

How the COVID-19 crisis is impacting African pension fund approaches to portfolio management

By Jacqueline Irving

Ahead of the onset of the COVID-19 crisis, local pension sectors had been growing rapidly across the African region since the late 2000s. Further development and appropriate regulation of local pension funds and other institutional investors with longer-term investment horizons could enable these financial institutions to become important sources of local finance for infrastructure and other longer-term socioeconomic development needs.

This note assesses the short-to-medium term impact of the COVID crisis on emerging African pension fund sectors' portfolio management approaches and related challenges and opportunities that the crisis has brought to light. From a policy-response perspective overall, the crisis has underscored the need to give greater priority going forward to increasing the level of longer-term domestic savings in African economies and providing for more extensive participation, including by those in the informal sector. The crisis has also elevated the broader policy discussion on determining the best means of tapping into pools of domestic capital, where they exist, which will be important to a sustainable economic recovery.

I. Characteristics of the largest emerging Sub-Saharan African pension markets

Although one or a few large state-run schemes continue to predominate in several of the region's countries, privately managed, employer-based pension schemes have been emerging and proliferating in an increasing number of the region's economies. This has occurred as the shift from defined benefit (DB) to defined contribution (DC) schemes has been gaining momentum across the region over the past decade and a half under pension system reforms that allow a larger role for privately managed pension fund administrators that have targeted growing middle classes.¹ The shift also has been spurred by increased funding risks in the form of growth of liabilities outpacing assets as well as higher life expectancies resulting in an inability to maintain fully funded systems. Even in the case of DC schemes in some markets experiencing economic challenges in the years preceding the COVID crisis, a shortfall in contribution remittances to schemes negatively impacted funding risks.

The overall shift toward privately managed and defined contribution funds in the region since the late 2000s has

provided a positive competitive spur to fund management practices within national pension systems and has contributed to a trend of rapid increases in assets under management (AUM). Total AUM for Nigeria’s pension sector, the largest of the five top-ranking national pension sectors in Sub-Saharan Africa (excluding South Africa) based on AUM, increased more than 9.5 times since end-2006, to an estimated US\$33.3 billion by end-2019, a few months ahead of the onset of the crisis (Table 1).

A few to several large funds continue to predominate in some of the region’s markets, however. Even in Namibia’s sizeable pension sector, the top five pension funds were holding just over three quarters of the sector’s total investments and the largest fund held more than two-thirds of the total in 2019.² This prompted the regulator

NAMFISA to declare a concentration risk, particularly in a scenario where the five largest funds experience “extreme shocks” simultaneously.³

At the same time, participation rates in pension fund systems overall remain relatively low. This is largely due to the still-predominant role of informal sector jobs in the region’s private sectors. In several markets, such as Kenya, policy priorities for the pension sector in recent years have included developing schemes to attract pension savings for workers in the informal sector, which can comprise up to 90 percent of the economy.⁴ High financial literacy rates as well as low, unstable income levels and low life expectancies keep savings rates relatively low in the region and contribute to the low pension fund participation rates.⁵ Gross savings relative to GDP averaged 19.9

Table 1

Largest pension fund sectors by assets under management (AUM) in Sub-Saharan Africa (excluding South Africa)¹

	Total pension fund AUM at year-end (US\$bn-equivalent) ²		Total pension fund AUM relative to GDP (%)
	End-2006/1	End-2019	End-2019
Nigeria	3.5	33.3	8.4
Kenya	1.8	12.8	14.6
Namibia	3.3	12.3	84.6
Botswana	5.4	8.8	47.8
Mauritius	3.0	4.7	33.0

Sources: Estimates for 2019 are based on data sourced from national pension fund regulator periodic reports. AUM data estimates for 2006 for Kenya, Namibia, and Nigeria are sourced from Irving and Manroth (2009). AUM data estimate for 2006 for Mauritius is sourced from OECD, *Pension Markets in Focus 2007*. AUM data estimate for 2010 for Botswana is sourced from NBFIRA, *2011 Annual Report*. Nominal GDP estimates are for 2018 based on most recent available data from the World Bank WDI database.

/1 End-2010 for Botswana due to lack of publicly available AUM data prior to this reference date.

1 South Africa’s more developed pension fund sector is the region’s largest ranked by AUM, estimated at US\$180.8 billion equivalent as of end-2018, according to data sourced from the EIU *South Africa Financial Services* report, Q3 2019.

2 Total AUM estimates are for end 2019 for Botswana, Kenya, Nigeria, and Namibia; total AUM estimates for Mauritius are as of end-2018 for the private pension schemes and Sept. 2019 for the National Pension Fund.

percent as of 2018 for developing economies in Sub-Saharan Africa, compared with an average 41.7 percent for East Asia & Pacific and a global average of 25.3 percent.⁶ Perception issues about the role of contractual savings institutions have also impeded participation rates: in certain countries (in Niger, for example), some people have viewed insurance services as improper because they involve speculating on an individual's lifespan.⁷

Overall, DC schemes are less costly, more transparent, and easier to manage than DB schemes. DC schemes and their members may place more emphasis on returns and asset growth over the short term, however. In contrast, DB plans overall are meant to be structured to take more of a longer-range view to generating returns to reach a predetermined target over members' working life spans so that they have sufficient income at retirement.⁸ Although an overall shift from DB to DC has been underway in most sizeable pension markets across the African region for more than a decade,⁹ the relative prevalence of DB versus DC schemes continues to vary by country. Moreover, the largest pension fund regionwide and one of the largest pension funds in the world, South Africa's Government Employees Pension Fund, is a DB fund.¹⁰ While the Botswana Public Officers Pensions Fund (BPOPF) remains the largest pension fund in that market, it was reformed in 2001, transitioning from a DB to a DC fund. Pension funds have been mostly DC in Nigeria's pension system for more than a decade, a characteristic that gained momentum following pension reforms in 2014. The systems in Kenya, Mauritius, and Namibia are more mixed. Kenya's system includes a large DB social security fund, the National Social Security Fund, although privately-managed (DC) occupational schemes have been increasing rapidly in number over the past decade. Similarly, the Government Institutions Pension Fund (GIPF), Namibia's only DB scheme, is a predominant player, while DC (occupational) pensions are common in the private sector. In Mauritius, the DB scheme for the civil service was closed to new public sector hires after 2012, as they have access to a funded DC scheme. Two other large players in Mauritius's pension system are the National Pension Fund, a funded DB scheme for private-sector workers, and the National Savings Fund (NSF), a compulsory DC scheme, along with smaller voluntary (DC) occupational schemes.

More recently, DeMarco and Stewart (2020) have analyzed how DC systems generally tend to expose members more directly and immediately to market volatility while DB systems are more directly impacted, including in this crisis, by the financing challenges related to eroding assets and increasing liabilities with interest rates low and falling. Government-funded DB schemes are also directly impacted by the severely limited fiscal space in the current context. In contrast, the actual members of DB schemes will not experience an immediate impact to their contracted pensions from the crisis or market volatility, as their sponsoring employers assume the risks where pension assets do not cover liabilities.¹¹ Although the assets in DB pension systems may be subject to the same market forces as DC schemes, the reactions of the managers of those assets will vary depending on their particular asset allocation strategy and how actively they manage scheme assets, which is typically predetermined by prescribed limits. (As mentioned above, DB plans are intended to be structured and managed for the longer term, setting financial targets to correspond with working life spans). Given that DC plan members maintain direct access to how assets are allocated within their individual portfolios, they may suffer further losses to their contractual savings where members opt to take a shorter-term perspective in the face of volatility, than they would have if taking a more patient, longer-term view to their investments. The discussion in Section III below elaborates further on some of the particular characteristics of African pension systems and capital markets more broadly that likely have impacted their portfolios and how they are being managed.

II. Overview of direct impact of the crisis on the pension fund sector

In the short term, the COVID crisis can be expected to have a strong impact on the pension fund industry in African countries through a few main channels. **Broadly speaking, the crisis is impacting and will continue to directly impact pension funds via members' reduced contributions, early withdrawals, and shifts in and likely reduced investment overall across asset classes by the funds themselves.** However, investments of contractual savings institutions such as pension funds and life insurance firms are typically more stable in a crisis than

bank deposits held by households and businesses. Bank deposits can be withdrawn from banks more easily than pension savings, particularly in Sub-Saharan Africa where deposit tenors tend to be at shorter terms generally than in other regions. Moreover, early withdrawal of pension savings typically is subject to tax penalties.

One initial and direct impact of the crisis on defined contribution pension funds has been the impeded ability of employers, particularly in hard-hit sectors such as tourism and hospitality services, to make their periodic contributions to funds on behalf of their employees.¹²

Kenya, for example, has seen its hospitality sector heavily impacted, while other sectors have been relatively more resilient in the crisis. Pension fund schemes also face the risk of mass employee exit from funds due to job losses, particularly in hard-hit sectors. Pension fund regulators in a number of countries have come under pressure to relax employer contribution requirements, particularly in industries with large fund member job losses and unpaid leave. Arguments in support of these measures have included that the resulting reduction in labor costs may enable employers to retain more employees.

Box 1

TASK proposal in Kenya to leverage pension assets to combat the COVID crisis

A proposal by the Actuarial Society of Kenya (TASK) aims to mobilize assets held by the pension industry to finance interventions needed to mitigate the health and economic implications of the COVID crisis¹. Under the proposal being discussed as of mid-May 2020, pension funds would be asked to 1) voluntarily defer the yields earned from their holdings in local government securities and 2) reinvest in short-term government securities any interest payments due for a period of up to two years. With approximately 40 percent of total pension sector AUM held in government securities, TASK expects these measures to help close the fiscal gap by an amount estimated at K sh60 billion (US\$560mn) a year in a policy context of limited fiscal space. Any such deferred funds reportedly would be ringfenced for designated uses to respond to the crisis, including financing public health interventions, providing for household income and food security, protecting jobs, and providing economic stimulus packages for both large manufacturers and MSMEs. TASK further proposed that the state-owned National Social Security Fund provide the government a “soft loan” of up to K sh25 billion, earmarked for combatting the negative socioeconomic impact of the crisis.

Critics of the proposal, including the Association of Kenya Insurers (AKI), pointed out that pension schemes rely heavily on the interest earned on government securities for their more liquid (immediate) financing needs. Although the vast majority of pension fund liabilities tend to be longer-term, pension funds need to make regular payment of pension benefits to retired members and unemployment and other periodic payments.

The AKI also called for clarity on whether the government would be expected to ultimately pay the deferred interest to the pension funds. Concerns also center on whether such a remedy would constitute a form of de facto domestic debt restructuring, potentially impacting the sovereign credit rating.

At the same time, employers, particularly in hard-hit sectors, are facing revenue declines and potential losses, which impedes their ability to make the usual periodic contributions to pension schemes on behalf of employees. Under the TASK proposal, statutory contributions by employers and employees to the NSSF, NITA, and possibly the NHIF would be suspended for a period of six months. The proposal also seeks to make it possible for pension scheme members to borrow against up to 25 percent of the funds held in their account, up to a maximum loan of Ksh500,000.

1 The Actuarial Society of Kenya (TASK) Covid-19 Proposals to the Government of Kenya, April 2020, http://www.actuarieskenya.or.ke/wp-content/uploads/2020/04/TASK-Force_Covid-19-Proposals-to-Government-of-Kenya-April-2020.pdf.

As the scale of the economic impact of the COVID crisis became increasingly apparent, union and/or pension fund members in some countries began pressing governments to tap pension funds to help alleviate some of the immediate negative economic impact of the crisis, including on particular sectors. Policy measures under consideration in a number of markets have included requiring the pension schemes to release some amount of their assets without penalty to members as a means of enabling them to meet basic needs in the face of sudden unemployment or reduced working hours.¹³ In Nigeria, for example, the government considered requiring the contributory pension scheme (PFAs) to release some amount of their capital as a “palliative” to help households cope. Proponents of these proposals have argued that such measures could actually lead to an increase in DC pension fund membership after the crisis as nonmembers would see additional merits to pension fund membership during a severe downturn. A spokesperson for Nigeria’s pension regulator, the National Pension Commission (PenCom), pointed out recently that Section 7(2) of the Pension Reform Act 2014 already permits an employee disengaged from employment before age 50 and unable to secure another job within four months to withdraw up to 25 per cent from his or her account.¹⁴ Nigeria’s PFAs and others opposed to going beyond what Section 7(2) already provides pointed out that 1) this would be counter to the Pension Reform Act guidelines on how funds managed by the PFAs should be used and 2) the majority of the funds are in relatively illiquid, longer-term asset classes including government bonds.¹⁵

In the context of limited fiscal space, some African governments have turned to pension funds and other assets managers to help provide fiscal support, including by accepting a temporary reduction in yields from their holdings of government securities. As an immediate response to the crisis, for example, Ghana’s Ministry of Finance called on pension funds and other assets managers to accept a 200-basis point reduction on yields from short-term government securities such as T-bills and 364-day paper. According to the Ministry of Finance, this would be expected to reduce government expenditure on interest payments by over GHS300 million, as part of measures to help “close the fiscal gap” so as to better

respond to the impact of the crisis.¹⁶ Also in Ghana, the government’s newly introduced Coronavirus Alleviation Programme (CAP) is seeking additional funding, including by partnering with pension funds to create guarantees and first-loss instruments.¹⁷ In Kenya, a similar proposal aims to enlist the pension sector in agreeing to defer yields on its investments in local government securities and reinvest interest payments due for up to two years (see Box 1).

It is clear that quick and creative solutions may be needed in the short-term to raise financing to combat the severe direct effects on health systems, extensive insolvencies, job losses, and additional fallout from the crisis.¹⁸ It will remain important, however, for policy makers and market participants to devise solutions that don’t compromise the main objective of pension funds through and beyond the crisis—safeguarding their role as contractual savings institutions for the longer term.¹⁹

III. Expected impact in the short-to-medium term on large emerging pension systems’ portfolio anagement

This main section of the Note draws on recent asset allocation data for the five largest emerging pension systems in Sub-Saharan Africa to assess the expected impact of the crisis on portfolio management in these markets in the short-to-medium term.

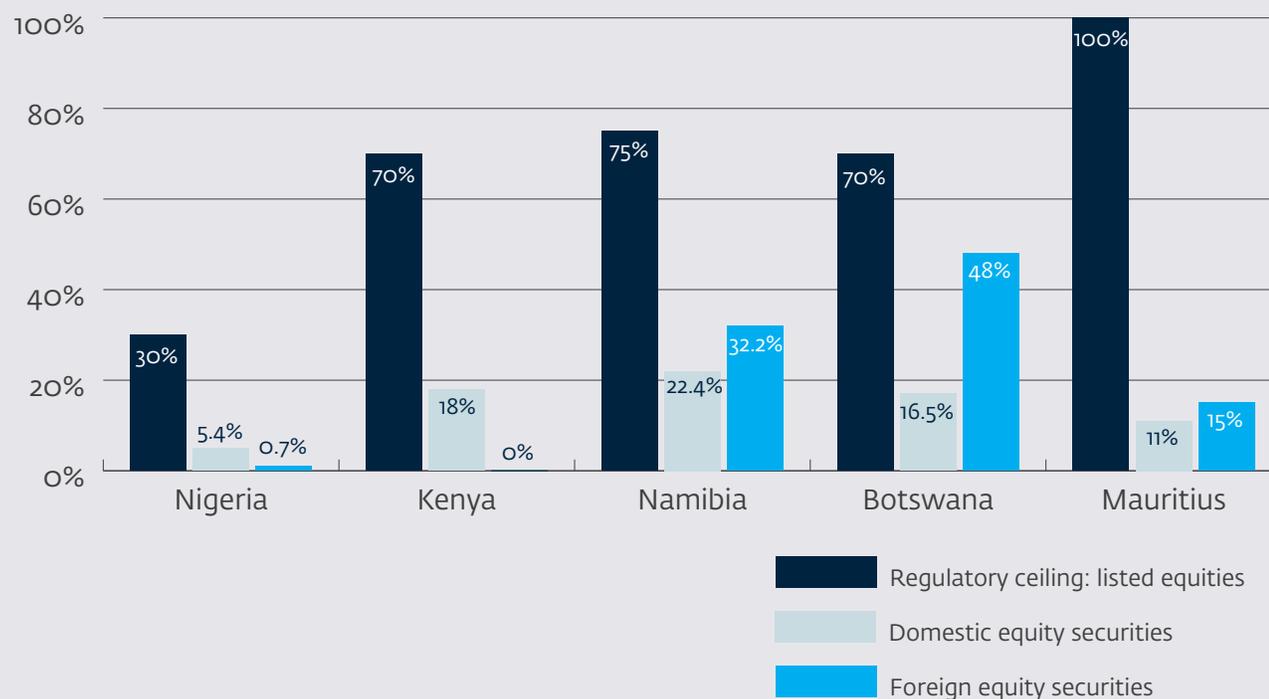
Because most African local pension funds, including privately managed funds operating DC schemes, have tended to hold a relatively limited share of their portfolios in listed equities and other corporate securities, their limited exposure is expected to have shielded their portfolios from the more immediate crisis impact of downturns and volatility in capital markets.²⁰ Even in Nigeria, Africa’s largest economy and the second-largest pension fund sector on the continent based on total AUM, pension fund portfolios overall were affected much less than counterparts in more developed economies. Total AUM continued to increase in local currency terms after the onset of the crisis (albeit at a slower rate), from ₦10.2 billion at end-2019 to ₦10.3 billion at end-March 2020, to ₦11.086 billion at end-June 2020.²¹ This was at least partly because the industry’s share of total AUM in

equities going into the market downturn was relatively low, at just 6.11 percent of total AUM as of end-2019²²—and considerably below the upper end of the regulated ceiling for equities as an asset class of 30 percent of AUM (Chart 1).²³ This also partly reflects a relative “lack of product:” equity markets remain relatively small in terms of market capitalization and number of listings in Nigeria and the other four countries with the region’s largest

emerging pension sectors.²⁴ In general, the region’s local capital markets, excluding the Johannesburg Securities Exchange, remain underdeveloped—having a relatively small number of listings and market capitalization with limited trading activity—which has limited the exposure of pension funds to listed securities. Some pension sectors such as in Botswana and Namibia, however, were significantly more exposed to equities as an asset class

Chart 1

Share of AUM held in listed equities prior to COVID crisis vs. regulatory limits, percent of AUM as of end-2019¹



Sources: Based on data and information sourced from national pension fund regulators including periodic reports; for Mauritius, OECD, *Annual Survey of Investment Regulations of Pension Funds*, 2019.

¹ Regulatory limits by asset class are typically more restrictive by single issuer and for sub-asset classes: for example, in Namibia a 5 to 10 percent of AUM limit per issuer applies as well as a 10 percent of AUM limit for dual listed shares. For Nigeria, ceilings for share of AUM held in listed equities range from 5 to 30 percent, depending on type of pension fund. For Botswana, allocation by asset class data are for end-2018 (most recent published); according to the Botswana Financial Stability Council’s *Financial Stability Report 2020*, 64.2 percent of total AUM was invested in equities at end-2019, but a breakdown for the domestic vs. foreign equity allocation was not included. For Mauritius, the share of AUM by asset class is for the National Pension Fund only (as of end-March 2019) due to available data limitations (<http://socialsecurity.govmu.org/English/Department/National%20Pensions%20Scheme/Pages/PortFolio-of-NPF-as-at-June-2010.aspx>). For Namibia, domestic vs. foreign equity securities allocation was estimated based on reported total amount allocated to equities and reported share of AUM held in domestic vs. foreign asset classes in NAMFISA-Bank of Namibia, *Financial Stability Report*, April 2020.

when the crisis hit, holding an estimated 64.5 percent and 54.6 percent of total AUM, respectively.

According to NAMFISA, the regulator of Namibia's pension sector, pension fund assets grew by 9.4 percent in 2019, largely driven by improved equity market performance in the final quarter. This largely reflected Namibia's pension fund industry exposure of 47.9 percent to the Johannesburg Securities Exchange All Share Index, which increased particularly during the fourth quarter of 2019. With more than half of Namibia's pension fund sector's AUM in equities as of end-2019, equity market volatility caused by the crisis was expected to have a significant negative impact on AUM in the short term.²⁵

However, the longer-term nature of most of the liabilities of pension funds should confer longer-term investment horizons on these investors (where feasible). This implies that losses incurred by pension funds with more exposure in equity markets, such as in Botswana and Namibia, potentially could be recouped over the medium-to-long term, as share prices recover. Funds domiciled in Namibia and Botswana also tended to have relatively more diversified portfolios in terms of having significant holdings in nonlocal assets (see below). The Board of the Botswana Public Officer's Pension Fund responded relatively quickly to release a public notice reminding its members that the fund maintains a long-term investment strategy, "which allows sufficient time for recovery," as well as an approach that diversifies across different asset classes beyond equities.²⁶

Poor equity market performance in the near term could affect the funding level of pension funds with significant holdings in equity securities, however.²⁷ In Namibia, for example, the crisis has increased market risks with a potentially negative impact on DB pension fund solvency as well as funding levels. NAMFISA is closely monitoring pension fund funding levels, requesting that funds prepare plans on how they would restore funding levels in the event that limits are breached. According to a joint NAMFISA/Bank of Namibia assessment, if funding levels remain below 100 percent indefinitely, DB funds would be unable to pay out retiree pensions.

Where listed equity share prices have declined since the crisis onset, many pension funds are taking advantage of the opportunity to selectively buy equities that have been issued by strong, financially sound firms at the lower prices, according to anecdotal reports from credible pension market sources. In this way, pension funds can seek to maximize returns for contractual savers for the longer term, as the market recovers—while simultaneously providing investment needed to raise share prices. According to senior managers with capital markets stakeholders in Ghana and Kenya, as of mid-May 2020 local investors were active in taking up equity securities trading on their exchanges, motivated by valuations.²⁸ Total equity and bond portfolio outflows from Africa at record levels since early this year underscore the importance of a well-functioning local institutional investor base with capacity to take up issues.²⁹

As African pension funds have been reviewing their investment strategies over the past few months in the context of the crisis, there has been a significant move toward a more defensive investment strategy by many funds, however. According to one market source in Kenya's pension industry, close to 75 percent of AUM is currently held in fixed-income securities. As of end-2019, just ahead of the onset of the crisis, relatively well-developed pension sectors in the region, such as in Nigeria and Mauritius, already held as much as nearly one-third and just under one-quarter of total AUM, respectively, in relatively liquid, short-term assets (Table 2).

In the short-to-medium term, African pension funds will likely experience losses (particularly in real terms) from the impact of monetary policy responses to the crisis – reductions in policy rates. The lower interest rates will reduce returns on relatively liquid asset classes such as bank deposits and short-term government securities. This impact could be further compounded in markets (e.g., Ghana) where policy makers have requested that pension funds accept a reduction in yields from their holdings in local government securities.

In high economic growth periods as well, African pension funds overall have tended to hold a relatively larger share of their AUM in liquid, short-term assets, however, often

Table 2

Share of AUM held in relatively liquid assets prior to the COVID crisis percent of AUM as of end-2019¹

Asset class allocation as share of total AUM (%)				
	Liquid deposits/ money market instruments/cash	Short-term government securities	Total government securities (all maturities)	"Total fixed-income securities"
Botswana	9.8%	...	18.1%	
Kenya	4.2%	...	40.1%	
Mauritius	2.0%	21.0%		
Namibia	8.4%	...		27.1%
Nigeria	12.1%	18.4%		

Note:... indicates data not available. Botswana, Kenya, and Namibia do not report a breakdown for assets allocated to short- vs. longer-term government securities. Available end-2019 data for Namibia reports assets allocated to total fixed-income securities, which would include government securities (further breakdown not specified).

Sources: Based on data and information sourced from national pension fund regulators including periodic reports.

¹ The table plots share of AUM held in short-term government securities, time deposits, and cash at end-December 2019 for these markets, where data breakdowns are available. For Botswana, allocation by asset class data are for end-2018 (most recently published data). For Mauritius, the share of AUM by asset class is for the National Pension Fund only (as of end-March 2019) due to available data limitations.

because of a lack of alternative investment instruments.³⁰

Where financial sectors are underdeveloped, it is not uncommon even for investors with largely longer-term liabilities such as pension funds to hold a large proportion of their portfolios in relatively lower-yielding assets such as bank deposits and short-term government securities. However, investors with longer-term liabilities ideally should not hold a significant share of their assets in relatively low-yielding, short-term assets from a risk-return standpoint. Moreover, while cash and very liquid short-term instruments such as treasury bills are traditionally considered relatively “risk-free assets,” they become relatively riskier assets in a longer-term portfolio sense because they must be rolled over at uncertain future interest rates.³¹ Where these short-term assets are in the form of government securities, this can also potentially create a captive market for government debt securities issued at suboptimal short terms and may impede capital market development.³²

Merits of a diversified portfolio approach

In the medium term and beyond, where pension schemes have diversified their portfolios, this is expected to provide some protection from total losses on the investment side. Diversification of pension systems in terms of their members’ industry sector coverage may also enhance overall system resilience.³³ Where a full range of sectors are represented in the national pension system—ranging from financial and energy to the public sector and consumer goods manufacturing—the broad-based pension system may be better positioned to sustain shocks that may affect different sectors in different ways. Although the COVID crisis has impacted economies and their industry sectors severely across the board, certain sectors (such as hospitality and other services) may be more heavily impacted than others.

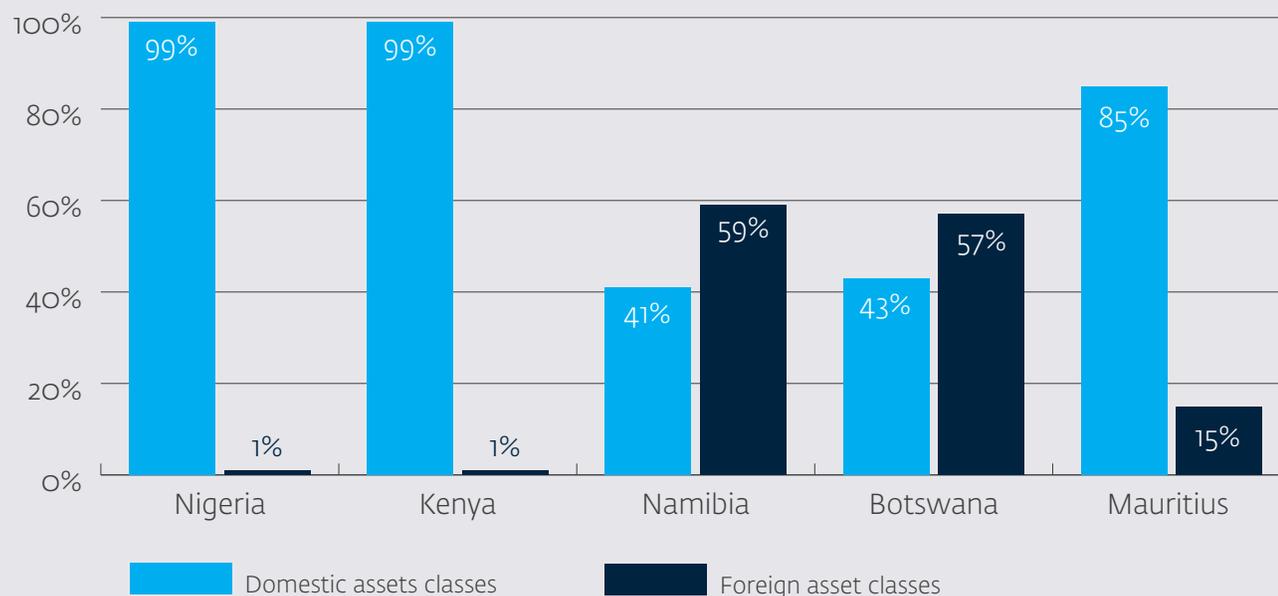
A more diversified portfolio geographically could provide some means of protection in the event of negative

shocks such as the COVID crisis, particularly where markets are not closely correlated in their movements. A relatively high exposure to foreign asset classes could increase risk and portfolio losses, however, at least in the short term. The risk of these losses being significant is considered relatively low overall, however. Pension system regulators in African and other emerging systems tend to set relatively low ceilings on the amount of AUM allocated to foreign assets.³⁴ Moreover, as the crisis broke, the vast majority of assets held by the region's largest emerging pension systems were held locally, based on asset allocation data as of end-2019 (see Chart 2). The two largest emerging pension sectors in the region based on AUM, Nigeria and Kenya, each held only 1 percent of their total AUM in foreign-domiciled asset classes.

In the few months ahead of the crisis, nearly 60 percent of total assets held by pension fund industries in Botswana and Namibia were in asset classes domiciled outside of their borders, however.³⁵ These were significant investment amounts relative to the size of these economies. As of March 2019, Botswana's local pension fund offshore investments were an amount equivalent to 27 percent of GDP. Motives included the prospect of generating returns in the global bull market while it lasted: According to a NAMFISA assessment, a rise of more than five percentage points over the year to end-2019 in the share of total AUM by Namibia's pension sector allocated to non-CMA offshore investments likely was attributable to increases in major global market indices such as the U.S. S&P 500 and the German DAX.

Chart 2

Share of AUM held in foreign vs. domestic asset classes prior to the COVID crisis
Percent of AUM as of end-2019¹



Sources: Based on data and information sourced from national pension fund regulators including periodic reports.

¹ For Namibia, share of AUM held in foreign asset classes is further broken down to 35.5 percent of AUM in nonregional foreign asset classes and 23.5 percent of AUM held in nonlocal regional asset classes at end-2019, according to data reported in NAMFISA-Bank of Namibia, Financial Stability Report, April 2020. For the other four country markets, the breakdown of percent of AUM held in local regional assets versus assets outside the region is not available. For Botswana, data are for end-2018 (most recent published). For Mauritius, data are for the National Pension Fund only (as of end-March 2019) due to available data limitations.

Asset allocation data available for Namibia reveals that 23.5 percent of AUM was held in nonlocal asset classes within the Common Monetary Area subregion, as compared with 35.5 percent of total AUM held outside the region.³⁶ This further breakdown is important to consider in the case of Namibia, in particular. As members of the CMA, Namibia and the other CMA members peg their currencies to the South African rand while capital flows freely within this subregional monetary union. In Namibia, the local currency depreciated rapidly against the U.S. dollar in the period since the onset of the COVID crisis through April 2020, reflecting Moody's downgrade of South Africa's credit rating, Namibia's currency peg with the rand, as well as the impact of the pandemic itself. However, the fact that a sizeable share of foreign assets held by Namibia's pension funds are within the CMA would provide some mitigation from the usual negative impact of currency declines on investment portfolios.³⁷ It is likely that Botswana's pension funds also hold a relatively high share of nonlocal currency assets within the subregion: Botswana is a member of the Southern African Customs Union with the CMA members (South Africa, Namibia, Lesotho, and Eswatini) and allocates a large share of its currency basket to the South African rand.³⁸

More cross-border activity within the region—cross-border listings and cross-border investment by African institutional investors—could help overcome national capital markets' impediments of small size, illiquidity, and inadequate market infrastructure. In so doing, this could facilitate the ability of firms and governments in these countries to raise financing for infrastructure and other long-term financing needs. Where a regional approach involves the sharing of market infrastructure, this can reduce costs and improve efficiency. Firms and governments seeking to raise longer-term financing may be able to tap a larger investor base within the region, which can lower costs and improve liquidity. Well-functioning intraregional capital markets may facilitate the development of cross-regional firms and infrastructure projects. However, it is important to bear in mind the importance of appropriate sequencing: regional cooperation and, at a later stage, integration, if carried out at the right pace and in a pragmatic way, could improve the liquidity, efficiency, and

competitiveness of local capital markets, including the “buy side.”³⁹ Adequate progress in developing national financial markets must precede any actual moves to integrate capital markets, however. Too early a move to an integrated securities market could merely create a large, illiquid market—depending on the liquidity and development levels of existing national markets and the extent to which regulatory and tax policy frameworks have been harmonized.⁴⁰

IV. Challenges and opportunities going forward, post-crisis

With growing portfolio assets, and given their largely longer-term liabilities, pension funds operating with appropriate incentives and regulatory contexts have natural incentives to invest more in assets of longer maturity terms. The COVID crisis's impact on the industry has shed new light on **the importance of encouraging a more diversified portfolio approach by pension funds that allows for investment in a range of asset classes as a means of enhancing risk management,** including during times of crisis and economic downturns. Where pension funds diversify into alternative assets that tend to have lower correlations with equity or bond markets, they may gain some downside protection even in the short-to-medium term.

By taking a more diversified portfolio approach, local institutional investors could provide some means of risk mitigation in the event of future negative shocks. The large-scale withdrawals of foreign capital from emerging markets—with a flight to cash and “safe haven” assets by international investors—puts new emphasis on the importance of developing and strengthening local investors with longer-term investment horizons such as pension funds.⁴¹ In this way, the crisis provides an opportunity to deepen local participation in the market.

A lack of a diversified approach to asset management may reflect different factors that can vary by market and level of development. These factors may include national regulatory restrictions on cross-border investment or holding certain asset classes, internally-set investment ceilings and limits, capacity limitations in evaluating

risks associated with newer kinds of asset classes, as well as a lack of investable product. These impeding factors can be addressed through appropriate sequencing and regulation that strikes the right balance in safeguarding pension funds' role as contractual savings institutions while enabling them to maximize returns on investment, including by introducing new asset classes tailored to investor needs and strengthening investors' capacity to evaluate and manage associated risk.⁴²

The COVID crisis also underscores the importance going forward of accelerating the reform agenda so as to bolster and further grow local pension funds/contractual savings institutions in African economies, including by enabling more extensive participation. Coverage ratios remain relatively low across the vast majority of African pension systems—typically less than 15 percent of the labor force. Some countries have made significant progress: For example, Kenya's pension coverage ratio (proportion of the labor force participating in a pension arrangement) was 20 percent as of 2019, up from 15 percent in 2015—albeit still low compared to the global average coverage ratio of 51 percent for middle-income countries.⁴³ A key element of this policy discussion is whether participating in a pension product should be legally mandatory—e.g., deducted automatically from pay—as is common in Latin American markets,⁴⁴ or whether tax and other incentives would be more effective. Mandatory pensions that deduct contributions automatically from salaries would still overlook the vast numbers of workers employed in the informal sector in African economies, however.

With the informal sector comprising up to 95 percent of the private sector in many African economies, extending pension coverage to informal sector workers is a priority if there is to be more comprehensive participation across the labor force. While it is clear that micropension products geared to informal sector workers could help boost the participation of the active labor force in access to savings for retirement, there is some debate about whether and to what extent these products should allow early access in a crisis. Proponents argue that a clear framework that sets limits on permissible controlled and temporary access in the face of a severe negative shock could enable micropensions to provide some means of

cushioning households against the worst immediate effects in the absence of any other form of savings, financial support, or adequate social welfare safety net.⁴⁵ Opponents point to the need for more financial literacy/education—both in the educational system curriculum and at the point of microcredit and other microfinance product transaction—to actively promote a culture of savings, even among the very poor with limited means.

The crisis also has shed new light on the need for countercyclical microfinance savings products to build resilience to future shocks. There is scope, for example, to apply the digital financial services (DFS) technology used in online microloan platforms that have emerged in financial sectors across developing economy regions to innovate and promote online platforms for longer-term microsavings for retirement and other longer-term financing needs. In this respect, there is large, untapped potential for take-up of DFS-enabled longer-term savings microproducts geared to the region's large young-adult populations.

From a policy response perspective, the crisis has underscored the need to give greater priority going forward to increasing the level of longer-term domestic savings in African economies. Although the immediate policy priority is, of course, implementing short-term measures to help support businesses and vulnerable groups, the crisis has highlighted the fact that more extensive access to robust pension systems, and other longer-term savings schemes more broadly, can help provide a safeguard to economies in the event of future negative shocks. Through contractual savings institutions, private individuals and their households can better manage their risks, grow their savings, and smooth their consumption over time. Where they seek out longer-term investment opportunities that maximize returns and diversify risk while safeguarding members' savings, pension funds can have strong demonstration effects in creating a savings culture and mobilizing local capital to rebuild the economy. In this way, more people may be incentivized to place money with contractual savings products and other longer-term savings instruments with the onset of recovery.⁴⁶

The crisis also has elevated the broader policy discussion on determining the best means of tapping into pools of domestic and intraregional capital, where these exist, which will be important to sustainable recovery from the crisis going forward. Proposals that would raise financing to help combat the health effects and other impacts of the crisis have included rallying local pension funds to pool their investments together, including intraregionally, to invest in social bonds. A mid-April 2020 forum of the heads of African institutional investors and sovereign wealth funds discussed possible interventions, including in partnership with policy makers as part of a response to the crisis.⁴⁷ High levels of foreign currency-denominated debt, together with declining local currencies, also highlight the issue of debt sustainability and the importance of increasing local and intraregional pools of capital with the asset-liability and currency matches for funding longer-term development priorities.⁴⁸

Deep and liquid local capital markets are fundamental to economic growth because they help channel longer-term domestic savings of an economy to their most productive uses. An important step toward developing well-functioning capital markets is to develop the “buy side,” including by encouraging greater participation in local capital markets by local institutional investors. Further development of local institutional investors can potentially enable these financial institutions to evolve to become important sources of local long-term finance for infrastructure and other longer-term socioeconomic development needs. Moreover, by reducing an economy’s reliance on foreign portfolio investors, a well-functioning local institutional investor base can play a role in bolstering the economy’s resilience to sudden, destabilizing capital flow reversals.⁴⁹ This further highlights the need to accelerate the reform agenda to develop a local institutional investor base that can effectively perform its dual mandate of financing sustainable, long-term economic growth (via its access to large pools of local capital) and prudentially managing members’ longer-term savings.

Prior to the COVID crisis, there were long-running policy discussions among market stakeholders in a number of countries about how pension funds and other local

institutional investors with longer-term horizons could pool their resources together—including intraregionally—to better manage risk, obtain economies-of-scale benefits that lower costs, and maximize their collective bargaining power. Kenya’s pension fund industry has made strides in this regard, in forming an umbrella body, the Kenya Pension Fund Investment Consortium, which participates in infrastructure and other large-scale investments. The crisis and its ramifications for African economies, including the need to bolster these economies’ healthcare infrastructure and meet other longer-term socioeconomic development needs associated with rebuilding economies, give new priority to devising innovative structures for pooling pension fund and other longer-term savings to invest in effective new initiatives to this end.

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ABOUT IFC

IFC—a member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets. We work in more than 100 countries, using our capital, expertise, and influence to create markets and opportunities in developing countries. In fiscal year 2020, we invested \$22 billion in private companies and financial institutions in developing countries, leveraging the power of the private sector to end extreme poverty and boost shared prosperity. For more information, visit www.ifc.org.

Endnotes

- 1 In a study on the financial systems of 24 African focus countries for the AU/NEPAD-commissioned Africa Infrastructure Country Diagnostic project, Irving and Manroth (2009) found that in 12 of the countries with a pension system in place, DC schemes were becoming more prevalent while the role of DB schemes was declining as pension systems overall allowed a larger role for privately-managed pension fund administrators.
- 2 Ranked third largest among emerging SSA pension sectors based on total AUM, Namibia's pension fund sector holds a significant share of total AUM in nonlocal assets, particularly in South Africa, reflecting the two economies' close links (see below). An issue for further, more in-depth research is whether specific industries or sectors in African pension systems are subject to particularly high concentration risk.
- 3 NAMFISA, *2019 Annual Report*.
- 4 See Ratemo 2019.
- 5 See, for example, the discussion in Beck, Maimbo, Faye, and Triki 2011.
- 6 See World Bank, World Development Indicators, Gross Savings (percent of GDP). Available at <https://data.worldbank.org/indicator/NY.GDS.TOTL.ZS>.
- 7 See, for example, "Institutional investors as a potential source of infrastructure financing" within Irving and Manroth 2009.
- 8 See Stewart 2014.
- 9 See Irving and Manroth 2009.
- 10 Founded in 1996 as a result of the consolidation of multiple public sector pension funds, the GEPF currently has over 1.2 million active members and had R1.82 trillion in AUM as of March 2019. See <https://www.gepf.gov.za/wp-content/uploads/2020/02/GEPF-Annual-Report-Approved-20191129.pdf>.
- 11 Notably, because DB funds commit to pay a specific amount on retirement to each member, where funding levels become insufficient, a DB fund would be unable to pay retirees the committed pension.
- 12 Kenya's Retirement Benefits Authority (RBA) recently issued guidance clarifying situations where employers are permitted to suspend or reduce their contributions to pension funds. The RBA has suspended the requirement that employers make periodic contributions to pension funds for employees who are on unpaid leave and reduces the contributions accordingly where employees are on reduced working hours. Where employees continue to work and earn full salary, however, the RBA has clarified that employers are obliged to continue making these contributions in full. There is one exception to this, however: it is possible to temporarily suspend contributions for a specified period in cases where an employer secures consensus approval of the plan members. See Kenya RBA, "Third Communiqué to retirement benefits industry in light of COVID-19 pandemic," May 4, 2020.
- 13 The Ghana Revenue Authority has waived taxes on selected third-tier pension withdrawals as one of several measures to "provide some relief" to households and businesses in coping with the crisis impact. See Ghana Ministry of Finance statement to parliament on the economic impact of the COVID-19 pandemic, March 30, 2020.
- 14 *Punch*. 2020. "Only jobless contributors can withdraw from pension savings—PenCom," April 26, 2020 (<https://punchng.com/only-jobless-contributors-can-withdraw-from-pension-savings-pencom/>).
- 15 By end-April 2020, Nigeria's government had ruled this proposal out, at least for the near term (<https://www.businessamlive.com/covid-19-pfas-under-pressure-to-release-pension-fund/>).
- 16 Ghana Ministry of Finance statement to parliament on the economic impact of the COVID pandemic, March 30, 2020.
- 17 Ghana Ministry of Finance. 2020.
- 18 The negative measures that countries have been forced to implement to constrain COVID's health impact—such as lockdowns—reinforce the negative impact of the crisis on economies and financial systems: the impact of sharp declines in commodity prices; disrupted trade flows and restrictions on the movement of people; fiscal impact; and financial flow stops and reversals.
- 19 In some countries (e.g., South Africa), union and/or pension fund members were pressing governments to tap pension funds to help alleviate some of the immediate negative economic impact of the crisis including on particular sectors. In Uganda, one of the main pension funds (NSSF) recently issued a statement notifying members that the fund has no legal basis to make ad hoc partial payments as had been proposed. As the situation in many countries is quite fluid in terms of proposal and adoption of these policy responses, an area for future research could be to analyze ex post the impact of national proposals that are implemented. The IMF has established web pages tracking the ongoing adoption of national policy responses to the COVID crisis, including in the pension sector. See "Policy Responses to Covid-19," Updated June 12, 2020. Available at <https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19>.
- 20 Future, more extensive research could examine the crisis impact on portfolio management by pension systems at varying levels of development across the African continent. Although recent asset allocation data for less-developed, predominantly state-run pension systems tend to be scarce, these systems would be expected to be less impacted by capital market volatility because pension funds in these systems would be less likely to have invested in securities on capital markets (which, correspondingly, would tend to be less developed—if these markets exist at all).
- 21 PenCom. Dec. 2019-June 2020. *Monthly Reports* (<https://www.pencom.gov.ng/category/publications/monthly-reports/>). AUM amounts are provided in local currency for comparison purposes, given that amounts denominated in US dollars would reflect the significant recent declines in the naira and therefore would mask the actual increase in AUM over the period.
- 22 The share of total AUM allocated to listed equities remained relatively unchanged as of end-June 2020 at 5.37 percent. See PenCom's Dec. 2019 and June 2020 *Monthly Reports*. (<https://www.pencom.gov.ng/category/publications/monthly-reports/>)
- 23 For Nigeria, ceilings for share of AUM held in listed equities range from 5 to 30 percent, depending on type of pension fund.
- 24 According to IFC's capital markets database covering 90 developing countries with functioning equity markets, Nigeria's equity market ranked 60th as of end-2018 in terms of domestic market capitalization relative to GDP (at 7.9 percent), although 28th in terms of number of equity listings (163).
- 25 Pension fund AUM and other data for the first quarter of 2020 had not yet been released by NAMFISA as of mid-September 2020.
- 26 Botswana Public Officers Pension Fund Press Release, March 30, 2020. (https://www.bpopf.co.bw/sites/default/files/news_docs/COVID%20Press%20Release%202.pdf).
- 27 Data on the financial impact of the crisis on the pension industries of the five focus markets in this note had not yet been publicly released as of September 2020.

- 28 Making Finance Work for Africa-Price Waterhouse Coopers webinar discussion, “Review of Africa’s Capital Markets between 2010 and Q1 2020,” May 19, 2020. Asset allocation data have not yet been published in Ghana or Kenya for periods since the onset of the COVID crisis.
- 29 According to EPFR Global, total equity and bond portfolio outflows from the African region exceeded \$4.2 billion over the January-to-early April 2020 period, reportedly the fastest rate of withdrawal on record.
- 30 The lack of development and sophistication of local capital markets can be challenging for the development of the pension industry (the “buy side” of capital markets) even during periods of high and stable economic growth. For an in-depth, data-driven discussion of these challenges with a focus on Rwanda as a small, underdeveloped capital market, see for example “Capital Markets in the East African Community: Developing the Buy Side” (Irving, Schellhase, and Woodsome 2017).
- 31 Campbell and Viceira 2002.
- 32 Roldos 2004.
- 33 This point was emphasized by Nzomo Mutuku, CEO of Kenya’s Retirement Benefits Authority during a May 21, 2020 “Dialogue on the resilience of Kenya pensions and savings in the Covid crisis” webinar.
- 34 See for example citations of this literature in Irving, Schellhase, and Woodsome (2017) including Chan-Lau (2004), who examined restrictions on pension funds in seven developed and eight emerging markets, concluding that regulatory limits on foreign asset classes were relatively stricter overall in emerging markets; and a 2012 IOSCO survey of institutional investors in 21 developing countries, which found that seven jurisdictions required prior authorization to invest abroad, and 12 imposed limits on foreign investments.
- 35 Botswana Financial Stability Council, *Financial Stability Report 2019*, September 2019.
- 36 The Common Monetary Area links South Africa, Namibia, Lesotho, and Eswatini in a monetary union. Namibia pegs its currency to the South African rand as a member of the CMA. As a member of the Southern African Customs Union with the CMA members, it is likely that Botswana’s pension funds hold a similarly high share of nonlocal currency assets within the subregion. A corresponding asset allocation data breakdown for the subregion vs. outside the subregion is not available for Botswana, however.
- 37 Bank of Namibia and NAMFISA, *Namibia Financial Stability Report*, April 2020.
- 38 Botswana is not a member of the CMA, but Botswana has strong economic links with the four CMA members: Botswana pegs its currency to a trade-weighted basket allocating a 40 percent weight to the rand and all five countries are members of the SACU customs union.
- 39 Irving 2005.
- 40 Moreover, liquidity is one of the most essential elements for a strong link between stock market development and long-term economic growth. Levine (1991) argues that liquid stock markets can encourage more investment in high-return projects that require long-term capital commitments. Liquid equity markets give a project’s initial investors some assurance that they would not necessarily have to tie up their savings for the duration of a long-running investment but could sell off their stakes quickly and cheaply. Levine and Zervos (1996) looked at cross-country growth regressions to further evaluate the relationship between stock market development and long-run economic growth, finding a strong correlation.
- 41 Total equity and bond portfolio outflows from the African region have exceeded \$4.2 billion over the January-to-early April 2020 period—reportedly the fastest rate of withdrawal on record, according to EPFR Global. Nigeria’s large economy saw portfolio outflows equivalent to nearly 0.1 percent of GDP over the period Jan. 21-Apr. 6, 2020, based on data compiled by Haver Analytics.
- 42 See for example findings from an extensive survey of local institutional investors in EAC members Rwanda, Tanzania, and Uganda (as well as Kenya), assessing factors impeding a more diversified portfolio approach (Irving, Schellhase, and Woodsome 2017).
- 43 Remarks by Nzomo Mutuku, CEO of Kenya’s Retirement Benefits Authority, during launch of the Octagon Micro-pension Solution, August 27, 2019 (<https://www.rba.go.ke/2019/08/27/rba-remarks-at-octagon-launch-of-micro-pension/>).
- 44 As pointed out in Demarco and Stewart (2020), mandatory DC pension schemes rarely exist in Africa, East Asia and Pacific, and South Asia, but are common in Latin America and, to some extent, Europe and Central Asia.
- 45 The large role of the informal sector in African economies not only renders containment measures ineffective, but leaves vast portions of the population particularly vulnerable to the pandemic’s impact on a number of levels: health-wise, but also socially and economically, due to the fragile nature of informal sector incomes and the lack of social protection program coverage.
- 46 See Inderst and Stewart (2014).
- 47 In a mid-April 2020 forum of the heads of African institutional investors and sovereign wealth funds to discuss interventions, including in partnership with policy makers as part of a response to the crisis, the following were among interventions discussed: collaborating in assisting to provide SME supply chain and trade support through digitization (particularly healthcare and agriculture related); pursuing environmental, social and governance (ESG)-compliant infrastructure co-investment partnerships; encouraging governments to consider channeling some of their crisis response funding through sovereign wealth funds to allocate and invest in local and regional economies; and engaging in policy partnerships with national financial authorities in framing new regulatory and investment priority needs of post-COVID economies to better sustain future crises. See <https://africa.com/african-sovereign-wealth-and-pension-funds-united-in-fight-against-covid-19-in-africa/>
- 48 Weak fiscal situations with high external debt levels preceded the COVID crisis in many African economies. Pre-crisis, there already were warnings that corporate as well as sovereign foreign-currency debt levels were too high in many developing economies.
- 49 Because capital markets can be subject to sudden reversals in foreign portfolio investment flows, there is a need for these markets to strike an appropriate balance in accessing local and foreign capital. A large share of foreign-currency denominated debt can render an emerging market economy vulnerable to capital flow reversals and financial crisis. See, for example, Goldstein and Turner 1996.

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