The POINT

Bulletin of the Institute of Economic Affairs | [Issue No. 51 : January 2002

Charting the Future for Kenya's Retirement Benefits Industry

Reforms within the retirement benefits and pension industry in Kenya began with the enactment of the Retirement Benefits Act (1997) that established the Retirement Benefit Authority (RBA). Since then, the industry regulations were gazetted to come into effect in October 2001. Many policy arguments have arisen in respect of the compliance with the regulations. The Institute of Economic Affairs held a public forum on the 21st November 2001 to take stock of the compliance issues as schemes prepared for operation under the new regulatory dispensation. ***Mr. Rick Ashley*** (Chief Executive, Old Mutual Assets Management Ltd.) and ***Mr. Sundeep Raichura*** (Hymans & Roberston Actuaries) made presentations on the compliance issues, the regulatory challenges and the scope for growth. The Point presents a synthesis of the discussion points.

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This Bulletin has been published with funding from the Hanns Seidel Foundation

Introduction

Kenya begun to reform the retirement benefits industry by the establishment the Retirement Benefits Authority to guide the developments within the industry. Government established the Retirement Benefits Authority in 1997 by the introduction of the Retirement Benefits Act (1997). This was a significant development since there were private and public pensions and provident schemes operating in the country without clear regulatory guidelines.

In addition to securing the funds of contributors, it became more evident that the industry was a significant growth area that had been neglected for a while and there was need for structural changes in management. It must be taken to mind that by this time, the National Social Security Fund (NSSF) was the main public retirement benefits scheme in the country and handled statutory contributions. In addition, the coverage by the existing schemes was so low that there was need to begin to extend the coverage to ensure that a greater population was covered.

Establishment of the RBA was considered necessary because of the delicate nature of contributions and the vulnerability of the contributors in the lack of oversight over the managers of the pension schemes. Clearly, part of the reason for the government response by the establishment of a regulatory authority was the need to protect contributors by remedying the problem of mismanagement of funds.

Roles of the RBA

Upon its establishment, the RBA was mandated by law to "regulate and supervise the establishment and management of pension schemes" that preceded its existence and those that were to be formed thereafter. In addition, it was expected to promote the development of the retirement benefits industry through the enactment of regulations for schemes to use in managing the contributor's funds. Tied to this is the goal of protecting the interest of members who contribute to the schemes that have been licensed. Protection of the members of specific schemes was important because of the public concern that some retirement schemes were run poorly.

The RBA's role also includes making policy recommendations to the minister for Finance in respect of the pensions and retirement benefits industry in Kenya. Essentially, this places the RBA in an advisory role and with the possibility of leading policy formulation for the industry in which it takes charge.

Finally, the RBA is a national institution that will be in the forefront in of the implementation of the government policies touching on the retirement benefits industry. The industry encouraged the establishment of the RBA as a positive policy development because of fast growth without any clear policy or regulatory provisions. At the same time, there was understandable concern by contributors to the private and public schemes that there was insufficient protection for them due to the lack of clear rules and oversight institutions over the managers of the industry.

With this wide mandate and brief, the RBA is critically positioned in terms of guiding the growth of Kenya's retirement benefits and pensions industry. In the time since the RBA formally begun its work, the industry has experienced adjustments as the authority began to make progress in guiding the variety of schemes to comply with the regulations. Since its inception in 1997, the RBA has sought to justify to Kenyans the need for the setting up or joining retirement benefits schemes that are suitable to them.

? ***Mobilisation of savings***

In spite of the demographic and economic differences that exist among nations, it has now become evident that pension systems and retirement benefits schemes are necessary for developing countries like Kenya not only to secure people's livelihoods after retirement, but also due to the fact retirement schemes provide an avenue for mobilizing savings for long-term investments. This has necessarily led to increased prominence for the pension and retirement benefits industry since it serves the economy variously. This is by ensuring that individuals have savings that may be used to sustain their standards of living after retirement and in the process providing funds for development.

? ***Globalisation***

Part of the pressures of globalisation is that countries must begin to develop and facilitate investments that require huge input through the development of retirement schemes. The overall rise in the prominence of pensions and retirement schemes is demonstrated by the ratio of the pensions and retirement benefits industry contribute towards overall investments. In addition, the retirement benefits funds are preferable because they tend to be available for the long-term. As a result of this realization and the growing size of retirement benefits funds in the developed countries, the discussions on public policy in the financial services has come to include retirement benefits more prominently. For Kenya's case, it is palpable that the level of care provided by families to members is beginning to show strains on account of the rising levels of poverty and urbanization.

? ***Increased old-age poverty***

As a result of the rise in the national incidence of poverty, the provision and care that Kenyans can provide to elderly citizens is severely limited by the low incomes. On the other hand, the contraction of the economy is leading to more retrenchment of workers, thereby increasing the dependency ratios. Notwithstanding the fact that some of the elderly are retired and held employment with reasonable incomes, they are often unable to maintain their standards of living upon their retirement. Coupled with the fact that the younger generation has been equally affected by the economic contraction, the vulnerability of the elderly.

Transition and Compliance Criteria

The Minister for Finance issued RBA regulations in accordance with the requirements and powers of ***section 55*** of the Retirement Benefits Act of 1997. Transitional regulations published in 2000 required the schemes to amend their trust deeds and internal rules to comply with the regulations that were to come into full effect on the 9th October 2001. These trust deeds, which are the basis for the existence of the schemes, are required for registration with the regulatory agency in order for the scheme to have legal status.

Considering that compliance with the new regulations required substantial amendments to the trust deeds of individual schemes, the regulations allowed for concessions to schemes that could not immediately comply. However, these schemes were required to present proposals to the authority on the timeframe that they needed before they would attain full compliance. This plan of compliance is to be prepared and presented by the trustees of the scheme under regulation 11 and should detail the progress that is being made to ensure complete compliance and the period within which the trustees expect to regularize the operations of the scheme.

> "The table under this section sets limits on the variety of investments and specifically sets a limit of 30% on immovable property"

- ***Trustees***

Besides the need to rework the trust deeds and to prepare compliance plans where necessary, schemes were expected to appoint trustees subject to the provisions of ***section 26(2)*** of the Act. The trustees have the legal obligation to ensure that the scheme adheres to the Act and are the link between the contributors and the authority. Appointment of trustees was among the major compliance criteria that the authority considered when the regulations took effect. Evidence of such appointment of the trustees was to be presented to the RBA in the Deed of Appointment.

In the appointment of the trustees, it was required that the minimum number of trustees would be three, of which one third must be nominated by the general membership of the schemes. The requirement for one-third representation of the membership among the trustees is intended to secure the active involvement of the contributors in the major decisions that affect their contributions and savings.

- ***Scheme Report***

Related to the representation of the membership as trustees of the scheme is the express requirement for all defined contribution schemes to submit a report of the soundness of the scheme by all defined contribution schemes. This financial statement ought to be signed by an actuary as confirmation of the accuracy of the report.

- ***Investment guidelines***

Investment guidelines in the rules sought to ensure that schemes diversified their risk by reducing the extreme reliance on real estate investments. This was done by the establishment of guidelines on the maximum proportions of the scheme funds that were to be invested as prescribed in ***regulation 38***. The table under this section sets limits on the variety of investments and specifically sets a limit of 30% on immovable property. Most managers considered the limits an important introduction by the regulatory authority since many schemes had earlier concentrated on the acquisition of real estate at prices that were far too high and therefore without the possibility of making returns for the scheme members.

- ***Segregated duties***

As a result of these regulations, all funds are expected to split the roles of fund managers, custodians and trustees in distinct but mutually enforcing roles. In essence, the new structure has resulted in the division of roles such that the managers will only take decisions on investments and are otherwise detached from other decisions regarding the membership and the internal affairs of schemes. Custodians on the other hand are charged with the duty of coordinating the transactions by taking custody of the funds, while the trustees are the link to the contributors.

Each of the three has definite legal responsibilities prescribed under the act and with specific sanctions for the failure to abide by those laws. The logic behind this disarticulated structure is that the separation of duties that clearly provides not only for more transparency but allows for individuals and institutions to provide expertise in areas that they are most qualified. Because there were no rules governing such divisions, many schemes tended to be run entirely by institutions that had consolidated all the functions.

Compliance Costs

In spite of the fact that the RBA worked to create better understanding of the regulations and the manner in which they would be enforced, a number of institutions that run schemes expressed dissatisfaction with some of the rules. Given that there are a variety of schemes in the country in terms of size and structure, it is now known that different schemes have been affected differently by the regulations.

For instance, Insurance companies in Kenya have argued that most of them tend to run far smaller schemes than other institutions by virtue of limitations in the Insurance Act. As a result of that fact, they are unable to completely absorb the costs of the disarticulation of duties between managers and custodians because this introduces different tiers of professionals.

They also further argue that funds run by insurance companies are assured hence are not subject to a reduction in value since the contributors are completely cushioned from movements in the prices of instruments taken up by the insurers. For this reason, it is not necessary to impose the same conditions on funds run by insurance companies since they have already a statutory instrument for securing the funds of their contributors.

In the definition of the duties of managers as differentiated from the custodians, insurance companies insist that the former are actually agents of the trustees and their role is to offer investment advise and the development of the mandatory investment policy. Strictly speaking therefore, their description as managers is not correctly derived from the investment advice duties that they offer to the schemes. Due to the fact that virtually all the schemes managed by the insurance companies in Kenya have an insurance element and are guaranteed funds, the requirement for a custodian where the managers also exist merely duplicates their roles and increases costs for the insurers. While still on the issue of increased compliance costs for insurance companies, they argue that the requirement for actuarial valuations should be considered unnecessary for guaranteed funds.

The major thrust of the arguments by insurance companies on this score is that the total effect of all the separate requirements may impose differential costs on schemes, with the insurance companies bearing far higher administration costs in comparison to their nett worth.

Considering the issue of the investment guidelines and the limits that it places on instruments, various fund managers consider that those limits were set too conservatively. As already mentioned, the guidelines were designed to discourage the managers from the disproportionate investment of the funds in real estate. However, larger problems with the guidelines relate to the limits set for other instruments such as corporate debt in Kenya. In prescribing the maximum that a scheme may devote to corporate bonds at 15%, that the regulations may constrain the development of capital markets on corporate bonds. Many fund managers considered that the regulations should have allowed for a far higher limit to enable schemes to take advantage of this underdeveloped market.

Some of the concerns expressed by insurance companies in terms of compliance costs are legitimate. However, it is prudent to consider that it may not be possible to significantly reduce these costs immediately since the regulations have just come into force and the initial compliance costs have been significant for nearly all schemes. Considered widely, these may be referred to as the costs contingent to the introduction of the regulatory structure since the regulation of the industry has not been centralized before this time.

In spite of the fact that the regulations had been published early enough to afford most schemes sufficient time to learn the regulations and effect the changes, a number of schemes still had to rush to meet the deadlines that had been set. In this rush to amend documents and put structures in place, it is possible that a number of schemes may have had insufficient time to consider some changes that were made. This requires that the RBA be more careful in this first period after the compliance deadlines since the import of some of the errors that have been made will begin to emerge only then.

Drivers for Pensions Industry Reform

The drivers for pensions reform in Kenya are entirely different from those of the developed countries. Naturally therefore, the challenges that are posed and to which policy responses are due, differ markedly and must be informed by Kenya's peculiar circumstances. Whereas a regulatory vacuum existed before the establishment of the RBA, its establishment through legislation has partially alleviated the problems that were posed by the lack of an enabling institution.

It is positive movement in policy for the RBA to be recognized as an advisor to the Minister for Finance on the national policy regarding the retirement benefits industry. This role is however compromised by the fact that there is no stand alone policy on the industry against which the performance of the regulator may be measured. The regulatory vacuum has been covered but is clearly insufficient without an explicit policy. It is imperative therefore that the RBA insist on the development of the policy document in consultation with the wider industry so that the regulatory and policy vacuum is completely addressed.

While it is readily conceded that the retirement benefits and pensions industry in Kenya has been growing, there is the greater challenge of raising the savings rate above the present 8-9% figure generally. While this is an altogether important concern, it is also recognized that the level is determined largely by the fact that Kenyans have grown progressively poorer over the last decade. It could therefore be surmised that it is not exactly possible to raise the proportion of incomes that Kenyans may save when they are unable to meet even basic needs.

Thirdly, the majority of the Kenyan labour force is employed within the informal sector. On the other hand, the design of the retirement benefits and pensions industry has drawn largely from developed countries where virtually the entire labour force is engaged in formal sector occupations. As a result, the retirement benefits and pensions industry in Kenya has not been optimised to serve the informal sector. Recalling that a number of formal sector employers are laying off workers, it is likely that most of them are taking up opportunities for employment within the informal sector and thereby increasing the size of the informal sector within the real economy. While incomes in the informal sector support a majority of Kenyan households, it is also true that the character of employment therein suffers from seasonal fluctuations in work and thereby affects the regularity of incomes. This character of Kenya's labour force presents a challenge to the extent that ideal retirement benefits and pensions systems presuppose regular incomes that facilitate regular remittances.

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Fourthly, many Kenyans have traditionally relied upon their offspring to care for them in the post retirement period. There is evidence now that the social fabric is gradually breaking down hence this form of social security may not be reliable much longer. The social security provided by offspring for their retired parents is further undermined by the national economic underperformance. For this reason, even where the offspring may be willing to take on the responsibilities of caring for their elders, their incomes may limit the amount of assistance that they may be able to provide. As a result, the problem of old age poverty will definitely be aggravated because the government- run pensions system cannot provide sufficient sums for retirees to rely upon.

Also significant is the fact that the retirement benefits industry is far more diverse in terms of operations and size than other industries within the larger financial services industry. For instance, the division of roles within the industry has led to tiers of responsibility that are not common to other financial sub-sectors. Essentially therefore, the industry is fairly complex on account of this variety. It is expected

TABLE 1: COMPLIANCE DEADLINES SUMMARY TABLE

	OCTOBER 9, 2000	APRIL 30, 2001	OCTOBER 8, 2001	OCTOBER 30, 2001
REQUIREMENT	Development of investment policy	Submission of 2000 accounts for schemes with year ending Dec. 31	Amendment of schemes rules to comply with Act & Regulations	Submission of 2001 Accounts for Schemes with year ending June 30
	Compliance with investment guidelines or submission of plan of compliance	Payment of levy for schemes with year ending Dec. 31	Appointment of trustees in accordance with the Act and Regulations	Payment of levy for schemes with year ending June 30
			Appointment of a registered manager and custodian	
			iew for all DC Schemes	

Source: RBA News, Vol. 1 No. 1, September 2001

TABLE 2: RBA INVESTMENT GUIDELINES

Item	Column 1	Column 2
	Categories of Assets	Maximum % of aggregate market value of total assets of scheme or pooled fund
1.	Cash and Demand Deposits in institutions licensed under the Banking Act of the Republic of Kenya	5%
2.	Fixed Deposits, Time Deposits and Certificates of Deposits in institutions licensed under the Banking Act of the Republic of Kenya	30%
3.	Commercial Paper, Corporate Bonds, Mortgage Bonds and loan stocks approved by the Capital Markets Authority and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category	15%
4.	Kenya Government Securities and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category	70%
5.	Preference shares and ordinary shares of companies quoted in a stock exchange in Kenya, Uganda or Tanzania and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category	70%
6.	Unquoted shares of companies incorporated in Kenya and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category	5%
7.	Offshore investments in bank deposits, government securities, quoted equities and rated Corporate Bonds and offshore collective investment schemes reflecting these assets	15%
8.	Immovable property in Kenya and units in property Unit Trust Schemes incorporated in Kenya and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category	30%
9.	Guaranteed Funds	100%
10.	Any other assets	5%

Source: Kenya subsidiary legislation 2000 (Legal Notice No. 118) , 9th October 2000, page 451

that with the introduction of the regulations, more schemes will be registered and this will add to the diversity and number of schemes beyond the 1250 that are currently registered. With this factor in mind, the level of supervision in the industry has to be conducted delicately so that it does not lead to micromanagement and a rise in the supervision and compliance costs for the regulator and the individual schemes respectively.

Finally, reforms in the pensions industry are occurring within the context of a liberalizing economy. The overall pace of this liberalization may be slow, but the financial sector in Kenya was among the first to experience liberalization. Hand in hand with the increased involvement of the private sector in other sectors of the economy, it is expected that in due course, the level of private sector involvement will rise as government role diminishes proportionally. With government gradually adopting liberalization policies, private retirement benefits schemes will not only become more prominent, but that the range of investments will be continually diversified. In due course, policy discussions will be focused on whether the public retirements benefits and pension schemes ought to be retained and how may the structural reforms be conducted.

Policy Challenges for Pensions Industry in Kenya

Proposals for the adjustments and growth of the retirement benefits and pensions industry in Kenya must necessarily take into account the major drivers identified above. It is also relevant to note that an elaborate pensions regime is absolutely necessary for the workers in any country across the world.

For the reason that the retirement benefits and pensions industry is undergoing reforms, both the government and RBA must begin to reconsider the role of the National Social Security Fund (N.S.S.F). The reason for this being that it is the largest single player in the industry and stands as a public institution for pension payments to retired contributors. Due to the scope of its coverage and the concern regarding its investment policies, the regulation of the NSSF is a matter of legitimate public interest. In light of the argued reforms and structural changes taking place in public pension systems across the world, this industry will not be completely competitive and prepared for contribution for national development without the public's fears being addressed concerning the safety of the funds held by the NSSF.

At the same time, the system of predetermined and fixed contributions by workers is inequitable because the predetermined sum is a disproportionate charge to the lower income earners as compared to others. As a public institution therefore, the NSSF must begin to regain the confidence of contributors by publishing its records and injecting efficiency into its operations. This means that a radical human resource and management reform exercise is inevitable.

> "Due to the scope of its coverage and the concern regarding its investment policies, the regulation of the NSSF is a matter of legitimate public interest"

Kenya's retirement benefits schemes presently cover only 15% of the workers due to the large informal sector in the country. Considering that the informal sector is still growing while the formal sector is stagnant, the RBA must render policy advise to government on mechanisms for extending coverage to the workers in the informal sector. It is also strategically important for the country to be able to harness the savings of the larger proportion of the working population by developing innovative products to extend coverage to the informal sector. Granted that there are no legal barriers to the establishment of a scheme for informal sector workers, government must still play a role in encouraging informal sector workers to save as often as they can.

In view of the fact that there is a grey area in respect to the liability of scheme managers, the whistle blower's role will be appreciated where it alerts the RBA on matters that may adversely affect the schemes. This suggestion recognizes that such oversight can also be enhanced through raising the standards of professional conduct required in the industry and the critical education of trustees. Considering that the education of contributors generally and the education of trustees is being undertaken by the

RBA, the levels of professional misconduct that have been common are expected to reduce substantially. With the accommodation of genuine whistle blowers and the existing disclosure requirements in place, it is far more difficult for the sponsors of the schemes to divert scheme funds into unauthorized business that were common before the RBA published the regulations.

Thinking of the potential and reforms within the retirement benefits industry in Kenya, it must be recalled that these reforms in the industry must take place within the context of the entire financial services sector reforms. Meaning that reforms in the operations of the insurance, banking and the equity markets will need to be aligned closely and coordinated with the reforms within the retirement benefits and pensions industry.

To start with, there is obvious need to re-examine the extent of overlap between the Capital Markets Authority, the Commissioner of Insurance and the Retirement Benefits Authority since they are all agencies regulating institutions that play significant roles in the retirement benefits industry. Reforms within the broad financial services sector must be in view of the fact that there is also a discernible and rational trend towards the convergence of regulatory functions in the sector.

Kenya's retirement benefits and pensions policy should be drawn with a futuristic outlook. The present rules are a too restrictive in the way that the contributors may utilize the savings. Policy should allow for flexibility so that the contributors could to use the saved funds as collateral for education or as a loan for the acquisition of a home. Because the opportunity for reasonable credit is constrained severely by the size of wages in Kenya, the retirement benefits policy should envisage the need to leverage contributions as collateral for either skills that may raise their incomes through education or to acquire home loans. If the country's retirement benefits and pensions policy was constructed this flexibly, then average contributors would save with a far wider goal

Conclusion

The establishment of the RBA has began to regularise the operation of schemes within the retirement benefits and pension industry in Kenya. This development has brought the industry to face new challenges emerging from various directions. However, these policy challenges have been clearly understood and must be addressed promptly within a comprehensive policy setting benchmarks for the development goals that the industry is expected to achieve. While there are challenges related to the overall macroeconomic growth, expectations remain high that the RBA regulations will give way to a healthy policy environment for the industry.

A Comprehensive Report of the meeting is available from IEA offices.

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PUBLISHED BY THE INSTITUTE OF ECONOMIC AFFAIRS, 5TH FLOOR, ACK GARDEN HOUSE
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