Article | August 29, 2023

Restrictions on related party service providers: Are Pension Schemes missing cost efficiencies?

Introduction

The Pension industry in the last decade has undergone many changes. In tandem with those changes, the sector has grown significantly and is currently estimated to be managing assets in excess of Kenya Shilling one trillion. Obviously, such a significant sector is always being scrutinised by policy makers albeit not always with good results. In fact, with every budget reading it is normally expected the relevant Cabinet Secretary will make changes to the legislation relating to the pension sector.

One such change was introduced in 2021 affecting all three categories of retirement benefit schemes being occupational schemes (ORBS), individual schemes (IRBS) and umbrella schemes (URBS). The specific change was to the effect that a trust corporation could not appoint an administrator, fund manager, custodian or approved issuer that is related to it.

Additionally, the Retirement Benefits (Managers and Custodians) Regulations prohibit a scheme from appointing a fund manager who is related to the custodian. The Retirement Benefits (Administrators) Regulations prohibit appointment of an administrator that is related to the fund manager.

These are in addition to restrictions prohibiting a trust corporation from being related to the sponsor of the scheme and the investment advisor assisting in preparation of the Investment Policy Statement being related to the fund manager.

Compliance Costs

From a member's perspective, a scheme running on a segregated basis may end up paying for up to six or more service providers. These include the trust corporation, custodian, fund manager, fund administrator, fund auditor, investment advisor, lawyers and scheme actuary. These professionals do not come cheap.

The obvious question is whether some of these roles are complementary. And if they are why can they not be effectively be performed by one party.

Complementary Services

For pension schemes, the role of the custodian and a trustee is one such role. The primary duty of a custodian is to keep the safe custody the scheme assets and the documentation relating to those assets. Connected to this role is keeping of proper records and statements on those assets.

The trust corporation obviously sits in the place of trustees and their duties are very broad. Among them is the duty and obligation to keep records on the scheme including records on the assets. No role performed by a trust corporation would conflict with that of the custodian so as to require these services be provided by unrelated parties. In any event, rules on maintenance of Chinese walls and separation of functions can be issued specifically to address the concerns that may arise in such scenarios.

Similarly, the roles of fund managers and fund administrators are complementary. The primary role of a fund manager relates to deciding where to invest the scheme funds. The fund administrator handles back-office operation including processing benefits, keeping accounts and ensuring compliance with legal requirements affecting the scheme.

Equally, no role performed by the fund manager is in direct conflict with those of the scheme administrator to require that they should not be related. It is noteworthy that for collective investment schemes in the capital markets space, the fund manager serves both as fund manager and fund administrator.

The Rationale

There are good and sound reasons (both ethical and governance related) for having specific roles performed by different parties. However, these reasons are not the subject of this article.

In the financial services sector, it common to have sector players being related entities. They are however legally distinct from each other and are merely related through common ownership. The key reason for this is operating in the financial services sector inherently comes with high capital and compliance costs. In order to enable players to be competitive and to keep operational costs low, they share common resources.

It is therefore easier for an existing player to set up another entity to provide a complementary service than for a new player to set up business. The savings obviously are intended to improve profit margins. However, it also allows for pricing of services more competitively.

This can translate, for pension schemes and their members, to lower service costs amongst other benefits.

Comparative Practice

In other jurisdictions, financial conduct rules and prudential rules are in place that mitigate the risks associated with related party transactions. These rules are put in place by either the primary regulator or a financial conduct authority where it exists.

This category of rules would require a player in the financial markets to act in a particular manner when they find themselves in a position of conflict. They would also address the ethical and governance related issues that are inherent in related party interactions.

The current retirement sector rules do not prohibit the licensing of related parties but rather the provision of services by related parties to the same scheme. However, some services provided to a scheme are complementary and do not inherently conflict.

Conclusion

The restrictions on related party appointments are only likely to lead to fragmentation in the service provider market. This directly impacts the ability of pension schemes to deliver competitive returns to members. The high compliance costs should be a key concern for the sector if it hopes to achieve its primary objective of giving members a healthy retirement pot.

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