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Household financial assets and the changing interest rate environment

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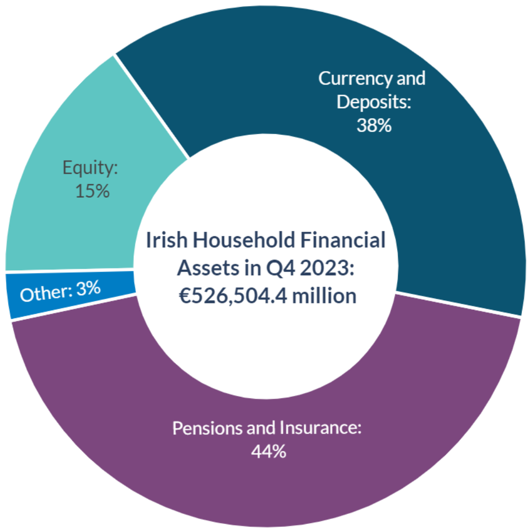
Central Bank quarterly financial accounts statistics show that as of Q4 2023, aggregate Irish household financial assets are primarily comprised of 'currency and deposits' (38 per cent), and 'pensions and insurance' (44 per cent), together making up over 80 per cent of household financial assets. The rest of the household financial assets are divided between equity and other financial instruments such as debt securities and investment fund shares. (Figure 1). This *Box* considers recent developments in the two main components of financial asset holdings of Irish households – 'deposits' and 'pensions and insurance' - in the rising interest rate environment. We focus on the evolution of household deposit growth and composition, as well as on the movements in pensions and insurance holdings and asset valuation as a response to interest rate changes in recent years. [1]

[1] The recent economic letter 'Unravelling household financial assets and demographic characteristics: a novel data perspective' (Arrigoni, Bénétrix, McIndoe-Calder & Romelli, 2024) considers further the characteristics of households and their financial asset holdings

Currency, deposits, pensions and insurance make up over 80 per cent of Irish household financial assets

Figure 1
Irish household financial asset holding categories (per cent)



Source: Central Bank of Ireland Quarterly Financial Accounts Statistics

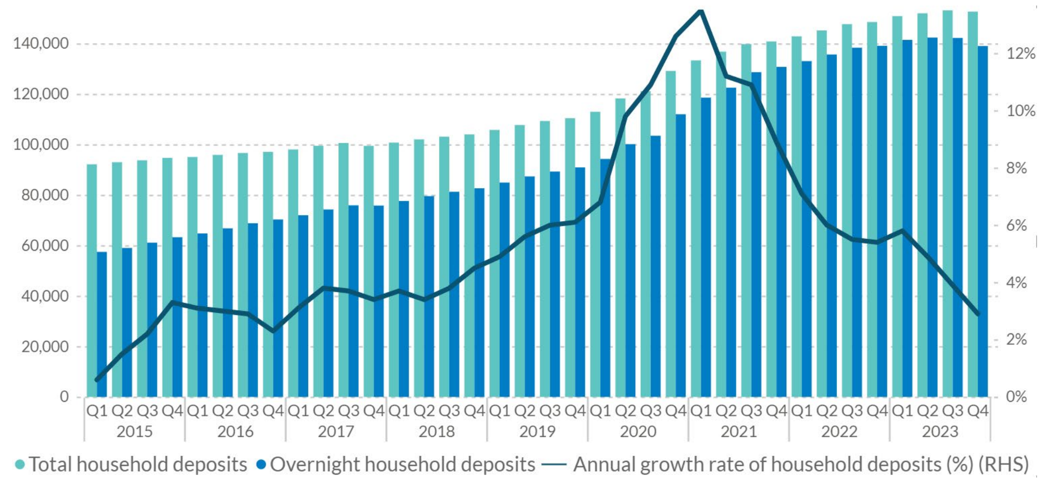
Money and banking statistics show the value of Irish household deposits increased substantially during the Covid-19 pandemic, with annual growth reaching a peak in Q1 2021 at 13.5 per cent. Annualised growth has now declined back towards pre-pandemic rates and at the end of 2023 it returned to being below 3 per cent, standing close to 2016 rates. Despite the decrease in annualised growth, the value of total household deposits did not show any decrease, even during the recent cost of living crisis period, and reached €152.4 billion by Q4 2023.

As of Q4 2023 over 90 per cent of deposits are held in 'overnight deposits' while term deposits (covering 'redeemable at notice' and 'agreed maturity' deposits) make up the remainder. The latter's share of household deposits, while small, has increased from 6 per cent a year ago to 10 per cent, reflecting the increased, albeit slow, return offered on such deposits. (Figure 2).

Household deposit growth has returned to pre-pandemic levels while remaining positive

Figure 2

Irish household deposits (€ million) and annual growth rate (per cent)



Source: Central Bank of Ireland Summary Irish Private Sector Credit and Deposits Statistics

'Pensions and insurance' provide protection against a range of risks as well as having a longer-term savings role for households. Insurance and pension fund statistics show Irish households predominantly hold these assets in the form of longer-term pensions and life insurance. [2] Nonlife insurance (for example, property or motor insurance) makes up a smaller share, in part reflecting the shorter-term nature of these products (Figure 3). Life insurance holdings partly reflect pension investment as life insurers provide pension products (for example personal pensions, annuities and drawdown products) as well as other life insurance products (such as mortgage protection).

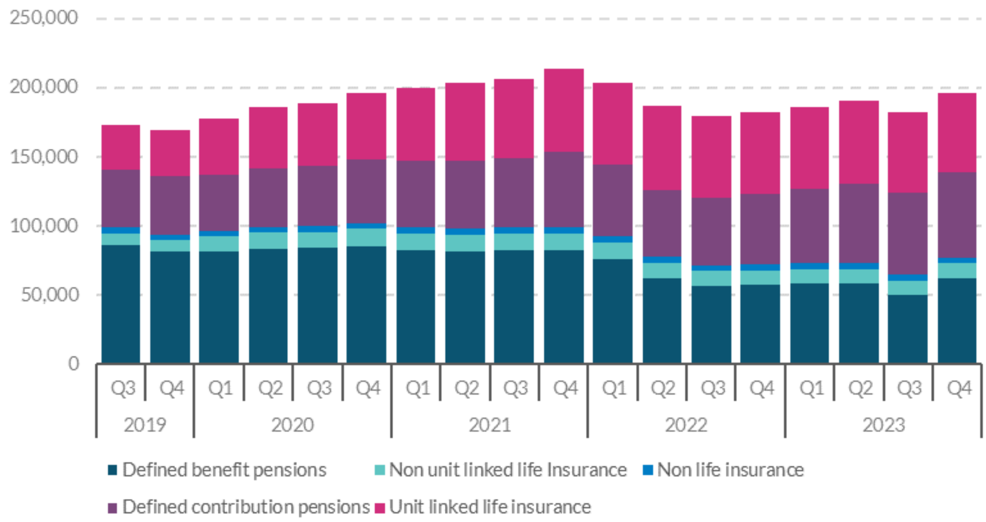
For defined contribution (DC) pensions and unit linked (UL) life insurance, the household asset valuation generally mirrors the movements in premiums/contributions invested in asset markets such as bonds or equities, with risk[3] borne by the household. For defined benefit (DB) pensions and non- unit linked (N-UL) life insurance, the benefits received by the household are generally independent of the assets invested and, therefore, risk is borne by the pension

[2] While being significant components of household income, due to their unfunded nature, state pension and public service pensions are not included as household assets. However actuarial reviews undertaken every three years show that, as of 2021, state pensions have an 'accrued-to-date-liability' of €471 billion and public service pensions of €176 billion.
[3] Including, for example, risk of investments decreasing in value, or not providing sufficient income for the rest of the beneficiary's life in retirement

fund or the insurer. These products are valued using actuarial techniques and depend on a range of variables including interest rates. There has been a longer-term trend away from risk being borne by insurers and pension funds towards it being borne by households driven by transactions in these products.

Irish household holdings of pensions and insurance assets declined during 2022 but began to recover in 2023

Figure 3
Irish household holdings of pensions and insurance assets (€ million)



Source: Central Bank of Ireland Insurance Corporations and Pension Funds Balance Sheet Statistics
Notes: Insurance data adjusted for international effects and life insurance provided to the pension fund sector, nonlife insurance includes provision to business. While the pension fund sector is domestically focused the insurance sector in Ireland has both a domestic and international role. The life insurance sector provides products both directly to households and indirectly through pension funds.

As euro area inflation and policy rates increased in 2022, market interest rates such as the yield on sovereign debt[4] also increased and, at the same time, the market value of assets held by insurers and pension funds declined. As a result, household holdings of DC pensions fell by 11 per cent between Q4 2021 and Q3 of 2022 but have since recovered by 23 per cent. Having experienced growth prior to 2022, UL life insurance levelled off and declined slightly

[4] The 'behind the data' 'The Insurance & Pension – Sovereign Nexus' discusses the role of the insurance and pension fund sectors in the sovereign debt market

in 2023. The impact of these movements could vary depending on the circumstances of the beneficiary, for example if or when any change in valuation is realised or changes in annuity rates occur.
Similarly, interest (or discount) rates used to value DB pension and N-UL life insurance[5] products increased in 2022 which has led to a decline in the actuarial valuation of these products. In general, higher interest rates reduce the cost of future benefits to the insurer or pension fund - although an indexation of benefits to inflation could partially offset this. DB pensions fell in value by 32 per cent between Q4 2021 and Q3 of 2022 and have since recovered by only 8 per cent, while N-UL life insurance fell 10 per cent and recovered by just 1 per cent over the same periods.

Retail interest rates statistics show that deposit interest rates were slower to respond to the changing environment. While ‘redeemable at notice’ and ‘agreed maturity’ household deposits interest rates started to increase in 2023, interest rates for overnight deposits have shown only marginal growth, increasing to 0.13 per cent by Q1 2024 (Figure 4).

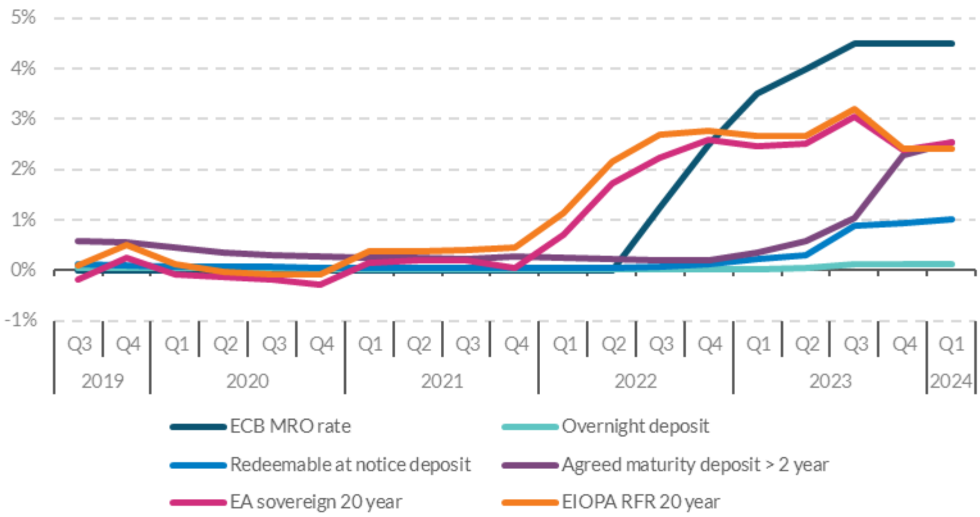
Despite potential risks emerging internationally (for example the UK gilt crisis), the changing interest rate environment has seen the net worth[6] of Irish DB pension funds improve, moving from a deficit to a surplus in aggregate. Total assets of the sector fell by 15 per cent between Q4 2021 and Q3 of 2022 while liabilities declined by 23 per cent over the same period. Since then, assets have recovered by 12 per cent and liabilities by 14 per cent, with the sector’s net worth remaining positive in 2023. As seen in the second half of 2023, net worth is sensitive to movements in assets and liabilities, including as a result of volatility in interest rates. If interest rates were to decline then this could see a reversal of the upward movement seen in recent years, with the evidence of the recent period showing that pensions and insurance valuations move with markets while there is a lag in the pass through on interest rate changes on retail deposits.

[5] For example, the EIOPA risk free rates used to calculate liabilities under Solvency II
[6] i.e. the difference between assets and liabilities

Market interest rates have increased while overnight retail deposit rates have not grown at the same pace as other deposit rates

Figure 4

Development of various interest rates (per cent)



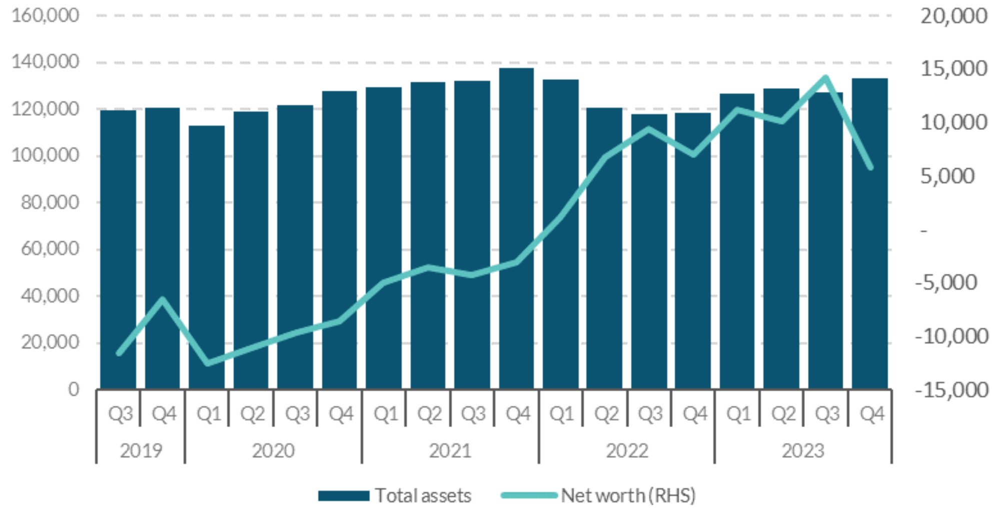
Source: Central Bank of Ireland, European Central Bank and European Insurance and Occupational Pensions Authority

Notes: Euro area (EA) sovereign yield curve calculated by the ECB; 20 year rate presented given the longer term nature of pensions and life insurance liabilities; all values displayed at quarterly frequency. Risk free rates (RFR) produced by EIOPA are used by insurers to calculate liabilities under Solvency II; Main refinancing operations (MRO) is the rate banks pay when they borrow money from the ECB for one week

Irish pension fund net worth turned positive in 2022 as interest rates increased but with volatility in 2023

Figure 5

Irish pension fund sector total assets and net worth (€ million)



Source: Central Bank of Ireland Pension Funds Balance Sheet Statistics