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Monetary policy: How are monetary developments impacting the financial sector and the economy?

Speakers

William R. White
Bank for International Settlements (BIS) , Previously, Economic Adviser and Head of the Monetary and Economic Department

Philippe Bordenave
BNP Paribas , Chief Operating Officer

William R White

The question that has been posed is a very practical one, certainly for discussion at a meeting such as this: what are the consequences of lasting zero interest rates for banks and their customers?

I wrote a paper in 2013, which was called *Ultra Easy Monetary Policy and the Law of Unintended Consequences*. The starting point – and I think this is an important point to make – for that analysis was that the modern economy is not a machine, which is the way most of the models treat the economy. It is not a machine, but a complex, adaptive system, like many other systems in nature and in society. In such systems, policy levers often do not have the effect that people expect them to have, and they often have effects that people do not expect them to have – the unintended consequences.

At that time, I outlined very briefly a whole series of possible unintended consequences. One of them had to do with the prospects for rising inflation; resource misallocations going back to Hayek and the Austrians; exclusive debt accumulation – the problem that Richard Koo calls 'balance sheet recessions'; disruptive international capital flows; threats to the independence of central banks; threats to income distribution – monetary policy making income distribution worse, not better; and a whole series of possible side effects.

One of the most important ones, however, was the implications of ultra easy monetary policy for the financial sector, which is what we want to talk about in more depth today. I am very pleased that we have Philippe Bordenave here. He is Chief Operating Officer of BNP Paribas and is plugged right into the system and probably as well qualified as anybody to talk about these issues. I want to welcome Philippe to start with, and then to ask him a series of questions. We have only 20 minutes, so we will have to be fairly brief in treating this big and important issue.

The first question, I guess, about lasting zero interest rates or ultra easy monetary policy really has to do with the question of whether it will work. There, I think we go back to the question of what the impacts are of these things, as Philippe sees it, on the banks' customers, which is to say virtually everybody in this room and all our friends and acquaintances. Philippe, is it going to work or what?

Philippe Bordenave

You are perfectly right: the theory is not always followed in practice. In theory, a decrease in interest rates encourages savers to reduce the amount of their remunerated savings, as their opportunity cost decreases, and it prompts borrowers, on the other hand, to increase their indebtedness, as it reduces their financial burden. In practice, however, things at the moment are a little more complicated than that, as everybody sees.

This low interest rates environment translates into higher household and corporate-sight deposits

It is because we are in an environment of weak economic growth, which makes households feel uncertain about their jobs, and non-financial corporations feel unsure about their ability to sell their products to customers. As a result, the increasing economic uncertainty leads savers to increase their savings, rather than decreasing them, for precautionary purposes, and they invest less in riskier asset classes as they become more risk-adverse. It makes borrowers less reactive to a decline in interest rates, as their commercial prospects are decreasing.

As a consequence, this low-interest-rate environment translates into higher household- and corporate-sight deposits, as well as a decline of the money multiplier; hence, the monetary policy is not that well transmitted to the real economy, in as much as this is in addition to the impact of the new liquidity requirements on this money multiplier. Therefore, from an economic perspective, all this is quite similar to the famous liquidity trap.

William R White

You are doubtful, then, about the efficacy of these measures in terms of stimulating aggregate demand, but what do you think the implications of this are for the banking sector? Banks do an awful lot of different things – is this going to be good for some activities and bad for others, or good for all of them, or bad for all of them?

Philippe Bordenave

Before we start, I would like to stress that this monetary policy has been induced by a very weak economic environment. The demands on monetary policy have been huge, because it has not only to address the deflation risk but also to offset the regulatory impact on the macroeconomy. To the extent that it has slowed down the negative effects of regulatory policy on banks, it has helped all banks – that is the backdrop to everything.

In more detail, it is clear that low interest rates have a negative impact on retail deposit banks in particular, because their business consists of maturity transformation between costless and short term deposits, and long-term loans. Quite understandably, the interest margin depends on the interest-rate levels of those long-term loans. When interest rates go lower and lower for a prolonged period of time, back-book loans are progressively replaced by lower-yielding loans in the banking book.

Conversely, the same low-interest-rate environment is positive for many specialised financing activities such as factoring, leasing, consumer loans and long-term car rentals, as those businesses usually fund themselves at market rates, without any transformation. For them, then, client and funding rates decline in parallel, and margins remain stable, with a benefit from the demand increase brought by lower rates.

To be complete, I would like to mention that, eventually, corporate and institutional banking and market activities are more or less rate-neutral because all loans and deposits are indexed to floating rates in that business.

William R White

I take away, then, that, within the diverse banking activities, some sectors and activities will gain, and some activities will lose, but I guess the big question is: net, what does this mean for banking profits? What I think is interesting is that this negative interest rate that we have had for the last little while has attracted a lot of attention because of the impact on bank profits. When you think about the policy that has been followed for the last number of years, however, it has been designed to reduce credit spreads and term spreads. This, then, is just, in a way, more of going further down a path that we have been going down. What does it mean for bank profits, which do not look so good at the moment?

Philippe Bordenave

Even before the lowering of interest rates to zero or even below zero, European banks' profitability has been low for quite a while. On average, the return on equity in 2014 in Europe was 3.7%, as compared with a little better but not brilliant 6.9% for US banks, while non-financial companies are yielding a 10% return on equity. It is expected to be a little better in 2015, when we have all the figures, but not significantly – only marginally.

Monetary policy is becoming part of the problem

Clearly, the ongoing decline in interest rates and the significant flattening of the yield curve weigh on the profits of retail deposit banks that traditionally benefit from maturity transformational activities. Even more than the back book maturing and being replaced by lower-yielding loans, the non-maturing back book is also, I would say, endangered by what we call the renegotiation of rates, because clients are asking for lower rates on their current loans. For commercial reasons, very often in several eurozone countries, banks are obliged to accept, which rapidly reduces the average rate of the loan book.

On the liabilities side, banks can lower interest rates on interest-bearing deposits, but only to a certain extent, because, of course, interest rates generally have a zero floor. As we are already there now, there is not much more to do than what has been done already. The margin pressure from low interest rates, then, forces retail networks to cut costs and to look at how to charge for services. This is a big question and a big problem, especially for pure retail deposit banks, which are clearly the most impacted.

William R White

If the banks are having problems with respect to profits, the obvious question is: so what? What sorts of consequences fall from that?

Philippe Bordenave

The consequences are manifold. The first consequence is that there are much fewer incentives for investors to buy banking shares, which is reflected in the relatively low price-to-book ratios in the banking sector, especially if you also take into consideration the regulatory uncertainties such as the gold-plating of the supervisory authorities, which is unpredictable and may create some new surprises, as well as the upcoming Basel IV regulation, which is also frightening for any investor.

The result, then, is that they invest much less in bank shares and require an increase in dividends, since they consider that it is less value-destructive for banks to give back equity rather than trying to invest further in insufficiently profitable banking activities; hence, it is very difficult for banks to further strengthen their equity while the regulator keeps asking for more and is determined to really increase banking capital above current requirements year after year.

There is, then, a Catch 22 situation, from which the only way to get out is to lend less and to further deleverage, retrench and reduce the size of the bank.

William R White

Some of you may remember or at least know about Harry Truman, the President of the United States. He was constantly being confronted by economists who said ‘on the one hand’ and ‘on the other hand.’ There are tradeoffs, and Harry Truman preyed for a one-handed economist. The reality, I think, as Philippe notes, is that there are tradeoffs. On the one hand, we have both monetary policy and regulatory policy weighing on bank profits, which, on the one hand, is a negative; on the other hand, both of these sets of policies have positive effects in the sense that monetary policy will raise the demand for loans, and the regulatory tightness will, of course, improve the stability of the financial system, so we have to be two-handed economists. I guess my question to Philippe at this point is: given these tradeoffs, have the authorities got it right, in your view, or is there some way that they could do it better? I would remind you that we do have a banker speaking.

Philippe Bordenave

Clearly, I was impressed by Mr Knot's speech. It came from a central banker and is probably the first speech from a central banker that I have heard without any mention of strengthening banking regulation. It was more focused on growth. Those two objectives are a bit at odds with one another, and the idea is to find the right balance. At the moment, however, the balance is probably too much in the direction of exclusive regulation for banks, which are prevented from financing the economy as they should do.

As far as large corporates are concerned, I would say that a very pragmatic solution has been found. Clearly, the new regulatory frameworks reduced European banks' lending capacity, and banks were no longer really in a position to fund big corporates. They were not even able to be market makers in corporate securities; while securitisation has been shown as a solution, you need market makers. Clearly, banks' securities inventories decreased by more than 40% between 2008 and 2015; hence, it was difficult to have a liquid market for those debts.

Market makers, however, will, it seems, be substituted by the ECB, which will buy some of those bonds via its quantitative-easing policy, as it does already for sovereign bonds. For large corporates, a solution has been found: they issue bonds in the market, which are bought by the ECB, so large corporates are going to be funded by the ECB. The latter becomes a lender of first resort, which will allow central banks to avoid being the lender of last resort. I don't know if this is a good improvement but it is pragmatic and it works.

A greater concern comes, however, from SMEs, I would say, because their financing relies almost exclusively on bank loans. They do not have easy access to financial markets. These loans are at stake because of the very significant capital requirement increases that will be induced by the introduction of Basel IV, which is currently under discussion. In that context, I think that, in order to preserve the financing of SMEs, we may see a new step in quantitative easing in the future, with the ECB purchasing loans to SMEs. That may be the solution for the future.

William R White

I have to say that, when I start thinking about the transfer of all of these risky assets to the central bank, it does not leave me with a warm and fuzzy feeling. It may seem to solve today's problems but I think everybody here would admit that there is going to be something wrong when it is the central bank that ends up taking on all of these risks. It is not unprecedented because, in Mexico, prior to 1994, reserve requirements went up so high that the central bank wound up making all the commercial loans, which they quickly decided was not a good answer.

We have a problem here: if the banks are constrained, it seems to me – and this gets you back into the capital markets initiative and securitisation – that there have to be better ways of ensuring that it is the private sector that is making these needed loans and taking the associated risk on them. We will come back to this range of territory in the last session this afternoon, when we talk about the feedback exercise etc.

Philippe, we have outstayed our welcome on this. Going back to the point that was made by Governor Knot to begin with, central banks can buy time and they can provide the opportunity for governments to do the things that need to be done but, if the underlying problem is more akin to an insolvency problem than it is to an illiquidity problem, it is pretty clear that central banks do not have the permanent means to deal with that issue.

Governments must act, and we will get back into some of these questions a little later on, but the first point to clearly get out there is that they are buying time, and time has its price. Governments should be thinking about the things that they should be doing, not least of which are the structural reforms that have already been referred to.

Let me close this session and move into the next. Philippe, thank you very much indeed.

Philippe Bordenave

Thank you.

Acronyms Used:

BIS - Bank for International Settlements

ECB - European Central Bank

SME - small- and medium-sized enterprise

Executive Summary

Monetary policy: How are monetary developments impacting the financial sector and the economy?

Many leaders of the industry stressed that lasting ultra-low interest rates were causing negative effects on the economy of the euro area. Indeed banks' profits are significantly reduced due to ultra-ease monetary policy and prudential banking regulations and this leads to a reduction of lending. In other words, in such circumstances, the transmission mechanism – through the banking sector – of the ECB's monetary policy is significantly weakened.

This low interest rates environment fails to reduce household and corporate sight-deposits

In theory, a decrease in interest rates encourages savers to reduce the amount of their remunerated savings, as their opportunity cost decreases, and it prompts borrowers, on the other hand, to increase their indebtedness, as it reduces their financial burden.

In practice, however, things at the moment are a little more complicated. We are indeed in an environment of weak economic growth, which makes households feel uncertain about their jobs, and non-financial corporations feel unsure about their ability to sell their products to customers. As a result, the increasing economic uncertainty leads savers to increase their savings, rather than decreasing them, for precautionary purposes, and they invest less in riskier asset classes as they become more risk-adverse. It makes borrowers less reactive to a decline in interest rates, as their commercial prospects are decreasing. When the yields fall or, sometimes even disappear, because of monetary policy, the shift of repressed financial savings to consumption doesn't seem to work in Europe. Indeed, one observes that a significant number of savers are trying to offset lower returns by more savings.

As a consequence, this low-interest-rate environment has translated into higher household- and corporate-sight deposits, as well as a decline of the money multiplier; hence, the monetary policy is not that well transmitted to the real economy.

Low interest rates have a negative impact on retail-deposit banks profitability and a positive effect on specialised financing activities

A representative of the banking industry stressed that low interest rates have a negative impact on retail-deposit banks in particular, because their business consists of maturity transformation between costless short term deposits, and long-term loans. Quite understandably, the interest margin depends on the interest-rate levels of those long-term loans. When interest rates go lower and lower for a prolonged period of time, back-book loans are progressively replaced by lower-yielding loans in the banking book.

Conversely, the same low-interest-rate environment is positive for many specialised financing activities such as factoring, leasing, consumer loans and long-term car rentals, as those businesses usually fund themselves at market rates, without any transformation. For them, then, client and funding rates decline in parallel, and margins remain stable, with a benefit from the demand increase brought by lower rates.

Corporate and institutional banking and market activities are more or less rate-neutral because all loans and deposits are indexed to floating rates in that business.

Clearly, the ongoing decline in interest rates and the significant flattening of the yield curve weigh on the profits of retail deposit banks that traditionally benefit from maturity transformational activities. Even more than the back book maturing and being replaced by lower-yielding loans, the non-maturing back book is also endangered by the renegotiation of rates, because clients are asking for lower rates on their current loans. For commercial reasons, very often in several eurozone countries, banks are obliged to accept, which rapidly reduces the average rate of the loan book.

On the liabilities side, banks can lower interest rates on interest-bearing deposits, but only to a certain extent, because, of course, interest rates generally have a zero floor. As we are already there now, there is not much more to do than what has been done already. The margin pressure from low interest rates, then, forces retail networks to cut costs and to look at how to charge for services. This is a big question and a big problem, especially for pure retail deposit banks, which are clearly the most impacted.

The persisting divergence between the cost of capital and the profitability of EU banks

Another leader of the industry highlighted the persisting divergence between the cost of capital for European banks and their profitability. Indeed, the cost of capital remained at the level of 10% while profitability for the European banking sector as a whole remains quite low, at around 5% approximately. One of the key factors which explains the elevated cost of capital in Europe is that, despite all the efforts undertaken, some buckets of risks that are associated with certain banks and certain countries continue to persist (high level of Non-Performing Loans…). This discrepancy between the cost of capital and profitability in Europe is also triggered by the uncertainty surrounding banking regulations.

The consequences of the decline of the profitability of the banks of the euro area are manifold. The first consequence is that there are much fewer incentives for investors to buy bank shares, which is reflected in the relatively low price-to-book ratios in the banking sector, especially if you take into consideration the regulatory uncertainties such as the gold-plating of the supervisory authorities, which is unpredictable and may create some new surprises, as well as the upcoming Basel IV regulation, which is also frightening for any investor.

The result, then, is that they invest much less in bank shares and require an increase in dividends, since they consider that it is less value-destructive for banks to give back equity rather than trying to invest further in insufficiently profitable banking activities; hence, it is very difficult for banks to further strengthen their equity while the regulator keeps asking for more and is determined to really increase banking capital above current requirements year after year.

There is, then, a Catch 22 situation, which imposes to lend less and to further deleverage, retrench and reduce the size of the bank.

The new regulatory frameworks have also negatively impacted the profitability of EU banks which reduced European banks’ lending capacity

Both monetary policy and regulatory policy are weighing on bank profits. Banks are in Europe the indispensable transmission belt of monetary policy: if banks are not profitable, they will not lend more. Clearly, the new Basel 3 regulatory frameworks reduced European banks’ lending capacity, and banks were no longer really in a position to fund big corporates according to different leaders of the industry. They were not even able to be market makers in corporate securities; while securitisation has been shown as a solution, you need market makers. Clearly, banks’ securities inventories decreased by more than 40% between 2008 and 2015; hence, it was difficult to have a liquid market for those debts.

Market makers would however be substituted by the ECB, which will buy some of those bonds via its quantitative-easing policy, as it does already for sovereign bonds. For large corporates, a solution has been found: they issue bonds in the market, which are then bought from Institutional Investors by the ECB, so large corporates are going to be funded by the ECB. The latter becomes a lender of first resort, which will allow central banks to avoid being the lender of last resort.

A greater concern comes, however, from SMEs because their financing relies almost exclusively on banks. They do not have easy access to financial markets. These loans are further at stake because of the very significant capital requirement increases that will be induced by the introduction of

Basel IV, which is currently under discussion. In that context, in order to preserve the financing of SMEs, we may see, according to a leader of the industry, a new step in quantitative easing in the future, with the ECB purchasing loans to SMEs. That may be the solution for the future.

Nonetheless, if the measures envisaged by the Basel Committee, notably to tighten the risk weighting process, were all decided by the end of 2016, European banks would see their capital requirements jump, on average, from 12% to 15% (or even 16%). The return on equity achieved in 2015 would fall to around 3%. This would not allow a large number of banks to cover their costs and thus to carry out their intermediation role.