Low-for-long interest rates

What impact for the financial sector?

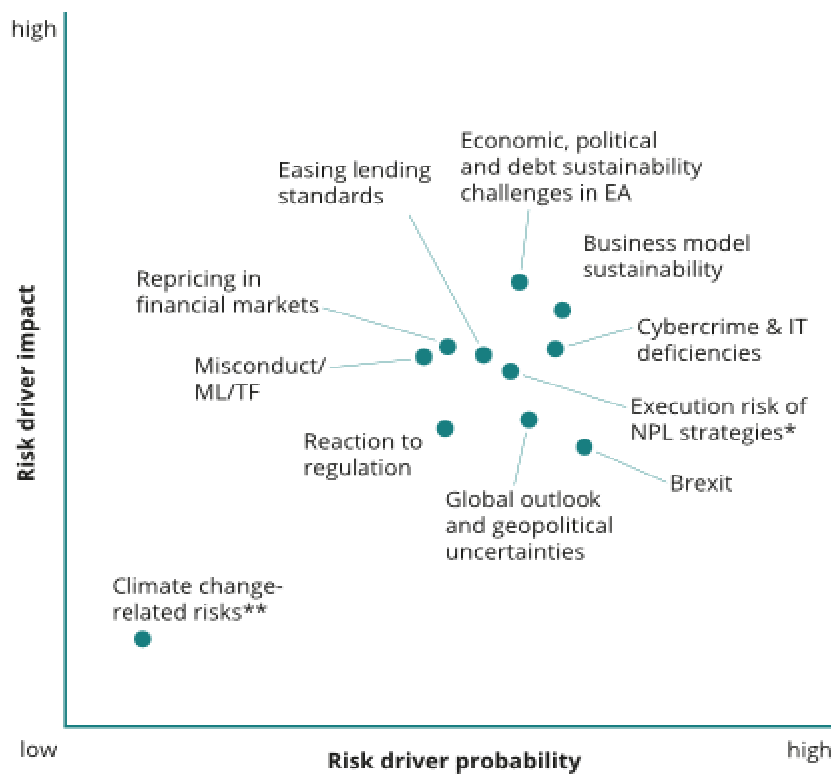
Breakfast on

Banking Regulation

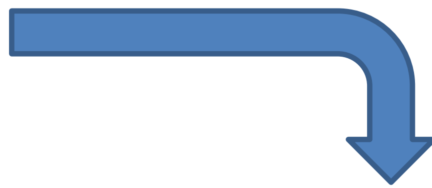
London, 17 October 2019 Frédéric Visnovsky Deputy Secretary General

SSM analysis for 2020 (1/3)

SSM Risk Map for 2020



Source: ECB and national competent authorities.
*The execution risk attached to banks' strategies for non-performing loans (NPLs) only applies to banks with high levels of NPLs.
**Climate change-related risks are more relevant over the longer-term horizon (i.e. a horizon of more than three years).



Key risk drivers

The three most important risk drivers are:

- Economic, political and debt sustainability challenges in the euro area
- Business model sustainability
- Cybercrime and IT deficiencies

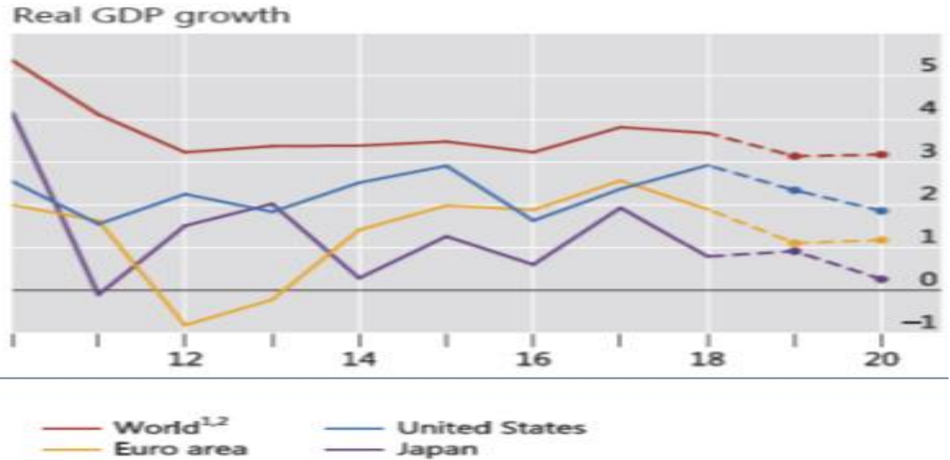
ACPR BANQUE DE FRANCE

SSM analysis for 2020 (2/3)

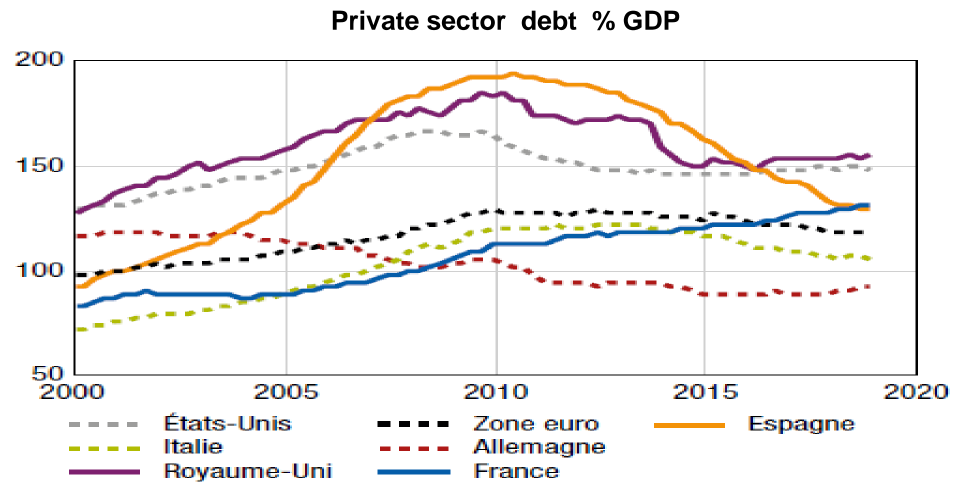
Economic, political and debt sustainability challenges in the euro area have grown over the past year, increasing risks to the euro area banking sector, including credit risk and profitability prospects.

- the euro area economic growth projections for 2019-20 have been revised down compared with a year earlier but still point towards economic expansion.

- debt sustainability concerns remain pronounced, exposing euro area countries with high debt levels to sudden changes in financial market perceptions



Source: Standing Committee on assessment of vulnerabilities, FSB, 2019

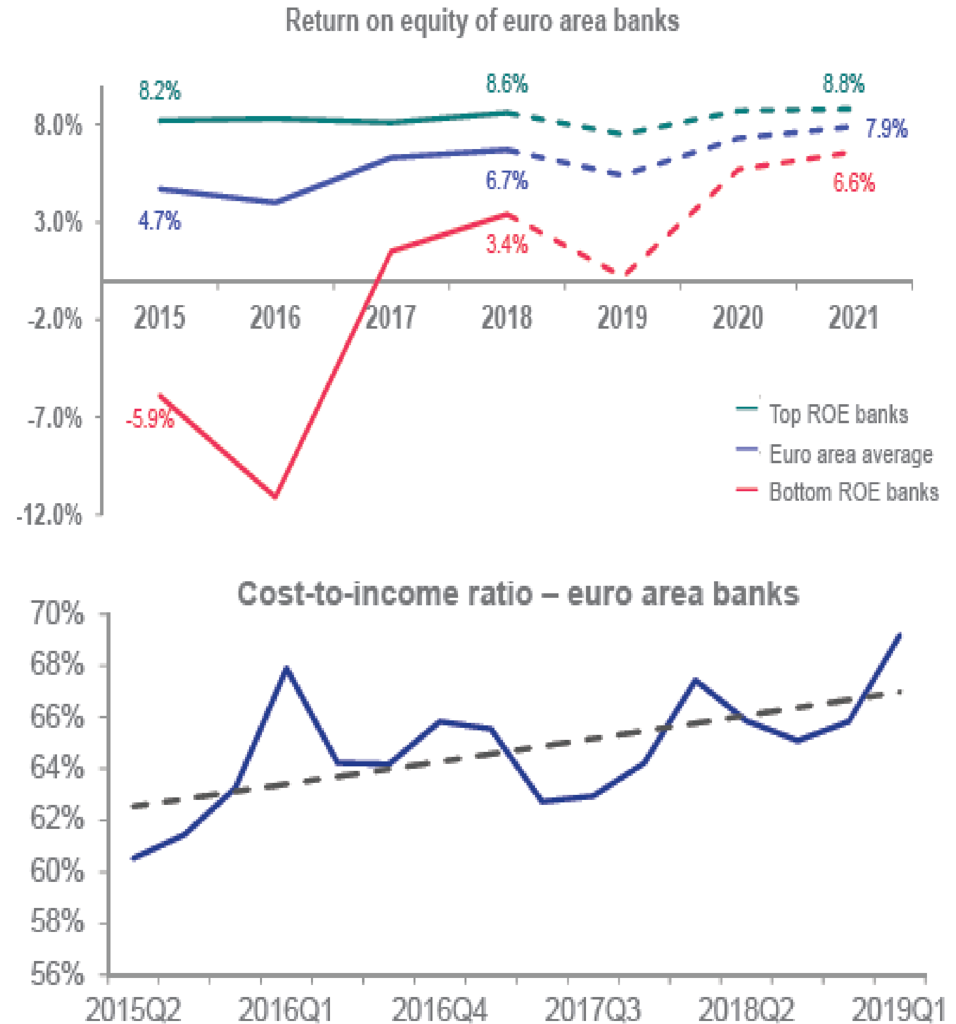


Source : Banque de France.

SSM analysis for 2020 (3/3)

Business model sustainability remains an area of focus as significant institutions (SIs) in the euro area continue to struggle with low profitability

- the outlook of prolonged low interest rates and intense competition weigh further on banks' ability to generate income.
- at the same time, expenses have remained stable on aggregate, as cost-saving efforts have been partly offset by factors such as rising salaries, the need for IT investments and improvements in risk management.



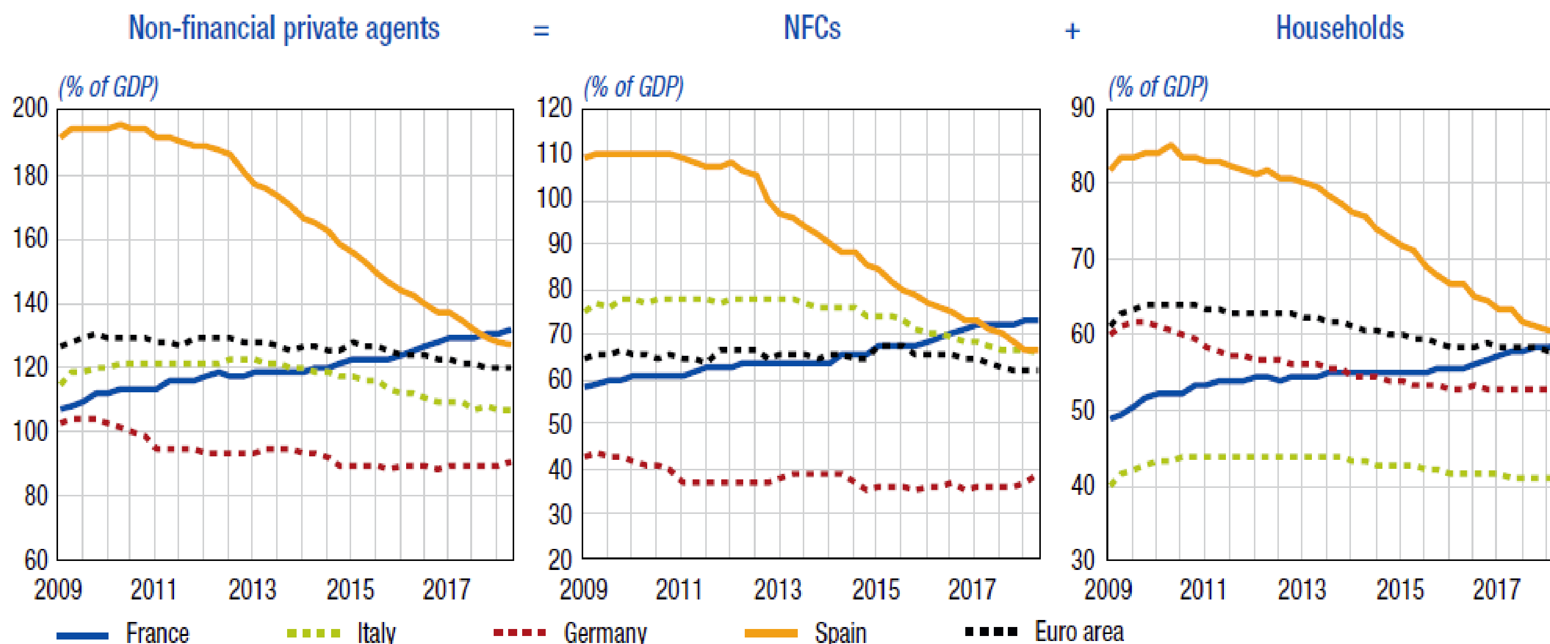
Source: A. Enria presentation at the Forum Analysis 17 September 2019

Effects of low rates (1/4)

Adverse effects	Positive effects
1. Pressure on net interest spread 2. The wave of early amortisation and forbearance 3. Excess liquidity weighing on profitability 4. The cost of capital constrains the market's ability to call 5. Excessive risk taking in credit extension and allocation of assets 6. Deferral of top borrowers on market financing 7. The drag on the deleveraging of the non-financial sector	1. Lower refinancing costs of banks 2. Lower financing costs for economic agents 3. Improved access to credit for individuals/corporates and increased credit volumes 4. Improving the situation of the non financial sector (individuals and firms) 5. Improving borrowers' ability to meet their commitments, raising asset quality and lowering risk

Effects of low rates (2/4)

Private debt is reaching elevated levels



Source: Banque de France.

Debt ratio of French non-financial private agents:

- lower than in the United Kingdom (155%), the United States (149%) and Japan (147%),
- but 12.3 pp above the euro area average (120%)
- mainly owing to the debt ratio of non-financial corporations, 11.2 pp higher than the euro area average.

Effects of low rates (3/4)

Macro prudential measures have been activated in France with the countercyclical capital buffer

- A general backdrop of a **supportive financial cycle:**
  - The deviation from its long-term trend in the ratio of credit to gross domestic product for France is maintained at a high level, and was in the 4th quarter of 2017 by 3.8 percentage points (compared with 4.1 percentage points in the previous quarter). The buffer rate that would mechanically result from the application of this benchmark would be 0,5 percentage point.
  - The deviation from its long-term trend in the bank lending ratio to gross domestic product is 0.7 percentage point (4th quarter 2017)
  - The dynamics of the leverage of non-financial agents, house prices or the evolution of financial, macroeconomic and monetary indicators confirm the acceleration in the financial cycle that has restored or exceeded its long - term average, and the persistence of cyclical risks at significant levels
- It was decided in June 2018 to raise the rate of the countercyclical capital buffer (CCyB), a capital surcharge for European Union (EU) banks in relation to their exposures in France, to **0.25%**, and in March 2019 to raise the buffer to **0,50 %.**
- The first measure entered **into effect in July 2019 and the second one will enter in April 2020.** They are intended to make the banking system more resilient. This will ensure that this latter is able to support credit supply in the event of a cyclical reversal, especially for SMEs, which are structurally reliant on it.

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Effects of low rates (4/4)

Net effects of low interest rates on banks depend on business models

1. Income structure (interest/commissions)
2. The level of diversification (bank, insurance, asset management)
3. The share of market deposits/financing
4. The share of fixed/variable rates in loans
5. Ability to reduce costs

With interest rates in a low-for-long scenario:

- clear pressure on margins for **banking activities**
  - ➢ reduce resilience by lowering profitability
  - ➢ reduce ability of banks to replenish capital after a negative shock
  - ➢ encouraging risk-taking
- challenges faced by **insurers**
  - ➢ rise of present value of liabilities more than that of assets, undermining solvency
  - ➢ steering of clients away from euro funds into unit linked product