The development of interest income and expenses and their impact on the financial performance of the banking sector

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This contribution follows on from the article "Analysis of the impact of monetary policy on interest receipts and expenses of enterprises and households" published in the previous issue of Biatec, which examined how interest income and expenses in the corporate and household sectors have been affected by monetary policy. Although that study did not identify an exact quantitative relationship, it is clear from the partial results of the econometric analysis and the chart-based analysis that monetary-policy decisions affect the level of interest expenses and receipts in both sectors. At the same time, these changes in the setting of monetary policy are also reflected in the structure of banking products.

In this brief analysis, covering a period ending prior to 2005, we will attempt to outline how these changes in respect of interest expenses and income affect the banking sector and its financial performance.

Given that the household sector is a long-term net lender to the banking sector and the position of the corporate sector has gradually changed from that of a borrower to a lender, the banking sector has been faced with the question of how to ensure that these trends do not adversely affect its financial performance.

In the past, as regards the corporate sector, interest income significantly outweighed interest expenses, but recent years have seen that difference narrow. In respect of loans, or interest income, this was related to a decline in the amount of corporate lending in connection with the restructuring of banks' credit portfolio, as well as to a reduction in interest rates on loans that reflected the official rates of the NBS. The interest rates on corporate deposits also declined, although the relatively sharp rise in the amount of deposits countered the decrease in interest expenses. In comparison with household deposits, interest on corporate deposits remained marginally higher. Because of these factors, there was a gradual decline in banks' net interest income from the corporate sector. This was also related to the corporate sector having a stronger position than the household sector in regard to the level of interest rate on deposits and loans and to the fact that the corporate sector uses deposits for operational purposes and is less interested

Chart 1 Interest expenses and income of the banking sector vis-à-vis enterprises

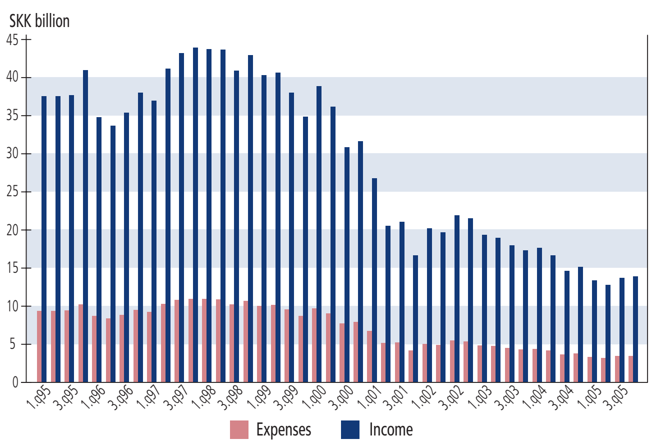
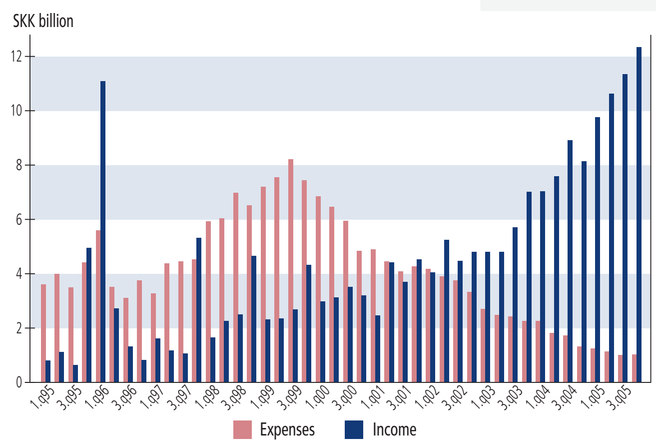


Chart 2 Interest expenses and income of the banking sector vis-à-vis households



Source: NBS.

Chart 3 Interest expenses of the banking sector

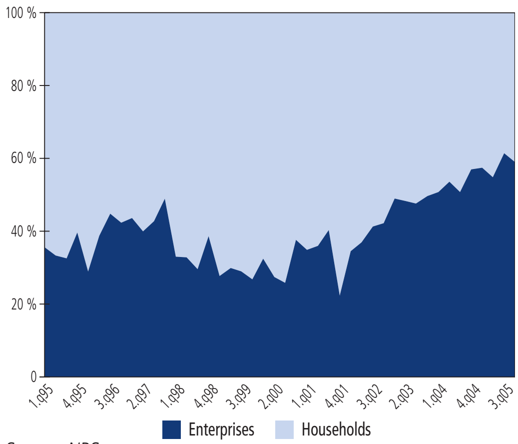
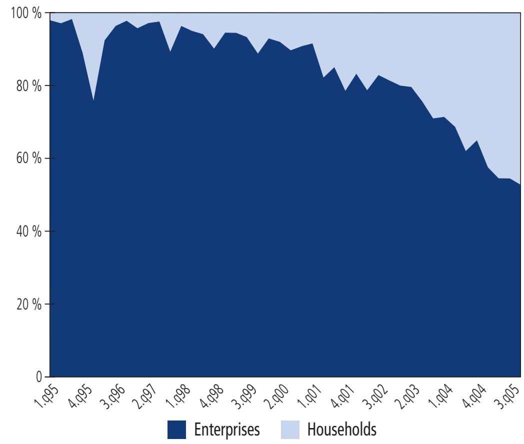


Chart 4 Interest income of the banking sector



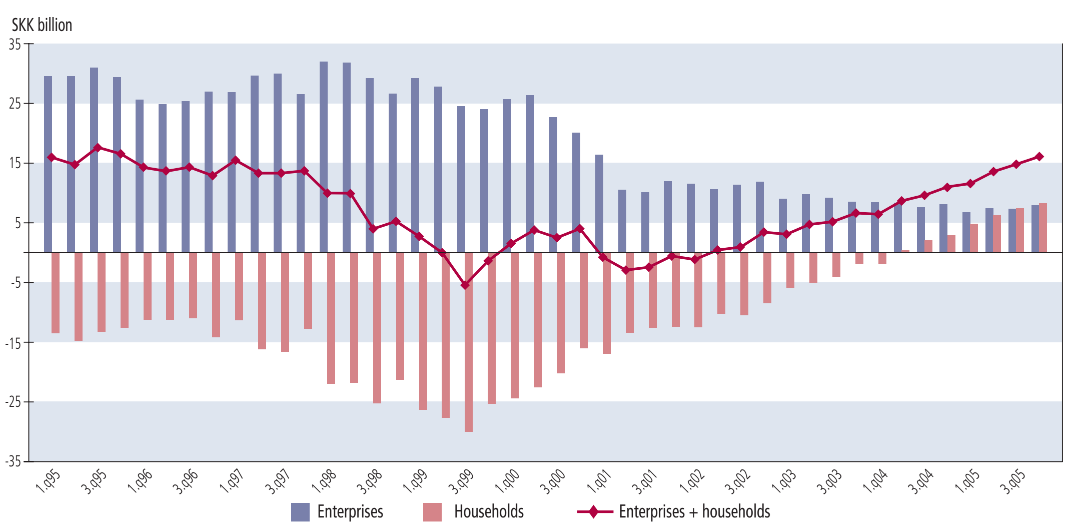
Source: NBS.

than households in investing them in alternative ways, for example, investment funds.

The household sector, unlike the corporate sector, was historically the sector in which banks recorded higher interest expenses than income, but this situation has changed substantially in recent years. Restructuring of the credit portfolio, standardization of the market environment, a decline in interest rates and the creation of necessary institutional conditions have given rise to the development of new credit products and led banks to focus strongly on household lending. The increase in lending volume alongside stagnancy in interest rates (on the outstanding amount of loans) was reflected in a rise in banks' interest income from households. On the other hand, the falling average interest rate on deposits resulted in stagnation or decline in the amount of household deposits, as households turned their attention to other forms of investment, in particular, investment funds. Both these factors brought about a gradual reduction in expenses related to interest on household deposits.

When drawing up their business strategies, banks took advantage of the environment of falling interest rates, especially in regard to the household sector. On the one hand, they flexibly passed on cuts in the NBS official rate to deposit rates, and, on the other hand, they substantially increased their credit exposure to households. Although the reported average interest rate on the outstanding amount of loans did not change, the amount of household lending increased. This clearly suggests that the structure of lending products changed significantly, as commercial banks began to offer mortgages as well as other riskier forms of credit, in particular, consumer loans without special purpose. In the past, the majority of lending was accounted for by building-society loans – the interest on which was fixed by law[1] until July 2003 – but the lending structure has recently shifted in favour of other products, with the interest rate set according to market principles. Although the reported average interest rate has not fallen, it should be noted that some credit products were previously not offered or its interest rate would have been substantially higher in that time. So effectively the interest rate has declined.

Chart 5 Net interest income of the banking sector



Source: NBS.

1 In force until 1 July 2003, Article 3(1) of Act no. 310/1992 Coll. on home savings, of 6 May 1991, as amended, stipulated that "a building society shall set interest rates on deposits and interest rates on home loans so that the difference between them is not more than 3%".

The intention to maximize net interest income was reflected in a change in the sectoral structure of interest income, as the household sector's share of interest income rose and its share of interest expenses fell.

To compensate for the substantial reduction in interest income from the corporate sector, banks both promptly reduced deposit interest rates in accordance with cuts in monetary-policy rates, and increased lending to households. Whereas net interest income from the household sector was previously negative, it has in recent years become positive and now compares in amount with the net interest income from the corporate sector. Hence overall net interest income from the corporate and household sectors is now reaching pre-1998 levels, but its sectoral structure is different.