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Markets regain confidence in banks

What's in it for you?

+8.9% QoQ TSR performance of Western European banks

- Global top 100 banks regained market confidence in Q2 23, thus recovering from the decrease in market capitalisation in the previous quarter.
- Although hit hardest by the banking turmoil, the recovery of U.S. banks (TSR +3.9% QoQ) was near par with the global top 100 banks (TSR +4.2% QoQ).

-0.3% YoY real GDP growth in Q2 2023 in Germany

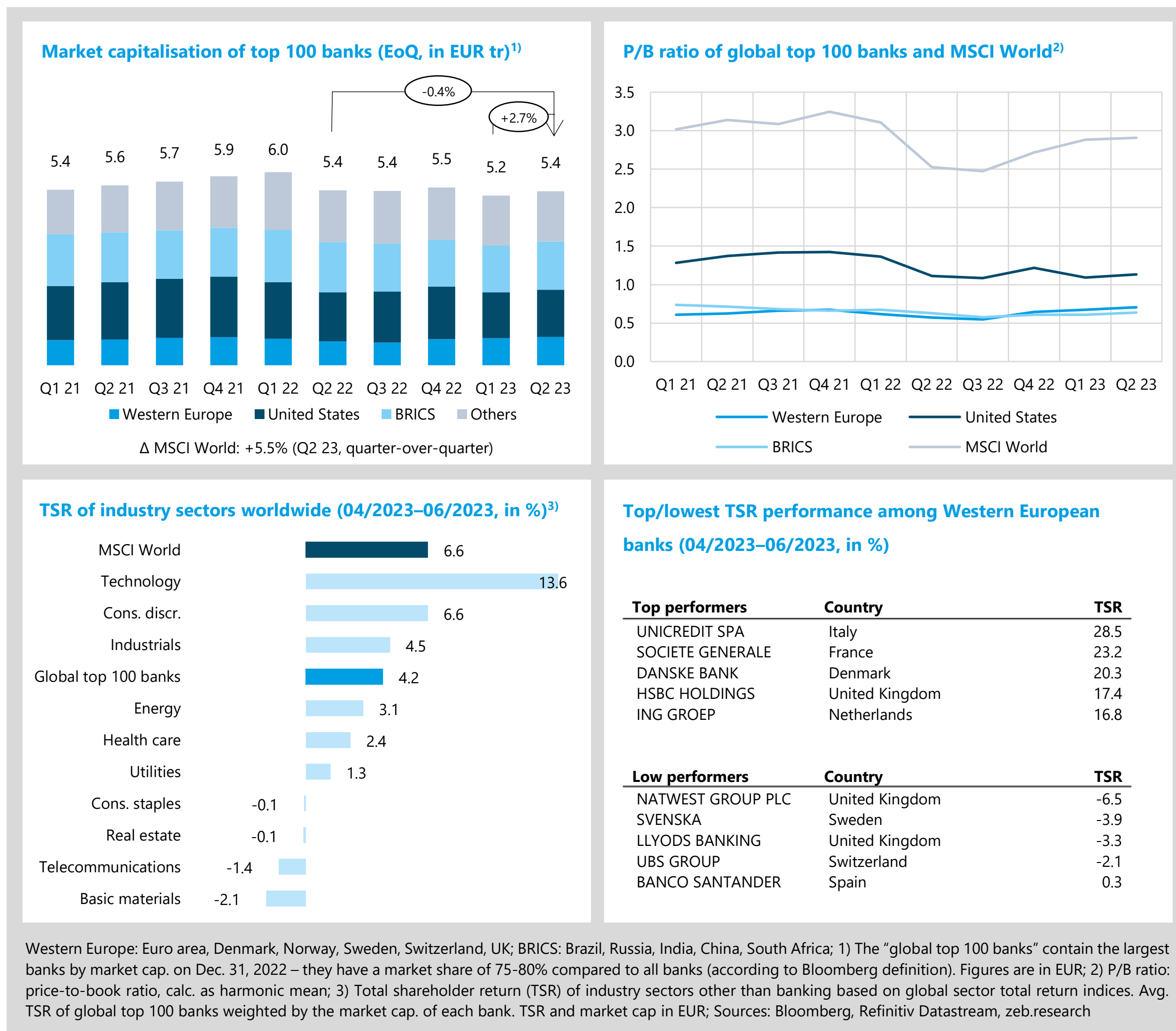
- While GDP forecasts for Western Europe and the U.S. improved slightly, a recession is now expected for Germany in 2023, contrasting previous estimates.
- High inflation rates in Germany (6.9% YoY) and Western Europe (5.9% YoY) remain sticky in Q2 23, keeping up the pressure on the ECB.

Regulatory gaps between the U.S. and the euro area

- The banking turmoil in March 2023 caused some U.S. banks to fail, while euro area banks remained stable – can these different developments be explained by significant regulatory gaps between the U.S. and the euro area?
- Our detailed comparison reveals existing regulatory gaps between midsized U.S. banks (still large banks by European standards) and euro area banks.

Banks regain market confidence in Q2 2023

After the collapses of Silicon Valley Bank and Credit Suisse in March 2023 had triggered turmoil in the banking world, **markets picked up again in Q2 23 –** both the banking sector and global capital markets (MSCI World TSR +6.6% QoQ, market capitalisation +5.5% QoQ). The major driver for the **recovery of the global top 100 banks** (TSR +4.2% QoQ) were **Western European banks** (+8.9% QoQ). In the U.S., market confidence in banks is **returning more hesitantly** (TSR +3.9% QoQ). The loss of confidence has particularly affected U.S. regional banks, which have been hit hard by customer churn. The loss of confidence may partly be explained by the **comparatively lax regulation of regional banks in the U.S. –** see this issue's special topic on regulatory differences between the U.S. and the euro area in chapter 3 for a more detailed analysis.



Top performers	Country	TSR
UNICREDIT SPA	Italy	28.5
SOCIETE GENERALE	France	23.2
DANSKE BANK	Denmark	20.3
HSBC HOLDINGS	United Kingdom	17.4
ING GROEP	Netherlands	16.8

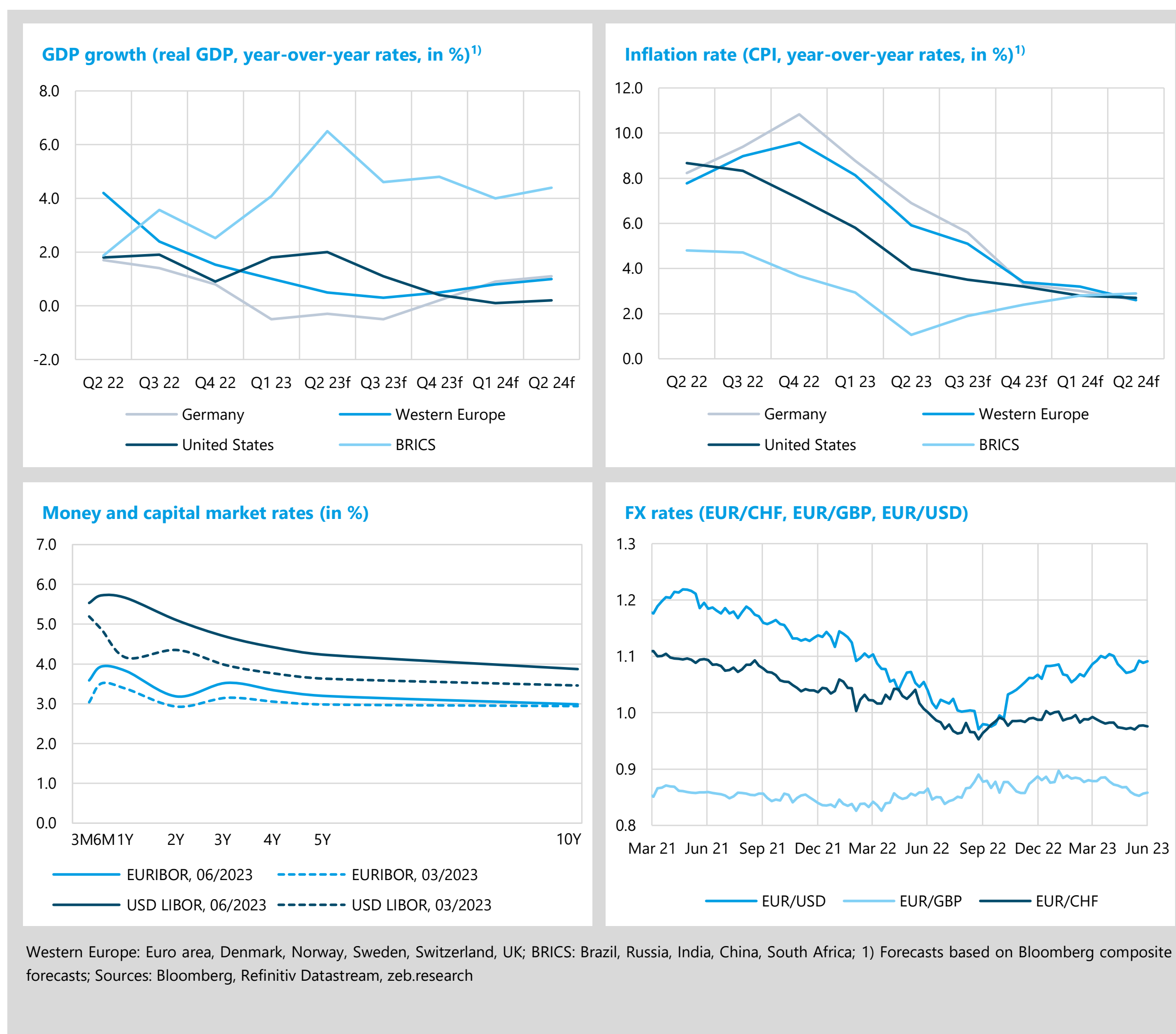
Low performers	Country	TSR
NATWEST GROUP PLC	United Kingdom	-6.5
SVENSKA	Sweden	-3.9
LLYODS BANKING	United Kingdom	-3.3
UBS GROUP	Switzerland	-2.1
BANCO SANTANDER	Spain	0.3

Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland, UK; BRICS: Brazil, Russia, India, China, South Africa; 1) The "global top 100 banks" contain the largest banks by market cap. on Dec. 31, 2022 – they have a market share of 75-80% compared to all banks (according to Bloomberg definition). Figures are in EUR; 2) P/B ratio: price-to-book ratio, calc. as harmonic mean; 3) Total shareholder return (TSR) of industry sectors other than banking based on global sector total return indices. Avg. TSR of global top 100 banks weighted by the market cap. of each bank. TSR and market cap in EUR; Sources: Bloomberg, Refinitiv Datastream, zeb.research

- Market capitalisation of the global top 100 banks rose to EUR 5.4 tr in Q2 23 (+2.7% QoQ), **almost reaching the level before the banking turmoil** in Q1 23. Even though the previous decline in market capitalisation was mainly caused by U.S. banks, **Western European banks were the essential driver** of the recovery in market capitalisation in Q2 23 (+4.4% QoQ, U.S.: +2.9% QoQ, BRICS: +2.9% QoQ).
- In Q2 23, the technology sector again exhibited the best TSR performance (+13.6% QoQ) among all industry sectors. Technology stocks keep profiting from market expectations of central banks' interest rate hikes coming to an end as well as the **market's current enthusiasm for artificial intelligence**.
- **Raising its full-year profit forecast** to more than EUR 6.5 bn, UniCredit continues its success story and ends the third consecutive quarter as the top performer among European banks with a TSR of +28.5% QoQ in Q2 23. The lowest performer in Q2 23 is NatWest (TSR -6.5%), for which forecasts suggest **underwhelming long-term earnings** despite the latest interest hikes and high current profits.

Bleak economic outlook keeps pressure on central banks high

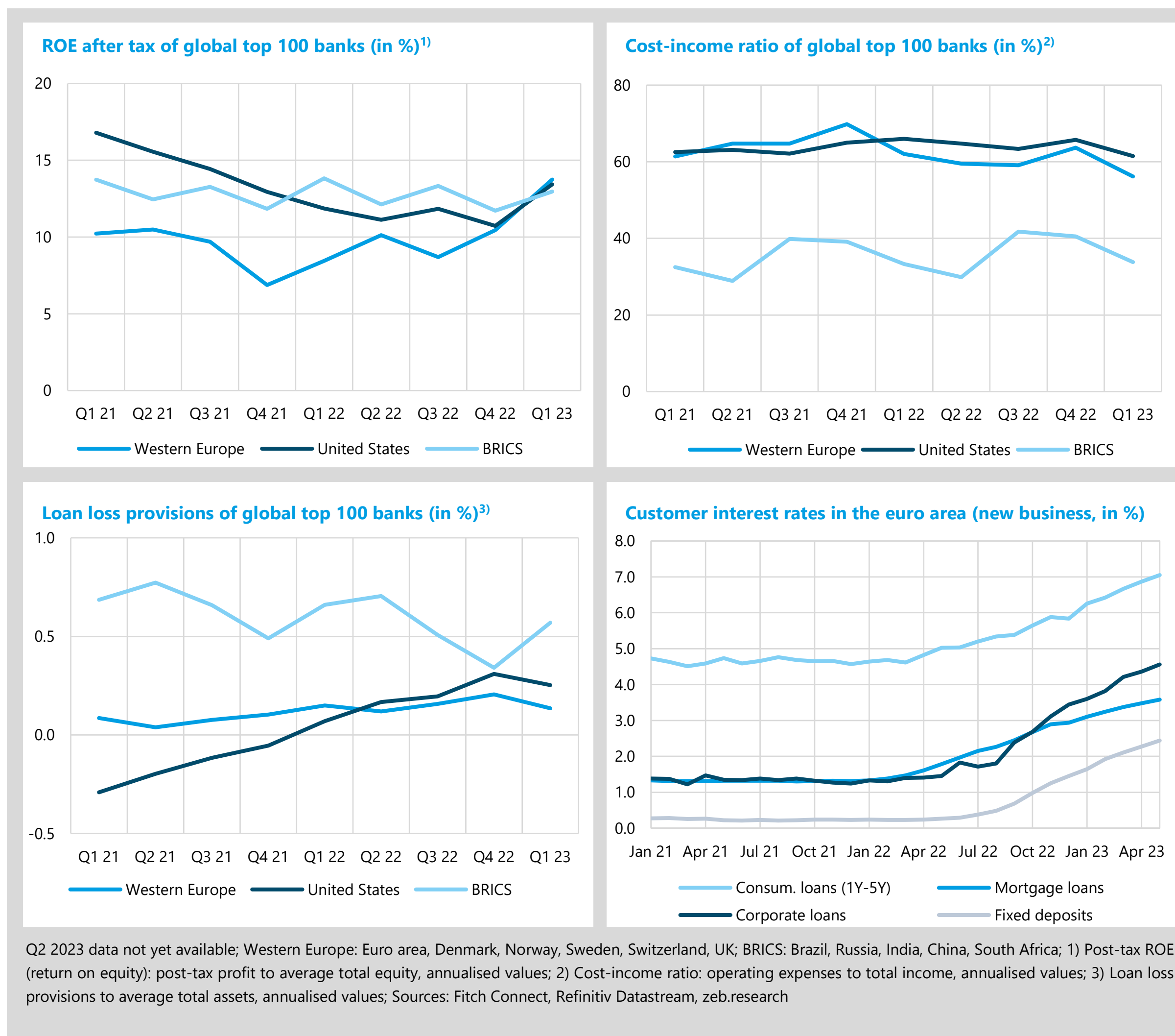
In Western Europe and the U.S., **growth rates are expected to remain low** in the upcoming quarters. In particular, the outlook for Germany has deteriorated significantly. Following negative economic growth in Q1 23 (-0.5% YoY), analysts expect GDP to decline in the two subsequent quarters as well, leading to a recession in Germany. The current economic outlook therefore increases the pressure on central banks to return to less restrictive monetary policies. Added to this is the pressure arising from the **risks of the historically sharp interest rate rises in the last year**, highlighted by the U.S. bank failures. What may be **overcome by regulatory adjustments in the medium term** poses another challenge – especially for the FED – in the short term. On top, inflation rates remain unacceptably high in Western Europe (5.9% YoY) and the U.S. (4.0% YoY) in Q2 23, **exacerbating the central banks' double bind**.



Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland, UK; BRICS: Brazil, Russia, India, China, South Africa; 1) Forecasts based on Bloomberg composite forecasts; Sources: Bloomberg, Refinitiv Datastream, zeb.research

- Economic growth in Western Europe in Q2 23 (+0.5% YoY) has slightly improved compared with the previous quarter's forecast (+0.0% YoY). Yet, current estimates expect **growth rates of less than 1% for the remaining year**. The expected growth rates for the BRICS group persist well above the level of Western Europe and the U.S. and show an expected spike for Q2 23 (+6.5% YoY).
- In Q2 23, inflation remains sticky in Western Europe (6.9% YoY) and the U.S. (4.0% YoY), while the BRICS group exhibited **inflation below 2%** for the first time in more than two years (1.1% YoY).
- The EUR/GBP FX rate fell below 0.86 in Q2 23, indicating market expectations that the **Bank of England's future monetary policy will become more hawkish** compared with the ECB's. Against the U.S. dollar, the euro ended the quarter at a similar level as at the beginning, but a temporary depreciation resulted from the **uncertain U.S. debt ceiling negotiations**.

In Q1 23, **Western European banks managed to enhance profitability** by +5.3%p YoY and +3.3%p QoQ. Although U.S. banks also saw a significant increase in ROE (+1.6%p YoY, +2.7%p QoQ), they were unable to prevent something unprecedented in the eleven-year-old history of the market flash: with an average ROE of 13.8%, **Western European banks surpassed U.S. banks** (13.4%) in Q1 23. While the overall performance of Western European banks in Q1 23 was already good, the **main driver for the beat was HSBC's** +121% QoQ and +228% YoY increase in its net income, which alone contributed +1.8%p to the average ROE. An already very good performance of HSBC was further aided by an accounting driven reclassification of the French retail business and a significant provisional gain on the acquisition of SVB UK.



Q2 2023 data not yet available; Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland, UK; BRICS: Brazil, Russia, India, China, South Africa; 1) Post-tax ROE (return on equity): post-tax profit to average total equity, annualised values; 2) Cost-income ratio: operating expenses to total income, annualised values; 3) Loan loss provisions to average total assets, annualised values; Sources: Fitch Connect, Refinitiv Datastream, zeb.research

- **Western European and U.S. banks reduced their CIR** in Q1 23 by -7.5%p and -4.2%p YoY, respectively – both due to considerably higher revenues (Western European banks: +9.3%p YoY, U.S. banks: +16.8%p YoY). While Western European banks also managed to slightly reduce costs (-1.0%p YoY), U.S. banks saw their costs increase in Q1 23 (+8.9%p YoY). **Benefiting from falling inflation rates, BRICS banks were able to reduce costs** (-3.3%p YoY). However, revenues also declined (-4.8%p YoY), leading to an overall increase in the CIR (+0.5%p YoY).
- After a **continuous expansion of loan loss provisions in the previous quarters** and in view of the recent steady GDP forecasts, **Western European and U.S. banks slightly reduced provisions** in Q1 23 (Western Europe: -7bp QoQ, U.S.: -6bp QoQ). BRICS banks, on the other hand, increased provisions by +23bp QoQ after two consecutive quarters of decreasing loan loss provisions.
- The ECB continued its interest rate hikes, with customer rates following accordingly. **Corporate loans experienced the strongest increase** of +3.1%p YoY to 4.6% by the end of May 2023. **Consumer loans exceeded 7.0%**, reaching levels last seen before the global financial crisis, while deposits climbed close to 2.5% in May 2023 driven by the ongoing and intense competition among European banks.

Special topic – regulatory gaps between the U.S. and the euro area

Recent bank failures in the U.S. all caused by liquidity issues due to large-scale deposit-withdrawals and poor (interest rate) risk management led to turmoil in international banking markets. While some banks in the U.S. failed quickly, euro area banks remained remarkably stable – the capital market outperformance of Western European banks (see chapter 1) is reflecting this as well. This raises the question of whether there are structural differences in the regulation of U.S. and euro area banks that explain the different developments. **How are the different regulatory frameworks designed?** What are the **differences regarding capital and liquidity requirements**, as well as **interest rate risk and overall risk management?** Are the **regulatory authorities in the U.S. and euro area aware of certain shortcomings** and what are the **regulatory road maps looking forward?**

In both jurisdictions, regulators assign banks to different regulatory categories, which are subject to stricter or rather lenient requirements. The classification is based primarily on the size of a bank in terms of their total assets. Other relevant criteria relate to the complexity, interconnectedness, and economic relevance.

Comparison of the regulatory categories of U.S. and euro area banks[1)]

	United States						Euro area	
	Category I	Category II[2)]	Category III[3)]	Category IV	Uncategorized	Others	Significant Institution[4)]	Less Significant Institution
Criteria	G-SIB	BS > USD 700 bn	BS > USD 250 bn	BS > USD 100 bn	BS > USD 50 bn	All other	BS > EUR 30 bn, or top 3 bank	All other
Number of banks	8	3	12	15	20	4,643	110	3,937
Market share	~45%	~2%	~16%	~10%	~6%	~21%	84%	16%
Supervisory body	Federal Reserve System (FED), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), state agencies[5)]						European Central Bank	National comp. authorities (NCAs)
Additional reg. cluster	G-SIB, stringent EPR[6)]	No "SIB" classification but under EPR			Marginal EPR[7)]	None	G-SII / O-SII	None / SNCI[8)]

1) All figures at end of 2022; values based on manual calculations and estimations by zeb.research experts; no official figures; 2) Or if cross-jurisdictional activity > USD 75 bn; 3) Or if domestic bank with total consolidated assets > USD 100 bn, or if weighted short-term wholesale funding, non-bank assets, or off-balance-sheet exposure > USD 75 bn; 4) Or if a country is of importance for a specific country, or if BS > EUR 5 bn, and cross-border assets/liabilities > 20%; 5) Supervisory body depends on federal- or state-charter, and/or FDS membership; 6) Enhanced Prudential Regulation; 7) Only risk mgmt. requirements such as forming a risk committee and appointing a chief risk officer; 8) Small and non-complex institution; Source: zeb.research

In the **U.S. there are six different categories** (see the figure above). Banks with total assets larger than USD 100 bn or fulfilling other complexity and interconnectedness criteria belong to Categories I–IV, while Category I is reserved exclusively for globally systemically important banks (G-SIBs). The remaining two Categories are Uncategorised banks (USD 50–100 bn) and Other banks. This rather granular categorisation differs significantly from the **euro area, where only two regulatory categories exist:** significant institutions (SIs) and less significant institutions (LSIs). Any bank with total assets greater than EUR 30 bn, the three largest banks in a member country or banks fulfilling other complexity and interconnectedness criteria will be classified as SI. All other banks in the euro area are considered LSIs. Globally systemically important institutions (G-SIIs) are just an additional regulatory layer for banks otherwise categorised as SI. In contrast, small and non-complex institutions (SNCI) as part of the LSI cluster gain limited regulatory relief.

As shown in the above figure, the **requirements to belong to the most strictly regulated category are comparatively low in the euro area**. A midsized U.S. bank from Category III or IV, or even some Uncategorised banks, would already be considered an SI in the euro area. With 4,706 banks and EUR 22,9 tr total assets in the U.S. and 4,047 banks and EUR 30,8 tr total assets in the euro area, **the more granular approach by the U.S. is not rooted in a vastly larger banking market** (figures as of 2022). In the U.S., 58 banks with a combined market share of around 79% make up the first five categories with the 8 G-SIBs already capturing a market share of around 45%. In the euro area, on the other hand, the 110 SIs have a market share of roughly 84%, which is less remarkable considering the large number of banks classified as SIs.

Another **difference between the U.S. and the euro area is the assignment to a supervisory authority** based on the regulatory cluster. **In the U.S., it is decisive whether a bank is state- or federally-chartered, or whether it is a member of the Federal Reserve System**. Accordingly, the prime regulatory body can be the FED, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation

(FDIC), the National Credit Union Administration (NCUA) or state agencies. In the euro area, **all SIs are supervised by the ECB**, while **all LSIs are supervised by national supervisory authorities**.

The **relevance of the classification** becomes apparent when considering that **all the recently failed banks** (Silicon Valley Bank, Signature Bank, and First Republic Bank) **have belonged to U.S. Category IV banks**. So, what are the differences and **potential gaps** regarding **capital and liquidity requirements**, as well as **interest rate risk** and **overall risk management** across the different categories and regions?

Some regulatory gaps become already apparent when looking at **capital requirements**. While the minimum CET1 ratio requirements are the same for all banks in both jurisdictions, significant **differences can be observed when considering countercyclical capital buffers (CCyB) and stress buffers**. The CCyB forces banks to accumulate capital to strengthen the resilience of the banking sector during periods of stress in dependence of banks' geographical loan activities. In the **U.S., only Category I–III banks potentially have to build up a CCyB**, while in the **euro area all banks must potentially create a CCyB**. In terms of stress buffers, there are also significant differences. While Category I-IV banks must maintain a stress buffer of over 2.5%, this value is lower for Uncategorised and Other banks. In the euro area, the systemic risk buffer consists of the 2.5% standard requirement, the Pillar 2 requirements, the Pillar 2 guidance and the systemic risk buffer for SIs and LSIs. All these additional requirements are set individually for each bank. Overall, the **minimum capital requirements in the euro area are substantially higher than in the U.S.** – while not necessarily true in comparison to the G-SIBs, surely when compared to U.S. midsized banks. This also explains why the average CET1 ratio of SIs in the euro area is 3-4%p higher than that of U.S. counterparts.

In terms of **liquidity requirements**, there is no significant regulatory gap with respect to the Basel III leverage ratio. However, this certainly does not apply to the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). In the **U.S. only Category I–II banks are obliged to comply with an LCR/NSFR requirement of 100%.** For Category III (85-100%) and Category IV (70-100%) banks, the requirements are already significantly lower, while Uncategorised banks and Others do not have to meet any LCR/NSFR requirement at all. In contrast, **euro area banks must comply with the full LCR/NSFR requirement of 100%.**

Another **regulatory gap** presents itself in the **interest rate risk management**. In the **U.S., not a single bank has an IRRBB** (interest rate risk in the banking book) **disclosure obligation**, while in the euro area the IRRBB must be disclosed by SIs at least annually and up to once per year by LSIs. Part of IRRBB disclosers are the results of stress scenarios simulating significant and abrupt changes to yield curves and the corresponding effects on banks. In a world that exhibited an unpredicted historically fast increase in interest rates over the last year (see chapter 2), the importance of such stress scenarios becomes apparent.

Finally, the degree of stringency in establishing **risk management requirements** varies across jurisdictions. In the U.S. all defined risk management requirements must be implemented by Category I–II banks. Fewer rules apply to Category III banks and significantly fewer rules to Category IV banks. Only marginal risk management requirements apply to Uncategorised banks and none to the 4,643 banks with a market share of around 21% classified as Others. In the euro area, all jurisdiction-specific risk management requirements apply to SIs and fewer rules to the LSIs.

In summary, there are no significant regulatory gaps between the very large banks in the U.S. and the euro area banks. The actual **regulatory gaps exist between midsized U.S. banks**, which still represent relatively large banks by European standards, **and the euro area banks**.

In April 2023, U.S. authorities acknowledged structural weaknesses in their approach to proportionality and have taken initial steps to address them. FED and FDIC want to **enhance risk identification**, for instance, by a reassessment of systemic risk, or by portfolio entrance exams when a bank grows rapidly and swiftly changes between regulatory categories (such as SVB). They also plan to **promote resilience**, i.e., by giving banks stronger incentives to manage risks effectively and measuring IRRBB. In addition, they want to **change their supervisory behaviour** by promoting more challenging judgements and being more consequential when findings are identified. They also want to **strengthen processes** by introducing a simpler yet stronger over-sight, rethinking the tailoring (Categorisation) framework, and hiring more staff.

European supervisors are aware that they may be better positioned and ahead of the curve, but they are also addressing upcoming priorities: they want to **improve risk management** (i.e., counterparty credit risk, IRRBB, climate risk, ...), **strengthen governance** by improving the functioning of management bodies and **take banks' business models** into account in supervisory processes. They will also **look more closely at model risks and parameterisation** in the management of interest rate risk and liquidity. **Contact us** for a more detailed analysis and our view on the necessary steps for bank management and supervision.

About zeb.market.flash

Compact. Competent. Independent.
Every quarter, zeb.market.flash provides an overview of the performance of the world's largest banks (measured by market capitalisation). The relevant factors are briefly and concisely described, analysed and classified by our experts. For our analyses, we take a close look at relevant indicators for the valuation of the capital market, such as stock returns, as well as macroeconomic and bank-specific drivers. These include return on equity, yield curves, or growth of the gross domestic product.

One focus is on the performance of the top banks in Europe in our sample. How does their development compare to that of the largest banks worldwide? Which European bank shows a particularly good, which a particularly weak capital market performance? What could be the reason for this? In addition, each issue deals in detail with a currently particularly relevant special topic in the industry.

Our background knowledge from 30 years of financial service consulting rounds off these assessments. This gives you an exclusive and compact insight into the global banking market. The zeb.market.flash is available on our websites and sent free of charge as a newsletter to all interested parties.

All data and calculations of this issue are based on the date of July 06, 2023. The global top 100 banks cluster contains the largest banks by market capitalisation on December 31, 2022 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.

About zeb

As a leading strategy, management and IT consultancy, zeb has been offering transformation expertise along the entire value chain in the financial services sector in Europe since 1992. We have five offices in Germany – Frankfurt, Berlin, Hamburg, Munich and Münster (HQ) – as well as 11 international locations. Our clients include European large-cap and private banks, regional banks, insurers as well as all kinds of financial intermediaries. Several times already, our company has been classed and acknowledged as "best consultancy" for the financial sector in industry rankings.

For more information visit **www.zeb-consulting.com**

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