

## Talking point

### European bank performance: The deposit conundrum

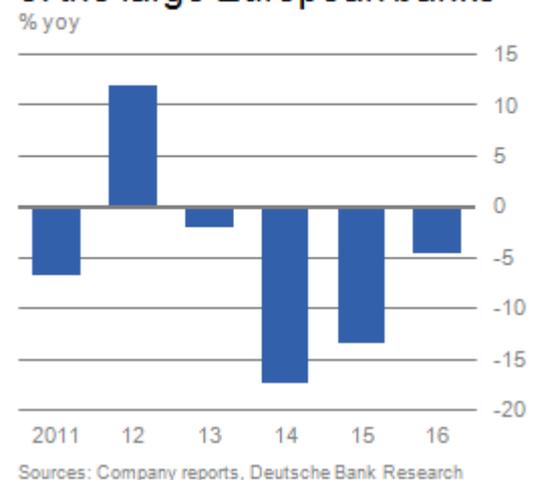
November 18, 2016

**European banking sector results improved in the third quarter after a weak first half of the year. Still, all revenue components registered year-over-year declines, only partly offset by falling costs and lower loan losses. While credit growth remains nearly non-existent, deposit growth has picked up further momentum and is now at its strongest since 2009. This comes despite record-low borrowing costs for customers and deposit rates virtually at zero. Going forward, following the US election, one of the biggest unknowns is the future direction of prudential regulation at the global level, where changes could have a material impact on European banks.**

European banks face a conundrum: their customers are taking out few loans but depositing lots of cash, despite unprecedented low interest rates. In the euro area, lending to the private sector is at the same level as in 2009, while deposit volumes are up almost a quarter. Traditionally, banks in Europe lend significantly more to households and firms than they fund through deposits. Now, the surplus of loans over deposits has fallen to its lowest level – just EUR 770 bn – since the start of the monetary union in 1999. Back in 2009, the gap was about EUR 2.5 tr. Even on a shorter time horizon, the puzzling picture remains: corporate lending at the moment is flat yoy, and retail loans are up only 2%, whereas private-sector deposits are expanding at 4.4%, the highest growth rate since 2009. The “deposit glut” is also a Europe-wide phenomenon and not just confined to countries with strong growth and income dynamics: deposit expansion in Italy, Spain and Portugal is very solid, too. What makes this truly remarkable is the exceptionally low costs and benefits of loans and deposits, respectively, for bank customers. Lending rates for corporates have never been lower – they are being charged about 1.3% p.a. for an average new loan larger than EUR 1 m, down from 5% in 2007/08. Likewise, households’ sight deposits yield only 8 bp any more, down from 1.2%. Hence, it has never been more attractive to borrow, at least in nominal terms, and it has never been less rewarding to save. Nonetheless, firms and households in the euro area are boosting their saving but not increasing their level of (bank) debt.

This has important repercussions for the banking industry. Its usual money machine – the lending and deposit-taking business – is spluttering. Net interest income is the largest revenue source for European banks, accounting for 54% of the total in 2015. But with virtually no volume growth and margins under pressure due to aggressive monetary easing, net interest income has been on a downward trend since 2010. Currently, i.e. for the first nine months of this year, it is down 4% yoy at the 20 largest European banks, a good proxy for the entire sector. Any hopes of this being offset by greater earnings from fees and commissions have not materialised to date – on the contrary, they are also down 6%. Finally, trading income, a less reliable income component, is 28% below its prior-year level. In total this makes for a substantial revenue drop of 5%. These figures have improved slightly recently, thanks to somewhat better market conditions in Q3, following a poor H1. Nevertheless, 2016 looks like a setback on the path to recovery for European banks.

#### 9M loan loss provisions of the large European banks



There are a few balancing effects that help to compensate for this weakness, but only partly. One is progress with regard to cost reductions. Administrative expenses, which include everything from employee salaries and IT outlays to compliance-related costs, fell 4% yoy. Furthermore, loan loss provisions continue to retreat, albeit only modestly (-5%). Bottom line, net income between January and September shrank 4%.

As the lending trends suggest, there is no balance sheet growth. Total assets were flat compared to September last year. Banks reduced risks though, with a moderate 2% decline in risk-weighted assets, which drove the fully loaded Common Equity Tier 1 ratio to a new record of 13.1% (0.9 pp higher than a year ago). The leverage ratio, under similar scrutiny by supervisors and investors, climbed 0.2 pp to reach 4.7%. While the CET measure would be broadly sufficient under Basel III, the leverage figure remains below a steady-state level at a number of banks.

One of the biggest questions currently relates to the future path of prudential regulation. Discussions continue about Basel IV and a further material rise in capital requirements. At the same time, the US elections have signalled a potential end to a broad-based additional tightening of rules and even raised the possibility of some relaxation in the US. Thus, the coming months may well decide the general course of financial regulation for the next couple of years, with all options still on the table – the implementation of even stricter standards, a softening, or anything in between. Likewise, it is unclear whether the globally coordinated approach by policymakers to reshaping the regulatory framework after the financial crisis will continue, or whether the common response has run its course and paths will diverge in future.



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