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Talking Point

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Crisis? What crisis? European banks rebound (again)

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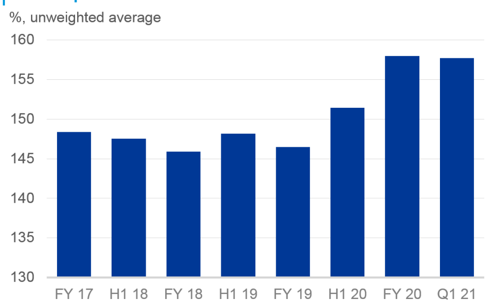
The recovery was quick and resounding. The banking sector in Europe has shaken off the impact of the pandemic and in many ways it looks like nothing happened in the past two years at all. In Q1 2021, profitability, costs, efficiency levels, several capital and liquidity indicators were all similar to Q1 2019. Nevertheless, the crisis has left its imprint: balance sheets are far larger, revenues and loan loss provisions are substantially higher, as is the CET1 ratio. Hence, there is still room for further normalisation.

After suffering from the heavy blow of the pandemic recession last year, the European banking industry is largely back to where it was beforehand. Many performance indicators for the major banks for the first quarter look as they did in 2017-19, including aggregate net income, average return on equity (7 ½%) and the cost-income ratio (61%). Likewise, some capital and liquidity figures have hardly changed – witness the leverage ratio of 4.8% and the Liquidity Coverage Ratio (LCR) of 156%. Even risk-weighted assets (RWA) and total administrative expenses are essentially on the same nominal level as before the crisis.

Liquidity Coverage Ratio of the top European banks



Sources: Company reports, Deutsche Bank Research

The LCR rose last year mainly because banks eagerly participated in the ECB's longer-term refinancing operations (TLTRO III) which are attractive as banks receive a negative interest rate of up to 1%. Many institutions soaked up liquidity but kept it at the central bank, thus boosting their liquidity reserves. The above leverage ratio figure disregards the temporary exclusion of deposits held at central banks. In the euro area, this is an option only until June 27th, in Switzerland, it expired at the beginning of the year and in other non-euro EU countries such as Sweden or Denmark, it was never implemented in the first place. On June 28th, a minimum leverage ratio of 3% will become a binding constraint in the EU under the revised Capital Requirements Regulation, CRR II. On top of that, from January 2023 on, a G-SIB (global systemically important bank) leverage ratio buffer applies, which is equal to half of the risk-based G-SIB buffer. i.e., a major bank, which is required to hold additional capital of 1% of its RWA, is also required to meet a leverage ratio of 3.5%. Most, though not all banks, are comfortably above that G-SIB threshold today. Other CRR II provisions also come into effect on June 28th which will change – sometimes reduce, sometimes increase – the leverage ratio exposure amount due to new rules for measuring derivatives (SA-CCR, a new standardised approach for counterparty credit risk).

But, back to bank performance. With so many indicators at 2019 levels again, has nothing changed? For sure, below the surface, dynamics have been remarkable. Start with revenues. Net interest income remains under considerable pressure (down 6% compared to Q1 2019), even more since volume growth in loans has slowed. With euro-area corporates, it has declined to 3.8% yoy, the lowest level since the beginning of the pandemic (partly a base effect given the surge in spring last year). Total private-sector lending (+3.6% yoy) is far outpaced by the inflow of deposits from the private sector (+10%). The gap between the two rates matches the previous peak during the European sovereign debt crisis in 2013. In turn, this dramatically raises banks' excess liquidity reserves at central banks. These are painfully costly – the ECB charges 0.5% p.a. – which is only partly made up by the negative TLTRO funding rates which should prop up net interest income to some extent in the next quarters. To receive the full benefit, banks have had to hold their lending volume with the private sector (excluding retail mortgages, i.e. corporate loans dominate) at least constant between February 2020 and March 2021. Many banks should have qualified for the -1% funding rate given strong loan growth in the first phase of the coronavirus crisis. Although in the second reference period, running from September 2020 until the end of this year, this threshold may be more difficult to achieve given slowing lending momentum.

On the other hand, fee and commission income (+16% over the past two years) and trading income (+44%) are bright spots, though some caution is needed regarding the robustness of these increases, due to usual volatility and the fact that not all banks report quarterly numbers. Bottom line, total revenues rose 7% which is fairly impressive given banks' perennial struggle to grow since the financial crisis. Of course, strong capital markets in recent months have provided a lot of tailwinds that may not last forever, but maybe bank revenues have indeed finally hit the bottom and left these behind.

Loan loss provisions, the biggest P&L driver last year, have already normalised somewhat. They are still more than 50% higher than in 2019, yet down 38% yoy. Furthermore, the 2019 figure was close to the bottom of the past 15 years, i.e. unsustainably low in any case.

Change over the past two years has been noteworthy in two more areas: balance sheets have expanded, and the CET1 capital ratio has risen. Total assets are up a substantial 10%, even though that is mostly due to the initial crisis reaction rather than a result of the last few months. Nevertheless, it is remarkable that, so far, there has been no reversal whatsoever. Similarly, total equity has increased by 2%, primarily because of the suspension and retention of dividends since last spring. This has also pushed up the core capital ratio by a full 1 pp to 14.4% on average over the past 24 months. Several EMU banks have resumed dividend payments now, but cautiously and in line with ECB guidance which stipulates that until September no more than 15% of cumulative 2019/20 profits or 20 bp of the CET1 ratio should be handed out to shareholders. With the situation gradually normalising and policymakers and the industry exiting these extraordinary measures, the CET1 ratio could come down a bit.

All in all, the European banking sector has recovered impressively from the coronavirus shock a year ago. Extensive fiscal and monetary support has certainly helped, both directly and indirectly through providing a life net for many firms and employees, and propping up financial markets. In Q1, stronger revenues and diminished provisions contributed equally to the yoy rebound in profitability, which also benefited from fewer one-off hits (despite two prominent failures of a British-Australian specialty-finance company and a US hedge fund). Given that, it may matter less that years of cost cutting could possibly come to an end in 2021, also because of higher compensation as a result of the better investment banking performance.