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Talking point

European bank results: Is the glass half-full or half-empty?

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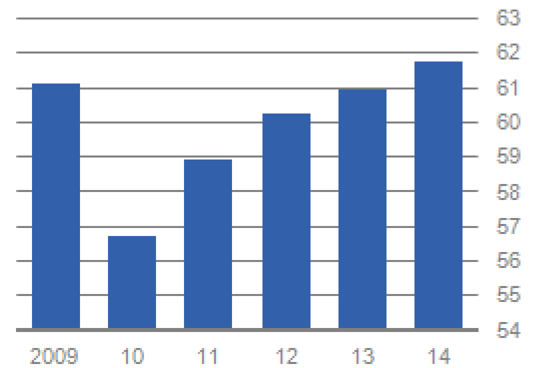
The half-year results of large European banks offer ammunition to both optimists and pessimists: loan losses and administrative expenses are shrinking, but so are total revenues. Net interest income, the sickly child of recent years, finally seems to be stabilising; however, net income is down again to poor levels. The state of an industry with two distinct faces.

European banks continue to struggle substantially with a rough external environment and home-made problems, yet their performance also shows small, incremental successes here and there. In their half-year results, the 20 largest institutions – which are a good proxy for the industry as a whole – reported a number of positives as well as negatives so that both optimists and pessimists may feel vindicated.

The bulls can mainly point towards three developments: i) administrative expenses are declining, ii) loan loss provisions are shrinking and iii) net interest income is stable or even slightly growing. i) That banks' operating costs are decreasing in absolute, nominal terms is by no means a small achievement for an industry that has long seen strong, often double-digit growth in most size and nominal performance indicators. Expenses in H1 2014 were down by 1.1% yoy, the third consecutive decline in the January-June period. ii) Loan loss provisions have been one of the true curses for banks in recent years, as asset quality significantly suffered during the two recessions triggered by the financial and sovereign debt crises. Here, finally, redemption may be nearing: provisions slumped by more than a quarter (27%) in H1, following a 10% decline a year ago. They are thus back at the 2008 level, though this was already elevated compared to the pre-crisis boom. iii) After three years of gloom during which net interest income shrank by a staggering total of 11%, it now seems to be stabilising. In fact, in the first half of 2014 it was up slightly (by 0.7%) on the prior-year period. This may be linked to banks working hard to defend margins despite the challenging interest rate environment and also due to a slowing decline in the volume of interest-earning assets (mainly loans and bond holdings). Other sources of revenues again delivered weak results: fee and commission income continues to stagnate; indeed, on total fees and commissions of EUR 63 bn, it was a mere EUR 19 m or 0.03% lower in H1 than two years ago. Trading income (-22% yoy) fell to the lowest level since at least 2005 (if one excludes the crisis year 2008) as tighter regulation continues to bite, some banks wind down their fixed-income business and financial market volatility declined to multi-year lows.

With the share of core, more stable revenues from interest income- and fee-generating businesses rising, the optimists will nonetheless say: at least the quality of earnings is clearly getting better.

By contrast, the bears have three other good reasons to feel similarly “encouraged”: i) total revenues continue to shrink, ii) banks are still not getting more efficient and iii) net income was down once more. i) At the end of the day, what counts is total revenues. And these contracted further (-4%), mainly, but not solely caused by the drop in trading income. Since their post-crisis peak in 2010, revenues had already declined steadily, three years in a row, by a total of almost 10%. The ongoing slide will keep up pressure to reduce expenses and look more intensively for new sources of growth. ii) Despite all their cost-cutting measures, so far banks' operating efficiency is not at all improving. In fact, albeit moderately, the cost-income ratio has now risen for four consecutive years, reaching 62% in H1 2014, even leaving aside reported one-off effects. As long as revenues deteriorate quicker than banks are able to adjust the cost base, the scope for improvements in profitability will narrow, especially given that loss provisions have already fallen substantially and the tailwind from a further reduction is likely to become lighter. iii) With the decline in loan loss provisions balancing out the decrease in revenues, and costs broadly flat, banks' operating results more or less stagnated in year-on-year terms. On the bottom line, however, net income shrank again significantly (-25%), which was to a large extent driven by litigation expenditures. H1 profits of just EUR 28.5 bn were the second-lowest since 2009 and, measured against a total equity base of EUR 1,095 bn, well below any reasonable return investors may expect at least in the longer term.



* excl. one-off effects; 2009 excl. KBC, 2012 excl. Crédit Agricole for lack of data

Sources: Company reports, Deutsche Bank Research

Beyond these pure P&L metrics, capital ratios keep on climbing. Fully loaded Basel III figures (now reported by all but one institution) are a strong 11.4% on average, a 1.1 pp improvement vs 12 months ago for those banks that already reported the ratio at that time. Transitional figures have dipped only slightly from 12.4% to 12.3% due to the tighter rules of Basel III (introduced in the EU on January 1, 2014) compared with Basel 2.5.

Finally, banks have become more optimistic about the economic environment, both evidenced by the ECB's bank lending survey and actual lending developments: since December, the shrinkage in outstanding loans to non-financial corporations by all banks in the euro area has slowed from -4.2% to -2.9%. Total assets at the 20 leading European institutions even rose by 3% (not annualised), although they are still down by almost 5% or EUR 1 tr yoy.

Overall, these are still tough times for the European banking sector. Bottom-line results are far from satisfactory and unsustainably low, recent achievements especially with regard to cost discipline notwithstanding. Besides, in a situation where the industry's core operating performance is relatively weak, uncertainty from potential further litigation risks remains a substantial concern. Hence, despite H1 results offering something for everybody, there is still a rocky road ahead for European banks.

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