

IMPACTS OF PENSION REFORMS ON THE KENYAN PENSION INDUSTRY

Masinde Mercy Victoria

John L. Olukuru

Victoria.masinde@strathmore.edu

Jolukuru@strathmore.edu

Abstract

The emergence of full-fledged reforms in Kenya from the introduction of the Retirement Benefits Authority in 1997 has rekindled hopes among the ageing population in Kenya. This paper examines the effect of the NSSF Act 2013 contribution rate by use of a contribution rate model as well as Kenyans' perception towards the yet to be implemented Act by use of questionnaire analysis. The study asserts that the set 6% is sufficient to meet the welfare conditions of Kenyans. Further, this study also identifies the main social welfare reforms put in place, as well as the effects and challenges towards implementation of the reforms on the performance of the industry with a critical theoretical look at the NSSF Act 2013.

Keywords: Pension Reforms, retirement, Contribution rate, social security, poverty

Introduction

Over the past three decades, the living condition of older persons in Kenya has deteriorated. This is as a result of the erosions of their economic power, changes in the family structures and roles, particularly on the care of older members of the immediate family unsustainability of the pension schemes and inability of government to fulfill her expected role in the care and support of older persons in the community (Reynaund, 2000). Worldwide older persons are regarded as vulnerable group, hence, it has been accepted that older persons, the children and women are in dire need of government attention. This is because poverty affects this class of people than any other categories in contemporary world especially in developing countries. Various efforts by various successive regimes in the country to address the needs of older members of the society have proved abortive.

Kenya being a British colony has adopted so much from the British system of saving. These include the formation of the National Social Security Fund (NSSF), similar to the state pensions of the United Kingdom (UK) and the occupational pension funds (Mghali, 2003). Ginneken (1998) defines social security as benefits that the society provides to individuals and households through public and collective measures to guarantee them a minimum standard of living and to protect them against low or declining living standards arising out of a number of basic risks and needs. Social security is thus a social insurance program. For our case in Kenya we have NSSF.

The social security after retirement concerns for the Kenyan work force is a factor that leads to growth of the pension industry. This has been so because a large task force of the Kenyan population is increasingly being employed in the private sector which has designated occupational pension schemes for the employees. There is need to replace income after the active working years for a person who has been used to a pay check at the end of every month. Reforms to improve the efficiency of the social security sector are therefore highly

needed. A vast understanding about the operation and implications of these laws is highly needed thus the basis of this report. The dilemma of efficiency of these reforms with regards to the pension industry is a big question to all stakeholders.

This paper evaluates the impact of reforms on both private and the social security system in Kenya. Specifically;

To identify the possible impacts of these identified reforms.

To identify the challenges towards implementation of these reforms.

The remaining part of the paper examines similar work done in pension reforms while section 3 looks at the contribution rate model. The data analysis and discussion of the results is done in section 4. The fifth section discusses the research findings which are based on analyzing the impacts of pension reforms.

Related literature

The need for reforms in social security is a question being impressed by many countries around the world. The OECD Secretary-General Angel Gurría asserts that “Further reforms are needed”. We cannot risk a resurgence of old-age poverty in the future. This risk is heightened by growing earnings inequality in many countries, which will feed through into greater inequality in retirement. This struggle to meet the above addressed issue is the main reason as to why many countries are reforming their pension industry.

The lifecycle hypothesis by Modigliani, (1963) deals with economic decisions on retirement saving in particular the rationalization of an individual’s income in order to maximize its utility over his lifetime. It stated that households accumulate savings during their working careers up to their retirement, and de-accumulate wealth thereafter.

The Chilean model of pension reform of 1981 replaced an earlier pay-as-you-go (PAYGO) and public pension system with a new compulsory system of individual funded and privately managed pension accounts based on Defined Contribution (DC) principles was credited for linking old age social security with the facilitation of macroeconomic growth. World Bank personnel in particular suggested that the Chilean case proved that a shift of pension provisions from the public to the private sector and from PAYGO to DC would maintain social protection while increasing economic growth via the deepening of financial markets (World Bank, 1994). In fact, the system delivered poverty pensions rather than old age security to most contributors. The former center-left Chilean government decided to phase in a new public and tax-financed basic social pension system in order to provide additional income for current and future pensioners with very small funded pensions (Riesco 2009).

Secondly came the Nigerian 2004 reform which was inspired by the experience of Chile, an economically more advanced country, Nigerian policy-makers attempted to replicate the 1981 Chilean pension reform Orifowomo 2006; Casey, 2009. Before the 2004 reform in Nigeria, the formal private sector was covered by a pay-as-you-go pension scheme, the Nigerian Social Insurance and Trust Fund (NSITF). However, its scope and coverage were more limited than those of public sector schemes. Only some larger enterprises offered access to the scheme and, since its foundation in 1994, the NSITF’s accumulated capital and pension payouts were low while administrative costs were high (ILO 2006). The resulting pattern of pension provisions was highly fragmented, and the available data suggest that only 10 percent of the Nigerian workforce (about 4.8 million out of about 48 million) belonged to the Formal employment sector, out of which about 3.7 million also belonged to a pension scheme (Casey, 2009).

On the Kenyan scenario Odundo, (2003) report on Supervision of public pension funds in Kenya points out some of the loopholes in the Kenyan social security system. One of the main challenges is the fact that the Kenyan investment profile is characterized by a lack of

diversity. Further Odundo, (2003) points out the fact that NSSF Kenya is faced with poor record keeping. This has led to delays in determining benefits precipitating a US\$100 million unallocated suspense account. Figure 1 below is shows the different reforms that have so far been implemented in Kenya.

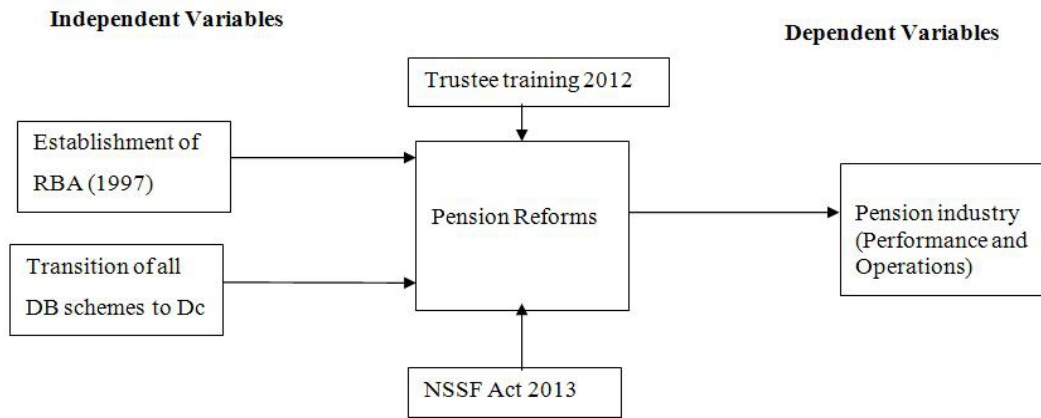


Figure 1: Different pension reforms

Methodology

Contribution rate model definition

The objective of a pension model is to evaluate the financial viability of a pension scheme or pensioner to confirm the income and expenditure that should remain in force over a definite period of time or make recommendations on the necessity to revise the contribution rate to maintain a sustainable benefit (Latulippe, 1997)

Model Assumptions

Assume that salary amount, S; Interest rate, r; Salary increase rate, e; Assuming an individual would like to maintain a given lifestyle after retirement his/her salary is expected to increase constantly at a rate r^s . Then the monthly effective will be

$$r^m = (1+r^s)^{1/12} - 1$$

A mortality table will then be prepared from the principle; $q_x = 1 - P_x$

Table 1 below shows values used for the specific assumption;

Table 1

Assumed Age of Entry	25
Assumed Retirement age	60
age of the ,member at date of valuation	30
Rate of pension accrual	80
Rate of Pension Increase	5.00%
Assumed annual salary growth	1.50%
Interest Rate	18%
Inflation Rate	7.36%

Table 2

Male Percentage	67%	
Female Percentage	33%	
Salary level	Min	Max
Males	\$4,011	\$14,815
Females	\$4,411	\$11,024

Dollar - Kshs Conversion Rate	90
-------------------------------	----

The model also incorporated mortality assumption; that is the Association of Kenya Insurers (AKI) tables were used.

Model Specification

The main objective was to determine the appropriate contribution rate that the individual can use to contribute an amount that will be able to sustain him/her during the retirement period. This was by use of a contribution rate model whereby a hypothetical situation of an average earning Kenyan was considered.

All the contributions were accumulated to age 60 years and the expected pension benefits discounted to age 60 years, using excel functionalities. An appropriate standard contribution rate that can make the difference between the individual contributions and his/her benefits equal to zero such that he/she does not under or over contribute was calculated. The model was meant to give an approximate estimate of the appropriate contribution rate to help compare with the proposed 6% in the proposed bill.

The model uses the following pension standard contribution rate formulas;

Attained Age Standard Contribution Rate (AASCR)

$$AASCR = \frac{\frac{(R-X)S}{A} \times \left(\frac{1+e}{1+i}\right)^{R-X} \times a'_R}{S \times a_{\overline{R-X}|}} \tag{1}$$

Where R is assumed retirement age, X is the age of member at date of valuation, S is salary at date of valuation, A is rate of pension accrual, E is assumed annual earning (salary) growth, I is discount rate, a'_R is value of annuity payable from age R (allowing for any spouses pension and pension increases) and $a_{\overline{R-X}|}$ is an annuity to determine the present value of all future earnings (Allowing for the timing of contributions and salary increases)

Entry Age Standard Contribution Rate (EASCR)

$$EASCR = \frac{\frac{(R-E)S}{A} \times \left(\frac{1+e}{1+i}\right)^{R-E} \times a''_R}{S \times a_{\overline{R-E}|}} \tag{2}$$

Where E is assumed entry age, $a_{\overline{R-E}|}$ is an annuity to determine the present value of all future earnings for a new entrant and a''_R is value of annuity payable from age R, based on assumed proportion of males and females in the scheme (Allowing for any spouses pension and pension increases)

Projected Unit Standard Contribution Rate (PUSCR)

$$PUSCR = \frac{\frac{1 \times S}{A} \times \left(\frac{1+e}{1+i}\right)^{R-X} \times a'_R}{S \times a_{\overline{1}|}} \tag{3}$$

Where $a_{\overline{1}|}$ is an annuity to determine the present value of earnings over the next year (Allowing for the timing of contributions and salary increases)

Current Unit Standard Contribution Rate (CUSCR)

$$CUSCR = \frac{\frac{1 \times S \times (1+e)}{A} \times \left(\frac{1}{1+i}\right)^{R-X} \times a'_R + (CUAL \times e)}{S \times a_{\overline{1}|}} \tag{4}$$

Where:

$$CUAL = \frac{P \times S}{A} \times \left(\frac{1}{1+i}\right)^{R-X} \times a'_R \tag{5}$$

Data analysis, discussions and findings

The data analysis and finding

Data was obtained from self-administered questionnaires, completed by 50% of respondents from different pension schemes in Kenya. Secondary data was also obtained from various researches done on the Kenyan pension industry.

The four funding methods of valuation of pension standard contribution rates gives the 6% line graph to be the average for all the four methods. This implies that the stated contribution rate in the act could be fair and is not lean on any particular individuals. The 6% deduction is not to be imposed on employees immediately but will be increased gradually over the next five years. Employers will also be required to match the deduction by every employee. An average employee changes jobs at least seven times during his or her working life. Under the current law, he can access up to 75 per cent of his pension contribution.

Attained Age Method (Attained Age Standard Contribution Rate (AASCR))

In this method, the model targets a stable level of contribution which can then be adjusted as appropriate with adjustment in the model parameter (age, salary retirement etc.) Assuming that the benefits are expected to be paid over the expected future membership of the beneficiary, this method gives a total contribution rate of 10.33%. This is to mean 5.16% employer contribution and the same rate also applies to the employee contribution. The deviation between the model result (5.16%) and 6% percent could be as a result of other extra scheme expenses like the regulatory levy and scheme administrative expenses. 6% could be a good contribution rate according to Attained age method.

Entry Age Method (Entry Age Standard Contribution Rate (EASCR))

The results are similar to AASCR above. The only difference is that for this method the calculations are performed at the beginning of the member's service period. In this case the entry age assumption (25 years) was used. The method gives a total contribution rate of 11.6%. This means 5.8% employer contribution and the same rate also applies to the employee contribution. These results are on average in agreement with 6% in the NSSF Act.

Projected Unit Method (Projected Unit Standard Contribution rate (PUSCR))

In this method, the present value of all benefits that will accrue in the year following the valuation date, by reference to service in that year and projected final earnings divided by the present value of all members earnings in that year. The method gives a total contribution rate of 11.92% as highlighted below. This is to mean 5.86% employer contribution and the same rate also applies to the employee contribution. These results are on average in agreement with 6% in the NSSF Act.

Different stakeholders' perspective about Impacts of pension reforms in Kenya.

Scheme Members expressed fears that whereas there is an opt-out clause in the Act, it could prove hard for companies to get the necessary waiver to run their own schemes. As the country moves towards implementing the proposed reforms, the NSSF will be expected to operate three funds the current provident fund, the new pension fund and a new provident fund.

Fund Managers

A higher contribution as expressed by some respondents means an additional expense on employers and may affect the new employment thus erasing the need to create about one million jobs promised by the Government. The old provident fund will be given five years to

settle its dues to members, after which it shall be closed down. East Africa has been looking for ways to reform its pensions sector.

On the other hand this increase in contribution rate may prompt an increase in the level of contribution to be invested hence more income for fund managers.

NSSF Perspective

NSSF research justifying the need for NSSF's transformation depicts that only 3.1% of elderly in Kenya above the age of 55 had reported receipt of any pension. It is therefore with this concern that we need such a reform to address the above issue.

Other factors that affect the performance of the pension industry in Kenya

The respondents indicated that the determinants already identified may influence the financial performance of pension schemes. The trustees considered the global economic conditions as crucial in determining how the Kenyan economy is going to perform. They cited the recent 2008-2009 global financial crisis which affected the general world economy. This crisis also shrank the gains which had been made by the retirement benefits schemes as most investments incurred losses.

They also noted the importance of analyzing the political situation in the country before investing in any sector. The long term strategies adopted by the scheme determine the strategies to be adopted by the fund managers in investing the schemes funds. This goes a long way in delivering good returns to the scheme.

Government regulation is also another factor which affects the performance of retirement benefit schemes. Some regulations cited was where the government allowed deferred members to withdraw some of their benefits before retirement. This occasioned losses in some schemes' since the funds had been locked up in long term investments.

From the questionnaires it was clear that already 86.5% of the sample data are registered members of NSSF. Of which 23% are satisfied with NSSF services. Some of the reasons given for satisfaction include the fact most people are aware of the tax benefits pegged on their NSSF contributions. Some of the positive aspects highlighted include the fact that all employees including self-employed persons can participate in the social security. The provisions that exclude contributions from attachment, including in bankruptcy proceedings, are commendable for their intention to insulate the retired against poverty. Most of the respondents are confident that NSSF will benefits will do help them meet their retirement needs.

On the other hand, some of the reasons given for those who are not comfortable with the act include their past bad experience with the old NSSF scheme. Respondents pointed out the fact that the act has several negative provisions that would impact on the retirement benefits industry and increase unemployment. It came out clear that the act re-establishes a statutory fund with no clarity as to whether it is to take the form of a trust or a body corporate and the reference to "pension" schemes rather than "retirement benefit" schemes limits the opt-out option to pension schemes. The NSSF Board of Trustees is set up as a body corporate thereby causing confusion and ambiguity as to whether the Fund is established as a statutory fund or as a trust. Furthermore, the NSSF Board comprising two principal secretaries, seven cabinet secretaries and a managing trustee appointed by the Board will be largely appointed by the Government. The Bill makes occupiers of premises liable to inspection and any employer, servants and agents of such occupier, and any employee, shall be required to furnish a Compliance Officer all such information and documents for inspection. This is notwithstanding Article 31 of the Constitution that grants natural and corporate persons the right to privacy including the right not to have their person, home or property searched; information relating to their family or private affairs unnecessarily required or revealed. The

Second Schedule to the Bill provides for the compulsory transfer of members from the old provident fund to the new fund, but prohibits the transfer of assets, including members' contributions, to the new fund.

Misappropriation of funds and mismanagement of investments come out clear from most of the respondents. According to the report by Auditor General, NSSF may have incurred up to 76.5% of contributions on administration fees. It is on this premise that is act has attracted scrutiny and criticism from most of the stakeholders.

Transparency of the act is one of the major concerns raised by the respondents. It is clear that stakeholder education is needed as most of the respondents as much they are so emotionally negative about the bill they seem not to understand the key aspects of this bill. Most of the respondents were not able to clearly state what the bill states. One thing that came out clear is that most respondents are aware of the increase in contribution rate though they cannot really explain how the increase is to be incorporated. With lack of awareness, most stakeholders pointed out the fact that the Bill risks creating greater confusion in the retirement benefits sector. As part of a solution for the same the respondents are of the opinion that there awareness sessions should be organized in order to enlighten the public.

60% of the respondents are both members of NSSF as well as private pension. Members are fascinated with the tier 11 option of opting out as this will help grow their private pension. Specifically the private pension administrators are of the opinion that this will help grow their industry as most of their trusted members will go for the opting out option. It is of concern to them that this provision of contracting out of regulations referred to in the Fourth Schedule, are yet to be prescribed and therefore employers cannot benefit from the said provisions. The CEO of RBA in his reports said that though the Bill has room for employers with sound benefit schemes to opt out of the mandatory NSSF contributions, the conditions for opting out have not been well defined under the proposed law. This is what brings tension to private pension holders as they are not sure if the provision may be made not to be in their favor hence stands a chance to lose out.

The opt-out provision of the NSSF Act 2013 is evidently a blessing as indicated by private pension scheme members. Members are of the opinion that in opting out one may use the opportunity to set up a private pension scheme account, take advantage of contributions beyond Tier 2, which are available to all members of private pension schemes as well as diversify your retirement savings investment strategy. Some of the reasons given as to why they want to remain in their private schemes included: Increased transparency on reporting and investing, Ease of accessing account statements, Ease of managing contributions beyond Tier 2, Ease of managing third party pension transactions, such as mortgage guarantees, Ease of accessing pension benefits upon attaining retirement age and Portability of the pension scheme

Conclusion

Reforms will always be welcome. I laud efforts by the forces driving the changes in NSSF. We support especially the drive to at least ensure that the benefits that NSSF provides to Members at their retirement are meaningful and if this is the only way Members can secure their retirement, so be it. For employers who have adamantly refused to allow their Members to enjoy the benefits of having their own occupational retirement benefits schemes, the new Fund will at least create a platform that will allow worker feel like their retirement welfare is at last secure. The current move to conform NSSF to the provisions of the Retirement Benefits Act is also long overdue and should be encouraged. It is hoped that investment returns will continue to increase as the administration costs reduce or at least arrested.

However, we must reiterate the need for NSSF (at least in the mutated form) will be fully compliant with the Retirement Benefits Act and more so that its management will be

required to accept the complete oversight of the Retirement Benefits Authority. This will inject professionalism, transparency and accountability

There is therefore a need to engage all the stakeholders in the pension's industry/sector so as to allow them air their views on the Act and have their contributions incorporated. This is in line with good Corporate Governance and industry best practice.

It is further opined that consequent to the NSSF Act 2013, the RBA Act No.3 of 1997 ought to be amended to provide that all employers must enlist their employees in a retirement benefit scheme of their choice or the NSSF. This is in line with international best practice industry standards. Consequently, the Retirement Benefits Authority (RBA) should be mandated to fully oversee the activities of NSSF in accordance with the provisions of the RBA Act;

The Pension Industry seeks a fair competitive environment where each player is given a freehand to offer service to members in the retirement industry.

According to the ILO, Universal Pensions are basically 1st Pillar social assistance measures formulated and funded by the state. A major element of the scheme is "Government or State Funding' through taxation measures so as to avail social security benefits to ALL persons and not just persons in employment. The social assistance is most critical to persons who cannot afford to support themselves and usually takes the form of social programmes such as Income Support or un- Employment Support, housing, medical aid etc. to persons who are vulnerable to a society. This is the basis of the Act.

References:

- (2000, 12 28). *After insurance: Need for focus on Pension Reforms to increase contractual Savings to fuel economic growth.*
- Alo, O. (2004). *Current pension reforms: implications for career development in the public and private sector.* Lagos.
- Bonilla, A. G. (2003). *Social Protection.*
- Casey. (2009). *Pensions in Nigeria:The performance of new system of personal accounts.* Geneva.
- Cooper, D. ., (2003). *Business Research Methods.* New Delhi: Tata Mc Graw-Hill.
- Dearborn. (1999). *Principles of Retirement Planning.* Prentice Hall New Jersey.
- Diamond, B. A. (2009). Reforming pensions. *Principles and Policy Choices.*
- Eisenhardt, K. M. (1989). "Agency Theory:An assessment and Review". *Academy of management review, 14(1), pp. 57-74.*
- European, C. (2006). *Long-Term Sustainability.*
- Feldstein, M. (1998). *Privatizing Social Security.* London: The University of Chicago Press.
- Friedman, M. (1957). *A theory of the Consumption Function.* Princeton: Princeton University Press.
- Fultz. (1997). Social Security for Rural Households Problems. *Challenges and Prospects.*
- Ginneken, V. (1998). *Social Security and Income Distribution.* Sankaram.
- Hawley, J.A. (1996). "*Corporate Governance in the United States: The Rise of Fiduciary Capitalism*". Working paper, saint Mary's College of California, School of Economics and Business Administration. California.
- Howse, K. (2004). Ageing horizons. *Social justice and pension reform.*
- ILO. (2006). *Federal of Republic of Nigeria: Report to the government-Actuarial assessment of NSITF.* Geneva.
- Latulippe, M. C. (1997). *Comprehensive Quantitative modelling for a better pension strategy.*
- March, P. (2003). *Quantitative Survey.*
- MCGraw. (2002). Business weekly. *The Enron Scandal.*
- Mghali. (2003). *Employee Pension and its Effects.* Nairobi.

- Modigliani, A. (1963). "The Life cycle hypothesis of saving: aggregate implications and tests.". *American economic review*, 53(1), pp. 55-84.
- Odundo, E. (2003). *Public Pension Fund Management-Proceedings of the second public fund management conference*.
- Oladimeji, A. (2004). *Current Pension Reforms: Implications for Career Development in the Public and Private Sectors*.
- Riesco, I. A. (2009). *Development welfare state and social change in Chile*. UK: Houndmills.
- Roscoe, J. (1975). *Fundamental Research Statistics for the Behavioural Sciences*. New York: Holt Rinehart & Winston.
- Taylor-Gooby, P. (2005). *Ageing and Pension Reforms around the World-UK pension reform*. Edward Elgar Publishing Limited.
- World Bank, Z. S. (1994). *Averting the Old age Crisis: Minimum pension insurance in the Chilean Pension System*. Washington.