The impact of low interest rates on insurers and banks

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Introduction

- Long-term bond yields have been trending down for a prolonged period of time
- ...but some resurgence in volatility since mid-2015 (see Vstoxx index)

Sovereign bond yields for selected euro area countries
(percentages per annum, Jan. 2012 – Jul. 2015)

Sources: Bloomberg
Notes: The line refers to 22 January 2015 which was the date when the extended APP was announced.

Eurozone corporate bond yields and financial market volatility
(Jan. 1999 – June 2015)

Sources: Bloomberg
Note: percentages (lhs), index (rhs)
Introduction

• What is the impact of QE/low interest rate environment on the risk taking of financial institutions?
• With very low interest rates, banks and insurers may become desperate for higher returns and shift toward riskier investments
• Regulators are concerned of such behaviors with the financial crisis fresh in mind: very low interest rates could be fueling speculative asset bubbles
• Challenge for regulators: the evidence of reaching for yield/risk taking is hard to come by:
  – Look at prices: but difficult
  – Look at supervisory data (balance sheet data)
  – Look at behaviors:
    • non-price terms (investors can make loans with fewer “covenants”)
    • Surveys on financial institutions
Outline

1. Introduction

2. Impact on Insurers
   - Results of EIOPA surveys
   - Search for yield: flight from quality? Evidence from EU and FR data
   - Adaptation of business models going forward

2. Impact on Banks
   - impact on banks’ profitability and banks’ adaptation
   - Some particularities of French banking system
   - impact on banks’ risk taking behaviors
   - impact on the risk-taking in the provision of credit
1.1. Impact on Insurers
A Search for yield?

Qualitative examination: EIOPA surveys

- **No overall trend towards a search for yield** (EIOPA LIR* exercise 2014)
  - EIOPA assess that, although some insurers are increasing their share of higher yielding instruments or asset classes in the investment portfolio, the overall trend is not yet remarkable.
  - Less than half of the 26 participating authorities reported an increase in the share of higher yielding instruments or asset classes, and around 25% pointed to an increase in the share of higher yielding sovereigns.
  - Several companies indicated that they already had the adequate asset structure in place to cope with a long-lasting low interest rate environment and therefore no immediate change in the asset mix was needed.

*Low interest rate environment stock taking exercise 2014*
1.2. Impact on Insurers  
Search for yield: towards a greater duration?


- **Goal:** Examine to what extent portfolio adjustments by long-term investors in anticipation of ECB QE may have exacerbated the rapid decline in long-term interest rates in 2014 and into early 2015

- **Hypothesis:** The fall of the term premium is not solely due to investors looking for riskier assets (and better yields), but is also in part the consequence of a “hunt for duration”, i.e. an attempt to contain duration mismatches in the context of falling long-term interest rates

- **Key findings from the model**
  - The demand function is not monotonous
  - Inverted for low values of interest rates

- **Consequence**
  - Such a behavior may result in a vicious circle:
    - Falling rates might foster insurers’ investments in longer term bonds
    - This, in turn, may push further down long-term interest rates

![Figure 3: Plots of the holding of the benchmark bond y in the immunising portfolio; black line is for T = 10, red line is for T = 5, green line is for T = 3.](image)
1.3. Impact on Insurers
Search for yield: towards a greater duration?

Focus on « The hunt for yield: not waving but drowning? », Domanski et al. (2015)

- Key observations from the data
  - Data was provided by Bundesbank on aggregate bond holdings by the German insurance sector
  - Asset duration did increase in response to the rising duration of liability

Econometric regressions confirm that the demand curve inversion is specific to the insurance industry, which, the authors argue, reinforces their hypothesis that the inversion comes from a duration-driven strategy.
1.4. Impact on Insurers
Search for yield: towards a greater duration?

Darpeix et al. (2015): Comparison between Germany and France

- According to data from Darpeix et al. (2015), the French insurance market has not experienced such a rise in the asset duration, but a minor increase of 3.6% between 2013 and 2014
- This could reflect the presence of structural differences between both markets

Trends in asset duration in France (FR) and Germany (DE)
1.5. Impact on Insurers
Search for yield: flight from quality?

European Insurance Portfolio Review

- **A stable asset class distribution**…
  - The bond portfolio remains, by far, the most material asset category for insurers; mostly investment grade bonds;
  - Investments in equities, ABSs and real estate still remain modest.

- **… but a slight trend to lower credit ratings**
  - An overall trend towards lower credit ratings is remarkable (from AAA to AA, from A to BBB)
  - Other factors could also be the motive of the trend: capital optimization, downgrades,…

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**Investment portfolio split of selected large euro area insurers (from 2011 to 2014)**

**Bond investments in selected large euro area insurers split by rating category (from 2011 to 2014)**

Sources: JPMorgan Cazenove, individual institutions’ financial reports (based on 15 large euro area (re)insurers)
1.6. Impact on Insurers
Search for yield: flight from quality?

French Insurance Portfolio Review

- **Quite steady distribution of bonds ratings**
  - Share of investments grade bonds has been slightly bigger in 2014 (+1.3pt to 78.2%).
  - But we see an increase in the lowest classes (A and BBB rated bonds with +0.8pt and +1.2pt) and a decrease in the highest quality classes bonds (AAA, AA).

- **Corporate bonds allocation**
  - At YE2014 French insurers’ corporate bonds portfolio has less of AAA corporate bonds compared to the European portfolio.
  - Financial institutions form more than half of the corporate bonds issuers (55% vs. 62% for the European insurers portfolio).

Bonds portfolio by ratings as YE2014 (outer circle) vs. YE2013 (inner circle)

Corporate bonds allocation by ratings and issuers types for French and European insurers

Source: Banque de France
Source: ACPR, EIOPA Insurance Stress Test 2014; Note: Europe includes France
1.7. Impact on Insurers
Adaptation of business models to the LIR environment going forward

- **Significant sales of unit-linked products**
  - The Euro-denominated contracts are still the life contracts most held (83% of provisions), but sales of unit-linked products have sharply increased since the beginning of the year and net premium in unit-linked products now overpass net premium in euro denominated products.
  - The new prudential framework also explains this growth of unit-linked products.

- **Downward trend of rates on life contracts**
  - The **guaranteed rate** on new business is largely established at 0% currently.
  - The **participation rate** on life contracts in France has been reduced from 4.1% in 2007 to 2.5% to 2014.

- **Diversification of liabilities**
  - Diversification strategies take place towards activities less sensitive to interest rate risks (health/protection, general insurance).

![Net inflows (premiums - claims) on the French market](chart.png)
2.1. Impact of QE/low interest rates on banks

- A prolonged period of low interest rates (LIR) and notably its negative impact on banks’ net interest income affects banks’ strategies towards looser risk tolerance.

- Banks generally follow ‘absolute return’ strategies pushing them to search for yield by:
  A. Increasing riskiness of exposures or investing into high-duration assets
  B. Increasing the share of trading activities and fee income
  C. Offsetting the decreasing net interest margin by higher volume of loans and lower credit standards

- Other effects of LIR/QE:
  i. Low interest rate environment incentivizes banks to engage into carry trades which may result into vulnerabilities in case of sudden reversal
  ii. QE might reduce market volatility which is bad for investment banking securities trading revenues
  iii. In low interest rate environment, incentives may become distorted, mispricing of risk may occur. Banks may over-invest in assets with higher duration. If interest rates rise unexpectedly, the value of those assets would fall.
  iv. Increasing asset prices as a result of QE may lead on one hand to profit frontloading and to limited reinvestment opportunities on the other hand.
2.2. Banks: impact of LIR on banks’ profitability and banks’ adaptation

Net interest margin is impacted by the low interest rate environment
(Annual data, 1995 - 2012)

Banks are looking into other sources of revenue to compensate for decreasing interest margins …
(2011 – Q1 2015, shares)

Breakdown of operating income for a sample of 91 SSM banks, in percentage

Sources: SSM supervisory information (FINREP and STE) for 91 Significant Institutions

Sources: Thomson Reuters Datastream
Some particularities of French banking system

- On the asset side
  - A larger share of loans is granted at fixed rate, 57% for the 5 largest banks (BNPP, GCA, SG, GBPCE, and GCM) at the beginning of 2014.
  - The negative impact of low interest rates may be attenuated.
  - However, the renegotiations of loans rates contribute to reduce banks’ NIM in low interest rate environment.

- On the liability side
  - The share of deposits in the financial liabilities amounted to 58% for the 5 largest banks in 2014.
  - Regulated savings represent a significant share of French banks’ liabilities: In 2014, the stock of Livret A represented about EUR 230 billion.

- A model of the NIM is estimated for French banks
  - The aggregated net interest income was EUR 70.4 billion in 2014.
  - We consider two scenarios and the impact on the aggregated NIM is:
    - A decline in the interest rate spread of -0.78 percentage points: NIM declined by EUR 4.6 billion.
    - Changes in 3 month Euribor (-0.01) and 10 year long term French government bond rates (-0.53) : NIM declined by EUR 5.3 billion.
2.3. Banks: impact of LIR on banks’ risk taking behaviours

The low interest rate environment has contributed to banks extending their asset maturities … (Q1 2003 to Q1 2015)

... and investing towards riskier asset classes (2014Q1 – 2014Q4)

Estimate of average asset maturity of euro area MFIs, in years

Source: ECB Balance Sheet Items

Banks’ holdings of newly issued securities in the euro area: distribution across rating classes (per cent)

Source: ECB
2.4. Banks: impact of LIR on the risk-taking in the provision of credit

- In terms of search-for-yield, the Bank Lending Survey shows some containment:
  - Narrowing of margins for average loans acute since 2012 but no significant narrowing for riskier loans
  - Credit lending standards for house loans (euro area): same levels as in 2005-2007.

*Evolution of loan margins based on the Bank Lending Survey for France*

*Credit lending standards based on BLS for the euro area*

*Source: Banque de France  
Source: ECB*