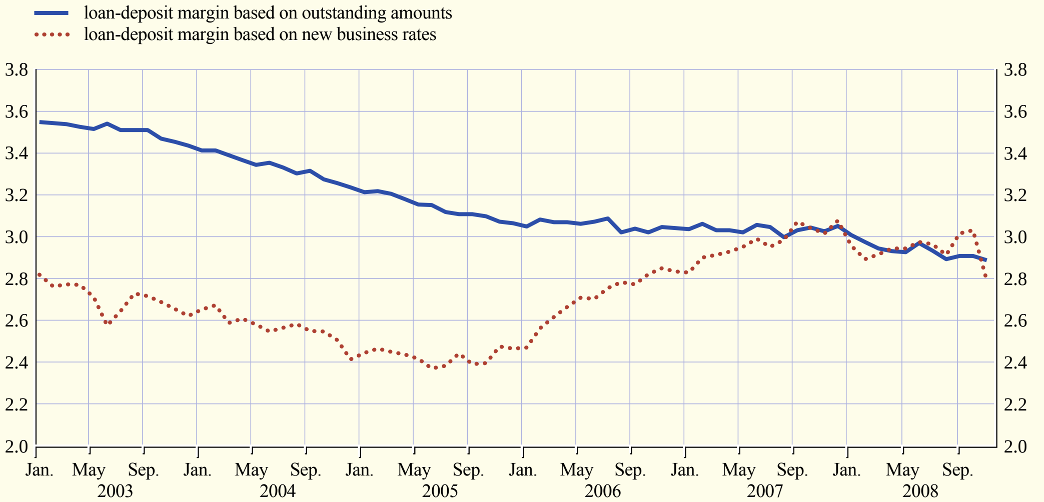
Box 2

LOAN-DEPOSIT MARGINS IN THE EURO AREA

This box examines developments in average MFI loan-deposit margins, defined as the difference between average interest rates on loans and average interest rates on deposits. Loan-deposit margins provide information about euro area banks' ability to generate interest revenues. Over the past two decades net interest revenues have become less important relative to other bank

Loan-deposit margins

(percentages per annum)



Source: ECB.
Notes: The "loan-deposit margin based on outstanding amounts" is calculated as the difference between the weighted average rate on loans to non-financial corporations and households and the weighted average rate on deposits from non-financial corporations and households (using the outstanding amounts as weights). The "loan-deposit margin based on new business rates" is calculated by first deriving the weighted average of new business loan and deposit rates (excluding rates on overdrafts, overnight deposits and deposits redeemable at notice) using the new business volumes as weights. In a second step, the weighted average new business loan rate is combined with the rates on overdrafts to non-financial corporations and households (using outstanding amounts as weights) and similarly the weighted average new business deposit rate is combined with the rates on overnight deposits and deposits redeemable at notice (again using outstanding amounts as weights). The difference between the two constitutes the loan-deposit margin on new business rates.

income sources (i.e. non-interest revenues) as banks have increasingly based their business model on activities generating fees, commissions and other operating income, but they remain the main component of total bank income.[1] Furthermore, the decline in banks' net interest revenues may also have been driven by intense competition and the relatively flat yield curve observed in recent years. In view of the still significant contribution of net interest revenues to the overall profitability of banks, MFI loan-deposit margins are monitored on an ongoing basis in conjunction with the regular analysis of developments in MFI interest rates.

The net interest margins referred to in this box relate only to loans to and deposits from the non-financial private sectors, as reported in the MFI interest rate statistics. As loans and deposits vis-à-vis the non-financial private sectors constituted respectively 30% and 21% of total MFI assets and liabilities in November 2008, it is likely that they account for most of the interest revenue generated by euro area MFIs. Two composite measures of the loan-deposit margin are calculated: the average MFI loan-deposit margin based on MFI interest rates on outstanding amounts (weighted by outstanding loans and deposits) and the average new business loan-deposit margin based on MFI interest rates on new business (weighted using a combination of new business volumes and outstanding amounts). Both measures have their drawbacks. On the one hand, as it is based on outstanding volumes, thereby implying that past activities are included in the weights, the margin based on interest rates on outstanding amounts may become biased in situations where there are substantial structural changes in the pricing of bank

1 According to the OECD's Bank Profitability Statistics net interest revenues amounted to 60% of total bank income by 2005, which compares with around 80% in the late 1980s; see also ECB (2003), "Structural analysis of the EU banking sector", November, and the article entitled "The role of banks in the monetary policy transmission mechanism" in the August 2008 issue of the Monthly Bulletin.

loans and deposits. Consequently, the margin based on new business, which is less sluggish by construction, can capture recent developments in bank interest income in a more timely fashion. On the other hand, the margin based on new business rates may be affected by the considerable amount of roll-over activity in new business volumes and hence may be biased towards short-term financing transactions.

The chart illustrates the developments in the two measures of the MFI loan-deposit margin since January 2003. In 2008, both types of margins hovered around the 3% level. While the margin based on new business, which reflects better the concurrent developments in bank rates, was lower than the margin based on outstanding amounts in the period 2003-07, the gap between the two measures narrowed towards the end of this period in parallel with the increasing level of short-term interest rates.

Looking in more detail, the MFI loan-deposit margin based on outstanding amounts narrowed somewhat in the course of 2008 and by November 2008 stood at 2.9%. This narrowing seems to reflect increases in both loan and deposit rates, while average deposit rates have increased relatively more, in part reflecting a shift from overnight deposits to time deposits, on which the interest rates are more sensitive to changes in corresponding market rates. From a longer perspective, since January 2003 the loan-deposit margin based on outstanding amounts has steadily narrowed, declining by about 60 basis points up until November 2008. The narrowing during the first half of the period since 2003 was mainly due to a stronger decrease in loan rates than in deposit rates, which possibly reflected the overall low level of interest rates and the compression of credit spreads in this period.

The generally more volatile loan-deposit margin based on new business rates overall remained broadly stable in 2008, reflecting the fact that the weighted averages of new business loan and deposit rates increased more or less in parallel during this period. The latest available data for November 2008, however, resulted in a 20 basis point decline in the new business loan-deposit margin, mainly owing to a sharp reduction of new business MFI loan rates. Taking a longer view, this margin currently stands somewhat above the level observed in early 2003, but around 40 basis points higher than the level observed in the second half of 2005. The increase in the loan-deposit margin based on new business between end-2005 and end-2007 was mainly due to a stronger rise in the composite new business loan rate than in the composite new business deposit rate.