Investment Strategy Bulletin

The ECB's path forward: struggling to change the game

Investment Solutions **5 June 2019**

In a nutshell

- While easy monetary policy has supported growth in the euro area, and deflation fears have largely subsided, the adverse effects of negative interest rates on banks are hard to ignore
- The ECB has belatedly started to acknowledge this. Talk of a "tiered reserves" system has emerged, especially as the trade-driven economic slowdown has raised the possibility of rates staying low for (even) longer
- The effect would be a less punitive system for banks and an enhanced ability for policy easing for the ECB. But the magnitude of the impact on growth and inflation is likely to remain limited, while a prolonged period of negative rates is probably bad news for banks

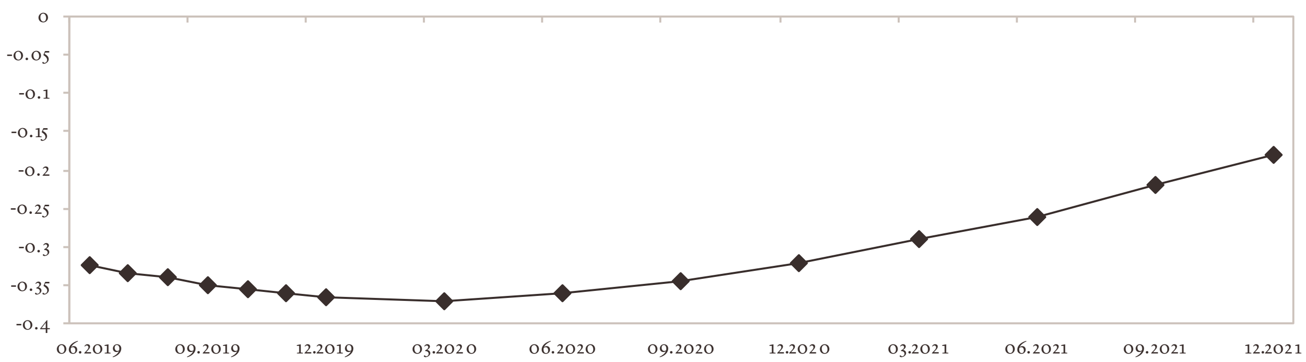
ECB: Towards additional easing policies?

The recent economic slowdown, combined with the subdued level of core inflation and – crucially – the persistence of risks related to global trade tensions and Brexit, has pushed back the European Central Bank's (ECB) normalisation plan and re-opened the discussion about available policy tools for further easing.

The ECB has already announced a new series of TLTROs starting from September 2019. At this point, the eurozone's monetary authority could also extend its forward guidance on interest rates further. Having previously renewed its commitment not to raise interest rates from "at least through the end of the summer" to "at least through the end of 2019", the ECB is likely to push the time horizon out even further, given the current context.

But considering current market expectations, which suggest no rate increase between now and the end of 2020, and which price only about 10 basis points of hikes by late-2021 (see chart 1), it is unlikely that a forward guidance extension would have much impact.

Chart 1 – Little room for forward guidance to move markets
3-month Euribor curve, derived from futures prices



Sources: Bloomberg, Lombard Odier

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Data as of 5 June 2019 unless otherwise stated.

What's left in the toolbox for further stimulus?

Given the limited impact of an extension of forward guidance and the very low likelihood of renewed asset purchases (due to political and technical constraints), the ECB is likely to focus on TLTROs[1] and the possibility of implementing a tiered reserve system as the most appropriate solutions at this point.

The TLTRO programme was an important innovation by the ECB – it aimed to incentivise banks to lend, by offering them a subsidy if they extended their lending beyond a given benchmark, as the applicable funding rate was as low as the deposit rate of -0.40%. While marginally helpful, the impact of this policy mix has been mixed when combined with negative deposit rates.

The ECB has not yet provided the details for the new round of TLTROs. This is likely to happen in this week's meeting (and at the latest at the next 25 July meeting). A key question will be how generous the ECB is willing to be this time: it may decide to set the relevant rate again as low as the deposit rate, or it could possibly set it closer to the 0% rate charged on its main refinancing operations (MRO), which, while less generous, would still be supportive of loan growth.

We believe that a new round of TLTROs would benefit Southern European banks the most, as they have made the most extensive use of TLTRO 2, and could continue to benefit from the lower funding costs if they roll it over. Importantly, a new TLTRO could also help prevent more fragile banks that are unable to find funding to repay the former round. Neverthless, we expect the impact on bank profitability to be very modest overall, adding approximately 2-3% to earnings.

Bank profitability has also been heavily affected by negative rates. While initially banks have been able to lower deposit and funding costs, this is now largely over. On the other hand, new loan yields are lower than those rolling off, and the same can be said for maturing investments in the banks' securities portfolios. This is leading to pressures on net interest margins, and given that net interest income accounts for roughly two-thirds of European banks' revenues, it is also weighing on profitability.

Meanwhile, given the probability of a prolonged period of negative deposit rates, addressing the impact on the banking system has become a critical question. Until now, the ECB has considered the costs associated with negative rates to be a relatively small side effect within the broader context of a growth-supportive policy framework. More recently, however, there has been a shift in this thinking: in his ECB Watchers conference speech last March, President Mario Draghi changed his tune and said the ECB would consider possible measures to mitigate the side effects of negative rates. This initiated the discussion about the possibility of implementing a system of "tiered" reserves, whereby only a certain part of banks' deposits would be subject to negative rates. However, we do note that there is still considerable scepticism within the ECB on the topic. For instance, Jens Weidmann believes that the relief provided by reserve tiering would likely be lower than the additional costs arising from shifting rate normalisation expectations. Others believe that restoring profitability is ultimately banks' duty, not that of the ECB.

Still, the discussion has started, and we think tiering could be implemented if rates stay lower for longer or if the ECB needs to ease further.

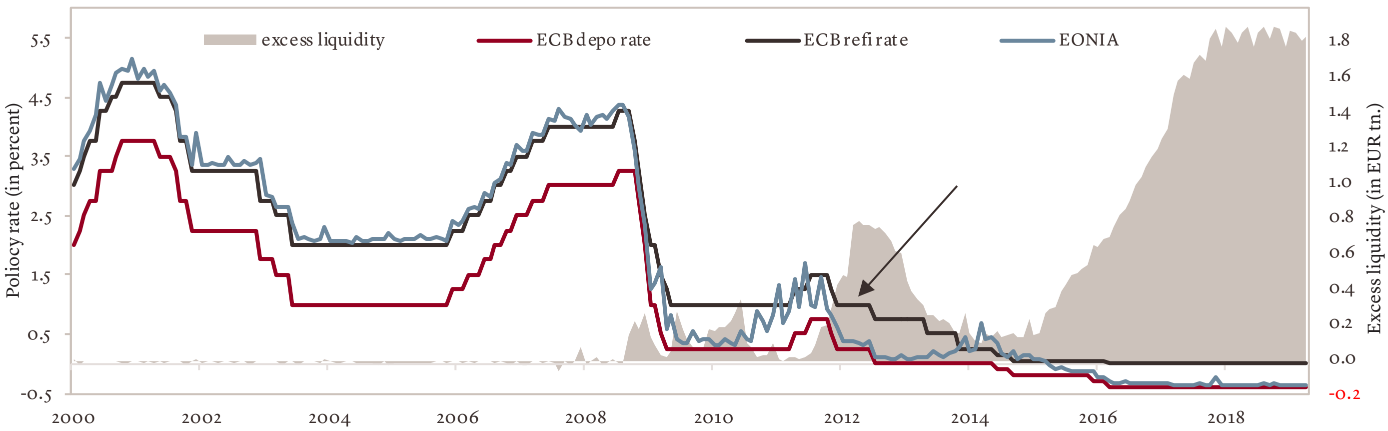
Tiering reserves

Such a system already exists in other jurisdictions with policy rates in negative territory. In Switzerland, the Swiss National Bank introduced negative deposit rates in late 2014, but the

[1] Targeted longer-term refinancing operations.

Chart 2 – Abundant excess liquidity assures overnight rates remain at the low end of the corridor

ECB policy rates, Eonia, and Eurosystem excess liquidity



Sources: ECB, Bloomberg, Lombard Odier

charge only applies to the tier of bank reserves in excess of an "exemption threshold" that stands at 20 times the minimum reserve requirement. In Japan, the Bank of Japan cut its policy rate to -0.10 in 2016, and put in place three tiers. This subjects only a small part of deposits classified as the "policy rate balance" to the negative deposit rate (a rate of 0% applies to the "macro add-on balance" including required reserves and balances related to loan support programmes, and a rate of +0.1% to the rest referred to as the "basic balance").

While tiering reserves create some complexity (which seems to have dissuaded the ECB from implementing such a strategy in the past), it can still be done without negative side effects for monetary policy. Although the total amount of excess liquidity is EUR 1.9 tn, a much smaller portion of reserves seems required in order to keep money market rates at their current levels. Given the historical relationship (see chart 2), it is likely that no more than EUR 500 bn of excess liquidity is needed for an efficient transmission of policy to money-market rates.

Currently, the vast majority of bank reserves earn negative interest: total reserves amount to about EUR 1.9 tn, with minimum reserves at just 130 bn. This results in a cost of approximately EUR 7.5 bn euros per year. A change in ECB's policy that makes the negative deposit rate only applicable to a tier of reserves above a certain threshold could reduce costs for European banks – especially in Germany, France and the Netherlands, which hold the bulk of the euro area excess liquidity.

By contrast, the share of Southern European countries is quite small, so reserve tiering would not help them much. Political considerations could also come into play and make implementation challenging. We also note that in terms of policy, there might be less justification for the ECB to do this as credit growth has been strong in France and Germany. Indeed, the very rapid credit growth has recently led the French central bank to require banks to hold an additional capital buffer, the countercyclical capital buffer, designed to act as a cushion when the cycle turns.

Indicatively, if one-half of excess reserves (about EUR 935 tn) were to become exempt from negative deposit rates and be remunerated at the MRO rate of 0%, this could save the banks up to about EUR 3.7 bn per year. Should the threshold be raised to two-thirds of total excess reserves (exempting about EUR 1.25 tn from negative rates), the savings would increase to up to EUR 5 bn per year. Overall, we think this would add roughly 2-3% to bank earnings on average, with some German banks likely seeing a much higher benefit.

The main objective of a tiering system would thus be to allow for deposit rates to remain negative for long, or even to be cut further, without damaging the banking system. This could prove useful in a broader easing package, whereby the ECB would provide attractive TLTROs at a lowered rate (particularly helpful to banks in the periphery), while at the same time tiering deposits (beneficial to banks in the core regions). Having always emphasised the complementarity of its various instruments, such an announcement would be consistent with ECB's previous policy. However, we think that such a measure might not be sufficient to fully offset the negative impact of lower or even more negative rates on banks' profitability, especially as as other measures (cost cutting, consolidation) are proving harder to implement. In addition, if the ECB was to cut rates further, it would likely be in response to a deteriorating economy, which could arguably also weigh on loan loss provisions, thereby further affecting profitability. In such a scenario, some banks could once again become very vulnerable.

A small step in the right direction

Overall, we expect the impact of these policy changes on growth and inflation to be relatively limited, and certainly smaller than previous steps such as the launch of QE or the initial versions of TLTROs. From a macroeconomic standpoint, with the economy on a more solid footing today and the fears of deflation largely removed, less aggressive easing steps appear a sensible policy choice.

In this context, the recent shift in tone by the ECB regarding the side effects of negative deposit rates seem more important in our view. This acknowledgement, and – more importantly – the willingness to consider mitigating measures is a step in the right direction, although the signal sent by keeping rates below zero for an even longer period is a negative one for banks. If additional easing measures are able to simultaneously support peripheral (generous TLTROs) and core banks (reserve tiering), while keeping the risks of unintended policy tightening at bay thanks to forward guidance, the policy mix would seem more sustainable and better suited to an environment in which the risks to the outlook are mostly external and trade-related.

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