International Monetary Fund

Governing Pension Funds: Securing the future

The way forward post-JDX

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[Greetings….]

Context of the JDX

My message this morning is that all challenges present opportunities. How one manages those opportunities depends on best practice governance.

Let me begin with a little history that I think you are all familiar with. Prior to the global crisis, Jamaica was faced with a persistent savings gap (financed by borrowing), low growth and high debt. The situation deteriorated significantly in FY2007/08 with a deepening of the global crisis. Jamaica's current account deficit increased from approximately 10% to a little over 17%.The widening current account deficit reflected lower demand for Jamaica's exports, a fall off in remittances and lower foreign direct investment (FDI), putting significant strain on reserves and the exchange rate. The condition in the wider economy was reflected in the government sector. The central government's deficit deteriorated with lower revenues as economic activity within the country slowed. With an increase in interest rates[1], interest costs which had also been on a declining trend increased significantly. Borrowing increased to cover the expanding deficit, leading to a rise in the Debt/GDP ratio following four consecutive years of improvement. Notably, following average growth of 1% for the last 3 decades, the economy contracted by more than 2% in FY2009/10 with the hit to major sectors. The lack of growth and the increasing debt put Jamaica, already in a precarious position, on an unsustainable path. It became increasingly obvious that something needed to be done, something drastic, something meaningful, and something to change the direction of the waves.

The Government of Jamaica approached the IMF in 2009 with a proposal to enter into a Standby Arrangement. The authorities requested a 27-month SBA. It was realized that if Jamaica were to move forward, the high debt servicing costs facing the government needed to be tackled, and urgently. At the time, not only was Jamaica's debt overhang very high, but in addition, a significant bunching of maturities would result in large gross borrowing needs in the years ahead. Jamaica was

[1] Based on increased pressure on the domestic currency the central bank tightened its monetary policy stance sharply with higher cash reserve requirements and a **680 basis point** increase in the policy rate to **21.5%** on the December 1, 2008.

also in the precarious position with 65% of the debt being held by domestic financial intermediaries. Consequently, a debt relief operation needed to be carefully designed to minimize the risks of financial sector distress. Disbursements under the Fund program were to be front loaded, with half available to establish the Financial Sector Support Fund, focused on providing liquidity support to financial institutions.

What became known as the Jamaica Debt Exchange (JDX) became a prerequisite for the SBA. The JDX was designed with a view of reducing the public interest bill by at least 3% of GDP in FY2010/11 and reducing the rollover requirements of domestic bonds over the next three years by ¾. This would give the government fiscal space to implement much needed reform. A par-for-par exchange was aimed at reducing direct adverse impact on the banking sector balance sheets, thereby preserving financial stability.

The JDX for all intents and purposes, with a participations rate of 99%, was extremely successful. The profile of government debt was significantly improved. The weighted average age of debt increased, variable rate debt declined. Medium-term debt servicing costs fell due to the lower coupon on the new debt instruments as well as the lengthening in the maturity profile. At the same time, an appreciation in the foreign exchange rate has also had a positive impact on interest cost and the value of debt.

Impact on Institutional Investors

Now these all augur well for the government, but what has been the impact on institutional investors such as pension funds? The simple (although universal) principle of duality applies – every transaction has two sides, each a mirror image of the party/counterparty relationship.

- The outcome of the JDX has impacted institutional investors both negatively and positively. The lengthening of the Government profile has perhaps provided for better matching of assets and liabilities for pension funds, whose liabilities are generally long-term in nature.
- The rolling of over 300 debt instruments into 26 benchmark instruments has improved the liquidity of the market for government debt instruments.
- The implementation of Central Securities Depository (CSD) should also help in this regard by providing a modern electronic clearing system that enables securities settlement, transfer and custody of domestic issues of Government of Jamaica fixed income securities. The main advantages of the system being: -

- Enhanced transparency, reducing the risk, for example, of persons using one security to back many liabilities.
- Improved financial stability and increased system efficiency.
- Significant savings in printing costs on paper certificates and reduction of risk.

Among the benchmark instruments offered in the JDX were two inflation-indexed bonds. These instruments are of course a healthy addition for pension funds as they provide real returns, protecting the portfolio against inflation.

The JDX however immediately reduced investors’ income, both current and expected. The impact has been larger than expected with a faster than expected decline in T-bill rates, subsequent to the exchange. The decline in rates has improved the value of the bonds post JDX but has also increased the net present value of liabilities.

The impact on funds surpluses is however what is most important. It can likely be argued that the impact of these lower market rates is better than would have obtained under higher rates. This is because the JDX has led to a lengthening in the maturity profile of assets and presumably better duration matching of assets and liabilities. This has been the case for the NIF, and I am sure many other funds.

Where are we now?

To foster growth opportunities and maintain economic and financial stability, interest rates must remain low, thereby providing a fertile environment for growth of assets other than government bonds. Jamaica can no longer bear the cost of high interest rates, having suffered long and hard under the yoke of low growth and high debt. Fortunately, there have been some recent improvements in the macro environment. Financials have improved since JDX:

- As we all know, interest rates on securities are the lowest in four decades.
- Loan rates are declining, although slowly; there are signs that banks are recognizing that they must compete for loans to earn decent returns.
- Financial sector risks, despite fears surrounding the JDX appear contained; consequently there has been no use of the Financial Sector Support Funds.

As we all know, real sector indicators are lagging. This is however not unusual. The private sector still remains cautious after many years of dependence on government instruments. It is hoped that Jamaica will return to growth soon and the trend has been one of smaller and smaller declines in recent quarters. Sectors like tourism, mining, and agriculture are showing improvement (a promising sign). Meanwhile, a number of fiscal and financial sector reforms are ongoing, which will aid the growth and economic stability agenda.

Challenges going forward

Lower Returns: Pension funds worldwide are facing funding risk in the current environment of low interest rates, slow economic growth, and more volatile markets. Jamaica must now grapple with a situation in which it has not found itself in close to four decades. The rate on the 90-day Treasury Bill has not been this low since 1973. Notably, lower rates means that companies can borrow more cheaply but at the same the time they may be forced to divert more money to their pension funds [to maintain payouts] and/ or look towards riskier assets that provide higher real returns.

Aging Population: In Jamaica, defined benefit plans, which account for over 70% of active pension plan assets, largely reflect surpluses. In other words, the actuarial liabilities of the plan are less than the assets invested on behalf of the members. Unlike more developed countries, a significant portion of Jamaica's population is still below retirement age. Recent statistics however show that the average age of Jamaicans has begun to increase. This implies that at some point in the future the liabilities of funds may increase significantly, impacting the pension surplus, much like it has in developed countries. Admittedly, this may be some years into the future.

Limited Investment Avenues: Government issues are limited, reflecting the dramatic decline in financing. Not only is the deficit lower this fiscal year, but also the debt profile has been extended by 3 years or more with the JDX. Accordingly, there are limited avenues to invest, while interest income, albeit lower than in previous years is nonetheless substantial. The high demand for fixed income instruments, and limited supply means that bonds are selling at high prices in secondary markets.

At the same time, pension funds may be faced with other factors which limit their investment options such as the BOJ regulation limiting foreign investment, while public funds such as the NIF are limited in the amount they can invest in the stock market in any given month ($10mn net per month). Additionally, long procedures for approval of the purchase of assets such as real estate can make diversification a difficult task.

What is the way forward?

In the current environment there may be the temptation to take on higher risk in an attempt to increase returns. However it must be understood that with higher risk comes added responsibility, bringing a need for best practice governance. Good governance, which can be defined as all resources utilized in the investment decision-making process, is increasingly being seen as an important aspect of an efficient pension system. Empirical evidence links good governance among funds to: -

- Enhanced performance and returns while maintaining stability;
- More control over how the plan is managed;
- Potential decrease in administration costs.

What does good governance involve?

According to best practice, pension fund governance systems should be ***risk-based***, varying according to the size and type of plan as well as with the extent of risks faced. In managing the risks of the fund the governing body should carry out such important functions as[2]: -

- ***Assessing of the performance of persons involved in the functioning of the fund***. This includes persons in operation as well as those in oversight and strategic decision making. Importantly this also includes outside service providers such as consultants, actuaries and asset managers.

- ***Conducting regular review of the compensation mechanism to ensure that incentives are aligned correctly***. Compensation should be designed to motivate the trustees to act in the best interest of beneficiaries, and importantly to focus on long-term sustainability of the fund as long as the fund is a going concern. In the case of investment managers, this may be accomplished by

[2] OECD Guidelines for Pensions Fund Governance, June 2009

partially basing compensation on risk-adjusted returns (returns alone may encourage unnecessary risk-seeking).

- ***Identifying, monitoring and correcting conflicts of interest situations***. Conflicts of interest can be managed by appointing independent board members. In many countries, regulators (UK, Australia) have been given the power to replace conflicted trustees.

- ***Implement adequate risk measurement and management systems***. The risk management system should look at the major risks to which the fund is exposed, whether investment or operational related. The risk management strategy should be proactive, focusing on balancing short and long term considerations.

- ***Assessment of compliance with local law***, which speaks for itself.

Conclusion

For a long time governance has been seen simply as a constraint. This is not specific to Jamaica. However, pension funds worldwide are beginning to realize that governance should be a top priority, not only because funds are responsible for a significant sum of money but also because they create an opportunity for wealth creation. Internationally it has been recognized that much of the underperformance of funds came about because of poor governance.

In practice, good governance has been shown to go beyond minimizing potential conflicts of interest to delivering better performance net of costs. An additional benefit of proper governance by institutions is it acts as self regulation reducing the need for more intrusive regulation, sparing the funds the impact of costs associated with excess regulation.

Improving governance is by no means an easy task for pension funds or their regulators; however the business of pensions is too important to the security of a nation for it not to be a priority. At this juncture, pension funds have an opportunity to be an active intermediary in the financing of growth, aiding the development of capital market, and leading through enhanced governance.