

Talking point

The sun is shining again: European banks rebound

August 21, 2015

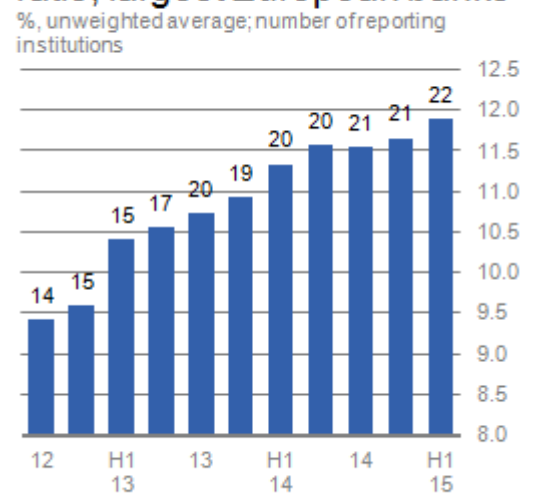
After literally seven lean years, the European banking industry's recovery from the financial crisis is now in full swing. Profits are at their highest level since 2007, revenues are growing across the board (helped by favourable currency effects) and loan losses are falling. Banks are also expanding business volumes. Capital ratios are on average substantially above Basel III requirements, though uncertainty has increased recently due to a pending further regulatory tightening ("Basel IV").

The recovery of European banks from seven lean years following the financial crisis finally seems to be in full swing. Net income of the 22 largest institutions reached almost EUR 50 bn in the first half of the year, the highest such figure since 2007. Improvements can be seen almost across the board: both net interest income and fees and commissions climbed 10% yoy in EUR terms, though this was partly driven by the heavy depreciation of the euro (down 19% versus the dollar) which boosted non-European earnings. Trading income surged by one-third on the back of increased market volatility and a very weak prior-year result. As a consequence, total revenues jumped by a staggering 15% to EUR 257 bn. Likewise, loan loss provisions, for many years a real drag on the P&L, fell 15% to just EUR 21 bn, their lowest level since 2007. Both total and risk-weighted assets grew (by 7% and 4.5%, respectively) but total equity expanded faster, at 13%, as banks increasingly issued Additional Tier 1 instruments to comply with Basel III requirements. For the EU banking sector as a whole, i.e. including small and mid-sized banks, balance sheet totals went up by only 3% yoy which i) testifies to the exchange rate effect on non-European operations and ii) indicates that smaller banks potentially still have a greater need to rebalance than larger institutions in light of stricter regulation. From a client perspective, lending to the private sector is recovering very slowly, with loans to households in the euro area currently up 1.3% yoy and corporate lending essentially flat.

Weaknesses in large banks' H1 results are harder to spot: first, operating expenses expanded by 12% yoy but, importantly, at a slower pace than revenues. Second, the strengthening of capital ratios is progressing, but not without bumps along the road – a relatively poor Q1 2015 was followed by a better Q2. The transitional Basel III Common Equity Tier 1 (CET1) ratio is now 12.9% on average, while the fully loaded ratio has reached 11.9%, an increase of 0.6 pp from June 2014. Considering the current discussion about a further tightening of capital requirements – the watchword is "Basel IV" – this will almost certainly not be the end of the story. And third, litigation costs remain high for several institutions, mostly those that are capital market oriented.

Nevertheless, large European banks all in all have become increasingly profitable again. One in two have been able to report a post-tax return on equity of above 9% for the first six months of the year. The average improved by more than 2 pp versus H1 2014. Granted, many banks are not yet in a sustainable position again, but they are clearly moving in the right direction. Roughly speaking, the industry may be about four to five years behind its US counterpart (broadly in line with the overall economic cycle), and judging from the developments on that side of the pond, the outlook for the European banking system is relatively promising. Unless there are major hiccups from a renewed European crisis or other potential market turmoil, the seven lean years after the financial crisis may have finally come to an end. Along with that comes a gradual re-privatisation of banks that were bailed out by taxpayers during the crisis and in which a number of governments still hold substantial stakes.

Basel III fully loaded CET1 ratio, largest European banks



Sources: Company reports, Deutsche Bank Research



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