INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS ("IOPS") CARIBBEAN REGIONAL WORKSHOP ON PRIVATE PENSION SUPERVISION

Presentation: The Impact of the Global Financial Crisis on Pensions Funds in the Jamaica and the Caribbean Region

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Introduction

In his 1977 article entitled "Caliban Ariel and Unprospero in the Conflict of Creolization", Kamau Brathwaite described the Caribbean as a having a culturally prismatic orientation, which conceived of all residents as equal and contiguous, despite the accidents of political history, each developing its own lifestyle from the spirits of its ancestors, but modified – and increasingly so- through interaction with the environment and the other cultures of the environment until residence within the environment becomes the process through which all will ultimately begin to share a style, even though that style will retain vestiges of their original ancestral heritage.

This prismatic orientation is indeed true in many respects – Our food, our music, our speech, our way of life. It is also true in the manner in which the regulatory framework for the pensions industry has developed in the respective jurisdictions with the region.

Permit me to cite some of these subtle, but yet important differences in pension arrangements. While all countries have both public and private pension funds, there exists a wide range of arrangements of private pension institutions covering mandatory and voluntary plans, defined benefit ("DB") and defined contribution plans ("DC"). In both the Cayman and the British Virgin Islands, there exist mandatory plans where each employer must establish a pension plan for its employees. In fact, 99% of the workers in the Cayman Islands are covered by a DC plan and 90% of these workers are in one of the six multi-employer plans operating there. In Jamaica and Trinidad and Tobago the employer is not mandated to establish a pension plans for his/her workers.

The pensions industries within the Caribbean countries are at diverse stages of development. For example, Jamaica, Trinidad and Tobago, Bermuda and Cayman have passed pensions legislation and have a regulatory framework in place. Barbados has also passed legislation, but yet to be implemented. Antigua of the Organization of the Eastern Caribbean States ("OECS") has its legislation in place, with other

members of the OECS to follow. Other Caribbean islands such as Bahamas and the Turks and Caicos have established task forces to begin their pension reform.

Likewise the regulatory framework varies among the islands. Trinidad & Tobago has one single integrated regulator – the central bank – for deposit–taking institutions, insurance, securities, and pensions. In Jamaica, the Bank of Jamaica, ("BoJ"), the central bank, supervises deposit-taking firms, while the FSC regulates insurance, pensions, and securities. In other islands, there is a separate regulator for pensions, while in Antigua the pension legislation is codified in the Insurance Act and hence the insurance regulator will be the regulator of the pension industry as well.

It should be noted that the different regulatory frameworks prohibit certain types of investments and, for those permissible investments; there exists various limitations on the type and the amount of local and foreign assets that can be purchased. In Bermuda, while the administrator is obligated by law to guide the members and exercise care, diligence and skill to prevent any undue losses, there is a greater scope of flexibility. For example, some DC plans are self-directed where individual members can choose a wide variety of assets including alternative investments to invest in from their individual contributions, given their age and risk tolerance.

Sources of Vulnerability

Pension plans are typically exposed to three major sources of vulnerabilities which are (1) asset and liability shocks, (2) income shocks, and (3) contribution shocks. The financial crisis has been described as the greatest crisis in at least a century as this crisis is unlike others in that it had a unique degree of financial contagion that caused many countries to be affected simultaneously[1]. In September 2008 with the fall of Lehman Brothers, the global financial crisis intensified and has had an adverse impact on all pension plans through these areas of vulnerabilities. The degree of impact on pension plans in the Caribbean varies with subtle differences that exist among the countries' economies, pension arrangements, and regulatory frameworks.

Let us begin to examine these three sources of exposure:

Asset and Liability shocks

During 2008, the stock markets in both developed and emerging markets fell significantly. The Organisation of Economic Cooperation for Development ("OECD") noted that by October 2008, stock markets in the US, European area, and emerging markets had fallen by nearly 50

[1] Financial Services Authority, 2009, The Turner Review: A Regulatory Response to the Global Banking Crisis See http://www.fsa.gov.uk/pubs/other/turner_review.pdf

percent of their value at the start of the year. [2] Caribbean islands that tend to have a greater portion of assets in the US equities market such as Bermuda (50%) and the Cayman Islands (40%) which would have seen their pension funds decline in values. While Jamaica has less exposure to the US equities market, total assets under management in the pension industry totalled $196.4 billion or US$2.56 billion as at the end of 2008, a 4.7% reduction from $206.1 billion (US$2.87 billion) as at June 30 2008. This decline is due in part to the fall in stock prices. By December 31, 2008, the Jamaica Stock Exchange ("JSE") main index lost 25.8 percent of its value since the start of the calendar year, with some 21.4 percent vanished in the last quarter alone of 2008. At June 2008, at least 15 percent of private pension assets were invested in the Jamaican equities market.

Therefore for each country, the main determinant of the magnitude of the change in pension asset values has been equity exposure regardless of whether it is in the US, regional or local market. Other asset exposures also contributed to the fall in pension assets value. These would include, but are not limited to:

- Sovereign bond spreads for emerging markets rose from approximately 450 basis point in September 2008 to 891 on October 24.[3] According to Merrill Lynch & Co.'s emerging-market sovereign indices, for Jamaica's Eurobonds, there was a 23 percent

[2] OECD, 2008, ***Pension Markets in Focus December 2008 Volume 5***
http://www.oecd.org/dataoecd/42/19/41770561.pdf Accessed January 28, 2009

[3] World Bank Group, 2008, *The International Financial Crisis What Next For Emerging Markets? See* *http://crisistalk.worldbank.org/files/International_Financial_Crisis.pdf* Accessed June 1, 2009

loss in 2008. [4] Furthermore, due to the implementation of a tight monetary policy to stem the devaluation of the Jamaican dollar after Lehman Brothers collapsed, the yields on local bonds have risen and consequently the prices of these bonds have fallen. At least 42 percent of pension assets are invested in Government of Jamaica ("GOJ").

- Pension funds in at least two Caribbean islands also suffered losses due to exposures to sub-prime assets and the Bernard Madoff Ponzi Scheme.

On the other side of the balance sheet, the value of liabilities for accounting purposes was also affected. Again we can see the melting pot effect as the techniques and parameters of valuation such as the costing methods, the term structure of the relevant interest rate used for discounting, and the locally prevailing accounting standards are heterogeneous across the region. Regardless of these differences, generally pension funds liabilities increase due to downward changes in interest rates. Furthermore lower asset prices and a drop in investment returns would have worsened their financial solvency.

Income Shocks

Ceteris paribus, the rate of return on investments normally decreases during a recession. The Caribbean, similar to the wider world, saw a

[4] Bloomberg, 2009, See http://www.bloomberg.com/apps/news?pid=email_en&sid=a1q2kf8IjmqI

decline in rate of return on investments. The fall in investment returns on all assets has reduced the investment income for pension plans.

However, in December 2008 the BoJ, increased the benchmark 180-day instrument by 7 percentage points to 21.5 percent in order to stem the devaluation of the Jamaican currency and to control inflation. The increase in interest rates and the devaluation of the Jamaican currency meant the holders of GOJ paper -- both local and Eurobond -- would have benefited from additional investment income. Today the interest rate has fallen to 17 percent and the general expectation is for this trend to continue.

With various authoritative individuals and organisations debating the early signs of economic recovery (or as they are called, green shoots) or the signs of a double-dip recession, one of the concerns for Caribbean pension funds is the consequence of a prolonged economic slowdown and persistent poor investment returns, as pension funds could come to a point where they will not be able to honour future obligations.

Contributions Shocks

The slowdown in economic activities was accompanied by job losses and business closures. Consequently, funding levels have deteriorated with the reduction in plan memberships due to redundancies and closure of

sponsor companies. Members of defined benefits plans are more at risk of having their pension benefits cut, which is most likely if the sponsoring company goes bankrupt. In addition, expenditure from such schemes will likely increase as more individuals seek pension benefits in face of the economic downturn.

To date, the FSC is aware of the following developments:

i. The Bauxite and Mining Sector accounted for approximately 8% of the pension industry in Jamaica. The fall in the price of aluminium due to the contraction in world demand has resulted in job losses and the winding-up of three out of the nine pension funds for this sector.

ii. Due to the impact of the financial crisis, one pension plan from the manufacturing sector has been wound-up in Jamaica.

iii. With job losses in the Agriculture Sector, three superannuation funds are being wound-up as a result of the divestment of sugar plants in Jamaica.

iv. In the Cayman Islands, the government is contemplating the decision to grant employers a contribution holiday from their mandatory contributions to pension funds for at least a year. These situations in Jamaica and the Cayman Islands call for greater vigilance on the part of regulators --with the FSC mandated to review the winding up process of these plans, while the Cayman Islands regulator will need to

follow up with these employers to ensure the deferred mandatory contributions are honoured.

v. While the global financial crisis was not the primary cause of the collapse of the Stanford International Bank (an alleged Ponzi scheme) and the CL Financial conglomerate and its subsidiaries, Clico Investment Bank and insurance provider CLICO, job losses occurred in Antigua and other parts of the Caribbean.

Structural Changes

Due to the fall in companies' revenue, companies might implement the following structural changes in order to reduce costs and risk:

- Converting from DB plans to DC plans in an effort to shift the risk from the sponsoring companies to members of the pension plans. It is anticipated that there will be an increase in the number of applications for conversions from DB to DC.
- Creating multi-sponsor plans resulting from the merger of pension plans in order for the sponsors to share administrative and investment costs as well as to ensure regulatory compliance.
- Winding–up of plans which could possibly result in an increase in membership enrolment in Retirement Schemes or Individual Retirement Plans. For the year ending March 31, 2009, 19 plans have indicated to the FSC their intention to wind-up.

- Rearranging their asset allocation by moving away from the equities due to the fall in the equities market. In Jamaica, with the spike in interest rates that occurred in the last quarter of 2008, investment managers shifted portfolios to take advantage of attractive interest rates arising from debt instruments issued by the BOJ. I anticipate that pension funds –both regional and international-- would have also reconsidered their alternative investments (hedge funds, private equity, commodities, etc). However investment managers need to time the market to be able to take advantage of buying equities at a lower price as the market begins to rebound.

Conclusion

Beneath these developments and numbers are the grave implications for people's retirement savings. These implications include, but are not exhaustive to

1. Reduction in pension benefits for members.
    - For DC plans, the severity of the impact depends critically on the fund's asset allocation and the member's age. Older workers or present pensioners in plans that have high equity exposures are the most affected and could see lower pension benefits as the wealth has disappeared. Furthermore with a decline in long-term interest rate and rise in life expectancy, it is therefore anticipated that there will be a fall in annuity

rates. Depending on the contractual arrangements, the pension benefit could be reduced and consequently making things tougher for persons nearing retirement. Consequently older workers might be forced to postpone their retirement age while present pensioners might need to re-engage themselves in some income generating activity. Younger workers, on the other hand, can recoup losses as equity prices and investment income return to pre-crisis level.

- Members of DB pension funds might see pension benefits cut due to worsening funding levels and employers going bankrupt.
- Participants in both DB and DC funds may also suffer benefit losses if they lose their jobs before completing the vesting period.
- Although our focus of this workshop is private pension plans, public pension plans are also affected. With falling revenues for governments, the ability to offer assistance is curtailed.

2. The adverse impact on pensions caused considerable anxiety and insecurity for members and current pensioners.

In closing, the impact of financial crisis on the pensions industry can have repercussions for governments not only as it relates to public

pension funds, but also for the private pension industry. For example, the financial crisis has led Argentina to nationalize US$30 billion in private pension funds [5] and Switzerland to bail out one of its pension plans. [6] To date and to my knowledge, the need for such an intervention has not arisen, in the Caribbean. However, I must admit that government interventions taken to stimulate the economy or to contain adverse impact of the financial crisis has generated positive spill over benefits for the pension industry.

Two examples of intervention in the Caribbean can be found in Jamaica and Trinidad &Tobago. Due to the tightening of liquidity and credit that accompanied the crisis, there was a significant increase in margin calls by the foreign institutions on the liabilities held by local securities dealers. The increase in margin calls resulted in severe foreign exchange instability. As a result, the BoJ established Special Loan Facility of US$300 million in foreign currency for securities dealers and deposit-taking institutions needing to repay margin arrangements to overseas financial institutions. Consequently, the liquidity impact of the exposure to margin calls was contained.

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[5] AFP, 2008, ***Argentina To Nationalize Private Pension Funds*** ***http://afp.google.com/article/ALeqM5g6evsfTuYtN0gWlilNg2Y6DZD50A*** Accessed Jan 26, 2008

[6] Mark Cobley and Elizabeth Pfeuti, 2009, Wall Street Journal, ***Europe Slowly Responds To Pension Issues*** [online] Available at http://online.wsj.com/article/SB123249167086099823.html?mod=MKTW&ru=MKTW Accessed Jan 26, 2008.

Meanwhile the Trinidad &Tobago government announced that it planned to spend US$809 million over the next two years to support liabilities related to CL Financial in order to protect policyholders and pension funds beneficiaries. However, there has been a more direct adverse impact for Caribbean governments as additional resources might have to be injected in social security systems to protect the elderly.

Given these negative effects on the pension industry, we should all be resolute in developing our regulatory framework for the pension industry in order to minimise as much as possible future contagion effects.

Thank you