	29.1
BANK RAKYAT INDONESIA	Indonesia	17.5
INTESA SANPAOLO	Italy	16.3
ICICI BANK LTD	India	16.2

Low performers	Country	TSR
BANCO DO BRASIL	Brazil	-19.9
QATAR NATIONAL B	Qatar	-14.2
SYNCHRONY FINANC	United States	-12.7
WESTPAC BANKING	Australia	-11.7
BARCLAYS PLC	United Kingdom	-9.9

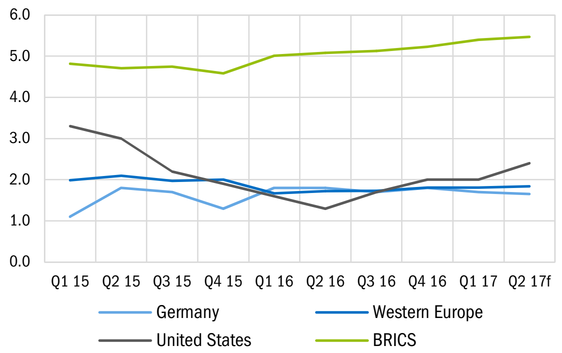
1) All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2016. Figures are aggregated in EUR, without adjustments for foreign currency effects; 2) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, 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 Q2 2017, the market capitalization of the global top 100 (EUR 5.3 tr) as well as the market cap of all banks (EUR 6.9 tr) slightly decreased compared to Q1 2017 (global top 100: -2.8%, all banks: -2.4%) in line with the development of the MSCI-World (-2.8%).
- Due to dividend payments, the TSR performance of the global top 100 banks showed a positive return of +3.7% in Q2 (MSCI: +4.2%).
- Due to the recent political turmoil in the Middle East, the Qatar National Bank showed a negative TSR of -14.2%, whereas the Saudi Arabian bank National Commercial is this quarter’s top performer with regard to TSR performance.
- The only European top TSR performer in Q2 was Intesa Sanpaolo due to a transfer of “good” assets from Veneto Banco and Banca Popolare di Vicenza to Intesa Sanpaolo.

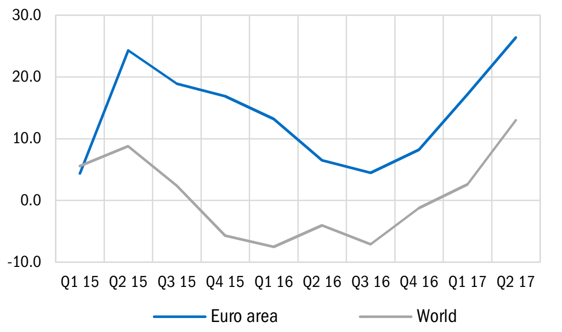
II. Economic environment and key banking drivers

Following the positive development in the first quarter of 2017, economic sentiment both globally and in the euro area continued its upward trend in Q2. Moreover, forecasts indicate a further acceleration of growth for BRICS and the United States, whereas no major changes are expected for Western Europe and Germany.

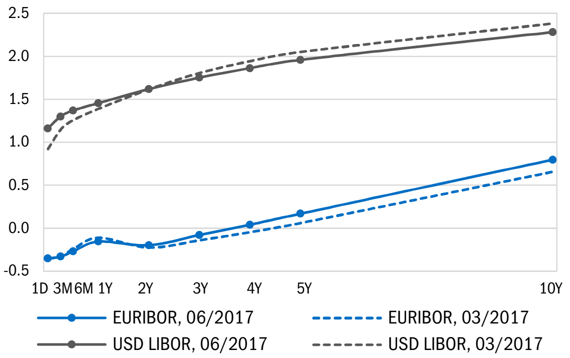
GDP growth and forecasts (real GDP, year-over-year growth rates, in %)[1)]



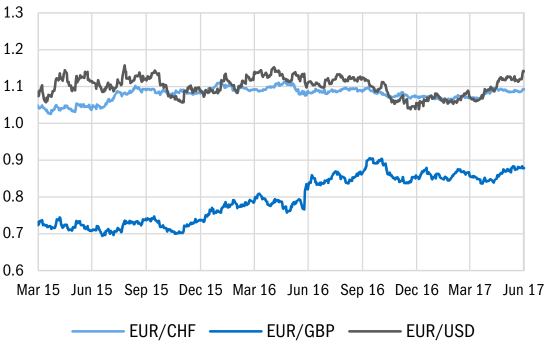
Economic sentiment (Ifo Economic Climate Balance)[2)]



Money and capital market rates



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

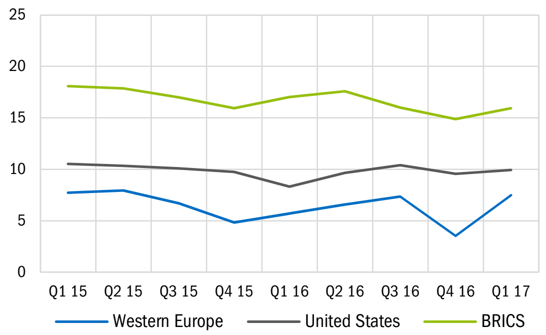


1) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; Q2 17 based on forecasts; 2) The Ifo Business Climate Balance is an assessment of a region's general economic situation and expectations regarding key economic indicators. In Q1 2017, the Ifo Institute eliminated index values from their survey and only provided balances. For the time t, the balance is the difference between shares of assessments with “good/better/higher” (+) and “bad/worse/lower” (-). The balance ranges from -100 points to +100 points. Data is only available for the euro area and world region; Source: Bloomberg, Ifo Institute for Economic Research, Thomson Reuters Datastream, zeb.research

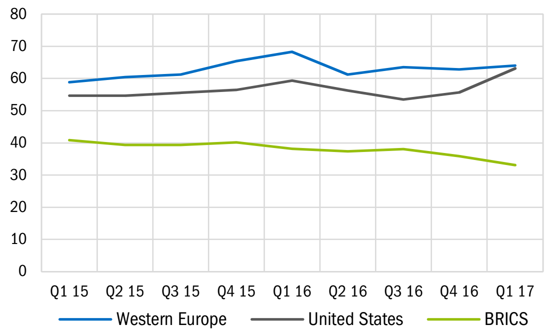
- According to the forecasts, BRICS and especially the US are expected to accelerate their growth in Q2 2017 (+0.07pp and +0.4pp respectively), whereas the forecasts for Western Europe and Germany remain more or less unchanged.
- The economic climate globally and in the euro area continued its upward trend. Sentiment improved significantly due to strong economic data indicating a positive economic outlook worldwide.
- In line with the positive economic expectations, the Fed increased interest rates for the second time this year by 25bp, leading to a slight downward shift at the long end of the USD LIBOR curve. Meanwhile, the ECB decided once again to leave interest rates unchanged resulting in a steeper EURIBOR curve due to an upward shift at the long end.
- The Euro strengthened further against the US dollar with a qoq gain of +6.6% in Q2 (in Q1: +1.4%). In addition, the Euro increased its value against the British pound (+2.6% qoq) and the Swiss franc (+2.0% qoq).

European banks' profitability significantly improved in Q1 2017, increasing to an average RoE of 7.5%. BRICS and US banks still remain ahead of their European peers as they were able to increase their profitability as well.

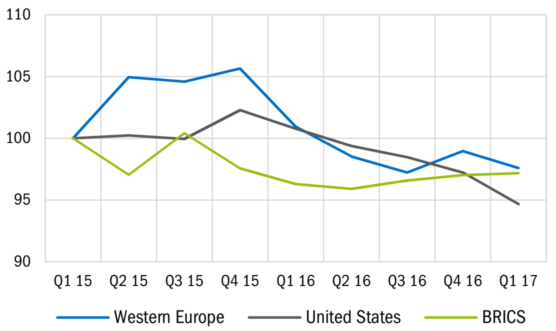
RoE after tax of global top 100 banks (in %)[1)]



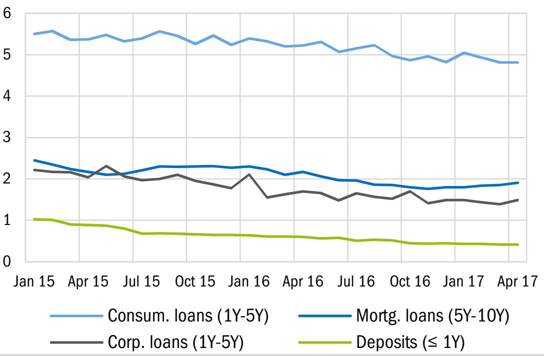
Cost-income ratio of global top 100 banks (in %)[2)]



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



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



Q2 17 data not yet available; 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 on March 31, 2015; Source: Fitch Connect, ECB, zeb.research

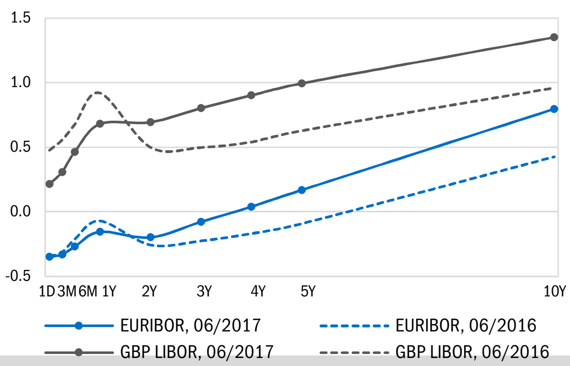
- European banks' profitability strongly increased by 4.0pp to 7.5% due to reduced extraordinary effects, so that European banks were able to considerably reduce the gap to their US peers.
- Regarding the average cost-income ratio (CIR), the gap of the last quarters between EU and US banks has been closed. While the CIR of EU banks increased slightly to 64.1%, the CIR of US banks (especially US investment banks) increased clearly by 7.4pp to 63.1% as some of the major players were impacted by lower global CIB business earnings.
- Customer interest rates in the euro area remain more or less unchanged on continuously low levels in the first months of 2017.

III. Special topic

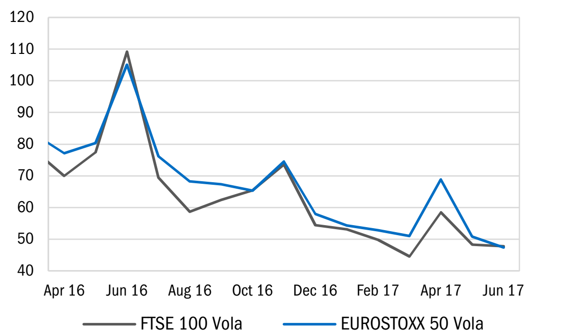
Brexit—first observations in year one after the referendum

Twelve months ago on June 23rd, 2016, the UK voted in favor of a British exit from the European Union. In March 2017, Theresa May's administration invoked Article 50 of the Treaty on European Union in a letter to the President of the European Council indicating that the UK is set to leave by March 2019. In June 2017, the official negotiations regarding Brexit started and, according to the official timeline, will take until October 2018 followed by the ratification process.

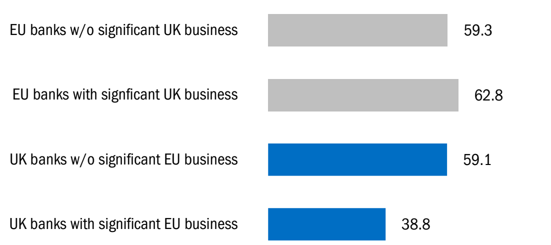
Money and capital market rates



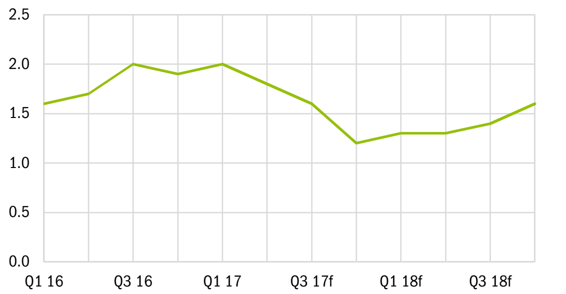
Average monthly volatility of FTSE 100 and Eurostoxx 50 (4/2016–6/2017)[1)]



TSR of UK and EU banks among top 100 by business activity (6/2016–6/2017, in %)[2)]



UK GDP growth and forecasts (real GDP, year-over-year growth rates, in %)[3)]



1) Volatility measured by the FTSE 100 and Eurostoxx 50 Volatility Index with June 2016 values standardized to 100; 2) Total shareholder return (TSR): average total shareholder returns are weighted by the market capitalization of each bank; 3) Figures Q3 2017 to Q4 2018 are based on forecasts; Source: Datastream, Bloomberg, zeb.research

The first weeks after the Brexit decision were characterized by strong market reactions. On the night of the referendum, the British pound dropped by about 6% against the Euro from 1.31 to 1.23. The average volatility of the Eurostoxx 50 and the FTSE 100 experienced a spike in the month of the referendum, representing a five-year high. To counter the referendum outcome and especially the potential weakening in economic growth, the Bank of England reduced interest rates by 25bp—the first reduction since 2009. This decision initiated a phase of stabilization. After some months, the GBP to EUR exchange rate is now stable, but has remained on average 14% below the previous year's value ever since. The volatility of the indices has returned to "normal" in 2017. Supported by the latest stock market rally during Q4 2016, the Eurostoxx 50 has gained 27.7% in total and the FTSE 100 +23.5% in total since June 23rd, 2016. From the third quarter of 2016 to the first quarter of 2017, the UK exhibited a stable GDP growth of about 2%. However, as a result of increased uncertainty, new forecasts show a gloomier economic outlook. UK GDP growth is expected to slow down to 1.2% in Q4 2017 (Western Europe: 1.8%) and to 1.3% in 2018 on average (Western Europe: 1.6%). In the long term, rather negative effects on the UK economy are expected: especially a hard Brexit and the resulting impact on the UK economy (e.g. potential recession, increasing unemployment, falling house prices) might hit UK banks and European banks with significant UK business hard.

These concerns are also reflected in the banking industry's total shareholder return (TSR). Following the positive development of the stock market, especially European banks, irrespective of their share of UK business, achieved a strong TSR performance of about +61% in the 12 months after the referendum. However, UK banks with significant EU business lag considerably behind with +39% on average in the same period of time (e.g. Lloyds: +29%, RBS: +44%).

As of today, the full range of possible Brexit negotiation outcomes is possible ("no deal" vs. "good deal"). However, there is no winning scenario for the UK and EU banking industry expected from the market. Consequently, as of April 7th, the Prudential Regulation Authority (PRA) requested contingency plans from banks, insurers, and designated investment firms undertaking cross-border activities between the UK and the rest of the European Union. The target group of the letter is encouraged to develop contingency plans for the full range of possible scenarios including the most adverse outcome of Brexit negotiations, i.e. "no deal", which translates into fallback to WTO (World Trade Organization) terms. The PRA forces banks to cover all relevant impact areas in their scenario assessment: from the macroeconomic impact of Brexit to regulation, legislation and taxation impacts and the effects on the operating, business and financial model.

In summary, the twelve months after the Brexit referendum were characterized by strong market reactions shortly after the referendum, a phase of stabilization beginning at the end of 2016 and a somewhat negative outlook for 2018. This negative outlook, ongoing political turmoil in the UK, uncertain economic impacts of possible Brexit negotiation outcomes and the PRA requirements represent major challenges for the UK and European banking sector and create needs for action. Some banks have already developed well-advanced contingency plans and some institutions have already unveiled plans to move jobs and operations out of the UK. However, there are still a lot of banks following a "wait and see approach". We advise our clients to start analyzing possible Brexit effects by means of a holistic analytical framework now.

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 3, 2017. The global top 100 banks cluster contains the largest banks by market capitalization on December 31, 2016 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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For more information: www.zeb.de

Contact

Dr. Dirk Holländer
Director and Partner

Taunusanlage 19
60325 Frankfurt am Main | Germany

Phone +49.69.719153.597
E-mail dhollaender@zeb.de

Volker Abel
Senior Manager

Taunusanlage 19
60325 Frankfurt am Main | Germany

Phone +49.69.719153.453
E-mail vabel@zeb.de

Dr. Ekkehardt Bauer
Senior Manager zeb.research

Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.225
E-mail ebauer@zeb.de

Maximilian-Josef Kaulvers
Senior Consultant

Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.399
E-mail mkaulvers@zeb.de

Dr. Benedikt Rotermann
Senior Consultant zeb.research

Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.390
E-mail benedikt.rotermann@zeb.de