REPLY
AVANTAGE

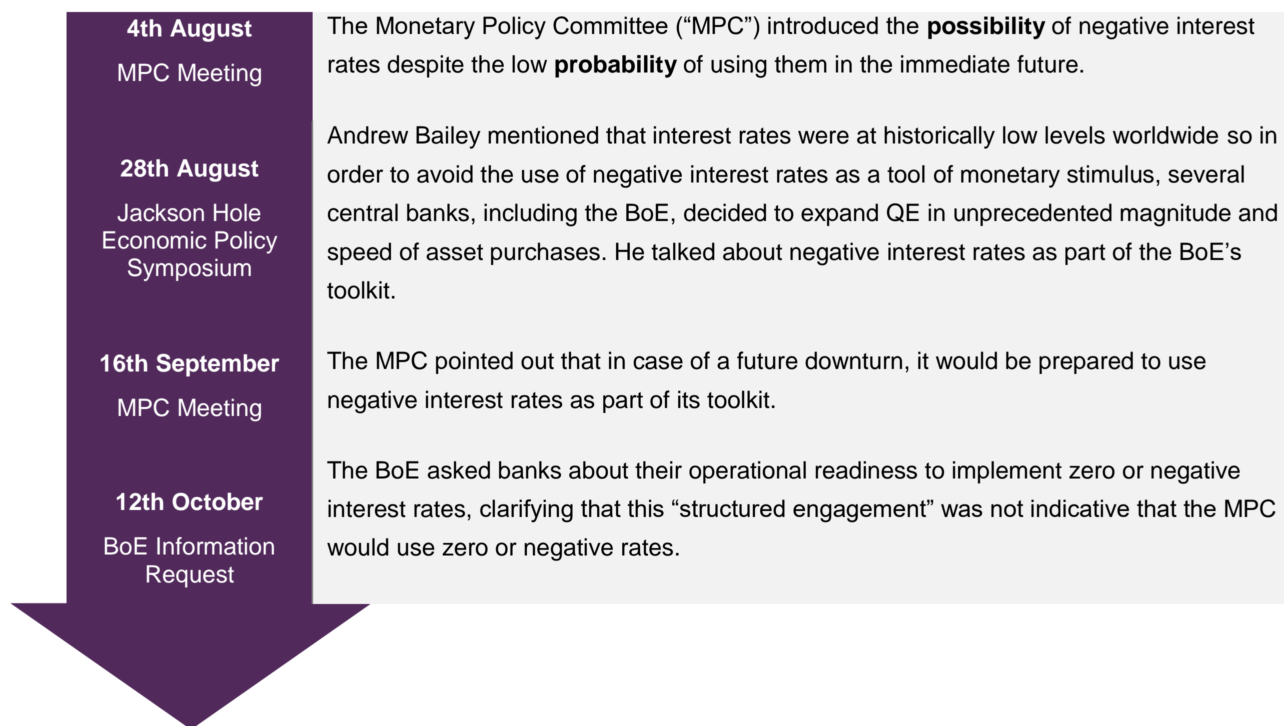
NEGATIVE INTEREST RATES – ARE BANKS READY?

The Covid-19 crisis required central banks to respond to an unprecedented economic shock. As part of its response toolkit, the Bank of England ("BoE") had two main monetary policy tools at its disposal:

- *Bank Rate* – i.e., the interest rate that it charges commercial banks to borrow money from it, and
- *Quantitative Easing* ("QE") – i.e., the creation of electronic money to buy corporate and government bonds

When it comes to the Bank Rate, there has recently been intense debate regarding the possibility of the BoE introducing negative interest rates and how they might impact the UK financial system. A brief timeline of some key discussion points on this topic is given below.

Figure 1: *Recent timeline of major BoE negative interest rate related announcements*



As policymakers actively discuss the possibility of negative rates, it is important to consider the high-level potential impacts from a macro-economic perspective.

Table 1: *Implications of negative interest rates*

KEY PROS	KEY CONS
Motivate consumers and businesses to spend or invest money rather than keep it in their bank accounts Stimulate borrowing due to the significant decline in cost of credit	Discourage commercial banks from depositing money with central banks Erode banks' net interest margins and reduce their profitability and capital positions over time – the financial system's stability could be undermined Prolonged use could have negative repercussions on economic recovery (e.g. sign of restricted growth, decline in consumer and investor confidence, fall in foreign direct investment)

We discuss each of the recent BoE announcements in a bit more detail to contextualise the evolution of this debate.

THE JACKSON HOLE ECONOMIC POLICY SYMPOSIUM

In his *Jackson Hole speech*, Bailey challenged the view that central banks, especially those with little space to cut interest rates, were running out of monetary tools in the recent economic downturn. He stated that *"we are not out of firepower by any means, and to be honest, it looks from today's vantage point that we were too cautious about our remaining firepower pre-Covid"*.

He explained that this crisis was unique because its roots lay outside the financial sector. Although central banks injected liquidity into the banks via repo operations and achieved some level of stability, these traditional monetary tools were deemed incapable of getting liquidity to the real sector rapidly enough. Therefore, the BoE pursued large and aggressive asset purchase operations to stabilise the economy.

Bailey stressed that the effect of QE is conditional on the state of the economy and the financial system, mentioning that the speed of asset purchases may be more relevant during a period when markets are disorderly and illiquid. He also emphasised the importance of the BoE preserving room to use its balance sheet aggressively in the next crisis, which might imply unwinding it ahead of any future interest rate rises. The BoE's guidance in August hinted that there would be a delay in the implementation of monetary policy tightening until there was sufficient evidence of a sustainable return to the 2 per cent inflation target and clearer signs of an economic recovery.

MPC MEETINGS

In its August meeting, the MPC introduced the **possibility** of negative interest rates while noting that the **likelihood** of using them in the immediate future remained very low. In its September meeting, though, the MPC pointed out that in case of a future downturn, it would be prepared to use negative interest rates as part of its toolkit. Financial markets considered this announcement as a confirmation of an increased probability of an interest rate drop into negative territory in early 2021.

However, some economists believed that the MPC does not perceive negative interest rates as an active policy option in its near-term agenda. Andrew Bailey seemed to confirm such assertions on a *British Chambers of Commerce webinar*, where he said that policymakers had looked "very hard" at the possibility to cut rates further, including below zero, but that did not mean they were going to do so now. Equally, he also announced that *"it would be a cardinal sin if we stated we had a tool in the box we didn't think we could use in practice"*.

FUTURE OUTLOOK AND OPERATIONAL READINESS

In a culmination of sorts on this discussion point, on 12th October, the *BoE asked banks about their operational readiness* and the challenges associated with the potential implementation of negative rates, particularly in terms of technological capabilities. More specifically, the BoE sought information about the important business services of a bank that would be potentially affected by negative interest rates. The extent to which the bank's existing systems can accommodate negative rates and their current limitations are also of interest.

Finally, the BoE aims to understand the bank's tactical (short-term) and strategic (permanent) system changes, governance, planning and testing required to implement negative interest rates as well as the associated time and cost of implementation. The

REPLY AVANTAGE

BoE has provided a data template[1] and, while its completion is voluntary, the deadline for banks to send their responses to the information request is 12th November.

Banks will have a number of challenges to grapple with a negative rate environment, some of which are identified below:

Table 2: *Key challenges for banks*

Strategic and business model considerations: *Banks may have to rethink their asset and funding models and product offerings, including reliance on net interest margins.*

Capital Assessments: *Banks will need to consider the impact on their capital adequacy assessments, including interest rate risk in the banking book, stress testing and scenario analysis, and macro-economic forecasting.*

Liquidity Assessments: *Banks will need to consider the impact on deposit outflow assumptions under base and stress cases under negative interest rates and how they may impact the liquidity and funding profile.*

Risk Appetite: *Banks will need to consider the impact on their risk management practices, particularly the setting of risk appetite and choice of strategic businesses to be in.*

Data and Systems: *Systems will need to be assessed for their ability to "handle" negative rates, including relevant data fields and flags to be added or adjusted. There may be significant impact on how different solutions/systems interact with each other based on capabilities of each individual solution/system and the data definitions resident within them.*

Product Pricing: *Pricing of key products and services will be impacted and banks will have to consider the mechanisms through which negative rates flow into pricing decisions.*

Customer communication and conduct: *Banks will need to consider how product pricing and features will need to be communicated to customers effectively and what implications it may have from a conduct risk perspective (including treating customers fairly).*

We believe that the recent BoE requirement is not the last the industry will hear on negative interest rates as a monetary policy tool. As banks navigate this challenging environment, Avantage Reply can assist in responding to these emerging requirements, particularly leveraging on its work in the broader European markets some of which have experienced the challenges of negative interest rates.

For more details, please reach out to the authors of this briefing note.

[1] It can be found at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/info-request-operational-readiness-policy-rates-app1.xlsx?la=en&hash=C645BBC29971A53F8315E9B66DA1B90987146EB0

REPLY AVANTAGE

CONTACTS

Vishwas Khanna, Partner

Vishwas specialises in prudential regulation, risk transformations, programme leadership and new bank authorisations. He is a trusted advisor to the C-Suite and senior management at banks and offers objective, independent advice to his clients to influence strategic decision-making.

vi.khanna@reply.com

Hadrien van der Vaeren, Senior Manager

Hadrien is a senior risk management practitioner specialising in prudential regulation, regulatory reporting, quantitative risk modelling and data and systems implementations. He has experience of delivering complex risk programmes across UK and Europe.

h.vandervaeren@reply.com

Rohan Wilson, Manager

Rohan has significant experience leading regulatory change and risk management projects at key FS clients across challenger and investment banks. He has also supported a European regulator with their internal action plans for resolution of entities.

r.wilson@reply.com

Anastasios Ioannidis, Consultant

Anastasios joined Avantage Reply after graduating from the University of Cambridge with a Master's in Finance and Economics. He has a strong interest in monetary policy and banking regulation.

a.ioannidis@reply.com

AVANTAGE REPLY

Avantage Reply, part of the Reply Group, specialises in Financial Services consulting with a focus on Risk Transformations, Treasury and Capital, Quantitative Modelling and Regulatory Advisory. With offices across Europe, Avantage Reply counts some of the world's most significant financial groups among its clients, including in Investment, Retail and Commercial Banking, Custodian Banking, Insurance and Investment Management.