

EFFECTS OF MONETARY POLICY NORMALISATION (INTEREST RATE RISES AND WITHDRAWAL OF MONETARY SUPPORT)

The intensification of inflationary pressures as a result of the war in Ukraine has led to a faster than expected normalisation of the European Central Bank's (ECB) monetary policy following a long period of low or negative rates and generous monetary stimulus.

Thus, in the course of 2022, the monetary policy decisions of the ECB Governing Council envisaged, inter alia, the following measures:

- a) Interest rate rises. They started in July, and represented an increase of 300 basis points overall through February 2023, with the deposit facility rate rising from -0.50% to 2.5%.
- b) Change in the conditions of TLTRO III (Targeted Longer-Term Refinancing Operations III). In October, the ECB changed the system for calculating the interest rates applicable to these operations from 22 November 2022, eliminating some of the incentives for their use. At the same time, it established three additional early repayment windows, two of which (in November and December) have already been used by credit institutions. Taken as a whole, the TLTRO III balance of Spanish institutions fell by EUR 155.7 billion, or 50%, from October to December 2022.
- c) Modification of debt purchase programmes. Net purchases in the Pandemic Emergency Purchase Programme (PEPP) and the Asset Purchase Programme (APP) have been discontinued, limiting the amount of purchases to the reinvestment of maturing principal. In the case of the PEPP, the period in which reinvestments may be made will be extended until at least the end of 2024, while in the case of the APP, such reinvestments will be reduced from the beginning of March 2023, so that the portfolio of debt acquired by the ECB under this programme will be reduced by an average of EUR 15 billion per month until the end of June 2023.

In addition, on 21 July, the ECB approved the Transmission Protection Instrument (TPI) for monetary policy, which provides for government bond purchases in the secondary market when it is deemed that there is an unwarranted deterioration in a country's financing conditions.

As regards the possible impact of these monetary policy measures on financial institutions' liquidity, the progressive reduction in TLTRO funding, due to early repayments or maturities, will entail a reduction in the high-quality liquid assets held by institutions for the short-term liquidity coverage ratio (LCR). In this regard, it should be noted that significant excess liquidity resulted in unusually high LCR coverage. In the Single Supervisory Mechanism as a whole, the reduction in liquidity may generate greater competition for re-sources and affect the conditions for obtaining funding in capital markets.

Moreover, interest rate rises could have opposing effects on the income statements of financial institutions. On the one hand, an improvement in net interest income is expected, since, in general, Spanish institutions are positively positioned in the face of interest rate rises because the rates on assets, as a whole, change earlier and to a greater extent than those on liabilities. On the other hand, the intensity and speed with which these rates have risen may lead to an economic slowdown that will ultimately affect the quality of loans and generate the need to increase loan-loss provisions.

Lastly, an additional risk that could affect institutions' income statements or their capital ratios is the possible increase in sovereign debt risk premiums if the recessionary environment and the increase in fiscal deficits generate a fragmentation of debt markets, despite the reduction of debt portfolios that may be affected by being valued at market prices and the existence of the aforementioned TPI agreed by the ECB, which tends to balance risk premiums in situations of stress.