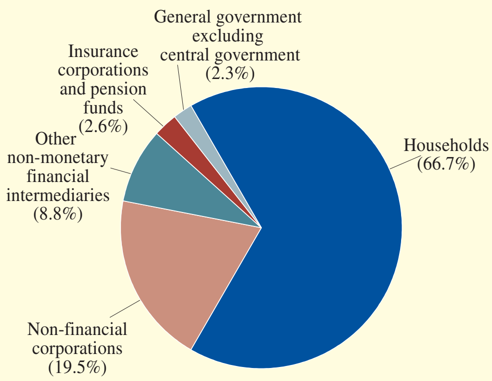
Box 1

THE INTERMEDIATION ROLE OF INSURANCE CORPORATIONS AND PENSION FUNDS AND ITS IMPACT ON MONETARY DEVELOPMENTS

Insurance corporations and pension funds (ICPFs)[1] hold between 15% and 20% of their assets in deposits, most of which are longer-term deposits not included in M3. In April 2005 ICPFs accounted for less than 3% of the holdings of short-term deposits and repurchase agreements included in the broad monetary aggregate (see Chart A), close to 80% of which is made up of deposits. The short-term deposits held by ICPFs thus constitute only a modest share of total M3. However, owing to the ICPF sector's role as an intermediary, primarily for the household sector, this share probably understates considerably the part played by ICPFs in shaping monetary dynamics over recent years. This box examines the nature of ICPFs' deposit holdings and the intermediation role they play through asset allocation.

Chart A Sectoral shares in total holdings of short-term deposits

(percentages of total short-term deposits and repurchase agreements; April 2005)



Source: ECB.
Note: The reporting sector comprises MFIs excluding the Eurosystem. Figures may not add up due to rounding.

The degree of "moneyness" of ICPFs' short-term deposit holdings

It should be noted that short-term deposits held by ICPFs may not lend themselves to an economically meaningful interpretation in terms of "moneyness". This is because they may be linked to off-balance sheet transactions that affect their economic character. ICPFs may use complex, structured products or derivatives in order to hedge positions or improve the risk/return profile of their portfolio. At the same time, they hold funds in the form of deposits as collateral. These deposits are held neither for transaction nor for saving purposes but in order to hedge the exposure or to cover possible margin calls. Although statistically treated as part of the money stock, they do not correspond to money in the usual economic sense but exhibit hybrid properties between those of money and longer-term securities.

The intermediation role of ICPFs

ICPFs are financed predominantly by the household sector. ICPF liabilities, mainly in the form of insurance technical reserves, therefore form part of the stock of household financial wealth. The importance of ICPFs to households has grown in recent years, with the share of insurance technical reserves in total household sector financial assets increasing from 21.3% in 1995 to 26.4% in 2003. A considerable variation in this percentage can be observed across countries, related to the extent of coverage offered by public pension systems and the depth of national

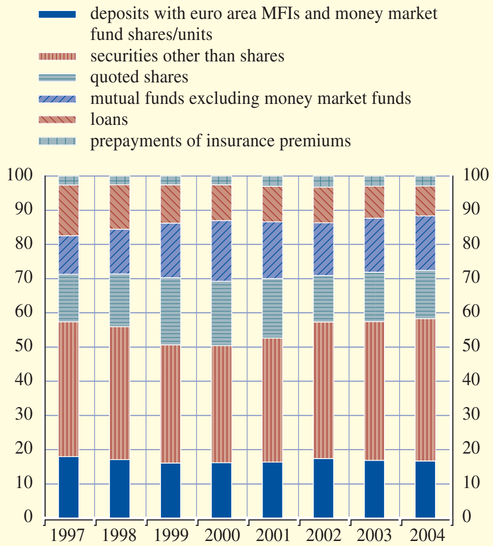
1 The ICPF sector is heterogeneous in its composition, comprising very different types of entities: life and non-life insurance corporations, reinsurance corporations and pension funds.

financial markets. Given that ICPFs are mainly financed by households, the asset allocation of ICPFs "replaces" household investment decisions. While households' direct holdings of deposits are concentrated in shorter maturities, which are included in M3, a large share of ICPFs' assets are deposits with an agreed maturity, particularly with a maturity of over two years, which lie outside M3. Changes in households' portfolio allocation towards a greater investment in ICPFs can thus have an important impact on monetary developments. For instance, ICPFs tend to actively manage their funds in response to capital market developments, shifting more often between deposits and other asset categories than households. These changes in households' portfolio allocation and the consequences of ICPFs' liquidity management could make monetary developments more volatile.

In general, the professional risk management pursued by ICPFs allows them to invest in riskier and longer-term assets than households. ICPFs, in particular life insurers and pension funds, traditionally invest their funds in fixed-income assets and are important players in the euro area long-term bond market. They also purchase significant volumes of equities, to a large degree outside the euro area. To the extent that such transactions involve international capital flows settled through the euro area MFI sector, this impacts on the net external assets of the MFI sector and the deposit holdings of euro area residents, in turn affecting monetary developments. However, ICPFs' investment behaviour is also governed by, among other things, regulatory mechanisms set up to safeguard the financial system and limit associated risks. In certain circumstances, such as a phase of declining stock market prices, these mechanisms can hinder ICPFs from taking a view that differs strongly from the market consensus. In Chart B, this is clearly visible for the period 2000 to 2002: ICPFs reduced their holdings of quoted shares while substantially increasing their holdings of securities other than

Chart B Asset allocation of insurance corporations and pension funds

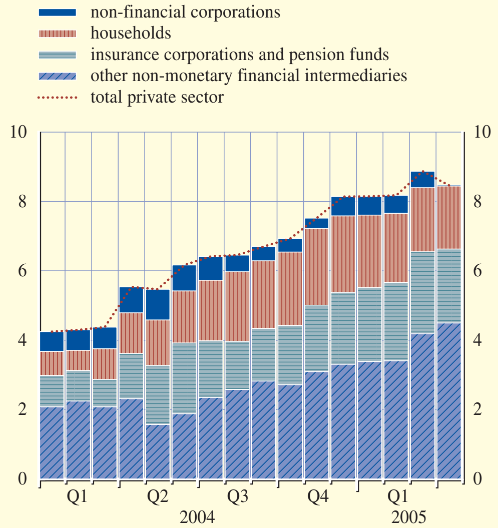
(percentages of total financial assets; end of period)



Source: ECB.

Chart C Longer-term deposits

(annual percentage changes; contributions in percentage points; not adjusted for seasonal or calendar effects)



Source: ECB.
Note: The reporting sector comprises MFIs excluding the Eurosystem.

shares, which are primarily long-term in nature, thus matching the behaviour of the non-financial sector. ICPFs held a significant share (31.2%) of MFI longer-term deposits in 2004 (those deposits falling outside M3) and have contributed to their rapid expansion since the second quarter of 2004 (see Chart C). To an important extent, the marked increases in ICPFs' holdings of longer-term deposits have been determined by two effects: first, the asset allocation behaviour of the ICPFs, and second, households' significant shift into insurance contracts in an environment of increased uncertainty related to the ageing of the population.

Overall, the intermediation role of ICPFs has increased in recent years and can be expected to gain further importance as changes to public pension systems are implemented and households' awareness of a need for private provision rises. Analysing the asset allocation behaviour of ICPFs and its impact on monetary developments in real time is thus an important issue for monetary analysis, which would benefit from the provision of more timely and detailed data on ICPFs' transactions and balance sheets.

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