

## **IMPERATIVE OF TRANSITION MANAGEMENT FOR ENTRECHMENT OF CONTRIBUTORY PENSION SCHEME IN NIGERIA**

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### **Abstract**

This study intends to examine the management of shift from one form of pension scheme to another. The management of transition from Defined-benefit pension scheme to Defined-contribution scheme in Nigeria is the main theme of this paper. A transition is a process of structural societal change from one relatively stable system state to another via a co-evolution of markets, networks, institutions, technologies, policies, individual behaviour and autonomous trends. The complexity of a transition implies that it has a multitude of driving factors and impacts. A transition can be accelerated by one-time event, such as crisis (a pension funding crisis). To investigate pension transition management in Nigeria, this paper relied mainly on array of secondary data from different sources which would be analyzed and make deductions about pension transition. This paper concluded that effective transition management is very imperative for the successful implementation and entrenchment of defined-contribution (contributory pension) scheme, so that backlog of unsustainable arrears are accounted and settled, and number of would-be pensioners who cannot be fit in into the newly introduced defined-contribution scheme be appropriately phased out and also to trim the pension bureaucracy.

**Keywords:** Transition Management, Contributory Pension scheme, Nigeria

### **1. Introduction**

Transition from existing defined benefit (DB) pension scheme to a newly introduced defined contribution (DC) pension plan in most countries is fraught with disruption and enormous cost which need to be efficiently managed to guarantee smooth transitions. Transitions are transformation processes in which existing structures, institutions, culture and practices are broken down and new ones are established. Hence, a transition is a process of structural societal change from one relatively stable system state to another via a co-evolution of markets, networks, institutions, technologies, policies, individual behaviour and autonomous trends. The complexity of a transition implies that it has a multitude of driving factors and impacts. A transition can be accelerated by one-time events, such as uncovering of massive fraud (e.g. Widespread scam in public sector pension in Nigeria) or a crisis (such as the

pension crisis) but is not caused by such events only. Slow changes in the external environment determine the undercurrent for a fundamental change; superimposed on this undercurrent are events such as calamities, which may accelerate the transformation process. Transitions thus are multi-causal, multi-level, multi-domain, multi-actor and multi-phase processes (Loorbach, 2007).

Managing transitions is by definition a highly uncertain and sometimes chaotic process, in which an attempt is made to link different actors and organizations with different time horizons, ambitions and values. For policy-makers, such an approach implies an entirely different way of dealing with policy-making and of organizing the process (Loorbach 2004; Rotmans et al. 2005). In this context, transition management is the process of managing changes to a pension fund's portfolio of assets. Similarly, towers watson (2015) stated that transition management is the coordination of a change in investment strategy or investment manager with objectives of preserving asset values and managing risk. The process includes selling securities from one portfolio and buying securities in another, while systematically controlling for operational risks, transition cost and market exposure relative to predetermined bench mark. The transition from a pay-as-you-go system to a fully-funded one has major fiscal implications. Pension reform creates transitional costs. Government still must pay the promised pension of future retirees in the old system while workers who switch to the new system stop contributing in the old system and new workers also contribute to the new system. So, how to cover these transitional costs? Pension fund introduction is very expensive and reform financing constitutes a real challenge.

A useful distinction for understanding the pension reform transition and how the implicit Defined Benefit (DB) debt is made explicit is between pension rights of current (pre-reform) pensioners and those due to workers in active service in lieu of their connection to the old pension scheme. Payment of benefits to current pensioners will be done through the specially established funds created for transition purposes. This will imply explicit transfer from central government coffers as long as the last current pensioner survives – for at least three decades from now on. The second and larger part of the implicit DB debt is past pension rights accrued to serving workers. Pension recognition bond will be issued to those currently active workers that transit from pre – 2004 DB scheme. Recognition bond will be issued by authorities central or regional where workers are serving before the shift to DC pension plan. According to Calfo (2012) unlike in a DB scheme, transitioning assets from one fund to another must ensure a complete and transparent process whereby individual members' assets are preserved and protected. Simply providing a “before” and “after” picture with little explanation or transparency of all the movements, costs and valuations affecting member accounts throughout the process is unacceptable. Moreover, complications arise since DC transitions are not often simply moving members' assets from one fund to another. Trustee decisions to change investment funds/managers usually involve the scheme default fund, which may be made up of a number of underlying funds. Furthermore, managing transaction costs, minimizing out of market exposure and ensuring the appropriate allocation of costs to scheme members is a challenge, particularly when it involves a number of participants in the overall process (i.e., managers, administrator, platform provider, scheme, members, etc).

## **2. Literature Review**

Shifting from defined benefit and largely unfunded pension plans to defined contributory and largely funded pension plans has gained much currency globally and is subject of much academic discourse among scholars and even board room analysts. Volumes of literature with varying themes x-rayed different facets of transition management of pension. Disney (1999) affirmed that, the most effective way of tackling pension transition phenomenon is what he referred to as a 'clean break' privatization of the pension programme. In this programme no further contributions are made into the existing unfunded programme. All new contributions after privatization are made to the private administrators or insurance companies or group providers and are assigned to individual pension accounts. On the other hand, pension or superannuation obligations of phase out unfunded pension regime which made up both existing and projected payments to current pensioners and the accrued pension rights of those who have not yet retired within the unfunded programme, have then to be financed by some means. This hanging financial burden, according to Disney (1999) is the crux of the funding transition problem: the implicit liabilities of the existing programme then become explicit and are supplemented by the additional liabilities arising from the transfer of all future contributions to the new, funded scheme. Of course, the accumulated contributions of the new funded programmes may be at par, or be less than or more than, the additional liabilities arising from the future stoppage of contributions to the unfunded programme. Nevertheless, the immediate impact of transition to privatization is an explicit jump in the liabilities of the public sector which need to be amortized. Amortization usually refers to the process of reducing a recognized liability systematically by recognizing revenues or reducing a recognized asset systematically by recognizing expenses or costs. In pension accounting, amortization is also used to refer to the systematic recognition in net pension cost over several periods of amounts previously recognized in other comprehensive income, that is, prior service costs or credits, gains or losses, and the transition asset or obligation.

There are, however, several ways of handling the transition issue. One is simply to accept the extra explicit burden of public liabilities and a higher perpetual burden of interest payments on the debt (Disney, 1999). Chand and Jaeger (1996), estimate the increase in pension liabilities from accepting the extra explicit burden in a range of industrial countries to be on average 152% of 1995 GDP.

Another alternative is to have an explicit transition finance strategy that effectively involves establishing a generational incidence of the transition burden. For example, Kotlikoff, in Feldstein (1998), uses the Auerbach-Kotlikoff (1987) General Equilibrium (GE) model to examine a transition to full funding in the US economy which contains three transition-financing 'scenarios': 'lump sum' transfers to compensate losing generations, a transition funded by a rise in income tax rates, and a consumption (expenditure) tax-financed transition. The latter gives the strongest aggregate welfare gain in the model simulations. Another transition strategy, where the generational incidence is less clear, is where the liabilities are in part financed by higher budget surpluses over a substantial period. These are achieved by, say, cutting public capital spending or by privatization of public assets. In the long run, the economy will have a higher stock of private assets in the pension funds and a lower stock of public assets; the welfare consequences of such a transition are more difficult to evaluate without knowledge of the incidence of the benefits from publicly-owned assets.

## **2.1 Pension Transition Cost**

Transition cost arises from the financing gap created when expenditure to pensioners and future retirees must continue even though part of the contribution have been diverted to funded individual accounts. According to Briggs (2015) Transition costs are temporary cost increases associated with switching from a defined-benefit to a defined-contribution pension plan. In examining classes of pension transition costs, Biggs (2015) identified two types of transition costs. The first arises from an interpretation of accounting rules promulgated by the Government Accounting Standards Board (GASB) and claims that GASB rules would require a closed plan to more aggressively amortize its unfunded liabilities, raising costs in the short term. The second type of transition cost is believed to be generated by the need for a closed pension plan to shift to a less-risky, lower-returning investment portfolio. Accounting-based transition costs are predicated on GASB accounting rules which requires that a closed plan pay off its unfunded liabilities more aggressively. Doing so would cause a short-term increase in amortization costs, followed by lower costs thereafter. On the other hand, Investment-based transition costs are based upon changing investment portfolios. The argument is that, once a DB pension is closed to new entrants, it must shift its investments toward much safer, more liquid assets that carry lower returns. Transition cost also comprise of explicit and implicit costs. Thus transition costs stems from the need to pay off, over some years, the debt of the old system. Drahokoupil and Stefan (2008) stated that, transition costs should not be understood as the funding of potential future deficits resulting from demographic aging in a PAYG system. The introduction of a fully funded second pillar was seen as a solution to this problem during the first-wave of reforms. However, from a macroeconomic perspective, a shift to funding is at best secondary since the only real measure to effectively counter demographic aging is the retention of output levels (Barr & Diamond, 2008). Transition costs could have potentially been covered through several means: increasing taxes; cutting spending in the general budget and/or the PAYG scheme; or by using the exceptional revenues from privatization (Drahokoupil and Stefan, 2008). Switching plan types usually increases administrative costs, since the existing pension must be maintained for current workers and retirees even if future benefits accrue under a different system. Two-tier DB-DC plans are inherently more expensive for similar reasons. However, cash balance plans that operate as a separate tier of an existing DB plan may not significantly increase administrative costs. Switching to an account-type plan may also accelerate payments to amortize unfunded liabilities. The Government Accounting Standards Board (GASB) has advised employers to amortize unfunded liabilities as a fixed percentage of payrolls (which normally increases with inflation and economic growth) or as a level cost, whichever is greater. When pension plans are closed to new workers, covered payroll shrinks, and employers switch to level (as opposed to increasing) amortization payments. In this case, switching to DC and hybrid plans increases short-term outlays, making it difficult to justify the switch as a solution to budget problems. Supporters of cash balance plans counter that GASB standards have changed, and that plans operating as a new “tier” of an existing pension would not lead to higher amortization payments (Costrell 2012; Biggs, McGee, and Podgursky 2014). However, Keith Brainard of the National Association of State Retirement Administrators points out that legal provisions in many states require policymakers to continue to adhere to these commonsense practices (Brainard 2012).

**2.2 Implicit Pension Debt (IPD):** The implicit pension debt refers to the benefit promises a pension scheme makes to workers and pensioners and is measured by adding the present value of benefits that have to be paid to current pensioners plus the present value of pension rights that current workers have already earned and would have to be paid if the system were terminated today. Implicit debt is a theoretical construct that refers to expected liabilities in the form of payments to pensioners due in the future (Cheikh and Palacios, 1996; Holzmann, Palacios, and Zvinien, 2004). In a PAYG system, these liabilities are financed by current revenues. The expected revenue streams could thus be understood as implicit financing. Real deficits can occur if current revenues do not match current liabilities. Over the long term, a PAYG system can therefore generate real deficits, or surpluses, if implicit debt and financing do not balance. According to Wang *étal* (2001), implicit pension debt, usually is calculated under the termination hypothesis that the unfunded system is to be terminated immediately and that all pensioners and workers must be compensated for their future pension and accrued right. Wang *étal* (2001) added that, size of implicit pension debt depends on many economic and demographic factors such as the age structure of covered workers and pensioners, pension system coverage, level of pension benefits, retirement age, replacement rates, indexation mechanism, and discount rate.

### **2.3 Financing Pension Transition Cost**

Transition from an unfunded to a funded scheme raises the issue of the repayment of the implicit debt of the unfunded pension scheme, hence the issue of financing the transition. According to OECD (1997), the two well known fiscal alternatives to finance a transition are pure debt financing and pure budgetary financing. Under pure debt financing, all the social security debt made explicit is added to the financial debt since no debt repayment takes place. Nevertheless, the budget is affected because higher revenues or lower expenditures are required to finance the true transition deficit resulting from a difference between the interest rate and the economic growth rate. Under pure budgetary financing (through higher revenue or lower expenditure, keeping the sustainable fiscal position constant), the government combines a pension reform with a contractionary fiscal policy. Dorfman and Sin (2007) stated that, a World Bank report in 2007 specified options to finance transition costs which include: financing from general revenues or dedicated social security taxes; using proceeds of selling state owned enterprises or other assets; and increasing in salary – linked contribution rate and financing from central and/or local government debt issuance (bonds).

Bonds are becoming increasingly an effective means of financing switch from unfunded to funded pension plans. Recognition bond gave switchers a formal recognition from the public pension program, with an explicit guarantee from the Treasury, of the debt that the program had with them, expressed as the necessary capital to finance the vested part of their pensions at the moment of the transfer. Iglesias (1997) maintained that, the hypothesis was that for many workers this document would have a much greater value than the pension promises made by the public pension programme.

The Recognition Bond (RB) is a document expressed in monetary terms, representing the periods of contributions that workers who changed to the funded program had already registered in the public pension system. The value of the RB is calculated as the capital needed in order for the

member to receive, at normal retirement age, a replacement rate, multiplied by the proportion of his/her active life during which he/she paid contributions to the public system. Furthermore Iglesias (1997) added that, there is a differentiation in this calculation between men and women and depending on the age of the worker, also this amount is adjusted automatically for inflation and is capitalized at a rate of particular percent per year in real terms.

The recognition bonds are guaranteed by the Treasury and are paid when the member retires (at that point the corresponding amount is deposited into the worker's retirement savings account). However, workers who want to anticipate their old-age pension are authorized to trade the recognition bond on the stock exchanges or, if they buy a life annuity, sell it to the life assurance company. The recognition bond changed the profile of payments of the accrued pension liabilities in the public pension system since it transformed a flow of pensions paid out over time into a value to be paid out at one given moment. Also, and because of the formula used to estimate its value, it may benefit some workers more than others. In general, all those workers who were members of public programs that offered replacement rates of less than 80%, and those who have a life annuity factor that is higher than the market factor (since when they retire they will receive a recognition bond that will allow them to buy a life annuity of more than the 80% contemplated in the recognition bond calculation), will benefit from the methodology applied for the recognition of rights accrued in the public programs (Marcel and Arenas, 1991).

Iglesias (1997) concluded that, the total spending generated by the recognition bond will be different compared to the expenditure on pensions that would have been paid to these same workers in a scenario without reform, but the direction and magnitude of this difference have not been estimated. So, it is not known if this particular element of the reform reduced or increased the (implicit) debt of the public pension.

## **2.4 Financing the transition.**

While the long-run benefits of any well-designed pension reform should outweigh long-run costs, the shift to a funded system almost always requires additional resources beyond those needed to service existing state pension commitments. Either the overall contribution rate must be raised to accommodate an added second pillar, or moneys previously used to finance ongoing PAYG spending are diverted to the funded pillar to purchase financial assets, leaving a fiscal hole in the PAYG system. This is often labeled the "double pay" problem.

**2.4.1 Debt financing.** In thinking about the challenges and options involved with moving toward to a pension regime that contains a funded component, a useful concept to employ is "implicit pension debt." Existing pension PAYG promises are like formal government bonds, although typically much more conditional. In theory each country's fiscal balance sheet reflects not only its explicit or formal debt, but also its implicit debt for PAYG *pensions and similar promises*. *If financial markets viewed each kind of debt as perfectly equivalent, a country could swap implicit for explicit debt with impunity.* That is, the government could finance transition costs by borrowing either domestically or overseas to pay for ongoing PAYG promises, freeing up equivalent amounts in new pension contributions for workers to purchase second pillar financial assets. Despite fiscal, legal and macroeconomic limits, debt financing remains a means an almost inescapable means, by which countries can spread higher up-front costs of transition

over a longer period

Even when debt financing takes the form of explicit government debt, rather than the sale of (now) non-government assets, the creation of a domestic capital market in government debt, where a market previously did not exist, can be beneficial. The existence of relatively liquid government bonds provides a useful benchmark for efficiently pricing private sector debt, and thereby helps deepen capital market development.

**2.4.2 Tax Financing.** Transitioning systems also may have recourse to the following measures to finance the transition, all of which can be considered a form of tax financing.

**2.4.3 Subvention from the Budget.** In theory, a government's central Budget could finance a portion of the transition costs (over and beyond that which might be necessary to offset higher interest payments from debt financing). Given already high tax burdens and expenditure demands from all other quarters, the usual policy conclusion is that the pension reform has to be largely self-financing. Chlon étal (1999) stated that in Poland, however, the need to deal with transition financing has put added emphasis of paring down the Budget to the essential core functions of the state, a reduction in subsidies to large state enterprises and utilities. Governments also might consider special purpose tax diversions or increases from, e.g., "sin" taxes, that might be politically sellable; particularly to mitigate the speed at which first pillar adjustments otherwise would have to occur.

**2.4.4 Increased pension contribution rate.** A country might choose to finance some or all of the costs of a second pillar by raising the overall contribution rate. With few exceptions, the overall tax burden, including contributions for pensions and other social insurance, is high in the ECA countries, a situation that has led to informalization and other forms of noncompliance (Rutkowski, 1998). Thus, the starting presumption in most deliberations about introducing a second pillar is that its eventual cost has to be squeezed within the contribution rate that currently exists. In some instances, this constraint may have to give somewhat to allow a successful reform to occur.

### **3. Pension Transition Management in Nigeria**

#### **3.1 Transition to Reformed Pension:**

To guard against the disruption associated with switch from pay-as-you-go pension scheme to contributory pension scheme, the Pension Reform Act provides cushions to smoothen the path to the new scheme. The Pension Reform Act exempt certain category of public servants which include: existing pensioners, workers that have 3 years or less to retire and categories of persons under section 291 of the constitution of the Federal republic of Nigeria, i.e. the chief justice of Nigeria, justices of the supreme court of Nigeria, president of court appeal and justices of court of appeal. To facilitate the transition some facilities and institutions are provided to ensure continuity in the Nigerian pension system.

#### **3.2 Public Sector Transition Provisions**

There is established for the public service of the federation and federal capital territory, pension Departments to be known as the pension transitional arrangement Department. The department

shall be made up of the existing pension boards or officers in the public service of the federation and federal capital territory which shall consist of the following departments:

- i. the civil service pension Department
- ii. the military pension department
- iii. the customs, immigration and prison pension department
- iv. the security Agencies pension department;
- v. in the case of the federal capital territory, Abuja be located in the office of the minister of the federal capital territory Abuja.

The pension Transitional Arrangement Departments shall on monthly basis render returns of the comprehensive list of pensionable staff, pensioners, deceased pensioners and their next of kin to the pension commission. These departments shall operate under the rules, regulations and directives made by the pension commission from time to time.

The pension transitional arrangement department shall carry out the existing functions of the relevant pension boards or offices in the public service of the federation and the federal capital territory and shall in particular make budgetary estimates for existing pensioners and the officers exempted from the contributory pension scheme by the provisions of section 8 of the Pension Reform Act 2004, make budgetary estimates for existing pensioners and officers exempted, receive budgetary allocations from the government and make payments to pensioners as and when due, and ascertain deficits in pension payments; if any, to existing pensioners or the categories of officers exempted under section 8 of the Pension Reform Act; and carry out such other functions aimed at ensuring the welfare of pensioners as the pension commission may, from time to time, direct.

The department shall pay gratuity and pension to the existing pensioners and the category of officers exempted, in accordance with the relevant and applicable computations under the existing pay-as-go pension scheme of the public service of the federation and federal capital territory officers. With coming into operation of the Pension Reform Act, the responsibilities; funds, assets or liabilities of all existing pension offices in the public service of the federation shall be vested in the transitional department as provided by the Pension Reform Act. The pension commission is to regulate and supervise the activities of the transitional department to ensure compliance with provisions of pension laws. The commission may also, at the request of the transition department, render technical support and advice on the management of pension matters.

Where an officer, who was exempted from the contributory pension scheme, dies in service or in the course of duty, the transitional department shall pay, embloc, his next-of-kin or designated survivors a gratuity and pension to which the officer would have been entitled at the date of his death calculated in line with existing pay-as-you-go pension scheme calculation formula. Also where an exempted officer is retired by his employer as a result of mental or physical incapability, the officer shall be paid gratuity and pension in accordance with existing pay-as-you-go formula. A properly constituted medical board shall advice the employer on the officer's state of incapability. The transitional department will wound up after the death of the last pensioner or category of employee entitled to retire with pension before the commencement of the Pension Reform Act.



**3.2.1 Retirement Benefits Bond Redemption Fund:** As part of transition provisions, a fund known as the Retirement Benefits Bonds Redemption Fund is to be established and maintained by the central Bank of Nigeria, in respect of the federal public service and federal capital territory. The federal Government will pay into the Redemption Fund an amount equal to 5 per cent of the total monthly wage bill payable to employees in the public service of the federation and federal capital territory. The total amount in the Redemption Fund shall be used by the central Bank of Nigeria to redeem any retirement bond issued by the federal Government. Payments into the Redemption Fund shall cease after all the retirement benefit bonds used have been redeemed.

**3.2.2 Retirement Benefit Bond:** A bond is a debt security issued by public authorities, credit institutions etc in which the authorized issuer owes the holder a debt (O'sullivan *etal*, 2003). Retirement Benefit Bond, is a bond that will be issued to those who are currently in employment of the public service of the federation and federal capital territory where the schemes were unfunded, who are not exempted from the new scheme but have worked for a specified number of years, in recognition of their accrued rights under the defunct pension scheme. This bond recognizes government indebtedness to them; however, it is only due and payable when they retire.

#### **4. Conclusion**

Transition from Defined Benefit plan to Defined Contribution scheme engendered heavy financial burden to be borne by the scheme sponsor either a corporation or a government. Converting from a public pay-as-you-go system to a public fully funded system requires financing by the government of three components of transition costs: the pension benefit of those already retired by the time the reform took place, the recognition bonds of those moving to the new system after having contributed to the old system, and the pension benefits that are guaranteed in the new system (minimum pension benefits and public assistance pension benefits. In Nigeria in addition to these three cost components, the transition also comes along with additional cost of creating fund to finance pension of category of persons exempted by statute from the contributory pension scheme, particularly persons mentioned in section 291 of the 1999 constitution of the Federal Republic of Nigeria. Managing the transition cost and the perpetual cost of exempted class of public sector employees need to be handle systematically, verified and accounted to enable the government ascertained its actual pension liabilities and workout appropriate and efficient way of amortizing it. Finally smooth transition from defined benefit plan to defined contribution scheme is hinged on outsourcing management of pension scheme to reputable private companies with good organizational arrangement devoid of excessive bureaucracy and corruption.

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