Negative Rate of Interest and its impact on depositors and banks

"Negative rate of interest" is the new buzzword. Not just one or two, but many countries in the world are experiencing negative interest rate regime. In Sweden and Switzerland, the rate of interest on deposits kept by banks with Central Bank has become negative. The European Central Bank also has a negative interest rate while the Bank of Japan has kept a zero rate of interest. While some countries are experiencing a negative rate of interest on deposits, the yield on government bonds is also turning negative. It is noteworthy that the yield on government bonds in Japan has turned negative.

For an investor in India, who is used to high rate of interest on both deposits and borrowings, this is simply unbelievable. A negative rate of interest on a deposit means that the amount received on maturity on a deposit is going to be less than the deposited amount. So how is it possible that some countries are experiencing a negative rate of interest and what are the potential impacts? How does this impact banks and depositors? These questions need to be investigated.

A negative rate of interest is prevalent in those countries where economic growth has been hit because of various factors. By repaying less than the original deposited amount, Central Banks in these countries are discouraging banks to keep deposits with more than the prescribed threshold limits. This would mean that banks will be forced to lend more, potentially pushing the economic growth rate upward in the country.

It is important to understand that negative rate of interest is not applicable for retail investors. It is primarily applicable to the banks, which maintain accounts with the Central Banks of the respective countries. As far as retail depositors are concerned, the rate of interest continues to be positive though the rate offered to them is as good as nothing. However, in comparison to other investment assets it is still attractive. Because returns on stock markets and various commodities related products have become negative. The other benefit is that it is possible to borrow at a lower rate of interest from banks.

Banks are the entities facing the real challenge. In spite of the rate of interest becoming negative, banks will still need to deposit money with Central Banks as it is part of statutory reserve requirements. A negative rate of interest is putting a burden on the balance sheet of the banks. As the rate of interest becomes more negative, banks will find that managing net interest margin will be difficult for them. Banks cannot afford to pay negative interest to their depositors while they are forced to receive a negative rate for their own deposits with the Central Banks. It is estimated that this may impact profitability of banks in the days to come.

Additionally, banks in negative interest rate countries have to buy Government Bonds with negative yields as it is part of their Asset Liability Management and also to maintain their Statutory Liquidity Reserves Requirements. So banks will have to maintain a minimum investment in these negative yield generating bonds. Basically, negative rate of interest has impacted both lending and trading books of banks and this will have impact on their profitability in at least short term near future.

So what is the way forward? It is estimated that as long as the economic growth in the country does not improve, the rate of interest on deposits is likely to be low. In other words, a part of the world has to learn to live with negative rate of interest.

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