Yves Mersch: The challenge of low interest rates for banks within the banking union

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Public Roundtable at the University of Luxembourg on "Banking Union – Quo Vadis?", Luxembourg, 3 October 2016.

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We are sitting here tonight in a room that was named after the first president of the University of Luxembourg, the late Professor François Tavenas. He once said "change is mandatory, survival is optional; choose wisely"[1].

Even though Tavenas was speaking about the impact of globalisation on universities, what he said also holds true for the euro area and its recent history.

When the financial crisis struck, it was clear that things could not go on as they had in the past. Change was mandatory. The banking union was the euro area's response – the most significant step towards closer integration in Europe since the creation of the single currency. This means that the euro area now has common banking supervision and a single resolution mechanism with harmonised rules and procedures. A European deposit insurance scheme is still under discussion.

Establishing the banking union has made the euro area financial system safer, but since it was proposed in 2012 its implementation has been challenging for banks, especially as it coincided with unprecedented monetary policy action and regulation.

Tonight, my fellow speakers will discuss the design and the achievements of the banking union in greater detail. I would like to focus on the other challenge banks are facing: an environment of low and negative interest rates.

Costs and benefits

Over the past eight years, central banks worldwide have had to go to extremes to honour their mandates to safeguard price stability and shield their economies from the fallout of the financial crisis.

In the euro area, the ECB started providing banks with abundant liquidity, also through long-term refinancing operations. We launched an asset purchase programme of unprecedented size, cut interest rates to record-low levels and embarked on forward guidance to give markets a clearer signal about our future policy path.

Among the major central banks, the ECB was the first to introduce negative interest rates on its deposit facility in June 2014. It now stands at –0.4%. No other central bank has gone as low without putting a multi-tier system in place. These very decisive policy measures have one objective: to fulfil our legal obligation, i.e. to ensure price stability defined as an inflation rate below, but close to, 2% in the medium term.

Our policy is working. Lending is gradually increasing as a result. In August, lending to companies grew by 1.9% year-on-year while household lending grew by 1.8%, both unchanged from July's reading. A broader measure of money circulating (M3) rose to 5.1% from an upwardly revised 4.9% in July.

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[1] François Tavenas, "Universités et globalisation: à la recherche de nouveaux équilibres", in Gilles Breton and Michel Lambert, Globalisation et universités : nouvel espace, nouveaux acteurs, Presses de l'Université Laval, 2003, p. 255.

Also, banks have considerably eased access to financing for the private sector. Between June 2014 and July 2016, the composite cost-of-borrowing indicator for new corporate loans fell by 152 basis points in Italy, 130 basis points in Spain, 40 basis points in Luxembourg, and 95 basis points in the euro area as a whole.

Although slow, economic recovery is under way. Unemployment is decreasing, economic growth is picking up, and inflation is expected to rise to 1.6% in 2018. When our next set of projections, which includes 2019, is published in December we might be broadly in line with our mandate of below, but close to, 2% over the medium term. We are on the right track.

We are aware, however, that in particular our non-standard policy measures come with side effects. Therefore, it is important to consider the combined effect of the full package of our policy measures when assessing the impact of our monetary policy action on banks.

Low rates put pressure on banks' profitability, particularly on banks which are very reliant on net interest income. Analysts forecast that negative interest rates will significantly reduce banks' profitability over the next five years, with the return on equity in some cases falling from 6.5% to 2%.

Obviously, our monetary policy package consists of other measures as well and ECB staff estimates show that the ***overall*** impact on bank profitability of recent monetary policy actions is net positive, compared with a scenario with no monetary policy action[2]. But we cannot ignore such analyses. And yet, one also has to ask if a bank that cannot weather headwinds over a few years still has a sufficiently robust business model to stay in the market.

A negative outlook for banks weighs on banks' share prices, thereby raising their cost of capital and ultimately decreasing the net return on lending. This may cause banks to become more conservative in their lending to euro area companies and households, which is key for the transmission of our monetary policy.

We already see that the low interest rate environment has sparked increasing competition from the non-banking sector. “Shadow banks” – an unfortunate label – or non-banks have increasingly moved into financial intermediation in the euro area since the financial crisis. Between the end of 2008 and the fourth quarter of 2015, non-banks expanded their share of financial assets held by euro area financial corporations from 42% to 57%[3]. This may suggest an improvement in the transmission of our monetary policy as these institutions are to some extent more flexible than banks because they are less strictly regulated and supervised. But at the same time, we need to be mindful that non-banks are also likely to retrench more rapidly in times of crisis.

Moreover, technological innovation and the search for yield in a low-interest environment are likely to intensify competition for credit and deposit-like savings products. The risk is that this will lead to lower lending standards, higher leverage and insufficient shock-absorbing buffers.

Last but not least, a protracted phase of very low interest rates weighs heavily on the profitability and solvency of financial companies which promise minimum nominal returns over the longer term, e.g. life insurers and pension funds. If this phase lasts for too long, it could challenge the viability of return guarantee business models. There is evidence that the insurance and pension sectors have already been moving from guaranteed-return to unit-linked business models. This shows that the industry is adjusting.

We need to monitor such risks, the side effects and the long-term impact of our monetary policy measures carefully. And we need to keep in mind that the longer our non-standard policy measures remain in place, the more pronounced their side effects will become.

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2 See Rostagno M. et al., “Breaking through the zero line: The ECB's Negative Interest Rate Policy”, Brookings Institution, Washington DC, 6 June 2016. Presentation available on the Brookings website.

3 ECB Economic Bulletin, Issue 4 / 2016, Article 1.

Interest rates have to stay low until the economic recovery in the euro area has gained sufficient momentum to lift the inflation rate to a level in line with our definition of price stability. This is, however, taking longer than we had hoped, mainly because the necessary political changes to make economies more competitive and flexible are lagging behind. The sooner these reforms are implemented, the stronger and more sustainable the recovery will be.

Although the notion of a "zero lower bound" no longer stands, there is a limit to how low interest rates can go – the point at which the costs of lower rates incurred by the banking sector outweigh the benefits. Many consider that we have reached the "effective lower bound" or that it might be not that far from the current deposit facility rate of –0.4%[4].

This level I would still deem to be "mildly negative" – but I would shy away from moving into "wildly negative" territory. Cutting interest rates even more would come with increasing risks as reactions to such cuts might not always be linear[5]. This needs to be taken into account when doing a cost-benefit analysis.

Conclusion

Let me conclude. Over the course of the crisis, the ECB acted decisively and in line with its mandate. Change was mandatory and the path we chose is helping the euro area economy to return to growth and price stability. But interest rates can only stay very low over the short term. The longer they remain low, the more pronounced the negative side effects will become.

So far, we do not see any developments that could give rise to major concern. The positive impact on the economy outweighs any drawbacks there may be. But we need to be mindful, even as the upsides of our monetary policy prevail, because of the multi-pronged approach of our unconventional, and by definition temporary, monetary policy.

Our unprecedented policy reaction to the crisis has clearly added to the list of challenges banks are facing today. But what we did was necessary to preserve price stability in the euro area, which is what we have been mandated to do. As such, we are fully aware of the crucial role banks play in transmitting monetary policy to the real economy. That is why we pay close attention to how banks are coping with all the challenges they face.

The banking union marks a significant change in the euro area financial system and it comes with a series of one-off adjustments for banks. Unlike the banking union though, our monetary policy measures lead to constant adjustments by the banking sector, especially the longer the current measures stay in place. It is therefore in everybody's interest to ensure that we can leave this period of low interest rates behind sooner rather than later. But it's not solely the responsibility of the ECB. It will also require courageous, far-sighted and sensible action by other policymakers to bring the euro area back to sustainable growth. May they choose wisely.

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4 Cœuré B., ***Assessing the implications of negative interest rates***, speech at the Yale Financial Crisis Forum, July 2016.

5 Mersch Y., ***Unkonventionelle Geldpolitik – eine ordnungspolitische Würdigung***, speech at the Albert-Ludwigs-University in Freiburg, Germany, June 2016