Original Article

The Nigerian pension system: Reform and expectations

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ABSTRACT Before the adoption of the new pension scheme in 2004, Nigeria's social security provision for the retired and aged was awkward. Most private sector establishments did not accord any priority to their retired workers after years of service. The newly introduced contributory pension scheme is seen as an important social security system that could address both structural and institutional dysfunctions in the country's social security obligations. This article examines, therefore, some salient issues about the scheme and people's expectations of it. By assessing its benefits and challenges, the article underlines the need for a strong structural and institutional framework to achieve the objectives of the scheme.

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INTRODUCTION

Compared with the defined benefit scheme (DBS), the contributory pension scheme (CPS) is aimed at enhancing the socio-economic capacity of the economy to provide security to retirees or the aged. The recent wave of social security reforms in both developed and developing countries has underlined the importance of a sound pensions system in economic prosperity. This article visits the argument put forward in favour of a change in the country's pensions scheme from a defined benefit to a contributory pension system.

From an historical point of view, the DBS has been poorly funded (or unfunded) owing to inadequate budgetary allocations, which had resulted in a pension deficit of over ₦2 trillion (in Nigerian naira). Before 2004, the proportion of pensions to salaries increased from 16.7 per cent in 1995 to 30 per cent in 1999. With a weak administration, the scheme was inefficient and, faced with corruption, non-compliance in the private sector and social and demographic shocks, the scheme was a failure (p. 1[1]; p. 7[2]).

The potential benefits of the CPS will definitely include economic growth. It would be more beneficial so to say, to developing countries particularly in the area of poverty alleviation, which involves reduction in old age poverty with attendant effects on their dependants, as well as reduced lending rates owing to increased funds available with lenders. It will also make room for job expansion by establishing new firms, providing more hands to work within this financial sub-sector, the pension funds administration and custodianship and the capital markets.

Pensions also come with some risks, which may occur in the short or long term. The most

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prominent of these is that is related to management of the funds. This comes in the guises of poor asset management, corruption or misappropriation of funds. Other risk factors that are peculiar to developing countries include policy inconsistencies, civil conflicts, political instability and a dysfunctional micro-economy.

The Nigerian pension reform became imperative in the face of the government's inability to meet the pension overheads any longer, which has continued to cut deep into the national budget. There was also the need to alleviate both old age and household poverty by extending the policy to all sectors of the economy. The DBS (or pay-as-you-go, as it is sometimes referred to), which the public sector has operated for many years, has failed to live up to the financial and development aspirations of the country (and its economy). The private sector compliance ratio has also been low, because of a lack of effective regulation and supervisory mechanism for the system (p. 1).[1]

The DBS was introduced into Nigeria by the British government during the colonial era with the aim of providing post-retirement security to the British working in the country. There have been a number of pension schemes in Nigeria; the first was legislated as the Pension Ordinance of 1951. The National Provident Fund (NPF) scheme of 1961 took care of the private sector, while several other schemes that followed included: the Pension Act No. 102 of 1979, the Armed Forces Pension Act No. 103 of 1979, the Police and Other Government Agencies Pension Act No. 75 of 1987, the Local Government Pension Edict of 1987 and the National Social Insurance Trust Fund scheme of Decree No. 73 of 1993, which replaced the NPF scheme before 1 July 1994 and involved the private sector, and made provision for loss of income in old age, invalidity or death.

Before the introduction of the 2004 Pension Reform Act (PRA), most private sector organizations, just like their public sector counterparts, operated the DBS, and in such a way that the final entitlements were calculated on the employees' length of service and terminal remuneration.

In the public sector, the DBS has been poorly funded and ill managed because it relied on budgetary allocations, which have been inadequate. The administration of the scheme was altogether weak, while inefficiency and lack of transparency characterized its overall management. A key focus of this article is to see how the reform of the pension system could bring greater benefits than the former scheme. However, this is not to underestimate any challenges that may be inherent in the new system.

Our study therefore proceeds as follows. In the following section, we examine the problems and uncertainty inherent in pensions generally. Pensions in economic progress are analyzed in the subsequent section, while people's expectations with regards the pension reform are examined in the penultimate section. In the final section, we shall draw conclusions.

PENSIONS IN NIGERIA: STRUCTURE AND FRAMEWORK

The reform of the pension system casts a light over the difference between the DBS and the CPS. The motive for these reforms in Nigeria and other countries (including developed ones like the United States) is obvious when we consider the problems involved in the DBS.

The DBS was the most popular and common type of pension plan practiced in most countries until the 1990s. It defines the benefit for a retiree, determined by a formula that takes into consideration the retiree's salary, years of employment, retirement age or years in the service of the company and so on. In Nigeria, the DBS was operated by both the private and public sectors before the introduction of the PRA in 2004. This type of pension was financed from budgetary allocations made by the government and has resulted in fiscal deficit to the government. But the scheme was poorly funded because the budgetary allocations made to it were grossly inadequate, hence making it unsustainable.[2]

The success of the pension to the retirees is measured by their receipts of the benefits due them. For example, the failure of the DBS was evident, because of the late payment of benefits

to retirees, poor management of the scheme, corruption and its lack of coverage across many private and informal sectors.

The adoption of the CPS, contained in the PRA, was made in the context of the above-stated problems. Part of the objectives is the reduction in old age and contagious poverty, which incorporates the further benefits of contributing to the country's social and economic development through the funds saved. And to make it sustainable, it was made compulsory for all organizations with at least five employees, with the National Pension Commission[3] as the regulatory body. A Retirement Savings Account (RSA) is opened by every employee with a Pension Fund Administrator (PFA) of choice, which serves as the point of transaction, and a contributor can only transfer to another PFA once in a year, during a 'window' period. So, the scheme allows for the mobility of labour without necessarily affecting the contribution of the employee. Withdrawal from the RSA is subject to the person turning 50 years of age;

(i) the employee having retired from active service, having been appropriately medically certified as unable to function or work anymore; or
(ii) the employee having retired in accordance with the terms and conditions of his employment.

On retirement or turning 50 years age, whichever is later, an RSA holder will utilize the balance standing to his credit to purchase an annuity from a life insurance company with programmed monthly or quarterly payments calculated on the basis of an expected life span. This is provided that the balance left after the withdrawal of the lump sum is sufficient to procure an annuity or fund programmed withdrawals that will produce an amount not less than 50 per cent of his annual remuneration as at the date of his retirement.

The PRA also provides an avenue for voluntary contribution to the scheme, which is taxable at the point of withdrawal before 5 years from the date it commenced, whereas the CPS is not taxable at all. The quota of contribution by both the employer and the employee under this scheme is such that the employer makes at least 50 per cent of the contribution (that is 7.5 per cent of the employee's basic salary, transport and housing allowances) as a reward for the employee's service to the employer or his organization (see Table 1). The combined minimum contribution into the RSA by both employer and employee is 15 per cent of basic salary, housing and transport allowances, which can be reviewed upward upon an agreement by both the employee and the employer. In the case of the military, the employer contributes 12.5 per cent and the military personnel 2.5 per cent, compared with other labour sectors that have a 50–50 per cent of the contribution between the employer and the employee, except where the employer opts to make the larger or entire contribution.

The PRA also established a body corporate known as the National Pension Commission, which may sue and be sued, to regulate, supervise and ensure the effective administration of pension matters in Nigeria. In these regards, it is empowered to

(i) approve, license, regulate and supervise pension funds administrators, custodians and other institutions related to pension matters, as the case may be;
(ii) formulate, direct and oversee the overall policies on pension matters;
(iii) establish standards, rules and guidelines for the management of pension funds under the Act and issue guidelines for pension funds investment;
(iv) promote capacity building and institutional strengthening of PFAs and PFCs, and also enlighten and educate the public on pensions; and
(v) receive and investigate complaints of impropriety leveled against any employer, PFA, PFC or any of their staff or agent and impose administrative sanctions or fines on erring employers, PFAs and PFCs.

A PFA is to perform the following functions:

(i) open an RSA for an employee and issued a Personal Identity Number;
(ii) invest and manage pension funds and assets in accordance with provisions of the Act;

Table 1: Outlay of employee–employer contributions to pension funds by sector

Serial no.	*Sector*	*Employee*	*Employer*
1	Federal public service (including the Federal Capital Territory (FCT))	Minimum of 7.5 per cent contribution	Minimum of 7.5 per cent contribution
2	Military	Minimum of 2.5 per cent contribution	Minimum of 12.5 per cent contribution
3	Others (particularly the private sector and other state and local governments)	Minimum of 7.5 per cent contribution	Minimum of 7.5 per cent contribution

Source: PenCom[3].

(iii) provide customer interaction service support to employees, including access to account balances and statements on demand;
(iv) carry out all calculations in relation to retirement benefits, and pay the benefits to employees.

A PFC is saddled with the following functions:

(i) to receive the total contributions remitted by employers, on behalf of the PFA, with the PFA notified of this within 24 hours of its receipt;
(ii) to hold pension funds and assets in safe custody on trust for the employees and beneficiaries of the RSA; and
(iii) to settle transactions and undertake activities relating to the administration of pension investments including the collection of dividends and related returns, and as well report all such to the PFA and PenCom.

All these interdependent functions are part of the risk management strategies expected to make the new pension scheme work effectively. Table 2 presents investment limits and performance guidelines for PFAs and PFCs. Other risk management strategies include that

(i) a company applying for a licence as a PFA is a limited liability company registered by the Nigeria Company and Allied Matters Act (CAMA) with the object to manage pension funds, and has a minimum paid up shares capital of ₦ 150 million, or such sum as may be prescribed from time to time;
(ii) the PFA satisfies PenCom that it has the professional capacity to manage pension funds and administer retirement benefits, taking into consideration that it has never been involved in any capacity in mismanaged funds or in distress owing to any fault or any extent. This is same for the PFC;
(iii) the PFA shall not engage in any other business other than pension funds management;
(iv) the PFC is a licensed financial institution registered under CAMA with a minimum net worth of ₦ 5 billion unimpaired by losses, or is wholly owned by a company with a minimum net worth of ₦ 5 billion unimpaired by losses or any such sum prescribed from time to time by PenCom;
(v) the PFC has a total balance sheet of at least ₦ 125 billion or is wholly owned by a licensed financial institution with a total balance sheet of at least ₦ 125 billion;
(vi) a PFC shall issue a guarantee to the full sum and value of pension funds and assets held by it or to be held by it, or where it is in the case of subsidiary, by a parent company;
(vii) the PFC undertakes to hold the pension fund assets to the exclusive order of the PFA on trust for the respective employees as may be instructed by the PFA;
(viii) the PFA and PFC shall submit their audited financial accounts to PenCom for approval no later than 120 days from the end of it's financial year, which shall also subsequently be published in at least two printed national daily newspapers within 1 month of approval by PenCom, and also exhibited in

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Table 2: Asset management limits and performance guidelines for PFAs and PFCs

Asset class	*Maximum investment as per cent of pension funds assets*	*Per issuer*	*Per issue*
Federal Government (FG) Securities/ Bonds	100	Maximum of 100 per cent of total issue of FG bonds	No limit
State Government (SG) Securities	20	Maximum of 2 per cent of pension funds assets in one SG	Maximum of 2 per cent of anyone (SG) issue
Corporate Bonds/Debts (Including REITS, MBS)[a]	30	Maximum of 2.5 per cent of all issues by one corporate organisation	Maximum of 2.5 per cent of anyone issue
Money market instruments	25	Maximum of 1 per cent of pension funds assets in all instruments issued by one bank	Not applicable
Ordinary shares	25	Maximum of 1 per cent of pension funds assets in one corporate	Maximum of 1 per cent of issued capital
Open-ended and closed-ended funds	5	Maximum of 0.5 per cent of pension funds assets to one issuer	Maximum of 0.5 per cent of any open, closed or hybrid fund issued

[a]REITS – Real estate investment trusts; MBS – Mortgage-backed securities.
Source: PenCom[3].

a conspicuous position in each of its offices and branches within 30 days of the approval throughout the financial year, and an annual report submitted to PenCom no later than 4 months thereafter;

(ix) external auditors appointed by the PFA and PFC reporting to PenCom;

(x) no PFA shall hold any pension fund assets, or keep with a custodian with vested business interest or link, or in its own holding group;

(xi) the PFA shall carry out its functions with the setting up of a Risk Management Committee and Investment Strategy Committee. The two committees shall as the cases may be, determine the risk profile of the investment portfolios of the PFA and advise as the case may be, and also formulate strategies for complying with investment guidelines issued by PenCom, as the board of the PFA may determine.

The PRA also outlines the composition of pension boards of the PFA and PFC, penalties to the contraventions of the Act and guidelines of PenCom, supervision and examination strategies, dispute resolution mechanisms as well as the legal framework that would make the new pension system sustainable.

PENSIONS IN ECONOMIC PROGRESS

Essentially, pensions serve as social security for old age. And the reforms that the pensions systems of many countries have undertaken are aimed towards attaining this development progress. According to DFID,[4] social pensions in developing countries raise the livelihood of older, poorer individuals and their families above the poverty level.

Low level of savings is one of the problems of increased poverty in developing countries, which has its root in low level of income. The role of social security is therefore crucial here. In South Africa and Brazil, the effectiveness of social pensions has been established. DFID[4] reports that the pensions covering about 5.3 million poorer, older people in Brazil has the capacity of reducing their households' exposure to poverty by 21 per cent. The pensions can also contribute to increased school enrolment through the availability of funds for school fees, books,

uniforms and transport. The positive effects of pensions in high HIV/AIDS and unemployment prevalent areas such as South Africa are also immeasurable.

Older people in developing countries are among the poorest in the world, with 100 million of them living on less than a dollar a day, 80 per cent with no regular income and with the proportion increasing.[4] By the year 2050, nearly one in four people in Asia and Latin America, and one in ten people in Africa will be over the age of 60 years.[4] In Sub-Saharan Africa and other parts in the world, older people are struggling alone to bring up and care for children.

The macro-economic implications of the new pension scheme are also in employment generation, which expands production through the making of funds available for firms and investors. The country's economy is thus positively affected. And aside this, it also boosts the performance of the nation's capital markets where most of these funds would be channeled to the deficit demand side of the economy.

To the government, pensions reduce the social cost of alleviating poverty. It also reduces the pension overhead costs to workers in the public sector, which has hitherto become a clog in the wheel of progress.[5] This is because pension overhead costs have overshot the salaries of public service workers, while having also created fiscal imbalance in government finance.

To the Nigerian economy, the scheme is expected to generate over ₦ 900 billion annually in long-term loan-related funds. This would be available not only to firms but also to government to finance capital projects such as transportation, energy, water and so on. The implication is that the small and medium enterprises will grow, leading to increased job creation and increased capacity productivity of the informal sector. This would have a positive impact on the GDP while also enhancing the growth of allied industries like the insurance and banking industries. Along these lines, interest rates may be inclined to fall, which would be very important for economic growth.

PENSION REFORM EXPECTATIONS

The pension reform refers to a set of actions taken to restructure the administration of old age security device of retirees. An important dimension here is its capability to sustain post-retirement life. On the one hand, it is capable of financing the livelihood of the retiree and his family over a long time; on the other, it could serves as a financing source for further economic activities he may wants to embark upon.

The DBS, which defines a benefit for an employee upon retirement, has been Nigeria's pension scheme over the years. It was the most popular and widely employed pension plan in most countries until the 1990s. The benefits are calculated as final leverage plans where the average salary over the last 3 or 5 years of employee's career determines the pension. This plan tends to be less portable than the defined contribution plan, and has the difficulty of calculating the transfer value. The employer bears the investment risk of low returns on contribution because the DBS pays its benefits as an annuity.[6] The DBS is an unfunded type, as no assets are set aside and so the benefits are paid for by the employer. This is the characteristic of most government-funded pensions with paying pool of funds from workers' contributions and taxes.

During the years from independence till 2004, pensions have been mostly inefficient and deficits accrued; the present system seeks to address past shortcomings especially with regards the collection of entitlements, which is designed independent of the employers. The other striking feature of the PRA 2004 is making the CPS compulsory, thereby ensuring that virtually all private organizations are involved. This makes it a more involving scheme so that its affects all workers.

The emergence of the CPS is therefore important for three reasons. First, the CPS is the best scheme and is widely accepted all over the world. When compared with the DBS, which was practiced in the 1990s, the CPS RSAs are the responsibility of the workers including their PFAs of choice. The CPS is also

more portable, whether the worker is switching between public and private sectors or from one firm to another. Second, the fiscal implications of the DBS for government finance are done away with, while the scheme makes funds available for economic activities through the stock market. Such funds can be utilized by firms seeking long-term funds, and by government for public projects. And finally, it goes on to reduce the poverty level of the households of retirees.

The CPS provides for the individual to account for his own self-security, along with the contribution of his employer. The benefits accrued are based solely on the amount contributed between him and his employer into his RSA. This contribution is thereafter invested in stocks or other financial instruments to the benefit of the employee. On retirement, the accrued amount serves as the retirement benefits. This type of pension is principally fully funded. As earlier stated under the DBS, the employer bears the investment risk but under the CPS, it is different. Aside from it's portability, it enhances individuals and national savings, makes funds available for investment, and also relieves the government of fiscal problems owing to pension overbearing capital deficit to public funds.

In view of the above, the need for reform became imperative in developing countries considering the need to reduce old age poverty, or in a broader sense, household poverty. This thus takes the place of social security, which is readily available in most developed countries.

The PRA 2004 therefore passes into law the CPS to replace the DBS. The intension was to reduce old-age vulnerability to socio-economic dysfunctions. This was in view of the fact that social welfare in Nigeria is poor, while family values are eroding fast.[7] The CPS is therefore seen as able to overcome the weakness of the DBS, that it can make critical contributions to poverty alleviation (p. 25).[4] This has been shown by the successes recorded in Brazil and South Africa where in Brazil; the funds helped 5.3 million poor older people, and reduced the household's probability of being poor by 21 per cent.[4] The funds also positively affect schooling, and it is also significant in high HIV/AIDS and unemployment prone areas such as South Africa.

CONCLUSIONS

As the poverty level keeps on rising in Nigeria, the social demand on government also keeps increasing. And yet, poverty alleviation remains the thrust of government reforms. This article therefore finds that poverty alleviation is the motivation for the pensions reform of government. In the light of the importance that academics and policymakers attach to the need for poverty alleviation, social programmes that address the welfare of the poor deserve serious attention.

This article, having made an extensive assessment of the benefits of the CPS over the DBS, which among other issues has no real social or economic benefits to either workers or the nation, has shown that the post-retirement lives of workers in Nigeria have seen them rather poorer, while the national budget has continued to bear the scars of financing an unproductive workforce under the DBS. The article also goes on to emphasize the legal and institutional framework of the new scheme, which takes into consideration the feelings of the workers by protecting their funds, a departure from the previous scheme, which was damaged by maladministration and corruption, leaving the government with a large fiscal deficit and debt to retirees.

At this end therefore, PenCom will need to constantly evaluate the performance of schemes with the activities of the PFAs and PFCs closely observed. A lack of oversight function of the activities of the fund managers, which had always been the bane of the country's programme could lead to the failure of the CPS.

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