

## **ROLE FOR PUBLIC POLICY, REGULATION AND BUSINESS STRATEGY IN BRIDGING INDIA'S PENSION COVERAGE**

**(Keynote address by D. Swarup, Chairman, PFRDA, 30<sup>th</sup> April 2008)**

Good morning, ladies and gentlemen. It gives me great pleasure to be here this morning on the occasion of the 8<sup>th</sup> annual IIEF pension policy and business conference. As you know, the theme of this conference is implementing an equitable and inclusive pension policy. I will today share with you some thoughts on the pension policy and regulations adopted in India and also highlight the developments in the implementation of the DC based New Pension System (NPS).

2. Firstly, I would like to talk about the background under which the NPS was introduced and then take you through the various stages of the journey of implementation of the NPS architecture so far. As most of you are aware, the need for pension reforms in India arises from low coverage of the existing old age security programmes, demographical trends, and the Government's fiscal constraints. Most of you are aware that India is perhaps the youngest country in the world today, with the average age being only 26 years. The dependency ratio in India is also one of the lowest in the world. The policy imperative of this demographical situation is that this is the right time to introduce pension reforms and establish a solid and sustainable social security arrangement in the country. However, India will not remain young for very long and is growing old at a very fast rate and the population of people above 60 years of age, which is 80 million today, would double in the next 18 to 20 years. Therefore, any delay in implementation of pension reforms will hit hard the reform process and nullify the advantages which we have today. As for existing coverage of old age income support systems, only about 12- 13 per cent of the total workforce is today covered by any formal social security system. The remaining 87 per cent do not have access to any formal scheme for accumulating wealth to sustain them after retirement. NPS is primarily meant for this 87 per cent of the workforce on a voluntary basis.

3. It has taken nearly 10 years to conceptualize, discuss and debate pension policy parameters and to devise a simple NPS architecture after detailed practical studies. Although we have drawn upon the experience of other

countries, I can say with confidence that the NPS architecture consisting of a Central Recordkeeping Agency (CRA) and competing pension fund managers along with the NPS trust, custodian, Trustee bank, Retirement Advisers and other players that we have devised is unique. We have studied the systems prevalent in both developing and developed countries, and have devised a system that meets Indian conditions and needs. We have tried to learn from the mistakes that some countries had made and attempted to design an architecture which is simple, cost effective and robust. The most distinguishing feature of NPS relates to seamless portability across jobs and across locations, unlike all current pension plans, including that of the EPFO. In other words, it would provide hassle-free arrangement for the individual participants. It is a pure DC product with no defined benefit element, returns being totally market related. NPS will also provide various investment options and choices to individuals to switch over from one investment option to another or from one fund manager to another subject, of course, to certain regulatory restrictions. No other pension scheme in the country offers this flexibility and freedom. To begin with, there shall be only two investment choices – investment of entire contribution in Government securities alone or adopting the investment guidelines applicable to non-government provident funds. The current government guidelines provide that upto 15% can be invested in equities and the balance 85% in fixed income instruments. Once the PFRDA Bill is passed by Parliament, the Regulator will provide more investment choices which will allow investment of upto 50% of the pension wealth in equities. It is also proposed to design a default option, which will be like a life-cycle fund for those who are either unable to, or do not wish to, decide for themselves. In the initial years, it is proposed to restrict investments through index funds and ETFs. In the United States, equity holding of pension funds is as high as 70%. Even in Peru and Chile major part of pension money is invested in shares of companies with lower concentration in public debt securities. It may take perhaps some time in India to allow only prudential norms for investment guidelines but let me assure you that we would move in that direction. Another feature of NPS will be comparatively lower costs.

4. PFRDA has completed the process of putting in place the full NPS architecture as per schedule. The selection of the Central Record Keeping Agency (CRA), Pension Fund Managers (PFMs) and Trustee Bank was made

through a competitive bidding process and after due diligence, taking into consideration their technical capabilities and fee/charges quoted by them. State Bank of India (SBI), UTI Asset Management Company (UTI-AMC) and Life Insurance Corporation (LIC) have been appointed as Pension Fund sponsors under the NPS. They have already incorporated their Pension Funds as new companies under the Companies Act, 1956 and started investing the NPS corpus. The accumulated corpus amounting to about Rs. 1200 crore has been transferred by the Central Government to the fund managers for investment. The State Governments have also been informed that they can log on to the NPS system and avail of the services of CRA and the PFMs. Most State Governments have already opened discussions with these entities.

5. As these intermediaries were selected through a bidding process, the fees/charges are very competitive vis-à-vis the prevalent fee/charges in the mutual fund and insurance industry. A Custodian of NPS assets and an NPS Trust have also been appointed. Once the volumes increase, these costs can only move southwards. Low costs will enhance pension wealth and bring in more customers. Once the volumes increase, these costs can only move southwards. Low costs will enhance pension wealth and bring in more customers.

6. 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 exist. Therefore, subscribers to NPS are at a disadvantage compared to the PPF especially 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.

7. We face several challenges in the development of this sector. The main challenges, to my mind, includes covering the unorganized sector i.e. bringing more and more people in the NPS fold, empowering the subscribers to take appropriate investment decisions based on their risk and return profile, provide safety and optimum returns, and to improve financial literacy levels. All stakeholders in pension reforms will have to make extra efforts to educate potential participants about benefits and advantages of saving for retirement. The NPS architecture is designed in such manner that the subscribers will have no direct link with the pension fund managers. Therefore, the exercise of choice in respect of fund managers and investment styles has to be made by subscribers. The retirement advisors will enable individual subscribers to plan for their retirement income which is adequate and also help in making the right kind of investment choice that meets her objectives.

8. NPS architecture for Government employees has already started functioning in terms of investment of NPS corpus and it is expected that the CRA will start functioning from 1st June 2008. The real challenge will be in seeing that the entire system functions smoothly. In this regard, issues relating to safety and high returns, extending coverage to as many people as possible and improving financial literacy levels would be of paramount importance. All stakeholders in pension reforms will have to make special efforts to educate and advice potential participants about benefits and advantages of NPS. We have to create a certain level of awareness amongst the NPS subscribers which will eventually empower each subscriber to make well informed investment choices to protect and further their own interests. Government employees, who are today the sole participants in the NPS, will be able to reap the full

benefits of the system once it is made available to the wider target group of the unorganized sector workers. It is only when the system is made available to all citizens that its full potential will be realized in terms of economies of scale and the subscribers will gain substantially in terms of even lower fees and charges and high returns.

9. Later in the day, I will be speaking on India's pension sector in 2020. I may as well give you a preview of that. I expect a robust, well-ordered and mature pension business 12 years from now; I expect all pension and PF streams obtaining today in the country to converge; I expect costs to go down dramatically due to competition and economies of scale and I expect rule-based regulations to give way to risk-based supervision.

10. Further, in the foreseeable future, savings generated through NPS will provide depth and stability to the capital market and enhance appetite for Government and corporate bonds. Pension savings will also provide the much needed funds for infrastructure development. At the same time, pension reforms will help the Governments to fund their pension liabilities. Most importantly, NPS will provide an opportunity to every citizen to save for retirement in a regulated environment and thus help in promoting inclusive growth.

\*\*\*\*\*