BBVA | Research

Monetary policy and bank profitability

Diario Expansión (Spain)

Santiago Fernández de Lis / Ana Rubio

15 Jan 2018

Monetary policy took centre stage in the recent international crisis - as a weapon against stagnation and deflation, as an instrument for re-establishing financial stability and, in the case of the euro zone, as a crucial tool for combating the financial fragmentation which at one stage threatened the very survival of the euro.

There was a certain feeling that monetary policy was the only instrument available, given the restricted room for manoeuvre of fiscal policy, the tightening of microprudential policies and the lack of experience with macroprudential ones.

The results have been generally successful: a deeper crisis was averted and the foundations were laid for a recovery which is being consolidated. However, these extraordinary measures have had some worrying side effects. In particular, negative interest rates and flat or downward-sloping yield curves bring great pressure to bear on banks' profitability. In Europe, banks' profitability is now below the cost of capital, which is the profitability demanded by the markets, leading to an unsustainable situation. There are fears in some quarters that if they are maintained for too long, the negative side effects of these policies will end up outweighing their beneficial effects, like a remedial drug that is over-prescribed.

In the United States, the process of withdrawing the stimulus measures is fairly well advanced; in Europe it is only just beginning, and its impact on the various different countries will not be evenly spread. In particular, banks or banking systems with relatively high proportions of floating rate loans, those with high proportions of retail deposits, and those whose funding is less dependent on that of their governments and that hold lower levels of public debt will benefit most. Taking all these factors together, the Spanish banking system should be among those most favoured by the withdrawal of the stimulus measures, just as it was among those most harmed by their introduction.

The withdrawal of stimulus measures entails a risk of the return of financial fragmentation in the euro zone, since euro zone banks will find themselves obliged to walk without the crutch of the ECB's cheap and abundant liquidity. This risk requires the change in monetary policy to be gradual and appropriately communicated; it also requires the Banking Union to be completed with a single deposit guarantee fund and back-up for the Resolution Fund.

Once the stimulus measures have been withdrawn, the banks' reactions to monetary policy will not be the same as they were before the crisis, for two reasons:

In the first place, the interbank markets are unlikely to function without collateral as smoothly as they did before the crisis. The central banks will play a bigger part in the intermediation of interbank flows, so banks will be more dependent on monetary policy decisions, which will more directly affect the terms or amounts of available financing.

In the second place, the experience of having used monetary policy tools with a significant impact on bank profitability will have repercussions for banks' strategies and business models. For example, we now know

that short-term interest rates can be negative for extended periods, and this will affect the strategy for granting loans at fixed or floating rates.

We must not lose sight of the fact that in the future we will continue to feel the effects of other far-reaching changes, such as more demanding banking regulation (as the reforms approved in the past few years are implemented), the digital transformation of banking, and competition from new intermediaries with powerful technological bases. Although prima facie the re-establishment of more normal monetary conditions must be positive for the sector, in that it reflects the improvement in the economic context, its final impact will depend on its interaction with a complex set of factors. Once the over-prescribed drugs have been discontinued, the patient's recovery will depend firstly on its own inherent health, and secondly on its environment.

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.