Cyclical investment behavior across financial institutions

Discussion

by

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Very nice paper!

- Paper makes use of **unique dataset** of securities holdings in **Germany** (over the period 2005-2014).
- Allows ***comparison* of investment behavior** across sectors **in the same environment**.
  - Do insurance companies behave differently from banks and investment funds, for the same security, and for the same change in price?
- Allows **clean identification** of differences**.**
- **Adds to existing single sector studies** of procyclical behavior:
  - Investment funds: e.g., Feroli and others (2014), IMF 2015 (April GFSR)
  - Insurance companies: e.g., Bank of England (2014), IMF 2016 (April GFSR)

Main findings

1. Investment behavior of **investment funds** (and banks) is **procyclical**.
   - Investment funds (and banks) **buy** when prices have **risen** and **sell** when prices have **fallen**.
2. Investment behavior of **insurance companies** and pension funds is **countercyclical**.
   - They **sell** after prices have **risen** and **buy** when prices have **fallen**.

- Findings are economically **sizable** and **robust**:
  - Security fixed effects, macro controls, country and time fixed effects.

Existing (and further) extensions

- Interaction with VIX (already done)
  - Significant for **investment funds**;
  - in line with redemption – fire sales channel.
    - Not significant for banks or insurance companies.
- Could try: interaction with pressure on capital/ profitability. Intuition:
  - When **banks** face capital pressure their procyclical behavior could be more pronounced (e.g., Adrian and Shin 2010)
  - When **insurance companies**' profits are under pressure they may not be able to afford to invest counter-cyclically
    - Low rates reduce profits.

Policy discussion: Investment funds

- Investment funds behave pro-cyclically, and this is stronger in periods of stress;
  - when redemption pressures may cause fire-sales of assets.
- Supports the search for macroprudential measures to **contain procyclical behavior** of funds.
- Under discussion (including internationally):
  - Liquidity requirements (or longer redemption periods) and stress testing;
  - Redemption gates and fees;
  - Changes to mutual fund share pricing rules (Sales price NAV).

Policy discussion: Insurance

- Insurance companies and pension fund act as **shock absorbers**, stabilizing financial markets.
- But **this should not be taken for granted**;
  - paper finds the effects to be weaker in the post-crisis period.
- Countercyclical behavior could be further **weakened by**:
  - Pressure on **business models**
    - Low interest rates may make traditional (guaranteed) insurance products non-viable, and lead to offering of mutual fund-type products by insurance companies.
  - Move towards **marking-to-market** of assets
    - Solvency II, from 2016 across the EU, requires marking to market of assets and liabilities.
  - Move to risk-based **microprudential capital requirements**
    - Solvency II introduces internal ratings based approaches to the calculation of risk-weights.

Policy discussion: conclusion

- Not all non-banks are alike.
  - Business models and funding structures determine contribution to systemic risk.
  - Focus of macroprudential intervention can differ.
- Investment Funds:
  - Need to find ways of **containing** procyclical behavior.
- Insurance companies:
  - Need to find ways of **preserving** countercyclical behavior.
    - So that insurance companies can continue to stabilize the system.