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**Article**

## How Do Low Interest Rates Affect Financial Institutions and Stability?

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Dieter Wemmer

## How Do Low Interest Rates Affect Financial Institutions and Stability?<sup>1</sup>

### THE LOW-INTEREST RATE ENVIRONMENT

Global financial markets have witnessed a secular decline in interest rates since the mid-1990s. This development was initially largely driven by the effects of globalization on production and increased trade, resulting in lower inflationary forces, especially in developed economies. In the wake of the financial crisis in 2008, this development was exacerbated by material interest rate reductions and additional emergency actions taken by various central banks to stabilize markets. The following public bail-out programs for the banking sector led to a government debt crisis that was particularly pronounced in weaker parts of the Eurozone, with the resulting flight to quality further depressing rate levels, especially for high quality issuers. Since then, market participants have experienced a steady decline in interest rates driven by the ECB's extraordinary quantitative easing program. This development culminated in unprecedented low rate levels in late 2016, which even turned negative for high quality benchmark bonds like the 10-year German Bunds, as illustrated by Figure 1.

The development is even more disconcerting in view of the fact that over 70 percent of total outstanding German public debt now provides negative returns. For the Eurozone as a whole, just over 50 percent of sovereign debt is traded at negative yields. This proportion rises to nearly 95 percent for short-term debt with a maturity of two years or less.

While at the time of writing this article rates have slightly increased due to inflationary expectations triggered by the new US administration, overall interest rates remain at an extremely depressed level.

### ECB MONETARY POLICY – A VICIOUS CIRCLE?

While the ECB has argued for some time that the extreme low-yield environment and quantitative easing is needed to re-ignite growth in Europe, a growing number of market observers are questioning the effectiveness of this policy. One of the key problems in that context from our perspective is the adverse effect of extreme low rates on trust (i.e., business confidence) and savings ratios. While conventional economic wisdom would predict that low interest rates lead to reduced savings and increased consumption thereby supporting economic growth, in reality the opposite

can be observed. The private households savings ratio in Germany increased between 2013 and 2016 by nearly ten percent as people understood that they need to compensate for lower interest rates with higher savings in order to keep their personal old age provisioning stable (especially against the background of an ailing public pension system). During the same period, business confidence in Germany stagnated, typically resulting in lackluster investments in the real economy and low growth.

In addition, the ECB's quantitative easing measures distorted bond markets by artificially increasing demand for eligible bonds, resulting in lower yields and the crowding out of actual investors. The same effect can be observed in real economy investments, where the ECB's "cheap money" policy in some countries is fostering public deficit spending, again effectively crowding out actual investors.

Finally, ultra-low interest rates increase the risk of asset price bubbles, particularly in the real estate sector and the stock market. A significant increase in market volatility can already be observed in various asset classes.

As a result, the ECB may be inclined to continue quantitative easing and extend the low interest rate policy in order to stabilize markets and trigger growth, ultimately resulting in a vicious circle.

### SOLVENCY II COMPLICATES THE SITUATION

The insurance industry has traditionally functioned as a volatility dampener in times of market disruptions, as also demonstrated during the last financial crisis. Unfortunately, the newly-introduced Solvency II requirements might actually challenge the "natural" role of insurers. While Allianz fundamentally supports Solvency II as a modern, risk-based supervisory framework, we are concerned in this context over some of its critical shortcomings.

Solvency II rightly incentivizes the matching of assets and liabilities for insurers. However, the underlying economics also result in a higher duration gap as interest rates decline. This, in turn, triggers higher demand for long-term bonds to re-balance the asset-liability profile, pushing interest rates down even further and fostering the pro-cyclicality of investments.

Furthermore, the Solvency II Standard Formula tends to distort asset allocation. The lack of risk charges for government bonds fosters excessive investments in this asset class at the expense of other investments. An inadequate thrust towards financing the public deficit rather than the real economy may result.

Last but not least, the currently incomplete reflection of the insurance business model results in artificial volatility. Solvency II requires a substantial risk capital charge for credit spread risk, which ignores the fact that (life) insurers can typically follow a "buy and hold" strategy (due to long-term stable liabilities), so that spread risk becomes irrelevant (and only default risk at maturity remains important). Unfortunately, this inadequate reflection of the underlying business and

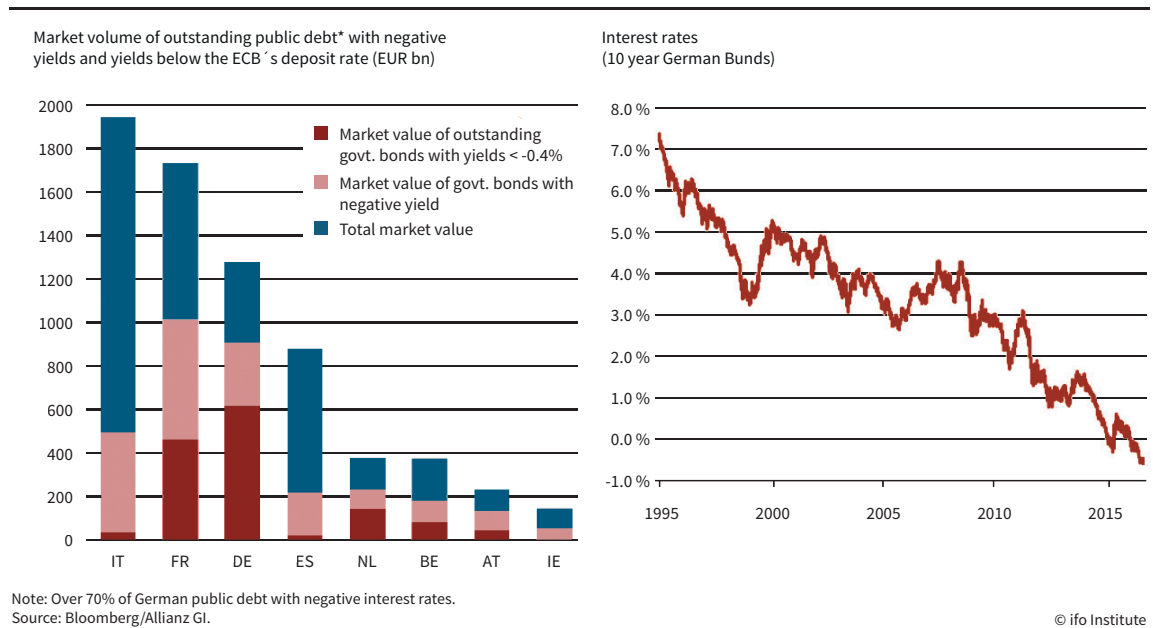


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<sup>1</sup> This article is based on a presentation by the author during the Price Stability Target Conference in Berlin, 28 September 2016.

Figure 1

## Development of interest rates



related risks forces insurers to act pro-cyclically (i.e., selling into falling markets) and display herding behavior.

Against this background, we believe that the EU legislators should tackle those critical shortcomings as early as possible in order to foster financial market stability and avoid market dislocations as an unintended consequence of regulation.

### STRATEGIC REACTION OF INSURERS

The problems associated with the low-yield environment and new regulation pose an unprecedented challenge to the insurance industry as a whole. In response, the industry has started to review strategic options with a focus on the investment approach, as well as changes to product offerings.

On the *asset side*, insurers should narrow their portfolio's duration mismatch by increasing the asset duration including the use of derivatives as relevant (e.g., when investments with long durations are not available). In addition, increased investments in alternative asset classes like real estate, infrastructure, renewable energies and private equity can help to extend the duration, while also providing attractive returns (subject to adequate risk management capabilities of the insurer).

On the *liability or product side*, insurers need to redesign their long-term saving products in particular. New, innovative products with lower guarantees (regarding level and timing) and increased flexibility (e.g., resettable guarantees) are important to reduce risk capital requirements, while at the same time providing attractive product features and return upside potential to customers. In addition, a stronger focus on

products covering biometric risks like mortality and longevity (in contrast to market risks) is meaningful.

### ALLIANZ'S RESPONSE TO LOW INTEREST RATES

In line with the considerations above, Allianz's response to the low-yield environment and Solvency II requirements has been a complete redesign of the product portfolio focusing more strongly on biometric risks and a significant increase in alternative investments within the asset portfolio.

We are pleased that the new range of products has gained substantial consumer demand since their inception in 2012, amounting to approximately 90 percent of total new sales in 2016 (see Figure 2).

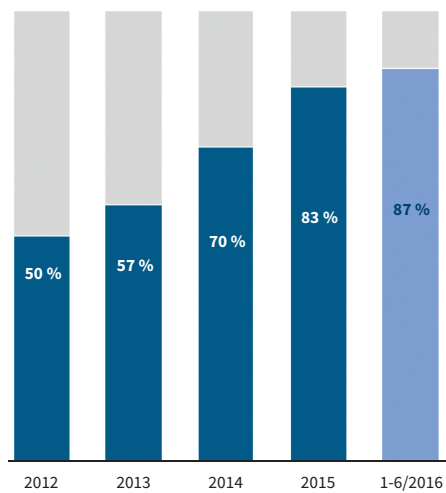
Similarly, on the asset side Allianz has also substantially increased duration by focusing on long-term alternative assets for new investments (see Figure 3). This helped to substantially reduce the duration gap between assets and liabilities while providing attractive returns for our policyholders.

### SUMMARY

The economic environment and the low-interest rate environment are likely to remain challenging for insurers, while new regulation might result in higher volatility and pro-cyclicality. In response, insurers need to adapt their product offering and investment strategy, which can be done successfully, as the example of Allianz illustrates. These activities should, however, be complemented by enhancements to Solvency II, so that insurers can fulfill their traditional role of financing long-term real economic growth and dampening capital market volatility again in the future.

Figure 2

## Allianz new product range and sales success



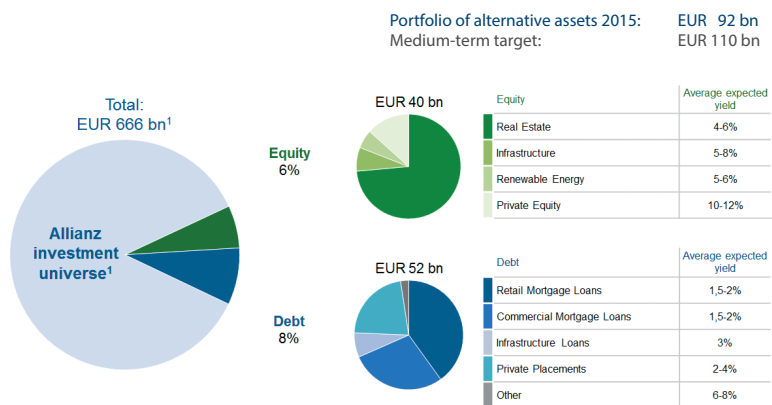
Note: Strong demand for the new concepts.  
Retail business: Portion of new guarantee concepts, including biometric risks (in % of valuation sum).

Source: Allianz SE.

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Figure 3

## Alternative asset portfolio as part of the Allianz investment universe



Source: Allianz SE.

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