KPMG

The Low Interest Rate Environment

Challenges for the Icelandic financial sector and possible effects

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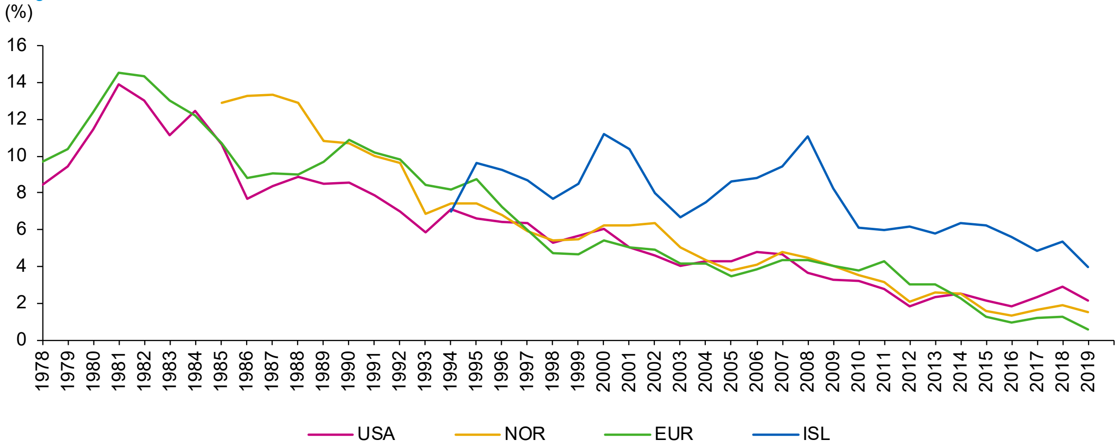
Contents

Introduction

The Icelandic economy is now characterized by a low interest rate environment like most other developed economies. The trend of decreasing interest rates spans decades and has been quite steady since the global financial crisis of 2008 and accelerated by COVID-19.

In 2009, the yields on Icelandic non-indexed treasury bonds ranged from 9% to 10%, and interest rates on indexed government bonds rose to almost 6%[1]. By the end of 2020, the yield on non-indexed government bonds was in the range of 1% to 3.2% and the yield on indexed government bonds 0.0% to 0.6%, after being negative for a portion of 2020. The policy rates of the Icelandic Central Bank are currently at 1.00%.

Long term interest rates



Note: Long term interest rates (10-year government bonds) of selected economies since 2078
Source: OECD Data

The current situation poses multiple challenges and opportunities to the Icelandic financial sector such as profitability, solvency and financial innovation. In 2015, the European Insurance and Occupational Pensions Authority (EIOPA) did a stress test for the Institutions for Occupational Retirement Provision (IORPs) and in 2018 for the insurance sector, specifically addressing a low-for-long scenario. The report pointed out that the risks could fall disproportionally on younger scheme members, for example via reductions in pension benefits for the younger generation.

The current situation of low interest rates and high unemployment could shift the balance between the use of capital and labour. Investments in the economy are expected to rise in this environment.

1 Yngvi Örn, SFF – pistill í Fréttablaðinu haust 2020

Extended periods of low interest rates generally have the following impact on household finances and the general economy:

Impact of low interest rates

Household finances

- Lower cost of borrowing
- Lower returns for savers and increased risk of negative real returns
- Real estate prices can rise
- Encourage spending and investment

General economy

- Can cause inflation pressure
- Equity investments become more desirable
- Can boost asset prices
- Can boost economic growth
- Lower government borrowing cost

By putting trends in Europe and the US into perspective regarding Iceland, we have identified the main drivers and options for financial institutions to consider in light of this new reality.

Conclusion

This low interest rate environment is impacting, even transforming, the financial sector's business model. The challenges and possible options of financial institutions are covered in this thought leadership report.

We expect the financial sector to be impacted in the following ways:

— Banks will need to deal with decreasing net interest income and relaxation of credit standards.

— Pension funds will face increased risk of not reaching the benchmark 3,5% yield on assets and incentives for working age population to opt for private pension schemes and life insurance contracts.

— Asset managers will face various opportunities in search for higher yield which will entail additional pressure on risk management.

— Insurance companies will face difficulties maintaining profit margins with decreasing yields and their insurance liabilities will be impacted.

Clear and actionable strategy and decision making on how to adapt to the new landscape can prove critical. Failure to adjust to a low interest rate environment in a timely manner can severely impair profitability. In principle, the following actions are key to thriving in this landscape:

1. Optimally select business opportunities
2. Match risk management with product offering
3. Be transparent and reach a mutual understanding with key stakeholders regarding risk and return profile

Spotlight on the common drivers

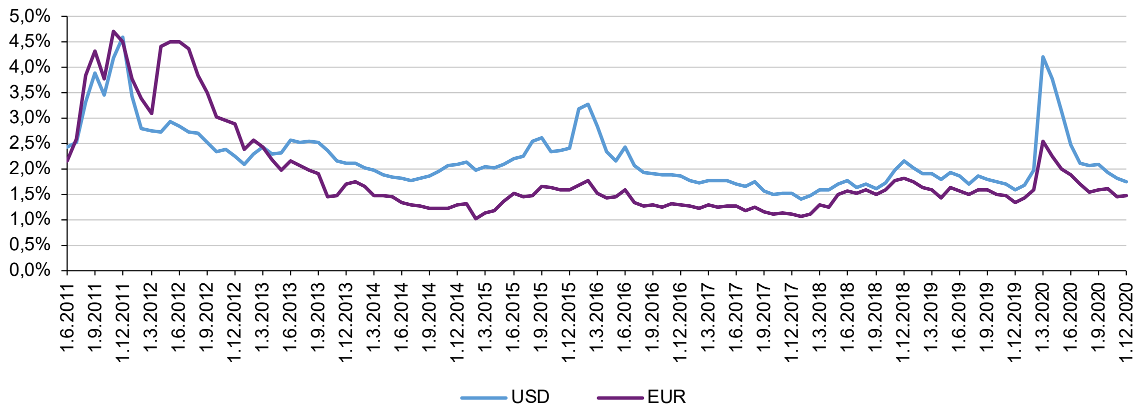
Search for yield

The search for yield leads to an increased risk appetite and misalignment between risk and reward to different assets. This adds pressure on risk management which needs to cope with increasing complexity in investment strategies and to properly disclose it to boards, customers and other stakeholders. Investing in high-yield bonds with lower credit quality, in infrastructure, hedge funds, private equity, derivatives, commodities, as well as providing direct credit to the economy in the form of mortgage loans, requires expertise that is not always available in smaller financial institutions.

The low yield era following the aftermath of the financial crisis in 2008 led to significant growth in the investment-grade corporate debt market. This is represented e.g. by the share of BBB rated bonds as a portion of investment grade debt rising steadily from 17,4% in 2001 to 50,3% in 2020. This change has been attributed to low interest rates driving capital to the corporate debt market and may be a signal of search-for-yield in other developed countries.

Despite the sharp rise in portion of BBB-rated debt since 2011, its credit spread has decreased, indicating strong flow of capital into the asset class.

BBB spreads



Note: Difference between yields of BBB-rated bonds and government bonds (US for USD and Germany for EUR) from June 2011 to December 2020
Source: Capital IQ, KPMG Analysis

An intense and broad-based search for yield may lead to financial asset price misalignments, creating risks of abrupt price reversals, e.g. in the event of a reassessment of risk premia or a correlated unwinding of positions.

The limited depth of the Icelandic investors landscape may create a higher demand for some assets, such as real estate, leading prices to reach levels that are disconnected from economic fundamentals. The emergence of new investors creating liquidity in the market could mitigate this risk.

Resilience

The “low for long” scenario constitutes a far-reaching and permanent change of conditions in which the financial system operates and could leave some business models unviable. In the long run, the main financial risk relates to the profitability pressure with a decreasing net margin. It is impairing the banks’ ability to accumulate capital and face deteriorating assets. A joint committee report from the European Supervisory Authorities pointed in 2019 that:

> *“Net interest income (NII) is the most important source of bank income, but has decreased by 6.2% from March 2015 to March 2019 (EUR 347bn) during the prolonged low interest rate environment, and in spite of growing lending volumes”*[2].

Investment fund managers or insurance companies could initiate new investment strategies with higher risk profiles or use more leverage, weakening their resilience in case of a downturn.

Credit risk

Easy access to financing and corporate need for funding will fuel the lending activity in coming months. The increased size of loan books may be an opportunity to compensate the reduced net margin. Credit standards could be relaxed excessively by the banks facing longer-term profitability pressures and growing competition from non-banking sectors. Combined with protracted low growth, this development may lead to a deterioration in asset quality. Higher debt servicing capacity of borrowers due to low interest rates could partly counteract this.

Sector analysis

The banking sector is under pressure

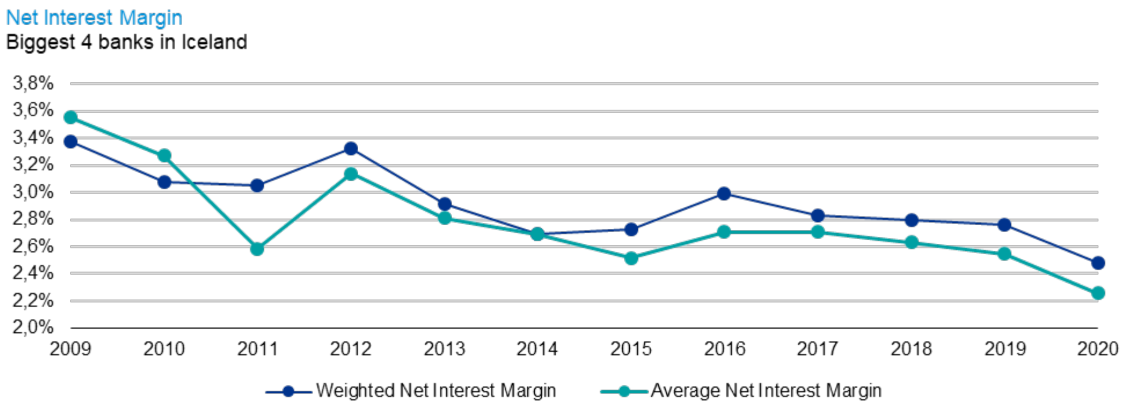
Strain on the business model

The banks net interest margin is under constant pressure, especially on the retail segment. Therefore, they will evolve with a shift towards commission-based income from the likes of payment and tech businesses especially for corporate clients. Savings banks will have limited options to make this shift, compared to the commercial banks. The net interest margin has been declining for the last 7 years and tier 1 debtors will likely use the low interest environment to refinance their loans and turn to other emerging lenders such as credit funds which will have lower costs than banks.

Also, attracted by the potential of higher returns, retail clients will allocate an increased portion of their savings to investment funds. In this situation, the banks will have to generate supplementary revenues such as distribution fees or indirectly through their return of capital as owners of the largest Icelandic asset managers.

It is also anticipated that households will be attracted to invest in the equities or bond market.

2 JOINT COMMITTEE REPORT ON RISKS AND VULNERABILITIES IN THE EU FINANCIAL SYSTEM, 26 August 2019



The banks will also be encouraged to maintain profitability by optimizing their cost base using e.g. process automation, robotics and artificial intelligence.

Managing liquidity

The combination of a low interest rate environment and the short-term effects of COVID-19 has put liquidity management under scrutiny. Already, Icelandic banks don't have a level playing field with their foreign counterparts due to higher capital ratio requirements in Iceland and may therefore struggle to compensate investors for their cost of capital. The options available to Icelandic banks to manage liquidity are limited. To broaden their options, the Central Bank of Iceland (CBI) could start offering three-year refinancing options similarly to the European Central Bank. The CBI could also relax collateral eligibility criteria, partially compensating for limited market size of eligible Icelandic instruments, compared to other developed economies.

In addition, we can expect that pressure on the shoulders of management teams will be different for state-controlled banks and listed private companies. The latter may struggle to deliver expected dividends in the current context and will have to send the right messages to their investors, especially abroad.

This illustration summarizes this chapter and provides an overview of how a low interest rate environment can impact the banking sector over time.

Short-term → **Long-term**

[3]	Immediate impact	Incentive for banks	Concrete actions by banks	Potential outcome		Potential structural changes
Low interest rate environment	Reduce interest margins Increase borrower's net worth Asymmetrically reduce lending and deposit rates Increase asset volatility Decrease cost of debt funding	Search of other sources of income Increase risk appetite Decrease incentive to raise capital Increase lending volumes Extension of maturities of market liabilities	Relaxation of credit standards Shift between loan portfolio/ business lines Impact on maturity transformation	Reduce asset quality Increase forbearance Difficulties to raise capital to back up asset expansion Limited room to maintain depositors	Higher impairments Sound credit crowed out Profitability decreases further Investor appetite (low prospects of dividends vs increased risk appetite overall	Cost efficiency via M&A or others Credit provisions by non-banks Deleverage Cases of gambling for resurrections Move from traditional banking to market-based model Development of deposit-like products outside banks

3 Technical Documentation, Joint ATC/ASC/FSC Task Force on « Macroprudential Issues and Structural Change in a Low Interest Rate Environment"

Pensions funds, the great re-allocation

What about the pension obligations?

The target for assessing obligations and future contributions is a real interest rate of 3.5%. The discount rate creates synthetic interest rates on the pension obligations side and therefore pension funds will need to match this rate for its assets to grow in line with pension obligations or otherwise reduce pension rights of its members. Depending on their investment strategy and risk appetite, the pension system has since 1998 used this rate as a minimum threshold to determine their investment strategy. A low interest-rate environment poses challenges and increases the risk of pension funds not reaching 3.5% rate of return. It is important that members of pension funds are informed about this risk and the impact it may have on their future pension payments. Testing the sensitivity of pension obligations in the pension fund system would spot the potential impact on contributions and payments, giving members an important insight.

Furthermore, it is critical that policy makers re-evaluate the 3.5% discount rate of pension obligations. Considerably higher discount rates than market interest rates incentivize the working age population to opt more extensively for a private pension scheme. Also, life-assurance contracts, which are common in other European countries, where insurance holder receives a pay-out at the end of the insurance term, will become more attractive.

The dynamics of the lending landscape

Icelandic pension fund's competitiveness in the lending market is influenced by several factors such as:

— different cost base due to different regulatory environment compared to lending institutions, the pension sector can attract the best borrowers with high quality assets.

— as market rates fall below the 3.5% CPI index level, the incentive for pension funds to compete at those interest levels diminishes, enabling banks to gain higher market share, as seen in 2020.

— the sector in a search-for-yield strategy may finance higher risk projects.

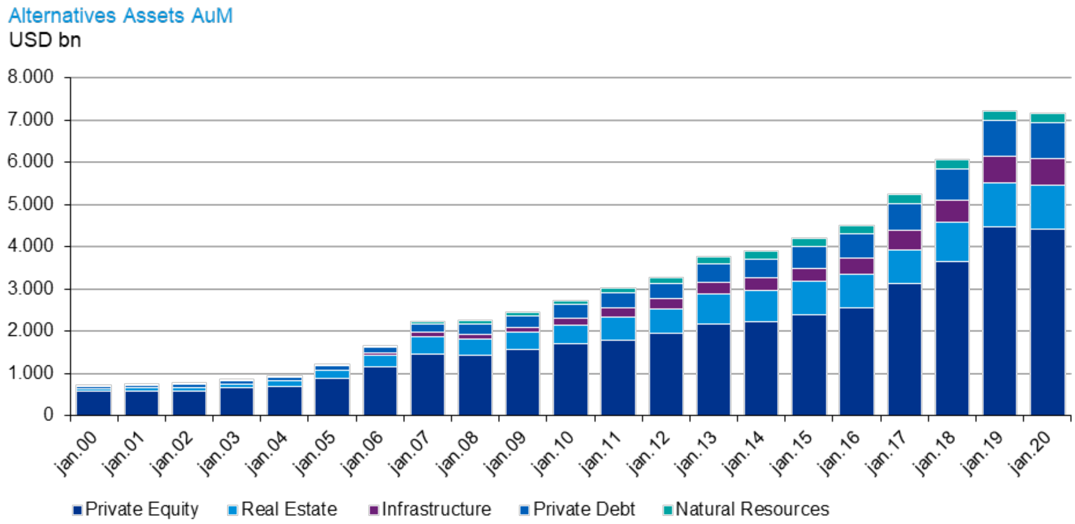
The credit quality of borrowers must be properly assessed and asset-backed loans should be prioritized to avoid concentration of risky profiles in pension fund assets.

The call for alternative asset class

The allocation of the largest institutional investors in Europe and the US's post-global financial crisis (as seen in the illustration), the turn to the alternative asset class (e.g. private equity, venture capital, infrastructure or private debt) has been part of the solution to reach yield targets. A recent survey performed by Preqin[4] illustrates that the proportion of this class for public pension funds increased from 18% in 2010 to almost 30% in 2020. The following graph depicts how the main alternative asset classes have developed from 2000 to 2020. Investors are still looking to increase their exposure to private equity, private debt and infrastructure.

4 Alternatives in 2020, Preqin ltd, 2020

In Iceland, this reallocation may be possible through the emergence of local players offering these investment strategies and through opportunities abroad. Also, the maximum regulatory exposure of pension funds to the unlisted investments would have to be reconsidered to achieve that.



Note: Development of alternative assets in Europe and US 2000 to 2020
Source: Alternatives in 2020, Preqin ltd, 2020

Horizon of opportunities for asset management

Innovation: new funds, new investors?

Asset managers are faced with great opportunities with investors increased will to invest in new type of financial products in their search for yields. This demand will be driven by institutional investors but also from the retail customers willing to build their own retirement plan. These opportunities are limited in the Icelandic pension system.

Innovation and differentiation will be the key to success with more specialized investment strategies, targeting for example a specific sector or green projects or providing recurring cash flows. These strategies entail higher fees, and innovation will be driven by new fund managers entering and benefiting from the AIFMD implementation.

Experience from other countries shows that the private debt market may increase its funding market share with credit funds investing specifically in asset-backed loans fueled by the willingness of the banks to reduce their balance sheet. With plenty of financing options eligible to funds exposed to credit risks, credit funds have potential to grow significantly in the near future through reallocation of loans from the banks. The asset management universe is moving from private/commercial real estate backed securities to mezzanine financing or senior loans to the largest Icelandic corporate companies. In more mature markets, retail investors can access private corporate bond or high yield bond markets through subscription to open funds.

There is also a strong emphasis on infrastructure projects, especially if they contribute to the decarbonization of activities.

Profitability and products range

Alongside growing allocation to alternative investments, asset managers will face a constant pressure on profitability. Fees generated by the traditional assets under management base will be under scrutiny and challenged.

The combination of cost increases from regulation in recent years, such as the AIFM directive and the pressure on management fees will impact profitability. This new reality will lead to the streamlining of core operations and strategic expense reduction for non-core operations. Process automation and adoption of industry leading platforms will increase. Asset managers will leverage e.g. machine learning and artificial intelligence to enhance core capabilities such as sales, investment research and portfolio management. There will be focus on secure, scalable and cost-effective solutions with potential M&A activity with foreign asset managers.

Access to the right opportunities

The success of the diversification of assets will highly depend on the capacity to assemble the right teams or projects locally and abroad. In a race to the best returns, investors look towards the best teams and projects that lead to (i) higher valuation and (ii) entry barriers. A number of successful and large private equity houses are putting a high threshold of minimum ticket commitments which may be difficult for Icelandic investors to reach. Levels of complexities are also increasing and the need for extensive due diligence can be a hurdle for the smallest investors. Also, pooling vehicles will be an alternative to ease the access to this range of financial products.

Complex structuring

The financial sector being highly regulated, development of solutions to facilitate the matching of offer and demand will require high expertise and deep understanding of the constraints of each party. On top of the willingness to get an increased exposure to infrastructure or credit, the investors will have to be sure that these investments comply with their own restrictions. Initiators of projects would have to comply with distribution and disclosure requirements. It is possible to cross this hurdle by providing a proper legal structuring to these unexplored territories. Nevertheless, this complexity increase must be supervised and controlled to avoid unnecessary financial losses and reputational risks.

Insurance companies are the common denominator

Insurance companies will face similar challenges as banks, asset managers and pension funds.

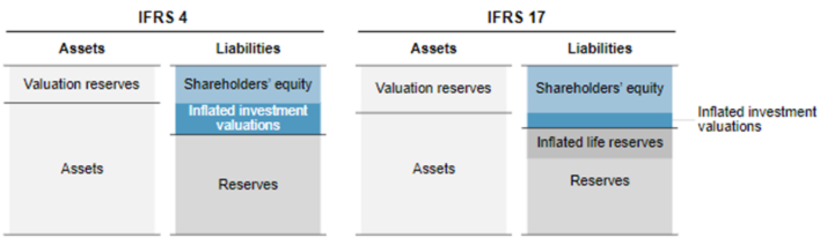
Historically, returns on assets have been the largest source of profit margins for the sector and, facing the erosion on yield, insurance companies will have to improve their cost base with a digitalization and automation effort of their platform. They will also be incentivised to investigate new investment strategies through direct and indirect exposure.

Finally, insurance companies might benefit from providing long-term investment solutions for retail customers and life-assurance contracts which is commonly seen in Europe.

Insurance liabilities

IFRS 17[5] will, as of FY2021, provide an economic view of insurers' balance sheets. This could assist insurers in flagging economic risks associated with low interest rates, and manage them.

IFRS 17 Removes Low Interest Rate Distortion



Source: S&P Global Ratings.

5 IFRS 17 requires a company to measure insurance contracts using updated estimates and assumptions that reflect the timing of cash flows and any uncertainty relating to insurance contracts. IFRS 4 Phase I included an accounting basis mismatch between market value assets and book value liabilities; IFRS 17 removes this. The effect of the mismatch, in many cases, was to overstate shareholders' equity by matching valuation reserves to bond investments, a problem exacerbated by persistently low interest rates in many regions around the globe (see chart)

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