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"Negative interest rates and asset purchases: the balance between intended and unintended consequences"

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It is a great pleasure to participate today in this panel discussing "Negative Interest Rates and Asset Purchases: The Balance Between Intended and Unintended Consequences". Bank profitability is the Achilles heel of the European banking sector and at the centre stage of the current worries about its fragility. The negative interest rate environment and asset purchases affect bank balance sheets and profits. But monetary policy is neither the cause nor the cure for structural constraints in banking leading to low profitability and limiting the transmission of monetary policy.

Let me start in presenting two stylized facts. The ECB had to master large parts of the crisis "running with a broken leg". The fact that the monetary transmission mechanism was impaired during the peak of the crisis gave rise to the Banking Union. A single rule book for bank regulation was adopted early on, a single supervisor and a single resolution institutions installed and a series of stress tests conducted. Thanks to new regulation, banks have become much safer (see slide 1). It is fair to say that the "broken leg" has been cured, though certainly not gained full strength, partly because higher capital requirements and tighter regulation have made banks less profitable.

Second, lower bank profitability is not only evident in Europe but also in the US after the crisis (slide 2). Return on equity has been converging in recent years between both banking systems, although there still is a gap. Banks are currently undergoing a structural transformation pushed by the regulatory changes and a need to adapt the old branch-based business model to the surging digitalisation of the business. The European experience is not an isolated phenomenon, but the challenges are more apparent and economically more significant because European economies depend much more on bank financing.

How do negative interest rates and asset purchases operate in such a banking environment? The current low interest rate environment, with policy rates at zero or even negative in the euro area, creates major challenges for banks. However, the low interest rates have had both positive and negative effects:

- Positive effects mainly refer to the fact that low interest rates have helped to create an improved economic environment, it led to lower inflows of new NPLs, allowed banks to report capital gains on their fixed assets portfolios (at least in the period 2013/2014) and lowered funding costs.

- Negative effects mostly refer to depressed interest rate margins, lower asset yields, and a distortion of prices of some asset classes as banks are incentivised to invest in more risky assets. This can give rise to asset price bubbles in the economy more generally.

- At the same time, the flattening of the yield curve lowers the incentive to engage in maturity transformation and extend credit. Banks' profitability originates from this core role they have in the transformation of short-term liabilities into long-term assets by profiting from the spreads. In addition, high funding costs are one of the main incentives banks have in cleaning their balance sheet from non-performing loans (NPLs). Reducing funding costs inadvertently reduces also the incentive to cut the stock of NPLs.

At this stage, there is little doubt that the lowering of interest rates and the non-standard measures of the ECB have helped the European economy. However, negative effects could outweigh the positive ones also for the banking system if these conditions persist in the long run.

The options available to banks or the support they can expect to receive from the external environment are limited. There is not much room to improve funding costs and interest rate margins. Second, options for asset repricing may also be limited. It depends on the composition and maturity of banks' balance sheets and is not possible for all banks. Moreover, it is a difficult strategy in highly competitive banking sectors, where banks may face in addition pressure from non-bank institutions. Third, there may be limited room for further revenue diversification. It is difficult to systematically increase gains from trading and fixed income, given the current market volatility. This option is not available for retail banks in any case. Also, fee income can be difficult to increase in the short run when banks are deleveraging and start cutting costs.

Given all these constraints to increasing revenues, banks have to rethink their business models and cost base. A key area where banks can clearly do more is to reduce costs further through the digitalisation of services, downsizing of staff and branch networks and consolidation. Moreover, banks with high non-performing loans need to address legacy assets. Many banks have already started taking this road and are cutting costs. Costs remained stubbornly stable during the crisis, but have started coming down at an aggregate level recently. Others will follow their example if they want to remain active players in the market.

At the same time, Member States are called upon to continue implementing reforms and update legislation and regulation – in particular to create the necessary environment for banks to handle legacy assets. For example, bankruptcy law should be modernised and harmonised. At the European level, the final steps for the completion of Banking Union are still pending. Notably, there is a commitment to design a common backstop to the single resolution fund before the end of the ramp-up period and a proposal for a common deposit insurance scheme was launched.

To conclude, it seems that negative interest rates and non-standard measures have worked to help the economy and in the short term, also to help banks. The better banks are able to address their costs and policymakers deal with legacies and create a backup ensuring financial stability, the better banks will be able to play their role in getting the economy going. Monetary policy is neither the cause nor the cure for the deeper structural challenges of the banking sector.