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# EVOLUTION IN THE PROFITABILITY OF THE CORE DOMESTIC BANKS OVER THE LAST DECADE

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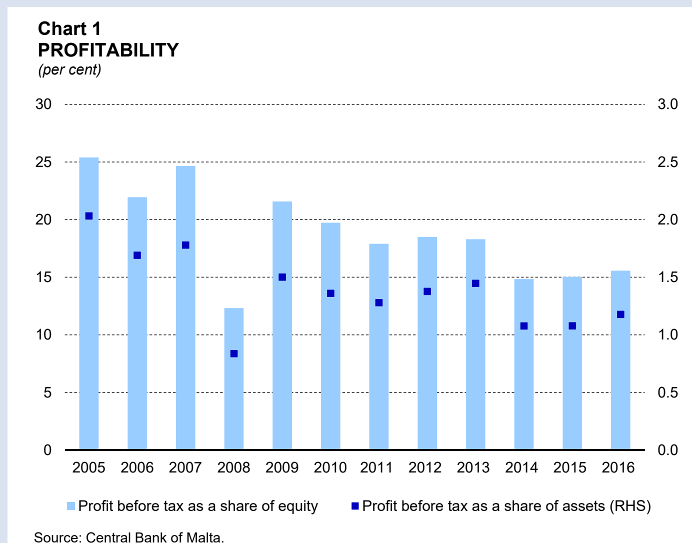
## BOX 2: EVOLUTION IN THE PROFITABILITY OF THE CORE DOMESTIC BANKS OVER THE LAST DECADE

The recent global financial crisis has brought along a number of challenges for most euro area banks. As economies fell into recession, lending became anaemic, while NPLs soared to high levels. In a bid to stimulate growth and eliminate the threat of deflation, the European Central Bank (ECB) loosened its monetary policy stance with the overnight deposit facility rate falling into negative territory since mid-2014, while its policy rate reached the zero-bound in 2016. At the same time, the ECB implemented non-standard monetary policy measures to further support the supply of cheap bank lending. The unfolding of the financial crisis has eroded profits of euro area banks, with post-tax profitability ratios declining significantly. Domestically, the drop in profitability ratios of the core domestic banks was comparatively milder.[1,2] This Box reviews the developments in the core domestic banks' key profitability drivers, highlighting trends over the last decade.

Core domestic banks reported higher profits, albeit profitability abated over the last decade. Since 2005 core domestic banks' pre-tax profits increased in absolute terms, on the back of a doubling of their balance sheet. The latter partly reflected the licensing of two new banks but also through organic growth of existing institutions.[3] Nevertheless when expressed as a share of assets and equity, indicators signal some weakening in profitability levels (see Chart 1).[4] Notwithstanding, core domestic banks faired comparatively better than their euro area peers on average throughout the crisis (see Table 1).

The decline in profitability levels of the core domestic banks was largely driven by developments in operating income, mainly from lower NII from securities holdings on the back of declining interest rates. Concurrently, NII from intermediation (i.e. through the granting of loans and accepting deposits) grew, as banks managed to maintain a relatively stable spread in spite of a declining interest rate environment. Deposit rates fell to historically-low levels while lending rates also dropped due to increased competition. This, coupled with a recovering real estate market and continued efforts to reduce risk (and return), led to a further shift towards higher mortgage lending by banks, where risk is spread across a large number of small borrowers, away from a small number of relatively large non-financial corporate borrowers. Meanwhile, the weakening in operating income expressed as a share of assets for euro area banks was much more contained than that for core domestic banks in Malta, contributing only marginally to the drop in profitability. Such decline in euro area banks' profitability




[1] See Chart 3.4: Profitability ratios – core domestic banks.

[2] Core domestic banks refer to the most systemically-important banks in Malta as listed in the *Financial Stability Report* 2016, pg. 8.

[3] Mediterranean Bank started operations in 2006, while Banif Bank started operating in 2008.

[4] Pre-tax profits expressed as a share of assets narrowed from 2.0% in 2005 to 1.2% in 2016. The same trend is observed should pre-tax profits be expressed as a share of equity, narrowing by about 10 percentage points to 15.6% in 2016.

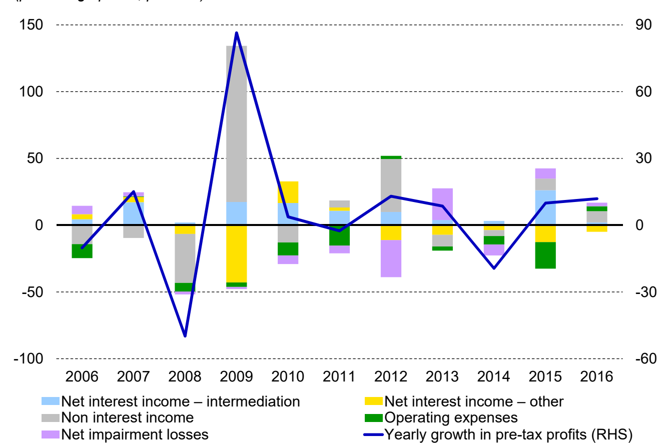
**Table 1**
**MAIN PROFITABILITY INDICATORS**

| | ROE | | Total operating income (% of assets) | | Net interest income (% of assets) | | Non-interest income (% of assets) | |
|---|---|---|---|---|---|---|---|---|
| | Euro area | Core domestic banks | Euro area | Core domestic banks | Euro area | Core domestic banks | Euro area | Core domestic banks |
| 2007 | 10.0 | 16.8 | 2.3 | 3.3 | 0.9 | 2.5 | 1.3 | 0.9 |
| 2008 | -0.8 | 8.1 | 1.6 | 2.4 | 1.1 | 2.2 | 0.5 | 0.2 |
| 2009 | 1.5 | 14.1 | 2.1 | 3.1 | 1.3 | 1.9 | 0.8 | 1.1 |
| 2010 | 3.2 | 13.4 | 2.1 | 2.9 | 1.3 | 2.1 | 0.8 | 0.8 |
| 2011 | -2.8 | 11.8 | 2.1 | 3.1 | 1.3 | 2.2 | 0.8 | 0.9 |
| 2012 | -3.2 | 12.1 | 2.0 | 3.4 | 1.2 | 2.1 | 0.8 | 1.3 |
| 2013 | 1.3 | 11.9 | 2.2 | 3.1 | 1.3 | 2.0 | 0.9 | 1.1 |
| 2014 | 3.3 | 9.8 | 2.1 | 2.8 | 1.3 | 1.8 | 0.9 | 1.0 |
| 2015 | 4.7 | 9.8 | 2.3 | 2.8 | 1.3 | 1.8 | 1.0 | 1.0 |
| 2016 | 3.8 | 10.2 | 2.2 | 2.8 | 1.2 | 1.7 | 0.9 | 1.1 |
| | ROA | | Total operating expenses (% of assets) | | Impairment (% of assets) | | Cost-to-income | |
| | Euro area | Core domestic banks | Euro area | Core domestic banks | Euro area | Core domestic banks | Euro area | Core domestic banks |
| 2007 | 0.5 | 1.2 | -1.5 | -1.5 | -0.2 | 0.0 | 65.1 | 44.9 |
| 2008 | 0.0 | 0.6 | -1.2 | -1.5 | -0.4 | -0.1 | 72.5 | 62.0 |
| 2009 | 0.1 | 1.0 | -1.3 | -1.5 | -0.7 | -0.1 | 60.0 | 48.1 |
| 2010 | 0.2 | 0.9 | -1.3 | -1.4 | -0.5 | -0.1 | 61.9 | 47.2 |
| 2011 | -0.1 | 0.8 | -1.3 | -1.6 | -0.8 | -0.2 | 63.1 | 49.5 |
| 2012 | -0.2 | 0.9 | -1.3 | -1.5 | -0.8 | -0.5 | 65.5 | 41.9 |
| 2013 | 0.1 | 0.9 | -1.4 | -1.5 | -0.6 | -0.2 | 65.1 | 45.6 |
| 2014 | 0.2 | 0.7 | -1.4 | -1.4 | -0.5 | -0.3 | 63.4 | 49.6 |
| 2015 | 0.3 | 0.7 | -1.4 | -1.5 | -0.4 | -0.2 | 63.3 | 52.4 |
| 2016 | 0.2 | 0.8 | -1.4 | -1.4 | -0.4 | -0.2 | 65.5 | 49.9 |

was driven from non-interest income, as otherwise NII as a share of total assets, expanded since the onset of the crisis. In turn, operating expenses remained relatively contained when expressed as a share of assets, indicating a relatively neutral impact both for core domestic banks and the euro area banks, on average.

Over the years, the main driver to the increase in the profits was NII from intermediation activities (see Chart 2). Other sources of operating income, such as NII from securities, and more predominantly non-interest

**Chart 2**
**CONTRIBUTION TO GROWTH IN PROFITS**
*(percentage points; per cent)*




Source: Central Bank of Malta.

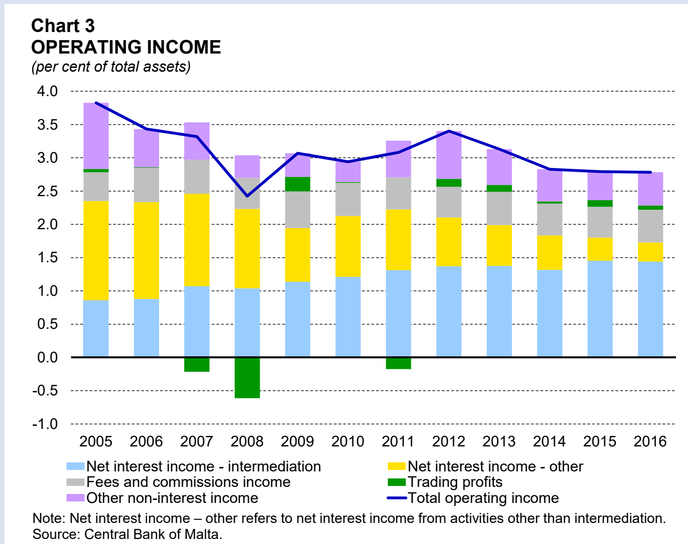
income were rather volatile and not a steady source of profit growth for the core domestic banks. Operating expenses generally grew, bar for a few years, pushing down profit growth. As the financial crisis evolved, net impairment losses also impacted negatively banks' profits to varying degrees, particularly in 2012, but these losses were recouped in the following year. Similarly, lower net impairment charges in 2015 and 2016 contributed positively to profits, adding 7.6 and 2.7 percentage points to profit growth, respectively.

## Pressures on operating income[5]

The weakening in profitability mainly reflected dwindling operating income which in relation to total assets shrank by 1 percentage point to stabilise at 2.8% between 2014 and 2016 (see Chart 3). Commensurate with their traditional business model of channelling deposits into lending, NII has consistently been reported as the core domestic banks' main income component, averaging around two-thirds of gross operating income. The remaining share consists of non-interest income.

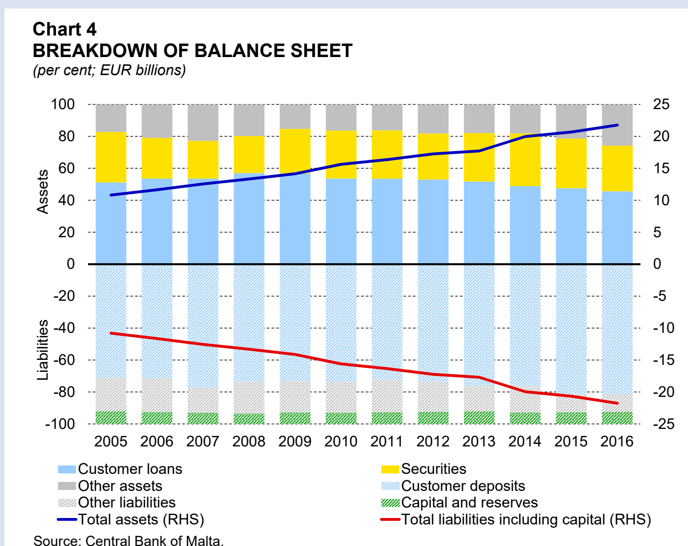
As a proportion of total assets, NII (from intermediation and non-intermediation activities) declined steadily, falling from around 2.4% to about 1.7%, with its two main components registering diverging trends. The weakening in NII mainly stemmed from non-intermediation activities, with such NII falling from 1.5% of total assets to just 0.3% in the period under review. Lower interest earned on investment securities mainly resulted from a price effect on the back of declining yields internationally, as core domestic banks rolled over their investments at lower rates. Concurrently, banks also reduced the share of their securities portfolio on their balance sheet, partly motivated by the implementation of the ECB's Extended Asset Purchase Programme, but also in a bid to reduce their concentration in domestic sovereign exposures (see Chart 4). In addition, the easing of

**Chart 3**
**OPERATING INCOME**
*(per cent of total assets)*




Note: Net interest income – other refers to net interest income from activities other than intermediation.
Source: Central Bank of Malta.

**Chart 4**
**BREAKDOWN OF BALANCE SHEET**
*(per cent; EUR billions)*




Source: Central Bank of Malta.

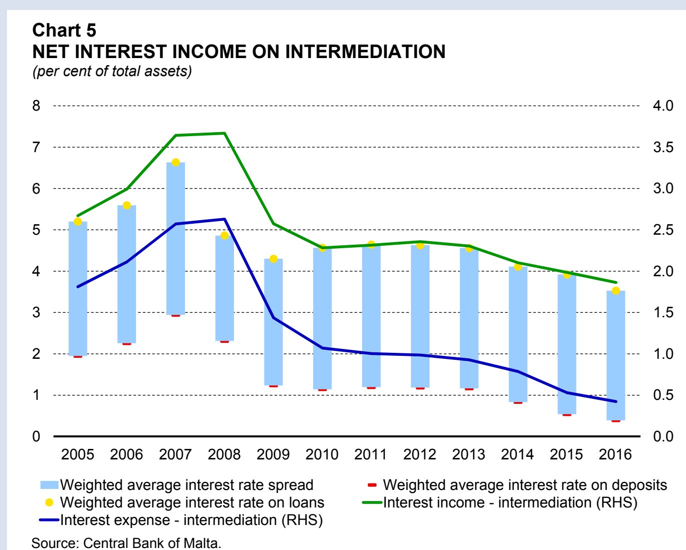
[5] Unless otherwise specified, the assessment on profits is conducted as a share of total assets, to measure developments in profitability. Should the assessment be based on the share of equity, the results would have broadly remained the same given the high correlation between the two denominators.

the ECB's monetary policy stance has pushed policy rates into negative territory; with excess funds held under reserve requirement, which has been increasing given the banks' ample liquidity from deposit-taking, attracting a negative remuneration. In addition the overnight deposit facility rate was also pushed into negative territory, affecting profitability since this facility is also frequently resorted to by the domestic core domestic banks. All of these events have contributed to the contraction in income from non-intermediation activities.

On the other hand, NII from intermediation improved considerably in the period under review, accounting from about 0.9% of total assets in 2005 to almost 1.5% by 2016. Although core domestic banks largely followed the ECB's monetary policy stance by cutting interest rates both for loans and deposits, they managed to maintain a sustainable and stable margin, which in turn, contributed to an improvement in NII from intermediation. While both lending and deposits rates have trended downwards, the fall in deposit rates was faster than that on loans, with the average cost per euro deposited falling significantly more than the average interest income of each euro loaned (see Chart 5). These developments were partly motivated by the elevated level of credit risk reported up to 2014, and also reflective of the corporate landscape in Malta, with small and medium enterprises accounting for the bulk of the banks' lending portfolio. These are generally considered to be less capitalised and thus more risky, with banks charging an additional risk premium. Meanwhile, the share of customer deposits to total assets grew throughout the years, up by about 10 percentage points exceeding 80% in both 2015 and 2016. Higher deposits mainly reflected a shift in preference by customers towards demand deposits, with the share of deposits of longer maturities contracting given the current low level of interest rates. This has further contributed to the declining costs of deposit funding. Furthermore, on the back of decelerating credit demand, the share of customer loans to total assets fell to about 45% – the lowest level since 2005, when growth in assets exceeded that of credit (see Chart 4). This led to a fall in the loan-to-deposit ratio from a high of 77.6% in 2009 to 56.0% in 2016. Such developments partly offset the gains obtained from the positive price effect on intermediation income.

Non-interest income has been more volatile, varying from a high of 1.5% of total assets in 2005 to a record low of 0.2% in 2008, recovering somewhat to 1.1% in 2016. Such volatility is mainly reflective of developments in trading profits owing to fair value movements of assets. Indeed, on the onset of the financial crisis, banks reported trading losses to the tune of 0.2% and 0.6% of assets in 2007 and 2008, respectively. Meanwhile, as the European sovereign debt crisis intensified and markets started to fear contagion across Europe, stock prices fell dramatically with the core domestic banks reporting further trading losses of 0.2% of assets in 2011. Other factors which led to some volatility in non-interest income were foreign exchange trading and non-trading profits, reflected in the 'other non-interest income' category (see Chart 3).[6]

**Chart 5**
**NET INTEREST INCOME ON INTERMEDIATION**
*(per cent of total assets)*




Source: Central Bank of Malta.

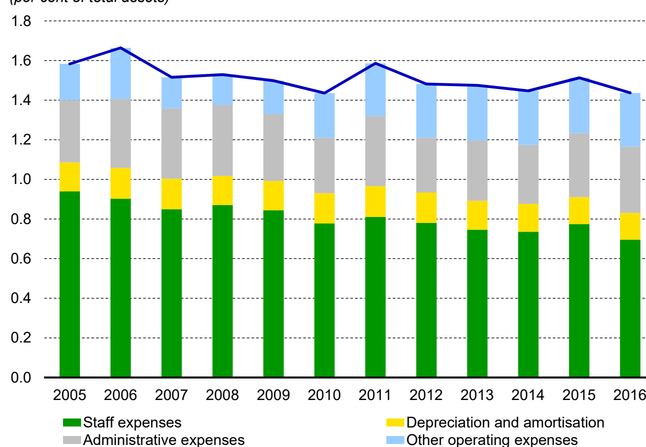
[6] Dividend income for 2005 was exceptionally high due to higher dividend income from a subsidiary company of one of the core domestic banks.

Fees and commission income has been the second-most important source of operating income, averaging 0.5% of total assets, and remaining broadly stable throughout the period under review. As the low interest rate environment persists, the banks may become under increasing pressure to seek alternative sources of income, adapting their business model towards growth in fee and commission-based activities.

## Operating expenses largely contained

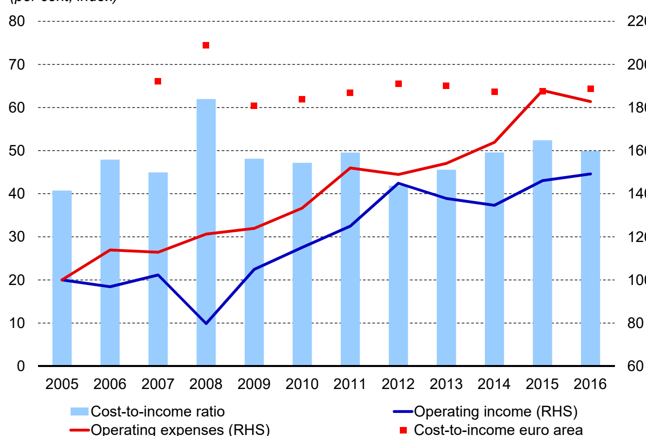
Through cost containment measures, the core domestic banks have managed to restrain the increase in operating expenses. Thus, given that assets increased faster than operating expenses, core domestic banks brought down their operating expenses to total assets ratio, to 1.4% by end 2016 (see Chart 6). Staff expenses, which make up the largest share of total operating expenses, declined from 0.9% in 2005 to 0.7% by 2016, driven by slower growth in the number of staff employed coupled with a number of early retirement schemes, which were aimed at consolidating future staff expenses. Furthermore, the aggregate number of local branches decreased to the lowest level over the past 12 years, despite the establishment of two new core domestic banks. Other operating expenses as a share of total assets still increased marginally, partly reflecting the higher regulatory costs following the financial crisis, as well as increased IT-related costs.

**Chart 6**
**OPERATING EXPENSES**
*(per cent of total assets)*




Source: Central Bank of Malta.

**Chart 7**
**COST-TO-INCOME RATIO**
*(per cent; index)*




Note: Euro area data refers to domestic banking groups and stand alone banks. 2016 data refers to Q3.
Source: Central Bank of Malta.

Over the years, cost efficiency deteriorated as growth in operating expenses outpaced that of operating income.[7] This pushed up the cost-to-income ratio by about 10 percentage points to 50% (see Chart 7). Nevertheless,

[7] Operating expenses exclude amortisation costs but include intangible assets other than goodwill.

the core domestic banks remained still noticeably more efficient, with the cost-to-income ratio standing well below the euro area average of about 65%.[8]

## Net impairment losses impacted banks' profitability

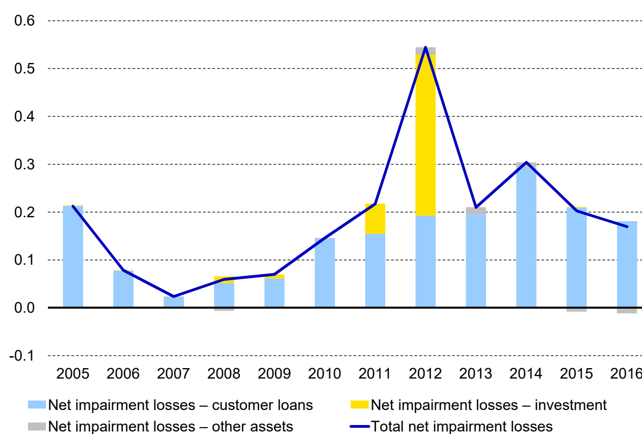
During the financial crisis, credit risk intensified, resulting in higher net impairment losses on customer loans. Indeed, impairment charges on lending rose steadily from almost none in 2007 to 0.3% of assets in 2014, mirroring the rising trend in NPLs. Subsequently, with stronger economic growth, net impairment losses waned in line with the reduction in NPLs (see Chart 8). Write downs on holdings of Greek bonds in 2011, and more predominantly in 2012, led to total net impairment charges to exceed 0.5% in 2012.

In sum, the traditional business model shielded core domestic banks from severe consequences of the international financial crisis, recording healthy profitability levels despite some weakening over the years. Such profitability levels were supported by the enhanced NII from intermediation, as banks were able to maintain a sustainable and stable interest rate spread in spite of the low interest rate environment.

Nevertheless, throughout the years core domestic banks embarked on various measures to enhance their performance, consolidating their non-core business activities in an attempt to de-risk their balance sheets. They have also engaged in cost containing measures including the streamlining of their branch network across Malta coupled with early retirement schemes. At the same time, banks are slowly and gradually adapting their business models, tapping more fee-generating income rather than relying on the traditional credit intermediation.

Looking forward, the prevailing low interest rate environment will continue to set challenges on banks' profitability, both domestically and across the euro area. While interest rates on deposits approached the zero bound, pressures to decrease the cost of credit continue, possibly narrowing margins. This, coupled with subdued credit developments, may exert additional pressure on the profitability of core domestic banks. New regulatory requirements are also expected to continue to impinge on the banks' profitability, both through higher funding and capital costs, as well as through further increases in other operating expenses, particularly investment in technology. The latter could also be another avenue for generating new income through the potential tapping of fintech opportunities through strategic alliances, while at the same time, increasing efficiency. Profitability of the core domestic banks is likely to remain healthy in the short to medium-term, supported by their comparatively low cost structure; improving asset quality and the current robust economic climate.

**Chart 8**
**NET IMPAIRMENT LOSSES**
*(per cent of total assets)*




Source: Central Bank of Malta.

[8] In 2008 the cost-to-income ratio surged to 62.0% due to the exceptional drop in operating income reported that year.