Questioning the panacea of global pension reform

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UWE Bristol

Taking Stock

- Churchill, J (2013) : ‘**Towards a framework for understanding the recent evolution of pension systems in the European Union**’, FESSUD Working Paper Series No.12, December 2013

Themes

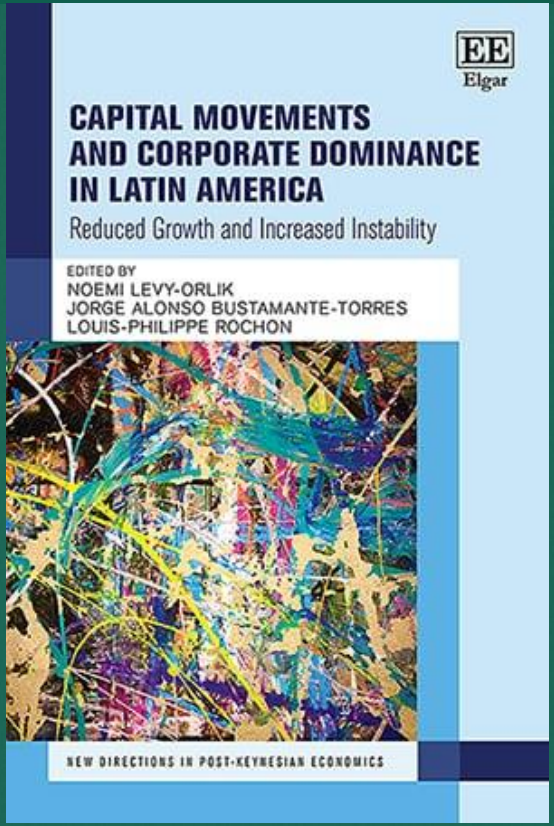
Pensions in the outsized financial market setting

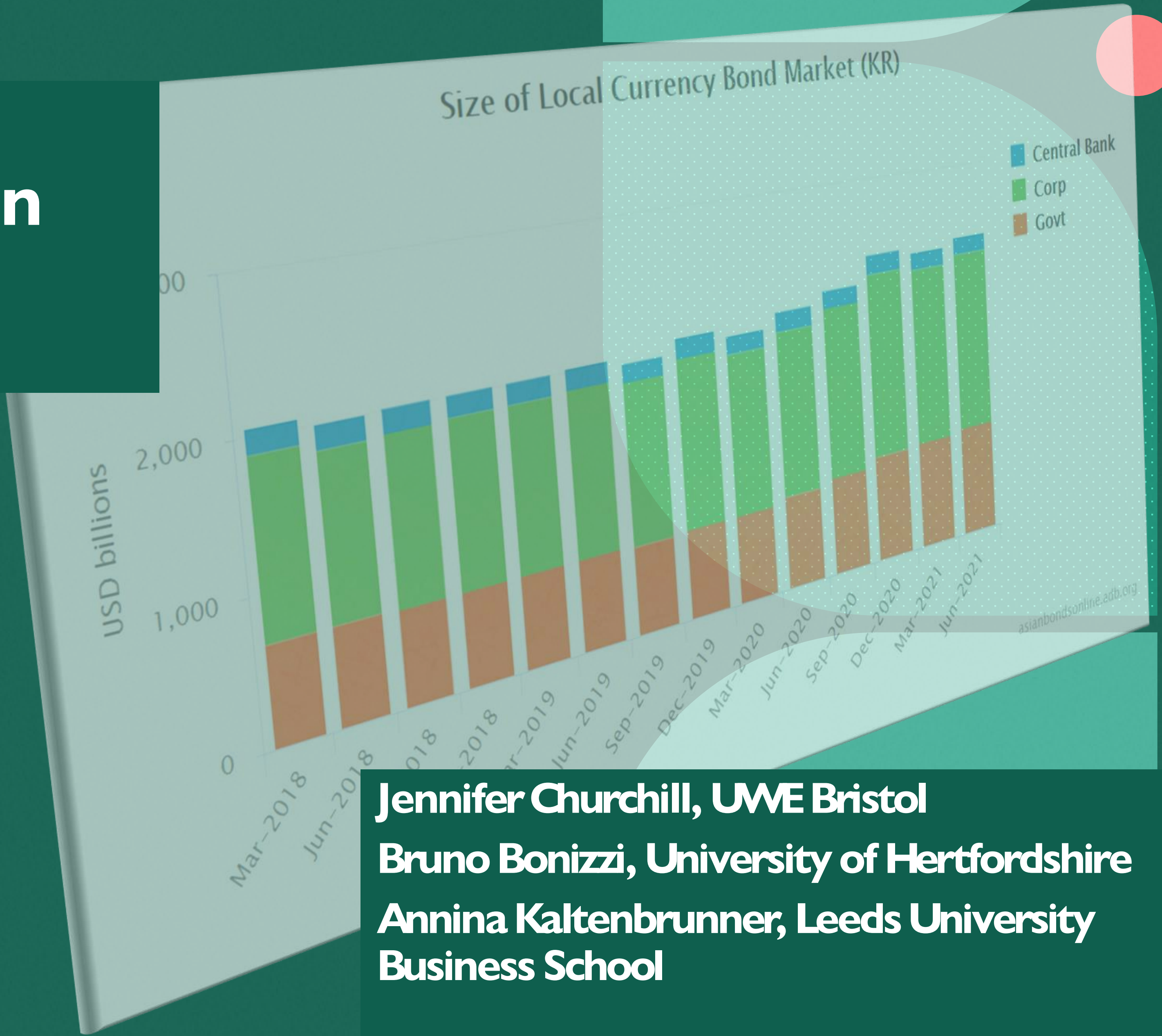
- Impatient capital: pension funds and liquidity spirals

Pensions in the ‘emerging’ financial market setting

- Pension funds, bond markets and financial stability

Pension funds and local currency bond markets in emerging economies





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Backstory

- Policy advice for emerging economies (EE): capital account liberalisation
- Asian Financial Crisis
- Reflection
- Next piece of universal policy advice: develop local bond markets


- Financial liberalisation in the absence of bond markets
  - Lack of investible assets – risk of housing and equity bubbles
  - No “spare tyre” when banking sector goes into crisis

Why focus on local currency?

- Cheap foreign currency denominated debt
- Currency mismatches
- Ex rate depreciation worsens net worth

The New York Times

Tumbling Baht Throws Siam Cement for a Loss

By Thomas Crampton, International Herald Tribune

July 11, 1997

Siam Cement, Thailand's largest industrial conglomerate, said Thursday that it would register its first loss in 84 years, because of unhedged foreign debt, in the first major example of corporate damage done by last week's flotation of the baht.

The report by Siam Cement Group, one of the largest, oldest and most diversified conglomerates in the country and a major motor of the Thai economy, was an indication that the pain from the nation's currency crisis would be felt by many. This includes the

Why borrow using foreign currency denominated debt?

Eichengreen, Hausmann and Panizza (2003): "original sin"

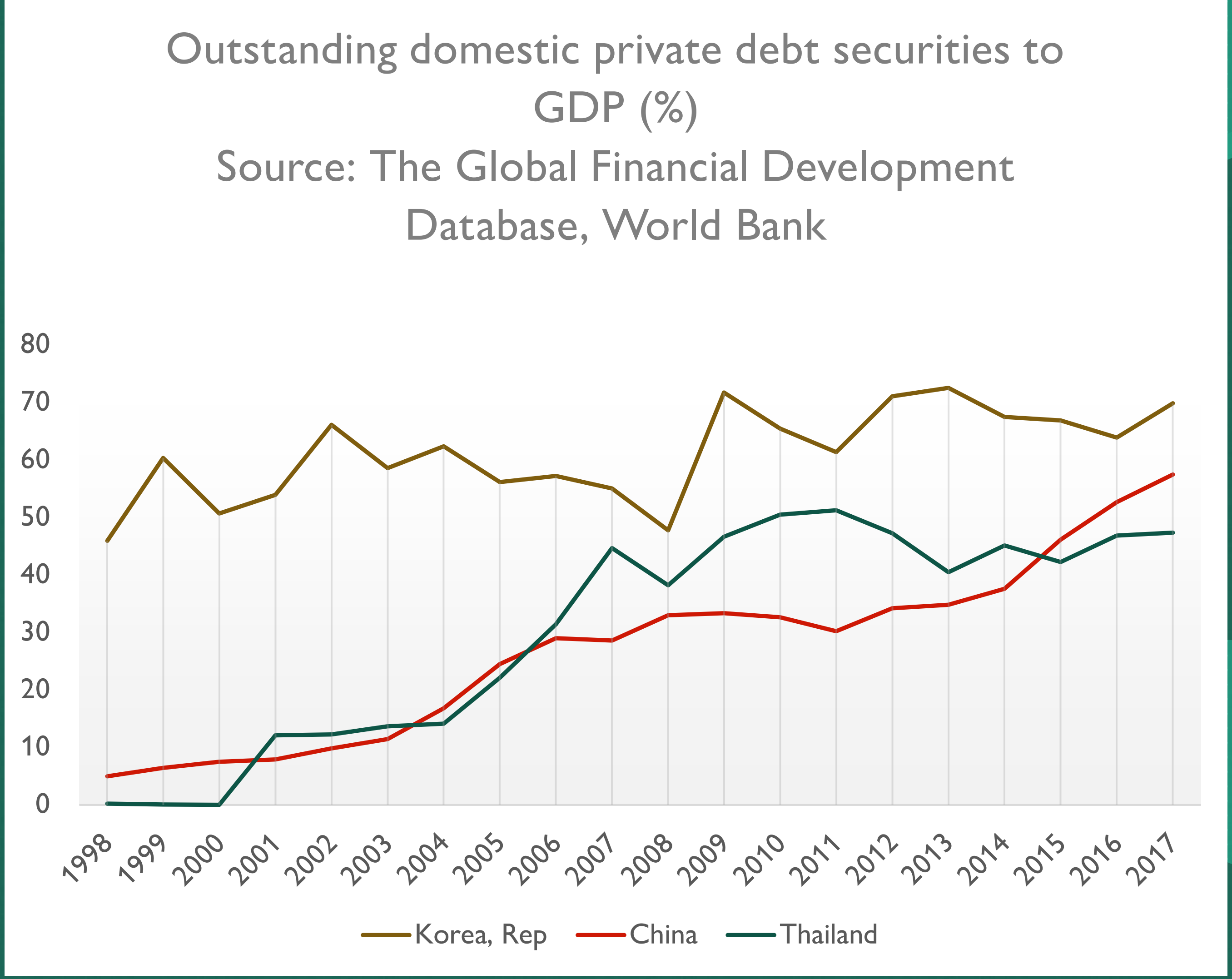
The difficulty/impossibility of some countries to borrow from foreign investors in their own currency - a difficulty lying systemically with the organisation of global finance, rather than being somehow the fault of the country in question

(Eichengreen, Hausmann and Panizza, 2003).

Policy push

2002 ASIAN Bond Markets Initiative(ABMI) launched

Aim: develop bond markets, with a specific focus on local currency bond markets, and to “promote regional financial cooperation and integration to strengthen financial stability and reduce the region’s vulnerability to the sudden reversal of capital flows” (Asian Development Bank, 2017).



Policy pile-in

- G20 Finance Ministers and Central Bank Governors, 2011;
- World Bank Group, 2012;
- IMF, 2013;
- The World Economic Forum, 2016;

encourage and enable, in particular, domestic local currency private bond markets

Alleged Consequences

By creating local currency domestic bond markets, these countries have ensured there are "investible assets" for patient institutional investors in advanced economies (AE), whilst protecting EE from capital flow and exchange rate volatility

Can Original Sin Absolved?

Understanding the foreign pension funds (Bonizzi and Kaltenbrunner, 2019)

The behaviour of foreign funds is ultimately determined by the nature of their liabilities, which are embedded in the conditions of the home economy.

Funding levels

Comparison between assets and liabilities

Liability side:

What will be the cost of future DB benefit payments?

Depends on:

- Inflation
- Longevity
- Interest rates

Liability-driven investment strategies

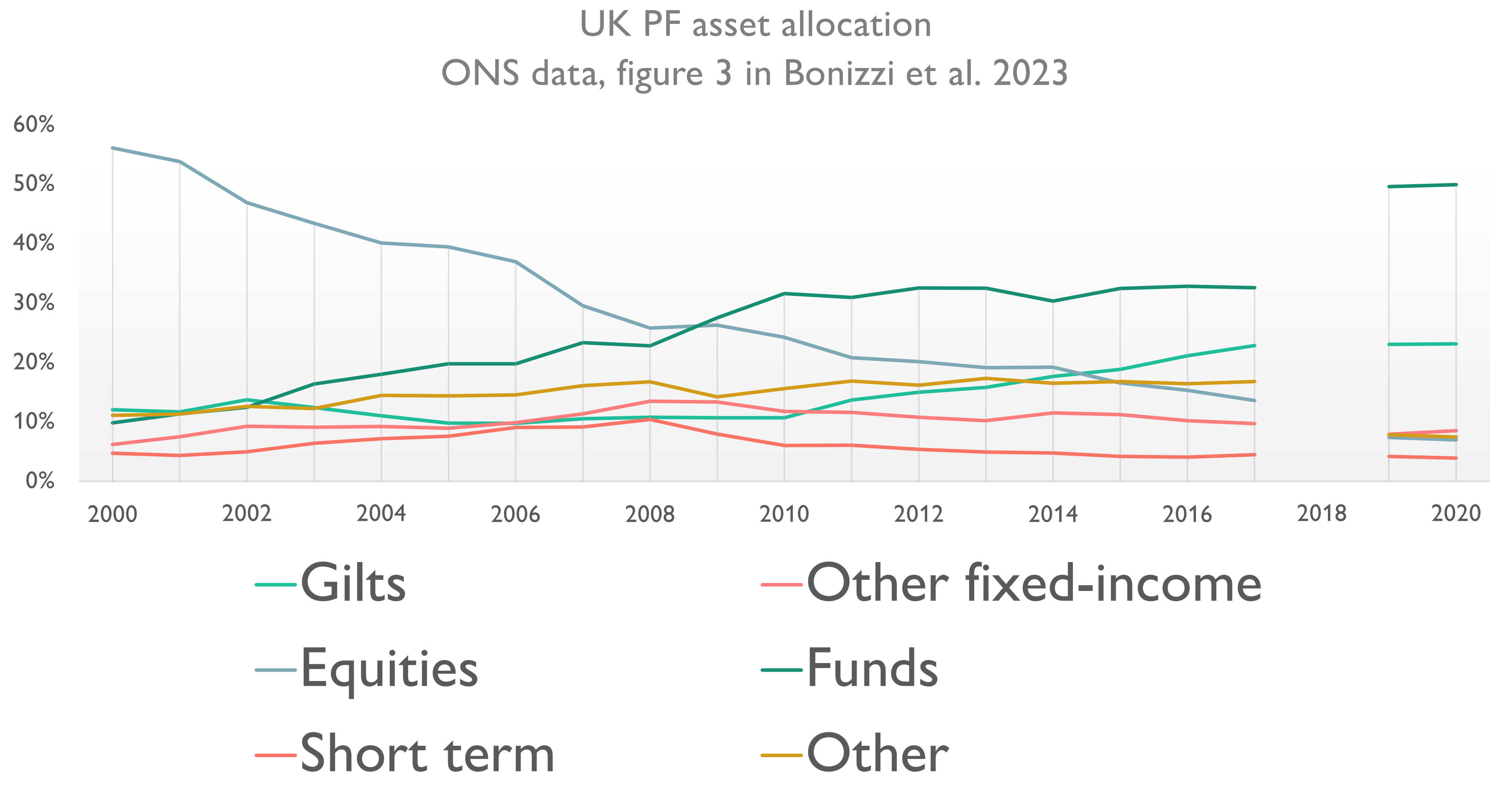
Maintaining funding level by matching interest rate sensitivity on both sides of the balance sheet

Present value of liabilities INCREASES with a decrease in interest rate (gilt rate)

$$PV = FV/(1 + r)^n$$

How to make assets move in same direction..

Hold bonds



What if not fully funded in the first place?

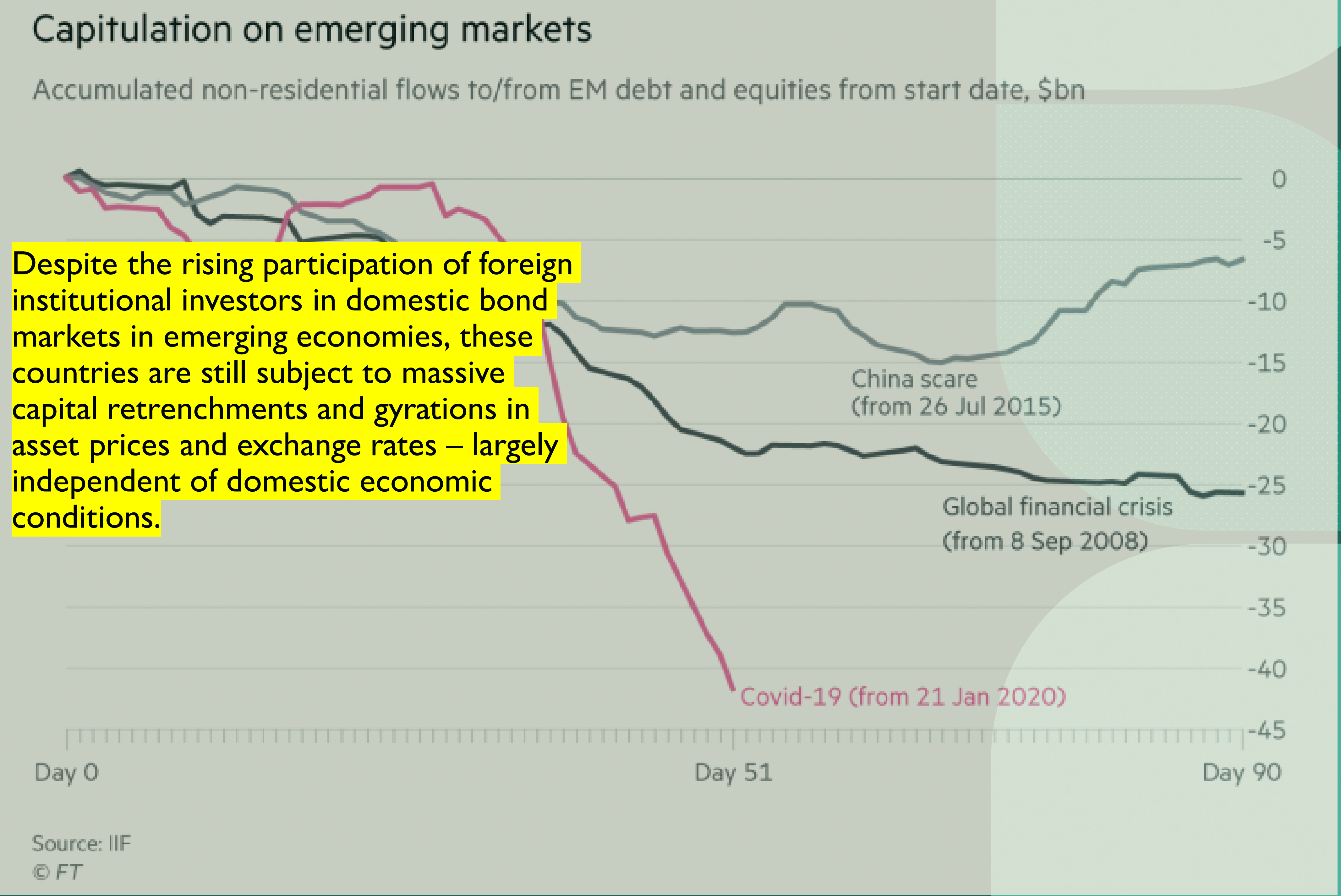
Bonds are low return

- Will need growth from elsewhere

Understanding the foreign pension funds
(Bonizzi and Kaltenbrunner, 2019)

The ability of these funds to follow through with patient and stabilising investment abroad is undermined.

Where funds are openly adopting liability-driven investment, emerging market assets form part of their growth portfolio, which is structurally volatile and open to more active management.



Despite the rising participation of foreign institutional investors in domestic bond markets in emerging economies, these countries are still subject to massive capital retrenchments and gyrations in asset prices and exchange rates – largely independent of domestic economic conditions.

“Original sin redux” (Hofmann, Shim and Shin, 2020a; Hofmann, Shim and Shin,2020b BIS).

Also new forms of financial subordination (Kaltenbrunner and Painceira, 2015) :

The participation of foreign investors in local currency bond markets reduces the currency mismatch (original sin) of domestic agents, BUT it shifts that same mismatch from the borrower onto the lender. A currency depreciation reduces the value of assets when converted into home currency.

"Original sin redux" (Hofmann, Shim and Shin, 2020a; Hofmann, Shim and Shin,2020b BIS).

Also new forms of financial subordination (Kaltenbrunner and Painceira, 2015) :

Depreciation induces sell-offs which can be discerned in higher emerging economy bond spreads. In support of this hypothesis, it is notable that "EMEs with higher shares of foreign ownership in local currency bond markets have experienced significantly larger increases in local currency bond spreads" (Hofmann, Shim and Shin, 2020a).

So…Develop a domestic institutional investor base?

Won't necessarily help..

The creation of pension funds does not guarantee the development of domestic bond markets

Peru and Colombia

Bonizzi, Churchill and Guevara, 2020

The ‘extraversion’ of the productive structure “leaves capital markets peripheral to financing domestic companies and limits public sector borrowing”, holding down the supply of bonds being issued.

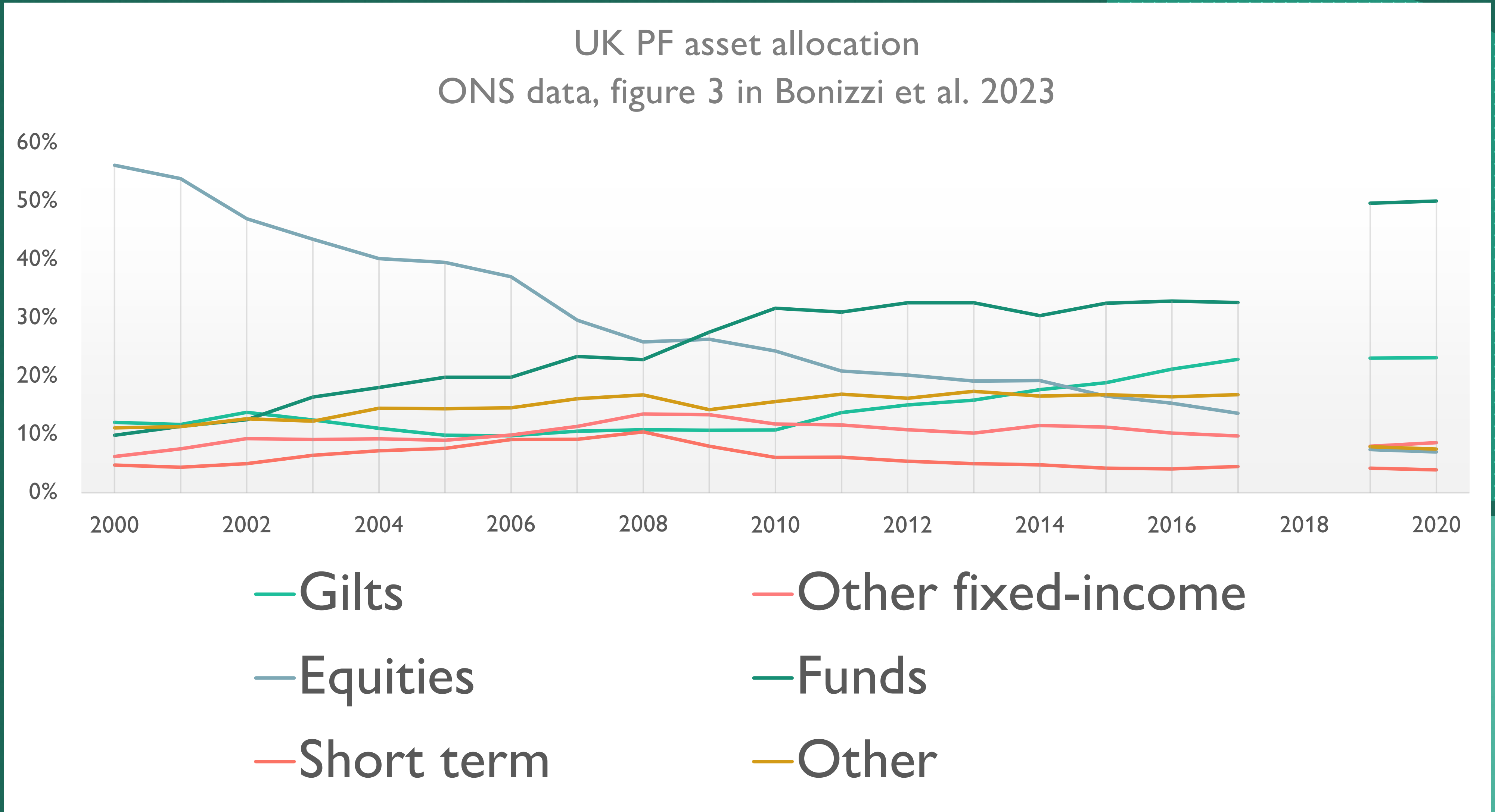
At the same time, subordinate financial integration has led to a growing presence of foreign investors in domestic financial markets, adding pressure to demand.


Pension funds are not
the panacea we thought in EEs
But things are going well
in developed markets, right?
?
imgflip.com

Liquidity concerns?

UK pension funds' patience and liquidity in the age of market-based finance

Bonizzi et al. 2023


UK PF asset allocation
ONS data, figure 3 in Bonizzi et al. 2023
60%
50%
40%
30%
20%
10%
0%
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
Gilts
Other fixed-income
Equities
Funds
Short term
Other

Pension funds appear to be seeking to secure their liquidity

- By holding good-quality collateral
- Investing in collective funds that allow daily redemptions

Connections again with Liability-driven investment strategies

i.e. holding bonds to maintaining funding level by matching interest rate sensitivity

What if not fully funded in the first place?

Bonds are low return

- Will need growth from elsewhere
- Financial wizardry could limit the requirement to hold bonds

(synthetic duration… playing with leverage and derivatives)

Derivatives and leverage

- Interest rate swaps

Pay a variable rate (e.g. the LIBOR or its recent replacement SONIA) in exchange for a fixed interest payment (the swap rate). By so doing they hedge against interest rate changes.

- Repo

Use gilts to borrow in the repo market, and then buy more gilts, effectively doubling their exposure to gilts, and thus the degree of interest rate hedging.

These strategies require collateral (bonds)

Pension fund demand in collateralised financial market structure

The ‘collateralised financial structure’ in which PFs are embedded can generate liquidity pressures that can force PFs to act impatiently in the face of margin calls

Doom loop – or liquidity spiral

- Value of collateral falls
- Margin calls
- Forced asset sales to meet calls
- Value of collateral falls further

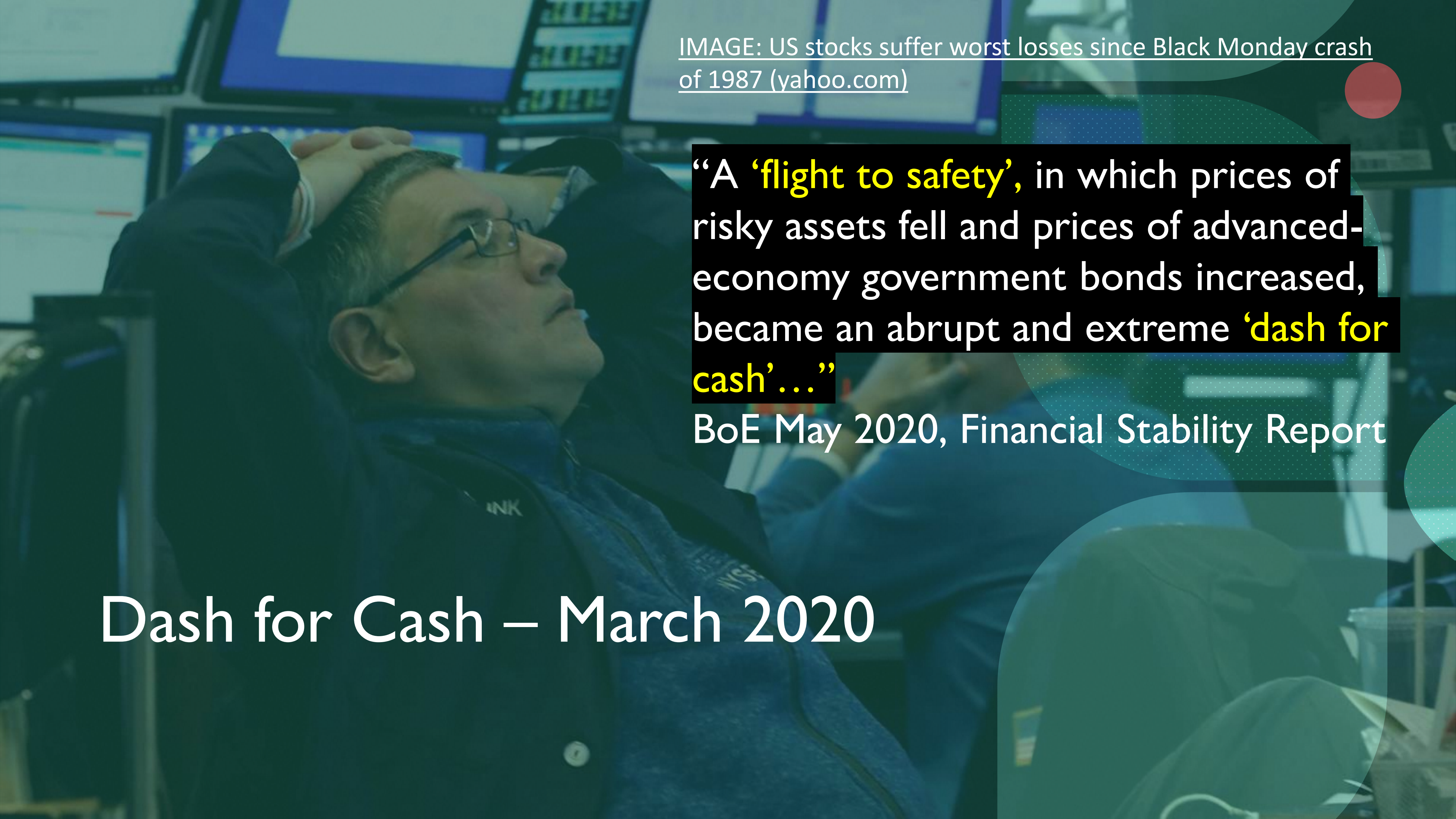


IMAGE: US stocks suffer worst losses since Black Monday crash of 1987 (yahoo.com)

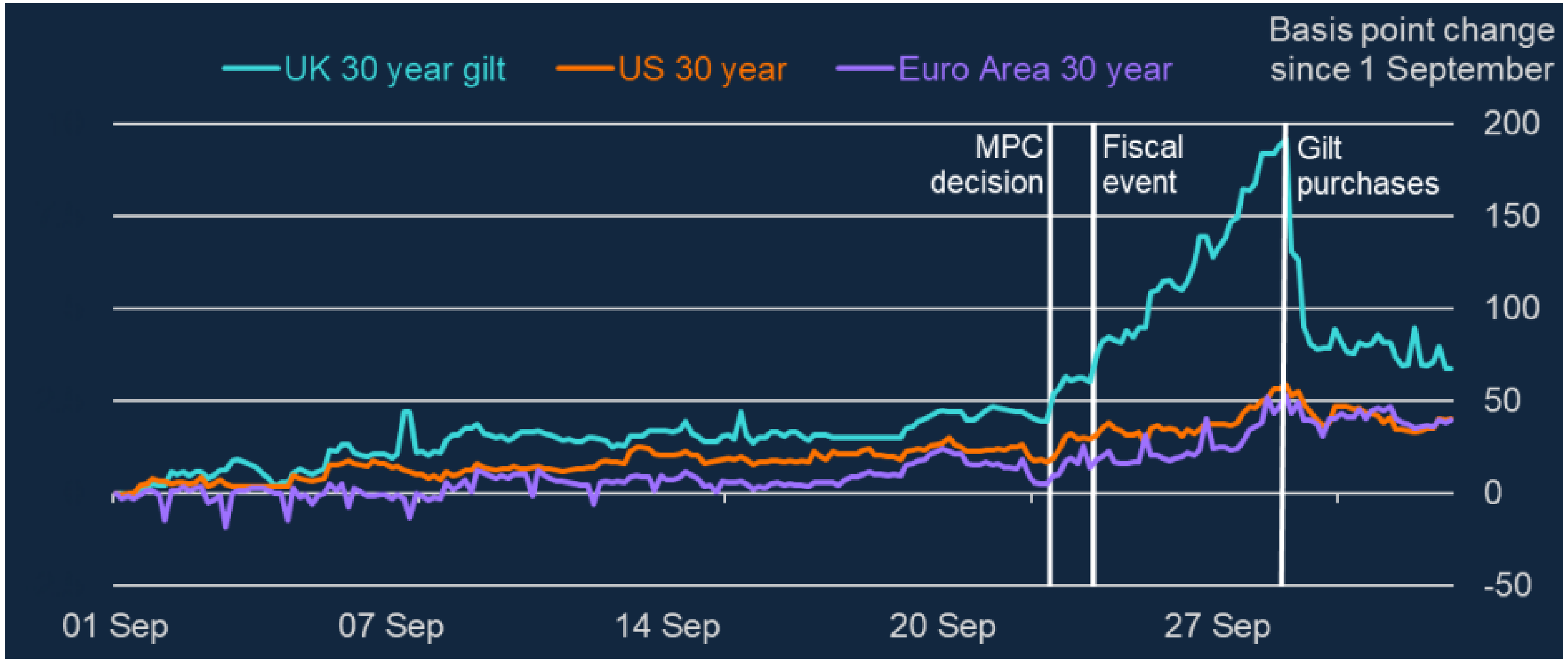
"A 'flight to safety', in which prices of risky assets fell and prices of advanced-economy government bonds increased, became an abrupt and extreme 'dash for cash'…"

BoE May 2020, Financial Stability Report

Dash for Cash – March 2020

September 2022 –
Bond market in crisis, again.

Figure 1: Cumulative change in long-term government bond yields since 1 September



Source: Bloomberg, Bank calculations

Conclusions: Pension funds have no essential transformative powers

Pension fund asset demand is shaped by the financial and economic structure in which the pension fund is embedded

- they cannot transcend structural financial problems like original sin or impatient investment
- they cannot transcend structural economic problems like global productive subordination or long-term investment droughts