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Determinants of Financial Performance on Pension Schemes: A Case of Kenya Retirement Benefits Authority

[1]Faustin Okhalo Were, [2]Prof. Mike AmuhayaIravo, [3]Muchelule Yusuf Wanjala

School of Human Resource Development, Jomo Kenyatta University of Agriculture and Technology, Kenya

Abstract: **Pension fund is a pool of resources contributed by the employees with the aim of having enough resources to cater for their needs after retirement. Therefore, pension fund needs to be invested to meet the aim of the contributors. However, the financial performance of pension funds in Kenya seems wanting thus raising doubts whether they can be able to achieve their primary objective. The pension should provide an adequate replacement income for the remaining life of the member or partner and remove the risk that the member outlives the resources. The poor performance of pension schemes jeopardizes this role, and hence the retired people may not be able to have a high degree of retirement income security. Due to the poor performance of pension schemes in Kenya, it was necessary to conduct a study to establish the determinants of this poor performance. It is in this line that the current study sought to analyze the determinants of financial performance on pension schemes in Kenya. The study specifically determined the effect of access to capital, the impact of firm size, retained earnings and leverage on the financial performance of Pension schemes in Kenya. The theoretical foundations of the study are the modern portfolio theory (MPT), finance theory and liquidity theory. A descriptive research design was used for the study. The target population for this study was all the registered occupational pension schemes in Kenya which according to the Retirement Benefits Authority report are 818 by the end of the year 2016. Random sampling method was used to come up with the sample size since the population was heterogeneous. The sample size for the study was 261 occupational retirement benefits schemes registered under the Revenue. The study used secondary data. Correlation analysis was used to establish the association between the study variables. A regression model was used to establish the relationship between the study variables. A multiple linear regression models was used to test the significance of the determinants of financial performance on pension schemes in Kenya.**

Keywords: **Collateral, Credit Guarantee Scheme, Contribution density, Financial Performance, Pension Fund.**

1. INTRODUCTION

In most cases, the amount released usually fell short of actual appropriation for pension payment in a scheme. Another issue was that the past pension schemes suffered because of politicians, eager to capture the votes of the electorates, were in the habit of offering fabulous pension increases that they either knew they were not going to pay or which may fall on regimes other than theirs. And because the pension account was not distanced from political control, politicians usually dip hands into pension funds to cushion up temporary fiscal shocks. Before enactment of the Pension Reform Act 2004, which establishes a contributory pension scheme for employees in Nigeria, the country had operated a Defined Benefit (DB) pension scheme, which was highly unfunded and non-contributory. The Scheme led to massive accumulation of pension debt and became unsustainable largely due to lack of adequate and timely budgetary provisions, as well as increases in salaries and pensions. The administration of the scheme was very weak, inefficient, less transparent and cumbersome, leading to bureaucracy and highly liable to corrupt practices.

As a result of the current crisis in the OECD countries, the losses of pension funds are estimated to be $5.4 trillion or about 20% of the value of assets in 2008 [2]. Consequently, in a large number of countries, policymakers are again paying attention to how private pension funds are managed and taking into consideration different reforms that may dramatically change the pension system in some countries. The goal of this reform is often to increase investment returns of pension funds and, consequently, their asset value.

According to [8], the age of a contributor to a pension fund is very significant in determining its performance. If a pension fund has majority young contributors who have not attained retirement age, it implies that they will have more financial resources that can be channeled into investment activities thus earning more income. Most of the contributors are old and almost attaining retirement, the fund has to spend more funds to service retirement packages for the contributors, and this implies there will be fewer funds available for investments. Pension schemes in Kenya comprise of the civil service scheme, occupational schemes, and the individual pension schemes. Pension schemes in Kenya are voluntary and are established under a trust deed. They are regulated by Retirement Benefits Authority. There are no minimum requirements for the levels of contribution by employers and staff. Legislation restrictions are in relation to minimum retirement ages, vesting, portability, preservation, and accessibility of benefits. Individual personal pension plans comprise schemes set up by institutional providers to target individual members not necessarily tied to an employer or any formal setting. The majority of these schemes are offered by insurance companies.

The coverage of these pension schemes is currently estimated at less than 15% of the total labor force. The NSSF has the highest membership proportion at about 67%, or about 800,000 members [11]. The civil service pension scheme follows at about 22%, and occupational retirement benefits schemes and individual retirement benefits schemes account for about 11% of total scheme membership in the country. The Government of Kenya in 1997 embarked on an overhaul of the retirement funds industry, previously plagued with the mismanagement and misappropriation of pension scheme assets [7]. This saw the enactment of the Retirement Benefits Act aimed specifically at regulating a market, which lacked a harmonized legal framework. Retirement Benefits Authority (RBA) is a regulatory body under the National Treasury, established under Retirement. Benefits Act. The Retirement Benefits Act was enacted as part of the on-going reform process in the financial sector to bring the retirement benefits industry under a harmonized legislation, to address the many problems that have hitherto faced the industry. The enactment of this Act filled a regulatory vacuum which had existed in Kenya. At the time the Authority came into existence, retirement benefits schemes in Kenya were regulated by fragmented legislation, mostly Trust and Income Tax Laws. The absence of specific retirement benefits regulations allowed schemes to adopt different styles of operation. Commonly, sponsors (employers) dominated the operations of the industry while members and beneficiaries were largely marginalized.

2. EMPIRICAL REVIEW

[13] asserted that pension is also the method whereby a person pays into pension scheme a proportion of his/her earnings during his working life. The contributions provide an income (or pension) on retirement that is treated as earned income. This is taxed at the investor's marginal rate of income tax. On the other hand, gratuity is a lump sum of money payable to a retiring officer who has served for a minimum period. A greater importance has been given to pension and gratuity by employers because of the belief that if employees' future needs are guaranteed, their fears ameliorated and properly taken care of, they will be more motivated to contribute positively to organization's output. Similarly, various government organizations, as well as labor unions, have emphasized the need for sound, good and workable pension scheme. According to [12], Pension consists of lump sum payment paid to an employee upon his disengagement from active service. According to him, payment is usually in monthly installments. He further stated that pension plans might be contributory on noncontributory; fixed or variable benefits; group or individual; insured or trustee; private or public, and single or multi-employer.

In a study to establish the determinants of performance of pension funds in Kenya, [11] used secondary data. An ordinary least square regression was used to analyze the data. The study was done on Kenyan pension funds at aggregate level using annual data on fund value, assets, age, contributions, and returns. The data was from between 2000 through 2012. Time series regression analysis was used to determine the relationship between returns as the dependent variable and fund value, assets, age and the contributions of pensioners as the independent variables. The study found a strong positive relationship between age of the investors measured by the national life expectancy of Kenya indicating that a longer life expectation positively affected returns. The study recommends the pension funds use the increasing value of their funds to generate returns for the pensioners. Secondly, there is need to utilize assets to generate income for the pension funds. Further, there is need to put the contributions of pensioners to more productive investments other that just keeping the funds safely for the pensioners.

A study was also conducted by [10] on the effects of regulations on the financial performance of the retirement benefits funds in Kenya. The objective of the study was to establish the effects of regulations on the financial performance of retirement benefits funds in Kenya. The study used secondary data and an OLS regression model for analysis. Correlation analysis was also established. The study found that regulations affect the financial performance of retirement benefits funds in Kenya. Thus the study concludes that since the enactment of the Retirement Benefits Authority Act, there has been significant growth in performance of retirement benefits fund. A comparative study on the performance of pension plans was also conducted by [1]. A panel data approach using secondary data used. The study established that the Sharpe ratio and attribution analysis show that, for those countries with enough information and data to adjust returns accordingly, privately managed pension funds have obtained a risk premium against short-term investment alternatives. It was also clear from the findings that pension funds have underperformed concerning the hypothetical portfolio with the highest (mean) return for a given level of risk. The results also confirmed that in several countries investment restrictions had had a negative impact on performance.

A study was conducted by [6] on determinants of retirement benefits schemes financial performance in Kenya. The study sought to examine the determinants of retirement benefits scheme financial performance in Kenya through the use of regression model that related the determinants and retirement benefits schemes financial performance in Kenya. The findings of the study suggest that all the determinants had a positive relationship with the schemes financial performance. The study thus suggests that all the determinants play a role in determining the schemes financial performance and more research should be done on the efficiency of the capital markets operations.

3. CONCEPTUAL FRAMEWORK

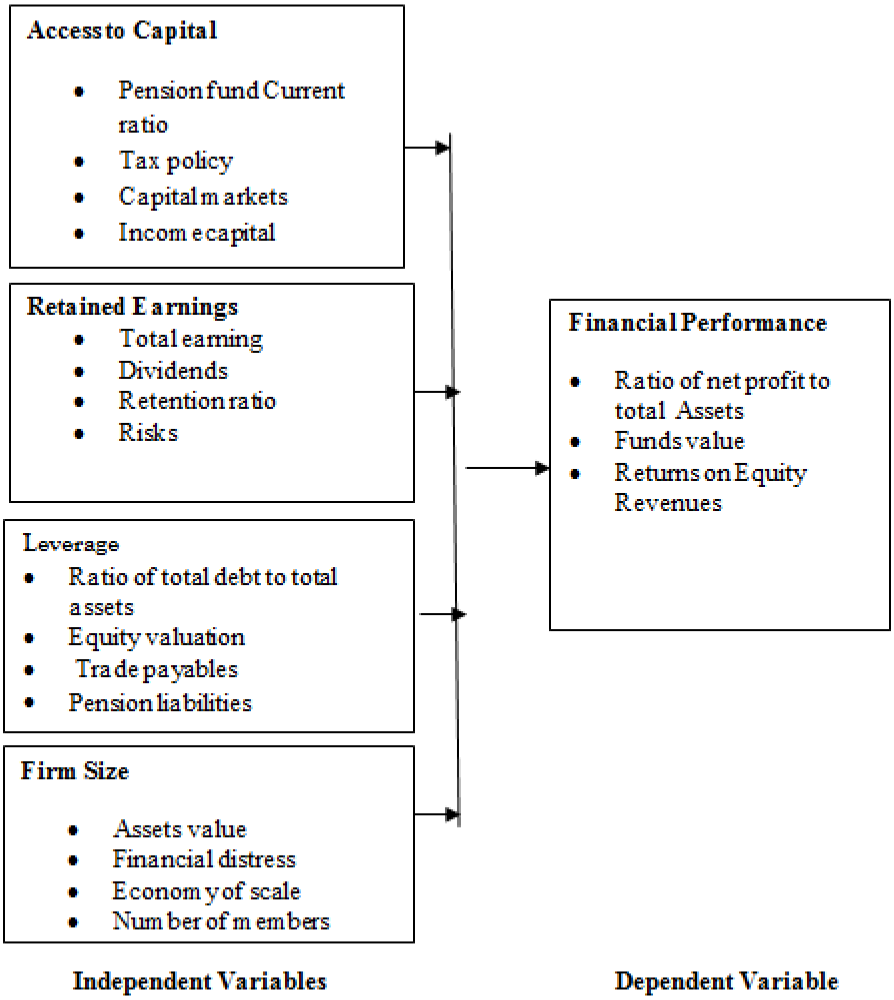

Figure 3.1: Conceptual Framework

4. SUMMARY AND CRITIQUE OF EXISTING LITERATURE

Empirical literature review indicates that demographic characteristics are among the most important determinants of financial performance of pension schemes. The phenomenon of population aging, occurring in many developed countries across the world cannot be underrated since demographic change is a growing concern for both developed and developing countries. For instance, increasing longevity and reduced fertility threatens the sustainability of traditional pay-as-you-go pension systems. This is hence a matter that needs to be investigated. [4] tried to link commitment to motivation and opined that commitment is also tied to how well an employee is motivated. The motivation here entails the process of influencing employee's behavior towards the attainment of organizational goals.

Motivation includes meeting the psychological, financial and emotional needs of workers because it creates an impression in them that there is life after retirement. In the words of [15], a good pension guarantees employee's comfort and commitment to the organization during his/her active years. A pension is a contract for a fixed sum to be regularly paid to a pensioner, typically will follow retirement from service the difference from severance pay because the former is paid in regular installments while the latter is paid in one lump sum. A pension plan created by an employer for the benefit of employees is commonly referred to as an occupational or employer pension. Labour unions, the government, and other organizations, also fund pensions. Occupational pensions are a form of deferred compensation, usually advantageous to employee and employer for tax reasons.

5. RESEARCH METHODOLOGY

The study used a descriptive survey design because there is a need to survey more than one pension scheme (261). This design was most appropriate. The target population for this study was all the registered pension schemes in Kenya Revenue Benefits Authority report. There are 1232 registered pension schemes in Kenya Revenue Benefits Authority by the end of the year 2016 (KRBA, 2016). Out of this, 818 are occupational retirement benefits schemes. The sample size for this study is 261 occupational retirement benefits schemes registered under the Revenue Benefits Authority. The study used secondary data. The data collection instrument used was a data collection tool. Secondary data was collected over a five year period from the year 2012 to the year 2016. Data collected was on access to capital, retained earnings, leverage, firm size, and performance of pension schemes.

6. RESULTS AND DISCUSSION

Pilot Study:

When reliability is upheld, then the research instrument should collect similar results when administered to different sampled populations exhibiting related characteristics. The study employed Cronbach's alpha to test the reliability of the research instrument.[9] Recommend a Cronbach coefficient of 0.7. The research tool met the necessary reliability for measuring the internal reliability between items. The permissible level coefficient value was a Cronbach alpha of 0.70. The research used all items in document analysis.

Access to Capital:

Current assets to current liabilities of pension schemes were well presented in all years with 2016 taking the lead. A ratio greater than one shows the firm has enough current assets to meet current liabilities hence access to capital. A ratio that is too high may indicate that the company is not efficiently using its current assets or short-term financing. However, major challenge in access cash for liquidity purposes is due to emerging markets. The findings concur with [14] who noted that individuals with low access to capitals are likely to face low accumulated assets at retirement age, and therefore are likely to have low retirement incomes

Leverage:

Debt/Equity Ratio is a debt ratio used to measure a company's financial leverage, calculated by dividing a company's total liabilities by its stockholders' equity. The proportion of debt equity in financing the firm's assets was highest in 2014 with a mean of 0.546 and lowest in 2012 where the mean of 0.435. This shows how much debt pension schemes are using to finance its assets relative to the amount of value represented in shareholders' equity. There is an indication that the debt paying ability has been reducing from 2014 to 2016 with a mean of 0.546. This indicates that pension schemes have engaged in other cash outflow entities. Regarding earnings retentions, [3] stated that there is always a conflict in determining the ratio or earning to be retained.

Retained Earnings:

The retained earnings are simple net earnings not paid as dividends. Retained earnings to total asset ratio have to be 1:1 for good performance. The higher the retained earnings to asset ratio the less reliant the scheme is of other common types of debt to equity financing. The retained earnings were highest in 2016 with a mean of 0.27 or 27% and lowest in 2012 with a mean value of 0.21 or 21%. The strong net earnings typically mean that the company remains in the growth stage and wants to use earnings to expand. However, with these earnings of below 100%, it means pension schemes paid dividends that reduced the amount. This indicates that retained earnings increased with increase in time.

Farm Size:

The firm size about the quality of asset was established through loan loss ratio, and therefore performance was highest in 2013 with a mean of 0.1712, and lowest amount was in 2018 where the mean was 0.2800. The lower the ratio the better the firm performance. This indicates that firm size quality of assets had decreased from 2013 to 2016. It is the major concern of all financial institutions to minimize cases of nonperforming loans. This will reduce cases of such loans affecting financial performance. A lower rate of nonperforming loans to total loans shows that the good health of the portfolio a credit giving institution. The manner at which an organization awards finances among investment channels matters most on total performance. [5], bigger schemes enjoy economies of scale they can spread costs across a wider membership base allowing them to give members a bigger return.

Return on Investment:

A business that has a high return on equity is more likely to be one that is capable of generating cash internally. Thus, the higher the ROE, the better the company is regarding profit generation. The amount of return on equity was highest in 2012 where the mean was 13.72, and lowest amount was in 2016 where the mean was 11.12%. ROE had the highest percentage value in all the years under study. ROE is what the shareholders look in return for their investment. ROE reflects how effectively a scheme management is using shareholders' funds.

Regression Model:

The regression model is as follows:

ROE=1.0856+0.4072(Access to capital)-0.1467(Leverage)+0.2122(Retained Earning)+0.1745 (Firm Size)$_{+}$ ε

Where Y is the dependent variable (financial performance), β_0 is the regression constant, β_{1-} beta coefficients, X_1 Access to capital, X_2 is Leverage, X_3 is Retained earning and X4is firm size and ε error term. The coefficient of determination (R Squared) of 0.75 indicates that ROE on its own in the model explains 75% of the variation or change in the dependent variable (ROE) which can be explained by access to capital, leverage, retained earnings and firm size.

7. CONCLUSION

The study concluded that access to capital, leverage, retained earnings and firm size are the key determinants of financial performance of pension scheme in Kenya. The results from the regression model revealed that the factor's that influenced pension scheme performance were statistically significant showing there was a relationship between the independent and dependent variables with an adjusted R of 0.75 meaning that 75% of the changes in Return on Equity can be explained by access to capital, leverage, retained earnings and firm size. Access to capital was found to be the most influential, retained earnings were found to be the second most influential variable, firm size third and finally, leverage was the least influential variable on the financial performance of pension scheme in Kenya.

The study concludes that since all the variables were loaded into one factor for each of the variables, this was a good indication that the constructs used in the measurement of all the variables were adequate and they measured the financial performance.

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