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European banks

Still standing strong

Author

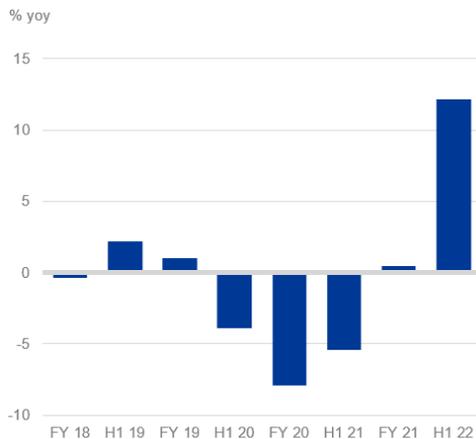
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In an unusual constellation, the banking industry is at the same time suffering and benefiting from the current difficult macroeconomic situation. Inflation is driving up expenses, but also triggering a monetary policy normalisation which has fuelled a jump in net interest income. Meanwhile, recession fears require higher loan loss provisions. The net effect has been manageable so far, but is hard to foresee in the second half of the year. The largest capital distributions to shareholders since the financial crisis have pushed the CET1 and leverage ratios lower, though they remain at robust levels. Balance sheet growth has accelerated due to buoyant corporate and mortgage lending, but this may not last given the looming economic slowdown and further interest rate increases.

Net interest income of Europe's largest banks



Sources: Company reports, Deutsche Bank Research

European banks remain in good shape, even though troubles loom from a potential recession in H2. The results for the first six months show remarkable resilience in light of the macroeconomic headwinds due to the energy crisis and surging inflation as well as other, idiosyncratic impacts of Russia's war in Ukraine. Net income of the top 20 European banks fell by only 9% from the prior-year level which had been the strongest since the financial crisis – a consequence of loan loss provisions rising by 40%, but from record lows, due to the clouded outlook. They are still far off the 2020 heights.

In addition, administrative expenses climbed considerably (+8½% yoy) which shows that European banks have decisively left behind the period of stringent nominal cost management which led to consecutive annual declines between 2016 and 2020. The expense bounce is driven by an array of factors: i) The general pickup in inflation to which banks are not immune, of course, including a tight labour market in many European countries and the US which induces upward pressure on compensation. ii) Higher contributions to resolution funds and deposit guarantee funds. The Single Resolution Fund alone collects annual fees of EUR 13.7 bn this year, a massive increase e.g. compared to EUR 7.8 bn in 2019, caused by ever-larger insured deposit volumes. iii) Currency effects play a (technical) role as well. The euro has weakened substantially over the past 12 months, by 13% versus the US dollar (end-of-June basis). This pushes up P&L figures in non-euro markets when converted into euro – even though European banks have (once more) reduced their exposure towards the US in recent years. iv) Higher litigation provisions also contributed to the yoy cost increase.

However, this double whammy was almost made up for by a strong revenue performance (+6½% compared to the previous year). This, in turn, was not due to fees & commissions and neither to trading income which both





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remained flat as the momentum in capital markets slowed significantly (trading income at individual institutions was quite heterogeneous). Instead, the sole driver was an impressive rebound in net interest income (+12%). Essentially it had been declining slightly (in nominal terms!) since the financial crisis before slumping during the pandemic, especially in its early phase. Since the beginning of 2022 though, with market rates – and policy rates in the US and UK – climbing rapidly, a recovery kicked in. Given the further expected rate hikes for at least some time more, whose effect in the euro area is yet to be fully felt, net interest income is likely to post further gains. So far, tailwind has come mostly from volume growth (see below) and margin expansion. Going forward, this is likely to weaken: the economic slowdown may dampen demand for credit.

In addition, several historical anomalies have already disappeared or are about to do so with the ECB putting monetary policy back on its feet. The normalisation involves i) the abolishment of negative deposit rates in July which had been a drag on banks' interest income and ii) similarly, however, the end of refinancing rates of at best -1% (available until June) through the central bank's TLTRO operations. This "funding benefit" will soon turn into a "funding cost" again. Likewise, income from deposit charges imposed on (mainly corporate) customers will evaporate. As of June, corporate deposit rates were still negative in the EMU, at -10 bp for time deposits and -4 bp for sight deposits. But overall, this may be outweighed by the steep increase on the asset side: new corporate loans larger than EUR 1 m have already become 0.7 pp more expensive on average since end-2021, with rates currently at 1.8% p.a. And more rises will follow.

Regarding banks' P&L, in addition to litigation which fed into expenses, the bottom line also suffered from other major non-operating one-off items. This includes charges from an exit from Russia or the lack of M&A-related gains recorded the year before which distort the comparison. Apart from that, profitability levels continued to be fairly solid, as evidenced by an average post-tax ROE of 7% (down only slightly yoy). The cost-income ratio was stable at 61%.

Remarkable movements took place on the capital front. Just for the second time since the financial crisis (after 2018), the core capital ratio/CET1 dropped meaningfully, from 14.8% on average in June 2021 to 13.8% this year, even though total nominal equity edged up 1%. Similarly, the leverage ratio (excluding the temporary adjustment from the exclusion of central bank exposures) declined 0.3 pp to 4.7%. Many banks have focused on returning surplus cash to their shareholders in the past few months through both large-scale dividends and share buybacks. This comes after a long suffering of banks' owners. The European bank stock index has never recovered from the slump 14 years ago and remains almost 40% lower even compared to its summer 2015 level. Thus, banks' understandable emphasis on capital returns. Two things have made this possible: improved profitability – last year was the industry's best since the financial crisis – and strong capital levels, especially after supervisors requested dividend restraint at the onset of the coronavirus pandemic and banks retained 2019 and 2020 profits, adding further to their capital positions. In that sense, the recent capital distribution included funds from previous periods and clearly exceeded current capital generation, hence it will not continue at the same pace in future. Nevertheless, capital ratios overall stay robust (some weakness in countries such as France notwithstanding). They are also essentially unchanged from two years ago.



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With regard to liquidity, the picture looks even more solid, with an LCR of 161% (-4 pp yoy).

At the same time, balance sheets are significantly in flux. Total assets and risk-weighted assets continue to expand strongly (up 7% and 6%, respectively). The latter was partly driven by regulatory changes as well as by rating migration due to Russia's war on Ukraine, and it contributed to the fall in the CET1 ratio. Uncertainty and rising input costs have caused a massive acceleration in corporate lending (+6% yoy in the euro area, compared to virtual stagnation a year ago). Residential mortgage growth fully maintained its momentum (+5.8%), despite (but also due to) elevated house prices in many countries. Yet real estate is often seen as an inflation hedge. In a sign of the growing burden of rising costs for many companies, corporate deposit growth has slowed (to 7% yoy) despite the pickup in lending. All in all, the strong previous expansion in deposits may have created large liquidity buffers and firms look relatively well prepared in this regard. Corporate deposits have surged for years (+50% in total in the euro area since the beginning of 2017 alone) and were never reduced, not even when the strains of the pandemic eased. Households' cash pile is equally substantial, but the increase has been more sluggish recently (+3.5% yoy), as consumption gained steam in spring, while inflation emerged in parallel as a growing headache.

Finally, EMU banks' liquidity holdings at Eurosystem central banks may have peaked, not least due to the end of quantitative easing (QE). Over the past half year, the volume has broadly plateaued and stood at EUR 4.5 tr at the end of June. This is equivalent to a massive 11.6% of total assets, versus 5.5% before the onset of the pandemic and 0.9% before the start of QE in early 2015. This mountain of liquidity could now slide moderately, but may remain permanently higher than it used to be, given banks have to maintain sufficient buffers in relation to their LCR requirements established a few years ago.



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