Box 1

HOUSEHOLD INVESTMENT IN INSURANCE CORPORATIONS AND PENSION FUNDS

Households typically invest their wealth in housing and/or financial assets.[1] Depending on the structure of the pension system (i.e. the importance of public pension provision as against provision by the private sector), a considerable part of households' financial wealth may, in turn, be invested in insurance corporations and pension funds (ICPFs). Analysing this type of investment is important for both the monetary and economic analyses. For example, given that households and institutional investors differ in their money-holding behaviour, changes in households' investment in ICPFs have an impact on monetary developments.[2] The growth of household money holdings is generally slower and less volatile than that of institutional investors' money holdings. Moreover, variation in wealth holdings in the form of insurance and pension products rather than other household assets may imply differences in the monetary transmission mechanism. Against this background, this box examines the investment of households in ICPFs over the period from 1995 to 2005.

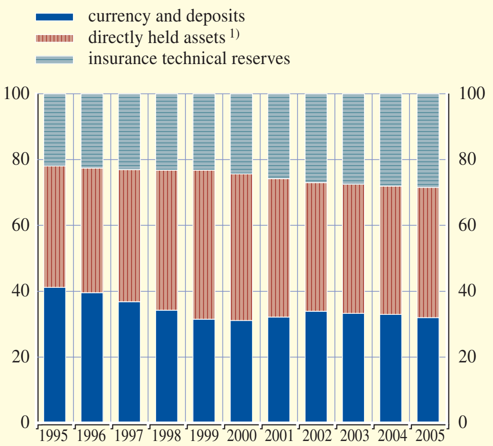
How important are insurance and pension products in households' financial portfolios?

In the Monetary Union financial accounts, the household sector's investment in insurance corporations and pension funds is recorded under so-called insurance technical reserves. These consist of households' net equity in life insurance reserves and pension fund reserves (representing the typically long-term claims from life insurance policies and pensions) as well

1 See also the box entitled "Estimates for housing wealth of households in the euro area" in this issue of the Monthly Bulletin. Throughout this box, the household sector refers to households and non-profit institutions serving households.
2 See also the box entitled "The intermediation role of insurance corporations and pension funds and its impact on monetary developments" in the June 2005 issue of the Monthly Bulletin.

Chart A Composition of household financial wealth

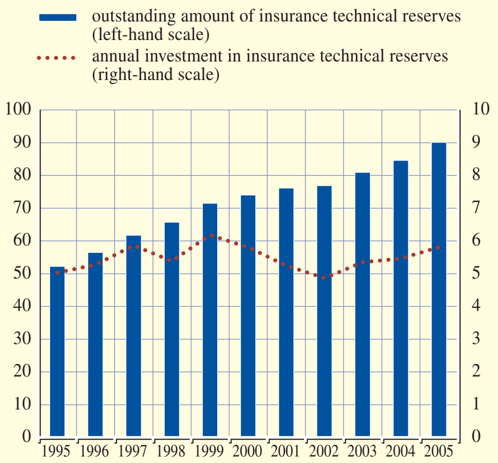
(as a percentage of total household financial wealth)



Source: ECB.
1) Directly held assets comprise the holdings of loans, securities and other accounts receivable held directly by the household sector.

Chart B Household investment in insurance corporations and pension funds

(as a percentage of disposable income)



Source: ECB.

as prepayments of insurance premiums and reserves for outstanding claims (comprising mostly short-term claims which may arise in connection with any type of insurance or pension contract). Chart A shows that on average over the period from 1995 to 2005 insurance technical reserves accounted for roughly 25% of households' financial assets. The chart also illustrates that their share in total financial wealth has steadily increased over the period under review, from 21% in 1995 to 28% in 2005.

Chart B shows that the amount of household wealth invested in insurance and pension products has increased substantially over the past ten years, to 90% of disposable income in 2005. By comparison, the wealth held in currency and deposits has remained broadly unchanged as a ratio to disposable income. However, wealth holdings reflect the cumulative impact of investment and valuation gains[3], so the decision to invest in insurance and pension products is better assessed on the basis of transactions. On average over the past decade, the investment transactions in insurance technical reserves amounted to 5.5% of households' disposable income (see Chart B), accounting for somewhat more than one-third of the aggregate household saving ratio.

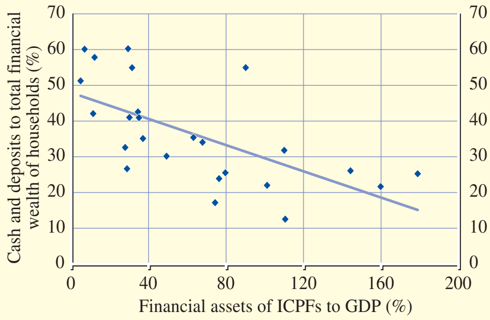
What explains the developments in insurance and pension products in past years?

Two broad sets of reasons can be put forward to explain the significant share of insurance and pension products in household financial investment. First, from a cyclical perspective, the relatively stable inflow into insurance technical reserves, particularly when compared with other forms of financial investment available to households such as equity or securities other than shares, suggests that the combination of risk and return offered by ICPF products has on balance been attractive in a period when stock markets underwent a pronounced boom/bust cycle.

Second, from a longer-term or structural perspective, the demand for ICPF investment has been supported by a growing awareness on the part of households of the challenges posed by population ageing and of the need to ensure adequate benefits in old age.[4] This development has been corroborated by recent reforms to mandatory public pension schemes, which in general have reduced the generosity of the system and linked the benefits level to life expectancy.[5] Partly related to this, tax incentives and the stronger emphasis on private pension plans have also supported the propensity of households to acquire ICPF products. Overall, the broad picture emerging from Chart A, i.e. a rising share of insurance

Chart C Households' holdings of cash and deposits in relation to the size of the ICPF sector

(annual averages for the period 2001-2004)



Sources: ECB, Eurostat, OECD, national central banks and national statistical institutes.
Note: The sample consists of 25 OECD countries.

3 Valuation gains on assets do not lead to higher insurance technical reserves in defined benefit schemes, while they do in defined contribution structures.
4 See also the article entitled "Demographic change in the euro area: projections and consequences" in the October 2006 issue of the Monthly Bulletin.
5 P. Whiteford and E. Whitehouse (2006), "Pension challenges and pension reforms in OECD countries", Oxford Review of Economic Policy, Vol. 22, No 1.

technical reserves in household financial wealth and a declining share of currency and deposits, is likely to persist.

Some evidence in support of this presumption is provided in Chart C, which shows, for a sample of 25 of the 30 OECD countries, that a larger ICPF sector in relation to GDP is in general related to a lower share of currency and deposits in household financial wealth, suggesting that in more developed financial systems, financial wealth is held less in the form of currency and deposits. The location of a country in this scatter plot also reflects a number of factors such as the country's demographic structure, the maturity of the pension fund sector and the fiscal position of the government.

Overall, the intermediation role of ICPFs as reflected in the developments in insurance technical reserves has increased in recent years and can be expected to gain further importance as households' awareness of the need for private pension provision rises. The understanding of these linkages and of their implications for economic and monetary analysis obviously hinges on the provision of timely and detailed data on ICPFs' transactions and balance sheets.