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# Nothing under the Sun is Forever

Aristotle had a problem with interest rates. Money was intended to be used in exchange, he wrote, but interest meant the birth of money from money. "That is why of all modes of getting wealth this is the most unnatural," wrote the man who gave economics its name. Aristotle would presumably have been highly satisfied when, in July 2016, a ten-year German Bund was issued with a zero-percent coupon for the first time.

In the financial sector, of course, the mood is different. Interest rates have remained at very low levels for years – and there is no change in sight. The historically long period of low interest rates is no longer just troubling those specifically affected by the collective savings or risk mitigation business model, such as life insurers, *Pensionskassen*[1] and *Bausparkassen*[2]. Low interest rates are now an issue affecting everyone in the industry who is dependent on interest income. 75 percent of the business of banks in Germany depends on net interest income. So a knowledge of higher mathematics is hardly required to recognise that a lot of credit institutions are going to get into difficulties if interest is as good as abolished.

The insidious thing about the current situation is that the pressures caused by low interest did not arise overnight, but slowly yet surely are eroding credit institutions' balance sheets like a slow drip of acid, adding to their already existing profitability weakness. In addition, it must be remembered that in recent years companies have received a strong boost from some positive effects, which cannot simply be repeated at will. These effects included, for example, more favourable terms for refinancing, higher volumes caused by the favourable lending conditions, which have created a virtual boom in certain forms of financing, and in particular the very low burdens, or even positive impact from the valuation results. This could easily give the impression that in fact, everything is fine. Yet a simple look back would not only be misleading, but would ultimately actually be dangerous. Competition in the business segments mentioned is extremely strong and, at some point, the economic tailwind will ease off. We have to pay close attention to ensure that no bubbles or risk concentrations occur.

All our analyses show that the low interest rate environment will weigh heavily on banks' balance sheets. As supervisors, it is our duty to take a close look at this situation. We do this in the Supervisory Review and Evaluation Process (SREP), among other things, where we check whether companies supervised by the Federal Financial Supervisory Authority (BaFin) are holding sufficient own funds for all material risks, particularly with a view to the interest rate risk in the banking book. BaFin puts institutions where this risk is particularly high under the microscope and asks them how they intend to cover the interest rate risk in the banking book in times of falling earnings prospects.

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We also look at what strategies banks are developing as a whole to compensate for dwindling interest income. Are they reducing costs? Are they strengthening their capital base? Are they scrutinising their business models and looking for ways to expand their non-interest bearing operations? Are banks offering their services at appropriate prices, for example? Even although there is no panacea and it is sometimes easier said than done, banks do have options and they should make use of them. The reason for this is that one thing is sure: institutions' reliance on net interest income certainly cannot stay as it is.

It is, however, not just banks that are facing major challenges due to the low interest rate environment: insurers are too. Life insurers, in particular, are struggling greatly with the historically low rates. They are suffering from visible drops in their investment income. It is difficult to tell how the situation will develop in the long term. It may be that, in the long run, not all companies will be able to withstand the pressure. However, we remain confident that German life insurance undertakings will be able to meet their commitments in the short to medium term.

The initial results of Solvency II have shown us that life insurers – and the insurance industry in general – have adjusted to the new supervisory regime and managed the transition from a book value to a market value approach. The transitional measures and volatility adjustment stipulated in the regulations are achieving the desired effects. That is no bad news, but the transitional measures will gradually run out within 16 years. They do not solve the problems, they just provide some time to adapt. Some insurers will need to make major efforts to strengthen their capital base. We also pay close attention to those insurers whose performance raises questions for the medium term. We want to know how they intend to ensure that their capital base is sufficient when the transitional measures have run out.

Since 2011, life insurers have had to make an additional provision to the premium reserve, the *Zinszusatzreserve* (ZZR) to compensate for the reduction in their investment income in times of low interest rates. This instrument is an important lever for ensuring greater stability. As a capital buffer, the ZZR is fundamental for insurers. However, we also need the additional provisions to protect the insured from the erosion of the economic substance of their life insurance. At the end of 2016, the pot for life insurers contained approximately 44 billion EUR. The ZZR will continue to increase in the years ahead. Of course, that represents a major burden on companies. We are keeping a close

[1] *Pensionskassen* are one of the two types of institutions for occupational retirement provision (IORPs) existing in Germany.
[2] *Bausparkassen* are credit institutions whose business objective is to accept *Bauspar* deposits (*Bauspareinlagen*) from *Bauspar* customers (*Bausparer*) and to grant *Bauspar* loans (*Bauspardarlehen*) from these aggregate savings to *Bauspar* customers for residential economic measures.

eye on developments, both at the level of individual life insurers and industry-wide.

As with banks, business cannot continue as usual for insurers in a stable, low interest rate environment. They, too, must use the options available to them to readjust their business policies. For example, companies can try to drive costs down and think about reinsurance solutions. They can work on their product range and develop new products with new forms of guarantee. The traditional guarantee products are not even offered by some insurers anymore, but of course, they are still possible. In the current market situation, the fact that the maximum technical interest rate for new contracts has been limited to 0.9 percent since January 2017 is, however, correct and unavoidable.

As for *Pensionskassen*, they are suffering at least as much from the low interest rates as life insurers. Their portfolio consists almost entirely of contracts, which oblige them to pay life-long pensions to the insured. These people are getting older and older, on average, which puts an additional burden on results. Against this background, *Pensionskassen* have been taking actions to support their ability to provide their benefits in full using their own resources. However, in case a benefit reduction should be necessary, the subsidiary responsibility laid down in the German Occupational Pensions Act usually holds the employer liable. It is possible, of course, for the employer to provide additional funds to the *Pensionskasse* to avoid such reductions in benefits.

It is beyond dispute that the sustained period of low interest rates poses great challenges to the financial sector – and it is not just regulators and supervisors who are aware of this. It is my impression that companies, too, have grasped the need for changes given the current outlook. However, there is less of a consensus of views when it comes to regulatory measures. In particular, there are, naturally, differing opinions on the right amount of regulation and supervision, depending on the respective perspective.

Of course I understand it when companies criticise regulation with a view to their costs. However, the past financial crisis brought it painfully home to us that we cannot do without an appropriate regulatory framework for the financial sector – and one which is effectively enforced. Good regulation and a functioning supervisory system are prerequisites for stability in the financial markets and – which is almost more important – for justified confidence in the stability of those markets.

Customers must be able to be confident that their deposits are secure and that the providers of insurance and pensions will be able to provide the promised benefits, even in times of low interest rates. As supervisors, therefore, we need the right tools at hand, so that companies in the low interest environment do not take excessive risks in order to fulfil their objectives and obligations. However, we have not observed a general trend of this nature as yet, neither among banks nor insurers.

But we need to remain alert. Nobody knows how long the low interest phase will go on – and even a rise in rates could cause difficulties if it came suddenly. It would not just be banks that offer long-term financing and have their own short-term financing, which would run into problems then – life insurers would be affected too. Many insurers have already invested large volumes under current conditions. More recent fixed income securities, in particular, could turn into hidden liabilities. So, if we were granted a wish, we would have to ask for a gradual rise in interest rates. Unfortunately, the good fairy only exists in fairy tales and despite various attempts to conjure it up, no real change to interest rates is in sight.

On the other hand, Anton Fugger, one of the most important financial businessmen of the late German Middle Ages, said: “Nihil sub sole perpetuum – nothing under the sun is forever”. And so the clouds darkening the interest rate skies may, at some point, clear again. Until that time comes, we have to work together to create strong and stable financial markets.