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Talking point

European bank performance: Weak start to the year, but no disaster

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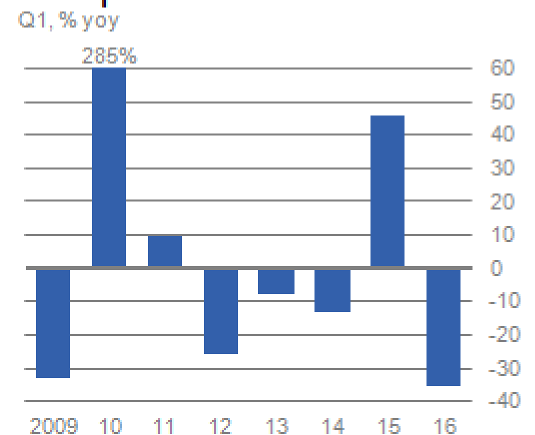
After two years of recovery, European banks suffered a setback in the first quarter of 2016. Capital market revenues were hit by concerns about global economic growth and banks' own business models. Cost cuts and a further decline in loan loss provisions helped only somewhat to smooth the fall in profitability. Still, net income was about the same as in Q1 2014, and progress continued in other areas.

European banks suffered a setback at the beginning of the year. Turmoil in financial markets kept investor appetite − and thus issuance and trading activity − below usual levels. As a result, trading income at the 20 largest European banks fell by more than half year on year, and fees and commissions dropped by 8%. By contrast, net interest income was almost stable (-1.8%, after a strong rise last year). Banks benefited from a continuing slow normalisation in lending volumes – credit growth of all banks in the euro area was running at 2% yoy with households and was basically flat with companies, both better than in 2015. Overall, large banks' revenues were 11% lower than in the prior-year period.



Some relief came from reduced administrative expenses (-4%) as well as another decrease in loan loss provisions (-16%). The latter have become less important in absolute terms over the past few years, though, thanks to improving asset quality in many European countries. Bottom line, net income fell by a third, thereby reversing the progress made in 2015, and was back at the Q1 2014 level. Nonetheless, with two exceptions, all large banks remained profitable – maybe a sign of indeed more resilient business models that are able to withstand even rather adverse market conditions.

Total assets, which had been inflated by the euro depreciation a year ago, now fell by 6% yoy at the large banks and by 4% in the euro area. The equity base hardly changed in either case, which supported capital ratios: the leverage ratio at the large banks went up by 0.3 pp yoy and has now reached 4.7% on average. Similarly, the fully loaded Basel III CET1 ratio gained almost a full percentage point, rising to 12.7%, thanks not least to a further reduction in risk-weighted assets by 3%.

Finally, with regard to liquidity, not all banks are reporting figures yet, but for those that do, the picture is quite clear. The liquidity coverage ratio (LCR) is not a major concern, with a current level of 139% on average (versus the benchmark of 100%) and still rising – 13 pp over the past year.

The medium-term outlook for European banks largely depends on three factors: i) political risk developments, ii) monetary policy and iii) progress in restructuring. i) Political risk is elevated with the imminent referendum in the UK, important elections in Spain and potential contagion effects in other parts of the EU. While negative political surprises usually have only short-term effects on financial markets, more fundamental decisions are on the table this time. Uncertainty is therefore particularly pronounced, which means that the impact may be more significant and longer-lasting. ii) With unrelenting pressure on margins in lending and deposit-taking, the forthcoming new round of long-term funding operations (TLTRO II) as well as the ECB intervening ever more aggressively also in capital markets (e.g. with the recent start of the corporate bond purchase programme), the European banking industry will continue to be heavily influenced by central bank actions. iii) Apart from these external factors, banks' performance will depend on how much further progress they themselves can achieve with respect to cost

containment, finding new sources of revenue (particularly on the fee side), successfully repositioning versus advancing new competitors, and resolving remaining litigation issues.

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