Long-term Bonds: different ways to support (and benefit from) pension needs

Uruguay: The case of Wage-Linked Sovereign Bonds

Rodrigo Saráchaga
Sovereign Debt Management Unit
Ministry of Economy and Finance, Uruguay
Organization of presentation

- Context
  - Creation of new unit of account indexed to wages (“Pension Unit”)
  - Opportunities and policy trade-offs
  - Next steps and concluding remarks
Since 1989, pension payments in Uruguay are constitutionally indexed to nominal wages.

In 1995, a pension reform established a mixed social security regime, with a state-managed pay-as-you-go pillar and an individual capitalization pillar.

In the individual savings pillar, Pension Funds managed workers’ contributions until their retirement.
✓ Pension funds' assets under management have continued upward trend

_Pension saving fund evolution_ (in % of GDP)

**Sources:** Central Bank of Uruguay
At retirement, the pension fund transfers to the insurance company the accumulated balance in the individual savings account, which is then in charge of serving the annuity.

Since 2016, as the accumulation stage has matured, the number of retirees that are entitled to receive an annuity began to grow fast, and is expected to increase rapidly.

Amount of annuities expected

(in number of people)

Sources: Dassatti & Maniño, “Maduración del Sistema Previsional: proyecciones y agenda”, 2014
The problem of currency mismatch

✓ Lack of regular supply of long-maturity market assets tied to nominal wages exposed insurers’ balance sheets to movements in real wages.

✓ CPI-linked instruments were the closest hedge available for annuity liabilities (yet, insufficient).

✓ This led private insurers, among other factors to leave the annuity business, leaving the state-owned insurance company as the only active player in the market.
The problem of currency mismatch

Inflation and Nominal Wages
(annual change, in %)

Sources: National Bureau of Statistic
Creation of *Unidad Previsional* (Pension Unit)

1. **08/2017** – Government submitted legislation proposing the creation of a daily accounting unit that would track changes to the NWI.

2. **04/2018** – *Unidad Previsional* approved by the Congress.

3. **07/2018** – Government starts issuing NWI-linked instruments as part of its domestic issuance calendar.

Inclusion of UP Treasury Notes in the semi-annual issuance calendar was meant to provide the market with a clear signal of recurrence and predictability.
How do UP-denominated bonds designed?

- UP bonds are provided with a fixed real coupon.
- Nominal coupon and principal are thereby linked to changes in the NWI, reflected in the daily variation of the Pension Unit.
- NWI is published by the National Statistical Agency.
- On-the-run issuances: 5,5y and 13,5y average life

**Holders of UP Treasury Notes**

<table>
<thead>
<tr>
<th>Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Insurances Companies</td>
<td>0.3%</td>
</tr>
<tr>
<td>Professional Retirement Funds</td>
<td>3.0%</td>
</tr>
<tr>
<td>BSE (Public Insurance Company)</td>
<td>20.4%</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>30.9%</td>
</tr>
<tr>
<td>Social Security Trust</td>
<td>45.4%</td>
</tr>
</tbody>
</table>

*Sources: Ministry of Economy and Finance, as of 03/18/2019*
Opportunities for Debt Management

✓ Wage indexation provides with a better hedge against output shocks that affect tax revenues.

✓ Demand for UP will help to underpin the public sector’s debt de-dollarization strategy, broadening its sources of long-term financing in local currency.

✓ Informational role of CPI-indexed and wage-indexed market.

Sources: National Bureau of Statistic & General Tax Direction
✓ Ensure the sustainability of the pension reform 2\textsuperscript{nd} stage
  • Need to develop wage-indexed instruments

✓ Promote and foster local currency market efficiency
  • Completing markets should take into account that too many different LC issues could significantly fragment the market (liquidity and marketability of issues would decline), disrupting efficient government funding.
  • \textit{Buy-and-hold} market requires a proactive attitude and regular presence.
Underpin on-the-run issuances and add more references in order to promote the development of a yield curve in UP.

Evaluate switch of old legacy bonds in Unidad Reajustable (closed, one-off issuances) and index swaps between CPI-linked and wage-linked instruments.

Promote issuances from other agents (public and private).