Interest margin analysis 2015

Retail banks and the risks of cross-subsidization
Introduction

In 2014, the median interest margin of Swiss retail banks fell year on year from 124 to 119 basis points. This signaled a continuation of the prevailing negative trend since 2007. The decrease has continued to affect investment margins, particularly in the last few years. In contrast, the asset margin and earnings from term transformation exhibit a positive development. There are very large differences between banks. The interest margin of the lowest 10% of banks (10th percentile) fell short of 100 basis points, while that of the best 10% exceeded 140 basis points (90th percentile). Our empirical analysis shows that both internal and external quantitative factors can explain up to 45% of the differences. These factors include the structure of assets, the share of customer deposits and the growth of the local mortgage market, for instance. The remaining 55% is affected by quantitative decisions, such as risk policy in the area of lending, exposure to interest rate changes and product design.

Many banks have responded to the current negative interest environment with a massive expansion of the asset margin in order to cross-subsidize deposits and compensate for the erosion of deposit rate margins. The same practice can be seen in Denmark - a country with a comparable interest level. However, alternative providers are turning the screws on these hiked-up margins. Against this backdrop and given the cost-intensive nature of the current funding mix, we believe that systematically reducing cross-subsidization will prove the single most important countermeasure, particularly in the event of negative interest persisting in the long term. In the medium term, banks should redouble their efforts to identify alternative revenue streams and tap cheaper sources of funding such as mortgage bonds (Pfandbrief) and other bonds rather than costly customer deposits. In addition, changes are needed in the pricing of products as well as a permanent reduction of the cost structure.

We hope you enjoy reading our take on the subject and look forward to discussing it with you. Please do not hesitate to contact us should you require additional background information, or wish to ask any questions or discuss specific aspects in greater depth.
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1. Development of margins 2014

An analysis of the balance sheets and income statements of 386 retail banks in Switzerland revealed that the median interest margin in 2014 (50th percentile) stood at 119 basis points. This means that the interest margin decreased by a further 5 basis points in 2013. The decrease corresponds to the annual average decrease over the period 2007 through 2014. Suggestions in the industry that slight increases in margins in the mortgage market could could serve to compensate for eroding margins failed to materialize.

The net interest income of banks also factors in the development of volumes.

Between 2003 and 2007, net interest income grew 5% with a limited distribution, driven by an increase in volume. In 2018, Swiss banks were still able to increase their net interest income thanks to a dynamic mortgage market and despite an initial drop in interest margins. A different picture surfaced in the years 2009 through 2011, in which growing volumes in the mortgage market could no longer compensate for the decrease in interest margin. This has resulted in a contraction of net interest income that has persisted over time, with the exception of 2012.

Figure 1: Development of interest margin(left axis) and net interest income(right axis) at 386 retail banks in Switzerland (Source: own presentation)
An in-depth analysis based on a selected number of banks shows that the margin erosion is predominantly allocable the liability and equity side of the balance sheet. In contrast, asset margins and earnings from term transformation do not show any significant changes (cf. Figure 2).

It should be noted that the liability margin responds to changes with some time lag, because the replication rates applied create a stable base of longer term investments.

As early as 31 December 2014, the marginal margin on deposits – the margin on new volumes – was already significantly in the negative zone at most retail banks. A comparable development is also evident in foreign markets exposed to a negative interest environment.
2. Evident differences in the interest margin

There are still very large differences between banks. These differences are surprising, given that providers have very similar business models and that Swiss retail banks do not have any significant differences with respect to the structure of the assets and the liabilities and equity sides of their balance sheet, risk policy, sales structure or ALM strategy. Statistical analysis was used to identify the central drivers of the interest margin, which could explain between 40% and 45% of the differences between banks.

2.1 Positive impact on the margin

- **Amount of bank costs**
  
  Banks with high costs need larger margins. That means that more cost-intensive banks impose their margins with greater discipline. In contrast, low-cost banks pass on part of their competitive edge to customers, although a more detailed analysis indicates that this transfer does not lead to a greater growth rate.

- **Structure of assets**
  
  The structure of assets has a big impact on the interest margin. The greater the share of mortgage receivables and the share of loans and advances to customers, the greater the interest margin. Consequently, holding surplus liquidity has a negative impact on the interest margin, even without the introduction of negative interest.

- **Magnitude of local mortgage market growth**
  
  In dynamic, high-growth markets, buoyant demand eases the intensity of competition. Banks can take advantage of this and (still) demand more favorable conditions, thus widening interest margins.
2.2 Negative impact on the margin

- **Proportion of customer deposits in balance sheet total**
  
  Customer deposits are the most expensive form of funding at present. As a result, the interest margin is lower the greater the proportion of deposits. Banks that make greater use of alternative sources of funding such as mortgage and other bonds generate higher margins. This situation is compounded by negative interest.

- **Growth of mortgage receivables compared with local mortgage market**
  
  It is only possible to generate above-average growth in mortgage receivables compared with the local market with aggressive market conduct. The resulting low-cost conditions have a negative impact. In other words growth comes at a "price".

- **Bank's geographic location**

  Retail banks in German-speaking Switzerland statistically have slightly lower margins than those in the French- and Italian-speaking regions.

- **Relative size of banks**

  The negative impact of relative bank size on margins can stem from the fact that larger banks have to offer their customers better conditions in order to sell products. Alternatively, it may be the case that the lower complexity costs borne by smaller banks allow them to impose more discipline in their sales activities and thereby capture better margins.
2.3 Irrelevant factors

▷ Bank clusters

The statistical analysis does not reveal any correlation between bank clusters (cantonal banks, credit unions or regional banks) and interest margins. Factors such as brand strength and government guarantees are also not statistically significant.

▷ Local market share

The statistical analysis indicates that local market share has no significant impact on the interest margins of retail banks. Markets remain highly competitive, even where individual players have large market shares, as is the case of cantonal banks in many cantons.
2.4 Other factors

The following are some of the factors that underlie the remaining 55% to 60% of the differences in margins:

- **Price structure and product policy**
  
  Research abroad has shown that substantial increases in margins are possible with clever pricing and product policies.
  
  Cross-bank, customer-centric product development enables greater value add compared with conventional product-centric business models. At the same time, banks with dynamic pricing structures can adjust to customer needs with greater agility and better address customers' willingness to pay.

- **Asset and liability management**
  
  On the one hand, margins are determined by the risk appetite with respect to interest changes. Relative to comparable German banks, Swiss retail banks have a greater exposure to interest rate risks on average. On the other hand, smart implementation and operationalization of ALM strategies have a positive impact on margins.
Advice quality / Quality sales

Highly enabled sales team can conclude far more transactions at equivalent prices. Both in the case of mortgages and investments alike, the quality and competence of advice are key decision factors, along with price.

Credit risk policy

In mortgages, as the main asset class, the risk policies of Swiss retail banks are practically identical. But in the corporates business, in particular, banks can exhibit marked differences in risk appetite.

Banks are therefore well able to actively influence the interest margin. Depending on the extent to which the interest margin has decreased over the last eight years, each bank should consider which levers it has at its disposal to most effectively raise profitability.

An optimal approach often encompasses a profiled mix of measures. The focus should lie on experience-based evaluation of new financing forms and risk policy with respect to exposure to interest rate risks. The importance of cost efficiency through simplification and standardization increases the larger the bank.
3. Negative interest: a new world

With the SNB's introduction of negative interest on 15 January 2015, the yield curve changed considerably again. For instance, SWAP rates in CHF up to a term of seven years were negative as of 31 August 2015.

Most banks do not pass negative interest on to retail customers and only unwillingly to corporate customers. This results in a drastic decline in deposit margins. At present, banks typically generate a negative deposit rate margin of 50 to 80 basis points.

At the same time, banks have been able to massively increase their asset rate margins. This expansion came to about 70 basis points as of 31 August 2015. The expansion has been realized across all terms.

Many banks and experts point to the increased funding costs as well as increased cost of collateral as an explanation for the increased asset rate margins. However both explanations are inadequate. If the increased cost of collateral were the reason for the increased margins, margins for LIBOR products, for instance, would have to be significantly lower than those for long-term mortgages.
In practice, asset margins are particularly high in the short-term range in particular (see Figure 3). What is remarkable if that short-term mortgage bonds have even higher asset margins.

This is attributable to the fact that asset margin stand at a base interest rate of 0% with a negative LIBOR. In other words, a negative LIBOR widens the asset margin. Collateral costs therefore do not provide an explanation for the widened margins of retail banks in the mortgage business.

Figure 3: Interest margin for short and long-term mortgages (source: banks covering 50% of the retail market, compiled 31 August 2015)
Banks with access to capital markets and sufficient cover funds eligible for mortgage bonds are able to obtain funds at the long end of the market at moderate premiums on the SWAP curve. This source of funds is also not subject to collateral cost. Figure 4 shows that the risk premiums of mortgage bonds have only increased marginally despite the introduction of negative interest on 15 January 2015. That implies that mortgage bonds are not necessarily affected by negative interest and that their funding costs against the SWAP rate have not increased.

Issues of uncovered bonds reveal a different picture. In January, the negative interest environment initially led to a steep short-term increase in the risk premium between bonds and the SWAP rate. In the interim, this spread has decreased again and the interest margin of uncovered bonds has again edged toward that of mortgage bonds.

![Figure 4: Development of interest margins for mortgage bonds and debentures in recent months (revised: 31 August 2015)](image-url)
Consequently, bank funding has gotten more expensive in the case of deposit products. That means that the sole purpose of increasing asset margins is to cross-subsidize deposit products. The financial statements for the first six months of the year as of 30 June 2015 show that the effects of the widening of asset margins and the erosion of deposit rate margins offset each other.

At present, the results of retail banks in the interest business are therefore not adversely impacted by negative interest.

The question is whether Swiss banks will be able to continue imposing the significantly greater asset margin, that is continue the practice of cross-subsidization. After all, there are a number of players, e.g., insurers who do not have to cross-subsidize customers’ savings and who have considerable surplus liquidity. In theory, such players would be expected to jump at the chance of taking advantage of the cross-subsidization by their competitors to win new business and thereby force banks to lower their asset margins.
However, banks de facto completely dominate the Swiss mortgage market, with a current market share of about 95%. The market share of insurers and pension funds has decreased in the last ten years. Indeed, numerous pension funds and insurers have completely pulled out of the mortgage business in the last several years. Private banks are likewise only active in selected mortgage segments, if at all.

Moreover, beyond mortgage banks, there is a lack of effective and standardized securitization instruments for mortgages in Switzerland – in contrast to the case in Denmark.

Consequently, retail banks, which all face a comparable increased cost of financing, have a very high price-setting power at present, that has allowed them to uphold their cross-subsidization policy.

A build-up of effective competition for retail banks, would put pressure on the market interest rate for mortgages and disrupt the status quo.

Such a build-up is already evident to some extent today, although we expect that it will take several years yet.

4. Excursus: Denmark

The Swiss interest environment is similar to that in Denmark, where the short-term risk-free interest rates stands at -0.75%. However, Danish banks generally do not pass on negative interest to their customers. Instead, they have significantly increased their lending margins in order to increase their interest income. This policy is implemented in the corporate customer segment in particular.

Several Danish banks are increasingly moving away from a risk mitigation approach and toward a focus on higher-margin, riskier loan products.

This mainly occurs through the issue of fast credit and corporate customer products with larger margins. Nevertheless, banks face intensified competition across all credit product segments. Pension funds are increasingly competing in the credit market, offering business loans in particular. As a result, the importance of cost-cutting strategies is to rise in the near term.
5. Future development

The SNB's decision to set a negative interest rate constitutes monetary policy. In practice, monetary policy is next to impossible to predict. From a current perspective, a number of scenarios are conceivable, from the prompt discontinuation of the negative interest, to an intensification of the negative interest, through to its stricter implementation (e.g., by reducing the exemption limits).

The consequences for banks can vary widely, depending on the duration of negative interest rates, a factor that is pivotal to the future development. The following scenarios are conceivable at present:

Scenario 1

Discontinuation of negative interest, return to zero percent interest environment

The discontinuation of the negative interest rate by the SNB would mean a return to the zero percent interest environment. One would expect the liability margin to revert to zero and the asset margin to decrease to about 90 basis points. Together with a term transformation margin of 10 to 25 basis points, this would allow most retail banks a return on equity just under the cost of capital.

It is possible to reach the cost of capital through cost cuts, active ALM and moderate growth coupled with a continued low level of non-performing loans.
Scenario 2

Prolonged negative interest

In the event of a prolonged negative interest rate, the duration will be the main determinant. A prolonged negative interest environment intensifies competitive pressure, as competitors will increasingly enter the mortgage market. Initially, these new entrants will likely be insurers and pension funds for the most part. A competitive funding structure allows these providers to offer mortgage loans at more favorable conditions. In order to keep up with the competition, strategies will have to encompass massive cost cuts and improvements in funding costs.

In the event that negative interest persists over a longer period, such a strategy will fall short of the mark. In the longer term, it leads to a sharp rise in competitive intensity. Apart from the aforementioned pension funds and insurers, other competitors are likely to enter the fray. Such players might stem from within the industry (e.g., private banks) but might also emerge from niche markets, such as banks with an entirely new operating business model (e.g., without deposits, off-balance-sheet lending such as peer2peer).

As a rule, banks should try to pass on the added cost resulting from the negative interest environment. One way of doing this would be to increase account charges, as these are indeterminate amounts (source of income without an interest component). An ALM optimization could also deliver additional benefits. More importantly, the practice of cross-subsidization should be systematically reduced. The funding mix today is highly cost-intensive. Funding could be improved by expanding the volume of mortgage lending, supported by a reduction of liquidity on the assets side of the balance sheet and a decrease in deposits combined with increased issue activity on the liabilities and equity side. Such an approach would also enable a reduction of the costs caused by the statutory minimum liquidity reserve.

Irrespective to the duration of the negative interest, it is unlikely in this scenario that the full cost of capital can be earned.
6. Conclusions

So far, the introduction of a negative interest rate has not had a direct negative impact on the ability of Swiss retail banks to maintain their margins. However, negative interest has led to increased cross-subsidization of deposits from the lending business. This practice of cross-subsidization makes retail banks vulnerable to attacks by potential alternative competitors in the medium term. A significant increase in activity by insurers is already evident in the mortgage market compared with prior years. However, such a development is premised on insurers sharpening their focus on systematic management and control of sales activities for mortgage products.

Banks cannot expect to be able to indefinitely maintain the very high margins they are currently earning in the asset business. Consequently, sustainable changes are needed in the operating business model to strengthen it against short- and longer-term shocks. At the same time, the practice of cross-subsidization should be reduced quickly and effectively.
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