Talking Point

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European banks

Solid fundamentals

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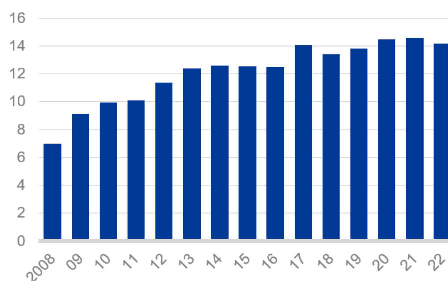
CET1 (Core Tier 1) capital ratio of Europe's 20 major banks

%, 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

Recent wobbles in US and European banking markets have been triggered by idiosyncratic issues at some institutions and broader uncertainty about the impact of central banks' monetary tightening. However, capital and liquidity levels of the banking industry in Europe continue to be very robust. In addition, asset quality and profitability are the strongest since the financial crisis 15 years ago. Nevertheless, the market tensions are likely to result in banks tightening lending conditions for the private sector further and they could fuel discussions about the effectiveness and potential adjustments of some regulations.

In recent weeks, there have been concerns in financial markets about European banks (and their US peers), triggered by a few failures of mid-size US regional banks and the emergency sale of the second-largest Swiss bank. However, such tensions are not unique – by contrast, they have popped up quite frequently since the financial crisis of 2007-09. For instance, during the European sovereign debt crisis of 2010-15, at first the soundness of Greek and Irish banks, and later Italian and Spanish banks was called into question by some market participants. Later, when the coronavirus pandemic hit in 2020, the banking industry across Europe as a whole came into focus as uncertainty surged with regard to the fallout from lockdowns and distressed corporate supply chains on credit quality. This time, in the case of the few US bank failures and the Swiss bank, weaknesses in individual business models proved decisive. The impact of central banks' massive and rapid monetary tightening is causing broader, industry-wide concern though. This is the strongest rate hiking cycle in decades and starts from unprecedentedly low (and in the euro area even negative) levels. Hence, the repercussions may have come as a negative surprise for some market participants, and it is the nature of modern financial markets that anxiety can spread instantly. Also, rebuilding confidence and trust takes time, given the experience of the past 15 years.

Yet paradoxically, the European banking sector's fundamentals are the most solid since the financial crisis. i) The industry has been running on high capital and liquidity ratios for years; ii) asset quality has gradually improved, with NPL ratios falling to new lows since 2008 even in previously troubled markets in Southern Europe; and iii) profitability has reached post-financial-crisis records. In 2022, European banks probably returned more capital to their shareholders than any time in the past 15 years.

Not to forget the massive improvements in risk management (incl. stress testing), the quality of supervision (incl. data gathering and market transparency), and its institutional setup, with the Single Supervisory Mechanism providing for a common and stringent supervision of all the larger banks in the euro area.

Finally, despite the recent fuss, banks are net beneficiaries of the tighter monetary policy, at least in the EMU. Net interest income, their most important revenue component, had been under structural pressure for more than a decade. Now, with interest rates rebounding forcefully in 2022, interest income also surged, by a staggering 18% yoy at Europe's largest banks. This more than compensated a sluggish fee and commission income (-4%) and outperformed trading income (+5%). Total revenues jumped by 8%, outweighing the 6% increase in operating expenses (not least due to inflation and the significantly weaker euro, which depreciated 11% versus the dollar in the year as a whole). Thus, the average cost-income ratio decreased to 61% (-2 pp). Given the macroeconomic headwinds and uncertainty because of the war in Ukraine and the energy crisis, loan loss provisions rose substantially (+66%), although from a record-low level. Russia-related losses also had a dampening effect on profitability. Net-net, the ups and downs cancelled each other out, the net income was unchanged from the prior year. At EUR 106 bn, this was again the best result since the financial crisis, at least in nominal terms. Had it not been for the meaningful release of loan loss reserves at some banks in 2021, which had been set aside at the onset of the pandemic, net income would have reached a new post-financial-crisis high last year. The median post-tax return on equity was almost 9%, even better than in 2021.

On the balance sheet, following three years marked by considerable asset growth, not least due to the pandemic, total assets were flat yoy in 2022. The corporate lending boom contributed to a 2% rise in risk-weighted assets. However, liquidity holdings at the ECB shrank significantly, as did corresponding funding. Exceptionally high dividends, special dividends and share buybacks meant that nominal total equity fell slightly, by 2%, also driving an 0.5 pp reduction in the CET1 capital ratio. Nevertheless, at 14.1% on average, it remains strong and close to last year's all-time high. The risk-insensitive leverage ratio, excluding temporary crisis measures, even ticked up 0.1 pp yoy to 5.1%. More importantly, thanks to robust profitability, most banks are easily able to build up capital organically if needed – a major improvement compared to just a few years ago. Overall, core capital ratios are twice what they were during the financial crisis, but in real terms, they even might have tripled, given greater risk weights for assets such as securitised products and tighter definitions of what counts as capital.

Banks also continue to be flush with liquidity. The Liquidity Coverage Ratio (LCR) edged lower by 13 pp yoy, to 153% on average, but remains far above the required level of 100%. Such liquidity measures did not even exist as an industry-wide regulatory standard back in 2008.

Another major distinction between then and now relates to interconnectedness: many European banks got into trouble in 2007/08 because of their investments in US securities, such as securitised subprime mortgages. Yet today, exposure to the US is much lower. Total claims of European banks (i.e. EU, UK, Swiss and Norwegian institutions) on US counterparties peaked at USD 5.1 tr in 2007/08. Subsequently, they almost halved until 2016, before recovering slightly to USD 3.3 tr currently. Still,

excluding UK banks, there has been no growth in European banks' US business for a whole decade – in nominal terms! Even more, the data does not fully reflect yet that two large banks from France and Spain sold their sizeable US (commercial bank) subsidiaries to North American competitors in recent years, which indicates a further disentanglement of EU and US financial systems. While this has meant European banks missed out on some growth opportunities when the US banking market was outperforming Europe, it has also reduced potential spillover effects from wobbly regional banks or troubles in the real estate market in the US.

Last but not least, what may be the consequences of recent events for banks, their customers and policymakers in Europe? There may be an even greater focus on stable – and well diversified – sources of funding such as retail deposits, and on prudent capital and liquidity management in general. Banks are also likely to become more cautious when taking risks, implying a further tightening of credit standards for both corporates and households, and probably higher collateral requirements. This should help central banks achieve their goal of bringing down inflation and allow for fewer additional interest rate hikes (which would provide partial mitigation for private-sector customers). At the same time, regulators might rethink the effectiveness of some post-financial-crisis reforms, for instance with regard to resolution regimes or easier rules for small and mid-size banks (the so-called proportionality in regulation), especially in the US.

Nonetheless, the new regulatory framework has overall proven robust in this and previous episodes of financial stress. And the fundamental soundness of the banking system has successfully limited contagion from the few failing institutions which were much more individual cases rather than the industry norm. In the end, it is clear: we see no real banking crisis in Europe, this is far from 2008.

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