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Talking Point

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Historic first half for European banks

More profitable than ever

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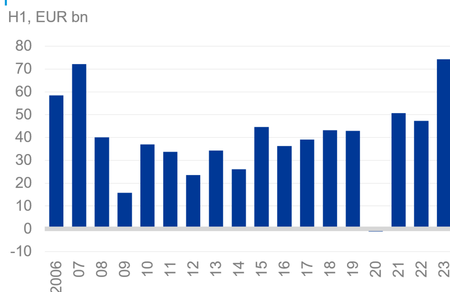
The banking sector in Europe is benefiting from a set of conditions which have allowed for the strongest bottom-line result on record, even surpassing the pre-financial crisis peak of 2007. Rising interest rates have led to a surge in net interest income, asset quality remains sound and provisions therefore contained, and banks maintain tight cost discipline. Capital and liquidity levels continue to be robust, considerable returns to shareholders notwithstanding. European banks have also caught up with their US peers with regard to profitability ratios, for the first time in many years. Further gains in this benign environment may be harder to achieve though.

Net income of Europe's leading banks*



Sources: Company reports, Deutsche Bank Research

Driven by surging interest rates, the European banking sector has rebounded. In the first six months of the year it achieved its best result since the financial crisis and even surpassed the pre-crisis peak of 2007, at least in nominal terms. The biggest driver at the 22 major institutions, a proxy for the whole industry, was the 20% yoy jump in net interest income. This came despite interest margin headwinds for French banks: in the domestic retail business, they face quickly rising funding costs due to the peculiarities of the popular Livret A deposit accounts, while mortgages are mostly fixed-rate, therefore limiting upside on the income side. In Europe on aggregate, 88% of the increase in total revenues since H1 2021 was due to higher interest income. It now accounts for no less than 56% of total revenues – underscoring the importance of rate normalisation for European banks.

This is especially the case given that the second-largest component, fee and commission income, remains sluggish, falling 3% yoy during the first half of this year. The relatively small and volatile trading income performed strongly too, though (+85%). All in all, revenues rose 14%. More surprisingly, banks managed to contain costs quite well, the inflationary pressure notwithstanding. Administrative expenses went up by only 3%, and even declined at several institutions. Likewise, loan loss provisions essentially stayed flat, with a handful of banks even reporting net releases. Despite the weak European economy, which has been teetering on the edge of recession for about a year, and despite the surge in interest rates, banks' asset quality has not deteriorated materially so far. The balance sheets of households and companies appear more resilient than expected.

Given the combination of strong results across revenues, expenses and loss provisions (and a few positive one-offs or lack of negatives), net income jumped 57% from the prior-year figure, which was not poor itself. This, as well as other numbers, excludes distortionary effects stemming from the merger

of the two largest Swiss banks, thus maintaining comparable data over time which appropriately reflects underlying performance. At EUR 74 bn, (absolute) profits rose to an all-time high, exceeding the pre-financial crisis record of EUR 72 bn. All but one bank reported a yoy increase.

The majority of banks reached a double-digit post-tax ROE. The unweighted average surged by 5 pp to 13%, its best level since 2007 (when, of course, the figure was much higher due to the smaller capital base). Only once since then, in 2010, had aggregated returns exceeded 10%, and barely so. The cost-income ratio declined meaningfully, by 6 pp, to no more than 52%, thanks to the improvement in revenues. More than half of the institutions got below the 50% mark, another achievement for an industry long plagued by stubbornly elevated costs. Admittedly, all of these are only H1 results and still need to be confirmed for the full year.

On the balance sheet, slowing loan growth and repayments of ECB funding (TLTROs) left their impact. Total assets declined by 3% yoy and risk-weighted assets by 2%. Total equity edged up only 1%, the bout of profitability notwithstanding, given unprecedented capital returns to shareholders. Paying dividends and buying back shares have been a top priority for many European banks in the past two years – made possible by significant organic capital generation. Despite the shareholder reimbursements, both the CET1 ratio and the leverage ratio rose yoy, making up for temporary weakness a year ago. The former climbed 0.6 pp to 14.4% on average, the latter 0.4 pp to 5%. In other words, overall capital levels remain comfortable, although a couple of banks have seen a meaningful drop since 2021.

Liquidity was in the spotlight again during the turbulence in March. Buffers continue to be very sizeable though, with the Liquidity Coverage Ratio at 152%. This is an 8 pp decrease yoy, yet most of it reflects the carefully managed exit from the central bank funding provided by the ECB during the coronavirus pandemic and is not a sign of deteriorating client balances. Interestingly, in the euro area, total outstanding deposits from private-sector customers have been more or less constant over the past 12 months. Growth momentum slowed materially as inflation took its toll and firms reduced excessive liquidity holdings.

How do these results compare to the performance of the US banking system? During the tensions in March, the impression arose that the entire sector could be in difficulties. Deposit flight at some troubled mid-size banks and unrealised securities losses of USD 500-600 bn in total grabbed the attention. However, the moderate industry-wide shrinking of deposits (since November last year) comes after a huge expansion during the pandemic – volumes are still up 31% versus the beginning of 2020. The book losses on bond portfolios are primarily an accounting phenomenon in periods of rapidly rising interest rates, and they have been roughly stable for several quarters now. Net-net, US banks may indeed be benefiting from a stronger surge in interest rates, although probably to a lesser extent than their European peers, which had suffered heavily from negative rates. Similar to Europe, net interest income at all US institutions jumped by 21% yoy in the first six months of the year, more than compensating for the 160% increase in loan loss provisions (but from a relatively low starting point). Net income also climbed 21% to its highest absolute level ever. Post-tax ROE reached about 13½%, its best figure since 2004.

Hence, current profitability ratios are about the same on both sides of the ocean. This is the first time since 2015 that European banks are not materially lagging behind their US competitors but have closed the long-lasting performance gap. This is despite the US banks not taking a lasting hit from the confidence issues in the spring; their Q2 results were stronger than in the year-before period.

Still, it is easily conceivable that banks in Europe could fall somewhat behind the US banking industry again. Further improvements will probably be harder to achieve, and some tailwinds will dissipate as funding costs may continue to rise and interest margins come under pressure (they have already started edging down in the US). The US economy appears stronger and more advanced in the cycle, as does monetary policy. Loan growth – though positive – is slowing in both regions but remains higher in the US, and the ECB may cut rates later than the Fed. Also, medium-term growth prospects look better on the other side of the pond. Nevertheless, Europe's banks enjoy a sweet spot right now, and the return to a normal interest rate environment should have a sustained positive effect even beyond the short run.

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