GR–NEAM®

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Quick Takes

Implications of Negative Yields in Europe

In a previous issue of Quick Takes *we covered the background to these exceptional times for Euro Area bond investors and explained what a negative yield on a bond actually means. The implications of these low yields for all investors, especially insurance companies are important and lasting. In this current* Quick Takes *we will explore these further.*

A Bit of Theory

Most commentators previously believed that interest rates were subject to a zero lower bound (ZLB) and thus it was inconceivable that nominal interest rates could be negative. The idea of a negative interest rate, however, is not new. Keynes cited the idea proposed by the German economist Silvio Gesell in the late 19th century to impose a tax on holding money and many economists have written about it since then, from Irving Fisher in the thirties to, more recently Willem Buiter – a former member of the Bank of England's Monetary Policy Committee. In 2009, Greg Mankiw referred to negative policy rates as a policy option in the New York Times.

The basic idea is that a negative interest rate acts as a tax on money which means that money depreciates in value over time, therefore spurring consumption. Recently there has been much written discussion on the extent to which interest rates can fall into negative territory. The limiting factor in how low rates can fall is cash (i.e. banknotes). Relative to a negative yielding current account, cash becomes a "high yielding" asset. The further rates fall into the negative zone the more banks and their customers would choose to hold cash. Holding cash, however, is not costless or riskless, but undoubtedly over time and depending on how deeply negative rates fall, households and businesses will find ways to avoid this "tax". This could range, for example, from prepaying bills to designing cash backed ETFs. While central banks could counter these strategies, clearly there are natural limits to just how negative interest rates may go.

About this Newsletter

GR–NEAM's *Quick Takes* covers timely topics relevant to the insurance industry and is written by our Client Strategy and Investment teams. Each edition is designed to keep insurance professionals informed on relevant topics in the industry by providing information on time sensitive issues.

For More Information

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Why Invest in Negative Yields?

As detailed previously, purchasing a bond with a negative yield and holding it to maturity means a guaranteed loss. Why would any investor enter into such a deal and who are the investors that are purchasing bonds with negative yields? Some investors may purchase negative yielding bonds if they expect continued deflation and if those negative yields are still higher than inflation, then a positive real yield may be attractive for them. Other investors may feel that yields will continue to drop further into negative territory and therefore the bonds will appreciate further in value and may be sold for a profit. Investors may also purchase negative yielding bonds for safety, justifying the negative yield as the price of holding a safe asset.

There are also investors who may purchase a bond denominated in euros at a negative yield and fund the purchase in another currency with the expectation that the euro will appreciate in value against the other currency. In this example the bond's negative yield is secondary to the main objective of currency appreciation. Index funds, ETFs and other passive investors with government bond benchmarks may also have to buy negative yielding government bonds to minimise tracking errors against their benchmarks.

Banks may also hold negative yielding bonds to avoid negative deposit rates. Additionally the Eurosystem itself (the ECB and its constituent National Central Banks), in implementing Quantitative Easing (QE), will purchase negative yielding bonds down to a yield limit of -0.20%, equivalent to its Deposit Facility Rate. Finally, investors may have to hold such bonds for solvency, regulatory or currency matching reasons. So there are many reasons why investors may purchase bonds which carry a negative yield.

Negative Yields and their Implications

The environment of very low or negative interest rates is already having major effects on financial entities and is potentially threatening their basic financial models – from pension funds and insurance companies to savings banks and money market funds. Euro denominated money market funds that invest at the short end of the yield curve are showing mostly negative yields, despite the fact that managers are already waiving management fees. For banks, lower interest rates may initially lead to widening bank margins as funding costs fall faster than asset loans re-price, but over time as an economy recovers, funding costs are effectively floored and lending margins decline. Banks, therefore, that follow a "funding" model, such as the German savings banks, are finding their model under threat. Defined Benefit Pension Plans that use longer term yields to discount future liabilities are finding that the fall in yields and related pension plan discount rates has led to a rise in pension scheme liabilities and a decline in pension funding ratios. Defined contribution pension schemes are also affected as the cost of buying an annuity is more expensive.

According to EIOPA, the European Insurance Regulator, the low levels of interest rates are also eroding the profitability and ultimately the solvency of the European insurance industry. Life insurance companies, given the nature of their products that often involve guarantees and the longer duration of their liabilities, are more sensitive to interest rate movements than non-life insurers. Non-life insurance business is also affected though by the low level of interest rates as investment returns – particularly for longer-tailed business lines – have historically contributed to product profitability. Unlike with banks, the negative effects of low interest rates on insurance companies builds slowly and is often extended by accounting conventions.

New regulations, such as Solvency II, which put a greater focus on asset-liability mismatches have driven insurance companies to shift their allocations towards fixed income and to extend the duration of their asset portfolios. Life insurance companies, given their longer term liabilities, do have a greater ability to ride out adverse market developments, so the issue is not the low levels of yields per se but rather the persistence of these low yield levels. The recent sharp sell off in European bonds may call into question the persistence of these low yield levels, but it should be remembered that the ECB is in the early innings of a major Quantitative Easing programme which will keep a lid on any future euro area interest rate increases.

Faced with zero or negative reinvestment yields, European insurance company risk allocations are increasing; they are extending their durations, increasing their allocations to credit, switching into other non-core sovereign markets and they are increasing their allocations to higher yielding asset classes such as equities and loans. However, as a recent Bundesbank study of German life insurance company solvency in various "low yield" stress scenarios shows, given that solvency capital levels will remain under pressure, in an environment of lower yields the ability for insurance companies to "re-risk" will be limited. Notwithstanding this, as the IMF recently pointed out in its Global Financial Stability Report, the fall in nominal yields – should it be sustained – raises a serious threat to the life insurance and pension fund sectors, especially in Europe.

Impact on Euro Area Bond Performance

In the beginning of April this year, Switzerland became the first sovereign government to issue 10-year debt at a negative yield. The 10-year bond was issued with a fixed coupon of 1.50% and an issue price of 116.00 to yield -0.055%. This is the longest maturity debt that has been sold directly to investors at negative yields. As outlined earlier, while these bonds pay positive coupons, their price has been bid so far above par or face value that the holder of the bond, over its full life, will face a certain loss at maturity.

German Government 10-year yields – the benchmark for Euro Area bond investors – were recently trading at a barely positive yield of 10 bps. The historical journey to these low yield levels has delivered extraordinary performance to Euro Area fixed income portfolios over the last years, as demonstrated, for example, by the historical performance of the German Government 10-year sector (represented by the BofA Merrill Lynch 10 to 15-Year German Government Index) which returned over 9% per annum over the five years to end 2014.

This Euro Area performance feast will now turn into a yield and performance famine as these low levels of yields are certain to deliver low to negative prospective returns. It is also worth highlighting that at these low yield levels, bond duration risk automatically increases for a given maturity as bond instruments behave more like zero coupon bonds. Zero income instruments will tend to trade more like a commodity over time and in a bond market that has at times demonstrated difficult liquidity conditions, this could lead to increased price volatility.

It is reasonable to assume that in a zero to negative yield environment that investor holding periods may shorten and this may further contribute to increased periods of volatility. With the ECB only beginning their asset purchase program, and with interest rate Forward Guidance and Long Term Repo Operations in place, Euro Area interest rates will remain suppressed for now, but fixed income investors need to be very aware of the asymmetric risk outlook that they are facing.

The spillover effects of ECB policy to other currencies should also be mentioned. As Euro Area interest rates remain suppressed, European investors will continue to look to other currencies for higher yielding opportunities. This will tend ceteris paribus to also suppress yields in other major markets, particularly given that the Euro Area current account surplus is running at about USD 400 billion each year. The USD bond market will be a natural home for European investors looking for yield, sector diversification, depth and liquidity.

Conclusion

These are not normal times and insurance investment portfolios must ensure that in setting their portfolio strategy their risk models take sufficient account of the current environment and emphasise a forward looking approach. We leave the last word again to Claudio Borio of the BIS: “The economic fabric of our society has been built on the premise of positive nominal interest rates. Negative interest rates are an unprecedented experiment. If it’s not temporary, there are going to be significant implications.”