

Monetary policy and financial stability



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Supporting monetary policy scrutiny



Economic Governance and EMU Scrutiny Unit (EGOV)
Directorate-General for Internal Policies
PE 747.841 - May 2023

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Abstract

Monetary policy tightening has led to a sharp steepening of the yield curve and this has had a negative impact on banks that were not well-positioned to cope with this shock. This paper reviews current banking tensions and argues that they are unlikely to have a major impact on the ECB's monetary policy decisions in the current cycle.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 5 June 2023.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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Manuscript completed in May 2023

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This document was prepared as part of a series on “Interaction between price stability and financial stability”, available on the internet at:

<https://www.europarl.europa.eu/committees/en/econ/econ-policies/monetary-dialogue>

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LIST OF ABBREVIATIONS

BLS	Bank Lending Survey
BRRD	Bank Recovery and Resolution Directive
CMDI	Bank's crisis management and deposit insurance
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
ELA	Emergency Liquidity Assistance
Fed	Federal Reserve
FOMC	Federal Open Market Committee
LCR	Liquidity coverage ratio
MMMF	Money market mutual funds
NSFR	Net stable funding ratio
SVB	Silicon Valley Bank
TFEU	Treaty on the Functioning of the European Union
US	United States

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EXECUTIVE SUMMARY

- **The simultaneous monetary policy tightening from major central banks around the world has led to a sharp steepening of the yield curve.** This has had a negative impact on financial institutions that were not well-positioned to cope with this shock.
- **This is the first period of monetary tightening and banking tensions experienced by the ECB since it took over as supervisor of the euro area's banks.**
- **Financial stability and price stability are not preconditions for each other.** The global financial crisis occurred after a long period of price stability and previous eras of financial stability have coincided with relatively high inflation.
- **There are concerns that the ECB's joint mandates relating to price stability and financial stability could influence monetary policy in a way that sees inflation stay higher for longer.** This concern does not seem valid because the ECB has a clear legal mandate with price stability as its primary objective.
- **If financial tensions were to escalate substantially, then the right policy for both price stability and financial stability would involve cutting interest rates.** The ECB's price stability objective relates to the medium-term horizon and it would need to factor in the negative impact on inflation of severe financial tensions.
- **Traditionally, it was thought that monetary policy tightening was bad for bank profitability because bank assets have longer maturities than bank liabilities.** However, the current tightening in the euro area is improving bank profits because it is raising net interest margins. Interest rates on loans are rising faster than the interest rates banks pay on deposits.
- **Euro area banks are also holding large amounts in the Eurosystem's deposit facility because of the ECB's asset purchase programmes.** The switch from charging negative rates on deposits to compensating them at a positive rate is also providing a boost to bank profits.
- **This year's US bank failures do not necessarily signal a wave of bank failures in the euro area.** One reason is that banking supervisory standards and applications of regulations were weaker for the failing US banks than the approach that is being applied in the euro area.
- **The absence of a large retail money market mutual fund sector in the euro area may also explain the relative stability of bank deposits in Europe relative to the US.** The failing US banks experienced a "push" factor due to their poor risk management and also a "pull" factor due to the attractiveness of retail money market funds now paying higher interest rates.
- **Markets and analysts do not see the banking sector tensions as changing the ECB's monetary policy in the coming year.** As with a few months ago, markets think policy rates will peak in July and start to fall next year.
- **There are still some areas where the euro area could improve its policies in relation to bank crisis management and deposit insurance (CMDI).** The Commission's recent proposals are welcome but steps to establish a common euro area deposit insurance scheme and to streamline the lender of last resort process would also help.

1. INTRODUCTION

Like all central banks, the European Central Bank (ECB) has a responsibility for monetary policy as well as playing a key role in maintaining financial stability. The latter role has grown in recent years as the ECB has become the direct supervisor significant banks in the euro area, playing an important role in stress testing the banking system and in deciding how to deal with failing banks. These tasks have been added to the traditional role that all central banks play in acting as a lender of last resort to troubled banks.

One issue raised by these multiple roles is there may be times when the goals of monetary policy, such as price stability, come into tension with the right actions to ease financial instabilities. There is a modern tradition of central bankers suggesting that this tension does not exist. For example, the ECB's 2021 monetary policy strategy review states *"Financial stability is a precondition for price stability and vice versa."* This is false on both counts. The global financial crisis of 2008/09 came after a long period of price stability. For the converse case, one can also look back to periods after the Second World War when high average rates of inflation coexisted with years of banking stability.

So, like most things in central banking, the relationship between price stability and financial stability is a complex one and may occasionally involve trade-offs. For the ECB, the choice as to which of its goals it needs to prioritise is simpler than for other central banks because it has a clear mandate of price stability being its primary objective. With banking sector instability evident in the United States in recent months and the controversial failure of Credit Suisse perhaps increasing concerns about the health of other large European banks, it is fair to ask whether the ECB continuing its aggressive monetary policy tightening will lead to a new European financial crisis.

My assessment is that, as of now, there is no great tension between price stability and financial stability. Higher interest rates are designed to slow inflation via many different mechanisms. Negative effects on various aspects of the banking sector, leading it to reduce the supply of credit, is one of those mechanisms. So, the impact on the banking sector is mainly a feature of monetary policy rather than a bug. If the current global banking tensions reach full-scale crisis level, then there will also likely not be tensions because banking crises have a very negative effect on the economy and such a crisis would likely result in a rapid decline in inflation, thus allowing monetary policy to ease.

This paper discusses the interaction between monetary policy and financial stability in light of recent tensions in the global banking sector. Section 2 discusses the Eurosystem's mandates in relation to price stability and financial stability. Section 3 describes the mechanisms through which monetary policy affects the stability of the banking sector, with a particular focus on the mechanisms at play as we emerge from a long period of very low interest rates. It is argued that the current euro area monetary tightening is having a positive influence on bank profitability. Section 4 discusses the recent banking tensions in the US and describes some differences between the failing banks in the US and banks in the euro area. Section 5 briefly discusses the impact of recent tensions on the outlook for the ECB's monetary policy.

2. THE ECB AND FINANCIAL STABILITY

If you based your assessment of the Eurosystem's role in relation to financial stability on the European Treaties, it may seem that this role was relatively minimal. Article 127 of the Treaty on the Functioning of the European Union (TFEU) states that the Eurosystem *"shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system"* while Article 25 of the ECB protocol states that *"the ECB may perform specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."* Other articles state that the ECB may "hold consultations" or "offer advice" on financial stability issues.

Despite these minimalist beginnings, the ECB is now the crucial body charged with maintaining financial stability in the euro area. Since 2014, the ECB has been the direct supervisory authority for significant commercial banks. The ECB plays a key role in the European Systemic Risk Board, which is responsible for the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk, with the ECB President chairing its board.

After the proposal to appoint the ECB as the direct supervisor of the euro area's banks was made at the June 2012 summit of euro area leaders, there was an active debate in European policy circles (including at the ECON committee) about this decision. Some felt that assigning the ECB responsibility for banking supervision could undermine its commitment to its goal of price stability. In my briefing paper on this topic, Whelan (2012), I argued for the benefits of central banks being banking supervisors and I think the arguments in that paper look stronger from today's perspective.

One reason why it is important for central banks to act as supervisors to the banking system is that central banks need to act as lenders of last resort. For public money to be used efficiently during a banking crisis, it is vital that the lender of last resort has a comprehensive picture of the institutions requesting liquidity. This facilitates the fast decision-making that is required during crisis periods and reduces the chances of making loans to institutions that are insolvent rather than just illiquid.

The crisis at Northern Rock in 2007 is a well-known example of how emergency lending decisions can be poorly executed. Supervision of all financial institutions in the UK had been given to a separate Financial Services Authority and the Bank of England was not well informed about Northern Rock's situation. This led to an inefficient response from the Bank of England to requests for liquidity assistance. This was one of the factors that contributed to the decision to return responsibility for banking supervision to the Bank of England.

The ECB's misadventures with Emergency Liquidity Assistance (ELA) during the euro crisis also point to the problems that occur when central banks are providing emergency lending to banks they are not fully informed about. Would the ECB Governing Council have approved the provision of enormous amounts of ELA for Anglo Irish Bank in 2009 and 2010 if they had a full appreciation of the bank's problems? Similarly, it is not clear that the ECB understood what it was getting in to when it approved ELA to the two largest banks in Cyprus in 2012.

Another benefit of central banks being bank supervisors is that information gained in the supervisory process can be useful in formulating monetary policy. Central banks monitor current bank lending conditions as well as future lending plans. The obvious external signs of this monitoring of lending conditions are surveys such as the ECB's Bank Lending Survey and the US Federal Reserve (Fed)'s Senior Loan Officer Survey.

While the ECB has ring-fenced communication between monetary policy and banking supervision, there is evidence to suggest that more qualitative information from the supervisory process is also

useful for monetary policy purposes. Federal Reserve economists Peek, Rosengren and Tootell (1999) showed that confidential information from supervisors can improve forecasts of inflation and unemployment. They argued that this information was actively used by members of the Federal Open Market Committee (FOMC) and that the information is best accessed directly by the central bank rather than indirectly through a separate regulator. For these reasons, I believe the so-called “Chinese walls” system that was set up to limit communication between the supervisory section of the ECB and the monetary policy section was possibly a mistake.

The ECB’s monetary policy strategy review in 2021 acknowledged the important role that financial sector issues should play in the formulation of monetary policy and recommended *“a more systematic evaluation of the longer-term build-up of financial vulnerabilities and imbalances and their possible implications for the tail risks to output and inflation.”*

But what about conflicts in pursuing the two different goals of price stability and financial stability? Could monetary policy decisions be distorted by a central bank having close involvement with the banking sector so that it decides to set low interest rates to assist weak banks?¹ These circumstances seem unlikely to ever apply to the ECB. Its clear primary objective of maintaining price stability means concerns such as financial stability cannot be used as reasons to set monetary policy in a way that deliberately allows inflation to be higher than necessary over the medium-term.

As of now, there is no obvious contradiction for the ECB between the pursuit of price stability and financial stability. Monetary policy is being used to cool an economy to restrain inflation and tighter financial conditions that induce difficulties for some financial institutions are part of this process. If this results in individual banks getting into difficulties, then the tools made available via the Bank Recovery and Resolution Directive (BRRD) can be used to solve them.

Of course, if financial difficulties reach a point where these problems are acting as a serious constraint on the economy or we are moving towards a systemic banking crisis, one could imagine the possibility of greater tensions between the goals of price stability and financial stability. However, monetary policy must be set in a forward-looking manner and the ECB’s strategy has a medium-term rather than short-term orientation for its goal of targeting price stability. Systemic banking crises have a large deflationary effect on economies. Most likely, if banking tensions were to accelerate, then cutting interest rates would be the right policy both for financial stability and for medium-term price stability.

¹ See Goodhart (2000) for a comprehensive summary of both sides of this debate from a pre-global-financial crisis viewpoint.

3. INTEREST RATES AND BANK PROFITS

It has long been understood that one of the mechanisms through which monetary policy affects the economy is through its impact on the banking sector. Higher policy rates increase the interest rates that banks charge on loans and usually result in a restricted supply of credit. But there are ongoing research questions around how exactly monetary policy interacts with the banking system. For example, there is the question of how increases in interest rates affect the profitability and solvency of banks.

The traditional answer to this question was that monetary policy tightening was bad for both bank profitability and solvency. Banks engage in what is known as “maturity transformation”, meaning the average maturity of their assets exceeds the average maturity of their liabilities. This can mean that the interest costs associated with a bank’s liabilities tend to rise more during monetary tightening episodes than the corresponding interest earnings from their assets. This will be particularly true if banks hold a lot of long-term fixed-rate assets previously purchased at low yields, such as fixed-rate mortgages or government bonds. Downward re-valuations of these assets could threaten a bank’s solvency. Banks that wish to maintain their capital ratios will tend to respond to lower profits and a reduction in their capital by tightening credit. Also, to the extent that threats to solvency raise concerns for those who provide funding to the bank, a monetary tightening could lead to liquidity problems. These mechanisms have been seen at work in recent US bank failures.

Another negative aspect of monetary tightening for bank profits is the increase in the credit risk of their loans. With higher costs of funding, banks have to raise interest rates on loans and this makes it more likely that borrowers will default. This additional risk also makes banks more reluctant to issue loans and thus adds to a tightening of credit conditions.

However, there are counterpoints to this traditional view of banks as being negatively affected by monetary tightening. Dreschler, Savov and Schnabl (2019) presented evidence showing that net interest margins for US banks did not vary much with the federal funds rate. On the liability side, short-term deposit funding from retail customers has always tended to be “sticky” and not very sensitive to market interest rates. For this reason, interest rates on deposits move less than one-for-one with monetary policy rates. On the asset side, banks also have assets that can be re-priced as interest rates increase such as variable rate mortgages and short-term securities. Dreschler, Savov and Schnabl show that net interest margins for US banks have historically not varied much with monetary policy rates.

There are also several unique factors about the current monetary tightening that point towards it most likely having a positive impact on bank profits, particularly in the euro area. First, the current tightening follows an unprecedented period for monetary policy in which interest rates were very low and expected to stay that way for a long time. Unlike previous times when monetary policy rates were expected to only be temporarily low, the low-for-long environment meant the yield curve was largely flat rather than upward sloping. This made it harder for banks to earn profits just by having assets with longer maturities than their liabilities.

Second, in contrast to the traditional story, the current increase in market rates is allowing banks to increase their net interest margins.² In the era when interest rates were very low, banks would have had to charge negative interest rates on deposits to maintain historical net interest margins. This was particularly true in the euro area due to the ECB’s policy of imposing negative interest rates on deposits

² ECB Vice-President Luis de Guindos made this point at the 16 March 2023 post-Governing Council press conference. <https://www.ecb.europa.eu/press/pressconf/2023/html/ecb.is230316~6c10b087b5.en.html>

with the Eurosystem. However, while it was possible for banks to apply negative rates to large corporate deposits, they decided it was not possible to impose such charges on retail depositors.

Figures 1 and 2 illustrate how net interest margins for euro area banks are increasing. Figure 1 shows the average cost of borrowing for non-financial corporations and for households purchasing homes, as calculated by the ECB. Since early 2022, both have risen by at least 200 basis points. Figure 2 shows interest rates offered by euro area banks on deposits of various maturities. ECB statistics show that overnight deposits currently account for about 60% of total deposits and interest rates on these accounts have remained below 0.25%. Interest rates on longer-term deposits have risen by more, but still by less than the interest rates being charged by banks. Taken together, these figures imply a substantial increase in net interest margins.

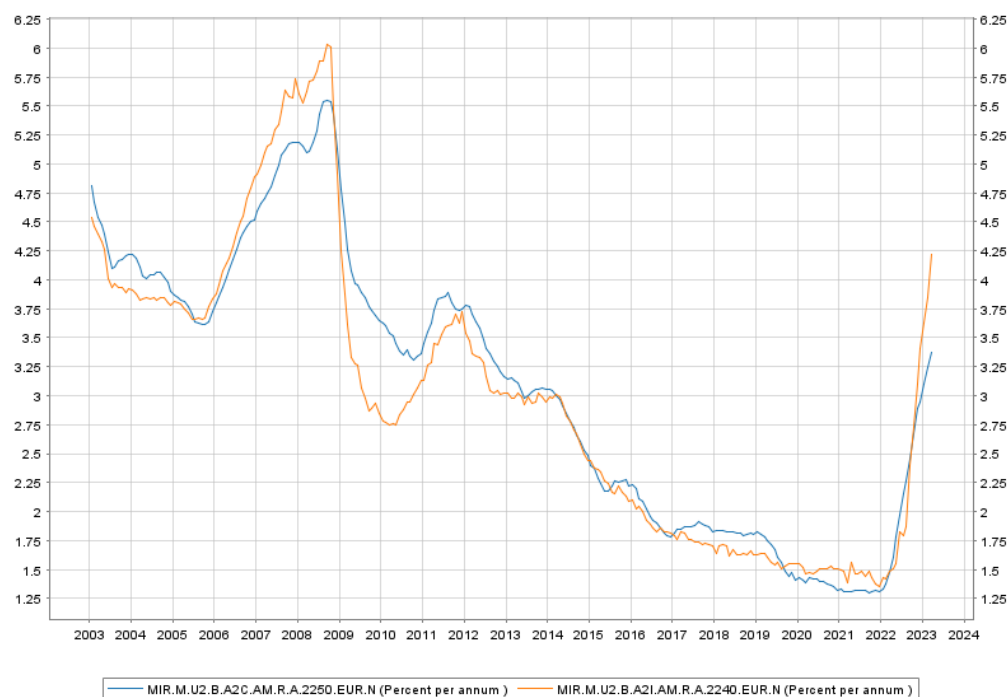
Over time, if interest rates remain above the historically low levels that prevailed in recent years, there will likely be upward pressure on bank funding costs due to depositors shifting away from overnight deposits to longer-term deposits with higher interest rates. Figure 3 shows the share of euro area bank deposits that have an overnight maturity. This share has declined a bit in recent months but it is still well above the levels that prevailed prior to 2015 and the introduction of quantitative easing programmes.

In addition to higher net interest margins on their lending activities, banks are also benefiting from the large stock of deposits they hold with the Eurosystem, which were created by the ECB's asset purchase programmes, going from costing them the negative deposit rate of minus 0.50% to earning them (at present) 3.25%. With over €4 trillion in the deposit facility, this change on its own will raise annual profits of euro area banks by about €160 billion.

Further evidence of the positive impact of monetary policy on bank profits comes from the ECB's Bank Lending Survey (BLS). For the latest survey, taken during the first quarter, the ECB added some ad hoc questions about how its policies have affected banks. Figure 4 repeats the figure from the survey describing how banks believe monetary policy is affecting their profit margins. The chart reports net percentages values, so a positive number here shows the percentage of banks stating the item has been positively affected minus the percentage stating it has been negatively affected. The chart shows that while banks expect tighter monetary policy to have some negative effects on profits due to its effect on factors such as lending volumes, capital losses and loan impairments, the overall impact on bank profitability is positive due to its impact on net interest margins.

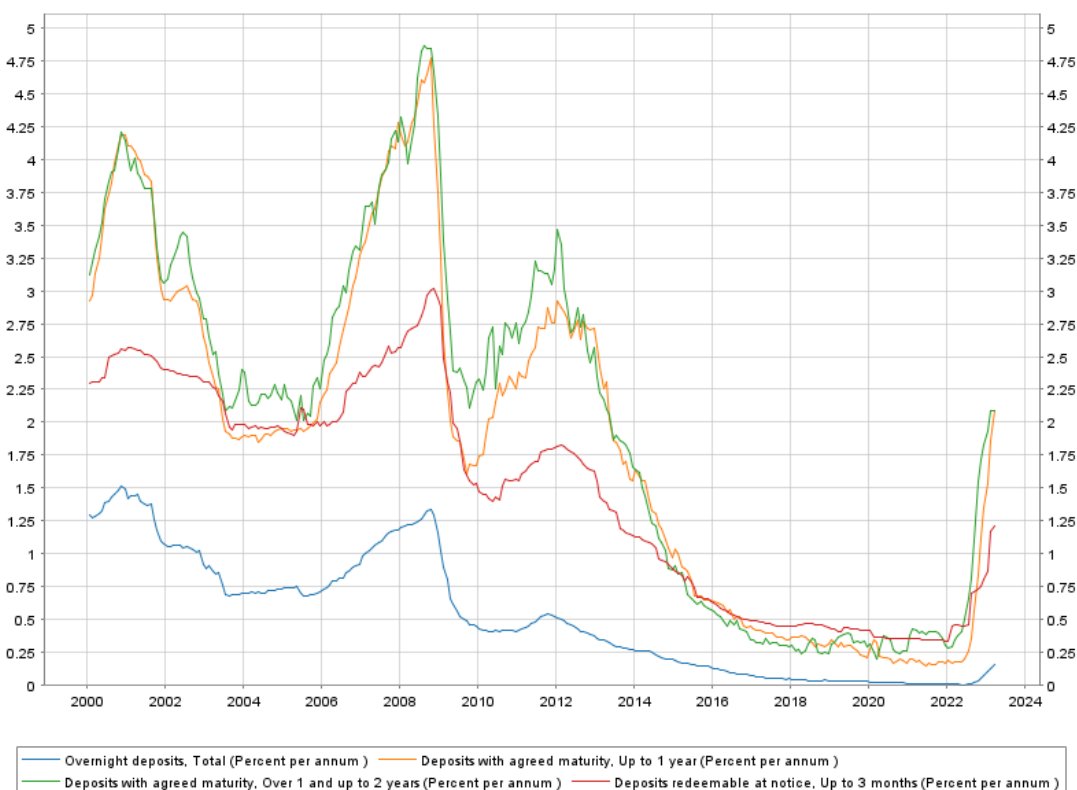
Elsewhere, the BLS reports widespread declines in the demand for credit from firms and households, with higher interest rates reported by banks to be the principal reason. Banks are also reporting tightening of lending standards and higher rejection rates for loan applications, with higher credit risk and changes in the bank appetite for risk being cited as the principal reasons. So, while the current monetary tightening has been good for bank profits, its overall effect on the supply of credit has been in line with what we would expect.

Figure 1: Cost of borrowing for non-financial corporations (orange) and for house purchase (blue)

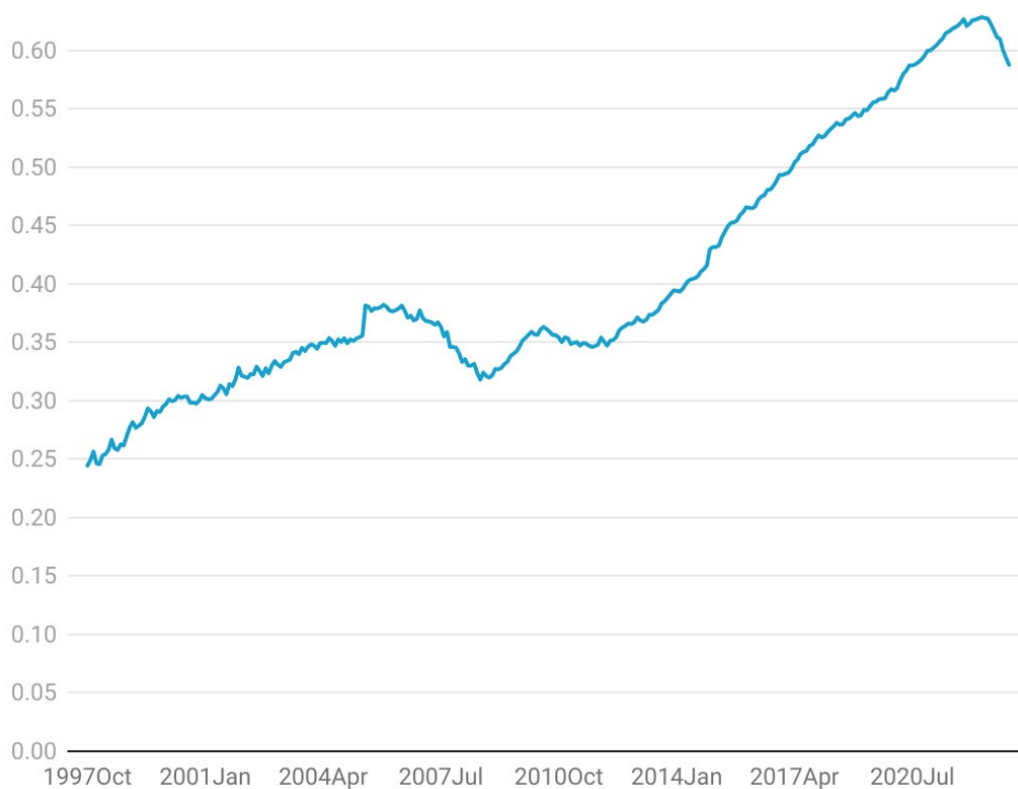


Source: ECB Statistical Data Warehouse.

Figure 2: Interest rates paid on commercial bank deposits of various maturities



Source: ECB Statistical Data Warehouse.

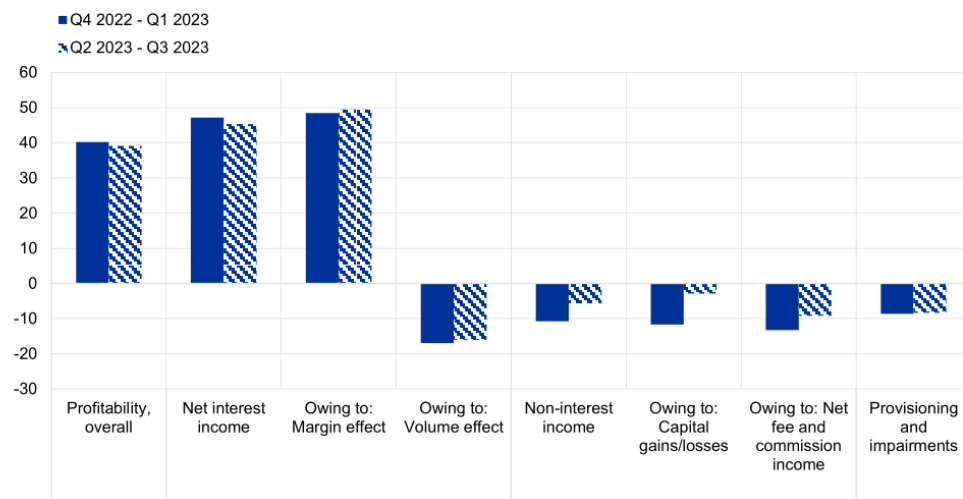
Figure 3: Overnight deposits as a share of total euro area commercial bank deposits

Source: Author's calculations based on data from ECB Statistical Data Warehouse.

Figure 4: Net percentage of banks reporting the impact of ECB interest rate decisions on different aspects of bank profitability

Impact of ECB interest rate decisions on euro area bank profitability

(net percentages of banks; over the past six months and the next six months)



Notes: The net percentages refer to the difference between the sum of the percentages of banks responding "increased considerably" and "increased somewhat" and the sum of the percentages of banks responding "decreased somewhat" and "decreased considerably". The dashed bars denote expectations indicated by banks in the current round.

Source: ECB Bank Lending Survey.

4. COMPARING THE US AND EURO AREA

Here, I compare the banking situation in the US and the euro area. First, I discuss the banking tensions in the US and discuss why the euro area has not experienced the same problems. Second, I describe some remaining risks that exist for banking stability in the euro area.

4.1. Why has Europe been different?

While I have stressed that the current monetary tightening has largely been positive for bank profitability in the euro area, it still needs to be acknowledged that global monetary tightening has caused some serious tensions in parts of the banking system, most notably in the United States.

There have been three high-profile bank failures in the US (Silicon Valley Bank, Signature Bank and First Republic) and recent months have seen a significant reduction in deposits in the US banking system. The most recent data show deposits at US commercial banks down about 5% relative to a year earlier (see Figure 5). This type of deposit contraction is unusual and did not occur in the US during the global financial crisis. Deposits are also contracting in the euro area but at a slower pace than in the US and slower than seen in Europe during the global financial crisis and the euro crisis. (See Figure 6). More generally, there are fewer signs of financial stress in the European banking system than in the US.

There are a few potential explanations for this difference.

1. Better banking supervision in Europe

A recurring theme in the information released about the three US banks that have failed in 2023 is that the banks were badly run and poorly supervised. The Fed's report on Silicon Valley Bank (SVB) acknowledges both the extensive management failures within the bank and the negligence of the Fed's supervisors.³ SVB made a series of risk management mistakes, including relying too much on a particular type of technology business to provide most of its deposit base, having a high share of its deposits be uninsured and investing a large fraction of its assets in long-term fixed rate securities without hedging any of the corresponding interest rate risk. With the latter a threat to solvency and the former a threat to liquidity, the bank was an accident waiting to happen.

The poor nature of the Fed's supervision of SVB was not an accident. In response to President Trump's Economic Growth, Regulatory Relief, and Consumer Protection Act in 2018, the Fed shifted its supervisory approach in a way that, to quote the Fed's SVB report *"impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach."* In particular, the Fed only maintained its "enhanced prudential standards" for the eight US banks labelled as global systemically important banks. Crucially, this meant that banks like SVB no longer had to satisfy the Liquidity Coverage Ratio (LCR) or Net Stable Funding Ratios (NSFR), which were key liquidity requirements brought in as part of the Basel 3 process. The LCR requires banks to have a stock of "high-quality liquid assets" that will allow it to meet their short-term obligations during a stress scenario of 30 days of significant outflows. The NSFR placed restrictions on the extent to which banks could fund themselves with "non-sticky" funding such as uninsured deposits.

Enforcement of these requirements would have uncovered serious problems with the SVB's liquidity management and perhaps have prevented it from failing. Weak management and supervision could also be seen with the other two failing banks, with Signature Bank being too reliant on business from the failing cryptocurrency sector and First Republic relying too much on uninsured deposits.

³ The Fed's report on SVB is available at <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>

In contrast, all of the euro area's major banks have to satisfy the LCR and NSFR. These banks also have to co-operate with regular stress tests that run through the implications of various risky scenarios. These scenarios have included how European banks would respond to a large increase in interest rates.⁴ There may well be some European banks that will fail in the coming months but, at present, it appears the ECB's supervision of the sector has been superior to the corresponding US agencies.

The other banking event that has created concerns is the failure of Credit Suisse, leading to its takeover by UBS and the write-off of subordinated bonds. The fact that Credit Suisse's equity was not written to zero while subordinated bonds were written off raised concerns about how any future European bank failures would be handled but the euro area authorities have been clear to signal that the hierarchy of creditor claims established by the BRRD will be respected in any future resolution of a euro area bank.

The failure of Credit Suisse also raised questions about whether other large European banks could fail in a similar way. I can't claim to know the business models of all large European banks but my assessment is that Credit Suisse was most likely a *sui generis* case. It was an extremely large and complex bank with many different business lines and, over time, it had accumulated substantial reputational damage from a series of scandals. The most obvious comparator among euro area banks is Deutsche Bank. Like Credit Suisse, Deutsche Bank has been through various scandals leading to fines and reputational damage but the consensus among banking analysts is that the bank has moved in the right direction in recent years, streamlining its operations and improving the health of its balance sheet.⁵ It seems likely that the ECB's supervisory regime has played a role in this improvement.

2. Money market mutual funds

The US has a thriving retail money market mutual funds (MMMF) sector. These funds invest in short-term high-quality securities and provide investors with easy access to their money while earning higher interest rates than on bank deposits. The sharp increase in short-term retail interest rates due to the Fed's tightening has made MMMFs highly attractive, particularly to those who have large uninsured deposits with commercial banks. Data from the Federal Reserve show that retail MMMFs have increased their assets by about \$400 billion over the last year. This has likely accounted for about half of the outflows from commercial bank deposits.

In contrast, Europe does not have a well-developed MMMF sector, perhaps due to the limited supply of AAA-rated short-term securities. So, while the absence of the chronic management problems that created the "push" factor from banks like SVB has played a role in Europe's banks being more stable, the absence of the "pull" factor of attractive money market funds has also been relevant.

3. Differences in asset holdings

European banks also differ from US banks in having somewhat different exposures on their balance sheets. For example, long-term securities tend to account for a larger fraction of the assets of US banks than European banks. This is due to the more developed nature of US securities markets and the central role securitisation plays in the US mortgage market. American commercial banks are more likely to sell their mortgages to be securitised with more of their exposure to interest risk being via holding of Treasuries and mortgage-backed securities.

⁴ At a recent ECON committee meeting, the Chair of the ECB's Supervisory Board, Andrea Enria, described the recent stress testing of interest rates increases and some of the actions that the ECB took in response to the results. His remarks are available at https://www.bankingsupervision.europa.eu/press/speeches/date/2023/html/ssm.sp230321_1.en.html

⁵ This recent article by Financial Times journalist Olaf Storbeck provides a useful summary of the situation with Deutsche Bank. <https://www.ft.com/content/06158598-daa0-4560-b072-a57bcbd7697c>

To the extent that banks hold mortgages on their balance sheets, US mortgages are predominantly fixed rate, whereas the importance of these mortgages varies across euro area members. Albertazzi, Fringuellotti and Ongena (2019) report that fixed-rate mortgages are dominant in countries such as Belgium, France, Germany and the Netherlands, while adjustable-rate mortgages are standard in countries such as Austria, Greece, Italy, Portugal and Spain. For countries where the mortgages rates are adjustable, there are unlikely to be problems with the value of these bank assets being written down.

4.2. Risks for euro area financial stability

Despite the positive points just noted, there are clearly some risks ahead for European banking stability. Bank balance sheets tend to be opaque so it can be hard to judge the extent to which banks have managed risks. There may well be some large European banks who are sitting on large as-yet-unrealised losses related to fixed-rate mortgages or long-term securities that could threaten their solvency. Other sources of vulnerability include commercial property lending (with loans for office projects performing badly due to the switch to working from home) and investments by banks in non-bank entities that have taken on risks that regulatory policy has discouraged banks from taking. Moreover, the effect of the sustained monetary tightening on household and corporate credit quality will take time to appear, so there will likely be a pattern of banks gradually writing down asset values over the next few years.

More generally, the banking sector is innately prone to bouts of instability, particularly when there are large amounts of uninsured deposits. Continued banking stresses in the US may lead to liquidity problems for institutions that appear to have operating models similar to failing American banks. Indeed, uninsured depositors may now feel less safe in the euro area than in the US because the Fed guaranteed that all deposits (both insured and uninsured) in the failed banks would be made whole. In contrast, the European resolution rules put in place by the BRRD explicitly include uninsured deposits among the class of bank liabilities that can be bailed-in and people can point to the haircut of depositors in Cyprus in 2013 for an example of how uninsured deposits can suffer large losses. In addition, the thresholds for deposit insurance are lower, at €100,000 compared with \$250,000.

One can also point to weaknesses in the euro area's deposit insurance schemes. The European Commission has tabled proposals to reform the existing bank crisis management and deposit insurance (CMDI) framework which would strengthen aspects of deposit insurance, such as ensuring that depositor protection extends to public entities and client money deposited in certain types of funds as well as harmonising the protection of temporary high balances on bank accounts in excess of €100,000 linked to life events such as inheritances.⁶ However, in the absence of a common euro area scheme (the so-called European Deposit Insurance Scheme, EDIS), the perceived adequacy of the insurance provided by states may vary depending on the beliefs of depositors about the fiscal capacity of states. Despite the bold proclamations of euro area leaders in 2012, we have not necessarily broken the loop between banks and sovereigns.

The euro area could also strengthen its decision-making process around failing banks. The recent Commission CMDI proposal is also intended to make resolution tools, rather than public funds, be used to deal with failing medium-sized and smaller banks but these reforms are not yet in place. The current arrangements for lender of last resort in the euro area are also unsatisfactory since they still feature

⁶ The Commission's proposals can be found at https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2250

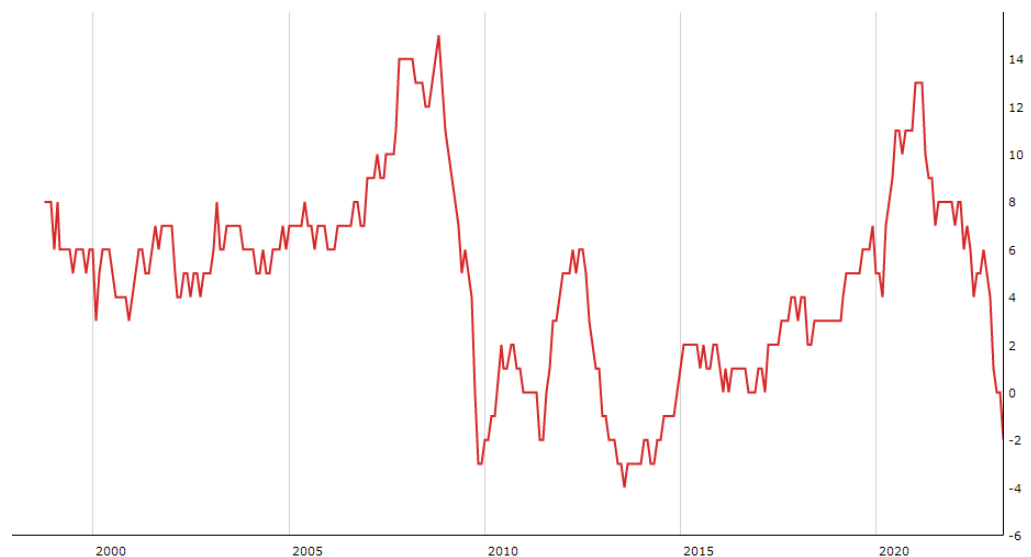
national central banks providing ELA, which can then be ended by a two-thirds vote of the ECB Governing Council. I have written a lot in these briefing papers over the years about flaws in the ECB's policies towards ELA. Here, I will just say that we are long past time for the responsibility for all ELA decisions to be made by the ECB Governing Council. Huertas (2022) discusses a range of reforms to the euro area's CMDI framework, including the ECB making all ELA decisions and the automatic triggering upon an ELA request being made of an examination by the ECB's supervisory arm of whether the bank was "failing or likely to fail". This could speed up the resolution of failing banks and perhaps limit losses for creditors.

Figure 5: Year-over-year growth rate of deposits at US commercial banks



Source: Federal Reserve Bank of St. Louis.

Figure 6: Year-over-year growth rate of deposits at euro area commercial banks



Source: ECB Statistical Data Warehouse.

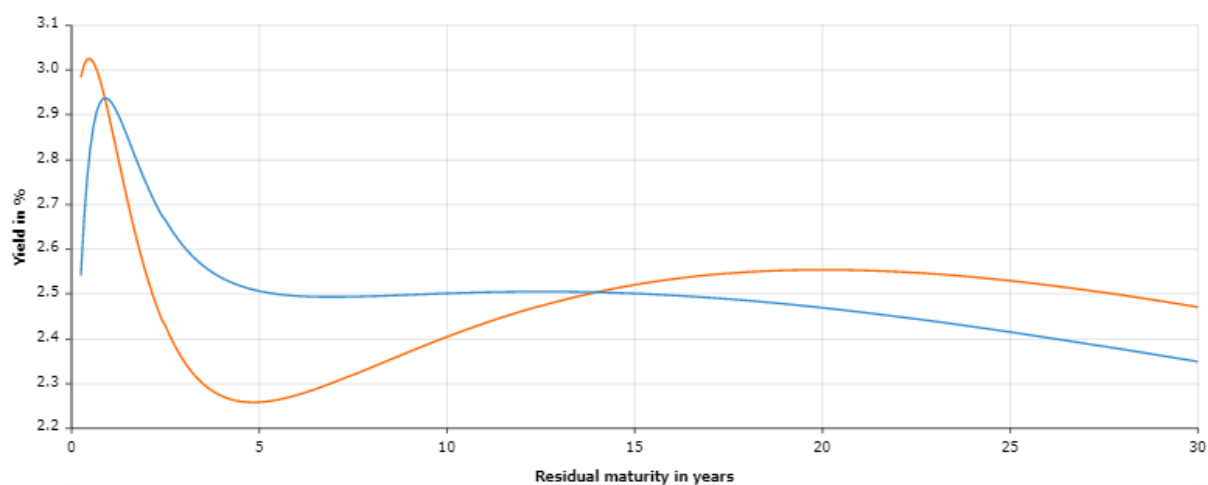
5. IMPACT ON MARKET EXPECTATIONS

The tensions in the global banking system have had, at most, a modest impact on market expectations of the ECB's monetary policy. The ECB's current policy rates are a little higher than expected by markets and analysts a few months ago, reflecting ongoing high inflation readings, but the overall pattern of expected policy has not changed much. For example, in the ECB's May survey of monetary analysts, median expected deposit facility rate now peaks at 3.75% compared with 3.25% in the February survey. However, both surveys forecasted that the peak rate would be reached in July and rates would start to fall in the second quarter of next year.

The euro area AAA-rated yield curve shows a bit more sign of changing expectations at a longer horizon. The figure below shows forward rates derived from yield curves from 15 February and 15 May. In other words, it shows the market-implied future short-term yields suggested by the pricing of bonds of various maturities. The May curve is a bit higher in the shorter-term but a bit lower from one year onwards, indicating markets seem to believe that policy will be loosened a bit more next year than they had believed a few months ago.

These modest movements suggest that the key factor driving market expectations in the coming months will be incoming inflation data rather than banking sector tensions.

Figure 7: Forward rates for AAA-rated bonds in February (Blue) and May (Orange)



Source: European Central Bank.

6. CONCLUSION

The simultaneous monetary policy tightening from major central banks around the world has led to a sharp steepening of the yield curve and this has had a negative impact on financial institutions that were not well-positioned to cope with this shock. It is understandable that there is a lot of nervousness around the world about the tensions evident in the US banking sector given our memories of the global financial crisis. However (and being wary of the risks that come with saying “this time is different” ...) the current banking sector tensions seem unlikely to cause major macroeconomic difficulties over the next year. The high-profile failures of Credit Suisse and a number of US banks do not seem likely to be repeated across the euro area and the ECB will most likely be able to focus on returning inflation to its target levels without having to cope with a banking crisis along the way.

This is not to say there will be no tensions or bank failures in the coming years. Banking is an innately unstable business and failures of individual institutions are inevitable. It is to be hoped that improved supervision and the higher capital levels built up in recent years will limit the extent of future bank failures in the euro area but, when they happen, it is important that swift and appropriate action is taken to resolve them in ways that preserve financial stability while minimising public costs.

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Monetary policy tightening has led to a sharp steepening of the yield curve and this has had a negative impact on banks that were not well-positioned to cope with this shock. This paper reviews current banking tensions and argues that they are unlikely to have a major impact on the ECB's monetary policy decisions in the current cycle.

This paper was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 5 June 2023.
