The ECB recalls 'tiering'

The idea: differentiated rates on excess liquidity to lift banks' margins

Banca Promos
Investment Banking Desk

Alessandro Sica
Analyst
+39 081 01 70 622
alessandro.sica@bancapromos.it
investment.banking@bancapromos.it

Paolo Cozzolino
Managing Supervisor
+39 081 01 70 617
paolo.cozzolino@bancapromos.it
pcozzolino2@bloomberg.net

Preface

Just a month has passed since March 7, when the ECB Governing Council announced a change in **forward guidance** and the launch of the **third TLTRO**. Yet the European Central Bank is already reflecting on further measures to be put in place to provide support to a slowing European economy.

New instruments, those being examined by the central bank, which however look back to the past (three years ago, precisely), when for the first time the ECB began thinking about a **tiering mechanism to limit the application of the** (already negative) **deposit facility rate only to a part of** the huge **excess reserves** held by European banks as a result of QE.

Now as then, the debate on this measure is technical as well as political. **Technical** because **it assumes clear ideas about the effects of negative rates on banks' profitability**. **Political** because, **if implemented, it would favour especially the cash-rich lenders in the core countries of the eurozone**, **Germany** and **France** above all (just as **TLTRO III** will mainly meet the liquidity needs of Italian and Spanish banks).

Some observers interpret the renewed interest in tiering as an attempt by the ECB to demonstrate that its **toolkit** is still rich in tools. Others believe, on the contrary, that the very fact that a dated idea like tiering is recalled, actually shows that the ECB is **running out of policy options**.

It is difficult to imagine **the launch of a multi-tier system for euro area banks in the short term**. There is no doubt, however, that **the topic will be at the centre of the next ECB meeting on April 10** and of the following press conference held by Mario Draghi.

Below zero

Since the ECB decided, in **June 2014**, to bring the deposit facility rate (DFR) in negative territory, this rate has ceased to indicate the interest that banks receive against **liquidity deposited overnight** at the ECB and has begun to signal how much euro area banks must pay the central bank on their deposits.

Since then, the DFR has slided to **-0.40%** and the volume of **excess reserves** has increased enormously due to the unconventional monetary policy measures deployed by the ECB (**Quantitative Easing** in the first place). The **cost to the European banking system of the negative rate on deposits** has been assessed **between 7 and 8 billion euros a year**.

Key ECB interest rates

Deposit Facility	**-0.40**
MROs	**0.00**
Marg. Lending Facility	**0.25**

Source: ECB

Next monetary policy meetings of the Governing Council of the ECB

April 10, 2019

June 6, 2019

July 25, 2019

September 12, 2019

October 24, 2019

December 12, 2019

Source: ECB

Executive Board members: terms of office

May 31, 2019
Peter Praet
(Chief Economist)

October 31, 2019
Mario Draghi
(President)

December 31, 2019
Benoit Coeure
(In charge of Market Operations)

December 14, 2020
Yves Mersch
(In charge of Risk Management)

January 26, 2022
Sabine Lautenschlager
(In charge of Statistics)

May 31, 2026
Luis de Guindos
(Vice-President)

Source: ECB

The theoretical debate

Negative DFR and banks' profitability: what connection?

There is no consensus on the effects of negative rates on bank profitability and its subsequent effects on the **real economy**.

On the one hand there are **those who defend the measure**, claiming that **it has generated more benefits than costs** for European banks, without particular spillovers on the **bank lending channel** (which, indeed, would have been strengthened, thanks to lower lending rates and greater demand for credit). Therefore, the **low profitability** of eurozone lenders shouldn't be **attributed to** ECB's measures but, instead, to **high cost-to-income ratio and high loan losses**.

Moreover, supporters say, **even if the side effects of negative rates were to be demonstrated, other ECB measures**, such as the bond purchase program, **would have more than offset** the lower bank profitability **thanks to capital gains** on the securities held by banks in their books.

On the other hand, **detractors** of below-zero interest rates **state that** banks' **interest margins have been compressed**. Indeed, banks preferred not to transfer the negative rate on ECB deposits to their customers' deposits. This is mainly due to the fear that, in the face of negative rates, **depositors** would have preferred to **convert** their savings into **cash**, thus benefiting from a nominal return of at least zero.

In this regard, according to critics, although the goal of the ECB is to ensure **price stability** and not to support bank profitability, a banking system weakened by rates below zero would be less effective in **transmitting monetary policy** impulses to the real economy, with consequences for the supply of credit and economic growth.

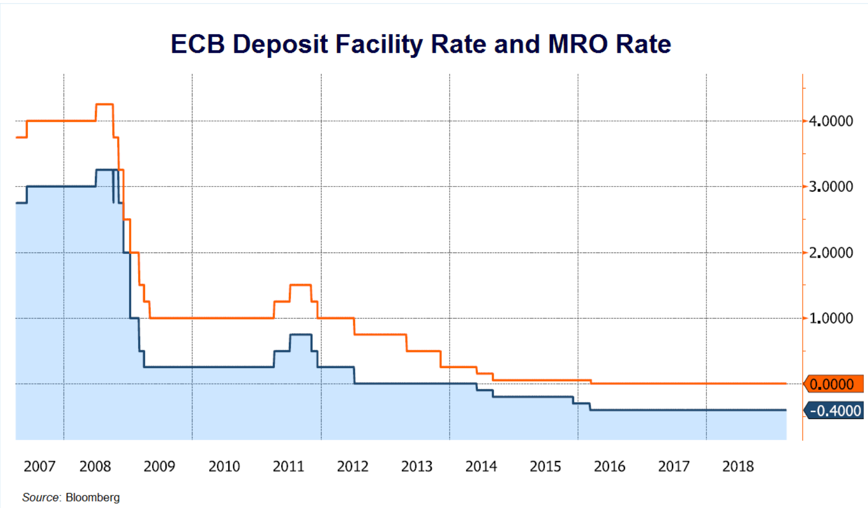
The fact that the ECB has come back to discuss the topic would suggest a theoretical repositioning (of at least a part) of the central bank, driven by the current economic slowdown and **the prospect of a period of low interest rates far beyond the end of 2019**.

Tiering

Relieve banks from the burden of a negative deposit rate

No details have yet emerged on its possible architecture, but the **tiering** mechanism under discussion at the ECB **would provide for the exclusion of a part of the excess reserves** deposited by European banks at the central bank **from the application of the negative rate** of -0.40% (which today, instead, is applied to the entire amount of excess liquidity).

The idea is based on the consideration that, **to anchor interbank market rates on the levels desired by the ECB, it would be sufficient to apply the negative rate only to a minority of the overall excess liquidity**. **On the** (larger) **remaining part, the rate on the Main Refinancing Operations** (MRO), **currently zero, could be charged instead. A three-tier system with three different rates** (negative, zero and positive) **cannot be excluded neither**.

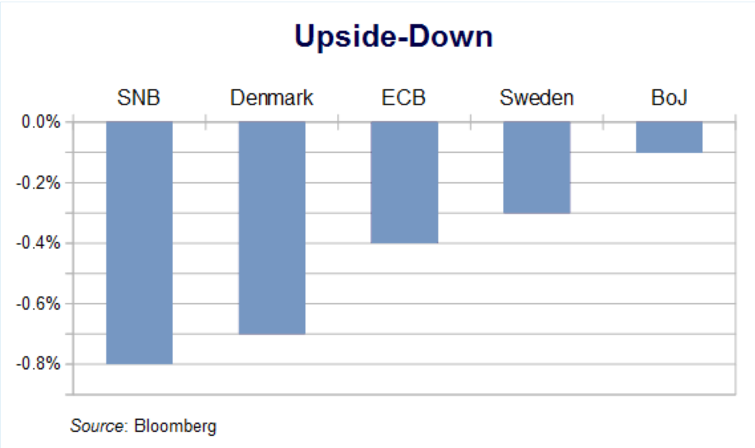


Background and international experiences

The ECB assessed it in 2016; in Japan, Denmark and Switzerland it already exists

Three years ago, ECB policymakers discussed the issue of **a two tier system to be applied to the excess liquidity** of European banks. The option was then set aside during the **March 2016** monetary policy meeting as it was deemed too **complex** and difficult to implement in the **heterogeneous banking system** of the eurozone, where excess reserves are not uniformly distributed among banks of different countries. Furthermore, on that occasion, policymakers concluded that there wasn't **enough evidence** about the side effects of negative rates on banks' profitability.

Internationally, there are **only five economic areas where negative interest rates have been introduced** as a response to the crisis. In the **eurozone** and in **Sweden**, systems with a single tier have been implemented. **The multi-tier solution** currently studied by the ECB **already exists in Japan** (three tiers), **in Denmark and in Switzerland** (two tiers).



Draghi's speech

The current economic slowdown reopens the debate about the side effects of negative rates

The current phase of the debate on negative rates has begun last **March 27**, when ECB President **Mario Draghi** spoke in Frankfurt at the 20th edition of the conference 'The ECB and its watchers'. The attention of his listeners was catched in particular by **three sentences** pronounced at the end of the speech:

“We will continue monitoring how banks can maintain healthy earning conditions while net interest margins are compressed. And, if necessary, we need to reflect on possible measures that can preserve the favourable implications of negative rates for the economy, while mitigating the side effects, if any. That said, low bank profitability is not an inevitable consequence of negative rates.”

While not explicitly mentioning **tiering**, Draghi's words officially reopened the debate closed by the ECB in March 2016.

Press rumors

On the same day as Draghi's speech, news agency Reuters, **citing two sources**, reported that among the options **under assessment by the ECB** to mitigate the unfavorable effects of the negative deposit rate there would also be that of a **multi-tier system**.

The work – for the moment being conducted at the **staff level** and not discussed by the **Governing Council** – **has been underway for years but an acceleration now could signal that interest rates will remain low for a time longer than currently indicated by the ECB's forward guidance** ("***at least through the end of 2019***").

Other ECB members

Villeroy de Galhau and Nowotny are favourable, other central bankers are more lukewarm

From March 27 onwards, several ECB members have expressed their **views** on the effects of negative rates on the banking sector and on the opportunity of **fixing the current single-tier deposit rate**. The divergence of opinions emerged so far supports the conviction that a long discussion will be necessary in the **Governing Council** before reaching an agreement on a multi-tier system.

Luis de Guindos (ECB Vice-President)

The compression in interest margins poses a **challenge to banks** but the benefits of negative rates have so far offset their costs. Alternatives in terms of **tiering** are continuously analyzed but no decision has been taken yet. The reasons behind the **low profitability** of European banks go beyond the potential impact of negative interest rates.

Peter Praet (ECB Chief Economist)

The ECB's staff is examining the issue of tiering but it is **premature** to talk of its introduction. Any change must be fully justified on **monetary policy grounds**. Looking at the **bank lending channel**, there are no particular problems, but given the current economic weakness, **you have to be ready**.

Yves Mersch (Member of the ECB's Executive Board)

The ECB's unconventional monetary policy instruments bring with them some **side effects** but their **benefits** have outweighed their costs. The ECB continues assessing the impact of its measures, and of negative rates in particular, also on **bank profitability**.

Klaas Knot (Dutch Central Bank Governor)

A multi-tier deposit rate would favor banks with a certain **business model** over others and the ECB should avoid such a **market distortion.** Banking profitability is of **secondary importance** for the ECB. It is good for the ECB to revisit this topic but it is difficult to reach a conclusion **different** from that reached in the past.

Francois Villeroy de Galhau (Bank of France Governor)

Draghi's choice to mention the side effects of negative rates has been **wise**. It is good for the European Central Bank to periodically review the effects on intermediation and on the **transmission of monetary policy** of its non-conventional measures, including negative rates.

Ewald Nowotny (Austrian Central Bank Governor)

The debate over the side effects of negative rates is **healthy** and the ECB should look at how **Switzerland** and **Japan** have managed negative rates. It would be good to achieve some **mitigation** of the side effects of negative rates.

Markets' reaction

News and statements about tiering have triggered a **positive reaction of European banks stocks** (which would benefit from the exemption, even if only partial, from the negative rate on deposits) associated with a **reduction in government bond yields**, especially for the core countries of the monetary union (due to the corresponding expectation of a delay of the first rate hike).

March 6-7 minutes

In the account of the March monetary policy meeting (published on April 4) it is reported the following:

“Concerns were voiced that over time the effects of persistently low rates could depress banks’ interest margins and profitability with negative effects on bank intermediation and financial stability in the longer run. It was recalled that the consequences of low rates differed across the maturity spectrum and across banks, depending on their business models and the structure of their assets and liabilities.”

Potential alternatives

DFR lifting or TLTRO III calibration?

According to some observers, rather than creating a complex (and virtually ineffective) tiering system, the ECB should simply **raise the deposit rate**. In this way, eurozone banks would obtain an immediate saving on the overnight deposit of their excess reserves.

However, other commentators object, the widening of banks' interest margins, favored by the rise in the rate on deposits at the ECB, would also imply a rise in the **lending rate** to households and businesses, an effect that is not ideal in the current context of economic slowdown.

A second alternative solution would be for the ECB to define the features of **TLTRO III** in order to mitigate the inconvenience of a deposit rate stuck at -0.40% longer than expected.

However, the hypothesis of a TLTRO rate lower than -0.40% should be excluded for at least two reasons: i) it would allow European banks to perform an easy **carry trade**, re-depositing in the ECB at -0.40% the cash collected with TLTROs at a lower rate; ii) so far, several ECB members have stated that TLTRO III would have been **less generous** than the previous TLTRO II.

As anticipated by Peter Praet, the **features** of the 3rd round of TLTRO will be announced at the **ECB meeting in June**, together with the publication of new updated **macroeconomic forecasts** for the euro area.