Lawrence Schembri: Double coincidence of needs – pension funds and financial stability

Remarks by Mr Lawrence Schembri, Deputy Governor of the Bank of Canada, to the Pension Investment Association of Canada, Quebec City, Quebec, 15 May 2014.

* * *

Introduction

Thank you for the invitation to address your spring conference.

One of my responsibilities at the Bank of Canada is overseeing our analysis of the financial system in Canada and globally, and our activities to support its stability and efficiency. The Bank's core mandate is to promote the economic and financial welfare of Canada, so we take a system-wide view of how the different components of the financial system fit together to form a stable and efficient whole.

The Bank is not responsible for prudentially regulating and supervising the activities of individual financial institutions.[1] Rather, our perspective is the entire financial system. Its stability is an important precondition for effectively implementing monetary policy, and for achieving low and stable inflation and promoting sustainable economic growth.

We bring that system-wide perspective to the table when contributing to the development of global financial reforms and their implementation in Canada, in collaboration with federal and provincial regulatory agencies.

In Canada, the financial system is large and well developed; its assets amount to about 500 per cent of GDP. The pension industry holds about 13 per cent or roughly $1.2 trillion of those assets, and is second in importance only to the banking system.[2] Of the almost 8,000 pension funds in Canada, four are included in a list of the world's 40 largest pension funds.[3]

Because the pension fund sector has such a significant presence in the Canadian financial system, we, at the Bank of Canada, are interested in better understanding it.

For this purpose, I am here to talk to you today about the role that we see the pension industry playing in the financial system, and, in particular, its contribution to financial stability. We strongly believe that healthy, well-managed pension funds help to reduce systemic risk and preserve financial stability. And a stable financial system helps maintain the health of pension funds.

We want to work with you to strengthen the contribution you make to financial stability, so your feedback is important.

I'll first discuss this double coincidence of needs – your need for financial system stability and the system's need for robust, well-managed pension funds.

Second, I'll review the challenges faced by pension funds in this low-for-long, post-crisis environment, which is the timely and important theme of this conference.

---

[1] Under the Payment Clearing and Settlement Act, the Bank of Canada has responsibility for the prudential oversight of systemically important financial market infrastructures.

[2] International Monetary Fund, "Canada: Financial Sector Stability Assessment", Country Report No. 14/29, February 2014.

[3] The four pension funds are: CPPI Investment Board, Ontario Teachers' Pension Plan, PSP Investments, and OMERS (*The Economist*, 3 March 2012). www.economist.com/node/21548970.

Third, I will examine how the G-20-sponsored global financial reforms will improve stability by strengthening the resilience of the global financial system. And I'll comment on the implications of these reforms for pension funds.

Just to be clear, the reforms are not targeted at pension funds, which were a source of resilience during the crisis. Rather, they address the serious fault lines exposed by the crisis. All financial sectors, including pension funds, stand to benefit from the reforms, which will reduce the likelihood and adverse impact of future crises.

Financial stability: its importance to pension funds

Why is financial stability important for pension funds?

To answer this question, let's start by defining what we mean by financial stability in this context.

It is important to recognize that volatility does not necessarily imply financial instability. Asset prices in well-functioning markets typically exhibit some degree of volatility because they reflect the arrival of new information and a diversity of opinion. Generally, such diversity and volatility are positive because they are consistent with liquid and efficient markets.

But there are instances – in 2008, for example – when volatility spiked because market liquidity had dried up. In such circumstances, the financial system cannot perform its critical intermediation function, resulting in adverse effects on real economic activity.

Hence, the Bank defines financial stability as the resilience of the financial system to unanticipated adverse shocks to enable the continued functioning of the financial intermediation process.[4]

Given this intuitive definition of financial stability, it is clear that financial system instability can undermine the fundamental objectives of pension funds. Without financial stability, it would be difficult for sponsors to develop and confidently fulfill a pension promise. Pricing in a well-functioning market is critical to assessing and managing risk with confidence.

To understand why, let me give you a macroeconomic perspective of the recent financial crisis.

The financial crisis had pervasive adverse financial and economic impacts. Financial markets and institutions came under severe stress and economic activity slowed sharply as the Great Recession took hold. Pension funds experienced large losses as asset prices plunged.

Central banks responded by aggressively reducing interest rates and providing extraordinary liquidity in an effort to restore financial market functioning and support economic activity. In the absence of central bank and other public policy actions, the immediate impact of the crisis on pension funds would have been far worse. Indeed, a repeat of the Great Depression was avoided.

However, given the slow recovery of the global economy, central banks have kept their policy rates low for an extraordinarily long period and have resorted to unconventional means to provide additional stimulus. While these measures have raised asset prices, low interest rates pose a serious challenge for pension funds.[5]

---

[4] Bank of Canada, *Financial System Review*, (December 2013): iii.

[5] The Mercer Pension Health Index in Canada, which tracks the ratio of assets to liabilities for a model defined benefit pension plan, shows that the ratio fell to slightly more than 70 per cent in early 2009 and began rising in 2010 but fell below 80 per cent again in 2012. It has since recovered and at the end of March it stood at 104 per cent. These movements reflect the immediate decline in asset prices and their subsequent recovery, but also the impact of the low interest rate environment on the discount rate. The combination of the immediate decrease in asset values and the increase in liabilities led to a large unfavourable swing in the

The Bank of Canada monitored pension funds during the crisis and took actions to support market liquidity because we recognized that it was critical for them and for other market participants.[6]

Let's now look at how pension funds can best contribute to financial stability.

Pension funds: their contribution to financial stability

The simple answer is that, given their size and importance to the Canadian and global financial systems, pension funds contribute meaningfully to financial stability by helping to maintain the diversity of market behaviour.

Diversity across financial market participants underpins well-functioning markets and a resilient financial system by reducing common exposures and procyclicality.

Pension funds contribute importantly to financial diversity because they are among the most varied and thus the most "cool" market players for three main reasons:

- First, pension funds are market participants with long investment horizons.
- Second, they are predominantly real-money investors; that is, they fund their investments primarily from contributions, rather than from borrowing.
- Third, employee and employer contributions are largely locked in.

Allow me a few comments on each of these sources of diversity.

Because pension funds are investing to help fund the retirements of members over a wide age distribution, they have the luxury of patience, of being able to withstand short-term market volatility or liquidity stresses to earn returns over the long term. They are the Warren Buffetts of the financial system. In other words, pension funds can more easily bear market and liquidity risk and earn the associated risk premiums because they can diversify these risks over time.[7]

Their long investment horizons are different from those of most other market participants, who are more focused on short-term returns. Thus pension funds have the capacity to smooth and absorb short-term volatility and act as a net provider of liquidity and collateral to the system, especially in times of stress.

Pension fund rules for asset allocation, position limits and rebalancing work in the direction of smoothing asset prices. Rebalancing encourages pension funds to sell assets that have gained in relative value and vice versa. Consequently, via rebalancing, pension funds can help to mitigate excessive asset price movements.

Pension funds do not rely primarily on borrowing to fund their investments, and are not vulnerable to excessive leverage or significant liquidity and maturity mismatches, which

---

funding status of pension funds, greatly increasing the burden on plan sponsors in the aftermath of the financial crisis. The Mercer Pension Health Index assumes contributions equal to the current service cost plus solvency deficit payments, and no plan improvements http://m.mercer.ca/press-releases/1593805?detail=D. Note that, in contrast, the risk for defined contribution plans was borne by the beneficiaries, although the impact was equally serious.

[6] For example, in February 2009 the Bank of Canada included private sector bonds in the list of acceptable collateral for term purchase and resale agreements.

[7] Credit risk generally increases over time. For more information, see J. Nugée and A. D. Persaud, "Redesigning Regulation of Pensions and Other Financial Products", *Oxford Review of Economic Policy*, 22, no. 1 (Spring, 2006): 66–77.

caused many banks, both traditional and shadow banks, to fail during the crisis.[8] Hence, they are, in general, not a source of systemic risk to the financial system.

Finally, because the contributions to most pension funds are locked in, they are not subject to massive withdrawals or runs of the kind we witnessed during the financial crisis, such as Northern Rock or U.S. money market mutual funds.

Given these important differences from other market participants, pension funds have had, in general, a positive impact on financial stability. Although not definitive, there is some anecdotal evidence that pension funds contributed to financial stability during the crisis by acting in a countercyclical fashion, buying assets when their prices fell.[9]

Recent challenges and responses

In recent years, however, pension funds have encountered three major challenges that have affected their ability to play this stabilizing role.

By far the biggest challenge faced by defined-benefits pension funds since the financial crisis has been the low level of long-term interest rates. Low rates have increased the value of their liabilities and sharply reduced their solvency ratios, especially in the immediate aftermath of the crisis. These ratios have now partially recovered, as low interest rates have boosted equity prices, but interest rates are likely to remain relatively low for an extended period as the Canadian and global economies slowly recover.[10]

In their search for yield in this low interest rate environment, many pension funds have increased their exposure to alternative investments in real estate, private equity and infrastructure. Given their long investment horizons, they are well suited to holding a portion of their funds in less-liquid assets to earn a liquidity premium. As long as the liquidity, market and credit risks associated with these investments are prudently managed, this is a positive development.[11]

A second challenge is longevity. According to the Canadian Institute of Actuaries, existing mortality tables based on the U.S. experience significantly understate Canadian life expectancy by 2.3 years for a 65-year-old man and by 3.3 years for a woman of the same age. As funds transition to the new Canadian mortality tables, pension obligations could rise by as much as 7 per cent, although the typical increase will likely be in the range of 3 to 4 per cent.[12]

Clearly, a challenge of this magnitude, especially one that will likely persist or even increase, may not be fully addressed by asset-management strategies alone. In some cases, adjustments to contribution rates and benefit levels will be part of the solution.[13]

---

[8] Pension funds that invest directly in real estate or infrastructure, for example, sometimes borrow against this collateral to help to finance their purchases or they may invest indirectly in related funds, whose managers may also borrow.

[9] For mixed evidence of the countercyclical behaviour of U.K. pension funds during the crisis, see A. Haldane, "The Age of Asset Management?" (Speech delivered at the London Business School, London, U.K., 4 April 2014). www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf.

[10] Recent increases in long-term interest rates have also improved solvency ratios. Also see K. Ambachtsheer et al., "Risks of a Prolonged Low-Interest-Rate Environment for the Pension Sector". Report Submitted to the Global Risk Institute, Rotman School of Management, University of Toronto. (September 2013).

[11] In their search for yield, pension funds should avoid taking in "crowded" positions and taking other common exposures that reduce market diversity and their contribution to financial stability.

[12] *Canadian Pensioners' Mortality*, Canadian Institute of Actuaries, Final Report, February 2014. www.cia-ica.ca/docs/default-source/2014/214013e.pdf?sfvrsn=4.

[13] Outside of Canada, some pension plans have transferred longevity risk to insurance companies, for example.

A third challenge has been the introduction of fair-value accounting for pension promises and the interaction with regulatory solvency requirements. The new accounting rules, which use the yield of AA corporate bonds to discount liabilities while valuing assets at current market prices, have led to an increase in balance sheet volatility.

In response, many funds have attempted to "de-risk" their plans with higher allocations to long-term bonds, which provide a better hedge against the impact of interest rate fluctuations on their liabilities. However, to compensate for the opportunity cost of a smaller equity weight, some funds have also leveraged their bond portfolios. While the use of leverage may help to raise returns, it also increases risk, because such a position may be difficult to roll over in stressed markets.[14]

The pressure to minimize the volatility created by fair-value accounting and solvency rules may also entice some funds to favour strategies that shorten their investment horizons.[15] However, such "short-termism" may be costly, since it could detract from the contribution that pension funds can make to financial stability. Fortunately, most funds are committed to disciplined rebalancing, which will allow them to play a stabilizing role in our financial system.

In addition to these challenges, pension funds will also have to adjust to major reforms to the global financial system that are currently under way. Let me give you a brief overview of those reforms.

Financial reform and pension funds

In the wake of the financial crisis, G-20 Leaders adopted a sweeping set of financial sector reforms to build a stable and resilient global financial system that will promote global economic integration and sustainable growth.[16]

At the macro level, the reforms will make the global financial system more resilient to shocks. Financial crises will be less frequent and less severe, which will clearly benefit pension funds as well as other market participants.

At the micro level, pension funds will be affected by the implementation of four priority reforms:

- the enhanced Basel III bank capital and liquidity framework;
- an effective resolution regime for financial institutions that are seen as "too big to fail";
- requirements to reduce systemic risk in shadow banking; and
- rules and infrastructures for over-the-counter derivatives.

Basel III

Since pension funds are low credit risk exposures for banks, the impact of the new Basel III capital rules on pension funds will be small. Under the new liquidity rules, however, pension

[14] Bank of Canada, *Financial System Review*, (December 2012): 36–38.

[15] For example, long-short equity strategies. For more information, see C. Severinson and J. Yermo, "The Effect of Solvency Regulations and Accounting Standards on Long-Term Investing: Implications for Insurers and Pension Funds", OECD Working Papers on Finance, Insurance and Private Pensions, No. 30, OECD Publishing (November 2012). http://dx.doi.org/10.1787/5k8xd1nm3d9n-en.

[16] The G-20's four core reform priorities are: (1) to make banks safer; (2) to end the problem of financial institutions that are "too big to fail"; (3) to transform shadow banking activities into resilient market-based finance; and (4) to ensure continuously functioning core financial markets. For an update on the reforms, see www.financialstabilityboard.org/publications/r_140411.pdf.

funds may have to increase the amount and quality of the collateral supplied to banks for derivatives, repo and securities-lending transactions.

Resolution

A key component of the framework to achieve the resolution of large financial institutions without disrupting the financial system will be new "bail-in" debt and preferred-share instruments, which can be converted to common equity to absorb losses should the institution come under stress.[17] These instruments will be issued in large amounts and will have equity-like characteristics that pension funds may find attractive.

Shadow banking

The shadow banking reforms can be viewed through two lenses: (i) financial market activities, particularly, repos, securities lending and securitization; and (ii) less regulated financial institutions, such as money market funds, finance companies, hedge funds and managed-asset funds. Because the sector is so heterogeneous, broad regulatory principles, rather than explicit reforms, have been developed that jurisdictions can apply to mitigate systemic risk – namely, to reduce procyclical behaviour and the likelihood of runs. These principles focus on reducing four sources of systemic risk: excess leverage; undue liquidity and maturity transformation; imperfect credit risk transfer due to incentive problems; and a lack of transparency.

It is important to stress that pension funds, while a type of managed asset fund, are not normally considered to be a source of systemic risk, despite providing non-bank financial intermediation, because these four sources of systemic risk are generally not present. Nonetheless, pension funds will be affected by these shadow banking requirements to the extent that they engage in these activities or interact with these institutions. In particular, certain repo and securities-lending transactions will be subject to minimum haircuts to reduce procyclicality.

Central counterparties for repos and over-the-counter derivatives

For repo and derivatives transactions, central counterparties reduce common counterparty exposures and systemic risk. We are encouraging some of the largest and most active pension funds in the Canadian repo market to become direct clearing members of the Canadian Derivatives Clearing Service (CDCS), the central counterparty (CCP) owned by TMX Group. The goal is to allow the large pension funds to participate directly in CDCS in a way that permits risk to be managed without requiring them to be subject to mutualized loss-sharing arrangements. Less-active pension funds should become indirect clearers through a dealer to realize these benefits. Such participation will greatly enhance the resilience of the repo market.

Similarly, pension funds should clear interest rate swaps through a bank that is a clearing member of SwapClear in London.[18] Both of these CCPs come under the surveillance of the Bank of Canada.

Financing long-term investment

The G-20 is committed to creating a climate that facilitates increased long-term investment, particularly in infrastructure.[19] To achieve that goal, the G-20 will promote private financing,

[17] The preferred-share instruments are known more formally as non-viable contingent capital. See remarks by Assistant Superintendent Mark Zelmer to the BMO "First Annual Reserve Management Conference", Toronto, 7 May 2013. www.osfi-bsif.gc.ca/Eng/Docs/mz20130507.pdf.

[18] Because the use of CCPs reduces counterparty risk, collateral requirements will be less than those for bilaterally cleared transactions, not only for the parties involved, but also for the system as a whole.

potentially through pension funds and possibly with the use of high-quality securitization instruments. This is a positive development for Canadian pension funds because they are already active in funding infrastructure globally.[20]

Conclusion

I'd like to conclude by emphasizing again that we recognize the contribution that pension funds make to financial stability. We want to work with you to enhance this contribution because what makes you stronger makes the system stronger.

For our part, as public authorities we need to ensure that the reforms are coherent and don't conflict with existing regulations, particularly tax and solvency rules.

We also need to coordinate regulations and information sharing across federal and provincial agencies. In this regard, the Canadian Association of Pension Fund Regulators has made important and useful contributions, but more can be done.

And we need to encourage the safe use of derivatives and other instruments, such as a repo CCP, to better manage risk.

For your part, your funds must have realistic return targets and effective risk governance.

Our combined efforts will help to promote a stable and more resilient financial system that will better serve not only your plan sponsors and beneficiaries, but all Canadians.

Thank you.

---

[19] Communiqué, Meeting of Finance Ministers and Central Bank Governors, Sydney, 22–23 February 2014.

[20] Canadian-based public pension funds have an average current allocation in infrastructure investments of 5.9 per cent and a target allocation of 8 per cent. See "Comparing Infrastructure Investments among U.S. and Canadian Public Pensions – February 2014", Preqin. https://www.preqin.com/blog/101/8338/us-canada-public-pensions.