Talking point

European banks: Exit the crisis, enter the new normal?

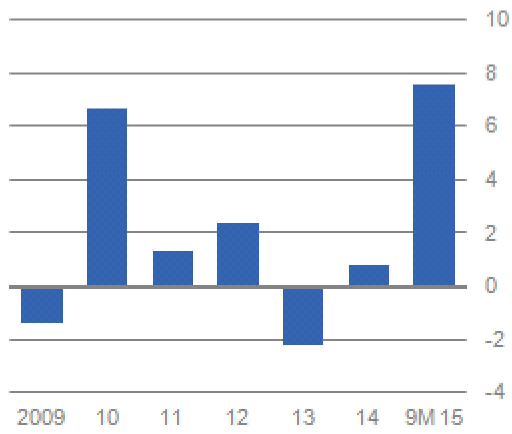
December 18, 2015

With 2016 just around the corner, the outlook for the European banking sector in the new year looks more promising than it has been for almost a decade. Growth, though meagre, has returned to many business segments and regions. Despite unrelenting pressure on interest margins, total revenues are expanding. Asset quality is improving and profits in 2015 may be the highest since 2007. The biggest questions surround the future path of regulation (where another major round of tightening could paradoxically threaten the recently hard-won stability) and of the European and global economy (which has repeatedly and substantially surprised to the downside in recent years) in 2016.

Balance sheet and P&L developments at European banks overall continue to look healthy. Judging from the latest hard data, the outlook for 2016 remains relatively encouraging, although regulatory uncertainty has made a forceful comeback and is casting a shadow over the ongoing progress in the sector. Profits at the 20 largest European banks were up by half in the first nine months this year compared with the same period in 2014. In part, the jump was due to a dismal starting point – net income is still far below pre-crisis levels. But equally it was driven by a strong rebound in revenues, which outpaced administrative expenses (10% increase vs 7.5%). Admittedly, favourable exchange rate effects played a role in this nominal boost, with the euro now so much weaker than last year. Nevertheless, the broad base of the rise is a clear positive – net interest income was more than 6% higher yoy, fee income up by more than 8% and trading income no less than 23% higher. The strength in fees and commissions, which are growing for the third year in a row, is particularly important as it helps banks to become less dependent on traditional lending and deposit taking, which in the current zero-rate environment remains fairly difficult, as well as on a volatile trading business.

Administrative expenses at Europe's largest banks

% yoy



Sources: Company reports, Deutsche Bank Research

Another driver of profitability improvements is the further decline in loan loss provisions. With NPL levels in hard-hit countries such as Spain or Italy decreasing steadily or at least stabilising, bad debt charges of the large European banks on aggregate fell again by 13.5% yoy, marking a better result for the third consecutive year. LLPs are now almost one-third below their 9M 2012 level.

All of these incremental steps have led the banks to come out of their shells a little and actually start accelerating new business activity slightly, albeit cautiously. Balance sheet growth, at 2%, is in the same range as the expansion in risk-weighted assets, at 3%. Total assets of the EU banking sector as a whole, including small and medium-sized institutions, are also up 0.6% yoy, despite the lower exposure to non-euro markets. With respect to capital, little by little, banks are building buffers beyond the Basel III requirements, probably already taking into account potential further tightening (“Basel IV”) in the form of higher risk weights for trading assets, a higher leverage ratio than the initially proposed 3% or a greater emphasis on the standardised approach in calculating RWAs, which may lead to higher figures in the end. In fact, according to the current rules, the largest European banks on average now exceed the 13% Common Equity Tier 1 threshold for the first time, while on a fully loaded basis they have equally reached 12% (12.1% to be precise) for the first time. For the latter, this is 0.5 pp more than a year ago and a level that under normal circumstances would be considered robust enough given ordinary Basel III requirements of some 8-9% for large, systemically important banks. But with regulators hinting at another round of RWA inflation and stricter leverage rules, the banking industry will probably still not be able to calm down anytime soon.

A final word on old-style performance indicators: with most large banks back in broadly normal operating mode, and in the absence of massive extraordinary effects (i.e. charges), a look at underlying efficiency and profitability measures is becoming more meaningful again. Since 2013, the cost-income ratio has been virtually unchanged at 61%, arguably an acceptable level only if the sector has indeed adopted a stable, resilient business model. Return on equity figures also might suggest a return to business as usual (of some sort, given the "new normal") – for the great majority of banks that report a post-tax ROE, its average rose to 8.6% in 9M 2015, up 1.3 pp yoy.

Author: Jan Schildbach (+49) 69 910-31717

...more information on **banking and financial markets**
Talking Point - Archive