



## Pension Funds

### Overview

The growth of contractual savings schemes such as pension funds and life assurance has been an important but relatively low profile development in Botswana's financial system over the past ten years. During the 1990s, contractual savings funds have grown to become probably the largest recipient of household financial savings in the country, with assets of over P2 billion. By their nature, they deal with long-term savings and provide a source of long term capital to finance investment. However, most of this capital is at present invested overseas, and an important challenge is to find ways of improving links between these long-term savings and the country's long term investment needs.

### The Nature of Pension Funds

Contractual savings are so named because they involve a contract to save regularly (usually monthly) over a relatively long period of time. In Botswana the most important form of contractual savings are pension funds, followed by life assurance schemes.

Most medium-sized and large firms in Botswana have established pension funds for their employees. Typically, both employees and employers make a monthly contribution into the fund, which will eventually provide for a pension for that employee when he or she retires. Although contributions are paid by both employer and employee, the employer's contribution is technically part of the employee's remuneration; hence, in economic terms, pension contributions are classed as savings by individuals (or households).

Because these contributions are paid over a long period of time, substantial sums can accumulate, which will only be required for paying out the pension perhaps 20 or 30 years into the future. In the meantime, the accumulated contributions are invested in order to generate further returns that supplement the value of the fund and hence boost the value of the future pension that can be paid out.

Most firms do not manage their pension fund investments directly. Pension fund contributions and assets are generally placed in the hands of professional fund

managers, who invest these funds in a variety of financial instruments and other assets. The objective of the fund management strategies is to generate as high a level of investment returns as possible, without taking a level of risk that would jeopardise the fund's assets and its ability to meet its future pension payment obligations.

Investment strategies are devised within the parameters laid down by actuarial analysis of pension fund liabilities. The actuary will determine what the pension fund's future obligations are in terms of the anticipated level and time profile of pension payments, and ensures that the fund's assets are invested in such a way as to meet these obligations. The assets must therefore be matched to the liabilities in terms of maturity, liquidity, and risk - avoiding, for instance, major currency mismatches of assets and liabilities.

There are two essential elements in minimising risk. The first is avoiding individual high risk investments - where there is a high level of uncertainty over the maintenance of the principal value of assets. Hence pension funds are not well suited to providing venture capital investments. The second element is asset diversification, where a certain amount of risk can be accommodated if funds are invested across a wide enough range of assets with different characteristics.

Hence pension funds are typically

invested in a range of different assets, with blue-chip equities (company shares) making up the largest single proportion. Other assets include bonds (both corporate and government), shorter-term securities such as Treasury Bills, fixed deposits and property. Each of these assets has a different risk/return profile, with equities having higher risks (in terms of volatility of returns) but higher average returns than, say, T-Bills and fixed deposits, which are safe but not particularly rewarding. By investing in a portfolio that includes a wide range of such assets, the risk/return combination can be improved. Risk is also reduced by investing across a range of markets in different countries and currencies. Because of the very long time horizon of pension fund investments, pension fund managers can - by investing predominantly in equities - benefit from the generally high returns on stock market investments without being unduly concerned with the short term fluctuations that stock markets are often subject to.

### Life Assurance Funds

A closely related type of contractual savings is life assurance. Here a policyholder makes regular premium payments towards a policy that will mature when he or she reaches a certain age, or, alternatively, if the policyholder should die before reaching that age. Such payments are also typically made over a long period of time,

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and also give rise to an accumulated fund that can be invested to generate further returns for the policyholder. Because they are closely related to pension funds, life assurance funds are often managed by the same fund managers. Together, pension funds and life assurance funds make up the bulk of long term savings generated within an economy.

## PENSION FUNDS IN BOTSWANA

Pension funds in Botswana have grown rapidly over the past ten years.

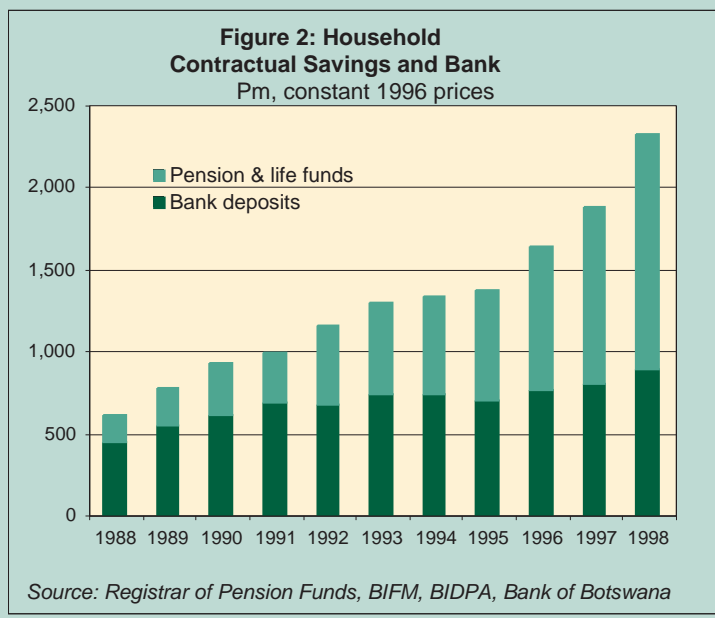
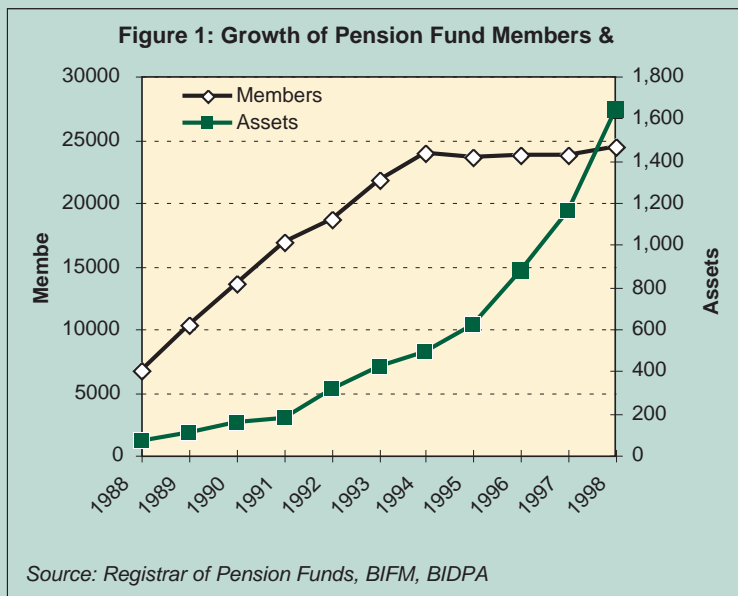
\* The total number of employees who are members of pension funds has grown from 6 700 in 1988 to 24 400 in 1998; an increase from 6% to 17% of all formal sector employees in the private and parastatal sector over this period. These employees are mostly those at middle and senior levels.

\* Total assets under management (including both pension and life funds) have grown from P64m in 1988 to P1 650m in 1998 and an estimated P2 200m in 1999 (see figure 1), an average growth rate of 36% a year in nominal terms and 25% a year in real terms.

\* Annual contributions have grown from P8m in 1988 to P84m in 1998, with average annual

contributions per member rising from P1 142 to P3 456 - keeping slightly ahead of inflation.

It is interesting to note that the growth in members was most rapid between 1988 and 1994, but has tailed off since then - indicating that most potential pension fund members have by now signed up. Growth in assets has, however, continued steadily, partly reflecting the high returns that pension funds have earned in recent years.



While the Registrar of Pension Funds has records on just over 100 funds, most of the assets are accounted for by just a few of the largest funds. Indeed, total pension fund assets are dominated by the

Debswana Pension Fund, which had assets of around P600m in 1998, accounting for over 40% of total pension fund assets. The next largest are those of the banks and some parastatals.

The rapid growth of contractual savings has also boosted their position relative to the size of assets and liabilities held

by the banks, and in particular relative to the size of deposits held by households. In 1988 pension and life assets were equivalent to only 8% of assets of the banks, but by 1998 this had risen to 25% - whereas pension fund assets grew by 36% a year, bank assets grew by only 21% - compared with inflation averaging 11% over the same period. Furthermore, in 1988 pension and life assets were equivalent to only 35% of the bank

deposits held by households. Since then, household deposits at the banks have been growing relatively slowly - 17% a year on average - and by 1996 pension and life assets had become larger than household deposits in the banks, and by 1998 were equal to 160% of household bank deposits. At the beginning of the 1990s bank

deposits represented the largest single financial asset of the household sector, and were the main form in which households kept their financial savings. However the 1990s saw a major

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shift in the structure of household savings, so that by the second half of the decade, pension and life assets were a more important financial asset for households and hence a larger repository of household financial savings (see figure 2). The growth of savings in the form of pension and life assets also means that the trend of decreasing net savings with the banks by households (so that households are now net borrowers or dis-savers with the banks) is less worrying that it would have been otherwise.

**INVESTMENT OF CONTRACTUAL SAVINGS**

As we have seen, pension and life fund managers now control assets of over P2 billion on behalf of households. The way in which these funds are invested is therefore of considerable economic importance.

There are a variety of legal restrictions imposed on how these funds can be invested, which are mainly aimed at protecting members and ensuring that their savings are not jeopardised by excessively risky investment strategies (which could put their future pensions at risk). These restrictions, as well as other rules governing the operation of contractual savings schemes, are set by the Registrar of Pension Funds, located in the Ministry of Finance and Development Planning. In addition, funds have historically been subject to exchange control regulations on the amounts that could be invested outside of Botswana (when exchange controls were abolished earlier in 1999, this proportion was 70%; in the absence of exchange controls, a similar restriction has now been imposed by the Registrar).

As figure 3 shows, in recent years the amount of offshore investment by institutional investors has increased sharply. While not all fund managers invest the maximum amount offshore, the general level

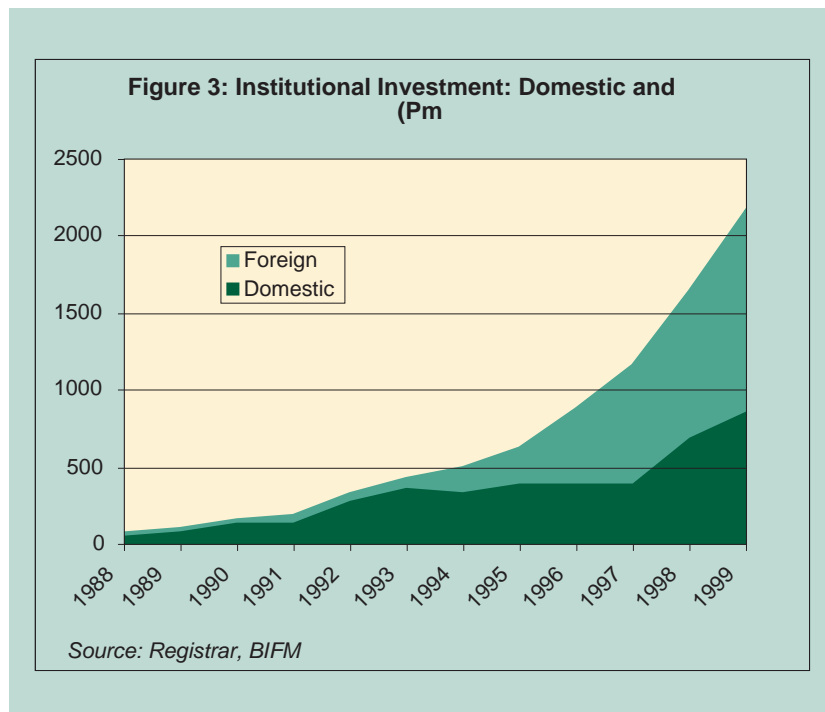
of offshore investment has been close to the limit. This has brought some criticism of pension and life funds, for not investing sufficiently within Botswana. While this criticism is at least partly misplaced, it does raise the question of how to improve the channels through which pension fund assets can be used to promote investment in Botswana - a point which we return to below.

Pension funds are also important investors in the local stock market, in that they are by far the most important local holders of shares on the Botswana Stock Exchange. Pension fund purchases of shares have been one reason for the relatively good performance of the BSE (by international and emerging market standards) in recent years. Indirectly, this encourages other companies to come to the market for listing and capital raising by reducing the cost of share capital for firms. Pension funds have also been important purchasers of bonds issued by parastatals (Botswana Development Corporation and Botswana Telecomms), thus boosting the investment resources available to these companies.

With respect to offshore investment by pension funds it is

important to note that Botswana has a surplus of savings over investment. Therefore it must be the case that there is a capital outflow from the economy as a whole as the country builds up foreign assets equal to the gap between savings and investment (which also equals the current account surplus on the balance of payments, or the capital account deficit). This is a macroeconomic reality. If the pension funds did not export capital, some other institution (such as the commercial banks or the Bank of Botswana) would be doing so in order for the macroeconomic accounts to balance. In a sense, the export of capital and the purchase of offshore assets by pension funds is simply an inevitable symptom of Botswana's generally high savings rate.

In the light of this, any moves to encourage or require pension funds to keep more money onshore must be accompanied by an increase in the availability of investment opportunities within the country that offer returns matching those of offshore investments. Without this, there would be no change in the macroeconomic balance or the overall outflow of funds. It could also distort local markets (such as



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the stock market and the property market), and could reduce investment returns and jeopardise future pensions.

More generally, the Botswana economy lacks mechanisms for absorbing long term savings and applying them to long term investments, especially given the low-risk needs of institutional investors. Although there is a domestic stock market, it only covers a limited range of economic activities and a small number of companies. There are no channels whereby institutional investors can invest in established activities such as mining, and access to emerging export-related activities such as manufacturing (e.g., the motor industry and textiles) and tourism is limited. Investment in listed domestic equities is largely limited to activities related to domestic consumption, which can yield good returns but tend to be highly cyclical. Furthermore, the attractiveness of property investment is constrained by the short term nature of commercial leases in Botswana (typically 5 years, compared to 15 years or more in developed countries). Finally, the lack of government bond issues either domestically or internationally closes off another investment option that institutional investors typically make extensive use of. This gap also inhibits the emergence of a market-determined domestic yield curve that would help corporate bond issuers to price debt and hence encourage greater use of such bonds.

Nevertheless, contractual savings funds do provide a source of long term savings that could go some way to meeting the demand for long-term investment finance in Botswana - an area where constraints are sometimes cited by

potential investors. One way to achieve this is to encourage more companies to list on the stock market, which would enable them to tap into this source of funds. An important advantage of this approach is that it provides a market mechanism for evaluating good and bad investments - companies that perform well by making good investments will find it easier to raise capital, and hence funds will tend to be directed towards more worthwhile investments.

A second approach is for fund managers to take a more active role at board level in promoting strategic long term investments by companies in which they have substantial shareholdings - and in using those shareholdings to discipline poor management if that is a problem. Thirdly, fund managers can play a more strategic role in the economy - reflecting the substantial funds at their disposal - by promoting new investment projects and bringing together the parties necessary to make such projects succeed.

## A GOVERNMENT PENSION FUND?

The above discussion refers only to employees of firms in the private and parastatal sectors, whose employees are members of company-specific pension funds. The largest single employer in Botswana is of course government, which accounts for around 40% of total formal sector employment of 240 000. Government employees with permanent and pensionable status do receive pensions, but these are "unfunded", meaning that they are paid out of general government revenues (taxes) rather than from a pension fund. It is estimated that the government's current pension liability is some

P3-4 billion (i.e., the present value of future pension obligations). Fortunately, government has some P20 billion in savings at the Bank of Botswana, and so there is no problem of resources to finance its pension liability. However, if these savings decline, as they will do if government runs budget deficits rather than surpluses, there could potentially be a problem with pensions funding in future. As a result, it has been argued that government needs to earmark a specific portion of its savings as a pension fund that it could not use to finance other types of spending. It could also sustain this fund by making explicit contributions itself, as other employers do, and by requiring government employees to make contributions from their own salaries. At present the government's savings are managed by the Bank of Botswana as part of the foreign exchange reserves Pula Fund. However, if a government pension fund were established, the "best practice" management guidelines for this fund might not be the same as those of the Pula Fund, which is managed according to different, broader national objectives (i.e., it is not managed with the objective of maximising the pensions of government employees). For instance, a pension fund would typically have a much higher proportion of equities than the Pula Fund, and hence would be expected to earn higher returns over a long period. This would reduce the cost to government of meeting specified pension commitments. However, it would be essential to ensure that a government pension fund were protected from pressures to use these resources for investments that are motivated by political rather than economic objectives.

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