# 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

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# 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
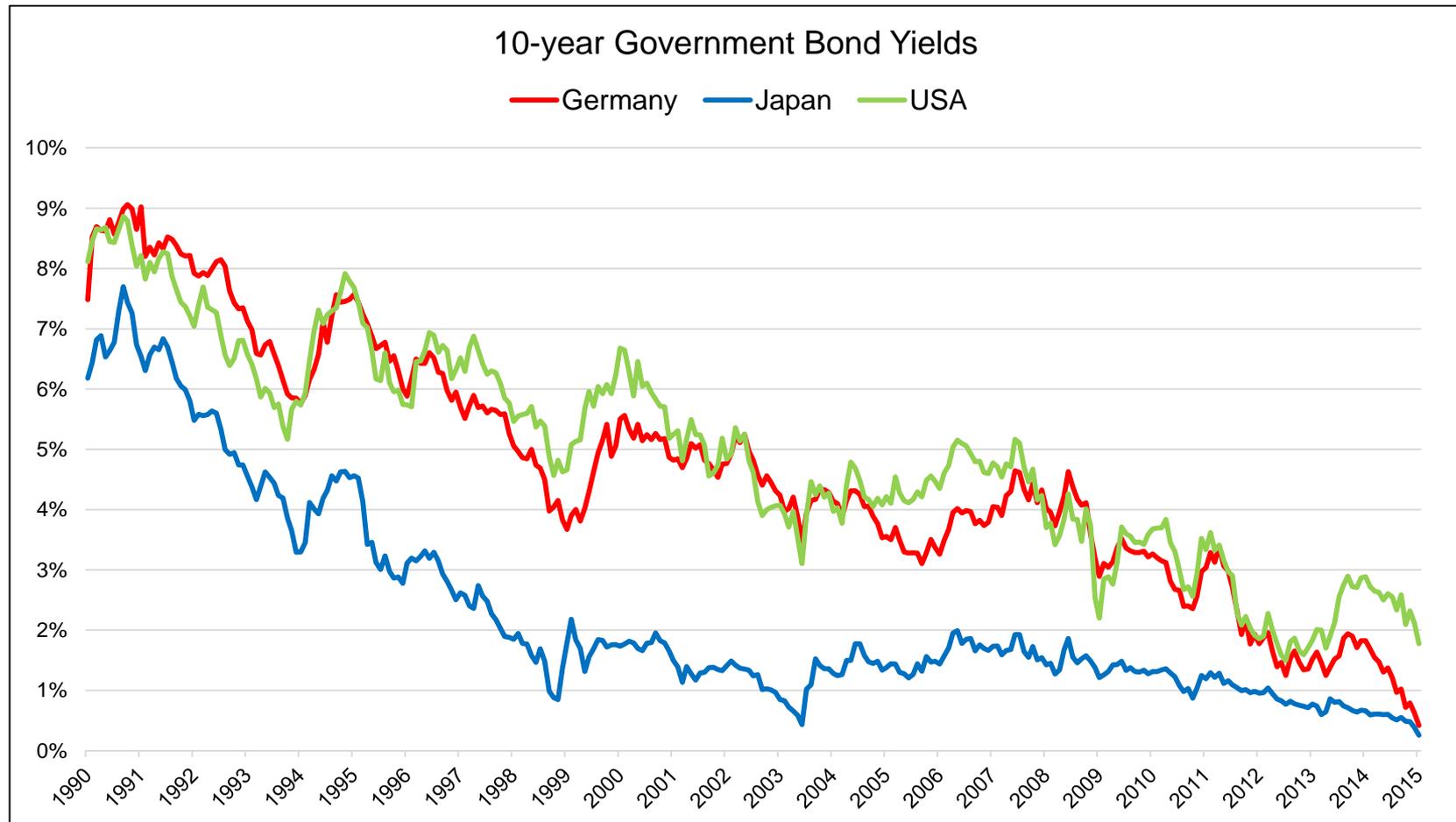
# Developments in the Eurozone

- 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

# Life Insurance Companies
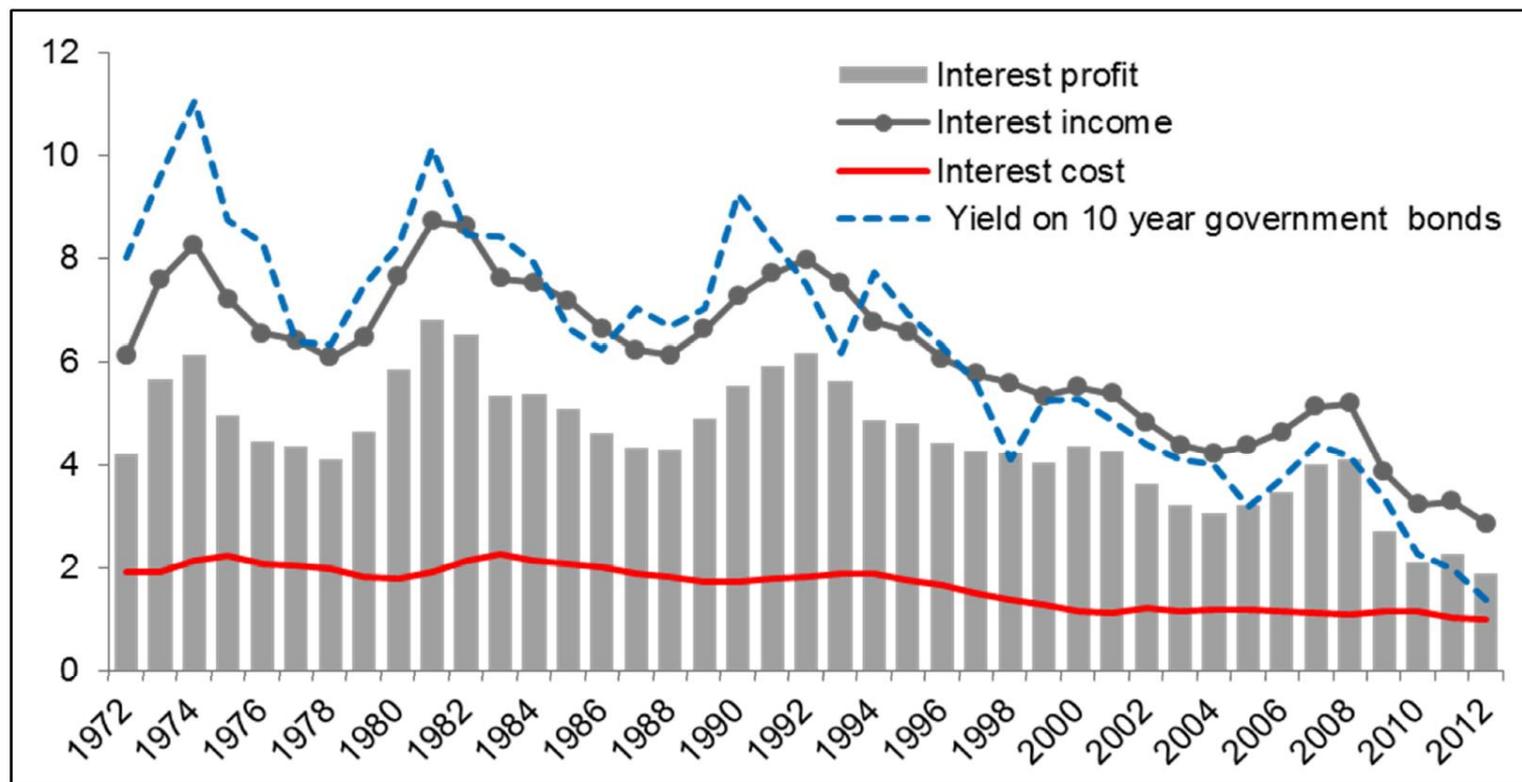
- Low interest rates are becoming a threat to the stability of the life insurance industry

- 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.

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# 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
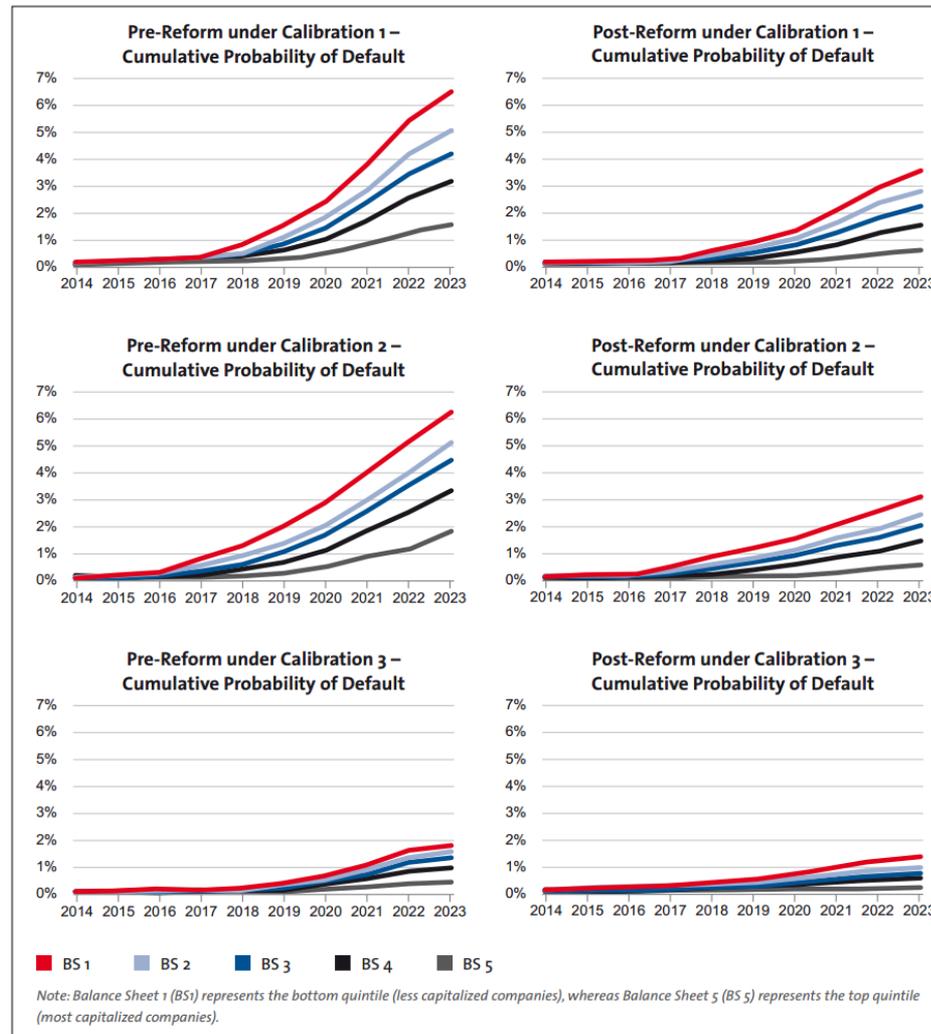


Source: Berdin and Gründl (2014)

# 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

| | |
|---|---|
| Less than 10% pension assets as % of GDP, mostly DB and hardly changing | Greece |
| Less than 10% pension assets as % of GDP, mostly DB and changing towards DC | Luxembourg |
| Less than 10% pension assets as % of GDP, mostly DC or substantial shift towards DC | Bulgaria<br>Croatia<br>Czech Rep.<br>Estonia<br>Latvia<br>Lithuania<br>Romania<br>Slovakia<br>Slovenia<br>Turkey |
| 10 to 50% pension assets as % of GDP, mostly DB and changing towards DC | Germany<br>Norway |

| | |
|---|---|
| 10 to 50% pension assets as % of GDP, mostly DC or substantial shift towards DC | Austria<br>Hungary<br>Italy<br>Poland<br>Portugal<br>Spain |
| More than 50% pension assets as % of GDP, mostly DB and changing towards DC | Belgium<br>Finland<br>France<br>Netherland |
| More than 50% pension assets as % of GDP, mostly DC or substantial shift towards DC | Denmark<br>Ireland<br>Sweden<br>Switzerland<br>UK |
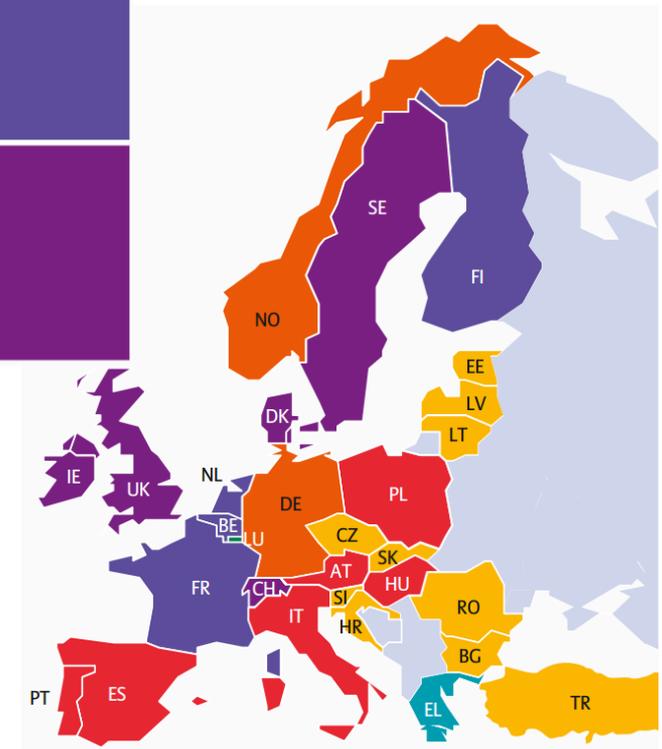
Source: Allianz International Pensions (2013)

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# 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

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