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Sixty second summary

Negative interest rates

With economies facing deep recessions from the economic shock caused by the COVID-19 pandemic, all measures to boost demand, including negative interest rates, will likely be on the table. While negative interest rates remain under "active review" at the Bank of England (BoE), we consider the potential merits of the policy, the possible impacts on scheme assets and liabilities and the actions trustees might want to take.

Negative interest rates are not unusual anymore

With economies facing deep recessions from the economic shock caused by the COVID-19 pandemic, all measures to boost demand will likely be on the table, especially if fiscal policy were constrained by politics or the size of sovereign debt burdens.

Negative interest rates were already in place in many developed economies well before the pandemic. The European Central Bank (ECB) was the first out of the traps when they lowered the deposit rate for commercial banks to -0.1% p.a. in June 2014. Denmark, Japan, Sweden and Switzerland are countries that have all since taken policy rates negative. The ECB, Japan and Sweden deployed the policy with the aim of rekindling inflation expectations while Denmark and Switzerland have used negative rates to halt currency appreciation and reverse massive capital inflows.

The BoE cut interest rates to 0.1% p.a. in March and restarted purchases of government bonds under their quantitative easing programme. The tone has changed noticeably on the use of negative interest rates in recent months: initially described as something the bank was not "planning or contemplating", negative interest rates are now under "active review". Indeed, UK nominal gilt yields are already negative between 1 and 6 years and in May the UK sold 3-year debt at a negative yield for the first time. While unprecedented in the UK, this issue joins the $13tn of debt, globally, that trades with a negative yield.

Why might interest rates become negative?

Cutting interest rates aims to stimulate demand from households and companies. With rates at 0.1% p.a., rates cannot be taken lower without moving into negative territory. The theory is no different to that behind any other interest rate cut: if banks earn less or are charged, in the case of negative rates, on money deposited at the central bank, they should be more incentivised to lend rather than leave on deposit. To the extent that rates are passed on to households and businesses, there should be greater incentive to borrow and spend, rather than save.

Another potentially beneficial impact of negative interest rates could be to weaken the currency, making domestic products more competitive compared with imports.

Ultimately, the aim of negative interest rate policy is to combat the self-fulfilling low growth and low inflation environment many major advanced economies have found themselves in, even prior to the pandemic. The long-term decline in interest rates and bond yields has gone hand in hand with ageing demographics, a savings glut, globalisation and the mass adoption of technology, and, some suggest, a rise in inequality as a larger share of wealth goes to those most likely to save it.

Diminishing marginal returns and the “reversal rate”

However, there are potential risks associated with negative interest rates and many commentators have highlighted the potential damage their use may cause.

Central bankers are growing increasingly concerned that there exists a level of interest rates, known as the “reversal rate”, below which further cuts become contractionary for lending as negative rates reduce a bank’s net interest margins, and hence profitability, and may cause a pull-back in lending activity.

Negative interest rates would likely exacerbate affordability challenges for pension schemes and insurance companies that use long-term yields to value their liabilities and also hold large amounts of bonds to honour those liabilities.

Paradoxically, it is also suggested negative interest rates may force people to save even more – not less – to compensate for the prospect of reduced retirement income, in turn exacerbating the issue the policy is trying to address.

Ultimately, negative interest rates cannot force households and companies to borrow or create attractive investment opportunities. As many central bankers have observed recently, ongoing fiscal policy may be required to stimulate growth and inflation as conventional monetary policy faces diminishing marginal returns of further cuts from already low levels.

Impact on assets and liabilities

The impact on assets and liabilities will, to a large extent, depend on how successful the market believes the policy will be in rekindling future growth and inflation. If the market believes short-term rate cuts are sufficient to deliver a substantial rise in future growth and inflation, the yield curve would be expected to steepen – falling at shorter-terms, reflecting the potential path of interest rate policy, and rising at longer-terms to reflect growth and inflation expectations.

Of course, longer-term bond yields are of far more consequence to pension scheme liabilities than changes in short rates. The uncertainty lies in the potential reaction of the market to shifts in monetary policy described above. Though, once we know the impact on longer-term yields, the subsequent impact on liabilities is a formality. If the market is convinced that central banks will deliver sufficient stimulus to raise growth and longer-term yields, this would reduce liabilities. If, on the other hand, negative rates served to entrench expectations of low growth and lower long-term yields, the value placed on liabilities would increase. On top of this, increases or decreases to inflation expectations will also impact the value placed upon inflation-linked liabilities.

All else equal and assuming a parallel shift in yield curves, negative interest rates should tend to raise asset prices – a mathematical certainty for bonds and in theory for other assets, as lower risk-free rates imply a higher present value of all future income.

However, for credit, equity, and property – not risk-free assets – the context in which rates are being lowered will be important. Central banks can lower rates, but what is happening to the future stream of income and the risk attaching to the anticipated income stream will influence the overall impact on prices. In short, if a reduction in risk-free rates is accompanied by expectations of increased defaults, a reduction in earnings or fall in rental growth, investors would demand a higher risk premium and therefore lower prices. Alternatively, lower interest rates may mean investors are willing to pay more for those assets if their view of the fundamental investment characteristics is unchanged.

Impact on scheme funding – actions for trustees

The overall impact on scheme funding levels will be determined by the level of hedging and the relative impact between liabilities and assets. While the impact on the value placed upon the liabilities, hedging assets and government bond prices is formulaic the potential impact on other assets will also be driven by changes in the risk-premium demanded by investors.

Trustees need to recognise the potential for nominal short rates to become negative and the impact that subsequent changes in longer-term interest rates and expected inflation might have on both liabilities and assets. Thinking about the potential consequences for the assets they hold will help them decide whether their investment strategy remains appropriate, or whether they should consider changes to make the strategy more resilient.

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