Paul Hartmann: Status and future of retirement funds in Namibia

Address by Mr Paul Hartmann, Deputy Governor of the Bank of Namibia, at the Old Mutual Namibia "Retire right" conference, Windhoek, 23 February 2005.

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The greatest problem about old age is the fear that it may go on too long.

A.J.P. Taylor

Chairperson, Ladies and Gentlemen,

It is a pleasure to be with you this morning and to address this distinguished gathering. I would like to thank the organisers for this invitation and for putting together this conference. The theme of my remarks today is on the "Status and Future of Retirement Funds in Namibia".

Introduction

As a starting point, it is necessary to recognise the principal role played by the financial system in any country is to provide the infrastructure to allow surplus resources to be allocated to those individuals and companies with deficits. The positive impact of a well-functioning financial system on economic growth of a country is well documented. In most countries, the financial system extends beyond traditional banking institutions to include insurance companies, mutual funds, unit trusts and other financial service providers. These non-bank financial institutions provide services that are not necessarily suited to banks, but they also serve as competition to banks. Having a multi-faceted financial system, which includes non-bank financial institutions, can protect economies from financial shocks. However, in countries that lack a coherent policy framework and effective regulations, non-bank financial institutions can exacerbate the fragility of the financial system.

There has been tremendous growth worldwide in the mobilisation of financial resources outside traditional banking systems. Channelled mainly through capital markets, such rapid financial diversification is posing new challenges equally for investment managers as for regulators in many emerging and developing markets. The pension fund industry, in particular, has grown rapidly during the past decade, which is ascribed to a combination of demographic, political and economic influences.

We also take note of the widespread turbulence which is affecting almost all social security schemes throughout the world. In retrospect, the 1980s and 1990s may appear as one of the great watersheds in the development of social policy. A large number of countries are at present contemplating, planning or implementing major changes to their existing schemes of retirement protection.

The issues surrounding retirement funds which you are discussing today are so multi-faceted and affect so many people and households that it makes sense to host a conference of this nature.

Importance of the retirement fund industry

Let me start by looking at the essence and the role of the retirement funds in the economy. These funds perform various functions in the economy, including consumption smoothing, insurance and redistribution of income. A key function of retirement plans is to enable individuals and households to smooth consumption over the life course, by collecting savings during people's working lives and providing retirement income.

The second function of the retirement plans is the insurance. The retirement fund provides insurance against a range of contingencies which may otherwise adversely affect household consumption. Uncertainty over the time of death, disability, retrenchment, retirement, etc., is a primary factor in explaining the establishment of retirement plans. The insurance function of the retirement fund is extremely important but the insurance properties of the fund plan are often not well understood especially in developing economies and, as a result, greatly undervalued. This is one area where, I think, retirement funds should become more transparent by reducing the amount of "small print" in their rules and contracts.

The third function is the redistributive function. Retirement funds, particularly the defined benefit types, collect contributions from one group and pay to a different group, enabling the pursuit of social norms and policy objectives with regards to the distribution of income in society. Further, they can also redistribute income within generations for example by skewing entitlements in favour of women or poor pensioners.

I would also like to cite some of the key roles played by these institutions in developing the financial sector of a country. The development of retirement funds leads to increasing demand for long term financial assets, thus promoting financial market development and improving the capacity to manage financial risks. They compete with investment banks which lead to more efficient primary markets. Furthermore, they play a major role in enhancing market discipline, for instance by stimulating transparency on securities market, and they have the ability to actively promote the interests of minority shareholders of the firms in which they invest.

Future of retirement funds in Namibia

Ladies and Gentlemen, the retirement fund industry in Namibia has certainly grown strongly in line with the global trends. In 2002, the assets under management by retirement funds totalled N$16.3 billion, which is equivalent to 48.5 percent of GDP. This ratio compares well with that of 20.3 percent in emerging markets. Among the 19 emerging market economies, only Chile, Malaysia and Singapore boast with higher pension fund assets in relation to GDP.

The tremendous growth in retirement fund assets in Namibia is ascribed to several factors. As said before, demographic factors are at play here where our young population starts aging too thanks to improved health facilities and services and because of the realisation that the State pension is insufficient to provide for a decent living for the aged. The savings behaviour of Namibians has also changed over time. Contractual savings of individuals have by far exceeded their discretionary savings, meaning that the typical Namibian prefers entering into a compulsory savings arrangement rather than making regular, but voluntary, deposits in other savings vehicles. This also explains why the growth of domestic liabilities of banking institutions has begun lagging behind the liabilities of retirement funds.

Allow me to highlight what I would regard as some of the key challenges that trustees of retirement funds, their members and the regulators are facing before I shed light on the future of the retirement funds in Namibia.

As industry players, you are certainly fully aware of the high incidence of HIV/AIDS among the Namibian population and its potential harmful financial impact on retirement funds and, of course, on the financial system taken together. Because many HIV infected retirement fund members die prematurely, pension schemes may find it difficult to replace lost contributors with new ones. Therefore, the HIV/AIDS pandemic needs to be properly researched and factored into the rules and investment of funds, while NAMIFISA will also have to take a keen interest in the issue and look at possible options and reforms.

Developing countries often lack the pre-existing capacity to regulate financial markets and institutions. Some observers believe that a country that is not able to properly manage an unfunded or funded public pension system, because of administrative inefficiency, shortage of skilled personnel or political interference, would most likely be unable to regulate and supervise a private pension system. Namibia, however, seems to have done quite well in terms of setting up the regulatory framework and institutions to ensure smooth administration of private retirement funds.

In recent years we have seen the progressive integration of the world's economies. Technical progress, improved communications and expanded trade and investment flow have led to a growing globalisation of economic activity. The impact of globalisation on retirement funds comes from enhanced competition, raised mobility of factors of production and a greater need to diversify portfolios globally. Given the improved sophistication of local institutional investors in managing foreign assets, it is therefore understandable that the local retirement fund industry is calling for a greater opportunity to place offshore investments.

(a) Regulatory issues

In most emerging and developing market countries, the regulation of private pension funds is based on quantitative investment limits – the so-called draconian regulation. Regulators in emerging markets consider investment limits to protect pensioners' rights better than regulations based on the "prudent person" rule. The latter rule requires managers to follow high fiduciary standards in investing the funds. It allows fund managers to set their own investment guidelines, encourages financial innovation and avoids the pitfalls of government direction of funds and interference with market processes.

Prescribing quantitative investment limits is generally defended on the basis that the underdevelopment and lack of transparency of local security markets make them susceptible to manipulation and excess volatility; and that the general public, pension fund trustees, and fund managers lack financial sophistication. Investment limits can also be prescribed with a view of obliging pension funds to make a greater contribution to national development in both the real economy and the local financial market.

The downside of draconian regulation is that in some parts of the world they have created distortions in asset management, limited opportunities for diversification and, as a consequence, have hampered the performance of retirement funds.

Ladies and Gentlemen, for the regulators, especially in developing countries, it is important to strike a suitable balance between draconian regulation, on the one hand, and absolute liberty in the way funds are managed and invested, on the other. Draconian regulation is more appropriate for mandatory systems that are newly created in countries with shallow and dysfunctional financial systems and little tradition of private retirement funds.

Today, there are numerous means through which governments regulate pension funds and these are not limited to developing countries, but could be found in many developed and emerging market economies. They include prohibiting or limiting investments in assets considered to be risky, volatile or complex, restricting investments in foreign securities and even going as far as prescribing minimum returns.

The modern trend is to move away from quantitative investment restrictions and to rather empower the trustees with fiduciary powers to take sensible, prudent, strategic, tactical and socially responsible investment decisions. The regulator's responsibilities are reduced to ensuring high corporate governance standards and reasonable returns on investments.

Given these trends, one may ask whether the Namibian retirement fund industry is ready to assume greater responsibility to manage retirement funds without prescriptive investment regulations. There are, in my view, two compelling reasons why I have to answer this question with a qualified no. It is my considered opinion that we are not ready yet and that some form of prescription is necessary to protect the investors and to assure socially responsible investments. I'm not saying that boards of trustees are irresponsible and would not act in the best interest of their members, but the following are factors that need to be considered. First, we are faced with a porous financial system, meaning that savings can flow freely within the CMA, which, in my view, warrants some form of prudential intervention to allow for some domestically generated savings to be invested locally in financial and real assets. Second, the compulsory nature of many retirement schemes in Namibia may warrant some form of prescription. Third, the short history of private retirement funds and the lack of familiarity by large numbers of workers with capital market instruments may justify the State's regulatory duties.

Many of these justifications would become less relevant over time as the reform takes root and gains public acceptance and as capital markets become deeper and more robust and as workers become financially more sophisticated.

(b) Retirement funds' contribution to financial market development

What role can retirement funds play to deepen and broaden the local financial market? In many emerging and developing economies, retirement funds have increased depth and liquidity in the local government bond market. Retirement funds in these economies, however, have had a limited role in the broad development of local equity markets and there is experience of equity markets being negatively affected. This is ascribed to low volumes of corporate bonds and equities which are chased by increasing pension assets, and in some cases causing asset price bubbles. In a few countries, pension funds' exposure to equities is prohibited or kept to a minimum.

Today we know that Regulation 28 has without doubt meant a lot to the development of the Namibian money and capital market and has also made a market for securities issued by private and public sectors. The local investment requirement also paved the way for the establishment of the NSX, the deployment of stock brokers and asset managers. In short, the regulation was instrumental in retaining at least a portion of accrued retirement savings in Namibia and in channelling these savings into productive domestic investments in real and financial assets. Moreover, a number of financial institutions emerged creating additional employment in specialised financial disciplines that were hitherto absent in the country.

However, Regulation 28 in its current form also has its weaknesses. The existing regulation makes little distinction between secure and risky investment opportunities, which should be an important feature of the investment policy of any fund. For example, a fund may invest up to 75 percent of assets in shares, debentures and unit trusts in Namibia and the rest of the CMA. Also, investment in property and property-based instruments, as well as equity investments, which are known for their volatility, are not given lower priority ranking than less volatile investment avenues.

In this context, the large equity exposure of retirement funds in Namibia is a concern and this has also been amplified by the IMF Article IV mission to Namibia late in 2004. The mission concluded that there is a need to introduce prudential investment limits by type of assets, including specific limitations on the equity risk in line with international best practices. The mission further notes that this should apply especially to defined benefits plans which have 60 percent of their assets invested in equity.

As far as the local investment requirement is concerned, it is interesting to note that retirement funds in developed countries have shown a clear "home bias" in their investment allocations and have usually stayed well within officially imposed limits. Even retirement funds operating in countries that have adopted the "prudent person" approach have also exhibited a strong "home bias". Let me state, however, that the local investment requirement only makes sense if sufficient, safe and well-performing assets are available. If the local investment requirement is used as a captive source of funds for unproductive purposes, its benefit is lost.

Let me not dwell further on the regulatory issues, as NAMFISA, I believe, will address you on this specialist subject matter this afternoon. Suffice me to say that I expect a greater Namibian content in investment decision with regard to local savings directed towards retirement funds. Equally, I expect the key industry participants starting to put up local systems to be able to link up to the national payment system that is provided to them.

Conclusion

Ladies and Gentlemen, let me conclude by restating the fact that retirement funds will continue to play a very important role in our economy where the twin problems of unemployment and poverty constitute major development challenges. I hope that you will agree with me that well-targeted and pragmatic government intervention in this sector remains indispensable for the time being. These are serious challenges. Finally, of equal importance to the development of retirement funds are sound macro-economic policies and financial stability. Retirement funds and other institutional investors cannot function properly in an environment of high inflation, unstable monetary developments and unsustainable fiscal conditions. In this respect, I believe, the authorities are giving you the required backing.

Looking at the subjects of papers to be discussed in the course of this conference, I am convinced that numerous policy issues will be raised and useful recommendations will emerge at the end of the different sessions.

I wish you successful deliberations.