Expanding Unremunerated MRR: Potential Impact On Eurozone Banks

Presentation to SUERF BAFFI Bocconi webinar

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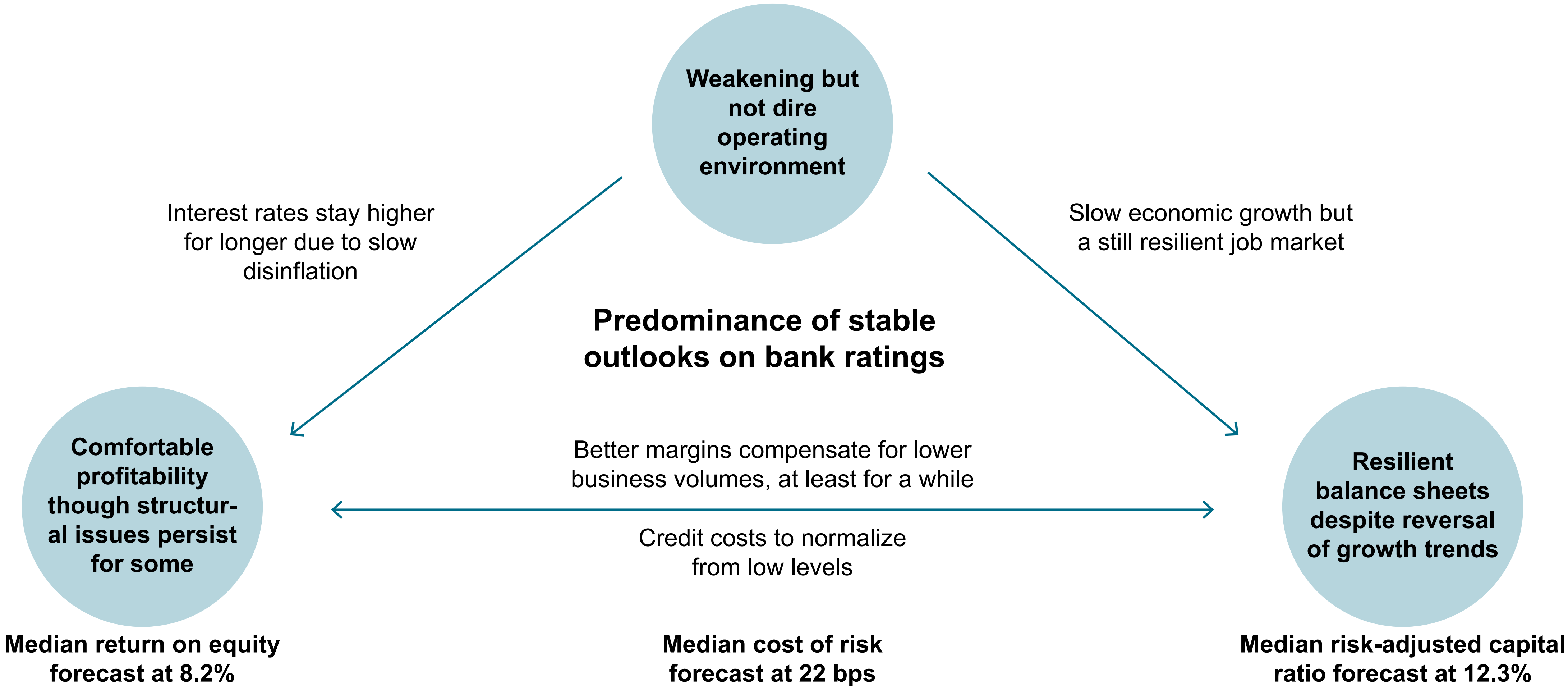
December 12th, 2023

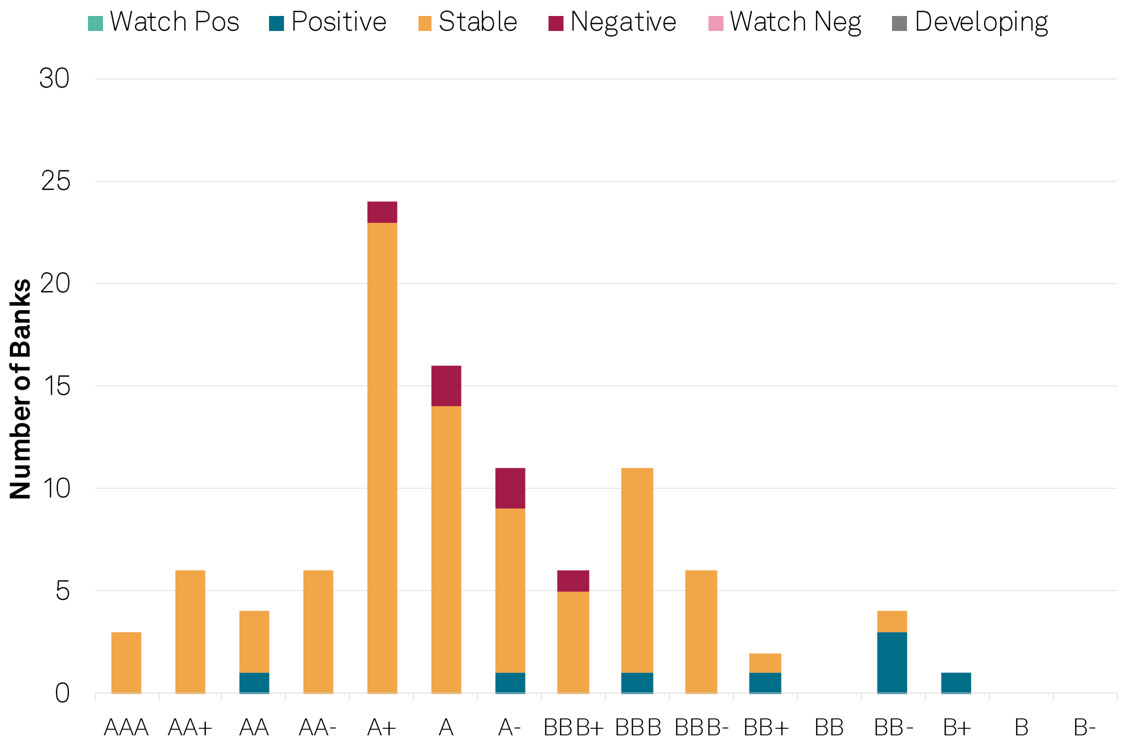
S&P Global Ratings

Our Prognosis For Rated European Banks In 2024



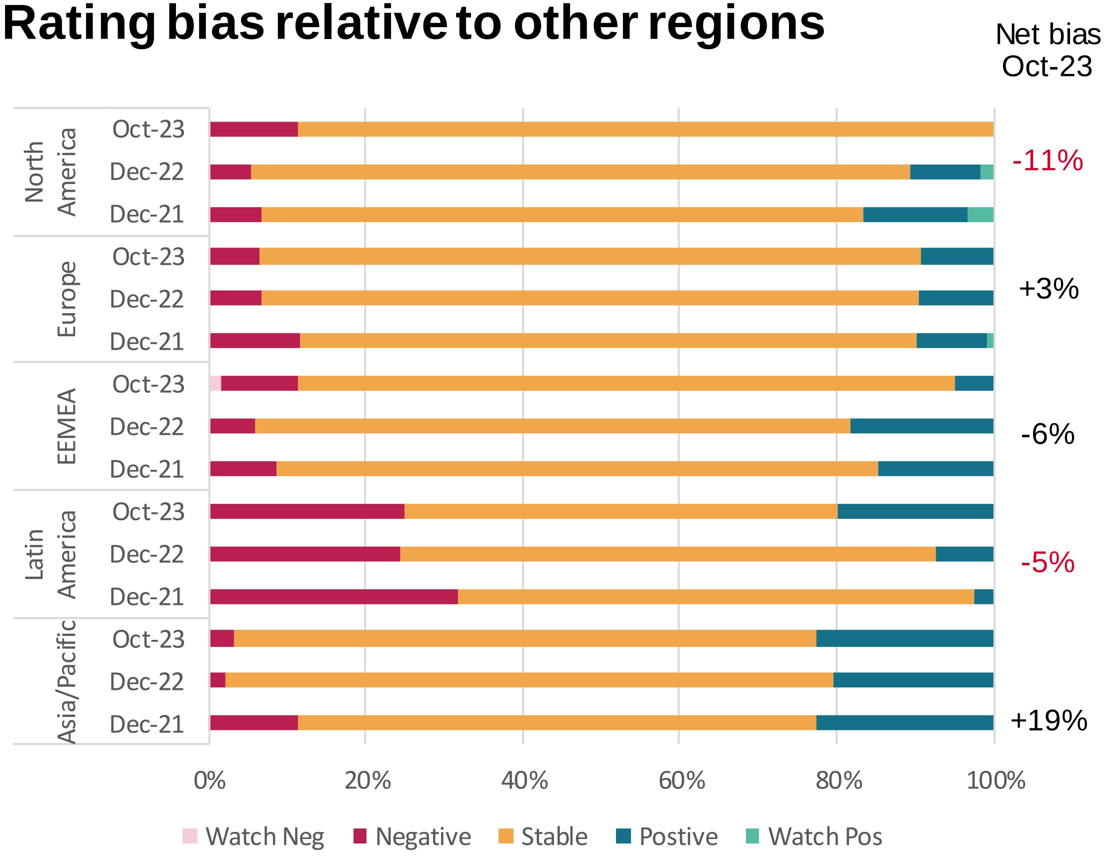
European Bank Ratings | Stability On The Horizon

Positive outlooks are mainly among lower ratings



Covers Top 100 European banks only. Data as of Nov. 02, 2023. Data reflect outlooks at the level of the lead operating company. Source: S&P Global Ratings.

Rating bias relative to other regions



Data as of Oct. 31, 2023. Reflects rating bias of all rated banks in each region. EEMEA – Eastern Europe, Middle East & Africa. Source: S&P Global Ratings.

Eurozone Banks | Higher MRR Would Dent Profits And Liquidity

Under current ECB/NCB policy, required reserves are not HQLA eligible and remunerated at 0%. Assuming a moderate increase in MRR (for instance a return to 2%), we find a manageable impact in most systems.

Impact of increase in MRR on eurozone banks' LCRs
Sensitivity analysis

LCR (%)	Minimum reserve requirements (currently 1%)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Austria	171	168	165	163	160	157	154	152	149	146
Belgium	166	159	153	147	140	134	128	121	115	109
Germany	154	148	142	136	130	124	118	113	107	101
Spain	173	169	165	161	157	153	149	145	141	137
Finland	174	170	166	162	158	154	149	145	141	137
France	156	153	150	147	144	141	138	135	132	129
Greece	205	200	194	188	183	177	172	166	161	155
Ireland	180	173	166	159	153	146	139	132	126	119
Italy	194	187	181	174	167	161	154	147	141	134
Netherlands	156	153	150	147	144	141	138	135	132	129
Portugal	248	239	229	219	209	199	190	180	170	160
Slovenia	289	281	274	267	259	252	245	238	230	223
Eurozone*	165	160	155	151	146	142	137	133	128	123

Due to missing datapoints, we exclude Croatia, Cyprus, Estonia, Lithuania, Latvia, and Slovakia. Additionally, we exclude Luxembourg from the analysis because of discrepancies in the reporting of minimum reserves.
LCR--Liquidity coverage ratio. MRR--Minimum reserve requirements.
Sources: ECB Data Warehouse, S&P Global Ratings.

Impact of increase in MRR on eurozone banks' net interest income
Sensitivity analysis

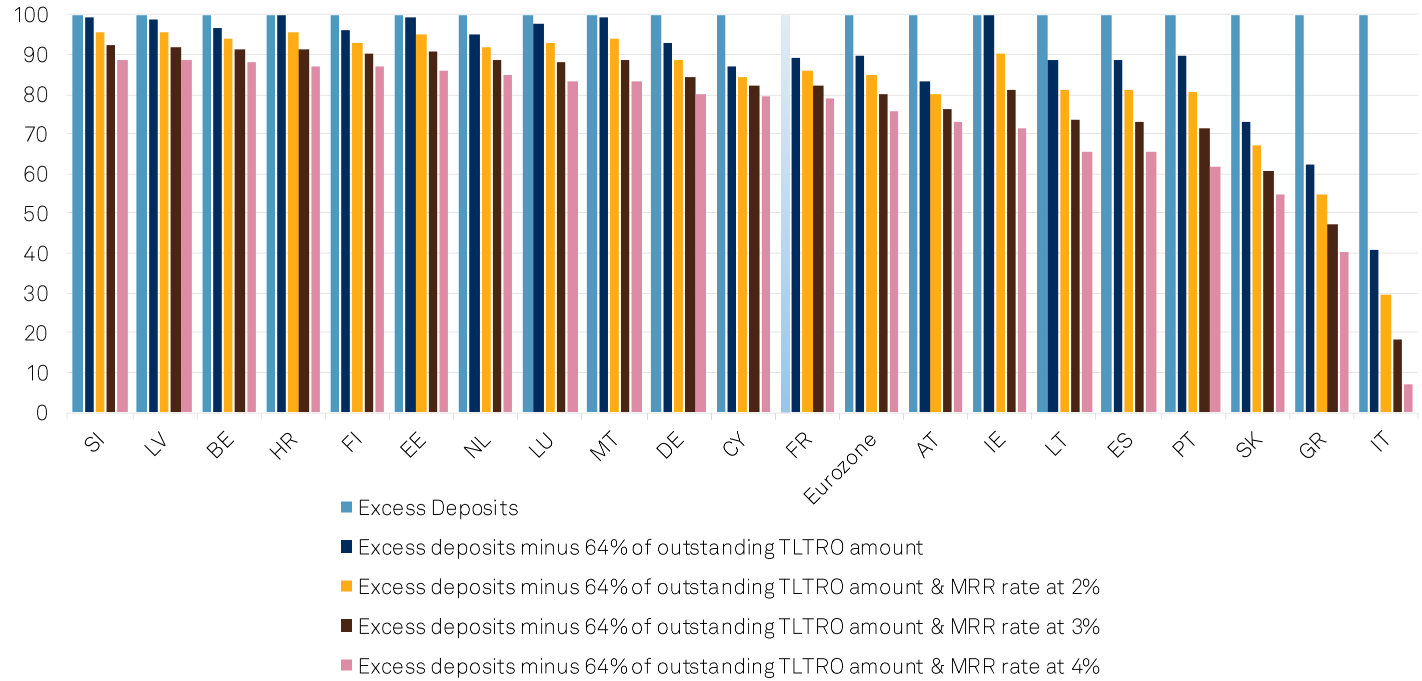
Decline in net interest income versus 2022 (%)	Minimum reserve requirements (currently 1%)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Austria	0	(1)	(1)	(2)	(3)	(4)	(4)	(5)	(6)	(6)
Belgium	0	(2)	(4)	(5)	(7)	(9)	(11)	(13)	(15)	(16)
Cyprus	0	(2)	(5)	(7)	(9)	(11)	(14)	(16)	(18)	(20)
Germany	0	(2)	(5)	(7)	(9)	(12)	(14)	(16)	(19)	(21)
Estonia	0	(1)	(2)	(4)	(5)	(6)	(7)	(8)	(10)	(11)
Spain	0	(1)	(2)	(2)	(3)	(4)	(5)	(6)	(7)	(7)
Finland	0	(2)	(3)	(5)	(7)	(8)	(10)	(12)	(14)	(15)
France	0	(2)	(3)	(5)	(6)	(8)	(10)	(11)	(13)	(15)
Greece	0	(1)	(3)	(4)	(6)	(7)	(8)	(10)	(11)	(13)
Ireland	0	(4)	(8)	(12)	(16)	(19)	(23)	(27)	(31)	(35)
Italy	0	(2)	(4)	(6)	(8)	(10)	(12)	(14)	(16)	(18)
Lithuania	0	(3)	(6)	(9)	(13)	(16)	(19)	(22)	(25)	(28)
Latvia	0	(1)	(1)	(2)	(3)	(3)	(4)	(5)	(5)	(6)
Malta	0	(1)	(3)	(4)	(6)	(7)	(8)	(10)	(11)	(13)
Netherlands	0	(1)	(3)	(4)	(5)	(7)	(8)	(10)	(11)	(12)
Portugal	0	(2)	(3)	(5)	(6)	(8)	(10)	(11)	(13)	(15)
Slovenia	0	(1)	(3)	(4)	(5)	(7)	(8)	(9)	(10)	(12)
Slovakia	0	(1)	(3)	(4)	(6)	(7)	(9)	(10)	(12)	(13)
Eurozone	0	(2)	(3)	(5)	(7)	(8)	(10)	(12)	(14)	(15)

Note: We exclude Luxembourg from the analysis because of discrepancies in the reporting of minimum reserves. MRR--Minimum reserve requirements. Sources: ECB Data Warehouse, S&P Global Ratings.

Eurozone Banks | Monetary policy uncertainties

Together with upcoming TLTRO repayments (and potentially a switch to active QT), an increase in MRR would deplete excess reserves, which are not equally distributed across systems.

Potential Depletion of Excess Reserves Due to TLTRO Repayments* and increase in MRR



Source: S&P Global Ratings, ECB Data Warehouse. * Assuming a 64% pass-through between TLTRO repayments and decline in excess reserves, in line with trend observed in the eurozone in the past year.

Excess reserves are not equally distributed across systems and banks.

- Effect would therefore be asymmetric and lead to further differentiation in banks' funding costs.

In case the MRR is raised meaningfully, some banks would need to source reserves on the interbank market, or let go of some deposits.

Banks would also likely react in many other ways:

- shift deposits where they are not subject to MRR (for the banks that can); and/or
- Seek to offset the loss of interest income by taking on more risk (e.g. interest rate risk)

Eurozone Banks | Normalising Monetary Policies Requires Careful Communication

And the ECB has tools to manage potential risks, should they materialise.

Review of the operational framework (MRR, refinancing operations, role of forward guidance)

Uncertainties in the real economy

Financing needs from governments, i.e. fiscal trajectories.

Financing needs from the broader economy

ECB's risk management tools: full allotment procedure, TPI

Uncertainties in the financial system

Quality of interest rate risk management by bank and non-bank FIs

Amount of liquidity with which banks wish or are required to operate

Impact on money markets (esp. repo markets)

Speed and extent of balance sheet reduction

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Annex

Further Details In Our Published Research

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Credit FAQ:

What An Acceleration Of Quantitative Tightening Could Mean For Eurozone Banks

September 13, 2023

Amid a broad consensus that core inflation will remain above target for another two years, S&P Global Ratings' economists expect the European Central Bank's (ECB's) monetary policy to continue normalizing once rates have peaked. If inflation does indeed exceed the target for another two years, we believe the current passive form of quantitative tightening (QT) could give way to a more active form, which would involve the ECB starting to sell bonds on the market.

Today, the ECB holds about €5 trillion in bonds and we believe it could reduce this sum by €1.0 trillion-€1.5 trillion. This is on top of a €600 billion balance-sheet reduction via targeted longer-term refinancing operation (TLTRO) repayments that are set to take place by the end of 2024. One important question is at what speed the reduction in bond holdings should occur.

For eurozone banks, a hypothetical acceleration of QT would not have a major direct impact on their capital adequacy or liquidity and funding ratios. However, it would fuel the normalization of funding costs and net interest margins already under way (see "European Banks: Protecting Liquidity Will Come At An Increasing Cost," published June 29, 2023). Indeed, active QT would likely lead to deposit outflows, as nonbanks use bank deposits to buy parts of the bonds that the ECB sells.

The ECB could also decide to lower the remuneration of banks' excess reserves to incentivize them to buy parts of these bonds. A key determinant of banks' willingness to buy the ECB's bonds will be the risk-adjusted spread between the yields on the bonds and the rate at which banks can deposit their excess reserves with the ECB, namely, the deposit facility rate (DFR; currently 3.75%). For now, this spread is mostly negative, meaning that banks have few incentives to swap deposits at the ECB for bonds.

Besides this, the acceleration of QT could lead to unpredictable secondary effects on banks and the financial system at large. In the U.S., where the Federal Reserve restarted its QT program in April 2022, banks have seen deposit outflows weigh heavily on their funding, liquidity, and spread income. In the eurozone, we see banks as well placed to manage the transition, but we are mindful that QT could also have profound implications for financial institutions' business models and financial profiles. Competition for a shrinking pool of deposits could intensify, leading to a rise in banks' funding costs. Tighter liquidity conditions could exacerbate refinancing risks for nonbanks. Banks may also increase exposures to their domestic sovereign over time, thereby reinvigorating the so-called sovereign-bank nexus--the interconnectedness of sovereigns and banks--which was a major catalyst of previous financial crises.

As the ECB proceeds with QT, we expect it to remain data-dependent, taking into account the

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Eurozone Banks: Higher Reserve Requirements Would Dent Profits And Liquidity

October 24, 2023

Key Takeaways

- As part of a review of its operational framework, the European Central Bank could decide to hike the minimum required reserves (MRR) for eurozone banks.
- This would dent banks' liquidity and profits, but we expect the overall impact to be moderate, providing that the increase in MRR remains modest.
- That said, higher MRR could meaningfully deplete some banks' excess reserves, which are unevenly distributed across the eurozone banking system. This could accelerate the normalization of their funding costs.

Eurozone banks' liquidity and profits could take a hit if the European Central Bank (ECB) hikes the minimum required reserves (MRR). The ECB recently embarked on a review of its operational framework, namely, the range of instruments that it uses to manage short-term market interest rates, and it expects to conclude this review by spring 2024. This includes setting the minimum reserve requirements for banks. The reserve requirement rate is currently 1% and represents the share of deposits, debt securities, and money market paper that banks operating in the eurozone must hold at the ECB.

S&P Global Ratings considers that a modest increase in MRR--for instance, to the historical level of 2%--would lead to a moderate reduction in eurozone banks' profits and liquidity. For eurozone banks in aggregate, and all else being equal, we estimate that a one percentage point increase in MRR could lead to an immediate gross reduction in profit before tax by 3.3% and in the liquidity coverage ratio (LCR) by 4.7 percentage points. Most European banks currently have comfortable profits and liquidity buffers, and, in our view, would likely take action to mitigate the impact of higher reserve requirements.

That said, such an increase could weigh on investor sentiment vis-à-vis eurozone banks. Furthermore, higher MRR could lead to a meaningful depletion of excess reserves for some banks that will also need to repay their targeted longer-term refinancing operations (TLTRO) funding by the end of 2024. This could be the case for some smaller Italian and, to a lesser extent, Greek banks. For these banks, we see the additional funding needs as manageable, but the reduction in excess reserves would contribute to the normalization of funding costs that we already see at play and expect for 2024.

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European Banks: Protecting Liquidity Will Come At An Increasing Cost

June 29, 2023

Key Takeaways

- So far, European banks have kept funding costs relatively low despite rising interest rates.
- However, there are major differences across banks and markets, reflecting banks' funding profiles and liquidity levels, but also the degree of market competition.
- As central banks drain off excess liquidity, banks' funding costs will inevitably continue to rise, and we expect large rated European banks' net interest margins and income to peak later this year.
- Our base case remains that these incremental funding pressures will represent a cost challenge rather than a funding availability problem.
- The pace of quantitative tightening and its impact on deposit outflows and financial conditions is a key source of uncertainty for European banks.

The huge changes in monetary policy that Europe's central banks have been making over the past 12-18 months are putting the spotlight on the funding profiles of the region's banks. S&P Global Ratings believes that European banks' funding profiles have stood up relatively well to the changes so far. However, funding costs will inevitably continue to rise as the deposit market becomes tighter and competition picks up. As a result, we expect that large rated European banks' net interest margins (NIMs) and net interest income (NII) will peak later this year.

European banks have largely kept their funding costs low since mid-2022, despite rising policy rates. Overall, the average deposit beta--the share of the increase in policy rates that banks pass through to the interest rates on deposits--is only 20%, which, for banks, compares favorably with historical precedents. There are significant differences across countries, however, with deposit betas ranging from only around 5% in Cyprus, Ireland, and Spain to above 30% in France and Luxembourg. In most Central and Eastern European countries, deposit repricing has been far slower and less pronounced than the increase in policy rates, with the notable exception of the Czech Republic.

We see two key drivers of these differences. First, banks' starting levels of liquidity, with those holding more liquidity less prone to compete for deposits and therefore pay up, and second,

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