Financial Stability Implications of a Prolonged Period of Low Interest Rates

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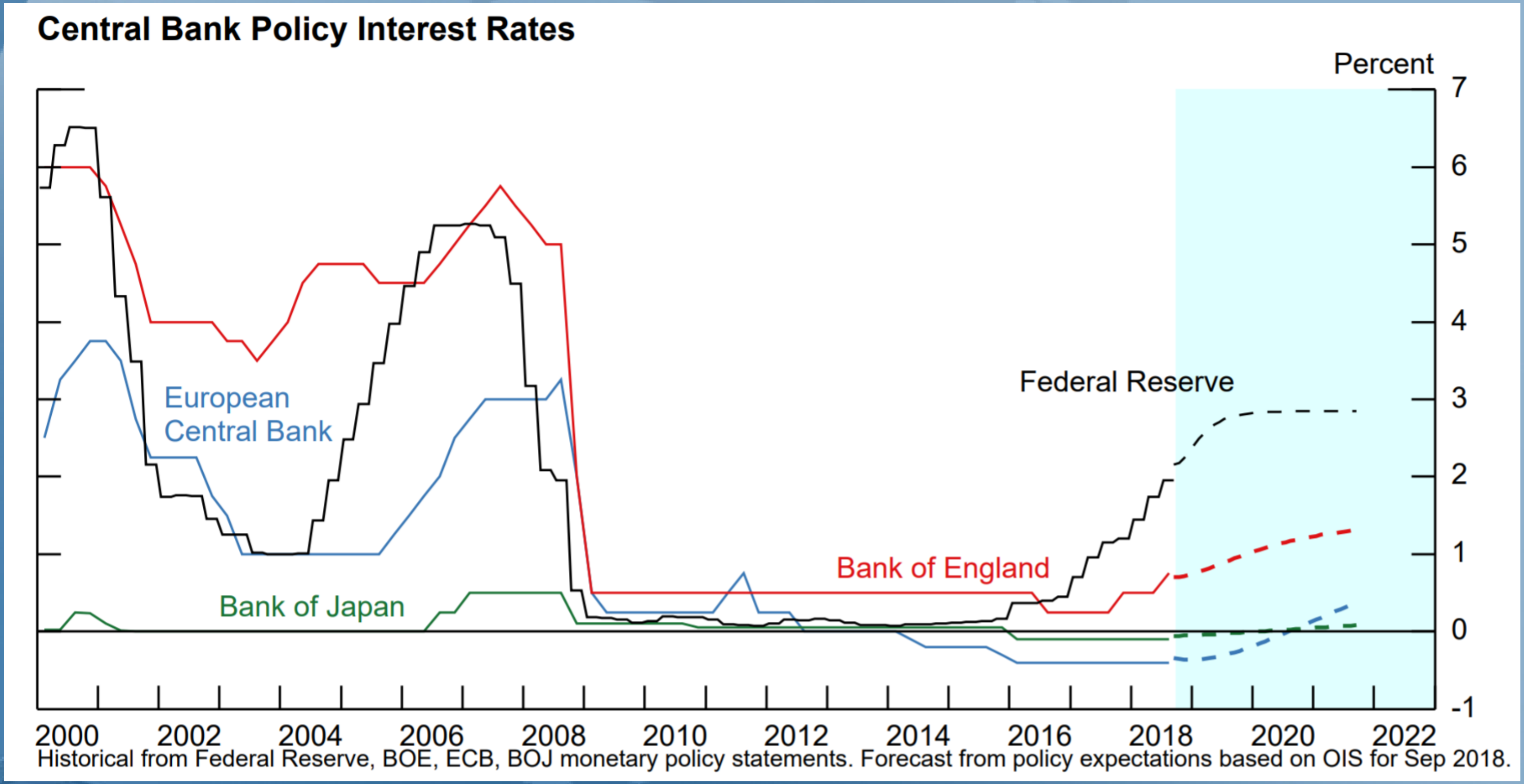
October 2018

Advanced economy (AE) policy normalization expected to proceed slowly.



Implications of prolonged low interest rates for financial stability

Might a further prolonged period of very low rates:

- reduce viability of financial institutions?
- incentivize risk-taking?
- increase vulnerability to a subsequent snapback in rates?
- threaten financial stability?

BIS Study Group

- Bank for International Settlements (BIS) study group:
  - Input from 19 central banks; led by Ulrich Bindseil (ECB) and me.

- Focus on two broad categories of financial institutions:
  - Banks
  - Life insurance companies and private pension funds (ICPFs)

- Analysis applied to over 20 countries; I'll be focusing on examples from U.S. and Japan.

- Report available at: https://www.bis.org/publ/cgfs61.pdf

Effect of Low Rates on Banks

Channels Through Which Low Interest Rates Might Affect Banks

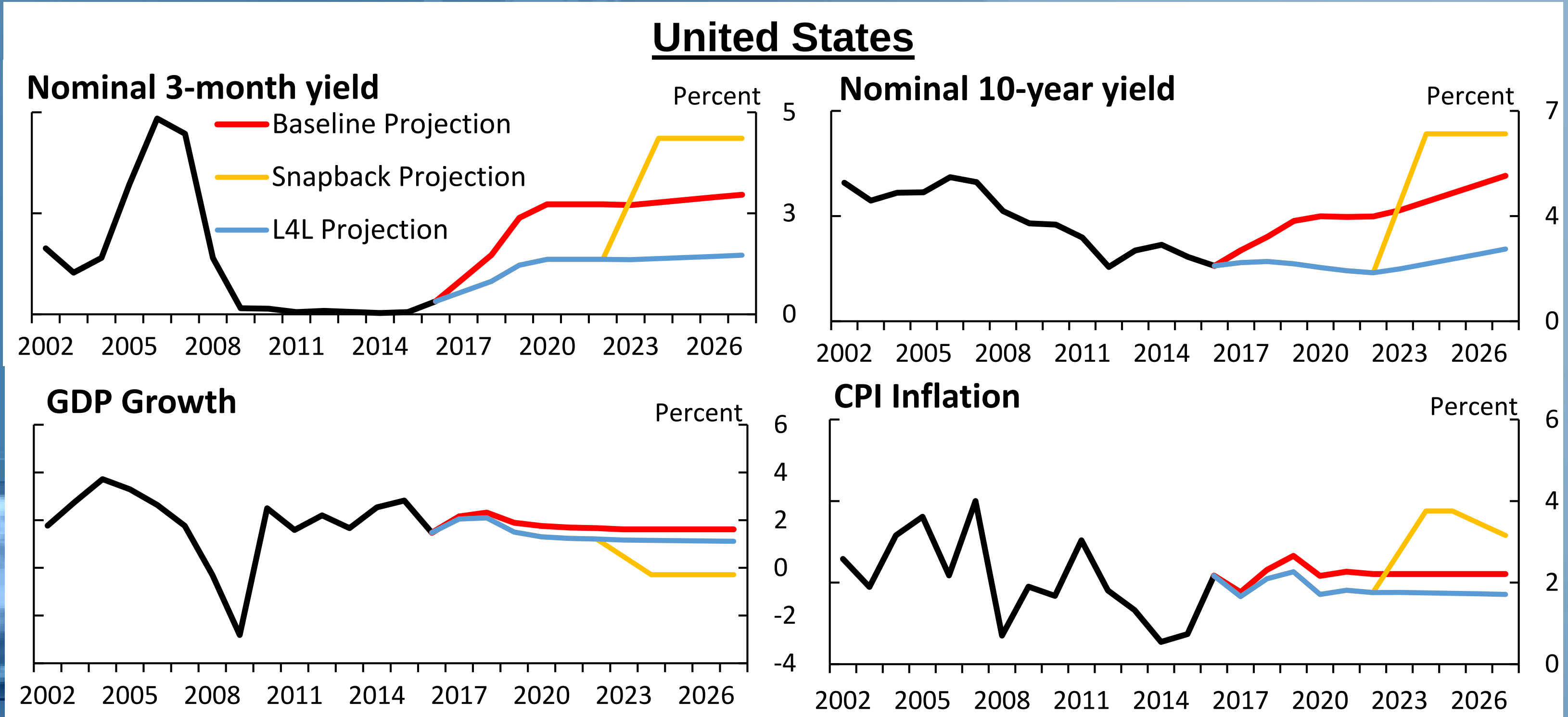
- Squeeze net interest margin (NIM) if deposit rates are stickier than loan rates.
  - Lower profits may reduce capital and resiliency.

- Shift to riskier loans (“search for yield”).

- Could lead to future snapback in interest rates that triggers losses.

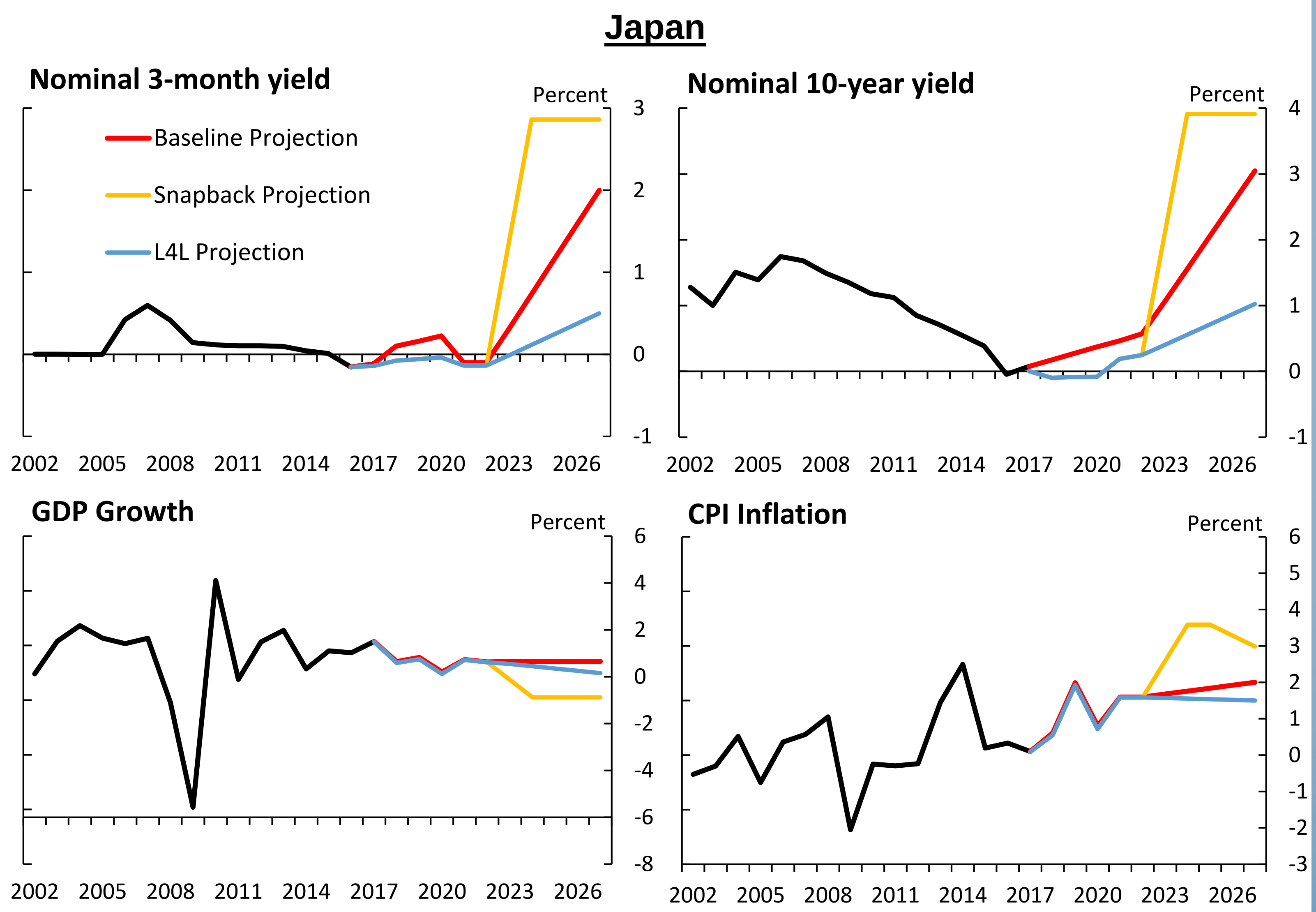
Effect of Low Rates on Bank Profits: 3 Scenarios

- Baseline: rates gradually rise to more normal levels.
- Low-for-long (L4L): continued weakness in demand and inflation keep rates low.
- Snapback: rates later rise sharply in response to higher inflation.



Source: "Financial Stability Implications of a Prolonged Period of Low Interest Rates," Committee on the Global Financial System, 5 July 2018.

Effect of Low Rates on Bank Profits: 3 Scenarios



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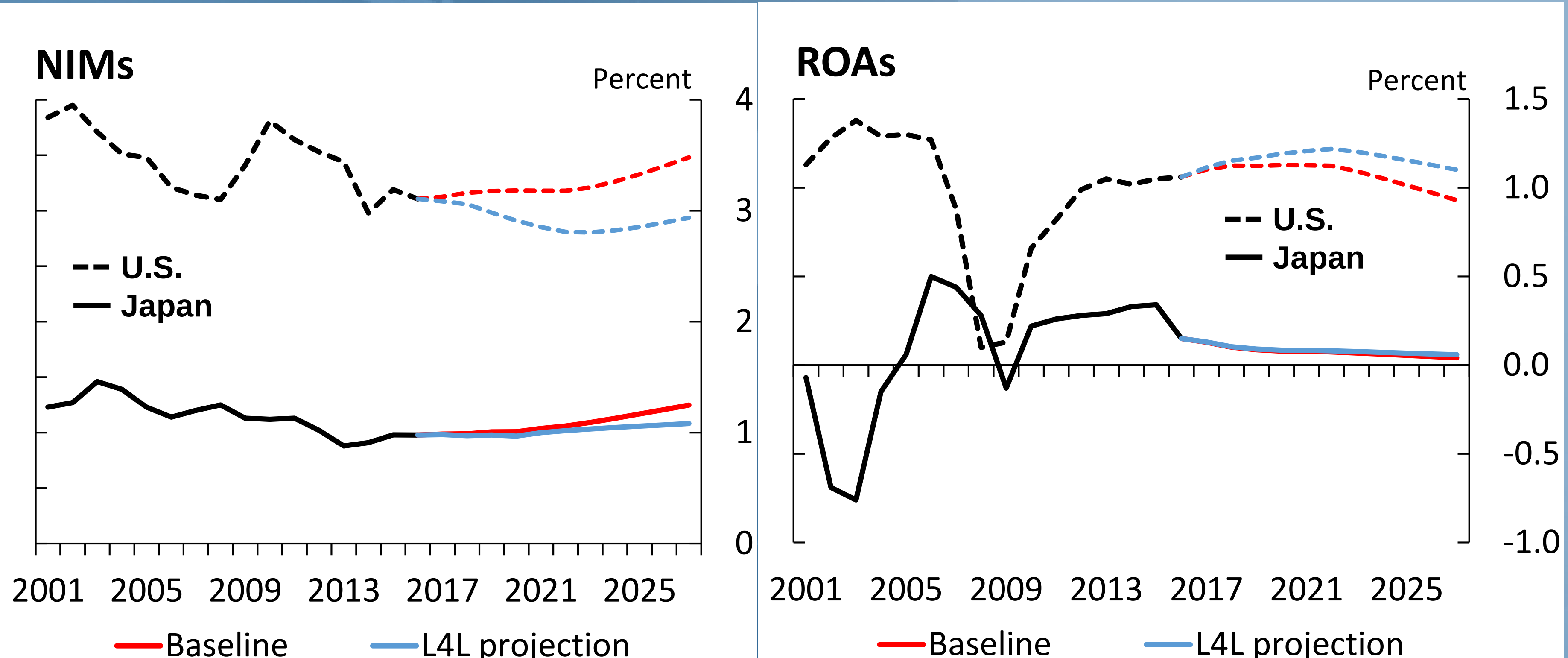
Projections of Bank Profits in Different Scenarios

- Net interest margins (NIMs) would fall materially in a low-for-long (L4L) scenario compared with Baseline.
- But overall profitability -- return on assets (ROAs) -- would not.



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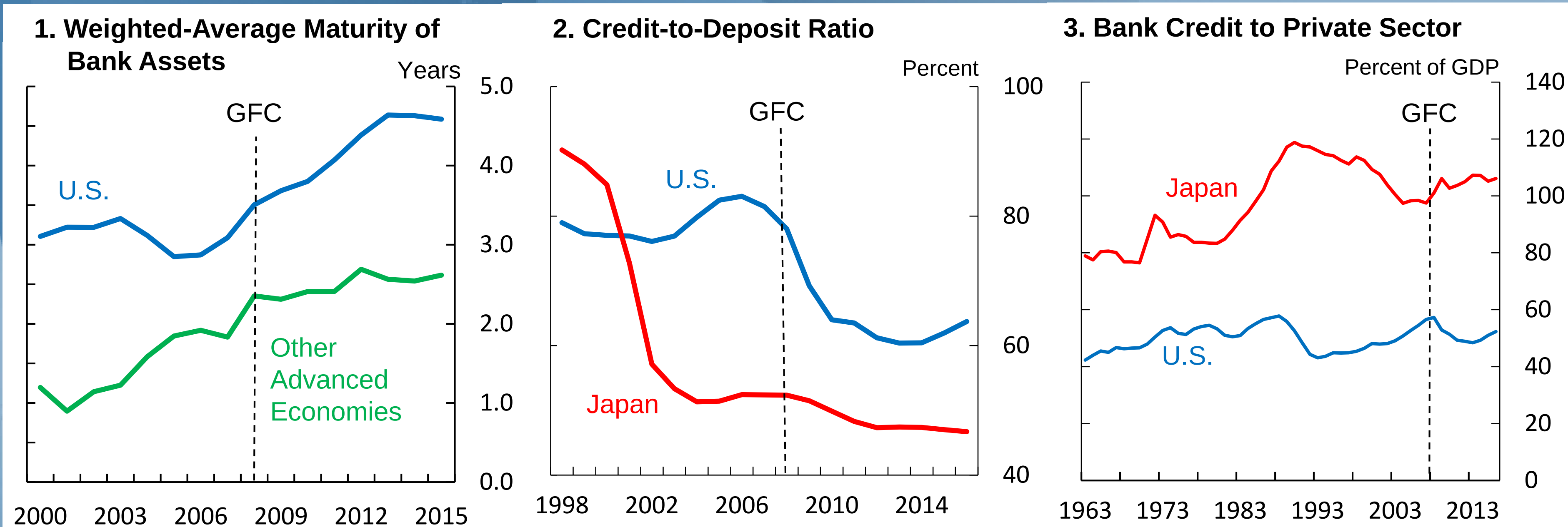
Limited Signs of Low Rates Encouraging Risk-Taking

- Banks in some economies have shifted assets toward longer maturities (panel 1); also increased concentration in real estate loans.
- But credit-to-deposit ratios have declined (panel 2), and bank credit-to-GDP ratios are also subdued.
- Bank capital is up everywhere after the GFC.



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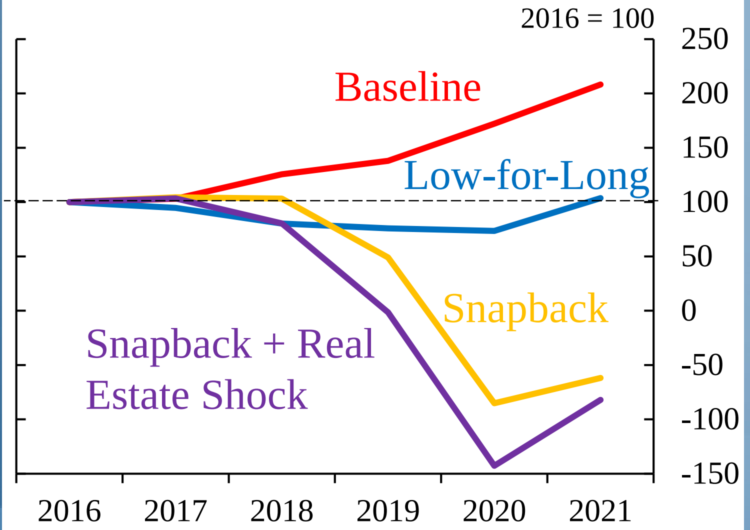
So, limited adverse effects of low rates, but some points of concern…

- Concern 1: Rate sensitivity of bank profits stronger when:
  - Yields already low.
  - Banking more competitive.
  - Banks depend heavily on deposit funding.
  - Thus, regional banks in Japan.

- Concern 2: Subdued risk-taking may not continue.
  - Recent experience reflects de-risking and tightening of standards and regulations in wake of the GFC.

- Concern 3: Future snapback in interest rates could lead to valuation and credit losses.

Net Earnings Projection: Switzerland



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Insurance Companies and Pension Funds (ICPFs)

Key Findings for ICPFs

- Low rates undermine ability of some insurance companies and pension funds to make promised payments, threatening their viability.
- However, deterioration in condition will be gradual, allowing time to adjust business models and exit unprofitable activities.
- Japanese insurers have already faced low-for-long rates, and systemic impact proved containable.
  - Insurance company bankruptcies of the 1990s addressed without significant contagion to the financial system.
  - Japanese insurers have adjusted business models so as to maintain viability.

Overall financial stability and policy implications of prolonged low interest rates

- Financial institutions should generally be able to cope with prolonged low rates,

- But this will require concerted attention and adjustment by firms' management,

- As well as close monitoring by regulators.

Thank you!