PENSION FUNDS' ASSETS INVESTMENT IN NIGERIA: A CASE FOR CHANGE IN REGULATION TO PROMOTE STOCK MARKET DEVELOPMENT

by

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DECLARATION

I, Sarah Oreoluwa Oluyeju declare that this Mini-Dissertation which is hereby submitted for the award of **Legum Magister (LL.M)** in **International Trade and Investment Law in Africa at International Development Law Unit, Centre for Human Rights, Faculty of Law, University of Pretoria,** is my original work and has not been previously submitted for the award of a degree at this or any other tertiary institution.

Signed: Sarah Oreoluwa Oluyeju

Date: November 2017

DEDICATION

To God and father of our Lord Jesus Christ; the Alpha and Omega, and he alone that does great wonders.

Blessed be your name forever.

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LEGAL INSTRUMENTS

Pension Funds Act 24 of 1956

Regulation 28 of the Pension Funds Act 24 of 1956

Pension Reform Act 2004

Pension Reform Act 2014

Regulation of the Investment of Pension Funds Assets 2017

LIST OF ABBREVIATIONS & ACRONYMS

AFP *Administradoras de Fondos de Pensiones*

CAPM *Capital Asset Pricing Model*

CBN *Central Bank of Nigeria*

CPFA *Closed Pension Fund Administrators*

CPS *Contributory Pension Scheme*

EMH *Efficient Market Hypothesis*

FRC *Financial Reporting Council of Nigeria*

GDN *Global Depository Notes*

GDP *Gross Domestic Product*

GDR *Global Depository Receipts*

ILO *International Labour Organisation*

IPO *Initial Profit Offering*

MDFO *Multilateral Development Finance Organizations*

MPT *Modern Portfolio Theory*

NDC *Notional Defined Contribution*

NPF *National Provident Fund*

NSE *Nigerian Stock Exchange*

NSITF *National Social Insurance Trust Fund*

OECD *Organization for Economic Cooperation and Development*

PAYG *Pay As You Go*

PENCOM *Pension Commission*

PFA *Pension Fund Administrators*

PFC *Pension Fund Custodian*

PRA *Pension Reform Act*

RSA *Retirement Savings Account/ Retiree Savings Account*

SEC *Securities & Exchange Commission*

SME *Small & Medium Enterprises*

SPV *Special Purpose Vehicle*

SSA *Social Security Administration*

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SUMMARY OF THE STUDY

The Nigerian stock market has been underperforming in recent years partly due to the bias of the investors towards the issuance of bonds and other debt instruments by governments and corporate organisations. And over the years, Nigeria's pension funds' assets under management has grown massively into a potential investment capital capable of closing investment gap in the Nigerian stock market to deepen the market in terms of the depth and liquidity and promote the economic development of the nation. However, this is being curtailed by the extremely low investment limit of pension fund assets in the stock market, hampering the development of the market. Although a new regulatory regime was introduced recently, it has not made an impact in resolving the restrictive investment limits of the pension assets in the stock market.

This research has therefore sought to investigate the how reform of the regulatory framework for the investment of pension assets could deepen the stock market, providing investment capital to revive the struggling stock market. The thesis of this research is that the overly restrictive regulation on the investment of pension assets should be re-examined to provide the much needed finance the stock market requires for development.

The results of this proposed study will help inform the need for the legal reform to unlock pension fund assets as a source of finance to deepen stock market development.

CHAPTER 1

GENERAL INTRODUCTION

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CHAPTER 1

GENERAL INTRODUCTION

1.1 Background to the study

Over the years, economic growth and development in Nigeria has been hindered by the inability of the financial system to effectively intermediate through the mobilization and allocation financial surplus to the critical sectors of the economy.[1] This failure is a result of the weak and shallow financial system, especially the capital market. This has led to stunted economic growth in all sectors of the economy.[2]

Typically, a financial system provides the architecture and the physical infrastructure for capital to flow;[3] and it consists of entities that help facilitate the flow of funds from those that have funds to invest to those who need funds to invest.[4] A well-functioning, diversified and strong financial system facilitates the allocation of resources in an efficient, competitive, sound and stable manner. It also ensures that risks in the economy are well spread out among the various sectors. Therefore, financial system remains a critical imperative for a nation's economic wellness.[5]

The primary purpose of a financial system is facilitating the channelling of financial resources from the capital-rich to the capital-poor through third-party intermediaries.[6] In addition, it also enables individuals to directly provide surplus resources through capital markets where individuals and institutional investors with surplus capital invest.[7] For that reason, one of the key financial intermediaries in a financial system is the capital market. Capital markets facilitate the flow of funds from savers to long-term investors who invest in physical capital, which is necessary to increase production capacity and promote economic growth.[8] Studies have also suggested that deep and liquid capital market drives economic

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[1] OD Madukwe 'Effects on contributory pension scheme on capital market in Nigeria' (2014) 2 *International Journal of Management and Commerce Innovations* 202.
[2] As above.
[3] DBS & NEPAD Development Report 'Financing Africa's development: enhancing the role of private finance' 2003 44.
[4] Drake, Pamela and Frank Fabozzi (2010) *The basics of finance An introduction to financial markets, business finance, and portfolio management* 13.
[5] World Bank 'Making finance work for Nigeria'123.
[6] Spratt, S Development Finance, Debates, dogmas and new directions 2009, Routledge UK, 3
[7] As above.
[8] M McLindon *Privatization & Capital Market Developments* (1996) 11.

growth by channelling savings to long-term productive investment on the basis of market signals and prospects for risk and return.[9] Capital market therefore has a critical role to play in driving economic growth and development especially in developing countries by channeling funds to domestic markets, thereby creating capital to be invested in sectors of the economy.[10]

On the contrary, the absence of capital market obstructs the development of the private sector in every aspect of a national economy, and therefore long-term investment, economic growth and development will be unsustainable. This is because the role of the capital market in channelling savings to long-term productive investment would be lacking, hindering private sector development in industry, commerce and infrastructure.[11]

It has also been theoretically and empirically proven that capital market development is positively linked with economic growth and development because as mentioned above, capital markets facilitate the transfer of funds from savers to long-term investors who invest in the physical capital critical to building supply capacity and driving economic growth and development.[12] Investment in capital markets is done through the provision of debt financing companies by buying corporate bonds, or by providing equity financing to the companies through the buying of shares.[13]

1.2 Defining the research problem

One of the challenges facing capital market growth and development in Nigeria is the bias of the investors towards the issuance of bonds and other debt instruments by governments and corporate organisations.[14] This bias has taken a huge toll on the development of stock market segment of Nigeria's capital market. It has been reported that investors may have lost about ₦2.3 trillion in recent years as a result of the preferential investments in favour of the fixed income market. This preference was on the heels of the rise in return on debt instruments issued in the debt capital market which are guaranteed for fixed period of their tenure unlike

[9] McLindon *Privatization & capital market development* 3.
[10] As above.
[11] As above.
[12] As above.
[13] As above.
[14] 'Investors in equities lose N2.3 trillion to bonds, others' *The Guardian* 23 March 2017.Last seen at https://guardian.ng/business-services/investors-in-equities-lose-n2-3trn-to-bonds-others/ .

equities which are exposed to the vagaries of the market forces as they are traded daily.[15] As reported by one of the Nigerian dailies, the market capitalisation of quoted equities which was put at ₦11,237 trillion as at January 5, 2015 stood at ₦8,842 trillion as at Tuesday, March 21 2017, down by ₦2.3 trillion, while the All-Share index declined by ₦8,384.72 points or 32.8% from 33,943.29 to 25,558.57.[16] Again, this problem is also traceable to the priority that the debt instruments enjoy over and above equities because of the perception that there is more risks associated with equities compared to debt instruments. The implication of this is that the stock-market is weakened as funds required to boost trading are being gradually crowded out by incessant bond issues by government thereby creating distortions with negative impacts on the growth and development of the market and the national economy at large.[17]

On the other hand, pension funds have massive assets at their disposal which form part of investment landscapes all over the world.[18] An emerging economy like Nigeria needs a deep and liquid stock-market to achieve economic growth and development. It was recently reported that Nigerian pension funds' assets have grown by 3% between March and April 2017 alone to a record ₦6.5 trillion.[19] By nature, pension funds are long-term assets which when invested in the capital market would promote access to financing for underdeveloped sectors of the economy.[20]

However, section 8 of Regulation of Investment of Pension Funds Assets in Nigeria[21] limits the scope of allowable investment of pension funds' assets in equities- only up to 10% of total assets under management may be invested in equities. The implication of this is that the proposition which this research intends to make regarding the catalyzing the growth and development of Nigerian stock market by increasing the quantum of accrued pension funds' assets to be invested in the market cannot be met without the review of the regulation under

[15] As above.
[16] As above.
[17] As above.
[18] 'Pension fund management' *Africa Investor* Volume 14 Issue 5 2016 19.
[19] PENCOM "Summary of pension funds assets as at 30 April 2017" 30 April 2017 http://www.pencom.gov.ng/mobi/publications.php (accessed 21 June 2017).
[20] 'Capital market as a long term option for financing infrastructure development' A paper delivered at the "Central Bank of Nigeria Infrastructure Finance Conference" by Ms. Arunma Oteh Director General, Securities and Exchange Commission December 2010 1.
[21] Regulation of Investment of Pension Funds Assets in Nigeria 2017 (hereafter Amended Regulations).

reference.[22] Statistics show that pension assets account for 6% of the GDP, 7% of the domestic stock market and 55% of the local currency bond market in Nigeria as at 2015.[23] Therefore, increasing the quantum of pension funds' assets invested in stock market could resuscitate the declining stock market and induce a deep, liquid and vibrant market that would aggressively contribute to the nation's economic growth and development.[24]

It is in the light of the research problem defined above that this study will make a case for the upward review of regulatory-induced investment limits to allow for increase in the quantum of the accrued pension assets under management invested in the Nigerian stock market to catalyze its growth and development and the nation's economy at large.

1.3 Research question(s)

The broad research question which this study will seek to answer is: can the review of regulatory-induced investment limits of the accrued pension funds' assets under management be used to promote stock market development in Nigeria? And if so, how?

This study will also endeavour to answer the following sub-questions-

i. Which theories underpin the central thesis of this study?

ii. What is the nature and context of financial system and its role as a linchpin for national economic development?

iii. What is the role of pension fund as financing capital for development?

iv. What are the industry-specific laws and regulations that govern Nigerian pension system and administration of pension funds' assets and how can the review of the regulatory-induced investment limits of the accrued pension funds' assets under administration be used to increase the quantum of assets invested in stock market to drive the development of the market in Nigeria?

v. What lessons can Nigeria learn from other jurisdictions in the area of policy and regulatory reforms of administration of pension funds' assets to achieve constructive investment purposes?

[22] As above.
[23] As above.
[24] As above.

1.4 Thesis statement

This study will proceed from the assumption that the preference of the investors for fixed income market is partly responsible for the decline of the equity market as evidenced by its present shallowness and illiquidity.[25] In addressing this problem, this study will argue for the upward review of regulatory-induced investment limits to allow for increase in the proportion of the accrued pension funds' assets invested in the Nigeria stock market to promote depth and liquidity of the market.

1.5 Objectives of the study

An emerging economy like Nigeria needs a deep and liquid capital market to attain sustained economic growth and achieve the set development goals, and as mentioned above, a well-functioning, diversified and strong financial system which would allocate resources in an efficient, competitive, sound and stable manner, is an imperative. In addition, a liquid stock market is required to ensure that risks in the economy are well spread out among the various sectors.[26] Therefore, the core objective of this research is to propose the deployment of the massive pension fund assets under management in Nigeria to induce the deepening and liquidity of the equity market in particular and capital market in general to catalyse economic growth and development of the nation.

1.6 Research methodology

This proposed study will essentially be desk-top and library-based. In addition, it will be approached from a slew of research approaches such as theoretical, descriptive, analytical, comparative and prescriptive approaches. The study will also be multi-disciplinary in nature in the sense that ideas and concepts from other disciplines will also be used. In terms of sources, reliance will be on primary and secondary sources such as related laws, regulations, published articles and books, occasional papers written by experts and related institutions especially those that are regulatory in nature.

1.7 Literature review

The starting point is that the thesis of this study is premised on the assumption that the preference of the investors for fixed income market of the Nigerian capital market is

[25] 'Investors in equities lose N2.3 trillion to bonds, others' *The Guardian* 23 March 2017.Last seen at https://guardian.ng/business-services/investors-in-equities-lose-n2-3trn-to-bonds-others/ .
[26] World Bank 'Making finance work for Nigeria' 123

responsible for the shallowness and illiquidity of the stock market and that deploying a quantum of the accrued pension fund assets under management in Nigeria into Nigerian equity market can potentially promote depth and liquidity of the market.[27]

In a book,[28] Jackson discusses capital market development in Sub-Saharan Africa and argues that foreign public pension funds will aid in the development of sustainable securities market She describes the nature of pension funds and argues that the structure of public pension funds encourage investment decisions that promote sustainable development. Furthermore, she contends that public pension funds are long-term investors with long-term interests and that public pension funds lack the conflict of interest and short-term thinking known to private funds. [29]

The position of the author of the book under review that the investment of pension funds can fund capital market development tallies with the thesis of this proposed study, but the point of departure is the argument that foreign public pension funds be attracted to the continent. Foreign investment plays a key role in the development of an economy, but the question is how much of foreign investment can be attracted to the continent? Hence the argument that African countries should invest the assets they have in their economy to promote growth and development seems more plausible. [30]

Rene Swart in her article [31] proposes that pension funds can be smartly invested through long term bonds to address the socio-economic issue of higher education funding in South Africa She posits that this can be done by altering the lower limit in Regulation 28 of the South African Pension Funds Act so that a 2% investment in tertiary education government bonds will be prescribed.[32] She argues that although Regulation 28 sets out the minimum and maximum investment limits of pension funds in various asset classes, the alteration of the investment limit would guarantee the investment of pension funds in the government bonds

[27] African Investor 'Infrastructure development and domestic capital markets' Vol. 14 Issue 6 2016 45.
[28] K Jackson 'Pension-Funding the Future: Encouraging the Sustainable and Socially Responsible Development of Securities Market in Sub-Saharan Africa' (2010) 44 International *Lawyer* 792.
[29] As above.
[30] As above.
[31] Rene Swart 'A regulatory tweak could unblock billions for South African student fees' 7 November 2016 http://theconversation.com/a-regulatory-tweak-could-unlock-billions-for-south-african-student-fees-68082 (accessed 25 February 2017).
[32] As above.

assets class.[33] This study agrees with Swart's proposition by making a case for the use of accrued pension funds' assets for constructive investment purposes. This study, however, diverges in that regard in the sense that it focuses on the deepening of the Nigerian equity market.[34]

McLindon argues in his book[35] that it makes sense for pension funds which are institutional investors to buy stocks and bonds as it enables them match their liabilities with long terms assets. Furthermore, he identifies the reasons why institutional investors in emerging markets are unable to fulfill their roles of marshaling assets for productive use in economies.[36] These include: the ownership of institutional institutions by the government, unfunded social security systems that are government managed and policies restricting investment largely to government bonds. He further contends that the development of these institutional investors is critical to the long-term development of capital markets in developing countries. Again, he posits that the size and volume of funds create a demand for capital market instruments, in particular equities, which are known to have a high return rate, are appealing to pension funds.[37]

Melton in his book[38]explained in detail why an investor will choose to invest in equities. Although the book was written about two decades ago, the attraction of equities remain the same, giving investors a clear description of the benefits of equities to investors who might be unsure of what returns they might receive when they invest in equities. He went straight to the point in the answering the question of why equities by saying: '…over the long term, shares tend to give you a higher return and- believe it or not- a safer one.'[39]

In the book, he rallied evidence in support of the edge that stocks should ordinarily have over bonds by citing a book, In *Stock for the Long Run*, authored by one Siegel which showed that despite the fact that stocks might seem more volatile than bonds, it was observed that over a 30-year period since the year 1871, shares had performed better than bonds. Melton argues that even though many have criticised the evidence saying that it cannot be concluded that

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33 As above.
34 As above.
35 McLindon *Privatization & capital market development* 139.
36 As above.
37 As above.
38 Melton *Investor's Guide to Going Global with Equities* (1996) 3.
39 Melton *Investor's Guide to Going Global with Equities* 1.

stocks perform better than bonds merely on the basis of old evidence, history cannot and should not be ignored. Siegel further noted that: 'over the last century, accumulations in stocks have always outperformed other financial assets for the patient investor.' Although Melton seemed to have missed the point by focusing on the past, recent evidence shows that stocks still perform better than bonds many decades after.[40]

1.8 Limitations to the study

A major limitation to this study is that even though the researcher has attempted to access the most trusted and accurate statistical data regarding the quantum of accrued pension fund assets invested in Nigeria's capital market, these statistical sources are sometimes inaccurate and could therefore have influenced or skewed the views expressed in this study.

1.9 Structure of the study

This study is structured into 5 chapters.

Chapter 1 provides an overview of the proposed study and discusses introductory matters such as the research problem, research questions, thesis statement, objective of the study, research methodology, literature review and the limitations to the study.

Chapter 2 discusses the nature and context of financial system and its role as a linchpin for economic development and explores the theories underpinning the thesis of the research which cut across many disciplines.

Chapter 3 investigates pension system and administration and the role of pension funds as financing capital for development.

Chapter 4 analyses the industry-specific laws and regulations that govern Nigerian pension system and administration and how the review of the regulatory-induced investment limits of the accrued pension funds' assets can be used to increase the quantum of assets invested to promote the deepening and liquidity of Nigerian stock market. Furthermore, it engages in a comparative narrative analysis with a view to draw lessons for Nigeria from Chile and South Africa in the area of public policy initiatives and regulatory reforms of administration of pension funds' assets to achieve constructive investment purposes.

[40] Melton *Investor's Guide to Going Global with Equities* 3.

Finally, chapter 5 provides the summary of findings, makes conclusions and recommendations.

CHAPTER 2

EXPLAINING THE FINANCIAL SYSTEM

2.1 Introduction

2.2 The meaning of theory

2.3 The importance of theory to a research

2.4 Theoretical analysis

2.5 Explaining the financial system

2.6 Financial system as a linchpin for development

2.7 The Nigerian financial system

2.8 Conclusion

CHAPTER 2

FINANCIAL SYSTEM AS THE LINCHPIN FOR DEVELOPMENT

2.1 Introduction

The research agenda of this chapter is to examine the nature and context of the financial system and the vital role it plays in stimulating growth and development in a nation. Specifically, all the core issues surrounding financial system such as the objectives, functions and components will be broadly discussed. In addition, Nigerian financial system and the place of the financial system as the linchpin for growth and development will be examined.

As a run-up to the discussion, related theories that underpin the thesis of this research will first be explored. The discussion will commence with the definition of the term 'theory', thereafter, the relevance of theory in an academic investigation will be explored. Lastly, the analysis of the relevant theories that can assist in addressing the research question and find an answer to the research problem will presented.

2.2 The meaning of theory

Generally, theories explain how aspects of human behavior are organized and thus enable the prediction of such behavior. Specifically, Longman Dictionary of Contemporary English defines the word 'theory' as "…general principles and ideas about a subject..." [41] Furthermore, Moore describes theory as "…the summary and synthesis of what is known about a field. It is the reduction of our knowledge to the basic ideas, presented in a way that shows their underlying patterns and relationships."[42]

In addition, theories provide complex and conceptual understandings of things that cannot be exactly defined, like how society works, how organizations operate and why people behave in certain ways.[43] Theories therefore enable researchers to view their research problems through different lenses and focus on different aspects of an issue. In other words, theories provide a framework within which researchers conduct their research.[44]

41 Longman Dictionary of Contemporary English 2009.
42 G Moore *Crossing the chasm* (1991) 2.
43 A Seidman et al *Using law for good governance and development* (2007) 5.
44 As above.

The pertinent question then is: what are the various uses of theories in an academic enquiry? This will be answered in the next section.

2.3 The importance of theory to a research

The general aim of theory is to assist in understanding a certain reality or phenomenon. Theories can be explanatory, analytical, descriptive, prescriptive, and predictive (to a certain degree). Theory therefore entails a unit of knowledge that comprises of hypotheses, facts, and assumptions. Theoretical inquiry is very crucial for the development of a field of practice.[45]

Michael Graham Moore compares a theory to a map.[46] A map shows what is known and it shows what is not known[47]. Doing research without investigating theories is like going on a journey without using a map. The main value of a theory, apart from assisting in understanding what is already known, is that it shows the areas available for further research. Without theories, there cannot be research.[48] A theory may either be normative or positive. The difference between the two is that a normative theory attempts to explain what should be, while a positive theory tries to explain what is already in existence.[49]

A theoretical approach from an academic point of view involves using principles or ideas to explain a subject or phenomenon, rather than its practical uses.[50] Theories are therefore based on certain assumptions and are attempts to explain a complex concept by extracting them from reality through simplified assumptions. This is based on the fact that the world system is complex, and describing it is complex, if not difficult.[51]

Researchers use theories in three various ways: heuristic, as a critique and as a metaphor. Each of these has different implications for policymaking.[52] As a metaphor, policy makers get policy from logical constructs called theories or models. These theories do not need to be related to real-life scenarios.[53] The researchers would determine which strategy would solve the particular problem in their model's ideal world, and then would apply to the world the

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[45] Børje Holmberg et al 'The theories and the theorists: why theory is important for research' http://www.cairn.info/revue-distances-et-savoirs-2007-3-page-427.html (accessed on 26/05/2016).
[46] As above.
[47] As above.
[48] As above.
[49] Seidman *Using law for good governance and development* 59.
[50] As above.
[51] J Martin et al *The theory of finance: evidence and application* (1988) 23.
[52] Seidman *Using law for good governance and development* 59.
[53] As above.

policies- the model suggested. In this way, the theory is applied as an ideal construct-as metaphor.[54] As critique, theory can be applied to critique social practice.[55] This approach is pragmatic, and the critical function of theories is meant to show that values implicit in social practices and then to advance those values, thorough a self-reflection process.[56] In fact, this critical function increases the insight about a theory.[57] Concerning the heuristic function of theories, researchers are guided by theories towards the use of valuable data. Theories prove valuable in giving insights, and solving problems, and diverting researchers from unnecessary data.[58]

Theories construct concepts to define and explain a process. Therefore, theories consist of possible relationships developed among concepts and sets of concepts and provide model for understanding a phenomena. It is important to note that theories differ from hypothesis in the sense that they cannot be disproved as they are different lenses through which phenomena can be viewed. [59]

In the next section, the related theories, multidisciplinary in character, will be investigated to explicate the central thesis of this enquiry and make the research trajectory clearer.

2.4 Theoretical analysis

There are a couple of related theories that undergird the thesis of this study. This will now be interrogated one after the other.

2.4.1 Modern Portfolio Theory (MPT)

Marin explains the importance of the Modern Portfolio Theory (MPT) by way of an illustration when he states -

> "…consider an equation 15/30/50 where for every $15 you put into retirement savings (presumably over a 40 year retirement life cycle), you should accumulate $35 in compounding before retirement and an added $50 postretirement, assuming you drawdown at 60 percent of your preretirement income. This is actually quite logical if you stop to consider the compounding math and the timeframes involved in retirement

[54] As above.
[55] Seidman *Using law for good governance and development* 61.
[56] As above.
[57] As above.
[58] As above.
[59] B Kawulich 'The role of theory in research' 3.

> cycles. And the funny point is that this assumes an investment return of only 5 percent, and if we raised that to 10 percent, almost 99 percent of the value comes from compound return earnings. The point is simply that how your money is invested is far more important than the amount you save (actually somewhere between 6 and 100 times more important). And, in addition, it only gets more important in the later periods once the retirement pool is accumulated."[60]

He then concludes that pensions must rely greatly on their investment strategies in meeting their objective of providing retirement income security.[61] The MPT is based on the concepts of market efficiency and mean variance optimization of portfolios and that investors should try to diversify away as much security-specific risk as possible within the portfolio in order to focus on market or systemic risk.[62]

No investment can be undertaken without an element of risk, and any investment scheme must focus on risk management on how the investment is deployed. Diversification is therefore vital in reducing risk while allowing the maximization of return. These are both critical concepts in pension fund management.[63]

Harry Markowitz further quantified the concept of portfolio management which is based on the understanding that investors can reduce risk by investing in a varied pool of assets Markowitz's proposition was that an investor (who is assumed to be rational) will only undertake more risk if there is a possible additional return to be gained.[64] The riskiness of an asset can be assessed by how much deviation there is from the expected returns on the assets.[65] This is known as standard deviation which is a statistical measure of the extent to which a set of values deviates from the average or mean value.[66] Investments should therefore be assessed on the basis of their contributions to the risks and returns on a portfolio of assets rather than in isolation.[67]

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[60] RA Marin *Global pension crisis (*2015) 63.
[61] Marin *Global pension crisis* 63.
[62] OECD Investment governance and the integration of environmental, social and governance factors 2017 22.
[63] As above.
[64] FJ Fabozzi et al. *The basics of finance* (2010) 421.
[65] As above.
[66] AM Chisholm *An introduction to international capital markets products, strategies, participants* (2009) 135.
[67] As above.

There are further developments with the modern portfolio theory such as efficient portfolios which Markowitz describes as diversified portfolios which optimize return for any level of risk. It would therefore be irrational for an investor to invest in a less than efficient portfolio when there is an alternative that can produce higher returns for the assumed risks (or lower risks for the expected returns).[68]

Although the modern portfolio theory is based on the presumption that all investors are rational, in reality it cannot be assumed that all investors are rational. It also cannot be assumed that all investors share the same expectations on the returns and risks on an asset. The portfolio theory will therefore not be effective in all market conditions. However, the relevance of the theory remains that when risks are diversified, investors can maximize their returns.[69]

The MPT is an important theory for pension funds, as it is useful in setting targets for individual portfolios, monitoring investment methods, measuring, analyzing and attributing performance.[70]

The roles of the MPT are further discussed below.

Setting targets

Targets have to be set in managing a portfolio and questions such as these have to be addressed: how aggressively a portfolio should be managed?; within what limits will a pension fund operate?; against what standard will portfolio managers be assessed?; and within what time-frame should a strategy be assessed?[71]

Although the MPT cannot address all the issues mentioned, it will be valuable in enunciating them accurately. In setting the parameters for the portfolio management style, the portfolio manager’s work is clearly set out and this will enable the monitoring and calculation of resultant performance.[72]

Monitoring of investment methods

68 As above.
69 As above 137.
70 As above.
71 As above.
72 AG Shepherd *Pension fund investment* (2009) 147.

The MPT enables trustees to monitor and control the investment methods of the portfolio manager to ensure he or she stays within the limits. An accurate measurement and attribution of performance can only be possible if inventories of the shifts in portfolio management methods are taken.[73]

Performance measurement

Trustees must look beyond aggregate performance numbers in addressing the question of whether the portfolio manager delivered on what was agreed upon. It is also important to find out what percentage of the manager's actual returns is as a result of the investment strategy and what percentage was incidental. This is because portfolio managers tend to claim credit for all positive results including those that were incidental.[74]

The Principle of diversification in investment

There is a widespread consensus amongst economists that the most important element in determining long-run investment performance is asset allocation.[75] This principle associated with the prudent person rule is known as the principle of diversification.[76] In terms of this principle, the investment portfolio of a pension fund must be suitably diversified among appropriate asset classes and within each asset classification. This is to prevent the concentration of investment and the accumulation of risk in a particular portfolio. This principle is usually referred to as an explicit rule, but it is often without specific quantitative limitations. Simply put, quantitative limitation regulations are therefore the principle of diversification set out in an explicit and numerical form.[77]

[73] Shepherd *Pension fund investment* 148.
[74] Shepherd *Pension fund investment* 152.
[75] OECD "Prudent person rule" standard for the investment of pension fund assets 2.
[76] The prudent person rule is a behavioural-oriented standard which is generally stated in terms of the following principle: *A fiduciary must discharge his or her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims.* It has its roots in trust law, which is a concept of Anglo-Saxon law and the rule may apply to the duties and obligations that a fiduciary or trustee may have in respect of a trust, pension plan or fund. OECD "Prudent Person Rule" 3. In the *Harvard College v Amory* decision, a US state court introduced a prudent person standard that was broad and a departure from its traditional narrow counterpart. It permitted the investment of trust assets in the stock of private enterprise. The judge held:
"All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."
[77] OECD Prudent Person Rule 7.

2.4.2 The Capital Asset Pricing Model (CAPM)

The CAPM was introduced by William Sharpe in the 1960s and is similar to the MPT. It is based on the construct that the return on shares (dividends plus capital gains) are generally higher but subject to more variation that return achieved on government securities such as treasury bills.[78] The minimum return that investors expect on a currency such as the US dollar is based on the yield on government securities.[79]

A market risk premium is explained as "the excess return over the risk-free rate demanded by investors to hold a highly diversified portfolio of assets". If an individual share has the same risk profile as the market as a whole, the required return on that share is exactly the same as the market portfolio return. If pension fund managers follow the CAPM formula, they are more likely to receive higher return on their investments.[80]

2.4.3 Tragedy of the pension commons

The tragedy of the commons was described by William Foster Lloyd, a professor of political economy who used it to depict the tragedy of the Malthusian population growth. The term refers to the problems that become present due to reckless consumption of public resources freely available to everyone.[81] This research proposes that the tragedy of the commons applies equally to pension and pension funds investment.

Common property resources are subject to the tragedy of the commons theory which was introduced by Hardin.[82] Tragedy of the commons is used to describe the depletion and overexploitation of resources held in common when individuals are only concerned with securing their own benefits, without thought of the benefit of all[83]. Investopedia further describes the tragedy of the commons as an economic problem in which every individual tries to benefit the most from a common resource. As this naturally leads to the higher demand than the supply of such a resource, each additional unit of a resource consumed by one individual directly harms another who can no longer consume the resource.[84]

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[78] Chisholm *An introduction to international capital markets* 176.
[79] As above.
[80] As above.
[81] DeRobertis M & Lee RW The tragedy of the commons of urban (and suburban) arterial 1.
[82] Hardin, Tragedy of the commons 1968.
[83] Borck, R 'Investment and tragedy of the commons' (2001) Vol 4 No 1 *Economics Bulletin* 1-6.
[84] Tragedy of the commons http://www.investopedia.com/terms/t/tragedy-of-the-commons.asp#ixzz4rYVZGLGK (accessed 17 August 2017).

i. The pension commons

As Marjan mentioned, the more working class are included in pension schemes, the more resources are available to the elderly as pensions.[85] The number of workers who contribute to a pension scheme has rapidly grown in most countries and this creates a problem. Today, the fundamental problem is that there are regulatory restrictions on the use (investment) of these assets. In most developing countries, pension fund assets are thus idle.[86]

The lesson from Hardin's theory of the tragedy of the commons is that individual rationality (greed) will lead to failure on a communal level; it is therefore essential that the community govern and manage the use of available resources (the commons) which in this instance is the pension fund assets. The community is not just the beneficiaries of the pension schemes, but the economy as a whole and the society at large. Schlett puts it this way: "The reasonableness of the decisions made in relation to the tragedy of the commons lies in their benefitting the individual who makes the decision at a particular moment".[87]

The example of commons Hardin gave is about the increase of individual short-term benefit by reducing the long-term benefit of the community.[88] Although every pension scheme contributor is eager to receive their pensions on retirement, this pension will be unable to sustain them if the economy fails or inflation rates rise. Although the rationale behind pensions is social security, these assets are held in trust and instead of being idle, can be used to invest in the economy to promote growth and development.[89] Considering the state of the economy in most developing countries, retirees might be unable to live on their pensions alone and might possibly become a burden on the government or society. Although the effort to obtain short-term personal benefit might not necessarily cause damage at a societal level, it could cause a problem.[90]

Hardin suggested that the tragedy of the commons can be overcome through what he called 'enclosures'. Enclosures here mean privatization, which developed in the 90s when many countries introduced the defined contribution pension systems.[91] One of the arguments in

85 A Marján 'Az öregedés és az európai nyugdíjrendszerek' (2008) *Pénzügyi Szemle* 1/2008 62.
86 A Schlett 'Population ageing and the tragedy of the pension commons' (2011) *Ekonomika* Vl. 90(3) 63.
87 Schlett 63.
88 As above.
89 As above.
90 Schlett 'Population ageing and the tragedy of the pension commons' 64.
91 As above.

favour of privatization of pension schemes was that it encourages long-term savings and consequentially, investment which will substantially contribute to economic growth as the pension funds' assets can be invested.[92]

A major problem with the previous pension scheme in Nigeria was the mismanagement of pension funds' assets which was the fall-out of when the custody, management and investment of these assets were made the responsibility of irresponsible and corrupt officials.[93] These officials manage assets with only their best interests in mind. The triggered the belief that the management of pension funds' assets are best left in the hands of private-sector professionals, who would do so under strict regulation and monitoring.[94]

2.4.4 Modern development theory

This theory concerns the evolution of growth and income inequalities and their presence in unified models.[95] Financial market imperfections play a key role in modern development theories and influence decisions concerning human and physical capital accumulation. For instance, in theories regarding capital accumulation, the extent to which the poor can borrow to invest in physical capital are determined through market imperfections and in theories, emphasizing entrepreneurship, financial market imperfections determine whether talented but not well-off individuals can raise funds to initiate projects.[96] The conclusion is therefore that the advancement of financial development, growth and intergenerational income dynamics are interlinked. Finance undoubtedly has an impact on the allocation of resources in the economy and opportunities for individuals.[97]

The modern development theory highlights the key role of finance in the economy. The focus on the financial sectors has strengthened with the historical development of views on how economic growth and income inequality is linked.[98] Due to the belief that poverty was a given in the infant stages of economic development and that rich people are more likely to save, it was always argued that the financing of large investment projects can only be

[92] Schlett 65.
[93] African Business 'UK-Africa: trading up or trading down?' No.436 December 2016 64.
[94] BusinessDay *Contributory* pension scheme- no looking back! July 27 2017.
[95] Finance for All? Policies and Pitfalls in Expanding Access, World Bank, November 13, 2007 23.
[96] As above.
[97] As above.
[98] Finance for All? Policies and Pitfalls in Expanding Access 24.

achieved through wealth concentration.[99] This inevitably led to what was described as a "fundamental trade-off between growth and social justice."[100]

It is believed that inequality in an economy is present due to financial market imperfections.[101] For instance, the model presented by Galor and Zeira believes that financial market frictions is the reason why poor people cannot invest in educating themselves despite what was described as their marginal yield of investment.[102] In addition, Banerjee and Newman's model suggests that an individual's choice of occupation, whether they choose to be entrepreneurs or wage-earners, is directly linked to their saving rates and what risks they can bear, having an implication on growth and income distribution in an economy. The point to be taken from these models is that a lack of access to finance can be the cause behind lower growth and the widening inequality gap.[103]

Modern development theories therefore argue that one of the keys to economic growth is wealth redistribution and financial growth.[104] Therefore, if the cause of this inequality is capital market imperfections, policies that might remove these imperfections should be considered. However, researchers view capital market imperfections as a given and instead suggest various redistributive policies to promote growth and development most of which if carefully considered, could be disincentives to working and saving.[105]

A better approach will be to reduce capital market imperfections through investment to expand individual opportunities and promote growth and development.[106] Empirical evidence shows that there is a link between the depth of financial markets and growth. It has also been shown to significantly reduce inequality and poverty. In taking a step towards economic growth, deepening our financial markets is therefore our first task.[107]

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[99] As above.
[100] As above.
[101] As above.
[102] O Galor & J Zeira 'Income distribution and macroeconomics' *The Review of Economic Studies* (1993) Vol. 60 35-52.
[103] As above.
[104] Finance for All? Policies and Pitfalls in Expanding Access 24.
[105] As above.
[106] As above.
[107] As above.

2.4.5 Institutional legislative theory

The theory of designing law to promote development focuses majorly on the potential of the law as a tool in the government's hand to solve social problems. It especially concerns the design of detailed rules and regulations to engender transformation of historically dysfunctional institutional patterns which have threatened good governance and economic and social development.[108]

In explaining problematic behaviours of social actors, three interrelated jurisprudential and philosophical foundations are identified: legal realism, sociology of law and problem-solving.[109] Legal realism recognises a well-established reality; the theory of law is different from its application and drafters must therefore work to reduce the gap between the law and the practicality of applying or implementing it. In doing this, a crucial question must be addressed: why do people behave the way they do in the face of the law?[110] The answer is believed to be on the basis of the sociology of law and the realistic school of philosophy's problem-solving methodology.[111]

Firstly, the sociology of law gives insights into the behavioural tendencies of people when they are faced with a rule of law. Seidman describes the sociology of law as taught by Kelsen thus-

> A law always targets two sets of role occupants: (1) the social actor in civil society (a 'primary role occupant'); and (2) the agency (sometimes called the 'secondary role occupant') whom the law directs to implement its provisions aimed at inducing the primary role occupant to conform to the behaviours the law prescribes. (A simple example illustrates this proposition: A law prohibits the operator of a motor vehicle from exceeding 65m.p.h on a freeway. Either the same law or another commands a policemen, who observes a car travelling on a freeway in excess of that speed, to arrest the operator. The same law or another commands a judge, if it appears before the judge that the operator violated the rule addressed to the primary role occupant, to impose a stated sanction.)'[112]

[108] Seidman *Using law for good governance and development* 15.
[109] As above.
[110] Seidman *Using law for good governance and development* 22.
[111] As above.
[112] Seidman *Using law for good governance and development* 29.

Sociology therefore teaches that a person behaves by making choices within the constraints and resources within which such a person decides. As illustrated above, in making a decision, a role occupant considers three factors: the rule, the expected behaviour of the enforcement authority and the many objective and subjective non-legal factors that make up the particular country and location specific circumstances.[113]

2.4.6 The theory of law and development

Law and development concept is a subset the social theory of law largely based on the modernization and dependency theories which developed after the Second World War and the idea of legal liberalism being the central thesis. The thesis is that in implementing social change and institutional reform, the only tool available to governments is the law.[114] This theory projects the interface between law and development and articulates the development functions of law.

Development is a continual process of social change which requires institutional change in tandem.[115] Government officials who make decisions on whether and how to implement government policies are therefore also institutions.[116]

In present day society, law plays many roles-regulation, control, creation of order, determination of outcomes, prescription of penalties, outlawing acts or actions. Laws are further tools of administration and management. However, law could promote or restrict development depending on its objectives and purpose as well as the manner in which legal rules are implemented. [117]

All laws have an indirect effect on development, and others are enacted with the purpose of achieving particular goals. Such laws are laws that have a development function and form the framework within which development is managed in a country.[118] Development laws are therefore based on development policies, and policies come into existence through the policy-making process. The policy-making process begins when political leaders attempt to respond to the needs and problems of the people. These problems are usually identified by research,

[113] Seidman *Using law for good governance and development* 30.
[114] Seidman *Using law for good governance and development* 21.
[115] Seidman *Using law for good governance and development* 20.
[116] Seidman *Using law for good governance and development* 21.
[117] As above.
[118] As above.

inquiries and consultation with the public, thereafter which a general discussion document is drafted. [119]

Development law includes common law, international law, case law and customary law. These laws are however not restricted to laws by Parliament and other authorities. They also include administrative law and regulations such as the ones that govern pension systems and administration of pension funds' assets.[120] No matter how well researched and drafted, policy cannot of its own bring about development. It is the implementation of laws and policies that would bring about the desired change and development in the economy. However, enacting well-researched and drafted laws is the first step in the development process. [121]

Furthermore, development laws set out the rights and duties of role-players in the development process because development is an inclusive process which requires the input of people and organizations for its success. Development law is therefore the framework within which the development process is managed.[122]

2.4.7 Efficient market theory

A major area of interest in finance is whether financial markets are efficient or not. According to Fama, an efficient market is defined as 'one in which prices always fully reflect available information.'[123] There are a number of perspectives from which the efficiency of capital markets can be assessed: allocative, operational and informational efficiency.

Allocative efficiency concerns how good capital markets are at allocating scarce capital to their most productive uses. For instance, allocating assets to firms that can achieve the best return.[124] Operating efficiency is the cost efficiency of capital markets in raising capital. This means transaction costs will be reduced and long-term investors will be able to raise capital as easily as short-term investors.[125] Information efficiency refers to 'the extent to which

[119] Scheepers *A practical guide to law and development* 18.
[120] As above.
[121] As above.
[122] Scheepers *A practical guide to law and development* 21.
[123] E Fama 'Efficient capital markets: a review of theory and empirical work' (1970) *Journal of Finance* 383.
[124] As above.
[125] As above.

market prices of securities fully incorporate information and react to changes in information so that abnormal returns cannot be made on a consistent basis'.[126]

That said, in the following sections, the nature and context of the financial system and the vital role it plays in stimulating growth and development in a nation will be examined. Specifically, all the core issues surrounding financial system such as the objectives, functions and components will be broadly discussed.

2.5 Explaining the financial system

It is in this context that Faure describes the financial system as:

…a set of arrangements/conventions embracing the lending and borrowing of funds by non-financial economic units and the intermediation of this function by financial intermediaries in order to facilitate the transfer of funds, to create additional money when required, and to create markets in debt and share instruments (and their derivatives) so that the price and allocation of funds are determined efficiently.[127]

Fundamentally, a financial system provides the architecture and the physical infrastructure for capital to flow.[128]

Generally, a nation's financial system is made up of entities that help facilitates the flow of funds from those that have funds to invest to those who need funds to invest.[129] Therefore, the role of financial system is largely the same as in Walter Bagehot's description of the London money market in 1864: 'It is an organization of credit, by which the capital of A, who does not want it, is transferred to B, who does want it'.[130]

Players in the financial system who are involved in buying and selling of financial instruments constitute what is known and described as 'financial sector'. Financial sector is

[126] K Pilbeam (2010) *Finance and financial markets* 237.
[127] AP Faure 'Fundamentals of the financial system' in K van Wyk et al (eds) *Understanding South African financial markets* (2012) 3.
[128] DBS & NEPAD Development Report 'Financing Africa's development: enhancing the role of private finance' 2003.
[129] Fabozzi et al *The basics of finance* 13.
[130] W Bagehot (1978) *The collected works of Walter Bagehot: the economic essays* 422.

therefore 'all the wholesale, retail, formal and informal institutions in an economy offering financial services to consumers, businesses and other financial institutions'.[131] It is a widely known fact that the financial sector plays a vital role in the development of an economy. A well-developed and healthy financial sector catalyses economic growth and development.[132]

In the next section, one of these essential elements-financial markets will be discussed.

2.5.1 Financial markets

Financial markets are institutions and individuals who create and trade financial assets.[133] Financial markets are responsible for channelling surplus savings usually from households to economic units that cannot finance their activities from their own savings such as businesses and governments.[134] Financial markets therefore intermediate parts of a country's investment and if this function is performed efficiently, they reduce the costs of intermediation. Intermediation is the cost of transferring resources from savers to investors, increasing saver's returns and reducing an investor's costs. [135]

They also promote productive investment through careful project selections by private sector intermediaries such as banks, institutional investors and securities firms.[136] This increases the productivity of investment and produces positive results and higher return. Furthermore, financial markets facilitate investment and are therefore directly related to economic growth. Decent interests rates encourage saving, savings induce financial depth and financial depths encourage more investment. [137]

The main actors in financial markets are households, businesses and governments. Households seek to diversify risk through portfolios with real and financial assets.[138] Claims against future income can be held by households directly or through financial intermediaries.[139] Businessmen strive to raise funds to finance their projects when they run out of internal funds. This is usually done through borrowing from financial institutions,

[131] Department for International Development (DFID) Importance of financial sector development for growth and poverty reduction, Policy Division Working Paper (2004) 6
[132] A, Olusegun, S, Ganiyu & A, Oluseyi 'Impact of financial sector development on the Nigerian economic growth' (2013) Vol. 2 No. 4 *American Journal of Business and Management* 6.
[133] Fabozzi et al *The basics of finance* 14.
[134] As above.
[135] McLindon *Privatization and capital market development* 43.
[136] As above.
[137] McLindon *Privatization and capital market development* 43.
[138] As above.
[139] As above.

issuing corporate bonds or by issuing equities to new owners.[140] Finally, governments raise funds when tax revenues are insufficient to cover expenditures. The best way of doing this is to raise revenue through government bonds.[141]

Financial market consists of money market, derivative market, capital market and foreign exchange market. The various markets that make up financial market will be briefly explored in the next section.

i. Money market

The money market is a market where short-term retail and wholesale securities are issued and traded. It is the sector of the financial market made up of instruments with a maturity date of one year or less and is a means for households, government and business sectors in need of short-term funds to meet economic entities with a surplus funds and engage on various forms of transactions such as lending, borrowing and trading.[142] Lending and borrowing in the money market is effected through direct and indirect financing with and without of a financial intermediary.[143]

ii. Foreign exchange market

The forex market is characterized by capital inflows and payments and receipts for imports and exports. There is both the retail and wholesale forex market.[144] The retail market is where currency conversions at a Bureaux de Change takes place while the latter is where exchange rates are determined.[145] The forex market facilitates the mechanisms for the exchange of one currency for another, and banks are said to *make* this market because they are always ready to bid and offer exchange rates. For the forex market to function, it is important that there is a steady demand and supply of forex.[146]

It is also important to note that the foreign exchange market (forex) is not in the sense of the word ‘a financial market’ because borrowing and lending does not take place.[147] However because people can borrow and lend offshore, and foreigners can borrow or lend from local

[140] McLindon *Privatization and capital market development* 44.
[141] McLindon *Privatization and capital market development* 42.
[142] Fabozzi *The basics of finance* 26.
[143] Z Botha ‘The money market’ in van Wyk *Understanding South African financial markets* 244.
[144] Faure ‘The foreign exchange market’ in van Wyk *Understanding South African financial markets* 417.
[145] As above.
[146] Faure‘The foreign exchange market’ 419.
[147] As above.

financial institution, transactions are facilitated, giving the forex market a domestic and foreign borrowing and lending dimension. [148] The forex market can therefore best be described as a 'conduit' for investments in financial markets. There are a number of participants in the forex market such as, authorised dealer banks, foreign exchange brokers, foreign banks, the central bank etc.[149]

iii. Capital markets

Chisholm describes capital markets as 'places where those who require additional funds seek out others who wish to invest their excess'.[150] They provide platforms where the market players, the sellers and buyers of securities, 'can manage and spread their risks'.[151]

Capital markets are made up of two segments: securities and non-securities segment. Securities are more liquid than non-securities as they can be bought and sold more easily without large swings in the price. Individuals and institutional investors therefore tend to prefer securities.[152]

Generally, one of the core functions of capital market is to facilitate the channelling of funds from savers to long-term investors who invest in physical capital which is necessary to increase production capacity and promote economic growth. Capital markets trade in instruments that are over a year or more and include long-term debt obligations such as government bonds and equities. These instruments usually involve longer maturities and higher degrees of risk.[153]

Other functions of the capital market include: **e**conomic function which is a crucial function and involves the mobilization of capital from borrowers to savers;[154] continuous pricing which entails the capital market providing market participants with accurate and updated price information;[155] and fair pricing which removes the fear of buying or selling at an unreasonable price in the market.[156]

[148] As above.
[149] Faure AP, 'The foreign exchange market' 417.
[150] Chisholm *An introduction to international capital markets* 1.
[151] As above.
[152] McLindon *Privatization and capital market development* 44.
[153] McLindon *Privatization and capital market development* 44.
[154] RA Strong *Portfolio construction, management and protection* (2009) 241.
[155] As above.
[156] As above.

It should be noted that capital market promotes economic growth by channelling savings to long-term investments based on market signals and risk prospects and returns. On the other hand, the lack of capital markets is known to hinder the development of the private sector in industry, commerce and even infrastructure.[157] Without a stable and vibrant capital market to direct domestic savings (such as pension fund assets) to long term investments, economic growth cannot be sustained.

Hanke and Walters described the crucial function of capital markets thus:

[S]table financial systems and free and open capital markets have played a major role in the development of many advanced or rapidly developing countries. Free capital markets do not guarantee rapid development; other ingredients are needed. Nevertheless, an ossified financial system will inhibit or even stop development. Therein lies the hope for reform.[158]

Components of capital market

Broadly speaking, the capital market consists of three major sub-markets: bond market, derivative market and equity market. Three markets will be explored in the next paragraphs.

Bond market

Bonds are financial instruments which obligate the issuer, who is the borrower, to pay interest and repay the capital amount to the holder over a certain period of time. The buyer provides a loan to the issuer which will be repaid at the maturity of the bond. A bond is therefore a debt to the issuer.[159] Bond market, also known as fixed income market, enables corporations and governments to borrow directly from investors through the issuance of bond in the capital markets. It works like this: bonds are issued in the primary market and traded in the secondary market.[160] The debt then provides investors who purchase the bonds with a regular source of income through interest payments (i.e. coupons) for the lifetime of the bond as well as payment of the principal amount upon maturity of the bond. The value of the bond is

[157] McLindon *Privatization and capital market development* 3.
[158] Hanke, SH& Walters, AA *Capital markets and development* (1991) 42.
[159] C van Zyl 'The bond market' in van Wyk *Understanding South African financial markets* 307.
[160] As above.

determined at the time of issuance, hence the reference to fixed income.[161] This debt can be traded in the secondary market

In the secondary markets, a dip in bond prices creates a resultant increase in the interest rate or yield paid as the fixed interest rate becomes a larger percentage of the bond price.[162] A rise in the price of a bond creates the reverse. A decrease in the demand for bond will lead to falling prices and rising interest rates. A higher interest rate is a reflection of an increase in the risk of the bond.[163]

Derivatives market

Derivatives are financial instruments whose values are derived from the value of underlying securities and variables.[164] They are contracts that stipulate that the contract-holder has the obligation or choice to buy or sell an underlying asset at a later date. The underlying asset can be a stock, bond, financial index, interest rate, currency or a commodity. Derivatives include futures, forwards, options and floors and they play a major role in providing a transactionally efficient vehicle for protecting investors and issuers against different types of risk.[165] It further helps businesses hedge risks that are associated with external factors such as volatile commodity prices, interest rates and foreign currencies.[166]

Equity market

Equity represents the risk capital of a company. This term is usually used as a synonym for shares, although Falkena insists that equity is a sort of broader concept than shares.[167] This is because "…it embraces, in addition to the ordinary share capital of a company, its reserves, any irredeemable preference capital in issue and minority interests less goodwill."[168]

Shares are equal indivisible rights or interests in the management, profits, and assets of a company which becomes the property of those who own the shares and are evidenced by a certificate. Shares entitle its owners to one vote on matters of company governance at the

161 Spratt Stephen *Development Finance Debates, dogmas and new directions* (2009) 4.
162 As above.
163 Spratt *Development Finance Debates, dogmas and new directions* 4.
164 I Goodspeed 'The derivatives market' in van Wyk *Understanding South African financial markets* 389.
165 Fabozzi *The basics of finance* 29.
166 Goodspeed 'The derivatives market' 389.
167 HB Falkena et al *The equity market* (1993) 1.
168 As above.

company's annual general meeting and to share in the financial benefits of ownership. The owner however incurs no liability for his shareholding.[169]

Investors are able to obtain a percentage of the ownership of a company when they invest in equities. There are two forms of equity market and these are: public equity markets and private equity. In public equity markets, companies list their shares for trading and investors who purchase the company's shares become entitled to share in the company's profits in proportion to shares purchased. The profits are known as dividends and they are paid to an investor annually. Although anyone can invest in most public equity markets, it is usually institutional investors such as banks, insurance companies and pension funds that invest in public equity markets.[170]

On the other hand, in the private equity market, shares are sold directly to investors rather than listed on a public market.[171]

Equities are a means of raising capital. As mentioned above, this is done by selling shares in a company. Equities are important to the investment of pension fund assets because of their characteristic as long-term capital.[172]

The major distinction between bond and equity market is the nature of the risk involved.[173] The issuer of a bond bears the principal risk while in equity market, the primary risk rests on the investor because the dividends are paid out based on the performance of the company in a year.[174] In the case of bonds, the risk is on the issuer of the bonds because payments must be made to the investor irrespective of the financial performance of the company.[175] This might be considered as a disadvantage, but in terms of the MPT, if an investor diversifies his or her risk, this should not be problem.[176]

Normally, equity markets develop more rapidly compared to bond markets and this is due to the fact that equity shares afford investors a pro-rata interest in the company. The argument is

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169 As above.
170 Spratt *Development Finance Debates, dogmas and new directions* 5.
171 As above.
172 S Valdez & P Molyneux *An introduction to global financial markets* (2010) 11.
173 As above.
174 Valdez & Molyneux *An introduction to global financial markets* 7.
175 As above.
176 Spratt *Development Finance Debates, dogmas and new directions* 5.

that because equity finance creates ownership rights in a company or firm as compared to other instruments, these rights are usually permanent in nature.[177]

In the next few paragraphs, the functions of the equity market will be examined.

Functions of the equity market

The equity market plays a crucial role in the generation of risk capital and the creation of a market for securities to be traded freely under a regulated process.[178] The equity market is vital in an economic system and its functions include-

a) Channeling savings into investments

Equity in itself does not contribute to the productive capacity of an economy. This is because productive capacity is a function of the real assets of the economy which are the physical and human capital resources.[179] However, equity provides for the separation of the ownership and management of a company (real assets) thereby facilitating the transfer of funds to enterprises with attractive production capacities.[180] Financial assets increase the wealth of the holder, representing an entitlement to the income generated by the real assets in the economy. The equity market further serves as the principal source of information on the availability and cost of capital. In addition, the equity market provides the basis for the terms and conditions for new issues in the market.[181]

b) Providing investment liquidity

The equity market provides liquidity for short-term investors which enables them channel these short-term funds into the economy for long-term investments, thereby providing the economy with alternative resources.[182] Furthermore, the dominant market price of a share provides an investor with an evaluation of the financial well-being and prospects of a company and even in the market as a whole.[183] This way, an investor will be able to monitor his equity holdings or liquidate and reinvest them in new listings if he so desires. Therefore,

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[177] M Choudhry et al *Capital market instruments: analysis and evaluation* (2012) 4.
[178] As above.
[179] Falkena *The equity market* 39.
[180] Falkena *The equity market* 40.
[181] As above.
[182] As above.
[183] As above.

short-term investors enable the financing of long-term investment in capital goods with short-term savings.[184]

c) Evaluation of securities and management

The equity market also functions in overseeing and assessing the performance of management as companies are usually concerned about their share prices.[185] Companies naturally desire a steady and reliable increase in their share prices over time and will be motivated to avoid reductions in share prices.[186] This reiterates the vital role of the equity market in supplying individuals, institutions and companies with information to make wise investment decisions and providing the economic system with a remedy against companies which are unable to meet the market's requirements.[187]

In addition, there are two other markets which are also part of the financial market in an economy and they are-

iv. Primary market

The primary market is the market where new securities are issued. Issuers or borrowers usually raise capital for new investment in the primary market.[188]

v. Secondary market

The secondary market is the market where previously issued securities are traded. When these securities are traded, the proceeds are not the issuer's but that of the seller of the securities, who is the previous owner.[189] Secondary markets can further be categorized into a call or continuous market. A call market is a market in which individual securities trade at specific times. Orders to buy and sell are accumulated over a period of time, with a single price set to meet the largest number of orders thereafter. The rest of the securities are also

[184] Falkena *The equity market* 41.
[185] As above.
[186] As above.
[187] Falkena *The equity market* 42.
[188] Z Botha 'Financial market terminology, technicalities and theories' in van Wyk *Understanding South African financial markets* 202.
[189] As above.

traded at the same price. A continuous market is a market like a stock exchange where securities trade at any time, provided the market is open.[190]

Stock markets therefore function as primary markets where shares and other instruments are issued and as secondary markets where existing equities and other financial instruments are traded.[191]

Having discussed the nature and context of financial system broadly, the role of financial system as a stimulant for development will be discussed in the next section.

2.6 Financial system as the linchpin for development

Finance is an important aspect of the development process and well-functioning financial systems has been suggested to be critical for economic growth and development.[192] In the absence of inclusive financial systems, small businesses and poor individuals would need to rely on their own earnings and insignificant savings to invest in their education, become business-persons or be part of the emerging growth opportunities.[193] Financial inclusion is an attribute of development and also indication of the inclusivity of a developed financial system.

In the World Bank report, [194] the authors are of the opinion that-

> well-functioning financial systems are by definition efficient, allocating funds to their most productive uses. Well-functioning financial systems serve other vital purposes as well, including offering savings, payments, risk-management products to as large a set of participants as possible, and seeking out and financing good growth opportunities wherever they may be.[195]

The preamble to the United Nations' General Assembly's Declaration on the Right to Development196 broadly defines the term 'development' as -

a comprehensive economic, social, cultural and political process, which aims at the constant improvement of the well-being of the entire population and all individuals on the basis of

[190] As above.
[191] As above.
[192] Finance for all? Policies and pitfalls in expanding access ix.
[193] As above.
[194] As above 1.
[195] As above.
[196] United Nations General Assembly Resolution 41/128 of 4 December, 1986.

active, free and meaningful participation in development and in fair distribution of benefits resulting there from.[197]

Theo Scheepers followed suit by defining 'development' broadly as follows:

Development is a people-centred process of change depending for its ultimate success on the capacity of people to manage the process through a variety of critical steps and phases within the limits of an institutional and value framework that will guarantee meaningful and lasting improvement of quality of life for all in a peaceful, stable and well-governed environment.[198]

A strong, well-functioning, competitive and resilient financial system is crucial for sustained economic growth and development in the sense that it would ensure that risks in the economy are well spread-out among the various sub-sectors and allocate resources to firms that are more efficient, competitive, sound and stable.[199]

There is no gainsaying the fact that financial markets are an efficient means of channelling resources to productive use. This is because financial systems provide for the renewal of the economy through the pulling of funds from underperforming sectors of the economy to innovate and newer sectors that can put such resources to good use.[200]

Specifically, a financial system facilitates the efficient transfer of funds by mitigating information asymmetry between investors and borrowers. It functions primarily in channelling of funds from sectors of the economy with a surplus to sectors that have a shortage of funds.[201] It is also the centre of production as it performs a myriad of roles in the economy such as financial intermediation and provision of payment services amongst others.[202]

The presence of financial sector development is usually evidenced by the effects of information search, transaction costs and rule enforcement being reduced by financial instruments, markets and intermediaries.[203] This implies that a developed financial system is

[197] As above.
[198] Scheepers *A practical Guide to law and development* 8.
[199] 'Making Finance work for Nigeria' 2009 World Bank 23
[200] E Avgouleas *Governance of global markets* (2012) 23.
[201] Faboozi *The basics of finance* 14.
[202] J de Haan et al. *Financial markets and institutions* (2014) 5.
[203] As above.

one which provides satisfactory financial services that meet the needs of people and provides a wider access to finance in an economy.[204]

Empirical evidence on the link between a developed financial system and economic growth suggest that the deeper a financial system is, the higher its potential for growth becomes.[205]A study conducted by King and Levine where 80 countries were examined over three decades found that there is a definite, positive relationship between various financial development indicators and economic growth.[206] Furthermore, Calderon and Liu conducted an analysis on whether there is a link between financial sector development on growth and growth on financial sector development.[207] Their results showed the affirmative, that there is a 'bi-directional causality; financial sector development has a causal effect on growth and growth has a causal impact on financial sector development.[208] Nonetheless, the impact of financial sector development is more important than the impact of growth on financial sector development. The conclusion that can be made from these empirical evidences is that if a country's financial sector is underdeveloped, this will likely hinder growth in developing countries.[209]

As mentioned above, the main purpose of the financial system is to channel funds from sectors that have a surplus to sectors that have a shortage of funds.[210] In pursuit of this, the financial system performs four critical functions which will be discussed in the next sub-section.

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[204] As above.
[205] Avgouleas *Governance of global markets* 31.
[206] RG King & R Levine 'Finance, entrepreneurship, and growth: theory and evidence' (1993) 32 *Journal of Monetary Economics* 513-542.
[207] C Calderon & L Liu 'The direction of causality between financial development and economic growth' (2003) 72 *Journal of Development Economics* 321-334.
[208] As above.
[209] Avgouleas *Governance of global markets* 32.
[210] As above.

2.6.1 Functions of the financial system

i. Reducing information asymmetry and transaction costs

The financial system plays an important function in bridging the information asymmetry between borrowers and lenders.[211] An information asymmetry occurs before and after a financial contract is concluded where borrowers know more about investment projects than the lenders.[212] A situation of *adverse selection* also arises when borrowers who are so eager to transact causes an undesirable outcome for the lender.[213] For instance, individual lenders may not have the time or means to collect and process information on borrowers as obtaining such information is costly, therefore hindering the flow of funds in the market. This is where the role of financial intermediaries becomes crucial as they reduce the costs of acquiring and processing information, thereby improving the allocation of resources.[214]

Financial intermediaries reduce the time and resources expended on carrying out transactions. This is because they have the expertise to utilise economies of scale and scope.[215] For instance, financial intermediaries accumulate capital from savers to use for investment. This is known as pooling without which savers would have to buy or sell entire firms. The costs of channeling funds are substantially reduced, freeing resources for other productive uses.[216]

ii. Diversification and risk management

Risks associated with investment projects are mitigated through the provision of opportunities to diversify risk and this could positively affect economic growth in the long-run. High-return investments usually involve more risk than low-return investments, and the financial system makes it easier for investors to diversify risk by presenting a broad spectrum of high and low-risk investment opportunities. This creates a diversified portfolio for

[211] Haan et al. *Financial markets and institutions* 9.
[212] As above.
[213] As above.
[214] As above.
[215] Haan et al. *Financial markets and institutions* 10.
[216] Haan et al. *Financial markets and institutions* 10.

investment, reducing risk and promoting investment in activities that innovate and enhance economic growth.[217]

Furthermore, the market provides liquidity which is the ease with which financial instruments can be converted into money. Levine defines liquidity as '…the ease and speed with which agents can convert assets into purchasing power at agreed prices'.[218] Savers are usually hesitant to leave their saving to investors over long periods, and this may mean that investment might not occur in high-return projects which require a long-term commitment of capital.[219] The financial system creates the possibility for savers to hold liquid assets which they can sell easily to access their savings, and also converting the liquid financial instruments into long-term capital investment at the same time.[220] The financial market therefore provides liquidity for investors, without which investors would be bound in illiquid long-term investments that only yield a high return at the end of an investor.[221]

Securitisation is also another means through which the financial system performs this important function. Securitisation is defined as 'the packaging of particular assets and the redistribution of these packages by selling securities, backed by these assets, to investors.'[222] Securitisation is therefore a process of converting illiquid assets to liquid assets. Residential mortgages were the first securitised financial assets, but more recently, catastrophe bonds have emerged.[223]

iii. Corporate governance

Financial markets can become good agents of effective corporate governance under certain circumstances. The absence of financial arrangements enhancing corporate governance may hinder the mobilization of savings and the flow of capital to profitable instruments. Financial

[217] Haan et al. *Financial markets and institutions* 11.
[218] R Levine 'Financial development and economic growth: views and agenda' (1997) 35 *Journal of Economic Literature* 688-726.
[219] As above.
[220] As above.
[221] As above.
[222] Haan et al. *Financial markets and institutions* 11.
[223] For instance, if insurers have built up a portfolio of risks by insuring properties in a region that may be hit by a catastrophe, they could create a special-purpose entity that would issue the catastrophe bond. Investors who buy would therefore make a healthy return on their investment, unless a catastrophe, like a hurricane or an earthquake, hits the region, because then the principal initially paid by the investor sis forgiven and is used by the sponsors to pay their claims to policy holders. Haan et al. *Financial markets and institutions* 12.

markets thereby fulfill an important function as a disciplinary mechanism through creditor monitoring, stock pricing and the operation of the market for corporate control. [224]

Two essential elements of the financial system critical to this research include financial intermediaries, which facilitate the lending and borrowing process, and the financial markets, which are institutional arrangements and conventions that exist for the issue and trade of financial instruments.[225]

2.7 The Nigerian financial system

The Nigerian financial system is considered one of the largest and most diversified in sub-Saharan Africa.[226] It is the most populous country in sub-Saharan Africa (SSA) with a population estimated at 215 million. It is also the second largest economy in the region with a GDP of $337 billion in 2010 and a per-capita GDP of about $2500.[227] However, given the natural resources in the country, the oil resources, and with a highly educated workforce, financial development statistics is described as disappointing. An estimated 70 percent of Nigerians still live on less than $2.50 per day. This is attributed to the unstable and inefficient financial system of the country.[228]

There are four categories of financial markets in Nigeria; the money market, capital market, bond market and foreign exchange market.[229] The money market facilitates the creation of short-term debt instruments with a maturity date of between one to three years such as treasury bills and certificates, commercial papers, certificates of deposits etc. Institutions which play a major role in the creation of these instruments include discount houses,[230] commercial banks, merchant banks and low-income institutions. Of note is also the inter-bank market which provides a platform for lending and borrowing between banks.[231] The capital market facilitates the creation of medium to long-term financial assets and the mobilization of these assets for development and investment. Institutions operating in the

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[224] Avgouleas *Governance of Global Markets* 29.
[225] As above.
[226] As above.
[227] Olusegun et al.'Impact of financial sector development on the Nigerian economic growth' 5.
[228] As above.
[229] Chinedu B. Ezirim, Michael Muoghalu DBA, Emmanuel Emenyonu 'Intermediation behaviour of the financial superstructure in response to environmental stimuli' (2007) 8:2 *Journal of African Business* 61-89.
[230] A discount house is a firm that buys, sells, discounts and/or negotiate bills of exchange or promissory notes on a large scale with transactions such as government bonds and treasury bills. http://www.investopedia.com/terms/d/discount-house.asp.
[231] As above.

Nigerian capital markets are the Securities and Exchange Commission (SEC), the Nigerian Stock Exchange (NSE), issuing houses and stock broking firms.[232]

The Nigerian financial sector is made up of two sectors: the formal and informal sector. The informal sector is the undeveloped, limited sector which is not integrated into the formal financial system such as informal money lenders and savings associations.[233] The formal sector is made up of the capital and money market institutions such as banks and authorised financial institutions. The 2008 Central Bank of Nigeria (CBN) Annual Report and Statement of Account described the Nigerian financial system as consisting of the CBN, the Nigerian Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the National Insurance Commission (NAICOM), the National Pension Commission (NPC), deposit money banks, microfinance banks, finance companies, bureaux-de-change, stock exchange, commodity exchange, primary mortgage institutions, development finance institutions, discount houses and insurance companies and registered insurance brokers.[234]

The Nigerian stock market is the second largest in the continent, trading roughly 300 companies with a capitalization of 35 percent of GDP. Its bond market trades in securities with maturities of up to 20 years and an estimated 50 insurance firms are also in operation.[235]

2.7.1 Recent developments in the Nigerian stock market

In 2008, the Nigerian stock market experienced a sharp decline, with the All Share Index losing more than 60 percent of its value.[236] The NSE became one of the most over-valued exchanges in the world, driven by the banking and insurance sectors. This was caused by the withdrawal of foreign investors from the market, leading to margin calls and the increase of required collateral. For instance, market capitalisation which was $110 billion in early 2008 had dropped to $32.5 billion by mid-February of the following year.[237] Another major cause that was identified was the reliance of the market on few sectors in the economy, which means that there were little or no opportunities for diversification. [238]

[232] Ezirim et al. ‘Intermediation behavior of the financial superstructure in response to environmental stimuli’ 9.
[233] Olusegun et al. ‘Impact of financial sector development on the Nigerian economic growth’ 4.
[234] As above.
[235] As above.
[236] ‘Making finance work in Nigeria’ 2009 World Bank 105.

[237] As above.
[238] As above.

The Nigerian stock market used to be mostly driven by foreign investors, who all left the market due to overvalued naira, inconsistent regulations and restriction of the remittance of dividends.[239] Local investors who are capable of playing the role foreign investors played in the stock market are being restricted by regulation, such as the investment of pension funds' assets, who are only permitted to invest up to 10 percent of their assets under management to equities.[240] With an efficient framework in place, local investors such as pension funds are capable of providing a substantial portion of the investment gap in the stock market.[241]

The development of the Nigeria stock market is a social imperative which should be given priority on national development agendas to induce the mobilisation of domestic sources of funding. First, the government must prioritise stock market development at national level as regulatory reform required to effect this development can only be possible through government involvement.[242] Second, financial institutions must lead by example as they are vital stakeholders without which stock market development cannot be achieved.[243] However, to achieve this objective, relevant stakeholders such as regulators (central banks, pension fund regulators and the Securities and Exchange Commission) must provide the relevant support.[244]

2.8 Conclusions

In this chapter above, the related theories that underpin the thesis of this research were discussed. The discussion commenced with the definition of the term 'theory' and thereafter, the relevance of theory in an academic enquiry was explored. The conclusion is that theories are based on certain assumptions and are attempts to explain a complex concept by extracting them from reality through simplified assumptions. In other words, theories provide complex and conceptual understandings of things that cannot be exactly defined, like how society works, how organizations operate and why people behave in certain ways. Theories therefore enable researchers to view their research problem through different lenses and focus on different aspects of an issue.

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239 African Finance 'Africa's debt spare' May 2017 56.
240 As above.
241 As above.
242 As above.
243 As above.
244 African Banker 'The development of Africa's financial market is a social imperative' 4th Quarter 2016 74.

In addition, the nature and context of the financial system and the vital role it plays in stimulating growth and development in a nation have been examined. Specifically, all the core issues surrounding financial system such as the objectives, functions and components were be broadly discussed. In addition, Nigerian financial system was also discussed and the place of financial system as a linchpin for growth and development was interrogated.

The conclusion is that finance is an important aspect of the development process and a strong a strong, well-functioning, competitive and resilient financial system remains an imperative for sustained economic growth and development in the sense that it would ensure that risks in the economy are well spread-out among the various sub-sectors and allocate resources for inclusive development in the broadest sense of the word, and promote an efficient, competitive, sound and stable economic system.[245]

[245] 'Making Finance work for Nigeria' 2009 World Bank 23

CHAPTER 3

PENSION SCHEME ADMINSTRATION AND REFORMS

3.1 Introduction

3.2 Objectives of pension system

3.3 Types of pensions

3.4 Economics of pensions

3.5 Pension reforms

3.6 Conclusions

CHAPTER 3

PENSION SCHEME ADMINSTRATION AND REFORMS

3.1 Introduction

In chapter 3, the nature and context of the financial system was examined and its role as a linchpin for growth and development was interrogated. The conclusion was that finance is an important aspect of the development process and a strong, well-functioning, competitive and resilient financial system is an imperative for sustained economic growth and development by ensuring that risks in the economy are well spread-out among the various sub-sectors and allocate resources in an efficient, competitive, sound and stable manner.

This chapter investigates the pension system administration and reforms. This will be followed by discussions around pension fund being one of the creative sources of financing for development.

3.2 Objectives of pension system

For individuals, pension is a form of income security in old age and it requires two types of instruments: a mechanism for consumption and distribution and insurance.[246] These are expatiated below-

3.2.1 Consumption smoothing

Generally, people seek to maximize their well-being over time, as opposed to a single point in time. This is because extra consumption in the future is valued more than extra consumption today. Thus, the main purpose is consumption distribution which entails saving during a person's productive years for his or her retired years.[247]

3.2.2 Insurance

The reason why individuals save during their working life to finance their retired years is because they seek certainty as they face uncertainties including how long they would be able

[246] N Barr & P Diamond 'The economics of pensions' (2006) 22 (1) *Oxford Review of Economic Policy* 15-39 16.
[247] As above.

to work or how long they are going to live. The insurance provided by pension systems also extend to spouses and young children and even against disability.[248]

3.2.3 Redistribution

Pension systems reallocate income on a lifetime basis, for instance, by paying pensions to low-income earners that are on a higher percentage than their previous earnings.[249] This will provide an insurance against low earnings and redistribution can be effected towards families and across generations.[250]

Other objectives of pensions system include economic growth and development through investment of pension fund assets.

3.3 Types of pensions

There are different types of pensions, depending on the way they are organised and how contributions and benefits are linked.

3.3.1 Fully-funded schemes

In a fully-funded pension scheme, pensions are paid based on a fund that is built over a number of years from contributions by members. They are primarily based on savings and funding is, hence, a means of accumulating assets which are traded for goods later on. This scheme usually has enough reserves to pay outstanding financial liabilities, and the accumulation finances a retiree's consumption through an annuity or any other way.[251]

3.3.2 PAYG schemes

Pay-as-you-go (PAYG) schemes are pension schemes run by the government and are described as contractarian in nature because the State can accumulate pension assets for future claims and also require the working population to pay the pensions of the retired population.[252] The PAYG pension system works like this: a worker pays contributions now based on the promise by the State to pay him or her pensions in the future. This means that there is no obligation on the State to match the benefits received to the contributions made; benefits are not directly linked to the contributions. [253]The PAYG therefore redistribute and

[248] As above.
[249] Barr & Diamond 'The economics of pensions' 17.
[250] As above.
[251] As above.
[252] As above.
[253] As above.

share risks across generations. It is hence possible that every generation may receive more in pensions that they contributed if the growth of total earnings exceeds the interest rate.[254]

3.3.3 Defined-contribution schemes

Under this scheme, each member of the scheme pays a fixed portion of his or her earnings into a designated account.[255] These contributions are used in purchasing assets, which are accumulated in the account, with the returns included as well. When a member reaches retirement, the assets in the account provides for retirement consumption by means of an annuity.[256] In a pure defined contribution scheme, which is one with no redistribution across individual accumulations, consumption in retirement is determined by the size of a person's lifetime pension accumulation[257]. There is however a lot of risks associated with this type of scheme, and it even affects labour market incentives.[258]

3.3.4 Defined-benefit schemes

A worker's pension is based on his or her wage history, or even length of service rather than on accumulation. This kind of scheme can be run by the State or employers. Where a State scheme is financed through contributions, the risk is borne by the contributors, and where there is a taxpayer subsidy, the risk rests on taxpayers. In an employer scheme, the risks rest on the employer. Therefore, in a pure defined-benefit scheme, risks are not directly borne by pensioners.[259]

3.4 Economics of pensions

In analyzing the economics of pensions, three functions of pension systems are proposed: what matters is output; imperfect information and imperfect decision making are pervasive; and pension schemes face large and unpredictable risks.[260] These propositions are discussed below:

3.4.1 What matters is output

Security in old age is sought in two ways: storing current production for future use or exchange current production when younger for a claim on future production when older. The

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254 PA Samuelson 'An exact consumption-loan model of interest with or without the social contrivance of money' (1954) 66(6) *Journal of Political Economy* 467-482.
255 Barr & Diamond 'The economics of pensions' 18.
256 As above.
257 As above.
258 As above.
259 Barr & Diamond 'The economics of pensions' 19.
260 R Hinz 'The World Bank's pension policy framework' in L Bovenberg; C van Ewijk & E Westerhout *The future of multi-pillar pensions* (2012) 48-49.

first approach is inadequate for consumption needs because it is expensive, does not resolve the issue of uncertainty and cannot be applied to services derived from human capital.[261] There are two ways to go about using the second approach-a worker saving part of his or her wages to amass a pile of assets which can be exchanged for goods produced by younger people after his or her retirement or such worker can obtain a promise (from either his or her children, employer or government) that goods produced by younger workers after his or retirement will be given to him or her after retirement.[262]

What pensioners are mostly interested in is consumption; to have the basic necessities of life after retirement. Consumption comes from goods produced by younger workers during retirement. Future output is therefore of importance and pay-as-you-go and funding are mechanisms for laying claims on that future output.[263] Theoretically, pensioners are not restricted to consuming domestically-produced goods and may consume foreign goods if they can lay a claim to such goods.[264] For instance, if Nigerian workers spend some of their savings in the purchase of South African factories, they can sell their shares of the factory's output for South African currency to buy South African goods, which can then be imported to Nigeria.

3.4.2 Imperfect consumer information

There is an assumption in the case of pensions that the consumers are well-informed.[265] However, this is not necessarily true as individuals are imperfectly informed because they are uncertain about the future. Individuals are also imperfectly informed in respect of the risks involved. Furthermore, imperfect information arises with complex products based on a range of financial institutions and instruments like defined-contribution pension. Even in a developed country like the USA, over 50% of individuals did not know the difference between a share and a bond.[266] The implication of this is that the least informed people are the least well-off individuals.

Also identified is what is known as an information-processing problem. In this instance, matters are too complex for individuals to make a rational choice even if they are provided with the right information. This problem can arise where the time purview is long (like

[261] As above.
[262] As above.
[263] As above.
[264] As above.
[265] As above.
[266] Barr & Diamond 'The economics of pensions' 9.

pensions), where the good or service entails complex probabilities (like life expectancy), where the information is in itself complex and where advanced analysis is required for use of the information.[267]

Although some information problems can be reduced or solved through education of the public, others are inherent and cannot easily be resolved in that manner. Also of importance are issues of the quality of decisions made by workers and how it affects them and their families.[268]

3.4.3 Pension schemes face unpredictable risks

Pension schemes face many unpredictable risks and these include: macroeconomic shocks affect output, prices or both; demographic shocks affect all pension schemes (see section 3.2), by affecting market prices and quantities and pension claims.[269] Political risks affect all pension schemes because all depend critically, albeit in different ways, on effective government; management risk can arise through incompetence or fraud, which imperfectly-informed consumers generally cannot monitor effectively; investment risk-private and public pension accumulations held in the stock market until retirement is vulnerable to market fluctuations; annuities market risk-for a given pension accumulation, the value of an annuity depends on remaining life expectancy and on the rate of returns the insurance company can expect over those years (and is thus also a form of investment risk).[270]

3.5 Pension reforms

Pension reforms, which is one of the World Bank's focus areas, is vital to the well-being of the working community all over the world because pension constitutes the social security for workers when they retire. Pensions reduce old-age poverty and ensure stability for the lifetime of a worker helping them maintain living standards even after retirement.[271]

The rationale for pension reforms is sustainability; the sustainability of a pension system and ultimately of the economic and social well-being of a country. The need for pension reform became more pressing over the last two decades as a result of two factors – demographic aging and mismanagement of pension funds. These therefore put strains on the already

[267] As above.
[268] Barr & Diamond 'The economics of pensions' 10.
[269] As above.
[270] Barr & Diamond 'The economics of pensions' 11.
[271] As above.

insufficient government budgets, especially in developing countries. 'Strains on the government' means threat to macroeconomic stability and social security. [272]

The World Bank reported that countries with a high percentage of their population reaching retirement age are most likely to experience fiscal imbalances due to demographic problems. Latin American and Caribbean countries face this issue which is aggravated because employment rates keep declining in relation to the increasing number of retirees. [273]

Although pension reforms have far-reaching effects on financial markets, and by extension, economic growth, the primary objective of pension reforms is the provision of adequate and affordable retirement benefits. In addition, another objective is the creation of a link between contributions and benefits 'in order to minimize any incentive-distortions on the functioning of labor markets and avoid capricious and perverse redistribution caused by volatile inflation and inconsistent eligibility requirements'.[274] Finally, pension reform is undertaken with the aim to generate long-term savings that can deepen capital markets. This is because pension funds changes the composition of financial assets and increases the supply of long-term savings.[275]

There are three possible forms of pension reforms-parametric, notional-defined contribution (NDC), and systemic reforms.[276] Parametric reforms involve increasing the retirement age, lowing benefit rates, combating evasion etc. This kind of reform is primarily concerned with fiscal imbalances and do not address distortions between contributions and benefits. On the other hand, reforms based on NDC plans focus on reducing labour market distortions which are caused by high evasion rates and the growth of informal markets. NDC reforms try to directly link benefits to contributions to discourage evasion. Neither of the above-mentioned forms of pension reforms directly impacts on financial market development.[277]

Systemic reform involves the creation of funded pension systems and therefore has a direct impact on financial market, and therefore economic development.[278]

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[272] D Vittas 'Pension reform and capital market development: "feasibility" and "impact" preconditions' World Bank Development Research Group Policy Research Working Paper 2414 2

[273] As above.

[274] As above.

[275] As above.

[276] As above.

[277] As above.

[278] Vittas Pension reform and capital market development: "feasibility" and "impact" preconditions' 3.

3.5.1 World Bank Pension Reform Strategy

In light of the many problems countries faced in relation to their pension systems, the World Bank presented a strategy for pension reform in the 2001 document 'Social Protection Sector Strategy: From Safety-Net to Springboard'(hereafter Strategy).[279] This became a template for many countries to model their pension reforms on with a number of recorded successes such as Chile.[280] In the Strategy, the World Bank suggested the multi-pillar pension system which consists of three pillars based on different forms of income support with certain prerequisite conditions to be met.[281] The first pillar is a publicly-managed unfunded plan; the second, a mandatory privately-funded plan; and the third, a voluntary, privately-funded plan. It further recommended complementary retirement income for workers not covered by a pension scheme and the poor. This has been the basis for a number of pension reforms in countries all over the World.[282]

3.5.2 Impact of pension reforms on capital markets

There are many positive impacts of pension reform on capital markets such as increasing savings, boosting liquidity and affecting long-term asset returns. Unlike a PAYG pension system, contributory pension systems leaves individuals with no choice but to save for their retirement. Behavioural evidence also points to an increased awareness of the need to save for retirement, when individuals are forced to save. This naturally encourages increased savings.[283]

The introduction of contributory pension schemes affects the allocation of the savings between different asset classes. Large shares of savings are channelled to the capital markets, which increase security demand. Statistics show that currently total assets under management amount to about US$ 46 billion worldwide. [284]

3.6 Conclusions

This chapter has interrogated the pension system administration and reforms focusing on its structural framework, identifying its strengths and challenges. The global evolutionary trends of pension system and pension reforms were also discussed. In addition, pension fund as one

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[279] Hinz 'The World Bank's pension policy framework'47.
[280] As above.
[281] As above.
[282] As above.
[283] C Nickel & J Almenberg, 'Ageing, pension reforms and capital market development in transition countries' European Bank for Reconstruction and Development.18.
[284] As above.

of the creative sources for funding development was also examined by interrogating the impacts of the recent pension reforms on the capital markets across the globe.

The conclusion therefore is that the introduction of contributory pension schemes globally has positively affected the allocation of the savings between different asset classes in that large shares of savings are channeled into the capital markets, which increase securities demand. By implication, pension funds' assets have become financial capital for development around the world.

In the next chapter, this study presents the Nigerian pension scheme and the underpinning industry-specific laws and regulations.

CHAPTER 4

NIGERIAN PENSION SCHEME AND THE UNDERPINNING INDUSTRY-SPECIFIC LAWS AND REGULATIONS

CHAPTER 4

NIGERIAN PENSION SCHEME AND THE UNDERPINNING INDUSTRY-SPECIFIC LAWS AND REGULATIONS

4.1 Introduction

In the previous chapter, the pension system administration and reforms were examined with focus on its structural framework, identifying its strengths and challenges. The global evolutionary trends of pension system and pension reforms were also discussed. In addition, pension fund as one of the creative sources for financing development was also explored by interrogating the impacts of the recent pension reforms on the capital markets across the globe. The conclusion therefore is that the introduction of contributory pension schemes globally has positively affected the allocation of the savings between different asset classes in that large shares of savings are channeled into the capital markets, which has increased securities demand thereby elevating pension funds' assets to the pedestal of financial capital for development around the world.

The aim of this chapter is to examine the Nigerian pension system and present an analysis of the industry-specific laws and regulations that govern Nigerian pension scheme and administration of pension funds' assets. Furthermore, the study will explore how the review of the regulatory-induced investment limits of the accrued pension funds' assets can increase the proportion of assets invested to promote the deepening and liquidity of Nigerian stock market. Furthermore, comparative narrative analyses of South Africa and Chile will be conducted with a view to inform public policy initiatives and regulatory reforms of pension fund asset management in Nigeria.

4.2 The Nigerian pension system

The first ever legislative instrument enacted regarding pension matters was the Pension Ordinance of 1951 which had retroactive effect from the 1st of January 1946.[285] Although provision was made for pensions and gratuities, they were not right as they could be reduced or withheld entirely if the Governor-General was satisfied that an officer was found guilty of

[285] N Abdulazeez 'Pension scheme in Nigeria: history, problems and prospects' (2015) Vol. 5:2 *Arabian Journal of Business and Management Review* 3.

negligent behaviour, irregularity or misconduct. The pension scheme in Nigeria has however undergone various stages of development.[286]

In 1961, the National Provident Fund (NPF) Scheme was established by an Act of Parliament to fulfil the requirement of the International Labour Organisation (ILO) that provision be made for income-loss protection for employees.[287] This scheme however only covered employees in the private sector and the monthly contribution was 6% of an employees' basic salary, subject to a maximum contribution in equal proportion of ₦8 and ₦4 each by the employer and the employee. This scheme was later converted to a limited social insurance scheme by the Decree 73 of 1993 and was administered by the National Social Insurance Trust Fund (NSITF).[288]

The NSITF was a defined benefits scheme that covered employees working in a private sector organisation with a minimum of 5 employees. Employees were catered for regarding loss of employment, old age income, invalidity or death. Initially, the monthly contribution was 7.5% of basic salary, proportionally shared by the employer and employer 2.5:5%. This was later revised in 2002 to 10% of an employees' gross salary shared in the ratio of 3.5:6.5% by the employee and employer.[289]

4.3 Industry-specific laws and regulations

4.3.1 Pension Reform Act of 2004

Prior to 2004, the pension scheme in operation was the Defined Benefit or Pay as You Go (PAYG). Nigeria was the first sub-Saharan country to introduce a pension system based on individual-funded accounts. The pension payment was done through budgetary allocations each financial year.[290] One feature of the PAYG system was that the burden was on the employer to contribute to the scheme. The advantages of the PAYG scheme was that pension increased proportionate to any wage increase because monthly pensions always increased whenever there was an increase in salary. Furthermore, payment by an employer is deferred until retirement and there were less administrative costs. However, this scheme was not without its challenges and problems.[291]

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[286] As above.
[287] International Labour Organisation Social Security (Minimum Standards) Convention 102 of 1952 27.
[288] As above.
[289] As above.
[290] As above.
[291] ILO Convention 102 of 1952 28.

The myriad of problems that beset the PAYG and other pension schemes necessitated the 2004 pension reform in Nigeria.[292] A major problem of the PAYG was that it depended solely on budgetary provisions for funding making it unsustainable. It was made worse by increases in salaries and pension payments. The corruption in the country also contributed to the problems of the pension schemes that were in existence before 2004.[293] Lack of adequate budgetary provisions contributed to the scheme becoming unsustainable and prevented investment of pension funds in sectors of the economy that needed it much. Inefficiency and lack of accountability on the part of Pension Funds Administrators (PFAs) and poor supervision of PFAs in collecting, managing and disbursing pension funds played a big role in the collapse of the non-contributory pension scheme[294].

i. Defined-contributory scheme

The contributory pension scheme was introduced in 2004 with the promulgation of the Pension Reform Act of 2004[295] and changed the pension model in Nigeria from a defined-benefit scheme to a contributory pension scheme. The main objective of this reform was to encourage long-term savings amongst employees for retirement and establish a uniform set of rules that will apply to workers both in the public and private sector.[296]

Employees are required to maintain a retirement savings account (RSA) with a pension fund administrator of their choice into which contributions from the employee and employer will be deposited. There are currently 20 PFAs, 7 closed pension fund administrators (CPFAs) and 4 pension funds custodians (PFCs).[297]

The enactment of the Pension Reform Act in 2004 heralded a revolution in the management and administration of pension and pension funds in Nigeria. The administration, management and maintenance of pension funds were assigned to private sector companies, PFAs and Pension Fund Custodians (PFCs). The PRA 2004 introduced the Contributory Pension Scheme which is fully funded and privately managed by Pension Fund Administrators

[292] EB Essien & MS Akuma 'The new contributory scheme in Nigeria: gleaning from past pension schemes' (2014) Vol.2 :5 *IOSR Journal of Economics and Finance* 35.
[293] As above.
[294] As above.
[295] Hereafter the PFA 2004.
[296] Essien & Akuma 36.
[297] As above.

(PFAs). The assets are held by the Pension Fund Custodians (PFC) under the supervision of the National Pension Commission (PenCom).[298]

ii. Fund Management

The functions of the above-mentioned pension operators under the Pension Reform Act will be briefly explained below.[299]

a) National Pension Commission (PENCOM)

PENCOM which is the first of its kind in Nigeria was established to regulate and supervise pension administration. The function of the new scheme includes *inter alia*:

- The establishment of standard rules for the management of pension funds;
- Approving licensees and regulating operators under the new scheme (the PFAs and PFCs);
- The management of a national database on pension;
- Ensuring the constant payment and remission of contributions to the pension funds;
- The imposition of sanctions or fines on erring employers, PFAs and PFCs; and
- To ensure that the beneficiaries of retirement savings are paid as at when due.[300]

b) The Nigerian Pension Fund Administrators (PFAs)

The new scheme permits pension funds to be managed privately only by licensed PFAs who will invest and manage the pension funds according to the provisions of the PRA 2014. A PFA must be a limited liability company with the sole objective of managing pension funds and must have a required share capital of N150m (approximately US$1m). It is reported that there are about 20 registered and licensed PFAs currently in the country.[301]

c) The Nigerian Pension Fund Custodians (PFCs)

The primary responsibility of these pension operators is the safekeeping of pension funds' assets as PFAs are not allowed to keep pension fund assets. These two operators therefore

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298 AM Abubakar 'Pension fund investment in Nigeria: Islamic perspective' 2014 Conference Paper 3.
299 As above.
300 As above. Pension Reform Act 2014.
301 Abubakar 'Pension fund investment in Nigeria: Islamic perspective' 4.

function as a grid against fraud. To be licensed as a PFC, the Custodian must be a licensed financial institution with a minimum net worth of N5m and a total balance sheet of not less than N125m. Its main functions are listed as receiving and holding the fund assets in trust for contributors and beneficiaries, settling investment transactions on behalf of the PFAs, providing independent reports to PENCOM and to undertake statistical analysis on investments and returns.[302]

4.3.2 Pension Reform Act of 2014

The Pension Reform Act of 2014 enacted and signed into law on July 1 2014. The crux of the Act is to encourage the participation of employees in the CPS. The CPS applies to two types of employees: those in the public sectors and in private organizations with a minimum of 15 employees. Provision was also made for employees in private organizations with less than 3 employees; such employees will be governed by guidelines issued by the PenCom[303].

The Act further introduced changes to the rates of contributions to be made to the scheme. Employer and employee alike are required to make a minimum of 10% and 8% respectively to an employee's monthly emoluments. The definition of monthly emoluments were expanded to include the total compensation as stated in an employee's contract of employment provided it is not less than the total of the employee's basic salary, housing and transport allowance. Employers can also take full responsibility for the contribution, in which case the contribution shall not be less than 20% of an employee's monthly remuneration.[304]

In respect of investments of the pension funds' assets, the 2014 Act expanded the scope of investment further to include specialist investment funds and other financial instruments that may be approved by the PenCom.[305]

4.4 Challenges of the new pension scheme

Despite the good intentions of the pension reform, a large percentage of the population remained uncovered by the contributory system, especially workers in the informal sector. This was largely due to the general misconceptions and distrusts of pension schemes as previous pension schemes had failed.[306] A major challenge of the new schemes was the

[302] E Adejoh (2013) 'An assessment of the impact of contributory pension scheme to Nigerian economic development' *Global Journal of Management and Business Research* Vol 13 No. 1USA *2*.
[303] As above.
[304] As above.
[305] PwC 'Pension Reform Act 2014 key highlights and salient points' July 2014.
[306] Abdulazeez N 'Pension scheme in Nigeria: history, problems and prospects' 3.

mismanagement and misappropriation of pension funds, especially in the public sector. As a result, many retirees were unable to receive payment, or did not receive it regularly. [307]

There were also many reports of the scandals and corruption of the pension funds. One of the intentions of the new contributory system was the supply of investment capital to boost the local capital markets. However, this was hindered by the limited array of investments in local capital markets as pension funds' investments were mostly limited to investment-grade instruments which are not readily available in emerging capital markets. Under the scheme, the investment risk was borne by the employee,, as it was the employee who determined who managed his or her savings account and as a result bore the risks involved.[308]

4.5 Pension fund assets in Nigeria

Pension funds are a crucial aspect of social security in a nation and personal retirement saving make up a large percentage of most people's lifetime wealth. First, at macro-economic level, pension funds contribute greatly to deepening of local capital markets and overall economic growth through its investments. The role of pension funds as institutional investors cannot be overestimated or ignored.[309]

In 2015, it was reported that the contributory pension funds in Nigeria has hit a record ₦5 trillion and as April 2017, it stood at N6.5 trillion.[310]

4.5.1 Investment of pension fund assets in Nigeria

Management analysts are of the opinion that the youthful composition of Nigeria's pension scheme which is comprised majorly of youthful population, bodes well for the sustainability and the potential to contribute to the nation's economic development if allocated in the right instruments.[311]

As mentioned above, pension funds' assets in Nigeria are valued at about ₦6 trillion. Despite the large growth in pension assets and large pool of funds invested in retirement savings, there are growing concerns that there are limited avenues to deploy these funds to the benefit

[307] As above.
[308] As above.
[309] A Olaifa 'The impact of pension funds investment on economic development in South Africa' unpublished MA thesis, Nelson Mandela Metropolitan University 2012.
[310] PENCOM 'Summary of pension funds assets as at 30 April 2017' 30 April 2017 http://www.pencom.gov.ng/mobi/publications.php (last accessed 21 June 2017).
[311] A National Pension Scheme Memberships Statistics released in November 2016 reported that contributors to the pension scheme in Nigeria were majorly youth, with 49% aged below 40 years of age and 76% below 50 years old.

of the economy, leaving them at the risk of being idle.[312] Importantly, regulatory restrictions and investment limits are hampering further growth in the pension industry. There is growing concern amongst the operators in the industry that not enough money is being invested in capital markets which have the implication that there is not much happening in terms of investment. Majority of the pension funds are reported to be invested in government bonds because of the restrictive regulations regarding investment of pension funds' assets in corporate bonds.[313]

The contributory pension scheme is most concerned about the safety of the pension funds and the sustenance of returns on investment.[314] A major attribute of the contributory scheme is the institutionalization of risk-based regulation as a way of encouraging sustainability of the pension industry.[315] According to the Pension Reform Act 2014, pension funds' assets may be invested in any of the following-

a. Bonds, bills and other securities issued or guaranteed by the Federal Government and the Central Bank of Nigeria;
b. Bonds, bills and other securities issued by the State and local governments;
c. Bonds, debenture, redeemable preference shares and other debt instruments issued by corporate entities and listed on a stock exchange registered under the Investment and Securities Act;
d. Ordinary shares of public limited companies listed on the Nigerian Stock Exchange registered under the Investment and Securities Act;
e. Bank deposits and bank securities;
f. Investment certificates of closed-end investment fund or hybrid investment fund listed on a securities exchange registered under the Investment and Securities Act with good track records of earnings;

[312] PENCOM 'Summary of pension funds assets as at 30 April 2017' 30 April 2017.
[313] Leriba Consulting 'Opportunities in the Nigerian pension fund industry' 2014 www.leriba.com/insights/reports/opportunities-within-the-nigerian-pension-fund-industry (accessed 15 July 2017).
[314] JO Odia & AE, Okoye 'Pensions reform in Nigeria: a comparison between the old and new scheme' (2012) 3 *Afro Asian Journal of Social Sciences* 2232.
[315] As above.

g. Units sold by open-ended investment funds or specialist open-ended investment funds registered under the Investment and Securities Act;

h. Real Estate Development investment; or

i. Special Investment Funds and such other financial instruments as the Commission may, from time to time, approve.[316]

Section 90 however by regulation gives the Commission (PENCOM) the power to impose additional restrictions on investments of pension funds' assets to protect the interest of beneficiaries of the RSA (retirement). Investment of pension funds' assets is risky and given the level of restrictions of investment, there are a lot of funds left idle.[317]

The next step in the reform of the Nigerian pension industry is the channeling of the accrued pension funds' assets to invest in the economy.

4.5.2 Regulation on the Investment of Pension Funds' Assets 2017

Great economies are those with the financial backing, and the CPS has the potential to provide the necessary backing the Nigerian economy with the pension fund assets in addressing the nation's developmental needs.[318] The pension industry has grown in leaps and bounds; from a deficit of more than ₦2 trillion under the old pension scheme to assets amounting to about ₦6 trillion despite less than 10% of the working population being a part of a pension scheme. This is a pointer of the immense potential of the industry in playing a critical role in the economic development of the nation.[319]

Undoubtedly, there is a need for a tight and strict policy framework for the investment of pension assets to reduce risks to its absolute minimal as the runaway corruption that characterised the old scheme is still reported to exist.[320] However, these assets cannot be left idle or invested solely in government bonds as there are unexplored opportunities for these assets in the equity market.[321]

[316] Section 4 of the Amended Regulation 2017.
[317] GA Ekpulu & PF Bingilar 'Pension fund in Nigeria: an appraisal' (2016) Vol. 1&2 *Quarterly Journal of Contemporary Research* 202.
[318] As above.
[319] As above.
[320] BusinessDay 'The liquidity squeeze and the traction of pension funds' April 5 2016.
[321] As above.

PenCom is given authority to issue regulations and guidelines on the investment of pension funds' to reach investment goals. In February 2015, PenCom issued a draft of proposed amendments to the Regulation on Investment of Pension Funds' Assets, 2012 for review by various stakeholders. The thrust of the amendment was to expand the assets classes in which pension funds' assets under management by Pension Fund Administrators (PFAs) can be invested, as well as the threshold/limits of such investment.[322] About two years later, PenCom released the Amended Regulation in April 2017 pursuant to the Pension Reform Act 2014.[323]

Key provisions that were in the 2012 Regulations are retained in the 2017 Regulations with a few changes to some conditions and requirements for investment of pension funds' assets.

The Amended Regulation on Investment of Pension Funds' Assets 2017 introduced a multi-fund structure for PFAs and RSA funds,[324] which groups assets into four fund types based on the exposure to various income instruments, and other factors such as the age of the contributors, work status and risk exposure elements.[325] In addition, Islamic bonds (known as sukuk instruments) which are issuable by qualified state and local governments, state agencies or companies wholly owned by a state government are now included in the class of allowable instruments in which PFAs may invest pension funds' assets under management.[326]

Furthermore the 2017 Regulation contains new quality requirements-

i. Auditing of annual financial statement- Sections 5.2.3(iii)(c) and 5.2.11(i) of the 2017 Regulations require accounting firms that are required to audit the annual financial statements of the funds in which PFA seeks to invest to be reputable firms of chartered accountants and be registered by the Financial Reporting Council of Nigeria (FRC);

ii. Investment limits in infrastructure funds, private equity funds, bonds and sukuk instruments issued by multilateral development finance organizations (MDFOs) - The threshold of pension funds' assets invested in either of the above instruments issued by MDFOs have been reduced to 60% under the 2017 Regulations;

[322] Businessday 'PENCOM releases the amended regulations on investment of pension fund assets' 18 May 2017.
[323] As above.
[324] BusinessDay 'New pension guidelines spur stock market rally' May 15 2017.
[325] As above.
[326] *Banwo & Ighodalo* 'PenCom releases amended regulations on investment of pension fund assets' Newsletter, April 2017.

iii. Specified exit routes from infrastructure funds–The 2017 Regulations includes IPO, sale to other infrastructure funds, trade sales and sale to a strategic investor as exit routes from infrastructure funds.[327]

iv. In terms of section 5.2.4(i) of the 2017 Regulations, the investment of pension fund assets in the ordinary shares of public limited companies is now permitted with the condition that *"the issuing companies' shares are listed/quoted on a securities exchange registered by SEC or proposed to be listed/quoted through an IPO."*

v. Investments may now be made in non-interest complaint money market instruments;

vi. In terms of section 5.2.4(iii) of the 2017 Regulations, pension fund assets may be invested in a newly established quoted company that was created as a result of merger, acquisition or any other combination arrangement of existing corporate entities on the condition that at least one of the former companies had satisfied the minimum quality requirements for investment in ordinary shares stated in section 5.2.4 (i) & (ii) of the 2017 Regulations.

vii. Pension funds' assets are permitted to invest in Eurobonds, general depository receipts (GDRs) and general depository notes (GDNs).

Some players in the pension industry have remarked that the introduction of the multi-fund structure provides PFAs with the opportunity to make strategic and well-tailored investments and diversify risks that are come with undiversified portfolios. The introduction of new asset classes was predicted to broaden the spectrum of investment for PFAs.[328]

[327] Section 5.2.3 (iii)(d) of the 2017 Regulation.
[328] *Banwo & Ighodalo* 'PenCom releases amended regulations on investment of pension fund assets'.

4.6 A case for change in regulation of investment of pension funds' assets to promote stock market development

The starting point here is to justify investment in equities.

4.6.1 Why invest in equities?

It is a widely acknowledged fact that shares offer a higher and considerably safer return to investors. Siegel wrote that 'Over the last century, accumulations in stocks have always outperformed other financial assets for the patient investor'. Furthermore, Ellis' description was similar in his book *Institutional Investing*: 'A portfolio of conservative equities has been and is very likely to continue to be greatly superior to a bond portfolio on all counts.'[329]

There are many benefits of the equity market for the economy, the financial system, companies and individuals and institutional investors. Bencivenga et al insist that it is "…beyond dispute that there is a close, if imperfect, relationship between the effectiveness of an economy's capital markets and its level (or rate of growth) of real development."[330] Equities therefore provide savers with a higher return over time and this encourage saving and the channeling these into productive investments which promotes growth and development.[331] In addition, equity markets stimulate the financial system, with equities especially giving a balance to economies which are inclined toward debt and increases efficiency and lower risk in the financial system. Although they compete with banks, the equity market nevertheless complement them. For instance, equity markets provide banks with strong balance sheets, which encourages bank lending.[332]

In addition, equity markets provide enterprises or institutional investors with the long-term financing they need.[333] They therefore improve efficiency and lower the risks in the financial system, thereby boosting economic growth. Equity markets also encourage transparency as the value enterprises by measuring risks and returns of enterprises. This improves auditing standards, thereby providing efficient information to shareholders outside the enterprise and a reference for capital markets agents to value other companies and new issues. Furthermore,

[329] Melton *Going Global with Equities* 1.
[330] V Bencivenga, B Smith & R Starr 'Equity markets, transaction costs and capital accumulation: an illustration' policy research working paper 1458, The World Bank, Washington D.C 1.
[331] McLindon *Privatization & capital market development* 55.
[332] As above.
[333] As above.

usually, companies cannot afford to finance all their investments from internal savings, and borrowing from banks would create too much debt on their balance sheets. However, equity provides long-term finance for companies, and compensates investors for risks taken through high returns.[334]

Interestingly, the equity market provides a means of exit for venture capital owners, who can sell their ownership claims for cash. This provides entrepreneurs and venture capitalists platform to sell their shares at decent prices, giving them the freedom to use their original capital and gains for new ventures. The equity market is more attractive for savers as they can save for long-term goals, and do not have to manage their portfolios themselves as they can save through professionally managed institutions such as mutual and pension funds, which have higher return rates. [335]

4.6.2 Investing pension fund assets in the stock market

In terms of section 8.1 of the Amended Regulations, not more than 10 percent of the total pension assets under management aggregated in all the RSA funds, shall be invested in all securities (equities, money market and debt) issued by a corporate entity.

The argument of this research is that while regulation must first and foremost protect contributors, severe constraints should not be imposed on pension fund managers in investing. So they can invest the pension assets in assets that can produce higher returns.

As mentioned in the background to this research, pension funds in Nigeria are usually invested in bonds.[336] This has been confirmed by many reports of pension assets being invested in bonds. In 2013, a whooping N3.34trn was reportedly invested in bonds, with the hopes of generating more funds. This has been reported to be due to illiquid foreign markets which limit participation in the equity market. Causes of illiquidity were linked to a drop in the oil prices, which is Nigeria's mono-product and caused risk averse behaviour among local

[334] As above.
[335] McLindon *Privatization & capital market development* 57.
[336] A study conducted by Watson Wyatt Worldwide showed that there is a shift to investment of pension funds in bonds globally. Comparing the years 1998 and 2007 the US's percentage in equities was down from 62 to 59, Japan's from 67 to 46and the Netherlands from 46 to 41. Even the UK who had always had a high percentage in equities was down to 64 percent in 2007 from 71 percent in the year 2000.

funds. 'Asset allocation is getting more conservative so equity allocation has dropped. Pension fund investors have become more risk averse'[337]

Recently, an analysis by Quantitative Financial Analytics showed that allocation of funds to domestic ordinary shares had reduced since 2013.[338] At December 2013, investments in domestic ordinary shares were 14.58 percent and had fallen to 11.79% at the same time in 2014. By 2015, pension fund managers had reduced their allocation to the stock market by a further 2 percent. By January 2017, a shocking mere 8.13 percent were allocated to domestic ordinary shares.[339] As seen above, the asset allocation of pension funds is not indicative of a diversified portfolio. It was correctly pointed out that '…Nigerian pension fund managers' ability or willingness to diversify is being stymied or fettered by regulatory impediments which specify, among other things, the required maximum allocation to a given asset class'.[340]

In 2015, Nigerian stocks were reported to be down 14 percent and was further predicted that if pension funds continue to shun equities, the stock market will have a hard time recovering its lost ground. An analyst explained that this was because PFAs are very cautious regarding investment in equities and are therefore limiting the assets exposure to equities.[341] Although the shift to investment in bonds is due to the poor performance of the equity market, it is believed that investment in bonds will lead to under-performance in the long-term as equities will always recover, steered by technological development, productivity and world trade.[342]

Pension assets are currently the largest pool of available capital to invest in the economy. The equity market is therefore a potential avenue for pension assets to reap higher and stable returns on investment if conditions such as adequate policies, structures and regulations are present.[343] Although the current investment regulation is more robust than its predecessor, the allowable investment limits in equities has the potential to be relaxed more to produce

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337 Reuters 'Nigerian pension funds shift to bonds as currency woes deter equity investors' 7 October 2016 http://www.reuters.com/article/amp/idUSL5N1CC4QP (accessed 24 August 2017).
338 As above.
339 As above.
340 Proshare 'Nigerian pension funds continue to reduce exposure to equities' 24 April 2017 https://www.proshareng.com/news/PENSIONS/Nigerian-Pension-Funds-continue-to-reduce-exposure-to-Equities/34565 (accessed 24 August 2017).
341 'Pension funds ₦2.8trn in bonds mean harder path for stock rebound' *BusinessDay* 24 February 2015.
342 Valdez & Molyneux *An introduction to global financial markets* 205.
343 As above.

enviable results.[344] More importantly, Nigerian stocks have been doing well lately, with a reported monthly gain of ₦1.25trn in July 2017, which is the highest monthly gain ever. Analysts predict that the monthly gains will increase due to what was described as far-reaching fundamental factors such as stable policies and sustainability as well as macroeconomic recovery, which triggered optimism in the stock market.[345]

4.7 Comparative narrative analysis: lessons from other jurisdictions and OECD Guidelines on pension fund assets management as international best practices

The choice of South Africa was informed by the fact that Nigeria and South Africa are the largest economies with the largest volumes of accrued pension funds' assets under management on the continent.[346] However, in terms of effective regulation of pension system and effective administration of pension funds' assets management, South Africa is well ahead of Nigeria.[347] Besides, there are many lessons Nigeria can learn from South African experience where 75% of the pension assets under management is invested in equities.

Chile came into picture because the Chile is regarded as a pioneer in successful pension reforms in the Southern hemisphere which other Latin American countries have followed and reformed their social security systems.[348] Specifically, the Chilean pension reform contributed greatly in developing Chile's capital market, reducing government contingent liabilities, and helped to boost Chile's low saving rate. Accordingly, a good number of pension reforms in economies around the world are being tailored after the Chilean reform. Nigeria can therefore take a cue from pension reforms and the regulation of investment in other jurisdictions such as South Africa and Chile.

In addition, there is a discussion around OECD's guidelines which are believed to be some of the international best practices.

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[344] *BusinessDay* 'Institutional finance development banks needed to drive pension investment in infrastructure' 16 November 2016.
[345] *BusinessDay* 'Nigerian stocks hit biggest monthly gain of ₦1.25trn' 31 July 2017.
[346] African Banker 'The power of pension funds for African infrastructure' Issue 38 52-53.
[347] As above.
[348] Edwards 2.

4.8 Lessons from South Africa

In South Africa, the investment of pension funds' assets is regulated under the Regulation 28[349] of the Pension Funds Act, 1956[350] which sets out the investment limits. The PFA 1956 governs private pension funds and provides for how the pension assets should be invested.[351]The Minister of Finance is vested with the authority to define classes of assets in which pension funds can be invested, setting investment limits across asset classes. This is to reduce the exposure of pension assets to risk through diversification to ensure that pension assets are not invested in high-risk assets which could lead to a loss for pension fund members.[352]

The Regulation was amended in 2011 because of the urgent need for reform the previous Regulation, which was came into effect over 50 years before and was last amended in 1998. The main objectives of the pension reform were the protection of vulnerable pensioners, addressing the loopholes in the previous regulation and the reduction of systemic risks which are likely to occur in poorly regulated areas such as unlisted derivatives, private equity and hedge funds.[353] The primary objective of this regulation is to protect the retirement funds of members from what is described as poorly diversified investment portfolios by limiting the exposure of the funds to more risky assets classes. In doing this, members' retirement funds are protected. [354]

The Regulation gives effect to section 36(1) (bB) of the Pension Funds Act and it limits the amount and extent to which pension funds may be invested in certain assets or assets classes.[355] Under the Regulation, pension funds' assets may be invested up to 75% in equities in listed companies and up to 10% in private equities. There is therefore a total investment threshold of 85% of assets under management in the stock market.[356] This is a far cry from the limit under the Amended Regulations and serves as a template for the Nigerian economy.[357]

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349 Hereafter Regulation 28.
350 Hereafter PFA 1956.
351 National Treasury 'Regulation 28: response to public comments received' 2 December 2010.
352 As above.
353 As above.
354 National Treasury 'Regulation 28: response to public comments received' 2 December 2010.
355 African Banker 'The power of pension funds for African infrastructure' Issue 38 52-53.
356 As above.
357 As above.

4.9 The Chilean experience

For many years, the Chilean economy was underperforming, with modest growth and one of the highest inflation rates in the world. In the early 1980s, a privately managed, fully-funded pension system was introduced in Chile based on individual capital accounts.[358] This had significant effects on the functioning of the Chilean economy. The most mention-worthy effect was on the nation's public savings rate which was less than 10 percent in 1986 and moved to almost 29 percent a decade later.[359] The increased savings created a virtuous cycle; increased savings meant increased growth and increased growth generated higher private savings.[360]

Chile was the first country in the world to implement a mandatory, privately-managed pension system in 1981 through a pension reform.[361] Under the administration of pension fund administrators,[362]a contributor, who was referred to as an 'insured' opened a private account and paid a defined contribution of their monthly wages which financed a benefit calculated on the basis of the accumulated savings, life expectancy and market interest rates.[363] Thereafter, the Chilean pension reform became a model for pension reforms worldwide, after the country became democratic in 1990 and conformed to the hegemony of neoliberal policy approaches.[364]

The reform was supported by the World Bank through the introduction of what was known as the multi-pillar pension model.[365] Latin America became a 'pension reform laboratory', with other countries following suit in the late 1990s.[366] The core of the Chilean pension reform was the privatization of pension systems, which was justified on many grounds. Privatization of pension systems was said to be efficient, inducing savings and accumulation of capital.[367] It was further argued that privatization of pension systems increases savings, contributing to the establishment of stock markets and the financial sector in general which is essential in

358 OECD 'The Chilean Pension System' Ageing Working Papers 6.
359 As above 15.
360 As above.
361 A Barrientos 'Pension reform and pension coverage in Chile: lessons for other countries' (1996) Vol.15:3 *Bulletin of Latin American Research* 311.
362 Administradoras de Fondos de Pensiones –AFPs.
363 K Hujo *Reforming pensions: trends, debates and impacts* (2014) 17.
364 'Reforming pensions: trends, debates and impacts' 1994 World Bank 17.
365 Hinz 'The World Bank's pension policy framework' 48. R Holzmann 'The World Bank approach to pension reform' (2000) 53 *International Social Security Review* 17.
366 As above.
367 Hujo *Reforming pensions: trends, debates and impacts* 18.

accumulating and allocating capital.[368] More recently in 2008, Chile undertook another pension reform with its main objective being the expansion of the coverage of the existing pension system in the country.[369]

Pension funds became the largest institutional investor in the capital market, with its total assets accounting for more than 40 percent of the nation's GDP. The huge amount of pension assets accumulated has helped in providing long-term financing for investment projects by firms and even the government, among others.[370]

The Chilean pension reform is regarded as a pioneer of pension reforms in the world as it effectively replaced an inefficient PAYG system with a privately-managed pension system which meets the needs of its people, while also providing finance for firms and deepening its capital market.[371]

4.10 The OECD Guidelines on Pension Fund Assets Management as international best practices

Players in the Nigerian stock market, such as the government, pension fund managers and investors etc. should collaborate and draw from international best practices. The time has come to unlock opportunities for pension funds as investors to benefit from assets that can generate income and capital gains over a long period of time.[372]

Pension funds are key players in many OECD countries, with over $15 trillion of assets accounting for more than 80 percent of GDP in the OECD area. The investment of pension funds is one of the core functions of the pension fund managers and to promote the performance and security of pension assets, care must be taken in managing and investing these assets to ensure that the prudent management and investment of pension funds. [373]

The OECD Guidelines on Pension Fund Asset Management set out a framework of regulation for pension funds investment. Regulation is defined broadly and may include: '…the main body of the pension law; related laws (e.g. trust law); tax requirements; standards set by pension and financial sector supervisory authorities; codes of conduct developed by

[368] As above.
[369] As above.
[370] As above.
[371] S Edwards 'The Chilean pension reform: a pioneering program' in M Feldstein (ed) *Privatizing social security* (1998) 52.
[372] African Investor 'Infrastructure development and domestic capital markets' Vol. 14 Issue 6 2016 45.
[373] OECD Guidelines on Pension Fund Asset Management 2.

professional associations (e.g. a pension fund association); collectively bargained agreements; or plan documents (e.g. trust documents).'[374]

Although portfolio investment limits vary in different countries, the OECD provides basic guidelines which serves as a model for the regulation of investment limits of pension funds' assets and which can be incorporated into domestic regulation.[375] The guidelines are as follows:

i. They must be consistent with, and promote, the prudential principles of security, profitability, and liquidity pursuant to which assets should be invested;
ii. The matching of the characteristics of assets and liabilities (like maturity, duration, currencies, etc.) is highly beneficial and should not be impeded by for instance minimum limits;
iii. There should be an established procedure for correcting excesses within specified time limits;
iv. Self-investment by those undertaking investment management of pension funds should be prohibited or limited;
v. Investments in assets issued by the same issuer or by issuers belonging to the same group should not expose the pension fund to excessive risk concentration;
vi. Investment abroad by pension funds should not be prohibited but take into account country risks, including currency risk and associated matching needs between pension plan assets and liabilities;
vii. Legal provisions should address the use of derivatives and other similar commitments, taking into account both utility and the risks of inappropriate use. The use of derivatives that involves the possibility of unlimited commitments should be strictly limited, if not prohibited; and
viii. All legal provisions setting out quantitative portfolio limits should be regularly update to keep track of market developments and to allow optimal strategies.[376]

The management and other interested parties of a pension fund are required to be subjected to the prudent person standard, so that the investment of the pension assets are undertaken with care, prudence, due diligence and professionally. It is further recommends that where

[374] As above.
[375] As above.
[376] OECD Guidelines on Pension Fund Asset Management.

pension fund managers lack expertise, they should seek external assistance from an expert. In addition, the establishment of a strict process through which investment of pension assets is undertaken is recommended, such as internal controls and an effective monitoring system.[377]

4.11 Conclusions

In this chapter, the Nigerian pension system has been examined and an analysis of the industry-specific laws and regulations that govern Nigerian pension scheme and administration of pension funds' assets have been presented. The chapter also explore how the review of the regulatory-induced investment limits of the accrued pension funds' assets can increase the proportion of assets invested to promote the deepening and liquidity of Nigerian stock market. The conclusion is that with the review of investment limits, the accrued pension assets could be invested in the stock market to promote the development of the market for economic growth and development of the nation.

Furthermore, comparative narrative analyses of South Africa and Chile are presented with the view to inform public policy initiatives and regulatory reforms of pension scheme and pension fund asset management in Nigeria for constructive investment purposes. The conclusion is that there are lessons for Nigeria to learn from the comparators countries-South and Chile. In addition, the OECD guidelines are also very instructive to Nigeria in this regard.

[377] OECD Guidelines on Pension Fund Asset Management 6.

CHAPTER 5

FINAL CONCLUSIONS AND RECOMMENDATIONS

CHAPTER 5

FINAL CONCLUSIONS AND RECOMMENDATIONS

5.1 Recap of the research agenda

This study proceeded from the assumption that the preference of the investors for fixed income market is responsible for the decline of the Nigerian equity market as evidenced by its present shallowness and illiquidity.[378] In addressing this problem, this study gas sought to make case for the upward review of regulatory-induced investment limits to allow for increase in the quantum of the accrued pension assets under management in Nigeria invested in the stock market to promote depth and liquidity of the market.

5.2 Summary of findings

In chapter 2, the related theories that underpin the thesis of this research were discussed. The discussion commenced with the definition of the term 'theory' and thereafter, the relevance of theory in an academic enquiry was explored. The conclusion was that theories are based on certain assumptions and are attempts to explain a complex concept by extracting them from reality through simplified assumptions. Theories therefore provide complex and conceptual understandings of things that cannot be exactly defined, like how society works, how organizations operate and why people behave in certain ways.

In chapter 3, the nature and context of the financial system and the vital role it plays in stimulating growth and development in a nation were examined. Specifically, all the core issues surrounding financial system such as the objectives, functions and components were broadly discussed. In addition, Nigerian financial system was also discussed and the place of financial system as a linchpin for growth and development was interrogated. The conclusion was that finance is an important aspect of the development process and that a strong, well-functioning, competitive and resilient financial system remains an imperative for sustained economic growth and development.

In chapter 4, the pension system administration and reforms were investigated focusing on its structural framework, identifying its strengths and challenges. The global evolutionary trends of pension system and pension reforms were also discussed. In addition, pension fund

[378] *The Guardian* 'Investors in equities lose N2.3 trillion to bonds, others' 23 March 2017 https://guardian.ng/business-services/investors-in-equities-lose-n2-3trn-to-bonds-others/ (accessed May 2017).

as one of the creative sources for funding development was also examined by interrogating the impacts of the recent pension reforms on the capital markets across the globe. The conclusion therefore was that the introduction of contributory pension schemes globally has positively affected the allocation of the savings between different asset classes in that large shares of savings are channeled into the capital markets, which increase securities demand thereby elevating pension funds' assets to the pedestal of financial capital for development around the world.

In chapter 5, the Nigerian pension system was examined and an analysis of the industry-specific laws and regulations that govern Nigerian pension scheme and administration of pension funds' assets were presented. The chapter also explored how the review of the regulatory-induced investment limits of the accrued pension funds' assets could be used to increase the proportion of assets invested to promote the deepening and liquidity of Nigerian stock market. The conclusion was that with the review of investment limits, the accrued pension assets could be invested in the stock market to promote the development of the market for economic growth and development of the nation.

Lastly, in chapter 6, comparative narrative analysis of South Africa and Chile were presented with the view to inform public policy initiatives and regulatory reforms of pension scheme and pension fund asset management in Nigeria for constructive and specific investment purposes. It was concluded that there are lessons for Nigeria to learn from the comparators countries-South and Chile especially South African experience where 75% of the pension assets under management is invested in equities. The OECD guidelines are also very instructive for Nigeria in this regard.

5.3 Final conclusion

In concluding, it is obvious that Nigeria's pension funds' assets under management has grown massively into a potential investment capital capable of closing investment gap in the Nigerian stock market to deepen the market in terms of the depth and liquidity and promote the economic development of the nation. In this regard, the overly restrictive regulation on the investment of pension assets should be re-examined to provide the much needed finance the stock market requires for development.

5.4 Recommendations

In line with the OECD Principles of Corporate Governance and the OECD Guidelines for Pension Fund Governance, there are five policy areas that special attention must be paid to. First, the local financial regulatory framework should be strengthened to accommodate the growing pension assets in Nigeria. Second, regulations that restrict the diversification of pension assets should be re-examined to increase the share of equities permitted in the investment portfolio which would contribute to the deepening of the Nigerian stock market, which has been under-performing recently and would also encourage a change in the current pension investment patterns in government bonds. However, this must be accompanied with effective monitoring standards to ensure prudential care and accountability on the part of PFAs.

In addition, it is suggested that PFAs should be allowed to offer members a diverse funds' portfolio as the possibility of multiple funds will encourage information-seeking by members on the performance of different fund investments, which may then improve resource allocation. Furthermore, high administrative fees and costs charged by PFAs to their members should be given consideration as this can be discouraging.

Lastly, it is recommended that regulations regarding pension funds and their investment be revised to enforce the responsibility of PFAs as fiduciaries of people's retirement assets as this would improve governance of pension funds and their assets. [379]

[379] OECD Guidelines on Pension Fund Asset Management.

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