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Talking Point

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European banks in a sweet spot

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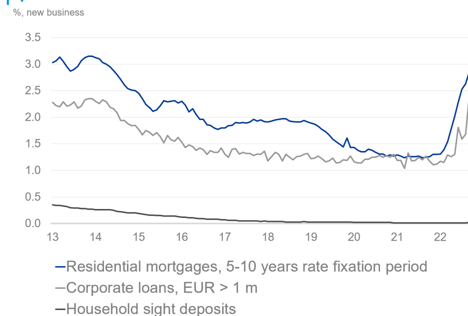
Lending & deposit rates with the private sector in the euro area



Source: ECB

The European banking sector is currently enjoying a sweet spot. Recent interest rate increases by central banks in most advanced economies combined with strong credit growth are having a pronounced positive impact on revenues, while loan loss provisions remain fairly low so far, although they have started to climb. Bottom line, growth in administrative expenses, individual banks' tax and litigation payments as well as Russia-related losses have reduced net income, but the industry is still on track for a decent full-year result. More importantly, fundamentally higher-for-longer interest rates may support banks' business prospects also in the medium term.

Since spring, interest rates in Europe (as in the US and other major economies) have surged at a pace not seen for decades. This has enabled banks to strengthen their net interest margin, as lending rates have risen faster than deposit rates. E.g., in the euro area, average rates for new corporate loans of more than EUR 1 m in size climbed from 1.1% at the beginning of the year to 2.4% in September, and average rates for new mortgages with a typical rate fixation period of 5-10 years more than doubled from 1.3% to 2.8% over the same period of time, whereas rates for sight deposits of households, the single largest funding category, so far have remained flat at zero (other deposit rates have edged up though).

All in all, this has fed into a substantial 11% jump in net interest income during Q1-Q3 at the leading European banks compared to the prior-year period. It was the main driver of the 6% yoy gain in total revenues, while fees and commissions were down 2% and trading income only improved 2%. Revenues benefited from a weak euro which boosted income from non-EMU countries measured in the single currency – the euro depreciated a hefty 16% yoy against the US dollar until September. At the same time, however, weak core investment banking activity (debt and equity underwriting and M&A advisory) and lower capital market valuations and therefore asset management earnings were a burden for fee and commission income.

On the other hand, inflation is making itself felt. Operating expenses were up 6% yoy, which includes increased regulatory costs from resolution fund and deposit guarantee fees. The average cost-income ratio stayed flat at 61%. Loan loss provisions grew 16% versus the first nine months of last year, but that level had been close to record lows. In addition, some banks suffered one-off hits from higher tax and litigation payments and Russia-related losses following the country's invasion of Ukraine. Post-tax profits thus declined a relatively moderate 16%, implying an average ROE of 7% (-2 pp yoy), which is quite a robust result given the strong 2021 benchmark, the economic

slowdown year-to-date and the looming recession. GDP is expected to shrink next year in the euro area, led by Germany, and in the UK, while the US, too, may experience a mild recession although it could avoid a contraction in 2023 as a whole.

This is going to have a profound impact on banks. Currently, the expansion in interest income is driven not just by wider margins but also due to larger volumes. Corporate loan growth in the EMU has accelerated to a staggering 8.2% yoy, the highest since January 2009, because of working capital needs in light of surging input costs – raw materials, energy – and demand for comfortable liquidity buffers in an uncertain and challenging environment – Ukraine war, energy crisis, coronavirus pandemic, supply chain issues etc. This could cool off as firms are able to pass on rising costs to their customers and shrink investment budgets to safeguard cashflows. Likewise, retail loan growth may slow down from 4.7% in September, as its main component, mortgages (+5.7%), suffers from the drastic increase in interest rates. Indeed, in the ECB's bank lending survey, a net 64% and 27% of reporting institutions forecast shrinking demand for residential mortgages and long-term corporate loans, respectively, in Q4 (qoq) (20% still see an increase for short-term corporate loans). In September, new mortgage business volumes were already 17% lower than 12 months before, the sharpest deterioration in 4½ years.

As a consequence, the so far dynamic evolution of the balance sheet may slow down next year. At Europe's 20 major banks, total assets were up 7% yoy in September, and risk-weighted assets up 6%, which was also supported by the weak euro. The total nominal capital base remained unchanged as banks are determined to return large chunks of their surplus capital to shareholders. This year, dividends and share buybacks (partly ongoing) could reach the highest level since the financial crisis although this includes delayed payouts which had been suspended during the pandemic and now prop up the underlying profit distribution. Hence, the average CET1 ratio declined 1.1 pp yoy to 13.5%, the leverage ratio 0.3 pp to 4.7% (on a look-through basis, i.e. leaving out the temporary exclusion of central bank exposures). Both figures are essentially back at where they were in 2019. Liquidity continues to be strong, with the LCR at 161% (-9 pp).

While loan growth should slow, next year may see further tailwind from ongoing rate hikes by central banks, at least for some more time. Currently, the ECB is expected to increase its main refinancing rate by another 1.5 pp from 2% today. The Fed may implement additional hikes worth 1 pp until spring, on top of today's range of 3.75-4%. On balance, higher-yielding assets should buttress banks' net interest income, even though funding costs will move up, too. An open question remains whether banks' higher loan loss provisions will turn out sufficient or not enough. During the pandemic, actual loan defaults came in lower than originally envisaged, allowing banks in 2021 to release part of their loss reserves built up in the previous year. A repeat next year cannot be ruled out, but this time, loan loss provisions are only about 50% of their 2020 level. It is therefore also conceivable that additional reserve build will be necessary and no major release is possible. In any case, with economic forecasts very much in flux recently, a recession likely but its depth in doubt, banks will be navigating murky waters during the next couple of months.

More important for the longer term, however, is the normalisation of monetary policy. The end of the historical outlier of negative nominal interest rates is a turning point and decisively putting European banks' most important revenue source – net interest income – back on its feet. It brings to a close a "state of emergency" that had lasted for several years, at least in the euro area and Switzerland, though not in the US or the UK. From the financial crisis until last year, net interest income in the EMU had fallen by 13%. Now, it is on course to reverse that picture, and not just temporarily, as interest rates may well stay higher for longer.

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