Banking – Conceptual and Related Issues

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Conceptual Issues – Insights from Japan’s 2001-2006 QE

Bank Portfolio Rebalancing and Signalling effect – Early evidence from Japan’s QE 2001-2006

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<th>Portfolio rebalancing effect</th>
<th>Signaling effect</th>
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<tbody>
<tr>
<td></td>
<td>JGBs</td>
<td>High grade corporate bonds</td>
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<tr>
<td>Oda and Ueda (2005)</td>
<td>Insignificant</td>
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<td>Takeda et al. (2005)</td>
<td>Significant (at the time of introduction)</td>
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<td>Kimura and Small (2006)</td>
<td>Significant (with additional 10 trillion yen of CABs, +1-4bp for Aa grade)</td>
<td>Somewhat (Some measurements insignificant)</td>
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<tr>
<td>Sadahiro (2005)</td>
<td></td>
<td>Insignificant</td>
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Ugai, H (2006) The effects of QE policy, A survey of empirical analyses, Bank of Japan Working Paper, 6-e10, July, Figure 7
Large recent literature on the impact of UK and US CB asset purchases

1) Impact of asset purchases on financial markets:

   Impact varies depending on type of financial assets the CB acquires. Purchase of MBS seems to have had bigger impact on financial markets

2) Impact on the wider economy:

   UK - Kapetanios et al (2012), Bridges and Thomas (2012); Pesaran and Smith (2012)
   Japan – Berkmen (2012)

   QE has a modest impact on economic indicators – output / growth / inflation
Large recent literature on the impact of UK and US CB asset purchases

3. Yield curves:
QE has effectively lowered long-term yields and lowered volatility


BUT There has been very little analysis of the effects of QE/asset purchases on banks!!!! Apart from:

4. Bowman et al. (2011) – Japan’s QE between 2001 and 2009 had a modest positive influence on bank lending
Joyce and Spaltro (2014) – UK – modest impact on bank lending
Impact of QE on banks – Empirical studies

Empirical literature appears to focus more on the influence of financial markets and (via) yield curve effects as it looks like this is what policymakers view as the main channel of QE / alternative monetary policy

(This is illustrated in the bold lines shown in the first figure in this presentation)

So there is need for more work on the impact of QE on banks, particularly as there is evidence elsewhere that alternative monetary policy can have specific industry effects – see following slides:
Banks: US QE announcement risk-positive – longer-term P&L effects negative

In the 1 month following the 6 QE announcements, banks outperformed in 4 cases. Medium term, however, profitability suffered, owing to margin pressure. QE introduced the following moving parts:

- **Margin pressure**: funding cost decline was more than offset by the fall in securities yields. Banks’ NIMs were pressured, and profitability impacted, as a consequence.
- **Lower volatility**: By reducing volatility, QE impacted investment banks’ securities trading operations.
- **QE-related deposits**: institutional investors placed some of the excess liquidity as deposits. Deposit volumes grew, and bank liquidity positions improved.
- **(Some) book value accretion**: ALM portfolios showed an uplift, owing to unrealised gains.

We note that banks underperformed in the years following QE extension, despite an initial positive reaction on the announcement date. This underperformance is reflective of factors other than QE (litigation, regulation, volume pressures).

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**Exhibit 2**: Banks outperformed after the extension of QE1, but have consistently lagged the broader market in subsequent years

S&P 500 and S&P 500 Banks sub-index (1st Oct 2008 = 100)

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*Source: Goldman Sachs (2015)*
Eurozone banks and QE

Banks: Initial gain, longer-term NIM challenge ...

QE will compress NIM across the Eurozone. In the core, we expect this process to be particularly acute (Sell Commerzbank). On the periphery, the initial impact of asset yield compression could be offset, owing to a fall in liability spreads. Longer term, however, we expect the margin compression (especially through ALM revenue reduction) to offset this benefit.

We see Intesa (CL-Buy) as a relative beneficiary in a Euro banks context, while we see Commerzbank (Sell) as exposed to NIM pressure from the onset.

QE should result in: (1) compression in sovereign yields across the Eurozone, thus (2) reducing funding costs for the peripheral banks, (3) and (further) lowering reinvestment yields. We expect the medium-term effect of margin compression to be most visible in the core, where the liability cost reduction does not act as an offset. Peripheral banks, therefore, should find the medium-term impacts more manageable, in our view.

Exhibit 3: As interest rate expectations have continued to fall...
EUR 5y swap rate and EUR 3m swap rate, %

Source: Datastream

Exhibit 4: ...margins in the core have compressed, with margins in the periphery still somewhat above that level
Margins on corporate lending (new business funded by corporate deposits)

Source: EOS, Goldman Sachs Global Investment Research

Source: Goldman Sachs (2015)
Eurozone banks and QE

In addition to margin compression, there are several other impacts on the European banking sector:

- **Pressure of ALM revenues (carry trades).** Many banks with significant holdings of Eurozone periphery sovereign debt in their ALM portfolios are likely to experience a one-time benefit from the upward revaluation of these assets, should QE lead to a reduction in yields. Although only a one-time impact, it would still count as CET1 under end-point CRD IV regulation, hence a small positive for thinly-capitalised banks. That said, the re-investment risk will have risen.

- **Positive gearing to increasing valuations of real assets.** Rising equity values could provide some offset, boosting the revenues of banks with significant Private Banking, Asset Management (both equity and FICC) or cash-equity exposed businesses.

- **GDP effects.** If, following QE, Eurozone economic growth improves, this would be a longer-term positive for European banks, as it would improve asset quality and provisioning. This impact would be particularly positive for banks with larger legacy portfolios, whose asset valuations may see an improvement.

*Source: Goldman Sachs (2015)*
Japanese banks: Prolonged period of deleveraging reflected in material decline in loan to deposit ratios

Source: Bloomberg

Euro Area banks: Loan to deposit ratios continue to decline since crisis but still above 100% - Banks continue to be the dominant funding source

Source: FDIC, J.P. Morgan estimates

US Banks declining loan to deposit ratio post crisis since 2006 – Capital markets funding much more developed than Europe

Source: J.P. Morgan Cazenove (2015)
...in addition, NIM remain under pressure with asset margins feeling the pain - U.S. banks tell similar story...

- NPL improvement and loan growth picked up in US in 2010 post crisis. Net Interest Margins as well as yield on interest earning assets for U.S. banks, as represented by the FDIC insured institutions, started to decline in 2010.

- While European banks are not showing any loan growth currently, NIM has been protected by declining funding costs. However, we have started to see some signs of pressure on the asset margins with Q3 results of Spanish and Italian banks. Hence we find it hard to envisage a different scenario for European banks and expect NIM to be under pressure even potentially in a higher loan growth environment.

Conclusions

• Increasing academic interest in the impact of QE and alternative monetary policy but little work on banks too date
• Academics typically focusing on country specific issues whereas analysts are more interested in international comparisons
  ➢ Alternative policy appears to have a substantial impact on yield curves and financial markets
  ➢ Less impact on macro indicators
  ➢ Modest influence on bank lending (although evidence here is somewhat limited)
• Recent analyst work focuses on margin pressures; and also notes lower volatilities, but as far as I am aware little work done in this area. There is some evidence that bank profits were positively impacted by early US Fed asset purchases but this has not yet been confirmed.
References


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