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White Paper

Interest Rate Rises: A Savior or a Damp Squib for Eurozone Banks?

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Over the past year, most major economies have seen the introduction of higher interest rates, with rises recorded in the United States, China, and the United Kingdom. However, the situation in the Eurozone has lagged behind, with rate rises not expected here until the end of 2020. Banks have been clamoring for a rate rise for several years, in the hope that this would allow them to climb out of the slough of despond characterized by negative interbank rates and low net interest rate margins.[1] But are rising rates really the savior they are heralded to be?

We have looked at the impact of rate rises in many markets, with a focus on the Eurozone. Our analysis indicates that although bank revenues are set to increase, interest rate rises will not be the cause. While such rises might have an uplifting effect in the short term, particularly on net interest margins attributable to retail savings, the margins for most other products might well continue to decline. This white paper will look at how and why we believe this could happen, but will also consider two possible alternative scenarios resulting from rising rates. In particular, we examine the possibility that rate rises coupled with a looming economic downturn might lead to another, even deeper, bout of depression for European banks.

Interest Rates: Prognosis and Impact

Interest rates have recently risen in countries such as the United States as a result of an improved economic outlook. However, the European Central Bank (ECB) has not yet followed suit with a rate rise of its own.

Many observers predict that the negative interest rates which currently hold sway in the Eurozone will undergo a modest increase in the coming years. For example, analysis by Bloomberg suggests that annual average overnight rates will rise from -0.4% in 2018 to 1.0% by 2022. We at BCG work with a scenario in which rates remain at a low level throughout 2019, with a slight rise by 2020.

[1] Net interest margin is defined as the client interest rate minus the cost of funding

The general perception among banks, for example within German savings banks,[2] is that such a rise in interest rates would have a significant positive effect on their overall performance. We analyze whether such optimism is well founded, and investigate the impact of two possible future scenarios, with very different interest rate movements and overall economic performance postulated in each.

Scenario 1: Slow rise in interest rates and economic stability

In one possible course of events, continued stable economic performance across all markets in the Eurozone would prompt the ECB to slowly raise reference rates.

It is commonly believed that such a rise would boost banking revenue in Eurozone states. According to this line of thinking, revenue from liabilities would especially benefit, as a low level of client sensitivity to rate changes could allow banks to delay the introduction of a client interest rate rise for retail deposits and hence widen net interest margins for the banks.

However, it is not so much the interest rate level itself but rather the slope of the yield curve (market interest rates for the various tenures from overnight to 10 years and more) that enables banks to earn margin from customer business by lending out more expensive long-term loans which they refinance through cheaper short-term deposits.

BCG analysis of sample countries suggests that any increase in net interest margins for retail deposits would be short-lived. Contrary to the widespread assumption, banks in this scenario will have to pass on rate rises to customers relatively quickly as a result of intense market competition.

[2] See comments of Hans-Walter Peters, president of the Bundesverband deutscher Banken: “Wir können die EZB nur bitten: Nehmen sie die Negativzinsen aus dem Markt, und zwar schnellstmöglich." As quoted in the article “Nehmen Sie die Negativzinsen aus dem Markt" in: Frankfurter Allgemeine Zeitung. Edition from October 13th 2018. Available online at https://www.faz.net/aktuell/finanzen/finanzmarkt/banken-mahnen-ezb-nehmen-sie-die-negativzinsen-aus-dem-markt-15835904.html

Moreover, a rate rise could have almost no effect whatsoever on net interest margins for corporate deposit business. In this instance, the higher rate would be immediately passed on to customers, since corporate clients tend to be more sensitive to rate changes and react more swiftly to them.

On the asset side, meanwhile, a rise in interest rates could lead to increased cost of refinancing. The scale of this increase would be determined by the funding structure of banks' loan books. A larger share of short-term deposits would entail a greater increase in refinancing costs. In addition, as customer loans in most European markets have longer fixed interest rate periods, banks could only adjust client interest rates upwards for new and renegotiated loans, hence only impacting a certain share of the entire loan book.

Moreover, competitive pressures will make their mark here too. In this scenario, banks would hesitate to raise interest rates on new customer loans for fear that they would take their business elsewhere. Meanwhile, the majority of the loan book would be locked in fixed interest rate periods which cannot be adjusted at all. These effects, coupled with the higher cost of refinancing, would reduce net interest margins.

Exhibit 1 projects how we believe any movements in net interest margins emerging from this possible scenario would affect revenue composition in France. The main reasons for this picture in France are the prevailing pass-through rates and the expected flattening of the spread between overnight and ten-year interest rates.

Interest rate rises would have no positive effect on loans and financing because new long-term low-priced assets might have to be refinanced in part by deposits that are becoming more expensive. This would be especially true for shorter tenures, depending on the maturity selected for the funds transfer pricing process. We have witnessed parallels in the United States market, where the impact of recent interest rate rises has produced similar consequences to those we are projecting for the Eurozone. (See Exhibit 2).

Exhibit 1: Impact of Scenario 1 on Bank Revenue in France

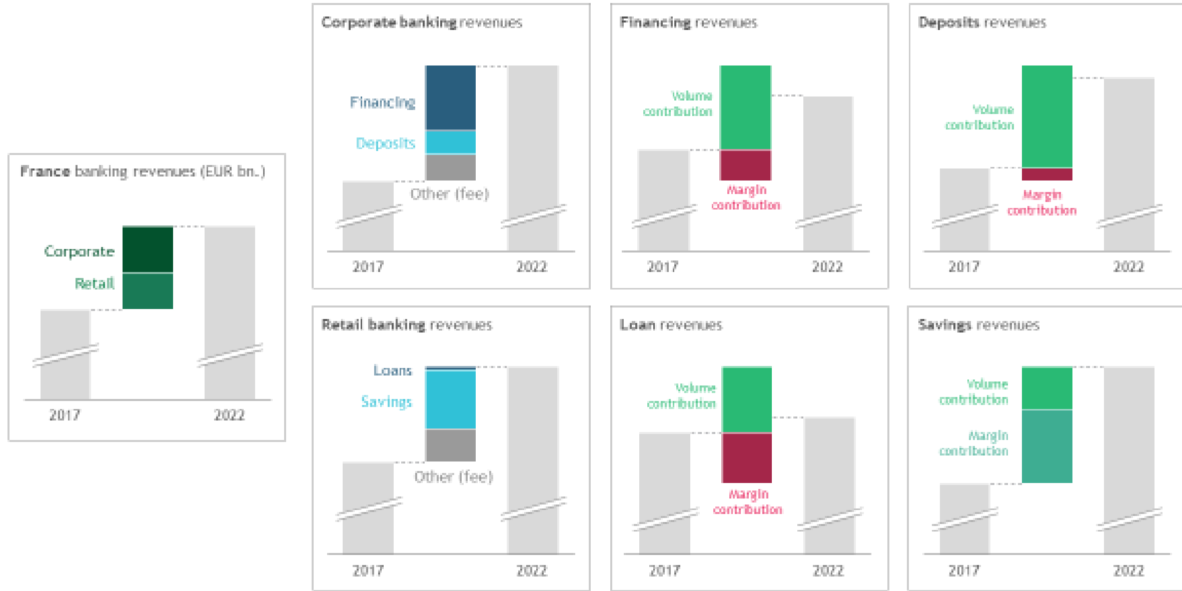


Exhibit 2: Impact of Similar Scenario on Revenue in the United States

One of the principal repercussions of a rise in interest rates would be an increase in the number of bank switchers in any given market, as clients strive to secure the most attractive rates for themselves.

The extent of this phenomenon would depend on the level of competition in the marketplace, and the degree to which nimble direct banks and FinTech institutions have already established themselves. If such competition is intense, incumbent banks may well fail to benefit from any positive effect of rate rises. For example, a direct bank rival could take away customers from the now potentially more profitable deposit business, placing even more pressure on refinancing costs.

Overall, the projected growth in revenue would be largely a result of an increase in business volume due to the stable economic situation, as the rate rise would only have a small impact on net interest margins. It stands to reason that any deterioration of the economic climate would lead to a reduction in banking revenue.

Scenario 2: Rapid rate hikes and economic downturn

In a possible alternative scenario, we postulate sharp increases in interest rates. This scenario would not be so much caused by policy makers and the ECB, but by the market adjusting interest rates on government and corporate bonds based on a changed risk perception.

The market-driven rate increases would no longer have a positive impact on net interest margins for deposit business, but rather would lead to stagnating margins. On the lending side, the outcome would be even gloomier, with banks experiencing a steep decline in margins as refinancing and cost of risk both rise.

In addition, risk-weighted assets might soar and exert pressure on capital ratios, thus making it harder for banks to generate new business volumes. In the worst-case outcome, they might even be forced to raise capital. In other words, such a scenario would have an unambiguously negative impact on banks, with gross margin growth

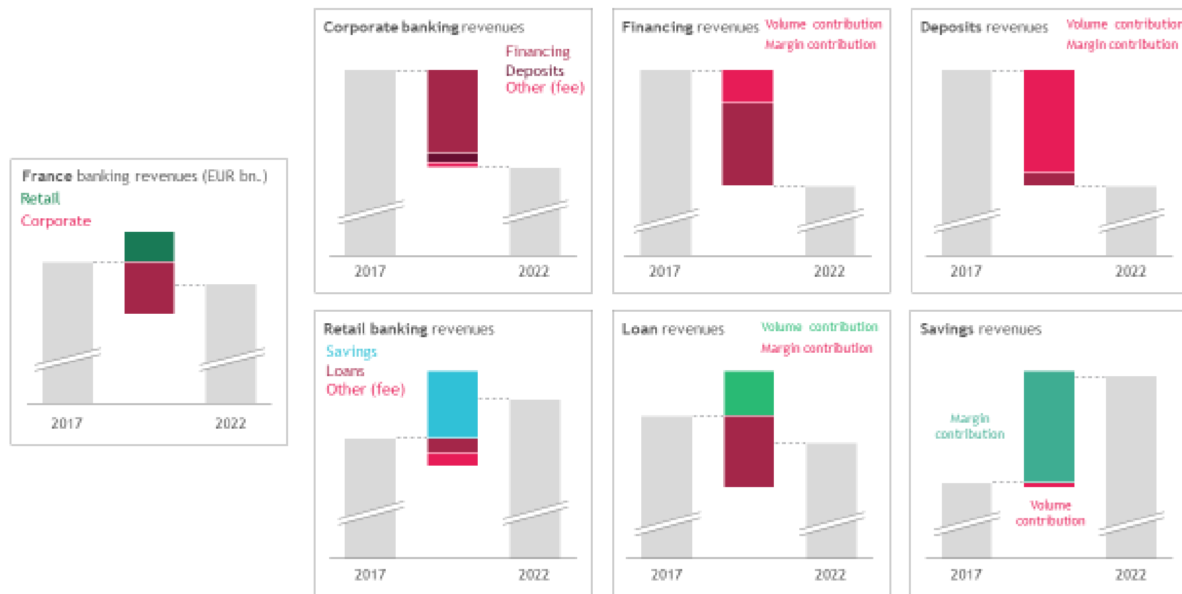
either stagnant or negative for both deposit and lending products, particularly with regard to corporate banking.
Another adverse consequence could be that sharp increases in rates would exacerbate the expected slowdown in growth within the economy as a whole, and this in turn would have an inevitably detrimental effect on sales volume growth across the product portfolio. Fee products could also be adversely affected by a decrease in the number of transactions. The overall impact would be a decline in revenue.

Such an economic slowdown is increasingly anticipated, even though it is not yet part of official forecast scenarios, such as from the Economist Intelligence Unit (EIU). This widespread view results from the fact that the Eurozone has undergone a prolonged period of growth, and some economies are already exhibiting some signs of a slowdown.

The basis for our assessment of the impact of this scenario on broader economic performance was the same stress test applied by the European Banking Authority. Our expectations of a worsening of the economic slowdown in the wake of this scenario are echoed by the Ifo Institute for Economic Research, and other economic experts.

Exhibit 3 illustrates the projected impact of this scenario on banking fortunes in France.

Exhibit 3: Impact of Scenario 2 on Bank Revenue in France



Key Conclusions

The main lesson from these scenario projections is that a higher interest rate level might not be the prime determinant of higher net interest margins, even if higher margins are more attainable when higher rates are in force.

Rather, it is likely to be the spread between short-term and long-term rates that determines the margin evolution, and enables banks to realize any potential gains if their approach is right. In either scenario, a lower spread between short-term and long-term rates limits any positive commercial impact from interest rate rises. (See Exhibit 4).

Let us say a bank granted a loan in 2017 with a fixed interest rate period of seven years at an interest rate of 3.5%. In parallel, a retail customer deposited the same amount for one year at the bank at an interest rate of 0.5%. Hence, the bank recorded a net interest margin of 3.0% from lending out a one-year deposit for seven years.

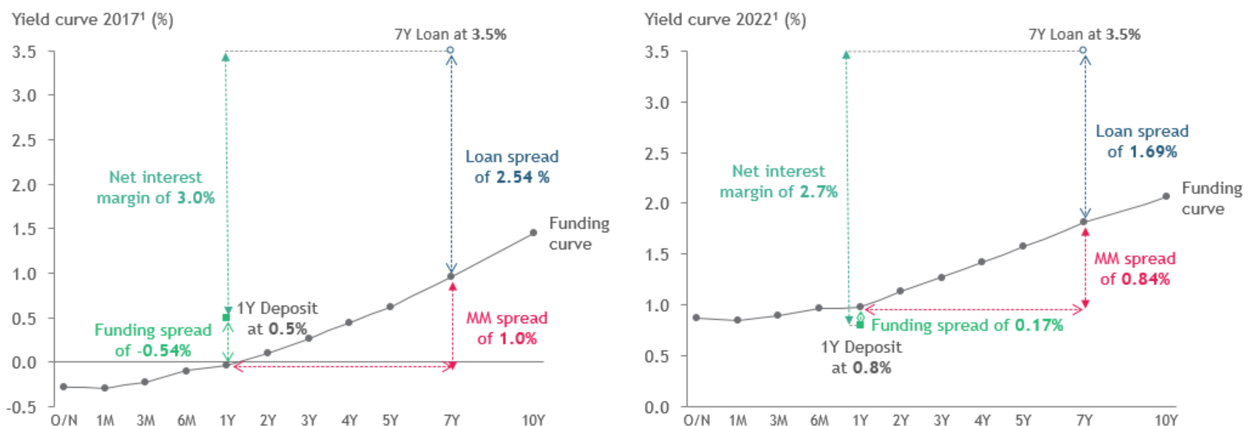
Without this directly-linked customer business, the bank would have to refinance the loan on the capital market for 0.96%, which would earn it a spread on the loan of 2.54%.

The retail deposit could be invested on the capital market for only -0.1%, allowing its funding spread to stand at
-0.6%. Combining both deals, the bank would have only made 1.94% (2.54% less 0.6%). The difference from the actual net interest margin of 3.0% would therefore be 1.06%, which can be attributed to the maturity transformation.

In 2022, the same loan still earns the bank 3.5%. On the deposit side though, the bank has had to increase client interest rates for one-year deposits to 0.8%, squeezing the net interest margin for the bank to 2.7%.

While the funding spread would benefit, the loan spread would suffer from rising interest rates. Both products together would earn the bank 1.86%, resulting in a decreased maturity transformation result of 0.84% due to the flattened yield curve.

Exhibit 4: Impact of Interest Rate Spread on Net Interest Margins



1. Risk-free curve (Interbank rates up to 1y tenor and swap curve for tenors of more than 1y) adjusted for country's banking sector risk
Source: BCG Banking Pools 2018, Bloomberg

Overall, we believe that banks are not preparing sufficiently for adverse scenarios and a major disruption of the market. In a real stress scenario, with an economic recession leading to negative development of GDP, revenues in our sample country France would be affected even more. In such a scenario, we would expect a decrease in revenue of between 3% and 5% per annum.

To prepare for such eventualities, banks have to analyze and understand how these rate rise scenarios might affect their particular circumstances. The potential impact on the balance sheet and profit and loss statement has to be carefully evaluated, especially when contemplating adverse developments in the economic situation,

This assessment should not be limited to a bank's individual situation, but should also take into account how the market as a whole, in individual countries and throughout the entire Eurozone region, might be affected. How would competitors, the regulatory authorities and foreign market investors react?

Of course, when considering the impact of the scenarios set out in this paper, some additional points should also be taken into account.

For example, cross-border business can be a mitigating factor – no bank treasurer will invest only in their domestic market. Some risks would therefore be alleviated through hedging with various counterparties in different currencies, thereby limiting any potential negative impact of interest rate movements in the Eurozone. In addition, some banks may have included stipulations in client agreements to purchase swaps in case of rising interest rates.

Banks still face further challenges however. Stringent regulations on risk-weighted assets and loan loss provisions will place further pressure on profitability, and increase the risk that any economic slowdown would have a substantial negative impact on banks' fortunes. Meanwhile, banks are still burdened by a high cost base resulting from an outdated core banking system, an extensive physical branch network, a low level of digitization, and many complex back-office processes. Such costs are exacerbated by necessary investment in digitalization, and a regulatory environment which creates additional structural costs while also placing pressure on revenue by forcing greater price transparency.

We have already seen that an intensification of competition would swiftly force Eurozone banks to pass on any interest rate rises to savers. More generally, this

competition from direct banks and even non-banks, spurred by the march of digitalization, continues to place substantial pressure on interest margins.

But every disruption, especially if it relates to entire markets, also represents an opportunity. Depending on the outcome of the careful assessment of the market and the bank's own particular situation, there are various ways to tackle the challenges that lie ahead. This could involve the acceleration of ongoing transformation efforts, or the reappraisal of the current business strategy.

Once the bank's own situation has been considered, effective measures could include a customized pricing strategy that is tailored to each individual client. This would allow banks to mitigate the effects of the rising cost of risk, as rates would reflect client-specific risk affinity. At the same time, customized pricing and product portfolios should make banks less vulnerable to changes in the interest environment. Banks could leverage insights from existing data and technology to understand customers' needs and to develop tailored offers.

In general, banks will have to analyze and understand how flexibly they can react to changing market conditions in a stress scenario. If banks are willing to confront these questions and challenges, they will have the chance to alter the course of their business.

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The analyses in this paper are based on data available from the BCG Banking Pools. If you are interested in learning more about this proprietary database, please contact Petra Demski at: demski.petra@bcg.com.

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