Session 2: “Competition and Profitability”

Discussion of: “A portfolio perspective on euro area bank profitability using stress test data”

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Summary

- **The paper:**

1. Assesses euro area banks' profitability using **granular stress test data from 3 EU-wide exercises**, coordinated by the EBA, that took place in 2016, 2018, and 2021.

2. Uses granular stress-test data to calculate **portfolio-level risk-adjusted ROAs** for the euro area as a whole and for individual countries.

3. Provides insights into the question of how **adverse macroeconomic and financial developments affect the profitability of bank intermediation** and, in particular, the **profitability of specific banking activities/portfolios.**

Summary

- **Methodology:**

1. The study focuses on the **5 main portfolios of banks**: Financials, Households – Consumer Credit, Households – Mortgages, Non-Financial Corporations and Sovereigns.

2. The measure developed for portfolio profitability reflects (i) **interest earned on assets**, (ii) a **weighted-average cost of capital** and (ii) the **cost of risk**, abstracting from any market risk considerations or any type of overhead costs.

3. This measure is then used to analyse (i) the **profitability of each portfolio over time**, based on historical data reported by banks and (ii) by using banks' projections, how **macroeconomic conditions, including the low interest rate environment, may affect the profitability of each asset class** under analysis. **Heterogeneity across countries** (in addition to portfolios' heterogeneity) is also explored as well as **portfolio transition** (between profitable and unprofitable "status").

Summary

- **Main findings**
  1. **Retail portfolios have the highest returns, followed by exposures to NFC**, but are also sensitive to macroeconomic conditions. **Sovereigns consistently record zero/negative returns**, while interbank exposures record low overall returns that barely cover the CoR.
  2. A scenario of a severe recession coupled with low for longer interest rates (2021 stress test scenario) yields the **strongest drop in profitability for all portfolios, but sovereigns**. For the latter, a strong increase in interest rates with a relatively higher impact on funding costs than on returns, as considered in 2018 stress test exercise, results in the strongest drop in profitability.
  3. The **heterogeneity of the metric increases under the adverse scenarios**, with the increase being larger for the 2021 exercise. Regarding **portfolio transitions**, while the number is rather limited for the 2016 adverse scenario, it increases slightly for the 2018 exercise and is the highest under the 2021 adverse scenario.
  4. The switch to negative portfolio profitability is **more pronounced for portfolios that already recorded low (but non-negative) profitability** at the start of the adverse scenarios.

Comments

- **Computation of WACC (1):** Due to the weights being used, it seems that some heterogeneity across different portfolios is considered in the CoF. However, the main hypothesis followed in the paper is that the **CoF is assumed to be the same for each asset class for a given bank.** This approach thus seems to be missing variation in the CoF based on the loan's maturity/cash-flows and/or repricing dates. To what extent this might be influencing the results?

- **Computation of WACC (2)**: The **same hypothesis is followed for the CoE** (assumed to be the same for all portfolios). To what extent the different RWs associated to each exposure/segment are being taken into account in the analysis made?

- To what extent the **constraints embedded in the EBA stress test exercise** (notably the imposed caps and floors for interest rate margins) are influencing the main conclusions of this study?

Comments

- One of the conclusions of the paper is that “exposures with already low profitability at the start of the projections could be those with the largest deterioration of their profitability”. To what extent this result **challenges the idea that more profitable assets tend to be the riskiest and more volatile ones**?

- To assess the robustness of the paper’s conclusions, **some further analytical work may be needed**. In fact, it is not always easy to check some of the paper’s conclusions from the graphs presented in the paper and the robustness of the correlations underlying the conclusions drawn could be further assessed.

Comments

Questions for clarification:

- The computation of the CoR takes into account, not only the transitions from S1 to S3 and from S2 to S3, but also the impairment flows associated to S3 exposures. But why should the latter be scaled? And why should they be scaled by the “remaining maturity”?

- The paper mentions that “it is unlikely than on aggregate banks shift the allocation of their assets away from the portfolios that will be most affected by the adverse scenarios”. Is this conclusion based on substituting effects that may occur across the different banks of the system?

- The paper would benefit from further clarification on how the CoE and CoF are computed.