

## Talking point

### European banks: Healing continues

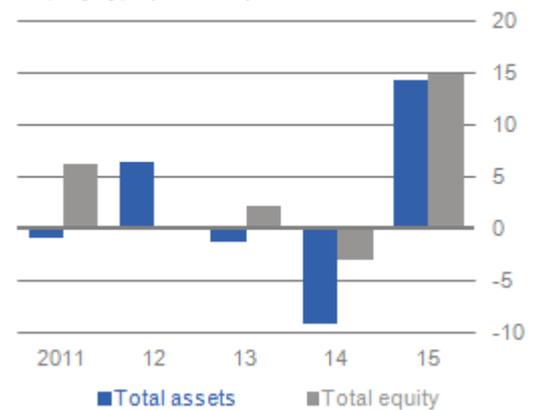
June 11, 2015

**European banks had a successful start into 2015. Business activity improved, asset quality did so as well and profitability rose again, as the rebalancing of the industry made further progress. The ECB's new large-scale market interventions helped strengthen sentiment in financial markets, and contributed to the continuing decline in the euro exchange rate – which on balance may have been beneficial for banks.**

Lending to both corporates and households in the euro area picked up somewhat in the first quarter of 2015. In line with that, banks' total assets expanded by 4%, the strongest growth since 2011. For the 20 largest European banks, asset growth was even much more pronounced (9% qoq, 14% yoy). Admittedly, part of this was due to significant exchange rate movements as the following back-of-the-envelope calculation shows: with the euro losing about a fifth of its value against the US dollar over the past 12 months, and taking into account that the large European banks generate roughly a quarter of their revenues outside Europe, the EUR-USD movement alone may explain a year-on-year increase of approximately 5% in all nominal balance sheet and P&L figures of large European financial institutions. This is based on the assumptions that i) most leading Asian currencies broadly follow the dollar's path versus the euro, and ii) the non-European share is relatively similar for banks' total revenues and their balance sheet totals, i.e. revenues and assets are more or less linked. This "given" 5% increase that is solely due to the euro's depreciation against the dollar needs to be kept in mind when looking at developments in other P&L and balance sheet components of large European banks.

#### Balance sheet figures recently inflated by euro depreciation

Q1, % yoy, top 20 European banks



Sources: Company reports, Deutsche Bank Research

More specifically, net interest income surged by 10% yoy in euro terms in Q1 2015 – half of this was driven by the exchange rate though. Nonetheless, this is a clear sign of life also on an underlying basis, following an 8% slump over the past four years. Fee and commission income climbed by 8% yoy in Q1, while trading income jumped by no less than 59% due to a favourable market environment (major equity as well as bond markets hit new records during the quarter) and a very low prior-year result. Taken together, revenues were up a whopping 15%. Of course, the euro effect inflated cost levels, too, as operating expenses rose by 13%. However, as banks were able to keep the increase in costs below that in revenues, net income grew an impressive 46% to the highest level since 2011. A further 8% decline in loan loss provisions helped as well – the cost of risk thus fell to its lowest level in 7 years.

As a consequence of this progress in the operating business, both the cost-income ratio and the return on equity improved substantially on average. The CIR decreased more than 4 pp to 57%, and the ROE jumped to double digits (i.e., 10.1%) – for those institutions that report it. Indeed, several of the large banks finally seem to be shaking off the legacy of the financial crisis and have been posting healthy returns for the first time in many years. Granted, Q1 was just a start. It benefited from a positive environment and is usually the best quarter of the year anyway; hence banks have yet to prove these results are really sustainable.

What has become more worrying instead, recently, are the changes – or rather the lack of them – on the capital front. On face value, a fully loaded Basel III Common Equity Tier 1 ratio of 11.8% on average looks solid, and it is 0.6 pp above the year-ago level. However, there are two reasons for becoming slightly uneasy. First, the regulatory momentum with regard to tighter capital requirements has clearly picked up in the past few months,

again. Authorities are discussing a number of additional measures to come on top of the already adopted Basel III accord: a leverage ratio higher than the initially agreed 3% seems to be an option, as well as higher risk weights stemming from the Fundamental review of the trading book currently being conducted by the Basel Committee. Also, the harmonisation of risk-weighted assets through the introduction of new floors in the internal risk modeling process may equally lead to higher RWAs. In sum, the buzzword “Basel IV” is already making headlines, as regulators still do not seem satisfied with the greatly strengthened capital buffers banks have achieved so far. Second, banks seem to have become a bit too relaxed following the completion in late 2014 of the ECB’s Comprehensive Assessment, which almost all large institutions passed successfully. In fact, the upward trend in capital ratios weakened towards the end of last year. And in Q1 2015, the average fully loaded CET1 figure has not improved further at all – it was simply flat. The current level, however, will most probably not be sufficient given all the new regulatory initiatives (and the new stress tests looming next year).

The recent disappointing “lightness” on capital is driven to a considerable extent by banks’ increased risk-taking. The link between balance sheet expansion, larger lending volumes, a surge in trading income and higher RWAs is straightforward. Banks seem to have prioritised growth (which the industry painfully had to forego for several years) over raising capital ratios further. RWAs were up 6% yoy, 5 pp of which came in Q1 alone. On a side note: all leverage ratio discussions notwithstanding, at 30%, (large) European banks’ RWA intensity relative to total assets remains fairly low compared to the US banking sector’s 72%. Overall, European banks may well be forced to pay greater attention to capital levels again, while simultaneously providing enough resources to grasp and fund the newfound opportunities for precious business growth.



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