Asset-Liability Management with Ultra-Low Interest Rates

Institutional Investors’ Perspectives

Overview

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1. The Low Interest Rate Environment and its Background
Global Perspective

- Low interest rates: a phenomenon for several decades
- Trend enhanced by monetary policy in the European Union

10-year Government Bond Yields

- Germany
- Japan
- USA

Graph showing 10-year government bond yields from 1990 to 2015 for Germany, Japan, and USA.
Developments in the Eurozone

- Financial crisis and the subsequent recession
  - Weakened many European banks and led to a temporary breakdown of the interbank market
  - Caused public debt to increase noticeably

- Euro debt crisis
  - Doubts about fiscal sustainability worsened the risk assessment of several Euro countries

- Quantitative Easing by the ECB Quantitative Easing
2. The Impact on Banks, Life Insurance Companies and Occupational Pension Schemes
Banks

- Interest income of German banks has fallen since the mid-1990s
- The reduction is in line with the decreasing yields of government bonds
- After 2008 the decline of banks’ interest income has accelerated
- As interest cost hardly sank, interest profit has also significantly declined after 2008

**Figure 2-2: Bank profitability in Germany**
in per cent

![Graph showing bank profitability in Germany](image-url)
Life Insurance Companies

- Low interest rates are becoming a threat to the stability of the life insurance industry

- This is especially the case in countries such as Germany or Austria, where products sold in the past had relatively high guaranteed returns and still represent a significant share of the total portfolio

- Duration mismatch between assets and liabilities:
  Lower interest rates decrease insurers’ equity capital.
Life Insurance Companies - Implications

- A prolonged period of low interest rates will lead to relatively high cumulative probabilities of default for less capitalized companies.

- A moderate rise in the interest rate level would considerably increase solvency margins, thus reducing the probabilities of default.
Life Insurance Companies - Implications

Source: Berdin and Gründl (2014)
Occupational Pension Schemes

Defined-benefit (DB) versus defined-contribution (DC) plans

- Safety of DB plans at risk owing to a protracted low-interest-rate environment

- DC plans: In the long run, lower investment returns will translate into lower annuities, unless employees and employers make higher contributions or pension funds take on more risk in their investment portfolios

Trend towards defined contribution plans in Europe over the last 10 years

- DC plan penetration differs from one European country to another

- Examples of countries with a large proportion of DC plans are UK, Denmark, Sweden, Switzerland and Ireland
## Occupational Pension Schemes in Europe

<table>
<thead>
<tr>
<th>Category</th>
<th>Countries</th>
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<tbody>
<tr>
<td>Less than 10% pension assets as % of GDP, mostly DB and hardly changing</td>
<td>Greece</td>
</tr>
<tr>
<td>Less than 10% pension assets as % of GDP, mostly DC and changing towards DC</td>
<td>Luxembourg</td>
</tr>
<tr>
<td>Less than 10% pension assets as % of GDP, mostly DC or substantial shift towards DC</td>
<td>Bulgaria, Croatia, Czech Rep., Estonia, Latvia, Lithuania, Romania, Slovakia, Slovenia, Turkey</td>
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<tr>
<td>10 to 50% pension assets as % of GDP, mostly DB and changing towards DC</td>
<td>Germany, Norway</td>
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<td>Austria, Hungary, Italy, Poland, Portugal, Spain</td>
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Source: Allianz International Pensions (2013)
Consequences for Investment Policy of Financial Institutions

- Gambling for resurrection?

- Locked-in in low-yield instruments?
Regulatory Consequences

Introduction of Solvency II:

Example for both “Regulatory Capture” and “Regulatory Forbearance”

- Several postponements
- Term structure of interest rates to be used for evaluating long-term guarantees
- Transitional measures