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Talking Point

Initial US bank performance in the corona crisis

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The economic slump is taking its toll on the banking industry. For the major US banks, profits in Q1 more than halved compared to the prior year, as loan loss reserves jumped. Revenues declined moderately with weakness in interest income and fees and commissions partly compensated for by a jump in trading income. Deposits, loans and other assets surged because clients hoarded liquidity. Banks' capital ratios fell only somewhat and they remain well capitalised. Banks in Europe may have faced similar trends overall but will probably have benefited less from the supportive trading environment and suffered more from declining capital ratios. They are also handicapped by their much lower starting level in terms of profitability.

US banks' results for the first quarter 2020 offer a first glimpse of the heavy impact of the corona-induced recession on the banking sector. On balance, the seven largest institutions reported a drop in net income of 58% year-over-year, to USD 14 bn. At least, all banks remained profitable. The slump was almost entirely due to a surge in credit loss provisions which rose to USD 26 bn, i.e. 4½ times the level a year ago. Revenues suffered also, falling 3% to USD 114 bn but this masks diverging trends: on the one hand, a recent deterioration in many business segments, from a slowdown in M&A advisory to lower asset management fees and pressure on net interest income. The latter had already been visible for some time since the Fed started cutting rates in summer 2019, but in Q1 it slashed them to zero. Some banks also took write-downs on securities and short-term bridge loans. On the other hand, debt and equity underwriting performed well and trading activity during the market crash in March was exceptional, which strongly lifted banks' trading income.

Likewise, on the balance sheet, there were some extraordinary movements. Over the last three months alone, i.e. not annualised, total assets jumped by 10% to USD 12.5 tr on aggregate, driven by surging trading assets, higher interbank deposits and a substantial increase in loans (up 5 ½%) as – mainly corporate – customers drew down credit lines. At the same time, there was an enormous inflow of funds into the banking system, with deposits rising 11% as customers became more risk averse and cut back spending and investments, but also liquidated risky assets such as stocks.

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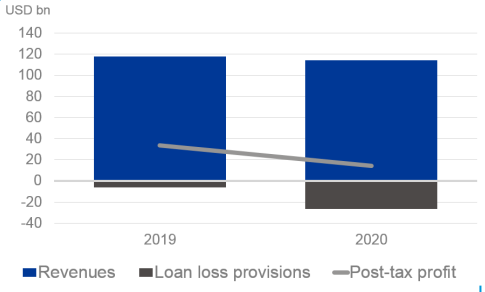
Q1 results of the 7 largest US banks



Sources: Company reports, Deutsche Bank Research

In times of crisis, capital and liquidity are particularly in focus. At the top US banks, since year-end 2019, the fully loaded CET1 ratio declined 0.6 pp to 11.5% (unweighted average). Though the level is not outstanding, the only moderate contraction in such a quarter is a sign of strength. Usually, the banks follow the capital ratio under the standardised approach of Basel III which tends to be lower than under the advanced approach, as the lower of the two ratios is the binding one according to US regulation. In the recent quarter, however, at some institutions, the advanced approach capital ratio dropped below the standardised approach ratio. Similarly to CET1, the leverage ratio dipped 0.2 pp compared to December, to 6.6%, which is still a very robust figure. In addition, from Q2 on, banks will benefit from relaxed rules that temporarily exclude US Treasuries and deposits at the Fed from the leverage ratio denominator. Liquidity-wise, although disclosure remains somewhat patchy, the large banks seem to operate with sizeable buffers and the LCR in some instances even increased during the quarter.

What do the results imply going forward?

- First, in terms of the P&L, in the next few quarters, the negative repercussions of the recession may be felt more strongly by the banks, while some of the mitigating factors are likely to disappear.

1. The shutdown of the US economy took place only in the second half of March, hence most business lines were hardly affected for most of the first quarter. This will be much different in Q2 and presumably also afterwards.
2. The macroeconomic forecasts e.g. underlying the loan loss provisions have deteriorated since 31st of March and provisions could therefore rise even further, not least in those segments where lending had been growing particularly quickly in the last couple of years: small businesses, credit cards, car and student loans.
3. As volatility and trading volumes in capital markets are partly coming down, trading income will return towards more “normal” levels and the tailwind for banks will lose steam.
4. The Fed’s March emergency rate cuts will probably, with some lag, leave a bigger imprint on banks’ net interest margin and thus interest income than has been visible so far.

- Second, in terms of the balance sheet, the recent asset growth may slowly reverse, as typically happens during a recession. Trading assets should fall as markets calm down to some extent and companies that initially stacked up their liquidity buffers turn cautious about large spending and investment projects in times of weaker operating cash flows. Banks also need to watch rating migration and the impact increased lending will have on their risk-weighted assets and capital ratios. In line with that, deposit growth may slow considerably as households feel the negative effect of reduced income due to rapidly expanding unemployment.

- Third, with profitability diminished, the macroeconomic outlook even darker than at the end of March and risk-weighted assets on the rise, capital ratios are highly likely to dive further. Nevertheless, even if they

temporarily slipped into single digits, the large US banks look well capitalised and able to rely on their enormous underlying profitability to replenish capital buffers relatively smoothly, all the more since they stopped their large-scale share buybacks a month ago.

Finally, what do the US results signal for banks in Europe? While many of the same effects will play out here as well, there are a number of important differences:

- European banks may have benefited less from the recent trading bonanza in capital markets. Among the top seven US banks are five of the largest – arguably the five largest – investment banks in the world. Their market share has also grown at the expense of their European competitors since the financial crisis. The latter ones overall rely less on investment banking and more on traditional commercial banking which looks set to be hit more due to the nature of the crisis with its focus on the real economy.

- Most major banks in Europe use internal risk models and calculate capital ratios under the Basel III advanced approach. This approach as well as a different business model (e.g., more low-risk mortgages on-balance sheet) result in a lower risk intensity than at US banks – in Europe, risk-weighted assets are typically far lower relative to total assets than in the US. This might indicate a higher vulnerability to an increase in risk during a major recession. In fact, for almost all the US banks that published both the standardised and the advanced approach, the Q1 capital impact was substantially bigger under the advanced approach. Hence, for the major European banks, a larger reduction in the CET1 ratio than in the US has to be expected.

- Whereas the overall length of the crisis will probably not differ a lot across countries, timing still matters: in many countries in Europe, the lockdown took place a few weeks earlier than in the US. Thus, the economic consequences may have been felt more strongly in Q1 already (and potentially a bit less in Q2 or Q3, depending on when the measures can be lifted again). European banks' earnings could show even greater scars than their US peers have just reported.

All these effects point towards (at least initially) weaker bank performance in Europe. Importantly, however, this comes on top of the decade-long divergence in banks' fortunes on both sides of the Atlantic. US banks had become much more profitable than their peers in the Old World. The current crisis may therefore pose a significantly greater threat to European than to US banks.

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