NaSIA
Namibia Savings & Investment Association

ADVISORY NOTE: ASSET ALLOCATION REQUIREMENTS FOR PENSION FUNDS AND LONG-TERM INSURERS IN NAMIBIA (REGULATION 13 AND 15)

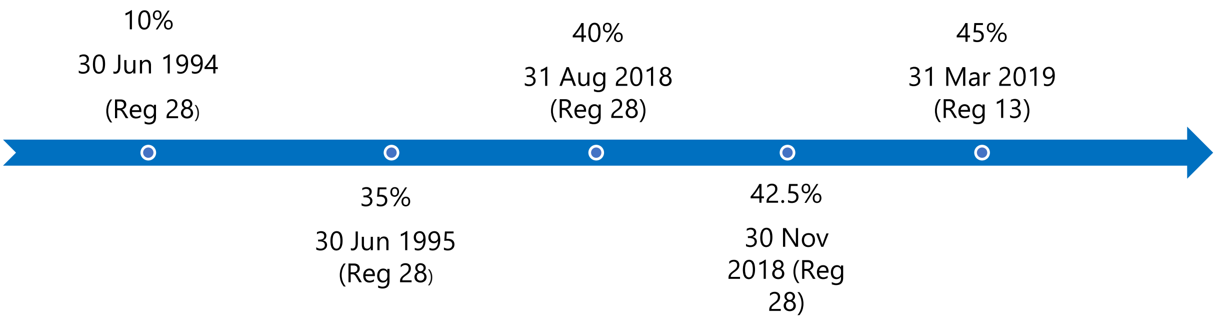
Before the Namibian government amended the Pension Fund Act of 1956, Namibia's contractual savings were managed by Asset Management Companies in South Africa. These savings were invested in shares listed on the Johannesburg Stock Exchange (JSE), South African government and corporate bonds, property, bank deposits in South Africa and a very limited number of assets outside South Africa[1]. The Namibian Government amended the Pension Fund Act of 1956 in 1994 with the aim of channelling some of these contractual savings into investments in Namibia. Regulation 13 (2) (The current regulation governing pension funds investment in Namibia) stipulates that "a fund must keep invested in domestic assets not less than 45% of the market value of its total assets"[2]. The limits for pension funds to invest in various asset classes provided for in regulation 13 (6) and a similar regulation applies to long-term insurers under Regulation 15 (7).

The Namibian government phased in amendments to the minimum domestic asset requirements for pension funds and long-term insurers. This was intended to support and deepen the domestic capital markets as more funds are required to stay in the country; to spur financial innovation; and to encourage new listings on the Namibian Stock Exchange (NSX). The amended Regulation 28 of the Pension Funds Act of 1956 obliged these funds to increase the proportion of the Namibian assets they invested in, from 10% on 30 June 1994 to 35% by 30 June 1995. In a series of step-ups, pension funds were further required to hold not less than 40%, effective 31 August 2018. The requirement was further stretched to 42.5%, effective 30 November 2018 and thereafter further to 45% effective 31 March 2019. In addition, the proportion of dual-listed shares that qualify as domestic Namibian asset decreased to 30% in January 2014 and further in annual increments of 5% to 10% by 1 January 2018. In essence it means that the 'purely' Namibian minimum asset requirement increased from 0% before 2014 to 25% from January 2018 and further to 35% in March 2019.

[1] Sherbourne, R. (2004). The Namibian stock exchange and domestic asset requirements: options for the future. *The Institute for Public Policy Research & Namibian Economic Policy Research Unit: NEPRU Research Report*, *26*, 1-154.

[2] Pension Funds Act 24. (1956). Retrieved from: https://www.lac.org.na/laws/annoREG/Pension%20Funds%20Act%2024%20of%201956%20-%20Regulations%202018-211.pdf.

Figure 1: Historic timeline



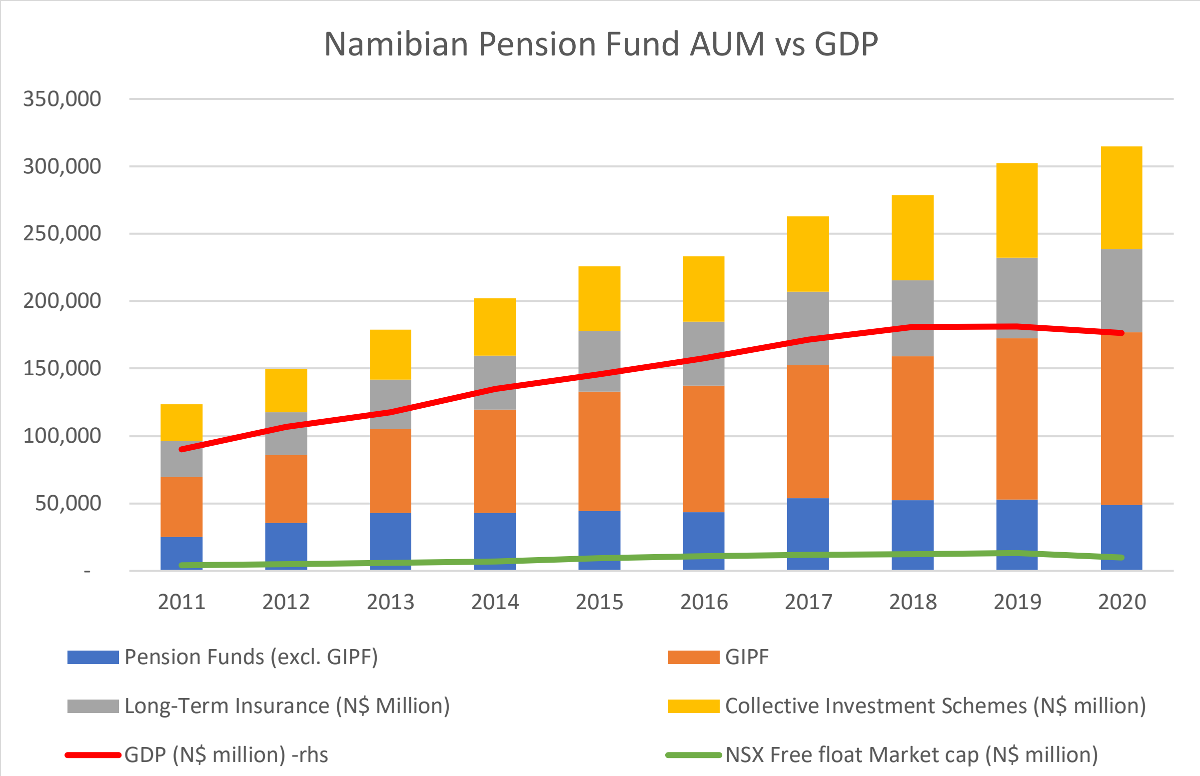
Source: NaSIA

Pension funds are important vehicles through which retirement assets are invested. The return on pension fund assets is mobilized through individuals or employees who regularly contribute to a pension, retirement, or provident fund. The process through which investors' funds are spread across various asset classes such as equity and bonds is known as asset allocation. Research on asset allocation regulation, performance of pension funds and understanding who these funds belong to, is intended to serve as input into policy and regulation, in line with NaSIA's strategic objective of being an advisor to government. The operations of pension funds are highly influenced by regulatory reforms. Namibia currently has stringent requirements with regards to where pension fund and long-term insurance assets may or may not be invested.

Namibia has one of the highest relative contractual saving pools in the world *(Refer to appendix A)*. Figure 2 below shows that there is a stark disparity between the sizes of the savings pool and local stock market capitalisation in Namibia *(Refer to appendix B)*. By the time regulation on domestic asset requirements was phased in, a total of four Namibian companies had listed[3] on the NSX. Two South African companies had also dual listed their shares on the NSX. However, problems have become apparent during recent years and the local equity investable universe has not seen nearly the amount of deepening envisaged. Namibian companies are not listing on the NSX, despite relaxation of listing requirements, with only ten locally listed shares on the main board up from nine in 2006. Local listed companies have also experienced a decline in share prices in 2020 due to the economic situation exacerbated by the pandemic. Investing our savings within Namibia which has very few listed companies is therefore a challenge. It is clear that Namibia is a country with an impressive amount of savings but limited options for investing it at home.

[3] Sherbourne, R. (2004). The Namibian stock exchange and domestic asset requirements: options for the future. *The Institute for Public Policy Research & Namibian Economic Policy Research Unit: NEPRU Research Report*, *26*, 1-154.

Figure 2: Namibian Pension Fund AUM vs GDP.



Source: Namfisa, BoN, GIPF, NSA & NSX

First and foremost, it is important to differentiate between defined benefit and defined contribution schemes. In defined benefit schemes, the fund provides/guarantees benefits to intended beneficiaries upon retirement and this comes with a formula set out in the rules based on the employee's tenure of service and age, as well as the earnings through his/her working life. On the other hand, the benefit available to a member under defined contribution scheme is simply based on the accumulated contributions made to the fund by the member, employer (if any), as well as the investment returns earned by these contributions.

Secondly, one should be mindful that the capital in question is not an ownerless resource but comes from an individual's hard-earned income. Individuals are required by law to contribute to a pension fund for a specific purpose, and that is to develop a resource pool that can sustain them after retirement. As these resources belong to individuals, and is saved for a specific purpose, any proposed changes in such regulation should therefore first take cognisance of the interests of asset owners before consideration is made to the national objectives of job creation, funding the budget deficit and transformation within the industry, amongst others. Regulation is justifiable if it can result in a balanced outcome where a degree of synergy exists between the owner's interests and political or national objectives.

The current regulations are already difficult for asset owners as they have implications on their risk/ return considerations particularly in defined contributions schemes, as well as guarantors in defined benefit schemes. The regulations have forced a material percentage of the total assets of these funds into a small pool of locally available assets, and this has risk/return implications for the capital owners in the long term, which can be summarized as follows:

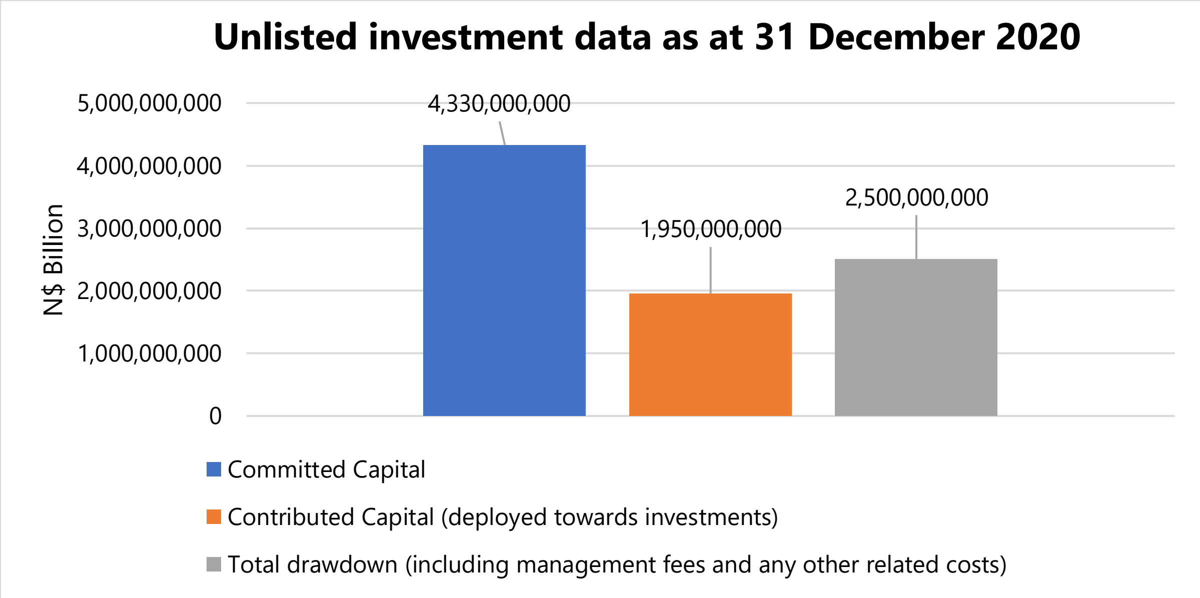
Lack of diversification options: There are currently very few listed companies and substantial debt issuers (main issuer being government) in Namibia. Approximately half of local equity available on the NSX (and over 60% of the dual listed companies) comprises of financial services companies. Ultimately, options to diversify are limited. Diversification across sectors, companies, asset types and currencies are a critical risk-return tool for asset allocators. Without the flexibility to diversify, asset allocators are not in a position to optimally manage risk or optimize return for asset owners. It is therefore prudent to increase the offshore component of Reg 13, especially considering that offshore markets are relatively lowly correlated with both the NSX and the JSE.

Shortage of local assets: Regulation on domestic asset requirements continue to influence the geographical allocation decisions of the schemes since invested pension funds are required to comply with statutory investment limits of regulation 13. Pension funds are forced to allocate larger proportions of their assets to local assets than would be optimal. Other local investment challenges such as lack of quality investable assets and lack of mechanisms to align their risk-return appetite ultimately condemns these funds to subpar returns over the long term.

High risk of investing in unlisted securities: In order to try and draw a more direct link between the nation's aggregate savings and economic activity, as well as improve diversification opportunities, a big regulatory push was introduced in 2015 to encourage investments into the unlisted investments space, with the current ceiling set at 3.5% and the commitment period being set at 2 years[4]. Despite the high risk that comes with this asset class, its potential multiplier effect (if invested in high impact businesses and industries) on the Namibian economy cannot be underestimated. Private Equity (PE) players are however finding it difficult to deploy capital given the small number of "viable" businesses for investment in the economy. In addition, Private Equity (PE) are constrained by other challenges such as having to conduct detailed market, financial, environmental, management due diligence which take several months before they make a final decision on investing, as well as being required to do follow up investments which they may not necessarily do within the first 2 years of their commitment period when an investment is made. Figure 3 below shows that as at 31 December 2020, N$4.33 billion was committed to these funds, with N$1.95 billion being deployed towards investments.

[4] Pension Funds Act 24. (1956). Retrieved from: https://www.lac.org.na/laws/annoREG/Pension%20Funds%20Act%2024%20of%201956%20-%20Regulations%202018-211.pdf

Figure 3: Unlisted investment data as at 31 December 2020



Source: Namfisa

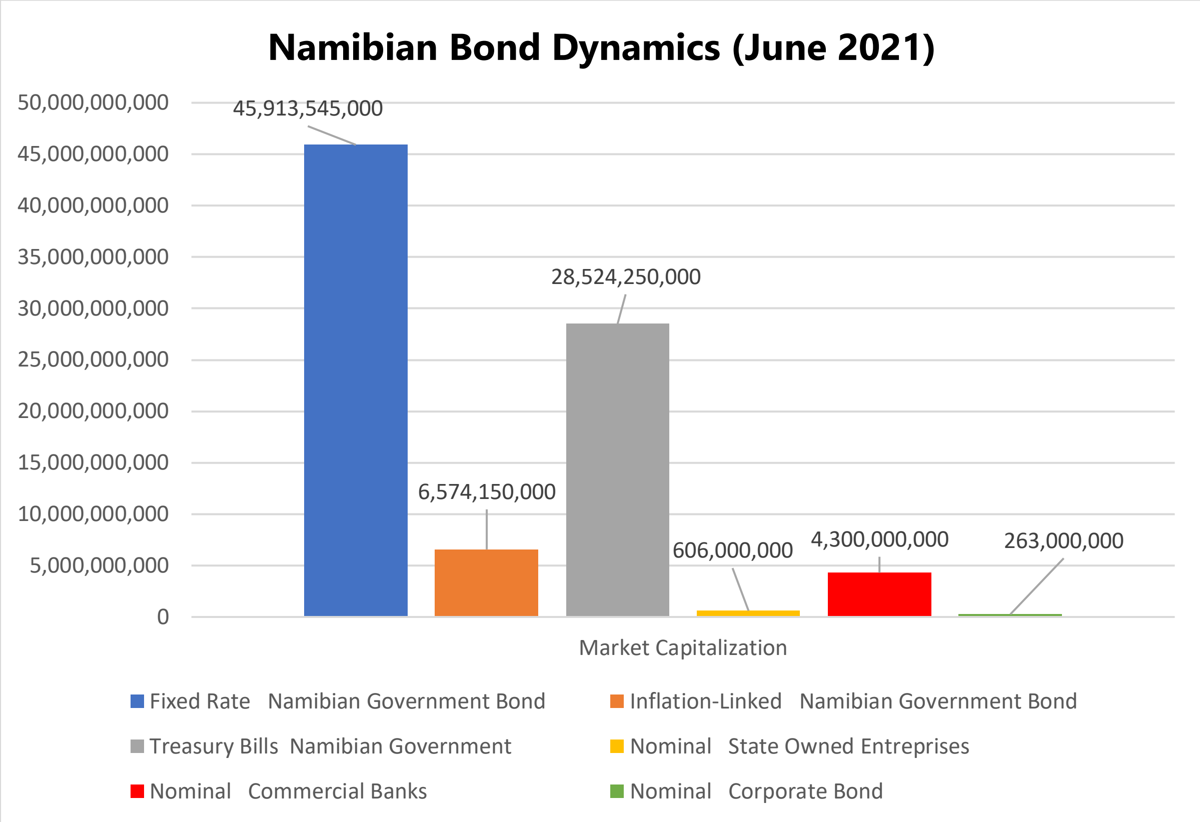
A consideration can be made to increase the ceiling from the current 3.5% to 10% (not mandatory but just to allow for flexibility) only if considerable effort (from a policy perspective) is made to create a pipeline of high impact businesses by investing in start-ups and SMEs. Government has to drive legislation that simplifies doing business and encourages entrepreneurship. Over time, these businesses will graduate to be potential candidates for PE players and ultimately list on the NSX (therefore creating much needed diversification on the local bourse). Even though these investments have been met with mixed success thus far and in some cases come at a material cost to the asset owners (pension fund members), they could create lasting benefits in the long term.

Excess debt in the portfolio: not only is there a *de facto* requirement that pension funds deploy capital into Namibian Government debt, but the imbalance between available local assets and the quantum of the local assets required to be held means skewing away from the ideal asset-allocation model (with high equity holdings) towards a lower-risk, often lower return, asset class: debt. At present, less than 20% of the available local assets (NSX free-float, dual listed equities (as limited in regulation) and (unlisted equity) are equity, while the remainder is predominantly made up of government debt.[5] If we only look at purely Namibian assets (therefore excluding dual-listed), equities make up less than 10% of available assets. Looking to the future, the rate of growth in Government debt is very likely to materially outstrip the rate of growth in available local equity, meaning this ratio is expected to fall further. The increased debt weighting in the portfolio of pension funds can be expected to have a long-term detrimental impact on returns. Figure 4 shows how a lack of depth exists in the Namibian

[5] At present, available local assets consist of around N$81bn of domestic Government debt (N$45.9bn in IRS, N$6.6bn in ILBs and N$28.5bn in TBs), around N$2bn in ZAR bonds and N$18.1bn in Eurobonds. On the equity side, the NSX free-float market cap is N$9.1bn, while dual listed equity that can be counted as local assets is capped at 10% of total assets. SOEs have listed debt of N$606 million, while non-bank corporates have outstanding listed debt of N$263 million. Banks have listed debt of N$4.3 billion, and NCDs of around N$22 billion. Other assets include unlisted equity and debt, which is estimated at less than N$4 billion in total.

bond market, with Government bonds by far being the biggest part of the market, which forces pension funds to deploy capital into Government bonds[6].

Figure 4: Namibian Bond Dynamics (June 2021)



Source: BoN & Namfisa

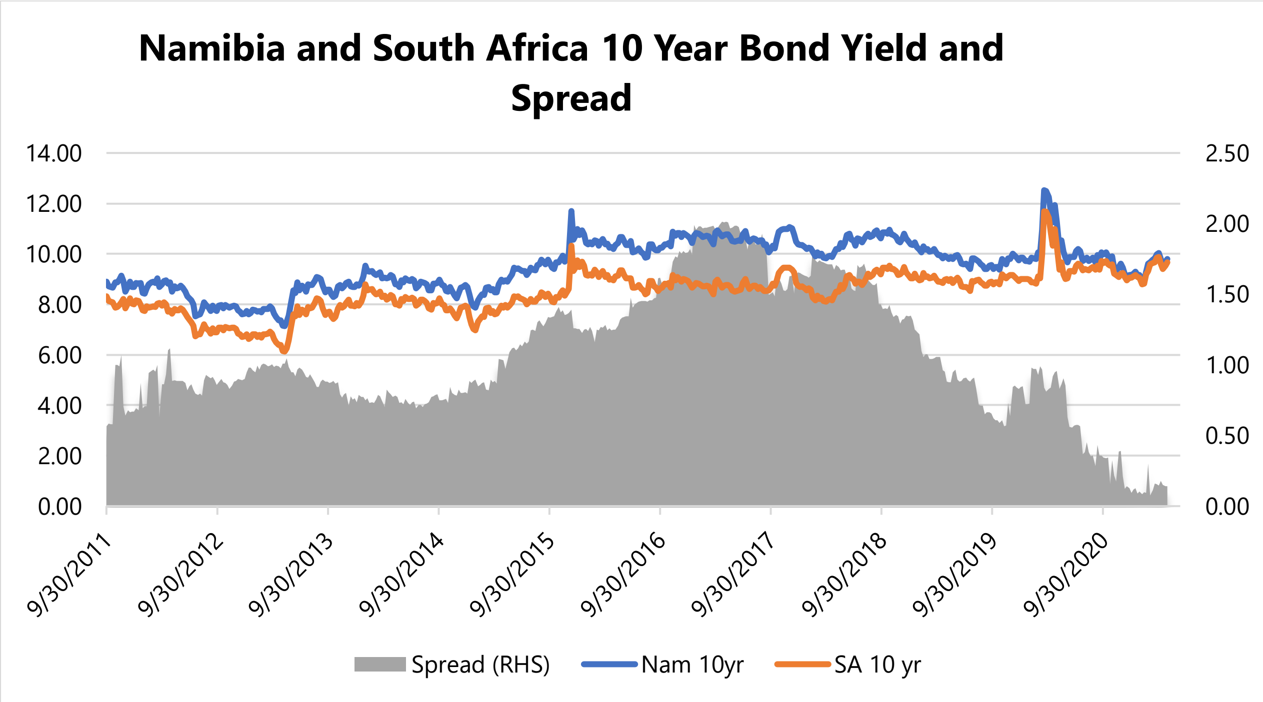
Borrowing future returns: The above mentioned issues may, however, have been masked by temporary local asset price inflation - forced buying (transitory buying, while pension funds become compliant with changing regulation) has resulted in price appreciation. This is particularly the case with bond returns, which have been bolstered by transitory buying thus driving up mark-to-market pricing. For example, in 2020, the government bonds brought about an aggregate return of 14.1% despite the unfavourable macroeconomic conditions such as experiencing the largest budget deficit on record, highest debt to GDP on record and multiple credit rating downgrades deeper into the junk bond territory *(Refer to the appendix for information on Namibia's credit rating scale).*

Namibian government's debt burden is heavily skewed towards relatively shorter-term repayment requirements (roughly 30% constituting of Treasury bills and rest comprising of bonds maturing over the next six - seven years), unlike countries like South Africa that have a much longer repayment runway, and this creates added pressure when borrowing for future returns[7]. Figure 5 below shows the decline in spreads on the Namibian 10-year government bond yield over its South African counterparts' bond yield since 2018, when Namibian pension funds were required to fully comply with the 45% local asset requirement (and ultimately a convergence between the two bond yields)[8]. Future bond auctions may be met with wanning

[6] Bank of Namibia. Government finance statistics.
[7] Bank of Namibia. Government finance statistics.
[8] Bank of Namibia. Annual Reports, Research Department, Windhoek.

demand because investors would want higher yields to compensate for the risk that they are taking by investing in Namibia, whose economy has been contracting versus a still (albeit mutedly) growing economy in South Africa.

Figure 5: Namibia and South Africa 10 Year Bond Yield and Spread



Source: BoN, Cirrus Securities

It is important not to understate the impact of asset allocation limitations on compound interest as many pensioners with defined contribution benefit schemes may be left without the resources they need in retirement. For defined benefit schemes, these changes can be expected to erode actuarial reserves and may result in future actuarial liabilities for fund guarantors.

In this regard, the scope of utilization of regulation for objectives, other than those of the savers whose capital is being discussed, has already exceeded the point at which that utilization can be justified as a "win-win" and the benefit of these changes is now carried as a cost by members. Thus, further restrictions on capital allocation options for these funds should not be considered (and if possible, the existing restrictions should be eased), and the interest of fund members (the capital owners) should be placed ahead of the interest of political and other groups in the decision-making process.

General recommendations

1. **Allow professional capital allocators the flexibility to structure their portfolio in the best interest of the investors/savers.** Do not further increase local asset requirements under any circumstances and do not impose further limitations on the current allocation for local assets. Ideally, reduce it back to 35%. Also, for non-local assets, remove judicial constraints entirely, and rather focus on single issuer, asset class and currency constraints.

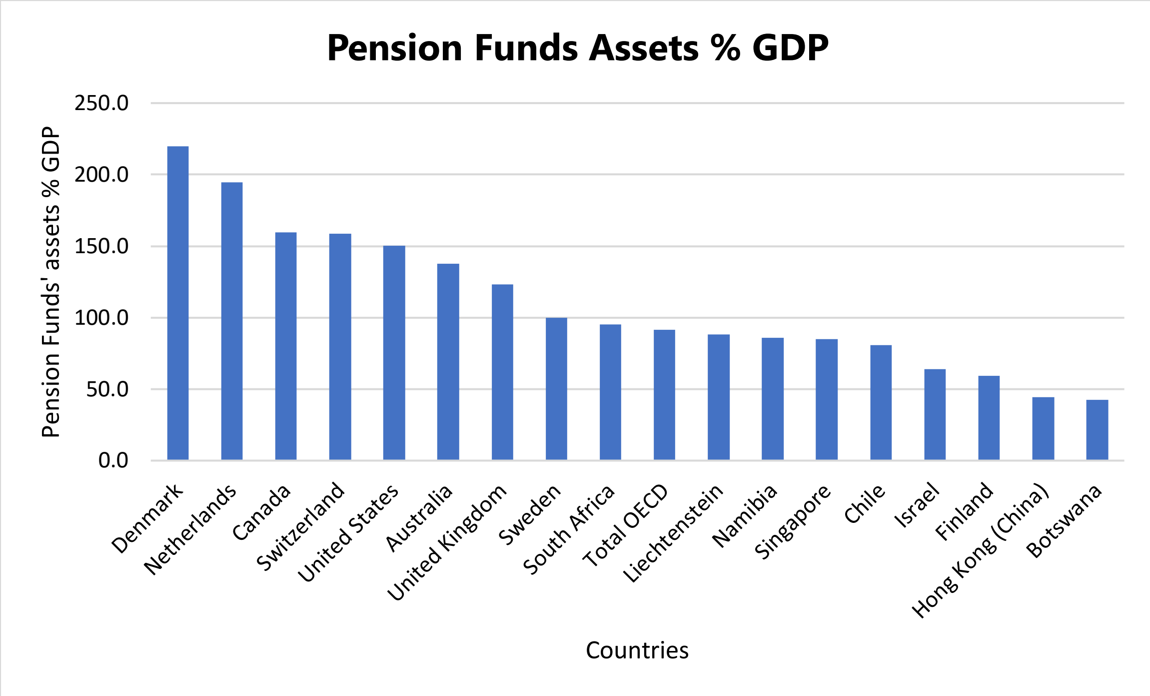
2. **Improve diversification options within the market**: Encourage local entities to list through various incentives (tax and otherwise) and list viable Public Enterprises where suitable. Also, ensure that foreign currency debt issued by local issuers (including non-government entities) is considered a local asset.

3. **The twin deficit funding:** Rather than using pension fund regulations as a tool to fund the budget deficit, extensive effort should be put into securing other forms of funding:
   (i) Encourage foreign capital to flow into the Namibian local currency debt space by fast tracking the implementation of the CSD (digital trading and settlement of bonds), and on-market transactions of such and by encouraging investors to purchase Namibian debt through local brokers and make use of New Funds S&P Namibia Bond ETF.
   (ii) Utilise alternative options to fund the budget deficit, after carefully weighting up funding costs and additional risk (such as forex). Options include JSE listed bonds, Eurobonds, multilateral and bilateral funding.
   (iii) Attract foreign direct investments to encourage growth, reduce fiscal deficit, and drive a capital and financial account inflow.

APPENDICES

APPENDIX A: COUNTRIES WITH THE HIGHEST PENSION FUND ASSETS

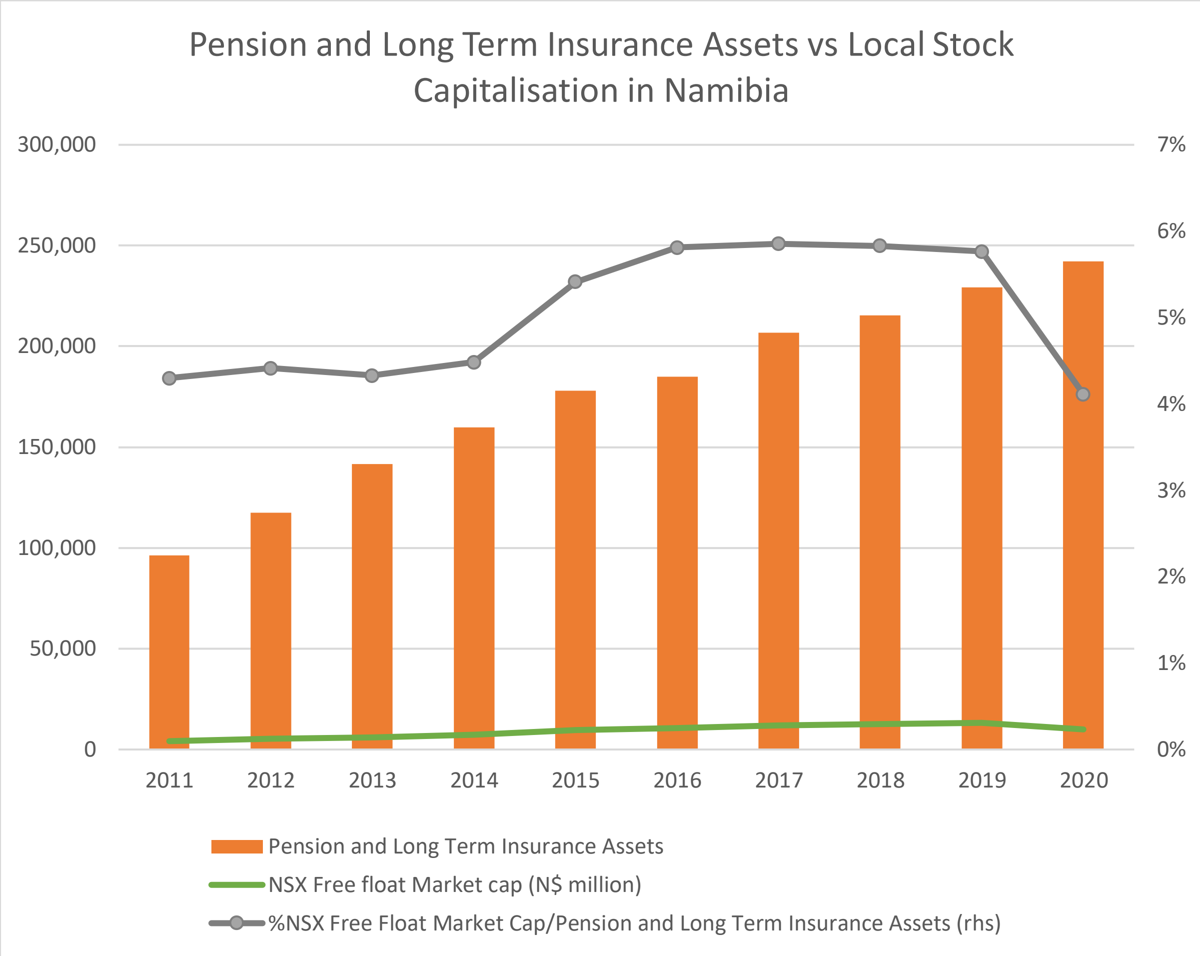
Figure 1: Pension Funds' assets % GDP



Source: OECD

APPENDIX B: PENSION AND LONG-TERM INSURANCE ASSETS VS LOCAL STOCK MARKET CAPITALISATION IN NAMIBIA

Figure 2: Pension and Long-Term Insurance Assets vs Local Stock Market Capitalisation in Namibia



Source: Namfisa, GIPF & NSX

APPENDIX C: CREDIT RATING SCALE

Table 1: Credit rating scale

Moody's	Fitch	Description	
Aaa	AAA	Prime	
Aa1	AA+		
Aa2	AA+		
Aa3	AA'	High grade	
A1	A+		
A2	A		
A3	A'	Upper medium grade	
Baa1	BBB+		
Baa2	BBB		
Baa3	BBB'	Lower medium grade	
Ba1	BB+		
Ba2	BB 		
Ba3 	BB'	Non-investment grade speculative	
Ba1	B+		
Ba2	B		
Ba3	B'	Highly speculative	
Caa1	CCC	Substantial risk	
Caa2		Extremely speculative	
Caa3			
Ca	CCC		
	CCC	Default imminent with little prospect of recovery	
C	D	In default	Junk

Source: Fitch, Moody's, S&P