Opinion **FTfm**

Negative interest rates can be a doom loop for pension investors

Fixed income is turning into fixed expense for those who seek haven assets for capital conservation

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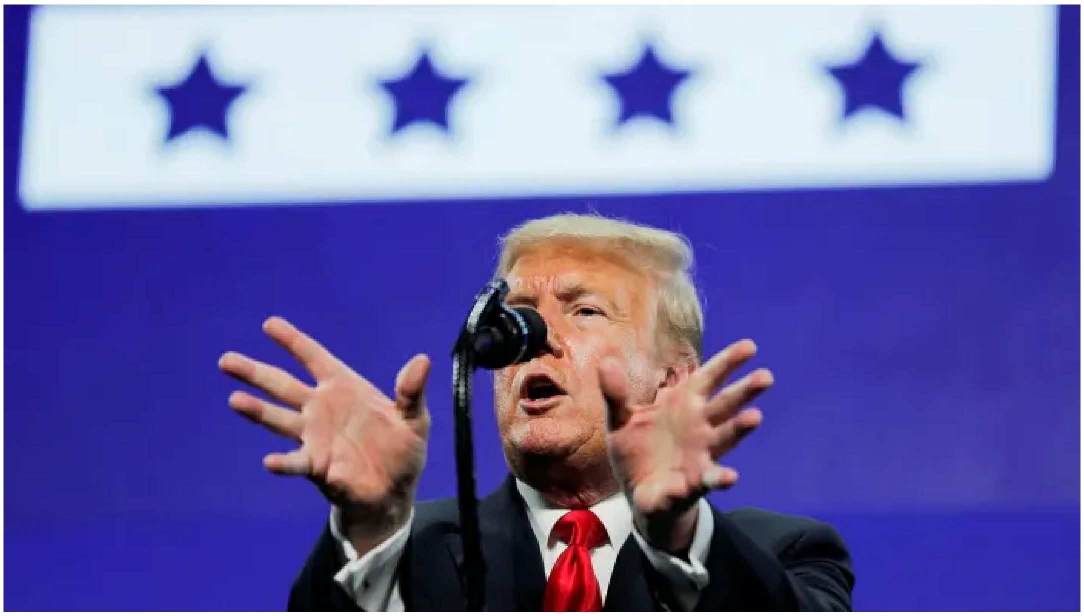

US President Donald Trump has been pressuring the Federal Reserve to embrace negative rates © REUTERS

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“On the whole, negative interest rates, no . . . not an area I would want to go to,” said Bank of England governor Andrew Bailey to members of the UK parliament in March. Two months later Britain sold a government bond with a negative yield for the first time, as Covid-19 created the dystopian reality of deserted airports and traffic-free highways.

Negative interest rates are an oxymoron. Most people’s jaws drop when they first hear of them. Yet, about $15tn of bonds already had a negative coupon at the end of 2019. Even the US Federal Reserve has been under pressure lately from President Donald Trump to embrace them.

The German government’s €2.4bn 10-year Bund sale in March 2019 was oversubscribed threefold even though it offered a negative rate of 0.05 per cent. Investors were willing to pay the issuer half a per cent each year for the next 10 years for the privilege of lending it their money. Thus, fixed income is turning into fixed expense for those investors seeking haven assets for capital conservation or balance sheet management.

The starting gun was fired by the European Central Bank when it cut its deposit rate for commercial banks to minus 0.10 per cent in June 2014. Denmark, Japan, Sweden and Switzerland followed suit. The ECB, Japan and Sweden wanted to rekindle inflationary expectations. Denmark and Switzerland wanted to halt currency appreciation to reverse massive capital inflows.

Whatever the reason, negative rates mark the latest twist in a prolonged downward spiral, as the global economy became trapped in a self-fulfilling slow growth/low inflation funk, aided and abetted by ageing demographics, the savings glut and revolutionary technology.

In response, central banks have been cutting rates — mostly in vain — to stimulate aggregate demand by households and companies. The bang per buck for each extra dollar of stimulus has been getting smaller in a perverse environment where inflation has gone from being a destroyer of financial wealth to a measure of economic health.

Negative rates could end up doing more harm than good, according to a research paper from asset manager Pimco. While successful in easing conditions in financial markets, they come with three health warnings.

They impair the banking system, as banks earn less on their assets. They pose massive challenges for insurance companies and pension plans that are obliged to use bonds to honour income guarantees to the end-savers. Finally, perversely they may well force people to save even more — not less — to compensate for the prospect of reduced retirement income.

"It is not clear where exactly the switch is flipped between wanting to save less and wanting to save more," says Eric Lascelles, chief economist at RBC Global Asset Management. He adds that different central banks have come to varying conclusions, with the ECB and the Bank of Japan judging that slightly negative interest rates may help the macro economy.

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Of course, unusual times demand unusual measures. But that does not mean they will all work. Despite its formidable arsenal, the Fed has been powerless to force creditworthy households and enterprises to borrow, nor to create profitable ventures for capital to invest in. Negative rates cannot cure the problems that caused negative rates.

As a side effect, the falling rates of the past decade have already made defined benefit plans ruinously expensive for employers seeking to provide decent retirement income to their employees.

Last month, the Dutch cabinet proposed a new system in which pension entitlements will simply rise and fall in line with markets. “DB plans will disappear and the pension contract will have a DC character,” says Frank Driessen, chief executive of Aon Retirement & Investment Netherlands. People will just have to spend less, save more, save early and retire late. Interest rates will no longer matter in determining pension affordability, after continuously plumbing fresh depths.

Alongside ballooning pension liabilities, the timing of falling rates has been most inopportune. They have shrunk the income from bond portfolios traditionally used to fund regular payouts just when ageing member demographics have been forcing pension plans to de-risk their portfolios by loading up on bonds — only to discover that they deliver a pittance.

The latest data from pension consultancy Mercer show that 64 per cent of plans across Europe were in negative cash flow territory in 2019 — there was more money going out to retirees than was coming in from investments and monthly contributions. And 91 per cent of them are now forced to raid their capital base to bridge the gap, bearing a worrying resemblance to a Ponzi scheme.

Mr Bailey’s abrupt pivot only goes to show how times have changed: what seemed like heresy 10 years ago is the new orthodoxy. The same with the pension promise: it is no longer sacrosanct.

Amin Rajan is chief executive of Create Research