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DOES REGULATION MATTER? RISKINESS IN PENSION ASSET ALLOCATION

Abstract:

We investigate the influence of investment regulations on the riskiness and procyclcality of defined-benefit (DB) pension funds' asset allocations. We provide a global comparison of the regulatory framework for public, corporate and industry pension funds in the US, Canada and the Netherlands. Derived from panel data analysis of a unique set of close to 600 detailed funds’ asset allocations, our results highlight that regulatory factors are vitally important – more so than the funds’ individual and institutional characteristics, in shaping these asset allocations. In particular, risk-based capital requirements, balance sheet recognition of unfunded liabilities, lower liability discount rates, and shorter recovery periods lead pension funds to decrease their asset allocation to risky assets. Risk-based capital requirements reduce overall risky asset allocation by as much as 5%, but they do not affect the asset classes identically. While equities, real estate and mortgages are at a disadvantage, high yield bonds and commodities are slightly favored.

Keywords:

Solvency, Pension funds, Defined Benefit, Liability discount rate, Valuation requirements, Financial stability, Regulation

JEL Classification: G28, G11