ROLE OF PENSION SCHEMES IN FINANCIAL INTERMEDIATION

Presentation for Cytonn Wealth Management Training

Cytonn

Disclaimer

Please note that the contents of this presentation are for education purposes only. It is not intended as a substitute for financial advice. Investors are advised to consult their Financial Advisor before making decisions based on the contents of this presentation

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Overview of The Firm

ABOUT US

Cytonn Investments is an investment manager with presence in East Africa, Finland and the US. We provide investors with exposure to the high growth East African region. Our investors include global and local institutional investors, individual high net-worth investors and clients in the diaspora.

FACT FILE

82 B Over Kshs. 82 billion worth of projects under mandate

20+ Over 20 agents across the country and offices in 2 continents

400+ Over 400 staff members

10 10 investment ready projects

A unique franchise differentiated by:

Independence & Investor Focus

Focused on serving the interest of clients, which is best done on an independent platform to minimize conflicts of interest

Alternative Investments

Specialized focus on alternative assets - Real Estate, Private Equity, and Structured Solutions

Strong Alignment

Every staff member is an owner in the firm. When clients do well, the firm does well; and when the firm does well, staff do well

Committed Partners

Strong global and local partnerships in financing, land and development affiliate

WHY WE EXIST

Africa presents an attractive investment opportunity for investors seeking attractive and long-term returns. Despite the investments markets in Africa having high and stable returns, only a few institutional players serve the market. Cytonn is focused on delivering higher returns in the investments markets, while providing the best client service and always protecting our clients' interests.

We collect funds from our clients → **We invest them in high growth opportunities** → **We deliver the best possible returns**

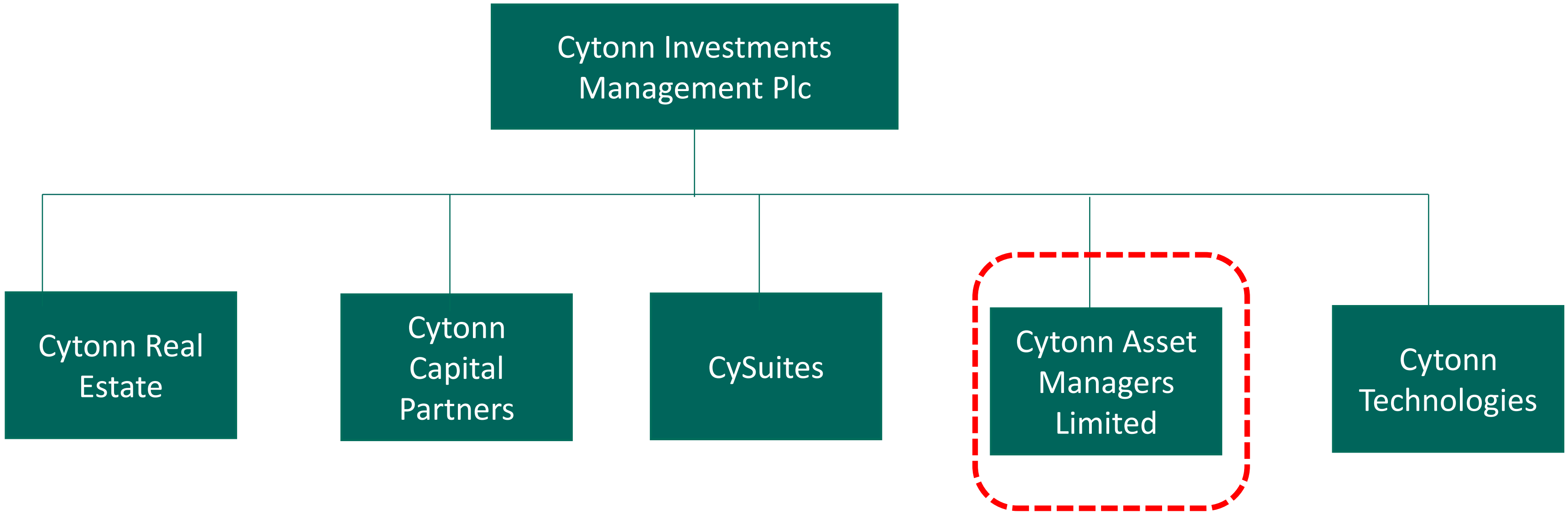
From:
- High Net-worth Individuals
- Diaspora Clients
- Global and Local Institutional Clients
- Asian Market
- Retail Clients

Through:
- Real Estate
- Education
- Hospitality
- Financial services

Impact:
- Growing the economy
- Creating Jobs
- Improving the standards of living

Cytonn Asset Managers Limited

Cytonn Asset Managers Limited is the regulated affiliate of Cytonn Investments Management Plc



- Cytonn Asset Managers Limited (CAML) is the regulated affiliate of Cytonn Investments Management Plc. CAML is licensed by the Capital Markets Authority and the Retirement Benefits Authority and its key focus is on Pension Fund management and Collective Investments Schemes

- Our objective is to offer superior risk adjusted investment returns to our clients that is above market average through investments in both public markets and alternative investments markets

Our Collective Schemes Offerings

CYTONN ASSET MANAGERS

Cytonn Money Market Fund (KES)
The Cytonn Money Market Fund provides investors with a high level of current income while protecting their capital and offering added liquidity. The Fund has been outperforming the market and offering above average returns.

Cytonn Money Market Fund (USD)
The Cytonn Money Market Fund provides investors with a high level of current income while protecting their capital and offering added liquidity. The Fund is ideal for investors who wish to invest directly using the U.S Dollar currency.

Cytonn Balanced Fund
The Cytonn Balanced Fund focuses on offering investors current income, while also offering capital appreciation to investors in the Fund.

Cytonn High Yield Fund
CAML also offers a sector specific Fund called Cytonn High Yield Fund (CHYF).This fund invests heavily in the Real Estate sector thus giving investors access to the high returns in this sector and also offering capital appreciation to investors in the Fund.

Cytonn Africa Financial Services Fund
Cytonn Africa Financial Services Fund is another sector specific Fund by CAML that seeks tap into the attractive returns in the financial services sector in the larger Sub-Saharan Africa Region.

Cytonn Equity Fund
The Cytonn Equity Fund is focused on investing in the best risk-adjusted returns in the equities market in Kenya and East Africa

2. Introduction to Pensions

Retirement Benefits Schemes

Retirement Benefits Schemes give you a retirement income upon retirement

- Retirement benefits schemes allow members to make regular contributions during their working years into these schemes and there after get retirement income from the schemes upon retirement
- Retirement Benefits Schemes also serve to provide assistance to beneficiaries of the member upon his/her death
- Two main types are:
  a) **Pension Scheme (Lump sum + Periodic Income)**
  b) **Provident Fund (Lump sum)**

Categorization based on membership

Umbrella Retirement Benefits Schemes allow multiple employers to make contributions

Occupational Retirement Benefits Schemes

These are schemes that are set up by an **employer** where only members of their staff are eligible to join

Umbrella Retirement Benefits Schemes

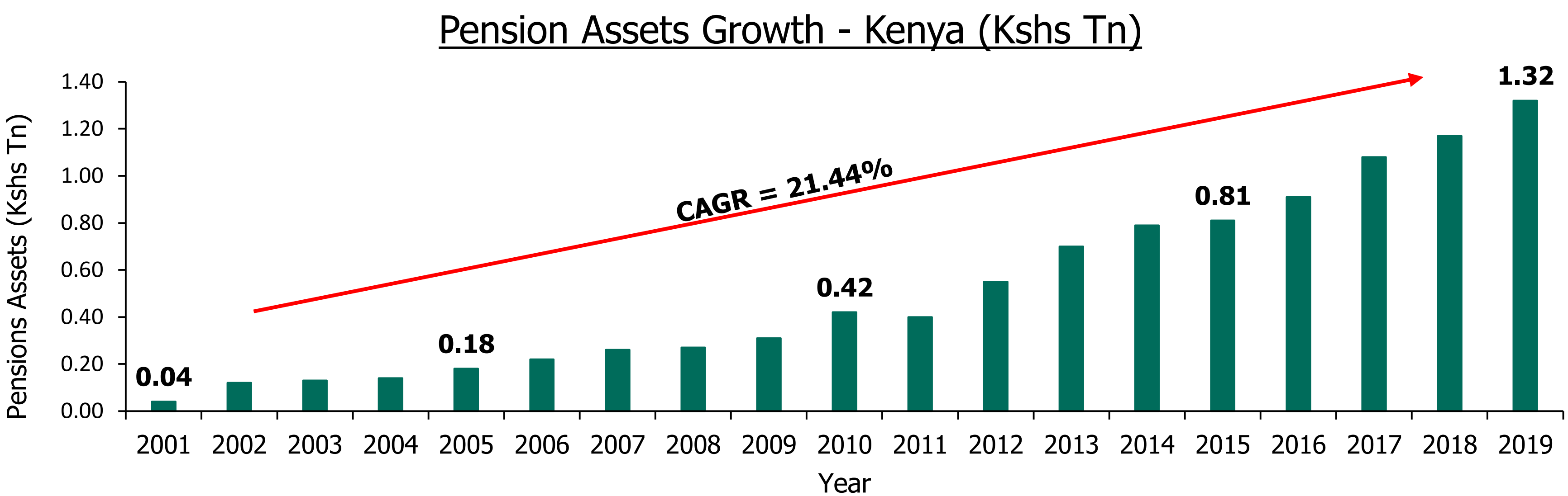
These are schemes that pool the retirement contributions of multiple employers on behalf of their employees thereby reducing the average cost per member and enhancing the overall returns of both the employer and the employees contributions

Individual Retirement Benefits Schemes

These are schemes where individuals contribute directly into the scheme towards saving for their retirement. The contributions may be flexible in order to accommodate an individuals financial circumstances

Pensions Industry in Kenya

Pensions Industry is overseen by the Retirement Benefits Authority (RBA)



- The retirement industry plays a big role in the economy of Kenya with assets worth Kshs 1.32 tn as at December 2019 and averaging 13.55% of the country's GDP over the last 10-years
- The industry has witnessed significant growth increasing by a 9-year CAGR of 17.6%, from 0.7 mn registered members in 2010 to 3.01 mn members as of December 2019, according to the Kenya National Bureau of Statistics (KNBS) FinAccess Report 2019

3.01 Mn

Pension Scheme Members as at Dec 2019

Benefits of Joining A Pension Scheme

A scheme member may purchase a residential house with a portion of their savings

Benefits to Members/Individuals

i. **Tax relief** on contributions to a maximum of Kshs 20,000 per month or 30% of one's salary, whichever is less
ii. **Flexible** arrangement in payments contributions as low as Kshs 1,000 per month (Cytonn Personal)
iii. **Mortgage** – The Trustee can assign up to 60% of their accumulated retirement savings towards securing a mortgage facility
iv. **Purchase a Residential House** with a portion of retirement savings
v. **Earn Returns** – through the Schemes you shall have an opportunity to be part of an investment portfolio that is structured to optimize investment returns and offer the members above market average returns
vi. **Tax-free investment income** and as such contributions grow faster
vii. To be able to live the lifestyle you desire even after retirement
viii. To avoid being a burden on your children/relatives when old

Benefits to Employer

i. **Ease of set up** - Employer joins an already existing and well governed scheme (Umbrella Scheme)
ii. **Employee motivation** and retention
iii. **Tax relief** on contributions;

3. Financial Intermediation

Financial Intermediation

Financial intermediation involves linking savers with borrowers/investors through a third party

- **Definition:** Financial intermediation refers to the activity or the process of linking savers to borrowers indirectly through a third party that may be an institution or an individual
- A financial intermediary is an institution/individual that creates the link and facilitates the movement of uninvested capital deposited by savers to parties that need the funds through lending

Financial Intermediation

- Where lenders avail funds directly to a borrower, this is known as financial disintermediation

Financial Intermediation…

Financial intermediation involves linking savers with borrowers through a third party

Key Functions of Financial Intermediation:

1. Risk Transformation - Lending to multiple borrowers to reduce the risk
2. Convenience Denomination - Matching small deposits with large loans and large deposits with small loans
3. Reconciling conflicting needs of lenders and borrowers alike – can convert short term liabilities into long term assets

Benefits of Financial Intermediation

a. **Risk aversion** – intermediaries can spread the cash out to many borrowers and spread risks
b. **Cost advantage** – economies of scale helps in reducing the costs involved in finding a lender, a borrower or even transactional costs
c. **Financial innovation** – this is possible due to economies of scope; intermediaries focus on demands of lenders and borrowers and are able to enhance their products and services
d. **Market failure protection** - by reconciling different needs in the market
e. **Financial Deepening –** Financial intermediaries act as additional sources of finance and add to variety of options available
f. **Market Development** – capital markets, infrastructure etc. for example infrastructure bonds

Examples of Financial Intermediaries

The following are or can act as financial intermediaries

- Banks
- Mutual Funds
- Credit Unions
- Building Societies
- Stock Exchanges
- Insurance Companies
- Pension Funds

Information Asymmetry

- The primary reason why people give their money to financial intermediaries instead of lending or investing the money directly is because of the risk that is present from the information asymmetry between the provider of funds and the receiver of those funds
- A borrower knows more about his financial condition and his future prospects than the lender. How can the lender be sure that the borrower will not simply disappear with the funds? Or that the borrower will take enormous risks?
- On the other hand, a company that sells stock may not put the money to its best use. It might be used to pay extravagant compensation to its CEO or to pay huge bonuses to bankers who practically destroy their company
- These examples illustrate the 2 types of risks that are present when there is information asymmetry:
    a. **adverse selection,** which is a risk exposure that exists before the money is lent or invested and
    b. **moral hazard,** which is a risk after the financial transaction.

Moral Hazard

- Moral hazard is the risk that the receiver of funds will not use the money as was intended or they may take unnecessary risks or not be vigilant in reducing risk
- When you give money to someone, you want to be sure that you will get it back with interest. However, this is less likely if the money is misused or the borrower takes on unnecessary risks resulting in loss of the money
- Examples of moral hazard:
    a. Insurance – insured takes more risk
    b. Employment – employee with security of tenure makes bad work decisions (self-serving)
- **The remedy to information asymmetry is more information** – Financial intermediaries can gather a lot of information at a lower cost and more efficiently
- Financial intermediaries can use reliable information that they gather to extend financing to many firms or individuals who would otherwise not get it

4. Pension Schemes as Financial Intermediaries

Pension Schemes as Financial Intermediaries

Historically, in former British colonies (including Kenya) priority was given to employment schemes

- Pension Schemes have some characteristics that make it suitable as an intermediary and are found in other institutional investors. These include:
  - ✓ Risk pooling for investors
  - ✓ Have diversification by investing in spread out securities in the capital market
  - ✓ A preference for liquidity and as a result a preference for large and liquid capital markets
  - ✓ Large size and thus economies of scale, which result in lower average costs for investors
  - ✓ Expertise - ability to absorb and process information, superior to that of individual investors in the capital market

I. Clearing and Settling Payments

Pension funds help to generate liquidity by demanding it

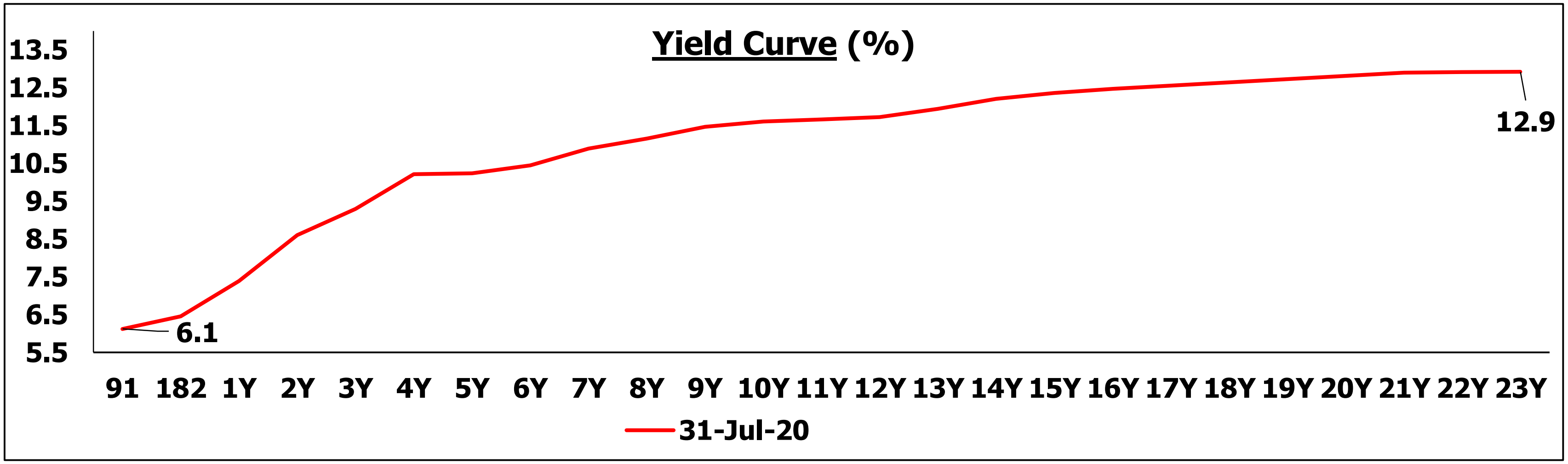
- Pension funds have an important indirect role in boosting the efficiency of the financial systems, by influencing the structure of securities markets and this effect can be linked to their demand for liquidity
- By demanding liquidity, pension funds help to generate it
- They press for improvements in market structure and regulation. These include advanced communication and information systems, reliable clearing and settlements systems, and efficient trading systems, all of which help to ensure that there is efficient arbitrage between securities and scope for diversification
- The resulting financial structure reduces volatility and enables financial and non financial institutions to hold, obtain and transfer liquidity much more readily
- Increases in liquidity should in turn be beneficial more generally to the efficiency of capital markets, as well as diminishing the role of banks in liquidity provision

II. Provision of a Mechanism For Pooling of Funds

- Pooling and diversification is a fundamental characteristic of pension funds, given their size and consequent economies of scale
- Pooling **facilitates participation in the capital markets** by helping to navigate around transactional costs such as minimum investment barrier that sometimes hinder individuals. Other costs include resources used in learning about a company before investing or continuous participation costs incurred by an active trader
- Pension funds also negotiate lower transactions costs and custodial fees while professional asset management costs are shared
- Pooling of funds in a pension scheme means:
    1. improves governance and investment oversight of assets
    2. By the virtue of its increased scale, can command higher returns or facilitate investments
    3. Pooling also shares risk and losses among a high number of scheme members
    4. Possibility of investing in large denomination and indivisible assets such as property

III. Provision of Ways to Transfer Economic Resources

- Pension funds act increase the volume of saving. This may be through voluntary action or by the compulsory nature of statutory and occupational schemes
- Pension funds also help in transferring short term resources into long term assets that ultimately yield a higher return. An individual scheme member is unlikely to take up an 8-year bond especially if they are not an active investor/trader



- The implication is that pension funds increase the supply of long term funds to capital markets, and reduce bank deposits

IV. Provision of ways to manage uncertainty & risk

- Pension schemes diversify assets to control and hedge risk
- The diversification is further enhanced and regulated by the provisions of RBA regulations below:

Asset Category	Maximum Allowable
Government Securities	90.0%
Quoted Equities	70.0%
Immovable Property	30.0%
Guaranteed Funds	100.0%
Listed Corporate Bonds	20.0%
Fixed Deposits	30.0%
Offshore	15.0%
Cash	5.0%
Unquoted Equities	5.0%
Private Equity	10.0%
REITS	30.0%
Others e.g. Unlisted Commercial Papers	10.0%

- Pension funds act as form of retirement income insurance – this extends to employment uncertainty

V. Providing ways to deal with incentive problems

- There are limits to pension funds involvement especially in debt financing, leaving a role for banks
- Pension funds cater for a limited range of borrowers – high quality borrowers that can issue bonds (govt. & corporates). This leaves room for banks to play a role in individuals and small business financing
- Equity Financing
  - **Problem**: Principal-agent problem in ownership and control of firms
  - **Solution**: Effectiveness is enhanced by presence of large investors e.g. pension funds. They can make managers distribute profits to external financiers directly through influence or even by threats of sale
- Another incentive problem is in the relationship between asset managers and investors as the asset managers may act in its own interests or those of a related financial institution contrary to the investors'
  - **Solution**: Pension schemes can overcome these by imposing performance review and changing managers when dissatisfied with the performance

Summary of Role of Pension Funds in Financial Intermediation

1. Increase long term capital available in the market
2. Diversification of scheme member's funds helping to reduce risk
3. Pooling of funds – Helps in improved governance and reduced costs
4. Increase savings level of an economy
5. Facilitation of participation in capital markets
6. Help in improving financial systems and regulations
7. Management of uncertainty

5. Pension Funds Asset Allocation

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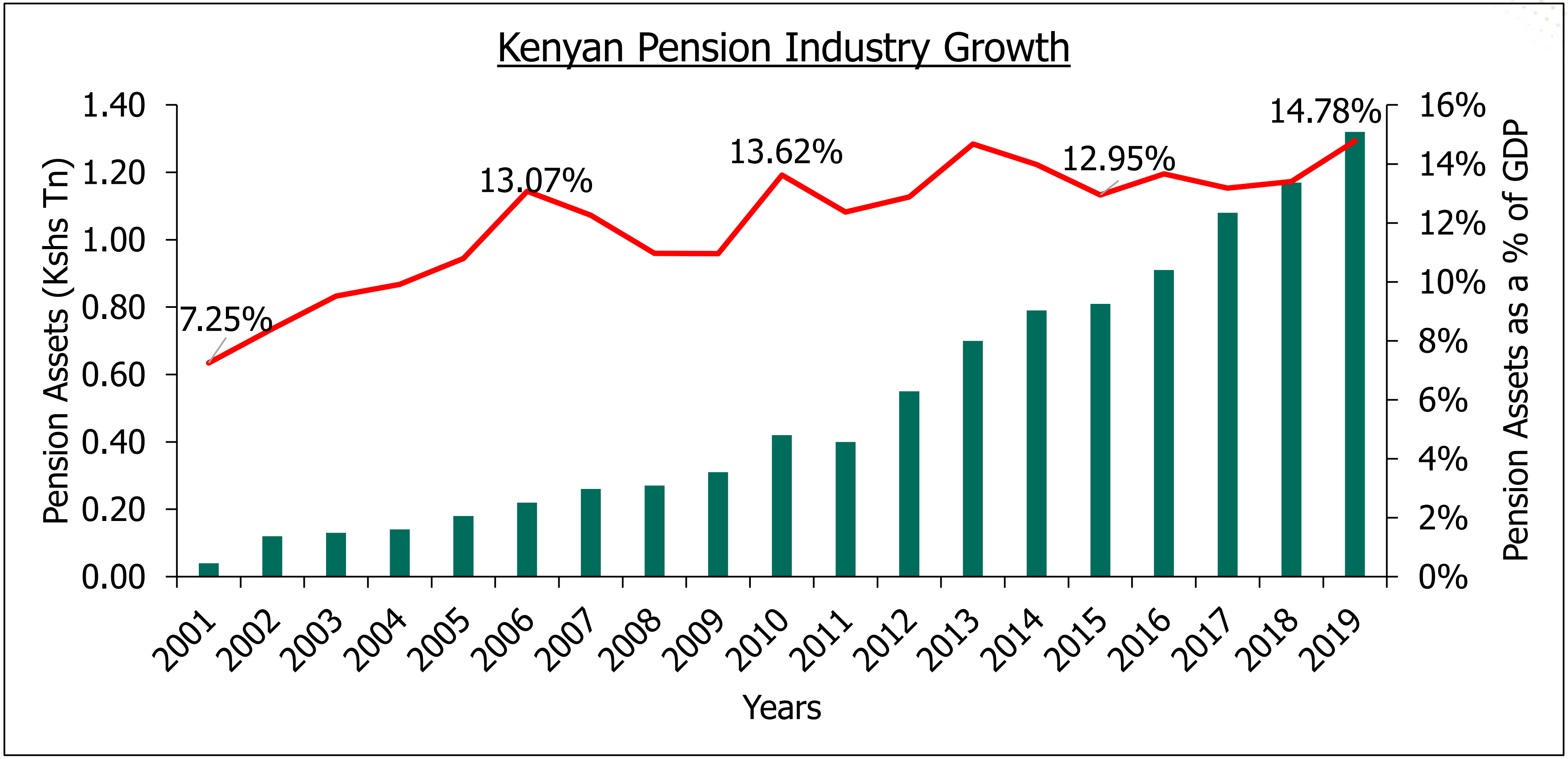
Kenyan Pension Funds Asset Allocation

Kenyan Pension Funds Asset Allocation (Kshs millions)											
Asset Category	Dec-15		Dec-16		Dec-17		Dec-18		Dec-19		Allowable Limit
Government Securities	242,430	29.8%	349,150	38.3%	394,190	36.5%	459,680	39.4%	563,350	42.5%	90.0%
Quoted Equities	186,810	23.0%	159,070	17.4%	210,170	19.5%	201,510	17.3%	234,610	17.7%	70.0%
Immovable Property	150,780	18.5%	178,420	19.5%	226720	21.0%	229,910	19.7%	238,540	18.0%	30.0%
Guaranteed Funds	99,400	12.2%	129,580	14.2%	142970	13.2%	167,450	14.4%	201,614	15.2%	100.0%
Listed Corporate Bonds	48,090	5.9%	46,950	5.1%	41990	3.9%	40,280	3.5%	19,590	1.5%	20.0%
Fixed Deposits	55,610	6.8%	24,570	2.7%	32880	3.0%	36,390	3.1%	40,020	3.0%	30.0%
Offshore	7,160	0.9%	6,960	0.8%	12770	1.2%	13,130	1.1%	6,320	0.5%	15.0%
Cash	11,260	1.4%	12,930	1.4%	12950	1.2%	12,720	1.1%	14,120	1.1%	5.0%
Unquoted Equities	2,770	0.4%	3,950	0.4%	4060	0.4%	3,790	0.3%	4,944	0.4%	5.0%
Private Equity	170	0.0%	220	0.0%	322	0.0%	860	0.1%	969	0.1%	10.0%
REITs	-	0.0%	840	0.1%	1030	0.1%	710	0.1%	473	0.0%	30.0%
Commercial Paper, non-listed bonds by private companies*	-	-	-	-	62	0.0%	60	0.0%	59	0.0%	10.0%
Others e.g. Unlisted Commercial Papers	9,620	0.0%	-	0.0%	-	0.0%	-	0.0%	-	0.0%	10.0%
Total Assets	**814,100**	**100.0%**	**912,640**	**100.0%**	**1,080,114**	**100%**	**1,166,490**	**100%**	**1,324,609**	**100%**	

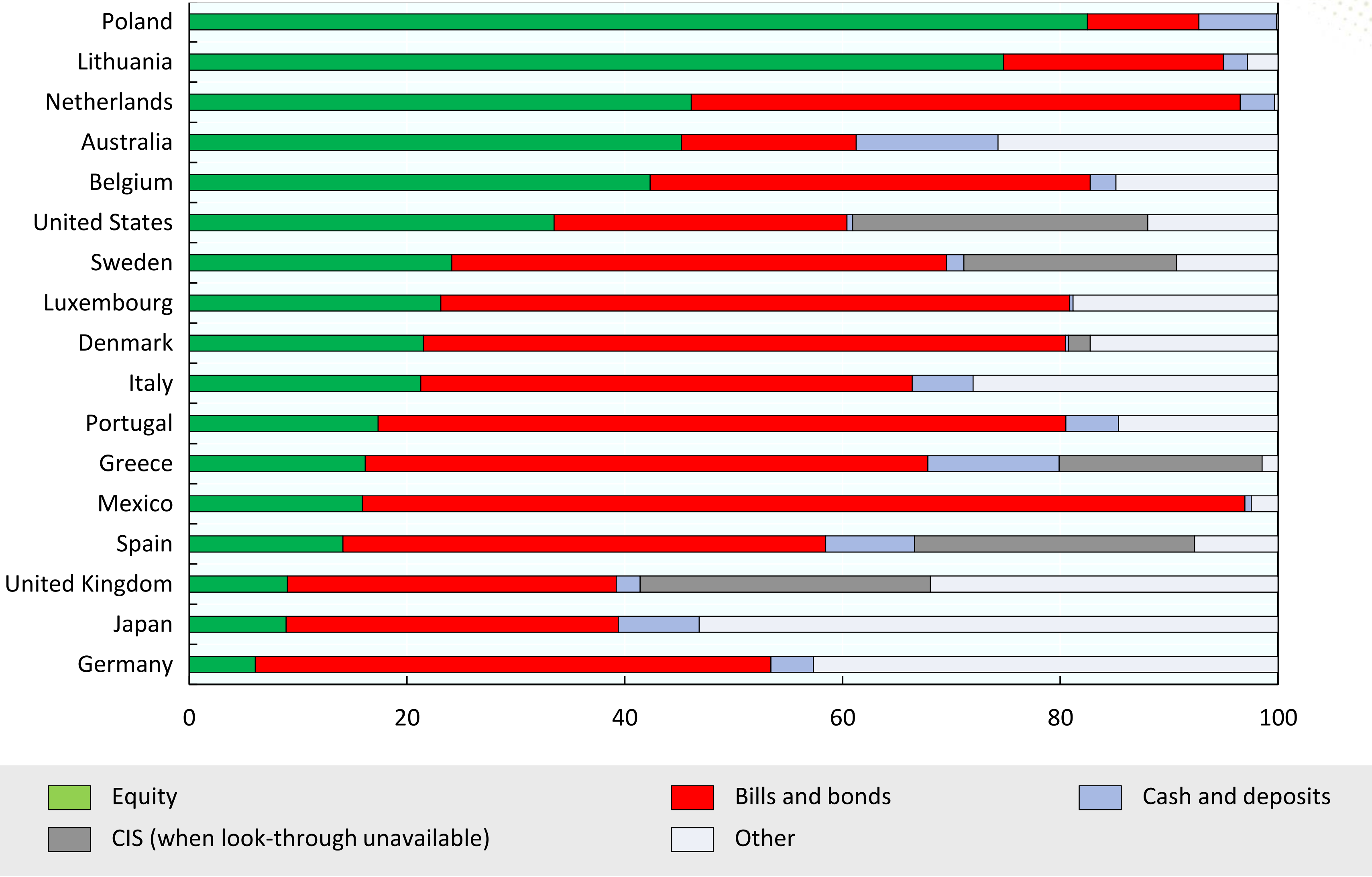
- Pension Fund Assets of Kshs 234.61 Bn as of December represents 9.34% of the total NSE market capitalization of 2.5 Tn as of 30th December 2019

Kenyan Pension Industry Growth

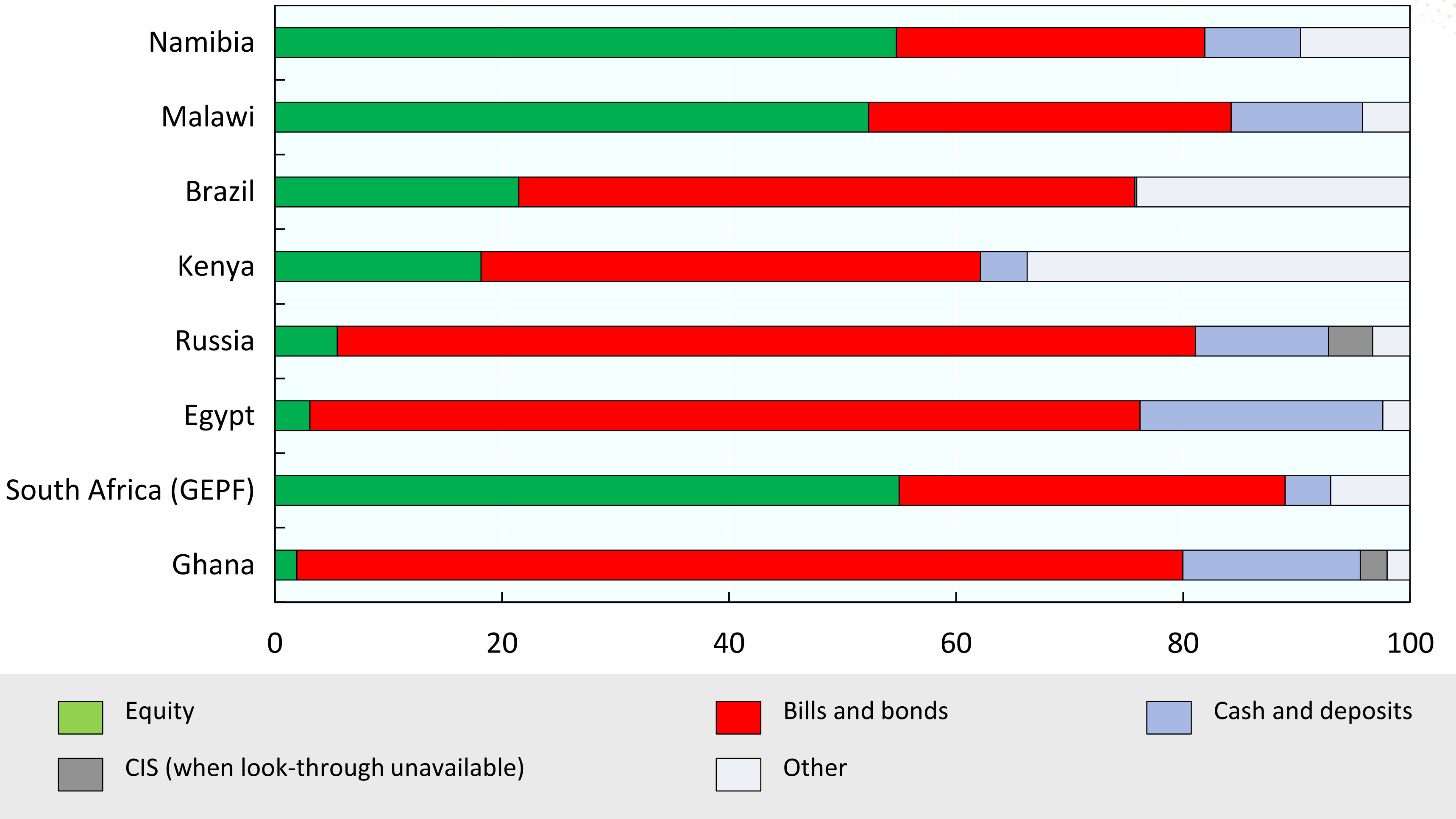


- The retirement industry plays a big role in the economy of Kenya with assets worth Kshs 1.32 tn as at December 2019 and averaging 13.55% of the country's GDP over the last 10-years
- This is still low especially in comparison with the OECD countries average of 60.1% pension assets-to-GDP ratio. The United Kingdom and Netherlands' ratios in 2019 were 123.3% and 191.4%

Pension Funds Asset Allocation – Select OECD countries 2019



Pension Funds Asset Allocation – Select Non-OECD countries 2019



Main beneficiaries of pension funds financial intermediation are government and publicly-listed companies

6. Ways to Improve Pension Coverage

Ways To Increase Pension Coverage in Kenya

WAYS TO INCREASE PENSION COVERAGE

Formal Sector

- Conduct Regular Trainings – to sensitize on benefits and ways of joining pension schemes
- Suitable marketing strategies – use of celebrity power and key market players to drive the conversation
- Target sectors individually

Informal Sector

- Sensitization Drives by both the government and the private pension firms
- Lower Contribution Amounts
- Easier methods of joining and contributing– e.g. USSD, MPesa
- Partnerships with Workers Associations and Chamas
- NSSF suitability to informal sector

7. Cytonn Pension Offering

Cytonn

CAML Pensions offering

CAML has a personal and an umbrella scheme to cater for individuals as well as organizations

1. Cytonn Personal Retirement Benefits Scheme

- Enables individuals to save for their retirement by making regular contributions into this scheme during their working years and grow their retirement savings
- The minimum amount is **Kshs 1,000**
- The money at retirement is provided as a lump sum
- Has a **free life cover**

2. Cytonn Umbrella Retirement Benefits Scheme

- Scheme targets employers or organizations that do not have an occupational retirement benefits scheme and gives them an opportunity to save for retirement for their employees and themselves
- The minimum contribution is 2.5% of employee monthly salary, which is matched by employer
- The employer chooses whether at retirement the employees will receive their benefits as a lump sum or pensions
- Has a **free life cover**

CAML Pensions offering …

The Cytonn Income Drawdown Fund provides an alternative to taking up an annuity

3. Cytonn Income Drawdown Fund

- Provides individuals and members of retirement benefits schemes an option to access their benefits as a regular income through an investment fund upon retirement rather than taking up an annuity
- The minimum investment amount is **Kshs 1,000,000**
- The lockdown period is 10 years

4. Segregated Fund Management

- Cytonn Asset Managers offers fund management services to existing and new segregated retirement benefits schemes
- Our value proposition includes:
    - Management Experience
    - Attractive Returns
    - Exceptional Client Service
    - Trainings

Q&A / AOB

For any queries call us on 0709 101 200

Or email

clientservices@cytonn.com

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