Why negative rates are positively scary for the global banking system

By Eric Reguly
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Nine years after the collapse of Lehman Bros., the banking crisis should be dead and buried. It is not. If negative interest rates, the devil child of the European Central Bank and other central banks, endure, the banking industry will enter a new crisis. It looks like it has already started.

Banks are still remarkably fragile creatures even though they might look like the financial equivalent of the nuclear generating industry. Nukes are tightly regulated for safety, with abundant backup systems subject to frequent and thorough inspections. Ditto banks. Regulators oversee their every move. They insist that the banks boost their capital to protect themselves against economic calamity and that investment banking losses do not overwhelm the retail businesses. Every day, banks look more and more like utilities governed by armies of regulators.

But just as an earthquake can cripple an apparently solid nuke, banks are vulnerable to seismic events. In the banks' case, the earthquake is the central banks and their campaign to stoke economies and boost inflation by driving interest rates to zero and into negative territory. The European Central Bank on Thursday left its deposit rate – the rate it charges banks to hold cash reserves at the ECB – at minus 0.4 per cent.

That's bad news for the banks: The ECB gave no indication that interest rates would rise any time soon because growth and inflation rates are stuck in the basement.

Commercial banks make money in a lot of ways. They charge you annoying fees for routine services such as printing cheques or making payments with ATM cards. Some of the biggies make (and lose) fortunes on investment banking, a broad pursuit that includes raising capital for companies through initial public offerings, advising on takeovers and financing leveraged buyouts. But the core business of any commercial bank remains "the spread" – the profit, or net interest margin, between what the banks charge their customers to borrow and what they pay for funding.

That spread is getting crunched at alarming rates, especially in Europe, where negative interest rates are all the rage, pushing down bank profits. New loans are being priced at rates that barely make money for the banks, or no money at all. Meanwhile, the ECB is charging the banks to keep deposits at the ECB and banks are paying more to hold some sovereign bonds than the bonds actually yield. The yield on Friday on German 10-year bonds was minus 0.04 per cent and was 0.5 per cent on equivalent Swiss bonds. Costs are not coming down fast enough to offset the profit and revenue downturn.

In an August report, Deutsche Bank Research noted that net interest margin income of Europe's 13 largest banks fell by 4 per cent in the first half of this year over the same period in 2015. It said that "the longer-term decline in interest income, which has been in place since 2010, seems to have resumed … the outlook is hardly encouraging."

Worse, there is not much the banks can do to end their spread predicament. That's because the banks, more than ever, are creatures of the central banks, which are managing interbank lending rates and credit rates as they impose huge costs on the banks through endless layers of regulation. "We have never seen central banks hold such a grip on the banking market," says Thomas Mayer, founding director of Germany's Flossbach von Storch Research

Institute and Deutsche Bank's former European economist. "This is making the life of credit-extension banks unbearable. They are losing their spread."

Interest rates began to fall rapidly in 2012 and have gone negative in the euro zone, Sweden, Switzerland and Denmark where, bizarrely, some homeowners receive interest on their mortgages instead of paying interest. Sidney Homer and Richard Sylla, the authors of *A History of Interest Rates*, found no other instance of negative rates in 5,000 years. For the banks, the negative interest rates might hit hard at the end of the decade. That's because they're still making profits from old loans. As those loans mature in the next few years and are replaced by narrow-spread loans, profits will take another hit.

Negative interest rates and high regulation costs aren't the only shockers for traditional banks. So is the rise of the financial technology companies (fintech). They will face competition from electronic payment systems. Robo advisers – the digital wealth-management platforms that measure a retail client's level of risk and allocate their investment portfolios accordingly, all at fees the banks can't match – are proliferating.

The threatened business model might force the banks that survive into a strategic U-turn and embrace investment banking again. And wouldn't that be ironic? Regulators everywhere have been encouraging banks to rein in their investment banks and erect regulatory barriers around them so they don't wreck the rest of the bank if they lose fortunes or fail. A few big banks are giving investment bankers and traders and their hefty bonuses the meat-cleaver treatment.

If the business of credit extension is dying, a new profit centre will have to replace it. Central bankers might bring investment banks back to life. But before that happens, there will be a lot of casualties in the apparently never ending bank crisis.