A Publication on
Strategy,
Innovation,
Communication
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Issues in Nigeria's Contributory Pension Scheme

Perspectives on new policies in pension fund administration

In the last couple of years, there have been some significant developments in the Contributory Pension Scheme in Nigeria – the new rules for Voluntary Contributions, the emergence of the multi-fund structure and the kick-off of the micro-pensions scheme. What implications do these developments have for the average Nigerian as they plan towards their third career?

Voluntary Pension Contributions Still Make Sense

I was a guest speaker at an event some time ago on a completely un-related subject matter, when the audience, sensing my experience and affiliation with the pension industry accosted me with their concerns about the new guidelines regarding Voluntary Pension Contributions. My response was frank and brutal, reminiscent of a similar response I had to give about ten years ago on the subject of "margin trading" and the collapse of the Nigerian capital market. In both cases, people have lost their sense of the fundamentals of financial planning and investing and have allowed their greed to have the better of them. There is nothing wrong with the new PenCom guidelines on Voluntary Contributions – what is wrong is that a lot of employees had gotten greedy having taken advantage of a loophole that existed in the laws and now that their channel of exploitation has been closed, they are unhappy.

The truth is that the current regulations on VCAs are well aligned with the fundamental principles of pensions. If well understood and applied properly and prudently, it represents a veritable and indeed recommended product for saving, investing for the future, augmenting our retirement benefits and believe it or not – reducing our tax liability (not evading tax, but legally avoiding it). To address their concerns, I had to take them down memory lane, and build up the argument from there. I thought it was useful to share this on a much larger platform, hence the discourse that follows.

In November 2017, the National Pension Commission (PenCom) issued a Circular specifying new rules for additional voluntary contributions to Retirement Savings Accounts (RASs). The new rules require that 50% of voluntary contributions for employees covered by the PRA 2014 be treated as “contingent” and can be withdrawn once every two years, on an incremental basis, subject to the 5 Year Tax Rule (see below), while the balance of 50% can only be withdrawn at the point of retirement alongside the rest of the RSA. My audience’s reaction to the PenCom Circular was that the new rules would deter most people from making additional voluntary contributions going forward. This feeling is no doubt ill-conceived, but well rooted in the recent history of VCAs.

You see, after the review of the Pension Reform Act 2004, and the passing of the Pension Reform Act 2014, the rules for accessing VCAs changed. Under PRA 2004 and the Regulations issued before 2014, contributions to VCAs were tax deductible so long as the contributions were not withdrawn within five years of contributing. So, if you contributed Nxx and after three years you wanted to withdraw any part of Nxx, the tax that you had avoided at the point of contribution will now be suffered on you at the point of withdrawal of that amount. In all fairness, this process worked very well from 2006 up till 2014, although it was not as popular as one would have wanted, as only very few financially astute employees who were really taking a long-term view took advantage of it. In 2014, the laws were amended and the provision on VCAs was changed. Under the new law, only the income earned on the original contribution would be subjected to tax, if a withdrawal is made before 5 years. Clearly, this meant that all you stood to lose was a percentage of the growth on your contribution and not any part of the contribution itself. So, the greed and abuse began – employees who saw the loophole started to transfer larger sums of money from their salaries and benefits to their VCAs, immediately reducing their PAYE tax, and returning only a few weeks later to make a withdrawal of the entire amounts,

preserving the entire contribution and paying the penal tax only on the amount of growth of the contribution. They were not interested in long-term investing with their VCAs, but more interested in making a short-term gain. The system was inundated with these movements of large amounts of cash in and out of the VCAS, and to be honest since the law permitted it – the employees were legally avoiding tax, but the fundamental principles, philosophies and purpose for VCAs were discarded. It was no longer about saving to augment your retirement benefits, it was just about avoiding tax in the short-term.

My concern is that the VCA is not meant for such short-term exploitation, rather it is designed in a Defined Contribution (DC), Contributory Pension Scheme like ours to help people bolster their ultimate Retirement benefits, save more and enjoy some tax savings by doing so. It is a very important component of any successful DC Scheme and should be used for that purpose and nothing else. Anything else would be an abuse and a negation of its purpose.

The truth is that financially astute employees especially those in higher income brackets who otherwise are able to save and invest significant amounts of money in mutual funds or other long-term investment products can and should still do so with their RSAs. If you are a real investor in the make of Benjamin Graham and Warren Buffet, then taking advantage of the tax incentives of VCAs while sitting it out for the long-term is still more advantageous than most other long-term investment products that will not give you the tax protection that VCAs do (and I can prove this with actual calculations). VCAs are still very useful, and still do make a lot of sense for the truly wise, prudent and astute individuals.

TheyToo Need a Pension

Let’s think about the typical domestic worker that comes into Abuja, Lagos or any of our big cities from the villages or from other states in the hinterland searching for better opportunities. They come to our homes and we take them in and at best pay them the prescribed minimum wage for the work that they do. Most of them even though married with children and families, live away from their families, just so that they can stay close enough to us or actually live with us and serve our very important domestic needs. Each month, they remit most of the paltry salaries they are paid to their families back home to cover the school fees of their children and sustain the

livelihoods of their other dependents. They do this for many years – in fact all of their active years, never thinking about the fact that someday they will stop working, because they will be too old or incapacitated to work, or that they may be struck down by death at any time. They complain that their income is too low, and any suggestions about saving or investing towards retirement will fall on deaf ears. Their lower levels of education and exposure make it difficult for them to grasp the issues, and even when they think about it, they console themselves that their children whom they are ‘training” will provide for them in their old age. They fail to understand that in reality, it is more likely that their children will be too pre-occupied with their own challenges, families and worries of the life and most likely will not be able to provide for them both financially and emotionally in their old age. For most the concept of ‘retirement” is strange – they just never think about it. The population of such people is a significant part of the workforce in Nigeria – in fact, most families in Nigeria’s growing upper middle class have upwards of four or five domestic workers supporting their families. The truth - #TheyToo Need a Pension!

With the cyclical economic downturns that have become part of our economic history lately, more Nigerians are finding work in the informal sector, as the formal sector continues to right-size and down-size in a bid to cope with these structural economic challenges. Interestingly, most of Nigeria’s workforce is in what we describe as the informal economy – consisting of at the very highest level individual professionals across all professions who work independently or run very small sole proprietorships (accountants, lawyers, architects, media practitioners, bloggers and entertainers, etc.), all the way further down the spectrum to artisans, farmers, herdsmen, itinerant workers, traders, and the very interesting segment of domestic staff – drivers, cleaners, nannies and security men, etc. The informal sector is the most vulnerable economic group because their work, business and vocation do not attract the stable and sustainable income that is available in the formal sector; for some, their education, exposure and reach exclude them from access to the typical financial services that people in the formal sector enjoy; and their economic circumstances are significantly worse off, creating a bigger social security burden if they have no means of a livelihood in their old age.

Clearly, providing pensions and a means of livelihood for the ever-increasing population of Nigerians in the informal sector is a matter of grave concern for policy makers and the Government, hence the recent moves by the National

Pension Commission (PenCom) to introduce the Informal Sector Pension Scheme or what is also described as the Micro-Pensions Scheme to cater for the livelihood of these categories of persons when they stop work, retire and need a source of income to support them in their old age. It's a project that makes absolute sense, but one of its clear challenges as seen from other countries who have embarked on it, is actually getting people to see its benefits and participate actively and sustainably in it. Already, we are struggling with the level of compliance by the formal sector, because of low levels of awareness and buy-in and some of the psychological blocks that need to be addressed in ensuring the levels of financial inclusion that we seek. At the heart of every social campaign like informal pensions is selling the "Why" to the ultimate beneficiaries, participants and stakeholders. In this case it is simple - #TheyToo Need a Pension, and all of us who already have a steady source of income, better opportunities and a plan for our retirement must do something to ensure that the more vulnerable informal sector workers have a financial future that is safe, lest we will all pay the price of the social security crises that their "insecurity" will bring.

With the uncertainty of income and in most cases, the very low levels of income that informal sector workers have, it may seem a tall order to expect them to be able to save today to cater for their retirement in future. Yet, failing to do so is not an alternative worth considering at all!

More Investment Options for Pension Contributors

With effect from July 2018, contributors to Nigeria's contributory pension scheme (CPS) will now have options regarding how their contributions are invested and have the prerogative to direct their Pension Fund Administrators (PFAs) to invest their pension contributions in line with these options. Since 2004, when the CPS was introduced, the pension contributions of active contributors (those still in service) have been managed by their respective PFAs in a Single Investment Fund with the PFA choosing the actual portfolio composition and investment instruments in line with the Regulations for Investment of Pension Funds issued by the National Pension Commission (PenCom). With the new Multi-Fund Structure to be implemented from July 2018, three distinct Investment Funds will be available to active contributors called Fund I, Fund II, and Fund III, while the retirees managed by the PFAs will be placed in Fund IV. The core difference between the distinct Funds will be the amount of risk inherent in each fund driven by the minimum and maximum amounts of variable income

instruments that each Fund can contain based on the Investment Regulations. Essentially, RSA holders will be allowed to choose from these three funds and decide the amount of risk that they are willing to take in the management of their investment portfolios, in line with the Regulations.

Typically, when it comes to pension fund investments, the global best practice is for portfolios of different risk characteristics to be created and for investors to select the portfolios that align their risk appetites often driven by their age; level of income; liquidity needs, overall stock of investments, the level of diversification of their wealth and of course their past experience with investments that generally affects their risk appetite. So, for example, the younger people are, the more likely they would have a higher appetite for and ability to take on higher levels of investment risk. This ensures that younger contributors who have a longer gestation period for their investments up to retirement can exercise their prerogative to be more aggressive about their pension contributions and possibly earn higher returns on their pensions over this longer period. For example, a 25-year-old who just joins the CPS has in the minimum another 35 years to work and contribute, and so, should have the option to invest more aggressively than a 58-year-old who has just 2 years to retire. In the old arrangement, both the 25-year-old and the 58-year-old, and everyone in between them was placed in a Single Investment Fund that was invested in the exact same without recognizing the different risk appetites of RSA holders based on their age and other considerations.

Our CPS has now adopted this global best practice after fourteen years of implementation. From inception in 2004, we had anticipated that this day will come, and even in my book "Pension Fund Administration in Nigeria", published in 2007, the imperative of multi-funds was discussed. The only impediments to its implementation back then which I highlighted in my book were three-fold – 1) The need for us to transition from the old pension system to the new without creating too many changes that could confuse participants; 2) the depth of the financial markets and the dearth of financial instruments to accommodate the realities of a multi-fund structure; and 3) the low-level of financial literacy of most RSA holders that will affect their ability to make informed choices. The third impediment still remains an issue that the industry regulators and operators need to pay attention to – ensuring that RSA holders understand the workings of the financial markets and underlying investment instruments so that they can make appropriate choices regarding the options available to them. For this to happen, the

employees of the PFAs, especially the customer-facing employees in Sales, Relationship Management and Customer Service roles also need to improve their working knowledge of the financial markets and investment instruments so that they can properly educate and guide their customers who will be making these enquiries. We all need a healthy dose of both pension literacy – understanding the workings of the CPS and the Multi-Fund Structure as well as a dose of Financial Literacy – a broader understanding of personal financial planning, financial markets, investment instruments and investment management.

The new multi-fund structure will commence in July 2018 and PFAs will have up to 6 months after the commencement to restructure their portfolios to be compliant with the new regulations. According to the Regulations, the maximum exposure to variable income instruments will be as follows – Fund 1: 75%; Fund II: 55%; Fund III 20% and Fund IV – Retiree Fund:10%. There will also be minimum exposures to variable income instruments – Fund I: 20%; Fund II: 10%; Fund III: 5% and Fund IV – Retiree Fund: 0%. Both Funds I and II must have a minimum of 2.5% of their portfolio invested in Infrastructure Funds, Private Equity Funds and Real Estate Investment Funds. Variable income instruments are typically riskier than fixed income instruments like Treasury Bills, Government Bonds and Bank Placements and offer a higher potential reward. This means that Fund I is the most aggressive fund, while Fund IV is the most conservative fund. At the inception, RSA holders who are 49 years and below will be placed in Fund II, 50 and above in Fund III and retirees will be placed in Fund IV by default. Thereafter, Fund I will only be available on request by RSA holders who are below 50 years old, and RSA holders can switch from one Fund to another subject to these restrictions and other regulations.

Overall, the new multi-fund structure is a great innovation in our CPS and one that will ensure that our investment decisions are better aligned to the realistic needs of contributors. However, from all the investment jargons that I have used, it is imperative that RSA holders are better educated about financial markets and instruments and that the client-facing staff of PFAs are also educated and equipped to also educate them. With the proper investment in education and enlightenment, the multi-funds will be no doubt a huge success!

Omagbitse Barrow is the Chief Executive of Learning Impact NG, an Abuja based Strategy Consulting and Organizational Learning Firm. He is a prize-

winning Chartered Accountant and Fellow of the Institute of Chartered Accountants of Nigeria (ICAN). He worked previously as an investment banker and pension fund manager and is a member of the Financial Literacy Technical Committee of Nigeria's Securities & Exchange Commission (SEC). He has written books and developed games and resources on the subject of personal financial planning and teaches the subject to audiences across the country.

He is available at gbitse.barrow@learningimpactmodel.com and at www.learningimpactmodel.com