

SPEECH

Bank profitability: a mirror of the past, creating a vision for the future

Speech by Claudia Buch, Chair of the Supervisory Board of the ECB at Bocconi University^[1]

Milan, 16 October 2024

The history of banking contains many examples of institutions that reported high profitability before failing.^[2] This profitability concealed underlying risks and, over time, proved to be illusory. In the run-up to the global financial crisis, bank profitability was relatively high, but, as the crisis unfolded, these profits declined sharply and turned into losses.

Banking regulation and supervision have significantly improved since then. Regulation has been reformed at the global level, requiring banks to be better capitalised and more liquid, while the Single Supervisory Mechanism, underpinned by the Single Rulebook, has been established.

Bank profitability in Europe has increased in recent years. In some ways, the current levels of bank profitability mirror the past – structurally, by reflecting differences in markets and banks' business models, and more cyclically, by reflecting the changing macroeconomic environment and higher interest rates. This raises the question as to whether profitability is a good metric for assessing bank resilience or if there are other indicators we should consider.

In a market economy, profitability is a key performance indicator. It is highly correlated with business models, productivity and, in this sense, the contribution that firms make to economic welfare. Banks are no exception here.

At the same time, profitability does not measure firms' contribution to welfare more broadly. Generally, a high degree of profitability can signal excessive market power. In the financial sector, it can be difficult for outsiders to verify the quality of services provided and the underlying risks. High profitability can therefore also signal excessive risk taking or even fraudulent behaviour. Banks and their shareholders may take on more risk than is socially acceptable if there are potentially great rewards to be had and only limited downsides. Seeking to maximise profits in the short term can be detrimental to the longer-term sustainability of a business model. In addition, the public cares a great deal about banks' stability and resilience since banking crises can come at a significant cost to the taxpayer.

These considerations have three main implications for banks and supervisors.

First, high levels of bank profitability reflect good management and business franchise, but also good luck and a favourable macroeconomic environment in the short term. Some factors driving profitability are under the control of individual banks, others are not. Some are correlated with higher long-term resilience, others are not. Good risk management by banks needs to take these distinctions into account.

Second, supervisors' assessments of bank profitability focus on the long term. Factors that drive up profitability in the short term may come at the expense of weaker long-term stability. In particular, a high short-term return on equity without due consideration for the underlying risks is not necessarily conducive to bolstering resilience and maintaining financial stability. All other things being equal, lower equity capital increases the return on equity, but it also reduces bank resilience. More risk taking increases returns, but also leaves banks more vulnerable to shocks. This is why good supervision ensures that banks focus on their long-term profitability, anchored by a resilient and sustainable business model, governance structures that prevent excessive risk taking and sound capital planning that takes future uncertainties into account.

Third, banks' future profitability is shaped by their ability to respond to changes in the external environment, particularly the digitalisation of financial services. These services may increasingly be provided by strongly capitalised big tech companies with large IT budgets. They may also increasingly be provided across borders, which would reduce the importance of any inherited comparative advantage in local markets. Banks therefore need to find strategic responses to these challenges. They need to invest in IT and cybersecurity to improve their cost efficiency and take advantage of scale effects. Today's high profitability levels provide banks with a window of opportunity to invest in their vision for a long-term, sustainable business model in a world of digital finance.

Perspectives on bank profitability

Banks, supervisors and members of the public all have different perspectives on bank profitability.

Is profitability relevant for banks? At face value, this seems a strange question to be asking. For privately owned banks, profitability is obviously an important performance indicator. More profitable banks are in a better position to build buffers against risks, invest in longer-term projects and return more to their shareholders. All this makes them more attractive to potential future shareholders. More profitable banks can also afford to pay their staff higher wages and bonuses. At the same time, stakeholders have different perspectives on short-term and long-term profitability, depending on performance compensation and investment horizons. Some banks, particularly savings banks and cooperative banks, have objectives that go beyond maximising profits.

Generally, the perspective of banks and their shareholders may not fully reflect the perspective of society more broadly. Like many other companies, banks operate under conditions of limited liability. Losses are borne by shareholders and other creditors up to the level of their loss-absorbing capacity. Consequently, bank managers and owners may have an incentive to take excessive risks: shareholders would benefit from the upsides of this risk taking, but they would not have to bear the full losses resulting from a bank failure if the downside scenario materialised.

At the same time, bank failures often cannot be dealt with through standard insolvency proceedings. Banks perform critical economic functions and have short-term liabilities, which make them prone to runs. In the past, bank failures have therefore often placed a significant burden on public finances. Resolution regimes were established in the aftermath of the global financial crisis and banks are now required to have additional loss-absorbing capacities. In addition, the prudential authorities address banks' incentives to take risks.

So, is bank profitability a relevant metric for supervisors? The short answer is yes. But the time dimension is important here, as supervisors focus on banks' long-term, risk-adjusted profitability from a forward-looking perspective. Profitable banks are able to retain earnings and strengthen capital to cover risks, which is good for resilience. They can also invest in new technologies and risk control mechanisms, which is good for stability. However, banks may also pursue strategies to increase short-term returns which run counter to their stability. Increasing leverage or taking additional risks could lead, all other things being equal, to a higher short-term return on equity. But these strategies eventually reduce banks' resilience.

Banks' return on equity can therefore be disproportionately affected by leverage and risk taking, potentially concealing underlying vulnerabilities. By considering other aspects of financial performance, supervisors can reach a more balanced and dynamic assessment of bank profitability. Supervisory assessments therefore break down the different drivers of profitability and look at the longer-term viability of business models. European banking supervision's Supervisory Review and Evaluation Process (SREP) uses a wide range of metrics to do this. Return on assets gauges how effectively a bank is using its assets to generate income, regardless of its funding structure. The cost-to-income ratio provides insights into a bank's cost efficiency by comparing operating expenses to net revenues. Income diversification assesses the extent to which a bank's revenues are spread across different products, services and markets. The stability and predictability of revenue sources are scrutinised to determine their resilience to external shocks and business cycle fluctuations.

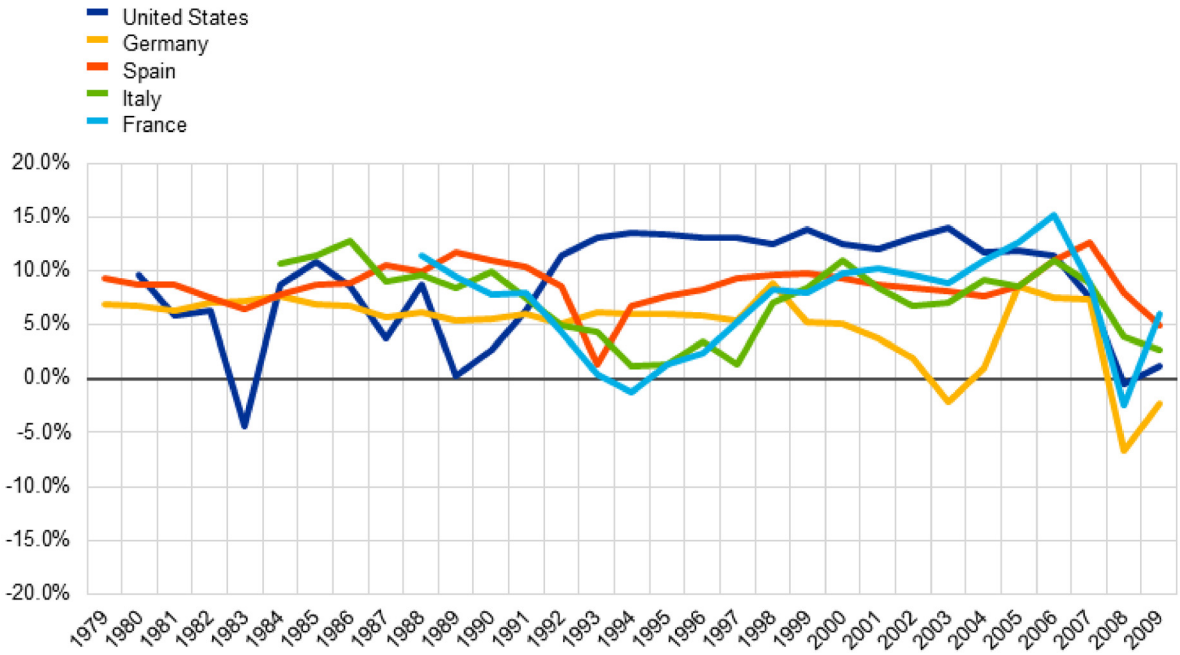
Our focus as supervisors is on sustained profitability to ensure banks' business models remain viable over time. Profitability metrics feed into our assessment of medium-term financial and capital trajectories as well as bank-specific distribution plans. This specifically requires banks to consider adverse scenarios in their capital planning which, while not part of the baseline, are still plausible.^[3]

Generally, a "follow the money" approach allows supervisors to assess the potential risks underlying headline profitability levels. If a relatively modest part of a bank's activity accounted for a significant portion of its overall profits, this could indicate that some of its core business areas were not viable on a longer-term basis, or that the modest part of the activity was recording strong profits due to excessive risk taking.

Bank profitability as a mirror of the past

Analysts, banks and supervisors tend to focus on current levels of bank profitability. But extending the time horizon and looking at historical patterns of bank profitability can be quite instructive. Thanks to statistics compiled by the Organisation for Economic Co-operation and Development, we can look at data on bank profitability from the late 1970s up to 2009. In the 1980s and 1990s, the profitability of European banks was more stable than that of banks in the United States or Japan.

Chart 1: Long-term trends in banks' return on equity (1979-2009)

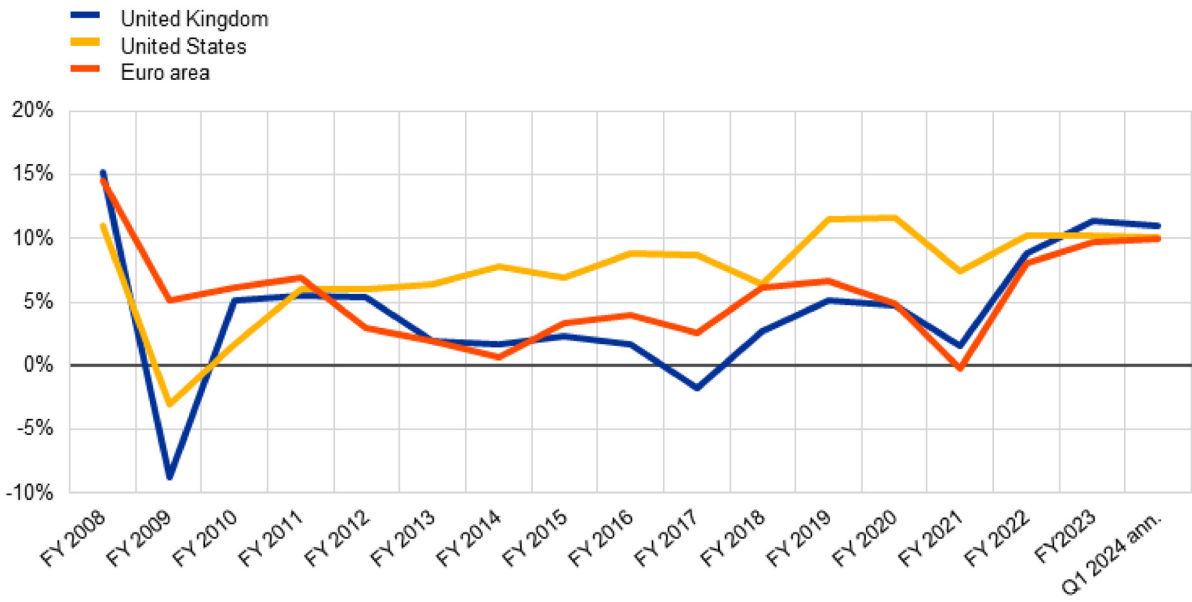


Sources: OECD and ECB internal calculations.

Notes: Return on equity has been calculated as the ratio of net income after tax (item IN50TC) to capital and reserves (item BL19TE).

It then declined in the 1990s. In the run-up to the global financial crisis, profitability increased – but not in a sustainable way, as it was driven by excessive risk taking. Bank profitability thus took a hit during that crisis.

Chart 2: Banks' return on equity (2008-2024)



Source: European banking supervision quarterly profitability monitoring.

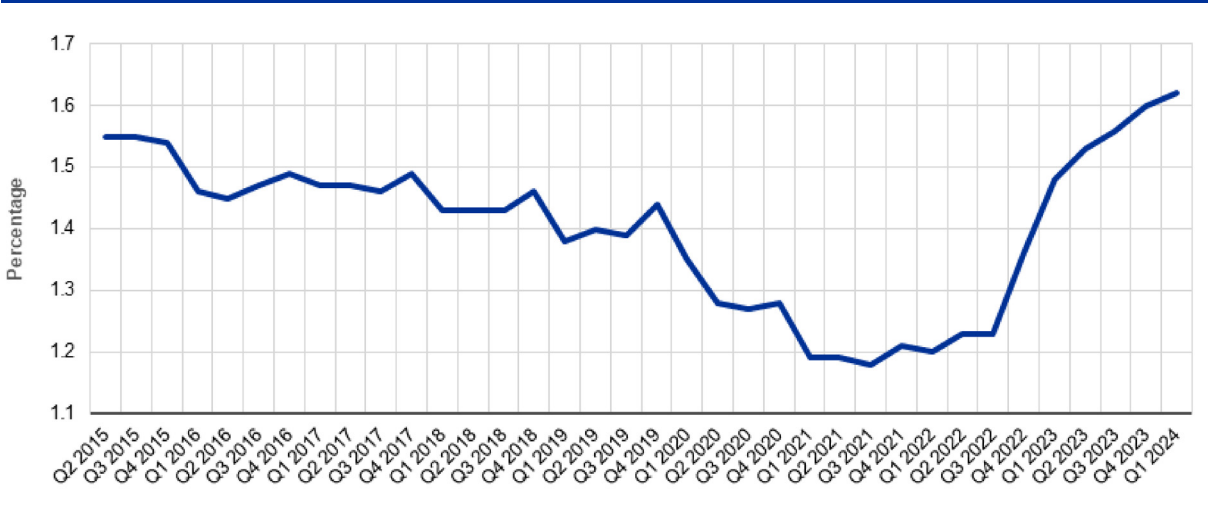
Notes: This chart shows the change in the weighted average, trailing four quarters annualised return on equity for selected global systemically important banks (G-SIBs), calculated as the sum of aggregate net profits divided by aggregate year-end equity. The data are taken from Bloomberg and publicly listed G-SIBs have been selected in the sample (four from the United Kingdom, eight from the United States and seven from the euro area) to enhance comparability. The sample is subject to change over time depending on the banks' G-SIB status.

Generally, periods with high levels of bank profitability were often followed by stronger credit growth, which sometimes became excessive and helped create the conditions that led to crises.^[4] This is why countercyclical macroprudential policy plays a key role in preventing such a scenario from materialising.

Over the past decade, European banks' overall profitability has increased. In 2024 banks under European banking supervision reported a return on equity of around 10%, compared with 6% in 2015.^[5] Banks' return on assets rose from 0.4% to 0.7% over the same period. However, during the period of low interest rates and low inflation, profitability was much lower and it only recovered when interest rates increased.^[6]

This shows the importance of the macroeconomic environment for bank profitability. Low bank profitability during the period of low interest rates did not necessarily reflect a structural decline in the longer-term profitability of banks.^[7] More recently, central banks raised interest rates to combat inflation, which has pushed up banks' net interest margins (Chart 3) and, in turn, their profitability, without necessarily having any implications for longer-term profitability.

Chart 3: Aggregate net interest margin

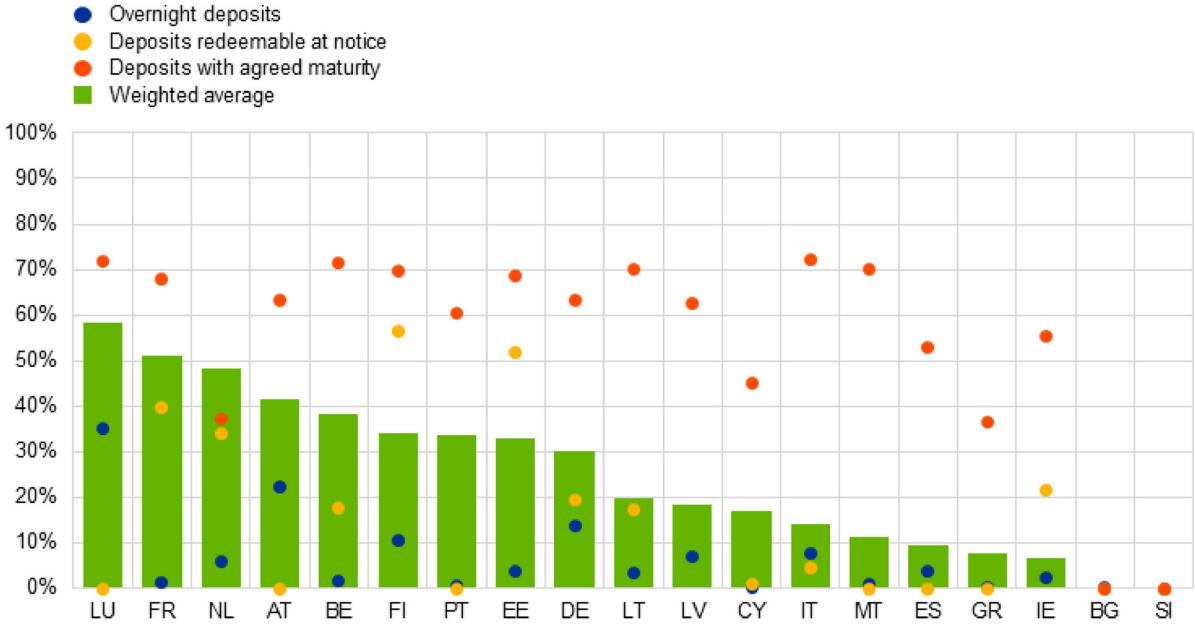


Sources: [Statistical Data Warehouse](#), ECB based on financial reporting submissions.

Notes: Net interest margin is equal to interest income divided by interest expenses. It is calculated as an aggregate for all significant institutions in countries participating in European banking supervision. The composition of the sample has changed over time to reflect changes in the list of supervised entities.

The speed at which higher interest rates have been passed through to banks, and the resulting impact on banks' profits, has differed across countries. Sight deposits, which are payable on demand, tend to be repriced slower than term deposits.

Chart 4: Pass-through of main refinancing operations to household deposits



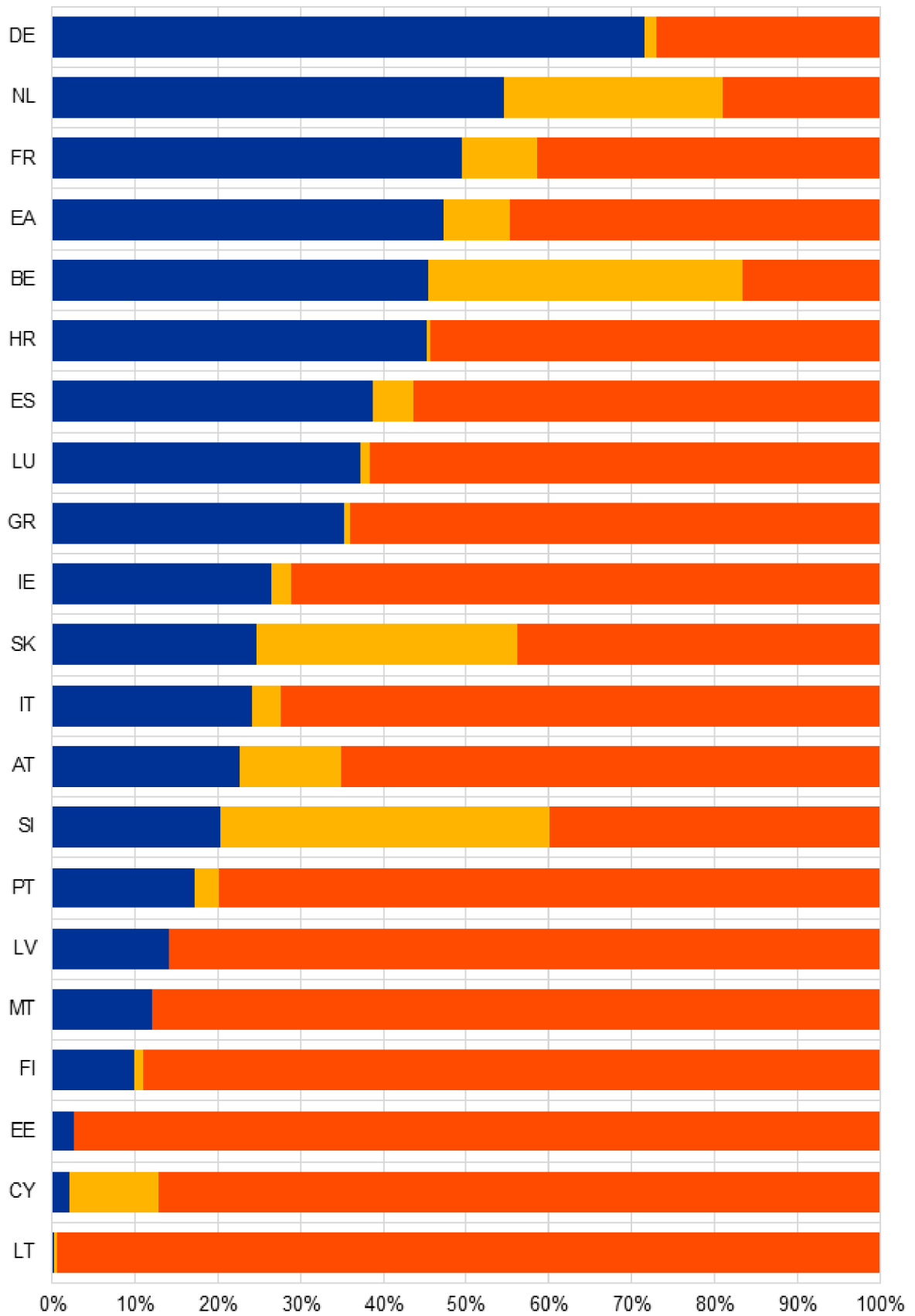
Source: MFI interest rate statistics.

Note: Pass-through is defined as the extent to which changes in the interest rate on the ECB's main refinancing operations lead to a change in deposit rates for households through banks' commercial policies.

The more depositors have shifted from sight to term deposits, the more sluggish the growth in banks' interest income has been. Moreover, in markets with a higher prevalence of floating rate contracts, banks have raised lending rates faster but the risk of borrowers being unable to cope with increased payments has also remained higher.

Chart 5: Share of fixed versus variable rate lending to non-financial corporations

- Fixed
- Mixed
- Variable



Source: ECB (2024), *Financial Stability Review*, May.

Notes: Lending shares refer to outstanding amounts for loans to non-financial corporations. “Fixed” indicates a rate that both parties to the loan contract agree to at inception. “Variable” indicates a rate linked to an exogenous parameter (e.g. EURIBOR). “Mixed” indicates a combination of fixed and variable rates.

Different patterns of bank profitability thus coexist within Europe. Banks retain significant pricing power in local markets – in spite of the fact that cross-border competition in financial services was already liberalised in Europe several decades ago, and that we now have a Single Rulebook with all banks being supervised using the same standards. But there are also differences between countries in many areas of relevance for banks, including tax and insolvency laws. This localisation of competition leads to discrepancies in profit margins.

Overall, the current levels of bank profitability mirror the economic conditions of the past. Bank-level cost and funding structures and banks’ ability to generate returns are key determinants of profitability. At the sectoral level, the degree of competition affects banks’ pricing power. At the country level, the institutional environment plays a role, notably differences in tax regimes and insolvency legislation. And finally, the macroeconomic environment has a strong impact on banks’ profitability.

Moreover, if governments implicitly or explicitly protect banks from failing, this leads to funding advantages for the banks that benefit from those guarantees. Implicit funding subsidies can lower funding costs, increase profitability and encourage risk taking, as the costs of failure may not be borne by shareholders. One of the main objectives of the reform agenda enacted by global regulators in the aftermath of the global financial crisis has been to reduce implicit funding guarantees, but they have not been fully eliminated.^[8]

Importantly, current patterns of bank profitability may provide limited information about future profitability.^[9] Structural changes in the real economy and the financial sector may diminish the forces that have contributed to high profitability in the past, and the macroeconomic environment is changing in terms of patterns of inflation, demographics and geopolitical risks. Banks need to come up with strategic responses to these trends.

Future sources of bank profitability

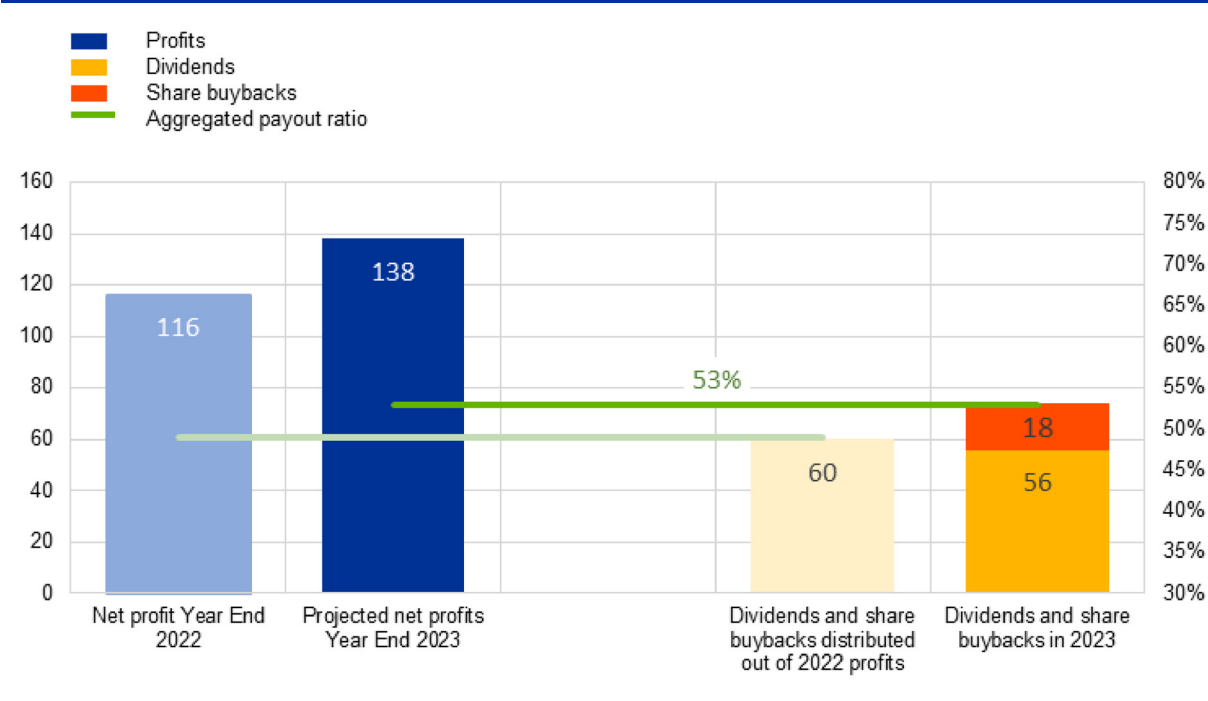
Digitalisation is one important factor that will drive bank profitability in the future. Banks will increasingly be competing to find the best digital solutions for providing services to their customers, using economies of scale and scope to manage IT infrastructure and the related risks, such as cyber risks.

Successful digitalisation requires banks to invest in IT systems and operational resilience. They need to respond to changes in customer preferences, and they need to come up with strategic responses to potential competition from non-bank financial service providers such as fintechs and, in particular, large big tech firms.^[10] These firms have state-of-the-art technology, considerable IT budgets, large market capitalisation and high levels of profitability, and can reinvest a significant part of their earnings in innovation and IT system maintenance.

So banks need capital to finance long-term investments. They can generate capital internally, through retained earnings, or externally, by tapping the capital markets. Current profitability trends reflect banks' potential to strengthen their capital base. For shareholders with a long-term investment horizon, retained earnings are not foregone. If banks were to invest in the sustainability of their business models, shareholders would benefit from lower risks and higher future share prices.

Banks typically distribute a portion of their profits to shareholders. On average across the significant banks under European banking supervision, approximately 50% of profits are distributed, mostly in the form of cash dividends but increasingly also through share buybacks. In 2023 significant banks distributed 53% of their 2023 profits, with one-quarter of the distributed amount taking the form of share buybacks.

Chart 6: Distribution based on 2023 profits



Source: ECB internal calculations.

Notes: Figures are in billions of euro. Weighted average. Includes interim dividends and share buybacks approved throughout 2023.

Ultimately, shareholders are the first line of defence if a bank incurs losses, so they expect compensation for the risk they are taking. Expected returns thus depend on the capitalisation and resilience of banks. The more banks pay out, the lower their resilience and the higher the risk for existing shareholders who, in turn, may expect higher compensation.

But what matters for shareholders is future profitability, not current profitability. While the two may be highly correlated if one looks through the cycle, high book values of profitability in a benign macroeconomic environment or due to the past strength of business models may give little indication about future profitability. In fact, markets seem to be better at predicting future profitability than book values, which reflect past profitability.^[11]

Supervisors can encourage banks to take a sufficiently long-term perspective when assessing risks and returns. We scrutinise banks' credit underwriting standards and their management of interest rate, liquidity and market risks, assessing both risk controls and risk levels. We also focus on sound capital planning, IT and cyber resilience frameworks, and governance structures – three areas that I will now discuss in more detail.

First, sound capital planning requires a multi-year assessment of a bank's ability to fulfil all capital-related requirements and cope with external financial constraints.^[12] This includes a credible baseline scenario and institution-specific adverse scenarios, each covering a three-year time horizon. Adverse scenarios should reflect macroeconomic and institution-specific developments that could negatively affect future capital headroom. Banks need to set management buffers to account for unforeseen events. A bank's management buffer should reflect its view on the capital it needs to sustainably follow its business model, in addition to the minimum capital requirements and buffers. Overall, our expectation is that hypothetical adverse scenarios in stress test exercises generate a significant depletion in capital, consistent with the severity of the assumed economic shock. Banks need to take this into account for the purposes of their capital planning.

As part of the yearly SREP assessment, and whenever banks decide to distribute dividends, we assess their payout plans. We challenge the soundness of individual capital plans to ensure that payouts are compatible with maintaining capital levels that allow banks to sustainably withstand even prolonged periods of stress and uncertainty. Economically, share buybacks and dividend payments are equivalent, as they lower a bank's capital compared with a situation when earnings are retained. We therefore expect share buybacks, just like dividend payments, to take place within the context of sound capital planning and management. However, the permissions regime and communication methods for cash dividends and share buybacks differ because share buybacks require a formal application and supervisory approval.

Second, banks' IT and cyber resilience strategies require investment and long-term planning. Cyber risk, data security and IT-related risks, particularly those related to third-party outsourcing, are key drivers of banks' operational risk, as a successful cyberattack can lead to material disruptions to critical services. However, around 10% of contracts covering critical functions are in fact not compliant with the relevant regulations.^[13] The ECB will thus continue to focus on cyber resilience, as reflected in our supervisory priorities for 2024-26 and the EU's Digital Operational Resilience Act. This year, the ECB conducted its first cyber resilience stress test, analysing how banks respond to and recover from cyberattacks.^[14] We found that banks are prepared but there are gaps in their recovery capabilities. Banks need to invest more in their response and recovery strategies, especially in the context of growing geopolitical tensions and the rise of cyberattacks.

Generally, sustained long-term profitability requires investment in cyber and IT resilience. The United States provides an interesting case study in this regard. US banks increased their IT investment sixfold, in nominal terms, from 2001 to 2021, driven in particular by larger banks. There is evidence to suggest that competition from fintechs has contributed to these trends^[15]. Large European banks' investment in IT, on the other hand, seems to have followed a more gradual path in comparison.

Third, sound governance and risk management systems are key to buttressing banks' long-term profitability. If they are incentivised to do so, banks' management may engage in short-term profit optimisation strategies, increasing risk and lowering resilience. Past crises have underscored how poorly structured incentives can undermine a bank's reputation and operations, and ultimately its viability. Generally, banks are paying more attention to governance, and risk culture has improved, for example in areas such as the role of non-executive directors. However, risk culture remains an area of supervisory attention for the ECB.

The recent draft ECB guide on governance and risk culture emphasises the critical role of well-designed incentive systems in fostering a sound risk culture.^[16] One key supervisory expectation is that variable remuneration must be closely tied to a bank's risk appetite framework.^[17] When determining how bonuses are allocated, key performance indicators need to be adjusted for risk, and they need to incorporate both financial and non-financial factors, such as risk management and control effectiveness. For banks to appropriately balance risk and reward, supervisors expect a portion of the variable remuneration to be deferred over several years, including the application of malus and clawback provisions. These mechanisms help ensure that employees are rewarded based on long-term performance sustainability, aligning remuneration practices with current and future risks.

Outlook

Bank profitability mirrors the past. It reflects prevailing business models, market structures and the macroeconomic environment. On the back of higher interest rates, European banks' profitability has increased significantly in recent years. However, while the turning of the interest rate cycle has been beneficial for banks so far, this may be insufficient to offset structural weaknesses that could re-emerge if and when downside risks to the economic outlook materialise. This is why banks need to continue adapting to a changing environment characterised by a digital transformation trend and a high level of macroeconomic uncertainty, especially in relation to geopolitical risks.

Sustaining future profitability and strengthening business models requires banks to have a clear vision: a vision for how to adapt business models; a vision for how to bolster IT systems to provide the best service to customers; and a vision for how to protect against cyber risks. Much of this requires long-term investment, long-term funding and a strong capital base. Shareholders benefit from visionary long-term investment strategies as the value of their shareholdings rises.

Short-term profit optimisation, on the other hand, may come at the expense of longer-term resilience and incentivise risk taking. To maintain financial and operational resilience, sound, forward-looking capital management remains key. We expect all capital management transactions, including distribution decisions, to be informed by sound capital planning that demonstrates that banks can sustainably withstand even severe stress scenarios. The current high levels of profitability provide a good opportunity for banks to invest in their future profitability.

1.

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Ramon-Ballester and John Roche for their helpful comments and input on an earlier draft. All remaining errors are my own.

2.

Reinhart, C.M. and Rogoff, K.S. (2008), "[This time is different: a panoramic view of eight centuries of financial crises](#)", *NBER Working Paper Series*, No 13882, National Bureau of Economic Research, March.

3.

For details on the ECB's supervisory approach to banks' capital planning and dividend distribution policies, see the [FAQs on ECB supervisory measures in reaction to the coronavirus](#), the assessment criteria outlined in a [presentation](#) by Andrea Enria in March 2022 and the [ECB clarification on ICAAPs & ILAAPs and respective package submissions](#).

4.

See, for example: Richter, B. and Zimmermann, K. (2019), "The Profit-Credit Cycle", December; and Dell'Ariccia, G., Igan, D., Laeven, L. and Tong, H. (2016), "Credit booms and macrofinancial stability", *Economic Policy*, Vol. 31, No 86, pp. 299-355. Over time, banks' returns have been shown to have a strong role in predicting future economic growth, notably in high leverage and low macroeconomic risk regimes. See Kuvshinov, D., Richter, B. and Zimmermann, K. (2022), "[The shifts and the shocks: bank risk, leverage, and the macroeconomy](#)", *Working Paper Series*, No 2672, ECB, June.

5.

Banks' return on equity averaged 5.9% between the second quarter of 2015 and the fourth quarter of 2019 but fell sharply to 1.2% in 2020 against the backdrop of the coronavirus pandemic. Return on equity then gradually recovered to such an extent that it is now above pre-pandemic levels, averaging 8.8% in the period from the first quarter of 2021 to the second quarter of 2024. Return on assets displayed a similar dynamic over that period, averaging 0.4% in the run-up to the pandemic, just 0.1% during the pandemic itself and 0.6% thereafter.

6.

See the ECB's [supervisory banking statistics](#).

7.

Borio, C., Gambacorta, L. and Hofmann, B. (2017), "The influence of monetary policy on bank profitability", *International Finance*, Vol. 20, No 1, pp. 48-63; Altavilla, C., Boucinha, M. and Peydró, J.-L. (2018), "Monetary policy and bank profitability in a low interest rate environment", *Economic Policy*, Vol. 33, No 96, pp. 531-586.

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For a discussion on the persistence of banks' profits, see also Berger, A.N., Bonime, S.D., Covitz, D.M. and Hancock, D. (2000), "Why are bank profits so persistent? The roles of product market competition, informational opacity, and regional/macroeconomic shocks", *Journal of Banking and Finance*, Vol. 24, No 7, pp. 1203-1235; and Goddard, J., Liu, H., Molyneux, P. and Wilson, J.O.S. (2011), "The persistence of bank profit", *Journal of Banking and Finance*, Vol. 35, No 11, pp. 2881-2890.

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Begenau, J., Bigio, S. and Majerovitz, J. (2019), "[Banks Adjust Slowly: Evidence and Lessons for Modeling](#)", *Working Papers*, No 3672, Stanford Graduate School of Business, April.

12.

The ECB's supervisory expectations regarding banks' capital management are set under Principle 3 of the [guidance](#) it published in 2018.

13.

ECB Banking Supervision (2024), "[Rise in outsourcing calls for attention](#)", *Supervision Newsletter*, 21 February.

14.

ECB Banking Supervision (2024), "[ECB concludes cyber resilience stress test](#)", 26 July.

15.

Modi, K., Pierri, N., Timmer, Y. and Martinez Peria, M.S. (2022), "The Anatomy of Banks' IT Investments: Drivers and Implications", IMF Working Papers, No 2022/244, International Monetary Fund; Ahnert, T., Doerr, S., Pierri, N. and Timmer, Y. (2024), "Does IT Help? Information Technology in Banking and Entrepreneurship", *Management Science*, forthcoming.

16.

ECB Banking Supervision (2024), "[ECB consults on governance and risk culture](#)", 24 July.

17.

Remuneration structures need to comply with European regulations. These include the Capital Requirements Directive, European Banking Authority guidelines and national laws.