Box 1.2

THE ECB'S RECENT MONETARY POLICY DECISIONS AND THEIR POSSIBLE EFFECTS ON BANK PROFITABILITY

The euro area's macroeconomic outlook has worsened considerably during the course of 2019. In particular, inflation decreased to 1% in July and the ECB's September forecast is for a rather weak recovery to 1.5% in 2021, well below the levels which may be considered consistent with the aim of holding inflation below, but close to, 2%. The ECB also revised downward the GDP growth forecast to 1.1% in 2019, 1.2% in 2020 and 1.4% in 2021. In view of this situation, at its 12 September meeting the ECB Governing Council adopted a series of monetary policy measures to ensure the sustained convergence of inflation towards its inflation aim.

The first of these measures was to lower the deposit facility rate by 10 basis points (bp) to –0.50%. Simultaneously, the Governing Council reinforced its forward guidance on interest rates. The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it sees the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence is consistently reflected in observed inflation dynamics. These measures seek to maintain an ample degree of monetary accommodation, particularly in the short to medium-term segments of the yield curve.

Second, it was decided to restart net asset purchases under the asset purchase programme at a monthly pace of €20 billion as from 1 November. The duration of this programme is undefined and the Governing Council expects it to end shortly before it starts raising the key ECB interest rates. The aim is to extend monetary accommodation to the long end of the yield curve.

Third, the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III), which commenced in September, were changed. The interest rates applicable were reduced and the maturity of the operations was extended from two to three years. The aim of these adjustments is to preserve favourable bank lending conditions.

Finally, it was decided to introduce a two-tier system for reserve remuneration, in which the negative deposit facility rate (–0.5%) does not apply to a portion of banks' holdings of excess liquidity (i.e. their reserve holdings in excess of minimum reserve requirements). The purpose of this decision is to support the bank-based transmission of monetary policy in a negative interest rate environment.

The financial markets began to anticipate this accommodative bias of monetary policy, stepped up following Draghi's speech at Sintra on 18 June. This was reflected in lower interbank and debt market rates, particularly at longer terms (see Chart 1).

The effects of these monetary policy measures on bank profitability are transmitted through various channels and may be of differing sign. This makes the overall net impact difficult to quantify.

On the downside, these measures may contribute to a narrowing of the spread between lending rates and deposit

Chart 1
MARKET INTEREST RATES

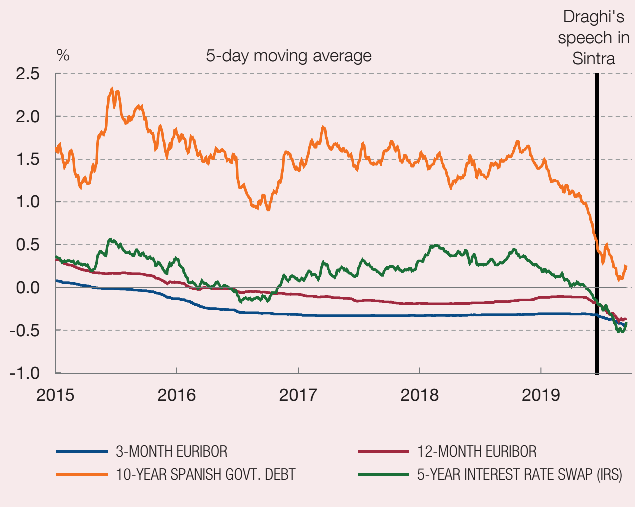
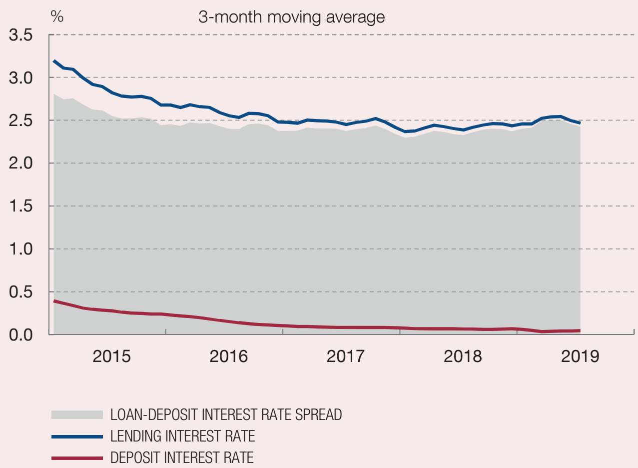


Chart 2
BANK INTEREST RATES ON NEW LENDING



SOURCES: Banco de España and Datastream.

Box 1.2

THE ECB'S RECENT MONETARY POLICY DECISIONS AND THEIR POSSIBLE EFFECTS ON BANK PROFITABILITY (cont'd)

Chart 3
BANK INTEREST RATES ON OUTSTANDING BALANCES

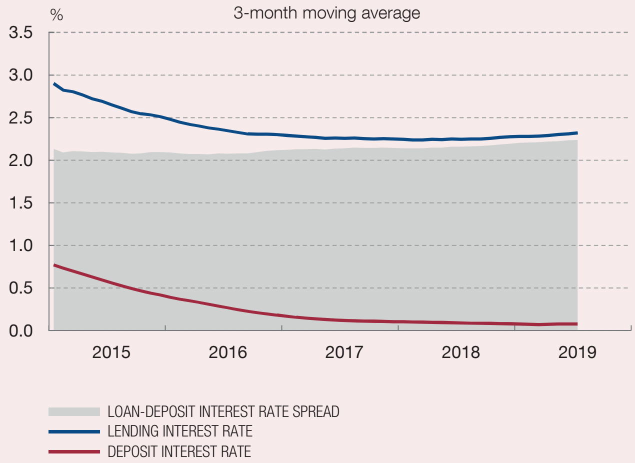
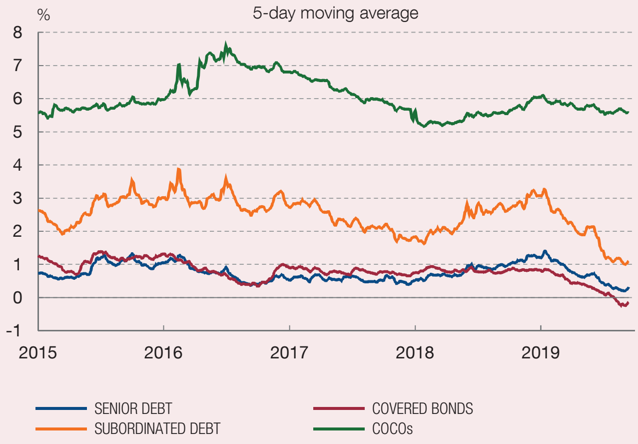


Chart 4
FUNDING COSTS OF SPANISH BANKS



SOURCES: Banco de España and Datastream.

rates. Indeed, falls in market interest rates may be expected to pass through to the return on lending to a greater extent than to the cost of deposits, since the latter has practically no room left before it turns negative. The remuneration of loans at variable interest rates, which accounts for a notable proportion of medium and long-term loans, will progressively adjust to the new prices as they are adjusted in line with changes in the reference indices (this usually occurs with a lag of less than one year).

Furthermore, if the decreases pass through to new transactions, as usually occurs, there will also be a cut in the average remuneration of assets through this channel. In previous bouts of interest rate cuts, the impact of the fall in loan remuneration was largely counteracted by a decrease in the cost of deposits. Indeed, the loan-deposit spread remained very stable both in new lending and in outstanding balances (see Charts 2 and 3). In fact, in the latter it has even widened somewhat in recent years, reflecting the favourable effect of the lower NPLs and the higher relative weight of consumer credit, with its wider margins. However, on this occasion the accommodative bias of monetary policy might be expected to cause the loan-deposit spread to narrow because there is little room to further reduce the average cost of deposits, since it is already near to zero.

Moreover, there is abundant theoretical and empirical evidence that, in a low interest rate environment, financial intermediaries may opt for more risky transactions in a quest for higher returns.[1] This is what is known as the "credit risk-taking channel" of monetary policy and it suggests that, to correctly assess the impact that measures of this type have on returns, it is necessary to take into account the risk incurred and, in any event, to keep a close eye on risk-taking, so that macroprudential measures can be taken if risk grows excessively.

On the upside, the monetary easing should help to improve economic activity and stimulate the flow of credit. The cost of wholesale bank funding has decreased significantly, coinciding with the intensification of the expansionary monetary policy, and in this case the value of zero does not act as a lower limit. Indeed, the average cost of some financing instruments, such as covered bonds, is now negative (see Chart 4). The lower cost of wholesale funding will also prompt the issuance of securities forming part of MREL (minimum required eligible liabilities), which banks must hold so that, in the event of resolution, they can be recapitalised by bail-in rather than bail-out.

Additionally, it should be taken into account that two measures approved by the ECB Governing Council

1 See, for example, D. Martínez Miera and R. Repullo (2017): "Search for yield", Econometrica, 85, pp. 351-378, or G. Jiménez, S. Ongena, J. L. Peydró and J. Saurina (2014): "Hazardous times for monetary policy: What do 23 million loans say about the impact of monetary policy on credit risk-taking?", Econometrica 82, pp. 463-505.

Box 1.2

THE ECB'S RECENT MONETARY POLICY DECISIONS AND THEIR POSSIBLE EFFECTS ON BANK PROFITABILITY (cont'd)

(more favourable conditions on TLTRO III and the exemption of a reserve tranche) will contribute to raising per-unit net interest income (difference between the return on assets and the cost of liabilities expressed in terms of the volume of assets) of banks. All this should serve to moderate the narrowing of the net interest margin.

Other potentially favourable effects of the accommodative bias of monetary policy on bank profitability will flow through various channels. Firstly, the fall in yields on the debt securities held in banks' portfolios affected by the new measures (particularly the restarting of the asset purchase programme) and the consequent rise in their market price will generate gains. However, this effect gradually fades once interest rates stop falling and, moreover, in recent years banks have substantially reduced their holdings in the available-for-sale portfolio, which, since it is valued at market price, is where such gains are recorded.

Secondly, the stimulus to the economy from the expansionary monetary policy measures and the lower cost of outstanding debt will have favourable effects on the quality of the credit portfolio, which will make for smaller credit losses and fewer non-earning assets (NPLs).

Lastly, the prices of real assets in bank portfolios will also increase, although in recent years this effect has become less important as banks' foreclosed asset portfolios have shrunk.