

Talking point

European banks' results: The long and winding road

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The fundamental transformation of the European banking sector into a leaner, less profitable, low-growth but also more stable industry in the "new normal" continues to make progress. Banks are shedding assets, reducing costs and raising capital ratios, with revenues in 2013 having declined for the third consecutive year. Legacy assets and litigation remained an additional, significant burden. Nonetheless, profitability has improved somewhat from its extremely low levels and may well rise further this year.

With the last of the major Italian banks finally having reported their full-year results for 2013, the extent of the challenges still ahead for the European banking industry has become clear. Net interest income at the 22 largest institutions – which account for about half of the sector as a whole – fell for the third year in a row (-7% yoy), with the pace of decline accelerating. Shrinking volumes and margin pressure from the low interest-rate level as well as intense competition in traditional business segments may be the most important drivers. Similarly, fee and commission income decreased for the third consecutive year, at least only relatively modestly (-1%). Against this backdrop, the 8% expansion in trading income, the smallest and most volatile earnings category, provided little comfort. Total revenues were also down for the third year in a row (-3%), underlining the difficult state of the sector.

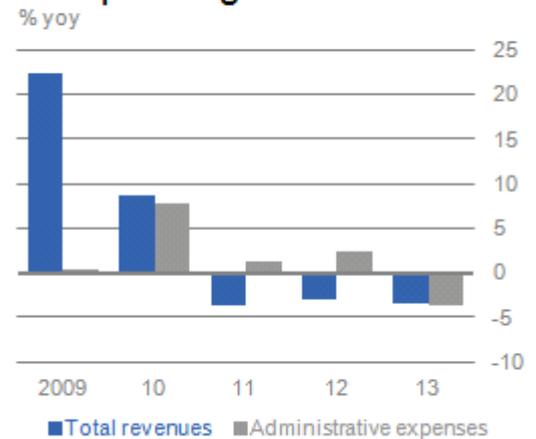
Having hesitated for long, hoping times would improve again, banks are finally tackling their problems in earnest. Administrative expenses, incl. staff remuneration, declined by 4% yoy in 2013. The P&L was also supported by loan loss provisions sinking 3%. Bottom line, this helped raise profits by a fifth from the miserable pre-year level, though the largest 22 European banks still posted an aggregate net income of only EUR 21 bn – on total assets of EUR 20 tr! This compares to USD 155 bn and USD 14.7 tr at all US banks combined. At least, the number of loss-making large banks in Europe fell to only five (located in Italy and the UK), while six banks achieved post-tax ROEs in excess of 8% (excl. one-offs).

The restructuring process of Europe's banks entails a significant shedding of assets and de-risking. Whereas in 2012, risk-weighted assets (RWAs) fell much more than nominal total assets, last year balance sheet totals slumped by a staggering 10% or EUR 2.3 tr at the largest banks, more than RWAs (-7%) and more than total assets of the sector as a whole (-7% in the EU), indicating greater pressure to adjust at the major institutions than at smaller banks. Overall, the European banking industry has come a long way from revelling in high growth for many years to becoming a giant that is shrinking in size at most fronts.

Reducing total assets more than RWAs came for a good reason: investors' and regulators' focus last year shifted somewhat from risk-weighted capital ratios to the leverage ratio threshold under Basel III which US authorities may even raise further substantially. Most large European banks have already reached compliance with respect to Common Equity Tier 1 (CET1) requirements – the fully loaded CET1 ratio rose to 10.8% on average (excl. two banks that have not disclosed this figure). Under the current Basel 2.5 regime, Core Tier 1 is now a comfortable 12.4% (+1 pp yoy).

One last observation: it seems to be becoming almost the norm for many banks to engage in some sort of "kitchen sinking" in the final quarter of the year, trying to stuff as many "one-off" charges from legacy assets or litigation into Q4 results as possible instead of carrying them forward into the new year. This has been a

Revenues and costs at Europe's largest banks



Sources: Company reports, Deutsche Bank Research

prominent feature since 2011 earnings releases and, at the very least, is making it harder to assess and predict overall bank performance based on results in the first nine months of the year.



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