RETIREMENTS BENEFITS AUTHORITY

THE RATIONALE FOR QUANTITATIVE PORTFOLIO CEILINGS ON INVESTMENT OF RETIREMENT BENEFITS FUNDS: THE CASE OF KENYA

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1.0 INTRODUCTION

1. 1 Background

Questions, concerns on or related to the quantitative ceilings on investments of retirement benefit funds imposed by the Retirement Benefits Act and Regulations, has become repeatedly asked in many organized fora hosted by the Retirement Benefits Authority. Questions such as 1) "Why restrict schemes from investing 100% of the scheme asset in government bonds? 2) Why restrict schemes from investing in one quoted company to 5%? 3) Should schemes with small fund value be subjected to the similar portfolio mandate as the schemes with large funds? "

Similar concerns on quantitative portfolio ceilings of pension funds are not unique to Kenya. Debates on this subject of investments of pension fund have been going on for decades and for various reasons.

Pension Funds have the freedom to invest in various and diverse financial securities. They even can own assets directly. Much as this may be, quantitative restrictions are applied for some reasons. This paper aims to discuss the reasons for regulating investment of pension funds in Kenya with the objective of convincingly answering the recurrent questions raised especially by trustees of Retirement Benefits Schemes.

1.2 Stylised Facts Kenya: The Unregulated and Regulated Regimes

Until 1997, the pension industry in Kenya was by and large unregulated. Only a few regulations relevant to retirement benefits were scattered in the Income Tax Act and the Trustees Act governed the industry. There were no specific regulations on investments, other

than that exempting all those schemes registered with income tax from the withholding tax imposed on investment income.

In 1997, the government enacted the Retirement Benefits Act and in 2000, approved the Retirement Benefits Regulation as new legislations to govern the entire management and administration of the pension industry. It is through this Act that investment guidelines of pension funds were drawn and subsequently came into force.

The core purpose of constituting the Retirement Benefits Act and Retirement Benefits Regulations was to deal with the problems the industry was facing. The pension industry was unprofessionally run. Though members made their contributions as required, schemes remained underfunded and unable to fulfill their promises to Retirees. The very guardians of the funds, the trustees, openly and consciously misappropriated and embezzled retirement funds under the cover of members who lacked knowledge and awareness and if they did, there was no recourse system.

Through the Act the industry has undergone a major structural change. All schemes, unless founded under a written law, are required to be established under an irrevocable trust, must be distinctly separated and maintained from any other funds under the control and influence of the sponsors, must engage the services of various external professional services providers among them fund managers, custodians, auditors, actuary all who provide necessary expert advice to trustees. All these players infuse a high degree of professionalism, good governance and accountability in the operations of schemes.

The Retirement Benefits Act provisions were intended to protect the interests of the members of a scheme by way of limiting access to the scheme funds by the employer or any of his cronies and essentially

and more important to protect members from any adversities ie double jeopardy that would occur if an employer's business were to collapse thereby exposing the employees to loss of jobs as well as their retirement benefits which would sink with the sponsors' business. The eventual objective was to ensure Kenyans secure optimal income for use in their retirement.

1.3 Statement of The Problem

Prior to the introduction of the Retirement Benefits Act, Pension funds were not prudently invested. Where funds were invested the portfolio mix of assets in most cases was disproportionately and professionally selected. There was little diversification leading to exposure of schemes. Trustees did not have the necessary know how of selecting assets. This meant that members were denied the growth of in their funds as the schemes did not attain optimal returns on there investments. It also further meant that that value of funds were not preserved. By the 1990's, the retirement benefits sector was faced by a confidence crisis as evident by the repeated demonstrations by workers and pensions. It was then apparent that government's intervention was needful.

This study aims to find out the impact of the retirement benefits regulations on investments in particular in terms of determining the portfolio mix of assets.

1.4 Methodology

This methodology adopted for the study has collected information from literature. To assess the impact of investment regulations, from the entire database of active retirement benefits schemes in Kenya, the schemes were arranged in accordance to the value of asset holdings based on the filed annual accounts. The schemes were then divided

into three in the order of asset holdings. A sample of the first ten schemes were selected from each category. Data was collected on their investments portfolio from as early as 1997. Investments portfolio was then compared between the periods before and after the Retirement Benefits Act was introduced.

1.5 Study Limitations

This study relied on the available information on scheme investments as provided in annual accounts. Not all schemes in the sample had filed returns from 1997.

There was no standard reporting format so disclosure was different from one scheme to another.

Reporting of schemes assets before the introduction was not fully disclosed by all schemes.

1.6 Investment of Scheme Funds Under the New Regime.

The Act devotes several sections in the Retirement Benefits Act and Retirement Benefits Regulation that provides directives or guidelines on investment of pension funds. These are contained in

- The Retirement Benefits Act 1997, sections 38 (1) (b), 39,40
- Regulation 31 (1) of the Retirement Benefits (Individual Retirement Benefits Schemes) Regulations 2000
- Regulation 38 (1) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations 2000

Section 38 makes distinct restriction on the use of funds. Scheme funds cannot be used to make direct or indirect loans or invested in a bank, non banking financial institutions, insurance company, or building society with a view to securing a loan.

- Retirement Benefits Regulations -Table G - r18

Table G lists the broad classes of investible assets permitted and the ceilings per each broad category of assets.

The investment regulation in Kenya requires that unless a scheme opts to invest in guaranteed fund or pooled fund, investments of scheme funds should be allocated guided by the stipulated percentage limits. However, such limits can be exceeded under special cases which are beyond the control of the scheme that include:

i) increase in market price of assets
ii) bonus issues
iii) transfer of investment from one class of asset to another.

The duration of time that schemes can hold investments above the required ceilings is limited to ninety days. Schemes must rebalance their investments within the ninety days.

The investment provisions act as more as guidelines and the Authority does not specify the assets in which scheme should investment. It is left to the scheme to entirely select the assets they deem best suitable to give the best optimal return in accordance to the scheme's fundamentals.

While the Table G gives the quantitative restrictions for each asset class, the Act also makes mention of other restrictions. The Act bars direct loaning of scheme funds to any person or the use of scheme fund as loan collateral apart from housing. *This is to change in 2008 following the passing of the Finance Bill to allow members to utilize their accumulate retirement benefits savings for acquiring mortgages*[1].

[1] Budget Changes – Kenya Finance Bill 2007

Table G: Investment Guidelines

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

The current investment scenario in Kenya shows that actual industry investments fall much below the stipulated limits which is a strong indicator that the guidelines have not in any way stifled the investments of scheme funds. The industry has room and scope of exploiting investing in the permissible assets.

The introduction of regulation on investments of pension funds in Kenya has brought in observable changes on the investments of pension fund. All schemes now must prepare an investment policy something that was little practiced. An investment plan acts as a professional tool that guides investments decision making and ensures that scheme investments are diversified to minimize investments risks.

Comparative Quantitative Limits

Country	Diversification requirements	Equity	Guaranteed Fund	Self Investment	Single Issuer	Foreign Assets	Govt Bonds	Real Estate	Mortgage Loans
Australia	none	No Limit		5%		0%		No Limit	No Limit
Austria	No limit	50%		10%			35%	20%	
Belgium	Yes with quantitative restrictions	65%		15%				40%	
Canada	Yes with quantitative restrictions	No Limit		10%	10%	30%		25%	
Denmark	No limit	40%	not permitted					40%	
Finland	Yes with quantitative restrictions	50%		25%	15%			40%	70%
France	No limit	65%		33%			50%		
Germany	Yes with quantitative restrictions	30%			5%		50%	25%	50%
Italy	No limit	No limit						No limit	
Kenya	Yes with quantitative restrictions	70%	100%	5%	3%	30%	70%		

2.0 LITERATURE REVIEW

2.1 Rationale for Regulation

There are two broad reasons why governments establish regulations:

1) Consumer Protection: A framework of rules that can help prevent the excesses and failures of a market if entirely left on its own devices
2) Maintenance of Stability: a public good that justifies a more elaborate framework of regulation and supervision

Regulators are established to manage the financial health of institutions. *(Taylor et al IMF Working Paper WP/02/46)*

2.2 Origin of regulations on Investments or Pension Funds

Pension plan arrangements began as informal arrangements by employers who chose to set aside funds to cater for their employees during their post working lives as an expression of kind gesture and goodwill. Unfortunately over time many companies began making promises to pay pensions without setting aside any funds to support the promise. Instead the monies would be diverted at the companies' discretion. While others would inject the monies for the good of the business others looted.

Overtime these arrangements became more formal and institutionalised and governments began playing a role. In particular, governments established regulations to ensure that promised pensions were made available to those promised. Companies were therefore required to put aside the necessary funds to ensure that pensions were paid.

Since companies were required to set aside monies to fund their pension promises, it became attractive to invest these funds to earn a higher return that would lower the cost of providing pensions. Initially companies invested in fixed income securities such as

government bonds or life insurance company annuities as they guaranteed both capital and return. The rise in inflation especially in the 1960s and 1970s, the consequential rise in salaries and low fixed-income returns from fixed income investments, pension plans became very expensive for companies. Companies increasingly invested in assets that yielded higher returns such as equities, direct real estate investments, venture capital and mortgages to lower the eventual cost of their pension plans[2].

Unfortunately, companies tended to over invest in one asset or invested in investments that were not readily realisable when cash was needed which amounted to a dangerous exposition of the pension funds because those entrusted were firstly, not so knowledgeable on investments and secondly, were not guided by investment plan. regulations were set in.

Today retirement plans are virtually sustained by investments. The performance of the investments determine the value of fund in both defined benefits or define contributions retirement plans though the latter plans have more direct dependence on the performance of investments. Pension funding level status and performance of pension plans are strongly influenced by investments returns. High asset returns translates into high fund value which go along way in increasing the retirement income for the members or reduce sponsors contributions.

[2] The Regulation of Funded Pensions A Case study of the United Kingdom

2.3 Forms of Quantitive Restrictions on Investments of Pension Funds

Fixing quantitative restrictions on investments is a global phenomenon as is evidenced by the many countries that have established regulations governing investment of pension funds.

Quantitive Regulations of investment funds take various forms:

1) Restriction on industry structure where specific institutions can carry out the fund management business. The Chilean pension reform established new pension fund management industry.
2) Regulation of fund performance. Pension fund must guarantee an absolute return on investment. The returns are chosen based on the industry's average performance. Germany and Chile
3) Regulation that imposes limits on the share of investment assets held by pension plans. Typically these consist of setting ceilings (maximum) or floors (minimums) on the fund that can be invested in given assets. Floors are less frequent.

2.4 Reasons for Quantitive Limits on Pension Funds

There are a number of reasons for application of quantitative restrictions on investments of pension funds

i) **Reduce conflict of interests of interest arising between the fund sponsors and the ultimate beneficiaries of the fund**. Proponents of quantitative restrictions argue that interference with the management of the funds and imposition of limits on self-investments protect the scheme from undue exposure and bankruptcy of the sponsors [3] warrant restrictions. The larger the pension fund than the sponsor's fund the more vulnerable the scheme to interference. Pension funds, therefore, require a set of

[3] Towards Better Regulation on Private Pension Funds

internal statutes and external regulations to ensure that they are managed in the best interest of beneficiaries[4].

ii) **Fixing problems in the pension industry** – An all inclusive regulations that could be stringent are very necessary to fix problems in a sector that is chaotic, non-performing and where stakeholders have lost faith and confidence in. But once order and direction is restored, the rules can be relaxed. The pension reform in Chile was implemented with excessive regulation an effort to redeem the industry that was plagued with under funding. Eighteen years after, much success measured by labor force participation, pension fund assets, and benefits growth has been realised. Today, more than 95 percent of Chilean workers have their own pension savings accounts; assets have grown to over $34 billion, or about 42 percent of gross domestic product[5]. Now that the system has matured, beneficiaries understand their pension obligation and rights and fund managers are experienced Chile is contemplating relaxing the pension regulations.

iii) **The lack of experience on investment in particular of managing risks leads to poor portfolio decisions** and therefore, quantitative restrictions tend to act as guidance until experience is gained. Trustees who have had little or no contact with the financial services and providers; and may also not be knowledgeable and aware of their investments mandate and may engage in investments strategies not in the interest of the fund. Fund managers too may lack the expertise to engage in diversification strategies by themselves.

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[4] Pension Fund Governance, Investment Strategies, and Their Role in Corporate Governance
[5]Chile's Private Pension System at 18: Its Current State and Future Challenges

iv) **Ensure Prudent Investment of Funds**- As indicated above, scheme trustees and administrators may not have sound knowledge of investments yet they are expected to build and preserve pension wealth, a docket fit for investment and asset managers. Trustees may prefer to put all eggs in one basket. Strategically, prudent investment demands a diversified portfolio which often includes a mix of equity investments, fixed-income securities corporate or government and cash deposits. This can be much appreciated by analyzing the characteristics of each asset group.

v) **Limit Foreign Currency Risks and losses**. Restrictions in foreign denominated assets are geared towards limiting losses in the wake of global financial turmoil in international financial markets.

vi) **Undeveloped financial services ie fund management industry** – undeveloped capital markets are usually fragile, lacking in both liquidity and transparency.

Countries with well developed capital markets and a population that has more investment experience who can audit fund managers may require a light regulatory presence. (World Bank Pension Reform Premier)

vii) **The absence of a legal and supervisory system** that is able to enforce prudent-man rule style of investments lends itself to quantitative restrictions.

viii) **For ease of verification on investments**

ix) **To some extent have control of those responsible for fund management.**

x) **The rapid growth of the defined contributions** where the retirement benefits are heavily depended on fund performance require detailed regulation.

Recent phenomenon experienced in the recent past that illustrate the need for quantitative restrictions on investment of pension funds. Studebaker Corporation scandal, Maxwell Scandal and the more recent Enron debacle led to insurmountable loss of pension funds. In the three cases, employers/sponsors secretly diverted pension funds to bail themselves out of falling profits, unfortunately they collapsed inflicting double tragedy to the employees –loss of their jobs and their life time savings. These incidences awakened the need to jealously protect the benefits of members through regulations.

The collapse in the early 1990s of the late Robert Maxwell's business empire and the subsequent discovery of broad misappropriation of assets from associated pension schemes spurred pension reform in the United Kingdom. A committee "Goode Committee" was established to review the regulation of pension schemes. The committee recommended a 5% limit of pension fund invested in self-investments specifically, stock of sponsor, land occupied by, or property used by the sponsor in business. Investments exceeding the 5% limit would lead to penalizing of trustees. The committee also recommended a complete ban on loans and other extensions of credit from a pension fund to a sponsor.

In America, Enron's debacle mirrored another historical. Studebaker had failed to adequately fund its defined benefit pension scheme. At that time defined benefits (DB) plans dominated the pension industry.

The fall of Enron in 2001 greatly shocked the American government. While the Employee Retirement Income Security Act (ERISA) was set to primarily protect members of Defined Benefits Schemes after the fall of Studebaker Corporation of South Bend, Indiana in 1970, ERISA it did not equally protect the defined contributions (DC) plans. Unlike the DB schemes, DCs did not promise any particular benefit hence there was no obligation for the employer to maintain any funding, or provide any federal insurance. Again in the case of DC plans members were empowered to select the preferred assets for investments.
In the case of Enron which had a DC scheme, Enron encouraged employees to invest their pension assets in the company's stock. Consequently, Enron employees had invested their own contributions to the plan in the employer's stock. When Enron collapsed in 2001, just like the case of Studebaker Corporation Enron retirees were rendered destitute and thousands of Enron employees lost not only their jobs but their retirement security.

The above experiences show that pension funds are by their nature subjected to potential conflicts of interest arising between the fund sponsors and the ultimate beneficiaries of the fund. In addition, economic, social and financial attachments to pension fund require existence of legal rules that must be continuously amended, to incorporate any new markets developments[6].

2.5 Investing Scheme Funds

Once the contributions are received by the pension fund from the sponsor and/or members it is upon the trustees to tackle the problem of investments. This can be a daunting task, as trustees are required to take decisions about matters in which they themselves may not be experts. To enable trustees make prudent judgment trustees must first clearly understand the constraints, goals and objectives of the scheme and also how the fund can achieve those objectives. Trustees are

[6] Financial Market Trends No. 75 pg 118

therefore obliged to set up an investment strategy/policy that documents the objectives and targets of the scheme. Fund managers fortify the trustees' decisions by tactfully or strategically allocating the pension fund based on more factual reasons prevailing in the investment market. Because of their long-term nature, pension's funds need to be invested more prudently to preserve their value.
The investment portfolio that a fund holds at one time is dictated by its unique profile of the fund that is generally expressed by the:

1. Demographic characteristics of the Fund membership.
2. Projected long-term flow of contributions.
3. The Fund's liabilities as at when they fall due
4. The Trustees objective for real rate of return.

Of all the above, the demographic profile of the fund influences the investment portfolio of any one scheme the most. The demographic relief describes the age of the scheme as young, middle and the retired age set groups. Asset allocation in each set group is different because of the of the time horizon that automatically determines the liabilities levels hence the investments are made to match the assets and the liabilities.

Common sense and written legislation demands a "prudent approach" investment - exposing different segments of the fund to different investment risks so as to achieve an averaging of risks in an effort to attain the highest practical return that can lower the cost of pension "obligation" considerably. In other words, investments by pension fund must constitute well-diversified and well-dispersed portfolio. Whereas diversification involves selection across major asset classes, dispersion involves selecting different investments within a number of subclasses of the major asset class.

The overall benefit of well diversified and dispersed portfolio of investments balances or offsets the risk that any one investment might pose individually. However, a break down of the benefits includes:

1. Reduced exposure to any single component of the capital market.
2. Reduced risk of not tracking inflation.
3. Reduced fund's total return variability by taking maximum advantage of the different market conditions and protecting the funds from the ups and downs.
4. Increased longer-term risk adjusted return potential of the fund.

It is through the diversification of investments that the tri objective of – Profitability, Liquidity and Security can be achieved simultaneously. While profitability entails investing to achieve highest returns that keep increasing overtime, liquidity rotates around the ability of the fund to pay all its liabilities as at and when they fall due and security involves concise effort in preserving and guarantying the value of the fund overtime by reducing the probability of loss. The tri -objective is achievable if and only if investors after attaining balanced portfolio mix and the mix sustained by readjusting investments with the age trend in such way that when some assets are down others are up.

2.6 The Efficiency of Fund Managers

The success of pension fund investments is depended on the efficiency is of the fund managers who are tasked with the responsibility of actual investments of scheme funds. Fund Managers in different jurisdiction handle different responsibilities.

In Chile, fund managers in addition to performing actual investments they are responsible for collecting contributions, arranging for disability and survivor insurance for the members and paying pension benefits. In the European Union, fund managers are responsible for

providing investment advise, executing trade, providing custody of the funds and marketing.

In Britain the fund managers are responsible for marketing as well as developing new products, strategic management of the funds which include long term tactic allocation of funds, research

In Kenya the scope of fund managers' role are to provide advisory services and perform actual investments of schemes funds through tactical asset allocation. They also undertake research activities. Fund Managers do not however handle the transaction and settlements of investment trade.

3.0 REGULATIONS ON INVESTMENT PORTFOLIO IN OTHER COUNTRIES

Different countries have adopted different degrees of pension regulations. Many countries start off with stringent regulations but relax overtime as the industry matures. For example Chile, after 18 years of excessive regulations on investment of pension funds, is continuously revoking and relaxing some of the quantitative restrictions on investment of pension funds. At the onset of the pension reform in Chile in 1981, Fund Administrators faced stringent restrictions on investments. Prior to 1985, private pension funds were allowed to invest only in four types of debt instruments. Equity investments were prohibited due to fears of fraud, however in 1985 the pension law was amended to allow equity investments but restricted to selected government-owned entities. In 1990s, major changes were effected in the pension law to relax the once restrictive pension law on investment. Pension companies are now permitted to invest in government securities, mutual funds, other Chilean equities and even in foreign equities. The Chilean government relies on the Risk Classification Commission set up in 1985 as well as rating agencies to evaluate the suitability of additional debt instruments for investments by pension funds. Despite an expanded investment options, the private pension funds are subject to portfolio limits. A fund can invest a maximum 40% in equities, 20% in commercial paper, 50% in government securities, 5 % self-investments and 12% in foreign investments.[7]

In Argentina 98% of pension funds must be invested in Argentinean investments. South Africa pension funds must be invested within allowable limits as directed in the Pension Fund Act 1956, section 19 and Regulation 28[8].

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[7] Investment performance of the Chilean Pension System, Journal of Pension Economics

[8] The essentials of Retirement Fund Management in Southern Africa.

Germany stringently regulates its investments through its Insurance Act. The Act enumerates and explains specific types of permissible investments and even imposes quotas on some of them[9].
South Africa has clear prescribed investment requirements for the investment of assets of a fund in the Pension Funds Act and in the Pension Regulations. A fund has to invest its total fund (calculated as market value) according to provided percentages whether as single or or combination of assets. 75% can be in equities of which only 10% can be invested in any one listed scheme. 90% can be invested as combined equities and property. The Act allows only 15% foreign investments.

Pension Funds in Iceland invest according to provisions given in the The Pension Fund Act (No. 129/1997). Only specific assets are restricted. It is thus not as restrictive as that of Kenya. Schemes can invest 100% in Equities and up to 50% of asset fund can be invested in foreign denominated assets[10].

US pension sector the largest and most established in the world – US $ 7,773bn (2002)[11], has no set regulations on investments of pension funds. It is a fully liberalised sector wholly reliant on the "prudent man rule" of investments after a undergoing through a period of restricted investments. United Kingdom (UK) regulates all the aspects of pension administration save investments, which remains unregulated. They too follow the principle of prudent man rule after a time of restricted investments.

[9] The philosophy of risk &the prudent man principle in relation to pension funds pg 4.
[10] Pension funds' assets and return on investment
[11] A perspective on pension fund investment world wide

4.0 CHARACTERISTICS OF INVESTMENT ASSETS

Cash

- ✓ Most liquid
- ✓ Most stable
  - × Yields the lowest returns than all other assets
  - × Returns do not keep with inflation.

Foreign Investments

- ✓ Increase diversification from political risks
- ✓ Provides an opportunity to invest in assets unavailable in the country
- ✓ Possibility of higher returns in economies growing faster than home economy
  - **x** Problem of currency risks
  - × Principle agent problem

Fixed Interest Assets - Corporate Bonds

- ✓ Easy to subdivide for trading purposes
- ✓ Guaranteed income and capital
  - **x.** Fixed income from coupons- cannot expect the income to increase regardless of the economic performance
  - **x.** Returns do not keep with inflation.

Guaranteed

- ✓ Known minimum level of return
- ✓ Additional gains expected depending on economic performance
- ✓ Insured capital

Equities

- ✓ Has produced the highest overall long term rate of return of all assets
- ✓ Keeps track of inflation

- ✓ Historically equity investments have persistently outperformed the debt investments over the longer term

x. Very volatile

Property

- ✓ Rental income increases with improved economic activity and through skillful asset management
- ✓ Keeps track of inflation by offering high current yields
- ✓ improves the anticipated returns per unit of risk
- ✓
    - × Least liquid asset and can be a challenge when a scheme is faced with sudden large cash requirements
    - × Open to rental defaults
    - × Difficult to subdivide for trading purposes
    - × Subject to depreciation ie site value, wear and tear,
    - × Maintenance costs can be high

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