



## Community Bank Views – Negative Interest Rates

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In this month’s installment of Community Bank Views, we discuss near zero and negative interest rates. More specifically, what should you and your board consider regarding this once un-heard of outcome? We will also give you some context on how other developed countries and their banking systems have been impacted by this unfortunate development.

### Introduction

Imagine getting paid interest to borrow money? This brave new world is upon us. As of the time of this writing, approximately \$13.2 trillion of developed world sovereign debt is trading at negative yields. While concerning on its own, the focus of this piece is on an even more disturbing phenomenon, negative central bank short rates (NIRP). First things first, why would a central bank do this? Many explanations exist however I tend to believe: 1) NIRP weakens a country’s currency to better service a ballooning debt load and / or 2) implement NIRP to incent banks to lend and consumers to spend in the hopes of stimulating the economy.

### The Research

Over the last seven years, at least seven central banks have implemented NIRP. A May 2018 Bangor University study by Phillip Molyneux, Alessio Reghezza and Rue Xie looked at NIRP’s impact on 7,242 banks in foreign countries. The authors state *“our results highlight that NIM contraction reduces banks’ profitability.....(and) the negative effect on profits and margins appears to have been stronger for banks that are small, operating in countries where markets are more competitive and floating interest rates predominate.”* Ex-NIRP, this landscape sounds a lot like the US banking system. Furthermore, the authors suggest the negative impact for smaller banks is a 21% decline in NIM versus non NIRP impacted banks. Oswald Gruebel, former CEO of Switzerland’s (NIRP) Credit Suisse and UBS, recently stated: *“Negative interest rates are crazy. That means money is not worth anything anymore. As long as we have negative interest rates, the financial industry will continue to shrink.”*

### Japan’s NIRP Banking System

How has the policy of near zero and NIRP impacted the Japanese banking system? Japan first took their short rate to below 0.50% in 1995.

### Changes in Number of Banks ↻

End of March	1990	1995	2000	2005	2010	2015	2016	2017	2018
City banks	13	11	9	7	6	5	5	5	5
Regional banks	64	64	64	64	64	64	64	64	64
Regional banks II	68	65	60	48	42	41	41	41	40
Trust Banks <sub>1</sub>	16	23	33	26	19	16	16	16	15
Long-term credit banks	3	3	3	1	0	0	0	0	0

Source: Japanese Bankers Association: <https://www.zenginkyo.or.jp/en/banks/financial-institutions/>

Somewhat to the surprise of this author, fewer banks exited than expected. Most of the impact was felt at smaller banks, the Regional Banks II, which shed approximately 40% of its banks since 1995. For context, the US banking system shed 7,229 banks (or 57% of its 1995 total) over the same time period. That said, those Japanese banks that have persisted now accept government utility like returns with ROAs near 0.30% versus. In contrast, the average US Bank ROA currently stands near 1.30%.

### What should you and your Board be thinking about? (some of this comes directly from our ALCO meetings)

- First, albeit still a low probability event, this unfortunate NIRP outcome should be an agenda item for your bank's senior management meetings.
- Stress test your balance sheet using an ALM simulation. Push all interest rates to near zero or negative and hold for at least 5 years. Review the results internally and present your findings, with an open mind, to your leadership and board.
  - Given this adverse scenario, how much upside (from a rising rate environment) are you willing to give up in order to lighten the blow from this adverse scenario. In other words, should you implement a rates down hedge?
- Install contractual floors on all adjustable / variable loans.
- Assuming at least a 20% reduction in Net Interest Income, how would you pivot your bank's overall strategy?
- What positive opportunities present themselves in a NIRP environment?
  - Increased allocation towards loans?
  - Stronger Credit Profile? Lower (negative) rates enhance borrower interest coverage ratios and the risk profile of your lending book.
- What appropriate operational activities can you perform today to make a potential NIRP outcome less onerous for your institution?
  - Cost controls for Property, Plant, Equipment
  - Headcount reductions?
  - What non-essential spending can you eliminate?
  - Seek out complementary non-interest income opportunities

Surely the Federal Reserve and our politicians understand that implementing NIRP in the US will cause more harm than good? Let's hope so. However, as bankers, we must be prepared for anything.

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