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Talking Point

European bank profits rise to post-crisis peak despite lower revenues in 2018 - capital ratios down for the first time

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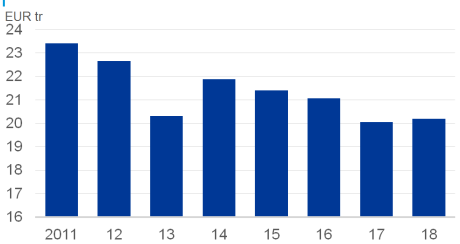
Author
Jan Schildbach
+49(69)910-31717
jan.schildbach@db.com

www.dbresearch.com

Deutsche Bank Research Management
Stefan Schneider

Total assets of the top 20 European banks



Sources: Company reports, Deutsche Bank Research

In 2018, net income at the major European banks climbed to its highest level since the financial crisis. Lower administrative expenses and a further fall in loan loss provisions to multi-year lows more than made up for a decline in revenues. Whereas net interest income stabilised, fee and commission income as well as trading income declined. Banks took a bit more risk, and risk-weighted assets edged up. Total capital remained flat despite higher profits as banks increased returns to shareholders and implemented the new IFRS 9 accounting standard. Consequently, capital ratios declined for the first time since 2008. The gap between European banks and their US peers remained huge as the latter benefited from higher interest rates and lower corporate taxes.

European banks pulled off a remarkable feat in 2018 – their best annual result since the financial crisis. It was all the more remarkable as revenues declined compared to the previous year. For the 20 largest institutions, net interest income was flat yoy but fees and commissions fell by 3% and trading income by 18%, leading to a contraction of 1½% in total income. However, the bottom line benefited from two major factors: the (still) conducive macroeconomic environment, with GDP growth in the EU a solid 1.9% (in real terms, in contrast to banks' P&L). This brought down loan loss provisions even further (-21%) to the lowest level since 2005. It also supported an uptick in lending. Outstanding loans to the corporate sector in the euro area were up 1.8% yoy in December, the first meaningful expansion for a decade. Loans to private households rose by 2.6%.

Banks also did some homework on costs, which shrank slightly more than revenues, by 2%. Negative effects such as litigation or one-offs like the US corporate tax reform proved to be less of a burden in 2018 than in the year before. All in all, net income jumped 25%, hitting EUR 88 bn and surpassing 2010 as the best year in absolute terms since 2007. Of course, relative returns remain a far cry from pre-crisis levels, but an average ROE of 8% (excl. one-offs) on a much larger capital base is a significant improvement after many years of disappointment for banks' shareholders. The adjusted cost-income ratio was down slightly yoy to 63%.

With profitability finally back within an acceptable range, returning the business to growth has become the biggest challenge for the European banking sector. In fact, banks and the economy they serve have decoupled to some extent. Compared to 2010, banks' nominal revenues are down 12%, while the

European economy has expanded by 24% (likewise in nominal terms). There are some minor indications that the industry might indeed change gear somewhat. Total assets in December 2018 were 1% higher than 12 months before, following annual declines in 2015-17. Risk-weighted assets were up 2%, possibly signalling banks' greater willingness to invest in future earnings.

The biggest question mark is now hanging over the trajectory of capital going forward. In general, capital ratios are at a sustainable level in light of Basel III/IV requirements, some individual adjustment needs (especially with regard to the leverage ratio) notwithstanding. However, banks have started returning more capital to shareholders through dividends and share buybacks after years of drought. This has kept total equity flat yoy, despite the rise in profitability, together with the accounting effect of the first-time application of IFRS 9 at the beginning of 2018, which led to a one-off increase in loan loss provisions. This was recognised in equity capital (though not through the P&L). Accordingly, the fully-loaded CET1 ratio fell by 0.6 pp to 13.6% on average, the first reduction since the financial crisis. Similarly, the fully-loaded leverage ratio decreased 0.1 pp to 4.9%. It may turn out to be a tricky balancing act for banks to grow the business (i.e. take more risk) and keep satisfying shareholders and supervisors at the same time, at least without a substantial further boost to profitability and organic capital generation.

Where could this come from? Expectations for interest rate hikes by the ECB have been delayed due to the economic slowdown. Additional cuts to administrative expenses will probably become harder to implement, particularly given that competitive pressure from tech firms is likely to heat up and banks are investing heavily to maintain (or achieve) a level playing field. Continued loan growth should provide some momentum, although it will certainly not go through the roof in light of the weaker economy. Another option for banks would be to put to work some of the enormous liquidity they have piled up in recent years. The average Liquidity Coverage Ratio climbed 6 pp yoy to 150%, which gives banks some leeway as this is probably beyond a reasonable level in the medium term. Considering the costly nature of such liquidity holdings (at 40 bp, the ECB deposit rate remains deeply in negative territory), using some of the funds for higher-yielding, longer-term assets might support the revenue base.

Did the huge gap between banks on either side of the Atlantic finally shrink a bit last year following the stronger performance of the Europeans? No. While in 2010, measured by revenues, the major European banks were of the same size as the entire US banking sector, the latter is now about 50% larger. The former generated EUR 445 bn in revenues in 2018, had expenses of EUR 263 bn and equity capital of EUR 1,199 bn. For US banks as a whole, these numbers stood at EUR 684 bn, EUR 389 bn and EUR 1,766 bn. What's more, they were able to increase revenues by 7% yoy, and post-tax profit by 29% (already taking into account the negative one-off impact from the tax reform in 2017), to EUR 201 bn. Both absolute figures represent by far the best result ever, whereas the European banks still struggle just to get in sight of their pre-crisis records.