Historic losses, insufficient explanations

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This article focuses on Spain, but what it tells is happening in all central banks in Europe. The current central bank losses are historic and involve an impressive transfer of public money to the banks. In 2023 the ECB and national central banks have paid the banks some 140 billion euros in interest, and European banks have committed to pay their shareholders some 120 billion in dividends and share buybacks.

The governor of the Bank of Spain (BE) recently published an article on the institution's blog explaining the bank's poor economic performance in 2023. I highly recommend reading it, it is a brief and didactic document, but his explanations are insufficient and leave important questions unanswered.

Private profits as historic as the BE's public losses.

It states that "for the first time in its history, the Banco de España has not made a profit", but it should say that it has made operating losses. Which is not the same thing. The zero-accounting result has been obtained by using some (misnamed) provisions created in previous years (we will see this later) of 6,612 million euros to cover a difference between its income and expenses for that same amount. It is valid to say that the BE has lost for the first time in history almost 7,000 million euros. Of course, the Treasury has stopped receiving dividends, and we do not know for how many years.

But nothing is said, explicitly, of the almost 8,000 million of interest that the BE has paid to the Spanish banks in 2023 for the 260,000 million deposited in the so-called marginal deposit facility (FMD) in the BE. Interest that has represented, on average, almost 50% of the profit obtained by the banks for their activity in Spain.

It is also stated that "the unconventional monetary policies of the last decade, in combination with the interest rate hikes, initiated in 2022 to combat inflation, explain this novel situation". And indeed, the cause of the losses is related to both factors. But total silence on the (not at all obvious) reasons for maintaining the huge payments to banks for their deposits.

The central banks of Germany, Austria and Italy are in favor of changing this excessive remuneration of banks by raising the ratio of non-interest-bearing minimum reserves (NRR). The Swiss central bank has just raised its CRM to 4% compared to the ECB's 1%. According to Bloomberg, in discussions within the ECB, Governor Hernandez de Cos was in the camp of those opposed. Is this true, and is it necessary to maintain these transfers for monetary policy to be efficient?

The changing superprovisions

On provisions and future results, he says: "In 2022, before the risks materialized, the provision reached €33 billion. According to the foreseeable scenarios, this buffer will serve to comfortably cover the temporary mismatch between financial revenues and expenses".

From 2012 to 2022 the BE retained profits and made provisions for unrealized losses, using generic concepts that have been changing from "provision for financial risks" to "provision for monetary policy portfolio". Recall that the BE's portfolio consists mainly of government debt, which does not require any provisioning (no private bank does).

Of course, the BE's debt portfolio is accounted for at amortized cost and not at market price, because it is assumed that it will hold the bonds to maturity. But if it were to sell now, it would have significant losses. So, it has latent losses that the BE does not disclose either, something that the US Fed does for transparency.

Provisions must respond to impairment of assets with credit risk during the year. How and why did no less than 33 billion of provisions (the largest in the Eurozone) accumulate over a decade? It is important to know because these provisions, if they were not losses for the year, were a "smoothing" of profits that avoided distributing them to the Treasury (the sole shareholder of the BE). This implies an opportunity cost in the use of that money. Not only should the BE clarify this, as it is the one who formulates the accounts, but also the Government, which is the one who approves them.

Furthermore, what assumptions support the assumption that there will be enough slack to cover future losses? Losses that continue to materialize with each passing month without any change in the current monetary policy framework. We do not know, at least for the time being, the assumptions about the evolution of interest rates, the level of the CRM and the size of the BE's balance sheet, on which the assertions made are based.

The problem is not the financial solvency of the BE, but its credibility.

Finally, it is said that "The lack of profits will continue for some more years, but it does not compromise in any way the room for maneuver to fulfill our functions". It is true that it does not have to affect the performance of its functions, but in no way can it be said that it is impossible that it could not be affected. How much loss and why does the Banco de España estimate for the coming years? For how many years?

Central banks' mission is to achieve price stability, they do not exist to make profits (although they usually do) and they cannot be declared bankrupt by a court of law. A central bank can continue to operate with a negative net worth in accounting terms because it has the power to create money and is exempt from normal corporate solvency rules. As the sole issuer of their national currency, central banks can always meet obligations arising from liabilities denominated in their national currency. But given the peculiarity of the Eurozone, it may be that if the BE were to run out of equity it would have to turn to the Treasury.

The question is the relationship between the Treasury and the BE and the consequences of transfers of resources from one to the other. The BE remunerates the Treasury when it makes a profit, which is normal, and the latter could cover losses (capitalize) the BE if its credibility (thus that of its currency) could be at stake. The fact is that there is currently no single recognized best practice model for regulating profit sharing and recapitalization arrangements between central banks and their Treasuries.

Movements of balances between two branches of the public sector (the Treasury and the BE) could be ignored as long as they are transparent (accountability). They are cancelled at the public sector accounting level. What cannot be ignored are balance movements that cross the division between the public sector and the private sector, as is the current case.

I conclude this reflection: Is an anti-inflationary monetary policy that remunerates the banks' excess reserves the only option or are there other options? And there are. For example, raising the CRM. And, moreover, it is more effective: there would be almost no losses (and no need for provisions) and less money would be injected into the financial system (money in the form of bank reserves), which, as we have seen, ends up in higher bank dividends and share buybacks.

The current situation entails high public costs and private benefits. And more risk and cost for the State, which sees how the current monetary policy shortens the average life of its debt and makes it more expensive.

The new governor and her/his deputy will be appointed shortly. Without detracting from the good work done by Governor Hernández de Cos, let us hope that the next governor will be more sensitive to the issues raised here. The independence of the BE is guaranteed by law, but it must be exercised with calm and clear accountability so as not to question its credibility. Even more so in the complex times ahead.

Central banks need to be more honest about their losses and Parliaments must demand it. Complacency on this issue, and little debate, are not acceptable.