



European banks

Shaking off the shackles of the past year, looking ahead to a better 2021

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2020 ended on a conciliatory note for European banks. Following a heavy hit in H1, H2 saw a dynamic recovery in the economy and financial markets, which helped slow down the rise in loan loss provisions and buoyed trading income. Corporate loan growth stabilised but remained elevated and retail lending shrug off the crisis, while banks' liquidity reserves at the ECB surged to unprecedented and unsustainable levels. Government bond holdings initially rose strongly before calming down a bit. Capital and liquidity ratios weathered the crisis well, without even needing support from supervisors which relaxed a number of rules, at the risk of undermining confidence and transparency though. The outlook for 2021 is more benign with bank profitability set to rebound significantly thanks to much lower loss provisions.

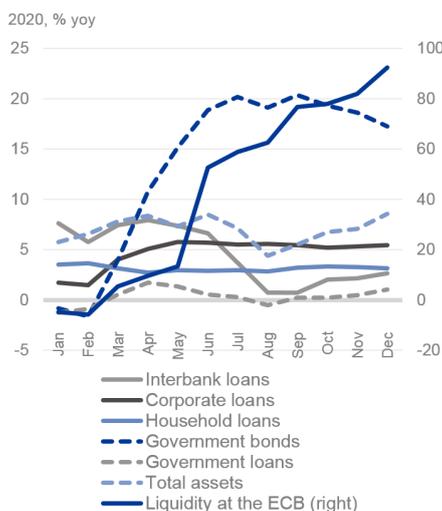
European banks are wrapping up the books for 2020 and one might expect to hear an occasional sigh of relief. Compared to the abyss they were staring into last spring, with countries around the globe entering harsh lockdowns, financial markets in free fall and economic projections indicating the worst recession since the Second World War, banks (and the economy as a whole) got away with two black eyes, in the end. Measures to contain the coronavirus were overall quite successful and people learned to somehow live with it, while governments and central banks worldwide intervened in the real economy and financial markets with unprecedented support measures. The manufacturing sector quickly recovered and the labour market proved surprisingly resilient, despite renewed lockdowns causing a lot of pain in the services sector. As a result, following a heavy hit in the first half of the year which drove many banks into loss-making territory, the second half turned out to be relatively benign, defying the gloomy predictions of March/April. Thus, some of the trends during the early phase of the pandemic slowed down later or even reversed, making 2020 a real rollercoaster for European banks.

On the balance sheet, this was reflected for instance in i) corporate lending and ii) government bond purchases. But of course, some developments continued unabatedly, including iii) the rise in liquidity reserves held at central banks and iv) lending to households.



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Major asset categories of euro-area banks



Sources: ECB, Deutsche Bank Research

i) In the euro area, corporate lending had surged initially, to a peak of 5.8% in the yoy growth rate in May. Subsequently, as economic uncertainty gradually receded and the economy started to recover, cashflows improved which reduced companies' demand for additional credit (moreover, banks moderately tightened lending standards). Loan growth therefore flattened out and stood at 5.5% at year-end.

ii) EMU banks' holdings of government bonds were shrinking before the coronavirus crisis hit. With government funding needs ballooning, banks quickly stepped in, boosting their outstanding investments by 20% in summer before pulling back again slightly. Currently, the portfolio is 17% larger than a year ago.

iii) The most extreme adjustment to euro-area banks' balance sheets took place in an area which is usually less in focus as it is not part of banks' client business and thus of less interest to policymakers: liquidity held at the central bank. Before the crisis it was down 6% yoy, but it rapidly started to rise dramatically. This was driven not least by cheap funding from the ECB (Pandemic Emergency Longer-Term Refinancing Operations, PELTROs) which often directly stayed at the central bank, as well as the ECB's quantitative easing (QE), i.e. bond purchases also from commercial banks. Hence, bank deposits at the ECB ended 2020 with almost twice the figure at the beginning of the year (+92%). In fact, total assets would have shrunk by EUR 0.3 tr since February had it not been for the jump in central bank liquidity. The latter now amounts to a staggering EUR 3.5 tr, equivalent to about three-quarters of the total corporate loan volume. It is obvious that something in the banking system is deeply flawed, with 10% of all assets not in productive use and even yielding a negative nominal return.

iv) In spite of last year's extraordinary circumstances, including social distancing rules, higher unemployment and strong uncertainty about the near future, retail lending in the EMU hardly budged. Instead, it continued to grow by roughly 3-3½% yoy throughout 2020, driven by robust mortgage lending, whereas consumer credit declined modestly. If anything, the pandemic seems to have turned the spotlight on the advantages of home ownership in times of working from home.

In European banks' P&L, the ups and downs of the past year are visible for instance in loan loss provisions and financial market performance (whereas trading activity was very strong throughout the year). As full-year reporting has just started, the 9-month figures can serve as an indication. For Europe's 20 largest banks, they already show that following a 150% increase in loss provisions in H1, they only rose by less than 25% yoy in the third quarter (some banks were even able to release some reserves, i.e. reported negative net new loan loss provisions). On aggregate, this amounts to more than a doubling in Q1-Q3. Remarkably, banks that typically have a relatively sound asset quality hiked their provisions to a greater extent than banks which usually see larger impairments. In the first basket, which includes banks from Switzerland, Germany, the Benelux and the Nordic countries, loan loss provisions surged by more than 300% yoy in the first nine months of 2020. French banks stood in the middle as their provisions more than doubled. In the other corner, which includes Italian and Spanish institutions, provisions surprisingly increased by only about 60%. In light of the experience in the



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aftermath of the financial crisis and the European debt crisis, when elevated provisions proved a prolonged burden particularly for banks in southern Europe, it remains to be seen whether banks in the first group have been too cautious or the latter have been too optimistic and have to follow through with additional provisions later on.

The swing in equity markets from record levels last February to the crash in March and a recovery to new record levels towards the end of the year is reflected in trading income. It fell in Q1, turned around in Q2 and after nine months, it was up a whopping 29% yoy in total. The biggest revenue component, net interest income, witnessed the opposite effect. A stable start turned into a 5% contraction after three quarters, primarily as a result of interest rate cuts in the US and central & eastern Europe, a stronger euro and lower dividend income, in addition to continuing margin pressure. Fees and commissions dipped 1% yoy. Bottom line, total revenues were slightly in the red (-1%), while banks managed to cut costs by more (-3%) which is encouraging looking ahead at more normal provisioning levels. All in all, net income slumped 61%, but was at least substantially positive compared to the minimal loss recorded in H1.

With regard to capital and liquidity, European banks remain well positioned. Not least thanks to large-scale credit guarantees by governments, a massive rebound in capital market valuations and reduced derivatives volumes, risk-weighted assets at the end of September were 2½% lower than a year ago. The absolute capital base remained almost stable, benefiting from the recovery in profitability in Q3 and the retention of dividends for the year 2019 which had already been accounted for. Taken together, this led to an increase in the fully loaded CET1 capital ratio of 0.6 pp yoy, to a very robust 14.1% on average. Driven mainly by banks' enormous liquidity holdings at central banks, the Liquidity Coverage Ratio (LCR) climbed 5 pp to 157%, a new high since its reporting started in earnest in 2017.

The leverage ratio is currently a special case. Regulators in general have issued a host of mostly minor relief measures in response to the coronavirus crisis, to alleviate the burden on banks, postpone loan loss provisioning, reduce capital and liquidity requirements to allow banks to continue lending freely to their customers. In the Banking Union of the EU, many of these steps were implemented through the "quick fix" of the Capital Requirements Regulation (CRR). However, in light of the revised Basel framework which was meant to establish capital standards that would work through the cycle and entail sufficient built-in, i.e. automatic, flexibility in times of crisis, this is a doubtful reaction by policymakers, their good intentions notwithstanding. It undermines trust of investors and customers and even the support from banks may primarily be driven by the desire to make a few relaxations permanent. Otherwise, it is hard to see some of them making sense. One case in point is the leverage ratio. The European Commission and the ECB (as well as some other supervisors) have allowed banks to exclude exposures vis-à-vis central banks from the leverage ratio denominator, total exposure, temporarily from September 2020 until 27 June 2021. That is, the officially reported ratio will increase ceteris paribus for three reporting dates, Q3 2020, full year 2020 and Q1 2021, before reverting back to the original calculation



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method. Yet such messing with regulatory standards in the middle of a crisis can:

- create considerable confusion;
- send a wrong signal to the market that there is serious need to worry and problems shall be swept under the carpet;
- undermine confidence in a robust and credible set of rules established only recently by the same authorities as a “bold” response to shortcomings that led to the financial crisis; and
- is often even futile like in this case as the large majority of banks continues to report the ratio also on a “look-through”, long-term basis. The market simply demands transparency and ignores temporary tinkering.

For Q3, the look-through leverage ratio dipped only mildly by 0.1 pp yoy to 4.8%, due to the still meaningful rise in total assets (up 4%). Some European banks outside the euro area did not even have the relief option, some banks decided not to use it at all, others reported only this adjusted ratio, while most institutions published both figures. For them, the uplift was anywhere between 20 and 70 bp, with the median at 38 bp, which is substantial, though it does not shift the figure in a completely different dimension.

The outlook for 2021 is significantly brighter than European banks’ results of the past year. The recent investment banking bonanza may not repeat itself with trading volumes probably coming down from very high levels, but overall, market valuations and capital issuance activity should stay elevated and the M&A business may pick up, not least due to monetary policy remaining extremely loose. Banks’ administrative expenses look set to fall somewhat further. The biggest change may be a strong reduction in new loan loss provisions which should trigger a rebound in profitability, similar to the Q3 effect. Where applicable, this may allow banks to resume dividend payments which had been suspended by supervisors last year. Net interest income is likely to remain under pressure though, especially if lending momentum slows. On the corporate side, this will probably be the case as the yoy growth rate has usually turned negative in the aftermath of past recessions. Total assets could also shrink as banks may seek to reduce their excessive and unsustainably high liquidity holdings at central banks whose costs are substantial (even though funding rates at the ECB can also be deeply negative). Of course, these prospects are contingent on the macro economy recovering as expected – real GDP may expand by 5.6% in the euro area, 4.5% in the UK and 5.9% in the US this year – which in turn will largely depend on the further course of the coronavirus pandemic and the progress on vaccinations.



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