Box 8

THE IMPACT OF THE FINANCIAL CRISIS ON BANKS’ DEPOSIT MARGINS

Bank funding risk has been one of the most important sources of banking sector vulnerability throughout the financial crisis. Indeed, one of the notable implications of the ongoing sovereign debt crisis was the intensification of this risk. Especially in some euro area countries where access to market funding has been particularly constrained in recent years, banks have tried to compensate for this by turning to more stable funding sources, such as retail deposits. In order to attract depositors, many banks have increased deposit rates, which has, in turn, resulted in decreasing, and lately even negative, deposit margins having adverse consequences for bank profitability. Using a panel econometric approach and exploiting confidential information from the Eurosystem’s bank lending survey (BLS), this box illustrates how impaired access to wholesale funding during the recent financial crisis has influenced the cost of euro area banks’ deposit funding.

Euro area bank deposit margins have declined sharply since late-2008, following the onset of the substantial monetary policy easing (see Chart A). As policy rates and, hence, short-term money market rates approached the zero lower bound, bank deposit margins were inevitably compressed (as banks typically set deposit rates somewhat below their reference market rates in order to operate with positive deposit margins). However, this compression of margins was compounded by the concomitant restrained access to market funding, which forced many banks to compete for the more stable deposit funding.

Consequently, since early 2009, retail and corporate deposit margins in many countries have moved into negative territory, and have thus adversely affected banks’ overall net interest income and profitability. Notably, these developments have been particularly pronounced in those euro area countries that were affected most by the constraints on access to market-based funding.

Chart A Banks’ retail and corporate deposit margins in the euro area

(Jan. 2003 – Dec. 2010; percentage points)

Sources: ECB, Thomson Reuters and ECB calculations. Notes: “Countries affected by constrained market funding” include Greece, Ireland and Portugal. Deposit margins have been calculated as the difference between market reference rates and the new business rates on different deposit categories (i.e. overnight deposits, time deposits with agreed maturity and savings deposits redeemable at notice). Market reference rates have been selected to mirror the same maturity band as the deposit rate categories, and thus include the EONIA, the one and three-month EURIBOR and two and five-year euro area government bond yields, respectively. Overall deposit margins have in turn been derived by weighting the margins on the different deposit categories using outstanding amounts as weights. In an intermediate step, new business time deposit rates were aggregated using new business volumes as weights.
In 2010 – in unweighted average terms – deposit margins in “stressed” euro area countries declined by 0.42 and 0.30 percentage points respectively to these developments. By contrast, over the same period corporate and retail deposit margins in the “non-stressed” countries increased by 0.12 and 0.28 percentage point respectively, with the variable “access to market funding” contributing positively to margins on corporate deposits and only very slightly negatively to margins on household deposits.

1 In general, banks’ interest rate-setting behaviour, as measured by the spread between retail bank rates and market rates, can be expected to depend on the degree of competition (or bank market power) and on factors related to the cost of intermediation, such as interest rate risk, credit risk, the banks’ degree of risk aversion, unit operating costs, bank liquidity and product diversification; for some general explanations, see X. Freixas and J.-C. Rochet, *Microeconomics of Banking;* MIT Press, Cambridge (Massachusetts), 2nd edition, 2008, and T. Ho and A. Saunders, “The determinants of bank interest margins: theory and empirical evidence”, *Journal of Financial and Quantitative Analyses*, Vol. 16, 1981.

2 The panel includes eleven euro area countries (the Euro 12 excluding Luxembourg) for the period from the second quarter of 2003 to the fourth quarter of 2010 with a quarterly frequency. The linear cross-sectional time-series models are estimated in first differences, and not in levels, the rather high residuals amount to 0.43 for the household deposit regression and to 0.44 for the non-financial corporate deposit regression.

3 Banks’ market funding structures are measured here by the ratio of covered bonds to overall bank securities outstanding. The proposition is that the nature of banks’ non-deposit funding also matters for the pricing of deposits. In particular, a high reliance on more stable sources of market financing, such as covered bonds, might allow banks to operate with lower deposit rates (i.e. higher margins).

4 See also ECB, “Recent developments in the retail bank interest rate pass-through in the euro area”, *Monthly Bulletin*, August 2009.

5 In 2010 – in unweighted average terms – deposit margins in “stressed” euro area countries declined by 0.42 and 0.30 percentage points for corporate and household deposits respectively. The constrained access to market funding contributed -0.07 and -0.22 percentage point respectively to these developments. By contrast, over the same period corporate and retail deposit margins in the “non-stressed” countries increased by 0.12 and 0.28 percentage point respectively, with the variable “access to market funding” contributing positively to margins on corporate deposits and only very slightly negatively to margins on household deposits.
conditions extracted from the BLS, that cross-subsidisation effects between the pricing of loans and the pricing of deposits are present in the euro area both for deposits by households and by non-financial corporations.6

In conclusion, the disruptions to market-based funding markets observed during the financial and sovereign debt crises in recent years are found to have adversely affected euro area banks’ deposit margins and, hence, their profitability and ability to rebuild their solvency positions. This highlights the importance of normalising conditions in euro area bank funding markets, which remain impaired at least in some euro area countries.