BANK OF ENGLAND

News release

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31 July 2014

Bank of England and Procyclicality Working Group Discussion Paper: Procyclicality and structural trends in investment allocation by insurance companies and pension funds

The Bank of England has today published, in conjunction with a group of academics and industry practitioners, a Discussion Paper which examines trends in the investment decisions of insurance companies and pension funds.

Life insurance companies and pension funds (ICPFs) are important financial intermediaries. They manage the long-term savings of individuals and provide investment to the real economy. In the UK alone, they manage nearly £3 trillion of assets, over half of the assets of the UK non-bank financial system by some measures.

The way in which they manage the investments that they make on behalf of individuals is critical, both for those individuals and for the wider economy. ICPFs have the potential both to provide long-term investment to the real economy and to act as a stabilising influence on the financial system, by buying and holding assets across the economic cycle.

However, it is also possible that the combination of factors that drive the asset allocation decisions of ICPFs – market conventions, accounting rules and regulatory requirements – may lead to outcomes that are suboptimal from the perspective of financial stability (through procyclicality) and long-term investment and economic growth (through an unwillingness to bear risk).

The study finds evidence of procyclical investment behaviour by insurance companies. For example, insurers were sellers of equities following the dotcom crash of the early 2000s and to a lesser extent during the recent financial crisis. UK defined benefit pension funds have behaved countercyclically in the short-term, while over the medium-term a structural "de-risking" trend (whereby pension funds have shifted investment allocations from equities to fixed income instruments) has dominated.

In the longer-term, the nature of investments by ICPFs has changed markedly over the past 15 years. Particularly striking has been the decrease in their holdings of (particularly UK) equities: the proportion of UK shares owned by UK ICPFs has fallen from over 50% in the early 1990s to just over 10% in 2012. These structural trends are relevant to the willingness of ICPFs to bear risk in the longer term and are potentially significant for the appropriate allocation of capital in the real economy.

The study finds that a combination of factors – in particular the underlying structure of their liabilities, regulation, industry practices, and accounting and valuation methods – influence ICPF behaviour.

The aim of the study is to initiate discussion and add evidence to the debate, as well as to highlight areas for further research which could influence the way that these investments might be managed in future. Although the Discussion Paper does not present policy conclusions, a clear high-level implication of this work is that policymakers should consider the aggregate impact of regulatory and ICPF industry trends on financial stability and the macroeconomy.

Notes to editors

Members of the Procyclicality Working Group are:

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- Ashok Gupta, Deputy Chair
- Ronnie Bowie (Hymans Robertson)
- Sarah Breeden (Bank of England)
- Peter Davies (Landsdowne Partners)
- Roger Gray (USS Investment Management)
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