Comité Latinoamericano de Asuntos Financieros
Comitê Latino Americano de Assuntos Financieros
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PUTTING PENSION FUNDS TO WORK IN LATIN AMERICA: NEW FINANCIAL INSTRUMENTS TO HELP DEEPEN FINANCIAL MARKETS

1. Introduction

Since 1981, ten countries have reformed their social security system moving gradually or completely away from pay-as-you-go to individual capitalization systems. As a result, privately run pension funds have progressively become major players in domestic capital markets in several Latin American economies. Assets under management of these funds have grown significantly and currently represent about 10 percentage points of GDP on average, although they exceed 50 percent of GDP in Chile. Moreover, these assets continue to grow at a rate between 1 and 3 percentage points of GDP per year (over and above GDP growth), and are expected to reach over 30 percent of GDP by 2015 in most countries. This size is comparable to that of most banking systems today in the region and larger than the combined capitalization of stock and corporate bond markets.

From the start, pension funds were regulated in order to ensure their safety, transparency and integrity. As part of the regulatory requirements, they were allowed to invest in four major asset categories: government bonds, capital market instruments (stocks and bonds), bank deposits and foreign assets with varying limits in different countries. As regards private-sector non-bank instruments, pension funds were required to invest only in publicly-issued, exchange-traded securities, subject to minimum requirements on liquidity and on credit-risk ratings, and other diversification limits. Capital market regulations largely imported the standards of industrial countries. Investment limits on government bonds were typically generous, reflecting not only the fact that these assets would form part of a well balanced portfolio, but also because governments needed to finance the transition from a pay-as-you-go to an individual capitalization system. Investment limits on bank deposits were also generous because authorities anticipated that banks would continue to represent the lion's share of financing, as other markets were still in their infancy. On the contrary, allocations into foreign assets were small in all countries, and have only expanded recently in Chile and, to a lesser extent, in Mexico.

In reviewing the experience, the Committee is aware of a number of important issues arising in the public discussion on the costs and benefits of pension reforms, including the still very limited social security coverage, the perception of high operating fees and commissions, the high concentration of the pension fund industry, and the fiscal costs and long-term sustainability of the reform effort. Despite the importance of these topics, which have been addressed extensively elsewhere, the Committee has decided to focus this statement on the narrower issue of how pension funds can help to deepen domestic capital markets in the region and play a more central role in raising investment and economic growth.

A key problem arises from the fact that while assets under management have grown rapidly **the supply of pension savings has outstripped the capacity of the market to supply instruments meeting the regulatory investment criteria.** Therefore, in most countries (with the exception of Chile and Peru) the portfolios continue to be significantly tilted towards public debt and bank deposits. On current trends this gap is set to worsen, creating the danger that the pension reform will not deliver its full potential in terms of growth and investment, while ensuring a healthy return to workers. This becomes all the more important as a significant share of the returns generated so far by pension funds have been founded on the high but declining real interest rates paid by governments, which translated into high coupons and capital gains on their bond holdings. The Committee does not expect that this circumstantial combination of events will recur in the foreseeable future. Hence, going forward, the achievement of adequate and safe returns represents a major challenge.

Part of the problem arises from the fact that growth has been slow in Latin America, reflecting a depressed demand for investment. The Committee believes that **a successful growth strategy would benefit from existing pension funds and would facilitate their development by creating more demand for their financial resources.**

However, regulatory frameworks are not conducive to this process. They have placed emphasis almost exclusively on publicly-traded securities issued by publicly-held companies. This collides with the reality of corporate structure in Latin America, which is quite different from that in industrial countries, the former being characterized by smaller, privately-held, largely family-owned firms. In this context, issuing capital market securities is subject to relatively higher fixed costs (compared to bank loans), requires complex corporate governance rules, and involves wide disclosure of information about the firm so that investors can assess their risk and return characteristics. Thus, companies may prefer to keep this information private so as not to inform the government, competitors, and in some cases even organized crime.

In addition, the regulation did not adopt the prudent man rule typical of Anglo-Saxon countries but instead relied on the adoption of ratios and investment limits fixed by law, making the adaptation of the rules more costly and difficult.

Thus, the Committee believes that **the challenge is to develop financial instruments that cater to the investment needs of Latin America, in a way that is compatible with the return and safety goals demanded by citizens of their pension funds.** The remaining of the statement contains specific recommendations both in terms of instruments and policy process.

2. New instruments may bring new opportunities

The Committee has identified **four asset classes that could help bridge the gap between the supply and demand for long term funds denominated in local currency,** some of them already existing in some countries to a limited extent: securitized bonds, mortgage securities, infrastructure finance bonds, and collateralized loan obligations.

Securitized bonds. Securitization consists in transferring claims from the originating institution to a separate legal and economic entity, called a special purpose vehicle (SPV), in exchange for a lump sum payment reflecting the aggregate value of these assets. In the case of bank loans, securitization frees up bank balance sheets and allows them to continue lending. The SPV issues liabilities that represent an ownership stake in the pool of underlying assets and hence the right to receive the payments is passed through to the SPV by the originating entity. It can be further backed by government or private insurance.

Securitization is normally applied to the pooling of bank loans, mortgages, and credit card receivables. There are a number of other receivables, such as bank and non-bank consumer loans, farm crops and livestock breeding, future flows of university tuitions or health care payments, etc., which could also be securitized and thus play an important role in providing a wider range of longer term instruments which could be suitable for pension funds. Some of these new securitization opportunities have been successfully implemented in some countries in the region.

Structured finance instruments represent a form of securitization and risk pooling which allows for creating asset classes with different risk-return profiles. The structured finance instruments carve out the SPVs liabilities into different tranches, creating a hierarchical capital structure that includes a senior-subordinate-equity type sequence for the distribution of receipts. Asymmetric information and different appetite for risk among investors or group of investors create opportunities for the pooling of assets and tranching of liabilities: less informed and/or more risk averse investors purchase senior tranches while more informed and/or less risk averse investors prefer the subordinated tranches. Customized tranches may be also created based on the demands of specific institutional investors that are profitable if the arranger can practice price discrimination in segmented markets.

To finance the acquisition of the debt obligations, the SPV issues rated and unrated liabilities called tranches, or classes with different seniority. The number of tranches can vary based on the manner in which risk is to be reallocated to investors.

Mortgage securities. Pension funds should play an important role in the growth of the mortgage industry in Latin America helping build up the real estate finance industry. Banks tend to shy away from this long-term market because credit and interest rate risks of mortgage assets are ill suited for their balance sheets. However, the nature of pension fund liabilities allows them to better manage these risks and provide the mortgage industry with long term financing. To this effect, it is useful to distinguish three types of mortgage securities: mortgage bonds, mortgage bond securities and collateralized mortgage obligations.

- Mortgage bonds (bonos hipotecarios, letras hipotecarias, cedulas hipotecarias): the issuer of these securities – a commercial, universal or mortgage bank -- holds mortgages as assets on its balance sheet. Investors, who hold mortgage bonds that represent liabilities of the issuer, hold a priority claim over the collateral in the event of bankruptcy. In some cases, these bonds are inflation-indexed. They are normally traded on exchanges and – provided that banks are solvent – they are suitable for pension fund investment. The Chilean experience shows that this has worked efficiently.

- Mortgage backed securities (MBS): also referred to as pass-through MBS, this type of security has payments to investors tied to the cash flows of an underlying pool of mortgages. This is an “off-balance sheet” bank instrument (mortgages are removed from the bank’s balance sheet and placed in a separate vehicle). Thus the bank does not typically hold the financial risk of the mortgages, and investors are not exposed to the corporate risk of the bank. Therefore, these securities require more advanced rating and monitoring systems to protect the interest of investors.

- Collateralized mortgage obligations (CMO): this is an instrument that carves out the pool of mortgages into tranches. In Colombia, a special purpose vehicle called Titularizadora de Colombia (Hitos) was created by the IFC along with five leading mortgage banks as a MBS company to securitize housing loans. The loans included government – guaranteed VIS loans (social housing loans for the low income sector) and non-VIS loans. Hitos issues securities called TIPS that are divided into tranches with different credit ratings and terms. Some of them are suitable for pension fund investments and other institutional investors such insurance companies.

Infrastructure finance bonds. The demand for infrastructure financing in Latin America (energy, transportation, sanitation, water and sewage systems, and telecommunications) has grown and is expected to continue growing significantly. As an example, the development of Asian markets will require reorientation of transportation projects towards the Pacific Ocean. The most popular arrangements have been concession contracts under which a private company is responsible for financing, building and operating an infrastructure asset for a fixed or flexible length of time, which can be as much as 20 to 30 years. With increasing strain on public budgets, there is serious concern that the volume of investment might end up being much less, unless additional non-public sources of financing are tapped. Infrastructure projects require long term financing which private domestic financial markets usually can’t provide.

Some of the demands of infrastructure financing are desirable features for pension fund assets: long term duration and local currency denomination. This creates an opportunity for diversification in pension fund investments. Moreover, improved infrastructure could indirectly benefit pension funds by stimulating economic growth and increasing employment, which would bring in greater contributions to pension fund portfolios. Chile provides an interesting example of how pension funds contributed to finance infrastructure; in the first half of the 1990s, these investments took the form of both publicly listed equity and bonds and handsomely contributed to the pension funds’ performance. Additionally, Chilean pension funds have invested in Infrastructure Bonds issued by private concession companies as well as shares in Real Estate and Company Development Investment Funds (Fondos de Inversion Inmobiliarios y de Desarrollo de

Empresas), guaranteed against construction and operational risk and thus with a AAA rating; this guarantee is provided by private insurance companies.

Collateralized Loan Obligations. One of the most significant challenges in Latin American markets is making local currency medium- to long-term credit available to the private sector, particularly small and medium borrowers (SMEs). Banks have been hesitant, for good reasons, to extend credit to riskier borrowers and for longer periods of time. To the limited extent that credit has been made available, it has resided on the balance sheets of banks in the form of loans and stymies additional lending capacity.

We recommend structured finance instruments called *Collateralized Loan Obligations* (CLO), a specific development within structured finance aimed at securitizing bank loans, and freeing up the balance sheets of banks for additional loan making.

CLOs are created by securitizing a pool of bank loans that serve as collateral; the pool size may include 100 or more loans, large or small, with or without collateral, spanning a wide range of industries. CLOs issues tranches with different seniority, duration, and hence, risk. The average life of the tranches varies with the senior-most tranch being the less risky and normally having the shortest duration. The originating bank keeps the riskier tranch (the equity tranch) on its balance sheet in order to ensure the right incentives are in place. Even if the CLO is composed entirely of sub-investment grade loans, the credit rating of tranches typically ranges from AAA to BB along with the unrated equity. CLOs thus effectively transform risky loans – which are essential to the growth of the corporate sector – into a combination of investment grade assets well suited to pension funds and high risk assets suited for other investors.

They are complex structures and require the skills and sophistication of institutions such as rating agencies, arrangers and investors. To the best of our knowledge, such products do not exist in Latin America today.

3. Regulatory reforms are required

The regulatory framework for pension funds in Latin America is based on quantitative limits on assets, setting minimum and/or maximum portions per type of assets. This type of binding regulation prevents pension fund managers from availing themselves of the opportunities of new instruments such as those described above.

In order to allow pension funds to invest in these new asset classes, laws and regulations in many countries may need to be adapted. In particular, the Committee believes that **pension funds should be allowed to invest in instruments which in some cases may not be publicly offered or traded in exchanges, provided that adequate disclosure and operational transparency allow for appropriate external auditing.**

Allowing pension funds to hold more diversified asset portfolios, at the expense of government bonds, would also contribute to strengthen fiscal discipline. **The Committee believes that increasing the portion of foreign assets in pension fund portfolios may help diversify and better manage risks,** especially in countries where limits are very low or zero. Increasing the portion of foreign assets that pension funds may hold contributes to reducing undesired side effects on domestic asset prices. However, caution must be exercised because even a minor change in their holdings of foreign currency denominated securities may translate into sudden and large changes in capital flows that exacerbate macroeconomic imbalances.

As a word of caution, the Committee recognizes that, despite the proposed regulatory changes, a number of risks factors are still likely to remain. In particular, current risk factors include: (1) size: pension funds are very important players in local financial markets while other investors such as insurance companies and mutual funds are usually much smaller; (2) concentration: experience shows that this industry tends to concentrate in few institutions; (3) homogeneous portfolios: regulations in many countries have made pension funds to have similar portfolios, mitigated in some cases by the multi-fund approach.

Additionally, financial markets may be severely disrupted by changes – or expectations of imminent changes – in the pension funds' portfolio rules. A clear example of such risk is illustrated by the recent Argentine experience, where the percentage of government bond holdings of pension funds was forcefully increased. Similar risks could be present when the percentage of stocks or foreign currency denominated securities is subject to drastic changes.

4. A successful strategy requires a renewed policy process

The Committee believes that **to develop these financial markets it is important that countries adopt a policy process that identifies opportunities and obstacles, and that addresses comprehensively the different parts of the legal, regulatory and institutional framework.** This requires coordination and trust between different stakeholders including workers, pension fund administrators, regulators, market participants, corporations, government authorities and parliament representatives.

To the extent that over time such process becomes effective, countries could consider moving pension fund regulations towards a prudent man rule-type rules as institutions evolve and experience allows for. With a longer term perspective, the region may benefit from harmonizing pension fund regulations. This would reduce opportunities for regulatory arbitrage, stimulate competition in the pension fund industry across the region, and eventually even allow pensioners to avail themselves of the services of pension funds in other countries.

As a possible way to jumpstart a comprehensive policy process, countries could establish a Financial Market Development Commissions (FMDC) with the participation of all constituencies involved and with a technical secretariat with the mandate to study proposals in depth. Their analysis should include the viability of the proposed initiative and their compatibility with the public interest in order to ensure the necessary transparency and accountability of the process. It is hoped that the FMDC will create an environment of participation, trust and credibility that will facilitate congressional discussion and approval of the proposed reforms. Since many countries in the region face similar problems, we suggest a more vigorous exchange of experiences take place. The Inter-American Development Bank (IDB) and the Andean Development Corporation (CAF) could facilitate this process.

5. Fiscal risks

In focusing on the potential beneficial role of pension funds on the development of domestic capital markets it is important to recognize the fiscal and financing implications that arise in the transition from pay-as-you to individual capitalization systems. In particular, most pension reforms were undertaken under the view that, since their implementation would improve public-sector intertemporal solvency, the transitional increase in borrowing requirements would be willingly financed by the capital market. Such a view, however, may have been too naïve, as the bonded debt was not viewed by the capital market as fully substituting for previously un-registered pension obligations.

Moreover, as liquidity considerations in capital markets effectively played a central role in emerging market finance, the larger borrowing requirements resulting from the transitional dynamics of pension reforms increased country-risk premia and, in some cases, may have contributed to the sudden stop phenomena that plagued emerging markets in the late 1990s. In the case of Argentina, for instance, the transitional dynamics of the pension reform accounted for almost half of the increase in public debt between 1993 and 2000, and an even larger share of the public sector's borrowing requirement.

On the basis of these observations, the Committee recommends that as pension reforms are implemented, **careful attention should be given to the ability of fiscal policy to respond to the transitional challenges.** Also, it suggests that there is a potential role for multilateral financing in ensuring that pension reforms are financially sustainable and maximize their contribution to the development of domestic capital markets.

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