

Talking point

European banks: Recovery running out of steam?

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The European banking industry has gone into reverse gear this year so far, following substantial progress in 2014 and 2015. Its revenues and profits have relapsed into contraction, and the potential for lower loan loss provisions to come to the rescue seems exhausted. Once more, cost cuts have not kept pace with the retreat on the income side. In a market environment that continues to be very challenging, banks may have to resort to even tougher measures to put themselves on a sustainable footing again.

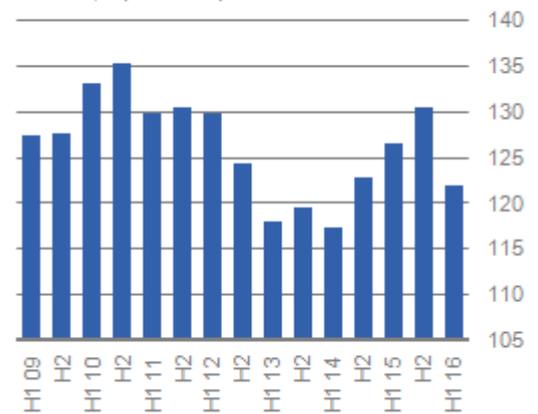
The large European banks are increasingly struggling with an adverse external market environment and in their efforts to mitigate these negative effects. It is also becoming clear that weak results may not only be due to financial market turmoil at the beginning of the year or the Brexit referendum in the UK, but the outcome of other, more fundamental problems.

Most worrying are the developments on the revenue side. While poor figures in Q1 could be blamed on a slump in capital markets, the situation has become even worse with the full H1 numbers. Net interest income was down 4% on the year, after it had received a boost in nominal terms in 2014/15 from the depreciation of the euro. This tailwind is now gone, and the longer-term decline in interest income which has been in place since 2010 seems to have resumed. With monetary easing set to continue, the ECB's deposit rate already at -0.4%, and margin compression traditionally stronger the longer rates remain low, the outlook is hardly encouraging. Banks (and central banks) hoping for volume growth to compensate for shrinking margins have been repeatedly disappointed by the sluggish recovery in lending. Credit dynamics indeed remain anaemic – outstanding loans to enterprises by all banks in the euro area were not higher in June 2016 than a year ago, while loans to households expanded only by a modest 1.7%. It obviously did not help either that lending rates have fallen even further (corporate borrowers pay a record low 1.4% for new loans larger than EUR 1 m, and average mortgage rates for households dropped slightly below the 2% mark for the first time ever in June). Total assets continue to stagnate.

Large banks' trading income in Jan-Jun was 37% lower than in 2015, confirming the diminished role it is playing since the financial crisis (it contributes only a tenth to total revenues any more). The emerging single largest problem, however, is fees and commissions. They dropped by a full 10% yoy to the lowest H1 level since 2009. This is confounding banks, which had pinned great hope on them to make up for shrinking interest income. Part of this is a result of reduced appetite by corporations and investors to issue and trade securities. Activity levels remained muted even as valuation trends in capital markets turned relatively benign in the run-up to the UK's EU referendum, after a poor start to the year. In addition, the persistent weakness in commission earnings points to graver underlying problems, namely banks' inability to raise client fees on a broader scale. There are two possible explanations: i) banks have not pushed as hard as possible yet, or ii) competitive pressure is preventing them from charging customers more than in the past. Depending on an individual bank's position, the consequences will vary. In the case of the former, clients are set to increasingly feel the heat, while for the latter, banks may have to focus even more on cost reductions.

Operating expenses did decline in H1 2016, but at a slower pace (-5% yoy) than total revenues (-9%). This is clearly unsustainable. As the multi-year fall in loan loss provisions is also nearing its end (on aggregate, they were

Net interest income
EUR bn, top 20 European banks



Sources: Company reports, Deutsche Bank Research

down only 2% any more), profitability has taken a severe hit with net income down by about a quarter, to EUR 39 bn, on revenues of EUR 234 bn.

This does not make the required build-up of capital any easier. With organic capital generation relatively slow and bank stock valuations at rock-bottom levels (the price-to-book ratio is currently at just two-thirds), European banks once more have to resort to de-risking to strengthen capital ratios. Hence, risk-weighted assets fell again by 6% yoy, bringing the fully-loaded Basel III CET1 ratio to 12.9% (an increase of 90 bp). The leverage ratio under final rules also rose by 30 bp to 4.8% on average. The liquidity coverage ratio is reported by most, though not all large banks yet, and stands at a comfortable 139%.

Bottom line, pressure on banks to take tougher decisions is mounting, given i) poor revenue developments across the board and the detrimental impact of negative rates, ii) an important driver of improvements in recent years – lower loan loss provisions – losing ever more momentum and iii) the outlook hardly brightening on the macroeconomic front (GDP growth forecasts for the EU lowered to 1.2% next year in the wake of the UK's Brexit vote), the regulatory front or the monetary policy front. A repeat of sudden financial market scrutiny, as was recently the case with the Italian banking sector, is thus not unlikely.



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