PACIFIC LIFE RE

Interest rates: riding the rollercoaster

Re:think

EUROPE | UK   December 2016

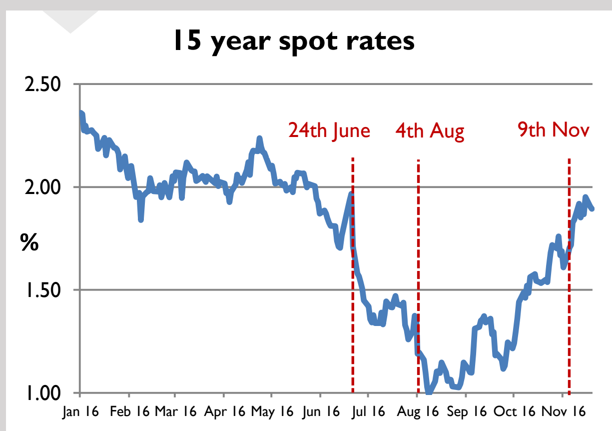
On the morning of Friday 24th June, the nation awoke to the news that the British electorate had voted to leave the EU. Sterling and the stock market dropped off a cliff with the latter rebounding in the following weeks. But the concern for many insurers was the yield curve. Yields dropped on news of the referendum result and then dropped again. But just when we wondered if record low interest rates were here to stay, the aftermath of the US presidential election caused yields to rise again.

BREXIT

Yields fell sharply on the 24th June and again on 4th August when the Bank of England responded to the prospect of economic weakness by reducing the base rate from 0.5% to 0.25% and announcing an extension of quantitative easing by £70 billion. As recently as 30th December 2015, the 15 year spot rate was around 250 basis points. It dropped to close to 100 during August.

US PRESIDENTIAL ELECTIONS

But then in November came the surprise result in the US Presidential elections. Yields which had been moving upwards since August jumped in the days following the result. The US Bond markets' expectation that the President-Elect's spending plans would drive inflation higher meant that US bond yields surged ahead and this pushed yields higher globally.



Source: Derived from Bank of England data

YIELDS MATTER

For insurers, yields matter. Lower yields mean lower returns on reserves. What's more, with Solvency II, there is an impact on regulatory capital. The cost of capital for the risk margin is fixed at 6% no matter what the interest rate is. So when risk free rates decrease, the 6% cost of capital rate for the risk margin remains unchanged. This has a profound impact, particularly for long term and whole of life policies. Lower long term interest rates mean that discounting has less effect on long term liabilities.

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Lower yields lead to pressure on margins and lower returns on capital. The consequences for regulatory capital could even constrain capacity for new business for longer term and whole of life policies. We could even see a reversal in the recent trend of decreasing office premiums.

So how have we got here and what does the future hold? At the start of 2008, the Bank of England base rate stood at 5.5% before a large number of cuts in quick succession left the base rate at 0.5% in March 2009. The base rate cut to 0.5% was regarded at first as an emergency cut with the expectation that things would go back to 'normal'.

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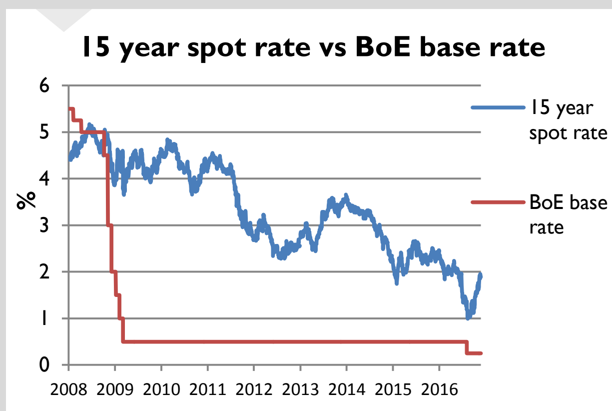

Source: Derived from Bank of England data

However, it soon dawned on markets that low base rates would be around longer than imagined and that realisation along with large doses of quantitative easing pushed long term yields lower. So that in the 7 years since base rates have been held at 0.5%, the 15 year spot rate has drifted downwards by about 200 basis points.

CAN YIELDS TURN NEGATIVE?

So could long term rates turn negative as in Germany where the 9 year spot rate is minus 0.12% or in Switzerland where even a 15 year spot rate is minus 0.21%? The key to answering that question is in considering why long term rates are negative in the first place.

Why would someone buy a German government bond which gives a guaranteed loss of 0.385% pa for 5 years or a Swiss government bond which gives a guaranteed loss of 0.18% pa for 10 years? The answer lies in the fact that in the Eurozone, the European Central Bank (ECB) charges European banks 0.4% pa for depositing overnight money. In Switzerland, the Swiss National Bank (SNB) charges 0.75% pa for overnight deposits.

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The ECB keep rates negative to stimulate investment and growth, while the SNB seeks to weaken the Swiss franc which has become a safe haven for global investors. In light of the rates for overnight money, the long term rates for debt issued by governments with little credit risk don't look that unattractive, particularly as you could still make a gain if long term rates become more negative.

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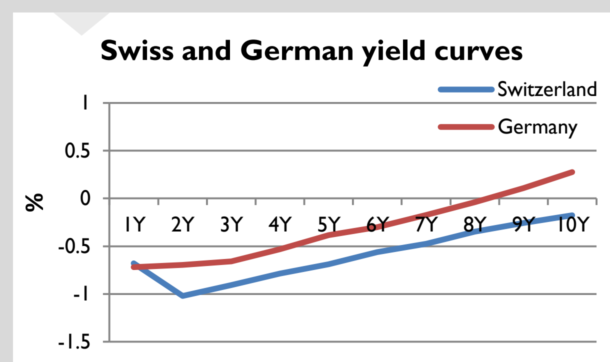
Furthermore foreign investors buying Swiss bonds do so with the knowledge that currency forward rates imply they will make a currency gain on the Swiss franc.



Source: SIX Swiss Exchange

Could banks keep their euros and Swiss francs under the proverbial mattress to avoid negative rates? Well, not really. The costs of storage and security for cash would be prohibitive.

Back in the UK, the Bank of England have stated that they will not set negative interest rates. Given that expectations theory says that the long term rates are a function of the expectation of short term rates, this would rule out the appearance of long term negative yields in the UK. But as we have all seen, things can change – including the policies of central banks.

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LOOKING AHEAD

In the summer, it looked like the downward movement in yields would never end but since then events have moved yields higher and almost to their pre-Brexit levels. Yet even at this level, yields are still low compared with their levels historically.

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The Chancellor's Autumn Statement heralded more government borrowing and the issuance of more government debt could drive yields higher. But these are still uncertain times as the UK begins the process to leave the EU. Any further signs of economic weakness could lead to another round of quantitative easing and even a hint of this could send yields lower again.

Finally global events, particularly in the US, will have an impact. So all in all, yields are likely to remain volatile in the months ahead.

As we continue to ride the interest rate rollercoaster, insurers are finding that their regulatory balance sheets are buffeted by volatile movements in interest rates due to the fixed cost of capital rate for valuing the risk margin. This interest rate volatility has generated a lot more interest from insurers who are looking to reinsurance to manage their capital and risk positions.

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