Peter Praet: Fixed income investment of insurance companies and pension funds in a low yield – but volatile – environment

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 2011 European Pension Funds Congress during the 14th Euro Finance Week, Frankfurt am Main, 15 November 2011.

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Ladies and Gentlemen,

It is a pleasure to speak here at the European Pension Funds Congress in Frankfurt, which forms an important part of the 14th Euro Finance Week.

Earlier this year I was asked to chair a global Working Group with participating central banks from North America, Europe and Asia for the so-called Committee on the Global Financial System, CGFS, which works under the Bank for International Settlement. Our aim was to assess how the regulatory initiatives together with the low-yield environment have affected the fixed income strategies of institutional investors, such as pension funds and insurance companies, and to draw implications for the financial system. In doing so, we relied on bilateral interviews and regional roundtables, involving 70 private sector institutions. Even after discounting industry complaints, there are grounds for expecting certain adjustments to the assets, liabilities and derivatives books run by insurance companies and pension funds.

I would like to share the main findings of the CGFS work with you and express some of my views on the topic.

Our exercise is published in the form of a CGFS Report, which can be found at the web-site of the Bank of International Settlements.[1]

I will first provide some background on the role of insurance companies and pension funds, then elaborate on the main changes concerning international accounting standards and the regulatory front, before presenting some views on potential financial system implications.

1. Background on the role of insurance companies and pension funds

Insurance companies and pension funds (ICPFs) indeed currently find themselves at the intersection of major developments. Having weathered the financial crisis on the whole comparatively well, they are now exposed to problems confronting some euro area sovereigns and banks, the low-interest rate environment, and they face upcoming changes in international regulation and accounting standards.

With combined assets of some $40 trillion, insurance companies and pension funds constitute a large segment of the institutional investor space and they are therefore important for financial system stability. In particular, they play a major role in fixed income markets, also as providers of long-term funding to banks and the public sector.

If we look at the situation within the euro area, the role of insurers and pension funds has been increasingly important as the size of the euro area sectors has grown rapidly over the

[1] http://www.bis.org/publ/cgfs44.pdf

last decade. It should however be noted that the prominence and asset allocation strategies of these institutional investors is very different in different euro area countries.

The investments of insurers and pension funds have created strong and important interlinkages with sovereigns as well as banks and other financial institutions.

Insurers and pension funds, with €1.1 trillion invested, hold almost 20% of the debt securities issued by euro area governments, which make them an important provider of governments' funding.

Euro area ICPFs are also providing funding to other sectors. After governments, the euro area ICPF sector has the second biggest debt securities exposure to euro area monetary financial institutions (MFIs), a sector that consists, in particular, of credit institutions. Euro area insurance corporations and pension funds hold about €600 billion of debt securities issued by euro area MFIs, which represents around 12% of the total MFI debt securities.

Most of the time, given the typically long-term investment horizons of insurers and pension funds, they are a source of stability in financial markets. In current discussions in different fora about systemically important financial institutions, I believe that it is therefore important to distinguish between "systemically important" and "systemically risky" financial institutions. A financial institution can in my view be important for the financial system even if it does not pose direct threats to it. I believe most insurers and pension funds fall into this category. They are unlikely to trigger financial instability but it is crucial that they maintain their important role in financial markets, an in particular as a source of long term funding in fixed income markets.

2. Changes in international accounting standards and in regulatory front

It is important to know that current regulatory standards and requirements differ between EU countries. Also, the timetable for the implementation of future regulatory changes remains in a state of flux.

It is therefore legitimate to ask whether we can draw any conclusions from such a mixed pie. Indeed, our first direct finding was that the uncertainty about the scope, timing and extent of accounting and regulatory changes increases uncertainty which makes it more difficult for insurance companies and pension funds to plan their investment strategies over the long-term. So let me briefly recall the main upcoming accounting and regulatory changes relevant for these investors.

I start with the ***changes in international accounting standards***. They should be implemented from 2013 or 2014 onward, though much remains to be decided. Alongside the gains in transparency and comparability, one can expect them to produce greater volatility in financial statements:

– For pension commitments: modifications to IAS 19 (concerning the measurement and recognition of "employee benefits") by 2013 will create more valuation changes in defined benefit (DB) pension plans which will be reflected in their funding status and the profit and loss statement of the sponsoring company. This is mainly attributable to the fact that the revised IAS 19 – among other things – eliminates the existing option to defer the recognition of gains and losses, known as the "corridor method".

– For insurance contracts: IFRS 4 Phase 2 proposes a single accounting model for insurance contracts by 2014 and requires that liability valuation changes are recognised in the P&L. This would also lead to greater accounting volatility, for the following reasons:

  - Going forward all life insurance liabilities and non-life (property and casualty) claims liabilities would have to be discounted either via a bottom up approach

(risk free + liquidity premium...) or a top down approach (starting from assets return). The discount rate would have to be adjusted regularly, namely at the end of each reporting period. In the IASB's tentative approach, the effect of changes in the discount rate must to be posted in P&L at each reporting date. As a result, the volatility in interest rates – as currently experienced with sovereign risk rates – will impact the annual results without consideration for the fact that the discounted insurance liability may span over very long term.

- On the other side, in response to mounting volatility of their liabilities, insurers may be tempted to – contrary to their current treatment – measure larger portions of their investments in fixed-income securities at fair value, reflecting all fair value changes in profit or loss ("net income"). With this new approach to classification and measurement of their investment portfolios, insurers would aim to reduce the "mismatch" between the valuation of assets and insurance liabilities (which is often referred to as "accounting mismatch").[2] Reducing any existing "accounting mismatch", however beneficial this may be, would on the other hand not alleviate another serious concern of insurers, namely the "maturity mismatch". As a general rule, insurance contracts tend to have a longer maturity than insurers' investments.

Such accounting measurement volatility will have an impact on the position of own funds and likely also on the ease with which insurers can secure capital through financial markets.

In both cases, there may be increased pressure from markets or sponsoring companies to de-risk asset holdings to limit volatility in financial statements.

On the international regulatory front, the main development is the introduction of ***Solvency II*** in Europe for insurance companies, requiring that:

- assets should be marked to market, and liabilities be discounted at risk-free rates, possibly augmented by a liquidity premium, or a countercyclical premium in case of stressed financial market situations
- insurers must hold loss-absorbing capital against the full range of risks on both their asset and liability side to withstand unexpected losses with a probability of 99.5% over a one-year horizon.

The fifth Quantitative Impact Study QIS5 by the European Insurance and Occupational Pensions Authority (EIOPA) on the impact of Solvency II shows that most insurers face no imminent need to raise new equity. But they may rebalance their asset portfolios in line with the new risk charges, as they tend to make it more expensive to hold equity, structured products, and long-term or low-rated corporate bonds, whereas government bonds and covered bonds get more favourable capital treatment. Sovereign exposures are exempted from capital charges under the latest Solvency II proposals.

It is important to prevent risks of heightened pro-cyclicality arising from these planned regulatory changes.

As Solvency II requires both assets and liabilities to be marked-to-market, one key question concerns the discount rate curve to be used for valuation. As already mentioned, IFRS 4 Phase 2 requires that future cash commitments be discounted using risk-free rate adjusted for a liquidity premium or a yield curve that reflects current asset returns. This contrasts with the experience during the crisis, when the liability cash flows often continued to be

[2] There is another potential problem for insurers' investment strategies related to the new IFRS 9 Financial Instruments. In contrast to the existing IAS 39, going forward insurers may no longer be allowed to recognise realised gains or losses (e.g. gains on sale) on their longer-term equity investments (e.g. in banks) in profit or loss (net income), but only in a separate reserve within equity ("other comprehensive income").

discounted at the risk-free rate. The application of a liquidity premium on the liability side could in principle reduce the valuation mismatch and thereby avoid situations where insurers are unduly forced to dispose of illiquid assets. Such a counter-cyclical mechanism might even mean that insurers would be willing to take on additional illiquid assets in a period of market distress. However, there are also some conceptual issues associated with this idea, mainly because insurance liabilities are different in nature from insurance assets and often do not have an accessible market. Nevertheless, it is important to find a method defining a discount rate that would be consistent from a financial stability perspective.

Overall, accounting and regulatory changes bring important benefits in terms of financial soundness and disclosure. But they could also cause portfolio shifts affecting financial markets. For instance, firms may want to divest equity and shorten the duration of their corporate bond holdings. But to limit the resulting duration gap, they may have to use more long-term swaps or buy more long-term low-risk bonds, as defined by regulation. This would tend to flatten the risk-free term structure, but steepens the term structure for lower-rated credit.

However, the financial market implications from asset allocation perspective may be transitory rather than permanent: other investors come in, and the phase-in period of Solvency II is very long and gradual. It remains to be seen to what extend the risk weight of the internal models will significantly differ from the standard regulatory risk weight.

3. Financial system implications:

Let me now move to my final part and elaborate on the potential main ***financial system implications****:*

First, insurers and pension funds are likely to continue to move away from products offering a guaranteed return or defined benefits. This trend is being reinforced by the low-interest rate environment and the consequences of the financial crisis. As was the case in Japan in the 1990s, low interest rates make it difficult for these institutions to meet future obligations out of meagre fixed income yields. Moreover, a negative duration gap means that falling interest rates raise the value of liabilities more than that of assets. This risk-shifting to households could eventually lead to greater sensitivity of household spending to changes in asset prices and interest rates, and more conservative asset allocation in aggregate (if households seek to reduce their direct risk exposure). This, in turn, may result in inefficient risk sharing.

Experience in the US has shown that when fully exposed to market risk, individuals may on average opt for pension plans or insurance policies with lower risk allocations. Such products may however not offer sufficient return to ensure adequate retirement income without additional saving.

Second, firms may engage in more risk transfer, not just on liabilities (securitisation, reinsurance) but also on assets and duration gaps, leading to greater use of derivatives such as interest rate swaps. Our interviews confirmed that insurance companies and sponsors of pension plans have already been placing more emphasis on ALM practices in recent years. This will involve still greater use of fixed income assets and long-maturity interest rate swaps to match more closely their liabilities' cash flows. Such a trend is relevant also for the current regulatory developments concerning the clearing of derivative contracts with a central counterparty.

Third, portfolio shifts may alter sectoral funding patterns. Up to recently, many observers expected a shift from corporate bonds to government bonds due to differential capital charges, LDI strategies, and the need to limit duration gaps. However, current unease about sovereign risk could mitigate this trend. Within corporates, the industry has been clearly reducing exposure to financial institutions, except for covered bonds.

The fourth issue concerns the role of insurers and pension funds as global providers of long-term risk capital. These institutions found it difficult to play this role during the crisis, due to extreme market pressure and volatility. But steeper risk charges will also make it costlier to hold long-term risky/illiquid assets in the future. Moreover, the investment horizon is being reduced by the one-year-horizon of Solvency II, shorter grace periods for pension funds to address funding shortfalls, and heightened accounting volatility. This limits the scope for taking long-term or illiquid positions without too much concern for short-term fluctuations in their value.

These factors tend to encourage a shift away from long-term investing in risky assets. A partial retreat of institutional investors from the long-term and/or illiquid segment of the credit market could reduce private and social benefits of long-term investing, and reduce the extent to which the industry mitigates the procyclicality of the financial system. These possible evolutions will have to be closely monitored.

Thank you for your attention.