



# Looking beyond the pandemic

## Strong comeback of European banks

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On face value, the European banking industry has recovered well from the coronavirus shock. Revenues, loan loss provisions and profits are largely back at their pre-crisis level, as is corporate loan growth. Below the surface, some shifts remain – interest income continues to suffer, but fees and commissions and trading income outperform. Funding from the ECB and even more so liquidity held at the central bank move from one record to the next, similarly to capital and liquidity ratios. The gap to US banks has widened further. EU implementation of the final Basel III rules has now reached decision stage, already causing concern about future European competitiveness.

One-and-a-half years after the onset of the coronavirus pandemic, the European banking sector has (mostly) exited crisis mode. Start with balance sheet trends: Lending to companies in the euro area had surged initially but has now returned to virtual stagnation, as the initial move is corrected. In many Southern countries such as Italy, Spain or Greece, where loan volumes had been declining at the start of 2020, they are currently doing so again.

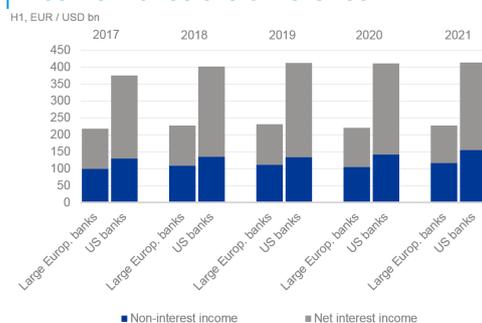
Second, mortgage lending to households continues to show no crisis impact at all. The robust expansion is gradually gaining further momentum and, at +5.6% yoy, already the strongest since 2008. This comes despite (but also due to) house prices rising unabatedly in many European countries which may partly reflect the perceived shortage of attractively valued other assets, in light of zero or negative interest rates and bond and equity markets close to record highs. It probably also plays a role that months of working from home have triggered a greater demand for space and comfortable “own four walls”.

Third, even the P&L broadly resembles pre-crisis times, i.e. H1 2021 and H1 2019 results for the 20 leading European banks have a lot in common and underscore how last year’s performance was, essentially, an outlier. Revenues had contracted by 5% at the beginning of the pandemic, but have now rebounded 3%. Loan loss provisions had tripled, yet have since fallen back to where they were before, and indeed somewhat further, matching the record low of H1 2018 (for a time series which began in 2006). Thanks to massive government and central bank support, the much-feared deterioration in asset quality did not materialise. In fact, despite the deep recession, NPL ratios have stayed fairly low (or even continued to decline) in most countries. They are now only 4.4% in both Italy and Spain, 2.7% in France and about 1% in Germany. Bottom line, the swings in provisions had the largest effect on banks’ net income. The latter had almost been wiped out last year, but reached EUR 54 bn in H1 2021, compared with EUR 48 bn two years before.



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### Revenue composition: Interest income makes the difference



Sources: FDIC, company reports, Deutsche Bank Research

By that measure, it was European banks' best first half since the financial crisis.

Still, the crisis has left some scars on the banking system. For instance, overall stability in revenues hides underlying divergence. Thanks to buoyant capital markets, fees and commissions as well as trading income are both up substantially versus H1 2019, while net interest income has suffered quite a bit (-8%) because interest rates have remained under pressure, particularly in the retail business.

Second, capital and liquidity ratios are significantly higher than two years ago. The CET1 ratio rose 1.3 pp to 14.9% over this period, even as banks recently resumed dividend payments and corresponding provisions. The ECB's guidance to refrain from or strongly limit shareholder paybacks expired at the end of September. The rebound in profitability over the last 12 months as well as modest de-risking (RWA -1%) were the main drivers of the capital increase. Likewise, the LCR climbed 11 pp to an elevated 159% on an unweighted-average basis, while the leverage ratio (excluding temporary regulatory changes) stayed flat at 4.9%. Both partly reflect prudent risk management, partly the considerable growth in ECB funding for profitability reasons. As a result, the equity base did not increase more than total assets.

This leads to the third main difference: across the euro area, the relationship between banks and the central bank remains much tighter than before the pandemic. Banks have used the ECB's targeted longer-term refinancing operations (TLTROs) to a large extent – currently, total ECB funding stands at EUR 2.3 tr, up from EUR 662 bn at end-2019 – because the central bank offers negative funding rates of up to -1%. This is welcome relief in times of interest margin compression and ever lower asset yields. Remarkably, the ECB is thereby competing ever more directly with ordinary private-sector deposits which have become financially less attractive for banks. This is particularly true for retail deposits (mostly priced at or slightly below zero), but also for corporate deposits even at -0.5%. If current circumstances were to persist in the longer term, this could therefore have meaningful consequences for banks funding structure and their relationship with customers, including a possible crowding out of private-sector deposits. In any case, the stigma which heavy dependence on central-bank funding carried for banks in the past is definitely gone.

At the same time, there is no equivalent demand for loans on the other side of the balance sheet, and securities investments are no foregone conclusion either given often ambitious valuations. Hence, banks have left most of this liquidity (and more) directly at the central bank – a massive EUR 4.5 tr in total. However, this is costly (the deposit rate remains at -0.5%, apart from the exempted volumes under tiering). It also provides evidence how distorted conventional commercial dynamics have become: banks "lend" almost as much to the ECB as to the entire corporate sector (loan volume EUR 4.75 tr). Of course, the microeconomic logic behind these developments is compelling but still, it is clear that this is not sustainable in the long run. Ever growing (financial) links between banks and the central bank on the one hand, and growing disintermediation with corporate clients on the other, as capital markets increasingly substitute for banks, point towards a changing role of Europe's traditional commercial banks in future.



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How does this compare to the situation on the other side of the big pond? Like in the past, US banks as a whole had provisioned more aggressively than their European peers at the beginning of the coronavirus crisis. However, this also allowed them to rebound more forcefully, with a considerable net release of loan loss provisions (USD 25 bn) in H1 2021 – something that has never happened in Europe at least in the past one-and-a-half decades. On top of that, revenues were slightly ahead of the H1 2019 figure, resulting in net income not only fully recovering but exceeding the pre-crisis (all-time) peak by about 20%. By contrast, post-tax profits in Europe are still far below their 2006/07 record high. On the balance sheet, corporate lending in the US, too, is more volatile than in Europe: the initial surge last year was more pronounced, as was the recent slowdown, which in the US meant a 7% yoy contraction as of Q2.

Finally, the European banking industry is not only trying to keep up with its US competitors. Apart from that, it is digesting the recently published legislative proposal of the European Commission for the implementation of the final Basel III (Basel IV) rules into EU law. The original Basel agreement of 2017 and particularly the output floor of 72.5% of risk-weighted assets under the standardised approach had caused serious concern about a potential further loss in competitiveness and a much greater burden for European banks than for US or other international banks. The current proposal signals some relief by making adjustments to take specific European features into account such as the high share of loans to unrated corporates (incl. SMEs) and of residential mortgages on banks' balance sheets. It also suggests to extend the multi-year phasing-in period until 2030. Still, sector-wide capital requirements may rise by up to 8.4%, according to the Commission's estimate (more for certain business models), and the outcome of the looming lengthy trilogue negotiations with EU member states and the parliament is open.

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