Helaba

Focus on: Credit
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Major European banks: Heading into 2024 with strong credit risk buffers

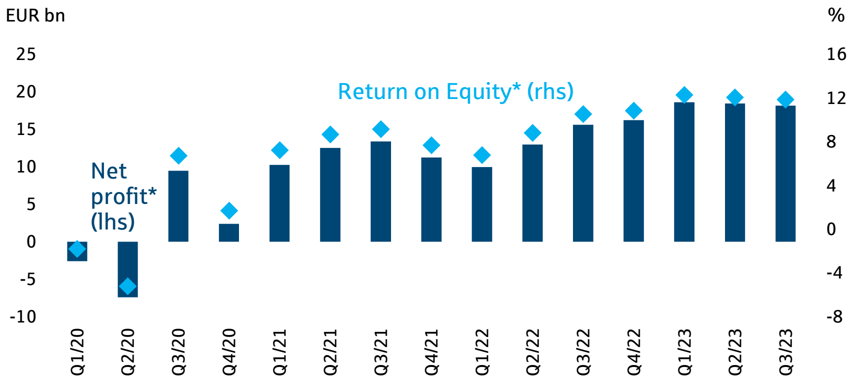
A transformed monetary policy environment has resulted in burgeoning profits in the banking industry since at least the middle of 2022. But the institutions we have been monitoring are increasingly passing on higher margins to their customers, while their new lending business has been under pressure from more restrictive financing conditions. On the positive side, though, the sector enjoys strong risk buffers, which can be largely attributed to loan loss provisions created in the course of the pandemic. Additionally, as a result of regulatory reforms over the last ten years, limits on dividend payouts during the COVID crisis and a steady stream of earnings, capital ratios have been high enough that banks should be able to maintain their dividend payouts and share buyback programmes without any significant hit to credit ratings.

The year in review: A positive interest rate backdrop for the banking sector in 2023

In spite of some intermittent bouts of turmoil, the European banking industry achieved remarkably strong results in 2023. The profits of banks we analysed were lifted by **high net interest earnings and a consistently low level of credit defaults**. The volatility triggered by the bankruptcy of some smaller US banks and Credit Suisse in March was swiftly contained. The fact that the sector rapidly recovered from this turbulence served to underscore its stability following sweeping regulatory reforms that were instituted since the financial market crisis. Ultimately, this has boosted the confidence of market participants in the industry's resilience.

In the first nine months of 2023, aggregated net earnings of the major institutions examined by us were around 23 % above the same period of the previous year. Having recorded sharp growth since the second quarter of 2022, lately there have been signs that this upward trend has been **levelling off**, however. Within the sample we looked at, some individual institutions have even experienced a slight decline in their most recent net results. Société Générale, for example, reported impairment losses on goodwill and deferred tax assets in Q3 2023, while BNP Paribas posted relatively weak earnings in its bond and currency trading business as well as an unexpectedly steep rise in costs. On top of that, most banks had set aside higher provisions for credit losses. In view of healthy capital ratios, we regard the average return on equity of 12 % as extremely robust.

Major European banks have achieved impressive profitability

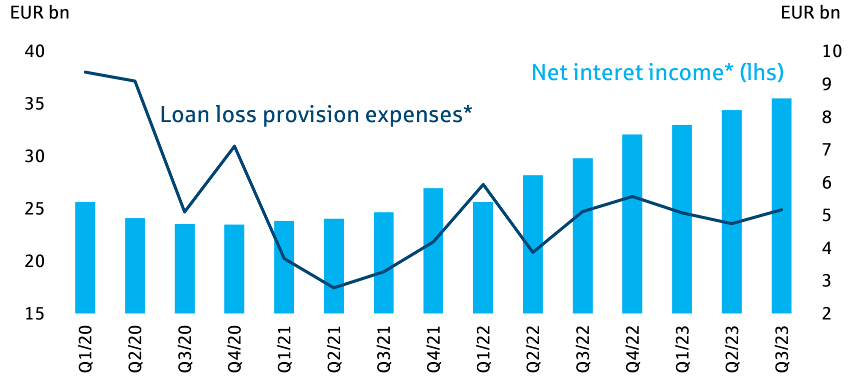


*aggregated figures for a selection of European banks (Banco Santander, BBVA, BNP Paribas, Commerzbank, Deutsche Bank, ING Group, Nordea, Unicredit, SEB, Société Générale, Swedbank)
Sources: Bloomberg, Helaba Research & Advisory

Net interest income set to level off on a very comfortable level

The principal factor driving banks' profits in 2023 was the radical turnaround in the monetary policy environment. In September 2023, the ECB raised interest rates for the tenth time in a row, taking the deposit facility rate to 4.0%. Having endured many years of negative interest rates, the sudden shift to positive rates has created a favourable situation for banks, whose business models can operate normally and in which they are **once again able to generate attractive margins**. There are two main ways for banks to achieve this:

Higher interest rates boost net interest income



*aggregated figures for a selection of European banks (Banco Santander, BBVA, BNP Paribas, Commerzbank, Deutsche Bank, ING Group, Nordea, Unicredit, SEB, Société Générale, Swedbank)

Sources: Bloomberg, Helaba Research & Advisory

- They are able to capitalise on significantly greater scope to adjust margins in their lending and deposit activities within an environment of higher interest rates
- As they generally maintain substantial liquidity reserves, mainly in the form of bonds, banks can benefit from higher fixed-income yields depending on durations and maturities

However, key rates at the ECB appear to have peaked and our economists expect the first cut in the ECB's deposit rate in the third quarter of 2024 to 3.75 % (see also our weekly outlook of 5 January 2024). For the rest of this report, our assumption is that average interest rates in 2024 will remain at the same level as in 2023. Consequently, from our perspective it would be reasonable to expect **interest income to stabilise** in 2024. We believe that the following arguments support this view:

Deposit beta the key driver for interest income

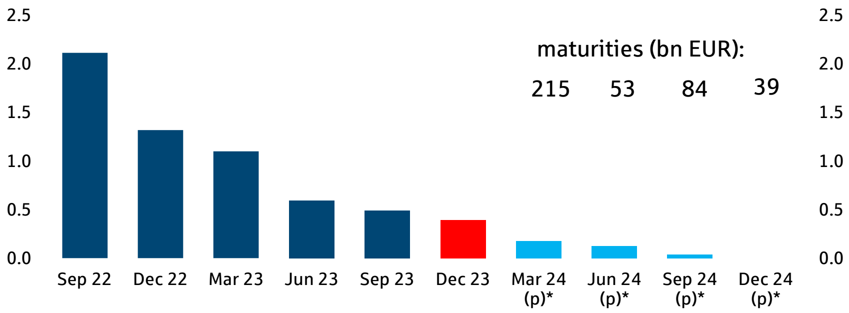
One of the main factors that suggest the rapid growth in banks' interest income will not continue is the fact that institutions are **increasingly passing on a portion of the higher margins to their customers**. In this way, the so-called deposit beta, in other words the proportion of higher interest rates that is passed on to customers, is currently rising. This is true for both business and retail customers.

This ratio at **Commerzbank**, for instance, rose from an average of 10 % at the end of 2022 to 25 % in the third quarter of 2023 for the bank's German business. By the end of the year, the bank expects a further increase to 30 % and the beta could continue its upward trajectory in 2024 towards its previous long-term level of around 40 %. Commerzbank's guidance indicates that a change in the deposit beta of +/- 1 percentage point at an interest rate level of 3 to 4 % would result in a change in net interest income of as much as around EUR 75 to 100 million. This would be offset, however, by the positive impact of reinvesting deposits, volume effects and changes in the product portfolio mix, for example. For this reason, the net effect would be considerably milder.

TLTROs playing increasingly negligible role in net interest income

Importance of TLTRO refinancing continues to decline

TLTRO III holdings in EUR (trillions)



*after deducting maturities
Sources: ECB, Helaba Research & Advisory

During the phase of low and negative interest rates, banks' interest income was further bolstered by the ECB's targeted longer-term refinancing operations. The TLTRO III programme, which was launched in September 2019, totalled EUR 2.2 trillion at its peak in September 2021. During its meeting on 27 October 2022, the ECB's Governing Council resolved to alter the previously highly attractive conditions of the programme. At the same time, institutions that took advantage of the programme were given the opportunity for voluntary early repayment of the funds they had borrowed to the ECB for the first time on 23 November 2022 and thereafter on a **monthly basis**. **By the end of December 2023, the total amount of outstanding borrowed funds had fallen to EUR 0.39 trillion** (see **communication from ECB on TLTRO III voluntary repayments** of 8 December 2023). As a result, the programme's importance has continued to decline. At Commerzbank, for example, additional earnings from the TLTRO programme amounted to EUR 189 million in 2022 but was negligible in 2023.

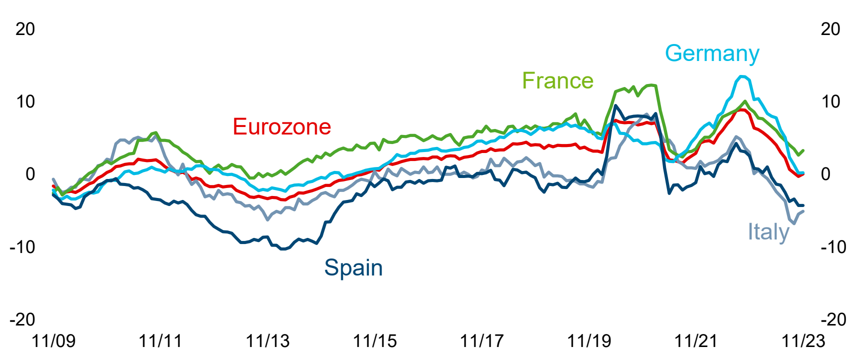
Remuneration of minimum reserved adjusted

From **20 September 2023**, the ECB reduced the **remuneration of the minimum reserve to zero** in a further monetary policy move that had a noticeable impact on earnings. Until October 2022, the interest paid was equal to the rate for the main refinancing operations. It was then reduced to the rate for the deposit facility before being lowered to 0 % (for more information see **ECB**). This means that banks, which had a most recent combined minimum reserve of nearly EUR 170 billion, will forgo around EUR 6.7 billion in annual interest earnings. There is also an ongoing discussion about raising the minimum reserve amount that is currently equivalent to 1 % of specific liabilities; until the middle of January 2012, this share was 2 %. A return to this minimum reserve level would correspond to a doubling in foregone interest income.

New lending business sluggish, potential for further widening of loan margins

According to data from the ECB, **demand for lending** among both retail and corporate customers has **slowed markedly** in recent months amid an economic downturn and a sharp rise in interest rates. Simultaneously, the appetite among banks to expand their credit portfolio has tended to decline. Growth in the outstanding volume of corporate loans fell from a record of +8.9 % in September 2022 to -0.3 % in October 2023 (both year-on-year).

Slump in corporate* lending

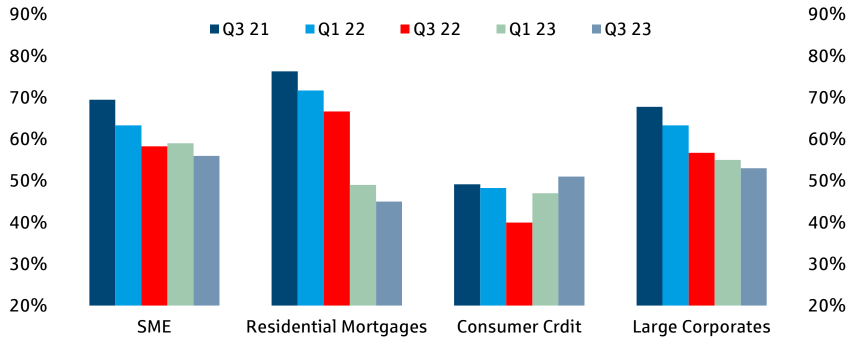


*loans to non-financial entities, adjusted for securitisations
Sources: LSEG, ECB, Helaba Research & Advisory

Results of the **transparency exercise** published by the European Banking Authority (EBA) in December 2023 reveal that fewer banks expect their loan portfolios to grow. The proportion of banks that anticipate an increase in lending volumes - especially corporate loans and retail mortgages - has been consistently declining, as shown by the most recent EBA survey in the autumn of 2023. Consumer credit is the only segment in which institutions expect to see any growth. However, in a recent **study**, the consulting firm EY forecasts that lending activity across all segments will rebound as soon as 2025.

Lack of momentum in new lending business

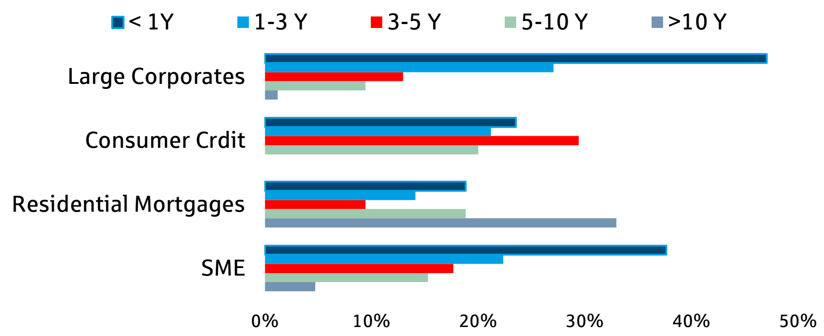
Proportion of banks that expect growth in lending volumes within the next 12 months, in %



Sources: EBA, Helaba Research & Advisory

Gradual adjustment to interest rates on loans

Fixed-interest periods for new loans, share in %



Sources: EBA, Helaba Research & Advisory

Another bright spot is the potential for a further positive adjustment to **loan margins** in the near future. For some portfolios, it takes longer to realise higher margins on new business due to **varying fixed-interest periods**. For instance, around 36 % of banks surveyed by the EBA stated that less than 20 % of their mortgage loans are scheduled for an interest rate adjustment in the next 12 months. In contrast, for other portfolios such as corporate loans, banks reported a comparatively high share of loans for which an interest rate adjustment is imminent within the next 12 months.

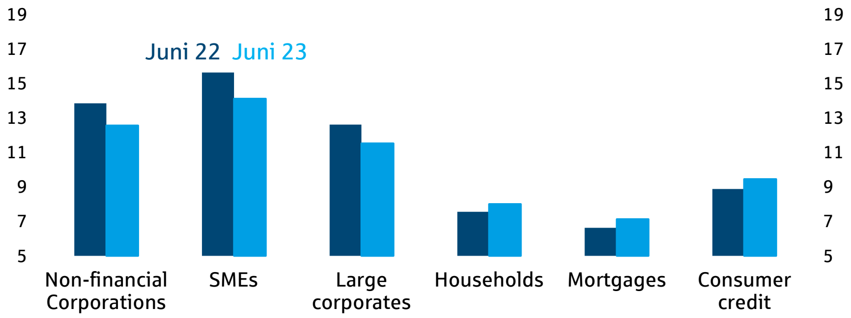
Credit quality: Rise in non-performing loans likely to be easily manageable

Despite the pandemic, the war in Ukraine (and associated rise in energy costs), higher interest rates and lacklustre economic activity, banks' **non-performing loan (NPL) ratios have remained at a low level for many years**. To a certain extent, this has been due to low unemployment and insolvency rates. Even 2023 did not see any notable rise in NPL ratios. According to the EBA, the proportion of non-performing loans as a share of European banks' total credit exposure has held steady at 1.8 % since June 2022 - a figure substantially below the previous peak of 6.5 % in December 2014.

In our view, it is likely that NPL ratios will rise from their current low level; at the same time, we assume that **they will remain modest and that banks will not have any difficulties managing them**. For example, our economists have forecast a 1.3 % rise in euro area GDP in 2024 (see our **weekly outlook** of 5 January 2024). Meanwhile, the EBA has pointed out the fact that lending standards have been relatively restrictive in recent years. Furthermore, most of the banks we monitor enjoy comfortable credit risk buffers, having set aside additional loan loss provisions during the COVID crisis that they have not yet reversed or reallocated due to the weaker economic environment.

Credit quality remains stable

Share of Stage 2* loans by segment, in %



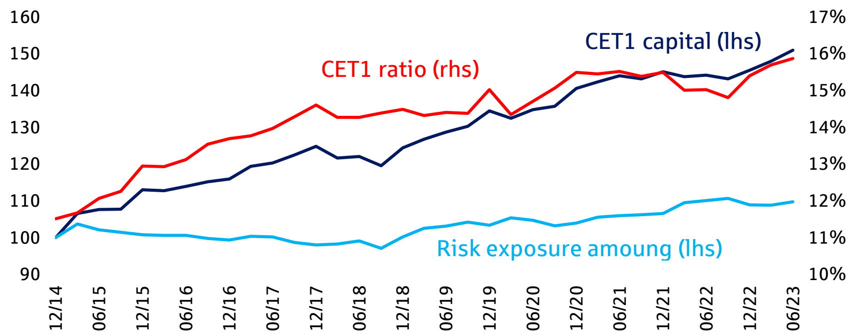
*loans with a significantly higher risk of default
Sources: EBA, Helaba Research & Advisory

Since the financial market crisis, the sector has undergone a fundamental restructuring process in the course of which certain higher-risk and non-core activities have been pared back and problematic exposures reduced. In addition, regulatory reforms introduced following the 2008/9 financial crisis, including stress testing and periodic reviews of banks' risk-bearing capacity by macroprudential authorities, have made a significant contribution to **the strong resilience of the sector**. For instance, the EBA published the results of the EU-wide **2023 transparency exercise** in December last year, in which 123 banks from 26 countries in the European Union participated and more than one million data points were scrutinised. The regulator used this opportunity to emphasise the important role this exercise played in helping to monitor risks and vulnerabilities and strengthen market discipline.

High capital ratios

Most recent CET1 ratios of European banks on a high level

Dec 14 = 100

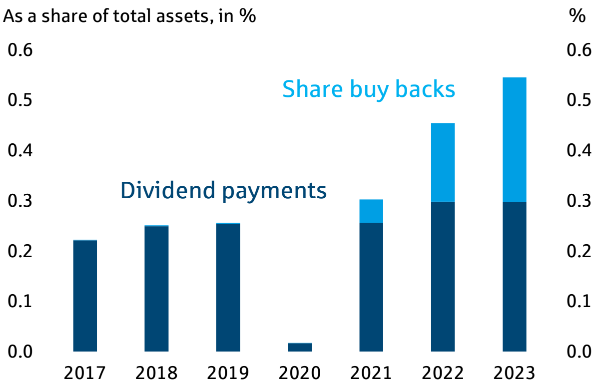


Sources: EBA, Helaba Research & Advisory

A **consistent trend towards higher capital ratios**, which provide a crucial buffer against losses for most banks, is another sign of the banking sector's strong risk-bearing capacity. European banks' most recent common equity tier one (CET1) ratio averaged an all-time high of around 16 %. The main factors behind this have been higher profits which, despite dividend payouts and share buyback programmes, helped push up this figure. Payout freezes during the pandemic as well as regulatory reforms after the financial crisis also played a key role in this regard. Today, the CET1 ratio across the banking industry is roughly twice as high as it was before the financial crisis while the credit quality, as explained above, has improved.

Scope for further dividend payouts

As a share of total assets, in %



Sources: ECB, Helaba Research & Advisory

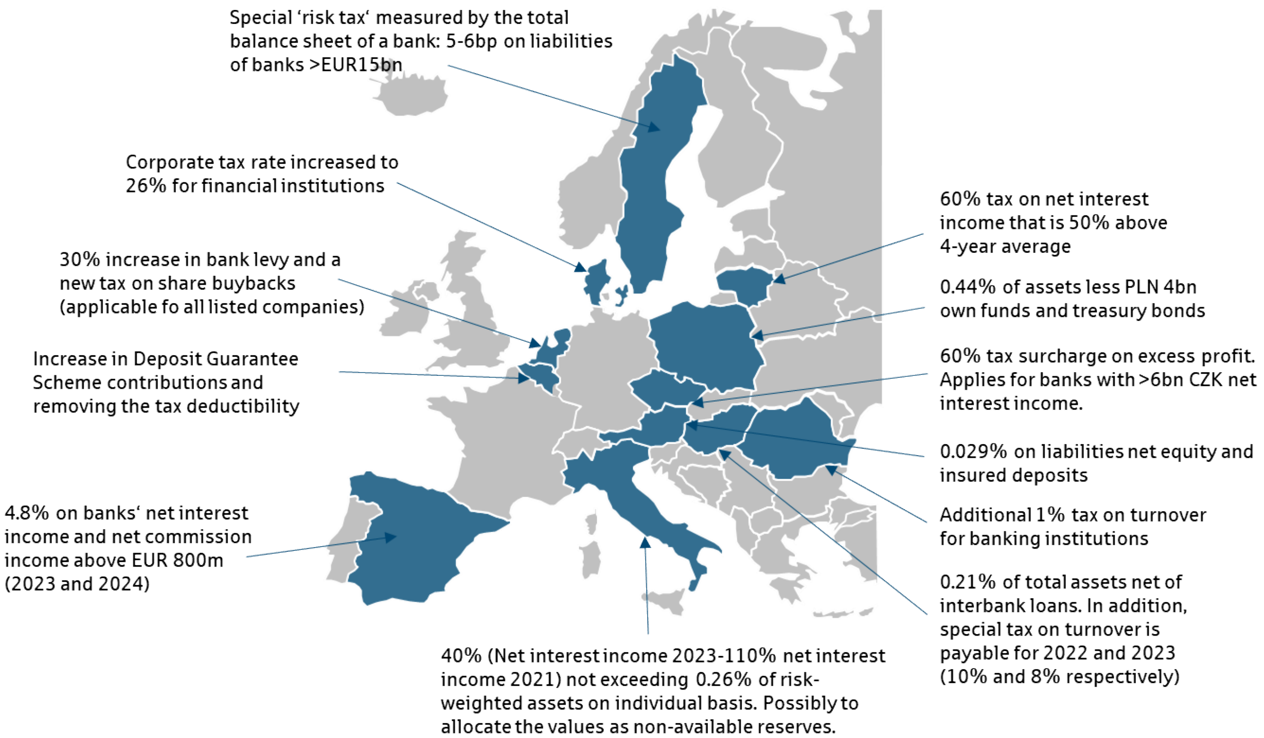
Based on calculations by Bloomberg, the ten largest European banks that have disclosed the level of regulatory capital they will have to set aside next year currently have surplus capital of more than EUR 140 billion. According to this analysis, this figure amounted to EUR 147 billion despite banks having since paid out higher dividends to their shareholders. In view of their earnings performance and capitalisation, it is reasonable to assume that those banks we monitor will **maintain their dividend policy**.

Excursus: Many European countries imposing windfall taxes on banks

A number of European governments are using the rising profits of banks as a justification to impose **new bank taxes**. According to **S&P Global**, these new taxes may remain in place for longer than originally planned. So far, Spain and Italy are the two largest European economies to introduce windfall taxes on banks, with other countries, particularly in Central and Eastern Europe, following suit. However, the reaction of rating agencies appears to suggest that these taxes will only have a minor adverse impact on the sector's credit ratings.

Imposition of bank taxes an increasingly common practice in the EU

Bank tax and levy activities in selected countries



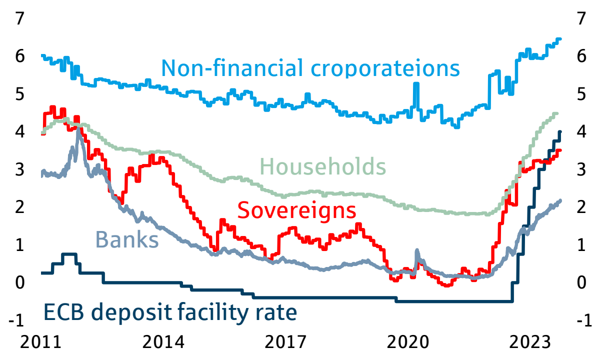
Sources: EBA, Helaba Research & Advisory

Keeping an eye on lurking risks

Our assessment therefore suggests that the overall situation is quite favourable for the banking industry. But potential risks still remain.

Growth in refinancing costs

Financing costs by sector, in %



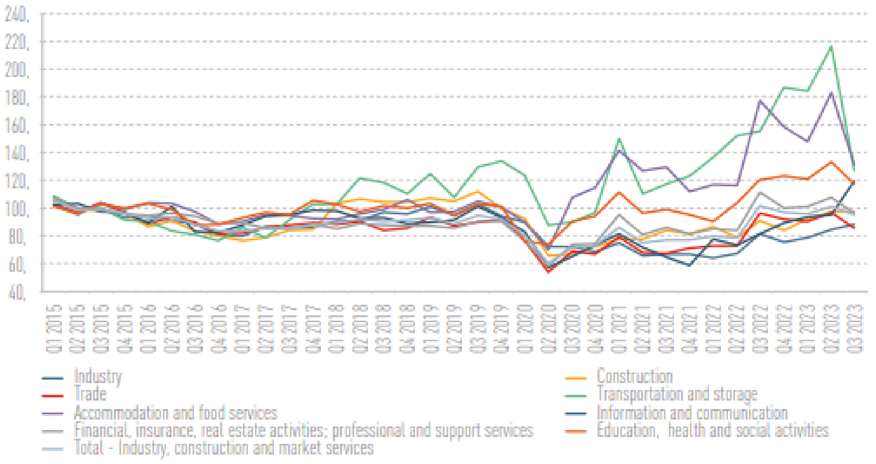
Sources: ECB, Helaba Research & Advisory

- Interest rate hikes have pushed up **funding costs for banks** - the flipside to higher margins on lending. Overall, though, experience has shown that the scope for wider margins in the current interest rate environment is greater than in a low-interest environment.

- **Key customer segments are facing spiralling financing costs**. In its **Financial Stability Review** published in November 2023, the ECB's banking supervisors pointed out that, as the duration lengthened in the financial system and the real economy during the low interest rate era, a major part of the impact of monetary tightening is yet to materialise. Geopolitical tensions in Ukraine and the Middle East, which could lead to higher energy prices, are amplifying the challenging economic environment. According to the Financial Stability Review, corporate profitability in the euro area has generally held up well, despite a modest rise in the debt service ratio, while higher refinancing costs could result in more bankruptcies. Having remained at historically low levels in recent years, an increase in NPL ratios within manageable limits would effectively represent a return to normal.

Risks remain under control

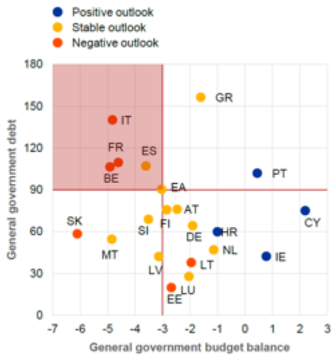
Insolvency filings by sector - 2015 = 100



Sources: EBA, Eurostat, Helaba Research & Advisory

- Given the increase in interest rates, the spotlight is returning to **public finances in some European countries with high debt-to-GDP ratios**. According to the EBA, the total exposure of European banks to sovereigns is on average more than twice as high as their capital (210 % of CET1 capital in June 2023). In many cases, there are considerable variations both at country level as well as between individual institutions. For instance, the EBA's analysis provides evidence that the exposure of banks to sovereign debt in Central and Eastern Europe as well as southern Europe is generally higher than in other regions.

Divergence in debt-to-GDP levels
General government debt, budget balance and rating outlooks*
% of GDP



*in the euro area
Sources: ECB, Helaba Research & Advisory

- In their Financial Stability Review, the ECB's supervisors further noted that **markets and non-banks remain highly vulnerable to adverse geopolitical surprises**. Growing vulnerabilities in the real economy can be expected to gradually impair banks' asset quality and this, together with lower lending volumes and rising funding costs, may challenge their profitability outlook. Geopolitical uncertainty remains high, with elections looming in some of the world's largest economies, including the United States, Russia and South Africa. Parliamentary elections are also being held in the European Union (**S&P Global Market Intelligence**).

- The EBA reported that European banks were holding EUR 3.45 trillion in **debt securities** at last count, of which more than 50 % were valued at amortised cost. However, Angel Monzon, Head of Risk Analysis and Stress Testing at the EBA, stated in an interview with Börsen-Zeitung in December 2023 that "There are signs that unrealized losses from banks' bond holdings remain limited".

- The current environment of elevated inflation and costs remains challenging. In this respect, restructuring and cost-cutting measures instigated in the recent past are paying off; but the issue of **reducing costs remains on banks' to-do lists**. In addition, the digitalisation of the sector is making good progress.

- Moreover, cyber risks are becoming an increasingly urgent issue. Although banks can draw on a high degree of expertise in IT security thanks to their IT-driven business models, they are not immune to cyber attacks. The ECB banking supervision is set to publish the results of its **cyber resilience stress test** in the course of 2024.

Key takeaway: Banking industry is well equipped to face upcoming challenges

Our assessment indicates that holders of bank bonds are well protected against default risks. This applies both to non-preferred bonds and, to an even greater extent, to preferred issues. While the sector faces challenges in 2024, with credit risk costs in particular likely to rise again after many years in decline amid an environment of higher interest rates, steps banks have taken to increase their risk buffers in terms of higher loan loss provisions and capital headroom as well as reforms implemented in the wake of the financial market crisis have rendered the sector resilient to potential stress.

Finally, efforts to promote sustainability continue to gather pace, with the integration of climate-related targets into banks' strategies, governance policies and disclosures making encouraging progress. At the same time, regulatory frameworks are becoming more clearly defined. The turn of the year marked a number of important milestones to further increase transparency, such as the publication of the green asset ratio. This will be followed by a gradual series of measures to align the industry with additional UN sustainability targets. One challenge that remains is collecting data and quantifying the risks associated with climate change (see our publication "**European banks: The sharpening contours of ESG disclosure**" of 30 November 2023).

Recent publications from Research & Advisory

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