

# RETIREMENT WITH INADEQUATE PENSIONS: WHY, AND WHAT CAN BE DONE?

BOTSWANA PENSIONS SOCIETY  
ANNUAL CONFERENCE

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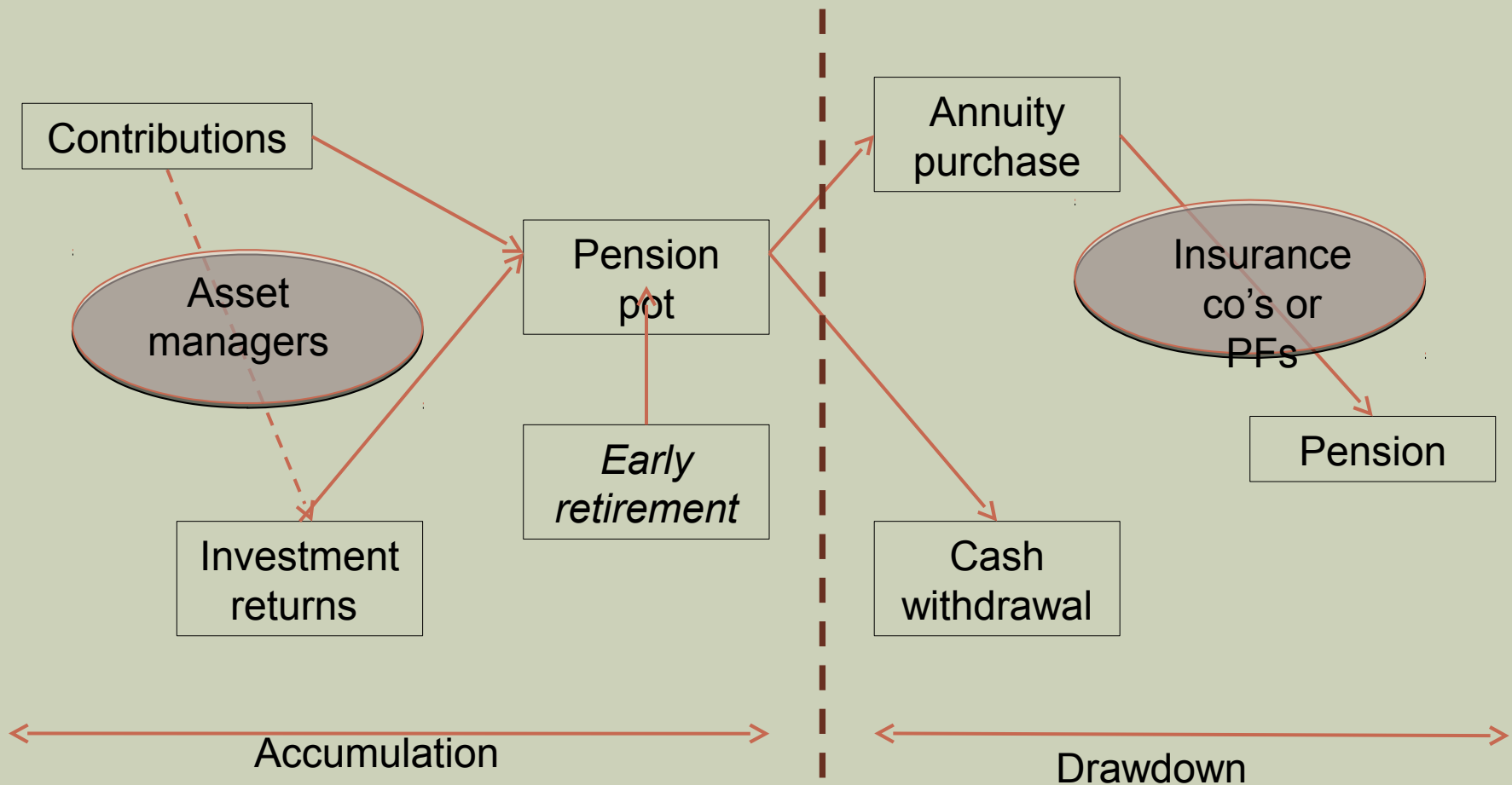
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# INTRODUCTION

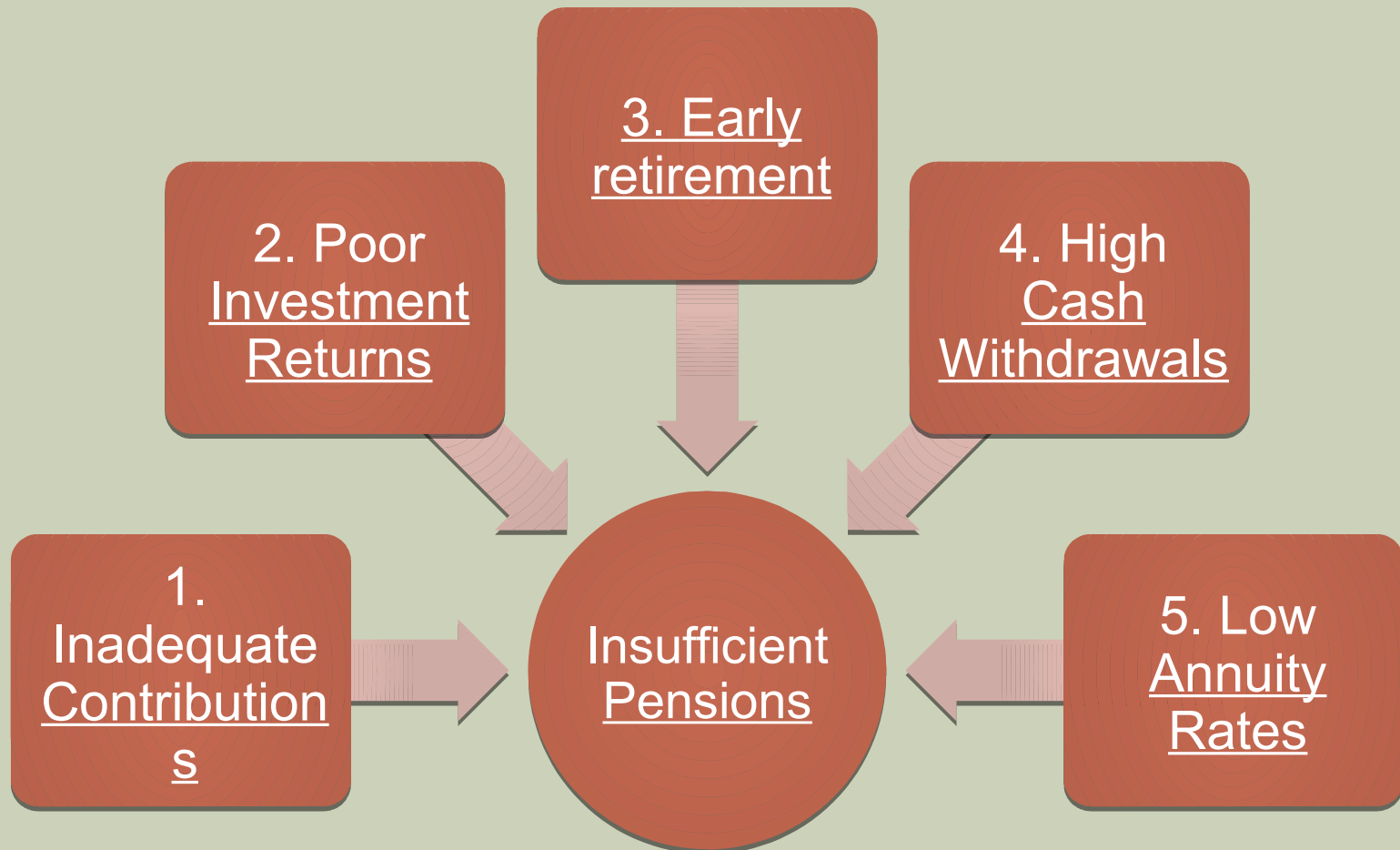
- Most pension fund members in Botswana belong to defined contribution (DC) funds
- Inadequate pensions (for PF members) are therefore due to gaps in the operation of DC schemes
- Most people of course are not members of pension funds, so we also need to consider these adults

# LOW PENSIONS FOR PENSION FUND MEMBERS

# THE PENSION PROCESS



# INADEQUATE PENSIONS MAY BE DUE TO...



# INADEQUATE PENSIONS

- Which of these five factors contribute to low pensions in Botswana:
  - Contributions?
  - Investment returns?
  - Early retirement?
  - Cash withdrawals?
  - Annuity Rates?
- This presentation will not provide answers, but will highlight the issues that could cause problems in each of these areas
- And will highlight possible resolutions

# CONTRIBUTIONS

## ■ Contribution rates

- Rates for most PF members are quite high
- E.g. 5% employee / 15% employer
- Probably not the main reason for low pensions
- Little scope for increase

## ■ Interrupted contributions

- Changes of employment (perhaps leading to fund withdrawals)
- Periods of no contributions
- Need to focus on preservation

## ■ Fee deductions

- Contributions are “net” after administration fees
- Management expenses
- Regulatory requirements
- Major problem for small funds

# INVESTMENT RETURNS

- Market performance
  - Global/local markets (benchmarks)
- Asset manager performance
  - Under/over-performance (vs. benchmark)
- Asset manager fees
  - Fees can consume a high proportion of gross returns
    - Especially in a low-return world
    - Especially for active managers
    - Managers are rewarded, even if they under perform
  - Lack of low-fee, passive (e.g. index) products
- Regulatory restrictions
  - Restrictions on portfolio composition, e.g. local asset requirements
  - Investment portfolios must be diversified – which requires offshore assets
- Lack of individual choice



# EARLY RETIREMENT

- This is one of the biggest “killers” of adequate pensions
- The main driver of pension pot value is cumulative investment returns
  - The size of the pension pot is driven more by investment returns than by contributions – because of compounding
- Early retirement reduces both the contribution period and the cumulation period of investment returns
- Early retirement also reduces pension levels, because annuities have to be paid for longer (life expectancy at retirement)
- “Early retirement” provisions – especially in the public service – are totally unhelpful

# CASH WITHDRAWALS

- Tax-free allowance
  - Most people take full one-third cash allowance
- Manipulation of rules
  - Annuity quotes engineered to yield low pensions, below the limit at which full encashment is allowed
- May be attractive for people with high cash needs
- May reflect unattractive annuity rates
- The effect is to reduce the size of the pot that can be used to buy pensions

# ANNUITY RATES

- Low interest rates
  - Local and global
- Limited choice of annuity providers
  - Small market
    - Lack of scale
  - Market structure
    - Pension funds and insurance companies
  - Tax and regulatory restrictions
    - Foreign providers not allowed
- Lack of choice in annuity products
  - Regulatory restrictions
    - Products allowed in other markets not allowed in Botswana
    - Innovation discouraged

# ANNUITY RATES

- Lack of matching (pula) assets
  - Pula-only products
  - Limited government bond issuance
  - Foreign currency annuities would not face a matching asset problem
- Annuity risks
  - Different regulations for pension fund annuities and insurance annuities
  - Playing field not level
- Unstable demographics
  - Lack of local life tables
  - Affects annuity pricing risk
- Poor annuity purchase decisions
  - Choosing an annuity without an escalation

INCLUDING THE  
EXCLUDED – GAPS IN  
THE PENSIONS  
SYSTEM

# BOTSWANA'S PENSION SYSTEM

- The current system has two components:
  - Universal state pension
    - Covers all citizen adults
    - Pension level very low (poverty line)
  - “Voluntary” Occupational Pensions
    - Membership determined by employer and occupational status
- Where are the gaps?
  - Most private sector employees not covered
  - Informal sector
  - Agricultural sector
- Compare with World Bank “Pension Pillar” conceptual framework

# WORLD BANK PENSION PILLARS

## Zero

Basic “social grant” pension

Non-contributory

Tax funded

Universal/means tested

## One

Partial income replacement

Mandatory

Contributory

Collective

PAYG, unfunded

## Two

Partial income replacement

Mandatory

Contributory

Individual accounts

Funded, DC

## Three

Higher income replacement

Voluntary

Contributory

Occupational/individual

Funded, DC/DB

## Four

Non-financial (mainly)

Social provision (e.g. healthcare)

Informal/Family provision

Home ownership

Tax or self-financed

# BOTSWANA PENSION PILLARS

## Zero (0)

Basic “social grant” pension

Non-contributory

Tax funded

Universal/means tested

## One (1a)

Partial income replacement

Mandatory

Contributory

Collective

PAYG, unfunded

## Two (1b)

Partial income replacement

Mandatory

Contributory

Individual accounts

Funded, DC

## Three (3)

Higher income replacement

Voluntary

Contributory

Occupational/individual

Funded, DC/DB

## Four (4)

Non-financial (mainly)

Social provision (e.g. healthcare)

Informal/Family provision

Home ownership

Tax or self-financed



WHAT CAN BE DONE?

# HOW CAN PENSIONS BE IMPROVED?

- Accumulation
- Drawdown
- National pensions

# ACCUMULATION PHASE

- Raise early retirement age (in public service)
- Encourage more investment choices for pension fund members (e.g. low fee products)
- Avoid well-intentioned but misguided policies, such as restrictions on offshore investments
- Monitor asset manager fees
- Consider regulatory impact on administration and compliance costs (and hence fees)
- Consolidation of small pension funds?
- The BPOPF is NOT a government fund

# DRAWDOWN PHASE

- Encourage competition in the annuity market
- Allow retirees to purchase foreign annuities
- Allow a greater range of pension annuity products
- Issue more long-term government bonds
- Consider more restrictions on encashment
- Monitor annuity profits and fees – due to limited competition
- Better regulation of annuity providers, especially by pension funds
  - Clear separation of investment management and annuity provision
  - Capital requirements as per insurance companies

# NATIONAL PENSION FUND?

- Consider how best to fill that gap in the pension pillars
  - Between universal state pension and private occupational pensions
- May be a need for a national pension fund, but many issues to consider
  - Relationship to existing funds
  - Voluntary/mandatory?
  - Incentives for low income members
  - Keeping costs low – administration and asset management
  - Dealing with low value contributions and investments
  - Replacement of existing gratuity/severance scheme
  - Expensive for government
  - Difficult to make it work financially
  - Burden on firms
- Raising the state pension

# THANK YOU

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