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Talking Point

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European bank performance - As good as it gets, despite recent wobbles?

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

www.dbresearch.com

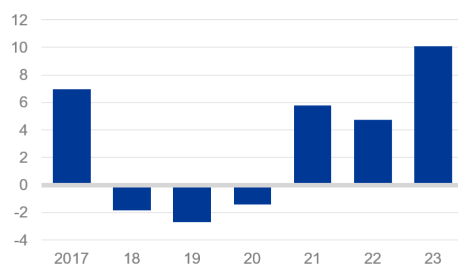
Deutsche Bank Research Management
Stefan Schneider

European banks are running at full steam, achieving the best start to a year since the financial crisis – the stress in March notwithstanding. Revenues have been buoyed by exceptional growth in interest income, while provisions for loan losses have fallen back again and costs remain in check. Capital and liquidity positions continue to be very robust, in spite of ample returns to shareholders and TLTRO repayments to the ECB. There are some clouds on the horizon though: interest rate increases are likely coming to an end and loan growth may slow further.

Have recent tensions in the European banking system impacted banks' business negatively and led to weaker results? Or were they even the result of an already deteriorating operating performance? Q1 figures answer both questions with a resounding "No". In fact, European banks have stayed strong, on aggregate even reporting the best (i.e. most profitable) start to the year since the financial crisis.

Revenues of Europe's largest banks*

Q1 results, % yoy



* excl. UK institutions

Sources: Company reports, Deutsche Bank Research

The continuing surge in net interest income is providing the biggest contribution. Up an extraordinary 28% yoy at the major institutions (all results excluding the large Swiss bank which failed in March), momentum may now be close to peaking, as interest rate increases – which started last spring – might come to an end by summer. Deposit funding cost will probably pick up in the coming months, limiting any further increase in the interest margin. At the same time, volume growth is highly likely to slow. Following several years of substantial loan growth, both with corporates and in the mortgage market, demand for credit is currently falling. A couple of factors are contributing to this. Companies – many of them still sitting on large liquidity buffers – are shying away from new investments, as reported by a net 33% of banks in the Q1 EMU bank lending survey. Secondly, even 40% of banks cited higher interest rates as a reason for corporate restraint. On the household side, an overwhelming 72% of banks (Q4: 74%) saw a contraction in mortgage demand, compared to the previous quarter.

This is gradually feeding into hard data. Outstanding loans to non-financial corporations by all banks in the euro area were up 8.4% yoy in October, but the increase has slowed to 3.6% as of April. Similarly, mortgage growth has almost halved from 5.9% in July to 3.1% now. An outright contraction of loan books may be unlikely, yet banks' perfect world of rising rates (and margins) and still significant expansion in volumes will probably come to an end. Interest income may continue to rise though, for some more time, as rate hikes take full effect, including the few more expected in the EMU.

Other revenue components hardly made progress in Q1. Fee and commission income retreated 4%, also due to subdued corporate finance activity, while the smaller trading income climbed 12%. These two changes essentially cancelled each other out. Total revenues thus increased by 10%. In addition, banks were able to cut loan loss provisions from the prior-year quarter (-29%), which had partly already been affected by Russia's invasion of Ukraine. Further upside may be limited though given the anaemic real economy in the euro area. It is expected to almost stagnate this year, not least due to the much higher interest rates and inflation. It remains to be seen whether asset quality – which has held up well so far during the headwinds of the pandemic and the energy crisis – will finally deteriorate.

Banks have managed to keep cost inflation relatively in check until now, with administrative expenses up by only 4% yoy. After years of moving sidewards, this helped bring down the cost-income ratio convincingly, to 54% (-4 pp). Altogether, net income jumped by 62%, driving the average post-tax ROE to an impressive 12% (+4 pp).

Balance sheet, capital and liquidity trends were mixed. Total assets fell by 4% yoy in Q1 – mainly as a consequence of TLTRO repayments and reduced liquidity holdings at the ECB. Risk-weighted assets declined by 2%. Banks continue to focus a lot on capital distribution to shareholders, via dividends and share buybacks. Nevertheless, nominal equity edged up 1.5% thanks to the improved profitability. Both the CET1 ratio (14.3% on average, +0.4 pp) and the leverage ratio (5%, +0.2 pp) remain strong, although some banks have returned more capital to their owners than they have generated organically in the past two years. Still, for the industry overall, this capacity is greater than at any time since the financial crisis, providing reassurance that banks would be able to quickly build up their buffers if needed. In the medium term, this may indeed be crucial with the looming implementation of the final Basel III (Basel IV) framework. Liquidity-wise, the shrunken TLTRO volumes resulted in a slightly lower LCR than a year ago (158%, -5 pp). However, the LCR stayed on a comfortable level and was also 3 pp higher than in December, as banks probably stocked up on liquid assets in light of the market tensions in March.

Going forward, some of the recent tailwinds for banks may weaken gradually, such as the benefit from rising interest rates and falling loan loss provisions, as well as the buoyant lending environment. Capital market activity could potentially rebound somewhat from the subdued levels of the past 12 months (some kind of "mean reversion") but is unlikely to make up for the slowdown in other areas. The structural impact of inflation on operating expenses is an open question, partly because of uncertainty about potential second-round effects (i.e., a wage-price spiral) and how quickly price increases will return to central banks' targets. Hence, bank profitability might remain elevated, even though further progress will probably become harder to achieve.

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