BANK OF JAMAICA

DISCUSSION PAPER

RELAXING THE LIMITS ON INVESTMENT IN FOREIGN CURRENCY ASSETS FOR PENSION FUNDS AND INSURANCE COMPANIES

AUGUST 2015

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I. Prelude

This Discussion Paper describes Bank of Jamaica's current position on relaxing the limits on investment in foreign currency assets for pension funds and insurance companies and proposes the next steps in the consultation process. The intention is for the BOJ to complete a final position paper with an implementation plan by 31 March 2016.

The Bank is now inviting responses from all interested stakeholders in the pensions and insurance industries to the issues raised in this Discussion Paper.

Responding to this Discussion Paper

Comments are most helpful if they:

- indicate the clause and specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/rationale proposed; and
- describe any alternative regulatory choices the Bank of Jamaica should consider.

Submission of Responses

Comments on the Discussion Paper will be received up to close of business on Wednesday, 30 September 2015 by email to **FinancialStability@boj.org.jm**

This Discussion Paper is available on the Bank of Jamaica's website at www.boj.org.jm.

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II. Summary of BOJ Position

1. The BOJ is considering amending the foreign currency limits across the non-deposit-taking financial sector, in particular by expanding the set of eligible investors for exemption under section 22B of the BOJ Act to include pension funds and insurance companies. The Bank has the view that widening the classification of eligible investors is best served by undertaking a careful assessment of the issues and to proceed in moderate steps. With regards to the insurance and pensions sectors, the relaxation of the cap on investments in foreign currency instruments will depend on weighing the macroeconomic costs (i.e., impact of capital flows) versus the diversification benefits. The Bank does not expect that this is likely to happen before the removal of the cap on foreign currency instruments for securities dealers ("SDs") and collective investment schemes ("CIS") by the end of 2016.

2. The BOJ supports the relaxation of the foreign assets cap for pension funds and insurance companies within the next three years (i.e., the medium term). However, the Bank is concerned that expanding the eligible investors at this time or in the near future would threaten system stability due to the following factors:
    a. Any material one-off reduction of the large holdings of domestic GOJ securities of pension funds and insurance companies, in order to increase allocations to foreign assets, would sharply adjust GOJ yields upwards possibly leading to capital strains across the financial sector.
    b. The need to build the NIR is a key programme objective with elevated risks to meeting near-term targets. Extra foreign currency demand pressures from pension funds and insurance companies could seriously threaten the BOJ's ability to achieve this objective.
    c. Reforming the SDs retail repo model requires transitioning retail repos to the Trust arrangement and phase down of retail repos would be hampered by excessive volatility in GOJ domestic bond prices arising from a re-allocation of portfolios by the pension and insurance industry.
    d. Given their illiquid maturity structure of liabilities, institutional investors, in particular pension funds, have the potential to exhibit 'herding behaviour' consistent with sudden shifts in portfolio allocation which could easily amplify volatility in the foreign exchange market as well as precipitously diminish the NIR.

3. The BOJ has reviewed initial comments regarding the relaxation of the cap on foreign assets for insurance companies and pension funds from the Caribbean Actuarial Association (CAA), the Pension Fund Association of Jamaica (PFAJ) and individual stakeholder institutions. This Discussion Paper represents the beginning of the process towards reaching agreement on a plan for a more liberal regime for insurance companies and pension funds but which take account of the magnitude of the potential foreign exchange market impact and potential drain on foreign exchange that their demand can pose. The key deadlines being proposed by the BOJ are as follows:

Activity	Proposed Deadline
1. Industry response to Discussion Paper	30 September 2015
2. Final position paper with implementation plan	31 March 2016
3. Removal of cap for SDs and CIS	30 December 2016
4. First step in lifting of cap for pension funds and insurance companies	31 March 2017

III. Background

4. In the Bank of Jamaica ("BOJ") Advisory to Securities Dealers, Collective Investment Schemes, Insurance Companies, Superannuation Funds and Retirement Schemes ("Advisory") regulated by the Financial Services Commission ("FSC") issued on 31 December 2013, the BOJ committed to entering into consultations with representatives of regulated entities in the insurance and pensions sectors during the first half of 2014. The aim of the consultations is to establish the scope and extent to which current limits under the BOJ Act regarding permissible investments in foreign currency instruments can be lifted over time.

5. The Advisory was in the context of a commitment to publicly pledge to a timetable for relaxing the cap on investments in foreign currency instruments for SDs and CIS from 5 percent of assets to at least 25 percent by end-2015, and removing the cap by end-2016 unless extraordinary circumstances require a reassessment.[1] This initiative is part of the wider financial sector reform to relax the existing cap on foreign assets applicable to non-deposit-taking financial institutions (including securities dealers, insurance companies, pension funds and collective investment schemes) by amending the limitations imposed by the provisions of the BOJ Act. These reforms are being carried out on a phased basis, starting with the SDs and CIS, because of the immediate need to
    a. provide a more diversified range of investment products to enable SD industry reform;
    b. facilitate an easier transition of SD's "retail repos" to a Trust arrangement;
    c. facilitate the phase down of the SD retail repo model over time; and
    d. meet challenging NIR targets pertaining to Jamaica's commitment under the EFF.

[1] At the time of the Advisory, SD investment in GOJ, US, UK & CND were exempt from the cap on foreign currency instruments by Ministerial Orders issued in 2003 but CIS were subject to the cap, under section 22B. Note also that section 22B does not name securities dealers or CIS as parties subject to Minister's directions regarding acquisition of foreign assets. However, CIS are subject to the prohibition regarding activities relating to foreign currency instruments referred to in section 22A. Following on the Advisory, SDs are allowed by Ministerial Oder dated 1 July 2014 to expand their permissible categories of foreign currency instruments to investment grade debt securities of sovereign and corporate issuers and shares of the latter category ("First Schedule Instruments") subject to a 7.5 percent cap. Under a similar CIS Exemption Order with effect 1 July 2014, the CIS managed by a SD are allowed to purchase 100 percent in the exempted securities which collateralized its "retail repo" portfolio of the SD as at 31 December 2013 as well as hold a maximum of 7.5 percent of First Schedule Instruments.

6. The BOJ Act prohibits dealings in foreign currency and foreign assets for certain institutions, in particular sections 22A, 22B and 22C of the BOJ Act Part IVA. Importantly, section 22A incorporates a universal prohibition on dealings in foreign currency and foreign currency instruments, save by authorized dealers. Section 22B prohibits certain institutions from acquiring foreign assets save in accordance with directives issued by the Minister of Finance. In particular, Ministerial directives issued under the BOJ Act limit investments in foreign currency assets by pension funds and insurance companies to 5 percent of total assets. In practice, the nature of permissible assets for each type of financial institution has also been governed by the issue of Ministerial exemption orders under section 22C or directives on the holding of foreign assets issued by the Minister of Finance pursuant to section 22B.[2] Broadly, permissible foreign assets held by pension funds and insurance companies under Ministerial exemption cover only fixed income instruments in United States Dollars, Pound Sterling and Canadian Dollars.

7. At the same time, FSC's prudential regulations for pension funds and insurance companies are more liberal than the special restrictions under the BOJ Act, including Ministerial directions and exemptions. In regard to the pensions sector, Pensions (Superannuation Funds and Retirement Schemes) (Investment) Regulations, 2006, place a quantitative restriction of 20 percent on the fair value of assets in eligible foreign currency securities (Regulation 31) as well as other qualitative restrictions which differ from those under the BOJ Act and Ministerial Order 2003 applicable to pension funds.[3] In the case of insurance companies, although regulations do not provide a direct ceiling for investment in foreign currency, Insurance Regulation 46, 59 and 65 imply certain quantitative and qualitative restrictions that apply to investment in foreign currency securities which also differ from the foreign asset restrictions under the BOJ Act.[4]

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[2] The Bank of Jamaica (Dealings in Foreign Currency) (Insurance Business) (Exemption) Order, 2009, exempts the following categories of business from the operation of sections 22A and 22B of the Bank of Jamaica Act: (a) General Insurance Business; (b) Ordinary Long Term Insurance Business (as defined in section 22 of the Insurance Act), excluding equity linked insurance products, and; (c) Sickness and health Insurance business as defined in section 2 of the Insurance Act.

[3] Pensions (Superannuation Funds and Retirement Schemes) (Investment) Regulation 24 allows pension funds to invest in sovereign obligations (rated A and above) as well as corporate obligations of entities incorporated outside of Jamaica and shares of such corporations.

[4] Note that in the case of insurance companies with overseas branch operations, the value of a company's foreign currency investment may not exceed its deposit and reserve requirements of that jurisdiction in securities of that jurisdiction possessing characteristics and similar quality as those prescribed in Part VII of the Insurance

8. Consultations with representatives from the insurance and pensions sectors commenced with a meeting of the BOJ, FSC, Insurance Association of Jamaica ("IAJ"), Pension Funds Association (Investment managers), and Caribbean Actuaries Association held on 5 June 2014. At this meeting the BOJ outlined the process involved in widening the classification of eligible investors and thus amending the applicable limit on investment in foreign currencies. Secondly, the BOJ in conjunction with the FSC, articulated a process of consultation and assessment for lifting the cap on foreign assets applicable to insurance companies and pension funds, which includes:
    a. inviting comment papers from stakeholders in the pensions and insurance industries including the IAJ and JSDA; and
    b. inviting the FSC to share their plans to transition to a "prudent person" rule to govern the portfolio limit on foreign assets as well as share relevant data for BOJ to do an FX market impact assessment.

9. Critical milestones in the consultation process include the preparation and distribution of this Discussion Paper by the BOJ, in consultation with the FSC, on the issues involved in lifting the cap, considering, inter-alia:

    a. the impact of FSC-proposed regulatory changes, including the prudent person rule, on foreign currency demand;
    b. its impact on the NIR path, incorporating the aggregate desired foreign currency investment projections ("FCIPs") for securities dealers and CIS;
    c. its impact on the domestic bond market;
    d. its impact on regulatory arbitrage opportunities;
    e. enforcement, regulatory and other issues.

Regulations. Further, an insurer may invest, in an aggregate amount not exceeding twenty percent of its assets in obligations of governments carrying a credit rating of A, or equivalent, or other obligations which have not been in default during the five years next preceding date of acquisition, and which are otherwise of equal or better quality to like Jamaica securities. In addition to the percentage of assets permitted, an insurer offering contract benefits payable in foreign currency shall invest additional amounts sufficient to cover the reserve liabilities on those contracts in obligations of the foreign country payable in that currency.

IV. Impact of FSC-proposed regulatory changes, including "prudent person" rule, on foreign currency demand

10. FSC recommendations regarding changes to their regulatory approach do not anticipate application of prudential quantitative limits on foreign currency investments for either pensions or insurance companies that are more restrictive than current or proposed restrictions under the BOJ Act. [5] The FSC indicates that their application of prudential limits is meant to be supportive of the macro-prudential objectives of stability in the foreign exchange market and foreign reserve adequacy pursued by the BOJ. It is noted, however, that this support is provisional as the stated direction of future FSC regulation is towards strengthening their application of the prudent person rule, especially in the regulation of pension plans, while addressing the management of investment risks by way of guidelines reinforced with regulatory penalties. The FSC also notes that the prudent person rule does not exclude basic prudential concentration restrictions with limits to different asset classes.[6] Consequently, notwithstanding the position of the BOJ, regulatory review regarding easing quantitative limits applicable to pension plan foreign currency investment will be conducted on a periodic basis.

11. As regards the regulation of insurance companies, the FSC does not intend to provide an explicit quantitative limit for investment in foreign currency instruments. Although the prudent person principle will not be strictly adopted under the proposed amended Insurance Regulation, insurance companies will be given greater regulatory latitude in carrying out investment management. Nonetheless, the FSC plans to implement currency matching rules for insurers, consistent with the introduction of broad asset-liability management requirements, with penalties for mismatch applied in the MCCSR or MCT calculation for capital. At the time of preparing this document the details of proposed changes to the investment regulations for insurers were not available.

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[5] See FSC (2014) "The Financial Services Commission's Approach to the Regulations of Investments of Private Pension Plans."

[6] Specifically, the FSC has proposed amending Investment Regulation 3(1) to explicitly state "the trustees and investment managers shall exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person; that the trustees and investment managers shall invest the assets of a superannuation fund or retirement scheme in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension superannuation fund or retirement scheme."

However, the FSC has indicated that the regulatory limit on foreign currency investments will be moved in line with changes to the BOJ cap on foreign assets that would allow insurance companies to take on such foreign currency liabilities which they will have to match with similar-denominated assets.

12. FSC's present review of qualitative regulatory restrictions for both pension funds and insurance companies support similar BOJ treatment of securities dealers and CIS, whereby pension plans and insurance companies should be "permitted to acquire, in all currencies, investment grade sovereign obligations, investment grade corporate obligations of entities incorporated outside of Jamaica and shares of such corporations".[7]

V. Impact of raising the limits on investment in foreign currency assets on NIR path

13. The BOJ recognizes that both quantitative and qualitative limits on investment in foreign assets can impede the attainment of economic benefits for pension funds and insurance companies as derived from global financial diversification. However, serious "negative externalities" exist for the foreign exchange market and the NIR which could destabilize the macro-economy if institutional investors are permitted to invest in foreign assets with wide-ranging discretion. Proponents of the prudent person principle argue that the governance and risk management framework for investment decision-making by each of these institutions should be left to bear full, or a major part of, prudential accountability for overseeing international investments subject to non-restrictive regulatory guidelines. However, account must be taken of the fact that institutional investors such as pension funds and life insurance companies are funded by long-term liabilities and therefore have major pools of reserves available to transact very large volumes in a very short time frame. Hence, even for investment allocations consistent with the prudent person principle, these institutional investors could easily amplify volatility in the foreign exchange market as well as precipitously diminish the NIR if a large pool of domestic funds is suddenly redirected to foreign assets. This

[7] See FSC (2014) "The Financial Services Commission's Approach to the Regulations of Investments of Private Pension Plans."

impact would be exacerbated if the pension fund and insurance company investors' exhibit "herd" behavior as is typical of institutional investors.

14. The BOJ stands ready to suspend the process of raising of the foreign assets cap to arrest any consequential occurrence of adverse conditions in the foreign exchange market. Based on end-September 2014 Foreign Currency Investment Projections (FCIPs) submitted to the FSC from insurance companies and 14 of the largest pension funds, aggregate desired foreign currency demand over the next three years is estimated at US$0.9 billion (September 2015 to September 2017). Taking into account the respective FCIPs of SDs and CIS of US$1.3 billion and US$0.4 billion for the medium term, this demand threatens the attainment of the NIR targets under Jamaica's EFF arrangement with the IMF. Note that the significant incremental demand for foreign currency over the medium term as reflected in the rise in SD FCIPs is not in line with the expected direction under the transition of SDs' foreign currency "retail repos" to foreign currency CIS.

VI. Impact of raising the limits on investment in foreign currency assets on domestic bond market

15. At the end of September 2014, Jamaica Dollar bond portfolios of pension funds and insurance companies amounted to $170.5 billion and $206.5 billion, respectively.[8] For the most part, if the cap were lifted for these sectors, the potential foreign currency demand to purchase foreign assets from closing domestic currency bond positions will be constrained by available liquidity of domestic currency bond instruments, in particular GOJ securities. It is anticipated that the domestic currency bond market will be illiquid underpinned by the heightened demand for foreign assets due to the lifting of the foreign assets cap for SDs and CIS. Also contributing to the illiquidity is the present thin trading of GOJ bonds since the reduction in coupons and lengthening of maturities in the recent National Debt Exchange. This liquidity pressure on domestic currency securities is expected to last at least until the demand for foreign assets from SDs and CIS has been more or less moderated after the full lifting of the cap in 2016.

[8] Jamaica Dollar bond portfolios include commercial paper, securities of governments, repurchase agreements bonds, debentures and promissory notes in the case of pension funds and public sector domestic securities, repurchase agreements and other securities in the case of insurance companies.

16. The lifting of their foreign assets cap of the pensions and insurance sectors before 2017 would aggravate imbalance between demand and supply in the domestic bond market. Consequent on the size of domestic investment portfolios within these sectors, the shift in portfolios could induce significant domestic bond price volatility and cause substantial distortions in domestic bond yields. Given current exposures of the financial system to domestic currency bonds, the balance sheets of some institutions could be strained, increasing contagion risk within Jamaica's highly integrated financial sector.

17. The BOJ will continue to closely monitor the risks to the domestic bond market as well as the balance sheets of financial institutions posed by the scheduled incremental raising of the foreign assets cap for SDs and CIS. The manifestation of risks would result in a reassessment by the BOJ of the announced timetable for raising of the foreign assets cap for SDs and CIS as well as the BOJ delaying any plans to begin lifting the cap for the pensions and insurance sectors.

VII. Impact of raising the limits on investment in foreign currency assets for select institutional groups on regulatory arbitrage opportunities

18. The BOJ recognizes that opportunities for regulatory arbitrage across balance sheets of institutions with different legal limits on investment in foreign currency assets could become more complex with the widening of the gaps. Against this background and in the context of diversification goals, pension funds and insurance companies will continue to be incentivised to circumvent restrictions such as through the use of domestic currency instruments linked either directly or indirectly to foreign currency assets ("foreign exchange derivatives") and "pooled funds". For example, data as at end-September indicate 30 percent ($97.3 billion) of pension funds aggregate investment portfolio in Investments in Deposit Administration Contracts and Pooled Funds. The intensification of this practice would cause a coincident increase in foreign currency demand if regulatory loopholes are not effectively closed.

19. Some stakeholders have argued that the existence of an "un-level playing field" within the insurance, securities and pensions sectors could impede development in the

pensions and insurance industries to the advantage of the securities dealer and CIS industries. This impact of this advantage is worsened by the fact that the consumers' investments in private pension funds and insurance are voluntary. However, the fundamental dissimilarities in liabilities among SDs, insurance companies and pension funds limit the scope for competition.

VIII. Enforcement, regulatory and other issues

20. Consistent with the BOJ's efforts towards the preservation of financial stability, section 22 of the BOJ Act serves as a macro-prudential overlay to FSC regulations and so does not discount these regulations which are grounded on micro-prudential principles. Hence, apparent differences in BOJ and FSC policy towards non-DTI financial institutions reflect the application of separate objectives. That being said, the BOJ is aware of institutional breaches of Section 22 of the BOJ Act, including current practices to circumvent restrictions through the use of local derivative instruments and pooled investment funds. The BOJ, in conjunction with the FSC, will strengthen the coordination of appropriate enforcement policies and supervisory protocols to prevent this practice.

5 August 2015