Profitability

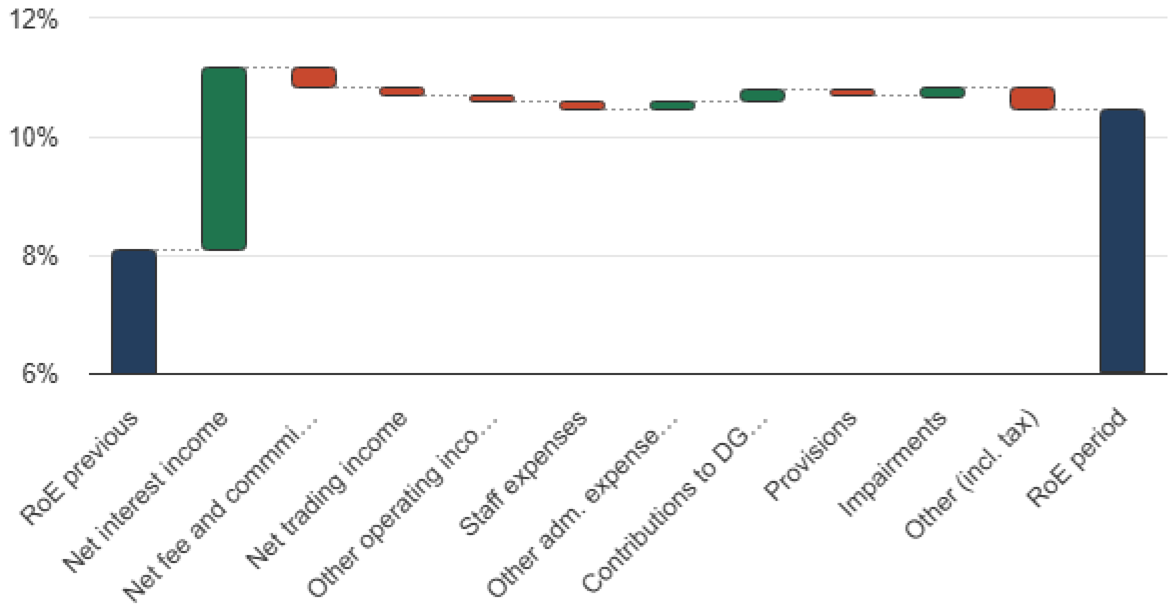
Key drivers and developments in EU/EEA banks' profitability

EU/EEA banks' net profits increased by around 32% YoY in 2023, driven by a large YoY rise of NII. The NII increase, which was particularly significant in the first half of the year, was mainly supported by a widening NIM rather than loan growth. On average EU/EEA banks were able to take advantage of the rising interest rate environment and expand their margins, as the repricing of the asset side was faster than the repricing of the liability side. However, following a stabilisation of the NII in mid-2023, some profitability indicators have begun to show the first signs of decline, albeit from extraordinarily high levels, indicating that banks' profitability may have already peaked. As rates have presumably reached their plateau, it is plausible to expect that going forward the interest rate environment will negatively affect the interest income and overall profitability of banks (on rate expectations see Chapter 1).

An NII-driven profitability boost

The return on equity (RoE) of EU/EEA banks grew substantially from 8.1% in December 2022 to 10.4% in December 2023. This increase was almost entirely driven by higher NII, whose positive contribution to the RoE rose by 308 bps compared to the previous year. Conversely, net fee and commission income (NFCI) and, to a lesser extent, net trading income (NTI) made negative contributions (34 bps and 12 bps respectively). Despite the inflationary pressures on wages in the economy, banks managed to limit the increase in their staff expenses (negative contribution of 14 bps), while also reducing other administrative expenses (positive contribution of 14 bps). Although provisioning-related costs adversely affected profitability (negative contribution of 12 bps), lower impairment charges entirely compensated for this increase (positive contribution of 16 bps) (Figure 40).

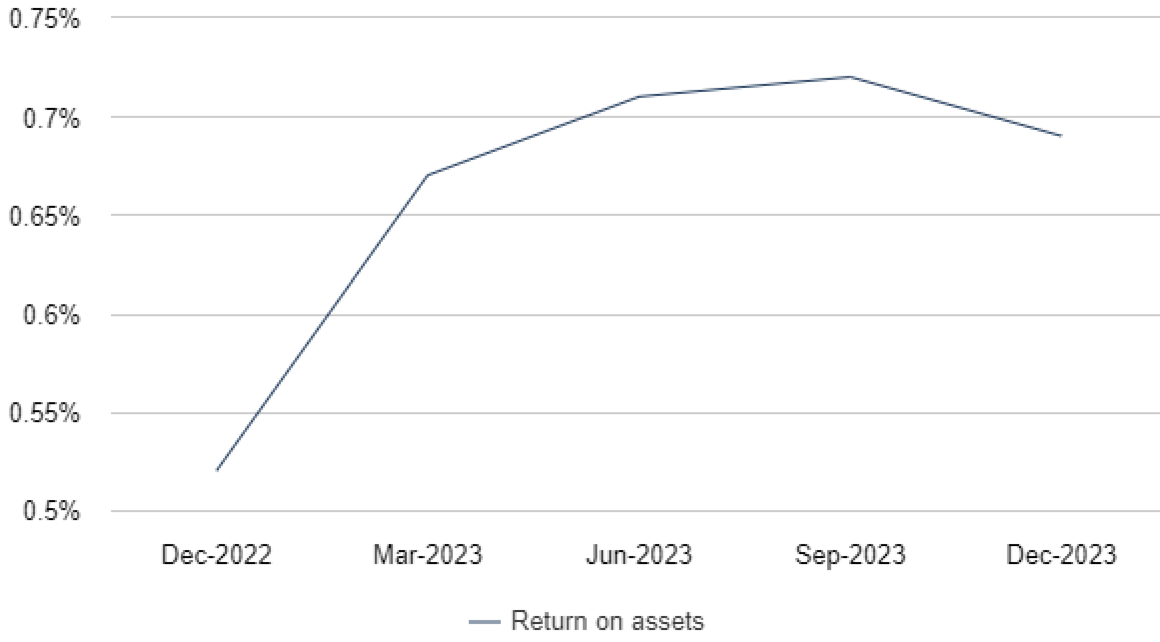
Figure 40: RoE and contribution of the main P&L items to the RoE, comparison between December 2022 and December 2023



Source: EBA supervisory reporting data

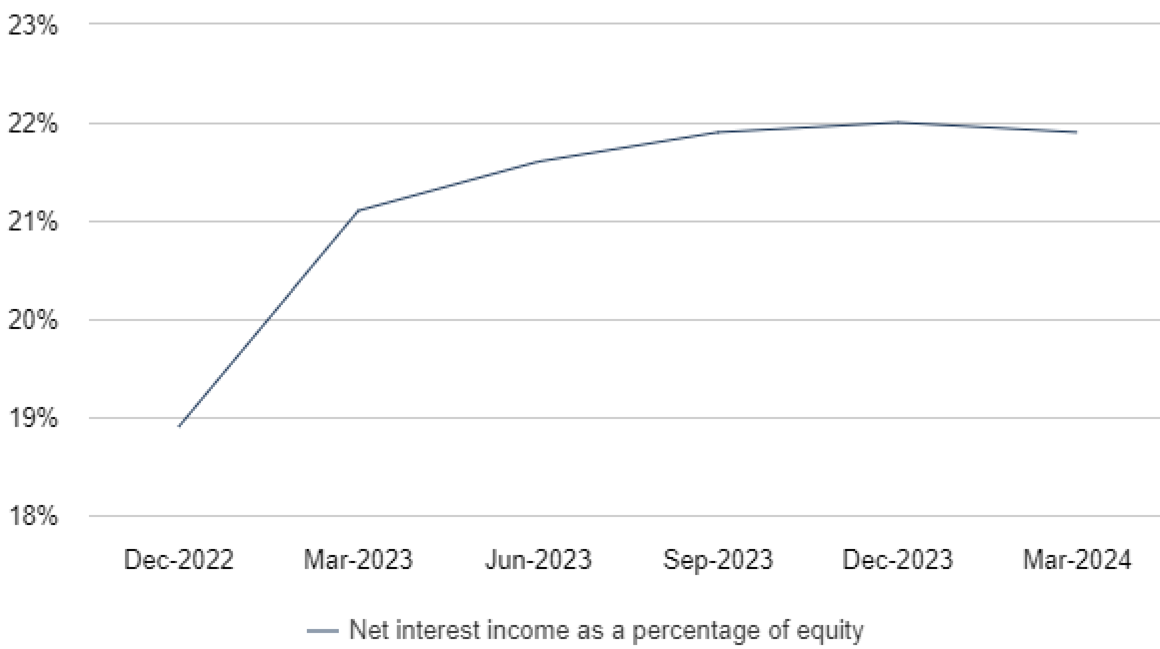
Return on assets (RoA) of EU/EEA banks also showed material YoY growth, reaching 0.69% in December 2023 from 0.52% in December 2022. The increase over the previous year in the RoA was even more pronounced compared to the RoE, as total equity displayed a more steady and significant increase than total assets during the period. Nevertheless, after an increase in the first two quarters of 2023, the indicator reached its peak (0.72%) in the third quarter and then started to decline in the last quarter of 2023. While the overall increase in RoA is linked to the rising NII, the small decrease recorded in the fourth quarter could be attributable to the slower growth of NII when at the same time other sources of income continue their previous decline. This stabilisation followed by a slight decrease of RoA would support the idea that profitability may have reached its peak before possible policy rate cuts by central banks (on rate expectations see Chapter 1, Figure 41). However, it should be noted that this might at least partially also be due to seasonality, with fourth-quarter profitability often being lower than in the third quarter. NII represented a bit less than 19% of total equity as of Q4 2022 but it increased materially in March and June 2023 to reach more than 21.5%. Since this uptick, NII broadly stabilised throughout the remainder of the year 2023 (Figure 42).

Figure 41: Evolution of EU/EEA RoA, between December 2022 and December 2023



Source: EBA supervisory reporting data

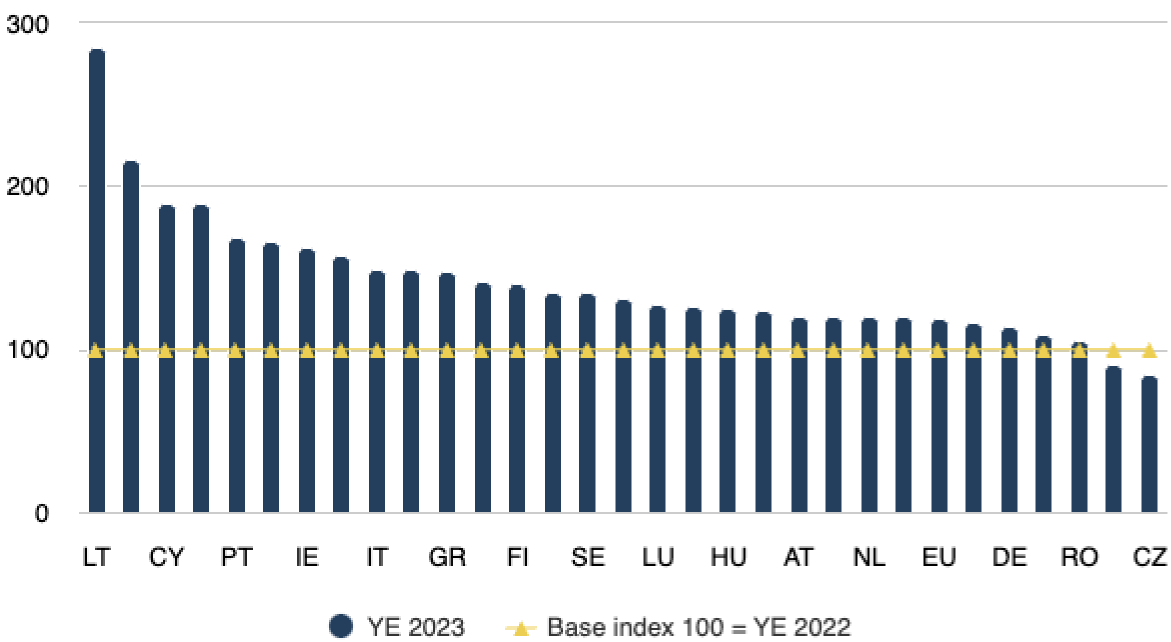
Figure 42: Year-on-year variation of NII as a percentage of equity, between December 2022 and December 2023



Source: EBA supervisory reporting data

In a context in which the growth of interest-earning assets is limited due to a challenging macroeconomic environment, with only 1.4% YoY growth in 2023, the increase in NII is driven by more than 90% by widening margins. While most countries are benefiting from last year's NIM movement, some countries show greater benefit than others. In particular, the Baltic countries have almost doubled their NIM, while the EU/EEA weighted average points to a 19% increase. Conversely, some countries have seen either limited growth in NIM or an overall decrease in NIM, as in the case of France and Czechia. In the case of France, this is not least due to the balance sheet structure, which is composed notably of a high share of fixed-rate assets, and certain rules and regulations, such as, for instance, those on regulated saving (e.g. Livret A), affecting both the asset and liability sides on e.g. mortgage and deposit pricing. In the case of Czechia, this is mainly due to the rising average cost of deposits amid a continued move of customer deposits from current to term and savings accounts, and stable and even slightly declining loan yields, as well as the end of remuneration of mandatory reserves at the Czech National Bank (Figure 43).[1]

Figure 43: Year-on-year variation of net interest margin by country



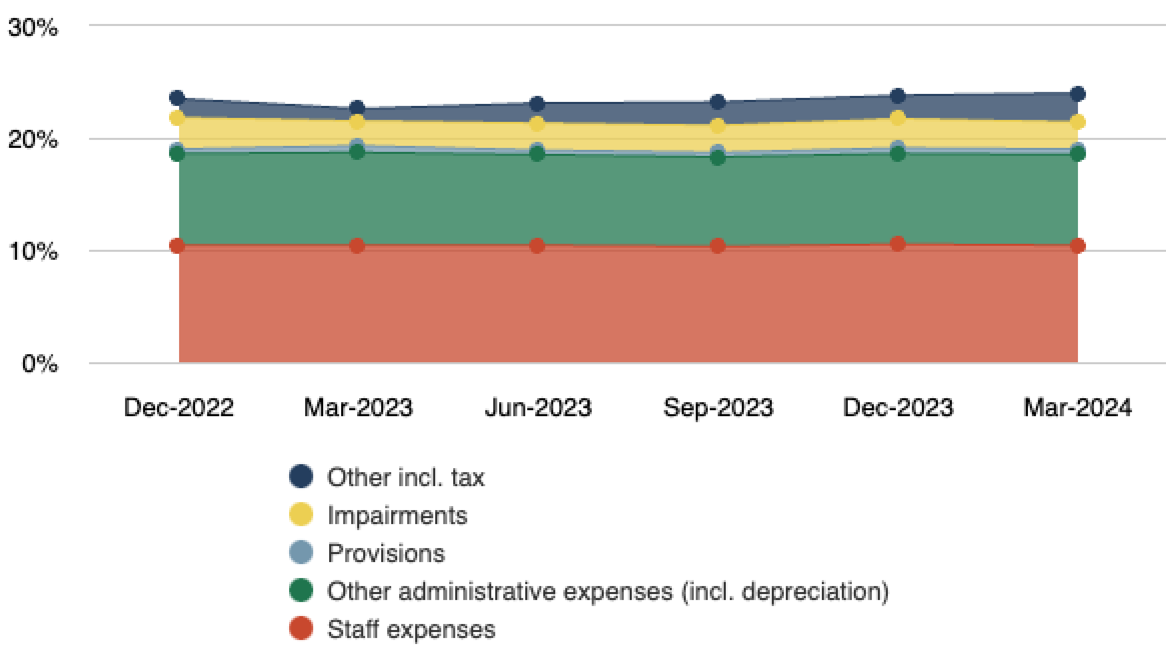
Source: EBA supervisory reporting data

These differences among countries largely point to national specificities in terms of business models. On a more granular basis, a bank-by-bank view highlights the importance of a sound interest rate risk on banking book (IRRBB) management and hedging policy in order to steer the banking book in a direction that will generate profits in line with expected changes in interest rates. Banks have to ensure that they manage interest rate risk and their NII cautiously and be prepared for a higher for longer rate environment as well as potential rate cuts. Hedging, including, for instance, through structural hedges, is one means to address these challenges.

A stable cost base

In a context in which inflation has been strong, albeit declining throughout the year, banks have managed to keep their cost base at a stable level, at around 25% of their equity. Such stability is remarkable as some costs tend to appear with some delay, of which notably staff expenses, which were flat over the period. Therefore, the cost picture in general did not change in terms of the share of the main costs (Figure 44). The cost-to-income ratio (CIR) accordingly reached one of its lowest levels reported, declining by 4.9 p.p. YoY to 55.6% as of Q4 2023. This was due to a bigger increase in total net operating income (denominator) compared to the rise in costs (numerator).

Figure 44: Evolution of cost base on equity, between December 2022 and December 2023



Source: EBA supervisory reporting data

Longer-term challenges to profitability

In the medium term, assuming that interest rates will continue their declining trend going forward, the contribution of NII to overall profitability will presumably go down (on the expectation of declining rates see Chapter 1). The fact that banks have locked in higher rates for their securities portfolios might help to buffer the impact of declining rates on NII at least to some degree (on the rise of banks' debt securities holdings see Chapter 2.1). However, as was the case in the low rate environment, banks will have to rely more on fees and commissions to generate profits, in a context where this source of income will be directly challenged in the coming years by the advent of new players.

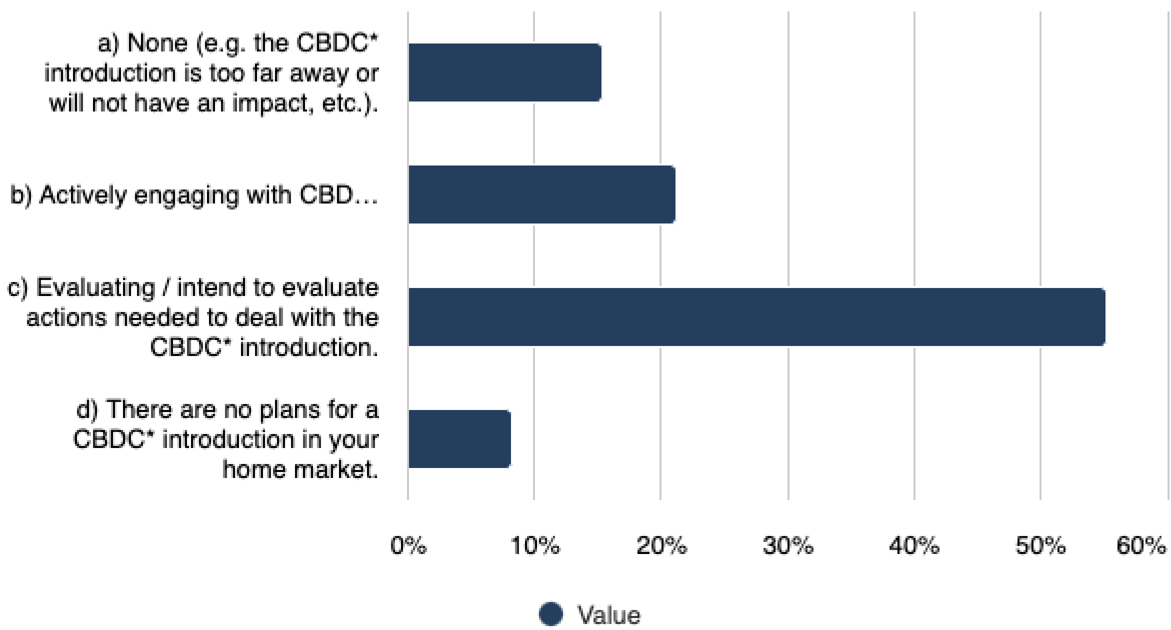
The onset of FinTechs, incl. BigTech, and central bank digital currencies (CBDCs) is poised to significantly reshape the landscape of EU/EEA banking, with potentially profound implications for profitability (on CBDCs see also the textbox within this Chapter). FinTechs, leveraging advanced technologies, might, for instance, provide personalised financial services, faster transactions and often an improved customer experience. As customers increasingly gravitate towards these digital platforms, traditional banks may face a decline in their income. However, whereas banks might also try to replicate FinTechs, other banks acquire FinTechs to add respective experience to their business. Looking at the introduction of CBDCs, they could have negative and positive impacts on the profitability of European banks. CBDCs could lead to a decrease in banks' transactional revenues and e.g. household bank accounts, thereby affecting their profitability through reduced activity and higher funding costs amid decreasing deposit volumes, which tend to be the cheapest source of funding. At the same time, they might have the possibility to offer new products, which could result in new revenue streams, or they could improve banks' ICT, which might reduce related 'running' costs. While these projects are still in the early stages, it is important that banks remain agile and flexible to sustain or even improve their profitability in an ever changing environment.

Thoughts on potential impacts of CBDCs on banks

Projects related to the introduction of retail CBDCs have gained pace inside and outside the euro area. The introduction of a retail CBDC is expected to also affect banks, in particular their funding and liquidity. This would happen because the CBDC might result in a certain outflow of household deposits, as households might change parts of their deposits into the CBDC. However, in general banks should be able to replace such potential CBDC-driven deposit outflows with other funding sources. Banks should also be able to disincentivise potential CBDC-driven deposit outflows, considering that the CBDC would not be remunerated. However, if need be, they can also tap central bank funding. In this respect, preliminary and indicatively calculated analysis shows that on average banks should have enough collateral available to pledge it with central banks (see Chapter 3.3 on asset encumbrance and available collateral for central bank funding). CBDCs might accordingly affect banks' profitability amid the replacement of client deposit funding with more expensive funding sources. Fee income might also be affected as well as operational expenses and operational risks. The latter includes, for instance, technology-related risks, and including fraud and similar risks.

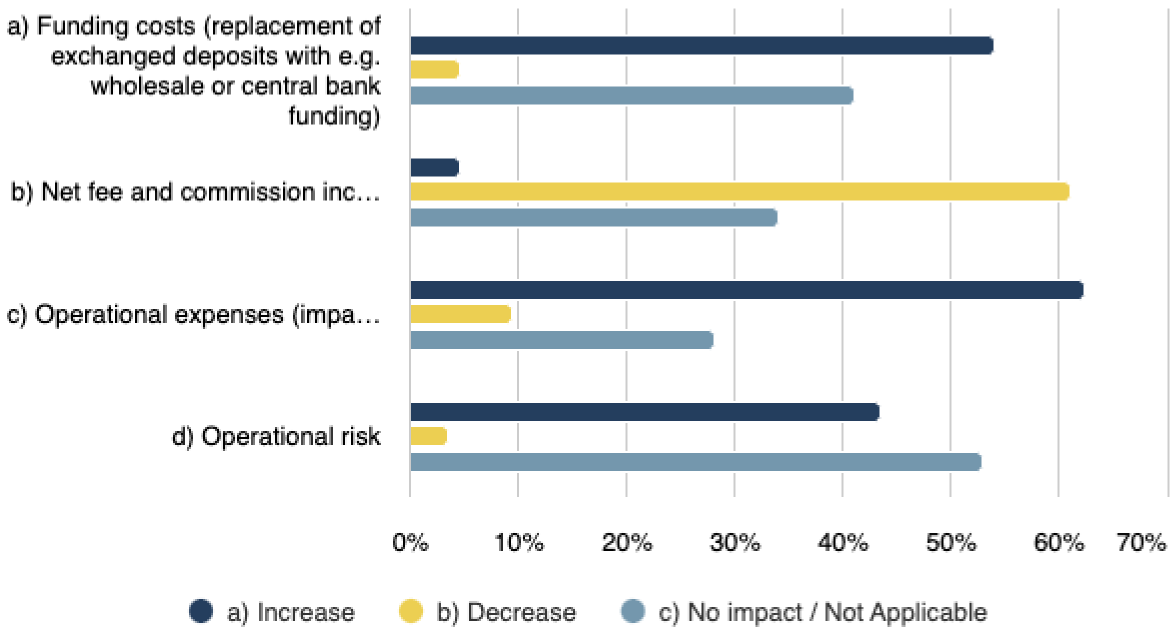
However, it needs to be stressed that CBDCs will also have positive implications for banks. Banks might, for instance, generate fee income on CBDC-related products or services. They might also gain new clients if they offer attractive CBDC-related products or services, for instance. There might also be positive impacts on operational risks, for instance resulting from fewer cash withdrawals or the replacement of legacy systems and processes with new technology. The concrete impact will depend on many parameters, some relating to the design of CBDCs (holding limits, limitation by type of customers, waterfall mechanisms to deposit accounts, compensation scheme, etc.) and others relating to the adoption rates of customers, be they households or corporates. One also needs to differentiate between normal times and times of stress. In a stress scenario the availability of CBDCs might exacerbate the potential risk of systemic bank runs, as CBDCs might be considered safer assets.[2] For normal times, preliminary and indicatively calculated analysis shows that CBDCs might have only limited impact on the banking sector, even though some banks might show stronger or even severe impacts on either their liquidity and/or their profitability. RAQ results indicate that banks are particularly concerned about CBDCs' negative impact on their net fee income, operational expenses and funding costs. Only around 40% expect a negative impact on their operational risks, which might also indicate that banks have not yet fully assessed the risks related to CBDCs. The fact that only around 20% have so far actively engaged with CBDCs might confirm this finding (Figure 45).

Figure 45a: Banks' level of engagement with CBDCs for what responding banks define as their home market



Source: EBA Risk Assessment Questionnaire

Figure 45b: CBDCs impact as expected by banks for what responding banks define as their home market



Source: EBA Risk Assessment Questionnaire

Banks' forecasts of client rates

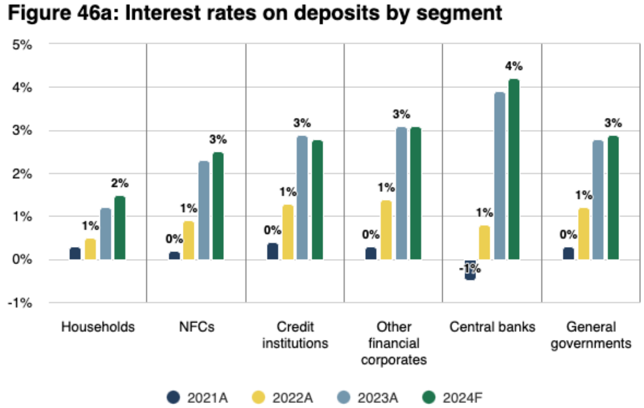
The interest rate hikes of the past two years have led to a repricing of banks' assets and liabilities. For loans, banks reported a significant increase in interest rates for all loan portfolios in 2023, with interest rates received on loans and advances to central banks recording the highest rise (on average +272 bps to on average 4.32%), followed by interest rates earned on loans to other financial corporations (+182 bps to 4.69%). Interest rates on loans to NFCs and on loans to households, which represent the biggest segments, increased by +166 bps to 4.63% and a smaller 84 bps to 3.69%, respectively.

With regard to deposits, by far the biggest liability class, banks recorded a significant increase in interest rates across all types in 2023. The largest rise was observed for interest paid on deposits from central banks (on average +305 bps to on average 3.87%), other financial corporations (+176 bps to 3.15%), credit institutions (+164 bps to 2.94%) and governments (+151 bps to 2.76%). Interest rates on deposits from NFCs rose by +132 bps to 2.25%. The lowest increase in interest rates was reported for household deposits (+67 bps to 1.18%). The latter is similarly reflected in so-called deposit betas (see on deposit betas a more detailed analysis in the [last edition of the EBA's Risk Assessment Report](#).

Expectation of still rising loan and deposit rates for some portfolios in 2024 with client spread widening coming to a halt

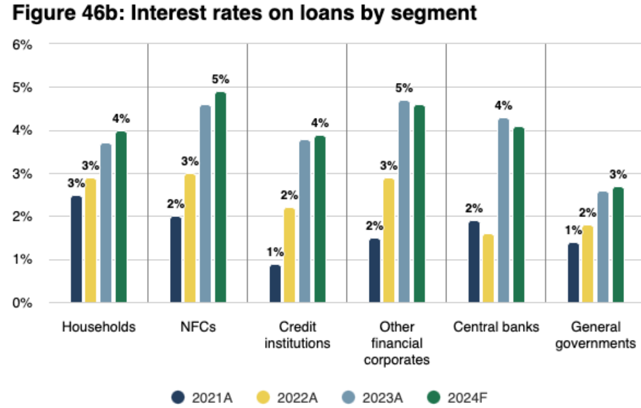
In 2024, considering that central bank policy rates should have already peaked, banks expect a reduction of interest rates on loans to central banks (-24 bps) and other financial corporations (-9 bps) on the asset side (on interest rate expectations see Chapter 1). On the liability side, they expect a decline in interest rates on deposits from credit institutions (-10 bps) and other financial corporations (-4 bps). For other loan portfolios and other types of deposits, banks anticipate further rate increases, albeit at a significantly slower pace compared to the previous year. This is presumably due to the replacement of maturing fixed-rate loans from times of (ultra) low rates, with loans that bear higher interest rates. The highest increases are planned for household loans (+30 bps to 3.99%) and NFC loans (+29 bps to 4.92%), as well as similarly for household deposits (+34 bps to 1.52%) and deposits from NFCs (+29 bps to 2.54%; Figure 46).

Figure 46a: Interest rates on deposits by segment



Source: EBA supervisory reporting data (funding plan data)

Figure 46b: Interest rates on loans by segment



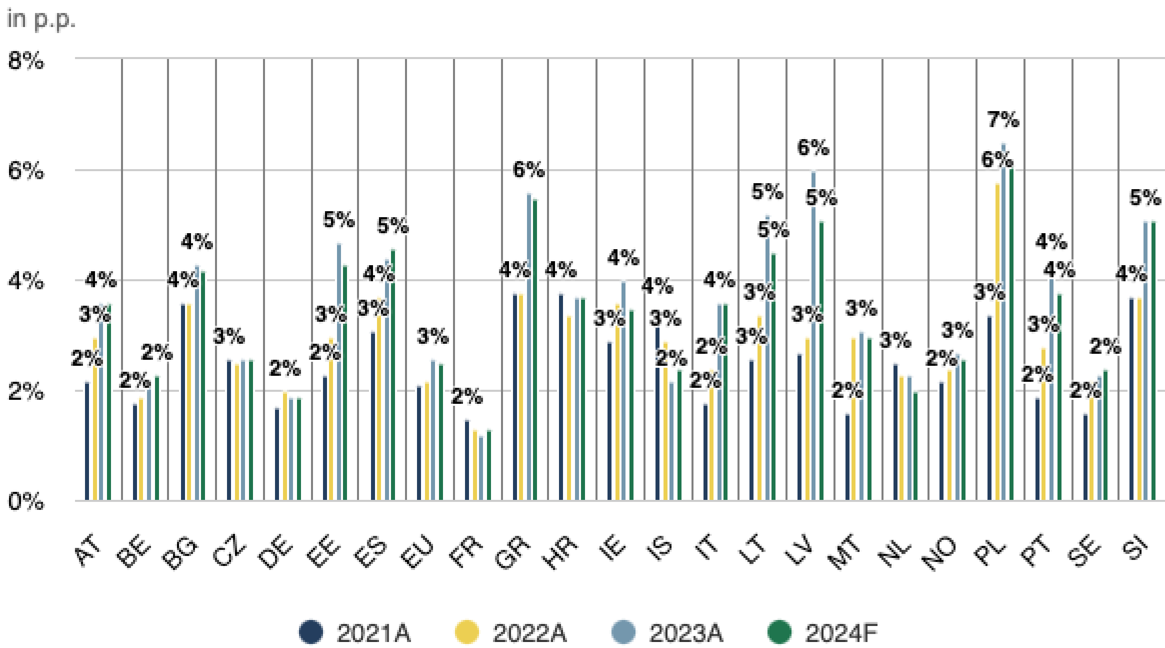
Source: EBA supervisory reporting data (funding plan data)

In 2023, spreads between interest rates for loans and deposits to/from household and NFC clients generally kept their upward trend, due to the increase in interest rates on loans, which continued to outpace the rise of deposit rates. As of December 2023, the EU/EEA average client spread was 2.57%, 32 bps above the spread observed one year earlier (2.25%). This YoY change was even more pronounced than the one recorded in 2022 (+19 bps). The largest yearly increases were reported by banks in Latvia (+293 bps), Lithuania

(+184 bps) and Greece (+175 bps). In a limited number of countries, including Iceland (-65 bps) and Germany (-9 bps), the client spread instead decreased in the last year.

Amid the expected changes in client loan and deposit interest rates, banks anticipate a stabilisation of respective spreads in 2024, with an average reduction of 2 bps in the EU/EEA. A certain divergence in client spread developments can, however, be seen at country level, with major reductions – albeit from extremely high levels – in Latvia (-91 bps) and Lithuania (-72 bps) but further increases in Iceland (+18 bps) and Spain (+18 bps) (Figure 47). These numbers confirm the idea that client spreads have presumably plateaued and could for now stay stable, before they might come under pressure.

Figure 47: Actual and forecasted spread between client loans and client deposits (households and NFCs)



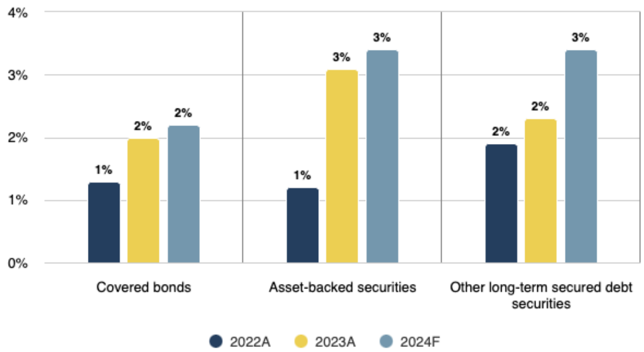
Source: EBA supervisory reporting data (funding plan data)

Further increases in pricing for banks' market-based funding instruments, forecasted mixed developments for next year

After the long trend of decreasing funding costs ended in 2022, the cost of market-based financing increased further in 2023. The actual cost of long-term funding in 2023 was reported on average at 2.95% in the EU/EEA, 98 bps higher compared to an average of 1.97% in 2022. The increase in funding costs could be seen at most banks in the sample. In

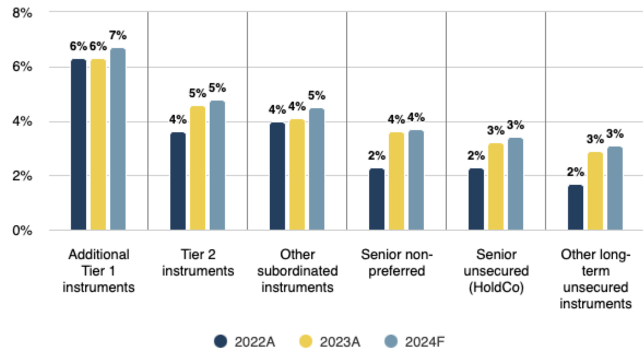
2024, most banks expect costs for long-term market-based funding to increase further, albeit to a lesser extent. On average, banks plan for a rise of on average 28 bps at EU/EEA level, with bigger differences between countries than in 2023.

Figure 48a: Actual and forecasted interest rates for secured debt instruments



Source: EBA supervisory reporting data (funding plan data)

Figure 48b: Actual and forecasted interest rates for unsecured debt instruments



Source: EBA supervisory reporting data (funding plan data)

As regards secured debt instruments, on average banks reported an increase in funding costs of 76 bps in 2023. The increase was notable for all categories of secured funding instruments. Funding costs for covered bonds rose by 70 bps to reach 2.03% in December 2023, while costs for asset-backed securities recorded a sharper increase of 187 bps, reaching 3.11% in December 2023. In 2024, banks expect a further, but considerably smaller increase in costs for secured debt instruments (covered bonds +18 bps, asset-backed securities +12 bps).

As regards unsecured debt instruments, on average funding costs went up by 97 bps in 2023. Mixed developments were, however, observed across the different unsecured funding instruments. On the one hand, some categories experienced significant cost rises, with the highest increases being recorded by NPS bonds (+128 bps to 3.58%), followed by T2 instruments (+108 bps to 4.64%) and senior unsecured (HoldCo) bonds (+88 bps to 3.18%). On the other hand, costs for AT1 instruments slightly decreased (-5 bps to 6.27%), after strong growth in the previous year. In 2024, banks anticipate further but generally moderate cost increases for all categories of unsecured debt instruments. The expected increase is stronger for AT1 instruments (+47 bps) and subordinated instruments (+36 bps), whereas cost rises are very modest for other categories of unsecured debt instruments, including T2 instruments (+16 bps) and NPS bonds (+17 bps) (Figure 48). These expected developments add to the idea that there is increasing pressure on EU/EEA banks' NII going forward.

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[1] See the Czech National Bank's statement on ending the remuneration of minimum reserves, starting at 5 October 2023.

[2] Currently applicable financial stability, central bank and bank risk management limits and tools should, however, help to prevent a CBDC from increasing the latent risk of systemic bank runs during periods of stress.