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SPEECH

Measures to support monetary policy transmission through banks

Welcome address by Luis de Guindos, Vice-President of the ECB, to the Money Market Contact Group

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In its most recent policy meeting, the ECB's Governing Council decided on a comprehensive easing package because the downward revisions in the projected inflation path warranted a vigorous policy response.

The easing package comprised five measures: lowering the deposit facility rate, strengthening the forward guidance on the likely path of policy rates, restarting the net asset purchases within the asset purchase programme, changing the terms of the third series of targeted longer-term refinancing operations (TLTRO III) and introducing a two-tier system for reserve remuneration.

We believe that the measures announced last week complement each other and together constitute an effective response to the environment that the ECB currently faces.

These decisions were taken against the following background. First, as a result of continued global uncertainties and their impact on confidence, our latest ECB staff macroeconomic projections were revised down. We face a more protracted economic slowdown than previously anticipated and see persistent downside risks to the growth outlook. Second, inflation continues to fall short of expectations. Headline inflation remains well below our medium-term aim, while core inflation has been hovering around 1% for an extended period of time. Market-based indicators of future inflation outcomes have stagnated at historical lows and the profile for headline inflation has been revised down, leading to a further delay in the convergence of inflation towards our aim. The case for a monetary policy response was clear and a comprehensive package of measures was judged to be the most effective response.

I will take this opportunity to delve a little deeper into two of the measures that may be especially relevant for the banking sector. The first is the changes to some of the parameters of the third series of targeted longer-term refinancing operations – TLTRO III – and the second is the implementation of a two-tier system for the remuneration of excess reserves.

Changes to the TLTRO III programme

You may recall that TLTRO III was announced in March to preserve the very favourable bank lending conditions in the euro area and to ensure the smooth transmission of our highly accommodative monetary policy stance. At the same time, indexing the TLTRO III rates to the main refinancing operations rate and the deposit facility rate implies that, should the ECB adjust these key interest rates, the average funding conditions under the programme would be correspondingly adjusted for banks, thus helping to align this programme with the broader monetary policy stance. The Governing Council made clear that the modalities of TLTRO III would take into account a thorough assessment of the bank-based transmission channel of monetary policy, as well as developments in the economic outlook.

The recent deterioration in the economic outlook prompted us to ease several of the terms of the new operations. The Governing Council decided to eliminate the 10 basis point spread over the key policy rates entailed in the initial pricing of the operations. In addition, the maturity of the operations was extended from two to three years, and an early repayment option after two years was introduced. The adjustments to the TLTRO III parameters signal that the Governing Council can act in an agile manner and fine-tune its monetary policy instruments, as needed, to ensure that they are efficient, effective and proportionate to the risks to price stability.

We believe that these changes represent a significant easing of banks' medium-term funding conditions, which in turn should contribute to improving the lending conditions banks offer to the real economy. The more accommodative pricing should strengthen support for bank funding, so that banks continue to offer loans to firms and households on favourable terms. The extended maturity of TLTRO III will be better aligned with bank-based financing of investment projects, thereby further supporting banks' financing to the real economy. Finally, in view of the lengthened maturity, the option to voluntarily repay the amounts borrowed before maturity at a quarterly frequency will provide greater flexibility for banks' funding plans.

The two-tier system

Let me now turn to the second measure. Banks in the euro area continue to benefit from the negative interest rate policy through the larger intermediation volumes and lower credit risk for borrowers associated with more favourable macroeconomic developments. This has helped support bank profitability across the euro area since the deposit facility rate turned negative in 2014. In addition, banks have been able to generate higher non-interest income as the compression of yields is reflected in higher asset valuations. Banks' funding costs in wholesale markets have also decreased, mitigating the impact of lower rates on net interest income.

However, the negative interest rate policy also entails costs for banks, and these are likely to increase the longer negative rates are in place, the lower policy rates are set and the larger the amount of excess liquidity.

The Governing Council therefore decided to introduce a two-tier system for reserve remuneration in order to ensure that the accommodative monetary policy stance continues to translate into favourable lending conditions, which is particularly important given that the European economy is largely bank-based.

Under the two-tier system, part of each bank's holdings of excess liquidity will be exempt from the negative deposit facility rate. The size of the exempted part of a bank's reserve accounts will initially be six times its minimum reserve requirement. This strikes a balance between two outcomes. It offsets the direct cost of negative interest rates on banks' profitability, thereby helping to sustain the pass-through of low policy rates to bank lending. And it also preserves the positive contribution of negative rates to the accommodative stance of monetary policy and the continued sustained convergence of inflation to our aim.

There are several reasons why the initial value chosen for the multiplier was six times a bank's minimum reserve requirement.

- First, it provides banks with some relief from negative rates. Based on current holdings of excess liquidity, the current calibration will entail annual savings for banks of about €4 billion.
- Second, it leaves the volume of non-exempt excess liquidity which is still remunerated at the deposit facility rate at a level which is sufficiently large to ensure that money market rates remain anchored to the ECB deposit facility rate. Given that minimum reserves are currently close to €130 billion, the exempt tier would amount to some €800 billion, implying that the non-exempt amount of excess reserves still remunerated at the negative deposit facility rate would be approximately €1 trillion, down from €1.8 trillion.
- Third, it dampens the risk of money market rates becoming subject to upward pressure due to the potential redistribution of excess liquidity among market participants to fill exemption allowances. For example, the system may induce banks that have an unused exempt tier to increase the amount they borrow from banks that hold more excess liquidity than their exempt tier. If such transactions were to occur at higher rates than before, then we may see upward pressure on certain money market rates. At this stage, we see very little evidence of this being priced in by the market, but the ECB will continue to actively monitor conditions in the money market.

Conclusion

Allow me to conclude. On 12 September the Governing Council decided on one of the most broad-based packages of monetary stimulus measures to date. Of the five measures in the overall package, the two that I have discussed today may be particularly relevant for banks. These are the modification of the terms of TLTRO III and the introduction of a two-tier system for reserve remuneration given banks' important role in monetary policy transmission. Both measures will serve to mitigate the risk that the possible side effects of the ECB's accommodative monetary policy stance on bank-based intermediation could undermine the sustained convergence of inflation to our aim. We are aiming to preserve favourable bank lending conditions in the euro area to further support the accommodative stance of monetary policy and ensure it is smoothly transmitted to the real economy.

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