Helaba

Focus on: Credits
16 November 2022

European banks: Q3 results instil confidence

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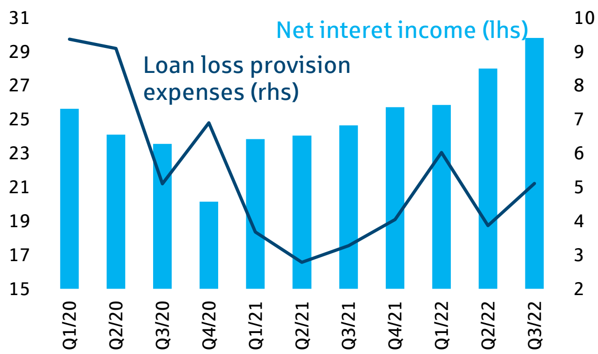
The third quarter of 2022 once again saw major European banks report strong earnings. This was primarily thanks to a further improvement in net interest income, while the widely held perception that cyclical risks are on the increase is not yet reflected in their lending portfolios. Given the difficult environment marked by crisis, however, anxiety is growing and we believe that it would be wise for financial institutions to take advantage of their very strong starting point in terms of both, capital and liquidity positions.

Net interest income sees further growth in Q3 2022

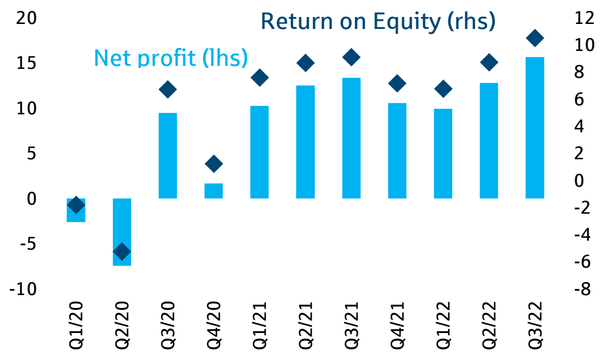
Earnings of major European banks in Q3 2022 once again showed that they achieved very stable credit quality metrics, with many institutions exceeding consensus forecasts that were already high. In some cases, profits even reached record levels. This outperformance was driven, among other things, by an undiminished trend towards sharply rising net interest income in a dramatically shifting interest rate environment (see also our publication "**European banks: Net interest income rises sharply in Q2 2022**" of 16 August 2022). However, despite continued low levels of non-performing loans (NPLs), banks set aside larger provisions for credit losses, reflecting a gloomier macroeconomic outlook[1]. In addition, inflation led to a significant rise in banks' cost base. On balance, though, costs were more than offset by higher earnings.

Unexpectedly steep rise in interest income



*selection of European banks (Banco Santander, BBVA, Commerzbank, Deutsche Bank, ING Group, Nordea, Unicredit, SEB, Swedbank)
Sources: Bloomberg, Helaba Research & Advisory

Most recent profits still at record levels



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Sources: Bloomberg, Helaba Research & Advisory

[1] Under the current accounting standard IFRS 9, for performing financial instruments whose risk of default has increased significantly since they were first reported in the balance sheet (Stage 2), expected losses over their entire remaining term must be recognised (Expected Credit Loss). This means that the impairment is recognised immediately - not when a default has already occurred and the loans are non-performing, as was the case under previous accounting standards (Incurred Credit Loss, which applied until 31 December 2018).

Banks among beneficiaries of rising interest rates

As a rule, banks are among the winners of rising interest rates in terms of earnings. This favourable trend is largely due to the fact that they are able to invest customer deposits and liquidity portfolios at more attractive returns. At the same time, lower values of assets in their balance sheets are offset by reduced valuations of liabilities, depending on the extent to which maturities are matched and interest rates are hedged.

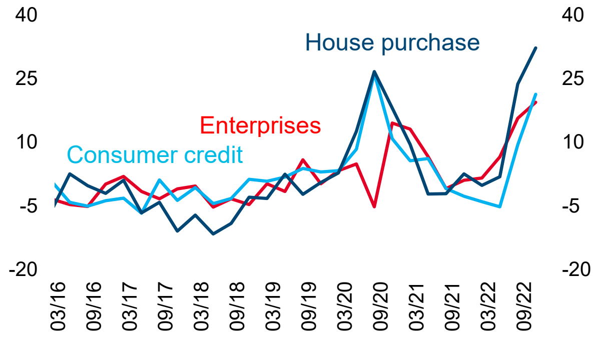
However, factors that have an adverse impact on earnings include (1) the absence of fee income from the pricing of customer deposits (negative interest rates) and (2) the absence of interest income from the ECB's targeted longer-term refinancing operations (TLTRO III, see also our publication "**SSA & Financials - Weekly Market Update**" of 27 October 2022, page 4). Net interest income from banks' core activities, which is driven by rising interest rates, significantly outweighs the latter factors that arose during the negative interest rate environment and COVID-19, as reflected in the sector's most recent quarterly reporting. Given the overall outlook for interest rates, this trend is likely to continue.

One example is Commerzbank, which aims to raise its net interest income of around EUR 4.9 billion in the 2021 financial year to over EUR 6 billion in 2022. Based on the EUR 4.5 billion it has already generated in the first nine months of 2022, we believe this figure would seem a realistic prospect. Thanks to its substantial volume of deposits from corporate and retail customers, amounting to a combined EUR 250 billion, the bank is a major beneficiary of interest rate hikes. As a result, in 2022 it expects to generate approx. EUR 450 million in additional net interest income from this business. According to the bank, this extra income is projected to rise to as much as EUR 750 million in 2023 and EUR 950 million in 2024.

It is important to note that, as part of its planning process, Commerzbank had to make assumptions about the extent to which it would be able to pass on the interest rate increases to its customers. In addition, it has not factored in any impact on customer loans and margins. Demand for mortgage lending is already slowing down noticeably, which is fuelling competition on margins. This is contrasted by a sharp rise in lending to corporates, who are ramping up their working capital and drawing down liquidity facilities amid a business environment beset by crisis. On top of that, Commerzbank booked a TLTRO benefit of around EUR 260 million and deposit fees of approx. EUR 250 million in 2021 - both of which will no longer apply in future. Furthermore, net interest income at its Polish subsidiary mBank has already risen strongly and, based on statements by its management, may recede over the next few years.

Banks tighten lending standards

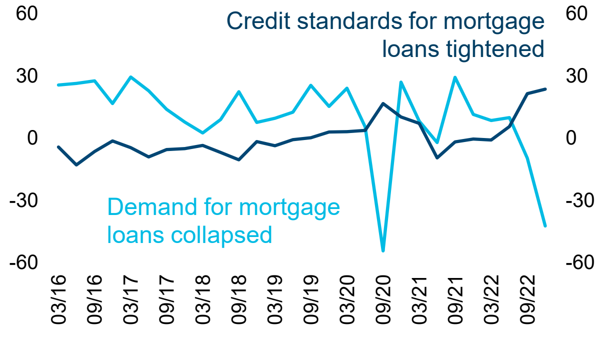
ECB Bank Lending Survey: Lending standards in %*



*positive values show tightening, negative values show easing
Sources: Refinitiv, ECB, Helaba Research & Advisory

Demand for mortgage lending plummets

ECB Bank Lending Survey: Lending standards in %*



Sources: Refinitiv, ECB, Helaba Research & Advisory

The interest rate sensitivity of net interest income to a simultaneous shift in the yield curve of 100 bps typically amounts to around 8 to 10 % for the banks we have analysed (excluding additional effects, especially impacts on volumes and margins).

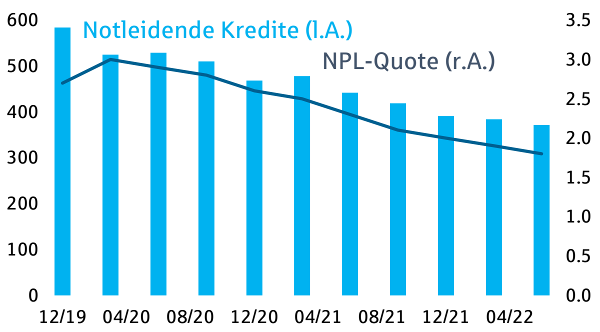
However, indications already pointing to rise in credit defaults in 2023

This positive forecast for net interest income contrasts with a foreseeable increase in credit defaults due to the higher level of interest rates. Additionally, a variety of adverse factors related to the crisis, especially high energy costs, are putting pressure on borrowers. Our own analysis shows that the German banking industry is relatively resilient as the volume of customer deposits is high compared to other countries and fixed interest loans with fairly long tenors are the norm for financing new construction. On the downside, energy-intensive businesses are reeling from the high cost of energy. This primarily affects small and medium-sized enterprises if they only have one or two manufacturing sites. The outlook for the credit quality of large, well-diversified corporate clients and those with scope to pass on price increases to their customers is expected to be more stable in comparison.

Up to now, the volume of non-performing loans (i.e., those for which payment defaults have already occurred) have remained stable on a low level. However, the proportion of loans for which the first signs of problems are already emerging (without having actually defaulted, so-called Stage 2 exposures[2]) has risen. Many banks are preparing for an increase in credit defaults in 2023 at the latest. While they have been able to reverse part of the additional provisions for credit risks allocated during the COVID-19 crisis, some of them have reclassified the respective items as reserves due to elevated recessionary risks. Therefore, based on the current volume of non-performing loans, banks still have an additional cushion of reserves for credit losses (a so-called management overlay)[3].

Historically low level of non-performing loans

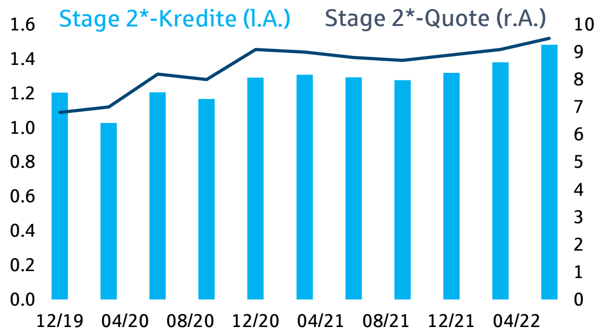
EUR (billions)* %



*EU banks
Sources: EBA Risk Dashboard, Helaba Research & Advisory

Loans with higher risk of default

Stage 2 exposures, in EUR (trillions) %



*EU banks
Sources: EBA Risk Dashboard, Helaba Research & Advisory

Key takeaway: Banks well positioned in a crisis-hit environment

Overall, based on the publication of financial institutions' Q3 results, we feel confirmed in our assessment that European banks are likely to post relatively strong earnings for 2022 as a whole for the second year running. Higher interest rates will remain a significant driver for net interest income and should more than compensate for the gradual loss of additional earnings from the ECB's longer-term refinancing programme (TLTRO III).

However, given the present combination of recessionary risks and inflation concerns, we expect rising credit defaults in 2023 due to a weaker operating environment. Overall, the latter should however remain comfortably manageable as banks have recourse to ample risk buffers in the form of both equity and loan loss provisions. Moreover, having eliminated problematic business and improved their risk management systems, they are in a considerably more resilient position than they were before the financial crisis.

[2] for a definition of Stage 2 exposures, see also footnote 1
[3] also known as a top-level adjustment

Nevertheless, uncertainty - and by implication, volatility - remains high on the markets and it is impossible to predict how the energy crisis will evolve over the winter months. Institutions would therefore well advised not to squander the strong equity and liquidity positions they find themselves in, such as by embarking on large-scale share buyback programmes. The precarious overall state of affairs is also reflected in substantial issuance volumes on the primary market as demand for high funding reserves increases in times of uncertainty (see our regular publication "**SSA & Financials - Weekly Market Update**", most recently of 10 November 2022).

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