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Talking Point

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Better Q2 results provide some relief to European banks

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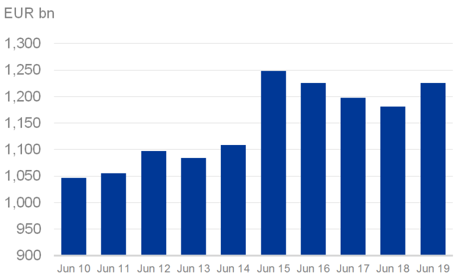
Equity capital at the top 20 European banks



Sources: Company reports, Deutsche Bank Research

Improved performance in the second quarter has given European banks hope that 2019 may still end on a more conciliatory note and that longer-term prospects are not quite as gloomy as some fear. In H1, net interest income rose year-over-year, despite unrelenting margin pressure. Other revenue components were mixed, with fee and commission income disappointing again. Loans and total assets in general increased. Banks cut expenses further, while loan loss provisions picked up from record lows. In the end, profitability and capital levels remained largely stable. Once more, the transatlantic gulf in performance widened slightly, as US banks reported another rise in net income to a new all-time high.

European banks saw a surprising improvement in their fortunes in the second quarter. After a weak Q1, this led to an overall solid performance in H1 as a whole. Since the summer of last year, net interest income dynamics at the 20 largest European banks have gradually strengthened from -2% yoy in H1 2018 to +2% in the first half of this year. This comes despite a further decline in interest rates which is slowly eroding net interest margins. But volume growth is currently more than compensating for the challenging margin environment. Total assets, which were still falling a year ago, are now growing at 4% yoy (risk-weighted assets climbed 3%). In the euro area, loan growth with the private sector has accelerated substantially to its strongest level since 2011. This is particularly true for corporates, where outstanding loans by all banks were up 2.4% yoy in June 2019 – the best figure since the financial crisis. For households, growth stood at 2.9%.

Apart from growing net interest income, the contraction in fees and commissions also slowed in Q2 to 4% yoy at the largest banks in Europe. Nonetheless, the second-most important revenue component remains a key weakness. Thanks to a somewhat more benign capital markets environment in Q2, trading income was flat yoy in H1. Overall, total income rose 2% – the first meaningful increase since 2015. A 7% fall in the average euro exchange rate versus the US dollar helped a bit, as it raised the euro value of earnings generated in the US and parts of Asia.

Banks were also successful in reducing costs further. Total administrative expenses fell 2% yoy in nominal terms – the fourth annual decrease in a row. On the other hand, loan loss provisions rose 20% from a record low level, in line with the considerable deterioration in the real economy. The trade war, Brexit uncertainty and the slowdown in Chinese demand took their toll. Together with some idiosyncratic charges, net income of EUR 48 bn was unchanged from a year ago. Banks' total capital base rose in parallel with total assets (+4% yoy), after a slow build-up in recent years. This caused underlying ROE (unweighted average) to slip 1 pp to 8%. The cost-income ratio stood at 62%.

Capital and liquidity levels were broadly flat and remained sound on aggregate. The fully loaded CET1 ratio was down 0.1 pp yoy to 13.6% on average; the fully loaded leverage ratio was up by the same amount to 4.9%. Almost all institutions now report the Liquidity Coverage Ratio (LCR), which edged up 1 pp to 148%.

This should allow banks to weather a normal, cyclical downturn in the economy, like the current one. In case of a massive worsening triggered by an intensifying trade war or a chaotic no-deal Brexit, for example, banks would of course quickly be in the front line, facing lower revenues and a surge in credit losses. Compared to that, the latest monetary easing by the ECB may only have a relatively mild, and mixed, effect on banks. On the one hand, deposit tiering brings the sector an immediate and non-negligible benefit from lower interest payments to the central bank. Higher bond prices could also lead to valuation gains in banks' securities portfolios. On the other hand, lower-for-longer interest rates (both through a lower deposit rate and new asset purchases) imply additional pressure on the interest margin and make a future normalisation of rates an ever more distant prospect.

How did European banks fare compared to their peers on the other side of the Atlantic? The US banking industry as a whole delivered another strong performance in H1 2019. Total revenues were up 3% yoy (growth was down, though, from 7% a year ago), driven by larger loan volumes and higher interest rates than in H1 2018. However, the latter may change soon, following the Fed's two recent rate cuts (and possibly more to come). Loan loss provisions climbed 11% to their highest level since 2012. Nevertheless, post-tax profits rose 6% yoy to USD 123 bn, which marks a new all-time record. ROE was basically stable at 12%. Bottom line: US banks' performance exceeded that of their European counterparts once more, and the gap has widened again. A glimmer of hope for the Europeans may be that the decade-long run in US banking seems to be slowing down, as the US economy is also cooling and rates are declining. What is more, European banks – after years of struggle – have probably become better versed in tight cost management than their "spoiled by success" US peers.

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