Analytical Review of the Pension System in Kenya

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1. Introduction

An increasing number of African countries have recently initiated reform of their pension and social protection systems. Over the last decade, Kenya has also undertaken a major reform of parts of its pension system. Whereas the primary motivation for reform of pension systems in many countries worldwide has been to address the growing fiscal burden of pension liabilities, in Kenya the major driver for reform was to strengthen the governance, management and effectiveness of the existing pensions system.

A new Retirement Benefits Act was enacted in 1997 and a comprehensive framework of regulations was implemented three years later in 2000. A regulatory authority, the Retirement Benefits Authority ('the RBA') was established at the same time to regulate, supervise and promote the retirement benefits sector in Kenya.

Reform of the National Social Security Fund ('the NSSF'), the mandatory scheme for all formal sector employees in Kenya (other than public service employees) has also been firmly on the national agenda with wide debate on the nature and extent of role the NSSF should play as part of the pension and social protection system in Kenya.

Kenya also has a separate pension plan for public service employees financed on a pay-as-you-go basis which is currently also part of the broader pension reform programme under consideration.

A decade into the reform is a good time to take stock and assess the reform initiatives and the results achieved. Some of the positive effects of the legislation have started to be seen and thinking is now shifting to policy issues and the challenges of increasing coverage, benefit adequacy and the growth of retirement savings. Indeed over the past three years in Kenya, there has been consensus on the need for further reform of the system. The achievements of the past decade, particularly with respect of voluntary employer sponsored occupational schemes, provides a good basis on which to implement further reforms to increase coverage and reduce post-retirement poverty levels.

The purposes of this paper are to (i) present an analysis of the current pension system in Kenya and the reforms undertaken to date, (ii) identify key areas and weaknesses of the existing system which merit further attention and (iii) suggest strategies that may enable the objectives of broader pension reform to be met.

This paper is structured as follows. The next section describes the current pension system in Kenya. Section 3 outlines the key tenets of the new regulatory framework and evaluates the results to date. Section 4 makes the case for further reform and the need for a coordinated strategy to reform. Section 5 suggests possible reform strategies for the different elements of the pensions system in Kenya and a suggested order of priorities. Section 6 summarises the key conclusions and lessons that may be learnt from the pension reform in Kenya.

This paper is prepared as a discussion document and hopefully highlights some of the key issues that policy makers and stakeholders may consider as part of the continued debate on pension reform in Kenya.

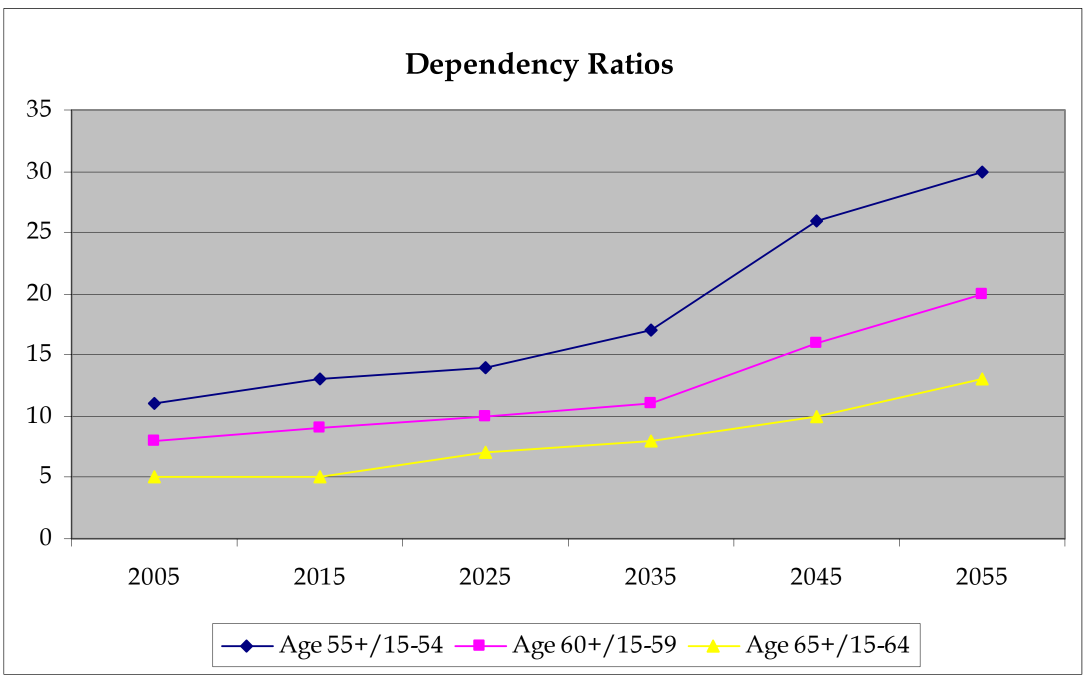
The views expressed in this paper are those of the author and not representative of his profession or employer. The author acknowledges the contribution of colleagues and in particular, Angela Okinda for assisting with some of the analysis in this paper and for reviewing the paper.

One of the key challenges faced in this analytical review has been the lack of readily available data and this has limited the scope of the analysis and the level of detail that can be presented.

2. Situation Analysis and the Current Pensions System in Kenya

i) Kenya's population and employment structure

Kenya's population at the last census in 1999 was indicated at 28.7m. The population is currently estimated at 36.1m[1] and is projected to increase to 55.4m by 2050. The proportion of the population above age 55 is estimated at 6% whilst 41% of the population is estimated to be below age 15. The population of Kenya is thus still young, but is projected to age and by the time today's labour force market entrants retire, the proportion of the population above age 55 is expected to almost triple. The dependency ratio (ratio of elderly to active labour force) is also expected to increase from 12% to 30% by 2050[2]



Source: Can we afford age old pensions by Charles Machira

[1] Source: Economic Survey 2007
[2] Interpolated from UN World Population Prospects base year 2000 projections

Total employment outside rural small scale agriculture and pastoral activities was estimated at 8.7m in 2006. Of this, formal sector employees comprised 1.9m (or 21% of total recorded employment) and the informal sector (commonly referred to as the *'jua kali'* sector) which covers informal urban and the agriculture workers comprised 79% of the total recorded labour force. More importantly, over 80% of the new jobs in the last three years have been created in the informal sector[3] As the table below shows, the proportion of formal sector employees has declined from 77.5% in 1988 to 21.3% in 2006.

Year	Total '000	Wage Employment (%)	Self Employed & Unpaid workers (%)	Informal Sector(%)
1988	1736.3	77.5	2.5	20.0
1989	1796.2	76.2	2.5	21.3
1990	2395.0	58.8	2	39.2
1991	2557.1	56.4	2	41.6
1992	2753.2	53.1	2	44.9
1993	2997.5	49.2	1.9	48.9
1994	3355.1	44.8	1.7	53.8
1995	3855.1	40.4	1.6	58
1996	4325.8	37.4	1	61.1
1997	4698.4	35.1	1.4	63.5
1998	5083.2	32.7	1.4	65.9
1999	5477.5	30.5	1.2	68.2
2000	5893.0	28.4	1.1	70.4
2002	6873.5	24.7	0.95	74.3
2003	7339.4	23.5	0.90	75.6
2004	7822.8	22.6	0.85	76.6
2005	8271.5	21.9	0.81	77.3
2006	8740.5	21.3	0.77	78.0

Source: Various Economic Surveys

Thus akin to many other countries in Africa, a significant majority of workers in Kenya belong to the informal urban or agricultural sector with the relative size of the formal sector workforce declining significantly as a percentage of total employment over the last two decades.

Also worthy of noting that females constitute 50.1% of the total population but only about 29.4% have formal employment and earn on average 33% less than their male counterparts[4].

[3] Source Data: Economic Survey 2007
[4] Maureen Were and Jane Kiringai, 2004

ii) Relevant macro-economic and poverty incidence data[5]

Kenya's GDP was estimated at K Shs 1,642bn (or US$ 22.01bn) in 2006 and per capita GDP at K Shs 45,485 (or US$ 650). Agriculture remains the mainstay of the economy contributing 23% of GDP. Other key contributors to GDP include tourism and manufacturing.

Government monetary policy has been directed at attaining and maintaining inflation at a rate of 5% or below, although actual rates have been higher.

Overall poverty incidence is reported to have declined from 52.3% in 1997 to 45.9% in 2006. Overall poverty incidence is estimated at 49.1% in rural areas compared to 33.7% in urban areas implying that poverty in Kenya is still more pronounced in the rural population.

According to the Welfare Monitoring Survey of 1994, only 3.1% of the elderly above 55 years reported receipt of any form of pension income, 90% of whom were male and only 0.2% of the total population reported receipt of pension income. Studies suggest that the incidence of poverty in Kenya and in many countries in Africa among the elderly (i.e. households with elderly only, elderly with children and elderly-headed households) is much higher than the average incidence of poverty.[6]

iii) Relevant financial sector data[7]

Compared to other countries in East and Central Africa, the financial services sector in Kenya is relatively more developed with close to 45 banking institutions and a similar number of insurance companies. Over the past five years, there has been a rapid growth in the customer base of banks and in the growth of consumer banking products. The level of penetration of life insurance remains low at less than 1% of GDP.

During the past few years, Kenya has made important progress towards improving the financial markets, including the dematerialization of securities, automated trading, the introduction of risk rating agencies and the introduction of new performance measurement indices, all of which have improved the investment environment in which pension schemes operate in.

The Government bond market has expanded significantly in the last seven years with bond tenors ranging from 1 to 15 years and this year (2008) seeing the introduction of a 20 year fixed rate Government bond. The Nairobi Stock Exchange has also experienced significant growth with a marked increase in market capitalisation to almost K Shs 1,000bn this year through an improvement in performance as well as a modest number of new listings and share offers.

There are 11 registered stock brokers, 14 fund managers and 9 registered custodians.

Kenya also has a vibrant cooperative sector with over 11,000 registered cooperatives, a membership of over 7 million and assets estimated at K Shs 30 billion.

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[5] Source Data: Economic Survey 2007
[6] Aging and Poverty in Africa and the Role of Social Pension Nanak Kakwani and Kalanidhi Subbarao
[7] Source Data: Economic Survey 2007

iv) Current pensions system in Kenya

The current retirement benefits system in Kenya can be classified into the following scheme types:

Scheme Type	**National Social Security Fund**	**Public Service Pension Schemes**	**Occupational Schemes**	**Individual Schemes**
Legal Structure	Act of Parliament	Act of Parliament	Established under Trust	Established under Trust
Membership	Employees in formal sector establishments with 5+employees excluding public service employees	All public service employees, including civil servants, teachers and disciplined forces. Separate scheme for armed forces	Formal sector workers in companies that operate retirement schemes	Open to all on voluntary basis
Funding	Funded	Non funded	Funded	Funded
Regulation	RBA	Act of Parliament	RBA	RBA

Source : RBA Website

In order to assess the aspects of the current pensions system, the following criteria[8] are used:

- ***Adequacy*** – benefits are for the full breadth of the population, sufficient to prevent old age poverty and provide reliable means to smooth lifetime poverty for the vast majority of the population.
- ***Affordability*** – both within the financing capacity of individuals and of society, and without undue displacement of other social or economic imperatives, or untenable fiscal consequences.
- ***Sustainability*** – which refers to financial soundness over an appropriate time horizon under a broad set of reasonable assumptions.
- ***Robustness*** - capacity to withstand major shocks, such as significant shifts in economic prospects or demographic trends.

a) The mandatory scheme for formal sector employees – the NSSF

Establishment

The National Social Security Fund ('the NSSF') was established under an Act of Parliament in 1965. The NSSF is established as a provident fund operating on a defined contribution basis.

[8] Old Age Income Security in the 21st Century Robert Holzmann and Richard Hinz

An amendment to the NSSF Act in 1997 defined the NSSF as a retirement benefits scheme and thus brought the NSSF into the regulatory ambit of the Retirement Benefits Authority.

Coverage

The NSSF covers formal sector sector employees in Kenya other than employees covered under the public service pension scheme. All employers are required to register with the NSSF but only employers with five or more employees are required to contribute to the NSSF. The total cumulated membership of the NSSF as per its records is estimated at 3.4m, but the active contributing membership is currently estimated at just over 1m. The number of registered employers with the NSSF (cumulative) is just over 74,000.

The NSSF introduced voluntary membership and contributions in 2006 and embarked on a marketing campaign to attract voluntary membership, particularly from the informal sector. The success or otherwise of this campaign to date is difficult to establish, although the number of such voluntary members is indicated at 13,000. No data is available to assess the frequency and amount of such voluntary contributions and the costs of collecting and administering such members relative to the voluntary contributions.

Statutory Contributions to the NSSF

Statutory contributions to the NSSF are set at 10% of an employee's pay, half of which is paid by the employer and half by the employee. There is a monetary ceiling on the maximum combined contribution to the NSSF of currently K Shs 400 per month (or at only 1.3% of average monthly formal sector earnings in Kenya of K Shs 31,357[9]). There have been only two adjustments to the statutory ceiling on contributions since the inception of the NSSF (i.e. an increase from K Shs 80 to K Shs 160 in 1977 and from K Shs 160 to 400 in 2001).

The Retirement Benefits Act includes a provision for employers with the consent of their employees to opt out of making statutory contributions to the NSSF and make contributions to another approved scheme. This clause in the Act has not been activated and no other scheme to date has been approved to receive statutory contributions.

Benefits Provided

The NSSF provides lump sum benefits on retirement at or after age 50, earlier invalidity, to survivors on death of a member and on permanent emigration from Kenya. A modest funeral grant and a maternity grant were introduced in 2004. The Act provides for interest at a minimum rate of 2.5% per annum to be credited to individual member accounts.

Institutional Framework

The NSSF is governed by a Board of Trustees appointed by the Minister responsible for matters relating to labour and social security. The composition of the Board is on a tripartite basis with representation from the Government, employers and workers.

The NSSF Act provides no explicit framework for investment and custody of the NSSF assets. The investments are currently managed in-house through an Investment Committee and an Investment Department. There is no external/separate custody of the assets.

[9] Source : Economic Survey 2007

Analysis of Emerging Experience[10]

An analysis of the emerging experience of the NSSF indicates the following:

- There has been an increase in the number of active contributing members from 750,000 in 2003 to almost 1m as a result of the improved state of the economy and improvements in the levels and enforcement of compliance[11]
- Contributions to the NSSF have increased from 2002 as a result of the increase in the statutory monetary ceiling on contributions in 2001. The level of standard contributions has more than doubled from K Shs 2.2bn in 2002 to K Shs 4.9bn in 2007;
- The level of benefit outgo has remained static at just over K She 2bn in the last 8 years reflecting a combination of a decrease in early withdrawals as well as the impact on benefit outgo of the lower allocation of interest to members' individual accounts;
- Total reported assets of the NSSF increased from K Shs 39.7bn in 2002 to K Shs 81.3bn in 2007;
- The portfolio weighting in land and property assets has decreased from a peak of 78% in 2000 to 34.6% in 2007;
- The proportion of the total assets invested in quoted domestic equities was 47.7% reflecting a relatively higher weighting in domestic equities compared to other large retirement funds in the country. Further the NSSF had a dominant shareholding in a number of companies listed on the Nairobi Stock Exchange. The portion of the NSSF assets invested in Government securities was 10.5%. There was no offshore investment;
- The net return earned on the NSSF assets (using cash flows) over the three years to 2007 at an annualised 10.5% has not compared unfavourably with benchmark returns and the returns earned by other asset management firms in Kenya over the same period[12];
- The rate of interest credited to member accounts has varied substantially from the net (of expense) rate of return earned on the Fund assets. The interest credited to members between 1993 to 2002 was substantially higher than that earned and from 2003 to date was lower than the returns earned. Since 2003, the interest credited to member accounts has been at the minimum annual rate of 2.5% although an increase to 5% has been proposed from 2009;
- The rate of interest credited to members also falls well short of the returns allocated by other retirement schemes in Kenya. This does create a disincentive to participate in the NSSF, encourages non-compliance and undermines support amongst members of the NSSF;
- Although there has been an improvement in operational efficiencies, the level of administrative and staff expenses remain high compared to country and international benchmarks, especially noting that the NSSF operates as a provident fund and does not disburse pension payments. Total expenses as a percentage of contributions have decreased from a peak of 127% in 2000 to 82% in 2003 largely reflecting the effect of the increase in the contribution ceiling in 2002. The current (2007) expense ratio is 46%, but is projected to increase to 60% of contributions in 2008. Expenses as a percentage of investment assets have averaged 4% in the six years to 2007. The per capita cost of the NSSF's total expenses assuming an active membership of 1m is about K Shs 3,500 per annum;

[10] NSSF Audited Financial statements 2001 - 2007
[11] NSSF Benefits Staff
[12] Alexander Forbes Consulting Actuaries Schemes' Survey

- Total expenses have been higher than investment income other than for 2007. The total outgo of the NSSF in terms of benefit payments and expenses has been higher than contribution income, but the difference has been covered by investment income.
- Even though a special department has been established to address the issue of the suspense account (i.e. contributions not allocated to individual member accounts as a result of incomplete or incorrect data), the size of the suspense account remains significant at almost K Shs 6bn, but has reduced as a percentage of total member accounts.
- Based on the NSSF's published financial statements for the year ending 30 June 2007, the reported assets adequately covered the disclosed liabilities to members. A more careful analysis of the values placed on the assets and liabilities, the individual member data, the nature of the assets and any contingent liabilities is required in order to express an opinion on the NSSF's financial position.

Analysis of NSSF with respect to Criteria

Adequacy

- The level of benefits, given the low monetary ceiling on contributions, is woefully inadequate. Indeed given current contribution levels, what is likely to be available to sustain one in retirement after 30 years of contributions to the NSSF is projected to be less than average earnings for just one year ;
- The high costs of administration, low investment returns and even lower returns credited to members also impacts on members' benefits;
- Further there is no consistency between the rates of return earned and those credited to members' accounts;
- The NSSF only provides lump sum benefits and there is no provision for annuitisation. There is a tendency for lump sum benefits to be poorly applied or squandered resulting in inadequate protection against poverty in old age;
- The range of benefits is limited, there is no pooling or sharing of risks and no minimum level or 'safety net' of benefits;
- The coverage of the NSSF is limited. The NSSF covers about 53% of formal sector employees in Kenya and 11.4% of total recorded employment. The percentage of the formal sector employees excluding public service employees covered by the NSSF though is almost 70%.

Affordability

- The level of contributions at effectively only 1.3% of average earnings (higher where earnings less than national average earnings) can be regarded as affordable.
- From a socio-economic perspective, however, past investments in low yielding property and land assets could be deemed to have displaced other economic imperatives through an inefficient allocation of capital.

Sustainability

- If NSSF remains a defined contribution scheme, assets should be in balance with liabilities by design;
- But differences in returns allocated to members viz returns earned can create mismatches between assets and liabilities;
- Legislatively stipulated minimum annual credit to members of 2.5% regardless of net return earned also impacts financial position
- Hence, the importance of regularly evaluating asset-liability relationship.

Robustness

- NSSF is not a pure defined contribution scheme, but overall ought to have the capacity to withstand major shocks subject to adopting a proper and more equitable basis of allocating net returns to members and asset liability management.

Discussions with the NSSF indicate progress in a number of areas including increased computerisation, improvements in processes, turn around times for benefit payments and customer care standards. A new customer service charter was launched in 2007 and for the first time ever the NSSF published its financial statements for the year ending 30 June 2007 in the print media. In spite of these improvements and the significant changes that have been made at an institutional level, there remain concerns over the institutional structures at the NSSF and their effectiveness. Nevertheless, with its established structures and wide branch network of 35 regional offices and provided that the institutional weaknesses are addressed, the NSSF can provide a good platform on which to implement further reforms of the pension system in Kenya.

Reform of the NSSF and its conversion to a pension scheme has been a Government policy objective for some years. The Government's Economic Recovery Strategy for Wealth and Employment Creation 2003 – 2007 explicitly provides for the NSSF Act to be reviewed to convert the NSSF into an autonomous pension fund with an increased coverage and range of benefits. A bill to convert the NSSF into a social insurance pension scheme has been presented to Parliament and possible reform options for the NSSF have been the subject of debate with stakeholders.

b) The pension scheme for public service employees and armed forces

Establishment

The provision and management of retirement benefits for public service employees is governed under a Pensions Act and Regulations. Certain provisions of the Constitution of Kenya are also relevant especially in the context of considering reform options for the current arrangements.

Coverage

The Public Service Pension Scheme ('PSPS') covers approximately 406,000 civil servants, teachers and police and prison staff and just over 180,000 pensioners. Separate arrangements apply for the armed forces and other military personnel.

Contributions

The PSPS operates on a defined benefits basis and is non-contributory other than modest contributions at 2% of salaries by male employees towards widows' and orphans benefits.

Benefits

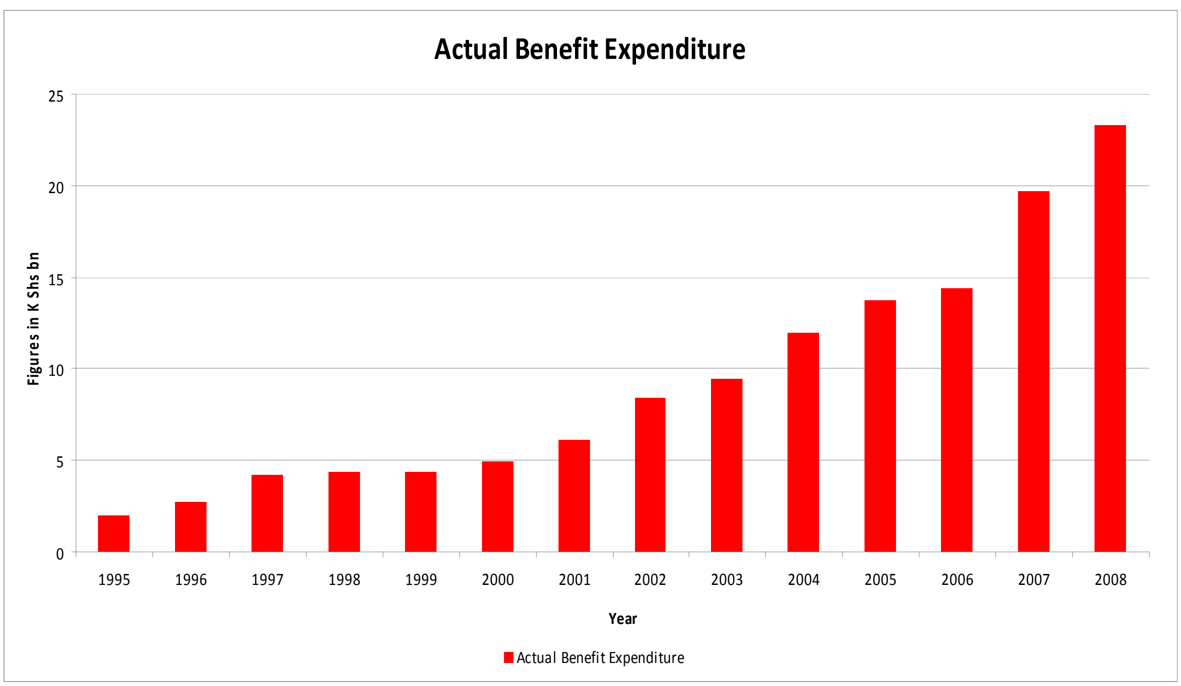
The Scheme provides a pension of 2.5% of final basic salary for each year of service on retirement from service at 55. Unreduced pensions are payable on retirement at or after 50 with the parent Ministry's consent or earlier on ill health retirement. The pension fraction targets a retirement pension of 75% of basic salary after thirty years of service (or an average of 50% of total remuneration for all categories of public service employees). A higher pension fraction applies for armed forces and military personnel. Retiring staff may opt to take up to 25% of their pension in the form of lump sum with a generous uniform commutation factor of 20:1 applying.

No guaranteed pension increases have applied in the past; there have only been four pension increases in the forty years to 2004 with the last increase having been in 1991. Modest pension increases at 3% every two years have been introduced since 2005.

Benefits vest after ten years of service and there is no portability of benefits and individuals who resign from service before retirement are not entitled to any benefits.

Benefit Expenditure

There is no pre-funding of liabilities; The scheme is financed on a pay as you go basis with pension costs met from Government revenues. The level of benefit expenditure has been increasing at an average of 19% per annum over the last 10 years and is shown in the graph below.



In 2007, benefit expenditure totaled 1.4% of GDP. The pension obligations already incurred would need to be quantified, but is expected to be a significant proportion of GDP[13]. In cash terms, the increase in expenditure over the last decade is only the start of a trend which would be expected to continue for the next two decades even if the existing scheme is closed to new entrants.

A significant portion of the benefit expenditure is in respect of lump sum pay outs from commutation of pensions. The cash flows also show the impact on benefit expenditure of salary increases and corresponding increases in average new pensions coming through in payouts.

Benefits Administration and Processing

The calculation of benefits and processing of the monthly pension payroll is handled by the Department of Pensions, a department under the Ministry of Finance. The Department of Pensions does not currently hold data in respect of in-service public service employees with the process of processing of benefits initiated by the Directorate of Personnel Management. Pension payments are paid through individual bank accounts although a significant number of pensioners without bank accounts are paid through a savings bank, the Post Office Savings Bank.

The Department of Pensions has 150 staff and internal administration is expected to improve with the installation of a new computer system to automate the pension payroll. The total operational costs of the Department are at just over 1% of the total pension's expenditure, with a significant portion of the expenditure relating to the costs of disbursing the pension payments.

Institutional Structures

The current Pensions Act does not contain any explicit provision on the constitution, operation and management of the PSPS; nor are there explicit provisions for disclosure and governance structures.

The current Constitution of Kenya provides that any modifications to the PSPS must not be less favorable for existing employees than the existing arrangements. This does limit the ability to reform the current system for existing staff although an amended scheme may be considered for new staff.

Analysis of PSPS with respect to Criteria

Adequacy

- Although not all remuneration is pensionable, the pension accrual fraction at 2.5% with the generous commutation terms targets a reasonable initial pension although the lack of full indexation impacts on the purchasing power of pensions with time;
- There is no portability of benefits or provisions for retaining deferred benefits restricting job mobility amongst public service employees;

[13] Author's approximate calculations

Affordability and Sustainability

- From the Government's perspective, the benefit expenditures is projected to increase as a percentage of GDP and the increase in the fiscal burden could impact on other priority expenditures;
- A key premise of the PSPS of salary sacrifice during a working career in return for a 'job for life' and a relatively more generous pension after retirement has been distorted by the pay reviews in the past six years with further reviews for some categories of staff proposed;
- The Government would need to assess whether the ongoing pension costs based on the improved salaries remain affordable and consistent with its remuneration policies.

c) Voluntary occupational schemes

Establishment

Occupational schemes are schemes set up by employers for the benefit of their staff. Such schemes are voluntary and are established under trust.

Occupational pension schemes are regulated by the Retirement Benefits Authority under the Retirement Benefits Act. There are no minimum requirements in relation to the levels of contributions by employers and staff. Nor are there any minimum requirements in relation to the types or levels of benefits other than legislative restrictions in relation to minimum retirement ages, vesting, portability, preservation and accessibility of benefits. There are however extensive requirements in relation to the governance and management of such schemes and for the protection of members' benefits stipulated in the Act and the Regulations made under the Act.

Coverage

The total number of occupational schemes is currently indicated at 1,379 of which 10.4% are defined benefit schemes and 89.6% are defined contribution schemes. The total contributing membership of occupational schemes is estimated at about 300,000 (or 16% of formal sector employment) all of whom are also required to be members of the NSSF and make statutory contributions to the NSSF.

Two thirds of the schemes have a membership size of less than 100 and as the governance and compliance requirements on schemes increase, the operational and cost efficiencies of small stand alone schemes may be impacted.

An average of almost 60 new occupational schemes have been established each year since 2000. The table below shows the number of new retirement schemes registered since 2000:

Duration/Year(s)	No of Schemes Established	Cummulative Schemes
2000	79	79
2001	74	153
2002	58	211
2003	41	252
2004	66	318
2005	56	374
2006	44	418
2007	40	458

Source: RBA

Based on market surveys, the most common rate of contribution to occupational pension schemes by employees is at 5% of salaries and typically ranges from 5 – 10% for employers inclusive of risk benefit costs. The table below shows the total contributions to occupational schemes over the four year period to 2006 compared with the aggregate contributions to the NSSF over the same period showing that contribution inflows to occupational schemes were higher than those to the NSSF.

	Occupational Schemes Contributions K Shs bn	NSSF Contributions K Shs bn
2003	6,405	3,602
2004	11,516	3,847
2005	12,803	4,267
2006	13	4,457

Source NSSF, RBA

Investment of Pension Assets

The total assets of occupational schemes are estimated at K Shs 181bn and are more than double those of the NSSF. Thus, the occupational retirement schemes sector in Kenya whilst smaller in terms of membership than the NSSF is larger in terms of invested assets reflecting the higher average contributions to occupational schemes.

51% of the total schemes by number are invested in guaranteed funds (i.e. invested with insurers on a pooled basis) whilst 49% are on a segregated basis; by value, however, over 90% of the total assets of occupational schemes are currently invested on a segregated basis. The schemes invested in guaranteed funds tend to be smaller schemes.

Positive real returns and stable operating costs have led to a positive growth in asset accumulation in the occupational sector (see Section 3(iv)).

Analysis of Occupational Schemes with respect to Criteria

Occupational schemes tend to target a higher income replacement with the contributions for many of the occupational schemes targeting income replacement of 60 – 75%. A 1994 Survey by the RBA however showed an actual average income replacement ratio of only 22%[14] for retirees from occupational schemes and this was largely attributed to shorter service durations and non-preservation of benefits on leaving service.

d) Individual personal pension plans

Establishment

Individual schemes or personal pension plans comprise schemes set up by institutional providers to target individual members not necessarily tied to an employer or any formal setting.

Coverage

Although the number of IPPs in the market have grown from 1 to 17 in a ten year period, the membership at currently less than 10,000 individual lives has failed to track this growth. The majority (11 out of 13) of the IPPs in the market are offered by insurance companies.

Investment of Pension Assets

The Retirement Benefits Authority has been promoting and encouraging the growth of such schemes as a means to increase coverage amongst the self-employed and the estimated IPPs asset value of K Shs 2 billion is expected to grow with more focus and strategic action by stakeholders and market players.

e) Taxation of pension system

The tax regime for pensions in Kenya is the EET regime i.e. contributions tax-deductible, investment income exempt and benefits taxed. There is a percentage limit on contributions (30% of pay) and a monetary ceiling on the tax deductible contributions (of currently K Shs 240,000 per annum). The monetary ceiling has not been adjusted for the last three years and is only irregularly reviewed.

[14] Retirement Benefits Authority Survey 2004

Pension payments after attainment of age 65 for pensioners are tax exempt.

3. The New Regulatory Framework in Kenya

(i) Motivation for new Legislation and Regulatory Framework

The pre-RBA era in Kenya saw a retirement benefits sector with little effective regulation and supervision. The interests of retirement scheme members and their beneficiaries were not sufficiently protected. There was concern about the design and financial viability of certain schemes in the country unless appropriate remedial action was taken. There was poor administration and investment of scheme funds with particular concerns on concentrations of investment, particularly in property. In the majority of cases, this was inadvertent and unintentional, but without adequate controls and supervision, there was always a risk of mismanagement and outright misappropriation. Further disclosure and accountability were lacking. The NSSF had also been riddled with governance issues and concerns over its investments and payment of benefits. Not surprisingly, confidence in the sector was low.

The primary motivation for reform and enactment of the retirement benefits legislation in Kenya in 1997 was thus to strengthen the governance, management and effectiveness of the NSSF and of the occupational pensions sector.

The enactment of the Retirement Benefits Act ('RBA') (1997) and the establishment of the Retirement Benefits Authority ('the Authority') in 2000 marked the beginning of a regulated, organized and more responsible retirement benefits sector in Kenya.

(ii) Fundamental Tenets of New Legislation

Through the regulatory framework and policies, new legislation since then has been founded on the following two (2) tenets:

a) Improvement of protection of member's benefits
b) Improved governance of schemes.

A closer look at the tenets

a) Improvement of protection of member's benefits

The new legislation provided for registration of existing and new retirement benefits scheme in the country with a transition period for compliance for schemes existing on the date of implementation of the new framework.

The law placed greater emphasis on protection of members' benefits through the imposition of design and viability checks, minimum funding requirements for defined benefit schemes and restrictions on adverse amendments to members' benefits. Key amongst the measures to safeguard members' benefits was the separation of roles between scheme sponsors, trustees and professional advisors. In particular, in-house investment and custody of scheme funds which was the norm before 1997 was no longer allowed under the Act with all schemes required to appoint external professional investment managers and custodians registered by the RBA. Investment guidelines were set out in the new Regulations which prescribed maximum limits on the amounts that may be invested in various asset categories including property and offshore investments and these were aimed at reducing concentration of risks and achieving more diversification of assets.

Since the promulgation of the initial regulations in 2000, there have been additional regulations to improve the protection of member's benefits. Some of these measures include:

- Reduction in the period for full vesting of benefits initially from five years to three years and now down to one year;
- Compulsory preservation of a portion of benefits on leaving service before retirement although the introduction of compulsory preservation has been resisted by members of schemes and employers ;
- Explicit clarification on treatment of death benefits under trust based schemes;
- Requirement for legally enforceable contribution schedules, penalties and interest on late contribution payments and criminalization of non-remittance of employee contributions deducted from pay;
- Prescribed time period within which benefit payments to be processed and provision for interest on late payments,
- Protection of members' benefits on winding ups and liquidation of schemes or scheme sponsors.

b) Improved governance of schemes.

The Act preserved the Anglo-Saxon model of trust based schemes in Kenya, but made explicit some of the requirements of trust law through regulation and made trustees the linchpin of the new legislation.

Legislation guided the composition and election/nomination of trustees to include member participation of at least one-third of a board of trustees (later increased to at least 50% for defined contribution schemes).

Schemes were required to conduct annual audits and periodic actuarial reviews and new disclosure requirements, including a requirement for annual benefit statements and annual general meetings for scheme members have also been introduced. In particular, the Regulations provide for submission of various documentations and reports to the RBA including trust deeds, amending deeds for prior approval, annual audits, actuarial valuations, investment policy statements, service provider agreements, quarterly investment and custody reports from service providers, quarterly contribution records, etc. Inspection of these documents and the timeliness of submissions enables the RBA to track a scheme's compliance levels with legislation and exposure to risk.

The Authority also has the powers to and has carried out scheme inspections in certain instances where there are indicators of poor scheme governance. The penalties and fines associated with non-compliance are stated in the Act and serve as a deterrent to would be offenders. The provision of a 'whistle blowing' mechanism by both the members and professional advisors leads to timely information that allows the Authority to take the necessary steps in good time.

Scheme administration which was recognized as a key risk area has recently debuted into the priorities list with the amendment of the Act to provide for registration of administrators and the formalization of regulations for administration of schemes in 2007 to improve the operation and management of schemes.

Again, as for the first tenet above, there has been a progressive increase in the level of responsibility placed on trustees and service providers and the level of accountability demanded of them.

iii) Role and effectiveness of the regulatory authority - the RBA

The Retirement Benefits Authority was established in 2000 to regulate and supervise establishment and management of retirement benefits schemes, and thereby protect the interest of members and sponsors of retirement benefits schemes. The Authority's mandate extended to promoting the development of the retirement benefits industry, advising the Minister for Finance on the national policy to be followed with regard to the retirement benefits industry and most importantly to implement all government policies relating to the retirement benefits industry.

In addition to its supervisory role, the RBA has also been at the forefront in:

- Seeking additional tax incentives for saving through retirement benefits schemes;
- Promoting the growth of umbrella (multi-employer) and individual retirement schemes;
- Encouraging development of the annuities market and alternatives to annuity purchase;
- Education campaigns to sensitize more Kenyans on the need to plan and save for retirement;
- Carrying out surveys of retirement benefits schemes and members;
- Engaging stakeholders in discussions of exposure drafts of proposed regulations, etc.

Towards Risk Based Supervision:

The main focus of the compliance based supervision utilized from inception of the Authority until today has been compliance with the regulatory framework and the retirement benefit legislation. However, analysis of this system has led to identification of gaps in the effectiveness of current supervisory practice. The RBA has indicated a shift to a risk based approach to supervision under which the RBA will direct resources and regulatory focus to the areas that pose the greatest risk to achieving statutory objectives. Adapted from the Australian model, progress has been made to implementing RBS approach, including:

- Adoption of new risk based model
- Training of technical staff

- Development of compliance visit manuals
- Progress in carrying our initial risk assessment audit of all registered schemes through on and offsite audits
- Sensitisation of service providers.

The risk mitigants that have already been identified by the Authority for prioritisation in RBS include the quality of the board of trustees, operational systems, information systems and financial controls, risk management systems and internal audit and compliance levels.

The challenges surrounding the implementation of RBS have impacted on the full implementation of the new model. RBS is still fairly new and untested in the retirement benefits sector and thus, there is very little supporting documentation to assist in the implementation of RBS. In addition to this, there is no standard framework or minimum requirements that must be satisfied by RBS and stakeholders are unclear concerning their level of involvement and their role in RBS; leading to unmatched expectations and demands.

The effectiveness of the RBA to date evaluated through the IOPS Principles of Pension Supervision can be rated as satisfactory. Overall, the RBA has been sufficiently equipped to fulfill its roles and has shown itself to be a proactive and responsive regulator and this is reflected in the outcomes to date. Clearly, the success or failure of the RBA is judged on its primary responsibility of ensuring effective regulation of the sector. It is important that its sector development responsibilities do not detract the RBA from remaining focused on its primary regulatory objective.

iv) Evaluation of Outcomes of the Retirement Benefits Legislation

Impact on NSSF

Under the legislation, the NSSF is deemed a retirement scheme and thus subject to the new legislation and under the regulatory ambit of the RBA. In the early years following the implementation of the new legislation, there was considerable friction between the NSSF and the RBA with the former contesting the basis of the regulatory oversight by the new regulator and the latter adopting a lukewarm approach to enforcement.

Nevertheless, the legislation has prompted a review by the NSSF of its role and operations resulting in:

- An improvement in operational efficiency and customer care standards at the NSSF;
- A review of the investment portfolio and a realignment of the investment porfolio towards closer compliance with the investment guidelines prescribed in the legislation;
- A review of the role and mandate of the NSSF.

In recent years, a more harmonious relationship and more consulative approach to addressing the issues has emerged and it is hoped that this will result in a better appreciation of each side's view points and enable effective solutions to be found.

Impact on Occupational Schemes

The primary focus of the new legislation and regulatory thrust of the RBA was to improve the governance and management of occupational schemes. By any reasonable measure, the new regulatory framework can be rated as having achieved some success in streamlining the occupational pensions sector and introducing transparency, accountability and professionalism in the management of these schemes.

Most of the new requirements put onto the statute what one would consider good practice and the well run occupational schemes had little difficulty in complying with the new requirements. Schemes which did not comply were given time to comply with the new requirements.

A fairly successful strategy adopted by the RBA has been to work with trustees and sponsors of schemes that did not meet the prescribed minimum solvency standard for defined benefit plans of an asset coverage of at least 80% of a scheme's liabilities. Whereas clearly there are weaknesses in the solvency standard as currently defined in the legislation, the RBA has been instrumental in encouraging the development and implementation of remedial plans to restore many of the schemes to financial balance through a combination of benefit redesign and financing plans.

Although not the primary driver, the additional legislative requirements for defined benefit schemes have accelerated the trend from defined benefit to defined contribution schemes in Kenya.

Contrary to initial fears, the new regulatory framework does not appear to have dramatically increased the costs of running pension schemes. Indeed an analysis of the available data does suggest that the expense ratios of most occupational pension schemes other than for smaller schemes are well within and in fact lower than international benchmarks.

Impact on occupational scheme members

The legislation has had a remarkable impact on occupational scheme members, particularly in terms of protecting members' benefit rights and reasonable expectations. The requirement for member representation on boards of trustees has led to an increase in member involvement in the running of schemes and the disclosure requirements have improved confidence in schemes and in the retirement benefits sector more generally. Members are increasingly more conscious of their benefits and rights.

Nevertheless there is a need for continual and enhanced education to increase members' as well as trustees understanding of their retirement benefits schemes and the factors impacting the levels of benefits, particularly for defined contribution schemes.

Impact on benefit adequacy

Since the legislation does not prescribe minimum contribution or benefit levels for retirement schemes, it has had limited impact on increasing benefit adequcacy other than incidentally through the impact on benefit levels in defined contribution schemes of improved investment management and operational efficiency. An RBA survey undertaken in 2004 -2005 indicated an average income replacement ratio of retiring members of only 22%.

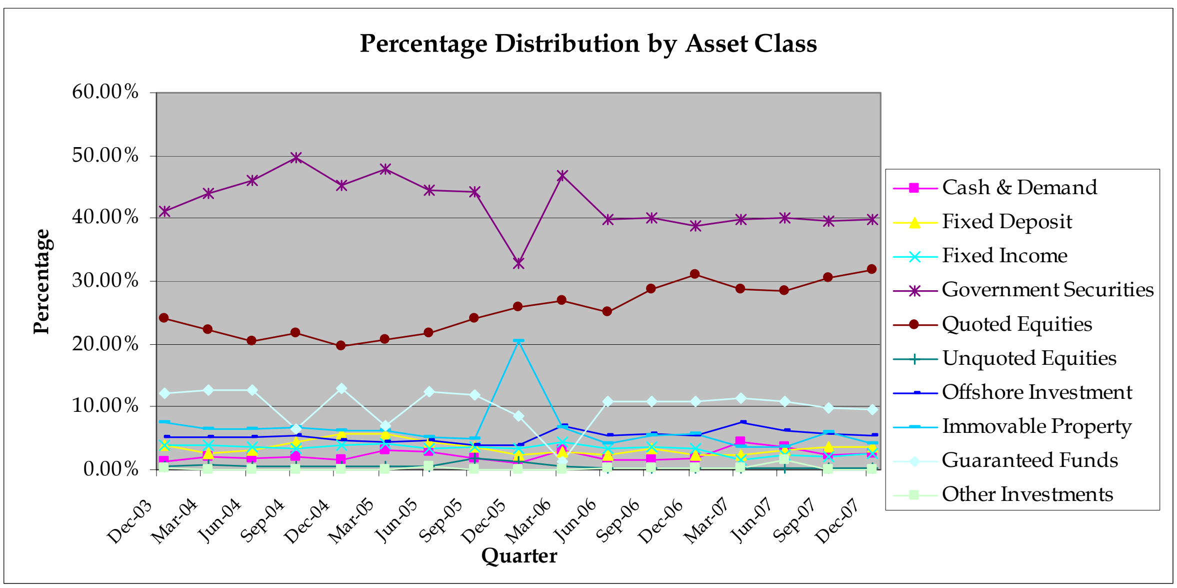
The reduction in the period for full vesting of benefits to one year and the introduction of compulsory presevation of part of the benefits is expected to increase the level of benefit adequacy from the current levels.

Impact on Coverage

The legislation has thus far had a limited impact on the coverage of retirement benefits in the country but the positive effects of the legislation does provide a basis on which to introduce further reform to increase coverage and social protection.

Impact on Occupational Scheme Investments

Assets under management for occupational schemes have increased from K Shs 120bn in 2002 K Shs 181 billion with about 1379 registered schemes. The graph below show the evolution of the aggregate investment portfolios of occupational schemes from December 2003 to December 2007



Source data from RBA (excl NSSF)

Across the various asset classes from 2002 to 2008,

- Government securities remain the most utilized asset class with the representation of assets fluctuating between 35% and 50%, averaging around the 40% mark in the last eight (8) quarters.
- Equities have experienced consistent positive growth from just over 20% to exceed the 30% mark in December 2006 and since September 2007

- Sliding from 11% in 2002 to below 9% in 2007, Guaranteed Funds are slowly experiencing a decline despite the overall growth in assets size
- The proportions invested in property have declined for most of the schemes which had significant exposures to property before 2000 as scheme comply with the 30% limitation on property investment
- Other asset classes fluctuating within the 0%-6% bracket include fixed assets, cash and demand and other investments.
- Offshore investments have stayed beneath the 10% mark despite the 15% allowance by investment guidelines.

The gross returns on occupational schemes participating in the Alexander Forbes Survey Consulting Actuaries Schemes' Survey over the one and three years to 30 June 2008 are tabulated below

	Performance per annum		Asset Class Allocation			
	1 year %	**3 years %**	**Equity %**	**Fixed Income Interest %**	**Property %**	**Offshore %**
AF Average	13.47%	13.74%	29.39%	62.55%	1.79%	6.40%
AF Weighted	14.09%	13.36%	31.95%	54.06%	7.07%	6.14%
Inflation	11.1%	12.21%				

There has been an increase in the types of instruments available for investment and some relaxation of the regulatory investment guidelines with more of a focus on scheme based investment strategies. As part of the closer integration within the East African Community, from 2007, investments in Tanzania and Uganda are treated as domestic investments for the purposes of determining a scheme's exposure to offshore investments.

Impact on Service Providers

The new legislative requirements have seen a number of local and international asset management and pension administration firms enter the market resulting in an increase in competition, lower fees and enhanced service levels.

Impact on financial markets

The efforts at streamlining the occupational pensions sector and in particular the requirement to appoint external investment management have seen a positive impact on the country's financial markets.

Pension schemes have had a positive influence on the expansion of the capital markets which have recovered from the depressed levels of the early 2000s. Holdings of Government debt securities by retirement schemes has grown from US$300m in 2002 to US$900m at the end of 2006 (or 18.7% of total Government debt instruments). The pensions sector has played a role in helping the Government to lengthen the maturity of its debt profile from reliance on short dated securities to more long dated securities. Retirement schemes through their fund managers have also become major players in the stock market with retirement scheme holdings holding about US$740m in domestic equities at the end of 2006 representing 6.3% of market capitalisation, but a reasonable proportion of the free float of quoted equities. There is evidence of more liquidity on the capital markets and greater volumes of trading.

In terms of macro-economic impact, the level of national savings has increased from 8.4%[15] in 2002 to 17.1%[16] with pension savings thought to be one of the key contributors to the increase in national savings.

4. The Case for Further Reform and for a Coordinated Strategy for Reform

i) The Case for Further Reform

As the analysis in the previous section of this paper shows, the reform of the pension system in Kenya to date has had a positive impact on the occupational pension sector, but a more limited impact in terms of addressing the key weaknesses of the current system of poor overall levels of coverage and benefit adequacy.

The key motivations for further reform include:

a) Increasing overall coverage

Under the present system, the NSSF and the PSPS in aggregate cover about 76% of the formal sector employment, but only 16% of total recorded employment. Occupational pension schemes whose members also contribute to the NSSF cover only 3.4% of total recorded employment.

Low income, informal sector workers and the life time poor have virtually no coverage other than reliance on intergenerational financial and non-financial support.

b) Change in social fabric of country

The social fabric of Kenya and indeed most countries in Africa is changing. There has hitherto been a reliance on the traditional forms of old age support such as extended family and community support, social culture and even taboos. However with the impact of urbanization, the breakdown of extended families and cultural values and the AIDS/HIV pandemic, these informal support systems are being stretched to beyond breaking point and even crumbling suggesting that lesser reliance can be placed on informal family support systems as a means of keeping the elderly out of poverty.

[15] Economic Survey 2007
[16] Economic Survey 2007

c) Demographic aging

Population aging is taking place in Kenya with the number of elderly as a percentage of the population expected to triple by 2050; hence reinforcing the need to ensure that some form of old age protection is provided to the elderly.

d) Changes in employment structures

Formal sector employment in Kenya is growing much more slowly than the informal sector. Whereas the reform to date has focused on the formal sector pension systems, there has been an inverse relationship between the reform focus and the relative size of the formal and informal sectors of the economy.

e) Benefit Adequacy

The level of benefits provided by the NSSF are woefully inadequate to provide any form of income replacement. Contributing members may prefer this situation as they may not value the benefits much while the real value of the deductions from their pay has fallen rapidly. If benefit adequacy levels and by corollary contribution rates are not increased, inevitably, the scheme will become irrelevant to most Kenyans thinking of saving for retirement.

On the other hand, occupational pensions schemes, whose members are also members of the NSSF, target a higher income replacement and the level of income replacement is expected to further improve with the introduction of compulsory preservation, reduced vesting periods and improved management and governance of schemes. Nevertheless without a requirement for minimum contributions or benefits, the overall outcomes are likely to remain unsatisfactory. Also like the NSSF, many of the schemes are structured as provident funds and provide lump sum benefits rather than pensions impacting on the nature of protection afforded in retirement.

The PSPS provides a reasonable target benefit to public service employees although the lack of indexation of pensions impacts on the purchasing power of pensions with time. There is also a need to provide for deferment and portability of benefits so as not to hinder job mobility in the public service.

f) Fiscal pressures and sustainability of elements of existing pension system

The fiscal pressures of financing the growing pension benefit expenditure in respect of public service employees analysed in Section 2 suggests an urgent review of the scheme to ensure a system that is more affordable, fairer and does not give preference to one group of the working population to the detriment of others and other competing demands on public expenditure.

A systematic review also needs to be carried out of parastatal and quasi-Government institution schemes to ensure that those schemes with actuarial deficits and structural weaknesses are restored to appropriate financial balance and have affordable ongoing pension costs through a combination of structural and parametric changes.

Generally, for all occupational defined benefit schemes, there is a need to prescribe more robust minimum solvency standards and for more regular oversight.

A separate but related point is the need for defined contribution schemes to have appropriate risk management and investment policies and to communicate these to their members.

g) Improvements to regulatory framework and capacity

As the pensions industry in Kenya evolves and grows, it is also becoming more complex. Benefit and investment options are becoming more innovative and complex and choices are wider. The financial markets are becoming more sophisticated. Individual schemes are becoming larger and so are there exposures. If broader reforms to introduce higher mandatory contributions are introduced, the regulatory capacity will need to be correspondingly increased.

Continuous improvement to the regulatory framework (e.g. through the introduction of risk based supervision) and enhancements to the regulatory capacity are necessary to ensure that the regulatory framework remains effective.

h) Behavioural obstacles to saving

The RBA has embarked on education campaigns to sensitise Kenyans on the need to plan and make provision for retirement. For many workers in Kenya as indeed in other low income countries, alternatives such as housing, education and health care tend to be regarded as more important priorities than saving for pensions. Nevertheless, a number of behavioral obstacles to saving for retirement even when affordable remain, such as procrastination, myopia, inertia. These behavioral obstacles support the case for introducing a modest element of compulsory pension saving for formal sector employees through participation in mandatory scheme(s).

ii) The case for a coordinated reform strategy

The current pension system in Kenya is fragmented and different elements of the system have evolved separately. The reform initiatives undertaken have also been piece-meal and institution specific rather than in the context of an overall policy objective. In some instances, different arms and institutions of Government have appeared to pursue different if not conflicting policy objectives. For example, the NSSF through its parent ministry has aimed to position itself as the first pillar of social security (analogous to Pillar I of the World Bank five pillar framework) through an intent to convert to a social insurance pension scheme. The RBA on the other hand had motivated for the NSSF to achieve full compliance within its current mandate and be opened to competition for the statutory contributions after an appropriate transition period as envisaged in the Retirement Benefits Act. This dichotomy of debate has detracted attention from the wider policy objectives that both sides espouse to.

A more co-ordinated approach to pension reform in which all Government policy arms and stakeholders actively engage and dialogue is necessary if progress is to be made in deepening pension reform in Kenya. This is best done through developing a national pensions policy which addresses all elements of the existing pension system.

5. Principal Objectives and Possible Options for Further Reform

Following on from the motivations for further reform outlined in Section 4 above, four key objectives for the next phase of pension reform in Kenya are suggested as follows:

a) Strengthening the institutional structures of the current pension system;
ii) Reforming the PSPS through a combination of parametric and structural reforms;
iii) Expanding coverage through appropriate policy measures, including exploring the feasibility of introducing a universal subsistence level tax financed state pension; and
iv) Increasing overall benefit adequacy levels of the pension system through a phased increase in mandatory contributions.

The first two reform objectives above are aimed at addressing the weaknesses of the existing pension system whilst iii) and iv) aim to broaden the pension system in Kenya by increasing coverage and improving benefit adequacy respectively.

The challenges of achieving these objectives are not unique to Kenya. Several other developing countries have embarked on similar reforms and lessons can be learnt from the successes and mistakes of other countries' experiences. It is recognised that there is no single right pension system and each country must develop a pension system or implement a reform programme that is appropriate to its socio-economic environment and level of development. It is also important for the reform not to create undue labour market distortions, discourage participation in the pensions system, increase business costs or reduce competitiveness.[17]

Undertaking a comprehensive reform of the type required to achieve the proposed objectives requires a co-ordinated strategy and a significant amount of ground work in terms of evaluation of policy and implementation choices extending to enactment of enabling legislation, building of institutional capacity and sensitisation of approved reform programmes.

It will also be critical to prioritise the reform objectives in implementing the reforms. Priority should be accorded to addressing the first two items, although much of the ground work for items iii) and iv) can be undertaken concurrently with the other items.

The detailed reform objectives and road map to achieving the reform objectives are best captured in the envisioned national pensions policy that the Government has proposed. In a paper of this type, it is only possible to suggest outlines principles/or options for achieving each of the proposed objectives. This is done below.

[17] Old Age Security in the 21st Century Robert Holzmann and Richard Hinz

i) Strengthening the institutional structures of the current pension system;

The NSSF is currently the only scheme mandated to receive mandatory contributions. Hence, irrespective of the NSSF's role(s) in a post-reform pension system (see v) below), an important immediate priority is to strengthen the governance and institutional framework of the NSSF, and in particular, the management of the NSSF's investments. Some of the specific steps that may be considered in this regard include:

- Regulatory oversight by the RBA;
- Implementing rigorous governance framework setting out roles and responsibilities and principles for accountability, transparency risk management and independent oversight
- Documenting and implementing comprehensive investment policy with clear objectives, asset allocation guidelines, investment mandates and performance benchmarks;
- Appointing of external fund managers and custodian
- Reappraising and restructuring of NSSF investments in property assets;
- Upgrading IT system to ensure effective and efficient administration and controls;
- Expediting reconciliation of suspense account;
- Implementing cost management strategies to reduce overall operating costs;
- Regular assessments of financial position.

It is acknowledged that considerable progress has been made by the NSSF in recent years to address some of the institutional weaknesses and many of the above steps are already in the process of being implemented.

In relation to collection of mandatory contributions, there is merit in considering whether the revenue collection authority, the Kenya Revenue Authority may be used as a collection agent by the NSSF for the purpose of collecting mandatory contributions on its behalf in order to reduce administration costs through economies of scale, improve compliance levels and benefit from more accurate data particularly earning data especially if contribution levels are increased.

The principles above also apply to voluntary occupational and individual plans through their regulation and supervision by the RBA. Stronger prudential standards would need to be developed for schemes that seek in time to qualify to receive mandatory contributions.

ii) Reforming the PSPS through a combination of parametric and structural reform

The restrictions in the Constitution of Kenya in relation to making adjustments to benefits for existing public service employees limit the scope for redesigning the existing arrangements for current staff. However, consideration may be given to closing the current PSPS to new employees and implementing parametric reforms to mitigate the potential future fiscal pressures.

A new scheme possibly operating on a notional defined contribution basis could then be considered for new entrants to the public service and as an option for existing staff with the benefit design and contributions set at a level that are considered appropriate and affordable.

There has been debate on the merits or otherwise of pre-funding the PSPS. Whereas it may not be practical or appropriate to fully fund the PSPS at this time, it would however be desirable to fund to an extent that can be affordable by the Government provided that the funding can result in a real increase in national savings and an efficient application of these savings.

Irrespective of the extent of funding, it is also imperative for the Government's pension costs to be carefully monitored and controlled through regular actuarial analysis and assessment of unfunded liabilities, ongoing costs and projections of benefit expenditure.

iii) Expanding coverage through appropriate policy measures, including exploring the feasibility of introducing a universal subsistence level tax financed state pension

The significantly larger size of informal sector employment relative to the formal sector, high levels of unemployment, rural based populations and demographic aging suggest that, fiscal conditions permitting, there is merit in introducing a universal basic state pension to all Kenyans above age 60, say.

Studies[18] carried out on the feasibility and fiscal implications of introducing a universal old age pension in Kenya show that a social pension would provide an important safety net in old age and alleviate old age poverty.

The study by Kakwani et al showed that a monthly grant of 20% of per capita GDP targeting elderly persons 60 years and older with a benefit level of 60% of GDP would cost 0.98% of GDP. Their simulation results showed even with this modest benefit level, the level of poverty incidence amongst the elderly would be reduced by 18% and overall national poverty by 2.36%. The study thus recommends that a social pension of 20% of per capita GDP for Kenyans age 60 and older ought to be a feasible pension option for Kenya.

The separate study by Charles Machira illustrates that under reasonable economic conditions, a social pension set at 50% of the absolute poverty line in the Welfare Monitoring Survey of 1997 targeting elderly persons 60 years and older would be expected to cost about 1.4% of GDP and this figure would be expected to remain stable over the next 35 years.

Introducing a social pension entails administering eligibility criteria and efficiently paying small amounts to a largely rural based population[19]. This ought not to be an insurmountable problem in the Kenyan context and could be quite easily implemented through a combination of using the Post Office network of over 400 branches across the country and the NSSF's 35 branch offices.

Further analysis based on the current household survey data will be required prior to implementing a universal pension. The Government needs to weigh the additional expenditure entailed of 1 – 1.5% of GDP against other competing priority expenditures but must take cognisance of the significant impact on coverage and poverty alleviation that a social pension would provide.

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[18] Poverty, Old-Age and Social Pensions in Kenya, Nanak Kakwani, Hyun H Son and Richard Hinz
The Case for Social Pensions: Are we ready to introduce universal old age benefits in Kenya? Charles Machira

[19] Old Age Income Support in the 20th Century

iv) Increasing overall benefit adequacy levels of the pension system through a phased increase in mandatory contributions.

The level of mandatory contributions to the NSSF of a maximum of K Shs 400 per month (or US$5) equating to an average to 1.3% of average earnings in Kenya is not sufficient to provide any reasonable measure of income replacement and need to be increased if it is desired to improve benefit adequacy. The monetary ceiling on contributions has not been increased since 2001 with inflation having severely eroded the real value of the contributions.

Voluntary occupational schemes which aim to provide higher income replacement levels currently only cover about 22% of formal sector employees. Hence, an increase in mandatory contributions is required if those not participating or able to participate in voluntary schemes are to able to achieve improved benefits.

Increasing the current level of mandatory contributions may also be justified on the grounds of protecting workers from their own "myopic behaviour"and failure to save for their old age and protecting society from the moral hazard of those who do not provide for their old age because they anticipate that society will take care of them[20].

In order to determine the level of mandatory contributions that would be appropriate and how these should be managed, the following issues are relevant:

1. The level of income replacement it is desired to provide a well as the levels of death and disability benefits. A modest income replacement level is initially recommended;
2. The rate of contribution required to finance the desired level of target benefit;
3. Whether the benefit should be on a defined benefit or defined contribution basis;
4. Whether benefits must be taken as a pension or lump sum;
5. Whether and the extent to which opting out of the NSSF would be permitted for the mandatory contributions.

An overall contribution rate of 10% (5% employees, 5% employer) would target a satisfactory retirement benefit. It is suggested that the introduction of contributions be phased in with the phasing in process being agreed with employers and employee bodies and be designed to work towards the necessary contribution rate over a period that will minimise the impact of the new scheme on the cost of employment.

A further consideration would be whether or not any part of the benefits from the increased mandatory contributions should be on a defined benefits basis to provide some form of minimum benefits so that the outcomes are more defined. If a universal social pension that provides reasonable benefits is introduced, then this would be less of an issue since the universal pension would provide a safety net.

Also important would be to determine whether part of the benefit may be taken as a lump sum or paid in the form of regular pension through annuitisation or phased withdrawal (income drawdown).

[20] Regulatory Controversies of Private Pension Funds Dimitri Vittas

An important policy decision would be on whether and the extent to which opting out of making mandatory contributions to the NSSF would be permitted. The following options may be considered in this regard[21]:

No opting out	All mandatory contributions to the NSSF	Overall increase in contributions, but likely crowding out of voluntary occupational schemes who would substitute increased mandatory contributions with reduced or no contributions to their occupational schemes Possible negative incentives of under declaring of incomes and employees
Full opting out	Employers may choose between making mandatory contributions to NSSF or approved accredited occupational or institutional scheme	Overall increase in contributions Possible opt out by employers with occupational schemes Possible increase in contributions to NSSF in respect of employers who have no schemes or access to institutional schemes
Partial opting out	Contributions up to monetary limit at current levels to NSSF and choice between NSSF and approved accredited schemes for additional contributions	Compromise between options 1 and 2 and could see healthy competition between the NSSF and private schemes

Further, opting out if and when permitted, would only apply for occupational schemes which meet prescribed more onerous conditions, including fit and proper standards for trustees and service providers, etc) charging structure, investment structures and governance standards.

Overall, the level of economic and financial service development in Kenya and the regulatory and supervisory arrangements do provide an enabling environment for introducing a higher level of mandatory contribution than the amount that currently applies of K Shs 400 (or US$5) per month.

Regulatory Framework

Both the regulatory framework and the regulatory capacity of the RBA will need to be strengthened in anticipation of a wider and stronger supervisory role for the RBA in an extended pension system.

6. Conclusions and Lessons from Pension Reform in Kenya

Akin to many developing countries in Africa, Kenya's current pension system is characterised by poor overall levels of coverage and benefit adequacy, small size of formal economy relative to informal economy, low levels of disposal income, insufficient insurance against longevity and competing priorities.

[21] Kenya: An Assessment of Pension Reform Directions

Nevertheless, there are important differences. Many African countries have dominant mandatory state schemes with little or no private pension systems. Kenya on the other hand, has had a smaller state scheme, the NSSF that has enabled a larger occupational pension sector. The level of financial sector and capital market development, stable macro-economic environment and existence of a regulatory framework make Kenya better positioned to embark on more fundamental and deeper reforms of the pension system. Compared to the experiences of the Latin American and Eastern bloc countries, other than addressing the institutional weaknesses in the current system and the financial sustainability of the unfunded PSPS, there are fewer legacy issues to be dealt with. This ought to make it easier to implement broader reform of the system.

The results of the reform so far have been positive in remedying some of the governance, benefit security and investment management problems of the pre-reform period, particularly in the voluntary occupational pension sector. The requirement for external investment management has seen a positive impact on the country's financial markets. The pensions sector has played a key role in helping the Government to lengthen the maturity of its debt profile and retirement schemes through their fund managers have also become major players in the stock market. National savings as a percentage of GDP have increased and increased pension savings are thought to be one of the key contributors to the increase.

Based on the results of the reform to date, there is now a better appreciation on the part of policymakers of the potential of a well developed pension system to contribute to economic growth and development of the country's capital markets and reform of the pension system is acknowledged as one of the key policy measures to achieving the country's Vision 2030.

There has been less of an appreciation of the potential of the pension system to alleviate poverty and achieve income redistribution, although the RBA has been at the forefront of championing a state financed universal basic pension. Introducing a social pension would provide an important safety net in old age and alleviate old age (as well as household) poverty and fiscal conditions permitting, this ought to be an important part of the policy options for widening coverage.

The successful reform to date provides a good basis on which to consider a deeper and broader second phase of pension reform. The key objectives of further reform are suggested as strengthening the institutional structures of the current pension system, reforming the PSPS, assessing the feasibility of introducing a basic universal grant financed from the national budget and increasing the level of mandatory contributions to the NSSF with participation by voluntary schemes for some element of the increased mandatory contributions .

Undertaking a comprehensive reform of the type required to achieve the proposed objectives requires a co-ordinated strategy and a significant amount of ground work in terms of evaluation of policy and implementation choices extending to enactment of enabling legislation, building of institutional capacity and sensitisation of approved reform programmes. It will also be critical to prioritise the reform objectives in implementing the reforms.

The detailed reform objectives and road map to achieving the reform objectives are best captured in the envisioned national pensions policy that the Government has proposed. An important lesson of the pension reforms in Kenya is to have a co-ordinated approach to pension reform in which all Government policy arms and stakeholders actively engage and dialogue.

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