Erkki Liikanen: Low interest rate environment and systemic risks – current issues

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the RiskLab/BoF/ESRB Conference on Systemic Risk Analytics, Helsinki, 6 October 2016.

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Accompanying slides can be found on the Bank of Finland's website: Slides (PDF).

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1. Introduction

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Since the financial crisis there have been significant efforts in fiscal, monetary and structural policies to resurrect demand across the globe. Monetary policy has had an important role. High debt levels in many countries are constraining fiscal policies. But even in those countries composition of expenditure could be more growth friendly.

There has been progress in the structural reforms, but there is still room to go beyond of what we have witnessed so far. On the side of the financial market regulation the regulators around the world have worked to make the banks and the financial system safer.

Banks' capital levels have been increased to improve resilience and more liquid assets are required to cover banks´ liquidity needs in stress. Banks will also be required to fund their operations from stable sources that reduce the reliance on the short-term wholesale market funding. Plans are laid out to guarantee an orderly resolution of the largest and systemically most important banks.

As banks adjust to these requirements they will have to re-evaluate their business models. While banks have become safer, the new requirements may have pushed parts of their traditional business outside the banking sector to the so called shadow banking sector, which has been growing recently.

In this talk I will discuss the underpinnings of the low rates environment and its implications for financial stability. I will also touch upon the developments outside the banking sector that we need to follow in order to make sure we make use of the lessons we have learned from the crisis.

2. The low interest rates environment

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Following the financial crises, the return to economic growth has been slow in many regions. This is explained in part by some of the long-term forces that existed already before the crisis, and partly by the effects that resulted from the crises.

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The potential long-term causes are related to ageing populations, and changes in the pace of technological development, which drive productivity gains.

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While the demographic trends are evident, a persistent decline in productivity growth is only one hypothesis. There are also more optimistic ones.

The effects caused by the crises relate to high debt burdens in both the private sector and the public sector in many countries. High debt levels tend to slow down recovery. The growth potential of the world economy may have temporarily deteriorated because of a prolonged high unemployment, lower investments and frictions in the reallocation of resources.

Research has also suggested that the crises have led households and firms to update their beliefs concerning the frequency of crises. In the language of risk management, they may have updated upwards their long-term expectations of “tail risks”, a term certainly very familiar to this audience. This may be one factor that weighs on real investments and hence on growth.

All these explanations for slower growth are plausible but they need to be researched further.

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In order to support the economy and bring inflation back to its target, monetary policy stance has been accommodative. This is the backdrop against which the current low interest rates and the use of unconventional monetary policy measures are necessary.

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But it is also important to keep in mind that there has been a declining trend in the global real interest rates since the 1990s. This trend could partly reflect the expectations of slower economic growth prospects. Another driving force of the declining rates has been the high global demand for safe assets. For example, many emerging market countries have sought ways to safely invest their current account surplus and newly created wealth in the global markets.

Given the focus of this conference, I will discuss potential risks to financial stability, which we have to consider in the low interest rate environment.

Search for yield

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Let me first consider search for yield and the consequent excessive risk-taking, which low rates might spur. One cannot help a feeling of déjà vu: search for yield was part of our concerns, and rightly so, already before the Global Financial Crisis.

How is the situation different now? At least with the benefit of hindsight, it is a rather common notion that the global monetary policy stance was too loose before the crisis with respect to real economic activity. In such a situation, relatively low interest rates spurred search for yield which turned out to be particularly dangerous.

The current situation is quite different in this regard. Rates are expected to stay low in the Euro area for a prolonged period precisely because we want to support the economy and to achieve a path of inflation in line with our target for price stability. Hence some forms of “search for yield” such as bank lending to the SME sector, are desirable, because they support the real economy.

Having said this, it is important to monitor potential excesses in individual segments and regions, and take targeted action to curb them if necessary. Macroprudential tools are the key policy instruments in this regard. Overall, banks’ resilience has significantly improved as a result of the regulatory reforms after the crises.

Profitability of financial institutions

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A second theme, which is related to financial stability concerns in the low interest rate environment, and particularly under negative interest rates, is the pressure on banks' profitability. It is important to note that there are several forces at work at the same time. Banks' net interest rate margin may be reduced if loan rates decline while retail deposit rates are sticky at the zero lower bound. However, the effects depend on many things such as the maturity structure of bank loans and liabilities.

Nonetheless, it is possible that banks with a strong retail deposit basis would increasingly shift to wholesale funding where the interest rates pass-through may be more effective. This is an issue for financial stability because we have learnt that a short-maturity wholesale-oriented funding structure can be risky. However, the new liquidity requirements in the regulatory framework are designed to safeguard banks' resilience in this regard.

Insurance companies – like banks – are also struggling with their profitability. On the life insurance side long term promised commitment returns are running well above those that can be found from the conventional investment products in the markets. This creates pressures for the insurers to move towards more risky assets to improve their returns while the low interest rate environment continues.

Importantly, low rates support the real economy and help borrowers to service their loans. Improved growth translates into higher lending volumes for banks and reduces loan losses which directly supports banks' profits. It is also up to banks themselves to adjust their business models to maintain their profitability in the changing environment.

On resource allocation

Although the low interest rates are supporting the real economy, there is one potential caveat to keep an eye on. The low rates may interfere with efficient reallocation of resources, which is often referred to as evergreening. This is why it is important to tackle the issue of non-performing loans properly. Corporate area may also need restructuring. This will allow new entrants to have an access to the market.

In order to align banks' incentives with the aim of efficient resource allocation from social perspective, the key is to make sure banks are sufficiently capitalized. It is an important task for the supervision to oversee that banks deal with any problems of non-performing loans in a determined manner.

3. Shadow banking and systemic risks

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In the wake of the financial crises, the so called shadow banking sector – entities that do similar things as banks but are not regulated as banks – has been growing again. The Financial Stability Committee has calculated that the so-called narrow measure of shadow banking assets have grown from to 36 trillion US dollars in 2014 with the growth having averaged over 6 percent across jurisdictions between 2011 and 2014.

At least three drivers can be behind this development. First, it may be a consequence of the search for yield, partly spurred by the long-term declining trend in interest rates. Second, regulatory reforms after the crises may have raised compliance costs and are hence pushing activities to the less regulated sector.

Third, technological developments, such as Fintech, may be providing new opportunities which are partly tested outside the traditional banking sector. This is very much in line with the capital markets union initiative in Europe that aims at provision of a larger share of the funding from market based entities as opposed to the current strong reliance on banks.

However, as non-banks assume a more significant role in credit intermediation one needs to pose the question: What are the financial stability concerns of these developments?

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The search for yield, together with declining rates, is closely related to the global excess demand for safe assets as plentiful savings seek safe investment opportunities. This can lead to creation of new “safe” assets which in actuality are increasingly less than safe. This increases the fragility in the financial system in the form of potential runs.

As we should well remember, this kind of development already once happened as the Global Financial Crisis hit the banking system that had increased its short term profits with securitization and leverage. The banks’ retained and off-balance sheet exposures to securitized assets were a significant contributor to their problems in the crisis.

The financial system is now more resilient, thanks to the regulatory reforms which have also reduced the links between banks and shadow banks, which proved fatal in the crisis. However, non-bank financial intermediation continues to be subject to “runs” and premature liquidation and is hence intrinsically fragile.

As the share of non-bank financial intermediation increases this fragility may expose the financial system to a risk of systemic disruption in case the run event results in contagion. Hence we cannot afford complacency and we need to monitor financial innovation. This is one of the key lessons to be drawn from the previous crisis.

Financial innovation now takes new forms, and part of it is true technological progress. In evaluating the usefulness of digitalization in the provision of finance we need to consider the benefits against the potential risks. Benefits include having a more diverse set of finance providers, more efficient use of algorithms and data bases with which credit decisions are made, and the improved access to finance for entities that would not have had the access otherwise. The potential risks stem from the possible flaws in these new lending algorithms and lack of experience with how they fare through the credit cycle. This is particularly relevant at this time as the new innovations are developed amid low interest rates.

But we should not be naive either: part of financial innovation may still be motivated by evasion of regulation and taxes. New types of links between banks and shadow banks may form. To stay on top of things, we will need in-depth analysis, building of risk scenarios and counterfactuals, and out-of-box thinking.

Non-bank financial intermediation also has the potential to move quickly between jurisdictions, and the new low-cost business models make this fairly easy. Hence, there is a need for international cooperation when it comes to regulation and macroprudential actions towards these entities.

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Let me also consider the question whether regulatory reforms have been excessive in the sense that they would be increasingly driving activity to the unregulated segments of the financial system. Looking back, bank regulation before the Global Financial Crisis was rather light, too light, at least in terms of banks’ true loss absorbance capacity. Yet, certain forms of shadow banking grew rapidly, motivated precisely by opportunities to increase banks’ leverage to even higher levels.

Hence, there is a certain irony in the current concerns that increased regulations, like higher capital requirements, are pushing activity to the shadow banking sector. The lesson of the past fifteen years is that there always seems to be this tendency, no matter how high or low the starting level of regulation is. Against this backdrop, I would put in perspective the current concerns of excessive regulation.

4. Conclusions

I would like to conclude with a reminder of the potential longer term challenges regarding productivity growth as well as the legacy of the recent crises that have contributed to the currently low long-term real interest rates.

Central banks' have responded with actions within their mandates to improve the overall economic situation. While we have some signs of improvement, at the same time we need to be aware of the risks that the low rates environment and the changes in the regulatory environment may result in. This necessitates in-depth supervision and analysis combined with good research. Elements from all these fields need to be combined to identify possible risks and to guide the policy makers in making appropriate changes that are necessary to foster financial stability.

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