Financial Performance of Registered Occupational Pension Schemes

Prof. Gregory Simiyu Namusonge
College of Human Resource Development, Jomo Kenyatta University of Agriculture and Technology P.O. Box 62000-00200 Nairobi

Prof. W.W. Sakwa
College of Human Resource Development, Jomo Kenyatta University of Agriculture and Technology P.O. Box 62000-00200 Nairobi

Mr. George Mwangi Gathogo*
School of Business and Economics, Murang’a University of Technology P.O. Box 72-00200 Murang’a

Abstract
The study sought to find out whether Agency cost is crucial in influencing the Financial Performance of Registered Occupational Pension Schemes. Agency cost is the total expenses paid to the professional service providers of these pension schemes. They include the Funds Administrators, Funds Managers and the Funds custodians. The study employed a descriptive design. The data for the empirical analysis were derived from a list provided by the Retirement Benefits Authority (RBA) for the period 2006–2016. Systematic sampling technique was used to select a probability sample of 297 sample units from a population of 1232 registered pension schemes. Information on this particular variable was obtained mainly through a questionnaire survey which was conducted between March and April 2017. The SPSS statistical package was used to analyze data. The study found that there is a negative correlation in the Financial Performance-Agency cost relationship which could be explained by the variations in the Agency costs. The study was guided by The Systems theory of organizations as founded by Ludwig von Bertalanffy in the early 1950s and the Agency Theory as forwarded by Jensen and Meckling in 1976.

Keywords: Agency Cost, Agency Theory, Systems theory, Systems, Sub-Systems Sponsor, Financial Performance, Occupational Pension Schemes

1. Introduction
The Pension scheme industry plays a crucial role not only in harnessing capital formation that is necessary for the development of a country, but also providing an employment income replacement upon the retirement of the pensionable population. Retirement income accounts for 68% of the total income of retirees in Kenya, while pension assets account for 30% of Kenya’s Gross Domestic Product (GDP). Occupational Pension scheme governance structure captures the relationship between the Principals or the key stakeholders (the Workers and the Sponsors) and the Agents (Trustees, Fund Administrators, Funds Managers, Custodians and the Auditors). Generally, the service providers have different rates and bases of computing the charges for services rendered. The choice of any service provider has a cost implication on the cash flows of the Occupational Pension Scheme.

The Occupational Pension Schemes are created by the organizations that would like to operate schemes on their own in line with the RBA requirements. In terms of numbers, occupational pension schemes are statistically the fastest growing schemes in the Pension industry according to the Retirement Benefits Act (RBA). They are modeled by companies to accumulate funds which are pooled together and professionally invested as required by the RBA. Unlike other type of the schemes, the employers of the Occupational pension scheme top-up their members’ contributions. This arrangement makes this category of the pension schemes unique and more attractive.

Pooling of the assets is done to capture the economies of scale and diversify risks. By definition, Economies of scale exits if the average costs of production decline with increase in the scale of output. In the case of pension schemes “output” refers to assets under management. Past Studies done in Kenya, mainly focused on trustees and regulations compliance issues leaving out the crucial issue of impact of the Agency cost on the financial performance of this category of schemes in the pension industry. The service providers to these schemes are many and appear to draw out more funds from the Schemes than other statutory and non-statutory deductions. The main objective of the study was to find out whether Agency costs are actually a determinant of the financial performance of the registered occupational pension schemes in Kenya.

These Occupational Pension Schemes are, by all means, expected to generate the highest returns possible from their investments and management choices, even under harsh circumstances, as compared to other classes in the pension industry as well as other forms of investments available in Kenya. The costs incurred in the
payment of the professional service providers should be relatively low as compared to the returns obtained from them. Studies have, however shown, that generally this is not the case despite the overwhelming support from the sponsoring companies, (Forbes A, 2013, RBA, 2014). Even if the gross returns may be higher than the other categories of the schemes, Agency cost appears to take a greater share of the scheme expenses. This cost reduces the amount meant for the stakeholders. Thus Agency cost seems to be an impending factor on the amount of returns from the investments of the Occupational pension schemes.  

According to (Tari, 2015) a few studies in Kenya have been conducted in relation to the investment returns of the Pension schemes in general, but not at all for the Occupational Pension Schemes. Other studies such as Hustead (2012), OECD (2013), and Rudolph (2012), have mainly concentrated on determining the end results or output of entities rather than the drivers of the financial performance. Specifically, there is no study carried out on influence of Agency cost on the performance of occupational Pension Scheme in Kenya. There is therefore, an informational gap about the impact of Agency costs on the financial returns arising from continuous long term investments.

Owing to the rapid growth of this category of pension schemes, it is imperative to urgently examine the impact of Agency cost on the financial performance of occupational pension schemes in order to fill in the much needed informational gap as well as improve their investment income streams. Knowledge about Agency costs has mostly been derived from data in developed economies that have many institutional similarities (World Bank). But different countries have different institutional arrangements, mainly with respect to their values and investment systems and policies. In addition, different countries have different levels of economic development. Different countries will therefore not have the same regard for the Pension industry as well as the retiring cohorts, particularly in relation to the Occupational Pension Schemes. These differences actually warrant taking a thorough look at the issue from the perspective of developing economies, especially within the context of sub-Saharan Africa which has unique characteristics.

This study examined whether Agency costs are the determinants of financial performances of occupational pension schemes in Kenyan firms. By studying the impact of the Agency costs on the financial performance of occupational pension schemes, this study is relevant in the Kenyan context given the important role that the occupational pension schemes are expected to play as the engine of growth as well as providers of income replacements of retirees.

2. Theoretical Framework

Financial Performance, in this context, is defined as the net returns after considering the Agency costs and other statutory and non-statutory deductions. The assets of the Pension schemes are either internally or externally managed. Where external managers are engaged in providing services such as securities selection, and executing the investment function, they are paid for such services. Such fees is referred to the management fees.

The theoretical basis for this study is derived from the Systems and the Agency theories. The Systems theory of organizations was founded by Ludwig von Bertalanffy in the early 1950s. The theory states that organizations regardless of their size and purpose should be seen as systems that have sub-systems that require inputs from and produce output to the environment. Occupational Pension Schemes are basically organizations with various service providers as sub-systems which are related structures and are interdependent (Oso et.al, 2013). Service providers are sourced externally to provide the much needed leadership on investments and cost management in order to enable schemes to generate adequate income replacements to the retirees. Both employees and the sponsors form one sub-system of contributors who give their collective contributions to their trustees to manage the funds on their behalf. The trustees form another sub-system. Through the laid down procedures, the trustees appoint the service providers, namely; the Administrators to the fund, the Fund managers and the custodians of the fund. The Retirement Benefits Authority (another sub-system) is expected to regulate the operations of the Fund as whole. Each of these forms a sub-system where each relates with others without duplication of duties. Like any other organizations, occupational pension schemes are in constant exchange of information and resources with the larger society. They are expected to draw more from the wider society than they contribute, but within the rules. The presence of each service provider has a cost associated with duties that each service provider performs. Ideally, service providers must operate efficiently in order to maximize the funds returns at minimal costs. Overall, the participation of service providers in the funds management is expected to bring synergy at minimal cost as compared to where management of funds is done by a single system without any separation of duties. Duplication of duties has got a cost implication. Thus Agency costs can be reduced to the bare minimum by reducing any overlap or duplication of duties.

Agency theory was advanced by two American Economists, Jensen and Meckling in 1976. According to Copeland and Weston (2012), the two Economists viewed corporations as “sets of contracts” between management, shareholders and creditors. Precisely, management which provided stewardship was viewed as Agents, while the shareholders and creditors who were providers of finances were the Principals. The Corporate governance is based on Agency theory, which is the relationship between agents and principals. This theory
explains how best the relationship between agents and principals can be tapped for purposes of governing a corporation to realize its overall goals.

Managers are said to have entrepreneurial skills necessary for the proper management of funds. The owners of capital (principals), ordinarily, have neither the requisite expertise nor time to effectively run their enterprises, they hand over the operations of the Pension schemes to agents (managers) for control and day-to-day operations, hence, the separation of ownership from control.

Agency Theory assumes that agents act selflessly for the best interests of their principals. Their interests are expected to come second in case of any possible conflict of interests. However, in reality agents tend to maximize their benefits through paying themselves allowances, increasing the number of meetings, inviting members for meetings and updates sometimes at exaggerated charges among other dubious methods of benefitting themselves instead of the members who mandated them to manage funds on their behalf. This situation creates the Agency conflict. The Agency costs charged are not standardized but are negotiated between service providers and the Trustees. Ideally, if the funds are well managed, they would generate better financial returns through synergy at minimal Agency costs. The absolute value of the Agency costs in these schemes cannot easily be compared given that each occupational pension scheme is unique in terms of their sizes, management structures, negotiation skills in relation to services costs for the services rendered and the choice of the service providers. Such factors would vary from one scheme to another but will, definitely, have a negative impact on the cash flows of the Occupational pension schemes.

The postulates of systems and Agency theories were to assist the researcher to find out whether the service (Agency) cost, if reduced, would help in maximizing the returns on investment for the occupational pension schemes.

3. Empirical Review
Empirical evidence on the relationship between Agency cost and Financial Performance indicates a negative relationship. This indicates that as the amount of the Agency cost increases, the net return meant for the stakeholders decreases. Studies conducted by Njuguna (2014) and Davis (2013) respectively confirmed the findings. As regards the Systems and sub-systems structure of Occupational Pension schemes, Njuguna (2014) indicates that Pension schemes can be viewed as open systems since they collect and accumulate contributions from employees (members) and their sponsors (employers who establish the pension fund, invest the contributions and hold the proceeds in stewardship for the benefit of the members until their retirement time. However such proceeds do not benefit the members in total, services must be paid for as well as other statutory and non-statutory deductions (Davis, 2013).

According to Mutuku (2014), in an Agency relationship, principals and agents have clearly defined responsibilities: Principals select and put in place governors (directors and auditors to ensure effective governance system is implemented, while agents are responsible for the day-to-day operations of the enterprise. According to (Copeland et. al., 2012), both parties are better off. The conflict between the two parties creates the Agency cost which includes the monitoring cost and losses arising from conservative choice of an investment objective and the information asymmetries.

The shareholders want to maximize the returns on their investments, while the agents want to maximize their own compensations within the agreed compensation contract. Based on a contract between the two parties; the Agent chooses a course of action related to financing and investment. In fact, the Agency problem arises in organizations because the corporate decisions made by the Agents (the managers) on behalf of the Principals (the Shareholders) bind the latter. The compensation of the Agents depends on the performance of the Agency. The Agent is paid according to the compensation contract, while the Principal remains with the balance (Copeland et. al.,2012). The payment to the Agents reduces the amount available for the members upon retirement. As per the research conducted it is clear that there is a strong negative correlation between Agency costs and the financial performance of Registered Occupational Pension Schemes.

Good service provision has been cited as one of the key factors that contributes to the effective development of work-related pension schemes as it leads to improved investment performance and retirement benefits (Stewart, 2011). Financial performance is influenced by the administrative efficiency, part of it being how pension schemes manage Agency costs (Nyangundi, 2009). Agency costs normally “eat up” the investment returns (the fruits) and in the extreme scenario these costs can eat up even the contributions from the members (the tree). The rationality of maximizing returns and even cash flows, at minimal cost, is clearly evident in this particular type of schemes. Stewart, F., & Yermo, J. (2008) also found out that the operation cost when kept at minimum possible level was an advantage to the pension schemes since there was an improvement in the cash flows.

4. Research Methodology
The study was conducted through a descriptive research design. This is where a researcher provides numeric
descriptions of some parts of the population (Sekaran and Bougie 2015). The survey is ideally suitable for studies where independent variables are described as they are (Kothari 2011; Orodho J., 2006; Mugenda and Mugenda 2003). The sampling frame was a list of Occupational Pension schemes registered, 2006 - 2016, by the Retirement Benefits Authority (RBA) of Kenya. A systematic sampling technique was used to select the sample of 293 units for purposes of study from registered Occupational Pension schemes. The sample units targeted either the Trust secretaries or the Trust Chairpersons. The latter were sent questionnaires to fill in. The questionnaires had structured qualitative and quantitative questions. The field survey was carried out between March and April 2017. The data for the empirical analysis were derived from the financial reports submitted to the RBA by the Registered Pension Schemes during the period 2006–2016.

Data collection involved collecting of observations on a cross-section of units over several time periods (Saunders, Lewis and ThornHill 2012). According to Saunders et al. time-series and cross section data approach is more useful than either of the two, since it gives a clear picture of the impact of the Agency cost on the financial performance of occupational pension schemes for a period of time across the section. The general form of the simple regression model can be specified as:

\[ Y_{it} = \beta_0 + \beta_1 X_{it} + \epsilon_{it} \]

The variable, \( Y_{it} \), represents the dependent variable in the model (Financial Performance), \( \beta_0 \) being the constant, \( \beta_1 \) representing the coefficient subscript “it” denoting the cross-sectional dimension and “it” representing the time-series dimension. The \( X_{it} \) contains the explanatory variable (Agency cost) in the estimation model. The error term \( \epsilon_{it} \) represents the unexplained changes in the dependent variable \( Y_{it} \).

5. Data analysis

Data collected was analyzed with descriptive statistics using SPSS which includes percentages, mean scores and frequency tables. The correlation coefficient that measures the relationship between two variables was determined using the Pearson formula in the SPSS program. The \( r^2 \) was determined to assess the extent of influence of the independent variable on the dependent variable. The regression was carried out using a Prais-Winsten specification because this approach shows signs consistent with theoretical predictions. In addition, it is useful for estimating linear cross-sectional time series models when the disturbances are assumed to be heteroscedastic across panels. The regression model employed is popular with this type of study and is also in line with what was used in the previous studies, with some modifications for the analysis (Saunders et al., 2012, Ajai and Ajai 2009, Sekaran et al. 2015). In testing the hypothesis test \( H_0 \); Agency costs are not determinants of financial performances of Occupational Pension Scheme at the significance level of 0.05, it was established that the P-value was 0.000. This was far below the recommended significance level of 0.05 hence we reject the null hypothesis and conclude that Agency cost has an impact on Occupational pension scheme performance.

6. Research Findings

The regression analysis in table below, “\( r \)” value measures the goodness of prediction of the variances. In this case “\( r \)” value of -0.861 is a good predictor of the financial performance by the independent variable: Agency Cost. On the other hand, the \( r^2 \) is the coefficient of determination which indicates the extent to which the dependent variable can be explained by the independent variable. In this case the \( r^2 \) value of 0.741 means that 74.1% of the corresponding variation in performance of pension schemes can be explained by the independent variable, Agency Cost.

<table>
<thead>
<tr>
<th>Model</th>
<th>Adjusted ( r )</th>
<th>( \text{r}^2 )</th>
<th>( \text{r} ) Square</th>
<th>Std. Error of the Estimate</th>
<th>( \text{r}^2 ) Square Change</th>
<th>( F ) Change</th>
<th>( \text{df} )1</th>
<th>( \text{df} )2</th>
<th>Sig. F Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>-.861( ^a )</td>
<td>-.741</td>
<td>-.740</td>
<td>.524</td>
<td>.741</td>
<td>708.850</td>
<td>1</td>
<td>248</td>
<td>.000</td>
</tr>
</tbody>
</table>

a. Predictor: (Constant), Agency Cost
b. Dependent Variable: Financial Performance

However, there are other variables not included in the study which account for 25.9% of the determinants of the financial performance of pension schemes. This outcome shows that the financial performance of pension schemes is to a large extent negatively impacted on by the predictor variable, Agency Cost. Thus, the greater the value of the predictor variable, the poorer it is the financial performance of pension schemes. This finding is in line with the study by Ogonda, J., 2006, which revealed that in order to improve the financial performances of investing units; both the management structures and services charges must be considered. Since pension schemes are long term investment units, this study has confirmed Copeland et al., 2012, findings. The same sentiments was put forward by Mutukucu (2014) who showed the relationship between pension schemes and employees as
agents of the members in a particular occupation who ensure that the members (principals) wealth is safely invested to be delivered in future when demanded. Stewart, F., & Yermo, J. (2008) also found out that the operation cost when kept at minimum possible level was an advantage to the pension schemes since there was an improvement in the cash flows. The capital accumulation kept on increasing the financial health of the pension schemes which was an improvement in their financial performances.

7. Conclusion and Recommendations
The study found that high level of Agency cost has an immense negative influence on the financial performance of Occupational Pension Schemes. This is in line with the Systems theory of organizations which emphasizes that sub-systems should inter-relate, interdepend in order to create synergy rather than overlapping and duplicating duties (Oso et.al. 2013). Much as the provision of professional and independent services is critical, managers of the Pension Schemes should seek ways and means of reducing the service costs to the minimum possible levels. This can be done by re-examining the costs charged and finding out where thin line of duties lies in order to avoid duplication of duties of services as provided by the service providers. Over and above, Trustees should renegotiate the terms of services as provided by the service providers.

The study focused on the financial performances of registered occupational pension schemes alone. It did not investigate the financial performances of the unregistered occupational pension schemes, which forms a sizable number of firms in the pension industry. The study therefore recommends that further research on the unregistered firms to be investigated in order to have generalized information of financial performances of the pension schemes in Kenya. In addition, the study established that 74.1% of the change in the dependent variable was explained by the changes in Agency costs, while 25.9% of the change in the dependent variable was not accounted for. Hence the need to investigate other factors that could possibly have an effect on the dependent variable procedures among others.

References

