

Talking point

European banks in 2016: A year to forget

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The European banking industry suffered a significant setback in 2016. Revenues declined across the board, cost reductions were unable to keep pace and loan loss provisions rose. As a result, net income fell by almost half. Banks resorted to aggressive de-risking, but a shrinking equity base meant that capital and leverage ratios stagnated for the first time since the financial crisis. By contrast, US banks continued to grow and set a new record in terms of nominal profits, widening the gap to their European peers.

2016 was not a good year for European banks. Though the economy picked up speed in most countries, banks suffered a setback caused mainly by market turmoil at the beginning of the year, high litigation expenses and large writedowns on loans and goodwill in the final quarter. But cost levels also remained stubbornly high.

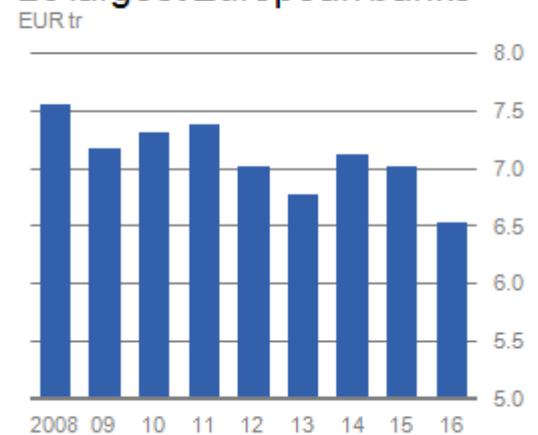
On the revenue side, all major components declined year-over-year at the 20 largest institutions. Interest income was helped by modest loan growth. Lending to companies was slightly positive, and loans to households were up 2% in the euro area. Interest margins, however, contracted by about 7% due to the further fall in the overall rates level. In total, this led to a significant drop in net interest income of 5%. Strikingly, banks seem to be unable to compensate for this even in part through a shift towards a more strongly fee- and commission-based business model. Despite efforts to increase income from accounts, cards, transactions and asset management, fees and commissions dropped by 6%, probably not least due to reduced client activity in volatile capital markets over the course of the year. Similarly, trading income slumped 14%. All in all, revenues shrank by a substantial 6.5%, thus reversing all the gains of the prior year.

This would not have been such a problem if banks had been able to reduce costs to the same extent, or if the cost of risk had continued to decline. Yet administrative expenses fell by only 5% – less than revenues, once more. In addition, loan loss provisions, which had provided tailwind in the past three years, climbed 27%. Having reached the lowest level since 2007 in 2015, this pickup was hardly a surprise given the modest improvement in loan growth. Still, there were very few bright spots in banks' results for 2016. Bottom line, net income plummeted almost by half versus the previous year to a meagre EUR 33 bn. This is the lowest level since 2013 and compares to a staggering EUR 135 bn a decade ago, just before the start of the financial crisis. The top 20 banks even made a net loss in H2 2016.

With profitability that much under pressure, banks again resorted to de-risking, deleveraging and shrinking. Total assets fell by another 2%, and total equity declined by 3%. The impact on risk-weighted assets was even more pronounced. They were cut by 7% to EUR 6.6 tr, the lowest level since 2008, despite large-scale inflation from tighter regulation (Basel 2.5 and Basel III). Over this period, banks have slashed more than EUR 1 tr in RWA, or 14% – an impressive achievement.

The most spectacular figure, however, came neither from balance sheets nor the P&L: for the first time since the financial crisis, European banks on aggregate did not manage to strengthen their capital levels in the past 12 months, in spite of de-risking. The fully loaded CET1 ratio remained flat at 12.7%, while the fully loaded leverage ratio even dipped slightly to 4.7% due to the shrinking equity base. Admittedly, capital ratios have risen enormously since 2008. Still, many banks are not yet comfortably above levels for both measures which would

Risk-weighted assets at the 20 largest European banks



Sources: Company reports, Deutsche Bank Research

provide them with substantial flexibility and freedom to either invest in business growth or return much of future earnings to their owners. This also shows that the European banking industry is far from a position where it could easily absorb a significant further tightening in capital requirements. In this regard, the effective impasse of the Basel IV discussions following the US election has provided some relief to European banks.

How does the situation of European banks compare with the performance of their peers in America? The entire US banking sector is smaller than the 20 largest European banks (when measured by total assets, though not by revenues). But US banks managed to generate net profits of USD 172 bn last year – a new historic record. Revenues are also increasing; they are now 25% higher than in 2006, whereas they are 10% lower at European banks. Net interest income at US institutions jumped by 7% last year. Loan growth is an important driver: corporate lending has boomed for several years now and was up another 8% in 2016. Household lending was more sluggish after the Great Recession, but also expanded 5% in the past 12 months. Hence, the transatlantic gap in the fortunes of the banking industry has significantly widened in the past year, and it was already substantial before that.



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