Pension Reform in India – A Social Security Need
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I am grateful to the Social Security Association of India for inviting me to speak on the issue of Pension Reforms in India. This gives me an opportunity to show-case an important reform being undertaken in India and to inter-act with a very knowledgeable audience. Let me begin by sharing with you, in brief, the background under which the NPS was introduced and then take you through the current status of implementation of the NPS architecture.

2. India has nearly eighty million elderly people, which is one eighth of world's elderly population. This segment of population is growing at a rate of 3.8% per annum as against a rate of growth of 1.8% for the overall population. A vast majority of this population is not covered by any formal old age income scheme and are dependent on their earnings and transfer from their children or other family members. These informal systems of old age income support are imperfect and are becoming increasingly strained.

3. Poverty and unemployment may have acted as deterrents to provide a tax financed state pension arrangement for each and every citizen attaining old age. Therefore, in the organised sector (excluding the Government servants) a pension policy has been adopted based on financing through employer and employee participation. This has, however, denied the vast majority of the workforce in the unorganized sector access to formal channels of old age economic support.

4. As all of you already know, a comprehensive pension system has 3 basic pillars. Pillar I covers every citizen of the country through a standardized, state-run pension system, which offers basic coverage and is primarily focused on reducing poverty. Pillar II is mandatory occupational

pension system where employee and employer contribute towards their pension. Pillar III is a voluntary, private funded system, including individual savings plans, insurance, etc. Let us now see where India is placed vis-à-vis this internationally accepted principle of providing income security after retirement. Pillar I i.e. State-financed pension has very limited coverage in our country- it covers indigent persons above 65 years through the NSAP for poor and elderly and persons employed by the Government through the traditional PAYG scheme or the defined benefit scheme. Pillar II covers workers in the organised sector through a DC-cum-DB scheme. Pillar III i.e. purely voluntary schemes is present in a very restrictive form through PPF, superannuation schemes and personal pension plans through annuity providers.

5. Pension Policy in India has primarily and traditionally been based on financing through employer and employee participation. As a result, the coverage has been restricted to the organized sector and a vast majority of the workforce in the unorganized sector has been denied access to formal channels of old age financial support. Only about 12 per cent of the working population in India is covered by some form of retirement benefit scheme. Besides the problem of limited coverage, the existing mandatory and voluntary private pension system is characterized by limitations like fragmented regulatory framework, lack of individual choice and portability and lack of uniform standards. High incidence of administrative cost and low real rate of returns characterize the existing system, which has become unsustainable.

6. Non-sustainability of the existing pension system is accentuated by the sharp increase in financial burden on the Government and the other employers on account of pension liabilities. While the total pension liability on account of the Central Government employees has increased at a

compound annual growth rate of more than 21% during the 1990s, the comparable rate for the State Government was 27% per annum.

7. As all of you would be knowing, Civil Servants' Pension (CSP) is a traditional defined benefit scheme which runs on the basis of pay-as-you-go-system, for employees of Central Government who were recruited up to 31st December, 2003 and employees of State Governments recruited up to the effective date mentioned in notifications issued by those governments. CSP is an unfunded scheme and there has been no attempt at building up pension assets through contribution or any other provision.

8. CSP scheme is indexed to wages and inflation. A modified one rank one-wage principle applies to it wherein all retired employees of a certain rank get the same pension. Pension payments are revised periodically to reflect the growth in wages and consumer price index. Growth in pension benefits in old age is typically higher than inflation.

9. The main problem under CSP is that of fiscal stress. CSP was designed at a time when going by the pattern of life expectancy most of the employees who retired at the age of 60 were expected to live up to the age of 68 or so. The value of the annuity embedded in the CSP has gone up due to elongation of mortality in the recent years. The mortality characteristics of Government employees, who belong to the higher income group than the average, are more or less in line with the OECD populations. The fiscal stress at the sub-national level has been more acute. Some of the State governments have not made timely payment of pension benefits. One State government chose to cut benefits by reversing recent increases in the pension benefits due to hikes in the wages of existing employees.

10. For the organized sector employees, excluding the Government employees, the basic structure of pension and other retirement benefits has

been outlined in the EPF & MP Act, 1952. The provisions of this Act are applicable to all defined establishments, employing more than 20 workers and cover about 40 million employees in the organized sector. This Act remained virtually unquestioned and there were virtually no changes in the contribution, administration and benefits being provided under this Act for almost four decades. First major change occurred in 1995, with the conversion of part of defined contribution EPF Scheme to a defined benefit scheme in the form of Employees' Pension Scheme. This change in the EPF & MP Act, 1952 marked an important break from the existing policy of the Employees Provident Fund Organisation in two ways:

(a) With this amendment, the concept of a mandated annuity to the employees of private sector was introduced for the first time.

(b) It added a new pension liability (since the scheme is not fully funded) to the existing liability with regard to the civil servants of Central and State Governments.

11. The EPF & MP Act, 1952 is administered by the Employees Provident Fund Organization (EPFO). At present, EPFO administers the following two old age income schemes, which are mandatory for all employees in the organized sector, earning a monthly salary of less than Rs.6,500/:-

(a) The Employees Provident Fund (EPF); &

(b) The Employees Pension Scheme (EPS).

12. All the functions/ processes of EPF and EPS are handled by the EPFO, except fund management, which has been outsourced to one external agency (State Bank of India). However, some establishments, which are under the purview of EPFO are allowed to manage their own funds. EPFO treats them as exempted funds. These exempted funds are,

however, required to follow the same investment pattern as being followed by EPFO and are required to match the returns of the EPFO.

13. The Employees Provident Fund (EPF) Scheme is an individual account defined contribution scheme wherein both the employee and employer contribute to the fund at the rate of 12% of the employee's pay. There are a number of provisions under the scheme for pre-mature withdrawal of accumulation. This pre-mature withdrawal provision is frequently used by the members of the scheme which leads to small balances at the time of their superannuation. Because of low balance in individual account of the members', old age income benefit is negligible. The EPFO scheme enjoys an 'EEE' tax structure which constitutes a major tax based subsidy.

14. The Employees Pension Scheme (EPS) is a defined benefit scheme, based on a contribution rate of 8.33% from the employee to which government makes an additional contribution of 1.16%. EPS was introduced in 1995, and is applicable to the workers who entered into employment after 1995. In case of death of a member the scheme provides for a pension to the spouse for his/her remaining life.

15. There are other voluntary pension schemes available for general public but these schemes cover a very small segment of the total population. Life Insurance Companies and Mutual funds are offering these plans. These are essentially defined contribution schemes. Personal Pension Plans and Group Pension Products offered by the life insurers are being supervised by the Insurance Regulatory and Development Authority (IRDA). Schemes offered by the Mutual Funds are regulated/supervised by the Security Exchange Board of India (SEBI). Tax benefits up to a specific amount are being offered to investors buying these pension plans. Total coverage under these pension plans is about 1.6 million.

16. The other popular scheme is Public Provident Fund (PPF) which is also a defined contribution scheme. Government is managing this scheme. A fixed rate of return is offered under the scheme. In addition, tax benefits are being offered for making investment in the Public Provident Fund account. Coverage under the Public Provident Fund is about 3.5 million.

Pension Market in India

17. The existing system of pensions which leaves more than 88 percent of Indian workforce uncovered is unlikely to act as a social security umbrella for the ageing Indians. Even for those that the system covers, the defined benefit is strictly not guaranteed as most DB schemes are either wholly unfunded or under-funded schemes. Improvement in healthcare facilities leading to increase in life expectancy, evolution of nuclear family systems and rising expectations due to increase in per capita income, education etc. are some of the factors likely to compound the problem in future. The new pension system, based on defined contribution and funded liability is a significant step in the direction of addressing this problem. Spread of NPS is seen by many as the direction in which the pension reforms need to move to find a viable and sustainable solution to the problem of old-age income security.

18. In 2001, Government of India appointed a group of experts to study the various aspects of extending an organized system of pension to the unorganised sector. The group submitted its report in October 2001. According to this report, the pension market (which includes pensions, provident funds and other small savings i.e. NSC, NSS) would grow to about Rs.4064 billion by 2025. The growth would largely be due to normal growth of economy in terms of growth in income and population and does

not consider the significant increase in coverage that would arise because of reforms in the insurance and pension sectors. A more conservative estimate is that the pension market will be worth about Rs.1808 billion by 2025.

The New Pension System

19. During the last seven years, from 2000 to 2007, a marked shift in pension policy in India was witnessed which culminated in introduction of a new pension system. A High level Expert Group (HLEG) and the Old Age Social and Income Security (OASIS) Project commissioned by the Government were the two initial milestones on the road to pension reforms for the Government employees and the unorganized sector respectively. These efforts culminated in setting up of the Pension Fund Regulatory and Development Authority (October 2003), introduction of a New Pension System (December 2003), and introduction of the PFRDA Bill in Parliament (March 2005).

20. HLEG suggested a new hybrid scheme that combines contributions from employees and the Union Government on matching basis, on the one hand, while committing to the employees a defined benefit as pension. The objective of the Government was to design a scheme for new entrants in Central Government service where the contribution is defined, where no extra infrastructure is sought to be created in Government and which is capable of serving other groups like State Government employees, middle class self-employed people and even those in the lower income bracket amongst the unorganized sector subsequently.

21. OASIS report recommended a scheme based on Individual Retirement Accounts to be opened anywhere in India. It was envisaged that Banks, Post Offices etc., could serve as "Points of Presence" (POPs) where

the accounts could be opened or contributions deposited. Their electronic interconnectivity will ensure "portability" as the worker moves from one place/employment to another. There will be a depository for centralised record keeping, fund managers to manage the funds and annuity providers to provide the benefit after the age of 60.

22. The New Pension System (NPS) which has its origin in the two reports mentioned above, was made operational through a notification dated 22nd December, 2003. It has been made mandatory for new recruits in the Central Government (except Armed Forces) from 1st January 2004. It marks a shift from the defined benefit to a defined contribution regime. It is based on the principles of defining upfront the liability of Government, giving choice to subscribers, facilitating portability of labour force and ensuring transparency and fair-play in the industry. About 100,000 Central Government employees (excluding employees of autonomous organisations) are already covered under the new pension system and contribute 10 percent of their salary and dearness allowance towards pension with a matching contribution from the government. Nineteen States have also notified and implemented a defined contribution pension system for new employees. Many other State Governments have made significant strides in this direction. NPS will also be available to all individuals in the unorganized sector on a voluntary basis.

23. Under the NPS, for all subscribers, at the time of retirement there will be compulsory annuitisation of at least 40 percent of the accumulated pension wealth and the balance will be paid as a lump sum. There will be multiple pension fund managers licensed by PFRDA and the choice would be with the individual subscriber to decide which fund manager to go with. There would be four broad categories of pension schemes offering investment options with varying ratio of equity and fixed income instruments. The choice of a scheme would rest with the subscriber. Full

transparency and disclosure of information regarding investments will have to be provided by the intermediaries. Portability will be provided to the participants along with the option to transfer accumulations from one fund manager to another.

24. To bring the new pension system within a statutory regulatory jurisdiction, an ordinance was promulgated on 29 December 2004 setting up a statutory Pension Fund Regulatory and Development Authority. Subsequently, a Bill was introduced in the Parliament to replace the ordinance. The Bill provides for establishing a statutory Authority to promote old age income security by establishing, developing and regulating pension funds and protecting the interest of subscribers to schemes of pension funds. Once the Act comes into force the Authority shall regulate all intermediaries under the new pension system including pension funds, central record keeper, points of presence, etc. It will approve the terms and condition of the scheme, lay down norms for the management of the corpus of the pension funds including investment guidelines under such schemes. The Bill envisages that the pension supervisor will provide robust regulatory umbrella essential to sustain member confidence and to protect the interests of the participants and to develop the pension system by inculcating saving habits for long term. The Bill also provides adequate safeguards to take care of the subscribers to the NPS and stringent penalties for contravention of the provisions of the proposed Act and the Rules and Regulations framed there under.

25. In accordance with Parliamentary conventions in India, on introduction in the Lower House the Bill was referred to the Parliamentary Standing Committee on Finance. The Committee, having considered the evidence and clarifications placed before it, opined that "...the reform process in the pension sector involving the setting up of the PFRDA as a Statutory regulatory body for managing the NPS is an urgent necessity

mainly on account of burgeoning fiscal stress of pension payments on the Central and State revenues and the need to provide a viable alternative to the populace at large to save for old age income security". The Committee approved the PFRDA Bill for enactment subject to certain modifications, which are under consideration of the Ministry of Finance, Government of India.

26. The Bill is yet to be taken up for further consideration by Parliament. Meanwhile, in view of one of the recommendations of the Standing Committee that the initial or broad contours of the regulations governing the implementation of the NPS under the infrastructure of PFRDA be framed and put in public domain, PFRDA has prepared the broad contours of Regulations on registration of intermediaries and put them in public domain for comments of stakeholders.

27. The NPS has been mainly designed to fill the gap of old age income security to the unorganised sector. The scheme is envisaged to be a voluntary one for this segment of the population. Given a high savings rate of 35% of GDP, Indian workers are encouraged in respect of their capability to contribute towards a self financed old age income security scheme. In this framework, the New Pension System will provide them with the opportunity to fulfil their needs of old age income support in the most productive way. Further, the system will also be capable of providing a delivery mechanism for the other segments of population viz. Pillar-I (population vide mandatory pension system) and Pillar-II (mandatory occupational pension system). The low cost structure of the architecture will enable Governments to utilise this infrastructure to deliver any scheme of old age income support to any segment of the population in the most efficient manner.

28. While the introduction of the New Pension System for new recruits of the Central Government/ State Governments is a positive step in the

direction of reforming the pension sector in India, the road ahead has many challenges.

29. The level of financial literacy and preponderance of rural aged make the task daunting. Sex ratio of the workforce and economic status of women pose special problems in the design of pension systems. Designing an effective, efficient and accessible system, which caters to the requirement of a heterogeneous work force, nearly 88 percent of which is not covered by any pension or old age security scheme, is the immediate priority of those concerned with pension reform process in India. The challenges of translating the design into reality will arise thereafter and will take a while to overcome.

30. The new pension scheme is an attempt to move away from the defined benefit pension plans to defined contribution based schemes. But, this change would be applicable only to the new entrants. The problem of financing the pension liability of those already under unfunded or partially funded schemes is like to cause fiscal stress for the next two or three decades. Some parametric changes will, therefore, become necessary for effective and efficient discharge of this liability. Thus, apart from spread of the new pension scheme, introduction of parametric changes in the existing defined benefit mandatory pension systems is equally necessary for reducing the fiscal stress. Attempts to estimate the future pension liability arising out of the existing unfunded pension plans are at a nascent stage in India. Recently, some private researchers have tried to undertake a limited exercise in respect of the defined civil service pension scheme. One such study puts the implicit pension debt liability of the Central and State Governments arising out of three components of civil servants pensions at Rs.20034 billion or 64.51per cent of GDP. While the methodology and/or the results can be questioned, the magnitude of the problem that this estimate suggests cannot be ignored. The enormity of the problem becomes even more

apparent when this liability is compared with the explicit internal public debt of Government of India, which is 84.86% of GDP (2004-05).

31. Empirical evidence collected through a nation-wide survey suggests that India is in transition from old age support systems based on the family to a new reality where for the generation of workers now aged 40, the balance between family support and self support in retirement is likely to fall heavily in the latter direction. It is, therefore, essential that policymakers correctly anticipate the course of the transition so that adequate counter measures are in place at the appropriate time. The survey also indicates that without guidance, encouragement and support, most Indian workers will not save sufficiently for their old age and the capacity of the State and the labour market to face the challenges is likely to become even more limited than is the case now. Recognizing the fact that pension reforms are an urgent social priority, policymakers in India are working hard to evolve suitable pension systems.

32. A major challenge of the New Pension System is to provide the individual subscriber with an adequate retirement income. Public sector pension schemes involve 'policy risk' inasmuchas the Government of the day may not be able to accommodate required pension outlays leading to delays in pension payments or defaults in some cases. On the other hand, private pension schemes are less subject to this 'policy risk' because Governments are less prone to confiscate private property. However, DC funds do involve 'market risk' during the accumulations phase when contributions and returns on investment build up in the fund. The risk is that the pension funds' performance may be insufficient to give reasonable retirement income to the pension subscribers. Our draft Regulations have addressed this issue by providing prudential investment rules and ensuring that Pension Fund Managers diversify their portfolios. Also, these

Regulations aim to promote competition by requiring standardized reporting and disclosure.

33. One issue which needs attention for making the new pension scheme equitable is the tax treatment. Pension savings in general and the NPS in particular is a very long term saving instrument having a time horizon of 30-35 years. Therefore, the treatment of this instrument from a tax perspective, if not the most preferential, should at least be at par with other medium or short term financial instruments. This is especially important at the nascent stage of the new pension system development. In this context, example of Public Provident Fund (PPF) and other such instruments are worth mentioning. PPF having a life cycle of 15 years is under an EEE (exempt-exempt-exempt) tax regime and is not taxed at any point whereas NPS being a 30-35 years instrument is taxed at exit. Therefore, subscribers to NPS are at a disadvantage compared to the PPF especially when when seen in the context that NPS is a mandatory scheme whereas PPF is a voluntary scheme. The Government employees appointed before 1.1.2004 participate in the GPF scheme which is again an EEE tax regime whereas NPS is subject to EET regime and the withdrawable tier-II account of NPS (a substitute to GPF) is envisaged to get no preferential tax treatment. Further, a common ceiling for contributions of both the employees and Government under the Income Tax Act, 1961 may be a disadvantage for the subscribers of NPS. Accordingly, a need is felt to treat all long term savings instruments equitably and provide the same tax treatment to NPS as being given to PPF and other similar schemes. The tax treatment merits a review so as to take care of the distortions across financial instruments and giving right fiscal incentives for the development of the pension sector.

Current status

34. Pending passage of the PFRDA Bill and establishment of full architecture of the new pension system (NPS), the contributions received under NPS are being kept in the Public Account of the Government concerned. While a fixed return of 8% per annum is given by the Union Government on total pension contributions, (both employee as well as the matching contribution by the Government), the actual return would have been in the range of 14-29% per annum if the proposed investment options were given to employees. Delay in the passage of the PFRDA Bill has thus resulted in lost opportunities to Government employees.

35. In order to address the issue of investment of pension contributions under the NPS through a mechanism of consensus, a Conference of Chief Ministers' on Pension reform was held on 22nd January 2007, which was chaired by the Prime Minister. All the State Governments, except West Bengal, Tripura and Kerala, were in favour of the proposal to adopt the guidelines applicable to the non-Government provident fund prescribed by Ministry of Finance for investing the accumulations under NPS till the Bill is passed by Parliament.

36. Consequent upon the consensus arrived at the Chief Ministers' Conference, Government has authorized PFRDA to appoint a Central Record-Keeping Agency (CRA) and three Fund Managers from the Public Sector to manage the accumulated funds of Central Government employees. The services of the CRA and the Fund Managers have also been offered to the State Governments to manage the funds of their employees.

37. PFRDA has identified National Securities Depository Limited (NSDL) as the CRA and is in the process of finalizing a contract with it. Three sponsors of Pension Fund Managers have also been appointed; they are SBI, LIC, UTI- AMC. All the three sponsors have incorporated Pension

Fund as separate entities and registered as new companies under the Companies Act, 1956. The selection process for the Trustee Bank and Custodian are also in the final phase of completion. An NPS Trust has also been registered which will be the registered owner of assets under the NPS. Thus, all the intermediaries under the NPS have been identified and the system is now ready to be rolled out by 1st June 2008. As regards the cost structure of the NPS, the fund management charges are to be in the range of 3-5 basis points (0.03%-0.05%) of assets under management. The record keeping costs are low compared to the low volume at present. This cost will decline further once the volume increases under the system. The total cost of the NPS is estimated to be around 1% of the total assets under management (AUM) in the initial years and expected to decline to less than 0.5% of AUM within few years of its operation.

38. Till the PFDRA Bill is passed, there will be two investment options: (i) as per investment guidelines issued by the Ministry of Finance for non-government provident funds (wherein upto 5% can be invested in equity and upto another 10% in equity-linked mutual funds, remaining 85% in debt instruments) and (ii) in government securities exclusively.

39. At conclusion, I would like to emphasise that pension reforms which have been set into motion in the last five years need to be taken forward immediately if India wishes to take advantage of the edge that its demographics offer over similarly placed economies. Average age of Indians in 2005 was about 26 years with 31% of Indians being younger than 15 years, and nearly 64% of Indians in the working population. Thus, the time for undertaking the reforms in the pension sector could not be more appropriate, but the need of the hour is to push the reforms further without delay in terms of offering this system to the unorganised sector workers. The demographic advantage is not going to last forever because India's elderly are growing at a much higher ate than the total population, as a

consequence of which the current dependency ratio of 15 is likely to shoot to 40 in the next four decades (dependency ratio here defined as the number of persons over age 60 years to number of persons between age 20-59 years). The implications of demographic dynamics for pension planning in India become more evident when one takes into account the fact that average life expectancy at age 60, which is currently 17 years, is likely to rise to more than 20 years in the next three decades and that the population over 60 years of age will approach 200 million in 2030. However, India is still at an early stage of the demographic transition. This is the right time, therefore, to roll out the NPS to all segments of workers. The New Pension System is designed to use the 21st century Information Technology so as to achieve portability, competition and coverage. In contrast to the traditional approach of mandating participation and contributions from the workers for old age income support coupled with tax incentives and guaranteed returns ,the voluntary nature of the NPS for unorganised sector is expected to succeed. However, poor financial literacy and the attitude of the households towards financial savings, risk and retirement planning, pose a challenge to achieving optimum coverage of NPS. Creating awareness about these reforms and gaining the confidence of the people to encourage them to be a part of this movement is the single most important challenge faced by policymakers today.

Thank you.

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