

# Overview of legal and regulatory aspects of negative interest rates in the Eurozone

A Background Briefing  
from our Eurozone Hub

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## **QuickTake:**

The prolonged negative interest rate environment has posed some unique challenges to banks of all sizes in the Eurozone in terms of legal, regulatory and consumer protection constraints. Amongst other pressures, banks will now also need to provide clients, notably retail clients, with ample notice of their intention to change the interest rate from a positive (or zero) rate into a negative one.

From a legal perspective, such a change is likely to be free from the risk of litigation and/or regulatory intervention certainly in Germany, as one of the larger Eurozone economies and a deep established retail market for financial services, the current view considers only individually negotiated and agreed contracts with new customers as a relatively safe option free from risk of litigation and/or intervention from regulators and/or consumer protection bodies.

# Introduction

This Background Briefing looks at the consequences of the negative interest rates in the Eurozone, in particular Germany given recent legal challenges and more specifically focuses on the corresponding legal and regulatory aspects and should be read in conjunction with related coverage from our Eurozone Hub.<sup>1</sup> This Background Briefing may be supplemented by Client Alerts or further client-only White Papers notably as we expect that in the EU, if moving to a more invasive NIRP may require further legal, tax and regulatory changes, that this may be beyond the ECB's own central bank and rule-making mandate.

With COVID-19 responses across many jurisdictions increasingly looking at the use of negative interest rates and extraordinary monetary policy including through asset purchases, financial institutions, notably outside of the EU-27, such as those in North America, the UK and Asia-Pacific region may wish to take note of some of the lessons learned in the EU and prepare accordingly. In the wake of COVID-19 negative rates may be on their way to those markets as well.

The European Central Bank (**ECB**)'s key interest rate, the Deposit Facility Rate (**DFR**) became negative in June 2014 and has remained negative ever since. The last decrease took place in September 2019, when the ECB lowered its DFR by 10 basis points to -0.50%. While the Governing Council of the ECB expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics in keeping with pre-COVID-19 projections and measures,

times and the outlook of economic recovery are changing. Inflation is sinking as consumers rein in their spending including as lockdowns shutter the economy.

If rates are set to remain lower for longer - and they could go lower still<sup>2</sup> - then the economic impact of the current and possibly prolonged pandemic preparedness measures<sup>3</sup> will likely continue and add complexity to how banks and their clients cope with negative rates. As part of the ECB's second phase of COVID-19 support the central bank announced<sup>4</sup> on April 30, 2020 a stark departure from consensus on agreed boundaries of extraordinary monetary policy activity. This was supplemented by further action, notably in upsizing the Pandemic Emergency Preparedness Programme (**PEPP**) by further 600 billion euro to an overall target size, at November 11, 2020, of 1,350 billion euro as well as decoupling the interest rates used as part of extraordinary monetary policy from main policy rates and thus running with dual interest rates, permits the ECB flexibility.

As part of this new shift in approach, the ECB will also provide commercial banks with access to its new pandemic emergency longer-term refinancing operations (**PELTRO**)<sup>5</sup> for liquidity support provided at rates as low as negative 1%, so long as the money banks borrow gets passed on via loans to businesses and consumers. The interest rate on all of the existing targeted longer-term refinancing operations (**TLTRO III**) will run at -0.5% (a further reduction of 25 basis points) from June 2020 to June 2021 (and perhaps beyond). Banks that met the March 2020 lending thresholds may be subject to an interest rate of -1%.

1 Available [here](#).

2 Particularly to support the breadth of fiscal support and regulatory relief measures see our coverage from Dentons' Eurozone Hub available [here](#).

3 See coverage available [here](#).

4 See statement available [here](#).

5 See details [here](#).

The ECB's measures, while necessary represent a significant firepower being deployed via monetary policy transmission channels that complement negative interest rate policies (**NIRPs**). In summary, NIRP's policy aims are supposed to transmit through various channels from the central bank and through commercial banks to a situation in which "loans pay money and savers lose money". This in turn is supposed to support a drive in demand for loans, which in turn incentivizes spending and investment and thus growth in the "real economy". With a continued absence of a joined up EU fiscal policy, hope still remains on central bank-led action notably through NIRPs and extraordinary asset purchase programs to complement the EU's own spending efforts to help spin-up the economic recovery.

With the ECB's December 2020 monetary policy meeting in focus, further changes to NIRPs and DFR levels could be well ahead as the EU looks to relaunch spending and growth following renewed waves of COVID-19 driven lockdowns. A key challenge to that approach is that many banks household and small business lending is beginning to tighten and mortgage and credit card loan rates are beginning to increase. This is due not least because of individual firm specific pressures, but equally due to new post-GFC regulatory reforms, such as those of the European Banking Authority's Loan Origination and Monitoring Guidelines<sup>6</sup> putting pressure on lenders to be more prudent. In summary, this squeezes the low to middle-income households' access to credit from existing banks but now increasingly also alternative lenders.

Other European central banks such as Denmark, Sweden and Hungary (in the EU but outside the Eurozone) and those that are closely linked to the EU, such as Switzerland, have taken similar measures to introduce NIRPs due to pressures in their own domestic markets but largely due to spillover effects taken in the larger market i.e., the ECB's actions in respect of its DFR which applies to the Eurozone's 19 (soon to be 21) jurisdictions. The UK's Bank of England began considering its NIRP options during August 2020 as a means to future-proof sufficient firepower against COVID-19's challenges.<sup>7</sup>

All European Union based central banks, save for the Swedish Riksbank, have been clear in their pre-COVID-19 related monetary policy communications and/or forward guidance that they plan to go "lower for longer" to support a return to inflation growth and economic conditions. This is likely to be the case as evidence from industry and academic studies in jurisdictions that have introduced NIRPs demonstrate that the aims have largely been satisfied i.e., NIRPs are seen, certainly by central banking economists, as vital tools to foster spending and thus economic growth. Certainty that a NIRP is going lower for longer ought to, in principle, encourage businesses and households to borrow and spend more, exactly what is needed to stimulate an economy in deep recession, if they know, with reasonable certainty that rates (assuming these are passed on) will remain at current low levels for a period of time. This also can lead to fueling in asset-prices and ultimately risk of bubbles, as evidenced notably in certain EU jurisdictions residential real estate markets irrespective of whether negative interest rate mortgages exist or not.<sup>8</sup>

Investors and savers may be less prone to agreeing with policymakers on such points and many borrowers, including some home loan/mortgage borrowers may see this differently as not all products available from providers are solely linked to the DFR or other "standard" rates including inter-bank offer rates (**IBORs**). The outcry of the damaging effect of zero lower-bound rates (**ZLBs**) and NIRPs from consumers but also large non-financial corporates has long persisted since 2014. This outcry pushes political and public backlash inasmuch as it also may incentivize, notably during economic uncertainty, such as that caused by COVID-19 for many to hold cash physically or outside of the financial system i.e., at an effective interest rate of zero.

Where money is "mattressed" held in cash i.e. outside of the financial system or in decentralized digital assets including virtual currencies (as opposed to kept in bank accounts or otherwise invested in yield-generating asset classes) this squeezes the net interest income of those offering accounts, a reduction in their profitability and in turn a potential reduced willingness to lend.

<sup>6</sup> See standalone coverage from our Eurozone Hub on this development available [here](#).

<sup>7</sup> While the Bank of England governor, Andrew Bailey has during August and September 2020 downplayed the likelihood of the use of NIRP, including stating as a House of Lords Economic Affairs Committee that "It would be a cardinal sin on our part if we said something was in the toolbox which we didn't know if it actually worked." Some banks have also highlighted that they may have ways to go in preparing for the breadth of technical and contractual issues that NIRPs bring with them.

<sup>8</sup> A negative interest rate mortgage, notably as first offered by certain Danish banks, rewards borrowers as the balance due is reduced over time.

This defeats the very purpose and aims of NIRP to begin with and thus merits central banks but also commercial banks balancing the needs, objectives and behaviors of all stakeholders. Some of this may also be viewed in the context of when a ZLB is replaced by an effective lower bound that in turn coincides closely with what is referred to as the “reversal rate”. The “reversal rate” indicates to the level of additional policy cuts would start to become contractionary, or the rate at which holding cash, net of storage and security costs become more attractive than holding bank deposits.

The economic pressures posed by COVID-19 and its impact on the economic outlook have, despite support measures taken by the ECB, EU and also at the national-level, returned to the question of “how low can rates go and equally what happens if they go up?” This question is also one being raised by a whole new generation of bankers but also economists, central bankers and supervisors, that may, certainly since the worst of the 2008 financial crisis (the **GFC**) be unfamiliar with rates as they existed prior to the GFC or indeed base rates during the 1970s.

Central banks, such as the ECB in the Eurozone, generally use NIRPs as a tool to provide additional monetary policy stimulus, by, in theory, reducing banks’ direct wholesale funding costs, as well as serving to stabilize inflation expectations, support growth by encouraging borrowing and spending and relieving FX rate pressures. Non-bank financial institutions (**NBFIs**), may also be affected either due to their banks being affected or NBFIs themselves coming under their own pressures to implement NIRPs.





## The impact of NIRPs and the new “new normal”

The impact on commercial banks of NIRP varies according to a bank's business model– notably the products and customer types it transacts with. Evidence in Europe generally suggests that smaller banks, which may be focused on domestic loans and deposits, are often hurt more than larger banks, which tend to be more diversified across currencies and have a larger share of fee generating business. Part of this may be explained by the availability of funding channels and the importance of the deposit base. Consequently, smaller banks, which are more reliant on a “steady” deposit base and less on interbank funding channels, may be more hesitant to impose negative interest rates on depositors to prevent a loss of their deposit base.

As a more general observation, banks operating in the EU regardless of their size and business type have however used recent years to prepare for the long-term effects of negative interest rates and extraordinary monetary policy measures including quantitative easing that beyond just affecting funding and market conditions also impact a bank's regulatory capital requirements but equally banks'

profitability. Some of these preparatory measures have seen banks in some cases increase their fees for services related to a product or a relationship to compensate for lower margins including narrowing net interest margins – the gap between commercial banks' lending activity and deposit rates. Much of this may also factor on the return a bank can achieve from assets it is required to hold, including for regulatory capital purposes, with a central bank.

Banks have to hold significant amounts of high-quality liquid assets (**HQLA**) to fulfill reserve requirements and those set by the liquidity-coverage ratio.<sup>9</sup> These assets predominantly consist of central-bank reserves or government bonds that (at the time of writing) are likely to mostly have negative yields. New regulatory requirements for term funding may extend the duration of liabilities requiring matching asset duration even more. Furthermore, the stability of new deposits – and thus their eligibility for maturity transformation – has become less certain.

<sup>9</sup> As an example, assume a retail customer deposits EUR 1,000 into a current account, i.e., a checking account at its bank. That bank is regulated by prudential requirements set at law and central bank requirements on what it can do with its funds and what needs to be held in HQLA. If a minimum reserve requirement is 10% the commercial bank would need to hold EUR 100 of the EUR 1,000 deposit in HQLA and could only lend out the remaining EUR 900. In times of economic uncertainty, the commercial bank may decide to or may be forced to hold more than the minimum reserve requirement thus reducing the EUR 900 available for lending to say EUR 700. To encourage the commercial bank to lend the central bank imposes a negative interest (i.e., penalty (-0.50%) held on voluntarily held excess reserves. To reduce the impact of this penalty the commercial bank has to keep its excess reserves at a minimum. It can lend the excess reserves (which is what the central bank wishes it to do), but it can also use the funds to purchase financial instruments that generate a yield.



This perceived decline in profitability may also be a factor that influences market concerns and thus a decline in Eurozone financial services providers' equity prices since mid-2015 – particularly amongst banks and insurers. Similar pressures have also been reflected in the portfolios of institutional investors, including insurance companies, asset managers, pension, mutual and sovereign wealth funds that often (are required to) maintain portfolios with a concentration of sovereign bond holdings in order to achieve stable, risk-adjusted returns to meet their long-term obligations. Prudential requirements and investment guidelines that apply to such firms have influenced the ability to hold such negative interest bearing assets as well as the products they in turn offer their clients.

In addition to the issues discussed above, NIRP, while supposed to incentivize borrowing and spending as opposed to hoarding of cash and near-cash equivalents has also raised concerns amongst central bank policymakers, financial services firms and ultimately corporates as to what happens when NIRP does not encourage such activity.

Many more prudent corporate treasurers have since the 2008 financial crisis sought to diversify their funding channels (moving to NBFIs facilities, including credit funds) and more broadly to build up or otherwise conserve their cash balances. Some have borrowed to build-up such reserves or obtained stand-by credit facilities. While welcome in terms of prudent planning, this does not translate into the spending component needed to make NIRP work in reinvigorating growth. Instead, this contributes to

a theoretical liquidity trap, which worsens if overall economic confidence worsens.

While NIRPs has been largely classified by banks and NBFIs as a risk to their operating environment, such risks, even if in the power of central banks and have also been highlighted by financial market supervisors, including the ECB acting in its role at the helm of the Single Supervisory Mechanism (**SSM**) component of the Eurozone's Banking Union, as a key supervisory priority and concern. Any action by affected financial services firms in respect of counterparties and clients as been largely firm-specific. These issues are explored in turn below and may also be supplemented by measures taken to respond to regulatory changes that further put pressure on banks' operations in an environment where NIRPs moved in 2014-2016 from the new "new normal" largely in 2017 to present to the "implemented normality". The impact of NIRPs is now increasingly being tested and assessed by the ECB, largely as sufficient data of the effects are now available but equally since the ECB had planned, as promised by current ECB President Lagarde, to carry out a "Strategic Review" of its monetary policy toolkit and the efficacy of deployment during 2020 – the first since the ECB's monetary policy strategy was adopted in 1998 and some of its elements in terms of strategy, models and methodology were clarified in 2003 prior to extraordinary monetary policy being put in place under the direction of ECB President Trichet in response to the GFC and then President Draghi pledging to do "whatever it takes" during the 2012 Eurozone Sovereign Debt Crisis.



In the ECB's own words: "Since 2003 the euro area and the world economy have been undergoing profound structural changes. Declining trend growth, on the back of slowing productivity and an aging population, as well as the legacy of the financial crisis, have driven interest rates down, reducing the scope for the ECB and other central banks to ease monetary policy by conventional instruments in the face of adverse cyclical developments. In addition, addressing low inflation is different from the historical challenge of addressing high inflation. The threat to environmental sustainability, rapid digitalization, globalization and evolving financial structures have further transformed the environment in which monetary policy operates, including the dynamics of inflation."

Some of the macroeconomic (but not the legal and regulatory) issues raised above have been discussed by academic literature as well as in the ECB's own "Working Paper Series – Negative Interest rates, excess liquidity and retail deposits: banks' reaction to unconventional monetary policy in the Eurozone" as well as "Working Paper Series – Monetary policy transmission to mortgages in a negative interest rate environment"<sup>10</sup> published in February and May 2019.

This analysis was supplemented by research by Miguel Boucinha and Lorenzo Burlon in "Negative rates and the transmission of monetary policy"<sup>11</sup> published as part of the ECB Economic Bulletin in May 2020 concluding NIRP and in 2014 the then "new" transmission channels had supported economic activity, largely through increased lending and contributed to price stability – somewhat to be expected in the ECB's official economic bulletin. In contrast, commentary on the impact of NIRP on banks' investment priorities by Johannes Bubeck, Angela Maddaloni and Jose Luis-Peydro in "Research Bulletin No. 70 – Do banks invest in riskier securities in response to negative central bank interest rates?"<sup>12</sup> concluded, that despite perceptions, market participants' priorities in a NIRP environment and a resulting search for yield differ due to their risk tolerance.

Robin Doetling's analysis assessed these questions in relation to bank regulatory capital requirements in the June 2020 "Working Paper Series – Bank capital regulation in a zero interest environment"<sup>13</sup> which proposes a "dynamic banking model to analyze how the zero lower bound (**ZLB**) on deposit rates affects optimal bank capital regulation and risk-taking. On August 26, 2020, ECB Executive Board Member, Dr. Isabel Schnabel reflected in her speech "Going negative: the ECB's experience" at the 35th Congress of the European Economic Association<sup>14</sup> that the ECB's cautious lowering of the DFR arguing that generally the ECB's NIRP and "transmission of negative rates..., in combination with other policy measures have been effective in stimulating the economy and raising inflation." and going further to state that "On balance, the positive effects of the NIRP have exceeded their side effects, in particular when taking into account the compensating effects of other policy innovations, such as the two-tier system and our targeted longer-term refinancing operations (**TLTROs**). At the same time, like with other unconventional policy measures, side effects are likely to increase over time, if the negative interest rate environment were to persist for too long. As negative

<sup>10</sup> Available [here](#) and [here](#).

<sup>11</sup> Available [here](#).

<sup>12</sup> Available [here](#).

<sup>13</sup> Available [here](#).

<sup>14</sup> Text of the speech is available [here](#).



rates are, by and large, a reflection of broader slow-moving adverse macroeconomic trends, the pandemic is a wake-up call for governments to foster innovation and potential growth, and to reap the benefits from further European integration.”

While these statements may be unsurprising, there is little offered in how to fix the following problems:

“Since banks are generally reluctant to pass on negative rates to their retail clients, mainly for competitive, but also for legal reasons, the funding conditions of deposit-taking institutions typically fail to drop in tandem with the decline in lending rates. This affects banks’ interest margins and hence profitability. This effect is particularly pronounced for banks with a high deposit-to-asset ratio. Financial market participants seem to have internalised this constraint. Studies document that a surprise hike in the policy rate has a negative effect on banks’ stock prices in normal times, but a *positive* effect in an environment of negative policy rates, which is increasing in the dependence of banks on deposits as a source of funding.”

Dr. Schnabel stated in her speech that there is “... considerable uncertainty as to the precise level of the “reversal rate” and current estimates suggest

that the ECB has not reached the effective lower bound.” To some this might suggest further cautious action ahead as she concluded that only a very small proportion of retail deposits are remunerated at negative rates. That population is growing as are the level of wholesale deposits of non-financial corporates that are subject to negative interest rates. Some of this was also explored in the economic model and analysis presented in ECB Working Paper Series 2847 “Reversal interest rate and macroprudential policy”<sup>15</sup>, which while not an official expression of the ECB’s views, does show the analysis of leading staff members assessing these salient issues and the interplay with macroprudential policy, notably countercyclical buffers. The authors of this paper conclude that:

“The prolonged period of ultra low interest rates in the euro area and other advanced economies has raised concerns that further monetary policy accommodation could entail the opposite effect than what is intended. Specifically, there is a risk that for very low policy rates a further monetary policy loosening might have contractionary effects. The policy rate enters a “reversal interest rate” territory, in which the usual monetary transmission mechanism through the banking sector breaks down.”

15 Available [here](#)

The authors go on to state that:

“In this paper, we show that a less well-capitalized banking sector amplifies the likelihood of encountering the reversal interest rate. This gives rise to a new motive for macro-prudential policy. Building up macroprudential policy space in good times to support the bank lending channel of monetary policy, for instance in the form of a countercyclical capital buffer, mitigates the risk of monetary policy hitting a reversal rate territory, or alleviates the negative implications if it does.

A key feature in understanding the potential threat of a reversal rate is the behaviour of different interest rates. The ECB deposit facility rate [i.e. the DFR], which is one of the key policy rates, and the average bank retail deposit rate paid to households co-moved strongly during the 2000s. Afterwards, the two rates decoupled substantially, highlighted by the fact that the deposit rate is still positive in 2019, whereas the policy rate is already negative. In contrast to this, the interest on government bonds followed closely the ECB deposit facility rate. This suggests that in an environment of very low interest rates the impact of the policy rate on retail and market interest rates can have negative repercussions on bank balance sheets through a declining deposit rate pass-through and losses on government bond holdings, which can potentially weaken the effectiveness bank lending channel of monetary policy transmission.”

In terms of the use of macroprudential policy, notably counter-cyclical buffers<sup>16</sup> in connection with the reversal interest rate, the authors conclude that:

“Using a newly developed non-linear macroeconomic model that captures the outlined stylized facts, we demonstrate the conditions where such a reversal rate could materialize. The model contains a carefully designed banking sector with three key features. First, banks are assumed to be capital constrained. Second, the banks have market power in setting the deposit rate. While the banks have market power for the

deposit rate in good times, the market power depletes if the policy rate approaches a negative environment. As a consequence, monetary policy affects the deposit rate less if interest rates are low. Third, the banks face requirements to hold low risk government assets for a fraction of their funding based on regulatory constraints. The key prediction of the model is that the effect of a monetary policy loosening is ambiguous in an environment of very low interest rates. We show that the model endogenously determines the reversal interest rate in a region of around minus one percent.”

The authors conclude their analysis that (notably there is no mention of the role of fiscal policy) in stating that the macroprudential provisioning in the good times, including through a build-up of the countercyclical buffer (i.e. saving against bad times) has the “...potential to alleviate and mitigate the risks of entering reversal interest rate territory.” Moreover, a closer link between monetary policy and countercyclical capital-based macroprudential policy can improve the effectiveness of monetary policy and thus financial stability so that all of these pillars are self-reinforcing on one another.

While the above, notably the analysis in the respective Working Paper Series contributions are “just” a model<sup>1</sup>, and one that is not endorsed per se, it does come during a period when the ECB is, even with COVID-19 having postponed its “Strategic Review”. Doetling’s analysis, as well as that in Working Paper Series 2487 and Dr. Schnabel’s statements are nevertheless indicative of some of the debate that might shape the future of how the ECB pursues its NIRP aims going forward. This applies both in terms of monetary policy and regulatory/supervisory priorities on banks in the Eurozone but also with respect to ultimately inflation targets as well as whether financial stability should be a more pronounced ECB – central bank goal as opposed to being in the main remit of the European Systemic Risk Board and supervisory mandate of the ECB.

<sup>16</sup> The Basel Committee on Banking Supervision prescribes that a counter-cyclical buffer is built up during a phase of credit expansion and can then subsequently be released during a downturn. The authors of WPS 2487 propose that macroprudential policy can lower the probability of hitting the reversal interest rate. “The banking sector builds up additional equity in good times, which can then be released during a recession. Having accumulated additional capital buffers during good times, the negative impact on the banks’ balance sheets of a reduction of monetary policy rates is dampened in a low interest rate environment. Consequently, monetary policy becomes more effective during economic downturns and the reversal interest rate is less likely to materialize, which improves overall welfare. In the context of a “lower for longer” interest rate environment, the risk of entering a reversal interest rate territory creates a new motive for macroprudential policy as it can help to strengthen the bank lending channel.”

# Regulatory pressure on banks

Banks have to hold significant amounts of high-quality liquid assets (**HQLA**) to fulfill requirements set in their legal minimum reserve requirements, including the liquidity-coverage ratio, as well as to settle interbank transactions. These assets predominantly consist of central-bank reserves or government bonds that since the introduction of NIRP mostly have negative yields. The post-2008 as well as the more recent regulatory requirements for term funding may extend the duration of liabilities requiring matching asset duration even more. Furthermore, the stability of new deposits – and thus their eligibility for maturity transformation – has become less certain.

NIRPs in practice when deployed means that central banks effectively charge, instead of paying, commercial banks for holding excess (cash) reserves with the central bank. These challenges have continued to grow for banks (and their customers) faced with a lack of investment combined with abundant savings and a diminishing pool of highly-rated low-risk fixed income assets and a diminishing real rate of interest.

To counteract some of these pressures since NIRPs were introduced both banks and non-bank financial intermediaries and investors have been under pressure for yield. Some may have been, certainly in the eye of financial market supervisors, been pressured to take excessive risk, which may contribute to the formation of asset bubbles that may not be sufficiently resilient against readjustments or, as COVID-19 has demonstrated, “pandemic proofed”. These issues not only pose problems in search of solutions for market participants but also the macroeconomic policymakers such as the ECB that has called upon fiscal policymakers for coordinated action to replace NIRP.

NIRP also poses challenges for central bank’s now quite new role where the EU’s economy might need massive targeted investment to support businesses in the “real economy” just to survive, especially if predicted contraction in the Eurozone alone could amount to 12% of GDP. NIRP may make that situation easier but it will also shift the traditional financial priorities of businesses but also of consumers of when to borrow and when to save.



# Repricing of deposits

One of the obvious areas of countermeasures relates to the liability side of the bank's balance sheet and consists in particular in the repricing of deposits. Due to legal, regulatory and consumer protection constraints, there is a marked difference between wholesale and retail banking deposits. This is discussed in the following paragraphs.

There are however, some common elements on how NIRP affects depositors, notably that NIRP may encourage a deposit outflow whereby the depositor holds<sup>17</sup> cash (thereby avoiding penalties even if it earns nothing). The outflows may either involve a depositor splitting larger sums into smaller amounts, so as to avoid penalties on sums when held in an account; transferring deposits from current to other savings accounts which are (currently) free from penalties but may instead have lock-ups; or ultimately converting the holding of cash into holdings of HQLA with near-cash properties. Equally, some depositors also more, given that the prospect of lower yields increases incentives to participate in investments with higher yield and a higher risk profile, may move to invest the deposits. While some of the may be welcome, this may also cause a risk propagation channel in its own right when firms are scrambling for cash to meet liabilities during economic stress.

## Wholesale banking

Some banks in the Eurozone started to charge negative rates on corporate depositors after the ECB's DFR became negative in June 2014. According to data of the ECB<sup>18</sup>, on average, interest rates became negative for around 5% of total deposits and around 20% of corporate deposits in the Eurozone as a whole. The picture in countries less affected by the sovereign debt crisis and with a stable banking industry looked somewhat different. In Germany for example, deposits remunerated below zero accounted for 15% of total deposits and around 50% of enterprises' deposits, according to data of the ECB.

Given that the deposit contract between the bank and the corporate depositor is typically negotiated individually, there is a general understanding amongst legal commentators, that such agreements are valid and binding.

A few banks even lowered the interest rate on corporate deposits below the ECB's Deposit Facility Rate and thus generated revenues using its least risky asset class. This however has remained an exception and it has obviously created a backlash from corporate treasurers asking that the banks in turn pay negative interest rates to a corporate where its bank accounts are in overdraft.

## Retail banking

The retail banking space looks very different compared to wholesale deposits. Banks are very cautious from a business and reputational perspective, to introduce negative interest rates for retail customers (which may also include high-net worth individuals in private banking product lines as well as certain small-to-medium sized enterprises that are treated as retail clients). The threat of negative interest on sight i.e. on-demand deposits (current accounts and overnight savers) or longer-term savings deposits originally attracted very vocal comments from consumer protection bodies and political opponents that cite fair and equitable treatment of retail savers and investors in light of banks reducing savings rates payable but not necessarily markedly reducing lending rates and fees that would be repayable – even though most consumer credit lending and retail mortgage interest rates have fallen since 2014. However, as NIRP has become commonplace in Europe and certainly the Eurozone attitudes have shifted. According to German consumer product comparison portal Verivox, 80 banks have published negative interest rate policies on their websites or price lists. This number rose from 41 in February 2020 to 80 in April 2020 and from 7 to 16 of which now apply this policy to small sub-100,000 euro deposits.

17 In the case of many retail clients, physically holding cash. It should be noted that the ECB's decision in 2014 to phase out the new issuance (but not the circulation and acceptance of the) EUR 500 banknote completely following a move from the first to second series of banknotes, while justified on the premise that it would limit financial crime, left the EUR 200 banknote as the highest denomination (even though it is quite rare) and the more commonly available EUR 100 banknote. The availability of bank notes and high denominations has an impact on the costs of physical storage of cash.

18 Working paper No 2289 / June 2019 available [here](#).

A second point to consider is that a different legal regime applies to retail banking products (irrespective of whether the client is treated as a retail client for EU regulatory purposes). Unlike wholesale deposits, which are primarily based on individually negotiated agreements, retail deposits are governed by general terms and conditions set by the bank.

**Existing customers:** The first publicly reported court cases (we imagine there have been a similar amount of complaints to national and/or EU-level ombudsman and/or consumer protection authorities – although this data is not publicly recorded) on negative interest rates indicate clearly that variable interest rate provisions in existing general business conditions cannot be used to charge negative interest rates. Such an attempt would be interpreted as a clause that is detrimental to the consumer client and would thus very likely be legally void under EU consumer protection standards that have been harmonized at the EU level, but also under non-EU harmonized provisions that are set out in German consumer protection laws and thus jurisdiction-specific. Other EU jurisdictions may have similar jurisdiction-specific provisions.

**New customers:** Introducing negative interest rates for new customers under general terms and conditions is also generally regarded as constituting a clause that is to the detriment of the consumer client. Such a clause would generally be held to be against German consumer protection law and similar situations apply in other EU jurisdictions. A number of German legal commentators have suggested in leading literature that banks may want to define such new contracts as “custody agreements”, as is done with corporate customers, thereby making it possible to charge custody fees. However, even if this were done in a manner that privity of contract is respected, it is not certain, that competent courts would follow this argument, as it does not take into account the strong consumer protection perspective followed by courts or equally a consumer protection authority including a national or EU-level ombudsman and would likely be viewed as circumventing what the legislator intended in terms of the level of consumer protection.

Therefore, consensus in the German market is that only individually negotiated and agreed contracts with new customers would be a relatively safe option from a legal perspective. Given that this is unlikely to be practical in a large-scale flow business such as retail banking, and given the alternative of retail customers swapping deposits for hoarding cash, in practice there exists a 0% interest floor on deposits from retail banking customers that historically was not crossed. This is now changing due to COVID-19 pressures as the Verivox study evidences.

In practice, the vast majority of banks have gradually reduced interest rates consecutively to as low as 0.01%. Only in very limited cases of individually negotiated contracts have the rates been set at a negative rate. The vast majority of such cases only charges negative interest if the deposit amount surpasses a certain threshold amount, such as for example EUR 100,000. It should be noted that EUR 100,000, represents the threshold of harmonized EU-wide guaranteed deposit protection as it applies to the aggregate of “eligible deposits” in the name of the depositor held with the relevant individual bank in the event of deposits being unavailable. A depositor splitting say 1 million euro into 10 deposits held with 10 different banks (within a jurisdiction and/or across the EU-27) that are not related to one another would benefit from the deposit guarantee threshold per bank.

The low interest rate environment has created demand for non-domestic but EU-27 based competitors offering custody accounts at considerably more attractive interest rates for retail clients. The EU-wide depositor protections have fuelled this ability for non-domestic competitors to offer retail clients higher rates. This is another reason why domestic banks are hesitant to change to negative interest rates. The rise in court cases, notably in relation to cooperative bank in the State of Baden-Wuerttemberg, which sought to impose a -0.5% interest on existing checking and various savings accounts exceeding EUR 10,000 in addition to normal fees. The judgment communicated principles that banks may now only apply negative interest rates to new customers but not existing ones. This could however be an area that banks seek to ignore thus leading to a range of regulatory complaints possibly leading to contentious proceedings, ombudsman disputes and litigation.

# Repricing of loans

From a bank's perspective, negative interest on loans or other credit products extended by it to clients are likely to require considerably lower negative interest rates on its funding side, in order to still be able to earn a margin to cover the bank's costs. Given the above-mentioned restrictions on negative interest rates for retail customers, this may not be an acceptable way forward for most banks. There have been individual cases in Denmark, where banks have offered 0% or even slightly negative interest rates on loans to customers. These are banks that are predominantly refinancing with institutional investors that themselves are paying negative interest rates. Furthermore, these financing banks offering such rates normally also charge certain fees to cover their expenses.

## Inter-bank lending

The reform of Euro Overnight Index Average Rate (**EONIA**) as a widely used interest benchmark is currently taking place in the euro market. The reform to EONIA, along with all other benchmark rates, was required because such inter-bank offer rates (**IBORs**) do not comply with the requirements of the EU Benchmarks Regulation (the **BMR**). The BMR was introduced in order to ensure the accuracy, robustness and integrity of benchmarks. In order to achieve this, the BMR created requirements in respect of governance and the processes used to determine benchmarks such as EONIA and EURIBOR but also other IBORs such as LIBOR, USD LIBOR which are rates used for various wholesale and retail banking products in the EU.

EONIA will be gradually replaced by the new euro short-term risk free replacement rate €STR, first published on October 2, 2019. €STR is the rate of interest reflecting the borrowing costs of Eurozone banks in the wholesale unsecured overnight market and it is produced by the European Central Bank. €STR is regarded as a more accurate and robust rate than EONIA. The stood at an average of -0.55% until the end of the September- October 2019 maintenance period. The initial pricing of the €STR shows, that the negative interest rate of -0.50% charged by the ECB under its DFR is passed on in the inter-banking market at a very similar rate.



# Steps taken by banks to mitigate risk associated with negative interest rates and to comply with legal and regulatory requirements

Specific steps obviously depend on the individual situation of the bank. Generally speaking, as a first step and based on experience in the Eurozone, banks ought to identify and understand all relevant risks associated with negative interest rates. Using IT and data reporting, banks need to achieve transaction-level transparency on clients, products and contract types (including governing law/jurisdiction clauses). They also need to get a sound understanding on which changes are permitted in the relevant jurisdictions and in respect of which counterparties and clients.

Some of this review and preparation of a “documentation inventory” may (and in the EU it certainly is) already be underway as part of banks preparedness with BMR compliance. This review ideally should focus on using the “five Ws and 1 H” approach to ascertain “who one is transacting with, in terms of what and where and who can do what, when and how in respect of changing an interest rate to negative and/or introduce other charges and/or make amendments to applicable terms and conditions?” Some of these questions may have already been captured by banks upgrading their IT infrastructure due to regulatory changes requiring them to establish and maintain a “single customer view” but for others this remains a target operating model that they have yet to achieve.

Consequently, in-house legal teams, working with their external counsel, may, to the extent they have not already done so, want to create and periodically monitor an inventory of their exposures to relevant counterparties and clients, segmented by the governing law of the contract and the jurisdiction of the counterparty and/or execution venue, as well as the booking center for relevant transactions, and therefore assess:

- types of:
  - relationship-specific documentation such as general terms and conditions and brand-specific terms and conditions;
  - transaction-specific documentation such as those that are transacted under or based on master agreement but equally may also include bilateral agreement loan and other credit product documentation suites, as well as any array of protocols, side letters and any other documented or undocumented arrangements that are relevant to the exposure(s);
  - the hierarchy of documentation described above to establish whether one exists, and if yes, which documents and/or specific terms take precedence over one another i.e., transaction- specific documentation is typically subject to the terms of relationship specific documentation but may also include carve-outs for certain types of transactions etc., but equally assess whether linked documentation i.e., hedging and loan documentation terms are connected; and
  - whether there are any material divergences in agreed terms to those that are considered market standard.

This documentation inventory is coupled with a need for banks to engage early on with their counterparties and client to explain “why and when” such change is needed. In Europe, dealing with retail customers, such advance warning may take place well ahead of any market practice minimum notification periods (typically 30 to 60 days prior warning) that such change to an interest rate and/or change in agreed terms will take place and may also require additional measures taken to deal with those retail clients that the bank (or the regulator) may deem as vulnerable customers.

Depending on applicable consumer protection laws, such vulnerable customers may typically include single income/single parent households, those that are heavily indebted – specifically payday loans etc., those that are elderly (including those near pensionable age) as well as the incapacitated. Similar steps may have been undertaken by some firms in dealing with their NBFIs counterparties and/or with SME clients. Some of

these measures and an emphasis on early engagement strategies, particularly with vulnerable customers, have been reinforced by the EU's rules on preventing and tackling non-performing loans and exposures, which we would be happy to expand on in detail.

As a general observation, we note that there are considerable regulatory pressures but also rewards in adopting an early engagement strategy with wholesale and retail customers to communicate changes to rates, charges and/or agreed terms of business. Given the more granular portfolio with individually negotiated contractual relationships, banks would typically start with corporate clients before moving to retail clients. Rate changes on the deposit side are likely to be based on a complex decision matrix taking into account business, legal and regulatory aspects. At the same time, bank's treasuries will have to incentivize its businesses to generate more products on the asset side, that come with high interest rates and banks have to further bring down their costs.

Approaching these issues earlier rather than later not only serves to deepen engagement with the client and possibly pick-up market share from competitors if circumstances of a change (such as a promotion etc.) allow, but also serve as a defensive measure in the event that engagement with a client turns contentious in the form of a regulatory complaint or a dispute. A bank may be able to point to its early engagement as evidence that it has taken proactive measures to treat the client fairly and act in its best interests – i.e., two items that are generally common to all conduct of business regulatory standards that banks are subject to comply with in addition to any consumer protection requirements. At the same time, bank's treasuries will have to incentivize its businesses to generate more products on the asset side, that come with high interest rates and banks have to further bring down their costs.



# Outlook

With negative interest rates for many already existing as the new normal and for others becoming so, affected financial services firms, notably banks may have to take appropriate steps to protect their net interest margins as well as competitive advantages. As has been seen in the European market, it is of utmost importance to tackle the risks associated with negative interest rates as early and as determined as possible as well as, where required, to recalibrate the bank's business model while concurrently reducing regulatory, reputation and litigation risks.

Some financial services firms, notably banks may also to see this as an opportunity to gain market share across existing product types as well as those that may be forged as a result of the fundamental rethink that NIRP means for those depositing, saving, investing or borrowing.

**We hope the above may provide some further insight into how to approach some of the solutions needed for what are indeed extraordinary times and very much new legal and regulatory challenges. Our key contacts stand ready to support you in helping you identify and understand all relevant risks associated with negative interest rates and how they could apply to your business operations and those of your clients. Please speak to your usual Dentons contact or our [Eurozone Hub](#).**



# Eurozone Hub: what we do and how we can help you

Our **Eurozone Hub** can deliver value to you by solving regulatory issues and using regulation to your advantage. Our team operates on a multijurisdictional and multilingual level. It includes bilingual native speakers of Central and South Eastern European languages, including Croatian and Bulgarian and we have experience in assisting on Banking Union “readiness projects” across the region.

We cover all regulatory topics at the EU and at national levels as well as across all sectoral rulebooks.

We help financial institutions during investigations from national and EU level regulators/supervisory agencies.

We lead on financial service license applications and other regulatory approvals.

We are fully familiar with the financial supervisory culture and expectations at every level across the EU.

We deliver workable solutions to address all “hot” key regulatory topics under global, EU and national rulebooks such as compliance, governance, risk management and cyber security.



We design, structure and implement new or evaluate existing regulatory capital instruments, financial products and trading documentation.

We advise on acquisitions and divestitures of regulated businesses.

We help clients participate and shape the debate amongst policymakers by representing needs of clients.

We help clients in the design, implementation and auditing of compliance with internal policies and procedures in a manner that meets Eurozone, EU and global requirements.

We help clients when faced with supervisory examinations, thematic reviews, sanctions or otherwise to “defend files”.

Download Dentons' **Eurozone Hub brochure** to learn more about navigating Eurozone regulation, supervision and monetary policy.

## Eurozone Hub

To find out about our Eurozone Hub and how to keep connected on Eurozone-specific regulation, supervision and monetary policy.

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## Endnotes

- 1 The non-technical summary in *Doettling* sets out that: “In the model, banks have market power over depositors, but nominal deposit rates cannot go negative because households can substitute deposits for money. On the asset side, banks make loans and control the risk of these loans by choosing their monitoring intensity. Banks have an incentive to take more risk than is socially optimal because deposits are insured by the government and shareholders enjoy limited liability.

Capital requirements limit the leverage banks can take and affect risk-taking incentives through two opposing effects. Via a skin in the game effect, higher capital requirements reduce risk-taking incentives as banks have more of their own capital at stake. On the other hand, tighter regulation can reduce a bank's profitability. Via this franchise value effect, higher capital requirements can increase risk-taking incentives as a lower continuation value induces a search for yield.

While capital requirements generally reduce bank risk-taking, I find that they are less effective when interest rates are low and the ZLB binds. When deposit rates are above zero, banks can pass on some of the cost of regulation to depositors by lowering deposit rates, limiting the negative effect on profitability (especially if banks have a lot of market power). Intuitively, this margin of adjustment vanishes at the ZLB, so tight capital requirements disproportionately hurt a bank's franchise value if the ZLB binds.

This result shows that one of the main regulatory tools to curb risk-taking may be weakened during times of low interest rates, when risk-taking incentives are already high. What does this imply for optimal, welfare-maximizing capital regulation? In a calibration to U.S. data from 1996 - 2017, I find that optimal capital requirements should be dynamically adjusted if the ZLB binds occasionally, varying between above 15% when- ever the ZLB is slack and below 10% when it binds. Generally, optimal capital regulation trades off the gain from reduced risk-taking against the cost of lower liquidity provision by banks. When the ZLB binds, capital requirements are less effective in curbing risk-taking, motivating a weaker use. In contrast, if the ZLB is slack today, but there is a chance for it to bind in the future, optimal requirements should be tightened. A potentially binding ZLB in the future depresses expected profitability going forward. This increases risk-taking incentives, which should be countered by tightening regulation.

To the extent that interest rates are correlated with the business cycle, the model thus delivers a novel rationale for cyclically adjusting regulation, distinct from the standard argument that buffers built up in good times should be available in bad times. The results are also relevant for the debate on whether monetary policy should target financial stability. Some commentators argue that monetary policy should focus on targeting inflation and let (macro-)prudential policies take care of financial stability. However, if very low interest rates undermine the effectiveness of prudential policies, the two cannot be set independently. For example, a higher inflation target can make capital requirements more effective by alleviating the ZLB problem.

The model also allows studying unconventional monetary policy in the form of subsidized refinancing operation. This policy resembles the ECB's LTRO program, which provides cheap funding to banks at negative interest rates. Subsidized re financing operations can alleviate the strain on interest margins and thereby restore franchise values and prudence incentives. However, the model also highlights negative side effects, as subsidized financing operations induce banks to grow too big in equilibrium relative to financial markets. The overall welfare effects of such policies can therefore be positive or negative.”



## ABOUT DENTONS

Dentons is the world's largest law firm, connecting talent to the world's challenges and opportunities in more than 75 countries. Dentons' legal and business solutions benefit from deep roots in our communities and award-winning advancements in client service, including Nextlaw, Dentons' innovation and strategic advisory services. Dentons' polycentric and purpose-driven approach, commitment to inclusion and diversity, and world-class talent challenge the status quo to advance client and community interests in the New Dynamic.

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