Non-technical summary for 'The Impact of Interest Rates on Bank Profitability: A Retrospective Assessment Using New Cross-country Bank-level Data'

By Callan Windsor, Terhi Jokipii and Matthieu Bussiere

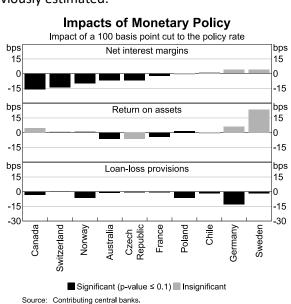
This paper is the culmination of a large international collaboration conducted under the auspices of the International Banking Research Network.

It examines the relationship between bank profitability and interest rates, during a period when interest rates were very low or even negative. Concerns were raised at the time about the potential side effects of very low interest rates on bank profitability. This is because banks tend to avoid reducing interest rates on deposits below a certain 'low-rate' threshold, which can lower their profits. This becomes problematic as lower profits weaken banks' capacity to build capital buffers, which can cushion future losses. Moreover, if banks decide to safeguard their profitability by not lowering interest rates on their lending, this could impair the transmission of monetary policy. So, it is important to look back at this period and assess the relationship between bank profitability and interest rates, as the challenges and consequences of low rates may arise again at some point in the future.

By working with banking sector experts from a large number of central banks, we are able to gather new estimates obtained from confidential data. Our analysis includes around 1,500 banks across 10 countries spanning the two decades leading up to the end of 2019.

A key takeaway from our investigation is that the effect of a decline in interest rates on banks' net interest margins – a component of overall profitability – is small, economically speaking. More importantly, perhaps, the effect of lower interest rates on net interest margins is larger than the effect on overall profitability as measured by the return on assets (see figure below).

Identifying the channels through which interest rates affect profitability allows us to dig deeper into this result. An important offsetting factor is that lower interest rates ease the burden of making repayments on loans, allowing banks to set aside less of their profits to cover future losses in the form of provisions. In addition to this, banks found other ways to offset lower interest rate margins, including by focusing more on cost efficiencies and streamlining business models. There is some evidence that the impact of lower rates on margins is higher when interest rates are very low, but only for a handful of countries in our sample. In addition, the effect of holding interest rates lower for longer does not appear to change the results noticeably and focusing on the countries that moved interest rates into negative territory yields estimates that are not economically large. Overall, therefore, the evidence points to smaller effects of falling and low policy rates on bank profitability than previously estimated.



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