Deutsche Bank
Research

Talking Point

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European bank performance in inflation times

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Rising interest rates due to rampant inflation will have a mixed impact on the banking industry. They are a boon for net interest income but also cool down loan demand (currently still buoyant) and may lead to higher loan losses. This will probably be reinforced by a mild recession in Europe caused by macroeconomic and geopolitical headwinds. As a result, net income may decline yet banks should remain solidly profitable. From a comfortable starting position, capital ratios could come under pressure if risk-weighted assets continue to rise which would dampen prospects for further significant shareholder returns through dividends and share buybacks. Liquidity levels have stayed strong so far.

Inflation, the dominant topic for the European (and global) economy right now, is also having a major impact on Europe's banking industry. It is running at its strongest pace in several decades, driven by a rebound from the pandemic, supply-chain disruptions and Russia's war against Ukraine. This has led central banks in many advanced economies to hike interest rates at a speed not seen for a long time, including the ECB. The repercussions for banks are profound, some are visible already, others will follow more gradually over the course of next year.

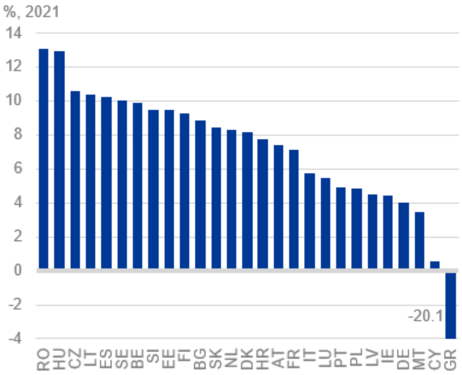
On one side, net interest income, the biggest revenue component, may receive a boost. Market interest rates have reacted more quickly than central banks' official policy rates. Hence, already in the first quarter, the 20 major European banks (a proxy for the entire industry) saw a 6% yoy increase in interest income. Lending rates in the euro area have risen further since then, particularly at the longer end and for larger loans. On the retail side, new housing loans with a fixed rate period of 5-10 years were most affected (rates climbed from 1.3% in December to 2% in May), even more than loans with a longer fixation period. Similarly, on the corporate side, where all loan categories with an interest rate fixed for more than 1 year – new business – witnessed an uptick in rates by 0.6-0.7 pp since December. With respect to loan size, rates edged up more for loans with a volume higher than EUR 1 m (from 1.1% to 1.3%) than for smaller amounts.
Finally, both the recent EMU bank lending survey (BLS) and the latest US bank results for the second quarter indicate a further rise in net interest income at European banks. The BLS showed a moderate tightening of credit standards and, particularly for riskier loans, a widening of interest margins in Q2, as well as similar expectations for Q3. The top US banks posted a jump in net interest income compared to the prior year. On a side note: euro-area banks may also benefit from a reversal of negative rates on their large

holdings of excess liquidity at the ECB, which may soon add to rather than subtract from interest income.

On the other hand, substantially higher interest rates may dampen economic activity of corporates and households – together with elevated price levels themselves and additional headwinds such as uncertainty about Europe's energy supply and remaining supply-chain bottlenecks. Europe as well as the US are likely to enter mild recession in the coming months. This may slow the demand for credit, and for corporate finance services. Reduced valuations on equity and bond markets will probably also be detrimental for asset management. On top of that, maybe most importantly, loan loss provisions are expected to climb, even though from low levels.

To what extent these risks materialise, will only become clear step by step. The starting point for Europe's banking sector is relatively encouraging. In the first quarter, total revenues were up 4% yoy, driven by the higher net interest income. Fees and commissions remained flat and trading income decreased slightly (-3%). Loan loss provisions on aggregate even fell by 11% but this was due to an outlier at a single institution last year which now dropped out of the statistics. Provisions were moderately higher at the majority of banks. Growth in operating expenses (i.e., cost inflation) accelerated to 7% yoy, outpacing the expansion in revenues. Still, a lot of that is beyond banks' reach – it is the consequence of booming bank levies and resolution fees whose burden keeps on getting heavier.

Banking sector ROE, post tax



Source: ECB

Bottom line, together with a normalisation of a one-off effect at a Spanish bank last year, this led to a 19% drop in net income – however, from an elevated level. 2021 had been the best year for the industry since the financial crisis. In addition, with a single exception, all banks stayed profitable in Q1. On an underlying basis, the cost-income ratio and the post-tax return on equity both remained almost unchanged (unweighted averages), at 61% and 8%, respectively.

While banks' liquidity position continued to be comfortable, with an essentially stable liquidity coverage ratio (LCR) of 165%, capital levels came somewhat under pressure. The CET1 ratio fell by 0.4 pp yoy to 13.9%, because of several factors:

i) Business growth, regulatory changes and rating migration, i.e. the impact of the Russia-Ukraine war all pushed up risk-weighted assets (+4%).

ii) Following two years of restraint regarding shareholder returns, banks continued with large dividend and share buyback programmes, confident in their ability to generate sufficient capital organically.

The leverage ratio stayed constant though, at 4.8%.

On the balance sheet, the higher interest rates have yet to feed through. So far, corporate loan growth in the EMU accelerated in the past few months to 5.1% yoy in May. Partly, this may be due to firms' increased liquidity holdings in light of rising input costs and macroeconomic uncertainty, partly it may be typical of the start of a new monetary tightening cycle as companies seek to lock in low rates. Similarly, household lending continued on its upward trajectory (+4.7%, the strongest figure in a decade). Mortgages were the main driver, although instalment loans have picked up too, recently. According to the BLS, banks expect private-sector demand for credit to decline in Q3, especially for mortgages (almost 50% of EMU banks forecast a reduction) and to a smaller degree from corporates. Nevertheless, this may still be the first time in the past 20 years or so in which the banking sector is not suffering on all fronts but is also benefiting from some upside regarding revenues thanks to rising rates, and where capital and liquidity levels are robust enough to make any major hiccups unlikely.