Ignazio Visco: Financial stability in a world of very low interest rates

Keynote speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the 43rd General Assembly of The Geneva Association, Rome, 9 June 2016.

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Since the 1980s we have been observing a marked downward trend in nominal interest rates in the major advanced economies. This decline is explained by lower inflation and inflation risk premia, and by a reduction of real interest rates. In these countries real long-term yields have fallen on average from around 5 percent in the early 1980s to about 2 percent before the financial crisis, and to approximately zero percent today.

More recently, very low or even negative interest rates mainly reflect the slack in the economy and excessively low actual and expected inflation. The euro area, in particular, is still slowly recovering from two consecutive financial crises and a long recession. Real GDP has only recently returned to the 2008 level and cyclical positions continue to differ across member states. Inflation remains well below the levels consistent with the ECB definition of price stability: it has now been below 1 percent for almost three years and in the last few months it has turned negative once again. Core inflation (which excludes the more volatile components) has not exceeded 1 per cent over the last two years; it reached a historical minimum (0.6%) at the beginning of 2015 and stands only slightly above it in the latest readings. The risk of a de-anchoring of inflation expectations has become material since mid-2014 and is still high, although it declined at the beginning of 2015 following the announcement by the ECB Governing Council of its public sector purchase programme.

While these considerations indicate that the current low level of interest rates is not an arbitrary choice of central banks, the risks posed by a protracted, very accommodative monetary policy need to be monitored carefully. And so they are. Very low (or negative) interest rates for too long raise fears that they may be a source of financial risks by fuelling asset price misalignments and endangering the profitability of financial institutions.

The risk of asset price misalignments (or "bubbles") is strictly connected to the incentives for an excessive "search for yield" that an environment of low nominal and real interest rates creates for investors and financial intermediaries alike. At present, indicators of imbalances in housing and credit markets do not point to increasing vulnerabilities in the euro area as a whole. To the extent that risks materialise, appropriate macro-prudential measures at a country level can be implemented to limit their accumulation. Moreover, in assessing the risks of excessive "search for yield" we should not forget that the quest for higher yields may also improve the scope for portfolio diversification. In the euro area, institutional investors certainly have room to better diversify their assets. According to recent estimates by the European Commission, for insurance companies and pension funds, the portfolio share of equity instruments is around 10 percent, compared to more than 20 percent in the UK and almost 45 percent in the US.

The other main concern for financial stability is that low or negative interest rates may have an adverse impact on the profitability of banks and institutional investors, ultimately putting their financial soundness at risk. In evaluating this issue we should take into account all the effects that low interest rates may have on the balance sheets of financial institutions. In the banking sector, the negative impact on interest income may be counter-balanced by a more favourable effect on other revenues: in addition to one-off capital gains on securities portfolios, an increase in fees and commissions from banking services and – given that low interest rates bring about an improvement in the economy and thus in borrowers' creditworthiness – a reduction in provisions. Institutional investors may also benefit from a stronger demand for asset management services by households, due to the latter's need to better diversify their portfolios, as well as from a broader range of investment opportunities thanks to corporations' greater demand for non-bank debt and equity capital.

In the short term, the main risk derives, not least for financial institutions, from the persistently weak and uncertain macroeconomic outlook; the most effective way to reduce this is to lift economic growth and employment. In the euro area, and in the other advanced economies that are still facing subdued activity and too-low inflation, this calls for economic policies to sustain aggregate demand; improvements in the cyclical position will also facilitate the implementation of structural reforms needed to raise potential output and ensure a sustained economic recovery.

Non-standard monetary policy measures are especially effective in alleviating the contractionary consequences of economy-wide deleveraging in an environment in which nominal interest rates are hovering around the zero lower bound. We have clear evidence that the measures undertaken by the ECB Governing Council over the last two years have been effective. Estimates, among others, by Banca d'Italia staff (which do not consider further possible non-linear effects) show that in the absence of the measures adopted between June 2014 and December 2015, both annual inflation and GDP growth in the euro area would be lower by about half a percentage point in 2015–17. The expansion of economic activity in 2015 would have been slightly below 1 percent, against an observed 1.6 percent; inflation would have been negative, at about –0.5 percent, against 0.0. These estimates are consistent with those of the Eurosystem and the ECB staff. In Italy, the effects are estimated to be even stronger.

From a medium-term perspective, the financial stability implications of a low interest rate environment require a deeper assessment of the fundamental forces shaping real interest rates. In the current debate there are varying views. According to the "debt super-cycle" view, interest rates, growth and inflation are low because of the legacy of the financial crisis; in the medium term they will go back to "normal". According to the today fashionable "secular stagnation" hypothesis, advanced economies suffer from a persistent imbalance resulting from an increasing propensity to save and a decreasing propensity to invest; excessive savings act as a hindrance to growth and inflation, and pull down real interest rates. A number of supply and demand factors, all characterised by a high degree of persistence, have been considered to justify this imbalance. Demographic developments, high demand for safe assets in emerging economies, increases in wealth and income inequality and a permanent decrease in total factor productivity are the main examples.

If we accept, instead, the view of those who suggest that we are in a transition towards the "second machine age", low interest rates may be seen as the result of an adjustment temporarily characterised by weak demand and high unemployment; in the longer run, productivity gains due to the ongoing digital revolution and many other current and foreseen technological innovations will increase economic growth and raise real interest rates, even if with uncertain consequences for the distribution of incomes. It is not easy to assess which of these views is more likely to be confirmed by the future evolution, but none of them can be totally dismissed *a priori*; future developments could result in a combination of these different hypotheses. All this considered, it is conceivable that real interest rates will go up in future years, but how far in the future this will occur is very difficult to assess.

Since a scenario in which a low interest rate environment extends for a long time into the future cannot be ruled out, it is important to assess its possible impact on financial institutions in order to identify the appropriate responses. The main vulnerabilities for life insurance companies and pension funds would result from maturity and yield mismatches between assets and liabilities. As identified by the 2014 stress test conducted by EIOPA, a low interest rate scenario could put under particular pressure the profitability and resilience of insurance companies with long-term guarantees and negative duration gaps, leading to shortages in their solvency capital ratio. The risk is significant in some euro-area countries; it may be less marked in Italy, thanks to a fundamentally balanced financial structure.

To mitigate profitability concerns, life insurance companies and pension funds will have to adapt their business strategies. So far, actions taken by insurance companies have differed depending on whether they are related to new or existing products. For new contracts, there is a general trend to offer lower or no guarantees and develop other types of products, including unit linked policies, in which the risk is held by policyholders and beneficiaries. This is also a response to the new Solvency II prudential regime, which requires additional capital for guaranteed products. For existing contracts, the main actions consisted in reducing the shares of returns distributed to policyholders and, where legally feasible, the renegotiation of contract terms.

As far as retirement savings are concerned, the persistently low market yields have strengthened the tendency, already established, to replace defined benefit schemes with defined contribution schemes. The mechanisms to mitigate the risk of the underfunding of defined benefit schemes vary across national jurisdictions; they include increased capital buffers, additional sponsor support and guarantee funds, as well as the reductions of accrued benefits.

From a regulatory viewpoint, the introduction of Solvency II for European insurance companies is a major turning point. The new regulatory regime is a valid tool for mitigating portfolio risks. Some provisions were introduced in Solvency II to dampen the impact of interest-rate volatility on insurance companies' balance sheets, such as those related to the parameters for the extrapolation of risk-free interest rates at very long-term maturities and other measures that are meant to smooth the transition to the new prudential regime; such provisions may also reduce the impact of a prolonged situation of low interest rates. The scope for portfolio diversification has been enhanced by introducing lower capital requirements for investments in high-quality infrastructure and securitisation instruments, as well as in shares of closed-end funds targeting long-term investments and venture capital. In order to deal with system-wide instances of instability, other measures are currently being discussed at a macro-prudential level, including a harmonised EU framework of recovery and resolution for the insurance sector; however, such framework is still at an early stage.

The low interest rate environment and the rapid pace of transformation of the supply of financial services make consumer protection as important as ever. Ensuring an appropriate level of consumer awareness and information is a policy priority, especially in countries where households depend, to a large extent, on guaranteed insurance savings products or funded pension schemes.

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We all face a highly uncertain future environment. A deeper understanding of challenges and possible consequences is crucial for all the stakeholders in the financial industry. Policymakers, financial institutions, firms and households need to be ready to rethink and, if necessary, adapt their behaviour.

In the short term, in particular in the euro area, an expansionary monetary policy remains of key importance to supporting aggregate demand and attaining price stability, and to preserving financial stability from debt-deflationary risks. As to the longer term, it is difficult to foresee how the factors affecting real interest rates will evolve; and this uncertainty bears on their current low level. Financial institutions should be aware of the compelling need to effectively adapt their business models, both in their internal organisation and in their supply of products; it will be especially important to fully exploit the new technologies in order to provide the most suitable financial products for firms and households. In any event, access to sound information about issuers and financial contracts, transparent behaviour by firms and financial corporations, improvements in households' financial education are key prerequisites for the financial sector to effectively allocate risks in the economy. For regulators, the challenge remains one of striking the right balance between allowing financial innovation while preventing it from endangering financial stability.