

Negative interest rates – implications and considerations

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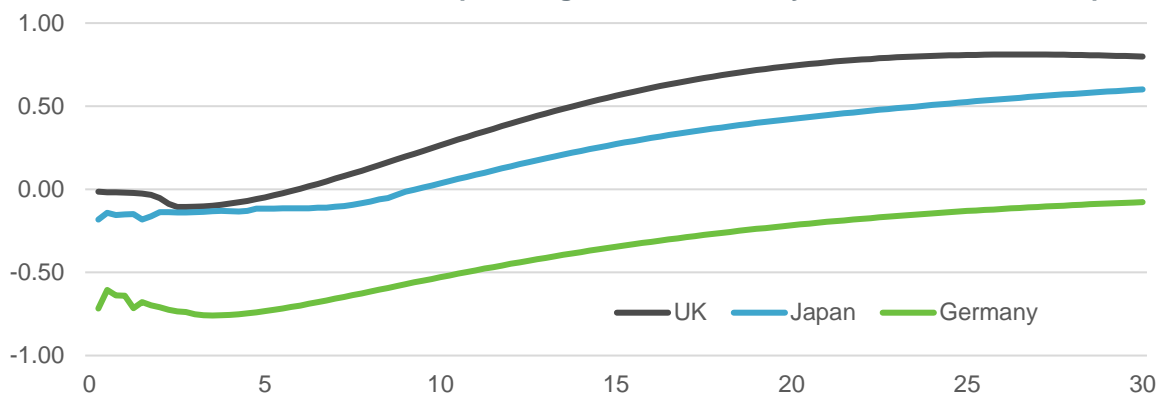
Here, we discuss the possibility of UK interest rates falling below zero and we consider some of the practical considerations and implications for assets and liabilities of negative interest rates.

Background

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. These measures include the potential for UK interest rates to go negative.

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.

Chart 1: Nominal UK, German and Japanese government bond yield curves as at 30 September 2020



The BoE cut interest rates to 0.1% p.a. in March 2020 and restarted purchases of government bonds under their Quantitative Easing (QE) programme. The tone has changed noticeably on the use of negative interest rates this year: initially described as something the bank was not “planning or contemplating”, negative interest rates are now under “active review”. In fact, current market expectations are indicating that interest rates could fall into negative territory in Q3 next year.

Negative interest rates not new

Over \$15tn of nominal debt, globally, already trades with a negative yield. 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.

In addition, real yields have been negative in the UK for a long-time.

Implications for value of 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. Based on the examples in Germany and Japan, it appears that cheap money is not enough, market participants need to have confidence in the stability of the economic environment.

If negative rates serve to entrench expectations of low growth and lead to lower long-term yields, the value placed on liabilities, including settlement costs, would increase. On top of this, increases or decreases in inflation expectations will also impact the value placed upon inflation-linked liabilities.

Based on the current situation in Germany, it is not impossible for the UK curve to shift below zero at all maturities. However, we also note that there is likely a limit on how much lower yields can fall.

All else equal and assuming a parallel shift in yield curves, negative interest rates should tend to raise all 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. 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, offsetting the lower interest rates. 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.

Implications for hedging

The decision to hedge interest rates becomes more challenging as interest rates approach zero or become negative, especially if there may be a limit to how much lower long dated yields could go. We expect, although this cannot be for certain, that the potential for future falls in gilt yields and price appreciation may reduce as gilt yields fall towards zero. Put another way, the risks may appear more asymmetric as yields approach zero.

The asymmetry of nominal yields does not apply as readily to real yields. We already have materially negative real yields in the UK and there does not seem to be a natural lower bound to which real yields may gravitate, as long as inflation expectations are allowed to rise.

In addition to the strategic implications for hedging from negative interest rates, there are a number of practical operational considerations to be aware of.

Implications for cash and other debt assets

Money market funds

Given their short-term nature, money market funds would likely quickly experience lower, or even negative returns, especially after fees, following the introduction of negative policy rates. In anticipation of this, money market fund managers may have or be switching their fund classifications to Variable NAV (VNAV) as it may not be feasible to continue with a Constant NAV (CNAV) or low-volatility NAV (LVNAV) pricing approach in a negative interest rate environment. This does not imply a change to the underlying credit quality of the portfolio, although this is something to monitor.

VNAV funds use mark-to-market pricing, while CNAV and LVNAV funds use amortised accounting to value the underlying assets. This means that the former are more likely to experience short-term (e.g. daily) fluctuations in unit prices. This loss of capital preservation (albeit marginal) is worth noting where cash is held to meet known or potential commitments such as benefits, investment capital calls, fx or other derivative settlement or collateral calls.

Floating rate credit

The introduction of negative interest rates is not positive for floating-rate credit assets, but will not necessarily result in returns turning negative in the short-term. Floating-rate assets pay a coupon which is set in-line with a reference rate (LIBOR or SONIA) plus a credit spread. In addition to the spread potentially still providing an overall positive return, many euro and sterling denominated floating-rate credit assets (less so US) have floors to prevent returns from turning negative. In practice, even in the absence of floors, euro-denominated floating rate assets have tended to cease paying

coupons rather than requiring payment from bond holders. European Residential Mortgage-Backed Securities and Collateralised Loan Obligations ('CLOs') historically also include interest rates floors.

Implications for derivatives

Interest rate paid on cash collateral

Derivative positions may be collateralised using gilts or cash. Where cash is used as collateral the derivative documentation will govern the rates being paid on cash collateral.

It is necessary to understand the extent of any mismatch between the cash rates that can be earned by investing the cash posted as collateral and the interest rate due on that collateral to the counterparty. Signing up to ISDA's negative interest rate protocol brings greater clarity that negative interest rates can be payable on cash posted as collateral.

Gilt repurchase or repos

Leverage of gilt positions is effectively achieved using gilt repos, i.e. borrowing cash to buy gilts, and the interest payable on that borrowing reflects the repo rate. As far as we are aware, there is generally no floor on the repo rate so it is possible for repo rates to become negative and in fact we have seen such repo rates going negative in Germany. This means that an investor borrowing to increase gilt exposure could be paid interest to borrow.

Interest rate swaps

Interest rate swaps involve one party paying/receiving a floating rate of interest (typically either LIBOR or SONIA) in return for receiving/paying a fixed rate of interest. Swap documentation should be reviewed to ensure there are no floors applying to the floating leg of a swap.

Additional Notes: Risk Warnings

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

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