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Talking Point

Still on a diet

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European banks continue to retreat

Author
Jan Schildbach
+49(69)910-31717
jan.schildbach@db.com

www.dbresearch.com

Deutsche Bank Research Management
Stefan Schneider

Shrinkage – and no end in sight: in the first quarter of the year, the European banks once more saw revenues and costs alike decline compared to 12 months ago (-2% each). Non-interest income was particularly weak. As a result, profitability dipped, with loan loss provisions also rising, albeit from very low levels. Banks tried to make up for the revenue loss by taking more risk and expanding their balance sheets. Total assets and risk-weighted assets both increased by 4%. Consequently, the average CET1 capital ratio fell 0.4 pp yet remained in comfortable territory.

The major banks in Europe had a frugal start into the year. Compared to a solid result 12 months ago, revenues and profits declined. Total income was down 2%, but with quite some heterogeneity underneath: trading income slumped 12% (due to lower volatility and less client activity in capital markets), and fees and commissions had a poor showing (-6%), whereas net interest income recovered slightly (+1%). Hence, the long-standing pressure on revenues continued unabated, despite banks' efforts to reverse the trend. To some extent, these efforts are reflected in higher total assets and higher risk-weighted assets (RWA), both up 4% yoy, partly due to lending growth. Outstanding loans to the private sector by all banks in the euro area were 2.3% higher than a year ago. However, exchange rate movements also contributed favourably. At the end of March, the euro was 9% weaker compared to the US dollar than in March 2018. Revenues and assets in dollar or dollar-linked currency areas therefore rose when measured in euro.

Similar to total income, administrative expenses also shrank 2% yoy at the 20 largest European banks. Loan loss provisions might have bottomed out though. Following a prolonged decline since the European debt crisis that brought them down to their lowest level since 2005, they have now climbed a moderate 7%. Overall, this led to a 9% reduction in net income. Average post-tax return on equity fell 2 pp to 7% and the cost-income ratio edged up 1 pp to 64% (both measures excluding one-off effects). The biggest challenge for many banks therefore remains fighting hard to contain structural (nominal) cost inflation, while there is no relief on the revenue front.

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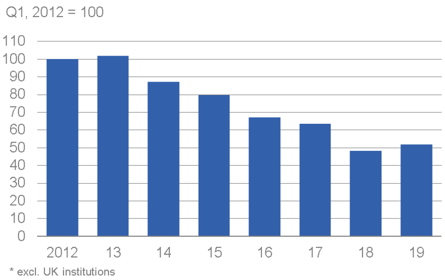
Loan loss provisions at the large European banks*



Sources: Company reports, Deutsche Bank Research

With capital ratios moving south in recent quarters, they have started to attract more attention again. Some of the decrease has been caused by higher returns to shareholders, be it through dividends or share buybacks, with another part attributable to greater risk-taking. Total equity at the end of Q1 was up 4% yoy, in line with total assets and RWA. Hence, there was finally some good news after roughly 3 years with weak absolute capital accumulation. Still, the fully loaded CET1 ratio contracted 0.4 pp to 13.3% on average; the fully loaded leverage ratio remained stable at 4.8%. In both respects, the vast majority of banks command a substantial buffer over requirements, but the potential to go down further without triggering unease among supervisory authorities and rating agencies is limited. By contrast, liquidity positions are very solid, with an average LCR of 153% (+5 pp yoy).

Over the course of the year, banks may set their hopes on i) a recovery in customer activity in capital markets, ii) a turnaround in interest income (either through volume growth or through tailwind from their US operations, which are benefiting from a higher rate level) and iii) further cost cuts. However, given that last year, European banks were at their most profitable since the financial crisis, further improvements and a catch-up with international peers will probably only be possible if margins recover somewhat and if banks manage to win back market share in areas where they have lost ground in the past few years. This is true, for example, in corporate funding (where financing has somewhat shifted towards the bond market, insurance companies or private equity funds), in payments (where the BigTechs have made substantial inroads) or in retail banking (where FinTechs and other newcomers are trying to chip away at established banks' customer base). Of course, higher interest rates would help, too, but expectations in this respect have been pushed into the distant future.