Retirement Benefits options i.e. Pension Funds vs Provident Funds

Introduction

Retirement Benefits Schemes are formed to provide income replacement to members after retirement or provide assistance to beneficiaries of the member upon his/her death. Retirement Benefits Schemes allow their members to make regular contributions during their working life and once a member retires either after attaining the retirement age or earlier due to other factors, such as ill-health, these contributions plus accrued returns are utilized to provide retirement income to the member. Additionally, for these schemes to meet their objectives i.e. the replacement of income at retirement, it is prudent that they;

i. Reliably collect contributions from employers and employees,
ii. Invest to get the best returns, so that
iii. They make timely payment of benefits to members of the schemes.

Retirement Benefits Schemes in the Kenyan market can be broadly categorized into two, and the main groups i.e.; (i) Pension Funds and (ii) Provident Funds.

There are very few people who are able to live comfortably after retirement. ICPAK carried out a study (Understanding Pensions, 2018) and according to the report 47.0% of the retired population are dependent on family and relatives, 31.0% have to continue working to earn a living, 16.0% are dependent on monthly pensions while only 6.0% are financially independent. The above problem is compounded by the rising old-age dependency ratios, changing family values necessitating retirees to secure their own financial support and increasing life expectancy.

For most people, the ability to get to the right Income Replacement Ratio is a big challenge and in Kenya, according to the RBA, the Income replacement ratio is below 40.0% compared to the recommended ratio of 75.0%. Some the reasons for the low replacement ratio include the low penetration ratio, currently at 15.0% and accessibility of pension when one changes jobs hence reducing the adequacy of the pension on retirement.

To help sort out this issue the Retirement Benefits Authority continuous to come up with measures to help with the above two main issues. For example, the establishment of the Personal Pension scheme is to help those without a registered scheme where they work or business people to be able to save towards retirement. Also, in this year's budget reduced the amount that one can access after changing jobs was amended to only the employee’s contribution to help with the preservation of contributions made.

There are two main types of retirement schemes that one can invest in i.e., Pension schemes and Provident funds. The main difference between pension funds and provident funds is the mode of payment of benefits at retirement. This note seeks to simplify this concept in order to boost the understanding of every eligible member of a pension scheme in our readership. As such, we will look at;

i. Pension schemes
ii. Provident Funds ;
iii. Comparison between pension funds and provident funds, and
iv. Conclusion

Section I: Pension Funds

In a Pension schemes, on retirement a member have a access a third of their funds as (a lump-sum and the balance of two thirds is used to buy an annuity or transferred into an income drawdown An annuity is an arrangement where a life office/insurance company enters into a contract to pay a set amount of money in regular intervals, usually monthly, to the annuitant or its beneficiary. An Income Drawdown is a fund that provides individuals and members of a Retirement Benefits Scheme an option to access their retirement benefits as a regular income through an investment fund upon retirement rather than taking up an annuity or taking their benefits as a lump sum.

Pension plans in Kenya are classified into:-

(i) Public service pension funds,
(ii) Occupational pension schemes,
(iii) Individual pension plans, which can pay out benefits as pension or provident funds depending on the needs of the individual, and
(iv) Umbrella schemes, which can pay out benefits as a pension or provident fund depending on the needs of the employer.

Section II: Provident Funds

A Provident Fund provides only a Lump Sum payment at retirement so the retiree accesses all their funds at a go. The member can use the funds to either buy an annuity, transfer into an income drawdown fund or use the money as he deems fit.

Of note is that the National Social Security Fund was established in 1965 as a provident fund operating on a defined contribution basis to provide basic financial security benefits to Kenyans upon retirement. In 2013, however, the National Social Security Fund (NSSF) Act was amended to establish two funds, namely, a pension fund and provident fund, to which every Kenyan with an income was to contribute a percentage of his/her gross earnings, and receive benefits out of the Funds in case of permanent disability or upon retirement, a monthly life pension; and upon death, a benefit is to be paid to their beneficiaries.

Section III: Comparison

Similarity

i. These two funds are similar in that both are designed to allow their members to receive their benefits at retirement. They both have the options of buying an annuity or transferring into an income drawdown on retirement.
ii. Tax benefits- Employees' contributions, regardless of the fund, are tax-deductible up to a maximum of Kshs 20,000.0 per month or 30.0% of one's gross salary, whichever is lower. Furthermore, investment returns from the investment of these funds are tax exempt.
iii. Also, in the case of a lump sum received from a registered retirement benefits scheme, the first Kshs 600,000.0 is not subject to tax. Lastly, pension payments after attaining the age of 65+ are also not subject to tax. Employers, on the other hand, receive a tax allowance on contribution by deducting it as an expense in the determination of taxable income, not exceeding 15.0% of each employee's salary.

Differences

The main distinction between a pension and provident fund is how the final benefit is paid out to a retiree. Pension funds are paid out either as an annuity or a combination of a lump sum and an annuity or income drawdown. Provident funds, on the other hand, are paid only as a lump sum and it is upon the member to purchase an annuity if he so wishes.

Section IV: Conclusion

It is important to note that saving through retirement schemes has significant benefits not only on retirement but during your working life as you benefit from tax exemption. One could, however, combine contribution into pension schemes with other forms of investments to enhance the income replacement ratio after retirement. Deciding on whether to join a pension or a provident fund should not be a difficult choice as the benefits for both are largely the same, other than the options available at retirement. For the people who are on gratuity, they can also consider converting those into any of the above.