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Talking point

Bank profitability after the crisis

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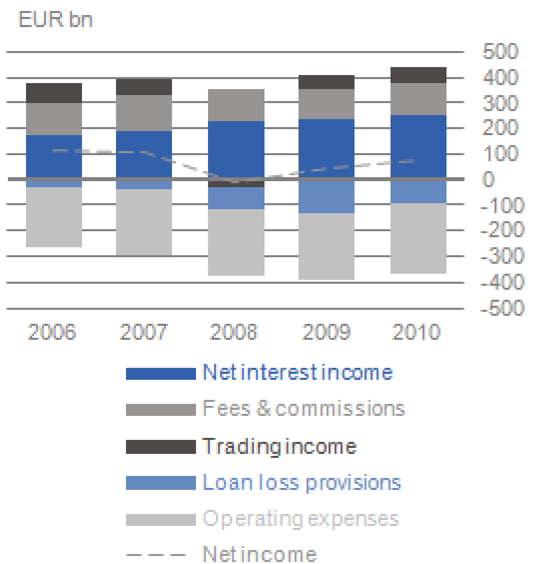
Two years after the end of the financial crisis, Western banks have returned to solid profitability. Prospects for further improvement, however, are less favourable because of rising interest rates and sluggish economic growth.

As two years have passed since the end of the financial crisis, it seems time for an analysis of how bank revenues and profits have developed in the interim, and what their future prospects could be. To do so, we shall look at data from both Europe and the US.

At first glance – considering the extraordinary proportions of the crisis – US and European banks returned to solid profits faster than expected: net income is now back to almost two-thirds of pre-crisis levels. Three factors have been the main drivers of the comeback: 1) a steady rise in net interest income, 2) a rebound in trading income and 3) a recent reduction of loan loss provisions.

Net interest income, most banks' largest revenue component, has shown impressive growth. Expanding by an average of 11% p.a. between 2007 and 2010 at the top 20 European banks and 7% at US banks, it continued its long-term upward trend, benefitting mainly from a decline in central bank rates and therefore funding costs.



Sources: Company reports, DB Research

With most economies having started to recover about two years ago, loan loss provisions also finally came down in 2010 by roughly one-third from their post-crisis highs, hence pushing the recent increase in profits.

Lastly – due to the broad-based rally in financial markets after the crisis – trading income has bounced back. In Europe, for example, there was a turnaround from losses of EUR 30 bn in 2008 to profits of EUR 60 bn last year. Admittedly, this revenue component continues to be relatively volatile.

Despite the recovery, prospects for further profit growth are rather meagre.

Banking may remain considerably less profitable than prior to the crisis, when net income was driven by ever lower interest rates (where there is limited downward potential), rapid lending growth (credit expansion is currently sluggish and may remain subdued for some time) and low credit losses (these have declined from extraordinary highs in recent quarters yet pre-crisis lows may not come in sight again). In short, the growth drivers of both the boom years until 2007 and the post-crisis rebound will probably not be able to bring about a significant further improvement in the medium term.

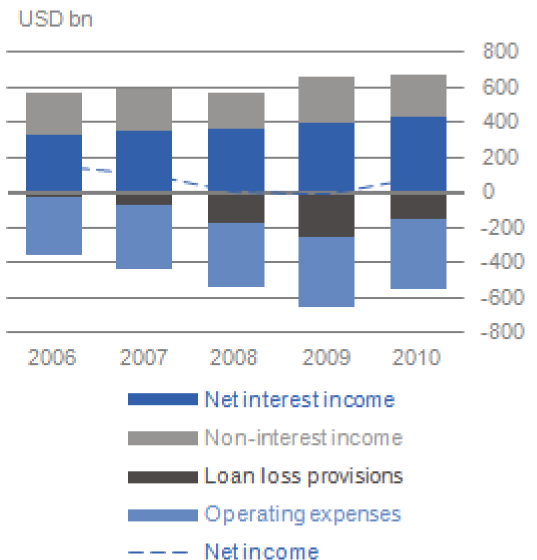
To be more precise, net interest income may even come under pressure relatively soon. At this juncture it is useful to distinguish between countries that have recently experienced a real estate bubble and those that have not. In the former case, it is highly likely that credit growth will remain anaemic for a longer period, as private households will need to reduce their debt levels further. In the latter case, interest rate developments will play a central role. First, the longer interest rates stay at their current record-low level, the more likely it is that margins will decrease after having been boosted by the rate cuts in 2008/09. Interest income is already falling in the US and growth has flattened out in Europe.

Second, as soon as rates rise again, two consequences need to be considered: a) a price effect and b) a volume effect. The price effect refers to banks' funding costs, which will probably increase. They are rising anyway on account of Basel III, the debt bail-in discussions, higher deposit insurance premiums and higher sovereign (i.e. benchmark) refinancing costs. But higher interest rates may exacerbate this effect as in most countries deposit rates are likely to rise faster than lending rates. It is only in those countries where adjustable rates – especially for mortgages – prevail over fixed rates (e.g. in the UK, Ireland and Spain) that profit margins might even increase with rising interest rates.

The volume effect in turn refers to the negative impact that higher rates have on credit growth and hence net interest income. Usually – in countries without deflating real estate bubbles – the volume effect is somewhat less important than the price effect.

In addition to the prospect of a squeeze on interest income, the decline in loan loss provisions may soon bottom out. Economic growth in Europe as well as in the US is likely to remain significantly below pre-crisis levels which, in many countries, were unsustainable and fuelled by the rapid expansion of credit. Growth even in non-bubble countries had benefitted though, too, e.g. through extensive trade links with the credit-driven economies. Moreover, the sovereign debt crises and painful fiscal consolidation measures continue to hurt sentiment, growth and employment and may hence prevent loan losses from falling much further.

It is difficult to see fee and commission income coming to the rescue. Earnings from securitisation and complex structured products, which had driven much of the pre-crisis growth, have suffered appreciably and may not return to their former strength any time soon. Demand for high-margin customised products could pick up somewhat as investors' risk appetite returns, yet momentum may not be sufficient to drive overall revenue growth again. Many of the flow businesses should, however, become more attractive due to the low capital requirements they face under the new Basel III regime.



All in all, the best times for European and US banks are probably over. As the very favourable circumstances of declining interest rates are history, net interest income may, for the time being, lose its role as a major growth driver. Rather modest prospects for general economic growth in the US and most of Europe in combination with overly indebted governments offer quite a meagre outlook for credit growth and may trigger an end to the fall in loan loss provisions sooner rather than later. Finally, trading income remains highly volatile and is increasingly being throttled by new regulations.

So what should banks hope for in the future, besides becoming more innovative and more efficient? Eventually, they may have to invest more abroad in order to escape the sluggish outlook they are facing in Europe and the US. Thanks to the better prospects for general economic growth, lower debt levels and sound demographics in the emerging economies, these may offer the only major ground for revenue growth in the coming decade.

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Philipp Scheuermeyer
Jan Schildbach (+49) 69 910-31717

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