Macroprudential Supervision and Pension Funds

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Let me first express my gratitude for the invitation to participate in this meeting of the Caribbean Association of Pensions Supervisors and as well let me congratulate the association for bringing together representatives from across the region. Such collaboration is essential for providing a forum at which financial supervisors of the Caribbean can seek to address issues of common interest and concern.

I've been invited to speak on macroprudential supervision, the application of which has risen in importance for financial sector supervisors across the globe. I'll spend the next few minutes discussing the following:

1. *What is macroprudential supervision?*
2. *The Jamaican framework and mandate.*
3. *Considerations for pension supervisors.*

Why are we here and what is macroprudential supervision?

I'd like to draw your attention to the following charts to reflect on their commonalities [Figure 1 & 2]. Often times financial and economic crisis involve a preceding period of economic growth and optimism. Often recognized after the fact, are the associated excesses and/or financial imbalances present during the expansionary period. A brief description of a few examples of financial crisis will help to set the stage for describing macroprudential supervision.

Argentina experienced macroeconomic excesses in the 1990's, demonstrating large levels of public sector debt. The country's current account was in large deficit implying that they were utilizing more foreign currency than they were earning. Based on these conditions Argentina appears to have been operating with a significantly overvalued currency. There were also other significant financial system imbalances. There was significant US dollarization in the economy and the banking system's short-term foreign currency liabilities were insufficiently matched by foreign currency asset. A "run on banks" emerged, which led to a collapse in the exchange rate and a default by the Government on its debt obligations.

During a similar time there was significant economic growth and optimism in the "Asian Tigers" and "Tiger Cubs". The economies of Malaysia, Thailand, the Philippines, and Indonesia had many perceived strengths. They had business-friendly policies, high rates of capital investment and accompanying GDP growth. However, during the late 1990's a financial crisis spread across East Asia. Apparent "hot money", reversed in direction, slowing growth sharply. Resultant sharp movements in the exchange rate increased the value of external debt, leading financial entities into distress and insolvency.

In hindsight, the Argentina Debt crisis, East Asian crisis and other systemic risk events such as those experiences by Mexico and the U.S, make clear that strong growth may mask

important vulnerabilities. For example, rapid credit growth may lead to a significant build-up of financial leverage. In addition, an over reliance on international capital, reflected by growing current account deficits, may lead to significant external debt. Borrowing in short maturities may also compound these risks as it leaves the financial system exposed to funding risks.

These case studies lead us to the **concept of systemic risk and macroprudential supervision**. Risk is considered systemic if its realization will significantly impair the provision of a financial services and have real impact on economic activity and growth. In other words, a systemic risk event will create widespread impact in the financial system and as well have a real impact on the economy, investment and future growth. Macroprudential supervision is aimed at mitigating and managing systemic risk.

As opposed to the more familiar supervisory or regulatory supervision, macroprudential supervision is concerned with those developments that relate to the whole or significant parts of the financial system rather than risk exposures of individual financial institutions. Macroprudential supervision looks at the collective actions of financial entities, its potential interaction with real economic developments and those risks that that could become systemic.

The macroprudential mandate in Jamaica

In October 2015, the *Bank of Jamaica Act* was amended to provide a statutory basis for the Bank's financial stability mandate. The need for this added mandate was highlighted by the global financial crisis of 2008 that demonstrated the disastrous possibilities that can stem from systemic financial risk, even in the presence of otherwise sound financial institutions. The amended law now mandates the central bank to:

- take a macroprudential approach to complement regulatory supervision;
- establish a Financial System Stability Committee responsible for reviewing the Bank's macroprudential assessments and advising on related policy;
- establish an emergency liquidity facility; and
- issue rules and codes to mitigate systemic risk.

The aim of this new macroprudential approach is to safeguard and strengthen financial system stability by preventing new systemic risks, managing and mitigating existing ones, while maintaining the financial system's contribution to economic value creation. The macroprudential approach is more than an aggregation of risks in individual institutions; it is also about risks that arise as a result of the collective behaviour of institutions and there interlinkages. For example, in cases where the measurement of a measured risk is a function of market prices, correlations between asset prices can contribute to systemic risk and is compounded if there is significant herd behaviour among financial institutions. Systemic risks are even higher due "procyclical" correlations in the price movement across different real and financial asset markets.

Potential policies to mitigate systemic risk

Prior to 2008, financial sector regulation, which predominantly included capital requirements and leverage caps, was static in nature. The financial crisis showed that this approach is insufficient. Let's recall that a major concern for financial stability, is overheating in the economy, and excessive asset price growth. One option is for financial stability to be managed with monetary policy, by using, interest rates to curtail asset bubbles. The challenge with this is

that this approach will have other direct influences on the economy. So the macroprudential approach involves the development of targeted rules.

What do these rules look like in practice? The Basel Committee on Banking Supervision together with the Financial Stability Board have agreed on the general principle that prudential standards should in part reflect the systemic significance of financial institutions. Institutions whose failure imposes larger costs on the financial system should have tighter standards. The 2010 Basel III accord has adopted this condition and has as well introduced the concept of counter-cyclical buffers. The accord requires financial institutions to set aside extra capital to deal with unexpected loss and shock and allows regulators to increase capital requirements when credit growth is deemed as excessive.

Considerations for pension supervisors

As supervisors you are usually concerned with the profile of the entity and sector, but often don't view, or have in your assessment framework, a view of the interdependencies of institutions' performance amongst themselves, across sectors and with the general macroeconomy. The objective of macroprudential policy is therefore to complement the traditional prudential or regulatory supervision that focuses on individual institutions, to limit systemic risk. The macroprudential approach applies primarily prudential rules to regulated firms but these instruments are, however, calibrated to be pre-emptive, forward looking and are generally concerned with financial shocks that -

i. can lead to a chain reaction within the system (interconnectedness of activity).
ii. may impact multiple firms at the same time (commonality of activity).

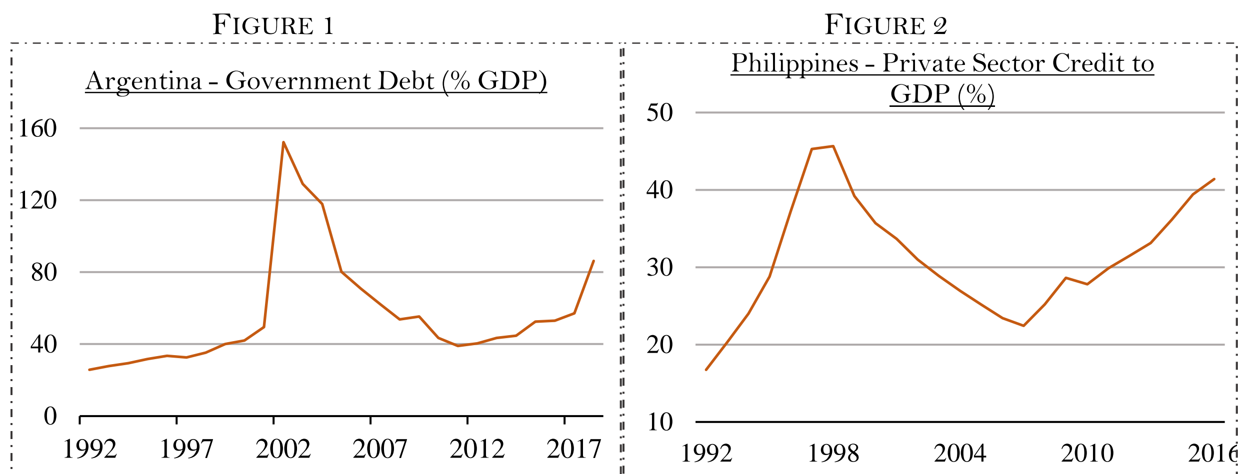
Pension funds have a number of characteristics that render them different from purely bank-type financial institutions. Firstly, pension funds do not operate on a leveraged basis. We know pension funds are often restricted from borrowing, except for short-term liquidity needs. This means that pension funds only invest those contributions paid into the pension fund by its members. So the potential systemic risk from the unwinding of leverage, is less than is in the banking or investment sectors. Secondly, the average duration of the liabilities of pension funds is between 15 and 20 years. This makes pension funds naturally long-term investors. Thirdly, unlike banks, direct linkages of pension funds to other financial institutions are limited.

Pension funds can however be the source of systemic risk. Those risks associated with occurrences when pension funds are in financial difficulties. In such cases pension contributions may have to be raised and/or the level of the pension benefits may have to be reduced. Both measures depress disposable income. The potential role of pension funds in generating macro-economic or systemic risk depends mainly on the size of the sector. The smaller the pensions sector is relative to the economy or the financial sector, the smaller the extent of potential systemic risk. In other cases, the pension funds sector may be so large as to cause systemic problems when they fall into financial distress

As the pensions sector continues to expand and increase its role in the allocation of capital to the real economy, its interlinkages with the wider financial sector will deepen. Stress tests are an important supervisory tool to provide insight into the risks and vulnerabilities of the sector designed to assess the resilience of pensions sector to an adverse market and economic scenarios using common methodologies. They should entail an assessment of the resilience of the

sector to a down-turn in the economic and financial cycle. Assessments should as well be conducted to map the asset exposure and interconnectedness with other financial institutions.

Thank you.



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