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European banks

On robust footing in turbulent times

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Like the real economy, the European banking sector is facing headwinds due to Russia's war in Ukraine. Nevertheless, balance sheets and profitability are strong; indeed, 2021 was banks' most successful year since the financial crisis and capital ratios are at record highs. And while loan loss provisions may now rise from unusually low levels, net interest income should also benefit considerably from higher interest rates as central banks combat surging inflation. However, both geopolitical and macroeconomic policy uncertainty remain remarkably high.

The European banking industry has just rebounded from the coronavirus pandemic – in fact recording its best set of results since the financial crisis – but it already faces significant uncertainty again due to Russia's war against Ukraine. In this sense, its position is no different than that of the real economy which had not even fully recovered from the external shock of the pandemic and is now confronted with the next one whose impact and duration is hard to foresee at the outset. For firms and households, the repercussions are mainly felt via surging prices for energy, commodities and food as well as through further disruptions of already stretched supply chains. This will reduce growth. And of course, many firms active in Russia have shut down or at least suspended their operations in the country.

This is similar for European banks. They also feel the consequences in other areas: unprecedented sanctions have been imposed by Western countries on transactions with Russian firms and individuals. Financial markets are down from their highs (this is also due to the expectation of accelerated monetary tightening though) and volatility has risen. Following a likely initial spike in corporate lending because of increased liquidity holdings and higher input costs, lower economic growth and higher interest rates may also dampen banks' lending business with companies and households. Most importantly, more private-sector customers will probably get into trouble and face difficulties repaying their debt, hence loan loss provisions are expected to climb.

Overall, banks' operating environment has clouded substantially over the past two months, even though the impact of war may be less severe than that of the pandemic. However, a lot depends on the future path of the conflict. A further military escalation or a long, drawn-out repeat of the Cold War between the West and Russia (potentially even involving other parties such as China) could exacerbate the costs also for Europe's banks.

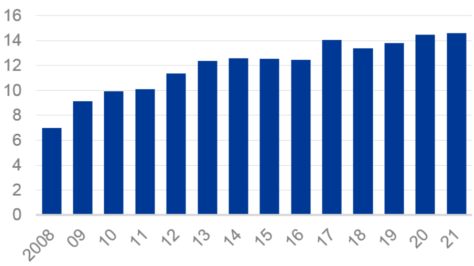
Right now, they stand in impressively good shape. True, with Q1 reporting season just started, the figures for 2021 are only a look in the rearview mirror, yet they still show fundamental improvements and a re-won strength of the European banking sector that allows it to face this next challenge with some confidence. Net income in 2021 almost quadrupled from the depressed prior-year level, surging to the best result since the financial crisis, surpassing 2018 as the previous peak. This was primarily due to reduced provisions: loan loss provisions were the lowest since at least 2005 when this time series started, driven by net releases at a number of banks.

Higher revenues also contributed to the rebound in profitability: total revenues increased by 5%, thanks to booming fee and commission income (+12%) and a stabilisation in net interest income which, after a weak start to the year, made up for that in H2. Likewise, trading income was essentially flat yoy. Administrative expenses rose for the first time since 2015, by 3%, but less than revenues.

The yoy swings in the P&L were unusually large and in some ways the consequence of banks' cautiousness in the first year of the pandemic which led to some "overshooting" in the second as the macroeconomic picture improved substantially and banks were able to partly reverse course. Thus, bottom line, post-tax earnings jumped by a staggering EUR 72 bn yoy, particularly driven by lower loss provisions (EUR -50 bn) and higher revenues (EUR +20 bn). Industry profits are still about a quarter lower than at the pre-financial crisis peak in 2006 though, in nominal terms, which shows the major changes and challenges the banking system has been going through over one-and-a-half decades.

CET1 (Core Tier 1) capital ratio of Europe's 20 major banks

%, unweighted average



Basel II until 2010; Basel 2.5: 2011-13; Basel III (transitional rules): 2014; Basel III (fully loaded) since 2015. Excl. ABN Amro for lack of data

Sources: Company reports, Deutsche Bank Research

Remarkably, the strength in profitability has not resulted in higher capital ratios. Both the average CET1 ratio and the leverage ratio (fully loaded) remained unchanged yoy, at 14.7% and 5.0%, respectively. The reason is simple: after many years of weak returns for shareholders (and therefore depressed share prices), banks have rushed to compensate their owners since the end of restrictions imposed by supervisors. They are spending impressively on regular and special dividends as well as share buybacks. Banks can afford to do so: capital ratios essentially stay on record highs, as does the LCR which edged up slightly (1 pp) to 158% following the surge in 2020. As a result, share prices have risen substantially. The Stoxx 600 Banks, which covers all of Europe, has climbed 70% since the depth of the pandemic in autumn 2020, the recent setback due to the onset of the war in Ukraine notwithstanding.

Balance sheet-wise, in line with the overall recovery of banks and the real economy, total assets expanded by 4% yoy, total equity by 6% and risk-weighted assets by 3%. The cost-income ratio continues to meander around the 63% mark (on an unweighted-average basis) where it has broadly remained over several years now. The post-tax return on equity, where reported, rebounded to 8% and thus its 2018 level. However, profitability is still markedly lower than in the US where the banking system as a whole achieved an ROE of more than 12% in 2021.

Under normal circumstances, the prospects for this year would have been quite benign, potentially even allowing banks to set their sights on reaching pre-financial crisis revenues and profits again. Triggered by surging inflation, market interest rates have jumped both in the US and Europe. And while the

Fed and the Bank of England have begun raising their main policy rates, the ECB may follow in a couple of months and hike rates by a considerable 2.5 pp this and next year combined. This will provide the banking industry with significant tailwind going forward.

On the other hand, the "honeymoon" in provisions is almost certainly over, for the time being. A normalisation was likely anyway in 2022, given the one-off character of reserve releases. Now, the war puts additional upward pressure on provisions. And shrinking loan demand (following a likely short-term boost) because of lower-than-expected private consumption and corporate investment could end the upswing in lending registered since the beginning of the pandemic. Up until the end of February, loan growth with firms (+3.5% yoy) and households (+4.4%, driven by mortgages) in the euro area had gained strength and been fairly robust. But bank interest rates had not moved like market rates to a higher level, hence the dampening effect is yet to come. And there is a risk that further down the road, in 2023, higher interest rates (as well as a US recession) could substantially slow economic growth, thereby amplifying the effects of weaker loan demand and higher provisions. At least, Europe's banking system is entering this period of uncertainty and headwinds with balance sheet and P&L strength, and even in the hope of partial mitigation, in contrast to some of the previous crises.