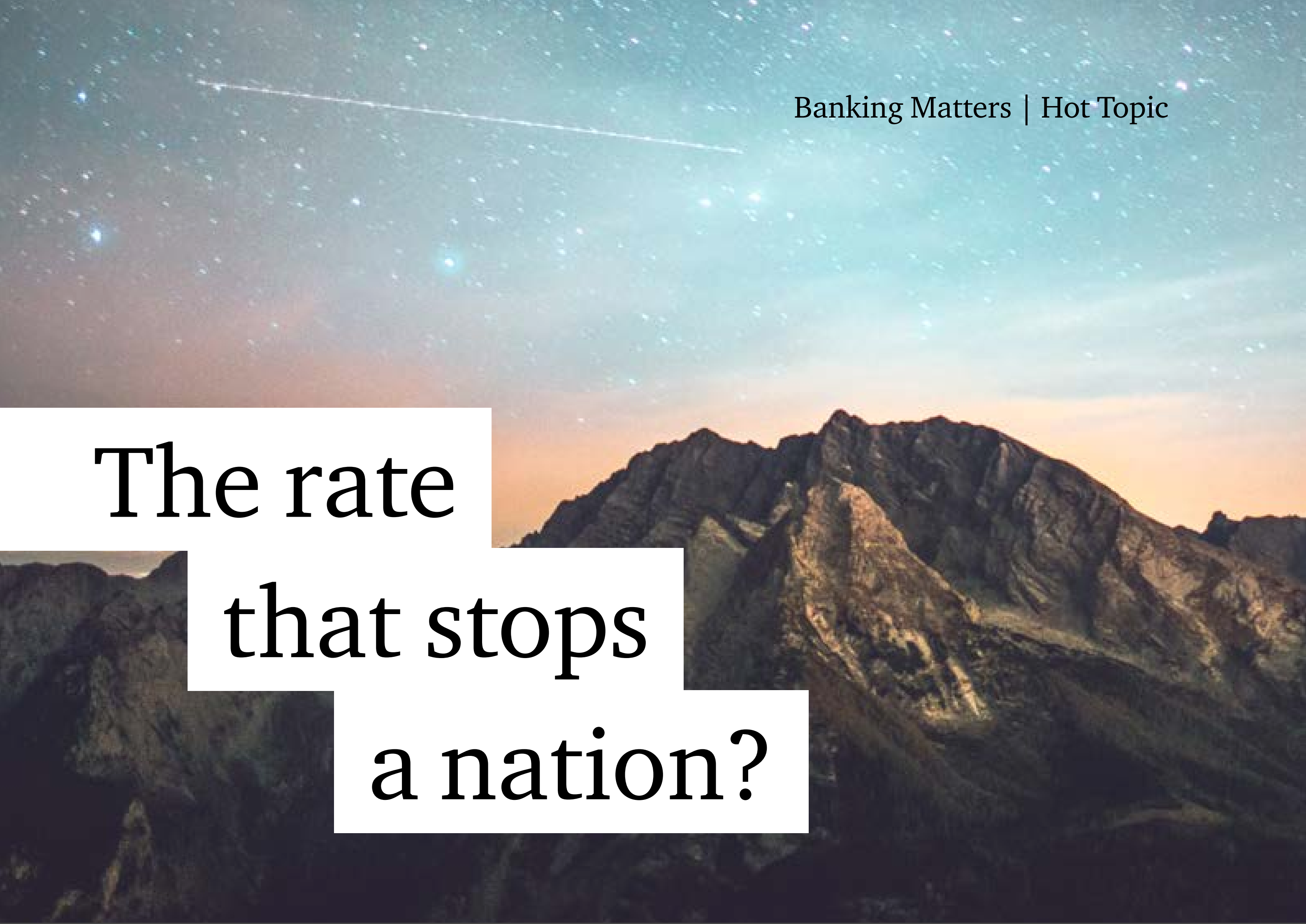


The rate that stops a nation?

Preparing for lower or even negative rates in Australia

On Melbourne Cup Day, many bankers breathed a sigh of relief when the Reserve Bank of Australia (RBA) announced a pause in the rate cutting which has taken the cash rate to 0.75% and which many expect to go further to 0.25% next year. Although the RBA downplays the possibility, its actions over the past six months force Australians to confront the very real scenario of interest rates going to zero or below – something that has already occurred overseas.

How can this be? And how does capitalism work in a world of negative interest rates (NIR) where borrowers get paid to take out a loan?

The short answer is: negative rates are possible – and yes, capitalism still works – but not in the same way.

Australian banks, investors, businesses and other stakeholders need to understand how negative rates are possible, what they mean for them, and how to prepare for a future economy which will look very different from the one they've known for a long time.

The good news for banks is that, aside from a number of technical challenges, the strategic imperatives for banks in a low-rate environment are not that different from the ones they face today:

- Consolidate and simplify to improve productivity,
- Build up services that customers value, and
- Make judicious choices about which customers and risks to focus on.

The bad news: low rates compress the time available to make the transition, and lower the margin for error along the way. If sustained, low rates could result in a profound realignment of the competitive landscape. Some players (including, we suspect, a number of new entrants) may find they have the agility to thrive in a leaner environment, whilst others do not.

Negative interest rates are a real possibility

Alongside its Cup Day announcement that it would hold rates steady, the RBA released a statement making it clear it was 'prepared to ease monetary policy further if needed'[1]. With the global economy in its tenth year of expansion, not to mention a daunting assortment of geopolitical risks, the likelihood that conditions may deteriorate is high. What's more, the minutes of the RBA's board meeting imply that November's decision *not* to cut was a close call[2]. This suggests that rate cutting could resume as early as December. What's more, the RBA also made clear that whatever reservations it may have about *negative* rates, decisions about what's best for the Australian economy cannot be made in isolation from the global macroeconomic context. If rates overseas continue to fall, they suggest, rates in Australia may have to as well. Presumably, this would be even more imperative in the next recession. Below we provide four key points about negative interest rates.

1. Capitalism won't break

There is nothing impossible about NIR. Zero is just another number in principle, so there exists no intrinsic reason why low or even negative rates must return to 'normal' any time soon. What's more, notwithstanding assurances to the contrary, as mentioned above, there is no reason to believe this cannot or will not happen in Australia.

2. Negative rates present challenges to the financial system and to the economy

Low and negative rates reflect a view of the long-term future which is far less optimistic than it has ever been. Advocates believe that negative rates reflect economic reality, and that the world would be worse without them. Whether they are right or wrong, the consequences of negative rates may leave us with a financial system and global economy that is smaller, less productive and less robust than the one to which we have become accustomed.

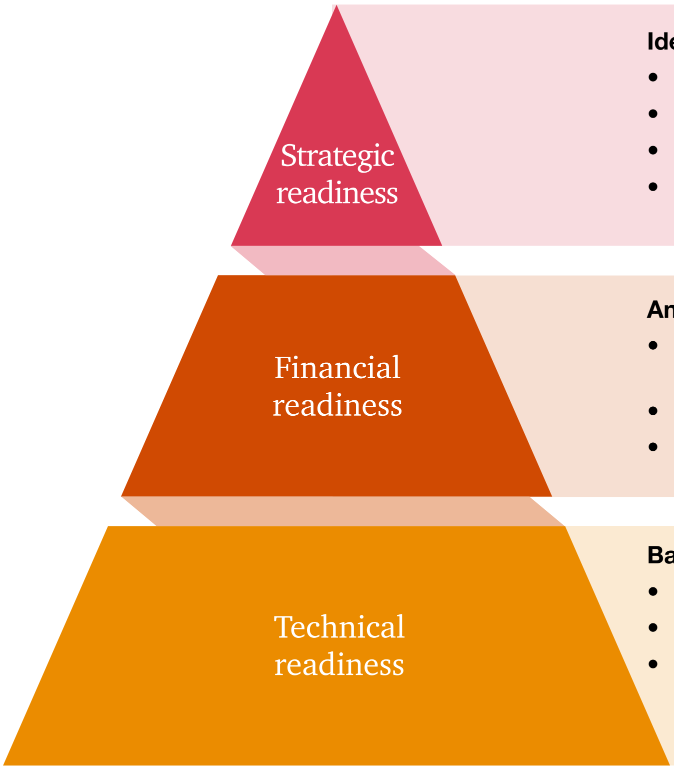
3. Three kinds of readiness required

The consequences of negative rates will affect every customer, counterparty and stakeholder. To be ready, banks should prepare in three ways. First, technical readiness will address the likely challenges to systems and processes. Second, financial readiness will address the likely impact on the balance sheet and profit and loss. And third, strategic readiness will lay out the fundamental business model and franchise choices to be made. These are illustrated in **exhibit 1.**

1 Statement of Monetary Policy, Reserve Bank of Australia, November 2019.

2 Minutes of the Monetary Policy Meeting of the Reserve Bank Board, Reserve Bank of Australia, 5 November 2019

Exhibit 1: Technical, financial and strategic readiness required



Identifying and making choices

- Alternative strategies for customer segmentation and risk selection
- New business / service models approach to pricing for them
- Changes to operating model and business architecture
- Implications for customers, employees and other stakeholders (especially government and regulator)

Analysing future scenarios – understanding what is to come

- Understand implications for each element of P&L and balance sheet
- 'Running numbers' to synthesise overall result
- Identifying points of vulnerability and notable risks

Battening down hatches – no choice

- Y2K style readiness for every system and process
- Downside risk mitigation
- May require specialist expertise where assumptions not obvious (e.g. use of Cox-Ingersoll Ross model for interest rate diffusion)

4. Getting started: no-regrets actions to take

Regardless of the outlook for rates, there are a number of steps for banks and their stakeholders to undertake today which will serve them in good stead. These include:

- Ensuring readiness (as described above),
- Getting fit to compete by addressing cost structure, simplicity of operating model, and strength of credit portfolio and balance sheet,
- Positioning to thrive by identifying the services customers value, and
- Identifying the customer segments aligned to the uniqueness of each bank's franchise (and prepared to pay for the services mentioned above) as well as the partnerships and capabilities required to deliver.

See **exhibit 2** for the key actions to consider.

Exhibit 2: Imperatives for everyone throughout enterprise

	Technical readiness	Financial readiness	Strategic readiness
Customer and channel management	Capability of origination, product, marketing and reporting systems Contractual formulae (break / exit fees, payouts, etc.) and product disclosure Training of front-line staff Protocol for waiver of floors	Modelling / understanding of customer and third-party partner impacts Margin, cash flow and profitability analysis per channel and segment (inc. dynamic 'break-even' modelling per product)	Customer / partner needs assessment and opportunities to support Consideration for customers with ineffective hedges or other unexpected outcomes Plan for communications to customers / partners
Pricing and product management	Capability of origination, product, marketing and reporting systems	Margin, cash flow and profitability analysis per product (inc. dynamic 'break-even' modelling per product)	Service-fee protection plan (waiver discretions on existing fees, plus new services and fees) Implementation of negative interest (payment vs balance amortisation) Plan for third-party commissions
Finance, risk and balance sheet management (inc. prop trading)	Models for pricing, origination and risk / regulatory reporting Training of traders, market makers and others on new model framework Transparency of embedded options (e.g. rate floors)	Response plan if deposits flee sector (esp. liquidity coverage ratio rules) Dynamic 'break-even' deposit rate analysis (incl margin and liquidity coverage ratio impact) Approach to delta-hedging interest rates near zero 'discontinuity'	Credit risk modelling without payment behaviour Loan-loss and liquidity coverage ratio models to be recalibrated Suitability of business counterparty credit limits / covenants (e.g. debt / earnings before interest, tax, depreciation and amortisation)
Technology and operations	Training of customer-service / contact centre personnel Capability of origination, product, marketing, reporting and ledger systems Error corrections and overrides	Operational capacity allocation (e.g. deposit vs loan origination)	Investment planning / hurdle rates

Interested in reading more?

Continue reading our full Hot Topic publication for a broader economic view on negative interest rates, an exploration of some of the serious challenges for the financial system and further details on the practical steps to undertake when considering a world with negative interest rates.

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