

Pension Funds and Investment in Bonds

Presented By

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Outline

1. Introduction to PFA Administration & Management
2. Investment Guidelines
3. The Nigerian Bond Market
4. Suitability of Bonds for Pension Investment
5. Use of Bonds in the Pension Fund Portfolio
6. Need for more Non-FGN bond issuances

Introduction to Pension Fund Administration

- **Pension Reform Act 2004**

The Pension Reform Act (PRA) 2004 provides for the establishment of a Contributory Pension Scheme for any employment in the Federal Republic of Nigeria.

It stipulates payment of retirement benefits to employees to whom the scheme applies; every public sector employee and for the Private Sector, employees in a firm with a staff strength in excess of 5 employees

Objectives of the scheme are to:

- Ensure seamless funding of the retirement scheme by assisting improvident individuals save in order to cater to their livelihood during old age
- Ensure that private and public sector employee receives his retirement benefits as and when due and to
- Establish a uniform set of rules, regulations and standards for the administration and payments of retirement benefits.

Introduction to Pension Fund Administration

- **Pension Reform Act 2004**
- The PRA 2004 also established the National Pension Commission (PENCOM). Its duties include;
 - Regulate, supervise and ensure the effective administration of pension matters in Nigeria,
 - Approval, licensing and supervision of all pension fund administrators
 - Establishment of standards, rules and issuance of guidelines for the management and investment of pension funds under this Act.

Introduction to Pension Fund Administration

- **Pension Fund Administrator (PFA)**

The Act provides that from the commencement of this scheme, pension funds shall only be managed by Pension Fund Administrators (PFAs) licensed by the Commission under this Act.

The PFAs are licensed under the Act to;

- Open retirement savings account
- Invest and manage pension funds and assets in accordance with the provisions of the Act
- Maintain books of account relating to pension funds managed by it
- Provide regular information on investment strategy, returns and other performance indicators to the Commission and employees.
- PFA's are also mandated to cause retirement benefits to be paid in accordance with the provisions of the Act alongside several other related functions

Introduction to Pension Fund Administration

- **Pension Fund Custodian**

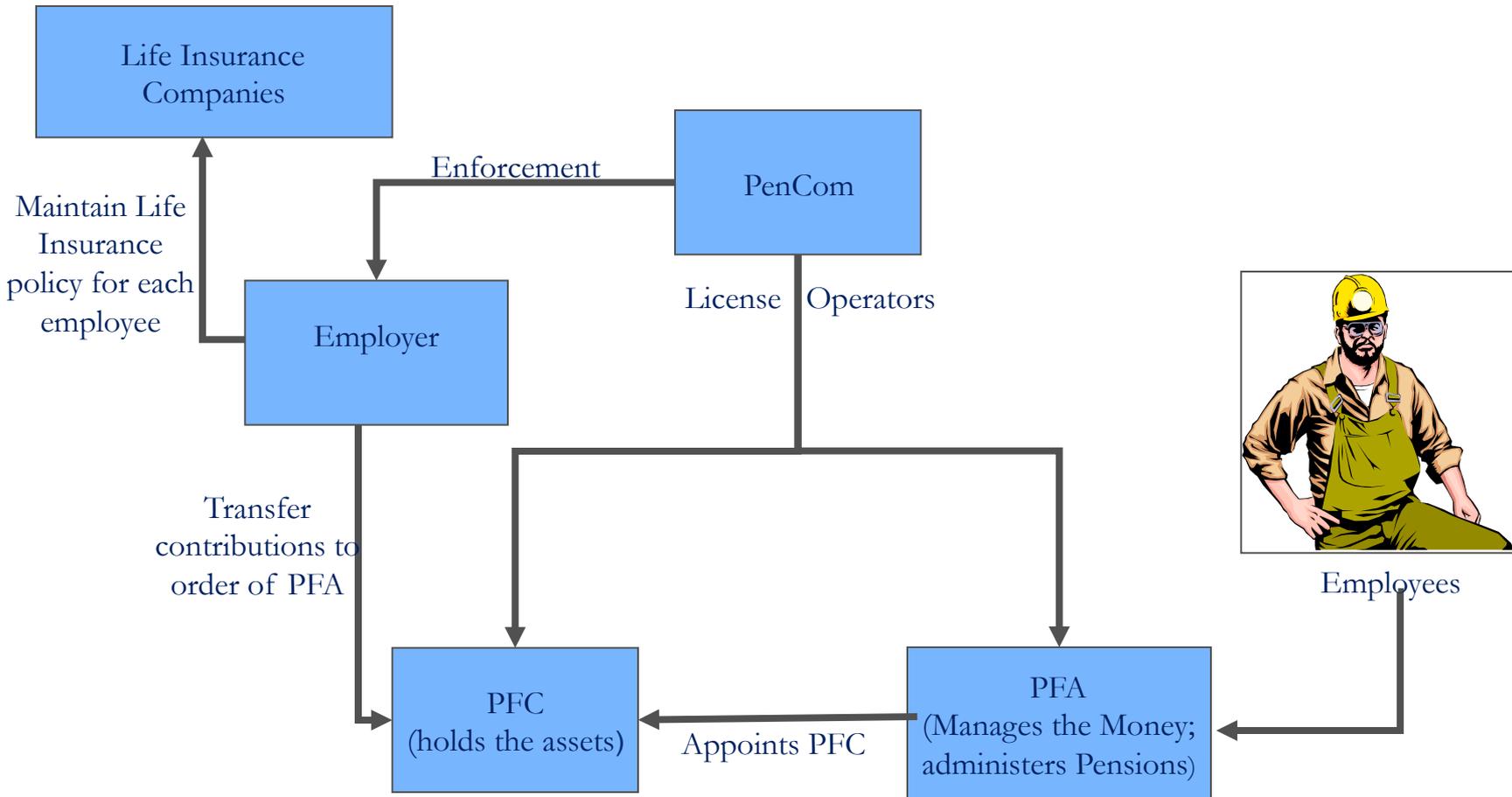
The Act stipulates that pension funds and assets are to be held solely in custody for the Pension Fund Administrator (PFA) by an independent Pension Fund Custodian (PFC).

The PFC has the responsible to

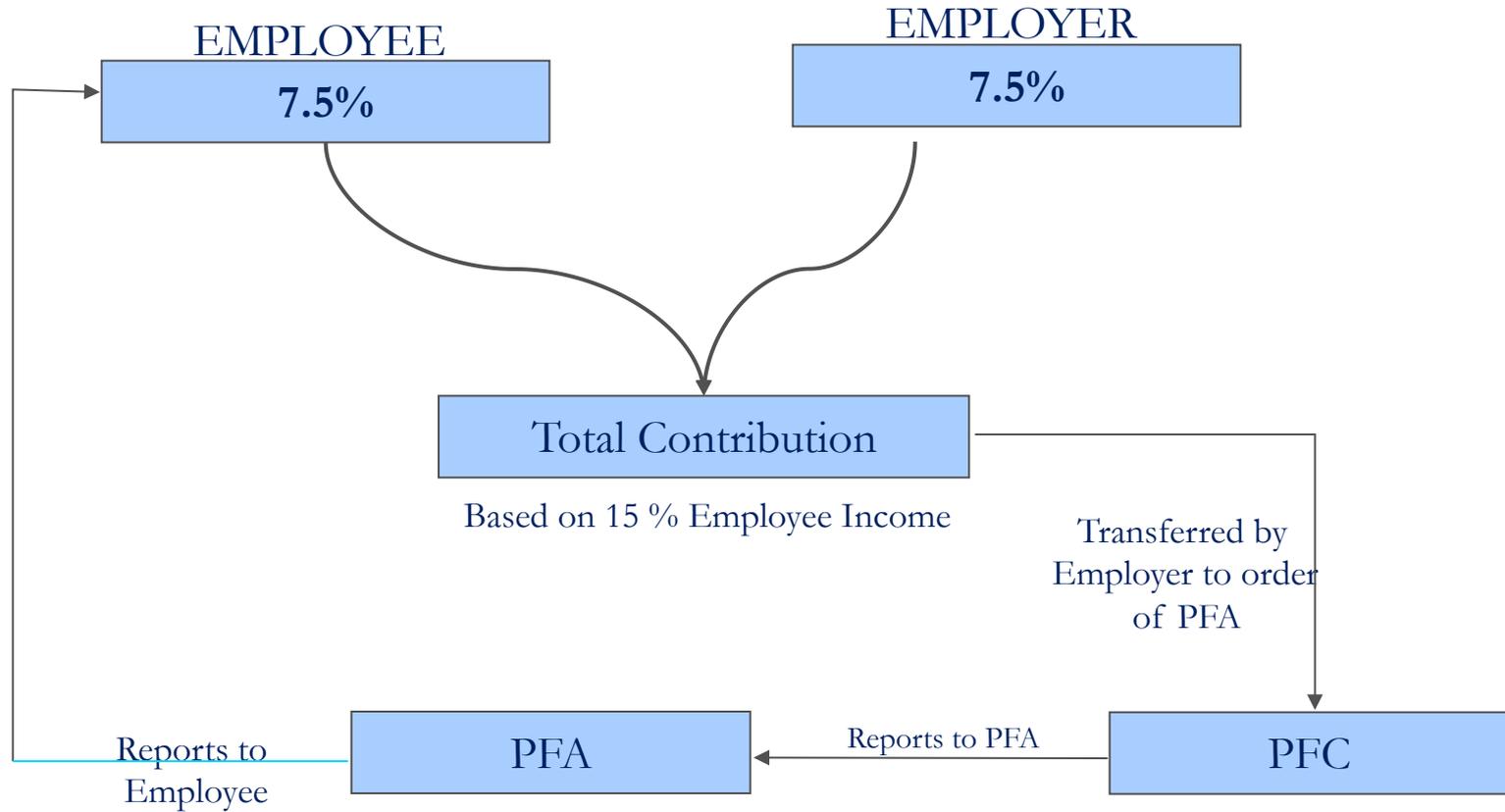
- receive the total contributions remitted by the employer within 24 hours, notify the PFA of same and hold the pension assets in safe custody on trust for the employee and beneficiaries of the retirement savings account.
- settlement of transactions and to undertake activities relating to the administration of pension fund investments including the collection of dividends.
- expected to execute in favor of the PFA relevant proxy for the purpose of voting in relation to the investments

The PFC provides some control over the activities of the PFA and provides a hedge against unauthorized access or trading. The custodian shall however not utilize any pension fund assets in its custody to meet its own financial obligations or that of a third party

Structure of CPS



Contribution Fund Flow



Introduction to Pension Fund Administration

RSA Registrations by end of 2010

Age Range	Public Sector		Private Sector		Total		Grand Total	
	Male	Female	Male	Female	Male	Female	Number	%
Less than 30 yrs	421,477	163,029	493,172	200,671	914,649	363,700	1,278,349	28.14
30 - 40 yrs	540,409	303,129	581,451	175,679	1,121,860	478,808	1,600,668	35.24
41 - 50 yrs	487,546	264,346	307,333	61,164	794,879	325,510	1,120,389	24.67
51 - 60 yrs	258,728	98,690	117,849	13,913	376,577	112,603	489,180	10.77
Above 61 yrs	22,500	4,456	24,216	2,492	46,716	6,948	53,664	1.18
Total	1,730,660	833,650	1,524,021	453,919	3,254,681	1,287,569	4,542,250	100.00

Introduction to Pension Fund Administration

- Pension industry has grown significantly since inception with Pension Fund assets growing from ₦815.18 billion in 2007 to ₦2.03 trillion in 2010.
- The Funds have however been invested largely in a limited number of outlets viz, ordinary shares, FGN and State Government bonds and money market securities.

Portfolio of Pension Funds as at December 2010

S/N	Asset Classes	2010		2009		2008		2007	
		Amount		Amount		Amount		Amount	
		(₦ Billion)	%	(₦ Billion)	%	(₦ Billion)	%	(₦ Billion)	%
1	Local Ordinary Shares	358.03	17.64	220.71	14.43	220.54	20.07	240.38	29.49
2	Foreign Ordinary Shares	24.10	1.19	2.80	0.18	2.23	0.20	3.06	0.38
3	FGN Securities	829.20	40.85	498.88	32.61	350.67	31.91	279.69	34.31
4	State Govt. Securities	69.60	3.43	33.71	2.20	0.16	0.01	0.05	0.01
5	Corporate Debt Securities	50.73	2.50	31.18	2.04	15.13	1.38	0.24	0.03
6	Local Money Market Securities	489.25	24.10	542.22	35.45	332.44	30.25	159.92	19.63
7	Foreign Money Market Securities	7.36	0.36	17.72	1.16	17.25	1.57	26.09	3.20
8	Open/Close-End Funds	8.61	0.42	5.74	0.38	9.03	0.82	4.46	0.55
9	Real Estate Properties	170.52	8.40	142.96	9.35	125.50	11.42	79.08	9.70
10	Unquoted Securities	8.18	0.40	6.18	0.40	6.86	0.62	4.43	0.54
11	Cash and Other Assets	14.19	0.70	27.53	1.80	19.20	1.75	17.13	2.10
Total Pension Fund Assets		2,029.77	100.00	1,529.63	100.00	1,099.01	100.00	815.18	100.00

Investment Guidelines

Pension fund assets are permitted to invest in the following asset classes

Equities

Pension Fund Assets may be invested in ordinary shares of public limited liability companies subject to a maximum portfolio limit of 25% of pension assets under management provided that such companies have made taxable profits in the preceding five years and have paid dividends of those taxable profits one of the preceding five years.

Money Market

Pension Fund Assets may be invested in money market instruments of banks/discount houses as well as the commercial papers of corporate entities subject to a maximum portfolio limit of 35% on pension assets under management

Infrastructure Funds

Pension Fund Assets may be invested in Infrastructure Funds subject to a maximum portfolio limit of 5% on pension assets under management

Private Equity Funds

Pension Fund Assets may be invested in Private Equity Funds subject to a maximum portfolio limit of 5% of pension assets under management

Investment Guidelines

Open/Close-End and Hybrid Funds including REITs

Pension Fund Assets may be invested in Open/Close-Ended Hybrid Funds registered with SEC subject to a maximum portfolio limit of 5% of pension assets under management

Global Depositary Receipts/Notes and Eurobonds

Pension Fund Assets may be invested in Global Depositary Receipts/Notes and Eurobonds issued by listed Nigerian companies for their operations within Nigeria as certified and approved by SEC

Bankers Acceptances (BAs) and Commercial Papers (CPs)

Pension Fund Assets may be invested in commercial papers of corporate entities provided it is in compliance with the CBN's guidelines on BAs and CPs

Bonds

Pension Fund Assets can be invested in FGN or CBN Bond and Securities to a maximum of 80% of pension assets under management.

Investment Guidelines

- Pension Fund Assets may be invested in bonds issued by
 - State and Local government or State Government Agencies or wholly owned companies , provided that such securities are fully guaranteed by Irrevocable Standing Payment Orders (ISPOs) or external guarantees by eligible banks or development finance institution or MDFOs.
 - Also included are bonds, debentures, redeemable/convertible preference shares and other debt instruments issued by corporate entities, including asset backed securities and infrastructure bonds and supranational bonds issued by eligible MDFOs

Investment Guidelines

OVERALL MAXIMUM INVESTMENT LIMITS

	ASSET CLASS	GLOBAL PORTFOLIO LIMIT	PER ISSUER LIMIT	PER ISSUE LIMIT
1	Government Securities	FGN & CBN Securities: 80%	Max: 80% of Total Issue	80% of the issue
		State & Local Govts: i. 20% if issue is backed by ISPO/ Guarantee ii. 3% for issue not backed by ISPO/Guarantee	Max: 5% of pension assets under mgt in total issues of any one State or Local Govt	Based on credit rating of bond/debt instrument: i. BBB Rating = 16% of issue ii. A Rating = 18% of issue iii. AA Rating & Above = 20% of issue
2	Corporate Bonds/Debt Securities (including ABS, MBS and Infrastructure Bonds)	35% subject to max of 15% in Infrastructure Bonds	Max of 5% of pension assets under mgt in total issues of any one corporate entity	Based on credit rating of bond/debt instrument: i. BBB Rating = 16% of issue ii. A Rating = 18% of issue iii. AA Rating & Above = 20% of issue
3	Supra-national bonds	20%	Max of 5% of pension funds under mgt in total issues of any one multilateral development finance organization	Based on credit rating of bond/debt instrument: i. BBB Rating = 16% of issue ii. A Rating = 18% of issue iii. AA Rating & Above = 20% of issue
4	Money Market Instruments (including Certificate of Deposits; Bankers Acceptances and Commercial Paper of corporate entities)	35%	I. Max investment of pension assets under mgt in all money market instruments issued by any one bank shall be subject to the issuer's credit rating: i. BBB Rating = 3% of assets under mgt ii. A Rating = 4% of assets under mgt iii. AA Rating & Above = 5% of assets under mgt II. Max of 3% of assets under mgt in money mkt instruments issued by any one discount house with a minimum rating of 'A' III. Max of 5% of assets under mgt in corporate papers of any one corporate entity with a minimum rating of 'A'	Applicable to Commercial Paper issues only: Based on credit rating of the corporate entity issuing the commercial paper: i. A Rating = 18% of issue ii. AA Rating & Above = 20% of issue

Investment Guidelines

OVERALL MAXIMUM INVESTMENT LIMITS

	ASSET CLASS	GLOBAL PORTFOLIO LIMIT	PER ISSUER LIMIT	PER ISSUE LIMIT
5	Ordinary Shares	25%	Max of 5% of assets in any one corporate entity	Max of 4.5% of the issued capital of any one corporate entity
6	Infrastructure Funds	5%	Max of 5% of assets in any one issuer	Max of 20% of the value of any one Fund
7	Private Equity Funds	5%	Max of 5% of assets in any one issuer	Max of 20% of the value of any one Fund
8	Open, Close-end and Hybrid Funds (including REITS)	20%	Max of 5% of assets in any one issuer	Max of 10% of the value of any one Fund

The Nigerian Bonds Market

- **Types of Bonds-**

There are several types of bonds available to fixed income investors and a few of these are:

Government Bonds-

These refer to Debt instruments or contracts issued by the Federal Government of Nigeria for an agreed period of time. They are considered the safest and least risky form of bond investments

Municipal Bonds-

These are next in the risk continuum and refer to State and Local Government issued debt. The debt is typically deployed to finance State and Local Government projects.

Corporate Bonds-

Typically characterized by higher yields as a result of the perceived riskiness of the issuing company relative to the sovereign backing of a government.

Development of the Nigerian Bond Market

The Capitalisation of the FGN bond market has grown steadily since 2006 and is reflected below

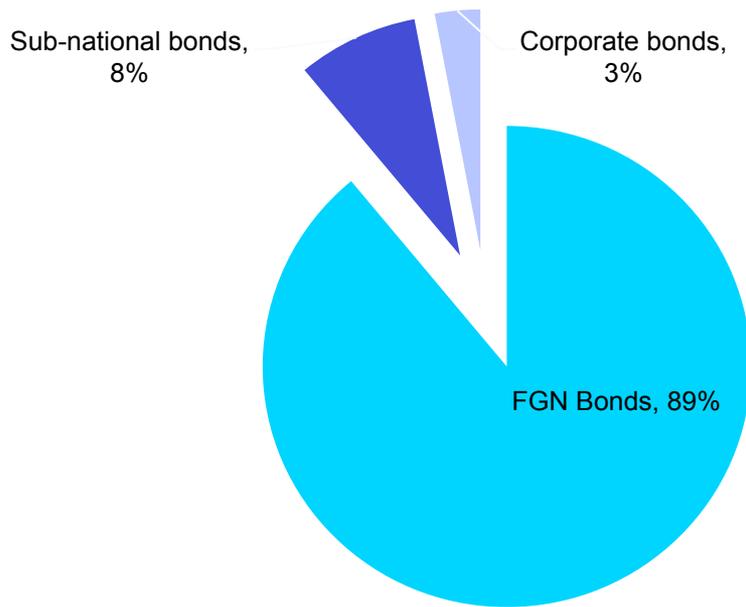
Year	2006	2007	2008	2009	2010	2011*
GDP (₦bn)	18,709.6	20,940.9	24,665.2	25,225.1	29,498.6	33,994.6
Market Capitalisation (₦bn)	400.0	500.0	1,363.1	2,301.1	3,034.4	3,323.4
Market cap. as a % of GDP	2.14%	2.39%	5.53%	9.12%	10.29%	9.78%
Amount in Issue (₦bn)	411.7	1,015.4	1,509.6	2,100.5	3,212.7	3,679.2
Amount in Issue as a % of GDP	2.20%	4.85%	6.12%	8.33%	10.89%	10.82%
Yearly Issuance (₦bn)	411.7	603.7	494.2	590.9	1,112.1	466.5



SOURCES: CBN, NBS, DMO, SEC, CSCS

Characteristics of the Nigerian Bond Market

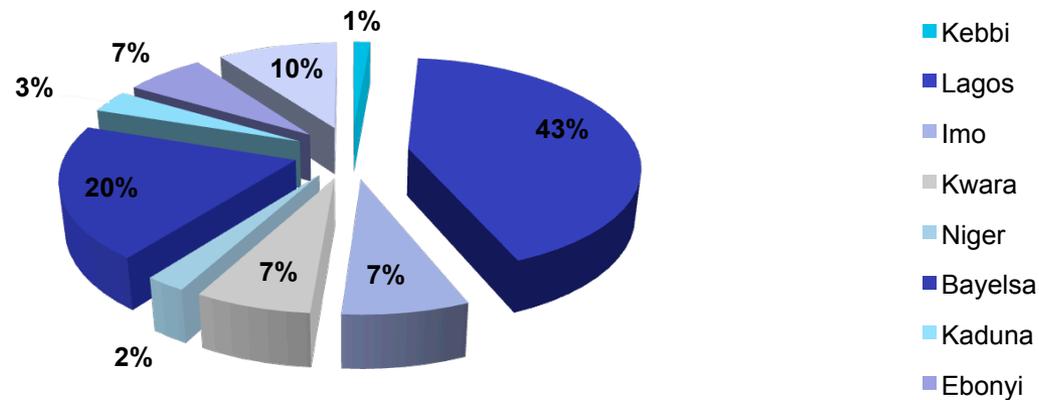
Relatively young and rapidly evolving bond market, concentrated largely in FGN Bonds. Debt Management Office (DMO) in 2003 commenced the regulation of FGN Bonds.



- FGN Bonds are issued under the authority of the DMO with the Central Bank of Nigeria (CB) acting as the Issuing House and Registrar
- FGN Bonds are listed on the Nigerian Stock Exchange and traded Over the Counter (OTC)
- The CSCS acts as the depository of the bonds traded on the NSE
- FGN Bonds can be issued through a primary issue effected through licensed Primary Dealers Market Makers (PDMMs) whilst the Secondary Market activities are also anchored mainly by PDMMs to ensure liquidity
- An auction takes place monthly based on a pre-determined auction calendar

Structure of Nigerian Bond Market

Sub - National Bond (2011)



Issuer (State)	Kebbi	Lagos	Imo	Kwara	Niger	Bayelsa	Kaduna	Ebonyi	Edo	Total
Amount Issued (₦bn)	3.5	107.0	18.5	17.0	6.0	50.0	8.5	16.5	25.0	252.0
Percentage of Issue	1.39%	42.46%	7.34%	6.75%	2.38%	19.84%	3.37%	6.55%	9.92%	
Duration	-	2.58	2.38	1.65	1.56	2.78	1.86	1.93	2.93	

Structure of Nigerian Bond Market- State & Corporate Issuances

State Government Bonds in issue as at Dec 2010

S/N	State Govt.	Issue size (₦ Billion)	Coupon %	Tenor (years)	Issue Date	Maturity Date %	Coupon pymt Dates
1	Bayelsa State	50.00	13.75	7	30-Jun-10	30-Jun-17	30 -June / 30-June
2	Ebonyi State	16.50	13.50	5	29-Sep-10	30-Sep-15	31-Mar / 30-Sep
3	Edo State	25.00	14.00	7	31-Dec-10	31-Dec-17	30-June / 31-Dec
4	Imo State	18.50	15.50	7	30-Jun-09	30-Jun-16	31-Dec / 30-June
5	Kaduna State	8.50	12.50	5	24-Aug-10	31-Aug-15	01-Mar / 01-Sep
6	Kwara State	17.00	14.00	5	5-Aug-09	5-Aug-14	5-Feb / 5-Aug
7	Lagos State (Series 1)	50.00	13.00	5	9-Feb-09	9-Feb-14	9-Aug / 9-Feb
8	Lagos State (Series 2)	57.50	10.00	7	19-Apr-10	19-Apr-17	19-Apr / 19-Apr
9	Niger State	6.00	14.00	5	16-Mar-10	15-Oct-14	15-Apr / 15-Oct
Total in Issue (₦'Billion)		249.00					

Corporate Bonds in issue as at Dec 2010

S/N	Corporate	Issue size (₦ Billion)	Coupon %	Tenor (years)	Issue Date	Maturity Date %	Coupon pymt Dates
1	C&I Leasing (variable coupon)	5.00	n/a	4	23-Feb-10	31-Dec-14	n/a
2	Crusader Nigeria Unsecured convertible)	4.00	12.00	5	30-Sep-08	30-Sep-13	30-Mar / 30-Sep
3	Flour Mills	35.00	12.00	5	9-Dec-10	9-Dec-15	9-June / 9-Dec
4	GTBank	13.17	13.50	5	18-Dec-09	18-Dec-14	18-Dec / 18-June
5	NGC Sterile Ltd (Private Placement)	2.00	17.00	5	1-Apr-10	31-Dec-14	n/a
6	UBA	20.00	13.00	7	28-Sep-10	30-Sep-17	28-Sep / 30-Sep
7	UPDC	15.00	10.00	5	8-Sep-10	17-Aug-15	17-Feb / 17-Aug
Total in Issue (₦'Billion)		94.17					

Structure of Nigerian Bond Market

A M C O N
Bonds have
ramped up
significant
volume in less
than one year

AMCON INTERVENTION BONDS @ JULY 2011

AMCON BONDS ISSUED	Date of Issue	Amount Issued (₦bn)
Series I Tranche I used to swap the Initial Consideration Bonds which were issued on December 31, 2010 to acquire non-performing loans (NPLs) from 21 Nigerian Banks.	Apr-11	1,165
Series I Tranche II was issued by way of a book build	Apr-11	20
Series I Tranche III was issued to purchase additional NPLs from 22 banks	Apr-11	535
AMCON bonds issued to capitalise nationalised banks	Aug-11	678
		2,398

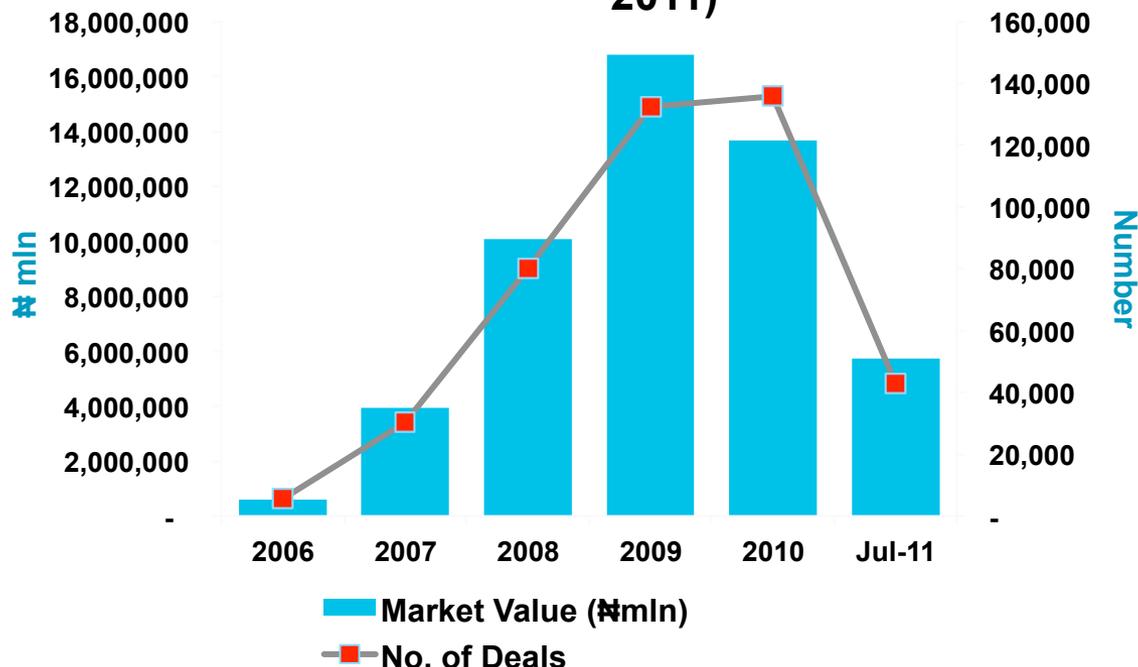
Structure of Nigerian Bond Market

Tradability and liquidity

Bond market suffers from a liquidity problem as besides FGN bonds, other bonds in issue have no liquidity or tradability.

Year	Market Value (₦mln)	No. of Deals
2006	585,411	5,482
2007	3,947,285	30,241
2008	10,090,236	80,135
2009	16,789,263	132,374
2010	13,677,152	135,874
Jul-11	5,718,612	42,983

Deals and Value of FGN Bonds (2006 - July 2011)



Suitability of Bonds for Pension Investment

Pension fund investments are made typically with an overriding consideration for principles of capital preservation and the importance of a guaranteed income stream.

The perceived safety of FGN bonds particularly demand that Pension Fund Assets be invested in Bond and other fixed income securities such as those issued by the Federal Government of Nigeria or the CBN.

Benefits accruable to pension bond investors include;

- **Guaranteed Long Term Returns:**
 - Half yearly returns in the form of coupon
 - Capital gains when yields drop
- **Liquidity :**
 - Periodic cash flows from the coupon payments provide funding for maturing obligations on the pension fund
- **Guards against Re-Investment Risk :**
 - Long tenors of bonds relative to money market instruments

Suitability of Bonds for Pension Investment

For FGN Bonds, the following benefits are accruable

- **Tax free Income:** interest received on FGN Bonds is not subject to withholding tax, company income tax, etc.(for non PFA managers)
- **Free from default risk:** Repayment is guaranteed by the FGN upon maturity of the FGN Bond
- **Easily Tradable:**
 - Unique quality of being quoted on the Nigerian Stock Exchange
 - Can also be traded over the counter (OTC).
- Thus FGN bonds can be traded down to provide liquidity to meet arising pension liabilities or to take capital gains where the yields permit .

Use of Bonds in Pension Fund Portfolios

Passive Bond Strategy

- Maximizing the income generating properties of bonds.
- Involves buying and holding bonds to maturity on the premise that bonds are safe predictable sources of income.
- Cash flow generated in the form of coupons are reinvested in the portfolio or deployed to meet arising obligations.
- Strategy makes no assumptions about interest rates or changes in the current value of the bonds.
- To implement the Passive Strategy, portfolio managers of pension funds can get involved in Bond Laddering which ensures that the principal is ably spaced and invested in a laddered style to ensure that the maturities cater to the liabilities stream as they fall due.

Use of Bonds in Pension Fund Portfolios

- **Indexing Strategy**

Quasi-passive by design with the intention of providing a return and risk characteristic closely tied to the targeted index.

- Carries some of the same characteristics of the passive buy-and-hold, with some flexibility.
- Bond portfolio can be structured to mimic any published bond index.
- The downside of this strategy is the transaction cost associated with not only the original investment, but also the periodic rebalancing of the portfolio to reflect changes in the index.

Use of Bonds in Pension Fund Portfolios

- **Active Strategy**

- The goal of active management is maximizing total return.
- Along with the enhanced opportunity for returns comes increased risk.
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- Examples include interest rate anticipation, timing, valuation and spread exploitation, and multiple interest rate scenarios.
- The basic premise of all active strategies is that the investor is willing to make bets on the future rather than settle with what a passive strategy can offer.

Most pension portfolio managers engage in a mix of both the active and passive strategies

Limitations to the Significant Role of Bonds as Pension Assets

- **Knowledge gap**
 - Dearth of experienced managers with vast technical skills in new assets class has also proven to be a limitation to the growth of pension assets.
 - This has also impacted the depth of the Nigerian bond market as option embedded bonds and bonds such as zero coupon and callable bonds are not available in spite of the potentials of these bond types.
- **Inflation Rate and Inflation Indexed Bonds**
 - Key challenges to long term investment in bonds is the threat of inflation which can result in capital erosion.
 - Option of investing in Treasury Inflation Protected Securities (TIPS) or inflation indexed securities arise to ensure that yields are adjusted for inflationary changes.
- **Yield enhancement and Lack of quality Corporate Bonds**

Corporate Debt Market remains significantly undeveloped currently accounting for c.3% of the Nigerian Bond market.

 - Yield enhancements (internal or external) have also not gained significant traction in the Nigerian market
 - There is also a dearth of infrastructure bonds and other such investible instruments within the Nigerian bond space.

Limitations to the Significant Role of Bonds as Pension Assets

- **Concentration and low yield on FGN bonds**
 - Lack of variety of issuer in the bond market has resulted in a concentration on FGN Bonds (89% of the domestic bond market) with Corporate and Sub-national bonds accounting for 3% and 8% of the total bond issuances respectively as at December 2010.
- **Limited Range of Bond Types**
 - The lack of sophistication of the Nigerian bond market has oftentimes discouraged issuers and subscribers especially due to the lack of options to hedge against unfavorable interest rate volatilities.
 - Lack of bonds types such as Option embedded bonds; Amortizing bonds; Floating rate bonds; Deferred coupon bonds; Infrastructure bonds; etc.
- **Credit and liquidity spread of state and Corporate Bonds**
 - Although we note that there are a number of Sub sovereign debt issuances (State and Corporate), they have been issued at yields that have failed to compensate for the credit risk, relative to sovereign issuances.
 - They are also issued at yields that fail to account for the lack of liquidity on sub national issuances and have made them unattractive to pension fund administrators.

Limitations to the Significant Role of Bonds as Pension Assets

- **Trading, Available For Sale and Held to Maturity**
 - Passive strategy will adopt HTM
 - Active Strategy will require the Portfolio Manager to mark to market, which introduces some volatility into the portfolio. These volatilities also present a challenge to the growth of bonds in pension fund investment
- **GAAP vs. IFRS treatment of Bonds**
 - MTM impact on capital and profit
- **FGN vs. AMCON vs. States vs. Corporate Bonds**
 - FGN Bonds remain the most liquid class of bonds within the Nigerian bonds market.
 - Lack of liquidity and low tradability of other bonds in issue

Limitations to the Significant Role of Bonds as Pension Assets

Distribution of Issuers @ JULY 2011

Issuer	Federal	State	Corporates	AMCON
Amount in Issue (₦bn)	3,354.0	252.0	93.2	2,383.5
No .of Instruments	16	8	7	1
Amount in Issue as a % of GDP(₦bn)	9.87%	0.74%	0.27%	7.01%

Limitations to the Growth of Bonds as Pension Assets

- ❑ Lack of Robust Systems
 - ❑ Trading platforms; settlement systems;
 - ❑ booking systems; STP
- ❑ Market Discipline
 - ❑ 2-way quotes; market abuse; front running;
 - ❑ PDMMs
- ❑ OTC Vs Exchange Traded Bonds
 - ❑ Bond Index; capitalisation; brokers & trading houses;
 - ❑ Listing fees; commissions; etc

Limitations to the Growth of Bonds as Pension Assets

- ❑ Securities Lending
 - ❑ Framework;
 - ❑ Wider playing field – Insurance Companies, PFC, Asset Manager, Brokers, Proprietary Traders, AMCON
 - ❑ Liquidity & depth

Way Forward

The Nigerian Bond Market is in dire need of more types of FGN Bonds and also non-FGN Bond Issuances:

❑ Diversification of Issuers

- Concentration in FGN Bonds has resulted in an erosion in returns on account of the risk-return scenario.
- Corporates and States will help diversify concentration risk

❑ Attraction of New Players

- Insurance Companies, Brokers, Asset Managers, etc
- New set of Investors

❑ Diversification of Bond Types

- Option Embedded, Floating Rate, Inflation Indexed, Deferred Coupon, Amortising Bonds, etc
- Satisfaction of different needs of wider variety of investors and issuers

❑ Improved Returns

- Adequate compensation for Credit and liquidity spread
- Risk – Return continuum

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Way Forward

□ Financing of the Real Sector

- Infrastructure deficit
- Specific Intervention Fund
 - Power
 - Aviation
 - SME
 - Agriculture
 - Manufacturing
- Long term financing for corporates –
 - Equity vs Debt

QUESTIONS