CIO | VIEW

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AN ECB GIFT WITH WORRYING STRINGS ATTACHED

Tiering may come, giving banks relief from the negative ECB deposit rate, but it might also delay monetary normalization.

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IN A NUTSHELL

- At today's ECB press conference, introducing a tiering system for banks' negatively yielding excess reserves at the ECB was once again a topic of discussion.
- German and French banks in particular would benefit from the relief. At the same time, the prospect of continued low interest rates is not helpful to the banking sector.
- A further downside is that the introduction of tiering may mean the ECB holds on to negative rates for longer.

IS ANOTHER UNORTHODOX INSTRUMENT AROUND THE CORNER?

"We did not discuss in the Governing Council whether the introduction of a tiering system would allow us to keep deposit rates lower for longer," Mario Draghi replied to a question at the European Central Bank (ECB) press conference on Wednesday, April 10. We interpret this as a diplomatic way to say that the council has not looked at it yet, but might do so soon. In order to understand why this topic is relevant today, we should look at how we got here: On June 11, 2014, the ECB broke new ground: negative interest rates were introduced in the Eurozone for the first time. It first lowered the deposit rate to -0.10%, followed by further minor adjustments, and since March 2016 the rate has been -0.40%. Despite this "penalty interest," banks hold large amounts of deposits with the ECB. Most recently, the excess reserve was just under two trillion euros. At the current interest rate, this results in a burden for the banking sector of around eight billion euros per year. Since most of these funds with the ECB are held by German, French and Dutch banks, the burden on the banking sector within the Eurozone is unequally distributed. With interest margins already narrow, many see this as an additional burden on the sector's profitability. In the past, the ECB in particular highlighted the positive aspects of negative interest rates. After all, they were introduced to make financing conditions easier and to anchor expectations of continued low interest rates. The French central bank's president recently warned, however, that adhering to negative interest rates for too long could impair profitability and the transfer of monetary-policy stimulus.[1]

Even within the Governing Council a re-assessment seems to be taking place. At the end of March 2019, ECB President Mario Draghi said that options to mitigate the harmful impacts of negative interest rates were being explored. This has fuelled speculation[2] in the capital markets about the introduction of a tiered system for the negative deposit rate. Thus banks might not have to pay interest on low levels of deposits with the ECB but rising interest rates on higher levels. A tiering system would send a strong signal to capital markets, according to Ulrike Kastens, DWS economist: "Introducing a tiering system would make it easier for the ECB to hold on to negative deposit rates for even longer. Say goodbye to normalization."

ARE THERE PROTOTYPES ALREADY?

In Europe, negative interest rates have recently been introduced in Sweden, Switzerland and Denmark as well as in the Eurozone. The smaller countries introduced the negative rates mainly for exchange-rate reasons: to prevent a further appreciation of their currencies. At the same time, however, they also wanted to avoid overburdening the banking sector. This led to the adoption of a tiering system by Switzerland and Denmark. In Denmark, individual current-account limits are set for each bank. If the limit is exceeded, the current deposit rate of -0.65% becomes payable. In Switzerland, on the other hand, an allowance of at least 10 million Swiss francs initially applies; for current-account holders subject to minimum-reserve requirements (domestic banks), the allowance corresponds to 20 times the minimum reserve requirement.[3] Japan as well has a tiering system.

[1] In an interview from February 27, 2019, Francois Villeroy de Galhau said: "If maintained for too long, they could weigh negatively on the profitability of financial intermediation with possible adverse consequences for the smooth transmission of monetary policy."
[2] According to Reuters, two ECB sources stated that the ECB was studying options to lower the negative impact of negative interest rates. They explicitly mentioned a tiered deposit rate.
[3] The Swiss National Bank sets fixed allowances for foreign banks. The part of the current-account balance that exceeds the allowance at the end of each calendar day pays a negative interest rate, calculated on a daily basis, of -0.75%.

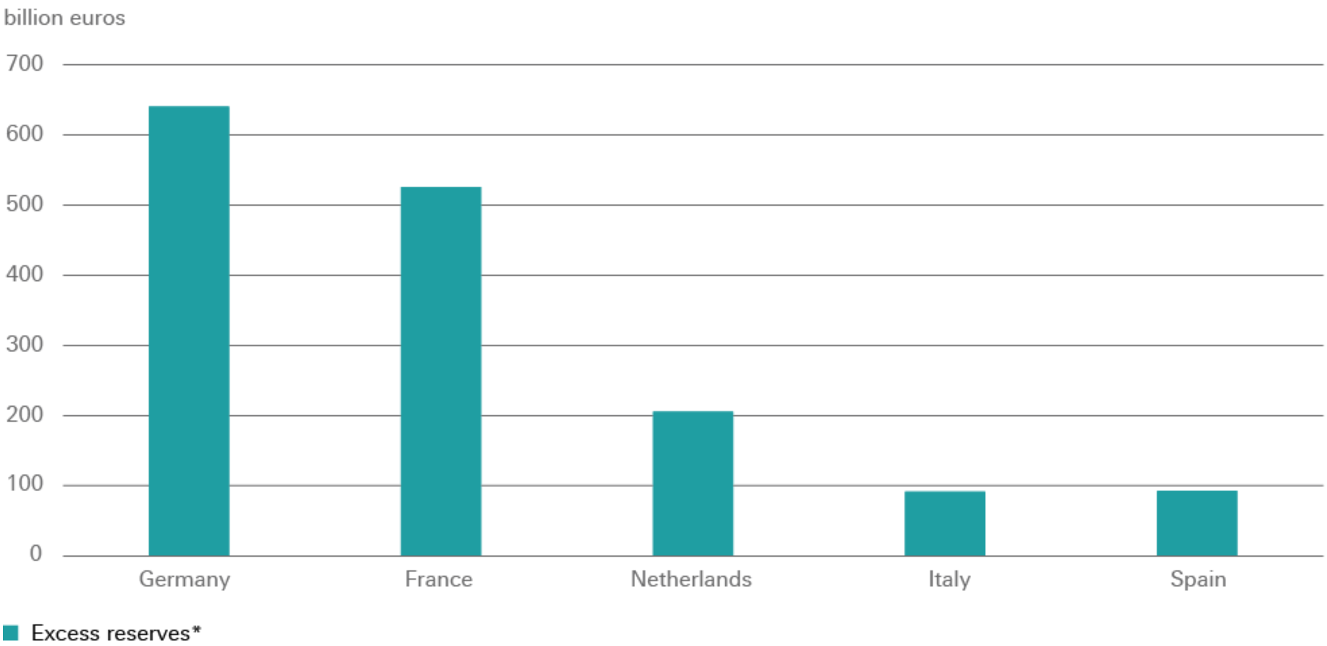
THE ECB'S MOTIVES: STRENGTHENING BANKS' PROFITABILITY?

At the press conference in March, Draghi made it clear that the negative deposit rate is an essential element of monetary policy, which has worked well in the past without impacting the banks' operational capabilities too much. Currently, within the Eurozone, lending to companies shows the highest growth rates in Germany and France, even though German and French banks have the highest surplus reserves.

It is, moreover, the responsibility of the banks themselves to ensure that the banking system is profitable. At the last ECB press conference, Draghi stated that banks in the Eurozone achieving the highest return on equity have three main characteristics: a low cost-to-income ratio, high IT spending and diversified sources of income in a low-interest-rate environment. In addition, aggregate bank profitability in Europe is lower than in the United States, but not significantly lower than in the UK and Japan. Overall, the extent to which the negative interest rate has an impact on banks' operational results will depend on the bank and the business segment in question. In a recent ECB survey in April 2019, 73% of respondents said that their net interest income was negatively impacted by the negative interest rate, compared with 68% in October 2018.[4]

Irrespective of these findings, the ECB seems increasingly concerned that weaker economic growth, in particular, could reduce the profitability of the banking sector – and, together with the negative interest rate, have a dampening effect on lending in the Eurozone, despite the continuing high ECB monetary-policy stimulus. These impacts might be mitigated by introducing a tiered deposit-rate system. Some might call it a special form of subsidy for the banking sector, similar to the further announcement of targeted long-term tenders (TLTROs) from September 2019, with the aim of alleviating the "funding pressure" on the affected banks.

CRUEL CASH: NEGATIVE-YIELDING EXCESS RESERVES HELD WITH THE ECB



Source: Halver Analytics Inc. as of 4/4/19
* Excess reserves include the current-account balance and the deposit facility

THE ECB'S POTENTIAL ALTERNATIVES

_ Why doesn't the ECB increase the deposit rate? At first glance, this would appear to be a simple way to alleviate the deposit-rate burden. Currently, however, the negative deposit rate constitutes part of the forward guidance on monetary policy. In addition, it is the anchor for the money market. An increase would shift the money market curve, with repercussions for the bond markets, which could lead to a slight deterioration in financial conditions. In addition, it would be a communication challenge to make clear that the cut in the negative rate would not lead to further, de facto, interest-rate rises within a 12-month horizon. Our impression, however, is that the ECB is wary of the risk of reducing the negative interest rate and potentially unsettling the market.

_ Why has the ECB not introduced a tiering system in the past? In the Q&A session following the ECB meeting in March 2016, ECB President Draghi explicitly commented on the impact of negative interest rates on the banking system. At that time, he answered with a clear "no" to the question of whether interest rates could be as negative as one wanted without it having any conse-

[4] https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2019q1~25cd122664.en.html#toc25

quences for the banking system. For this reason, the Governing Council decided against a tiering system at the time, also to signal that interest rates could not fall lower than the ECB wanted. In addition, the introduction of a tiering system is complex. In view of the unequal distribution of deposits held at the ECB between the individual countries, a tiering system would tend to favor individual banks from individual countries.[5]

WHY IS THE TIERING SYSTEM BACK ON THE AGENDA NOW?

At first glance, a tiering (sometimes also referred to as "staggered") system has its charms. The introduction of a tiering system, such as that in Switzerland, in particular, could ease the burden on banks. But it would have serious implications for the ECB's future monetary-policy orientation. On the one hand, the ECB would be signaling that interest rates could remain low for some time – after all, if a deposit-rate increase (a reduction of the negative rate) was imminent, it would not need to introduce this system now. In principle, then, the ECB would be rejecting the idea of normalizing monetary policy by eliminating negative rates. This is what the capital markets have increasingly suspected in recent weeks and months anyway. On the other hand, a tiered rate would reactivate the negative deposit rate as a monetary-policy instrument. In contrast to the statement in March 2016, it opens up the possibility of adopting a still more negative deposit rate without having any serious effects on the banking sector. This is because the tiering system would mitigate the negative impact on banks. In an environment where monetary policy (both interest rates and non-standard measures) is already reaching its limits – and the limit for the purchase of German government bonds within the framework of a new quantitative-easing (QE) programme has already been reached – a further significant economic slowdown could at least partially be addressed by adopting this still more negative interest rate. For us, this is the main argument for an introduction of a tiering system. The ECB's own discussions seem still to be in their infancy but the ECB seems likely to announce a tiering system after the summer break at the latest.

On the whole, however, it would not be a very encouraging sign for the future orientation of monetary policy. With the change in forward guidance and the renewed launch of TLTROs with a maximum term lasting to 2023, a very expansive signal was already sent out in March 2019. The introduction of a tiering system would further strengthen this signal. We did not expect a real normalization of monetary policy, only gradual tightening. But this step would make even a reduction in the current extraordinary monetary-policy measures a less likely prospect. The only conclusion that would remain is that normalization of monetary policy is a long way off and monetary policy in the Eurozone will remain more than expansionary for the foreseeable future.

ASSET-CLASS IMPLICATIONS

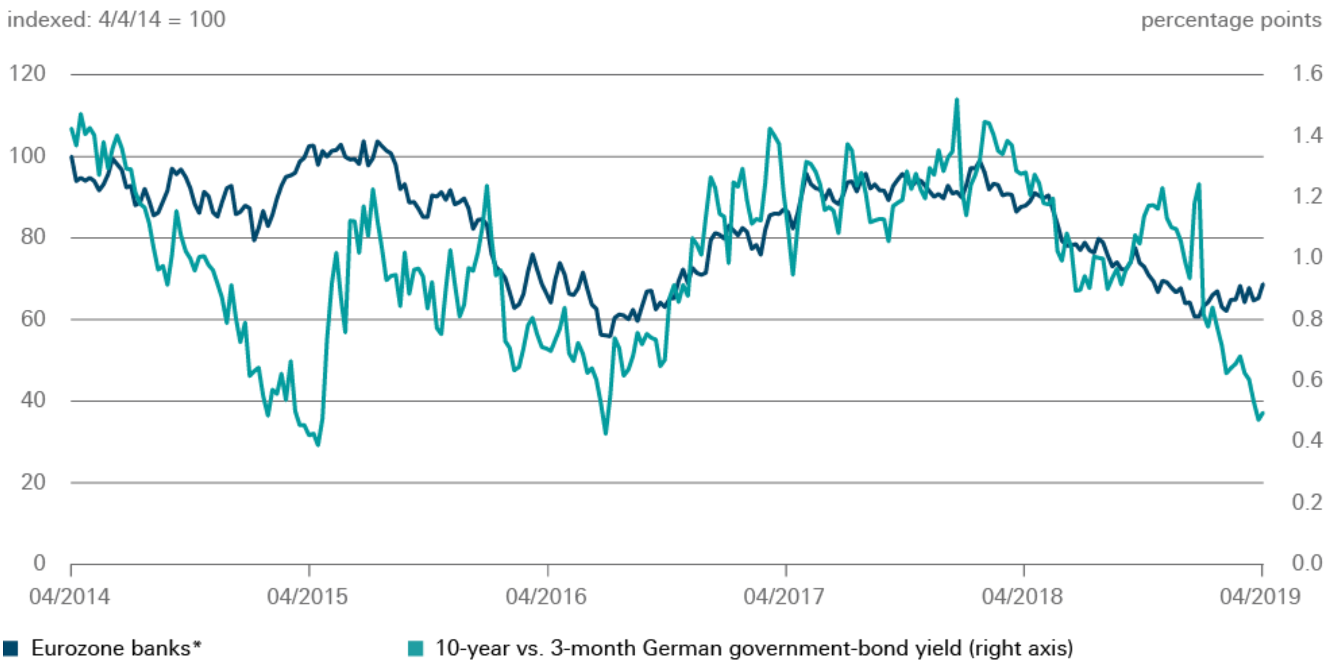
Bonds: The possible introduction of a tiering system accords with our fundamentally cautious view of German Bunds. By March 2019, we expect only very moderate increases in yields across the entire yield curve. We see the yield on 10-year German government bonds rising to only 0.3% by March 2020, for example. The yield curve is also likely to become only a little steeper. Oliver Eichmann, DWS Co-Head of Rates for EMEA, sums up the situation as follows: "The introduction of a rate-free allowance should be seen by market participants as a signal that the ECB will keep key interest rates at the current level for a longer period of time and may even give it scope to make deposit rates still more negative. Expectations of interest-rate hikes in the near future would therefore be dispelled. Bunds should benefit from this (ceteris paribus)."

Equities: Unsurprisingly, the possible introduction of a tiering system would have the greatest impact on Eurozone bank stocks. Here, too, both facets of a possible decision need to be taken into account. On the one hand, profit-reducing interest payments to the ECB might be eliminated. On the other hand, low interest rates might persist for both short and long maturities. The latest growth and inflation figures do not point to an increase in yields at the long end of the yield curve, either. For the banking sector, these prospects are not encouraging, as the chart shows. Here you can see the interplay between the Eurozone banks index and the government-bond yield curve, measured by the difference between 10-year and 3-month bonds. The yield curve has dramatically flattened over the past couple of weeks, which doesn't bode well for the sector. However, the positive effect of relief through tiering would not be negligible. On the basis of the excess reserves that banks of individual countries have parked with the ECB, it is possible to calculate the current burden on earnings: eight billion euros for all banks in the Eurozone, with Germany and France alone accounting for just over half. Since the German banks are also among the weakest in terms of earnings in Europe, the leverage offered by tiered negative deposit rates is likely to be greatest here, followed by France and the Netherlands.

From a global perspective, the only sector we are overweighting is financials, with a broad focus on U.S. banks, while being very selective in Europe. "Currently, there is hardly any local market in the Eurozone that is not struggling. We see the Benelux banking institutions as best positioned" says Tim Friebertshäuser, DWS expert for financial stocks.

[5] On March 10, 2016, Mario Draghi said: "But let me tell you: does it mean that any negative rate will be positive? Does it mean that we can go as negative as we want without having any consequences on the banking system? The answer is no. And you probably know that we've discussed for some time the possibility of having a tiering system, so an exemption system for this operation, and in the end the Governing Council decided not to, exactly for the purpose of not signalling that we can go as low as we want on this. So the Governing Council, although it gives a positive judgement about the past experience, is increasingly aware of the complexities that this measure entails."

THE YIELD CURVE OF GERMAN BUNDS HAS NO ROSY MESSAGE FOR THE EUROZONE BANKING SECTOR



Sources: Thomson Reuters Datastream, DWS Investment GmbH as of 4/9/19
* MSCI EMU Banks Index

GLOSSARY

Bunds
Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

Deposit rate
The **deposit rate** is the rate banks receive when they make overnight deposits with the ECB.

European Central Bank (ECB)
The **European Central Bank (ECB)** is the central bank for the Eurozone.

Eurozone
The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Forward Guidance
Forward Guidance is an indication by a central bank to the likely course of future monetary policy.

Inflation
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy
Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

MSCI EMU Banks Index
The **MSCI EMU (European Economic and Monetary Union) Banks Index** captures large- and mid-cap stocks from the banks industry group across 10 developed-markets countries in Europe.

Net interest margin
The **net interest margi**n of a financial institution is the difference between the average interest rate paid and the average interest rate received by the institution.

Quantitative easing (QE)
Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

Return on equity (ROE)
The **Return on equity (ROE)** is the amount of net income returned as a percentage of shareholders' equity.

Targeted longer-term refinancing operations (TLTROs)
Targeted longer-term refinancing operations (TLTROs) refer to the ECB's providing of financing to Eurozone banks.

Yield curve
A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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