Deutsche Bank
Research

Talking Point

European bank performance in review

Hitting the bottom, finally?

March 25, 2021

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

www.dbresearch.com

Deutsche Bank Research Management
Stefan Schneider

2020 was an extraordinary year for banks, as for most other industries. In Europe, banks barely made money, as revenues fell substantially and loan loss provisions doubled. Expense cuts cushioned the blow only partly. Capital and liquidity ratios reached record highs though, thanks to disciplined risk management and funding support from central banks. Once again, European banks underperformed their US peers. But how do their results compare in the longer term, ten years after the end of the financial crisis, and also vis-à-vis smaller competitors?

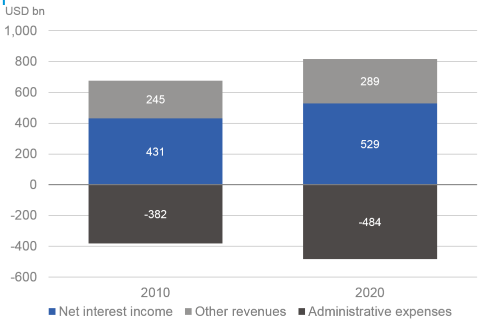
The coronavirus pandemic has turned the banking sector upside down, too, with loan demand by customers, issuance and trading activity in capital markets and banks' liquidity buffers all skyrocketing, governments providing broad credit guarantees, digital payments gaining much ground at the expense of cash, interest rates slumping to new lows and expected loan losses surging. The unprecedented difficulties of remote working did not make these challenges any easier.

Performance-wise, 2020 was also an extraordinary year. In Europe, the largest banks suffered a heavy drop in revenues of 5% yoy. The main driver was a 6% contraction in net interest income, due to lower rates in many markets (including the US), continuing margin pressure, a stronger euro and lower dividend income, a subcomponent. Fee and commission income dipped 1%, while trading income picked up 4%. Banks reduced administrative expenses further, by 5% (the fifth consecutive annual decline), but this was not enough to make up for the parallel drop in revenues. The average unweighted cost-income ratio – excluding one-off effects – therefore rose 1 pp to 64%. Even more importantly, loan loss provisions doubled as banks expected higher insolvencies due to the severe recession, especially in the corporate sector. Remarkably, so far actual credit losses have been limited and non-performing loans have hardly risen, not least because of unprecedented support by governments, including fiscal transfers and a waiver for mandatory insolvency notifications in several countries. All in all, post-tax profits slumped 62%, as a number of institutions made a net loss, sometimes also driven by goodwill writedowns and other one-off hits. Total net income was the lowest since 2013, during the European sovereign debt crisis.

However, the overall results mask significant changes over the course of these 12 months. For instance, the net interest income pain got gradually worse quarter by quarter, while trading income also lost some momentum towards the end of the year. Banks' cost cuts deepened in line. By contrast, loan loss provisions had more than tripled in H1 but slowed down a lot in H2, allowing for at least a meagre net income after it had essentially been wiped out in the first half. This bodes relatively well for 2021. Provisions will probably be materially lower and profitability may recover much of the recent setback. And once the pandemic is fully over, with huge stimulus packages continuing to boost the economy, inflation might pick up and interest rates might finally rise again, to the benefit of banks' revenues.

But back to the tough past year. Banks maintained their prudent risk management and were able to lower risk-weighted assets (RWA) by 2% despite a 7% jump in total assets – quite an achievement. On the other hand, total equity fell 2% even though banks, at the request of supervisors, retained dividends for 2019 which had already been set aside. The latter helped pushing up capital levels considerably, with the CET1 ratio climbing 0.6 pp to 14.6% on average, the highest figure on record (goodwill writedowns impact total but not core capital). The leverage ratio remained flat at 5%, whereas the LCR rose once more, by 10 pp to 157%. This is also a record high, as banks in a cautionary move beefed up their liquidity buffers (particularly at central banks) to be prepared for higher client demand or another crash in financial markets in a fast changing pandemic and recessionary environment.

Revenues & costs at all US banks



Sources: FDIC, Deutsche Bank Research

US banks in better shape

How does the situation look like on the other side of the pond? US banks on aggregate have weathered the coronavirus shock better than their European competitors, as they did in previous crises. Their revenues have been more stable (down less than 1% yoy) and their profits have declined less (-37%, to the lowest level since 2012). They were more resilient despite a bigger surge in loan loss provisions (about +140%, to the highest level since 2010) even though the US economy has been hit less hard by the crisis (2020 GDP -3.5% vs -6.8% in the EMU). The US economy is expected to surge this year, thanks to rapid vaccinations and a massive fiscal stimulus, providing even more tailwind. The higher stock of provisions and the better macroeconomic outlook should allow US banks to leave the crisis behind much faster than their European competitors.

Fundamental transatlantic divergence

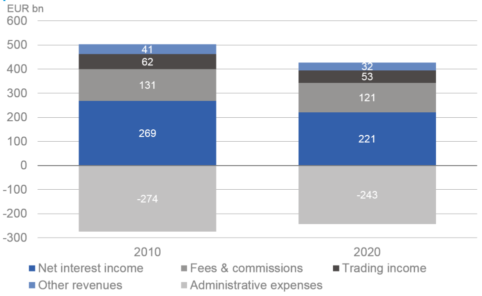
This comes on top of a trend of diverging fortunes since the financial crisis which has seen banks in the US getting ever more ahead of their peers in Europe. There are many reasons for that:

- Regulation: it is currently skewed towards the US bank business model e.g. due to the implementation of a binding leverage ratio in Europe and the upcoming new output floor under final Basel III/Basel IV rules which will trigger a substantial increase in RWA in Europe but not in the US.

- Monetary policy: interest rates in Europe have been lower for longer, negative, and the yield curve much flatter, creating a major drag on banks' biggest revenue source, net interest income. In addition, quantitative easing (QE) and the associated rise in bond and equity markets had a greater – more positive – impact in the US with its larger capital market.
- Market fragmentation: despite the EU's single market and the Banking Union, there is still a myriad of rules which differ in detail and implementation, and of national authorities which European banks have to deal with. This hampers cross-border business in Europe in contrast to the true single banking and capital market in the US. This problem has become even more pressing after Brexit.
- Margins and fees: they tend to be higher in the US than in Europe, including the crucial net interest margin. But the same is true for many services where retail and corporate customers are used to paying less in Europe (thanks to often stronger competition among banks), from cards and payment transactions to M&A advisory and stock issuance. Due to stronger underlying profitability, US banks have been less under pressure to restructure and shrink, and have found it easier to invest in people or new technology.
- Taxation: banks, like other corporations in the US, received a significant profitability boost from the 2017 tax cuts under then-President Trump. While some European countries have adopted similar reforms, many others have not.
- Economic growth outperformance: cumulative GDP growth over the last decade was 17% in the US versus only 2.9% in the EMU.
- Investment banking: European banks have lost much ground against their US peers in core investment banking, i.e. Origination & Advisory, which is a scale industry where top-tier players pocket the lion's share of profits and second-rank institutions struggle. While the top 5 US banks held their combined global market share steady since 2012 at 30%, that of the top 7 European banks fell by more than a third to only 14% any more. Total fees earned rose by roughly 70% during that time at the US institutions, but only by about 10% at the Europeans.

European bank performance in review

Revenues & costs at Europe's major banks



Sources: Company reports, Deutsche Bank Research

European bank performance: A decade in review

How do European banks' results compare to their own performance a decade ago, in 2010, after the end of the financial crisis? The dominant feature has been shrinkage. Total revenues are down a staggering 15% over this period, driven to a large degree by an 18% fall in net interest income. Importantly, these are nominal figures which would look even more alarming after adjusting for inflation. Other sources of income did not perform much better – trading income was 16% lower, other income 22% and only fees and commissions were relatively resilient (-7%). Overall, revenues in 2020 were at their lowest level since 2008, at the peak of the financial crisis. True, banks managed to reduce operating expenses significantly, too (-11%), thus partly cushioning the drop in earnings. The P&L contraction was in line with a massive de-risking of banks' balance sheets, as RWA declined by 14%. Total assets were slightly up (+1%), but solely thanks to the boost in liquidity reserves during the pandemic. The only real growth area since 2010 has been equity capital (+15%) as banks bolstered their buffers for hard times and regulators raised core capital requirements several-fold to make the system much more stable. Admittedly, the build-up of capital has slowed down a lot in recent years as banks have refocused on increasing returns to shareholders, mainly through dividends.

Structural differences between large & small banks

Finally, it is worth checking for structural differences between this sample of large banks and the total industry, which also includes thousands of small and mid-sized institutions. We use EU (incl. UK) banking sector data as a proxy which for P&L items and RWA are available only until 2019 (until 2020 for balance sheet figures), whereas our sample also covers Swiss banks and has data until 2020. Unsurprisingly, the overall trends are the same, but some differences are striking:

1. Net interest income over the past decade (until 2019, precisely) was down only 7% for the entire sector, i.e. far less than at the large banks. Similarly, total revenues fell by only 2%, again a much better result, not least thanks to a 6% increase in fees and commissions.
2. Major banks have been more successful though (or more under pressure) in delivering cost reductions, while expenses for the industry as a whole are in fact higher than after the financial crisis (+4%).
3. As a consequence, the big gap in terms of revenues is shrinking somewhat when looking at the operating margin, i.e. pre-provision profit. In both cases, it is much lower (20% for the major banks and 11% for the entire industry), but the difference is not overwhelming.
4. Sector-wide asset developments over the past decade look more benign (total assets +10%, RWA -8%) than at the leading institutions.
5. However, there was quite a similar increase in the total capital base which is up 17% since end-2010 at all banks combined.

Bottom line, large banks have lost market share versus their smaller European competitors over the past 10 years. The reasons may be manifold. Certainly the need to restructure and adapt to a new business environment was greater for the major institutions. Most of them are universal banks with a broad, diversified business model. So far, structural and regulatory change has been more pronounced in many of their business segments than in plain-vanilla private-sector lending and deposit-taking which is the mainstay of most smaller banks. The comprehensive prudential reforms adopted post-financial crisis with their massive tightening of capital and liquidity standards including top-ups for systemically important institutions, stricter compliance and conduct requirements, the strengthened role of risk management and more micro management by supervisors – all of this had a stronger impact on large, complex universal banks in Europe than on their smaller domestic peers. In addition, there has been the growing scale disadvantage in international investment banking, and in asset management which is consolidating ever more. In both areas, second- or third-tier institutions still have to run comparatively large (and costly) platforms while earning much less, in contrast to the period before 2007.

On the other hand, the benefits of digitisation are certainly bigger for larger European banks than for their smaller rivals. Investment needs are substantial, but so are economies of scale. Also, because they have faced headwinds for quite some time from international competition and from tech companies entering ever more parts of the value chain, large European institutions may have an early-mover advantage relative to some smaller, less diversified domestic peers. Therefore, it could turn out that the next decade will see a revival of larger banks.

See also: European banks: Shaking off the shackles of the past year, looking ahead to a better 2021