Institute and Faculty of Actuaries

Finance and Investment Research Sub-committee

'Long term investment mandates' Working Party

Background

The IFoA's Procyclicality steering committee has identified three areas for potential research one which is the basis of this new working party that will explore how changing investment mandates could be used to tackle this issue. The other two areas of research being commissioned on aspects of procyclicality are:

1. one looking at different aspects of the capital regulation of life insurers and whether changes would reduce the tendency for capital to be consumed or for capital requirements to increase in falling market
2. one looking at the identification of risk measures that reflect the underlying risk and economics of long-term contracts and which are conducive to long-term investment and long-term risk management.

These two new working parties will be overseen by the Life and Risk Boards.

Proposal

The substantial falls in risky asset prices experienced during the 'credit crunch' have prompted policymakers to consider the investor behaviours that can lead to seemingly exacerbated peaks and troughs for asset prices (heightened volatility). This has included consideration of the role of life insurers and pension funds in driving the prices of assets through market cycles. In the UK, these investors are responsible for around £3trillion of assets.

Procyclicality can be defined as "investing in the short term in a way that could exacerbate price movements and contribute to asset volatility, or investing in the medium term in a way that might exaggerate the peaks or troughs of asset price or economic cycles".

To help drive forward the understanding of the role of life insurers and pension funds in these cycles, the Bank of England established the 'Procyclicality Working Group' in 2013. The group produced a discussion paper in 2014 prompting areas for further research. Some of the salient points from the group's research were that:

- The investment decisions of life insurers and pension funds are likely to have important consequences for the UK economy as a whole.
- Their research showed some evidence of procyclical behaviour of insurers. The evidence for pension schemes was less clear, but the group did find some recent evidence of (short term) countercyclical behaviour and some moderate procyclicality over the medium term of UK pension schemes.
- The group signposted several areas for further research, mentioning in particular that the analysis of the investment behaviour of pension schemes and life insurers would be greatly improved by increasing the granularity, quality, frequency and timeliness of data on asset allocation.

Members of the actuarial profession have since distilled some of the key “procyclicality” issues into the following:

- A marked decline in the willingness of these intermediaries to take on investment risk (in particular equity risk).
- Significant herding in the way UK DB schemes have been investing.
- A short-term agenda driven by regulation such as the Solvency 2 framework.
- The need for a better understanding of risk; market risk vs investment risk.
- Simpler, more focussed institutions that address the structure of the industry and incentives for behaviours.

Working party objective/aims

This working party will be formed in the Finance and Investment practice area to help progress the research and understanding of this important topic. Progression in this area is crucial to help actuaries shape the future design of savings products and understand how/why countercyclical measures might be applied for existing products. Furthermore, an objective of the working party should be to investigate measures to dampen pro-cyclical behaviour.

There are other working parties currently being set up to consider specific strands of procyclicality, so some coordination will be required to ensure minimal overlap in the research and/or sharing or ideas/resources were possible. A review of the research by the Herd-Like Behaviour Working Party will also be relevant (and related JFAR paper). The broad areas to investigate by this working party are likely to include:

- Corroborate and extend the analysis of procyclical behaviour in the ongoing operation of UK insurers and pension funds. This will likely include drilling down into investment mandates and the management of investments within those (including manager incentives and benchmarks).

- To the extent possible, understand, measure and communicate the potential creation/destruction of value caused by procyclicality at different levels (e.g. to insurers, to policyholders, to the economy).

- Understand and actively investigates measures to dampen / mitigate the pro-cyclical behaviour given the current insurance capital regime

- Consider the question of investment risk vs market risk – are differences well understood by stakeholders (e.g. regulators, trustees, policyholders, shareholders, the financial press) who are often viewing balance sheet measures which inherently embed market risk focus? Can more be done to improve narrative/understanding of stakeholders in this area to help mitigate procyclical pressures?

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