Equity Strategy

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June 16, 2013

Financial Stocks Weekly: U.S. Bank Leverage, Is Better Than Europe Good Enough?

Summary--U.S. bank regulators and legislators are looking beyond the level of capital to risk-weighted assets to leverage ratios to determine balance sheet strength for the largest banks. There are good reasons for this, one of which is that ratios based on risk weightings are poorly related to market measurements of risk (see "Financial Stocks Weekly: Will the U.S. Close the Loophole on Basel Leverage?" from May 28, 2013). In this note, we update our measures of Basel III leverage ratios for large U.S. banks to make them comparable to KBW European Research measures of Basel III leverage for large European Banks. We find that all the U.S. big banks (those designated as globally systemically important) have stronger capital ratios than the large European banks, and all are above the current Basel III minimum of 3%. However, all the large U.S. banks except Wells Fargo would fall significantly below a 6% leverage ratio if U.S. regulators decide to impose higher capital ratios using leverage as their basis.

Key Points--

- U.S. universal banks stocks are up more than 20% this year, yet they continue to trade in line with their global competitors on a price-to-book basis relative to ROE. This is despite U.S. banks' being significantly better capitalized than European banks on a Basel III Leverage ratio basis. If U.S. regulators move toward a higher required Basel III leverage ratio than foreign regulators, it is likely that U.S. universal banks will have depressed ROEs versus European competitors, which would affect stock prices. The U.S. universal banks ranked from highest to lowest on Basel III leverage ratio are WFC, BAC, STT, GS, JPM, C, BK and MS, with only WFC above 6%.
- **The Week Ahead:** The focus of the market generally and the market for financial stocks particularly will be on the Federal Reserve's meeting next week and any signs of tapering of Fed bond purchases. In addition, PRU and BLK have investor days on Tuesday. The events for the coming week are included in Exhibit 9 of this report. The complete KBW Catalyst Calendar can be accessed from the home page of the KBW research library.
- **The Week Behind:** Financial stocks led the market lower last week, with financials down 2.1% compared to the S&P 1500 down 0.9%. Leading financials lower were the Diversified Financials and Universal Banks sectors. Earnings estimate revisions remained positive for the group, with 47 upward revisions compared to 16 downward revisions. The most upward revisions occurred in SMID-Cap Banks sector. CDS spreads for the largest banks widened in the week alongside volatility in the bond market.

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As we discussed in our note "Basel III Leverage Ratios Come into Greater Regulatory Focus" from May 23, 2013, we expect regulators to use the Basel III Leverage ratio to reduce systemic risk among the largest U.S. banks. In that note, we estimated Basel III Leverage ratios for the U.S. universal banks. However, the approach we used in that note was not entirely consistent with the approach used by our European colleagues for derivative exposures.

For the U.S. banks in Exhibit 1, we updated our estimate for each company's potential future exposure to derivatives (derivative add-on) to improve consistency and accuracy. The derivative add-on is one part of a bank's total leverage exposure, which is the Basel III leverage ratio denominator. We applied the same methodology and assumptions previously used to estimate the derivative add-on exposure for European banks— effectively harmonizing our calculation of the derivative exposure between banks. Previously, we estimated the potential future derivative exposure by only including a bank's exposure to OTC derivatives not subject to master netting agreements. The inclusion of derivatives subject to master netting agreements meant that, on average, our estimate for the derivative add-on for BAC, C, GS, and JPM increased by $368 billion and the Basel III leverage ratios declined by 87 basis points. For BK, STT, and WFC, leverage ratios declined by 11 basis points, on average, given the relatively smaller amount of notional derivatives outstanding.

Exhibit 1: U.S. and European Capital Levels

Company	Basel 3 Leverage	Basel 3 Tier 1 Common
Europe		
BNP Paribas*	3.3%	9.9%
Barclays*	2.9%	8.2%
Soc Gen*	2.7%	8.3%
UBS**	2.6%	10.1%
Credit Suisse**	2.5%	8.6%
Deutsche Bank***	2.0%	8.8%
U.S.		
Wells Fargo & Co.	7.3%	8.4%
Bank of America	5.1%	9.5%
State Street Corp.	4.8%	10.6%
Goldman Sachs	4.6%	9.1%
JPMorgan Chase & Co.	4.5%	8.9%
Citigroup Inc.	4.5%	9.3%
Bank of New York Mellon	3.9%	9.4%
Morgan Stanley	3.8%	9.8%

*Data as of 4Q12.

**FINMA Leverage Ratio - fully phased-in requirement 4.20% - 4.56% based on total capital requirement.

***1Q13 ratios pro forma for recent capital raise.

Note: Data as of 1Q13 except where noted. Ratios based on KBW interpretation of proposed legislation. European leverage ratios, are CET1 + CoCo leverage except Swiss companies, which are FINMA ratio. European Basel 3 Tier 1 common ratios calculated as CET1/RWA. For more information on the methodology used in our Basel III leverage ratio estimates, please see the European Research note dated May 21, 2013, "Markets supportive but upside reduced: UBS downgraded" and the U.S. Research note dated May 23, 2013, "Basel III Leverage Ratios Come into Greater Regulatory Focus". Source: Company reports, SNL Financial, Keefe, Bruyette & Woods Ltd. and Keefe, Bruyette & Woods Inc.

As shown in Exhibit 1, even with these adjustments, all of the U.S. banks have higher capital-to-asset ratios on a Basel III Leverage basis than the largest European banks. Further, all of the U.S. banks are above the Basel III Leverage minimum ratio of 3.0%, while for the European banks presented, only BNP is above that minimum ratio. The comparisons on Basel III leverage are significantly different than on Basel III risk-weighted ratios, where the ratios are similar across continents.

The relative capital positions of U.S. banks vary considerable depending upon which capital ratios are used as shown in Exhibit 2. Specifically, WFC looks the weakest on Basel III Tier 1 Common, but the strongest on almost every other ratio. The opposite is true for the largest brokers. Much of the difference between Wells Fargo and the other banks is the small relative derivative position of Wells, and Wells' smaller level of trading activity. The market appears to accept the non-Basel III Tier 1 Common ratios as Wells has the narrowest CDS spreads as shown in Exhibit 8.

Exhibit 2: Capital Ratios at US G-SIFIs

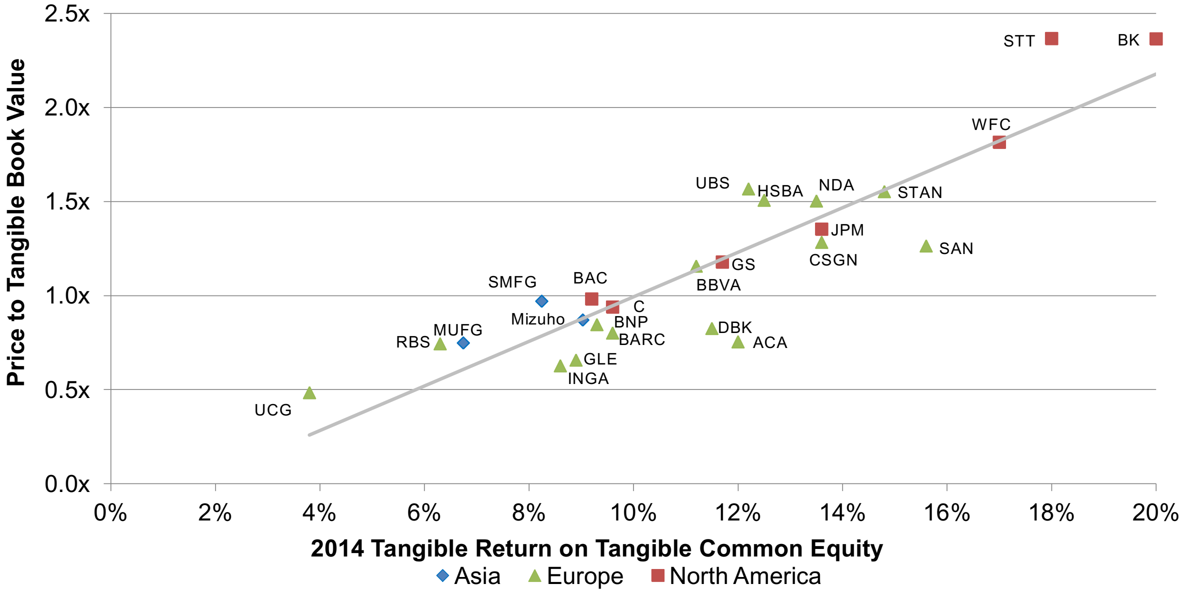
Ticker	Brown Vitter Ratio	Basel 1 T1 Common	Basel 3 T1Common	Basel 3 Leverage	TCE/TA	(TCE - DTA) /(TA - DTA)	Dodd-Frank Leverage
BAC	4.6%	10.6%	9.5%	5.1%	7.1%	5.6%	8.6%
C	6.0%	11.8%	9.3%	4.5%	8.9%	6.1%	10.0%
JPM	4.1%	10.2%	8.9%	4.5%	6.4%	5.9%	7.3%
WFC	7.1%	10.4%	8.4%	7.3%	8.5%	8.9%	10.7%
GS	4.5%	12.7%	9.1%	4.6%	7.0%	6.6%	8.3%
MS	4.0%	11.5%	9.8%	3.8%	6.9%	6.0%	7.7%

Note: Data as of 1Q13. Basel 3, Brown Vitter, and Dodd-Frank Leverage capital ratios based on KBW's interpretation of proposed legislation. For more information, see the reports published May 23, 2013, "Basel III Leverage Ratios Come into Greater Regulatory Focus"; and April 29, 2013 "Financial Stocks Weekly: The Attack on TBTF Capital Levels".

Source: SNL Financial and KBW Research.

Capital levels are important in stock selection among the largest global banks because they tend to trade together based on relative returns on tangible capital as shown in Exhibits 3 and 4. Levels of equity matter because returns on equity are directly related to the level of equity required to be held. As shown comparing the two exhibits, this relation holds even during a period of volatile stock prices such as have been experienced since February.

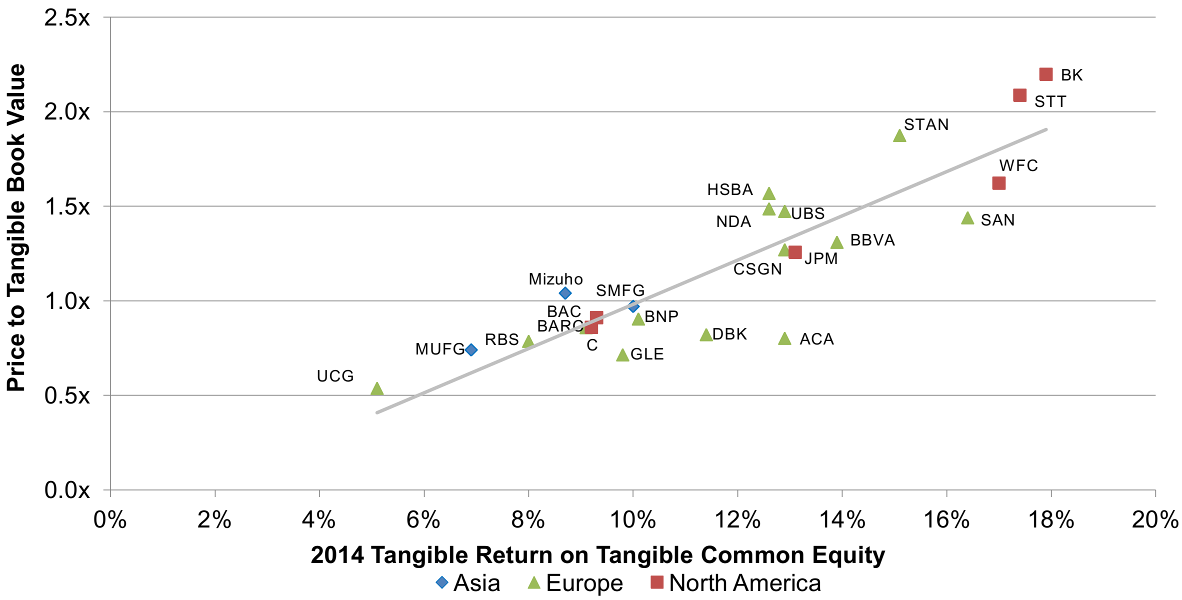
Exhibit 3: G-SIFI Valuation and Returns June 2013



Note: Pricing data as of 06/11/2013. G-SIFI list excludes MS, and Bank of China.

Source: FactSet and KBW Research.

Exhibit 4: G-SIFI Valuation and Returns February 2013



Note: Pricing data as of 02/13/2013. G-SIFI list excludes GS, MS, and Bank of China.

Source: FactSet and KBW Research.

Financial Stock Earnings Revisions

Earnings estimate revisions remained positive for the group, with 47 upward revisions compared to 16 downward revisions. The most upward revisions occurred in the SMID-Cap Banks sector.

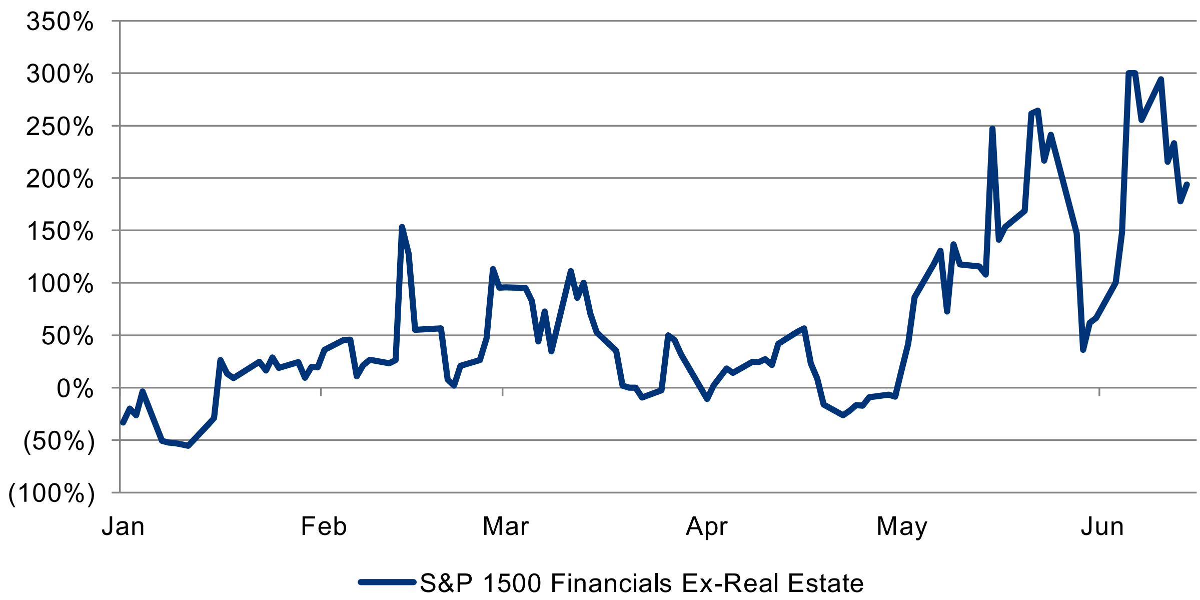
Exhibit 5: Financials Earnings Estimate Revisions*

Weekly EPS Estimate Revisions		
Sector	Upward	Downward
Universal Banks	10	2
Large-Regional Banks	4	2
SMID-Cap Banks	14	2
Capital Markets	7	6
Diversified Financials	4	3
P&C Insurance	7	1
Life Insurance	1	0
S&P 1500 Financials Ex-Real Estate	**47**	**16**

*Data as of 06/14/2013. Note: Upward and downward revisions measure the number of FY2 (next full unreported fiscal year) EPS estimate revisions to each constituent in the given sector.

Source: FactSet, Standard and Poor's, and KBW Research.

Exhibit 6: Financials Earnings Revisions Year to Date*



*Data as of 06/14/2013.

Note: Measures the difference between the number of upward and downward EPS estimate revisions for companies within the S&P 1500 Financials as a percentage of downward EPS estimate revisions. Upward and downward EPS estimate revisions measure the number of FY2 (next full unreported fiscal year) EPS estimate revisions to each constituent in the S&P 1500 Financials during the previous week. Estimate Revisions for the S&P 1500 Financials exclude revisions for companies in the Real Estate sector.

Source: FactSet, Standard and Poor's, and KBW Research.

Financial Stock Performance, Week Ending June 14, 2013

Financial stocks led the market lower last week, with financials down 2.1% compared to the S&P down 0.9%. Leading financials lower were the Diversified Financials and Universal Banks sectors.

Exhibit 7: Week-to-Date and Year-to-Date Returns

Calculated Returns for the Week Ending:*

KBW Model Portfolio	6/14/2013	S&P 1500 Financials	6/14/2013	Excess Return	6/14/2013
Universal Banks	(2.80%)	Universal Banks	(2.79%)	Universal Banks	(0.01%)
Large-Regional Banks	(1.67%)	Large-Regional Banks	(1.88%)	Large-Regional Banks	0.21%
SMID-Cap Banks	(1.47%)	SMID-Cap Banks	(1.19%)	SMID-Cap Banks	(0.28%)
Capital Markets	(1.72%)	Capital Markets	(1.76%)	Capital Markets	0.03%
Diversified Financials	(3.99%)	Diversified Financials	(4.48%)	Diversified Financials	0.50%
P&C Insurance	(0.80%)	P&C Insurance	(0.95%)	P&C Insurance	0.14%
Life Insurance	(1.40%)	Life Insurance	(1.45%)	Life Insurance	0.05%
KBW Model Portfolio	**(2.03%)**	**S&P 1500 Financials**	**(2.09%)**	**Excess Return****	**0.06%**
		S&P Composite 1500	**(0.93%)**		

Calculated Returns for full year:

KBW Model Portfolio	2013	S&P 1500 Financials	2013	Excess Return	2013
Universal Banks	25.49%	Universal Banks	21.54%	Universal Banks	3.96%
Large-Regional Banks	9.03%	Large-Regional Banks	14.51%	Large-Regional Banks	(5.48%)
SMID-Cap Banks	9.82%	SMID-Cap Banks	13.41%	SMID-Cap Banks	(3.59%)
Capital Markets	27.13%	Capital Markets	26.90%	Capital Markets	0.23%
Diversified Financials	13.46%	Diversified Financials	23.14%	Diversified Financials	(9.68%)
P&C Insurance	22.91%	P&C Insurance	22.29%	P&C Insurance	0.63%
Life Insurance	27.80%	Life Insurance	29.87%	Life Insurance	(2.07%)
KBW Model Portfolio	**21.93%**	**S&P 1500 Financials**	**21.63%**	**Excess Return****	**0.30%**
		S&P Composite 1500	**15.28%**		

*Market-capitalization weighted returns as of 06/14/2013.

** Excess return calculated arithmetically.

Note: Returns for the S&P 1500 Financials exclude the impact of companies in the Real Estate sector.

Source: Standard & Poor's, FactSet, and KBW Research.

Exhibit 8: CDS Pricing

	Price 06/13/2013	Change vs. -1 Day	-1 Week	-1 Month	-3 Months	-1 Year
BAC	113 bps	-6 bps	+5 bps	+17 bps	+6 bps	-184 bps
C	103 bps	-3 bps	+4 bps	+11 bps	+12 bps	-167 bps
JPM	83 bps	-2 bps	+1 bps	+2 bps	+11 bps	-85 bps
WFC	68 bps	-1 bps	-1 bps	+2 bps	+4 bps	-56 bps
GS	132 bps	-1 bps	+11 bps	+23 bps	+16 bps	-187 bps
MS	147 bps	+0 bps	+11 bps	+25 bps	+25 bps	-263 bps

Source: Bloomberg.

Exhibit 9: Key Events in the Upcoming Week

KBW Catalyst Calendar

June 2013

Banks | Diversified Financials | Insurance | Macroeconomic | Europe

17	18	19	20	21
May Monthly Card Metrics Data Release	FOMC Meeting	FOMC Meeting		S&P Quarterly Reweight Effective after the Close
	PRU Investor Day			
	BLK Investor Day			

Note: Dates listed in this report are subject to change. For access to our full catalyst calendar, please go to the home page of the KBW research library.

Source: Company reports, Bloomberg, and KBW Research.

Note: While not rated by Keefe, Bruyette & Woods Inc., the European and Japanese companies listed in Exhibits 1, 3 and 4 are rated as shown below by analysts at our U.K. affiliate, Keefe, Bruyette & Woods Ltd.

Companies Mentioned in This Report

- Mitsubishi UFJ Financial Group (8306.JP: ¥567, Outperform)
- Sumitomo Mitsui Financial Group (8316.JP: ¥3,990, Outperform)
- Mizuho Financial Group (8411.JP: ¥185, Market Perform)
- Credit Agricole SA (ACA.FP: €6.90, Market Perform)
- Bank of America Corp. (BAC: $13.07, Market Perform)
- Barclays (BARC.LN: p298, Outperform)
- BBVA (BBVA.SM: €6.75, Market Perform)
- Bank of New York Mellon (BK: $29.13, Market Perform)
- BNP Paribas (BNP.FP: €43.28, Outperform)
- Citigroup (C: $49.22, Outperform)
- Credit Suisse (CSGN.VX: CHF26.31, Outperform)
- Deutsche Bank (DBK.GR: €34.37, Outperform)
- Societe Generale (GLE.FP: €28.56, Outperform)
- Goldman Sachs Group, Inc. (GS: $162.92, Market Perform)
- HSBC (HSBA.LN: p680, Outperform)
- ING (INGA.NA: €6.92, Market Perform)
- JPMorgan Chase & Co (JPM: $53.13, Outperform)
- Morgan Stanley (MS: $25.83, Suspended)
- Nordea (NDA.SS: €78.25, Outperform)
- Royal Bank of Scotland (RBS.LN: p316, Market Perform)
- Santander (SAN.SM: €5.29, Market Perform)
- Standard Chartered (STAN.LN: p1,449, Market Perform)
- State Street Corporation (STT: $66.06, Market Perform)
- UBS (UBSN.VX: CHF16.48, Underperform)
- Unicredit (UCG.IM: €3.93, Underperform)
- Wells Fargo & Company (WFC: $40.16, Outperform)

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Market Perform [HOLD]	313	54.34	107	34.19
Underperform [SELL]	52	9.03	11	21.15
Restricted [RES]	0	0.00	0	0.00
Suspended [SP]	41	7.12	6	14.63
Covered -Not Rated [CNR]	2	0.35	1	50.00

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