

## INDIA'S PENSION REFORM INITIATIVE

### 1. INTRODUCTION

1.1 Nearly one eighth of world's elderly population lives in India. The vast majority of this population is not covered by any formal pension scheme. Instead, they are dependent on their own earning and transfer from their children. These informal systems of old age income security are imperfect and are becoming increasingly strained. People above the age of 60 years have grown at an annual rate of growth of 3.8 percent (75.9 million in 2001 and 55.3 million in 1991) during the period 1991-2001, as against the annual growth of 1.8% for the general population.

### 2. MANDATORY PENSION SYSTEMS

2.1 Pension Policy in India has 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.

2.2 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. The total pension liability on account of the Central Government employees has risen from 0.6% of GDP (at constant

prices) in 1993-94 to 1.66% of GDP (at constant prices) in 2002-03. As a percentage of net tax revenue, the total pension liability has increased from 9.7% to 12.68% during the same period. For the sub-national (State) Governments, the compound annual growth rate in pension expenditure during the period 1995-96 to 2000-01 was 27.1 percent. As a percentage of revenue receipts, the pension expenditure of the States has increased from 5.4% in 1990-91 to over 10 percent in 2000-01.

### 3. EXISTING PENSION FRAMEWORK

3.1 The pension schemes in operation in India currently can broadly be divided into the following categories:

Scheme	Employees Covered
Civil Services Pension Schemes (Pay-as-you-go)	12 million
Employees' Provident Fund	40 million
Employees' Pension Scheme	28 million
Special Provident Funds	2.1 million
New Pension Scheme (NPS)	0.3 million

3.2 A new pension scheme (NPS), which is essentially a defined contribution scheme, has been made compulsory for new recruits in the Central Government from 1<sup>st</sup> January 2004. Nineteen of the 28 State Governments have also notified similar schemes for new recruits.

#### The Civil Servants' Pension

3.3 The 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 31<sup>st</sup> 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.

3.4 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.

#### Pension liability

3.5 In the budget documents, the Union Government gives information on annual pension payout by the Central Government as well as the State Governments. Estimate of the unfunded liability associated with the benefits under this pension scheme is, however, not computed and disseminated. Details of the budget estimates of pension for different sectors/ services of the Central and State Governments for the years 1990-91 to 2006-07 are shown below:

Year	Pension Payments (Rs. in billions)	
	States	Central
1990-91	31.31	32.72
1991-92	37.16	37.48
1992-93	43.79	45.85
1993-94	51.07	52.06
1994-95	61.46	57.34
1995-96	78.13	69.28
1996-97	98.27	82.52
1997-98	115.99	113.76
1998-99	161.66	153.46
1999-00	226.79	194.46
2000-01	254.53	211.17
2001-02	281.96	218.26

2002-03	310.05	221.02
2003-04 (RE)	352.79	236.29
2004-05	383.70 (BE)	261.54 (RE)
2005-06	N.A.	278.17 (BE)
2006-07	N.A.	306.27 (BE)

BE: Budget Estimates RE: Revised Estimates

3.6 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 relatively 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.

#### 4. EMPLOYEES PROVIDENT FUNDS & MISCELLANEOUS PROVISIONS ACT, 1952 (EPF & MP ACT, 1952)

4.1 For the organized sector 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 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.

Employees Provident Fund Organization (EPFO)

4.2 The EPF & MP Act, 1952 is administered by an organization titled the Employees Provident Fund Organization (EPFO). At present, EPFO administers the following two pension 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)

4.3 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.

4.4 The Employees Provident Fund (EPF) Scheme is an individual account defined contribution scheme wherein both the employees and employer contribute to the fund at the rate of 12% of the employee's pay. The flow of contributions in 2002-03 was Rs.114 billion. As on 31<sup>st</sup> March 2003, total stock of assets under the control of EPFO was Rs. 1.03 trillion. There are 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.

4.5 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 the year 2002-03, Rs.48 billion were contributed into this scheme and the stock of assets of Rs.450 billion was under the control of the scheme. In case of death of a member the scheme provides for a pension to the spouse for his/her remaining life.

## 5. NEW PENSION SYSTEM (REFORM INITIATIVES)

5.1 Last seven years, from 2000 to 2007, have seen a marked shift in pension policy in India through introduction of a new pension system. The High level Expert Group (HLEG) set up by the Department of Pension and Pensioners' Welfare, Ministry of Personnel, Pension and Public Grievance and the Old Age Social and Income Security (OASIS) Project commissioned by the Ministry of Social Justice and Empowerment in the year 2000-2001 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).

5.2 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.

5.3 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.

5.4 The New Pension System (NPS) which has its origin in the two reports mentioned above, was made operational through a notification dated 22<sup>nd</sup> December, 2003. It has been made mandatory for new recruits in the Central Government (except Armed Forces) from 1<sup>st</sup> 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.

5.5 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.

5.6 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.

5.7 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.

5.8 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.

## 6. VOLUNTARY PENSION SCHEMES

6.1 There are some voluntary pension schemes available for general public but these schemes cover a very small pie of the total

population. Two of the important voluntary schemes in operation currently are listed below:

#### 6.1.1 Personal/ Group Pension Plans

Life Insurance Companies and Mutual funds are offering these plans. These are essentially Defined Contributions 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.

#### 6.1.2 Public Provident Fund

This is also a defined contribution scheme. The Government is managing this scheme. A fixed rate of return is being offered under the scheme. In addition tax benefits are being offered for making investment in the Public Provident Fund account. The Government is managing this scheme and there is no separate Authority to supervise it. Coverage under the Public Provident Fund is about 3.5 million.

### 7. PENSION MARKET IN INDIA

7.1 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 aging Indians. Even for those that the system covers, the defined benefit is strictly not guaranteed as the DB schemes are 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 because they feel that neither the existing system nor any anti poverty drive by the Government is likely to solve the problem.

7.2 The spread of the new pension scheme would be possible only through a combined effort of the public sector as well as the private sector. The private players who have hitherto played only a marginal role in the field are anxious to have a reliable estimate of the likely size of the market before venturing into it. Preliminary research shows that pension plans offer a lucrative business opportunity to many players, as this area is widely unexploited till now.

7.3 In the year 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.

7.4 The group projected the post reform scenario as under:

Contributions (In Rs. bn)	2010	2015	2020	2025
Funded schemes				
EPF EPS	461	696	1023	1498
of which voluntary	8.5%	9.3%	10.1%	11.0%
of total contribution	39	64	103	164
GPF	133	201	295	431

PPF	84	127	186	272
Individual Pension	183	306	513	756
Group Pension	708	824	968	1108
Total contribution	1569	2154	2986	4064

7.5 However, a more conservative estimate is that the pension market will be worth about Rs.1808 billion by 2025.

## 8. NATIONAL DATA SURVEY – INDIAN MARKET

8.1 A unique countrywide survey of unorganized sector was recently got conducted by the Department of Economic Affairs, Ministry of Finance, Government of India, with focus on the Government of India's objective of achieving high voluntary pension coverage among unorganised sector workers, including lower and low-level income workers. The Survey was conducted as a part of the Asian Development Bank Technical Assistance project. A sample size of 41940, consisting of 21060 rural and 20880 urban households was taken. The Survey was conducted with the following objectives in mind:

- § To identify nature and potential market size (Service Provider)
- § Accurate prediction of demand to ensure matching market response (CRA)
- § To understand preferences and perception of contributors regarding investment choices (PFMs)

8.2 Some of the key findings of the Survey are:

- § People are not saving enough to support themselves at retirement and may as a result fall into poverty in old age
- § Joint and extended family support in retirement will continue to reduce
- § Government's capacity to support the indigent aged in the future will continue to be limited

§ Longevity is extending – there is need to save more for self-support in retirement years

8.3 According to the Survey, structure of the Indian Workforce at a glance is as under:

	In Million
Total workforce	424.6
Urban workforce	97.7
Rural workforce	326.9
Total earners (85.6%)	363.4
Urban earners (92.4%)	90.4
Rural earners (83.5%)	273.0
Total unpaid family workers	61.2
Urban unpaid family workers	7.3
Rural unpaid family workers	53.9

There are 307 million unorganized sector workers (Including salaried workers in small firms) in India at present of which about 40 million are having taxable income and have the capacity to buy annuity. The survey indicates an immediate potential market penetration of about 20 million out of this group, based on the following criteria:

- § Capacity to redirect discretionary expenditure
- § High interest in the pension concept shown by the respondents
- § Age of potential contributors

The report focuses on the unorganised sector, but it is expected that once the new pension system is introduced others will also join this scheme so that the actual, immediate market size is likely to be much larger.

## 9. THE MAIN CHALLENGES AHEAD

9.1 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, which need to be tackled effectively for the system to spread wide enough to cover the unorganized sector, agriculture workers, temporary and casual workers and self-employed persons.

9.2 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 be overcome.

9.3 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 64.51 per 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).

9.4 Empirical evidence collected through a survey conducted by the Asian Development Bank 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. ADB data 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 pension systems, which are not only capable of meeting the present challenges but are able to adapt and restructure overtime to meet unforeseen developments in future.

9.5 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' inasmuch as 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 but DC funds do involve capital-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. The draft Regulation has 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.

9.6 Traditionally, coverage in India has been obtained by mandating participation and contributions coupled with tax incentives and guaranteed returns on retirement savings. The voluntary nature of the proposed NPS along-with poor financial literacy and the attitude of the households towards financial savings, risk and retirement planning, also 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.

## 10. CURRENT POSITION OF NPS ROLL-OUT

10.1 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.

10.2 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 22<sup>nd</sup> 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.

10.3 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.

10.4 PFRDA has identified National Securities Depository Limited (NSDL) as the CRA and is in the process of finalizing a contract with it. Four Pension Fund Managers have also been short-listed; they are SBI, LIC, UTI, AMC and IDBI Caps. Of these four entities, three will be appointed as Pension Fund Managers based on technical parameters and competitive bids.

10.5 Till the PFDRDA 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.