European banking sector: Finally heading for better times?

European banking sector: Finally heading for better times?

December 16, 2013

Following years of struggle and having seen their world turned upside down, European banks may finally be heading for a (somewhat) smoother ride in 2014. Profitability is returning, though so far this is mainly driven by lower extraordinary charges rather than improvements in revenues and costs. Pressure to build capital may lessen thanks to significant progress over the past two years, yet currently banks are still shrinking relentlessly. Much will also depend on regulatory and supervisory actions, especially on how the EU Banking Union is implemented.

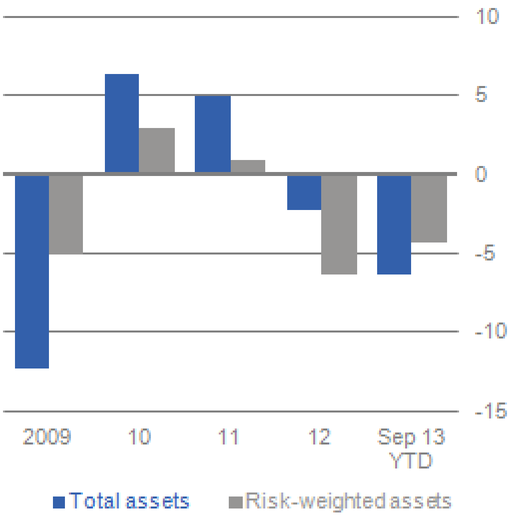
European bank performance is showing first tentative signs of a turnaround in fortunes after several years of turmoil and depression. 2014 looks set to become a year of improvements in the operating business (besides considerable supervisory changes due to the implementation of the EU Banking Union), yet for the moment the picture is still fairly bleak. In the 9-month results of the 20 leading European institutions, the negatives still outnumbered the positives: earnings continued to shrink significantly (-3% yoy), led by a dramatic decline in net interest income which is suffering from both reduced lending activity as well as margin pressure due to the extremely low level of interest rates. Small increases in fees and commissions as well as trading income were unable to compensate for this. With some justification, banks may pin their hopes for revenue growth next year on the EU economy, which has just left its prolonged recession.

On the cost side, administrative expenses were down 1% and loan loss provisions 3%. On both accounts, there is space to go further and a flat cost-income ratio, at 62%, demonstrates that banks so far have only been able to cut costs in line with the fall in revenues (sizeable litigation payments have not helped either).

Despite this, bottom-line profitability has increased substantially with net income bouncing back 42% from the pre-year lows. Of course, this is not the result of fundamental improvements in the business performance but mainly of the lack of extraordinary charges such as additional loss provisions in Spain or heavy losses on the sale of foreign subsidiaries that had depressed the comparable 2012 figures. Hence, while the burden from these one-offs has eased, the focus is now on the far-from-impressive “core” earnings – where banks still have a lot to accomplish.

European banks in a rush to shrink

% yoy, top 20 institutions



Sources: Company reports, DB Research

They have achieved much more with respect to capital ratios and indeed this gives some confidence in light of the balance sheet assessment soon to be carried out by the ECB. Capital strengthening has been remarkable over the past few years and many if not most large European banks are already Basel III-compliant. The Core Tier 1 ratio under the current Basel 2.5 regime is up 0.9 pp yoy to 12.4% on average and the fully-loaded Basel III equivalent has reached 11.2% for those banks that report it.

The way to raise capital levels has recently overwhelmingly been through a reduction in assets instead of a build-up of further equity. Risk-weighted assets have fallen by more than 5% yoy, while total equity remained essentially unchanged. Strikingly, the slump has even been greater with respect to nominal total assets, which are down a full 10%. This underscores the sudden and enormous pressure investors (and US regulators) have exerted on banks not only to adjust to higher risk-weighted capital requirements but also to comply with nominal leverage ratio demands.

Finally, this also defies the common perception of an industry that is becoming ever more concentrated: total assets of the EU banking sector, though not directly comparable due, for example, to the non-European operations of large EU banks, have declined by only 7.7% in the year to September. This means that the large banks are losing market share and shrinking faster than their smaller rivals. Large banks may remain under greater pressure to deleverage. After all, they are more exposed to US regulators and investors as well as potentially more intense ECB scrutiny. Also, some still have to shed assets to comply with EU state aid rules, while others are exiting business lines that have become unprofitable under the new regulatory standards. And in countries such as Britain, competition authorities are pushing for mid-size spin-offs from the largest domestic players to increase the number of market contenders. All in all, this may be a remarkable (though possibly temporary) period of de-consolidation rather than ever more market concentration.

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

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