Are banks' profits here to stay?

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Banks' profits soar to record highs as they reap the benefits of elevated monetary policy rates while keeping deposit rates low. This has raised many eyebrows in the context of the cost-of-living crisis. Still, bank profitability increases banks' resilience and thus their ability to provide credit in hard times.

But analysts and policy makers speculate about the sustainability of such large profits as some households and firms face heavier debt burdens. If past bank behaviour is any indicator, there is still room for further profit growth - but a wary eye is needed for the impact on borrowers' repayment capacity.

Banks benefit from unprecedented rate hikes

In July 2022, the European Central Bank (ECB) hiked official monetary policy rates for the first time since 2011. The current hiking cycle, in addition to atypically starting with an interest rate in the negative area, is unprecedented in terms of speed and magnitude. The ECB raised one of its main rates, the deposit facility rate, by 450 basis points in 16 months to a historical high of 4% in October 2023 from -0.5% (see Figure 1). [1] Compared to the previous tightening cycle over the same number of months (November 2005 - July 2008), the rate on the deposit facility increased by only 175 basis points to 2.75% from 1%.

Figure 1: Comparing ECB's deposit facility rate across tightening cycles

(in %)

Sources: ECB, ESM calculations

Banks have drawn extensive public scrutiny in most euro area countries for swiftly increasing the cost of their loans while keeping the remuneration of deposits low in response to the rate hikes. But this is indeed the reason for the current profit boom: the annualised return on equity for euro area banks in June 2023 is close to 10%, compared to an average of 4% during the previous decade. This boost in profits has been perceived as unfair by many, leading to public outcry and the imposition of windfall taxes in some countries.

Still, the story is more nuanced and varies by jurisdiction.

To better understand the actions taken by banks in the new interest rate environment, it is useful to look at the degree to which banks pass on changes in the ECB official rate to their customers - called the 'passthrough'. Deposit and lending 'betas' are estimates that measure the portion of this change in the monetary policy rate passed to depositors and borrowers, respectively.

For example, a 50% deposit beta means that following an increase of 100 basis points in the deposit facility rate, banks would increase the rate offered to their depositors by 50 basis points. [2] By measuring and comparing betas across different rate hike cycles and countries, we can learn the passthroughs to the deposit and lending rates and if bank behaviour differs from the past.

Deposit betas: lower and slower

Betas on current deposit accounts reveal that banks' passthrough to depositors is now slower and lower than in the previous hiking cycle for households and corporates in the largest euro area economies (see Figure 2a to 2d). [3], [4]

Differently from other types of deposits, deposit rates on household current accounts have yet to show any visible increase. Banks in all four of the largest countries are slower than in the past in passing the rate hike, with betas that have remained virtually flat until now. In Germany and Italy, banks have shown some increase in interest rates on current accounts, though still less than half than the previous cycle.

For corporates, the overnight deposit rates show an overall increasing trend, but a large gap compared to the previous cycle generally persists. Betas in the previous cycle were around 50%. Now, after the same number of months from the first ECB hike, they are between 10% and 20%, depending on the country. France is an exception, as banks are already behaving in line with the prior pattern.

What's the reason for these differences across cycles?

First, banks face reduced incentives to offer higher yields to retain depositors. Current financial conditions are significantly different than in 2005, allowing banks to still enjoy abundant liquidity without, as yet, being confronted with meaningful deposit outflows.

Second, a limited passthrough can help contain their costs as banks face the phasing out of the ECB's quantitative easing coupled with rapidly rising wholesale funding costs.

Third, after a decade of ultra-low and negative yields, banks are keen to reap the benefits of high official rates for as long as possible to boost their capital positions, create buffers to be used for a possible asset quality deterioration in the near future, and remunerate their shareholders after more than a decade of very limited dividend distribution.

Figure 2a-d: Cumulative deposit betas over tightening cycles

a. Germany (in %)

▯

b. France (in %)

▯

c. Italy (in %)

▯

d. Spain (in %)

▯

Sources: ECB, ESM calculations

Lending betas: quicker to take on profits

For lending rate passthrough, we observe that the interest cost has behaved more in line with the previous cycle for new corporate loans, albeit still somewhat lower. For households, the picture is more blurred.

The passthrough to corporates is quite similar in the two cycles, with betas after 16 months from the first ECB hike at around 75% in all four countries in the current cycle compared to an average of 85% in the previous one (Figure 3). Italy is the only exception with higher betas today.

In the current cycle, banks in the four largest euro area countries pass around 50% of the official increase to mortgages. While this behaviour was also observed in Germany and France previously, Italian, and Spanish banks' passthrough reached 100% in less than six months in the previous cycle (see Figure 3a to 3d).

These differences across cycles and countries are because the outstanding portfolio of loans reprices almost automatically following an interest rate hike for countries with high shares of variable rate loans, such as Italy and Spain, thus limiting banks' need to pass further increases to new customers. Additionally, higher mortgage rate expectations might have heightened concerns about dampening loan demand, resulting in a more contained passthrough.

Figure 3a-d: Cumulative lending betas over tightening cycles

a. Germany (in %)

b. France (in %)

c. Italy (in %)

d. Spain (in %)

Sources: ECB, ESM calculations

Profitability outlook and considerations for financial stability

If previous patterns are indicative of banks' behaviour, it appears that room remains for further profit growth, especially in Italy and Spain where current lending betas for households are half of those recorded in 2005-2008. Profitability has also thus far been supported by resilient asset quality and the resulting muted need for new loan provisions. As the increasingly cloudy economic outlook looms, high profits will allow banks to build up additional capital buffers, increasing their resilience and ensuring the provision of credit to the real economy during a downturn.

However, if the bank profitability peak has not yet been reached, it raises concerns about a possible reversal of the trend should asset quality deterioration materialise due to the higher interest burden faced by borrowers.

Figure 4a-d: Lending rates on outstanding loans

a. Germany (in %)

b. France (in %)

c. Italy (in %)

d. Spain (in %)

Sources: ECB, ESM calculations

As shown in Figure 4 (a-d), banks tended in the past to maintain a broadly stable spread between their rates on outstanding loans to households and corporates and the ECB's deposit facility rate of about two percentage points. Currently, the spread is nearly zero or, in the case of France and Germany, negative. This suggests that banks could continue to increase their lending rates to restore this gap, as they have done in the past. Still, the question remains: will borrowers be able to shoulder even higher lending rates? If not, the bank profit boom of today might dissipate should asset quality deteriorate. Therefore, any interventions should be made with scrutiny to the impact on financial stability.

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Footnotes

[1] The deposit facility rate is the interest rate banks receive for depositing money with the central bank overnight.

[2] Betas are calculated as the cumulative change in deposit and lending rates relative to the cumulative change in the ECB official rate.

[3] The largest economies taken into consideration for this blog post are Germany, France, Italy, and Spain.

[4] Betas on term deposits for both households and corporates (i.e. deposits locked in with the banks for an agreed period) are currently much higher. Customers partly move their money from current to higher-yielding term deposits, but they still account for a much smaller fraction of the overall deposit base.

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