Negative Rates and Tiering

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SOMMAIRE

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1 Introduction

Since the Great Financial Crisis some central banks pushed their monetary policy rates into negative territory.

The aim can be to stop deflationary pressure, incentivize banks to lend money, firms to invest and consumer spending.

Central banks can also use monetary policy rates to avoid their currency appreciation.

Through loans based on floating rates, a large portion of bank assets reflected the fall of monetary policy rates.

On the liabilities side, for legal and commercial reasons or for regulatory needs, banks have not passed on negative rates to a large part of their customers, putting parts of their balance sheets in negative carry.

To lessen the adverse effect of negative interest rates on banks' interest income, some central banks introduced in their policy framework a tiering system to reduce the amount of excess liquidity subject to a negative interest rate.

2

Denmark

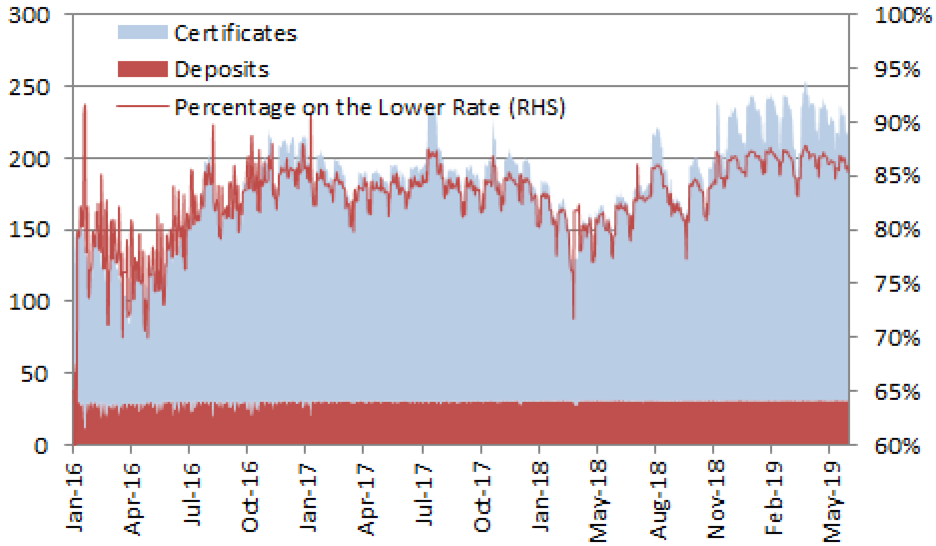
The Danmarks Nationalbank started to implement negative rates in July 2012 to prevent the appreciation of its currency in the context of the mistrust towards euro area and went deeper negative when the Swiss Nationa Bank renounced to cap its currency appreciation.

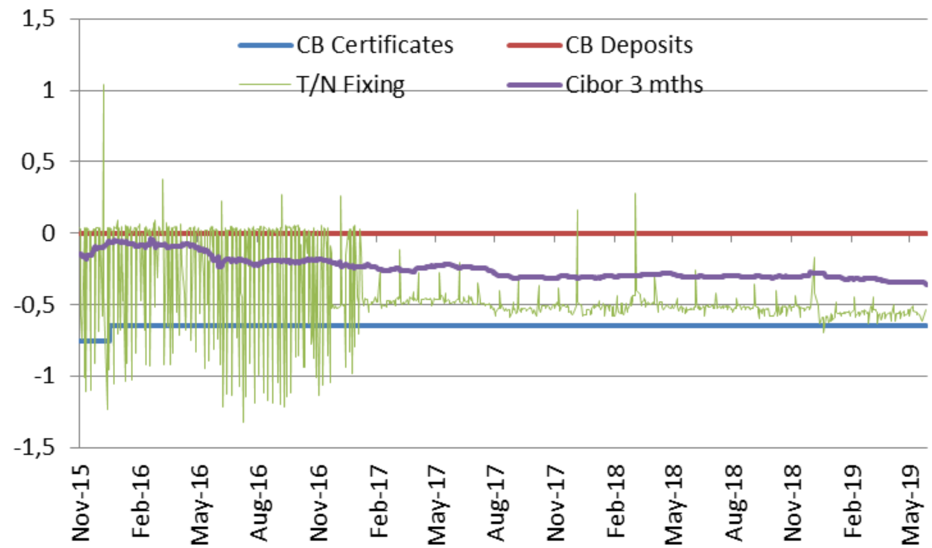
Banks can use their current account or certificates of deposits (7 days) to park their excess liquidity at the central bank..

Current account remuneration remainded at zero, Each bank has its own limit (that was increased when negative rates were introduced).

Liquidity above this limit has to be placed through the purchase of certificates of deposit.

The largest part of the excess liquidity is placed through CDs at the marginal rate (-0,65% since 2016) with a more efficient pass-through to money market rates since 2017.





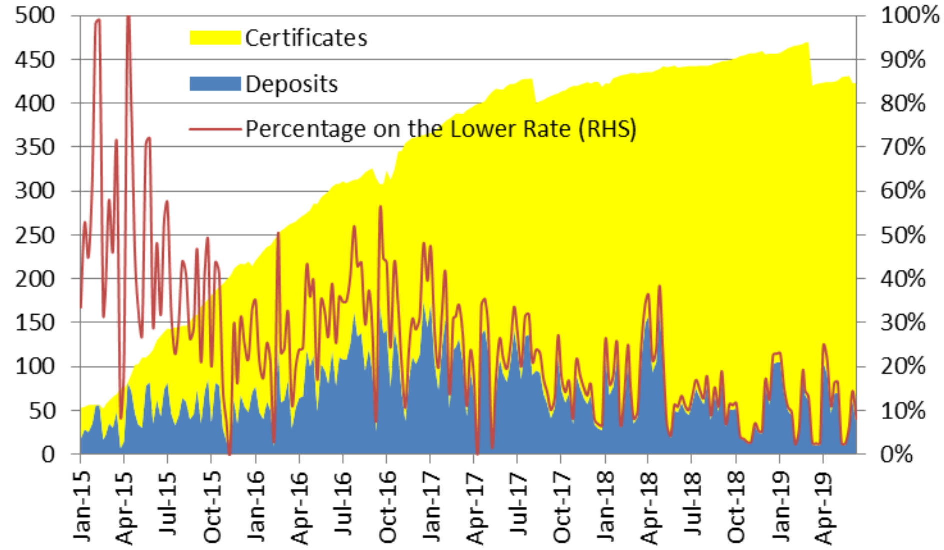
3 Sweden

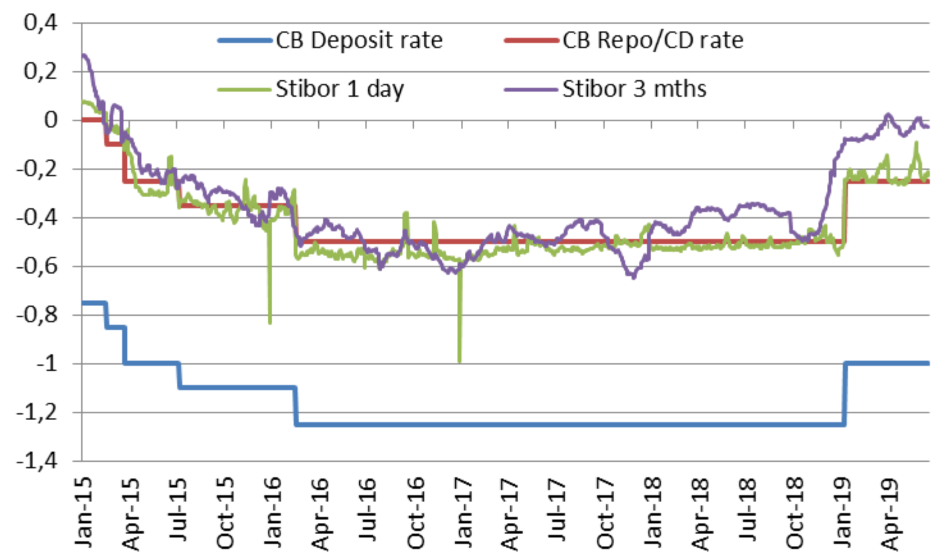
After a short experimentation in 2009/2010 the Riksbank really pushed its deposit rate in negative territory in 2015 to counter low inflation and prevent its currency appreciation.

Banks can use, for their excess liquidity, the deposit facility (-1% at mom) or purchase certificates of deposit (Repo rate -0,25%).

As there is no limitation to use certificates, only a small part of the excess liquidity is placed at the deposit facility and the repo rate is the effective monetary policy rate.

Therefore negative rates were passed immediately in the interbank market and but also (if more gradually) to firms and households because of competition from foreign bank and a greater usage of capital markets funding by non-financial corporations.





4 Switzerland

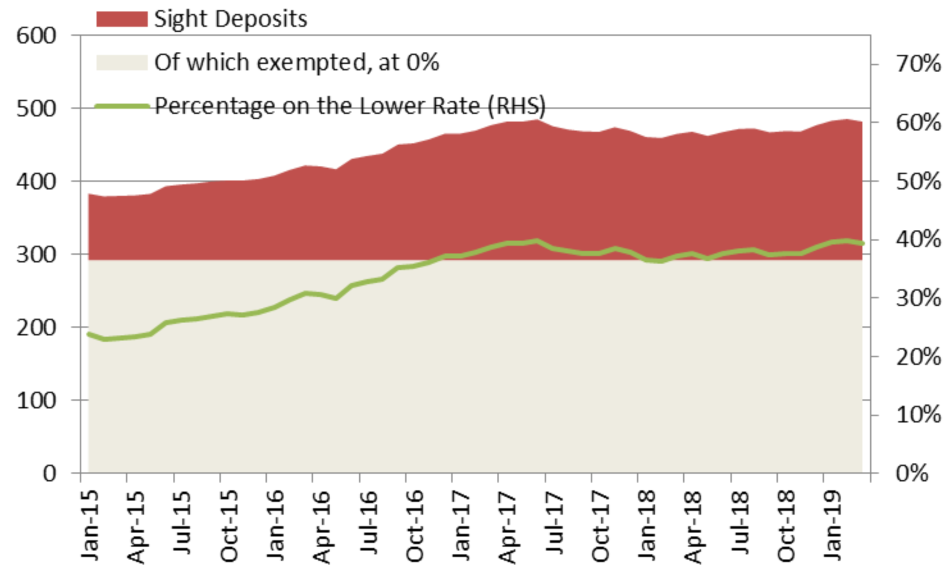
The Swiss National brought it sight deposits rate in negative territory (-0,25%) in December 2014 to avoid its currency appreciation and lowered further (-0,75%) in January 2015 when the central bank dropped the cap on the CHF.

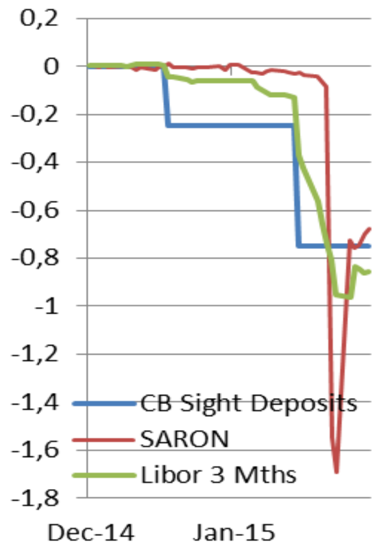
To offset the burden of clients cash, banks subject to reserves have an individual exemption of negative rate for 20 times their November 2014 reserves, or have an exemption threshold if not subjet to reserves (minimum CHF 10m).

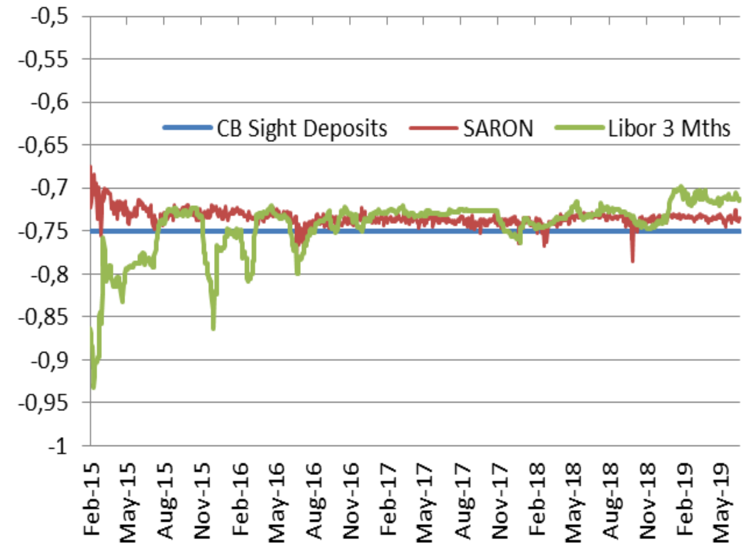
The threshold get reduced if banks switch their reserves into banknotes.

The SNB can also issue short term certificates (not used at the moment).

Banks who did not reach their exemption ceiling can go in the market and take the excess inflows due to the currency appreciation.







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Japan

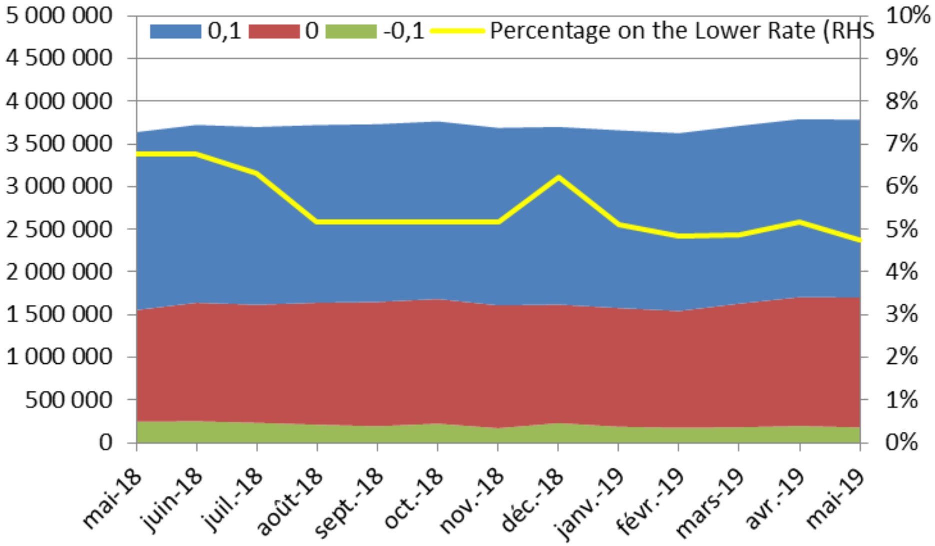
To strengthen its long-running anti-deflationary policy, the Bank of Japan introduced negative rates in January 2016 by cutting the current account rate to -0,10%.

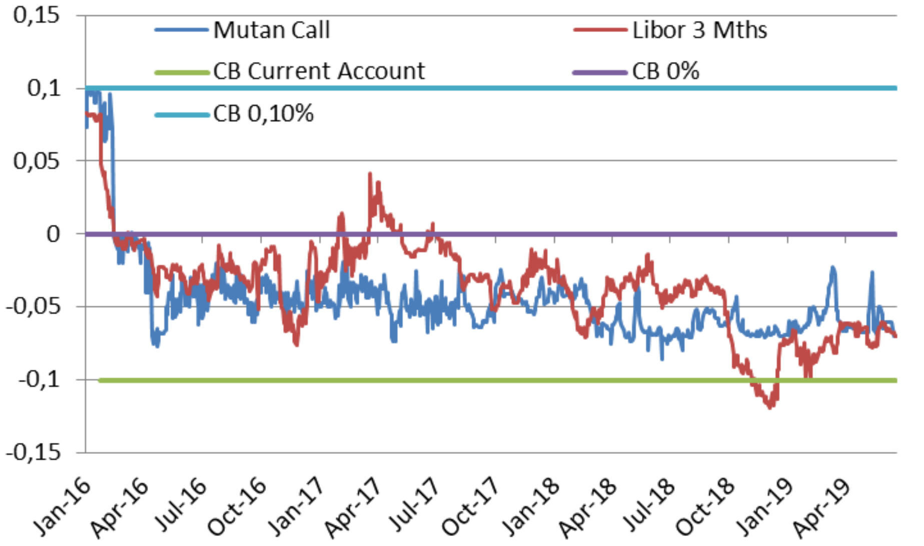
A rate of 0,10% is applied on the 2015 average balance of banks current account (Basic balance).

Banks are not charged on the required reserve, some special operations and an amount calculated as a ratio of their basic balance (Macro add-on).

Banks are charged -0.1% on the amount of reserves that exceeds the sum of the basic balance and the Macro Add-on Balance.

Through the Macro Add-on mechanism the BoJ can sterilize the effect of its expanding Quantitative Easing and at the end only a very small part of the excess liquidity is subject to negative rates.





6 Eurozone

In April M. Draghi said that the Governing Council would assess to what extend negative deposit rates could inhibite bank lending and whether mitigating measures needed to be taken.

Later statements suggested that the majority of the Governing Council sees no urgency to change the current system.

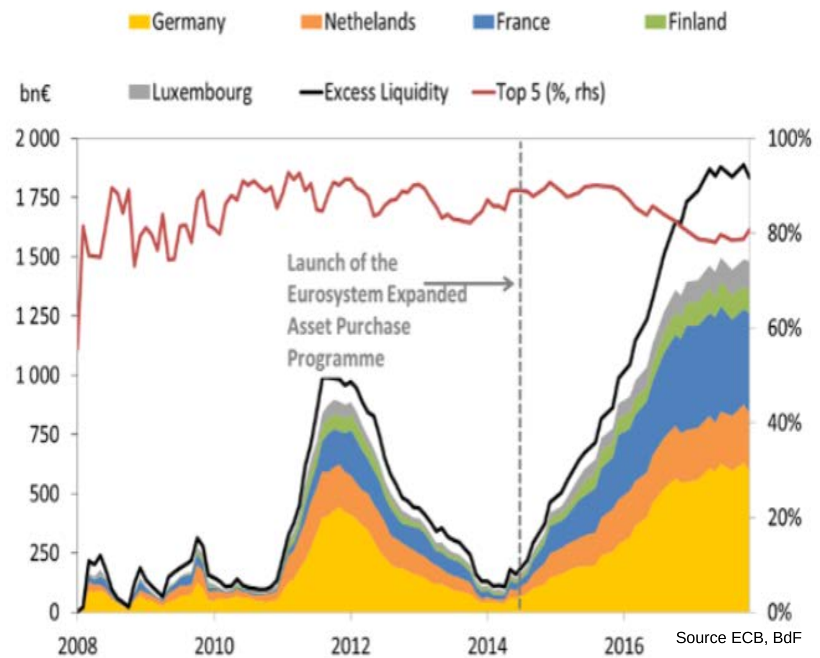
As ECB balancesheet expanded largely with the quantitative easing, the excess liquidity reached nearly 2000 bn€ of which nearly 95%

A tiering system would mitigate the effect of customer deposits floored at 0%.

A tiering system can be introduced through larger exemption on excess reserves, increasing reserve requirement or issuance of short term debt.

But the distribution of excess reserves is very heterogeneous among countries and 5 core countries concentrate 80% of the liquidity.

Distribution of Excess Liquidity in Eurozone



Source ECB, BdF

It look difficult to find a one-size-fits-all system, if politically acceptable, without side effects, on money market rates.

7 Potential side effects on money market rates

Among the risks are possible distortions in the short-term market with a rise in the short-term financing cost .

One can imagine that banks from core countries, where excess liquidity is abundant, would not change their pricing, while banks from peripheral countries might need to deal closer to the « tiered rate ».

- Euribor might be higher as there is no volume weighting between the contributors.
- Eonia (current methodology) might be higher as the volumes would remain very low and borrowers are usually from peripheral countries.
- €STR could remain unchanged if the same banks (core countries) still attract funds from NBFIs.
- If core countries repo rates should be unchanged, below the Deposit Facility, banks in peripheral countries, holding a large part of their domestic government bonds, might move part of their liquidity from the repo market to the « tiered » facility, triggering higher repo rates for peripheral debts.

A change in the short-term rates would potentially lead to a flattening of the curve and therefore affect banks net interest margin.

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