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Febaf and Oxford Economics webinar

Low interest rate environment (LIRE): Implications for the banking sector

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EUROPEAN CENTRAL BANK
EUROSYSTEM

ESRB
European Systemic Risk Board
European System of Financial Supervision

- New ESRB task force
- on the same topic ongoing

JOINT ATC/ASC/FSC TASK FORCE

MACRO-PRUDENTIAL ISSUES AND STRUCTURAL CHANGE IN A LOW INTEREST RATE ENVIRONMENT

Elena Carletti (Co-Chair, Advisory Scientific Committee)
John Fell (Co-Chair, Financial Stability Committee)
Jacek Osiński (Co-Chair, Advisory Technical Committee)

Presented to the GB in September 2016 – available at www.esrb.europa.eu

DNB-Riksbank Macroprudential Conference Series

third meeting

Bad zero: Financial Stability in a Low Interest Rate Environment

Elena Carletti (Bocconi University and CEPR)

Giuseppe Ferrero (Banca d'Italia)

Bad Zero …


il fumo causa
attacchi
cardiaci
Rauchen verstopft
Ihre Arterien

LIRE: An “old” topic but still very much fashionable

What is it?

- **LIRE**: Prolonged period of low **interest rates**, with stagnating **consumption**, **investment** and **output**
  - ✓ Different from **temporary** low short term interest rates
  - ✓ **Flattening** of the **yield curve**

- Important implications for the **entire** financial sector
- Interactions with **monetary policy**
- My focus: implications of LIRE for the **banking sector**

Low interest rates environment (LIRE): Determinants

Nominal interest rates can be **decomposed** into three components:

$$i_{j,t}^{L} = \underbrace{r_{RF,t}^{L}}_{\text{real interest rate}} + \underbrace{E_t \pi_{t+L}}_{\text{expected inflation}} + \underbrace{rp_{j,t}^{L}}_{\text{term and inflation risk premia}}$$

- All three components have declined since the 1980s
- Different explanations for real interest rates:
  - ***Real/structural* view** (Summers, 2014): **excess saving** over **investment**, drag on **growth** and **inflation**, and thus **real rates**
  - ***Financial/cyclical view*** (Borio, 2012; Lo and Rogoff, 2015): **extensive deleverage**, fall in **investment** and **real interest rates**, **decline** in **nominal rates** due to accompanying **monetary policy**

Why do we worry about banks in a LIRE?

Profitability pressures

↕

Search for yield:

Laxer credit standards

Investment in riskier segments (SME, CF)

↕

Increased credit risk

Booms and busts through mispricing

Uncertainty on asset fundamental values

LIRE and bank profitability

Short term → **Long term**

- Lower **funding costs**
- Higher **asset** and **collateral values**, etc.
- Lower **default risk** on new or repriced old loans
- Boost **equity values**
- More **funding&lending**

- **ELB** on **nominal rates**
- **Flattening** of the **yield curve**

- Reduced current and future margins from **maturity transformation**
- **Rigidity** in funding rates
- Lower returns on **fixed income** investments
- Higher real value of debt, when ELB is reached – debt deflation

- **Most immediate** concern, especially for institutions with
  - Marked **maturity mismatch**
  - With **floating interest rates**

- Existence of a "**reversal rate**" (Brunnermeier and Koby, 2017)?

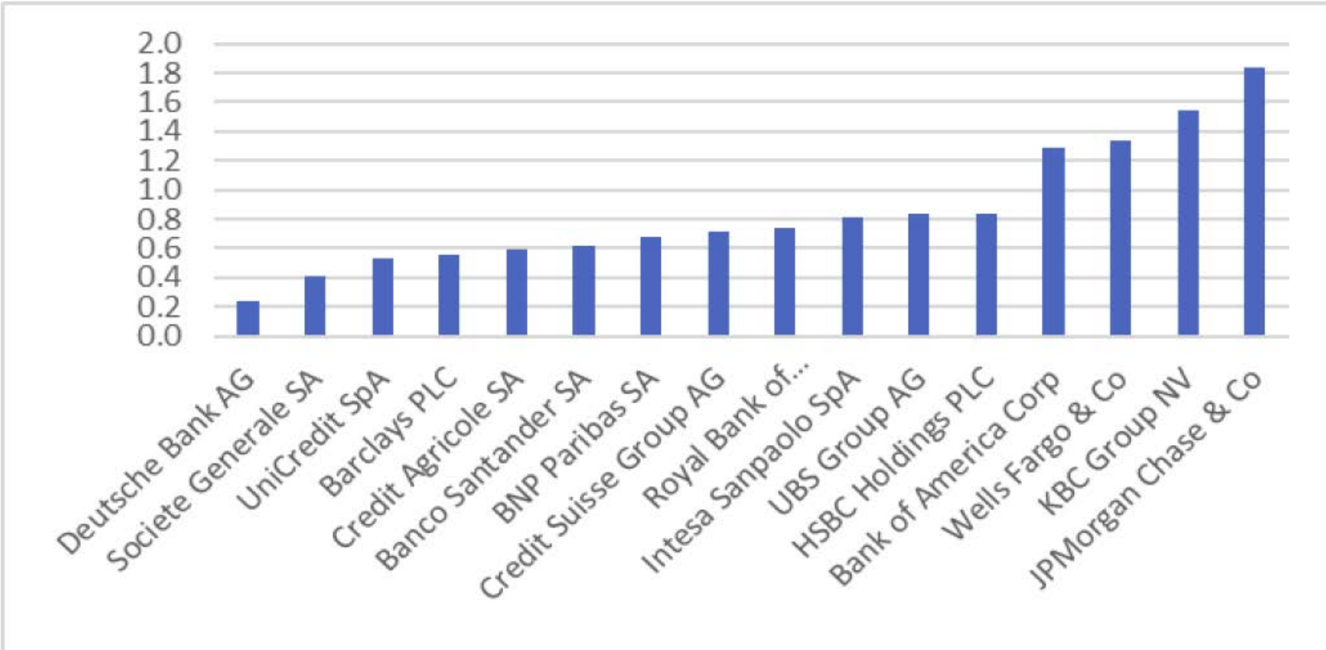
Yet, evidence is not clear

- Academic literature on **monetary policy**
  - **Negative** relationship between **short-term interest rates** and banks' **risk taking**
  - Effect is more pronounced with **negative interest rates**, especially in **poorly capitalized banks** and **high-deposit banks**
  - **BUT no consideration** for **slope** of the yield curve
  - Much **less clear** evidence in a LIRE

- Not conclusive evidence also in the policy arena

Still, low bank profitability is a problem…

Price-to-book ratio (2019 Q4)



Source: Carletti et al. (2020)

- **ROE < CoE** in the sector, reflected in **low market valuations**

Points for discussion

- Should we be concerned with **low bank profitability**?
  - Yes, although **not necessarily** due to LIRE
  - We need a **healthy sector** that can absorb shocks and play its intermediation role
- **Various options**
  - **Monetary Policy** (TLTRO, tiering, etc.)
  - **Negative** interest rates on **deposits**
  - Improve **cost efficiency** (cut costs, digitalization, etc.)
  - Adapt **business models** (product differentiation, etc.)
  - **Consolidation** (domestic or cross border)
  - **Overbanking** and need of proper **exit mechanisms**