Banks and Pension funds each serve a very vital role in the financial system:

**Banks** – intermediate between borrowers and savers, while generating income from the spread between what they charge on loans and the interest they pay to incentivize people to keep their money in the bank

**Pension funds** – provide deferred income for retirement in exchange for regular payments during a person’s working years

Historically both types of institutions have been able to function successfully due to traditionally healthy interest rate levels. However, the financial environment has changed quite dramatically in a number of ways since the Global Financial Crisis (GFC) of 2008/09.

**The effect on banks**

For banks it has led to severe erosion of profitability due to a number of factors. For one, the monetary policy of the ECB (and a number of other central banks) has made holding cash so pervasive that some banks have been forced to resort to unorthodox measures to discourage savers from depositing their savings. For example, a small Swiss bank began charging customers for holding their deposits in 2016. That didn’t bode well for people who wanted to get a return on their savings, who thought that banks would be able to offer them a stable return even in a tumultuous market environment.

Negative interest rates have been wreaking havoc since June 2014, when the ECB cut its deposit facility rate (the Eurozone’s base interest rate) to -0.10%, and subsequently took similar action on four more occasions, as a result of which the rate currently sits at an unnerving -0.50%, effectively charging commercial banks to store their deposits with the central bank. A similar case has been present in Japan since 2016. But why was this done? It was done with the aim to force banks to increase investments to the wider economy and thereby stimulate growth, or so the thinking at the time was.

Sadly, that plan failed to materialize. Banks have since been sitting on record levels of liquidity. The same scenario has repeated itself in 9 developed countries, which has caused their yield curves to reach negative levels.
the effect on pension funds

Pension funds, which are by nature risk-averse, would normally invest a significant chunk of their holdings in high quality sovereign bonds that generate steady and predictable cash flows, with a low risk of incurring losses. This ensured that savers’ projections with regards to post-retirement income would be met. Pre-2008, such government bonds would have been sufficient to protect the real value of pension savings and generate some growth.

For example, right before the GFC the 10-year German government bond was yielding around 4.0%. Ten years later, the same 10-year German government bond is yielding -0.36%. The situation is comparable to other major EU countries, including France and the Netherlands. Even European economies which were once at the brink of economic collapse are barely giving investors any returns – 10-year Greek bonds yield 1.36% and Italian bonds of a similarly tenor give just 1.18%. At this point in time there are close to $10 trillion outstanding government bonds that yield negative rates globally, according to Fitch, of which close to two-thirds belong to Japan. The remaining ones are located in Europe, where the ECB and several Scandinavian countries have been forced to keep rates at record low levels. In addition, there is a clustering in the remaining positive yielding bonds, such as US Treasuries, which is creating market distortions.

Things are no better with equity indices, which are currently at record highs, which makes them extremely expensive to invest in. Also, as recent events have shown, there is still extreme volatility, as the sudden drop in Q4 2018 and increase in Q1 2019 showed. If anything, markets are becoming more unpredictable.

Given the current pervasiveness of negative rates, different financial institutions and people in various countries have reacted differently.

european banks

In Europe, in the case of Switzerland, this was followed by an increase in property prices. Such investments, in the eyes of consumers, were seen as a better return than simply holding cash. A bank in Denmark was even forced to charge a negative interest rate mortgage at minus 0.5% and also a negative savings account that charges millionaires 0.6% per year. The situation is good news if you are trying to buy a home for the first time but very bad for savers and people. In Japan, the situation has meant that banks haven’t diversified their operations, and the only viable option in an overcrowded industry is to implement automation as a means of reducing their employee headcount to try and reduce costs. In Germany, banks are pushing to pass the associated costs to depositors, which would be highly controversial in the EU’s largest economy.

Another area where banks are facing difficulty is providing loans to viable businesses.

Unfortunately, this has led to the creation of “zombie” firms – a term used for companies that are not profitable enough to survive on their own, and which are only able to service their interest payments but not the principal of their loans, as defined by the Bank of International Settlements.
This is especially troublesome because banks that have loaned to these “zombie” firms in the past are undercapitalized, due to the high potential delinquency of these loans. Even if repayment requests were sent to these firms to repay their loans, the overall scenario would be that they would simply default and the banks would be left holding huge losses on their loan portfolios. So, the only option is to provide them with additional loans just to keep them afloat. The unintended consequence of this is that firms which would have normally gone under, thus making way for younger and more efficient enterprises, linger on for a number of years, thereby stifling the investments which startup companies need to grow. This problem has become very pervasive in Europe. It is estimated that at least 10% of the companies in France, Germany, Italy and Spain are zombies. But this problem is also not uncommon in Northern Europe, especially in the UK.

Just in the UK it is estimated that, from a set of 21,000 companies, close to 8% display zombie features. This is especially troubling news given the looming Brexit, which could put severe strain on companies. In Italy, it is estimated that 4% of companies are zombies, which actually drain 20% of the total capital. It is estimated that about 15% of all loans held within Italian banks are non-performing, which raises a lot of red flags.

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**European Pension Funds**

For pension funds with their strict mandates, the situation is even more precarious. If they cannot generate enough return, pensioners won’t have the necessary savings in their post-retirement years. But how have they reacted in the current environment?

In Germany, major pension fund schemes are facing very difficult decisions. Most pension funds in Germany are not allowed to invest more than 35% in risky assets, which means that the majority of their investments are in fixed income and properties. The current projections are that, in the coming years, Germany’s pension funds will be forced to allocate a significant portion of their investments towards equities and illiquid assets such as private debt, with the aim of generating higher return. These private debt investments will most likely be allocated towards projects linked to energy, power, water and transportation, as they offer significant illiquidity premiums. However, such projects also bring a lot of uncertainty because they are extremely difficult to sell in times of a liquidity crisis. Also, they are exposed to even bigger risks than normal investments and have to be managed in a responsible manner.

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**Other Countries**

In Japan, which has for years suffered from low yields, funds have started to invest more actively abroad. A prime example is Japan’s Government Pension Investment Fund (GPIF), which announced that it would allocate 5% of its €1.25 trillion assets into alternative assets. It has even dropped its government bond holdings from 60% to 35% during a five-year plan, which was in the making since 2014. Still, change is slow and troublesome.
As an example, two of the largest US pension funds have allocated close to 29% of their portfolios to such alternative investments - a mix of real estate and private equity. A similar case is found in Canada, where the largest pension funds have allocated 31% of their assets to alternatives. In Europe, Nordic funds prefer to invest in local markets and especially in real estate, with varying levels from 3% to 31%, while Dutch pension funds have moved 17% of their assets towards alternatives. As a final note to mention, in the UK several pension funds also pursue a very active strategy when it comes to such investments.

But, as shown above, these investments are highly risky and could lead to significant losses if interest rates rise and/or default rates increase for unprofitable businesses.

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**no clear-cut solution**

The extraordinary market environment has pushed both banks and pension funds into highly unusual territory. For the banking side, it means that urgent action is needed to recapitalize bad banks and limit the overall economic impact of zombie firms, in order to stabilize the performance of more efficient companies and bring new vigor into the otherwise struggling EU economic framework. Also, it means restoring the confidence of savers that they can get a viable return on their savings. For pension funds, lack of viable returns in the bond markets has pushed them to riskier and more opaque investments, especially in the real estate and private equity space. Returns from such investments can be very profitable, but they are also extremely risky and not that liquid in case they have be sold to meet unforeseen liabilities. There is no clear-cut solution to these issues, but the alternative might be grimmer if no action is taken.

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