



European banks suffer more than US peers in the corona crisis

August 27, 2020

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Large banks in Europe have taken a substantial hit from the recession induced by the coronavirus. Their revenues dropped 5% yoy in the first half of the year, driven by lower net interest income and other income, which a benign trading and underwriting environment on capital markets could not compensate. The biggest impact, however, came from a spike in loan loss provisions which more than tripled. As a result, post-tax profits nearly evaporated although banks successfully cut costs again.

Encouragingly, the average core capital ratio increased compared to 12 months ago, to 14%, and the leverage ratio dipped only slightly to 4.8%. Both benefited from the scrapping of dividend payments. Corporate lending boomed since the outbreak of the crisis, supported by public guarantees. Banks also expanded their deposits at central banks enormously, thus maintaining a strong liquidity position. Together with substantial government bond purchases, this drove up total assets.

In the next quarters, some of these effects will likely go into reverse. Corporate loan growth may slow considerably due to weaker demand and tighter lending standards, and banks may gradually reduce their excess liquidity reserves as financial market volatility subsides further and the economy starts to recover. This will probably mean lower revenues from securities trading, while loan loss provisions should slowly retreat from their high level.

Compared to their European competitors, the major US banks (similarly to the economy as a whole) have weathered the crisis somewhat better up to now. In aggregate, they remained moderately profitable, despite setting aside far more funds to cover future loan losses. Revenues grew 2% yoy, a stronger headwind from the Fed's interest rate cuts notwithstanding. Capital ratios, however, appear a bit weaker and less resilient than in Europe.



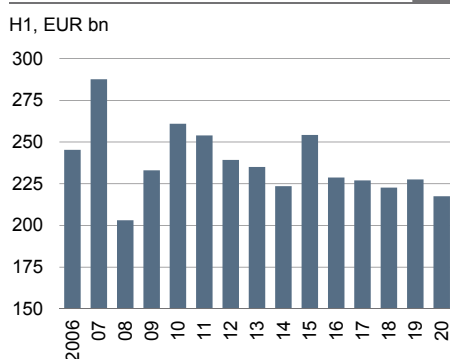
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Like many other industries, the banking sector is suffering considerably from the coronavirus recession. Granted, it has hardly been affected directly by lockdown measures or disrupted supply chains and has even benefited from greater demand for credit and increased trading activity in capital markets. Nevertheless, this has been far outweighed by reduced revenues in other areas and a surge in loan loss provisions. Overall, the impact has clearly been negative.

Revenue pressure and hit from loan loss provisions

Revenues at Europe's major banks

1



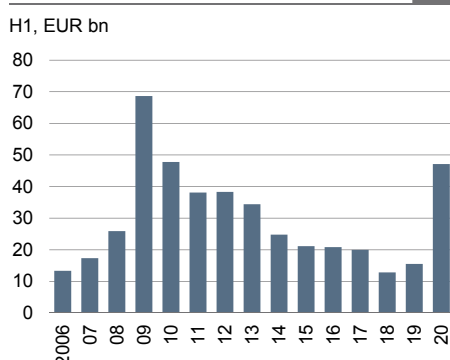
Sources: Company reports, Deutsche Bank Research

In Europe, revenues at a representative sample of 20 major banks fell by 5% yoy in the first half of the year. This was mainly driven by a 3½% shrinkage in net interest income and a 34% slump in other income. Interest income fell due to continuing margin pressure and as a result of rate cuts in the US and central and eastern Europe as well as appreciation of the euro versus many emerging market currencies. In addition, dividend income, which is a subcomponent, shrank as many companies cancelled or postponed dividend payments for 2019 in spring, partly because they had to delay their annual general meetings. This more than offset volume growth. The contraction in other income reflected, among other things, several one-off gains in the prior year and lower income from insurance business.

Fees and commissions were flat, with clients intensively trading in securities and higher underwriting revenues from bond and equity issuance on the one hand and lower portfolio management fees in asset management (due to reduced assets under management) and lower M&A fees on the other hand. Trading income was the only growth area (+7% yoy) thanks to a strong rebound in market valuations. But its importance has diminished so much as banks de-risked their business models in the past decade that it could not lift the overall performance. Banks managed to reduce administrative expenses to a similar extent (-4%) to the fall in income, leaving the unweighted average of the cost-income ratio flat at 62%.

Loan loss provisions at Europe's major banks

2



Sources: Company reports, Deutsche Bank Research

However, as expected, loan loss provisions went through the roof, rising to more than three times their level a year ago. This is the highest since 2010, in the aftermath of the financial crisis, and higher than during the European debt crisis, after which they had steadily fallen. Still, they remain significantly below the heights reached during the Great Recession, not least because of the unprecedented fiscal and monetary support currently provided to the private sector. European governments

- have issued loan and debt guarantees,
- established extended work protection schemes,
- implemented direct fiscal transfers to self-employed and small enterprises,
- allowed for deferrals of rent and mortgage loan payments and of insolvency notifications,
- cut value added taxes,
- are recapitalising large firms deemed too important to fail, just to name a few measures. All of this mitigates the impact of the crisis on employment, personal and corporate income and thus on the debt servicing capacity of firms and households. To what extent it will really prevent a wave of defaults is unclear, given
- the unprecedented nature of the containment measures,
- hard-to-predict consumer behaviour in the presence of a strongly infectious virus and



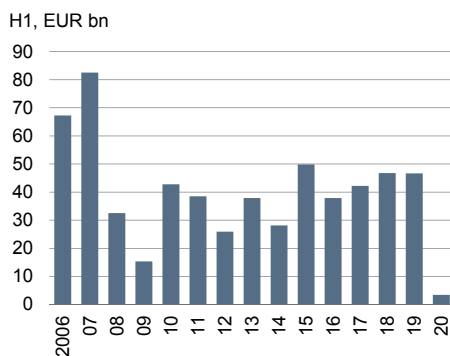
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- the uncertainty about the further course of the pandemic itself – whether there will be a second wave (forcing renewed restrictions on public and business life), how fatality figures will evolve, shifting regional patterns and, above all, the availability of treatment and a vaccine.

Hence, banks operate with macroeconomic, sectoral and financial market assumptions which contain an unusually high degree of uncertainty. Even the loss provisions of the first half of the year primarily reflect banks' baseline expectations about future loan defaults because so far, for the above-mentioned reasons, actual losses have been relatively muted. In the central scenario of a dynamic recovery throughout H2 and beyond, which is shared by most institutions, the current rate of loan loss provisions (though not the effective charge-offs) should also be at or close to the peak and slowly come down in the next few quarters. A pandemic and therefore economic setback, of course, would shatter this cautiously optimistic outlook.

On top of this, the more modest macroeconomic growth perspectives over the medium term have caused a few banks to reassess the value of some of their businesses, resulting in additional goodwill impairments. Unsurprisingly, the triple effect of lower revenues, goodwill writedowns and particularly the enormous increase in loan loss provisions have driven a substantial number of banks into the red. This applies to more than one-third of the 20 leading institutions. In aggregate, net income slumped 94% yoy, i.e. it was essentially wiped out. In fact, it was even lower than in H1 2008/09, during the financial crisis, which in itself demonstrates the gradual weakening of the continent's banking system over the past decade.

Net income at Europe's major banks 3

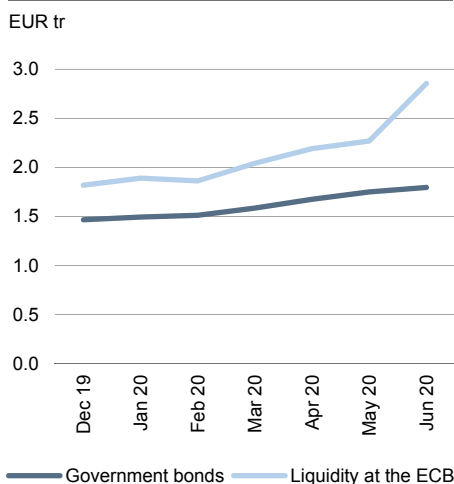


Sources: Company reports, Deutsche Bank Research

Resilient capital and strong liquidity

Remarkably, capital ratios hardly suffered, with the CET1 ratio even rising 0.5 pp yoy to 14% on average, while the leverage ratio went down slightly (-0.1 pp to 4.8%). A major supporting factor at most banks was the release of 2019 dividends which had already been accounted for, but were scrapped following ECB guidance not to pay any dividends in calendar year 2020. Also, goodwill adjustments affect nominal equity but not CET1 capital. Some banks now factor transitional regulatory relief with regard to IFRS 9 into their otherwise fully loaded Basel III CET1 ratio, without this having a material impact on the sector-wide average. Furthermore, some institutions issued new Additional Tier 1 (AT1) instruments which count, though not towards the CET1 ratio, at least towards the leverage ratio.

Euro-area banks' holdings of government bonds and central bank liquidity 4



Source: ECB

Overall, with positive and negative effects largely balancing out each other, total equity as well as risk-weighted assets (RWA) remained constant compared to 12 months ago. RWA declined in Q2 versus the prior quarter on the back of exchange rate movements (euro appreciation) as well as repayment of some credit lines by companies and lower derivative market values. These were partly compensated by higher market risk RWA due to higher average market volatility and some exposure migration into weaker rating buckets. The Liquidity Coverage Ratio (LCR) remained very strong, climbing 7 pp yoy to 154% on average, as banks expanded their holdings of deposits at central banks (often funded through new TLTROs) and partly also government bond holdings.¹ This, together with the growth in private-sector loans, drove up total assets by an impressive 7½% yoy or 9.2% since the start of 2020.

¹ All banks in the euro area, for instance, have added a staggering EUR 1 tr in reserves at the ECB to their balance sheet since February, as well as EUR 284 bn in EMU government debt.



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Outlook

Bottom line, European banks have been hit hard by the pandemic recession, and support factors such as the spring trading frenzy in capital markets are unlikely to be sustained in the second half of the year. Likewise, the corporate lending boom during the lockdown months is highly likely to subside as (sound) firms gain greater clarity on their cash flow needs and repay surplus liquidity. Tighter lending standards may also feed through as banks become more cautious in light of increased default risk (not all of which is covered by government guarantees) especially of cash-strapped enterprises in industries with poor prospects for a quick recovery. According to the bank lending survey, credit standards for companies were actually eased in Q2 in most of the large EMU countries, thanks to public guarantees. The exception was Germany where standards again were tightened moderately. On balance, EMU banks even rejected fewer loan applications than in the previous quarter as reported by a net 12% of the surveyed institutions. For Q3, however, a net 23% of euro-area banks expect to tighten lending standards when some guarantee schemes run out – with the effect similar across the board, for large and small firms, for short- and long-term loans and particularly pronounced in France and Spain.

The combination of weaker demand and more limited supply should bring about a gradual decline in outstanding loan volumes. On the positive side, new loan loss provisions will possibly also come down. Net-net, European banks will continue to operate in a rough environment for the remainder of the year (and probably beyond), with hopes pinned on the development and successful rollout of vaccines and the economy picking up more steam again.

Shared transatlantic destiny and a few differences

How does the European banking system's performance contrast with that in the US where the epidemiological situation remains far more tense? In US banking, many of the same trends hold true. Nevertheless, a number of differences stand out:

- The top 7 US banks have raised their loan loss provisions in H1 to a much greater extent than their European counterparts, to 5½ times the level a year ago. This is remarkable: in contrast to public perception shaped by the wider spread of the coronavirus in the US and its relatively better containment in Europe, the economic impact could still be heavier on this side of the pond. GDP is expected to decline by 8.6% in the euro area this year, by 11% in the UK and “only” 5.2% in the US, as the latter is less export-dependent, may see the larger fiscal impulse with regard to income and has also experienced less harsh lockdowns. As a result, the Q2 drop qoq was heavier in the EMU (-12.1%) and the UK (-20.4%) than in the US (-9.5%).

The more moderate provisioning in Europe is due to various factors – instructions by supervisors, government-guaranteed lending, a lower weight of high-risk credit card claims in the loan portfolio than at US banks, a higher weight of low-risk residential mortgages. But it could also be influenced by stronger pre-provision profits in the US and thus greater “affordability” to take a particularly conservative approach to provisions. The risk therefore seems profound that European banks will suffer a more prolonged drag from non-performing assets than their US peers, resembling the post-financial crisis situation.

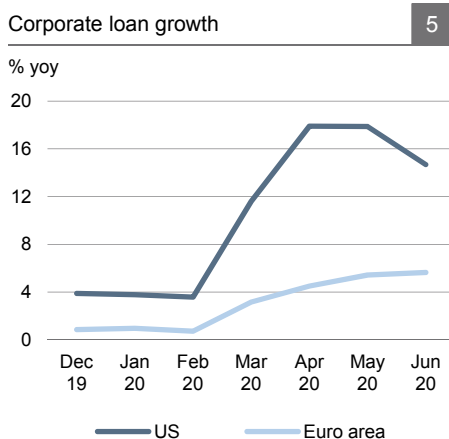
Loan guarantees that significantly reduce the credit risk for banks have only been issued in a number of European countries. Importantly, they just apply to new lending, not outstanding volumes which make up the bulk of banks' loan book. Defaults both of companies and households will still be



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painful for banks and they will have to digest most of the losses themselves. But also in the US, the government is reducing risks for banks, by directly propping up household and small business income. Finally, the day of reckoning for many exposures is yet to come in the US as well as Europe. Be it because existing reserves have been depleted after months of reduced sales, be it because of the end of public interventions such as the delay of mandatory insolvency notifications in Germany at the end of December. This will likely trigger a sizeable number of corporate bankruptcies afterwards. Even though most of the upcoming charge-offs should be covered by existing provisions, additional unexpected credit losses may also occur.

- The Fed has slashed interest rates by 2¼ pp to 0 since summer last year and by 1.5 pp since the start of the pandemic alone. By contrast, the ECB has left its main policy rates unchanged (its offer of even lower rates on the TLTROs notwithstanding). This has created considerable new headwind for US banks, visible in deteriorating interest margins, much more than for their European competitors. However, (strongly performing) capital market activities play a much bigger role for the leading US banks whose revenues as a whole were mildly up in H1 compared to the prior year (+2%), following a fall in Q1. European banks on the other hand could not make up for net interest income pressure and thus saw total revenues shrink in H1.
- In spite of the headwind from provisions and interest rates, large US banks on aggregate remained moderately profitable, thanks to strong underlying earnings. Net income tumbled by about 60% yoy in H1, similarly to Q1, which was basically entirely a consequence of the ballooning loan loss provisions. Nevertheless, it amounted to USD 26 bn compared to only EUR 3 bn at the European banks. In line with that, US supervisors allowed continuous payment of – typically quarterly – dividends (though they prohibit share buybacks). By contrast, banks in the euro area are not supposed to return any capital to shareholders this year after net income all but evaporated.



Sources: Fed, ECB, Deutsche Bank Research

- Corporate loan growth in the US is already down substantially whereas in the euro area, on a much lower level, it has kept accelerating so far. On a yoy basis, growth peaked at more than 19% in the US in early May and has steadily fallen since. In the euro area, where only monthly rather than weekly figures are available, it surged from February to April and edged up further in May and June, reaching 5.6%. But this may primarily be a timing issue as Europe will probably follow the US's lead in this respect. The picture is a bit muddled looking at total lending across sectors and at large versus small banks though. Major US banks have seen total (net) loans rise vigorously in Q1, before falling back as quickly in Q2 (to a minor extent due to the higher provisions). They ended the quarter at even lower volumes than at year-end 2019. They are also almost flat yoy. For the entire industry, total outstanding loans in June were still up 8% yoy and 6% compared to end-2019. Retail loan growth collapsed from 4½% yoy at the beginning of the year to zero by June. In the euro area, it stayed broadly flat at around 3%.

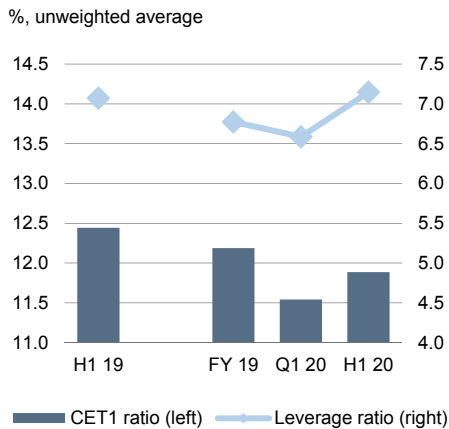
Aggregate balance sheet developments at the leading banks in the US resemble those in Europe. Total assets were 13% higher in Q2, both yoy and relative to the end of 2019. They even rose from the first quarter, despite the contraction in lending, as banks massively built up their liquidity reserves further.

- Leverage ratio developments on both sides of the Atlantic are currently not comparable. The European figures are cleaner and more sustainable: in the US, the Fed has temporarily (beginning in Q2, valid for a year) allowed banks to exclude US Treasury holdings as well as liquidity held at the Fed



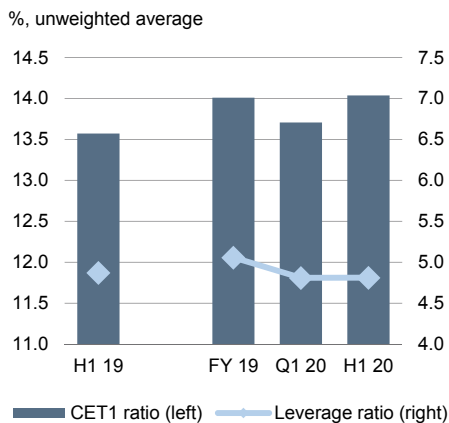
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Capital ratios of the top 7 US banks 6



Sources: Company reports, Deutsche Bank Research

Capital ratios of the major European banks 7



Sources: Company reports, Deutsche Bank Research

from the leverage exposure measure. This has had a big effect. Essentially the entire jump in major US banks' leverage ratio from an average of 6.6% in Q1 to 7.1% in Q2 is due to this regulatory relief. In the European Banking Union, policymakers have granted the ECB a similar authority with regard to liquidity held at the central bank, as part of the so-called CRR "quick fix". But so far, the ECB has not used it and the reporting framework stays unchanged at least for institutions under its direct supervision. Thus, the European leverage ratio will be more stable through the cycle.

Apart from these (past and future) quarterly movements, the level of the leverage ratio is also not comparable, as before. Particularly the netting of derivatives results in a much compressed leverage exposure figure in the US relative to the gross numbers used in Europe under IFRS. This leads to a structurally higher reported ratio in the US, in addition to differences in business models (more on-balance sheet claims in Europe, more securitisation and bond financing in the US).

- Similarly, the CET1 ratio of the top US banks has suffered more than in Europe. It is down to 11.9% on average and, despite a partial rebound in the recent quarter, remains significantly below both the level at the beginning of the year and 12 months ago. Of course, this is not least because the banks continue to pay dividends. A number of banks shifted from the standardised approach for measuring risk to the advanced approach in Q1 or Q2 which reduced the increase in the CET1 ratio. The leading US banks use the lower of the two ratios as the regulatory binding one. European institutions, in turn, have been running with higher risk-weighted capital ratios for a long time and now have extended their lead with the CET1 ratio not just higher yoy but also stable compared to end-2019. At least on the capital front, they look more resilient than their peers.

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Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN (Print) 1612-0272 / ISSN (Online): 1612-0280