PROBLEMS FACING KENYA'S PENSION SYSTEM: A CASE FOR REFORMS OF LAWS RELATING TO PENSIONS

BY

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DECLARATION

This is my original work and has not been presented for any of the study programmes in any university.

NYAKUNDI BONYI DAVID — **DATE** 12th June, 2007

This thesis has been submitted for examination with my approval as the university supervisor

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DATE 15th June 2005

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DEDICATION

This thesis is first dedicated to the Almighty God who granted me the physical and mental strength and privilege to accomplish this project within the prescribed time. Secondly, I dedicate it to my loving wife Orpha, my dear son Tambo and our sweet daughter Kemunto all who were a source of my encouragement even as they 'enjoyed' me all the way when I was writing this project.

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I thank my loving wife who kept inspiring me to undertake this postgraduate programme. Probably I may not have had the opportunity to write this project. I specially thank my children who have always remained a source of my encouragement, without forgetting *mama (my mother)*, Anna Moraa, who I know prays for me every day.

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ABSTRACT

The structure of Kenya's pension system comprises of (i) the civil service pension scheme (ii) the National Social Security Fund (iii) Private Occupational Pension Schemes and (iv) Individual Retirement Savings which are limited in significance for purposes of this project. Individual retirement saving schemes are insignificant in terms of their asset base and coverage and are therefore not discussed in this project.

The system is fragmented lacking a harmonized policy and operates on different Acts of parliament. The concerns of the pension system in Kenya relate to (i) lack of longevity insurance (ii) low coverage (iii) unfunded liabilities (iv) imprudent asset management (v) non-payment or delayed payment of pensions and (v) weak enforcement of pension laws. For purposes of this project, the problems facing Kenya's pension system which have been analyzed relate to (i) low coverage (ii) under funding in pension schemes (iii) imprudent asset management and (iv) weak enforcement mechanism of pension laws.

Low coverage of the pension system is attributable to the current pension laws which have established pension schemes largely for formal employees. A policy to initiate pension reforms which will extend coverage to majority of uncovered elderly poor by introducing a universal pension scheme will be ideal. In the meantime, National Social Security Fund Act, the Pensions Act and the Retirement Act should be amended to extend coverage to all formal employees.

Unfunded and under-funded liabilities in pension schemes raise the issue of long term sustainability of the current system. The unfunded civil service scheme is becoming too expensive to be sustained by general tax revenues. The NSSF although designed to be a fully funded provident fund with member accounts, it is under-funded owing to historical political influence on its asset management. The Kenya Social Security Pension Bill, 2005 which proposes to repeal the current NSSF Act if

enacted, will improve governance standards of the mandatory scheme and widen coverage to majority of the workers in the formal sector. Occupational pension schemes face problems of unremitted contributions from sponsors who go under any time leading to under-funded liabilities in these schemes. Section 112 of the constitution and the Pensions Act need to be amended to provide for a fully defined benefit scheme for civil servants and redefine the benefits structure to make the scheme affordable and sustainable.

In order to address funding problems in NSSF as a short term solution, it is recommended that section 33 of the Retirement Benefits Act must be operationalized to subject NSSF to competition as a way of improving its governance. Internal governance of NSSF needs to be reformed through clear provisions of an amended Act. Also, the collection of contributions will be enhanced if collected together with pay-as-you-earn taxes under Income Tax Act by the Kenya Revenue Authority.

Funding in Private Occupational Retirement Benefits Schemes can be improved by extending criminal sanctions to employers who fail to remit all contributions to schemes. The law should also provide adequate guidelines on applicable actuarial assumptions when valuing the funding levels of defined benefits schemes. Those defined benefits schemes which cannot meet the required funding levels should be obligated under the law to convert to defined contribution pension schemes.

Centralized management of NSSF assets exposes participants to a high political risk and imprudent asset allocation by trustees. There is a case to amend the National Social Security Act to create transparency in asset management with clear objectives for investment. The law needs to be amended to establish an independent and professional investment board to manage the assets of NSSF for investment purposes.

With regard to private occupational pension schemes, fund managers should be outlawed from assisting trustees to develop investment policies because of conflicts

of interests. The Retirement Benefits Act should differentiate the roles of fund managers and investment advisors in schemes. Investment Policies should enable fund managers to select investment securities which match the liability profile of the scheme. The Investment Guidelines under the Retirement Benefits Act need reconsideration with a view to allowing more assets to be invested offshore and allow to some extent the "prudent person standard" in asset management.

The enhancement of enforcement mechanisms of the law requires legal reforms of the Pensions Act to transform the governance structure of the civil service scheme into a statutory trust answerable to the Retirement Benefits Authority. The many laws, to which NSSF operations are subject to, need to be harmonized and consolidated in the National Social Security Act. The Authority shall then be mandated under the National Social Security Act to enforce and monitor compliance of that Act. This will restrict the Authority to supervisory role only rather then also playing the regulatory role on NSSF.

Further amendments to the Retirement Benefits Act need to refocus on the mode of supervision the Authority should adopt owing to its capacity limitations. This will enhance supervision so that it addresses risks rather than mere compliance with the law. Further amendments of the Act should enhance the autonomy of the Authority in order to enable it execute the statutory mandate without external interference. Enforcement of criminal sanctions should revert to the Attorney General and Police Department who have the capacity to arrest, investigate and prosecute offenders of the law. The current legal framework which requires the Authority to prosecute offenders of the Act does not seem to work owing to limited capacity and police reluctance to arrest and investigate offences under the Retirement Benefits Act.

In total sum the pension system in Kenya is now ripe for reforms designed to address its limited coverage in order reduce old age poverty. Pension laws in the country need to be reformed to address those concerns and guarantee old age income security to majority of the elderly poor.

DEFINITIONS OF TECHNICAL TERMS AND ACRONYMS USED IN THE STUDY

ACCRUAL RATE	A pension factor or a rate at which pension rights build up for each year of pensionable service in a defined benefit scheme
ACTUARY	An advisor on financial questions of a pension scheme involving probabilities relating to mortality and other contingencies
ACTUARIAL ASSUMPTIONS	A set of assumptions such as rates of return, inflation, salary escalation, mortality experience etc. used by an actuary in an actuarial valuation of a pension scheme
ANNUITY	A series of benefit payments made to a pensioner from a pension scheme or an insurance company which may be subject to increase.
DEFINED CONTRIBUTION SCHEME	A pension scheme where the benefits of a member are determined by reference to contributions paid into the scheme in respect of that member, usually increased by an amount based on investment return on those contributions
DEFINED BENEFIT SCHEME	A pension scheme where the benefit of a member is calculated by reference to the final pensionable salary of that member, usually based on pensionable service and a pension accrual rate
ILO	International Labour Organization
MEANS-TESTED PENSION	A scheme which provides reduced pension benefits, or none at all, for those whose income or assets exceed a specified threshold.
NSSF	National Social Security Fund established under the provisions of National Social Security Act (cap 258) Laws of Kenya

PAYG	(Pay- As - You – Go) an arrangement under which pension benefits are paid out of revenue and no pre-funding is made for future pension liabilities
RBA	Retirement Benefits Authority established under the provisions of the Retirement Benefits Act (Act No. 3 of 1997), Laws of Kenya
UNIVERSAL PENSION	It is a non-contributory flat rate pension payable to all citizens upon attainment of a specified age, regardless of income, assets or employment history. The benefits are financed from general tax revenues.

TABLES

CHAPTER ONE

HISTORICAL OVERVIEW OF KENYA'S PENSION SYSTEM AND STATEMENT OF THE PROBLEM

1.0 Statement of the Problem

This thesis is devoted to the examination of the deficiencies of Kenya's current pension system. The deficiencies in the system have made it fail its primary test and hence its universal goal namely, the provision of old age income security to as many people as possible.

The issue of deficiency of the system is characterized by low coverage of the pension system, imprudent management of pension assets in funded schemes, inadequate funding of pension schemes and weaknesses in the enforcement of current pension laws.

This study focuses on the problems which characterize the deficiency of the system. These problems are; (i) low coverage; (ii) imprudent pension assets management; (iii) under-funding and unfunding of pension schemes; and (iv) and inadequate enforcement mechanisms of pension laws. The study shall also make proposals on how these deficiencies can be addressed as a way forward.

The central concern in addressing this problem is that our country is poor and its margin of development is low besides being unsustainable and yet it is incumbent of the government to take care of the old and indigent through the provision or facilitation of an old age income security system. This is the

challenge to the government because other sub-Saharan countries have tried and are forging a head.

1.1 Justification of the Study

The major effect of the problems facing Kenya's pension system has been poverty among the elderly population in the country. With an economy which has been underperforming since the early 1990s, the creation of formal employment has been negligible while the informal sector has been growing. This has resulted in the exclusion of a large percentage of the working population from the coverage of the pension system which is basically designed to cover formal workers.[1] The extent of pension coverage currently in Kenya is only 15% of the total labour force.[2] There is justification to study the current structure of the pension system in order to appreciate the problems it faces. The findings hereof will enable policymakers in government to consider necessary legal reforms to extend coverage to the most vulnerable groups in the population, improve the management of the pension system in terms of asset management, funding inadequacies and enforcement of the law relating to pensions.

1.2 Background to the Study

Kenya's pension system dates back to colonial days, when the colonial government enacted the Pensions Act (cap 189), and commenced it in 1946[3]. The Pensions Act

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[1] Economic Survey Kenya, (2005) shows that Kenya's economic performance declined to 2% which was below the average population growth rate of 2.6%. The report also shows that 24% of the workers are in the formal sector while 76% excluding small scale agricultural workers are in the informal sector.

[2] Retirement Benefits Authority,(2006): Kenya's Retirement Benefits Industry and the Role and Objectives of the Retirement Benefits Authority (Unpublished Seminar Presentation)

[3] The Pensions Act commenced in phases by Legal Notice No 31 of 1950. Section 17 was commenced on 8th May 1942 while the rest of the Act was commenced on 1st January 1946.

established the Civil Service Pension Scheme to provide pensions to retired civil servants. In the private sector, few private pension schemes were set up by private companies to guarantee old age income for their retired workers. Due to racism, the pensions system covered mostly white employees. The natives relied on informal systems of social security where the extended families took care of the old and children. Most Kenyans started participating in the formal pension system after independence in 1963 especially after the establishment of the mandatory National Social Security Fund in 1965. The scheme extended coverage to majority of the formal workers.

The National Social Security Fund (NSSF) was established by an Act of Parliament as a provident fund[4] with the objective of providing financial security for retirees. The NSSF covers salaried employees in the private sector working in companies with more than 5 employees. Voluntary participation in NSSF is allowed for all other employees on condition that the employer also participates in making contributions.

Operations of the civil service pension scheme and the NSSF have since been carried out under the Pensions Act (cap 189) and National Social Security Fund Act (cap 258) respectively. Voluntary private pension plans however, have been operating outside statutory regulation except for those schemes, which employers sought to register under the provisions of the Income Tax Act (cap 470) for purposes of tax exemptions. Thus, prior to 1997 voluntary private pension schemes remained largely unregulated and operated without a harmonized legislative framework. Although the Income Tax Act and trust law to some limited extent formed the basic law for the operations of these pension schemes, these laws did not adequately recognize and protect member rights in a pension scheme. Employers were not under any obligation to disclose the performance of these pension schemes to the beneficiaries because they gave secondary consideration to the old age security interests of their employees.

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[4] A provident fund is a retirement benefits scheme where beneficiaries are entitled to a lump sum payment of benefits at retirement rather than a monthly pension or annuity. Provident funds operate individual savings accounts for each member out of which the lump sum benefits are paid.

Owing to the lack of a regulatory framework for the pension system, the sector continued to experience a myriad of problems. The NSSF was particularly facing a serious financial crisis. Its assets were mostly invested in overvalued and undeveloped immovable property due to a weak legal framework on its governance and the Fund's cash deposits were in politically correct banks, which have since collapsed. The payment of benefits to retired workers was getting delayed due to poor administrative and record keeping systems.

Voluntary private occupational pension schemes equally encountered problems which included under-funding of pension schemes due to non-remittance by employers of deducted contributions, poor investments of the pension assets, diversion of scheme funds by employers, poor administration of schemes which resulted in delayed payment of benefits and outright misappropriation of scheme assets.

In order to address the foregoing problems, in 1996 the government invited the World Bank, to provide technical advice on the restructuring of the National Social Security Fund intended to curb the aforesaid abuses. It was the desire of the government to enhance the Fund's accountability and administrative processes, and increase its autonomy by reducing direct government control on the Fund. Upon assessing the pensions sector, the World Bank opined that the absence of an overall policy and regulatory framework for the pensions sector posed a concern and recommended the establishment of a regulatory framework for the proper development of a pension system in Kenya.[5] This recommendation was followed by the enactment of the Retirement Benefits Act, 1997 which established the Retirement Benefits Authority (Authority) to regulate the pensions sector. The law mandated the Authority to regulate and supervise the establishment and management of pension schemes, promote the development of the pensions sector, protect interests of actors in the industry, recommend and implement pension policies to be followed in Kenya's pension system.

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[5] World Bank (1996): *Financial Sector Assessment Program, Kenya* (unpublished report, 1996)

At the same time NSSF Act was amended to limit the excessive powers of the Minister and requiring the Minister to consult with the board of trustees before making decisions, which affect the Fund. This was intended to provide some autonomy to the NSSF. Key amendments were introduced to the NSSF Act, which subjected it to the supervision of the Authority and created a right of choice for members to transfer their membership to some other scheme prescribed by the Minister as a way of subjecting NSSF to competition for statutory contributions with other prescribed pension schemes. The noble section unfortunately to date is in-operational because the government is unwilling the expose NSSF to market competition as it may lead to massive transfers by members who will prefer to transfer their accrued benefits and statutory contributions to alternative occupational pension schemes or individual pension plans. The effect of such massive transfers will expose NSSF to eminent collapse.

The civil service pension scheme faces a greater challenge of sustainability because of its large implicit pension debt which taxpayers in Kenya will be called upon to shoulder. This problem has arisen because of the statutory structure of the scheme. Under the provisions of the Pensions Act pension benefits for civil servants are designed as a defined benefit where the level of pensions is a fraction of final salary for each month of pensionable service. The pension scheme is not funded which means pensions are paid out of the consolidated fund. The valuation of the scheme in 2005 disclosed a pension debt of Ksh. 338.9 Billion[6].

From the above description of the system Kenya's pension policy can be noted. The idea of the pension policy is to guarantee a regular income to retired employees. The policy does not entail a universal pension to all Kenyans in old age instead the policy manifests itself in the establishment of (i) the civil service pension scheme (ii) the National Social Security Fund (iii) Voluntary occupational and Individual

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[6] Alexander Forbes Financial Services Limited: *Actuarial Study on Superannuation in the Public Service Kenya* (Unpublished report, 2005)

Retirement Benefits Schemes. In order to regulate the seemingly fragmented pension system, the Retirement Benefits Authority was set established to regulate the sector.

Apparently pension plans in Kenya, operate under different legislation and their features are dissimilar. The system is fragmented and requires a uniform policy. The fragmentation of the policy has resulted in the inability of the system to extend coverage to the rest of the population, which is outside the formal employment. Instead all the fragmented pension arrangements target to cover a small population of the formally employed. The major concerns of Kenya's pensions policy therefore is that it does not adequately address the problems of low coverage, poverty among the old in Kenya, imprudent central management of the assets of National Social Security Fund, unfunded liabilities both in the civil service pension scheme and parastatal pension schemes, and the inadequate governance structures in the system[7].

The foregoing highlight of the prevailing pension system begs the question of what the ideal pension system should be. In 1994, the World Bank in its effort to influence the global structure of pension systems published a book " ***Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth***" in which it advocated for what it called a multi-pillar or three -pillar approach to pension reform. The World Bank recommended a pension system comprised of the following components; (i) a first pillar of state –provided, redistributive benefits, such as a minimum pension or a reduced social security system (ii) a second pillar of a mandatory pension savings in privately managed individual accounts and, (iii) a third pillar of voluntary savings in funded individual or occupational pension plans. The recommendations of the World Bank were considered to be broad enough to be accommodated and mixed with existing social security systems in many developing countries.

However, in 2005 the World Bank revised its 1994 pension reform policy as it was found to be rigid and unsuccessful in a number of countries. A number of countries

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[7] World Bank (2003): *Kenya Financial Sector Assessment Program* (Unpublished report, 2003)

wished to have a wider range of tiers from which they could choose an appropriate pension system. While the World Bank continued to perceive the advantages of the 1994 three-pillar system, it also recognized that a range of choices of the pension pillars would be appropriate to a wider range of countries. The Bank then in 2005 published a book[8] in which the Bank recommended a pension system of five tiers. The recommended tiers were; (i) a non contributory or "zero pillar" scheme (in the form of a demogrant[9] or social pension) that provides a minimum level of protection to all citizens (ii) a "first-pillar" contributory system that is linked to varying degrees to earnings and seeks to replace some portions of income (iii) a mandatory "second-pillar" that is essentially an individual savings account in variety of ways (iv) voluntary "third-pillar" arrangements that can take many forms (individual, employer sponsored, defined contribution schemes) but are essentially flexible and discretionary in nature; and (v) informal intrafamily or intergeneration sources of both financial and non-financial support to the elderly, including access to healthcare and housing.

In developing the said broad and flexible policy on pension reform, the World Bank was guided by the fact that initial conditions in any one country that necessitate pension reform are different. Such conditions will form a basis on which a country enacts its pension laws and sequence the implementation of the proposed pension system model.

The World Bank approach is concerned with widening of coverage of the system without exposing the governments to unsustainable fiscal obligations. Kenya's pension system is ripe for a reform to widen coverage and to address shortcomings of governance in the prevailing system. It is observed however that the process of reforms needs to be driven by domestic socio-economic and legal considerations.

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[8] World Bank (2005): Old Age Income Support in the Twenty – First Century: An International Perspective on Pension Systems and Reform (The World Bank, 2005)

[9] A demogrant is the same as a universal flat benefit where individuals receive an amount of money based solely on old age and residency.

1.3 Research Methodology and Objectives of the Study

(a) Research Methodology

The primary sources of information for purposes of this study are Acts of Parliament in Kenya which make various provisions relating to pensions. The dependency on Acts of parliament as a source of primary information is because the study proposes reforms to these laws in order to address the problems in the pension system. Relevant provisions of the Constitution, The Pensions Act, The National Social Security Act and The Retirement Benefits Act have been considered. Various interpretations have been made from the provisions and were considered against the problems of the pension system.

Other sources of information for this study included relevant books, articles and reports on pension issues both on the local scene and other countries. The relevance of information obtained from these other sources for purposes of the study was considered against the Kenya's pension system in order to make appropriate recommendations on suitable reforms of the system.

The study therefore relied on available sources of information without collecting primary data by way of questionnaires and interviews because of the limitation of time.

(b) Objectives of the study

The objective of carrying out this study is to recommend legislative reforms to key pension laws in Kenya in order to (i) set up a sustainable universal pension scheme to widen coverage to the elderly poor in the society (ii) introduce some pre-funding in the civil service pension scheme so as to make it sustainable in the long term (iii) implement outsourcing of professional pension asset management by NSSF for purposes of improving the scheme's asset portfolio and (iv) enhance

compliance of pension schemes with legal requirements in the pension system. Kenya has a weak old age security system which leaves majority of the elderly poor out of coverage. Acceptance of an introduction of a sustainable universal pension scheme will help in the alleviation of poverty through direct cash transfers from general tax revenues. Reforms proposed to improve governance and adequate funding of schemes will act as an incentive for those members covered by the existing pension system to smoothen consumption during their working years and retirement years so that they do not suffer a huge drop in their standard of living.

1.4 Conceptual Framework

There are four major aims of a pension system; namely (i) consumption smoothing over the life cycles of beneficiaries (ii) providing insurance against risks especially the uncertainties of life expectancy after retirement (iii) redistribution of income using public pension schemes to achieve a more equal distribution of income through transfers from the rich to the poor, and (iv) poverty alleviation among the elderly[10]. The fundamental purpose of a pension system is provision of regular income in old age.

In most traditional societies, families or communities used to care for the old, the disabled or those who have lost income owing to the death of the bread winner. However, there are those without children to care for them or whose communities or families are too poor to care for the old or disabled. In some cases some are unwilling to provide for the care. As societies modernize and people move out of their communities, family and community ties weaken and leave the elderly and disabled without an adequate safety net. For these reasons, the government often takes on the role of availing a pension system to address the need for old age income support.

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[10] Holzmann,R & Hinz,R *Old Age Income Supporting in the 21st Century (The World Bank 2005) p.27*

Governments have therefore a societal and in some cases constitutional obligations to support pensions directly or mandate the participation in pension plans established by employers to address the ever increasing breakdown of traditional safety nets among communities. In order for the pension system to achieve the purpose for which it is established, the government is bound to get involved in the management of pension schemes.

In view of the foregoing, governments get involved in private pension schemes because (i) workers may suffer from myopia and not think about old age when economically active and (ii) workers may incur moral hazard by consuming as much as possible when economically active with an expectation that society will care for them when they are old. The only way that governments can limit the cost of caring for the elderly is to require participation in pension schemes for those who can afford it economically and then limit direct government financial support to those who are too poor to save during their working lives.

The structure of the pension system has evolved over the years. After World War II most European countries operated a policy of social welfare where the state, in public pensions and the employer, in private pension schemes centrally administered the contributions and benefits. Financing of the pension system was based on a pay-as-you-go where current payroll tax revenues are used to pay current pensioners. Anticipated pensions were provided in the laws on a defined benefit basis. Risks of lacking old age income, disability and survivorship were under the system pooled in the welfare system to provide social security against those risks[11]. This pension design ignored demographic risks, which have brought increased fiscal strain throughout the globe as populations rapidly age due to rising life expectancies and declining fertility rates[12].

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[11] Orenstein,M.A., *The New Pension Reform as Global Policy (Sage Publications 2005) p.11 - 12*

[12] Schwarz,A.M., & Kunt, A.D., *Taking Stock of Pension Reforms Around the World (The World Bank 1999) www.worldbank.org*

Pension systems have as a consequence undergone reforms to address the fiscal strain experienced by governments, enable equitable redistribution of old age income and to extend coverage of the system to all members of the population. The reforms resulted in multi-pillar pension systems comprising of unfunded state pensions for redistributive purposes, mandatory national pension schemes, supplementary voluntary occupational pension schemes and individual accounts saving plans[13]. The nature of pension reforms and designs depend on the legal framework and enforcement thereof obtaining in a given jurisdiction as determined by policies adopted by individual countries taking regard of the cost of reform[14].

Shortcomings of existing pension systems include their inconsistencies and unfairness across occupations in a given country. In many systems pension law provisions with regard to benefits have developed along professional lines commencing with civil servants and public enterprises and gradually extending to the private sector. The law would allow establishment of new pension schemes separately from existing ones containing different benefit rules and contribution requirements. This situation leads to distributive injustices, difficulties in enabling members exercise their pension rights in transferring benefits to other schemes of their choice and disables mobility of labor between sectors especially between the public and private sector[15]. The second shortcoming is that existing schemes promise much benefit but often deliver less because of inadequate governance, weak laws on regulation which result in poor collection of contributions and imprudent asset management[16]. Thirdly, most pension systems have been unable to provide old age income security coverage to the entire population. This situation is attributable to the reduced role of the state as an employer, lack of formal job creation in the private sector, inadequate design of the pension system[17] and failure by most countries to recognize social security as a right that need to be enshrined in their

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[13] Holzmann,R., *The World Bank Approach to Pension Reform (The World Bank 1999) www.worldbank.org/sp*

[14] ibid

[15] Holzmann R., & Hinz, R., supra p. 27

[16] Ibid p. 28

[17] ibid

constitutions. Certainly the failure of most countries in sub-Saharan Africa to extend coverage of old-age income security to the entire population is fundamentally attributable to under-performing economies in the region. This has led to narrow revenue bases of most governments and widespread unemployment, which has removed people from formal pension arrangements. Most governments and the private sector will thus find social assistance schemes such as pension schemes unduly burdensome[18].

But the old-age income issue does raise legal issues. Nagel (2002)[19] says that

> *"Rights to public pension for old are legal welfare rights. They are rights that can be traced back to the development of a welfare state, and they reflect what a given society defines as the best overall conception of welfare. Pension rights can be understood as basic income protection, as personal saving insurance, as entitlements, and as political and legal guarantees. A national pension scheme normally contains all five elements."*

Inadequacies in the system can raise constitutional issues, which may invite the judicial system to address. These matters call on pension policymakers to review legal structures of pensions system to ascertain whether they adequately address the rights of beneficiaries of the system.

Contemplated reforms of a pension system should be the outcome of a broad social consensus because they affect all citizens. Achievement of consensus in pension reforms forms a basis for the citizen's trust of the system. When developing a pension system and implementing reforms, each country will have to draw mainly on the national context and also observe the rights of beneficiaries of the pension system. Individual country pension reform steps must nonetheless be based on generally valid principles.

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[18] Olivier M. P., and Kalula, E.R., *Social Protection in SADC: Developing and Integrated and Inclusive Framework* (University of Cape Town, 2004) p.23

[19] Nagel, H.W., *Just Pension (University of Oslo 2002) p.5*

A broad structure of a pension system is generally agreed internationally owing to International Labor Organization (ILO) Conventions and the World Bank recommendations on pension reforms. The ILO's Social Security (Minimum Standards) Convention[20] makes provision for medical care, sickness, unemployment, old age, employment injury, family maternity, invalidity and survivors' benefits. Under ILO Conventions, member countries are required *inter alia* to establish a pension system to provide for old age income. ILO Conventions apply in local jurisdictions by way of ratification by member countries. However, countries with underdeveloped economies and poor medical facilities are exempted from full application of the Conventions and therefore such countries may extend social security coverage to a limited number of the population depending on the level of development.[21] ILO Conventions especially Convention 102 is flexible enough to allow member countries design a social security system for the provision of old age benefits in a manner suitable to the local circumstances without infringing international standards.

Without considering the underlying socio-economic conditions and legal circumstances in pension reform process, the system my be unsuitable to the public, fail to meet its objectives and may be unsustainable in the long term. The trust of the public in the pension system is supported by legal and economic guarantees provided for in the pension system. Legally, members of pension schemes expect the observance and protection of pension promises provided for in the scheme instruments and the law. Economically, members of pension schemes require assurance of the level of the pension for the whole period of its payment. The economic guarantee also includes a guarantee of the minimum pension with the aim of preventing poverty in old age.

To enforce these legal and economic guarantees, particularly in private pensions, a supervisory agency set up by legislation would become necessary. The agency will

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[20] ILO Social Security (Minimum Standards) Convention 102 of 1952

[21] Humblet, M. and Silva, R., Standards for the XXIST Century; Social Security (ILO, 2002) p. 9 - 10

protect and enforce rights of members besides enhancing governance in pension schemes with the aim of ensuring that they realize their objectives of providing old age income[22].

1.5 Study Approach and Profile

The profile of this study is stated as follows:

Chapter 1: In chapter one the statement of the problem for this study has been stated and a highlight of the historical overview of Kenya's Pension system discussed. The problem of Kenya's pension system is fragmented covering only a limited percentage of the labour force while the elderly poor are exposed to poverty. At the same time the prevailing pension system faces a problem of unsustainability because it is poorly funded, its assets are imprudently managed and its compliance with existing pension laws is inadequate. There is thus justification to study these problems in order to establish a basis for recommendations of appropriate reforms to widen coverage and improve governance and funding levels of existing schemes. The ultimate objective of the study as stated in the chapter is to propose for a provision of a sustainable universal pension scheme to extend coverage to the elderly poor in the society introduces pre-funding of the civil service scheme and improve pension assets management. The historical background to the study, conceptual framework, and research methodology has been discussed in this chapter.

Chapter 2: Chapter two highlights in detail problems facing Kenya's pension system. In this chapter a summary of the current pension system is described. In highlighting the problems of low coverage, inadequate funding, pension

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[22] Srinivas, P.S., Whitehoue,E. & Yerno, J., *Regulating Private Pension Funds' Structure, Performance and Investments: Cross Country Evidence (The World Bank 2000 Social Protection Discussion Paper Series No 0113) www.worldbank.org/sp*

assets management and enforcement of laws, the legal framework under which the system operates is explained. Interpretations of relevant provisions of the Constitution of Kenya, Pension Act (cap 189), National Social Security Fund Act (258), and Retirement Benefits Act, (Act No.3 of 1997) which relate to the current pension system, have been discussed in the chapter. Brief proposals on possible legislative reforms to address the problems in the system have been mentioned in this chapter.

Chapter 3: Chapter three tackles the issues discussed in chapter two by discussing possible solutions to the problems facing the pension system. Reforms of current laws are recommended purposely enable all formal employees to participate in the pension system as a way of extending coverage within the formal sector. The civil service pension scheme requires pre-funding in order to guarantee its future sustainability. The scheme also needs to be reorganized as a trust so that its governance is improved. With regard to private occupational pension schemes, criminal sanctions against employers who fail to remit their contributions to schemes should be introduced in the current law. This will improve the funding levels of these schemes. Owing to problems of asset management especially with regard to NSSF assets, it is proposed in this chapter that it may be appropriate to outsource the function of investment to external fund managers. Further, because NSSF is subject to a myriad of legislations, it is recommended that all laws that affect NSSF should be harmonized to enable compliance and enforceability. Proposals on the way forward in handling the problems facing Kenya's pension system are described in this chapter. The discussions in this chapter are answers to the research questions for this study.

Chapter 4: In chapter four conclusions and suggestions of further research are made. There is need to extend coverage to a wider population in Kenya in

order to reduce poverty levels among the elderly poor. An introduction of an affordable universal pension scheme which transfers minimum amount to the elderly in the society will help reduce poverty in old age. The current pension system does not extend coverage to all formal employees and reforms are required to enable at least all formal employees and a substantial number of those in informal sector to participate in the system. Lack of appropriate governance of pension schemes owing to lapses in legislation need to be sealed to enable the public have trust in the system and also for the system to guarantee its future sustainability. Further research on whether pension provision should be a constitutional right need to be explored. Since NSSF and private occupational pension schemes operate on the basis of trust law, there is need to research on the suitability of trust law as legal framework on which pension schemes should operate.

CHAPTER TWO

HIGHLIGHTING THE PROBLEMS FACING KENYA'S PENSION SYSTEM

2.1 Summary of Principle Features of the Existing Pension System

(a) Civil Service Pension Scheme

The current pension arrangements for pensionable employees of the civil service of Kenya are provided through the Pensions Act (cap 189) which was commenced on 1st January, 1946. A provision for grants of pensions to widows and children of deceased male officers in the civil service is governed under the widows and children's pensions Act (cap 195). Non-pensionable employees in civil service which comprise of junior subordinate staff currently participate in and contribute to the NSSF.

Under the provisions of the Pensions Act (Cap 189), membership in the civil service pension scheme is compulsory to all full time permanent and pensionable employees in the civil service. The Act does not apply to employees on non-pensionable contract terms or employees of state corporations which have been declared as public service because this type of employees are covered by their own separate pension plans or Acts of parliament. The civil service scheme is non-contributory with the government meeting the full cost of the pension benefits through tax revenues from the public. The continued sustainability of the scheme is fully depended on sustainable collection of tax revenues at the rate which is proportional to the increase in pension liability. The pensions Act (cap 189) does not specifically provide for a normal retirement date for civil servants. The Regulations to the Act however require that no pension benefits can be paid unless retirement is on; (i)

attaining 50 years (ii) the abolition of office (iii) compulsory retirement (iv) ill-health retirement subject to satisfactory medical evidence, and (v) termination of service in the public interest.

The in-service employees may retire at or after age 50 on unreduced pensions with the consent of government. Employees in specific categories (police officers or subordinate officers, prison officer below the rank of chief officer, administration police officers below the rank of senior sergeant, and forest guards of grade 1, 2 and 3) may not opt to retire after a period of service exceeding 12 years but not exceeding 20 years, provided that at least one month's notice of intention to retire is given[23].

Pension benefits accrue to a member of the scheme after such member has served for a period of more than ten years or pensionable service. An annual pension is 1/480ths of the final pensionable emoluments for each month of pensionable service[24]. The fraction of 1/480 of the final pensionable salary is applied to all the months of pensionable service of the member to determine the payable pension. Employees may under the law opt to commute or convert up to ¼ of their accrued pension for a cash lump sum payment on retirement. Currently, the applicable cash commutation is Kshs. 20 for each Kshs. 1 of the pension given to a member. On the death of a member while in service but before retirement, (i) a lump sum of the higher of twice pensionable emoluments at date of death and 5/480ths of pensionable emoluments multiplied by the period of pensionable service in months; and (ii) pension to the spouse or child for a period of five years at a rate not exceeding the pension that could have been granted to the employee if he had retired on ill-health grounds at the date of death.

On death of a pensioner, the pension payable continues for five years after death. If the pension payments received since retirement are in total less than twice the pensionable emoluments at the date of retirement, then the difference is paid a lump

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[23] Regulation 26 of the First Schedule of the Pensions Act (cap 189)
[24] Regulation 4 Ibid

sum[25]. The maximum pension payable under the Act may not exceed 100% of pensionable emoluments drawn by the employee at the date of his retirement[26]. The minimum pension currently payable is Kshs. 500 per month. The Act does not guarantee pension increases. There have been only four pension increases in the last 40 years.[27]

The foregoing depicts generous benefits design of the scheme. This will expose the schemes continued sustainability especially when the government continues to increase civil service salaries without adjusting the pension benefits. It is however important to note that civil servants pension is pegged to 'basic salary' which is usually very small and therefore the generous benefits design does not necessary translate to high benefits to an individual pensioner.

(b) *National Social Security Fund (NSSF)*

The NSSF is established under the provisions of the National Social Security Fund Act (Cap 258). The NSSF is a provident fund which operates on a notional defined contribution basis with a member maintaining an individual account with a number. The NSSF Act vests the management of the fund in a Board of Trustees of ten members appointed by the Minister in charge of labour and social security matters as follows[28]; (i) The permanent secretary to the Treasury (ii) The permanent secretary to the Ministry for the time being responsible for labour and social security (iii) The Managing Trustee of NSSF (iv) Two representatives of employers (v) Two representatives of employees and, (vi) Three others appointment by reason of their skill in matters relating to banking, insurance, investment, pensions, auditing, law and corporate business management. The Chairman shall be picked form those members who are not ex-officials.

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[25] Section 8 of the Pensions Act
[26] Section 10 Ibid
[27] Alexander Forbes Financial Services (EA) Ltd. (2005): Actuarial Study on Superannuation in the public service, Kenya; unpublished report submitted to the Government of Kenya.
[28] Section 1 of the First Schedule of the National Social Security Act (cap 258)

NSSF covers salaried employees in the private sector in respect of employers with more than five employees including employees of non-exempt parastatals and non-pensionable junior officers in the civil service. Contributions to the NSSF are set at 10% of wage, shared equally by employer and employee with a ceiling of Kshs. 400 per month. The Act requires employees to deduct the employees' contribution at the end of each month and remit all contributions to NSSF. The current contribution rate is trivial because an employee with a 30 years career history would accumulate Kshs. 144,000/= only in contributions. The NSSF is subject to the supervision of the parent ministry of labour but in addition, NSSF is subject to the provisions of the Retirement Benefits Act (Act No. 3 of 1997). The Retirement Benefits Authority therefore has regulatory and supervisory role over NSSF.

Part IV of the Act provides for the benefits structure payable by NSSF. The benefits payable include[29]; old age benefits, survivor benefits, invalidity benefits, withdrawal benefits, and emigration grant. Old age benefits are paid in the form of a lump sum at the retirement age of 55 but early retirement at age 50 is also allowed by the law.

The Board of trustees is vested with powers to invest the assets of the NSSF and the law does not require the use of professional asset managers in the investment of NSSF assets. NSSF however, is required to comply with the investment guidelines provided for in the Retirement Benefits Act[30]. The fund is yet to comply with those statutory guidelines which include the appointment of external asset managers and custodians due to the government exemption of NSSF from the provisions of the Retirement Benefits Act.[31]

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[29] Section 19 of the National Social Security Fund Act.
[30] Section 26 Ibid
[31] Legal Notice No 3 of 29th Dec.2004

(c) *Occupational Retirement Benefits Schemes*

As of May 2006, the Retirement Benefits Authority had recorded 1336 occupational retirement benefits schemes with an accumulated asset base of Kshs. 122 billion.[32] Around 80% of these schemes are defined contribution schemes and only 20% were defined benefit schemes. However, 40% of the total industry assets belong to defined benefits schemes[33].

Private occupational retirement benefits schemes are established under the law of trusts as irrevocable trusts except when established under a written law[34]. The management of this scheme is therefore vested in boards of trustees of not less than 3 in defined benefits schemes and 4 in defined contribution schemes[35]. To enhance governance, the Retirement Benefits Act Regulations require that in defined benefit schemes, members shall elect one third of the board of trustees while in defined contribution schemes, the members shall appoint 50% of the total number of trustees.

The trustees are legal owners of the scheme assets which they hold in trust for the benefit of the members. The duties of the trustees include[36], (i) administering the scheme in accordance with the provisions of the Retirement Benefits Act, Regulations thereunder and the scheme rules (ii) keeping all proper books and records of accounts in respect to income, expenditure, liabilities and assets of the scheme (iii) developing an investment policy to guide the asset manager of the scheme assets on the day to day investment of the assets of the scheme and (iv) ensuring collection of the correct contributions from the scheme sponsor and remittance of the same to the scheme custodian from where the assets are invested, and (v) appointment of professional service providers of the scheme including fund

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[32] RBA News March 2006
[33] RBA Registry Statistics
[34] Section 24 Retirement Benefits Act(Act No.3 of 19970
[35] Regulation 8 of the Retirement Benefits Act(Occupational Retirement Schemes) Regulations, 2000
[36] Ibid

managers and custodians who must be appointed because of statutory requirement in the Retirement Benefits Act.

Occupational Retirement Benefits Schemes are regulated and supervised by the Retirement Benefits Authority in accordance with the provisions of the Retirement Benefits Act, 1997. Each scheme pays pension benefits in accordance with the provisions of the scheme rules. Some are provident funds which pay lump sums at retirement date while others are designed to pay monthly pensions or annuities at retirement. However, the Minister through a Legal Notice No. 57 of 2005 published Regulation 19 (5) whose effect is to lock-in employer contributions in respect of a member who leaves employment before attaining retirement age. Scheme members who leave employment before attaining retirement age as specified in the scheme leaves can only receive a withdrawal payment form their pension scheme comprising of their contributions and interest only. The employer contributions will remain in the scheme until a member attains the retirement age. The exemption to the Regulation is when the member leaves employment on the basis of ill-health. The rule raised uproar from members of schemes basically on two arguments, i.e. (i) people know how to manage their finances and the government cannot assume the role of managing people's finances (paternalism) and (ii) high levels of unemployment.

The first argument may sound justified but in reality most workers suffer from myopia and often do not think about old age when they are young and healthy. The government has an obligation to rid its citizens from want and old age poverty and may be compelled to introduce laws which will introduce consumption smoothing during the economically active lives of workers in order to enable provision of old age income security to its citizens. Poverty in old age is always a burden to the society and the government can introduce legal reforms to reverse the problem.

The second argument equally has merit because it is often difficult for workers to secure employment when they have lost one. However, the argument seems to

indicate that pension arrangements are meant to address the problems of unemployment and job insecurity. The problems of unemployment should be addressed by employment policies and the tightening of labor laws. Pension systems are designed to provide an income to those individuals who suffer a loss in earnings capacity through advanced age, the experience of disability, or the death of a wage earner in the family. In view of the foregoing, the locking-in of the employer contributions in respect of a member leaving employment before attaining retirement age is intended to smooth consumption among workers so that the objective of a pension system is realized. Locking-in (a) protects the money from financial misapplication from its intended purposes i.e. provision of old age income and thus guarantees that the money will be used for retirement income (b) and also provides for maximum tax relief because earlier withdrawals attract higher taxes.

The Retirement Benefits Act also requires all defined benefits schemes to undergo actuarial valuations every three years[37]. Most of the defined benefit schemes are established by state corporations and owing to budget deficits of these corporations most of their pension schemes are under funded.

The discussed summary of Kenya's pension system discloses that it is comprised of pension schemes which do not belong to a consistent structure. A consistent structure of a pension system would operate under a harmonized framework where pension schemes are designed to address clearly identified needs in the society rather than all of them focusing on formal workers only. The major intentions of a pension system are to reduce old age poverty and to smoothen consumption during the working life and retirement period of workers in order to sustain an almost same standard of living. Kenya's pension system is comprised of schemes which work independent of each other in terms of addressing the common needs of the society and also tend to operate in competition with each other focusing on one class of people for purposes of coverage. The system ignores the unemployed who in old age are exposed to poverty and also it does not adequately provide for participation of

[37] Section 35 of the Retirement Benefits Act

the informal sector. The establishment of three types of schemes which apply to formal workers is a fragmentation of a system which does not adequately address coverage, old age poverty and smoothing of consumption of those in employment into their retirement period.

An ideal pension system would have a first pillar which will provide a social safety net in form of a universal pension to the elderly poor. The second pillar would address smoothing of consumption of those in employment by requiring mandatory saving and guaranteeing a limited replacement rate of about 25% of pre-retirement earnings as in the case of Canada mandatory pension scheme.[38] The third pillar will also address smoothing of consumption but with a higher incentive to save more to supplement income from the second pillar. Such structured system will widen coverage, to the poor in old age, enforce coverage to workers and encourage consumption smoothing for those in employment.

The system is inconsistent because it lacks a uniform law to set fundamental features of these pension schemes. This is because our system is fragmented. At any rate the system faces a number of problems which include; (i) low coverage, (ii) problems of under-funding (iii) imprudent asset management, and (iv) weak enforcement mechanism.[39] The subsequent discussion addresses each one of these problems highlighting some of the weaknesses of the legal framework under which system operates.

2.2 Low Coverage

Pension coverage is a significant determinant of integration and inclusiveness in social protection. The issue of coverage relates to the scope of risks covered by the pension system and the size of the covered national population. The risks covered by a pension system include old age poverty, loss of employment income and death

[38] Menard, J. C. (2000): The Canadian Retirement Income System (A presentation to the Kenyan delegation, 2000)
[39] World Bank Financial Sector (2003): Assessment Program (unpublished 2003) P. 19

of a family bread winner. A pension system should identify the risks and provide some coverage of those risks. Low coverage issues discussed hereof relate to the size of the population covered by the pension system in Kenya as opposed to the risks covered.

Most developing countries have pension coverage that is restricted to small segments of the workforce, such as those working for government or large companies.[40] Low coverage of the pension system in developing countries is attributable to the reduced role of the public sector as the main employer, lack of formal employment, inadequate design of the pension system[41] as a result of inadequate policy and legal provisions. More than 70% of the population in Sub-Saharan Africa lives in rural areas where they are dependent on subsistence agriculture for their livelihood.[42] This population cannot be covered by the pension systems because colonial laws were designed to cover formal workers in the public and private sectors. There are two major groups of the population which are largely excluded from this form of pension system coverage: (i) workers who have spent much of their lives in the informal sector (often self-employed or in small firms) in labor market jobs that are not covered by occupational pension schemes and (ii) women, who often work in the household rather than in the labour market, expecting to be supported by the informal family system which often may not guarantee old-age support.

Of concern is not only the size of the covered population, but also that the actual risks covered are equally low. Low actual coverage of the risks can be attributed to lack of compliance by the employers who often under-report the size of their workforce to reduce the pay roll tax and hence evade contributing to the pension system. For example, according to the 2003 Financial Sector Assessment Program

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[40]Kaneda, T. (2004): A critical window for policymaking on Population Aging in Developing countries (population Reference Bureau, 2004) P. 4 www.prb.org/Template.cfm

[41]World Bank (2005): Old Age Income Support in the 21st Century (the World Bank 2005) P 28

[42].Olivier, M.P., and Kalula, E.R., (2004) Social Protection in SADC: Developing an Integrated and Inclusive Framework (University of Cape Town 2004) P. 4

report on Kenya which was carried out by the World Bank, by 2003 only 800,000 members were contributing to NSSF representing only 30% of all registered members. In some cases employers default in the remittance of contributions to the pension system a fact which becomes apparent when payment of benefits is due. Of course, lack of compliance is a reflection of poor enforcement of the law.[43] The population covered by the pension system in sub-Saharan Africa is not necessarily insulated from old-age poverty because most of the pension systems lack systematic indexation of benefits to inflation.[44] The requirement to index benefits to inflation is economically prudent but often not provided for by the law under which pension system operate.

The aforesaid provides a general view of the problem of low coverage of the pension system especially in Sub-Saharan Africa. Discussed below is the highlight of the problem in Kenya's pension system.

2.2.1 *Civil Service Pension Scheme*

Part VIII of the Constitution of Kenya deals with the issues of public service. Section 112 of the constitution in particular recognizes the applicable pension laws and protects pension rights of public officers. In section 113(5) of the constitution, the pension benefits provided for under that section relate to, *inter alia*, public officers. The provision of pension to civil servants in Kenya is a constitutional requirement whose detail and administration is left to the various parliamentary enactments. The constitutional provision does not discriminate on the coverage of the public officers in the civil service pension scheme. The constitution, however, recognizes the existent of the pension law as at 12th December, 1963 and any other laws that may be enacted thereafter.

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[43] Ibid P. 5.

[44] Aninuddha, B. Pensions in Sub-Saharan Africa: The urgent need to Act (World Bank, 2003) P. 6 www.worldbank.org/etools/docs/library/76907.

It is legally a moot issue whether a legislation that may be enacted after 11th December, 1963 in respect of pension provisions to public officers can discriminate on the officers who will be covered under that scheme in view of section 112 (2) (b) of the constitution. The provision reads:

> *"The law to be applied with respect to pension benefits not being benefits to which subsection (i) applies shall (b) In so far as those benefits are wholly or partly in respect of a period of service as a public officer that commenced after 11th December, 1963, be the law in force on the date on which that period of service commenced, or any law in force at a later date that is not less favourable to that person".*

The provision preserves pension rights of a public officer which presumes that all public officers have a constitutional right of being covered under the civil service pension scheme.

The Pensions Act (cap 189) was enacted to provide for the grant and regulation of pensions, gratuities and other allowances in respect of public service officers under the Government of Kenya. Section 3 empowers the relevant government ministry to grant pension in accordance with the pension Regulations under the Act, to officers who have been in the service of the Government. Section 2 of the Pensions Act defines the "pensionable office" as

> *(a) in respect of an officer's office under the Government, an office*
> (i) *to which he has been appointed (on probation or otherwise) by the authority having power for the time being to make appointments to the service of the Government on terms which include eligibility for the grant of a pension under this Act or under any Act repealed by this Act;*

The aspect of eligibility for the grant of pension under the provisions of the Pensions Act is a term of employment which is left to the Public Service Commission, which under section 107 of the Constitution, is mandated to appoint public officers. It means that the Public Service Commission may appoint some public officers whose terms of service do not include eligibility to participate in the civil service pension scheme.

Therefore it is apparent that some public officers, depending on their terms of employment are not covered by the scheme. The constitutional provisions and the

provisions of the Pension's Act have left gaps which the Public Service Commission can utilize to deny some category of public officers from coverage under the civil service pension scheme. Certainly some categories of public officers may justifiably not qualify for coverage on the basis that they are engaged on short term contracts or as consultants. But the exclusion from coverage on the basis of rank in service and gender may raise equity and legal questions especially when employment terms are long term. Women for example have been since independence employed on contract terms by reason of which they could only qualify for gratuity, until the 1990s when the policy was changed to have them employed on permanent terms of service. Although they were employed on contract terms, majority of them served for long periods in the civil services without being covered by the pension scheme. It is argued that it was not the choice of women and the low cadre staff not to participate in the scheme, but rather a policy which was pursued to manage the cost of financing the scheme while ignoring the old age risks of those particular officers.

The main group of persons to whom the Pension's Act does not apply are employees on non-pensionable contract terms or employees in government institution declared as public service but covered by their own separate pension schemes. It is observed that the Civil Service Pension Scheme which is un-funded and established under the provisions of the Pensions Act to cover civil servants does not provide cover for all the employees in public service. All formal employees are exposed to old age income risks and it could be appropriate at least to have all long term employees in civil service covered by the scheme established for civil servants rather than deny cover on the basis of cadre and gender.

2.2.2 National Social Security Fund

The National Social Security Fund (NSSF) is a creation of parliament through section 3 of the National Social Security Fund Act (Cap 258). Coverage of NSSF is provided for in section 5 of the Act. Under that section, it is the Minister who, by an order, determines which employees should be registered as members of the scheme and

which employers should be registered as contributing employers to the scheme. The Minister acts on the basis of recommendations of the Board of Trustees. Once an order is made by the Minister, registration as a member or contributor is compulsory.

It is however observed that currently there is a Bill in parliament known as Kenya Social Security Pension Trust, 2005. The main object of the Bill is to repeal and replace the National Social Security Fund Act and it proposes to provide for a comprehensive social security for the members and their dependants who will participate in the proposed scheme. The Bill aims at converting NSSF from a National Provident Fund into a Social Insurance Pension Scheme.

On the issue of coverage, the proposed social insurance pension scheme intends to cover all formal employees in Kenya including all government employees. Regarding the self-employed, section 13 of the Bill provides for voluntary membership. Except for those persons not allowed under international conventions to contribute to social security and those persons who are not ordinarily residents but are employed on short contracts in Kenya, all other formal employees together with their employers are required under the Bill to register and contribute to the scheme. The Bill proposes to widen coverage to all formal sector workers and allows participation of the self-employed who under the Bill will participate in an inbuilt provident fund. There is however need to harmonize the proposed scheme with the civil service pension scheme and private occupational scheme so that they do not appear to be in competition for contributions from the formal workers. For example, the government may be unable to pay the current pension obligations while making mandatory contributions to the new scheme on behalf of current employees. At the same time, if contribution rates to the

proposed scheme are high, then employers may be unable to continue funding private occupational pension schemes.

While section 6 of the NSSF Act makes it possible for voluntary application for registration of employees and employers as members or contributing employers, respectively, employees cannot be registered as members if their employer is not a contributing employer. Unlike the provisions of the proposed new scheme, section 7 of the NSSF Act limits coverage by providing for a long list of exempt persons. Those specifically exempted from membership are; (i) casual employees unless the Minister has made an order specifically allowing their registration as members (ii) persons covered under the Pensions Act (iii) persons employed in the public service, local authority, corporation or body established for public purposes and are eligible for pensions under any statutory or non-statutory scheme approved by the Minister (iv) persons employed by a University or college and are entitled to receive benefits under any approved superannuation scheme (v) Persons entitled to exemption from contribution to social security schemes under any applicable International Convention (vi) members (other than civilian employees) of the armed forces, the Kenya Police Force, the Prison Services and the National Youth Service (vii) persons who are not ordinarily resident in Kenya who are employed for a period not more than three years and are entitled to benefit to a scheme approved by the Minister (viii) persons who are not ordinarily resident in Kenya, but are employed for a period of not more than three years, and are entitled to benefit from a scheme with comparable benefits approved by the Minister, and (ix) persons undergoing full-time instructions in schools, colleges, universities or similar educational institutions.

There is merit in exempting persons who, under international conventions, may not be required to contribute to social security. Also, there is merit in exempting persons who ordinarily are non-residents but employed in Kenya on short term contracts. But, it is arguable whether other formal employees in Kenya should be exempt from a mandatory national scheme. The proposed new social insurance pension scheme intends to cover almost all formal employees and allows, on a voluntary basis, the

participation of self-employees without requiring registration of their employers. The drastic reduction of exempt persons in the proposed new scheme seems to be a realization that the long list of exempt persons under the provisions of NSSF Act was not after all a good pension policy on the issue of coverage.

If parliament enacts the Kenya Social Pension Trust Bill, 2005 coverage will be extended to some extent and benefits will be improved. Currently, approximately 2,000,000 employees in Kenya are covered by the pension system against a labour force of 17.6 including the informal sector[45]. The covered population is only 6% of the total population of Kenya.

2.2.3 Private Occupational Retirement Benefits Schemes

These are retirement benefits scheme, unlike NSSF, established on a voluntary basis by employers for the benefit of employees. These schemes vary in design from one employer to the other unlike NSSF which the law requires that it operates as a provident fund. The employer in a private occupational pension scheme becomes the sponsor of that pension scheme. Section 2 of the Retirement Benefits Act (Act No. 3 of 1997) defines the sponsor as the person who establishes a scheme.

Section 26 of the Retirement Benefits Act, requires every pension scheme in Kenya to be established under an irrevocable trust except for those schemes established by a written law such as the Civil Service Pension Scheme, NSSF and Local Authority Provident Fund. All other pension schemes in Kenya are therefore required by law to be established as trusts. A trust is a legal relationship declared by a settlor where assets of the trust are held by a group of individuals (trustees) for the benefit of a third group of individuals (beneficiaries). The interests of the beneficiaries are set out in the trust deed. The trust serves three functions: (i) it is the primary source of

[45] Machira, C (2006): Can We Afford a Universal Pension Scheme? The Case for Kenya (A Masters Thesis, unpublished, 2006) p.9

payment of pension entitlement, (ii) it is a security for payment and (iii) it is a vehicle for the collective protection and enforcement of the rights of scheme members.

All pensions schemes established in Kenya by private employers are set up under the law of trusts as private occupational pension schemes to cover their employees against the risks of old age poverty. This position applies to all state corporations in Kenya, who under the law have established private occupational pension schemes for their employees.

The Retirement Benefits Act does not make it mandatory to establish pension schemes for their employees. The establishment of private occupational pension schemes in Kenya is voluntary. It therefore, means that private occupational pension schemes cover formal employees of employers which have opted to establish pension schemes for their workers. These schemes cover a very limited number of the population in Kenya of about 250,000 formal workers which represent 1.5% of the total labor force in Kenya.[46]

Regulation 18 of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000 sets out the membership eligibility requirements in private occupational pension schemes. The said Retirement Benefits Regulations outlaws restricting membership to the scheme on the basis of gender, race or religion or in any manner which is discriminatory. Membership to a scheme under the same Regulation cannot be subject to any discretionary power. An employee is entitled under the law to commence participation in the pension scheme within one year from the date of employment. However, new employees whose remaining working time is less than five years are not allowed to participate in the private occupational pension scheme which is designed on defined benefit basis because these kinds of schemes shift the risk of investment to the employer.

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[46] World Bank (2003): *Kenya Financial Sector Assessment Program* (unpublished report, 2003) P.13

The law does not specifically obligate employees on contract or those in casual basis to participate in the occupational pension schemes as the right of an employee to participate in the scheme vests after one year of employment. On the same vein, unless, it is a term of employment, an employee is not under obligation to participate in the occupational pension scheme set up by the employer for the benefit of employees. Regulation 18(2) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000 gives discretion to an eligible employee to elect to participate in the scheme set up by the employer within a period of twelve months failing to make such election, the employees' eligibility to membership will cease.

It is apparent that the Retirement Benefits Act and the Regulation made thereunder have not helped in the widening of the coverage of private occupational pension schemes to all the labor force in Kenya. Just as an employment relationship is voluntary on the part of both the employer and the employee, the setting up and design of pension arrangement for employees is voluntary. There is no law that compels a private employer to provide retirement benefits to its employees. At the same time, there is no law that compels an employee to set aside, or save, any portion of her/his income for future old-age support. An employee's compensation package will include a pension benefit from active employment if both the employer and employee agree that the employer will provide and the employee will accept a portion of her compensation in the form of legally enforceable rights to receive pension payments after retirement.[47]

In view of the legal deficiency on who should be covered by the private occupational pension schemes, most employers have subjected participation in these schemes to specific conditions such as permanent employment and job grade as a result of which some categories of employees have been excluded from coverage.[48]

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[47] Zante, P. M. Van (2004): The limitations of Retirement Plan Law (working paper, unpublished, 2004) www.chapman.edu

[48] OECD (1998) : Principles for the Regulations of Private Occupational Pension Schemes (OECD 1998) p.7

The Problem of coverage in private occupational pension schemes raises the question of adequacy of private pensions in the society. Some countries have sought to tackle this problem of coverage by making private occupational pension schemes compulsory or by providing substantial tax incentives to encourage the widening of coverage.[49] However, as a matter of policy and law, it is essential that access to existing occupational pension plans should be open without discrimination whatsoever.

Kenya's pension system is limited to those in formal employment. Only 15% of the workforce in the country is participating in any form of formal pensions and retirement benefits arrangement. This bears significant social security implications since the level of coverage shows that pension's coverage is still unavailable for majority of Kenya.[50] The Pensions Act (cap 189) which sets up the civil service pension scheme does not extend coverage to all employees in the civil service. Those employees on contract terms of employment and junior category officers whose terms are not permanent and pensionable are not covered under that scheme although they participate in NSSF from where they receive very limited benefits which may not guarantee a minimum standard of living in old age.

The National Social Security Act (Cap 258) which established the National Social Security Fund does not extend coverage to those employees on contract terms. This has led to most employers in the industrial and agricultural sectors to hire workers on contract so as to escape the obligation to contribute to NSSF. Private Occupational Retirement Benefits Schemes which are established as trusts under the provisions of the Retirement Benefits are voluntary schemes. Most employers in Kenya do not have pension schemes for their employees and thus a large population of the labour force is uncovered by the pension system.

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[49] Laboul A., (1998): Private Pension Systems: General Features (OECD, 1998) p. 4

[50] Institute of Economic Affairs: Developing a Home Grown Social Protection System (Published in the Point Publication)

In order to extend coverage to majority of the population, Kenya needs to establish a universal pension scheme like Mauritius or Botswana which is non-contributory providing minimum flat rate befits to all those Kenyans who are 65 five years and above. The proposals in the Kenya Social Security Pension Trust Bill, if enacted into law will also help extend coverage to the formal sector if accompanied by appropriate incentives such as good governance of the proposed scheme and favourable taxation to those who opt to save for retirement.

2.3 Problems of Funding in the Pension System

Funding in a pension system relates to the instruments of financing pension benefits. In order to pay pensions in old age the pension system would require an accumulation of funds for purposes of honoring the obligations of pension payment. The financing of pension benefits can be either through tax revenues or social insurance contributions.

James E (1996) says most public pensions the world over are centrally managed and designed on defined benefit basis that depend on the worker's earnings rather than contributions. These pension schemes are financed by payroll taxes on a pay-as-you-go (PAYG) basis. This means that today's workers are taxed to pay the pensions of those who have retired.[51] Funding a pension system faces a number of problems which include; (i) high and rising payroll tax rates that may increase unemployment (ii) evasion and escape to the informal sector, where workers may be less productive (iii) early retirement which reduces the supply of experienced labour (iv) misallocation of public resources, as scarce tax revenues are used for the provision of pensions rather than for education, health or infrastructure (v) failure to redistribute to low income groups, and (vi) the growth of a large hidden implicit

[51] James, E., (1996): New Systems for Old Age Security – Theory, practice and Empirical Evidence (World Bank, 1996) p.2

public pension debt which makes the pension system unsustainable in the long term.[52]

The Civil Service Pension Scheme in Kenya is designed on defined benefit basis with generous benefits. It is completely financed from general revenues just like wages. Like any other pay-as-you-go pension scheme, the civil service scheme promises pension payment on a continuous basis as they fall due. There is not any capital set aside for future pension payments. The sustainability of the system is dependent on the Government's ability to collect sufficient taxes to match the growing pension liabilities.

Lately, during the course of writing this project the government through an internal administration circular, proposed to commence a contributory scheme to run concurrent with the current pay-as-you go non-contributory scheme. Under the proposal, all new employees would join the scheme as contributors while those already in service would on their own opt to join the contributory scheme or remain in the current scheme. Except for the advantage of improved vesting period of the benefits, there was not any remarkable difference between the schemes except for the requirement of contribution to some members. The benefits which were promised in the proposed schemes were the same as those in the current scheme. The proposed scheme was not implemented because the proposals in the internal circular under which the scheme was being introduced were not in conformity with the provisions of section 112 of the constitution which provides that all pensions payable to civil servants are a charge on the Consolidated Fund. The process of converting the current non-contributory scheme to a pre-funded contributory scheme requires amendments of relevant provisions of the Constitution and the Pensions Act (cap 189).

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[52] Ibid. 2 - 3

Private Occupational Pension Schemes are required by law to be funded. Principle 6 of the Basic principles for the Regulation of Private Occupational Pensions Schemes,[53] states;

> *"Private schemes should be funded. While full-funding exists in principle for defined contribution plans, other types of plans should be subject to minimum funding rules or other mechanisms to ensure adequate funding of pension liabilities. Flexibility can be allowed for temporary limited under-funding under restricted circumstances. Consideration should be given to the development of adequate but flexible requirements for minimum capital/guarantee in pension funds taking into account of the long term nature of their liabilities. Tax and prudential regulations should encourage a prudent level of funding. Private unfunded pay-as-you-go schemes at individual company level (e.g. overheads schemes) should be prohibited."*

Private Occupational Pension Schemes should generally be funded through the establishment of a pension fund into which contributions shall be paid. The funding requirement is necessary in order to guarantee pension benefits. For defined contribution schemes where the employer does not bear the investment risk of the assets of the scheme, the legal separation of the scheme assets from those of the employer should be mandatory. These assets should be held by trustees of the pension scheme as trust property. In the case of defined benefit schemes the assets of the pension scheme should normally be legally segregated from the employer's assets through a pension fund or an insurance arrangement in order to ensure a minimum level of protection against the effects of possible insolvency of the employer.[54]

Funding Private Occupational Pension Schemes avails two major advantages: (i) discipline (ii) Security. Discipline comes from the employer bearing the cost of pensions in advance instead of paying them as they become due, out of current profits. This will deter employers from promising to pay pensions in excess of what, in the future, the enterprise will not be able to afford. Funding also increases security, since it increases the likelihood that those pensions will be paid. Security is

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[53] The International Network of Pensions Regulator's and Supervisors (INPRS): Basic Principles for the Regulation of Private Occupational Pensions Schemes (OECD, 1998) P.3

[54] OECD (2004): Guidelines on Funding and Benefit Security (OECD), 2004) P.4

further enhanced when the funding takes place through a trust which legally separates the scheme assets from the employer's assets.[55]

When pension schemes are not adequately funded, members' rights under the pension scheme arrangement are put at risk because the pension commitments may not be honored and those in receipt of pension (pensioners) may not benefit from a pension increase.

2.3.1 Financing the Civil Service Pension Scheme

Section 112 (4) of the Constitution of Kenya, provides that Civil Service Pensions to which the Pensions Act (cap 189) applies shall be a charge on the Consolidated Fund. The scheme therefore operates as an unfunded non-contributory pension scheme. In order for the government to continue paying pensions to retiring civil servants, it has to continue collecting sufficient tax revenues.

Civil Servants, under the current legal framework of the scheme, do not make any contributions to fund their scheme. The constitution guarantees them a pension financed by national tax revenues. There has been a rapid increase in pensions expenditure from Kshs. 1.5 billion in 1993/94 to Kshs. 11.9 billion in 2003/2004, then Kshs. 17.8 billion for the year 2004/2005 and is estimated to be Kshs. 21 billion in the year 2005/2006.[56] If the trend continues over the next decade the annual pension bill on the consolidated fund will increase to Kshs. 45 billion by the year 2012 and Kshs. 80 billion by 2016.[57] The effect of such growth of the Pension liability on the government is that it could commit up to nearly two-thirds of all tax revenues and deny expenditure on other key sectors such as education, health, security and infrastructure.[58]

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[55] Nobles, R., Pensions, Employment, and the Law (Clarendon Press, Oxford) P. 112
[56] Alexander Forbes Financial Services Limited: Actuarial Study on superannuation in the Public Service Kenya (unpublished,2005)
[57] Daily Nation Nairobi, The Pension Time Bomb (The Daily Nation Business Magazine of February 7, 2006) p.10
[58] Ibid P. 20

The legal question that arises out of this pension system is its justice and equity in committing a substantial amount of tax revenues to the benefit of a small population of the Kenyan society. The total number of the covered population is 418,425 in-service civil servants and 126,000 current pensioners.[59]

The pension system firstly, demonstrates glaring inequity for committing substantial tax revenues to the benefit of a small population at the expense of socio-economic development which would benefit a larger sector of the population. Secondly, the system does not appear sustainable if the cost of providing pension to the retired civil servants continues to increase at the rate higher than the increase in tax revenue. The constitutional promise of pension provision may not be unachievable if the legal structure of the current civil service pension scheme is not fundamentally reformed. The current system pension system transfers income from the economically active population in the form of tax to a small population comprised of pensioners. To maintain a financial balance, there must be either an increase of the revenues or reduction of the pension benefits paid out. Revenues can be increased by raising taxes and reducing pension benefits involves either lowering benefit levels or raising the pension age.[60]

An actuarial valuation of the pension scheme disclosed the Government's implicit pension debt to the scheme to be Kshs. 338.9 billion.[61] If the government desired to pre-fund the current un-funded accrued pension liability in respect of civil servants in service in full, then it would be required to pay the above amount. The said liability may not be sustained by the tax revenues in the long term.

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[59] Alexander Forbes Financial Services Limited: Actuarial Study on superannuation in the public service Kenya (unpublished report, 2005)

[60] Alexander Forbes Financial Services Limited: Actuarial study on Superannuation in the Public Service Kenya (unpublished, 2005)

[61] Section 10 National Social Security Fund Act

2.3.2 Funding Problems in the National Social Security Fund

Section 3(2) (b) of the National Social Security Act (Cap 258) provides that all contributions and payments required under the Act shall be paid into the NSSF. The Act, in section 10 requires registered employers to make a contribution in respect of the registered employees to the NSSF. The rate of contributions are set at 10% of the wage, shared equally between the employer and employee but capped at Kshs. 400/- per month. The Act[62] obligates the employer to deduct from the employee's wages at the end of each month or at such time the wages are being paid and remit all the contributions to the NSSF.

It is an offence under the Act[63] for an employer to fail to remit the contributions to NSSF within the periods set out in the Act. NSSF is under an obligation to establish and maintain for each member of the fund an individual account into which shall be credited all contributions made on behalf of such member.[64] NSSF has set an administrative interest rate of 2.5% per annum on contributions. This rate of contributions is considerably lower than the current interest applicable on government securities. The apparent poor rate of guaranteed return is in itself a disincentive to employees to participate in NSSF and would endeavour to avoid registration and making contributions to NSSF. Also with poor returns, beneficiaries receive inadequate old age benefits which will not provide longevity insurance. The lack of adequate incentive to participate in NSSF can be inferred from the distributions of benefits paid by NSSF. The distribution is as follows.[65]

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[62] Section 36 National Social Security Fund Act
[63] Section 9 National Social Security Fund Act
[64] World Bank: Kenya Financial Sector Assessment Program (unpublished report 2003) p. 9
[65] Ibid

Table 1: NSSF BENEFITS DISTRIBUTION

Benefit	Percentage
Withdrawal	57%
Old Age	27%
Survivors	13%
Invalidity	2%
Emigration	1%

Source: World Bank Financial Sector Assessment report on Kenya, 2003

The table shows that most members of NSSF are not ready to wait to retirement age in order to access the old age benefit. Only 27 % of benefits payable to NSSF account for old age benefit while most members would rather access withdrawal benefits which accounts for 57% of the total benefits.

It is estimated that only 30% of the registered members actively contribute to NSSF.[66] This has exposed NSSF to serious funding problem. The reason for such low compliance by members is due to lack of incentive to the members to participate in the scheme, the lack of online or real time information system to track member contributions and inadequate enforcement capacity in NSSF as regards the collection of contributions. As a mandatory national provident fund, contributions to NSSF should be actuarially determined with a view of guaranteeing at least 25% of the pre-retirement earnings as old age benefits. In Zambia it requires a contribution rate of 10% of total contributions to fund a pre-retirement earnings replacement of 40%.[67] The rate of contribution in Zambia may be justifiable because supplementary private occupational schemes are almost absent in Zambia. In Kenya where private occupational pension schemes are vibrant and encouraged by government policies, a total rate of contribution of 5% capped at Kshs. 2000 per month and shared equally between employee and employer will improve the benefits to members.

[66] World Bank (2003): *Kenya Financial Sector Assessment Program* (unpublished report, 2003) p.9
[67] ILO: Social Security Programs around the world, 2000

The effect of inadequate funding means that the net assets and investments of NSSF are decreasing such that NSSF will not be in a position to finance the payment of benefits and hence raising serious legal issues. There are legal questions as to whether funding deficits in NSSF which may have arisen due to poor collection of contributions, imprudent investments of the contributions and high administrative expenses can be financed by tax revenues especially when the scope of the benefits from NSSF only applies to a small population of Kenyans in formal employment. It will be unfair to make Kenyans pay for the past mismanagement of NSSF. It would thus be fair and socially just to restrict the funding of any deficits in NSSF to its registered members.

The actuarial valuation conducted on NSSF in 2002 concluded that NSSF had unfunded liabilities of Kshs. 17 billion. According to the actuarial valuation, the funding ratio was 65%. This funding deficit means that the promise to pay statutory benefits is always at a risk unless the legal and institutional structure of NSSF is overhauled in order to rid the Fund of inappropriate leakages of the members' funds.

2.3.3 Funding Problems in Private Occupational Pensions Schemes

Section 32 of the Retirement Benefits Act (Act No. 3 of 1997) obligates all retirement benefits schemes in the country to be funded except the civil service pension scheme. Each pension scheme therefore, must have a fund into which all contributions, investment earnings and all other moneys payable under the scheme shall be paid. Under the same section, the Minister is mandated to make regulations with regard *inter alia*, funding of pension schemes.

The assets of these pension schemes are held by trustees as legal owners but for the benefit of scheme members. Regulation 10(4) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000 requires that payment of contributions in respect of members to the scheme shall be made by the

10th day of every calendar month or before any other day that may be notified and approved by the Authority in writing. The obligation to collect the contributions payable to the scheme vests on the Trusts of the scheme.[68]

Sponsors of these schemes are expected to deduct the payable contributions at the payroll and forward the amount together with employer's contributions to the custodian of the scheme within the tenth day of the calendar month. The trustees have both a statutory and trust obligation to ensure that the correct amount of contributions based on correct pensionable emoluments have been remitted to the custodian of the scheme. In the event of default by the sponsor to remit the amount, trustees have a legal obligation under trust law to recover the amount owed by the employer through a judicial process in court.

The Retirement Benefits Act does not prescribe the amount of contribution payable to the scheme. The Retirement Benefits Occupational Schemes Regulations only require schemes to prepare and maintain a schedule showing the rates of contributions payable by or on behalf of the sponsor and members. The Regulations in the case of defined benefit pension schemes require that contributions shall be first certified by an actuary and approved by both the trustees and the sponsor. Any revision of the rate of contributions shall be first approved by the sponsor and the trustees and also certified by an actuary.

The special treatment of defined benefits (DB) schemes in terms of funding can be understood. As opposed to defined contribution (DC) schemes, DB Schemes carry guarantees which the sponsor is responsible to fund at all times the scheme is in existence. Because the benefits to members are defined in the scheme rules and therefore operating as a promise to the members, the rate of funding of the scheme has to be determined by an actuary in order for the scheme to adequately ascertain its financial viability to satisfy the defined benefits. The legal requirement for the certification of the rate of contributions in a defined benefit scheme is thus intended

[68] Koskie M., Barristers & Solicitors: Current Pension Issues and Trends. www.koskieminsky.com

to ensure that the funding of the scheme is adequate enough to satisfy the promised pension benefits.

In the case of DC schemes, the scheme rules do not define the benefit, but instead, the rate of contribution is defined. Members of a DC scheme are therefore entitled to a benefit arising out of the defined contributions of a member, the sponsor and the investment income that may have been accrued in respect of the contributions. In such a case, there will not be any need of an actuarial certification of the contributions as the member of the scheme carries the risk of investment of returns and the employer's obligation is discharged after the correct contributions have been paid to the scheme.

In order to ensure that pension schemes are solvent at all times, the Retirement Benefits (Minimum Fund Level and Winding up of Schemes) Regulations, 2000 sets the minimum funding level of Occupational Pension Schemes to be when the assets of the schemes are at least 80% of the value of accrued liabilities or when the scheme is able to meet its liabilities as and when they fall due. To ascertain the level of assets in relation to the pension scheme liabilities, a defined benefits scheme has to undergo regular actuarial valuations. In the case of DC Schemes, the funding level is determined when the scheme's assets match equally with its pension liabilities. However, the aforesaid funding levels assume that the scheme is a going concern. On a going concern basis, valuations of the pension scheme are premised on an assumption that the scheme is an indefinitely continuous entity and therefore, long term assumptions can be relied on in determining the funding level of a scheme. Such assumptions include; (i) expected investment rate of return on pension members, (ii) the life expectancy of pension members, (iii) the anticipated rate of salary increases, and (iv) the rate of inflation if the benefits are indexed. In principle, the said actuarial assumptions are stable over the short to medium terms, and hence will lend stability to pension scheme funding costs.

The situation can be different in the case of a solvency valuation. The solvency valuation will test whether a pension scheme has sufficient assets to satisfy all its liabilities as of the date of the valuation. A solvency valuation is premised on a wind up of the pension scheme.

Regulation 4(1) (1) (ii) of the Retirement Benefits (Minimum Funding Level and Winding up of schemes), Regulations, 2000 prescribes a funding level of schemes on a solvency basis i.e. the ability of the scheme to meet its liabilities when they fall due. The requirement calls upon trustees to assume the day of valuation as the day the scheme is being wound up and then test whether the assets they hold can meet the liabilities of the scheme in the form of payment of benefits. If the assets cannot match the liabilities, then the solvency valuation shall disclose a funding deficiency which the trustees and the sponsor of the scheme would be required under the law to address and eliminate.

The two valuation bases present two very different sources of problems. The going concern valuation basis is plagued by a tendency to make overly aggressive assumptions that reduce the projected cost of benefits. Actuaries, although hired by trustees are often paid by the scheme sponsors to carry out statutory actuarial valuations. They could thus find themselves under pressure from sponsors to adopt assumptions that will result in low pension funding costs. Consequently, actuaries find themselves in a conflict of interest and therefore, unable to objectively evaluate the funding level of a pension scheme in an effort to favour the sponsor in terms of financial obligations to the scheme.

The problem thrives because the legal framework of the pension system does not prescribe powers to the regulatory authority to subject the actuarial profession and actuarial assumption to closure scrutiny. At the same time, the law does not prescribe acceptable ranges for actuarial assumptions for purposes evaluations of pension schemes funding levels.

The challenge of solvency funding is different. Solvency funding is based on winding up of the pension scheme but which may never occur. If a wind-up of a pension scheme occurs, solvency valuation presumes and indeed Regulation 5 (11) of the Retirement Benefits (Minimum Funding Level and winding up of Schemes) Regulations, 2000, requires that accrued members be transferred to an individual pension plan to purchase a retirement. In the case of pensioners, the trustees will be required to annuitize its liabilities to enable the pensioner continue receiving a pension.

This can be done if the assets of the scheme are sufficient to match the accrued rights of the member or buy annuities. The annuities market is very thin in Kenya. The market for indexed annuities is too non-existent. Besides, annuities are priced based on very conservative assumptions like, for example, the assets used to support an annuity will be invested only in conservative government bonds. Equally, the price of annuities is high because of how conservatively annuities are priced in order to reflect a profit margin for the insurance industry. Pension laws in Kenya do not regulate the annuity market. The laws also do not require the protection of pension funds from the risks of under-funding by way of insuring the assets.

Another problem that faces Private Occupation Pension Schemes as far as funding is concerned is non-remittance of contributions to the scheme by the sponsor. Un-remitted contributions create a funding deficiency in a scheme and a member's right under the law in terms of benefits is exposed. This is occasioned by the loss in both the principle and investment of the contributions which are not remitted to the scheme for investment.

The under-funding of the scheme is compounded when the employer becomes insolvent. The amount of the under-funding ranks only as an unsecured claim, and its chance of being paid is only after all of the company's secured creditors have been paid in full. A pension scheme is not a secured creditor in the event of winding up

of a company which sponsored. Pension scheme members are therefore, exposed to a funding risk in the event of insolvency of the sponsor.

An amendment to the companies Act (Cap 486) in 2003 however, improved the situation when it provided that unpaid retirement benefit contributions and vested benefits should be given equal priority to that of accrued but unpaid wages or salary in the event of winding-up of the company. That treatment of unpaid contributions to the scheme does not raise the claim above that of secured creditors who will always have higher ranking after statutory claims.

Occupational pension schemes sponsored by government parastatals for their staff are largely under-funded because most of them depend on government budget allocation to, *inter alia,* fund their pension schemes. In most cases the government allocation to parastatals is inadequate and hence exposing the parastatals to failure in funding their pension schemes. By 2003, pension schemes sponsored by government parastatals were under-funded to an amount of Kshs. 30.7 billion.[69]

Other factors that affect the funding level of private occupational pension schemes are inadequate investment strategies and uncontrolled operational expenses which in most cases can be very high.

Some legal issues that arise out of these funding problems relate to; judicial view on the duty of an actuary who is determining the funding level of a pension scheme and the ability of trustees to sue the employer for un-remitted contributions. It is not very clear in Kenya's judicial system what attitude the courts would adopt when adjudication involves a judgment on the actuarial assumptions adopted by an actuary who is a professional. The problem gets complicated when the dispute is over a given method of an actuarial valuation of a pension scheme is adopted by an actuary as opposed to another method probably preferred by the members.

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[69] World Bank (2003): Kenya Financial Sector Assessment Program (unpublished report, 2003) P. 31 - 35

In an English case[70]the court in addressing the issue of applicable actuarial methods adopted by an actuary in determining the transfer values of members of a pension scheme said that; (i) the method of calculation is entirely a matter for the actuary provided the actuary uses a method acknowledged by the actuarial profession (ii) the method used makes no difference to the welfare of the scheme members, and (iii) the past service reserve method deals adequately with the entitlements and expectations of members.

The court appears to be reluctant to prescribe an actuarial method for the determination of the funding issues of a pension scheme and instead prescribes broad factors for consideration as an actuary considers a method to apply in evaluating the fund value of the pension scheme. But at least the court guides that the method adopted must be acknowledged by the actuarial profession and it should not diminish the benefit expectations of members.

On the issue of the trustees' capacity to sue the sponsor for the recovery of the unpaid contributions, the law[71] requires that the scheme rules provide for the mode of recovery of unremitted contributions which will include the treatment of unremitted contributions as a civil debt recoverable summarily by the scheme. The challenge Trustee will face is the composition of the members of the board of trustees. Regulation 8(1) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000, requires members and the employer to nominate trustees to the board of the trustees. In most cases the employer will appoint the chief executive and the senior managers of the employer as trustees while the members will nominate union representatives to the board of trustees. Such a composition of the board of trustees will unlikely resolve to sue the employer for unpaid contributions because the chief executive or his senior officers will be trustees themselves and they will not "sue" themselves. The member representatives in the Board of Trustees will be reluctant to sue the employer for fear

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[70] Re Imperial Foods Pension Scheme (1986) 1 WLR 717

[71] Regulation 7(L) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000

of being terminated from employment. The capacity of trustees to sue for the recovery of the unpaid contributions is thus limited under the current legal arrangement and does not avail a solution to the existing funding problem. However, in a composition of the board of trustees comprising independent trustees or pensioners, the possibility of suing for the recovery of unremitted contributions does exist.

These problems are attributable to an inadequate legal framework in the existing pension laws and there is need to criminalize the non-payment of contributions so as to expose employers to prosecution by state.

2.4 Pension Assets Investment

Investment of pension assets connotes that the scheme has assets. The analysis of the problems relating to investment of pension assets does not apply to civil service pension scheme because as earlier discussed, the scheme is an unfunded pay-as-you-go scheme hence it does not have assets. Section 32 of the Retirement Benefits Act (Act No. 3 of 1997) exempts the civil service scheme from establishing a scheme fund because benefits are payable from the consolidated fund. The section however, makes it mandatory for all other schemes to be funded.

The ability of a funded pension to honour its legal obligations of paying pension benefits to its members depends not only on adequate funding, but also the investment performance of the collected contributions. The legal owners of schemes have an obligation to not only pay benefits but also to build up reserves in order to cushion the scheme assets from market risks. The need to prudently invest pension assets becomes more urgent because most pension schemes have undergone reforms which emphasize the role of individual, privately managed defined-contribution schemes where the value of the pension benefit will depend on accumulated contributions and investment returns. These types of schemes are fully funded. Defined Contribution schemes expose members' future pension benefits to risks of

uncertain investment returns which are borne by the members. In an effort to mitigate these risks, regulatory agencies of the pension system have been established to regulate the structure, performance and asset allocation of pension scheme.[72]

The investment of the assets of a scheme therefore, is a core activity of a pension scheme. With regard to a defined benefit scheme, the goal of the investment function is to help the trustees of the scheme generate the highest possible returns consistent with the liabilities and liquidity needs of the pension schemes. Regarding a defined contribution scheme, the main goal of the investment function is to generate gains that accrue to individual account balances in light of investment goals. In light of the foregoing, it is critical that pension assets be prudently invested and regulated.[73]

With regard to mandatory public pension schemes like the National Social Security Fund, their boards set investment policies. These boards are often "tripartite" with representatives from labour unions, employers and the government. While the board may determine overall investment policy, an investment committee is often responsible for more detailed decisions and monitoring and evaluating the investments of the fund, trading and valuations. Most of these types of schemes would carry out the investment function in-house.[74]

The composition of the boards of mandatory public pension schemes often reflects domestic political circumstances because of the political interest on the huge assets of this kind of schemes. The composition of the board of mandatory public pension schemes may be irrelevant as far as investment of pension assets is concerned. For example, in Malaysia during the East Asia financial crisis, the Manathir government used the employees' provident fund to support government projects against the

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[72] Srinivas P.S., Whitehouse, E. and Yerno, J.(2000): Regulating Private Pension Funds' structure, Performance and Investment: Cross-country Evidence (The World Bank, 2000) P. 5.
[73] OECD Final Guidelines on Pension Fund Asset Management (OECD 2005) P. 2 – 3.
[74] Iglesias, A. and Palacios, R.J. (2000): Managing Public Pension Reserves; Evidence form the international experience (World Bank 2000) P. 10

objections of the trustees.[75] Assets of pension schemes in a number of countries in the world have been directed toward infrastructure projects or state enterprises. Whatever the merits of these politically directed investments, these assets often generate below market rates of return.[76]

The assets of mandatory public pension schemes which are often invested in government securities, bank deposits and socially directed investments such as housing, pose direct problems to members of these schemes. The most visible consequence of such investments is the low rate of return. Low returns will hasten the day when benefits will be reduced or when contributions will be raised in order to meet the legal obligation to provide pension benefits. If the design of the public scheme is a defined contribution scheme, members suffer more because the low rate is borne by the member as a risk and coupled with high inflation, the member will receive a benefit which is lower than the contributions made.

Low returns over a long period of time will result in the erosion of the credibility of the system. Members of the scheme will perceive the lost returns as a government tax and seek for ways of evading participation in the pension system. Imprudent investment of pension scheme assets is a reflection of inadequate governance structure of pension schemes.

The problem of imprudent pension asset management in Kenya is attributable to lack of legislation prior to 1997, inadequate governance and inability of trustees to diversify the investment of pension assets. These factors which affect investment of pension assets are discussed briefly.

Firstly, lack of legislation prior to 1997 to regulate investments of pension assets provided an environment where trustees, without any regard to professionalism and accountability, invested pension funds in securities allowable under the provisions

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[75] Ibid P. 11
[76] Ibid P. 14

of section 4 of the Trustee Act. The allowable investment securities under the Trustee Act are a replica of the ancient provisions of the 1925 Trustee Act of England. Most of the allowable investment securities in the Act have been overtaken by modern classes of investment securities which are not only tradeable easily, but also guarantee security of capital and offer favourable investment returns. Owing to lack of legislation trustees used to collect contributions from employees and invested them in low yielding investments. In some cases the market values of the assets were substantially less than what the scheme paid for them.

With the enactment of the Retirement Benefits Act, investment of pension scheme assets is currently subject to statutory requirements intended to introduce professionalism, good governance and accountability. Section 22 of the Retirement Act now requires that only registered fund managers are mandated to carry out investments of pension scheme assets. The fund manager is responsible for providing investment advice to trustees as well as investing the assets of the scheme in such manner as to balance the need for optimizing returns, reducing inherent risks and maintaining sufficient liquidity for the scheme to meet its obligations.

In making investment decisions, fund managers are subject to Table G of the Schedule to the Retirement Benefits Act which sets out portfolio limitations. The purpose of the maximum investment limitations in various investment securities is intended enable diversification, profitability and liquidity of pension assets. Some schemes like NSSF and parastatal pension schemes however have not been able to come out of past imprudent investments. However, investment guidelines under the Retirement Benefits Act were a bold step towards safeguarding the assets of schemes for the benefit of scheme members.

Secondly, inadequate governance which manifests itself through political interference and corporate governance deficits is also to blame for poor pension asset management. Political interference in the operations of NSSF is characterized by political appointments of some persons to the board of trustees who are least

qualified and lack expertise in pension asset management. The political class often tends to focus on narrow political and short-term interests in making appointments or issuing policy guidelines intended to govern public institutions. Taking advantage of discretionary powers conferred on them by legislation, ministers tend to appoint chief executives or board members on political considerations or sheer friendship.

Further, politicians have in the recent past advanced to NSSF expensive social investment policies in housing which have resulted in losses of pensioners funds. In some cases NSSF funds have been used to bail out financially ailing government institutions such as National Bank of Kenya. Such politically targeted investments which often result in low returns, do not necessarily consider the basic objective of NSSF which is to prudently invest contributions and to pay reasonable benefits to members at retirement.

Corporate governance concerns itself with the systems and processes that an entity uses to manage its affairs. The pillars of good corporate governance include: efficiency, effectiveness, accountability and probity or honesty. The whole idea about instituting good corporate governance is to enhance efficiency in operations. The introduction of performance contracting in public service is intended to enhance efficient and effective operations including the management of pension assets and payment of retirement benefits.

As a public body, NSSF need to embrace accountability in its operations. These principles will require NSSF to be accountable to the public by publishing its corporate governance reports, mandates, financial statements and operational processes. Without public accountability, investment decisions will be carried out under obscure management processes. In order to enhance probity, trustees of NSSF and other pension schemes ought to subscribe to codes of best practice in corporate governance. Political interference and poor corporate governance in NSSF has

continued to negatively affect the investment performance of NSSF assets and other parastatal staff pension schemes.

Thirdly, trustees of pension schemes have continued to invest only in domestic securities which are limited in scope. Consequently, assets of pension schemes are often not sufficiently diversified to reduce investment risk and enhance returns. This problem is occasioned by both lack of investment expertise on the part of trustees who under trust law need not have any skill and knowledge to qualify as trustees and also the inability of the domestic capital market to introduce a variety of investment securities in which pension assets can be invested. With limited knowledge in investment, trustees often prefer conservatism when developing the investment policy of a pension scheme which often avoids offshore investment. As a result, most pension assets compete for limited quoted stocks, government bonds and the illiquid property market. In view of high inflation rate, real investment returns are often in the negative.

In order to improve the investment of pension assets there are aspects of the investment guidelines as provided for in the current laws which require further reform. The statutory provisions with regard to investment of pension assets which pose problems are discussed below.

2.4.1 Investments of National Social Security Fund Assets

The Board of Trustees of National Social Security Fund is mandated by Section 27 of the National Social Security Fund Act (cap 258) to invest the assets of the scheme. The provision states:-

> *"All moneys in the fund which are not for the time being required to be applied for the purposes of the fund shall be invested in such investments, being investments in which any Trust fund (or part thereof) is permitted by the Trustee Act to be invested, as may be determined by the Board of Trustees with the approval of the Minister and the Minister for the time being responsible for matters relating to finance. Provided that investment under this section shall be subject to the provisions of section 37 of*

the Retirement Benefits Act, 1997 and any regulations issued under subsection (2) of that section."

The section vest the powers of investment in the Board of trustees and such investments have to be approved by both the Minister for labour and the Minister for finance. This power exposes the Board of Trustees to political manipulation especially when the securities in which they can invest are those prescribed by section 4 of the Trustee Act which is broadly general. The governance of NSSF is thus exposed to political interference when it come to investment making decisions and this interference is attributable to section 27 of the National Social Security Fund Act which requires the Board to seek the approval of the government Minister before they invest. The NSSF Board of Trustees lacks sufficient autonomy in investment decisions within its legislative framework.

The National Social Security Fund Act does not set out clear objectives for the investments of the assets of NSSF. On initial consideration, the objective would seem to be obvious: the funds are being invested in order to increase the amount of money available to pay promised benefits. However in reality, some considerations may come to play when deciding on how to invest assets of the scheme. Some of the considerations that may influence the investment of the assets of the scheme relate to; (i) the promotion of domestic savings and investment which would mean that the assets will not be invested offshore, and (ii) national economic and social development needs which influences decisions on the use of the assets of the scheme. The rationale is that assets of the national mandatory pension scheme when invested in national development, contribute to economic growth, improve the standard of living and ultimately strengthen the conditions necessary for the long-term sustainability of social security programmes. This often results in investments whose rate of return is lower than market returns.

The absence of clarity of objectives with regard to investments and the fact that approval from politicians is required before the Board invests has always exposed NSSF to imprudent investment objectives resulting in frauds and hence financial

losses over the years. In its audited financial statements for the financial year ending 30th June, 2004, NSSF reported a deficit in its assets of Kshs. 511.9 Million. That figure brought the accumulated deficit of the scheme up to 30th June 2004 to Kshs. 15.8 billion. The huge losses NSSF continues to experience can be attributable to the weak legal framework under which the scheme operates especially on the following areas; (i) lack of separation of the powers to carry out investment from those of governance of the scheme. The current arrangement allows trustees who are not appointed to those positions by reason of their expertise in investment and yet required by law to make investment decisions, (ii) lack of legal provisions in the enabling Act stating the clear objectives of investment of the assets of the scheme. The objective of investment of NSSF assets should be to enhance pre-funding in order to increase the value of the assets from which future promised benefits will be paid to members and, (iii) the governance structure of NSSF exposes the Board of trustees to political interference in investment decisions.

The law should shield the board trustees from political interference to enable them have the confidence to make prudent investment decisions which conform to the established objectives of the scheme. Because there will always be a temptation from government to influence the uses of the assets of the scheme, for short-term political purposes, or in some cases for personal gain, the law should make clear provisions to safeguard the use and the investments of the scheme. Although the provision to section 27 requires that NSSF assets should be invested in a manner consistent to the provisions of the Retirement Benefits Act, a number of legal problems can arise in enforcing that provision.

One, the provisions of the Retirement Benefits Act and the Regulation there under became fully operational in 2000 when the assets of NSSF had already been invested in poor yielding securities. The process of reversing that state would not be implemented immediately without affecting the market of some of those securities e.g. property investments. Consequently, NSSF has continued to remain

incompliant with the provisions of the Retirement Benefits Act as far as investment requirement are concerned.

Secondly, section 59 of the Retirement Benefits Act empowers the Minister for finance to exempt any scheme from compliance to some sections of that Act. By a legal Notice No 3 dated 14th January, 2005, NSSF was exempted from a number of requirements of the Retirement Benefits Act. In situations like those, the law simply helps in exposing the assets of the scheme to investments which would not be for the best interest of the members.

By the 30th June, 2004,[77] NSSF was in breach of the Investment guidelines under the Retirement Benefits as follows.

Table 2: NSSF Asset Allocation as at 30th June 2004

	NSSF Asset Allocation	RBA Limits	Variance*
Immovable Property	59.1%	30.0%	-29.1%
Quoted Equities	29.3%	70.0%	40.7%
Kenya Government Securities	7.7.%	70.0%	62.3%
Unquoted Stocks and Equities	2.5%	5.0%	2.5%
Fixed Deposits, Time Deposits and CDs	1.3%	30.0%	28.7%

Note *: Negative variance denotes non-compliance with the RBA investment guidelines

Source: NSSF Audited Financial Statements, 2004

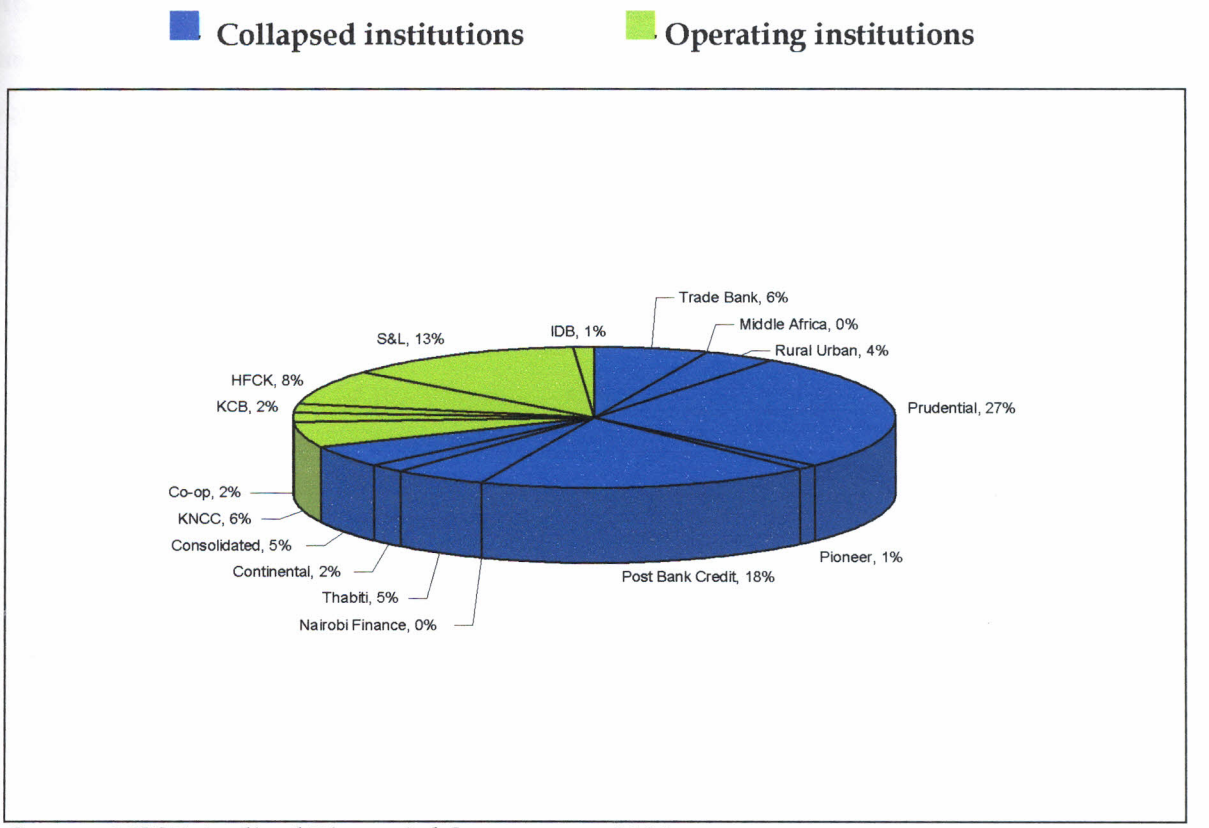
Section 38 (1) (c) of the Retirement Benefits Act provides that no scheme funds should be invested in institutions with a view of securing loans, including mortgages, at preferential rate of interest or for any other consideration to the sponsor, trustee, members or the managers or the scheme. But, NSSF had by the 30th June, 2004 deposited Kshs. 256 million in Savings and Loan as lien to secure staff mortgages. The amount deposited does not attract market rate return. The scheme

[77] NSSF Audited Financial Statements for the financial year ending 30th June, 2004.

has also deposited Kshs. 94 million in the same institution to enable staff secure cheap car loans[78].

The over exposure in the real property assets has exposed NSSF to substantial losses as a result of downturn in the property market and purchases of properties at prices that exceed market valuations due to political influence. As at June 30th, 2000[79] NSSF had made substantial deposits as shown in the table below in financial institutions which have since collapsed.

Table 3: NSSF DEPOSITS IN FINANCIAL INSTITUTIONS, JUNE 30, 2000



Source: NSSF Audited Financial Statements, 2000

From the foregoing, National Social Security Fund Act is inadequate in safeguarding the investments of NSSF as it leaves the role of investment to the Board of Trustees which is least qualified to make prudent investment policies. There is therefore,

[78] Ibidi

[79] NSSF Audited financial statements for the financial year ending 30th June, 2000.

need to reform investment provisions in the National Social Security Act and the Retirement Benefits Act to enable prudent investment practices of the assets of the scheme.

2.4.2 Investment of Assets of Private Occupational Pension Schemes

The broad mandate of managing the assets of a private occupational pension scheme is vested in the board of trustees of that scheme. Section 37 of the Retirement Benefits Act requires trustees to establish and maintain a prudent investment policy. The trustees have a statutory obligation to preserve the assets of the scheme and to invest judiciously *"so as to maintain the capital funds of the scheme and to secure market rates of return in the investment of such funds."* In doing so the trustees must therefore; (i) balance the interest of preserving the capital of the trust with the interest of increasing its income (ii) balance the interests of the scheme sponsor with that of the scheme members and at all times act impartially and in the best interests of the beneficiaries (iii) take sound professional advise on investment of scheme assets and, (iv) conduct the business of the pension scheme in accordance with sound business practice and the law.

Further, section 38 of the Retirement Benefits Act requires trustees of schemes to keep the assets of the scheme separate from all other funds. The section restricts the use of the assets of the scheme in that the trustees cannot use the assets to; (i) make direct or indirect loans to any person (ii) invest contrary to prescribed investment guidelines, and (iii) invest with banks, non-banking financial institution, insurance company or building society with a view to securing loans at preferential rate of interest or for any other consideration to the sponsor, trustees, members, or the manager or the scheme.

Section 22(2) of the Retirement Benefits Act requires that assets of schemes be managed for purposes of investment by a legal person called a manager of a scheme fund. Section 2 of the Act defines "manager" to mean *inter alia*, "a company whose business include *"undertaking, pursuant to a contract or other arrangement, the*

management of the funds and other assets of a scheme fund for purposes of investment." [80]Under the same section 22, a fund manager is required to be registered by the Retirement benefits Authority before being engaged by the trustees to invest the assets of a scheme. For purposes of investment of scheme assets, a manager is an agent of trustees and that is why a manager is appointed by trustees under a contract or other arrangement to render that professional service.

In the development of the investment policy, trustees are guided by Regulation 37 of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000 which requires that trustees must set down; the asset allocation policy, risk tolerance policy, and the asset realization policy. The Investment Policy must therefore indicate the broad policies of how the pension assets are to be allocated, realized and what levels of risk tolerance in asset allocation is to be adopted. This policy guides the fund manager on a day-to-day function of investing scheme assets and, according to the said Regulation, it is revisable by trustees after every three years. To enable trustees prudently develop the investment policy, Regulation 37 stated above shields the trustees from the influence of the sponsor by ensuring that the sponsor's consent on asset allocation is not required. This enables trustees to have the independence in determining the asset allocation policy.

At the same time, the same Regulation requires trustees to seek the advice of an investment advisor in the course of developing the investment policy. The Act does not define who an investment advisor is. The lack of a legal definition of an investment advisor will expose the investment of pension scheme assets.

Part of the investment policy is the manner of appointment of a fund manager, the range of the manager's activity and mandate and monitoring performance of such manager. Some other aspects of the policy which relate to the fund manager include the cost of asset management and related activities including research and transaction costs. Because the Act does not define what it means by an investment

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[80] Section 2 of the Retirement Benefits Act (Act No. 3 of 1997)

advisor who is allowed to advise trustees in the formulation of the investment policy, trustees will tend to engage the fund manager to develop an investment policy which trustees will rely on in appointing the manager, monitoring the manager's performance and costs.

This discloses a conflict of interest in the investment of pension scheme assets and portends a great risk in the assets of the scheme. The fund manager, taking advantage of trustees who lack the technical skill to appreciate the contents of the investment policy, will develop a compromise investment policy which will not reflect clearly the financial objectives of the scheme assets and the manner in which those objectives will be achieved. The investment policy will probably be tailored to meet the achievable mandate of the same manager, provide cost guidelines that favour such manager and incline to asset allocation policies in which the manager will have interest in. The effect of this position is that investments of the scheme assets will be carried out to suit the interests of the fund manager and not those of the sponsors and the members who participate in the funding of the scheme.

A reform of that fundamental legal anomaly in the provisions of the Retirement Benefits Act will help improve pension assets investment governance and seal possible investment frauds of those assets. Section 38 of the Retirement Benefits Act makes provision for the prescribing of investment guidelines. These guidelines bind the trustees and fund managers in the investment of pension scheme assets. The following table shows the assets allocation guidelines as prescribed in Table G of the schedule to the Retirement Benefits Act.

Table 4: Asset Allocation as per the prescribed guidelines

	Securities	Allowable maximum portfolio limit (%)
1.	Cash Deposits	5%
2.	Fixed deposits, Time Deposits or call deposits	30%
3.	Corporate paper and Bonds	15%
4.	Kenya Government Securities	70%
5.	Quoted equities	70%
6.	Unquoted equities	50%
7.	Off-shore investment	15%
8.	Investments in Real Property	30%
9.	Guaranteed funds issued by approved issuers	100%
10.	Other investments approved by the Authority	5%

The investment guidelines which set portfolio limitations are intended to restrict the range of asset allocation strategies by establishing quantitative limits on investment, typically by asset class. The limits are established as maximum permitted levels of investments in various asset categories. The general intent of such portfolio limits is to implement the prudential principles of security, profitability and liquidity of the assets of the pension system.

The investment guidelines are silent on the issue of maturity and liquidity matching requirement in investment of pension assets. Security of pension assets is achieved by two processes; Matching and diversification. Matching involves identifying types of liability in the scheme (e.g. membership profile) and seeking to guide investments whose value matches that of the liability in question. This is important for two reasons. First, if the assets and liabilities are not matched, the scheme may find that it cannot meet liabilities when they fall due, or can only meet pension liabilities by selling assets at unfavourable terms. Second, mismatch has implications on the contribution rate. If the assets increase in value substantially more than liabilities, then the pension scheme shall have a surplus. A surplus in a scheme is not always a positive position in a scheme. There is always a legal question as to who owns a pension scheme surplus. If the assets in the pension fund exceed the amount

required to secure the promised benefits, the employer may wish to have a contribution holiday or members may desire to have their benefits augmented. The question "who owns the pension fund surplus?" is a question about the ability of the parties to enforce these conflicting claims under a scheme's existing rules, or to secure changes in the scheme rules which will enable them enforce the conflicting claims.[81]

However, more worrying in the event of mismatching of assets and liabilities when carrying out investments is if the assets are outstripped in value by liabilities. This will create a deficiency in the scheme. According to Martin and Grundy (both actuaries)[82]

> *"The primary objective of the trustees will be to invest the scheme monies in such a way as to ensure that the scheme will always have resources available to meet its liabilities to pay benefits as and when they fall due at all times in the future, and in so doing, to take account of the risk factors inherent in any investment situation."*

Scheme trustees under the current legislation are not under an obligation to consider the matching of assets and liabilities as a factor when investing assets of the scheme. The effect of the lack of this legal requirement is that assets are invested just to satisfy the broad investment guidelines of the law but not for the specific objectives of the scheme which are unique from one scheme to another.

The investment guidelines have limited off-shore investments to 15% of the total value of the pension scheme assets. Further, the limitation extends to the type of assets that can be invested off-shore. According to Table G of the schedules to the Retirement Benefits Act, a scheme can only invest in deposits, quoted equity and rated bonds off-shore. The restrictive limitation appears to be based on political-economy factors rather than sound investment principles. The limitation has the capacity to undermine the profitability objective. Off-shore investments offer possibly the widest diversification and thereby allow protection against systemic

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[81]Nobles, R., Pensions Employment and the Law (clarendon Press, Oxford) P. 166-167
[82] Ibid p.175

country risk. This class of investment also allows access to assets that are not locally available. The justification of the restrictive limitation of off-shore investment is hard to establish other than political economy considerations which ignore aspects of prudence. A reform of the limitation will improve the asset base of the pension system in the country.

While market values of tradeable securities can be easily determined, some securities such as real property investments are not easily determinable. The current legal framework on the valuation of pension assets especially real property market is inadequate. Regulation 34(2) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000 leave the valuations of real property assets to land estate valuers. The law does not set down the factors of consideration in carrying out the valuation or even the methodology of doing so. The lack of statutory guidance in the valuation of real property assets has often resulted in the investment of pension assets in low yielding investments. In some cases the market value of the assets is substantially less than what the scheme paid for them such that when they are liquidated members' benefits are basically eroded. The current provision on valuations of real property investments need to address the problem of subjective valuations which often mislead pension scheme members as to the worth of the pension scheme base.

The portfolio limits set out in the Retirement Benefits Act, while allowing the fund manager to make asset allocation decisions in the prescribed limits, does not give the manager the required broad authority to invest pension scheme assets in a prudent fashion in light of particular needs of the plan of the scheme. The law does not permit the manager to invest scheme assets under the standard of a prudent person. A fund manager, who under the law has to be registered by the regulator after having satisfied the technical, institutional and capital requirements, is a skilled person with knowledge in asset management. Restrictive portfolio limits presupposes that even after the fund manager has been approved by the regulator is not prudent enough to undertake investments of pension assets with the skills and

knowledge of an 'expert'. The current portfolio limits can easily be complied with by ordinary trustees without the skill in investment. The idea of requiring an expert to make day-to-day decision on asset allocation mean that this expert is a prudent person and will execute his functions on fiduciary basis i.e. with an obligation to make investments decisions in the best or sole interest of the scheme members and the sponsor. This will justify the asset management cost payable to fund managers.

It is argued that the portfolio limits need to be re-written with a view of allowing fund managers to apply their expertise as prudent persons or experts in pension assets management. The current legal framework on portfolio limits restricts the application of expert knowledge of fund managers in asset allocation while they are paid for allocating assets in securities that are clearly spelled out in the law.

2.5 Weaknesses in the Enforcement Mechanisms of the Law

Before considering some of weaknesses in the enforcement mechanisms of the law in Kenya's pension system, by way of introduction a conceptual approach to supervision of the pension system is considered briefly.

Firstly, it can be argued that other institutions that supervise the financial sector such as central banks, revenue collection authorities, capital markets regulators and insurance supervision agencies carry out most of the activities of a pension supervision agency. If the argument is correct, then it is a moot issue whether there is a need of specialist regulator of the pension system. However, the need to encourage savings to provide for old age income is a state obligation intended to ensure citizens are not subjected to poverty in old age. In view also of the fact that some of the pillars of saving for old-age income are mandatory like in the case of NSSF, the state has a responsibility to ensure that pension fund management meets some basic rules and is carefully supervised.

Secondly, a specialiased supervisory agency for the pensions sector, capital markets, insurance sector and social security will have a unique combination. In Kenya, there is lack of prior experience of regulating a system with such complex interactions. At a minimum therefore, some formalized degree of co-ordination between different agencies would be necessary.

Thirdly, in cases of a reformed pension system, some of the aspects in the new pension system such as investment of pension assets were un-regulated in the past. The National Social Security Fund which is a national mandatory provident fund was until 2000 un-supervised with the assumption that standard government audit procedures would suffice. But this has proved wrong in many cases and assets of the scheme have been lost owing to imprudent investment and in some cases, fraud.

Fourthly, reforms of the pension systems create a higher expectation on the stakeholders of the system that the problems that had bedeviled the system would be eliminated. Therefore, in order to ensure the public expectation is met, a regulator to enforce the law is a desirable thing to do.

The next question that arises is the design of the supervisory system that needs to be adopted. The options in designing the supervisory system are between proactive and reactive models. The first approach involves detailed regulations of most activities of pension schemes and service providers. Supervisory and auditing activities must be detailed and well defined. The aim is to prevent possible wrong doing. The second option relies on self-regulation, with reduced instructions from the supervisors. Trustees of pension schemes in this approach are assumed to have right incentives for adequate self regulation.[83] The state intervenes only in few cases where pension schemes fail to abide with the regulations. In the reactive model, sanctions and penalties for violating the system's rules and the law need to be heavy.

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[83] Gustavo D. and R. Rofman, R. (1998): Supervising Mandatory Pension Funds: Issues and Challenges (World Bank, Social Protection Discussion Paper series No. 9817, 1998) p.6

In Kenya, the Retirement Benefits Act to a large extent prescribes a proactive approach to supervision of Kenya's pension system. The Retirement Benefits Act requires all pension schemes except the civil service pension scheme to make regular returns to the Authority. Those returns include; quarterly record of contributions, quarterly investment reports, annual audited accounts, actuarial valuations of all schemes with guarantees of benefits after every three years and scheme rules together with any amendments thereto. These returns enable the Authority to analyze the compliance status of the scheme to enable a proactive action in case a problem is noted from analyzed returns.

The approach assumes that the Authority is adequately equipped in terms of both technical and system capacity to efficiently analyze returns of 1350 pension schemes in Kenya[84] to enable prompt and accurate enforcement of the law against defaulting schemes.

The question that arises is whether RBA governance is adequate to enforce compliance of pension schemes with the law. The Retirement Benefits Act (Act No. 3 of 1997) created for the first time an Authority to supervise and regulate the retirement benefits Act. The Authority is a body corporate whose management is vested in a board of directors appointed by the minister and comprised of (a) chairman (b) the Chief Executive Officer (c) the Permanent Secretary in the ministry of finance (d) the Commissioner of Insurance (e) the Chief Executive officer of the Capital Markets Authority and (f) five members, not being public officers, appointed by virtue of their knowledge or experience in matters relating to administration of scheme funds, banking, insurance, law or actuarial studies. The chairman of the board is appointed from these five members.

Save for the broad qualification which these members must posses before they are appointed, the Act does not lay down the process of selection and appointment of

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[84] Odundo, E. (2005): Supervision of public pensions in Kenya (unpublished paper presented at a workshop on public pension's supervision in Costa Rica, 2005).

the directors. The minister is mandated by the Act to appoint directors so long as they are possessed of any of the qualifications set out in the law. A proper and fit test is not required in the appointment of directors and the process of appointment is left to the minister.

While the laying down in the law of the minimum qualification of directors is a positive development, the powers of the minister are too broad in the process and the minister may simply appoint his "friends" so long as they possess the said qualifications. The process therefore can compromise good corporate governance of the Authority especially if they purpose to pursue narrow interests of the minister at the expense of the public good.

The appointment of the Chief Executive is also provided for in section 11 of the Act. The person to be appointed as the Chief Executive is required to have ten (10) years experience in either retirement benefits, accounting, finance, insurance or baking sectors. The appointment is done by the Minister in consultation with the Board of directors. Again the Act does not prescribe the process of appointment. The position is not subject to competitive selection and the minister can appoint the Officer and seek the Board's ratification because the Board is subject to him. The law does not either require the appointment to be subject to a fit and proper test. Any "friend" of the minister with the minimum qualification can be appointment to pursue the narrow interests of politicians.

Corporate governance can be compromised under the current legal framework of appointment of the management of RBA. The pillars good corporate governance are; efficiency, effectiveness, accountability and honesty. The manner of appointing the Chief executive of RBA and its Board of Directors can affect the efficiency of the Authority's operations and hence

lack effectiveness. If the appointment of top management of RBA is carried out in less transparent manner, then the Authority is likely to be unaccountable and less transparent in its operations. This practice will raise issues of trust of RBA in regulating the sector. The law establishing the supervisory agency should therefore provide unambiguous conditions and process under which members of the governing body of the agency can be appointed and removed. In order for RBA to effectively implement its mandate, it should be free from inappropriate interference from the government in pursuing its objectives and meeting its responsibilities. Lack of independence of RBA is attributable to its failure to enforce some level of compliance against NSSF and the Civil service pension scheme.

Further, the Retirement Benefits Act is premised on the assumption that the past imprudent practices in the system would be overcome in a short time of three years from the date of its commencement[85]. Regarding, the National Social Security Fund, the Retirement Benefits Act was not adequately drafted to accommodate the unique features of the NSSF such as its mandatory status, its operation under an Act of parliament with clear mandates to its governing board, the illiquid nature of its assets and many other shortcomings it had gone into before the Retirement Benefits Act was enacted. With the foregoing, an examination of the weaknesses in the enforcement of the law is considered.

2.5.1 Civil Service Pension Scheme

Section 5 (b) of the Retirement Benefits Act mandates the Retirement Benefits Authority to regulate and supervise the establishment and management of pension schemes in Kenya. The mandate does not exempt any scheme from the jurisdiction

[85] Section 57 of the Retirement Benefits Act provided for a three year transition period from the date of its commencement.

of the Authority. However, section 32 of the Retirement Benefits Act exempts the civil service pension scheme from funding requirements.

Without assets, there will be very little that remains for the Authority to supervise except ensuring prompt payment of pension benefits when they fall due. The question then arises whether the Authority possesses sufficient powers to enforce prompt payment of pension benefits to retirees in civil service.

It is important to note that the Pensions Act (cap 189) does not contain extensive provisions on administration procedures or management of the scheme. Staff career files in civil service are manually kept meaning that it takes considerable amount of time to track the career record of a retiree before calculations of pension is commenced. Since the scheme is a defined benefits scheme, record keeping of career files is fundamental in the determination of benefits as they are earnings related.

To solve the problem of delayed pension payments, parliament amended the Pensions Act by adding section 16A which retains a civil servant who has attained retirement age in service and on pay until his or her pension is said. A new section 19A was also added requiring that pension benefits be paid within 90 days from the date retirement. That period conforms to the period provided for in the Retirement Benefits Regulations. The said amendments were intended to hasten the calculation and payment of pension benefits to civil servants. The delay is attributable to lack of statutory provisions on the keeping of career records of staff in the civil service. File history does not follow transfer of workers from one ministry to the other and the law should address administrative and record keeping processes of career files of civil servants.

In view of the many government departments involved in handling the files of civil servants, the Retirement Benefits Authority will not have the capacity to enforce compliance of prompt payment of pensions. Besides, the central government under which the scheme operates will not be threatened with sanctions by the Authority

which is answerable to a department in central government. In any event, the Chief Executive Officer of the Retirement Benefits Authority is appointed by the Minister for finance and thus lacks independence to enforce the law against the government officers managing the civil service pension scheme. Consequently, the Authority is always incapable of enforcing prompt payment of pensions of retired civil servants.

2.5.2 National Social Security Fund

Section 2A of the National Social Security Fund Act (cap 258) provides that the provisions of the Retirement Benefits Act, 1997 shall apply to NSSF. The provision obligates NSSF to comply with the provisions of the Retirement Benefits Act. The implication of the provision is that NSSF is required to abide by the following supervisory requirements under the Retirement Benefits Act:-

(i) Apply for registration to the Retirement Benefits Authority,

(ii) Appoint an external fund manager and a custodian for purposes of investing NSSF assets under section 27 of NSSF Act and the Guidelines set out in the Retirement Benefits Regulations,

(iii) Develop an investment policy which is revisable after every 3 years,

(iv) Undergo actuarial valuations after every 3 years and submit valuation the report to the Retirement Benefits Authority for purposes of ascertaining the funding level of the scheme,

(v) Under Regulation 7 of the Retirement Benefits (Occupational Retirement Benefits Scheme) Regulations, 2000, NSSF, collect all contributions from employers. Section 14 of the NSSF Act specifies sanctions available to NSSF against an employer who fails to remit contributions,

(vi) Under Regulation 30(4) Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000, issue membership statements to all members of the Fund and publish its annual audited financial statements in widely circulating national newspapers.

(vii) Hold annual general meetings with its members

(viii) Submit quarterly records of contributions to the Retirement Benefits Authority with a view of ascertaining the level of compliance in terms of contributions remittance to the scheme.

The principle functions of the NSSF are; (i) to enforce compliance against employers particularly in the remittance of accurate contributions on a monthly basis as provided for in section 10 of NSSF Act, (ii) invoke sanctions against a defaulting employer in terms of both non-registration if under the NSSF Act such employer is not exempt person, and in terms of non-remittance of accurate contributions, (iii) investing contributions in accordance with section 27 of the NSSF but subject to the investment guidelines set out in the Retirement Benefits Act as provided for in section 37 thereof, (iv) pay benefits to members as specified in section 19 of the NSSF Act. Section 37 of NSSF Act creates an office of an enforcement officer whose role is to ascertain whether the Act is being complied with by persons who, under the Act, are required to comply with the various provisions of the Act. Enforcement officers have powers to enter any premises and carry out inspections for purposes of ascertaining compliance.

The Above functions of NSSF suggest that the Fund has an internal self-regulatory legal framework for its efficient running and operations. The question that arises therefore is whether NSSF, which is a public mandatory scheme established under an Act of parliament, should be subject to the supervision of the Retirement Benefits Authority. If such supervision is feasible, then it should be clear in the law the extent to which the supervisory legislation should make regulatory provisions that affect the public scheme. Supervision relates to monitoring compliance with the law while regulation involves the making of the law which is to be complied with.

When the government established the NSSF under an Act of parliament, that Act should have been comprehensive enough in terms of its regulation. The current legislative arrangement subjects the Board of Trustees to a number of legislation

outside of the NSSF Act for purposes of its regulatory requirements which in some cases are in conflict. For example, section 32 of the Retirement Benefits Act requires schemes including NSSF to appoint qualified auditors within three months. As a state parastatal, NSSF is required by the Exchequer and Audit Act to be audited by the Auditor General. Only few countries have established supervisory authorities of public mandatory pension schemes. Costa Rica and Honduras are some of the few countries where supervision of public pension schemes has been established under special Acts of parliament.[86]

The compliance of the NSSF to the provision of the Retirement Benefits Act has been slow and minimal. As of May 2005[87] NSSF had not appointed independent investment managers and custodians, while the statutory requirement to, (i) preparation and publication of annual financial statements, (ii) issuance of member benefit statements, (iii) holding of annual general meetings with members, (vi) payment of the statutory levy to the Retirement Benefits Authority and (v) preparation of the investment policy, had been waived under a legal notice by the Minister for finance for one year up to 30th June, 2006. The statutory exemption of NSSF from the provisions of the Retirement Benefits Act by the government demonstrates the difficulties of regulating public mandatory pension schemes where government has an interest. It also demonstrates the difficulties of enforcing the provisions of the Retirement Benefits Act over NSSF which is also established under an Act of Parliament.

The Retirement Benefits Authority therefore faces a number of challenges in its effort to enforce the law on the National Social Security Fund. These challenges include:-

1. **The apparent conflicts between the provisions of the Retirement Benefits Act and the National Social Security Fund Act**

Some of these conflicts include:-

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[86] World Bank: Financial Sector Assessment Program, Kenya (unpublished report, 2003).
[87] Odundo, E, (2005): Supervision of Public Pensions in Kenya (unpublished presentation, 2005)

(i) The powers of NSSF to invest contributions provided for in Section 27 the National Security Fund Act are limited to the powers of trustees under the Trustee Act and the investments are to be approved by the Ministers for labour and finance. The section, however subjects this power of investment to the provisions of section 37 of the Retirement Benefits Act. The broad investment guidelines under that section are published by the Minister for finance without any consultation with the Minister for labour. These guidelines do not make any reference to the powers of investment of trustees under the provisions of the Trustee Act. Certainly, it will be hard to prosecute trustees of NSSF for failing to comply strictly with the provisions of the Retirement Benefits Act investment guidelines as the statutory requirements on NSSF trustees with regard to investment are clouded in an array of legislation which are not harmonized.

(ii) Section 4(4) of the NSSF mandates the Board of Trustees to report to and consult with the Minister for labour on regular basis. The Minister for labour has powers under the Act to, not only make regulations that shall bind the Board of Trustees, but also give government direction on NSSF in accordance with strategic plans of the ministry of labour. On the other hand, the Retirement Benefits Authority which is required to enforce the Retirement Benefits Act on the NSSF is subject to the directions of the ministry of finance. This legislative arrangement dissipates direction and control of the supervisory mandate to the detriment of benefits. It makes it difficult for the trustees of NSSF to discern which government direction they will be required to comply with because certainly the two ministries do not necessarily have a uniform position on how NSSF should be run.

(iii) Section 31 of the NSSF Act mandates NSSF board of trustees to prepare the accounts and submit them within four months to the Auditor-General (corporations) for purposes of financial audit. Under section 34 of the Retirement Benefits Act it requires trustees of schemes to prepare and

have the accounts audited within three months from the end of the financial year and submitted to the Authority within the fourth month of the end of the financial year. The section makes it an offence if a scheme fails to comply with the said provision. Again, the NSSF board of trustees is not in a position to control the period of the Audit of their accounts once submitted to the Auditor General because the Auditor-General operates under Exchequer and Audit Act. NSSF board of trustees is thus subject to supervisory legislation on financial audit which are not in harmony. In the event NSSF fails to comply with the requirement to submit audited accounts to the Authority within four months, it will be legally difficult for the Authority to sustain a criminal charge against NSSF if indeed the trustees had complied with preparation of accounts within four months and submitted them to the Auditor-General.

(iv) Section 59 of the Retirement Benefits Act, weakens further the capacity of the Authority to enforce the law on NSSF. The section empowers the Minister for finance to exempt any person or class of persons from, or extending the period of compliance with the provisions of the Retirement Benefits Act. The Minister for finance has already exercised this power by extending compliance of NSSF with the provisions of the Retirement Benefits Act for a year and the extension ended 30th June, 2006.

The rationale for exempting NSSF from complying from various statutory requirements in January 2005 arose because RBA had issued a statutory direction under section 39 of the Retirement Benefits Act against individual trustees of NSSF. The implication of the statutory direction was that trustees of NSSF could have faced criminal prosecution if they failed to comply with the direction. Owing to the fact that government has an interest on NSSF as a mandatory national provident fund, it had to intervene and protect NSSF trustees from prosecution. In so doing, NSSF

was given time to put in place a program towards compliance with the provisions of the Retirement Benefits Act.

Certainly NSSF has had governance deficits in the past leading to financial losses which could not be corrected in a short time and in appreciating that fact, the minister had to preserve some powers in the Act to enable him intervene and extend the period of compliance with the provisions of the Retirement Benefits Act when deemed necessary.

It is argued that the issue whether or not NSSF should be exempted from the supervision of RBA should not arise because NSSF is a retirement benefit scheme like any other scheme registered under the provisions of the Retirement Benefits Act. The issue which should concern the government is the damage the public would be exposed to when NSSF, as a mandatory retirement benefits scheme, fails to deliver its mandate of providing old age income security. In order to protect the interest of the public in NSSF, RBA should be granted more supervisory powers over NSSF to include carrying out efficiency monitoring and forensic inspections on the Fund's financial management.

If any exemption of NSSF from some provisions of the Retirement Benefits Act is to be considered, then RBA should under law be empowered to consider the merit of such consideration against clearly set conditions which must satisfied to earn the exemption. Such set conditions should include a demonstration by NSSF that it has improved the benefits to retiring members and further enhancement of benefits is being hindered by some provisions of the Retirement Benefits Act.

The current legal framework which allows the minister to exempt NSSF from the provisions of the Retirement Benefits Act without any requirement to disclose the merit of the exemption is capable of being

abused to the detriment of the interest of the public which should override the narrow political interests of the minister. The exemption criteria should be set out in the law and RBA mandated to consider the merit of any application for such exemption.

(v) Section 22 (i) of the Retirement Benefits Act outlaws the existence of retirement benefits schemes in Kenya which have not been registered with and issued with registration of certificates by the Authority. Section 22 (2) of the Retirement Benefits Act requires the management of scheme assets to be carried out by registered fund managers and custodians. The NSSF Board of trustees have since not been able to appoint fund managers and custodians. The fund is therefore not registered. The transition period for existing schemes provided for under section 57 of the Retirement Benefits Act expired within 3 years of the commencement of the Act. The Retirement Benefits Act is silent as to what should happen to the continued existence of NSSF which has not been registered as required under that law although its existence is by reason of an Act of parliament. Section 22(4) of the Retirement Benefits Act makes it an offence to establish a scheme contrary to the provisions of the Act. The Section does not address the case of schemes which existed and established under written laws. The mandate of the Authority to register all schemes including those existing on the basis of a written law is a reflection of the wide regulatory and supervisory powers granted to the Authority. It can be legally challengeable to refuse registration of NSSF on the basis that it has not met some requirements set out in the provisions of the Retirement Benefits Act especially because the scheme was established under the provisions of the National Social Security Fund Act.

(2) Historical factors relating to investment of the assets of the fund

The fact that the investment portfolio of NSSF is skewed towards real property means that it cannot easily be rescheduled to fit the investment guidelines set out in the Retirement Benefits Act. Further, any forced sale of those assets on a single objective of satisfying the investment guidelines under the Retirement Benefits Act shall result in losses that would contravene the objectives of NSSF of protecting member benefits and would also contravene section 37 of the Retirement Benefits Act which requires that capital funds of a scheme to be maintained at all times.

The foregoing indicates that the mandate of Retirement Benefits Act to enforce the law on NSSF as a regulatory and supervisory mandate was not well thought out and the legal framework for that purpose is inadequate requiring reforms. The policy makers need to consider whether a supervisor of a public pension scheme should also have regulatory powers of recommending a regulatory law for such public scheme, or be limited to the role of enforcement or supervision of the regulatory law that relates to that scheme. It appears that the problems of NSSF and the Authority relate to the regulatory laws provided for in the Retirement Benefits act which conflict with those in the NSSF Act.

The NSSF Act should thus be amended to include all the necessary regulatory requirements intended to improve its performance to the satisfaction of the public. In that case then the Retirement Benefits Authority, shall be empowered to enforce the regulatory laws set out in NSSF Act. That will make the role of the supervisor to be limited to ensuring full compliance of the scheme with the provisions of the law under which the scheme is established. Other laws that relate to the operations of the scheme should also be harmonized with both the regulatory end supervisory laws.

2.5.3 Private Occupational Retirement Benefits Schemes

Section 22 of the Retirement Benefits Act requires all retirement benefits schemes to be registered with the Authority except those established under written laws. Section

24(i) (a) of the same Act requires that the establishment of these schemes shall be under irrevocable trusts. The requirement to establish private occupational schemes under irrevocable trusts is also one of the requirements for registration of schemes with Kenya Revenue Authority for tax exemption purposes.[88] The general law under which schemes is operate therefore the trust law.

By requiring registration of all retirement benefits schemes the Retirement Benefits Act places all these schemes under the regulatory and supervisory powers of the Retirement Benefits Authority. The conduct of trustees and governance of schemes is subject to the supervisory and regulatory powers of the Authority. Consequently, the following statutory obligations are required of these schemes.

i. Unlike before the enactment of the Retirement Benefits Act, trustees of schemes, pursuant to section 26 of the Act must not be persons, (a) sentenced to imprisonment for a period of more than six months, (b) adjudged bankrupt, (c) previously involved in the mismanagement of schemes, (d) who have been under some other law disqualified to be trustees.

ii. Under section 23 of the Retirement Benefits Act, trustees are obligated to apply for the registration of the scheme with the Authority. This imposes certain requirements on trustees particularly in the type of information required to be submitted to the Authority before registration is granted.

iii. Trustees are required under section 34 of the Act to prepare and submit the scheme's audited financial statements to the Authority within four months after the end of the financial year. The auditor of the scheme's financial states while appointed by the trustees shall require approval by the Authority before commencing the audit work.

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[88] Income Tax (Retirement Benefits) Rules, 1994

iv. Section 35 of the Act requires trustees to prepare actuarial valuations of the scheme of such intervals as the Authority may require. Defined benefits type of schemes shall require regular valuations to ascertain their funding levels because they promise certain level of benefits in the scheme rules.

v. In order to instill prudent management of scheme assets, section 37 of the Act mandates trustees to prepare and maintain a prudent investment policy. Trustees are under an obligation to preserve the schemes assets and to cause the assets to be invested judiciously so as to maintain the capital funds of the scheme and to secure market rates of return in the investment of such funds.

vi. Trustees are required to keep scheme assets separate from their own in section 32 of the Act. This requirement aims at ensuring that the interests of trustees do not conflict with that of the scheme. Section 38 of the Act restricts on the use of the scheme assets by prohibiting making direct or indirect loans to any person or investing the assets contrary to prescribed guidelines.

Under the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000, trustees are required to submit the following returns to the Authority; (i) quarterly records of contributions (ii) quarterly investment returns from both the fund manager and custodian (iii) annual audited financial statements (iv) an actuarial valuation report (v) make an annual levy payment (vi) a copy of the schemes investment policy, and (vii) a deed of amendment of the scheme rules any time they are amended. The Authority is under an obligation to enforce those statutory obligations on schemes. In view of the fact that there are over 1300 schemes in Kenya, the volume of statutory returns in any one given year to the Authority must be enormous.

This raises the question whether the Authority is possessed of technical capacity and adequacy of the operational systems to perform the function of analyzing the returns for effective enforcement of the law. The Authority has 21 technical officers of

whom 3 are either out of country for studies or seconded to other government agencies.[89] Apparently therefore, the capacity of the Authority to manage both off-site and on-site inspection of all the schemes is hampered by staff under-capacity. The problem arises because the Retirement Benefits Act seems to adopt a proactive model of supervision. The Act has made provision for detailed regulation of most activities of the schemes. Returns on most of these activities have to be filed with the Authority at regular intervals in standard forms prescribed in the schedules to the Act.

The current approach of supervision has an orientation to mere compliance and does not address much on the risks faced by pension schemes. Risk-based approach to pension supervision would focus on enhancing internal capacity and systems of schemes to reduce risks that would affect the scheme. The approach would require some degree of self-regulation by the individual schemes while the authority focuses on apparent risks that would expose the scheme to failure. Some challenges faced by the Authority in its effort to regulate and supervise occupational retirement benefits schemes are discussed below:-

1. Enforcing funding requirements.

The Retirement Benefits (minimum funding level and winding up of schemes) Regulation, 2000 sets the minimum funding level 80% and 100% in respect of defined benefits scheme and defined contributions schemes respectively. Defined benefits schemes are required at least to fund 80% of its liabilities at any one time. For defined contribution schemes, because members maintain individual accounts and bear the investment risk of the scheme assets, the law requires that the assets and liabilities must be equal at all times. Under-funding of scheme arise out of a number of reasons such as poor scheme design, poor investment strategy, external factors such as market failure and non-remittance of due contributions to the scheme fund by the employers. The failure to remit contributions to the scheme and poor design

[89] Information obtained from the Human Resource Officer at the Retirement Benefits Authority.

of the scheme are in most cases to blame for under funding of the scheme and the schemes most affected by under-funding are those established by government parastatals.[90] As of June 2002, schemes established by parastatals were under-funded and carrying an actuarial deficit of Kshs. 30 billion which ideally is a government liability in respect of the affected parastatals.[91]

The Authority is empowered under the Retirement Benefits (minimum funding level and winding up of schemes) Regulations, 2000 to enforce compliance with funding requirements within a period of three years on affected schemes. Enforcement of such requirement on state corporations is not possible because these schemes rely on the exchequer for their annual revenues. The Authority will not be allowed to prosecute trustees of a state corporation scheme because that will mean forcing the government to allocate more funds to the parastatals than it could budget. Consequently, these schemes although continuing to operate, have continually remained financially weak and compromising the pension promise to their members besides remaining in breach of the law. There is need to reconsider the funding requirement rule and the design of schemes especially for state corporations.

Further on the issue of funding, the Retirement Benefits Act does not prescribe actuarial assumptions to be used by external actuaries in valuing the funding levels of defined benefits schemes. The Authority is not in a position to legally challenge the assumptions adopted by actuaries in carrying out valuations. The effect of these lacuna in the law is that employers and trustees together with the contracted actuary can agree to use assumptions which could create a surplus in the scheme with a view of enabling the employer enjoy a contribution holiday. The Act therefore needs amendments to provide for standards for actuarial valuations.

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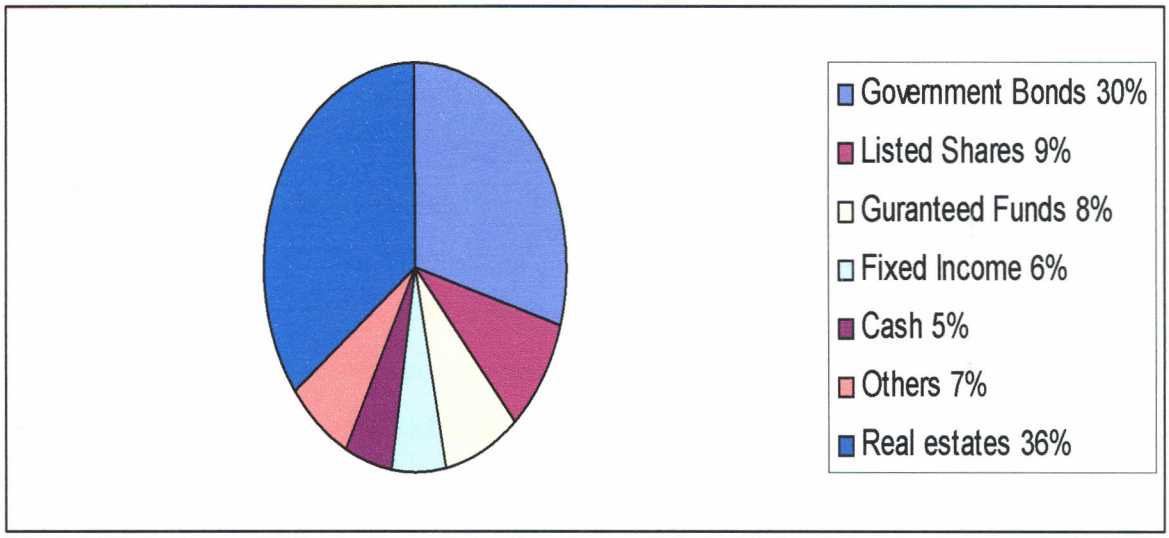
[90] World Bank (2003): Financial Sector Assessment Program; Kenya (unpublished report, 2003)
[91] Ibid

2. Enforcing investments guidelines

The Authority is mandated to ascertain compliance with investment guidelines of all schemes. This supervisory role is dependent on the capacity of the Authority to analyze all the quarterly investment and custody returns. On the basis of time, enforcement of this requirement may not be prompt.

However, most schemes especially those established by state corporations had in the past invested heavily in immovable properties.[92] Enforcement of the investment guidelines to such schemes means forcing them sell the properties in order to comply. The table below shows the allocation of schemes assets as of 2002.

Table 5 : Occupational Pensions Schemes Asset Allocation, 2002[93]



*Source: **World Bank: Financial Sector Assessment report on Kenya, 2003***

Most of the schemes as of 2003 had invested in real property and government securities. Returns from investments in government securities are always below

[92] Institute of Economic Affairs: Charting the future of Kenya's Retirement Benefits Industry; (An Article in the "point", issue No. 51, 2002) p.3
[93] World Bank (2003): Financial Sector Assessment Program; Kenya (unpublished report, 2003).

inflation rates and those investments in real property are illiquid. The process of selling properties where the government has an interest leave alone securing concurrence from government for that purpose will always be a huge challenge on the Authority and the affected schemes. The Authority is therefore unable to enforce compliance with investment guidelines on account of historical imprudence on the investment of assets of some schemes.

The Transitional Regulations under the Retirement Benefits Act which provided for a three year period of compliance from 8th October 2000 was not sufficient. The period appears to have been ambitious and was not based on proper appreciation of the difficulties some of the major parastatal schemes were facing. Because the Authority is unable to enforce compliance with investment guidelines of state corporation schemes, the law needs to be amended to either grant them a longer period of compliance or give them a period within which to convert the design of the schemes to manageable defined contribution schemes.

3. Capacity to prosecute trustees.

The Retirement Benefits Act provides for a number of sanctions that can be invoked against trustees and other service providers if they contravene particular statutory obligations in the Act. The sanctions created by the Act can be grouped into; (i) criminal Offences (ii) appointment of an Interim Administrator (iii) appointment of inspectors (iv) disqualification, and (v) deregistration. For purposes of this discussion, I shall consider the challenges of invoking criminal sanctions under the Act.

The Act creates a number of criminal Offences which arise out of the failure to comply with certain provisions of the Act. The offences created by the Act can be summarized as follows:-

i) **Section 22 (2) -** Failure to register a retirement benefits scheme with the Authority

ii) **Section 22 (2)** - Failure to register a fund manager and custodian with the Authority

iii) **Section 39 (2)** - Acting in contravention of a direction issued by the Chief Executive Officer of the Authority directing stoppage of pursuing unsafe or unsound practices that are deemed to be detrimental to the scheme.

iv) **Section 42 (2)** - Failure to produce any books, account records, documents, correspondence, statements, returns or other information to the inspector appointed by the Authority

v) **Section 42 (3)** - Refusing or failing to comply with a requirement of any inspector; or, obstructing or hindering an inspector in the exercise of his power, or furnishing false or misleading information to an inspector, or making a false statement to him.

According to section 26 of the Constitution only the Attorney General is empowered to institute and undertake criminal proceedings in Kenya or his subordinates but within his general and special instructions. Appreciating the difficulties of prosecuting criminal offences arising out of the breach of the provisions of the Retirement Benefits Act, the Attorney General through a Gazette Notice No 7106 appointed on 18th July, 2003 three employees of the Retirement Benefits Authority to prosecute offences created by the Act.

The Retirement Benefits Authority[94] has not been able to institute a single criminal case against any trustee(s). This is not because scheme trustees are not in breach of the law that creates offences such as non-registration of schemes, but it is largely because the Authority is not in a position to investigate and arrest trustees. Further, the police department who, on the report of the Authority, could have powers to arrest is unwilling to do so as they do not understand offences related to pension schemes. The offences under the Act have therefore not been preferred due to

[94] Information given by the Chief Executive Officer of the Retirement Benefits Authority following a short one-to-one interview.

incapacity and apathy on the part of the office of the Attorney General to prosecute offenders under the Act.

The law enforcement mechanism which vests with the regulatory and supervisory authority is weak and needs reconsideration. The governance structure of the Retirement Benefits Authority makes it operate as a department of the Ministry of Finance. It lacks autonomy because it is answerable to the Minister for finance. Under those circumstances, it is not capable of enforcing the law against the civil service scheme which is also a department in the ministry of finance.

The powers of the Authority as a regulator and supervisor of NSSF are grossly inhibited because of multiplicity of statutory law NSSF is expected to comply with and much of this law is in a number of ways contradictory. Further, the reporting lines of the Authority and NSSF are different with diverse policy objectives. The applicable laws to NSSF need to be harmonized to rid it of the justifiable excuses of non-compliance.

The Retirement Benefits Authority seems to have been successful in enforcing the law against private Occupation Retirement Benefits Schemes. However, provisions of the Retirement Benefits Act do not seem to have taken into consideration the unique situations parastatal schemes had been into before the Act was enacted. Under-funding of these schemes coupled with past imprudent investment practices would acquire a lot more time than the three years transition period envisaged in the Act. The next chapter shall propose reforms to address the discussed problems facing the pension system.

CHAPTER THREE

TACKLING THE ISSUES

In this chapter, possible solutions to the problems facing the pension system in Kenya are discussed. The solutions attempted address the legal weaknesses of the pension system but limited to the problems discussed in chapter 2.

As discussed in the previous chapter, Kenya's pension system covers only formal employees, and faces the problem of unsustainability especially with regard to the civil service pension scheme and the NSSF due to non-funding and under-funding respectively, asset management has been imprudent and the enforcement mechanism of enforcing pension laws is weak. The said problems undermine the basic objective of a pension system which is to provide income security to the most vulnerable in old age.

The regulatory and supervisory authority which is mandated to enforce the law has not been fully effective owing to insufficient capacity, lack of autonomy, its skewed focus to private occupational schemes and the statutory laws which appear to be in conflict. It is on the basis of these problems in the system that the following reforms of the law relating to pensions in Kenya are discussed here below.

3.1 Widening Coverage of the Pension System

As observed in Chapter 2, majority of the population in Kenya is uninsured by the current social security programs. While the level of economic development may be argued to be the determinant factor on the level of coverage, policies adopted by government also affect the level of coverage. The level of development will determine whether the economy shall finance the cost of extended coverage of the pension system or not. However, government policies if not well considered may

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result in low coverage of the pension system. For example, NSSF, although a mandatory contributory scheme, does not extend coverage to workers of an employer with less than 5 workers. That is more of a policy problem than an economic issue. With the establishment of many small and medium enterprises with small number of employees, the population of workers in these enterprises which is not covered under the NSSF is large. The introduction of structural adjustments programs in Kenya in the 1990s resulted in many formal job cuts. Most persons who were laid off from the formal sector joined the informal sector. According to the Government of Kenya Economic Surveys from 1995, employment in the informal sector has been growing from 58% of total labour force in Kenya (excluding small scale agricultural workers) to 70.4% in 2000. During the same period formal wage employment has been declining from 37.4% to 28.4%. The growing informal sector is not covered by any form of pension arrangements except for pro-active individuals who on their own volition participate either in NSSF or individual pension plans under the provisions of the Retirement Benefits Act.

The ILO presents four reasons for extending the scope for social protection.[95]

i. **Legal requirement**: in countries where the rule of law is practiced, basic legal instruments very commonly encompass the following two principles; (a) Non-discrimination (b) relieve of want and prevention of destitution. Therefore the legal provision justifies the coverage expansion.
ii. **Social considerations**: when some classes of people are left out of social protection which they consider essential to their well being, then social cohesion is compromised as people feel discriminated against. Against this backdrop, coverage of social security progress should encompass all members of the population.
iii. **Economic aspects**: expanded coverage might aid labor mobility and flexibility by encouraging people to move out of the state-owned enterprises that are

[95] World Bank (2002): Coverage; The Scope of Protection in retirement Income Systems: (World Bank, 2002) www.worldbank.org

restructuring into small employers where previously this could have entailed the loss of pension coverage.

iv. **Financial Resources:** new contributors will improve the finances of pay-as-you-go pension scheme, especially if coverage is extended to dynamic sectors of the economy e.g. the informal sectors.

There is merit for developing a policy to widen coverage to all formal workers in Kenya and provide incentives to encourage most of those workers in the informal sector to voluntarily subscribe to NSSF or individual retirement benefits schemes. The policy shall include improvement of governance aspects of the system so that the workers both in the formal and informal sector are encouraged to participate in it by saving their income for old age consumption. In order to increase participation in the pension system, the government may wish to consider; (i) offering incentives to service providers of pension schemes who participate in expanding coverage through their voluntary efforts. For example providers of individual pension plans, umbrella pension scheme and occupational pension scheme can be given favourable tax incentives upon attaining a particular number of participants in a given period, and (ii) the provision of a universal social assistance safety net scheme for those who are 65 years and above on a means test basis may help in expanding coverage to a larger population which was never engaged economically in formal employment, and those in self-employment and informal sector who may never be covered in the current formal sector pension scheme arrangements.

On the basis of the foregoing, it is proposed that the following policy and legal reforms may be appropriate in widening the level of coverage of Kenya's pension system to a larger portion of the population.

i. Coverage of the Pension system in Kenya is limited to those in formal employment. It is apparent that coverage of the pension system is influenced to great extent by the level of formal employment. In order for coverage to be widened in Kenya, the government needs to adopt macro-economic policies that

promote creation of more formal employment opportunities. If most of the workers currently in the informal sector were working in the formal sector, they would be under law required to contribute to NSSF. Creation of formal employment depends on favourable economic policies pursued by government such as investor confidence, fovourable fiscal policies and favourable cost of investing in Kenya. Under the current legal framework, in particular the provisions of NSSF Act, rising levels of formal employment will enable more people participate in the pension system.

ii. The current occupational private pension schemes are voluntary and employers are not under any obligation to establish pension schemes for their workers. With weak trade unions and lack of knowledge by majority of workers on the need to save for retirement, very few workers in formal employment are covered. Coverage of those in formal employment can be widened by sensitizing these formal employees on the importance of saving for old age income. It is expected that if the uncovered employees can exert pressure on their employers to establish occupational pension schemes for them and that their contributions are promptly remitted to their pension schemes, there will be a wider coverage of the system to the labour force. The current Collective Bargaining Agreement (CBA) clauses which promise retirement benefits to unioniseable employees from the revenue of employers without having the promises converted to funded pension schemes, has continually exposed employees because often employees wind up and are unable thus to honour the unfunded retirement benefit promises. On the basis of these unfunded CBA retirement clauses, most employers do not have pension schemes for most unioniseable employers. The Retirement Benefits Act should therefore be amended to specifically require the unfunded retirement programmes to be converted to pension schemes subject to the governance structures set out in the Retirement Benefits Act.

iii. A constitutional provision of a means-tested social assistance scheme to cover those outside the formal old age pension system and are poor, will certainly extend

coverage of the system. The scheme will be provided under the laws as a universal and non-contributory scheme as it aims at the poorest groups. However, the provision of universal pensions in Kenya's pension laws and in particular in the constitution to guarantee basic income floor to the elderly shall have the potential to achieve full coverage of the target groups. The advantages of the universal pension scheme which is funded by general tax revenues is that it does not carry social stigma and it avoids administrative costs associated with means-testing.

The scheme poses several other problems chief among them being fiscal problems. Universal flat old age benefits are costly and will become more costly as populations age. To finance a universal pension scheme in a developing country like Kenya requires either, large tax increases or a cut in other important social programs like health and education. The issue of sustainability may therefore scare the government of developing a policy towards the setting up such a scheme. According to Machira (2006), the population of age 55 years and above is currently estimated at 6% (1.9 million) of the total population in Kenya. If eligibility age for accessibility to benefits from a universal pension scheme is set at 60 years then the government can afford to pay US $ 0.5 per day which translates to shs 1065 per month to elderly Kenyans at a cost of 9% of the government revenue on a year-to-year basis. The estimated number of the population aged 60 and above is 1.4 million. That expenditure for the provision of universal old age pensions translates to 2% of gross domestic product.[96] A policy and legal framework to establish a universal pension scheme to provide minimum old age benefits will not only widen coverage but also significantly improve the quality of life of the elderly poor in Kenya.

v. Currently the provisions of the Retirement Benefits Act enable a member of a private retirement benefit scheme to transfer benefits from one scheme to another in the event of change of jobs. The provision enables even those employed on short

[96] Machira, C: Can We Afford A Universal Pension Scheme? The Case for Kenya (A Masters Thesis, University of Maastritcht, 2006)

term contracts to save for retirement because they can keep transferring their benefits from one scheme to another. Often, most employers in determining the eligibility criteria for membership in schemes have often excluded employees on contract on the basis that their term of employment is short. It is argued that the need to cover all formal employees should not be limited because of terms of employment since the current legal framework allows portability of benefits from scheme to another on account of job mobility. The Retirement benefits Act should outlaw discrimination of member participation in a private retirement benefit scheme on the basis of terms of employment.

v. As earlier discussed, if the Kenya Social Pension Trust Bill, 2005 is enacted, a wider coverage to formal workers and to some extent informal workers will be achieved because the Bill proposes to reduce the categories of exempt persons.

The foregoing proposals on how to enhance coverage of the pension system in Kenya requires a rewriting of Kenya's Pension Policy and legal framework which partially has commenced with the publication of the Kenya Social Security Pension Trust Bill, 2005.

The growth of coverage in old age security in Kenya will be primarily determined by the process of economic development. Coverage will gradually grow as contributory pension schemes are broadened to the self-employed and the informal sector. Contributions to schemes put the pension system on a financially sustainable basis to enhance its credibility.

A universal pension scheme will widen coverage to the elderly poor in the society and thereby improving the quality of life of the aged citizens. An enactment of a law to provide for the establishment and administration of such scheme should be considered.

3.2 *Addressing Funding Problems in Kenya's Pension System*

Kenya's Pension System faces challenges of unfunded and under-funded liabilities. The civil service pension scheme is, under the current law, a pure non-contributory pay-as-you-go defined benefit scheme. The NSSF is currently under-funded and thereby raising concerns of its viability.

Occupational Pension Schemes face cases of unremitted contributions from sponsors who could be under financial stress. Most occupational pension schemes established by state corporations are under-funded owing to their reliance on the state to finance their activities including their financial obligations to staff pension schemes. Funding problems have further been compounded by the inability of scheme trustees to collect unremitted contributions from the sponsor because in most cases trustees are the senior managers of the sponsor of the scheme.

The system is therefore unsustainable and its main objective of providing old age income has been compromised. Although NSSF and other defined contribution schemes in the private sector were designed to be fully funded, the civil service scheme and other defined benefits schemes are not designed in a way that is financially sustainable. The civil service scheme relies on tax revenues while other defined benefits schemes need to be at least 80% funded. The legal framework of these pension schemes does not effectively help in ensuring sufficient funding of the pension system so as to honour its mandate. Not the constitution of Kenya or the Pension's Act makes reference to the funding level of the civil service pension scheme. The law assumes that the government shall collect sufficient tax revenues to honour its pension obligations. At the same time, the law does not set out sufficient criteria for determining the funding level of private defined benefits schemes. The actuarial valuations are done by actuaries who use assumptions which are not regulated by any law.

Defined contribution schemes including NSSF carry unfunded liabilities because of weak enforcement mechanisms of the law in regard to the collection of contributions and weak governance structures which result in poor investments. Lack of sustainability of the pension system especially the civil service pension scheme, leads to higher rising budgetary deficit with negative macroeconomic consequences. Secondly, it raises equity question among citizens who have to pay higher taxes to finance the pensions of few members in the population. On the basis of the foregoing, the following legal and policy reforms are recommended to address funding problems in Kenyan's Pension System.

3.2.1. Civil Service Pension Scheme

Section 112 (4) of the Constitution provides that pensions to retired civil servants shall be charged upon the consolidated fund. The 1963 constitutional provision may have been intended to protect the then civil servants and pensioners who were to a large extent whites. It was for the interest of the British when they were negotiating the constitution for independent Kenya, to constitutionally preserve and guarantee pension rights. At that time, the size of civil service could have been small and pension liabilities could easily be met from the general tax revenues. The factors have since changed in the sense that the civil service size has tremendously grown since independence, salaries have increased and it cannot be argued that collection of tax revenues has been proportionately growing owing to economic decline since the late 1980s. Government expenditure on pension benefits since 1993 to 2005 has rapidly grown from Kshs. 1.5 billion to 17.8 billion. The current year's budget for the pension benefit payment is Kshs. 21 billion.[97]

It is therefore appropriate that the civil service scheme be reformed to a fully funded defined benefit scheme. The proposed reform requires fundamental amendments to section 112 of the Constitution and the Pensions Act (Cap 189) Laws of Kenya. The

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[97] Alexander Forbes Financial Services (2005): Actuarial Study on Superannuation in the Public Service Kenya (unpublished, 2005)

constitutional provision will require an amendment to remove pension liabilities from the consolidated fund. The constitution can then only provide for establishment of a funded pension scheme for civil servants under an Act of Parliament. The amendment will then mandate parliament to enact a new Act to provide for a funded pension scheme. The new Pensions Act shall (i) Create a fully funded defined benefit scheme for civil servants while guaranteeing existing unfunded pension rights. (ii) Establish a pension's trust to legally own and administer the scheme on behalf of its members (iii) provide for the governance and management of pension reserves (iv) define pension benefits structure and (v) provide for government obligations in the funding of the pension promises in form of contributions.

In view of current implicit pension debt of the government, the funding of the scheme fully may have serious fiscal implications on the economy. The implementations of the reformed pension laws as they relate to the government's portion of contributions can be restructured for a period that may be deemed as fiscally sound for the entire economy. In order to manage the cost of providing for those pensions, the law should provide for pensions based on career earnings rather than final salary as it is currently. It is argued here that pensions are deferred earnings and therefore these earnings of an employee should be replaced in retirement. Basing pensions on the final salary of a civil servant portrays pensions as extended earnings rather than deferred earnings. An employee's contribution earlier in his career should have the same value when it comes to calculating his pension as his final salary. The final salary principle favours those civil servants whose careers offer a higher salary during the final phase. Their pension will be higher in relation to their career earnings than for those whose salary does not change very much throughout their professional careers. The approach raises equity issues in the scheme. There is also a risk that the final salary principle may encourage

manipulation of an employee's earnings for purposes of achieving an excessively high pension.[98]

A reformed pension law for civil servants should provide for pensions based on career earnings. Because Kenya's financial markets i.e. the stock market and other investment options are underdeveloped the large reserves of the pre-funded civil service scheme will not have sufficient domestic securities in which to invest. On this basis, it is appropriate that the government carries the investment risk rather than a civil servant who has no control on the investment of the scheme reserves. It is recommended that the scheme remains a defined benefit scheme which always shifts the burden to the government to provide the promised pension. The legal liability on the part of government to provide pensions, shall act as an incentive to improve governance of the scheme assets especially in regard to investments of the huge reserves that shall arise from pre-funding.

The current Pensions Act [99] reduces pensions of civil servants to mere privileges and not rights. It means a decision of a government officer can deny a retired civil servant his pension. Although such decisions can be reviewed by a court of law, there is little justification for such provision if pensions are to be viewed as deferred earnings or in the case of unfunded pension schemes, as a trade off for a lower salary in career life in the hope of a higher pension in retirement. It is therefore justifiable to treat pensions as rights that have accrued to members during their working life and such rights should be by law realized at retirement.

In order to introduce a fully funded defined benefits scheme, section 112 of the constitution has to be amended and a new Pensions Act be written to create a funded civil service scheme which should operate on the principles of an occupational pension scheme set out in the Retirement Benefits Scheme.

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[98] OECD: Civil Service Pension Schemes (Sigma papers No 10, 1997) Pans, p. 38

[99] Section 5 of the Pensions Act (cap 189)

3.2.2. National Social Security Fund

According to sections 3, 10 and 11 the National Social Security Fund Act, NSSF is established as a fully funded defined contribution scheme. An individual account for each member is kept in NSSF into which contributions and investment income is credited. Out of the account benefits shall be paid to the member. In that sense, NSSF is under the law, required to be fully funded.

However, as discussed in the previous chapter, NSSF experiences low participation of members although it is a mandatory scheme. There has been poor collection of contributions, poor record keeping of members' accounts and hence NSSF has huge unfunded liabilities. One other reason why NSSF is experiencing funding problems is because of imprudent investment of its assets. The question which then arises is whether the government is liable to settle the unfunded liabilities of NSSF. Questions of legal fairness will arise if the government will tax the rest of the population which does not participate in NSSF to fund the existing liabilities for the benefit of a small percentage of the population.

One of the options being pursued by the board of trustees of NSSF is to convert the scheme to Defined Benefits pension scheme. While a pension scheme is superior to a provident fund, it carries higher financial liabilities than a provident fund. The contributions which will be required to meet the pension liabilities of a pension scheme and to cure the current funding deficits will certainly be high to most employers. With the lack of confidence by employers and employees in the scheme, the raising of contributions will create a disincentive to participate and most employers will look for ways to escape participation in the scheme.

As a short term solution, section 33 of the Retirement Benefits Act can be operationalized by the Minister by prescribing well run private occupational pension schemes to receive and invest statutory contributions otherwise made to NSSF. Prescribed schemes will be in a position to collect and administer contributions and

thereby giving an option to employers and employees to opt out of NSSF. This solution should not be allowed in the long term because the second and third pillars of the pension system should not be in competition. Currently the Minister has not prescribed any scheme to compete with NSSF in the collection of statutory contributions. The recommendation if adopted will enable members to transfer their account balances net of the relevant portion of unfunded liabilities. The unfunded liabilities will remain with NSSF but will not be growing and the government shall assume a fixed liability which it can fund over a period of working life of affected members.

Although section 14 of National Social Security Fund Act prescribes a pecuniary sanction for delayed payment of contributions and section 36 of the Act prescribing criminal sanctions for delayed or non-remittance of contributions, NSSF has not been able to collect all the contributions from the registered members. The analysis of NSSF financial statement for the year ended June 30, 2004 indicates that it accounts for contributions on a receipt basis. It means that NSSF is not capable of determining the owing contributions in order to enforce compliance. This is an administrative problem. In order to address the problem, it is recommended that since these are mandatory contributions and are targeted taxes, the level of collection will substantially rise if collected together with Pay-As-You-Earn (PAYE) under the Income Tax Act (Cap 470) Laws of Kenya. The said recommendation shall mean that National Social Security Fund Act shall be amended to mandate the Kenya Revenue Authority to collect those contributions and submit them to NSSF or its custodian for investment purposes. NSSF shall then focus on the registration of all employers and employees, and pay benefits.

3.2.3. Private Occupational Retirement Benefits Schemes

Under Section 32 of the Retirement Benefits Act, all private occupational pension schemes are required to be funded. However due to cases of non-remittance of contribution's to the scheme fund and inadequate actuarial valuations owing to legal

weaknesses, some schemes are under-funded. The problem is made worse by lack of capacity of the Retirement Benefits Authority to adequately analyze actuarial valuations, cases of employer insolvency, inability of scheme trustees to recover un-remitted contributions through a legal process from the sponsor due to conflicts of interests and inadequate budgetary allocation by government to parastatals.

During the course of writing this project paper, parliament had just enacted an amendment to the Retirement Benefits Act to criminalize non-remittance of member contributions by employers. Under the amendment, employers will be criminally liable for failure to remit employees' contributions to the scheme. While the amendment to a large extent reduces the problem of non-remittance of contributions, it does not eliminate it because the failure to remit the employer's contributions is not criminalized. It is recommended that non-remittance of the employer's contributions to the scheme should be made a criminal offence too. The Retirement Benefits Act should be amended further to extend the offence to the aspect of failing to remit the employer's contributions.

In order to adequately ascertain actuarial values of scheme assets especially those with guarantees, the Retirement Benefits Act needs to provide for legislative guidelines on the applicable assumptions and mortality tables. Currently, actuarial assumptions are left to the actuaries to determine and the possibility of being compromised with employers to present a scheme as adequately funded when it is not, always exist. The law should provide for the range of applicable actuarial assumptions in order to ensure that funding of schemes is not compromised. Due to shortage of qualified actuaries in Kenya, the periodicity of carrying out actuarial valuations should be limited to once after three years to reduce the cost of carrying out such valuations.

Defined benefits schemes established by government parastatals for the benefit of their workers face a more serious funding problem because they rely on government annual budgetary allocation. The government often will not allocate the requested

funds to parastatals and thereby exposing them to operate under financial stress. This often results in sacrificing remittance of contributions to their pension schemes.

The way forward on the problem may entail a government policy requiring all defined benefits schemes established by parastatals to be converted to defined contribution schemes. This policy will enable parastatals reduce their financial obligations to the schemes which often guarantee very generous benefits without sufficient funding. The investment risks of the pension assets will too be shifted to members as their benefits will be limited to the amount of accumulated contributions and investment income thereon. The policy will crystallize the current fund deficits at some determinable amount and the government can plan long term on how to gradually liquidate those past liabilities.

3.3 Addressing Imprudent Investment of Pension Assets in Kenya

The problem of imprudent investment of pension assets in Kenya applies to NSSF and private Occupational Retirement Benefits schemes. The Civil Service Pension scheme, although converting to a funded scheme, has not acquired assets that would require consideration of investment of assets on their part.

The value of funded pension schemes does not depend solely on contributions, but more critically on the investment performance. It could be expected that when contributions are mandatory like in the case of NSSF, the regulation of pension assets will be strict in order to protect members' benefits. This expectation, however, does not appear to be the case in Kenya where trustees of NSSF have in the past been allowed to centrally invest in anything allowable under section 4 of the Trustees Act (Cap 167) Laws of Kenya. The causes for underperformance of NSSF pension assets include[100]; (i) government interference in investment ranging from the imposition of

[100] Iglesias A and Palacios R (2000): Managing Public Pension Reserves PART I: Evidence from the International Experience (the World Bank Social Protection Discussion paper series, 2000) P. 30 www.worldbank.org/sp

social or development objectives on NSSF, such as forcing the fund to finance state corporations e.g. in National Bank of Kenya[101], and (ii) political interference in the management of the fund, so that the fund's investment policy is driven by political motives.

The effect of the foregoing on NSSF is that it has been exposed to deterioration of its financial position. The Fund's asset base has been skewed to illiquid assets in undeveloped land and buildings.[102] The central management of NSSF reserves for purposes of investment avails opportunities to political interference and requires reconsideration. The governance deficits of NSSF do have direct negative implications on NSSF investment strategy. The solution to imprudent investment of NSSF reserves lies in addressing governance structure, the investment policy, external or central management of assets and the reforms of the relevant laws.

Regarding Private Occupational retirement schemes, mandating fund managers to prepare investment policy for the assets of the scheme always portends risks because of the conflict of interest on the part of the fund manager. Investment guidelines set out in the Retirement Benefits Regulations; do not address the issue of maturity and liquidity matching requirement in investment of pension assets. This leaves the fund manager to invest assets in accordance with the statutory guidelines without regard to maturity and liquidity matching requirements in pension assets investments. The objective of investing assets so as to ensure liquidity at a given time to pay liabilities is not addressed in the Regulations.

Further, investment guidelines under the Retirement Benefits Act substantially limit offshore investment. The reason for limiting offshore investment is not on any fundamental economic considerations but issues of political-economy. The limitation denies pension assets a wider diversification which protects scheme assets

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[101] NSSF is a major shareholder of National Bank of Kenya after it converted its deposits in the Bank into equity.

[102] World Bank (2003): Financial Sector Assessment Programme (Kenya, Unpublished report, 2003) p. 12

from domestic market risks. Pension assets also face valuation risks while investing in real property because the law does not address valuation standards. Finally, statutory investment guidelines take away the aspect of a prudent person on the part of a fund manager thereby raising the question whether a pension scheme requires a fund manager. In view of the said challenges facing the investments of pension reserves in Kenya, a way forward is recommended hereunder.

3.3.1. Managing Assets of National Social Security Fund

Section 27 of the National Social Security Act provides that surplus funds of NSSF shall be invested as any other trust funds under the provisions of the Trustee Act subject to the limitations provided for in section 37 of the Retirement Benefits Act. The Section is silent on risk tolerance levels, parameters of asset allocation, parameters to be followed regarding the implementation of the investment policy and investment objectives. The trustees, accordingly, have tended to invest the assets without regard to its security, returns and liquidity.

The appointment of NSSF trustees is not based on their professionalism of asset management. It is a Representative Board which represents interests of government, employers and employees. The other trustees appointed on the basis of their skill in investment are either too view to carry the vote in the meeting of the board of trustees or they do not have any legal power to enable their investment views to bind other trustees. Accordingly the following recommendations will address investment problems of NSSF assets.

i) In view of the high political risk associated with central management of NSSF assets, the National Social Security Act need to be amended to establish an independent investment board. The investment committee shall be a professional committee comprised of investments, finance, economics and actuarial experts with a sole mandate of investing funds of NSSF. The committee should be shielded from ministerial interference and required instead to report to

a committee of parliament. The process of appointing those committee members shall be transparent, credible and beyond reproach. This process should be written in the law to avoid political appointees. The term of the committee members equally should be legislated with clear provisions on the causes and process of retirement, vacation and removal of a committee member.

ii) The NSSF Act should be amended to clearly state the objectives of investment. The investment Board should, under the law have a clear fiduciary duty to (a) manage NSSF funds in the best interests of members and beneficiaries and (b) invest the asset to achieve the maximum rate of return, without incurring undue risks and while taking into account the factors that may affect the funding and ability of NSSF to meet its financial obligations.

iii) Section 38 (2) of the National Social Security Act, provides that Chief Executive of NSSF shall be responsible to the Board of Trustees for the management of the fund. The section does not specify internal governance structures and processes in particular as regards the investment of the assets of NSSF. The broad discretionary powers available to the board of trustees and the chief executive in respect to investment of the assets are attributable to the notable imprudent asset management. Although these are areas of management, the Board of Trustee should be required by law to establish, publish the Fund's broad internal governance structures and processes as a way of promoting transparency and minimizing acts that promote corruption, mismanagement and aspects of fraud.

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iv) The National Social Security Fund Act does not specifically require the development of an investment policy and what the mandate of such policy should be. Although investments under section 26 of National Social Security Fund Act are subject to section 37 of the Retirement Benefits act which requires the development of an investment policy, it is notable that NSSF can avoid compliance with the provisions of the Retirement Benefits Act by seeking

ministerial exemptions. The National Social Security Fund Act should thus be amended to require the board of trustees to develop an investment policy. The policy should be documented and revisable periodically. The law should require that the summary form of the policy should be made available to the members of the fund. The policy should be aligned with the investment objectives of NSSF and should be designed to shield investment decisions from political interference. The investment policy should also state specifically that the purpose of accumulating and investing pension reserves is solely for the benefit of members of the fund. Such statement in the policy will deter political influence in investment decisions which often directs assets to either social development at the expense of members' interests.

The provisions of National Social Security Fund Act need to be fundamentally reviewed to introduce a comprehensive law on governance and management of the assets of NSSF. Legal reforms on governance issues shall address the issue of an independent investment board, the objectives of investments, the investment policy, actuarial valuations and internal processes of the fund intended to improve investment of NSSF reserves for the benefit of the members.

3.3.2. Improving Assets Management of Private Occupational Retirement Benefits Schemes

As intimated in the previous chapter, contributions to a scheme are but one source of the assets which secure the promised pensions to members. The other source of the assets is the return on investments of contributions. In that regard, the issue of investments in a funded pension is fundamental to the continued sustainability of the scheme. An analysis of investment provisions under the Retirement Benefits Act disclosed five problems which require legal reforms of the Act in order to address the problems. The problems are; (i) the reliance of trustees on an "investment advisor" to assist them develop an investment policy when the phrase "investment advisor" is not defined. This has resulted in scheme fund managers doubling up as

"investment advisor" and developing compromise investment policies which do not address the objectives of the pension scheme assets; (ii) the lack of statutory guidelines on the issue of matching scheme maturity and liquidity when considering investment decisions; (iii) restrictive limitations of offshore investments which ignore principles of investment prudence; (iv) lack of statutory guidelines in determining values of investments in real property leading to inappropriate investments of pension assets; and (v) the limitation of the prudent person approach in the investment of pension assets.

The foregoing problems have an effect on the performance of assets of private occupational pension schemes in Kenya. On the basis of the foregoing, the following legal reforms are recommended as an attempt towards solving the said problems.

i. In order to solve the problem of developing compromise investment policies, the Retirement Benefits Act should define who an investment advisor is for purposes of assisting trustees develop an investment policy. The definition should include minimum qualifications criteria of an investment advisor which should include adequate academic and professional skills. The law should indicate that an appointed fund manager of the scheme assets shall not participate with trustees in developing an investment policy because one of the issues the policy addresses is the criteria for the appointment of such fund manager and the benchmarks for the performance of the fund manager in asset allocation.

ii. In order to maintain the security of pension benefits the law should require the matching of maturity and liquidity of pension assets. Matching involves identifying types of liability and seeking to invest in those securities whose value matches that of the liability in question. The investment policy of a private occupational pension scheme should thus clearly provide for the matching of the scheme liabilities and its assets taking into account the maturity profile of the scheme.

iii. The limitation of offshore investments to 15% of the total fund value of a scheme is not based on justifiable economic argument. The limitation may undermine key investment policy objectives such as diversification and profitability. It is argued here that a widened ability to diversify investment internationally should be able to reduce investment associated with domestic market risks. With a slow growth of capital market securities in Kenya, the ever-growing pension reserves will push up the value of quoted stocks without adequate fundamental changes in listed companies. There is justification for allowing offshore investments beyond the current statutory limits. Investment Guidelines under the Retirement Benefits Act need to be amended to allow offshore investment beyond the statutory limit with the approval of the Retirement Benefits Authority. The statutory discretion to the Authority shall enable adequate consideration of relevant factors before trustees are allowed to invest offshore. It is important to appreciate that benefits of offshore investments need to be weighed against national policy considerations such as the use of pension assets as national savings intended to develop domestic capital markets. Also, when investing offshore, political and currency risks should be duly considered and addressed against the objectives of the investment policy. It is recommended that the law should allow offshore investment above the 15% limit but up to a maximum of 25% with the formal concurrence and approval of the supervisory agency.

iv. Investments in real property in Kenya are often a problem because of lack of sufficient statutory provisions in determining the value of real property. This problem has resulted in imprudent investment in real property especially occupational pension schemes established by state corporations. Out of Kshs. 122 billion worth of the asset base of private occupation pension schemes in Kenya, Kshs. 7 billion is invested in real property.[103] The correctness of the values of that class of investment cannot be ascertained with clarity owing to the subjectiveness of property valuations processes by property valuers. The Retirement Benefits Act should make provision for the publication of Regulations to guide the valuation

[103] RBA: RBA News Vol. 5 No. 3 of March 2006 (RBA, 2006) P. 7

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[103] RBA: RBA News Vol. 5 No. 3 of March 2006 (RBA, 2006) P. 7

operate in tandem with the portfolio limits provided for in the Retirement Benefits Act.

3.4 Addressing Enforcement of Pension Law Issues

In order to enforce pension laws, a supervisory agency is required. The agency shall have powers to license pension schemes, monitor and inspect compliance with the law, and enforce corrective measures on a pension scheme contravening the law.

In Kenya, the pension system was not under any supervision until 1997 when the Retirement Benefits Authority was established under the provisions of the Retirement Benefits Act. The Authority was mandated[105] (i) to regulate and supervise the establishment and management of pension schemes (ii) Protect the interests of members and sponsors of pension schemes (iii) promote the development of the pensions sector (iv) advise the government on the national policy to be followed with regard to the pensions sector and to implement government policy relating to the sector. These objectives are wide, and as far as regulation and supervision of pension schemes are concerned, the Authority is required to license and register pension schemes.

Before 1997, the primary legislation relating to the registration of pension schemes was the Income Tax (Retirement Benefits) Rules, 1994. These Rules only relate to very general aspects of pension scheme provisions which are important for the protection of tax revenues. Registration under the Retirement Benefits Act (RBA), does not replace registration under Income Tax Act. Registration under RBA is mandatory while registration under the Income Tax Act is voluntary. Schemes are registered under Income Tax Act for purposes of benefiting from tax concessions available to registered schemes.

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[105] Section 5 of the Retirement Benefits Act (Act No. 3 of 1997).

To enable the Authority enforce the law, pension schemes are required by the law to (i) submit annual financial statements to the Authority, (ii) carry out actuarial valuations and submit the valuation reports to the Authority (iii) Appoint external fund mangers and custodians, (iv) develop investment policies and invest pension assets in accordance with investment guidelines set out in the law and (v) avail information to members regarding the scheme.

The Retirement Benefits Act gives the Authority powers to inspect schemes and impose various corrective measures like the appointment of an interim administrator[106] of the scheme if the trustees are in breach of the law, and also impose various criminal sanctions against the trustees. The Act provides for sanctions some of which the Authority has not been able to invoke in order to raise compliance levels. The Authority's inability to invoke some sanctions such as criminal sanctions is attributable to; lack of capacity at the Authority, conflicting laws under which statutory schemes such as NSSF and the RBA are established, the design and governance structure of the civil service pension scheme and the lack of autonomy to of the Authority in carrying out its statutory mandate.

The capacity of Retirement Benefits Authority to enforce statutory obligations against senior officer in the Ministry of Finance who are in breach of the Pensions Act is in doubt. This is because the management of the Authority is answerable to Treasury senior officers. Also, the Authority's capacity to enforce compliance against NSSF is curtailed by conflicting laws to which NSSF is subject as was discussed in chapter 3. Offences created under the provisions of the Retirement Benefits Act are often not easily appreciated by police officers who will find them difficult to investigate. Probably these shortcomings were not anticipated when the Retirement Benefits Act was being enacted in 1997.

On the basis of the gaps discussed in chapter 3, there is need to consider reforms in the current pension legislation to enable improved compliance with the laws.

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[106] Section 45 of the Retirement Benefits Act.

3.4.1. Civil Service Pension Scheme

The Retirement Benefits Authority does not have the capacity to enforce prompt payment of pensions under the Pensions Act. The pension scheme operates as a department in the ministry of finance and considering sanctions against the ministry which the Authority is answerable to is not possible due to the apparent conflict of interest. For that reason, the Authority has not deemed it necessary to register the scheme leave alone enforce compliance with regard to prompt payment of pensions.

The Pensions Act does not provide for the structure and governance of the civil service scheme. The Pensions Department in the Treasury[107] is mandated to pay the pensions. The administrative structure of the scheme is not provided for in the law. There is need to reform the Pensions Act with a view to establishing a governance structure which is answerable to the Retirement Benefits Authority. The scheme should operate as a trust with a board of trustees nominated by both the government and members of the scheme including pensioners. The Act shall need an amendment to provide for the creation of a trust, the criteria of nomination and termination from office of a trustee, the mandate and functions of the board of trustees and their liability in the event of breach of statutory obligations. As an occupational scheme established under a written law, it should be under the control of a board of trustees who should be the legal owners of the scheme and directly accountable to the members and the supervisory agency. The duty of the trustees shall include, (i) administering the scheme in accordance with the provisions of the law and (ii) keep the career records of all civil servants from the date of recruitment to cessation of service.

Because of the crucial role the government plays in the funding of the scheme, the law should obligate the relevant government department to regularly furnish the board of trustees with information required to enable compliance with the law. The ability of the board of trustees to discharge these duties shall depend on the technical

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[107] Section 3 of the Pensions Act (Cap 189) Laws of Kenya.

skills they shall invest in and the operational systems they shall adopt. In order for the board of the trustees to be subjected to the supervisory authority, the Pensions Act shall require the board of trustees to comply with the provisions of the Retirement Benefits Act. This requirement will subject trustees of the scheme to several and joint liability for their breach of law.

The foregoing recommended legislative reforms will remove the civil service scheme form central government and establish it as a trust answerable to an autonomous supervisory agency. The Authority will then register the scheme and enforce compliance including prompt payment of pensions.

3.4.2. National Social Security Fund

The hindrance in the enforcement of the law against NSSF is attributable to; (i) many laws to which NSSF is subject which, in some provisions, are in conflict; (ii) powers of the Minister for finance to exempt NSSF from the provisions of the Retirement Benefits Act; (iii) reporting lines of NSSF, which currently is answerable to the ministry of labour and at the same required to comply to the Authority which is under the ministry of finance; and (iv) a weak legal framework under which it is established which is inadequate on the internal legal structure and governance of the fund. In order to enforce the law against NSSF, the following may have to be addressed; (i) the clarity of NSSF Act on the issue of liability of the board of trustees, governance of the board of trustees, effective accounts management and audit of the fund, effective custody of the fund assets, independent Investment Board, public transparency, reporting and independent supervision of the fund, and (ii) the issue of harmonization of the laws that relate to NSSF.

Currently, the NSSF Act makes little provision, if any, on the corporate governance of the fund. Section 4 of NSSF Act creates a board as a juridical person without clear liability and mandate provisions in the performance of the functions set out in the Act. The functions of the board and those of management are not set out with clarity

in the Act. The Board is required by law to report to the Minister for labour. Section 6 of NSSF Act mandates the Board to invest the Fund Assets in accordance with the provisions of the Trustees Act but subject to the Retirement Benefits Act. The Act does not state the objectives of investment which leaves the trustees with a broad mandate open to abuse.

The financial books of the Fund are audited by the Auditor General and the period of audit is set out in the law. These audits can therefore be delayed for a considerable period of time and thereby concealing any qualified accounts from the public. Section 31 of the Act requires the audited accounts to be published in the print media. This obligation has never been implemented by the board of trustees meaning that the public does not have access to audited financial reports of NSSF.

Section 33 of the Act does not prescribe the qualifications of the Managing Trustee nor does it provide for a transparent process of nomination and appointment of the managing trustee. The Minister is simply empowered to appoint the Managing Trustee on the recommendation of the board of trustee. Equally, Section 4 (i) of the Act does not provide for a transparent process for the appointment of the board of trustees. The Minister has powers to gazette the Board of trustees and remove them from office if, *inter alia*, they are unable or unfit to discharge their functions. With the lack of disclosure and reporting requirements in the Act, it will be difficult for the public to know whether the Minister was possessed with justifiable reasons to appoint particular trustees or remove them from office.

Appropriate enforcement of the law against NSSF board will depend on fundamental reforms of NSSF Act which will address internal structures and governance of the Fund including harmonization of laws which relate to NSSF. The proposed legal reforms relating to NSSF are as follows:-

(a) **Internal Governance of NSSF**

i. Liability of NSSF Board of Trustees

The NSSF Act should be amended to prescribe a transparent process of nominating and appointing the members of the board of trustees and the managing trustee. The law should prescribe a fit and proper test to which the possible appointees should be subjected to. The law should also prescribe the extent of liability of these trustees while discharging their duties. Currently, it is not clear whether the government is liable for any funding deficit that may be experienced by NSSF. The law should state who is liable for the funding of the deficit identified in NSSF assets. Lack of clarity on who is liable for the various activities that affect NSSF causes confusion which would result in poor decision-making and performance of the fund.

ii. Governance of the Board of Trustees

NSSF Act should provide for compliance with good corporate governance by the Board of trustees. The current law does not accord the board of trustees with independence from political pressure in order to guarantee and inspire public confidence in the fund. The mandates and powers of the Board should be reported on to the public at regular intervals as a way of enhancing good governance.

iii. Effective Accounts and Audit

Although NSSF Act requires financial audits of the Fund, the Act should go further and spell out the periods within which the audits should be completed, define clearly the content of the annual financial report to enable measurement and comparison. The law should specifically give particular disclosures in the accounts report such as fees and expenses. In order to rid the fund of the bureaucracy of the Auditor-General, the law should permit the use of external auditors independently appointed to audit the Fund on behalf of the Auditor-General.

iv. Custody of Fund Assets

The security of the assets of the fund is crucial in that it guarantees safety and also when done by an external custodian acts as a whistle blower in the event of misapplication of the assets. NSSF Act should therefore provide for the holding of the fund assets by an approved external custodian. The Board of trustees will thus be liable to identify and procure the services of a custodian to render custody services to the Fund.

v. Public Transparency and Reporting

NSSF Act needs to be amended to require particular reports such as, (1) a statement of the main mandate of the Fund (2) investment annual return of the Fund (3) risk exposure (4) organization of management (5) administration cost (6) the auditor's report (7) the mandate of management (8) un-remitted contributions to the Fund (9) custodian report and (10) the funding level of the fund, to be published for public information. The manner of presentation of the reports should be simple, clear and comparable to enable scheme members appreciate them. In order to provide for more information to members and clarify the report, the board of trustees should be required by law to not only provide benefits statements to members but also hold annual general meetings of members to receive responses of the members of their performance.

vi. The Need of an Independent Oversight

There is need for the NSSF Act to subject the board of trustees to an external supervisory authority whose function is not to prescribe a law for NSSF, but to examine the compliance of NSSF board of trustees with the provisions of NSSF Act. This external supervisory role can be undertaken by the Retirement Benefits Authority. Section 2A of NSSF Act imposes the provisions of the Retirement Benefits Act on NSSF. The two Acts are in conflict in some requirements on NSSF such as investment of assets, financial reporting requirements and powers to deregister a scheme. The powers of the Authority should be limited to

monitoring the performance of NSSF board on the basis of NSSF Act. External examination and verification of the Fund management and status will be essential because of public interest issue. The Authority should have clear statutory provisions to give it power over NSSF including power to commission independent examination of any area of NSSF functions which is a cause of concern to the public, members and the government and also invoke sanctions in the event of contravention of the law.

vii. Independent Investment Committee

NSSF Act should establish a separate juridical person known as NSSF Investments Committee to be responsible for the investment of the assets of the Fund. The investment committee, like the NSSF board of trustees should be shielded from political influence and provided with clear mandate and objectives. The investment committee shall not have administrative responsibility of the Fund but to manage the assets to the best interest of contributors and beneficiaries and to invest with a view of achieving maximum rate of return without undue risk of loss. Owing to the public interest on the performance of the assets of the Fund, the investment committee should be answerable to a committee of parliament.

(b) Harmonization of Laws Relating to NSSF.

With comprehensive reforms of NSSF Act all other statutory provisions that provide for additional obligations on NSSF board of trustees should be repealed to eradicate statutory duplicity and contradiction. For example, the Retirement Benefits Act should only provide for a power to enforce the provisions of NSSF Act against the board of trustees or any other service provider allowed under the provisions of NSSF Act to render a service to Fund. The current legal framework subjects NSSF board of trustees to numerous and unharmonised laws including the Retirement Benefits Act, Exchequer and Audit Act, The Trustees Act, Income Tax Act on application of unallocated surplus funds etc. The NSSF Act should be amended to

provide for all the obligations required of the Fund so that the external supervisor is only obligated to enforce compliance of Fund with the provisions of NSSF Act.

3.4.3. Private Occupational Retirement Benefits Schemes

The Retirement Benefits Authority has to a large extent been able to enforce the provisions of the Retirement Benefits Act. However, as earlier discussed, inability to attain full compliance with the law can be attributable to inadequate staff capacity at the Authority, lack of autonomy of the Authority, the model of supervision adopted by the Authority is intense and proactive, inability to enforce funding requirements against parastatal schemes' historical imprudence in asset management and the Authority's lack of capacity to prosecute offenders of the provisions of the RBA. Five years since the full implementation of the Act in 2001, some of the provisions thereof have been shown to have been ambitious and they require amendment.

i. The statutory requirements in Retirement Benefits Act and the Regulations thereunder to submit investments reports, custody reports, returns on contributions together with a list of active members of schemes every after 90 days is not necessary as the Authority staff is not in a position to analyze the same within 90 days in order to follow up those schemes which are in breach of the law.[108] It may be realistic to amend the law so that those returns are made after six months to enable sufficient time for analysis of the returns.

   With regard to returns on contributions, it will be sufficient for the law to require reporting on the remitted and unremitted contribution and the total number of active members of the scheme. The requirement to submit every quarter a list of scheme members together with their respective ages and gender does not add value in supervisory roles of the Authority. There is therefore, need for the RBA to be reviewed carefully with a view to clearly provide for the needed returns.

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[108] The writer is an employee of the Retirement Benefits Authority and has first hand experience on the analysis of returns to the Authority.

ii. The Retirement Benefits Act does not specifically provide for the model of supervision the Authority should adopt in its supervisory mandate. It can be inferred from the statutory requirement of huge returns to the Authority by schemes at short intervals that the model intended is pro-active and compliance based. The model is heavy in that the Authority has to analyze huge returns in short period of time to monitor the schemes and take pre-emptive action on the basis of acquired information. The model is labour intensive and does not discriminate between well administered schemes and the under-performing ones. It is recommended that the Act should be amended to clearly provide for a supervision model to be adopted by the Authority. Risk-based supervision where supervision is limited to management of apparent risks may be a preferred choice because the law will require schemes to establish internal scheme capacity systems to manage and reduce risks. This will introduce some degree of self-regulation within the schemes themselves. The Authority will be left to address apparent risks in schemes that would expose the schemes to failure. The recommendation will reduce the volume of returns to the RBA and supervision will focus on risk management rather than mere compliance.

iii. Many defined benefit pension schemes particularly those established by parastatals, inherited large shares of immovable property after the enactment of the Retirement Benefits Act. The inheritance of those immovable properties arose because before 1997, most of these schemes were unfunded.[109] Some of those schemes which were funded had adopted imprudent asset management policies leading to lack of diversification and investment in illiquid investments such as property. Most of these schemes are still not compliant with the provisions of the Investment Guidelines under the Retirement Benefits Act.

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[109] The since repealed pensions Regulations under the Kenya Ports Authority Act, Kenya Posts and Telecommunications Act and the Kenya Post Office Savings Bank Act, were examples of statutory regulations which provided pensions to respective parastatals employees although those pension schemes were unfunded.

The three-year transition period provided for in the law to enable incompliant schemes to come to compliance appears to have been ambitious and the Authority is unable to enforce compliance of those schemes without appearing to be unreasonable bearing in mind the historical problems of those schemes. The Act may have to be amended to extend the period of remedial plan to such period as the Authority may consider appropriate for different schemes so long further investment in those assets in respect of which the schemes are in breach is disallowed until compliance with the law is attained.

iv. With regard to liability to enforce funding requirements against under-funded defined benefit schemes particularly those established by parastatals, the Retirement Benefits Act should be amended to require those schemes to convert to defined contribution schemes as a way of limiting further liability on sponsors of the affected schemes. The process of scheme design conversion should therefore be detailed in the law and the members' unfunded accrued reserves in defined benefit schemes preserved and guaranteed by the sponsor who shall under the law be required to settle the unfunded liabilities overtime until the pension debt is settled.

v. The Authority has not been able to commence any criminal prosecution against trustees who are in breach of the Act. The prosecutors of offenders of the provisions of Retirement Benefits Act are employees of the Authority. The capacity of these prosecutors to arrest offenders is legally in doubt. The police department which has arresting powers is reluctant to arrest offenders of the Act on the basis that they are unable to understand the offences under the Act.[110]

The duty to prosecute offenders in Kenya rests with the Attorney General. The special nature of offences committed under the Retirement Benefits Act and other areas in the financial sector e.g. insurance, capital markets and banking sectors

[110] The writer who is one of the gazetted prosecutors has experience of officers being reluctant to arrest trustee who are in breach even after they have been informed of the offence

need to be handled by a special police unit properly trained to appreciate these sectors and the offences committed therein. The state counsel in the Attorney General equally needs to be trained to understand these specialist areas of law and the nature of offences committed therein. With such reforms of administrative structures under the guidance of the Attorney - General, offences under the Retirement Benefits Act can be effectively prosecuted. The current arrangement leaves the Authority and its prosecutors with an enormous task of initiating arrests, recording statements preparing charge sheets etc, without adequate cooperation from the office of the Attorney - General and the Police department. Unless, the Attorney General reorganizes the process, the Authority will continue to be unable to effectively enforce criminal sanctions in the Act.

CHAPTER FOUR

CONCLUSIONS AND SUGGESTIONS

4.1 CONCLUSIONS

The law relating to pensions in Kenya has been around since 1940s when the Pensions Act was enacted to establish the civil service pension scheme. The constitution of 1963 guarantees civil service pensions from the consolidated fund. Certainly, private occupational pension schemes, which are established under trust laws, were equally around albeit at a small scale and covering white workers in private companies. After independence, the government enacted the National Social Security Fund Act in 1965 to establish a mandatory provident fund to cover all formal employees except the pensionable civil servants, exempt persons and employees in small firms who had a staff of less than five. The above laws i.e. the pensions Act together with 1963 constitution, the National Social Security Act and trust law formed the legal framework under which Kenya's Pension System operated.

In 1997, the government however, enacted the Retirement Benefits Act to introduce regulation and supervision in the pension system. The Retirement Benefits Act sets out the requirements and duties of trustees of pension schemes, introduces the use of fund managers and custodians in asset management of pension schemes and addresses broadly administrative and funding issues of pension schemes. The Act seeks to protect members and sponsors of pension schemes by establishing the Retirement Benefits Authority which is the supervisory agency of the pensions sector.

The current pension laws are inadequate in addressing problems facing the pensions system in Kenya. The problem of limited coverage of the pension system to the

population of Kenya still remains unsolved. Imprudent investment of assets of funded pension schemes i.e. NSSF and Private Occupational has not been effectively addressed under the current legal framework.

Funding of pension schemes is fundamental if the system is to guarantee pensions to old retired Kenyans. The civil service scheme, although not funded, is carrying a large implicit pension debt which is a drain to the exchequer. The NSSF has experienced mismanagement over the years leading to deficits in its funding levels. Occupational pension schemes especially those established by government parastatals have experienced huge deficits on the basis inadequate government funding, mismanagement of resources and generous design of the pension schemes. The current law has not helped in enabling these schemes attain normal funding levels.

The enforcement of the pension law has only succeeded to some extent as far as private occupational pension schemes are concerned. However, with regard to the civil service pension scheme, the Retirement Benefits Authority finds itself inadequate to enforce the law against the government. Enforcing the law against NSSF is equally difficult because the scheme is subject to a number of Acts of parliament which are not necessarily harmonized and the government has statutory powers to exempt NSSF from aspects of the Retirement Benefits Act.

The following conclusions can therefore be made with regard to the problems facing Kenya's pension system.

i. The pension laws in Kenya were designed to establish a pension system which extended its coverage to the formally employed. The ideal coverage like in Mauritius[111] should extend coverage to at least 60% of the population above 60 years of age. Unfortunately, even among the formally employed, only 15% of the

[111] Bonnerjee, A. (2003): Pensions in Sub-Saharan Africa: The Urgent Need to Act, p.42; www.worldbank.org/etools/docs/library/76907

workforce is covered because the law has not put sufficient institutional framework in place to enforce coverage of all legible employers and employees to participate under the NSSF. The National Social Security Fund Act excludes from mandatory participation a large workforce in small and medium term enterprises whose workforce is below five and the Retirement Benefits Act does not make it mandatory for private employers to establish pension schemes for their employees.

The establishment of a universal pension scheme to provide minimum old age benefits equivalent to half a dollar per day will significantly improve the quality of life among the elderly poor. The scheme will widen coverage to most of the persons who were not able to save for retirement during their economically active years. The cost of financing such a scheme is within manageable levels of government. A policy to establish the scheme needs to be considered followed by appropriate legal reforms. Old age income security which forms part of social security protection is regarded by the United Nations as a basic human right.[112] The constitution of Kenya does not declare social security protection as a right to the citizens. The proposed constitutional reforms had proposed to declare social security as a basic right. It is recommended that social security be considered and constitutionalised as a basic constitutional right as a way of seeking to extend pension coverage to all citizens of the country.

ii. The funding of the pension system in Kenya is inadequate. Section 112 of the constitution guarantees a pension to retired civil servants although they do not make direct contributions to the scheme. The scheme has continued to rely on general tax revenues for its sustainability. There are questions on the equity of taxing every Kenyan to pay pensions to a small population of Kenyan. The scheme currently is having a huge implicit pension debt and hence starting to expose its sustainability. The current implicit pension debt of government is

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[112] ILO: Facts On Social Security in Africa: (International Labour Office, Geneva, 2001) www.ilo.org/socpol P. 1

Kshs. 338.9 Billion. With a rapid increase in pensions expenditure from Kshs. 1.5 billion in 1993/94 to be Kshs. 21 billion in the year 2005/2006[113] there is justification to consider reforms of the scheme to introduce pre-funding. If the current trend of pension expenditure continues over the next decade the annual pension bill on the consolidated fund will increase to Kshs. 45 billion by the year 2012 and Kshs. 80 billion by 2016.[114] The need to consider converting the scheme to a funded pension scheme and operate under the supervision of the Retirement Benefits Authority is overdue.

The legal structure of NSSF has left room for its underperformance resulting in its funding deficits arising out of huge administration expenses, poor asset management and administration, and inability to collect all due contributions from legible employees and employers. The law needs to undergo reforms to allow collection of contributions by Kenya Revenue Authority as it does pay-as-you-earn under the Income Tax Act. The scheme also needs administrative reforms to enhance its governance structures.

One of the ways to improve NSSF governance in the short term is to subject the scheme to competition with other schemes which can be prescribed under the law to collect and manage statutory contributions as envisaged under section 33 of the Retirement Benefits Act. Occupational Retirement Benefits Schemes are required to meet funding requirements set out in the Regulations to the Act. The funding problem in these schemes arises out of failure of the employers to remit contributions to the scheme and actuarial deficits which arise in defined benefits schemes. The amendment of the Retirement Benefits Act to criminalize non-remittance of employee's contributions by employers will help improve the collection of contributions. The amendment however, should extend to the non-

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[113] Alexander Forbes Financial Services Limited: Actuarial Study on superannuation in the Public Service Kenya (unpublished,2005)

[114] Daily Nation: The Pension Time Bomb (The Daily Nations Business Magazine of February 7, 2006) p.10

remittance of employer's contributions. Regarding actuarial deficits in defined benefit schemes, the Retirement Benefits Act should be amended to provide guidelines on actuarial valuation process so as to regulate the applicable actuarial assumptions when valuing the funding levels of these schemes. The current law leaves a lot of room for actuaries to apply assumptions they deem appropriate which may not necessarily lead to an accurate funding level of the scheme.

Sustaining funding levels in defined benefits schemes especially those established by parastatals is proving difficult. There is a case for the government to consider a policy and legal framework which will lead to requiring all financially stressed defined benefit schemes converted to fully funded defined Contribution Pension Schemes.

iii National Social Security Fund Act permits the NSSF board of trustees to invest the assets in NSSF in broad securities under the Trustee Act although subject to the provisions of the Retirement Benefits Act. The central management without clear statutory objectives has over the years exposed NSSF assets to mismanagement and political interference. A reform of National Social Security Fund Act will enable the development of an appropriate revisable investment policy of the scheme assets and the establishment of a statutory and independent investment board which is answerable to a committee of parliament.

The Retirement Benefits Act should be amended to define investment advisors and their role in the development of investment policies to avoid compromise policies which favour fund managers' mandates. Investment policies of private occupational pension schemes should be able to match assets and liabilities in order to take account the maturity profile which appears not to be the case under the current experience and the prevailing law.

The justification of limiting offshore investment to 15% is questionable and the law needs to be amended to open up for more pension assets to be invested offshore under a clear investment policy. The law needs to clearly provide for a justifiable means of valuing pension assets especially real property. This will enable trustees make prudent decisions when investing in real properties.

In order to improve the value of assets, Investment Guidelines under the Retirement Benefits Act need to leave room for a "prudent person standard" approach when managers are investing pension assets. This will enable fund managers apply their skill and professionalism in carrying out investment while taking into account not only the statutory limits but also the needs and objectives of a pension scheme.

iv. The Retirement Benefits Authority under the provisions by the retirement benefits Act has been mandated to police the pensions sector in Kenya. While it has to a large extent succeeded in creating some order in the sector there are cases where it has been able to enforce the law to stamp out some problems in the pension system. The Authority is unable to enforce quick payment pension benefits to retired civil servants, enforce compliance of NSSF with the provisions of the Retirement Benefits Act and to fully enforce sanctions against private occupational pension schemes.

The weakness in the enforcement of pension laws needs to be addressed through legal reforms to restructure the civil service pension scheme as statutory trust answerable to the regulatory Authority rather than operating as a department of the Ministry of Finance.

National Social Security Fund Act need to be amended and harmonized with all the laws that related to NSSF so that the regulatory authority can only be mandated to monitor the compliance of NSSF with its own Act and not a myriad of other laws which appear to be in conflict currently.

The Retirement Benefits Act needs further amendments to provide for the mode of supervision which the Authority should adopt in supervising the industry. The current legal set up, allows the Authority to seek large returns from the industry which it is unable to analyze within reasonable periods and hence compromising compliance. Supervision should be targeted at identifiable risk areas rather then enforcing compliance even against schemes which are prudently managed. At the same time the autonomy of the Authority need to be enhanced in the Act in order to enable the Authority execute its statutory mandate without political interference.

The enforcement of criminal sanctions against errant trustees and other service providers under the Retirement Benefits Act should be reverted back to the Attorney General rather than appointing the Authority's officers as prosecutors under the Act when the Attorney General and the police department appear reluctant to arrest and investigate the reported offences.

4.2 SUGGESTIONS AND AREAS FOR FURTHER RESEARCH

The pension system in Kenya is ripe for a comprehensive reform purposely to address the fiscal pressure in the civil service pension scheme, the issue of low coverage and reduction of poverty among the old in Kenya, the problems of NSSF scheme and the introduction of a harmonized pension system which is not fragmented as it is currently.

A comprehensive pension reform will aim at providing a sustainable old-age income to majority of the elderly poor in Kenya and will also aim at creating developmental effects by improving financial markets. In order to realize a comprehensive pension reform, there will be need to incorporate all in the development of a national pensions policy. The participation of the public, politicians and technical persons will firstly, enable acceptance of a policy which forms the basis of fundamental pension law reforms. Secondly participation of the public in policy formulation will

enable appreciation by all on how the pension system pillars support each other in the widening of coverage and provision of sustainable and affordable pension benefits to the majority of elderly citizens.

It is proposed that further research is required to establish the suitability of trust law as the basic law for occupational pension schemes in Kenya. In particular there are three areas in which further research would help in establishing the suitability of trust law in pension schemes. Those areas briefly discussed below.

i. Split-title in trust law

Under trust law, trustees of a pension scheme have the legal ownership of the assets of a scheme although they may not be beneficiaries. Members of a scheme have an equitable interest in scheme assets as beneficiaries. There appear to be a dual title to the assets of pension schemes which is, in respect of trustees, legal and to members, equitable. In law the 'split-title' between trustees and scheme members means that trustees with the legal title have powers to control, manage and posses assets of the pension scheme while members enjoy the use of assets as benefits upon attaining retirement.

One could expect that players in the pension trust will know and respect their boundaries as determined by trust law. But the emergence of associations of pensioners to fight for the rights of scheme members and pensioners demonstrate that the boundary set under trust law in respect of the dual title is unclear to trustees and members of schemes. Further, the founder of the scheme which is the employer often interferes in the running of the scheme irrespective of the limited role the founder has as a testator of the pension trust. Research on the legal and equitable title to pension assets will reveal whether in Kenya trust law has helped improve the structure, the distribution of rights and operations of pension schemes; or some principles of trust law

need to be limited by statutory law in as far as pension schemes are concerned.

ii. Whether pension funds are a deferred pay

Research is also required on the question whether pension funds are a deferred pay of employees which should be kept independent of the employer, or the funds are part of the employer's production costs and hence under the employer's control. If pension funds are comprised of members' deferred pay, then the current trust law in as far as pension schemes are concerned would require reforms because it is unsatisfactory. Under the current trust law, the employer establishes a pension scheme into which contributions in respect of an employee are made. If a contribution made by an employer is established through research to be an employees' deferred pay, then the powers of the employer to deny a member unvested employer contributions upon leaving employment are not based on good law. Equally the employer's ability to manipulate funding levels and an apparent right to access surpluses in scheme assets upon winding up of defined benefits schemes will have to be reviewed if indeed pension funds constitute deferred pay of employees.

It is argued that pension funds are not ex-gratia benefits from an employer to a retiring employee. The employer's contributions to a pension scheme could be viewed as money that would otherwise be available to pay current wages. A research on these opposing perspectives on pension funds from the employer and employee points of views, would establish whether indeed trust law is appropriate in its current form as the basic law for occupational pension schemes.

iii. Need for qualification of trustees

Finally, trust law does not require trustees to possess special skills or expertise to enable them discharge technical obligations they assume such as; management of pension assets, interpretation of actuarial valuation reports or even management of funding requirements of a pension scheme. Under trust law, it is enough if an appointed trustee is an adult of sound mind. There is merit to consider whether a trustee of a pension scheme should not possess some skills that would be necessary in proper discharge of technical common law and statutory obligations in pension management. Research on the effect of lack of capacity on the part of trustees in Kenya's pension system to discharge their duties would likely reveal that there will be need to introduce further qualifications trustees of pension schemes need to posses before they assume the office of a trustee.

Kenya's social security system is still at nascent stages which may be referred to as phase one. Like many third world economies in sub-Saharan Africa, this stage of Kenya's social security system provides weak social protection mechanism for the elderly in the society. Currently, only NSSF and private occupational pension schemes are offering some level old age income security to a small covered population. Kenya's old age population of above 65 years is still small owing to low life expectancy. This factor may explain why policy makers have not deemed it appropriate to concern themselves with developing a policy on old age income security in order to cover most of the elderly in Kenya.

There is however a need for the government to consider reforming the current social security system and move to higher level that would encompass not only old age income security, but also health care, unemployment benefits, well structured disability benefits and social assistance (a sustainable universal pension scheme) to Kenyan's above age 65 funded by general government revenues. In reforming the system, the existing pension schemes can be reviewed to address identified

shortcomings and hence improve their objectives. Efforts to reform the current social security system will improve the quality of life of most Kenyans which otherwise is very poor at the moment. The proposed reforms of the pension system will require reforms of current pension laws and introducing new ones to form a legal framework under which the entire pension system will operate.

APPENDIX

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