



# European banks – back for good?

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## Authors

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

Benjamin Goy  
+49 69 910-31946  
benjamin.goy@db.com

## Editor

Robin Winkler

Deutsche Bank AG  
Deutsche Bank Research  
Frankfurt am Main  
Germany  
E-mail: [marketing.dbr@db.com](mailto:marketing.dbr@db.com)  
Fax: +49 69 910-31877

[www.dbresearch.com](http://www.dbresearch.com)

DB Research Management  
Robin Winkler

Europe's banking industry had not reported new record profits for more than 15 years. Yet in 2023, based on reported results from 20 of the largest institutions, nominal net income finally surpassed the pre-financial crisis all-time high, as banks benefitted from rising interest rates. This dampened demand for credit, but cost of risk remained low. Capital ratios made up for the dip in the prior year and continue to be at comfortable levels, despite exceptionally large returns to shareholders. Both the cost-income ratio and post-tax return on equity improved significantly; the latter puts European banks on a par with their US competitors for the first time in many years.

The normalisation of the interest rate environment has led to an impressive rebound by European banks that was more forceful than could have been expected following more than a decade of headwinds. The 20 largest institutions, a proxy for the industry as a whole, saw an increase in revenues in 2023 which resulted in a jump in profits and a 13% ROE on average. It is an historic performance – by far the highest ROE since 2007 and the first time since then that full-year returns have reached double digits.

Net interest income started to rise two years ago. In 2023, it climbed again strongly, by 14% yoy. Admittedly, momentum slowed significantly in recent months, as rate hikes came to their end. In H2, interest income was up only slightly versus H1. In 2022, interest income – in nominal terms – was still lower than at the post-financial crisis peak in 2010. The zero and negative rate environment had been very painful. It is only now that European banks can begin to claim success in growing their biggest revenue component.

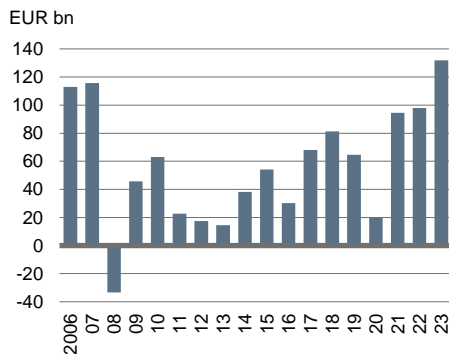
Other sources of income produced a mixed picture last year. Fees and commissions stagnated, partly because of sluggish core investment banking activity, while trading income, the smallest segment, jumped by 32%. Overall, this pushed revenue growth into double digits (+12%). Nota bene: despite the strong results, revenues are still below their 2007 all-time high. At the same time, banks maintained reasonable cost discipline, inflationary pressures notwithstanding. Administrative expenses increased on aggregate by 7%, but even declined at half a dozen institutions. This triggered a 3½ pp drop in the cost-income ratio to 54%, with the median even at the 50% mark. Equally important was the resilience in asset quality, which defied the much higher financing cost for borrowers. NPL ratios so far remain the lowest since the financial crisis, and banks' loan loss provisions edged down in 2023 (-5% yoy), following a widening in the previous year.



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Net income of Europe's major banks\*

1



\* excl. Swiss institutions

Sources: Company reports, Deutsche Bank Research

All in all, net income rose by 36%, from an already elevated level (this excludes the one-off gain from the merger of the two largest Swiss institutions). Thereby, in absolute terms, profits have indeed surpassed the pre-financial crisis record of 2007. The 4½ pp surge in the average, unweighted post-tax return on equity (to the 13% mentioned above) was only slightly smaller than the recoveries in 2009 – from the financial crisis – and in 2021 – from the coronavirus pandemic. The ROE level is also substantially higher than banks' cost of capital for the first time since 2007. With few exceptions, all individual banks achieved double-digit figures, underscoring the broad upswing across the entire industry.

Sizeable organic capital generation is relatively new for many European banks. And capital ratios are robust and do not need to rise further on aggregate. The CET1 ratio ticked up 0.3 pp yoy to 14.4%, with a similar movement in the leverage ratio (+0.1 pp to 5.1%). The more volatile LCR remained at a comfortable level (+4 pp to 158%). Both CET1 ratio and LCR partly recouped a dip in the year before. The combination of strong capital ratios and strong profitability opens up new possibilities. It allows banks to return considerable funds to their shareholders, after a lean decade, via dividends as well as share buybacks. Banks can also invest more in new technology (incl. artificial intelligence) or people. On a more medium-term horizon, sector consolidation might shift back into focus, too. Although it never stopped, it was largely confined to smaller transactions and national in scope in recent years, whereas there was a dearth in cross-border deals.

On the balance sheet, the slowdown of the prior year continued in 2023. Total assets were flat again yoy, having expanded considerably during the pandemic. Equity capital climbed 4%, despite the large payouts to shareholders. Risk-weighted assets were almost stable (+1%). Higher interest rates inevitably dampened demand for credit, reducing loan growth both with households (primarily driven by mortgages) and non-financial firms in the euro area to zero in the course of the year. On the other hand, lending volumes are not shrinking meaningfully, which is remarkable in light of the previous boom, the rate shock, and the weak macro environment – EMU GDP was up by only 0.5% in 2023.

This year, European economies will probably not gain much momentum either. Banks will likely feel pressure on the net interest margin. Declining interest rates could help lift credit demand to some extent and keep higher loan losses in check, while potentially also stimulating capital market activity. Bottom line, not least because of base effects, further revenue and profit growth will not come easily for European banks following last year's boost. But the current, elevated level is already quite comfortable for an industry that has gone through deep structural change and serious headwinds before.

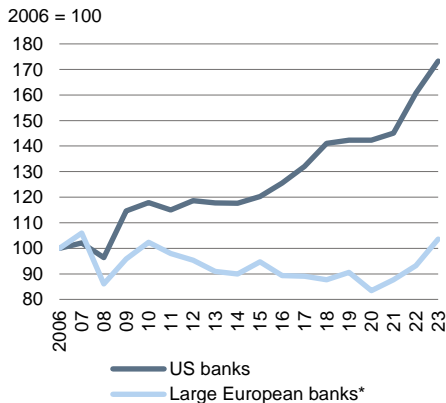
### Putting performance in a transatlantic perspective

European banks have suffered for a long time, particularly from poor revenue performance, which has led to moderate profitability levels, especially compared to their US peers. On the other side of the pond, revenue growth accelerated from 2016 onwards, following the Fed's first rate hikes since the financial crisis. Net income got another boost from the tax cuts enacted in 2017. The recovery from the pandemic lifted profits to a new level even though monetary tightening since early 2022 had a more mixed impact than in Europe due to larger securities holdings and higher provisions. Meanwhile, the rise in revenues was outstanding.



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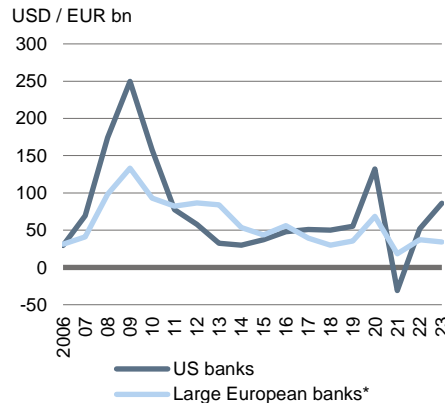
Total revenues 2



\* excl. Swiss institutions

Sources: FDIC, company reports, Deutsche Bank Research

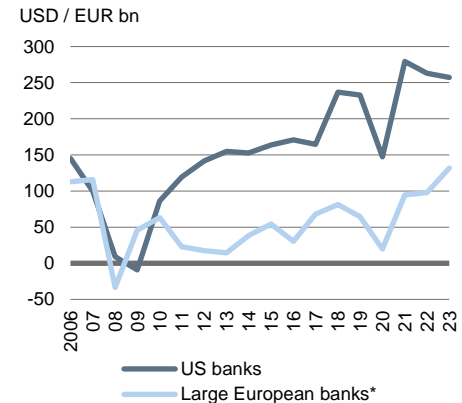
Loan loss provisions 3



\* excl. Swiss institutions

Sources: FDIC, company reports, Deutsche Bank Research

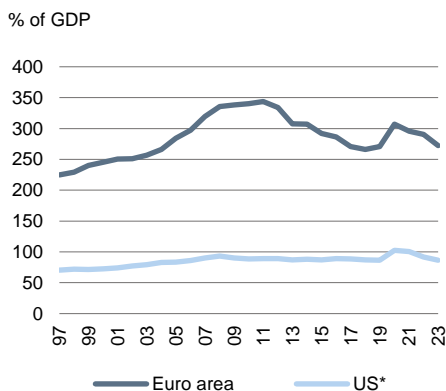
Net income 4



\* excl. Swiss institutions

Sources: FDIC, company reports, Deutsche Bank Research

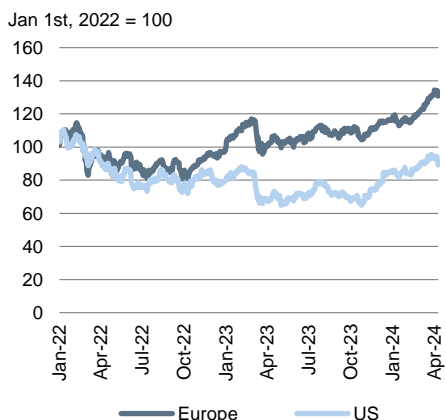
Total banking sector assets 5



\* Does not include some investment banking assets.

Sources: FDIC, BEA, ECB, Eurostat, Deutsche Bank Research

Bank stock indices since the inflation rebound 6



Sources: Bloomberg Finance LP, Deutsche Bank Research

Essentially, the US banking system has been a growth story for many years. Today, total assets are 70% above their 2011 figure, whereas for euro-area banks, the increase was much more modest, at only 17%. Similarly, industry size relative to the economy as a whole has been roughly stable in the US, at 87% of GDP. By contrast, the EMU banking sector has shrunk substantially, from 344% to 272% of GDP during the same time. But after prolonged restructuring, when banks became much leaner and more efficient, at least in terms of profitability ratios, the European banks have rebounded in such a way that they are now at eye level with the Americans. The 13% ROE in Europe in 2023 matches – and even exceeds – the system-wide ROE in the US (11.5%) for the first time in more than a decade. The Europeans look to be finally back in the global competition.

Stock markets reflect this. For many years, the gap between US and European bank stocks had widened. While the former have largely recovered from the heavy hit during the financial crisis, the latter remained at a depressed level compared to 2007 valuations. Yet, since the return of inflation and in its wake significantly positive interest rates, the share prices of European banks have outperformed those of their US peers which were also dealt a blow by the regional bank turmoil in March last year. Taken together, European bank shares are up by about a third since the beginning of 2022, in contrast to US bank stocks which are still slightly down. This does not make up for the previous long-run divergence, but it is a start for Europe's banking sector in its effort to regain a stronger footing with global investors.

Jan Schildbach (+49 69 910-31717, jan.schildbach@db.com)  
Benjamin Goy (+49 69 910-31946, benjamin.goy@db.com)



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