Q1 earnings support positive story for large European banks

First-quarter earnings for Europe's major banks may have been mixed in some areas based on year-on-year progressions, but the overall performance was decent if not stellar and core underlying returns held up reasonably well.

Excluding downside outliers, first-quarter returns on tangible equity were clustered around the high single-digit to low double-digit mark: from 8.4% for HSBC, 9.1% for Credit Suisse and 9.3% for RBS, to 10.4% at UniCredit, 11% at Barclays (excl. DoJ RMBS settlement and PPI); 11.9% at BNP Paribas, 12.4% at Santander and 13.6% for UBS.

The much-feared impact of the switch to IFRS 9 had a modest impact on capital ratios but brought real longer-term benefits for the transparency and accuracy of risk provisioning.

The overall earnings picture supports the positive European banking story. Most European banks hit or beat analysts' expectations for Q1 earnings. Where there were misses, the reasons were idiosyncratic rather than sector-wide – issues with cost discipline, exchange-rate effects, impact of business investments, non-recurring items, or in some cases coming off very strong first quarter in 2017. A lacklustre quarter in European fixed-income trading affected institutions with sizable trading operations.

In general, market observers are starting to buy the idea that the European banking sector is in a sweet spot, even while many of the region's major banks work through various stages of restructuring and/or business optimisation. Once those programmes reach their end-points and assuming broadly successful execution against a more conducive forward interest-rate and macro backdrop, a reasonable assumption is that the picture will improve further, barring unforeseen circumstances.

"Business volumes are gradually picking up as banks cautiously ramp up lending, leading to higher volume-driven revenues. And even though net interest margins remain slim owing to European monetary policy effects, investors have some comfort around greater predictability of earnings and their risk components," says Sam Theodore, team leader for bank ratings at Scope Ratings.

"Having done a lot of the heavy lifting around balance-sheet clean-up over the post-crisis years, European banks are, more than ever during the last decade, focused on repositioning for future growth. Beyond the revenue story, the European banking sector's prudential metrics are in aggregate much more reassuring for investors in terms of capital strength, liquidity and balanced funding."

Today's banking culture is more conservative and risk-averse than it was a few years ago, and Scope notes a relative convergence of balance-sheet fundamentals, and to a lesser extent business models as well. With few exceptions, banks are now focusing on low-risk lending and financial services. "If you were to take names off balance sheets, you might have trouble identifying which bank it is. That's not necessarily a bad thing since convergence has taken place in the right areas. There are still outliers, but they're not the main story," adds Theodore.

'Hunter' CEOs – those with a trading or investment banking background and a penchant for outsized risk-taking – have largely being supplanted by 'farmer' CEOs focusing on stable growth and avoiding excessive risk. As well as bringing this approach to business-as-usual, European banks will be more cautious about engaging in transformational transactions, be they large-scale mergers or acquisitions. That stance is unlikely to change in the foreseeable future.

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This is largely the result of their updated business strategies and more conservative demeanour, but it is partially also due to memories of the global financial crisis when banks were severely tested under adverse market conditions and forced to deal with local regulators from a very feeble position. That has bred a reluctance to embark on large-scale foreign adventures that regulators may frown upon.

Banks have undergone business simplification and are now clustered around a smaller set of core products for core clients for whom they can create value. They have also built slimmer geographical profiles ranged closer to home.

"Better financial fundamentals on the back of improving macro conditions, the positive effects of the stronger regulatory framework in terms of capital and liquidity, and more predictability around the behaviour of the banking industry are all positives for investors," Theodore says.

Europe v US

Much has been made of the comparison between European and US bank earnings. Taking investment banking (IB) and trading as a comparative proxy since it's easier to conduct a clean read-across, US institutions generate significantly higher revenues. So far so unsurprising. But it is important to make relevant comparisons.

First, US policy makers initiated the bank balance-sheet clean-up process and got their regulatory framework in place much earlier than was the case in Europe. Since the crisis, the US has enjoyed more robust economic growth and also benefits from deep capital markets.

Because of these factors, the US garnered 41.5% of global IB fees in Q1 2018 (equivalent to USD 9.8bn) against just 24% for Europe (USD 5.7bn), according to Thomson Reuters. The data cover advisory, debt and equity underwriting and syndicated lending.

The large US banks' heavy exposure to their domestic market (approximately 90% of net revenues for Bank of America; 72% for Morgan Stanley; 59% for Goldman Sachs; JP Morgan Chase and Citigroup presenting a more balanced geo-profile at approximately 50%) creates significant recurring revenue opportunities.

Most European banks with large wholesale operations, having historically struggled to sustainably maintain strong US market share, have scaled back their IB (notably US IB) ambitions as they rewire their strategies. US banks, meanwhile, continue to use their powerful domestic market share to leverage their positions in key international markets, including Europe.

That being the case, it is hardly surprising that Q1 earnings for IB and trading reflected a differential between US and European banks at least equal to the distribution of fee wallet but significantly more in equity and fixed-income trading and in advisory – where according to Thomson Reuters, the value of completed US M&A deals in Q1 was twice that of Europe.

To the extent that some European banks are re-appraising their commitment to IB and trading, the expectation would be that US/European earnings data will show continued divergence.

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