Report of the Committee to Review Implementation of Informal Sector Pension [CRIISP]

Pension Fund Regulatory and Development Authority
First Floor, ICADR Building, Plot 6
Vasant Kunj Institutional Area
Phase II, New Delhi 110 070

F.No.1/22/2010-PFRDA
Pension Fund Regulatory & Development Authority
1st Floor, ICADR Building, Plot No.6,
Vasant Kunj Institutional Area, Phase-II, New Delhi
*****

New Delhi, the 10th August, 2010

NOTIFICATION

Subject: **Constitution of a Committee to Review Implementation of Informal Sector Pension (CRIISP)**

It has been decided with the approval of the competent authority to constitute a "Committee to Review Implementation of Informal Sector Pension (CRIISP)". The composition of the Committee would be as follows:-

1)	Shri G. N. Bajpai former Chairman of SEBI	Chairman
2)	Shri Deepak Satwalekar, former MD, HDFC Standard Life	Member
3)	Professor Abhinandan Jain, IIM, Ahmedabad	Member
4)	Dr. Nachiket Mor President, ICICI Foundation	Member
5)	Shri P. K. Tiwari Executive Director, PFRDA	Member-Secretary

2. The Terms of Reference of the Committee would be as follows:

(i) The National Pension System (NPS) has not proved to be as popular as was envisaged under the original vision and architecture, especially in the non-mandated, non-Government/unorganized segment. The Committee will investigate the underlying causes for this tenuous beginning and suggest the remedial steps required to make NPS a viable pension system for all stakeholders.

(ii) In the backdrop of the criticism that there is no stakeholder performing the role of marketing/popularising the NPS, Committee to recommend which stakeholder, or group of stakeholders, are best suited to perform this role.

2/…

(iii) The Committee will examine the total cost structure of NPS, in comparison to international/domestic best practices, recommend whether there is a need to alter the present incentive structure of various stakeholders, and to suggest a viable economic incentive model, along with a robust regulatory framework which ensures that the interests of pensioners are protected. The Committee will also examine whether it is desirable to have differentiated incentive structures for the government and non-government segments.

(iv) The Committee to assess the desirability of including additional Pension Fund Managers (PFM), against the original architecture of limiting it to the present PFMs. If so, the Committee will spell out the eligibility criteria for the same, as also the merits of a uniform fee structure across PFMs, as compared to freeing the fee structure.

(v) The Committee is also requested to suggest a suitable revenue earning model for PFRDA, with a view to making its finances self-sufficient on a sustainable basis.

3. The Committee would start its work immediately.

Sd/-
(**Deepa Kotnis**)
General Manager

To

1)	**Shri G. N. Bajpai** former Chairman of SEBI
2)	**Shri Deepak Satwalekar** former MD, HDFC Standard Life
3)	**Professor Abhinandan Jain** Indian Institute of Management Ahmedabad
4)	**Dr. Nachiket Mor** President ICICI Foundation for Inclusive Growth

Copy to:

1)	**ED (RSN),** PFRDA
2)	ES to Chairman

New Delhi, July 1, 2011

The Chairman,
Pension Fund Regulatory and Development Authority
First Floor, ICADR Building, Plot 6,
Vasant Kunj Institutional Area,
Phase II, New Delhi 110 070

Dear Sir,

We submit herewith a Report of The Committee to Review Implementation of Informal Sector Pension (CRIISP).

Yours sincerely,

....

Shri G. N. Bajpai
Former Chairman, SEBI
(Chairman)

....

Shri Deepak Satwalekar
Former MD, HDFC Standard Life
(Member)

....

Shri Abhinandan Jain
Adjunct Professor IIM, Ahmedabad
(Member)

....

Dr. Nachiket Mor
Chairman, IFMR Trust
(Member)

....

Shri P. K. Tiwari
Former Executive Director, PFRDA
(Member-Secretary)

....

Shri Rajrishi Singhal
Head-Policy & Research
Dhanlaxmi Bank
(Adviser to the Committee)

CONTENTS

LIST OF ABBREVIATIONS……………………………………………6
FOREWORD ……………………..……………………………..……8
EXECUTIVE SUMMARY ……………….……………………..……..9-12

1. BACKGROUNDER ……………………………………………13-18
   The Existing Pillars of the System …...…………………………..….15
   The Journey from DB to DC ……………......……………………….…...16

2. THE BIRTH OF NPS ……………………………………………..19-22
   The Architecture ……………………………………………..........20
   Anatomy of NPS ……………………………………………..........21

3. THE OUTCOME SO FAR …………………………………….23-24

4. DIAGNOSING THE FAULT LINES …………………………25-30

5. RECOMMENDATIONS ………………………………………31-50

APPENDIX I ……………………………………………………51-53
APPENDIX II …………………………………………………...…54-58

List of Abbreviations

AML	Anti Money Laundering
BSE	Bombay Stock Exchange
BTL	Below-The-Line
CGF	Capital Guarantee Funds
CPF	Capital Protection Funds
CRA	Central Recordkeeping Agency
CRIISP	Committee to Review Implementation of Informal Sector Pension
DA	Dearness Allowance
DB	Defined Benefit
DC	Defined Contribution
DDO	Drawing and Disbursement Officer
Demat/Remat	Dematerialisation/Rematerialisation
DND	Do-Not-Disturb
DP	Dearness Pay
DTC	Direct Tax Code
EEE	Exempt-Exempt-Exempt
EPF	Employees Provident Fund
EPFO	Employees Provident Fund Organisation
FAQ	Frequently Asked Questions
FMCG	Fast Moving Consumer Goods
HSA	Health Savings Account
HTM	Held Till Maturity
IDFC	Infrastructure Development Finance Company
IRA	Individual Retirement Account
IRDA	Insurance Regulatory and Development Authority
IT	Information Technology
KYC	Know Your Customer
LIC	Life Insurance Corporation
MF	Mutual Fund
NABARD	National Bank for Agriculture and Rural Development
NAV	Net Asset Value
NGOs	Non-Government Organisations
NPS	National Pension System, unless otherwise specified
NSAP	National Social Assistance Programme

OASIS	Old Age Social and Income Security Project
PAN	Permanent Account Number
PFMs	Pension Fund Managers
PFRDA	Pension Fund Regulatory and Development Authority
PMLA	Prevention of Money Laundering Act
PoPs	Points of Presence
PPF	Public Provident Fund
PRA	Permanent Retirement Account
PRAN	Permanent Retirement Account Number
R&D	Research and Development
RBI	Reserve Bank of India
SBI	State Bank of India
SEBI	Securities and Exchange Board of India
SHG	Self Help Group
UK	United Kingdom
US	United States (of America)
USA	United States of America
UTI	Unit Trust of India

FOREWORD

I have great pleasure, on behalf of my colleagues in the Committee, to present the Report of the Committee to Review Implementation of Informal Sector Pension (CRIISP). The Committee was constituted by Chairman, PFRDA, in August, 2010 following recognition of the fact that NPS for the informal sector was faced with some issues that have hindered its proliferation. The NPS is a highly innovative and sophisticated financial product and its promotion and development is vital for the growth of pension sector in the country to achieve the twin objectives of providing old age income security to a vast multitude of our ageing population in the informal sector, and to provide for long-term investment needs of the economy.

While the Government of India has taken laudable steps to promote and popularize the NPS through policy and fiscal announcements, especially the economically elegant scheme of Swavalamban, the Committee has attempted to look into some generic and structural issues in NPS which, if addressed, should help remove the current bottlenecks in the optimum growth of NPS. It is our belief that the analysis of the Committee and recommendations made in the Report would help the policy makers initiate steps to address these issues and obviate the obstacles to the growth of NPS.

I take this opportunity to thank Chairman, PFRDA, Shri Yogesh Agarwal, for having reposed his faith in the Committee and also for having been patient. I take this opportunity to thank the cross-section of individuals and organizations that met with the Committee to share their views and suggestions in order to make NPS a more viable proposition. Our special thanks are due to Mr. Anil Kumar SG of the IFMR Trust who rendered invaluable assistance and research support to the Committee and Mr. Rajrishi Singhal, permanent invitee, for taking extra pains in assimilating the material to put it in the cogent form of the Report. Last but not the least, thanks are also due to Shri Sumantra Pal, Deputy General Manager, PFRDA, and Ms. Connie Franco of Intuit Consulting for providing valuable assistance and support during several meetings of the Committee.

(G. N. Bajpai)
Chairman, CRIISP

EXECUTIVE SUMMARY

1. India's economic growth and demographic transition is resulting in a falling birth rate, a slowing down of the death rate and a subsequent rise in the proportion of the aged population. A large part of the informal sector remains without any funded social security scheme. [paragraph 1.6 & 1.9]

2. In a significant move in December 2003, the Interim Pension Fund Regulatory and Development Authority was created as the watchdog and promoter for the pension sector, and, all government employees joining service on or after January 1, 2004, were compulsorily brought under the coverage of the 'New Pension System' (NPS) – a defined contribution scheme replacing the defined benefit scheme available to the Government employees until then. Most of the states have also migrated to the DC system under NPS, except three states. NPS was introduced for all citizens from May 2009. [paragraph 2.1]

3. The NPS was created with a unique and defining feature of individual retirement account with portability. [paragraph 2.3]

4. Despite its unique features and the potential to address the issue of old age income security in the informal sector, NPS has remained unpopular, possibly due to the faulty assumption that pension products do not need to be sold. From this basic flaw flow all the other infirmities in the product design and micro-structure. [paragraph 4.2]

5. The biggest problem with NPS is the absence of any clear idea about who owns the customer. While the existing unbundled architecture has its own advantages, it has ended up fragmenting responsibility for not only attending to customer grievances but for also selling the product to potential contributors. [paragraph 4.4]

6. The POPs have so far not actively marketed the product, despite some incentives announced by the PFRDA; nor have the PFMs, primarily because of a tacit arrangement that discourages them from active canvassing of accounts, possibly to avoid any mis-selling. [paragraph 4.6]

7. The reluctance by the POPs – especially bank-POPs -- in pushing NPS products might also be due to an inherent conflict with other products sold through the

branch, with incentives higher compared with NPS. The main reason behind the lukewarm response appears to be the low-to-negligible distribution incentive incorporated in the system architecture. [paragraph 4.7+4.8]

8. Costs are a deterrent too. The cost structure followed by PFRDA is based on the absolute amounts every subscriber is required to pay to each stakeholder in the NPS architecture. Although the amount seems small enough, but these absolute costs look pretty high in percentage terms. [paragraph 4.17]

Summary of recommendations

1. The committee recommends an ad valorem structure for POPs which has the potential of merging the advantages of volumes (from small investors) with value (high ticket investments from rich investors). The committee feels that the ideal rate should be 0.5% of the amount subscribed by the NPS subscriber, subject to an upper limit of Rs 50,000 and a lower limit of Rs 20. [paragraph5.10+5.11]

2. The Committee suggests that PFRDA engage with the postal department proactively to increase the number of branches selling NPS. Another option is to appoint the numerous mobile telecommunications service providers which have taken mobile telephony to the remote corners of this country. [paragraph 5.13 + 5.14]

3. The committee feels that there should be no upper limit or qualitative restriction on any category of distributor. Popularising NPS is a national priority and, as long as the basic criterion of "fit and proper" is met, PFRDA can look at appointing all categories of distribution agents to distribute NPS.[paragraph 5.17]

4. PFMs should be allowed to sell NPS but not directly. If within their corporate structure they have a POP, they should synchronise their actions. For all PFMs which do not have a POP, the committee recommends that they should be allowed to float POP subsidiaries which can then be used to source NPS accounts. These subsidiaries would be subject to PFRDA's extant rules and regulations applicable for POPs and would receive the same incentives as earned by other POPs. [paragraph 5.23]

5. PFRDA may consider changing the current rule requiring a minimum annual subscription of Rs 6,000 for NPS Main to bring it down to Rs.1000 per year so that any account-holder with this contribution can access the POP network in the country, and also avail of the benefits of Swavalamban. [paragraph 5.28]

6. PFRDA should take a fresh look into a break-up of the annual maintenance charge of Rs 280 or even the per transaction charge of Rs 6 levied by the current CRA. PFRDA should also revisit the suggestion of inducting in a few more CRAs, as was originally planned. [paragraph 5.30]

7. PFRDA should commission fresh research into calculating the costs of NPS delivery, especially in the light of the emergence of new cost-effective transaction channels. [paragraph 5.31]

8. Promotion of NPS should be a part of the national financial inclusion agenda. It would allow PFRDA to access the national pool of investor education funds and funded outreach programmes, since the target audience for PFRDA and the other programmes are common.[paragraph 5.36]

9. PFRDA should work out a comprehensive marketing action plan, including a branding programme. In addition, PFRDA should conduct an exercise to design a market development unit within the regulatory structure. This unit will be responsible for devising short and long term marketing plans for achieving PFRDA's developmental role. This unit may also develop a suitable branding and communication programme that would lead to desired level of customer acquisition and retention. [paragraph 5.37-5.46]

10. PFRDA should continue with the Tier-II for the moment but put in place adequate regulatory safeguards for this product in consultation with the Reserve Bank of India (with regard to the savings bank characteristic of the product) and the Securities and Exchanges Board of India (from the viewpoint that the funds management activity takes on the features of a liquid mutual fund). [paragraph 5.49+5.50]

11. The government should extend the Swavalamban incentive of Rs 1,000 every year for a longer period, if not for perpetuity. [paragraph 5.60]

12. PFRDA should consider introducing a dynamic element to the fee structure for the PFMs, a sort of sliding scale, which ensures that an increase in the assets under management automatically results in a lowering of the fee [paragraph 5.64]

13. PFRDA needs to re-examine the extant criteria for selection of PFMs. PFRDA can adopt the rules framed by Securities and Exchanges Board of India rules – with suitable changes. PFRDA can determine the number of PFMs it can optimally supervise. [paragraph 5.65]

14. PFRDA should be financially autonomous to help it discharge its duties as an independent regulator and to nurture a pension sector that is free from controversy or regulatory capture. [paragraph5.67+ 5.69]

15. There might be a case for issuing pre-paid PRAN cards. The KYC has to be the responsibility of the aggregator/POP. The distribution network of telecom companies selling pre-paid cards and Bill payment companies must be included as channels for mobilizing subscriber contributions to PRANs. [paragraph 5.70+5.71]

16. PFRDA should actively encourage Bank POPs to make available on their websites the pay online option in order to bring NPS within the easy reach of those with internet access. [paragraph 5.72]

17. It is recommended that the capital protection feature for the NPS product be offered to subscribers. Inflation indexed bonds of different maturities could allow NPS to hedge inflation risk and in turn offer investment products to retail clients that are protected against inflation. [paragraph 5.73+5.74+5.75]

18. PFRDA needs to evolve a regulatory framework for detecting and penalising instances of mis-selling. The committee feels that PFRDA should probably institute a separate committee to draft new rules and regulations to keep mis-selling at a minimum.[paragraph 5.78]

19. PFRDA should probably draft a code of conduct for all the participants in the NPS chain. This is necessary to avoid any ambiguities about their role. [paragraph 5.79]

20. PFRDA should also step up its inter-action with external researchers, especially by making clean data available to them. PFRDA, apart from actively publishing all research on its web-site, should also commission research and development from time to time.[paragraph 5.80]

21. PFRDA should find a way to work jointly with the insurance sector regulator, Insurance Regulatory and Development Authority, for developing a proper market for annuities.[paragraph 5.82]

Chapter 1: BACKGROUNDER

1.1 World-over, geographies across physical boundaries and economies across income divides are gripped with a sense of urgency about their ageing demographic profile and the unintended benefits of economic well-being. The developed economies – especially USA, large parts of Western Europe, Japan -- woke up in the mid-1980s to a rapidly transforming demographic profile of their nations, with the old and retired slowly out-numbering the young and working population. This had unforeseen consequences, especially since the existing economic support systems for the old-aged had not taken into account the consequences of such a seismic shift in the population profile. What aggravated the crisis was a realization that the government-sponsored formal mechanisms, as well as the traditional family-structured support systems, for the old-aged were inadequate to meet the requirements of the day. The West, with its rapidly graying population, felt the severity of the crisis first, largely through fiscal pressures when these promised payments came home to roost.

1.2 Japan is an appropriate example. In a recent special report on Japan's ageing society, London-based magazine *The Economist* wrote in its leader, The Japan Syndrome: "…a dwindling band of workers will have to support rising social-security payments, as the number of retired people grows. This will strain public finances. Ten years ago each person in retirement was supported by four in work. In ten years that burden will fall on only two workers. Already, the rising cost of caring for the elderly has pushed up the government deficit and the national debt. If Japan's workers cannot shoulder their burden, the country will find itself unable to honour fully its pension and health-care commitments. In effect, it will be forced to default on its obligations to society."

1.3. This malaise has spread insidiously from Japan into mainland Asia. Today many countries across Asia – especially the relatively more developed countries of South East Asia – are also faced with a similar crisis. While South Asia has been saved the blushes for now, this is a tsunami that cannot be averted for far too long. According to a working paper published by Asian Development Bank (*Ageing Asia's Looming Pension Crisis*): "A young continent reaping the demographic dividend of a large youthful workforce is giving way to a graying continent where the ratio of retirees to workers is on the rise. In contrast to industrialized countries, most Asian countries do not yet have mature, well-functioning pension systems".

1.4 This makes the task of pension reforms in India rather compelling in nature and a dire social necessity that cannot be forestalled for far too long. The Indian economy is currently basking in the glow of the so-called "demographic dividend", a fortuitous consequence of what was earlier considered a millstone for the economy – the country's burgeoning

population. The simple reasoning goes like this: the crucial ratio to track in any economy is the "dependency ratio" or the proportion of the number of people in the country not working/earning to the working/earning population. In India, till about 2005, the dependency ratio was 0.6. Now, this is expected to decline over the next 20-30 years as the real "demographic dividend" kicks in. With fertility rates dropping over the years, especially in the past 20 years, from 3.8 in 1990 to 2.9 in 2007 and expected to fall further, the number of new-borns will decrease. But, as a consequence of the higher fecundity rates earlier, a large number of today's population is in the age group 10-15. When this population cohort comes into the working force, the subsequent reduction in the fertility rate will lower the number of children below the age of 15, and therefore is bound to lower the overall dependency ratio.

1.5 The economic benefits of a lower dependency ratio are multiple: as a larger percentage of the population starts working, the savings and consumption levels in the economy also go up, thereby pushing economic growth to a higher trajectory. But, this dividend can also turn into what has been termed as a "demographic echo". Over time, this huge bulge in the working force – which is being considered as an economic windfall -- is expected to retire. At the same time, the lower dependency ratio will see fewer younger people joining the workforce, resulting in a graying of the economy. This has another outcome: the economy will have fewer working age people to support the old and if the retired do not have access to regular income streams by then, for which they need to save today, the burden on the economy is likely to be crippling in nature. A larger number of older and retired people, in the absence of a dependable pension system, will pose a danger to the old age income security in the country and put enormous pressure on the government of the day to re-route expenditure earmarked for public goods and services towards providing for health and pension spending. This causes a drain on the state of the fiscal and, subsequently, on the economy.

1.6 India's economic growth and demographic transition is resulting in a falling birth rate, a slowing down of the death rate (the drop is sharper than the fall in birth rate due to improved economic development, leading to increased life expectancy) and a subsequent rise in the proportion of the aged population. The proportion of those aged 60 and above is expected to climb from 4.6% in 2000 to 9% in 2030. In absolute numbers, the number of people above the age of 60 will increase from 87.5 million in 2005 to 100.8 million in 2010 and this is expected to jump to 200 million by 2030. By 2050, it is expected to be over 320 million (Source -- *World Population Ageing: 1950-2050, United Nations*). What makes this data-point chilling is the fact that improved economic development is bound to lead to a higher life span. The inability to implement a properly functioning pension system now is likely to affect a larger number of people in the future. Many members of this age bracket have just

entered, or are about to enter, the job market. This fact alone imparts a sense of urgency to the task at hand.

1.7 What further complicates matters is that only about 10-15% of the working population participates – and is eligible to participate -- in the mandatory, formal programmes designed for providing income security during the non-earning years. These employees are largely part of the formal sector (private sector and the government). The rest is either part of the informal sector (which goes unreported in the broader economic scheme) or does not enjoy adequate income streams that can be accommodated in the existing pension schemes.

1.8 In India, another added feature (which distinguishes India from all the other countries with a similar demographic profile) further complicates matters. Most of the other developing countries – and most certainly developed nations – have implemented some form of universal social security, which provides a state-sponsored (or self-financed) safety net to people without any source of income, or provides sustenance for periods of unemployment through an unemployment insurance programme. Going by the pressures on the fiscal and the current debate on economic reforms, it is moot whether India will implement an unfunded universal social security system any time soon. The government has indeed introduced the umbrella National Social Assistance Programme (NSAP), under which different schemes are housed for providing pensions to destitute and widows over 60 years of age. The states have been entrusted with the responsibility and execution of the scheme with the Centre providing matching financing. However, the Programme has had mixed results so far.

1.9 This leaves a large part of the informal sector without any funded means of providing for old age and for supplementing the lack of future income streams. This Committee's terms of reference restrict its scope to suggesting reforms for the pension schemes launched under the jurisdiction of the Pension Fund Regulatory and Development Authority and to recommend ways and means of popularising these schemes, launched under the umbrella name of the National Pension System. This will include all nature of wage earners, as well as myriad self-employed categories which do not have access to formalized pension schemes.

The Existing Pillars of the System

1.10. Any pension system in the world can be said to broadly conform to any one, or a combination, of three basic pillars. Classifying an individual pension scheme into a particular pillar depends on the stated need of the pension scheme and the manner in which it is funded. There are various definitions provided by different agencies on what constitutes each of the pillars. Here is a brief description of each of the three pillars along with the various existing schemes which fit into them.

1.11. **Pillar-I**: This pillar essentially comprises all the state-funded pension plans, which in theory should ideally cater to every citizen in the country. This is also the pillar under which the government launches some of its poverty alleviation programmes aimed specifically at the aged. Under this pillar, the system is publicly managed, the liabilities are not actuarially funded and the scheme works on what is termed as Pay-As-You-Go. This means that current revenues are used to meet current expenditures. But, in fiscal terms, the consequences need a slightly more detailed look – the current generation's tax payments are used to pay the pension liabilities of an earlier generation. The World Bank's now famous report on pensions, called *Averting The Old Age Crisis* (1994), defines Pillar-I thus: "…a publicly managed system with mandatory participation and the limited goal of reducing poverty among the old…"

1.12. In India, the defined benefit pension system in vogue for the civil services (discussed in slightly more detail later in this Chapter) at both the Centre and the state level – including in the railways, defense and telecommunication services – fall under Pillar-I, where the system is essentially non-contributory in nature and any particular year's pension liabilities are met from the government's annual revenue expenditure account for that year. The NSAP, described earlier in this Chapter, is also a candidate for Pillar-I.

1.13. **Pillar-II**: This typically comprises a mandatory savings programme at the employment level which is either privately or publicly managed. In simple terms, it is a forced savings pillar that provides benefits only to contributors, and, in general, incorporates a direct linkage between the volume of contribution and the extent of benefits received. In India, the Employees Provident Fund, which is India's largest defined contribution and publicly managed plan, is an example of this. In addition, there is the Employees Pension Scheme, a publicly managed scheme carved out of the EPF scheme with the objective of paying a monthly pension to workers after their retirement.

1.14. **Pillar-III**: This pillar includes all kinds of voluntary savings, available to everyone including those looking to supplement their Pillars I & II pension provisions. In India, the Public Provident Fund scheme fits the definition. The PPF scheme was introduced by the government in 1968-69 to provide workers from the informal sector with an option to salt away retirement savings.

The Journey from DB to DC

1.15. The government began to take note of the looming pension crisis once the structural readjustment of the fiscal was initiated. The consciousness was necessitated by an existing anachronism in the civil service pension scheme – a defined benefit scheme inherited from the British administration, which was showing all signs of being fiscally unsustainable -- and, secondly, by an important event in the mid-nineties in which a part of the age-old

defined contribution scheme, the Employees Provident Fund Scheme, was converted into a defined benefit scheme in the form of the Employees' Pension Scheme, 1995. This marked a curious move by the Indian government, particularly at a time when the rest of the world was moving away from DB to DC. However, the introduction of NPS a few years later might be seen as an attempt to make course corrections.

1.16. The Ministry of Social Justice and Empowerment (earlier called the Ministry of Welfare), in 1998, commissioned the first comprehensive study of India's pension sector under the chairmanship of former UTI Chairman Dr S A Dave, under the name of Oasis Project – Old Age Social and Income Security Project. While the original remit of the Oasis Committee was to provide a pension solution for the 90% of the informal sector workers, the committee ended up providing a prescription for overall pension reforms.

1.17. As part of its overall recommendations, the Oasis committee (which submitted its final report in January 2000) suggested a completely new and radically different architecture through portable individual retirement accounts, across-the-counter service delivery platforms, centralized record keeping, competing pension fund managers, extensive use of information technology, freedom to choose investment menus, among other things. While observing that there was a separate working group looking into the aspect of government pensions, the Oasis committee expressed its view on the issue rather succinctly: "…measures should be taken so that Government Pension liabilities become fully funded out of contributions made by government employees. This goal can be achieved over a period of the next ten years."

1.18. The turning point came on February 28, 2001, when former Finance Minister, Mr. Yashwant Sinha, announced this in his Budget speech for 2001-2002: *"The Central Government pension liability has reached unsustainable proportions: as a percentage of GDP, it has risen from about 0.5 per cent in 1993-94 to 1 per cent in 2000-2001. As such it is envisaged that those who enter central government services after October 1, 2001 would receive pension through a new pension programme based on defined contributions. In order to review the existing pension system and to provide a roadmap for the next steps to be taken by the Government, I propose to constitute a High Level Expert Group, which would give its recommendations within 3 months."*

1.19. After a flurry of activity and several reports by numerous working groups, including the World Bank and the Asian Development Bank, Finance Minister Jaswant Singh announced in his Budget speech of February 2003: *"My predecessor in office had, in 2001, announced a road map for a restructured pension scheme for new Central Government employees, and a scheme for the general public. This scheme is now ready. It will apply only to new entrants to Government service, except to the armed forces, and upon finalisation, offer a basket of pension choices. It will also be available, on a voluntary basis, to all employers for their employees, as well as to the self-employed. This new pension system, when introduced, will be based on defined*

contribution, shared equally in the case of Government employees between the Government and the employees. There will, of course, be no contribution from the Government in respect of individuals who are not Government employees. The new pension scheme will be portable, allowing transfer of the benefits in case of change of employment, and will go into 'individual pension accounts' with Pension Funds. The Ministry of Finance will oversee and supervise the Pension Funds through a new and independent Pension Fund Regulatory and Development Authority."

1.20. Thus began the transition from the age-old defined benefit scheme, which had become the dominant leitmotif for all government pension schemes, to the fiscally prudent defined contribution scheme. The next chapter details the first steps of the changes that took place subsequently, the grand parametric design and the specific architecture that was conceptualized and installed as part of the National Pension System.

CHAPTER 2: THE BIRTH OF NPS

2.1. As mentioned in the previous chapter, the pressure on the fiscal from rising pension pay-outs has forced the government to move the pension system for government employees to a defined contribution system. In a significant move in December 2003, the Interim Pension Fund Regulatory and Development Authority was created as the watchdog and promoter for the pension sector. Simultaneously, all government employees joining service on or after January 1, 2004, were compulsorily brought under the coverage of the New Pension System (NPS)—a defined contribution scheme replacing the defined benefit scheme available to the Government employees until then. Most of the states have also migrated to the DC system under NPS, except three states. Only one category of government employees has been exempted from mandatorily moving to NPS: personnel from Armed Services. NPS was introduced for all citizens from May 2009.

2.2. The government moved the PFRDA Bill in Parliament in March 2005 to provide legislative sanctity to PFRDA, which lapsed. The government has moved the Bill once again, and though the Bill is still pending in Parliament (thereby rendering the PFRDA as the interim regulator even six years after the Bill was moved for the first time in Parliament), the NPS has in the meantime evolved and acquired some semblance of a momentum, though the pace and its breadth of coverage have been far from satisfactory. While the NPS for the general public has received a lukewarm to cold reception, what's surprising is that the government component is also suffering from sub-optimal coverage, even though it has been made mandatory for all government employees who joined service after January 1, 2004. We will examine this alarming phenomenon in the subsequent chapters.

2.3. The NPS was created roughly along the architectural blueprint provided by the Oasis Report. The broad structure involves three agencies – Point of Purchase (POP) intermediaries, Central Record-keeping Agency (CRA) and Pension Fund Managers (PFMs). Under the structure, the POPs are the interface between the buyer of the pension products and NPS. The beneficiary approaches the POP and provides two important elements -- identity proof through appropriate documentary evidence and funds for investment. In the first instance, the documents are accepted and passed on to the CRA for due verification, after which a Permanent Retirement Account in the investor's name is opened and the investor is granted a Permanent Retirement Account Number (PRAN). This number is his key identifier within the NPS. This also then imparts a unique and defining feature to NPS: portability. The investor is allowed to shift his residence, his choice of PFMs or even his selected investment options. Through all this, his PRAN is constant and enables him to shift seamlessly from one geography to another, from one PFM to another or from one investment choice to another. In the second stage, the applicant has the choice of selecting from any of the seven PFMs selected by PFRDA and communicating to the PFM the

investment option chosen. All this is done through the POP, which is effectively the interface between the investor and the NPS.

THE ARCHITECTURE

In essence, the roles of the key constituents under NPS break down in the following fashion:

2.4. **POPs**: Essentially, as mentioned above, POPs are the interface between the investor and the NPS. Effectively, the POP is only a conduit between the investor and the CRA for information and between the investor and the PFMs for funds transfer, shuffling of portfolio between different PFMs, as well as managing the reverse flow of keeping the investor apprised with regular NAV updates. So far, the POPs have included branches of banks (from both the public and private sectors), post office branches, depository participant offices and NGOs. Apart from their transactional responsibility, there is some confusion whether the POPs should also shoulder the task of marketing NPS – including creating general awareness -- among the general public.

2.5. **CRA**: The backbone or the nerve centre of the NPS, the CRA provides the vital link between the investor, the POPs and the PFMs. CRAs perform the role of warehousing and managing the entire database of the NPS. The idea behind a centralized, IT-enabled information repository was to avoid the replication of data across separate PFMs, apart from achieving economies of cost. A centralized agency also allows for account portability, a key feature of NPS. Although six agencies had initially applied for the role of a CRA, PFRDA eventually chose only National Securities Depository as the CRA for the NPS.

2.6. **PFMs**: The PFRDA selected seven PFMs in two stages through a process of technical and business evaluation – LIC Pension Fund Ltd, SBI Pension Funds Pvt Ltd, UTI Retirement Solutions Ltd, IDFC Pension Fund Management Company Ltd, ICICI Prudential Pension Fund Management Co Ltd, Kotak Mahindra Pension Fund Ltd, and, Reliance Capital Pensions Fund Ltd. These PFMs manage the investment corpus of the investors, with only SBI, UTI and LIC managing the accretion of the central government employees.

2.7. The philosophy behind this three-tiered architecture has been summed up in the Oasis report: "The New Pension System should be based on individual retirement accounts. An individual should create this account; have a passbook where he can see a balance that is his notional wealth at that point of time; he should control how this wealth is managed; this account should stay with him regardless of where he is or how he works. He would make contributions towards his pension into this account through his working life (whether employed in the organized sector or not), and obtain benefits from it after retirement for the rest of his life."

ANATOMY OF NPS

The NPS has a few other distinctive features, apart from portability.

2.8. Each government employee contributes 10% of his salary (basic+DA+DP) to the pension account, which is then matched by a government contribution of an equal amount. However, non-government employees do not get the benefit of a matching government contribution. In both the cases, investors are free to contribute higher than what has been mandated. All these contributions are accrued in a pension account called Tier-I from which funds cannot be withdrawn. Once the account-holder reaches the proper exit age (60 years, relaxed to 50 years for Swavalamban beneficiaries in Budget 2011-12, see below), he/she can withdraw only up to 60% from the accrued savings corpus. The balance 40% in the savings corpus has to be used to compulsorily purchase annuities sold by any life insurance company. This annuity then provides for regular pension streams over the non-working life of the investor.

2.9. In addition, there is a tax issue at work here as well. The contributions to this account and the savings accrued are exempt from income tax, as per Section 80CCD. However, when the investor withdraws the amount on maturity, it is taxable. The Direct Tax Code is proposing to convert retirement savings from the current Exempt-Exempt-Taxable regime (which exempts contributions and the accumulated sums from income tax but levies tax on the final corpus) to a completely Exempt-Exempt-Exempt regime. The impact of this proposed change is yet to be ascertained.

2.10. In order to provide some flexibility to investors, especially to provide them with access to ready funds to meet exigencies, PFRDA decided to introduce Tier-II, a voluntary savings facility. While investors are free to withdraw any amount they wish from this account, their contributions however do not enjoy any tax benefits.

2.11. The PFRDA also introduced on September, 2010, a new variant called NPS-Lite to extend the coverage of NPS to the economically and disadvantaged sections of society. The main feature of the scheme is that the beneficiary is free to invest however much he/she likes every year. The scheme is operated through the aggregators or self-help groups (SHGs) and has an extremely low cost structure.

2.12. In Budget 2010-11, the finance minister Shri Pranab Mukherjee introduced a new incentive scheme called Swavalamban to encourage people from the unorganized sector to start saving for their old age security. Under the scheme, the government will contribute Rs 1000 for each new NPS account opened during 2010-11. The contribution will be available for every new account where the annual contribution is between a minimum of Rs 1000 and a maximum of Rs 12,000. The government set aside an allocation of Rs 100 crore for the

scheme. Despite this incentive from the government, the scheme has not met with much success. However, the government has decided to extend its commitment to Swavalamban – as part of Budget 2011-12 -- to contribute Rs 1,000 per account for the next five years. This augurs well for NPS. In later paragraphs (paragraph 5.60), this report discusses the merits of Swavalamban and the need to continue it.

2.13. Finance minister Pranab Mukherjee in his Budget speech for 2011-12 said: *"This scheme (Swavalamban) has been welcomed by the workers in unorganised sector. Over 4 lakh applications have already been received. On the basis of the feedback received, I am relaxing the exit norms whereby a subscriber under Swavalamban will be allowed exit at the age of 50 years instead of 60 years, or a minimum tenure of 20 years, whichever is later. I also propose to extend the benefit of Government contribution from three to five years for all subscribers of Swavalamban who enroll during 2010-11 and 2011-12. An estimated 20 lakh beneficiaries will join the scheme by March 2012."*

2.14. In the backdrop of this over-arching architecture adopted by PFRDA for NPS and NPS-Lite, and with the inclusion of Swavalamban as a sweetener for inducing new investors – especially those who have no old age savings -- to the NPS, the next chapter will examine the outcome so far and the proximate reasons for the results.

CHAPTER 3: THE OUTCOME SO FAR

3.1. Post the launch of NPS for government employees, it was assumed that all government employees joining government service from January 1, 2004, would mandatorily, and automatically, be drafted into the scheme. However, it is not yet clear (on the basis of PRANs registered) whether all the central government employees who have joined service after January 1, 2004, have become NPS members. There is no concrete evidence or any authorized government document to back this up, but going purely by the number of investors and the headcount of new appointments, there seems to be a gap.

3.2. Over 12 lakh government employees are currently registered with NPS. However, when weighed against the fact that it has been more than six years since NPS was first made mandatory for government employees, the enrolments at 12 lakh do seem to be on the lower side. Especially when one considers the fact that, with the exception of defence personnel, all government employees – this list includes all central government service employees, employees of central ministries or departments, employees of non-civil ministries or departments, including Railways, Posts, Telecommunication or Armed Forces (Civil), and employee of autonomous bodies, grant-in-aid institutions, Union Territories or any other undertakings whose employees are eligible to a pension from the Consolidated Fund of India -- are eligible to be drafted into NPS. In fact, while it is difficult to source data on the exact number of employees who have joined the abovementioned services since January 1, 2004, the number 12 lakh intuitively seems to be on the lower side.

3.3. This doesn't even take into account the 27 states – of which 17 states have started the process of transferring their employee pensions to NPS -- which have notified their acceptance of NPS as a pension scheme for their employees.This gap between new appointees and NPS members – if such a gap exists at all -- raises some vital questions: such as, what happens to the pensions of employees who have not yet been drafted into NPS? How will their pension be funded if their pension contributions do not get invested? Secondly, if this gap does exist, then the number of government employees being kept out of NPS could possibly be growing every passing year. This will then require the government to ring-fence this problem quickly before it becomes a threat to the fiscal once again.

3.4. The shift to NPS from January 1, 2004, involved some process re-engineering at the government end, especially at the Pay and Accounts end. However, while it is not clear what has exactly transpired, it is evident that there could have been some operational gaps between the government's payroll section and NPS implementation. The FAQ section in the PFRDA website outlines the process through which NPS deductions are expected to take place: "When you join service, your Drawing and Disbursement Officer (DDO) will instruct you to fill out a NPS form. You will be required to provide your full professional and

personal details including details of your nominee in this form. The DDO will issue you the PPAN number (a unique Personal Pension Account Number) and will also be responsible for all administrative matters related to your NPS accounts including deduction of your contributions, transferring your contributions and the matching contribution of the Government to your Tier-I pension account." (http://www.pfrda.org.in/faqdetails.asp?fid=245)

3.5. In May 2009, NPS was thrown open to the general public. The subscription levels so far have remained rather tepid and do not seem to reflect any investor interest in the product. The scheme has managed to draw less than 50,000 subscribers so far (May 2011). This is a rather low number, given that the scheme architecture was designed to make it attractive to the general public. What's even more surprising is that despite the government's offer of putting in Rs 1000 for every new account opened under the Swavalamban scheme, there have been very few takers.

3.6. In terms of money managed by the PFMs, as of March 31, 2011, the total assets under management by all PFMs amounted to Rs 8,585 crore. Of this, the contribution from the non-government sector does not exceed Rs 100 crore, of which a bulk has been contributed by two corporates which have migrated their employees' pension schemes to NPS. This reflects the sluggish growth of NPS.

This then raises a few moot questions.

1. Has the full potential of the government employees been realized under the NPS regime?
2. Why has the response from the general public been so tardy to a scheme that has not only been designed after much thought and debate but is also intended to benefit the investor?
3. What will it take to convince investors of all kinds – the private sector salaried employee, employees in the informal sector, the self-employed and the micro entrepreneurs – to start investing in NPS to take care of their own old age income security?

The next few chapters will try to find the answers to these questions.

Chapter 4: DIAGNOSING THE FAULT LINES

4.1. A first sight, the reasons behind the tardy subscriptions to NPS do not seem to lie in the product architecture. The emphasis on adopting an unbundled product architecture – which focused on keeping the POP, CRA and PFMs separate -- was finalised after much deliberation and examination of some of the pension models adopted elsewhere globally. However, on a closer assessment of the current NPS model, especially in the non-government sector, the committee has found a few gaps in the super-structure as the reason behind the tardy accretion of investments so far.

4.2 Despite its unique features and the potential to address the issue of old age income security in the informal sector, NPS remains unpopular. This may be due to the assumption that financial products, particularly pension products, do not need to be sold and that there exists a demand pull for such financial products. Nothing can be farther from the truth and the low level of financial penetration in India, despite the mandated government targets, is testimony to this axiom. From this basic flaw flow all the other infirmities in the product design and micro-structure.

4.3 At first sight, one of the main reasons behind the lackadaisical response is the lack of awareness of the product among the consumers/buyers of financial services. This particular lacuna has arisen because of a combination of structural flaws in the way the product has been designed for non-government contributors, especially with reference to the involvement of all the three players in the delivery mechanism. We will discuss this in the following paragraphs and highlight how these structural gaps have ended up creating an environment which has worked against creating awareness for the product.

4.4. The biggest problem with NPS is the absence of any clear idea about who owns the customer. While the unbundled architecture has its own advantages (such as, portability as well as purportedly lower administrative and transaction costs), it has ended up fragmenting responsibility for not only attending to customer grievances but for also selling the product to potential contributors. While other financial products – such as, mutual fund units or insurance policies – have seen some demand pull from the investing public, there seems to be a marked absence of an express desire to invest in NPS. This could be due to lack of awareness of the product. And, the only way to amend this would be to first delineate clear responsibilities on customer awareness, customer acquisition and customer servicing.

4.5. The moot question that arises then is: who will take responsibility for creating the branding and marketing thrust for NPS? A POP registered with PFRDA told this committee that its call centre received 4000 enquiries following a single advertisement from PFRDA.

Currently, the system blueprint requires the customer to access the POP and not the other way around. One of the original architects of NPS told this committee: "We thought then that the product had to be bought, and not sold." If that indeed is the over-arching objective, even then it needs to be followed up with active marketing, advertising and ground-level promotional activation on a national scale so that any potential investor feels motivated enough to approach the POP on his own initiative. This activity is necessary for another reason – not many people spare enough thought about providing for their old age income security, especially in the informal sector. Any promotional activity would have also conveyed the benefits of NPS, which allows small amounts to be saved during the earning age. While there is a conspicuous absence of any such endeavour, there is also some confusion about who should be entrusted with the responsibility for carrying out such an exercise.

4.6. From this flows another structural divergence, and in the mind of the committee, a crucial drawback for the product – that none of the intermediaries in the NPS design has an explicit marketing role. The POPs have so far not actively marketed the product, despite some incentives announced by the PFRDA, nor have the PFMs, primarily because of a tacit arrangement that discourages them from active canvassing of NPS, though this has not been committed anywhere in writing. The reason behind this unspoken agreement to desist from hard-sell could well be to avoid any episode of mis-selling. There is merit in the argument that the system needs to walk the extra mile to prevent any incidence of mis-selling, because public knowledge of even one isolated incidence can do sufficient damage to NPS credibility. However, the current regulatory structure may need to accommodate some changes that seek to strike a balance between a system that, on the one hand, encourages drumming up interest in NPS and, on the other, penalizes instances of mis-selling. This committee feels that in this debate between outreach versus consumer protection, both can be winners simultaneously.

4.7. The reluctance by the POPs – especially bank POPs -- in pushing NPS products might also be due to an inherent conflict. Many financial products targeted at the retail customer ó such as, insurance policies and mutual fund schemes -- are usually sold through the customer touch-point of a branch and provide incentives which are higher compared with NPS. In such cases, banks are faced with an inherent conflict and a moral dilemma: do they push products that offer better incentives or throw their weight behind financial products that are of national importance but offer low incentives? Members of bank branch staff are usually given stiff sales targets for insurance policies and mutual funds, since these incentives go straight to the bottom-line and hence are important for career progression. NPS, on the other hand, offers low incentives and is not yet seen as important for either the bottom-line or for career progression. It, then, becomes a casualty of this peculiar dilemma faced by bank staff.

4.8. It appears to the Committee, that the main reason behind the lukewarm response is the low-to-negligible distribution incentive incorporated in the system architecture. It was implicitly assumed during the construction of NPS that the product would generate its own demand pull and therefore any measures – such as designing an incentive structure to spur distribution -- would not be necessary.

4.9. In addition, it must be remembered that the largest chunk among the current lot of contributors – 1.5 million PRANs at the latest count – is the government segment, which has come to NPS without any prodding. The current architecture might therefore need some tweaking to adjust itself to a non-government sector, especially the sprawling informal sector.

4.10. Consequently, weighed down by the unspoken curb on going out and selling the product, or the absence of a viable incentive structure, none of the three key legs of the NPS infrastructure – POPs, PFMs or the CRA – has invested in a proper client acquisition practice.

4.11. It is well documented by now that optimal selling of financial products happens in India only when the distribution network is well lubricated with incentives. Sales of equity mutual funds – the category most preferred by the retail investor, even though it comprises only 25% of the total assets under management of the mutual fund industry – witnessed a sharp drop after markets regulator Securities and Exchange Board of India abolished entry loads. While there has been a pick-up in sales of equity funds in recent times, primarily through sales of Systematic Investment Plans, it is nowhere near the figures achieved prior to the ban.

YEAR	EQUITY MF SALES (Rs. Crores)
2007-08	119,838
2008-09	29,480
2009-10	61,114
2010-11	66,592.3
	Source: AMFI, SEBI

4.12. Given the vast geographical spread of the Indian landmass, and the visible lack of a delivery-based infrastructure, any investment in distribution will seek a visible and viable return on investment. Especially, since the success ratio of pitches to conversion is quite small in financial services.

4.13. To be fair, PFRDA has indeed put in place an incentive structure. Under the current structure, POPs earn Rs 40 for every new account that is opened. Thereafter, POPs earn Rs 20 per transaction. Additionally, in May 2010, in order to assist POPs in enrollment of subscribers to NPS, PFRDA announced a supplementary Rs. 50 per subscriber enrolled in

NPS. This incentive was further enhanced to Rs. 150 in December 2010, with a view to boost the POP's efforts to enroll subscribers in NPS. It was also mentioned that the incentive was meant to help POP in capacity building for promotion of NPS and redouble their efforts to popularize NPS.

4.14. Under NPS-Lite and Swavalamban, aggregators used to earn around Rs 50 per eligible account (contributors have to make a minimum annual contribution of Rs 1,000). This incentive amount has now been increased up to Rs 92 per subscriber. The payments are made by PFRDA out of its "promotion and development" fund. The conditions remain the same – PFRDA must be convinced that accounts opened during the previous years are still active, which means that all due installments have been paid up and the account is operational.

4.15. However, in its meeting with the various POPs, this committee was told repeatedly that the incentive structure is too low to compensate for any investment in sales and distribution. The proof lies in the numbers – of the 50,000 bank branches that could have potentially been active champions in pushing NPS, only 12,000 have been activated.

4.16. Even if we were to assume that PFMs too should act as an alternative channel for garnering new investments, the current fee structure (at 0.0009% of the average monthly assets under management) seems way too low for them to even meet their costs, let alone provide them with additional incentive to actively start championing NPS. It can be argued that the fee structure was decided after rounds of competitive bidding and that the fees were quoted by the funds themselves. However, the bidding process – believed to have been inspired by the EPFO bidding process -- was designed in a manner to favour the lowest cost bid. There is therefore substantial scope for revision in the bidding process, as well as the selection process adopted for PFMs. There might arise some legal and procedural tangles in overhauling the bidding process, empanelling new PFMs and transferring the current funds under management to a new regime, but the shift might be worth the cost. In any case, the current contract with the PFMs has a validity of three years, after which PFRDA is free to shift to a new regime without incurring any additional costs.

4.17. Costs are a deterrent too. The cost structure followed by PFRDA is based on the absolute amounts every subscriber is required to pay to each stakeholder in the NPS architecture. Although the amount seems small enough, but when considered in the light of the need to include larger sections of the population and that they need to be motivated to deposit comparatively smaller amounts, these absolute costs look pretty high in percentage terms. Below is a table of charges levied by the different stakeholders under the NPS architecture:

Intermediary	Charge Head	Service Charges*	Method of Deduction
CRA	PRA Opening Charges	Rs 50	Through cancellation of units
	Annual PRA Maintenance cost per account	Rs 280#	
	Charge per transaction	Rs 6#	
POP (Maximum permissible charge for each subscriber)	Initial subscriber registration and contribution upload	Rs 40	To be collected upfront
	Any subsequent transactions@	Rs 20	
Trustee Bank	Per transaction emanating from RBI location	Zero	Through NAV deduction
	Per transaction emanating from a non-RBI location+	Rs 15	
Custodian$ (on asset value in custody)	Asset Servicing Charges	0.0075% per annum for electronic segment and 0.05% for non-electronic segment	Through NAV deduction
PFM Charges	Investment Management Fees^	0.0009% per annum	Through NAV deduction

* Service tax and other levies as applicable levied as per existing laws

When the number of accounts in CRA reaches 30 lakh the service charges, exclusive of Service Tax and other taxes as applicable, will be reduced to Rs 250 for annual PRA maintenance per account and Rs 4 for charges per transaction. CRA charge for maintenance include charges for maintenance of electronic information of balances in the PRA, for incorporating changes in the PRA details received by the CRA in electronic form, for sending annual account information once a year in printed form, etc.

@ These include regular subscriber contribution, change in subscriber details, change of investment scheme/fund manager, processing of withdrawal request, processing of request for subscriber shifting, issuance of printed account statements, any other subscriber services prescribed by PFRDA.

+ Trustee Bank charges are not charged to subscriber directly. Transaction refers to entire chain of activities starting from receipt of electronic instructions/receipt of physical instrument to transfer of funds to the designated PFMs. On the outflow side, it would include all activities leading to credit of beneficiary account.

$ Charges for demat/remat, receipt of shares and SEBI charges are extra.

^ This is inclusive of all transaction related charges, such as brokerage, transaction costs etc, except custodian charges and applicable taxes. The investment management fee is calculated on the average monthly assets managed by the pension fund.

4.18. Therefore, it is quite evident from the above table that the low cost positioning of NPS might not be true. For a minimum contribution of Rs 6,000, the cost works out to 8%. This is quite high by any standards, especially when compared with some of the other competing products in the market – such as bank deposits, insurance policies or mutual fund schemes. The cost issue gets accentuated in the case of NPS-Lite. Despite the annual Rs 1000 monetary contribution from the government, promised to each account holder for the first three years of joining, the costs seem high because they are fixed and unrelated to the amount eventually contributed. Under NPS-Lite, account holders need to pay Rs 35 as joining fees to

obtain a PRAN Card. In addition, account holders have to pay Rs 70 every year – through NAV deduction – for meeting cost of record keeping.

Very clearly, NPS needs a dose of cost rationalization.

4.19. There are some unanswered questions or concerns too that have kept potential beneficiaries away from NPS. One question frequently asked, and supported by some POPs, is whether investments made in NPS can be guaranteed or not. The over-riding concern expressed by beneficiaries to POPs is whether PFRDA can reconsider the issue of funds being locked in till the age of 60. Beneficiaries feel that they should have access to their own funds in the case of an exigency, and frequently cite the example of the EPF scheme which allows for ease of withdrawal.

The next Chapter looks at how some of the gaps in the current architecture can be bridged, so that NPS emerges as a viable, old age income security plan, based on the DC model.

CHAPTER 5: RECOMMENDATIONS

5.1. It is by now patently clear that the entire NPS architecture has run dry and needs a rejuvenating dose of reforms. Detractors might be justified in asking whether it is too early in the evolutionary curve of this financial product to carry out institutional changes in the overall structure. The counter-point to this argument is that it might be prudent to correct the anomalies in the initial stages itself, before allowing the aberrations to take deep roots and upend the entire sector. The NPS architecture – as it was conceived and implemented -- is quite forward-looking and incorporates some of the global best practices. However, it does lack some key elements, and these shortcomings have got magnified when the sector was thrown open to the private sector.

5.2 The nub of the problem can be distilled down to two wrong assumptions and one fundamental gap in the product design and system architecture. The first wrong assumption relates to the misplaced confidence that what worked for the government employees would also work for the private sector without tweaking the engineering. The other wrong assumption – and the committee feels this is a large gap – is the notion that pensions will be bought by subscribers without any selling. From this arises the basic gap in the system -- the lack of an identifiable NPS owner who can impart the necessary push to the product.

5.3 A distinction also has to be made between incurring expenses for spreading awareness and the nature of expenses that can be allowed as direct incentives for selling NPS. In the case of the former, this committee envisages a role for the government and PFRDA, while in the case of the latter it is felt that some modifications to the existing structure might be necessary.

5.4 The following recommendations by the committee arise from the basic flaws outlined above and the dissimilarity in the nature of the expenses that need to be incurred by various players in the NPS scheme:

Need for a 'push' factor

5.5. It is by now a well-recognized reality of the Indian financial markets that most financial instruments in India are "push" products and not really "pull" products, which means that most financial instruments in the country do not enjoy an automatic demand and need to be sold proactively. On the face of it, the current incentive structure does not seem to adequately reward the efforts taken for selling a product where the benefit accrues to the beneficiary after a considerable period. Nor does it seem to take into account that there is considerable risk in selling a financial product – the percentage of successful conversion to pitches is far lower than most other products. People are reluctant to part with their money for intangible benefits. It also does not recognize that such incentives will be compared by

the POPs – a majority of which are bank branches – against the fairly aggressive commissions offered for selling other financial products across the same bank branch counter (such as, insurance, mutual funds, bullion). Push comes to shove, most bank employees will spend their time and resources in selling financial products that offer the highest commission. Therefore, there needs to be a rethink on whether the level of incentives should be higher than the current levels, or whether NPS should move towards a completely new incentive concept and structure. There is a third alternative: rope in completely new categories of transaction channels, where the cost economies are completely different. We will discuss that later in this chapter.

5.6. On balance, this committee feels it is absolutely unjustified to increase the POP incentives. This committee also feels that the current structure involving absolute values of incentives is basically flawed and must give way to a slightly more elegant structure. Increasing the absolute values of incentives only brings temporary relief and further distorts the cost structure. For example, if the POP commission for initial subscriber registration and contribution is raised from the current Rs 40 to Rs 60, it has a few repercussions. One, it immediately raises the upfront deduction for a subscriber contributing Rs 1000 from the current 4% to 6%, which is quite high compared to other financial products. Two, it perpetuates the perverse inverted incentive structure by penalizing the small ticket contributors, who end up cross-subsidising the large contributors. For example, using the same example above, for somebody contributing Rs 10,000, the upfront deduction goes up from 0.4% to 0.6%. Three, this incentive structure then comes embedded with the implicit character of a volume-driven product, which is anathema to bank branch POPs, since their cost structure, orientation and the uncompetitive NPS incentive structure inhibits them from actively selling NPS subscriptions. The table below computes the cost for a subscriber A, who transacts on an average 6 times in a year.

Table 1: Cost to Subscriber investing 6 times a year

Intermediary	Charges	Cost to Subscriber (Rs)
CRA	Account Opening Charges	50
	Annual PRA Maintenance Charge[1]	280
	Charges per Transaction (Total @ Rs 6 per transaction)	6x6=36
POP	Initial Subscriber Registration	40
	Any Subsequent Transaction (Total @ Rs 20 per transaction)	6x20=120
Total Cost to Subscriber		**526**

[1]The Annual maintenance number here is assuming outreach to 3 million subscribers.

Since there are 6 transactions assumed in a year, the minimum annual cost in the first year comes to Rs 526. The annual charges in subsequent year would drop to about Rs 436 a year. This amount would be steep for the lowest bracket saver who puts in an average contribution of Rs 1000 each. In addition to these flat charges there is an ad-valorem charge of 0.0084% [0.0075%+0.0009%] for custodian fees and the fund management expenses.

5.7. Let's take a look at Table 2 which compares NPS with other pension schemes available in the market such as MF Pension Scheme and Insurance Pension Fund Scheme, on the basis of different charges for this investor.

Table 2: NPS costs compared with similar Mutual Fund and Insurance Plans

NPS	Mutual Fund	Insurance PF Scheme
CRA Flat Charge @ Rs 366	Entry Load @ 0%	…
Custodian Charge @ 0.0075%	Expense Ratio @ 1.25%	Policy Administrative Charges @ 0.25%
	STT @ 0.125%	STT[3] @ 0.125%
FMC @ 0.0009%		FMC[1] @ 1.50%
POP's collection charges @ Rs. 120+40	Distribution Expense @ 1% on amount collected[2]	Agent Commission @ 2% on amount collected
Rs. 526 + 0.0084%	**2.375%**	**2.875%**

The above data is based on the information available on the AMC's and Insurance Companiees websites. Some of the pension schemes offered by Insurance companies may also have life insurance components and their pricing in addition to this. May of these schemes offer additional benefits like capital guarantee feature and may not be comparable.[1] Fund Management Charges, [2] SEBI in August 2009 abolished entry loads on investment in Mutual Funds but distributors can charge customers directly for the services rendered. [3] The number assumed to be equivalent to MF distributors but could be higher.

5.8. NPS charges a flat Rs 436 per year plus 0.0084% per annum. The other similar schemes available charge on an ad valorem basis in the range of 2.3-2.8% of the amount invested during a year. The flat charges of the NPS are very steep, which tilts the scheme in favour of wealthier investors. In fact, as mentioned earlier, it is quite likely that the bottom-of-the-pyramid customers end up cross-subsidising the wealthier investors. The fixed charges on account of annual maintenance and transaction charges amount to a large percentage of the amount invested by a small value investor. The same cost is a negligible load as a percentage of investment on a subscriber investing large amounts.

5.9. For the subscriber A, NPS becomes favourable only if the investments per annum are more than Rs 20,000 otherwise he/she is better off investing in a similar mutual fund. Also,

the per transaction charge acts as a negative incentive for investors who save small amounts in multiple transactions.

Ad-valorem incentive for POPs

5.10. The committee strongly feels that an ad valorem structure for PoPs is far better suited to not only re-aligning the incentive structure but also bringing some semblance of fairness to the current inequitable cost structure. Pricing is a critical factor in reaching a large number of potential subscribers. Ad valorem approach of charging the subscriber has the potential of merging the advantages of volumes (from small investors) with value (high ticket investments from rich investors).

5.11. The issue that arises next is what should be the ad valorem incentive rate? This committee feels that the ideal rate should be 0.5% of the subscription raised from the NPS subscribers, subject to the minimum of Rs. 20 –which a customer has to pay to the POP as transaction charge for each transaction. It was also felt that if the maximum rate is kept at 0.5% of the amount invested, it will spur POPs into chasing only the big ticket accounts, thereby negating the core idea of re-aligning the rates to make it equitable for the small and tiny investor. Therefore, this committee feels that there should be an upper limit of Rs 50,000 (which is 0.5% of Rs 1 crore), irrespective of the amount collected. The 0.5% rate does not seem to have any economic logic backing it at this point of time and can, therefore, be construed as a temporary measure till such time as the next two recommendations are in place. However, there is also a need to keep a floor rate of Rs 20 to avoid a race to the bottom.

Broadbasing the POP network

5.12. Arising from the unsuitability of the incentive structure, as discussed above, is a related issue: a dire need to broad base the network of POPs which can reach NPS in its various forms to Indian citizens across the length and breadth of this country. As experience has shown, the current crop of POPs – mainly branches of commercial banks -- have their own limitations, ranging from the economic feasibility of the incentives offered to the range of competing products sold from within the same portals of a bank branch.

5.13. Currently, the postal department is doing a stellar job of leveraging its extensive ground-level network to sell NPS. However, only a part of this network has been pressed into service and this committee suggests that PFRDA engage with the postal department proactively to increase the number of branches selling NPS.

5.14. Another option is to appoint the numerous mobile telecommunication service providers which have taken mobile telephony to the remote corners of this country. With an

extensive distribution network already in place, these companies are well placed to reach out to the target audience of NPS as well as Swavalamban. In fact, in their representations to this committee, representatives from the telecom companies did indicate that the existing level of incentives provided under the PFRDA rules was adequate for them to provide an additional service to their customer base.

5.15. But, beyond that, there are other synergies in appointing telecom companies as POPs. For instance, telecom companies have to mandatorily conduct extensive KYC checks before enrolling a new subscriber. Therefore, the KYC information for aspiring NPS subscribers already available with telecom companies can be shared with CRAs. In turn, telecom companies can extend NPS services through their customer care centres or through their extensive network of distributors.

5.16. In addition, it is possible to also appoint some of the well-known FMCG companies, as well as some third party corporate agents, which have extensive reach into rural India to add NPS to their existing pipeline of products delivered into the hinterland.

5.17. In fact, this committee feels that there should be no upper limit or qualitative restriction on any category of distributor. Popularising NPS is a national priority and, as long as the basic criterion of “fit and proper” is met, PFRDA can look at appointing all categories of distribution agents to distribute NPS.

PFM can have a role in selling NPS

5.18. In its meetings with a variety of stakeholders, this committee was often asked a question: who will own the “customer”? Associated with this question is the concern whether there should be any owner of the customer at all. The committee members had wide-ranging discussions on the issue and there were many divergent views expressed.

5.19. One section felt that PFMs have a purely fund management role, with no role whatsoever in promotion of NPS. Being the final recipients of funds in the NPS chain, they are an important stakeholder, but with little control over the process. However, among all the three intermediaries, it would seem that the PFMs have perhaps been the worst affected by the slow growth of NPS. This is because while the POPs have other revenue streams and the CRA has a captive government business, the PFM can only fall back on the funds received for management. Because of their low fund management charges due to competitive bidding, PFMs' problems have been accentuated by the slow growth in NPS. Therefore, an option that could be considered is giving PFMs a direct role in selling NPS. It was felt that if a PFM is willing to promote NPS, it should legitimately be able to claim whatever selling incentive is available to a POP.

5.20. It was articulated that there are no other entities, in the current scheme of things, more suited to play this role than the PFM. As far as global examples go, the 401(k) accounts in the USA are also owned and managed by the PFM equivalents.

5.21. However, there were also some legitimate concerns expressed about going down this path, namely the conflict of roles and the distinct possibility of mis-selling being the most important one. It was also felt that a PFM is a specialised entity focused on understanding the stock and bond markets and is, therefore, ill-equipped to take on the role of selling NPS. It was also felt that any amount of regulation may not be adequate to deal with a fundamental design that can lead to conflicts of interest. Therefore, for reasons of right sequencing, it was felt that if PFMs have to be allowed to sell NPS, PFRDA should first focus on strengthening the monitoring and regulatory framework to reduce the chances of mis-selling and then subsequently make changes in the distribution framework to enable larger participation in the NPS.

5.22. After hearing a cross-section of the views, this committee feels that since it has, in principle, agreed to allow a wide spectrum of intermediaries to sell NPS, it would be unfair to single out PFMs and exclude them from the opportunity on the grounds of "potential" mis-selling. Simultaneously, there is no denying the fact that the hazard of mis-selling is very real and cannot be wished away. However, on balance any possible misdoing would be substantially mitigated by a combination of strict regulations that ensures full transparency and disclosure.

5.23. Therefore, the committee has opted to walk the middle path. It recommends that PFMs should be allowed to sell NPS but not directly. If within their existing corporate structure they have a POP, they should synchronise their actions. However, not all PFMs have an existing POP in their larger corporate structure. For such PFMs, this committee recommends that they should be allowed to float POP subsidiaries which can then be used to source NPS accounts. These subsidiaries would be subject to PFRDA's extant authorization process and rules and regulations applicable for POPs and would receive the same incentives as earned by other POPs. Such a structure, it was felt, would allow for an end-to-end ownership of the customer.

CRA charges must be rationalised

5.24. There exist today different CRA charges NPS main and NPS Lite. The two schemes use two different entry points – the former has designated POPs as the entry point while the latter uses aggregators. The annual maintenance cost charged by CRA for NPS subscribers coming through POPs are Rs. 280 per year while for those coming through aggregators are Rs. 70 per year on account of differential in the level of services provided. However, it has been found that the services offered under both the schemes are not vastly different to

justify the gap between the costs – the NPS subscriber pays 300% more for additional services (such as, facility of telephone pin and internet pin, which are offered to the subscriber as a default option. It is unlikely that majority of low end subscribers will ever use these services; in any event the system must provide the subscriber with choices. This committee recommends that these services should be made optional, and the CRA charges proportionately brought down so that subscribers not wishing to opt for them have the choice of bringing down their costs.

Entry barriers to NPS should be removed

5.25. It is likely that the accretion under NPS is still below the desired level because of the existence of certain artificial entry barriers in the scheme format today. If NPS has to be popularized as part of a national agenda, these entry barriers must either be lowered substantially or eliminated altogether.

5.26. Since NPS was originally targeted at the middle class, the minimum contribution was pegged at Rs. 6000 with four installments per year and minimum Rs. 500 per installment. Subsequently PFRDA has dispensed with the requirement of minimum four installments but kept the minimum contribution of Rs. 6000 unchanged, which in effect prevents the lower end customers to join NPS through the POP-route. It might be equitable to re-consider the amount of the minimum contribution.

5.27. In the existing NPS distribution system the potential NPS subscribers with less than Rs. 6000 for contribution can access NPS only though NPS Lite, in which only an 'aggregator' is allowed to collect the installments from the subscribers, who in turn need to be part of a group of beneficiaries. Since the original design appointed only bank POPs, it was felt at that point that the aggregator might be the right vehicle to bridge the gap between the intended beneficiaries and the NPS left uncovered by the country's banking industry. While this has served a useful purpose, two important factors necessitate a rethink on the matter. Firstly, the announcement of Swavalamban incentive of Rs. 1000 by the Government to match a minimum contribution of Rs.1000 by each NPS beneficiary, has created the need for a more inclusive approach to NPS to make it available to the maximum number of people who need Swavalamban to support their old age social security need. Secondly, the `aggregator' model has its inherent limitations, in that it cannot cater to a retail subscriber as it is available to the groups of people. This is creating confusion and exclusion of a vast multitude of retail NPS subscribers like domestic workers, taxi drivers etc. from the NPS fold, as they neither can join NPS Main (saving less than Rs.6000) nor NPS lite (not belonging to a group).This needs to be set right.

5.28. There seems to be no alternative entry point for any individual wishing to join NPS with savings of less than Rs.6000 and without access to an enlisted eligible aggregator. It

may, therefore, be necessary to rewrite some of the rules governing NPS. This committee recommends that PFRDA may consider changing the current rule requiring a minimum annual subscription of Rs 6,000 for NPS Main to bring it down to Rs.1000 per year so that any account-holder with this contribution can access the POP network in the country, and also avail of the benefits of Swavalamban.

5.29. The idea is to make NPS accessible to every citizen of this country and any exclusionary rules or guidelines standing in the way of that objective being achieved need to be removed.

5.30. The cost structure needs to be linked with the type of beneficiary and the services likely to be availed of. Currently, the CRA charges Rs 50 for opening every new account, Rs 280 as maintenance cost per account and Rs 6 charge per transaction. The last two charges will be brought down to Rs 250 and Rs 4 respectively once the number of subscribers touches 30 lakh. The fees charged by the CRA seem to be too high and need drastic revision downwards to make NPS a success. Various stakeholders have also raised with this committee the issue of high fees charged by the CRA. This committee would request PFRDA to take a fresh look into a break-up of the annual maintenance charge or even the per transaction charge of Rs 6 levied by the current CRA. PFRDA should also revisit the suggestion of inducting in a few more CRAs, as was originally planned.

5.31. This committee would urge PFRDA to commission fresh research into calculating the costs of NPS delivery, especially in the light of the emergence of new cost-effective transaction channels. For example, a telco distributor's acquisition and servicing cost for each subscriber will be vastly different from that of an existing bank POP. Therefore, an equitable and viable incentive structure can emerge only after there is some idea about the revised cost of NPS delivery. Besides, there is also a need to identify the possible access mechanisms for different customer segments (which needs to be identified) across the length and breadth of the country. This might be necessary since the access mechanism may differ from one location to another or from one demographic profile to another. This will also be necessary for calculating the cost of delivery as well as finalizing the appropriate delivery channels.

Additional financial resources for promotion of NPS

5.32. The low level knowledge of NPS among large sections of society is an unfortunate by-product of the sub-par investor education and shallow financial markets in the country. Given this ground reality, it is only logical then to include in the overall NPS marketing strategy a scheme for incentivizing agents who undertake to distribute NPS among the target audience. This will be necessary to end the inertia borne out of lack of awareness and provide some momentum to a robust, self-funded pension culture. But the moot question is: who will foot the bill? Or, to be more precise, while the incentives for selling NPS can be

deducted from subscriber contributions, how will this expense (of spreading general awareness about pensions, in general, and NPS, in particular) be met?

5.33. It seems at this point of time that the pension sector regulator Pension Fund Regulatory and Development Authority (PFRDA) is best suited for this task, given the fact that the regulator also has the onus of developing the sector enshrined in its moniker. It is believed that the government may also not be averse to the idea of PFRDA incentivizing the distribution of NPS. But, then again, how will PFRDA fund this activity?

5.34. One option is dipping into the funds that the government has set aside as co-contributions to Swavalamban. As a process, PFRDA could appropriate a small portion from each tranche of government contribution towards building up an awareness and education corpus. The framework for this has already been provided for in the Finance Minister's speech in the Budget 2010-11, in which Finance Minister had stated that *"To encourage the people from the unorganized sector to voluntarily save for their retirement and to lower the cost of operations of the New Pension Scheme (NPS) for such subscribers, Government will contribute Rs 1,000 per year to each NPS account opened in the year 2010-11."* Therefore, the government could empower PFRDA to deduct a small sum of money from each tranche of its Rs 1,000 contribution to Swavalamban towards meeting the costs of popularizing pensions as a financial product. Alternatively, the government could continue to allocate additional funds towards the promotion of NPS, as has been done in the years 2010-11 and 2011-12.

5.35. Another solution could be to seek funding from the Investor Education Protection Fund managed by the Ministry of Corporate Affairs and Financial Inclusion Fund administered by NABARD. The end objective of this fund and PFRDA's objectives are pretty much convergent, since both seek to improve society's level of financial education and empower individuals to judiciously use financial instruments to improve old age income security. The modalities of sharing this fund can be worked out jointly between the officials from the Ministry of Corporate Affairs and PFRDA. Promotion of NPS should be a part of the national financial inclusion agenda.

Pension to be a part of financial inclusion agenda

5.36. Pension as a financial instrument should be dovetailed into the national financial inclusion agenda. Financial inclusion is no longer restricted to opening of only no-frills bank accounts, because empirically it has been seen that these accounts go dormant after a while. Alternatively, these accounts are seen as only the necessary platform for providing financial inclusion to the beneficiary. Used as a pass-through vehicle, such no-frills accounts can be used for making cash transfers, or for ensuring payments of entitlement schemes. But, they still fall short of financial inclusion, which can be accomplished through provision of micro-credit, micro-insurance (for crop, livestock), as well as micro-pensions. According to the

Raghuram Rajan Committee on Financial Sector Reforms: "*Perhaps the most important financial services for the poor are vulnerability reducing instruments. Thus, access to safe and remunerative methods of saving, remittances, insurance, and pensions need to be expanded significantly*." If pensions are included in the national financial inclusion agenda, it would allow PFRDA to access the national pool of investor education funds and funded outreach programmes, since the target audience for PFRDA and the other programmes are common.

Marketing of NPS

5.37. The Committee suggests that PFRDA should set up a marketing division that would be responsible for devising short and long term comprehensive marketing plans including branding branding and communication programme. This Committee also feels that PFRDA should conduct an exercise to determine the nature of the linkages that the division will have within PFRDA as well as with all the external stakeholders.

5.38. Given the desired NPS target audience and the geographical spread of the population, traditional media alone might not be the appropriate vehicle for achieving the objectives. Radio advertisements have already been launched, and it would be good to use other media also for this purpose. In addition to national and regional media campaigns, awareness generation should also be through below-the-line activities (BTL) comprising participation in exhibitions, establishing information desks, arranging seminars, creating a comprehensive website and link with other popular websites, providing quick response to subscribers through call centres and emails.

5.39. The government should put aside a budget for these activities during the first five years of the scheme. A comparable example is the Swabhimaan campaign launched by Indian Banks' Association to create awareness about the business correspondent model.

Marketing Plan

5.40. Given the diagnosis by the Committee, there is strong need to design an appropriate marketing organisation and planning system to achieve the mission and objectives of PFRDA. This might include the following:

5.41. Identify and Prioritise Market Segments: This would include:

a. Periodic surveys of actual and potential retirees to assess their requirements, their level of satisfaction with current products and services, and identifying gaps between their requirements and the current products and services. This would be more like usage and attitude studies relating to products and services which provide post-retirement benefits. These products and services may include other investment products (apart from pension products) to provide a wider frame of values sought from financial products by customers.

b. Grouping the potential retirees into segments with distinct needs and values, media habits, and access to and desirability of different channels, including the emerging ones (such as, telecom).

c. Assessing the gap between the requirements and availability of pension products and services for each group (segment).

d. Prioritising the segments on the basis of potential to achieve PFRDA objectives.

Research for above purposes could be syndicated or customised for PFRDA. Syndicated research can have the benefit of working with other pension sector players for mutual gain in terms of cost management and understanding the market.

5.42. Prepare Marketing Plans: For each segment, and for PFRDA as a whole, it is necessary to review the performance in the past year and prepare a plan for the next year. This may include plans for (a) next year's offers, including introduction of innovative features and products, (b) communication (awareness building, promotion), and (c) distribution (reach).

5.43. Marketing R&D: As the customer requirements are likely to be fast changing in an emerging market like India, the plan must include a sub-plan for marketing R&D. This would include identification, design, and testing of innovative products and services, distribution arrangements, promotional methods, etc. This would help review and revise products, distribution, and promotional mechanisms in line with market requirements. Each of these may be tested on a pilot basis in small but representative locations. The testing may include the participation of existing NPS players (CRA, PFMs, POPs) and can be extended to research and academic institutions. Results of this marketing R&D may be used for introducing changes in future (next year's) marketing plans.

5.44. Study to Design Marketing Organisation and Systems: There is a need to build a marketing organisation and design systems for carrying out the above tasks by PFRDA. A detailed study may be needed to identify the kind of organisation needed at head office level and possibly at state level. For this purpose, PFRDA may need to network with other (including private) pension providers, research organisations, and academic institutions.

5.45. Tasks To Be Performed: The following kinds of tasks may need to be performed for strategic market planning by PFRDA:

a. Periodic review of market priorities in line with mission and objectives of PFRDA,
b. Periodical review of customer satisfaction levels and grievance redressal processes for improving customer satisfaction leading to faster customer acquisition and greater retention.

c. Design and outsource research from MR agencies (and others), and interpret the results,
d. Product design and testing,
e. Plan and review adequacy of and plans for POPs and PFMs on monthly, quarterly, and yearly basis, and
f. Build the PFRDA (and NPS) brand.
g. Overseeing of planning, co-ordination and review of marketing function and co-ordination with other wings of PFRDA

5.46. In-house vs. Outsourcing: The study mentioned above may also be used for deciding what specific tasks need to be conducted in-house and which ones can be farmed out.

5.47. There is a demand from some quarters to rethink the requirement of the Tier-II account for NPS. The Tier-II accounts were added as a product feature to facilitate easy withdrawals of money before retirement. This facility allows the subscribers to accumulate in small amounts and then transfer from Tier-II account to Tier-I account or withdraw from it in case of a cash crunch. But a Tier-II account may not be the best vehicle to fulfill this objective for following reasons:

a. Tier-II account needs active management of funds and therefore will increase the cost of fund management.

b. At the front end, the product requires a different kind of institution with a different character. At a stripped-down level, the Tier-II account resembles a savings bank account without a chequing facility – from where an individual can deposit and withdraw money at will. So, for providing Tier-II facility to investors, institutions will be required to maintain a regular and continuous presence at the village level, so that people can actually use this bank account-like feature for deposits and withdrawals. Such a presence requires a different channel design strategy from the one that an institution focusing only on periodically collecting contributions would need to have.

c. At the same time, since the subscriber can place a withdrawal request any time, the money will have to be invested in short term debt instruments thereby reducing the overall returns.

d. There are hidden costs attached to it. There is liquidity to be maintained at the front-end channels to meet the customer's withdrawal requests. At the same time, the requirement of risk capital (operations risk) for the front-end entity goes up. At the back-end, an elaborate infrastructure needs to be set up to provide for liquid transactions. This cost increases the cost of delivery to the end subscriber who can avail the same functionalities through other channels at much cheaper costs.

e. Customers are therefore better off accumulating the amounts through other liquid savings/investment mechanisms, such as savings accounts with banks and liquid mutual funds. There are channels which have the expertise and wherewithal to deal with these products. This also allows PFRDA to focus on regulating pensions, while agencies like RBI and SEBI build the expertise to regulate other products.

f. The core value of the pension product is to provide a commitment device to address the self-control problems so that the individual cannot touch his/her long term savings easily, and therefore longevity of the investment is ensured. This also allows the fund to focus on long-term investment strategies. Therefore the best that the NPS has to offer to subscribers is the illiquidity.

Tier II account should continue

5.48. NPS should ideally work as a long term investment. Liquidity is not important for the pension product. And, therefore, the Tier-II account should ideally be withdrawn from the NPS scheme. This would save the cost of infrastructure, fund management expenses, the cost of risk capital and also offer the illiquidity that investors look for in a pension scheme.

5.49. However, in its meetings with various stakeholders, including aggregators representing the small savers, this committee was told repeatedly that liquidity was a desirable product feature given the myriad uncertainties that could arise in the lifetime of an individual, which gets compounded in the case of many account holders who do not have surplus capital for allocation to alternative savings channels. This committee, thus, feels that it might make sense to continue with the Tier-II for the moment.

5.50. The only complication that can arise is over regulatory jurisdiction. In its core characteristics, Tier-II can be seen either as a savings bank account or a liquid mutual fund, with the added layer of a pension feature added to the product. In this age of hybrid financial products, Tier-II can also be treated as a hybrid financial product, with over-lapping regulatory domains. This committee suggests that PFRDA put in place adequate regulatory safeguards for this product in consultation with the Reserve Bank of India (with regard to the savings bank characteristic of the product) and the Securities and Exchanges Board of India (from the viewpoint that the funds management activity takes on the features of a liquid mutual fund).

5.51. One of the reasons forwarded for retaining Tier-II is to allow for liquidity in the event of an exigency, especially a medical emergency. PFRDA may contemplate introducing a Health Savings Account to the NPS to provide old-age protection against healthcare expenditures. While the Rashtriya Swastha Bima Yojana scheme from the Ministry of Labor and Employment covers the major healthcare expenses that are unpredictable in nature and

outside the control of the individual -- such as, hospitalisation for random health conditions or critical care for costly diseases like cancer. Savings, rather than insurance, is the more apt funding source for more predictable requirement, such as increased health expenditure in retirement.

5.52. The funds contributed by a subscriber to a Health Savings Account (HSA) should be entitled to same income tax concessions at the time of deposit as is the case for Tier-I NPS accounts. Withdrawals from this account should be used towards only qualified medical expenditures.

5.53. In USA, many HSA schemes allow withdrawals for any purpose, but the withdrawal from HSA towards non-qualified medical expenditures has a tax penalty attached to it. PFRDA will have to devise multiple mechanisms for withdrawal of money from HSA. These could include limited purpose debit cards, mobile wallets etc.

5.54. There is a case for tightening certain other norms in Tier-II though. Given the different levels of KYC norms required by different agencies in the country, there is a tangible risk that NPS Tier-II could well turn out to be a happy hunting ground for those wishing to park unaccounted fund in liquid and interest-bearing savings options. Therefore, the above recommendation of allowing Tier-II to continue should be accompanied by concomitant attempts to bridge any regulatory gaps that might exist between the KYC norms demanded by banks while opening new savings accounts and the KYC norms required for opening a Tier-II account.

5.55. In fact, since money in NPS Main stays locked in for a long period, there is little scope of it being used as a platform for money laundering. Therefore, while there could perhaps be a case for relaxing KYC norms for NPS Main, there is definitely a strong case for keeping the KYC norms for NPS Tier-II extraordinarily tight.

5.56. CRA's database of PAN card holders can be leveraged for sending out electronic communication to potential NPS beneficiaries. If the PAN geographical information is available for data-mining, POPs can be directed to utilize the locational data. It is no additional capital cost to the CRA since the investment in the PAN database has already been made. Also, POPs/CRA can use the growing mobile telecom network to conduct tele-marketing for NPS. This might need an exemption from the DND list of the telecom ministry. The same data mining exercise should be used to weed out existing NPS subscribers to spare them from the messages inviting membership into NPS.

5.57. Admittedly, there can be cases where an existing NPS subscriber may not be the owner of a mobile connection and therefore unable to fully leverage the benefits of telco POPs. In such cases, a subscriber can be convinced to acquire a mobile – albeit after satisfactory

acceptance of the KYC process, comprising proof of identity and residence – with the CRA backend being in a state of readiness for inter-operability. Any request from the mobile customer can automatically result in a PRAN generation. Apart from ease of use, such a symbiotic structure also has some unintended benefits: it can help in digitizing the NPS database, thereby further reducing the lead time in activating subscription requests.

5.58. In fact, inducting NPS members from the PAN universe enjoys another inherent advantage. The subscriber can avoid enduring the lengthy process of submitting KYC proof since the process for grant of a PAN identity would have already taken care of that requirement.

5.59. There is another suggestion that might be worth considering. PFRDA could consider easing the KYC norms for entry into NPS Main while insisting on strict KYC proof or PAN documentation at the time of withdrawing funds. This would, however, be subject to the national AML regime as prescribed in the PMLA or any other law.

<u>Swavalamban should continue</u>

5.60. The government has decided to extend the Swavalamban incentive of Rs 1,000 every year into each Swavalamban scheme for five years. The government might want to examine the prospect of extending it for a longer period, if not for perpetuity. This can act as a potent marketing force and draw in multiples of new Swavalamban members. This has a strong economic logic to it too.

a. Any contribution from the government lends credibility to the scheme and provides a source of confidence for those hesitant in joining up.

b. The government's contribution goes directly into the beneficiary's pension account through electronic transfer thereby eliminating any leakage.

c. The funds set aside by the government for the Swavalamban does not amount to consumption expenditure, as compared to some of the other cash transfers effected by the government. The funds stay in the beneficiaries NPS account till the person reaches the age of 50 or has been a member for at least 20 years, whichever is later.

d. The funds are, in a manner of speaking, long term investment since these funds are available for capital expenditure in long gestation projects, such as critical infrastructure projects.

e. The possibility of perverse investment choices can also be avoided since the ultimate investment is made by a professional fund manager, who is guided by strict and parameterised investment guidelines set by the regulator. And, investment flows

into both public and private sector projects based on the viability of the project in question.

f. There is a multiplier effect at play here. A contribution of Rs 1,000 by the government can leverage a savings of anywhere between Rs 1,000-12,000 every year. This has major implications for channeling retail savings into long term investment in the economy.

g. The contribution is also a form of funded social security without jeopardizing the future health of the fiscal.

h. In some senses, in strict economic terms, this makes more sound fiscal sense than lowering taxes since any increase in disposable income from tax cuts tends to go towards consumption rather than result in increased savings.

i. This provides pension in the informal sector some parity with the formal sector, popularly known as the employees' provident fund scheme. Currently, all formal sector employees covered by the EPFO are also covered by the Employees' Pension Scheme, 1995 under which the Government of India contributes 1.16% of their wages (subject to a monthly cap of Rs.6500) towards their pension. Thus, there is every reason to accord the same treatment to the persons in the informal sector to whom NPS applies.

Optional use of telecom services

5.61. CRA should provide electronic messaging to all NPS subscribers. This could include electronic reminders through mobile telephony for subscribers whose installment payments are falling due soon. This can be followed up with a confirmation message when the payment is received. Not only does this improve service stickiness at an affordable rate but also acts as a check against fraud where aggregators collect money from subscribers and deposit these funds on their behalf with the POPs.

5.62. NPS was created as a low cost option initially. However, over the past few years, the over-arching design – especially the fee structure – has made it slightly costly for small savers. One way to reduce costs would be to leverage the telecom experience. For subscribers wishing to recharge their accounts (or, pay their installments), there could be an option of pre-paid NPS cards of different denominations. These will be akin to scratch cards with a unique pin number. When the subscriber buys a card of a specific denomination, and sends the unique pin number as a mobile phone message to a pre-determined number, his account is automatically topped up to the extent of the pre-paid card's denomination.

5.63. Under normal circumstances, the POP would deduct Rs 20 from the installment as his fee. In this case, the deduction could be brought down significantly – a mobile pre-paid card distributor, for example, charges a margin of Rs 2-3 per pre-paid card. Most telco distributors would be willing to distribute NPS recharge cards, irrespective of the face value, at the same margin. This will not only improve access to NPS but will also bring down intermediation costs substantially. However, this Committee feels that if telecom service providers are appointed as POPs, they should fulfill all the fit and proper criteria laid down by the regulator, including the minimum capital requirement and accountability for acts of omission and commission undertaken by their channel partners. This should also be applicable to all other POPs – convention or non-conventional -- appointed by PFRDA.

PFMs

5.64. It is nobody's case that the fees charged by the PFMs should be reviewed. Currently, it is too low and merits to be raised. However, whenever the fees are indeed increased, it should be accompanied by an increase in the number of PFMs willing to manage pension funds. Currently, the low fees are an outcome of a competitive and fair bidding process. It can be assumed that, among other things, PFMs might have agreed to a low fee to gain exclusivity. In the same token, if the fees are to be increased now, the exclusivity also has to give way proportionately. At the same time, compensation for PFMs cannot be static. PFRDA should consider introducing a dynamic element to the fee structure, a sort of sliding scale, which ensures that an increase in the assets under management automatically results in a lowering of the fee.

5.65. PFRDA also needs to re-examine the extant criteria for selection of PFMs. PFRDA can adopt the rules framed by the capital markets regulator, Securities and Exchanges Board of India, for allowing mutual funds to conduct business – such as, sponsor's net worth, the asset management company's minimum capital, the "fit and proper" rules – with suitable changes. PFRDA can determine the number of PFMs it can optimally supervise, depending on its state of readiness and wherewithal, and increase the number progressively as it grows in size and resources. This is to ensure that the selection process doesn't become a prisoner of the "lowest-cost bid" syndrome.

5.66. There should be some clarity on the nomination process followed by NPS. Currently, an investor does have the option of appointing a nominee, and this is included in the joining form. However, the policy of nomination is not spelt out clearly in the offer document. For instance, in the event of the demise of an investor before the maturity of the account, it is not clearly mentioned whether the nominee will receive the full commuted amount, or receive 60% cash and 40% as annuity, or whether the nominee has to continue contributing to the

scheme till the maturity of the scheme. This needs elaboration and clarity in the offer document.

Revenue model for PFRDA

5.67. This committee's terms of reference include suggesting a "suitable revenue earning model" for PFRDA, so that the institution becomes self-financing on a sustainable basis. This committee firmly believes that PFRDA should be financially autonomous to help it discharge its duties as an independent regulator and to nurture a pension sector that is free from controversy or regulatory capture. Therefore, it is indeed important to find a revenue earning model for PFRDA that helps it become independent.

5.68. The only way PFRDA can raise revenue is through levying fees on the intermediaries in the NPS architecture. And, in the entire chain, only PFMs and CRAs are in a position to pay fees. Among these two intermediaries too, PFMs seems better placed to pay the levy, but only when they reach critical mass in their assets under management. The formula can be based on a percentage of the assets under management (AUM) reported by the PFMs – for example, it could be pegged at 1 basis point of the AUM. On an AUM of Rs 1,000,000 crore, this would fetch PFRDA Rs 100 crore – the kind of funds PFRDA would require for building an effective regulatory and supervisory regime.

5.69. In the meantime, before the PFMs are in a position to pay a percentage of their profits as fees, the government can continue to fund PFRDA. In fact, it might be recalled that the government provided both SEBI and IRDA with Rs 100 crore each as a long term loan or grant to tide over the initial institution-building expenses before net revenue exceeds expenditure. In fact, this committee feels that part of this fund can even be used towards investor education.

5.70. There might be a case for issuing pre-packed PRAN cards. Such pre-issued temporary PRAN cards can be made available with POPs or aggregators. This could go a long way in reducing the rather long turn-around time taken for a new NPS member to get his/her subscription currently. The KYC has to be the responsibility of the aggregator/POP and they have to ensure that proper proof of address and identity has been obtained before the card is activated.

5.71. Subscribers should have the option of making contribution to PRAN through e-payment. Bill payment companies have the capability to allow NPS to leverage the power of connectivity to provide subscribers with a wide range of online payment solutions that can effortlessly enable transactions regardless of computer or mobile device platform. Pre-paid companies and Bill payment companies must be included as channels for mobilizing subscriber contributions to PRANs.

`NPS at your desktop'

5.72. Bank POPs should make available on their websites the pay online option through following facilities:

i. Bank account to PRAN transfer

ii. Card to PRAN transfer

In this connection, the Committee was enthused to know about the online NPS account opening facility offered by the ICICIDirect, which enables the subscriber also to pay online as his NPS account is linked, along with his demat account, with a common savings bank account. PFRDA should actively encourage other bank PoPs to offer similar facility in order to bring NPS within the easy reach of those with internet access.

5.73. For NPS to grow, a wider range of options must be made available to the subscriber. It is recommended that the capital protection feature for the NPS product be offered to subscribers. As investors in NPS are investing for post-retirement income prolonging their cash inflows during old-age, these investments should be protected against losses for NPS to be an appropriate retirement saving product. By design, NPS should let investors benefit from the positive movements of capital markets and at the same time provide protection from their down side risk. Under the capital protection option, investment should be permitted to be made only in approved fixed income instruments of specified maturities. PFMs should not have the discretion of investing in any other schemes/instruments for the purpose of capital protection, other than those approved by PFRDA from time to time.

5.74. Inflation index bonds of different maturities could allow NPS to hedge inflation risk and in turn offer investment products to retail clients that are protected against inflation. RBI is actively considering issuance of Inflation indexed bonds. They had earlier issued capital indexed bonds in 1997 which had not received an enthusiastic response. They had later modified the structure of capital indexed bonds to offer investors protection from inflation as measured by Wholesale Price Index for commodities. These bonds have not yet been issued because of the uncertainty of demand.

5.75. NPS can greatly benefit from investments in such bond and can offer inflation protection feature to boost the take up rates. With NPS planning a huge outreach in coming months, RBI can be convinced of the continuous demand for such bonds.

5.76. Over time, as accretions to NPS and all the other schemes pick up, PFRDA might consider expanding the list of eligible asset classes. This will depend on the maturity of the investment product, the existence of sufficient knowledge about the financial product among the PFMs, a fully developed regulatory regime which is cognizant about the latest developments in the asset class. While it might be pre-mature at this stage to even consider any other asset class for the pension sector, given the pension industry's relative position on

the growth curve, this committee feels that PFRDA should keep all its options open and review all eligible asset classes from time to time.

5.77. We have listed out in the above paragraphs possible new channels of distribution and identified newer corporate distributors. But, at the same time, this needs to be accompanied with the need for training of this distribution force. NPS and its derivatives are not simple products. It needs to be understood well by the distributor, who in turn needs to explain clearly to the customer the nature of the product. If it is a well-trained distributor (trained in financial products), he can advise customers not to put every last rupee of his savings into a pension product, but only such portion as he can afford not to draw upon. The distributor is probably also the only person who can convince subscribers that salting away funds earned today will stand them in good stead in the future.

5.78. Given the wide spectrum of POPs being suggested for selling NPS, there is a strong risk of mis-selling by resellers and other distributors down the sale chain. PFRDA thus needs to evolve a regulatory framework for detecting mis-selling and penalizing the deviant. The act of detection can be achieved through random audit or even micro-regulation. This committee feels that PFRDA should probably institute a separate committee to draft new rules and regulations to keep mis-selling at a minimum. This will be crucial since even one isolated incident of mis-selling can do a lot of harm to the brand image of NPS.

5.79. In addition, PFRDA should probably draft a code of conduct for all the participants in the NPS chain. This is necessary to avoid any ambiguities about their role.

5.80. PFRDA should also step up its interaction with external researchers, especially by making clean data available to them. PFRDA, apart from actively publishing all research on its web-site, should also commission research and development from time to time.

5.81. Finally, seen dispassionately, NPS is actually a pre-pension product. It is only a means to accumulating a corpus that will yield a pension many years later. In fact, so are most of the other pension products in the market, such as EPF or PPF. So, what then actually constitutes a pension market? Strictly speaking, the sale, purchase and the structuring of different kinds of annuities could be termed as a pension market. There can be many kinds of annuities – fixed and variable annuities, guaranteed annuities (such as, life annuities or annuities certain), joint annuities, impaired life annuities, and so on.

5.82. It is also a well-known fact that the market for annuities – which are sold by insurance companies – still has a long way to go in India. The question that arises then is: given the fact that PFRDA is the regulator for the pensions market, should the oversight for annuities also be handed over to PFRDA? This could lead to regulatory overlap and a tricky situation since annuities are structured by leveraging a key skill residing only in insurance companies

– actuarial science. This would then require PFRDA to regulate insurance companies for their annuities business, which could possibly lead to some avoidable legal tangles. The solution, in this committee's opinion, is for PFRDA to find a way to work jointly with the insurance sector regulator, Insurance Regulatory and Development Authority, for developing a proper market for annuities.

APPENDIX-I

1. If a maintainable post-retirement standard of living is the objective, the life-cycle concept of personal finance offers a checklist of the pension plan elements that must be well thought out. They comprise outlook about years of employment/labour, incomes, investment returns, as well as the mitigation of uncertainties around these expectations.

2. One of the major uncertainties for retirement planning is inflation, which reduces the purchasing power of an individual and thus affects the standard of living. Financial planning from a pension perspective gets affected greatly by small fluctuation of 2-3% in inflation. It can even deplete the investment corpus. Any depreciation of capital in the retirement corpus because of market fluctuations can cause inconvenience to the individual as money invested today towards retirement planning is important for individual post-retirement well-being. To safeguard NPS customers from this risk NPS should offer capital guarantee and inflation protection. Safety does dictate quite a few decisions of human-beings. And the impact of safety feature is amplified in an investment decision for retirement when the income sources dry up.

3. Capital guarantee and inflation protection features attached to the product will definitely boost take-up of the product. This can be done by allocating NPS investments to

a. Capital/inflation Indexed Bonds – Inflation index bonds of different maturities could allow NPS hedge inflation risk and in turn offer investment products to retail clients that are protected against inflation. RBI is actively considering issuance of Inflation indexed bonds . They had earlier issued capital indexed bonds in 1997 which had not received an enthusiastic response. They had later modified the structure of capital indexed bonds to offer investors protection from inflation as measured by Wholesale Price Index for commodities. These bonds have not yet been issued because of the uncertainty of demand.

NPS can greatly benefit from investments in such bond and can offer inflation protection feature to boost the take up rates. With NPS planning a huge outreach in coming months, RBI can be convinced of the continuous demand for such bonds.

b. Capital guarantee funds (CGFs) / Capital protection funds (CPFs) – CPFs are structured to ensure the protection of original investment at the scheme's maturity with or without external support. CPFs in India are required to ensure capital protection only through portfolio characteristics and are not permitted to buy third party protection such as insurance. SEBI in India allows only closed ended CPFs. Debt investments by a CPF can only be in the highest rated investment grade papers. The two most common types of CPFs work on static hedge and dynamic hedge approaches. These approaches provide capital protection through debt-equity portfolios. The difference between the capital raised and the

present value of the capital is invested in equity and the remainder goes into debt. The investments in debt are done on HTM basis.

4. By allocating fund towards CPFs or functioning in their approach NPS can offer capital guarantee to its subscribers, which will influence investment decisions of NPS subscribers. NPS can then offer returns above the minimum by investing the rest of the funds in long horizon money in Index funds.

Table 1: Debt-Equity allocation for Capital Protection

Investment Horizon (Years)	Market Interest Rate[2] (%)	PV of Initial Investment (Rs.)	Investment in Debt	Investment in Equity
10	7.99%	46,355	46,355	53,645
15	8.32%	30,156	30,156	69,844
20	8.34%	20,130	20,130	79,870
25	8.40%	13,316	13,316	86,684
30	8.43%	8,821	8,821	91,179

5. The table above shows that for an initial investment amount of Rs. 1, 00,000 capital protection can be offered by investing only Rs. 8,820 in Government securities for 30 years. The remaining Rs.91,180 can then be invested in Equity for capital appreciation.

c. Minimum assured returns:

An index fund is an investment that tries to replicate the movements of an index on a specified financial market. Typically, the tracking of an index with index funds is done by holding all the securities in the index, in the same proportion as the index. Investments in equity (index funds) have over longer investment horizons can generate substantial returns at very low standard deviations. In the chart below it is depicted that for investment horizon of 15 years BSE Sensex on an average returned 9% per annum with a standard deviation of as low as 1.6%.

[2] Source:- G-Sec Yield Curve dated 6th September, 2010.

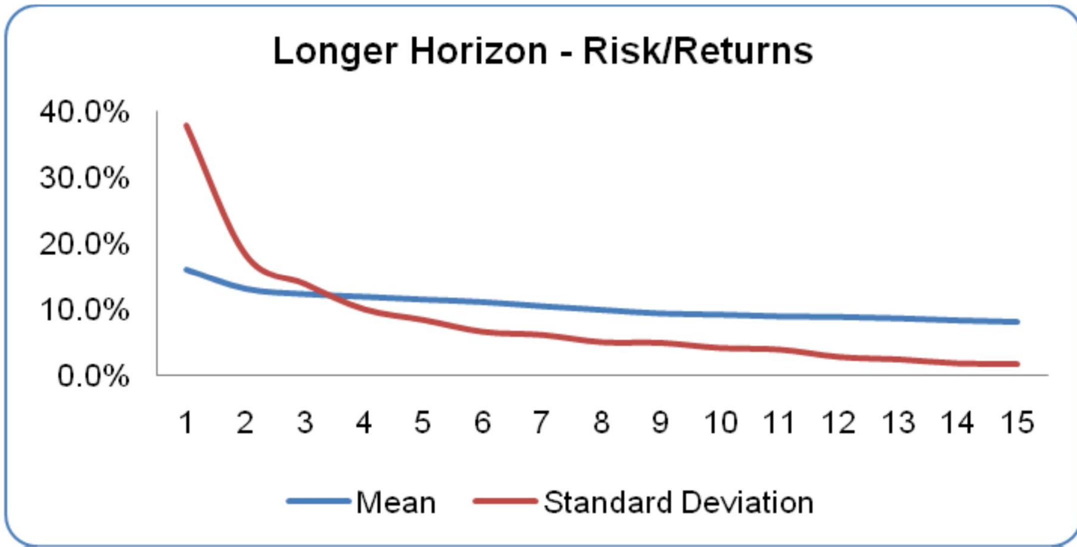

Chart 1: Depicting Risk/returns over longer investment horizon

Pension funds under NPS by allocating a major portion of its funds in equities (index) can provide good returns to NPS investors particularly if lock-in periods of a decade or more are ensured.

Enhancing NPS with the product features of capital and inflation protection and assuring minimum returns will appeal to potential NPS subscribers.

APPENDIX-II

Summary of global trends in voluntary pension schemes

1. A review of pension schemes around the world reveals a few features and trends. Pension and social security reforms are being undertaken across the world. One feature of these reforms is that governments are increasingly shifting the responsibility of provision from the state to employers and individuals, and there is also a shift away from a pure pay-as-you-go tax financed system, in which taxes from current workers are distributed to current retirees. This system is being replaced, in many countries, with a mix of pay-as-you-go tax financed system and investment-based personal retirement accounts. There is a rise of voluntary pensions funds, not unlike what NPS can be for the informal sector workers.

2. This increase in focus on voluntary funds is primarily driven due to the limitations of public pension systems to sustain themselves in face of demographic shifts, especially in European countries and in countries like the US. The pensions systems are not likely to withstand the pressure mounted by the debt servicing necessitated by them. Moreover, the public systems have limitations with respect to their revenue sources, especially in emerging markets where the tax base is quite small. When even in a country like US, social security presently funds only 40% of the final year earnings for someone who has had median earnings all his/her life, in emerging markets, due to the largely informal nature of the work force and small tax base, the ability of a tax-based public pension system to finance pension needs is even lesser. Hence, the need for voluntary pension funds is much higher in these countries. In the recent past, many such funds have been developed, and NPS can learn from these experiences.

3. According to research by World Bank, there seem to be four types of such funds . Following is a summary of these categories, and some examples of these funds in various countries.

A. Retail Funds: These funds typically have commercial fund management, but some with direct or indirect tax subsidy. The regulation of these funds is usually around transactions of the fund. The Individual Retirement Accounts (IRAs) in the United States are examples of such funds. Offering these accounts requires a simple registration of existing financial institutions with tax authority to enter market, with essentially no limitation on investment profile or fees. They are also tax exempt up to certain limits. Nearly four out of 10 U.S. households owned IRAs in 2009. Recently, rollovers from employer-sponsored retirement plans have fuelled the growth in IRAs. Contribution to IRAs has been somewhat low, with only 15 percent of U.S. households contributing to any type of IRA in tax year 2008. In addition, very few

eligible households made contributions to catch-up their shortfalls with IRAs. IRA withdrawals are infrequent and mostly retirement related. Pakistan has also recently (in 2004) initiated such voluntary pension funds, wherein existing asset management companies and insurance companies are allowed to accept pension funds.

B. Public Interface Hybrid: These funds, which are typically regulated by structural regulatory frameworks that define the principles of their overall management and governance, are usually also linked to the mandatory contribution systems. NPS falls under this category. Other, more seasoned examples of this are the voluntary tier of mandatory pillars of the pension systems in many countries of Latin America, Central & Eastern Europe, which allow additional contributions to specialized pension companies, and utilise same regulatory and transfer structure as that of the mandatory system. The Swedish Premium Pensions also come under this category. They are based on allocation of portion of social insurance tax, and have a central public clearinghouse. In 1998, these were introduced as a second tier of mandatory individual accounts in the public system. The individual accounts are self-directed and participants can invest in a broad array of hundreds of domestic and international funds. The asset management is open to all registered asset management companies. These asset management companies do not deal directly with the clients. For individuals who do not wish to make an active investment decision, a government-run default fund has been established, which is an interesting idea NPS could consider because even if it wants to offer choice of portfolio allocation to clients, many of them may not want to make active choices. The administrative fee for the Swedish system is around 0.3 percent of assets while the average money management fee is 0.43 percent of assets.

C. Private Interface Hybrid: Like the retail funds, these funds also depend on commercial asset management, but have more comprehensive regulation. These funds are also typically organised by employers. The most prominent example of this are the US 401(k) plans that are participant directed. These plans are built on employment based platform with payroll deductions and contribution sharing. They enjoy tax preference up to certain limits, and the employer selects suite of options, and the worker directs the fund investment. In the 1980s, the 401(k) emerged as an alternative to the traditional retirement pension, which was paid by employers. Employer contributions with the 401(k) can vary, but in general the 401(k) have had the effect of shifting the responsibility for retirement savings to workers themselves. In 2011, about 60% of American households nearing retirement age have 401(k)-type accounts. Employees choose the asset allocation, which is usually a selection of mutual funds that emphasize stocks, bonds, money market investments, or some

mix. The employee can generally re-allocate money among these investment choices at any time. In the less common trustee-directed 401(k) plans, the employer appoints trustees who decide how the plan's assets will be invested. As more people are retiring, it seems the payout from these plans are not sufficing to meet the retirement needs of many people, which makes this an interesting case in point on the issues with defined contribution plans from the point of view of the investors. Some pension funds in Lithuania and Slovenia also come under this category. In these funds, the employer or the union brings group of workers to funds, wherein asset allocation, fees and other elements are closely controlled.

D. Employer Sponsored & Managed: These are the traditional employee benefit programmes present in many countries. Countries like UK, US, Australia, Kenya, South Africa, India, etc. have these funds. The funds are held with employer managed trusts with minimal limitations. Both defined benefit as well defined contribution formats are seen, but the trend is towards defined contribution hybrid format. In South Africa and Kenya, the funds are managed entirely by trusts setup by the employees, and governed by structural regulations in place. In China also, defined contribution enterprise annuities are available. Netherlands is an interesting example for such funds, wherein partially voluntary nature has produced high coverage, with more than 90% of the working population covered under such funds. In the recent past, due to the financial crisis and increasing liability due to demographic shifts (ageing population and increasing life expectancy), the Netherlands pension system has been under considerable pressure for reform, because recent reports indicate that the system will not be able to meet the retirement financing needs of the beneficiaries. If such a wide reaching and acclaimed pension system can become so vulnerable to such crisis, it would be useful to study what went wrong, so that NPS can learn from investment mistakes made.

4. Most countries have mixed pension systems, wherein a combination of public pension systems and some forms of voluntary pension systems are complementing each other. It seems there are many insights to be gained from these experiences of voluntary funds, some of which started decades ago. Ranging from regulatory frameworks, to financial strategies, to operational practices and outreach approaches, there are a number of interesting experiments that have been tried.

5. There are some funds that are quite similar to NPS in terms of their objectives, and may offer some direct lessons for NPS to learn. The KiwiSaver scheme of New Zealand, which started in 2007, is an example. Under this system, every worker is automatically enrolled (by default), but can choose to opt out from day 14 to day 56 of their employment. When a person joins, they receive a $ 1,000 tax-free contribution to their savings account from the

government. They also receive a "tax credit" of up to $1,042.86 per annum. Employee participants can choose to contribute 2%, 4% or 8% of their gross pay, and can switch rates three months after setting a rate (unless employers agree to a shorter time frame). The self-employed and unemployed can choose how much they want to contribute.it has an investment lock-in of five years or retirement age. While most KiwiSaver schemes have minimum contribution amounts for people in this category, several schemes allow any level of contributions. Participants choose to put their savings in one of several approved savings schemes with varying degrees of expected risk and return. They can only belong to one scheme at a time, but can change schemes at any time. If they do not choose a scheme, they are assigned either to the employer's default fund or to a government-selected default fund. As of June 2011, almost 1.6 million people had joined the scheme. Though it allows access to contributions under some exceptional circumstances of distress, like illness and financial hardship, the KiwiSaver scheme focuses exclusively on retirement savings, and is therefore built around long-term investments. This is an interesting example for NPS, because there are advantages of building specialisation in only longevity and long-term investments, while leaving short-term liquidity to other instruments and mechanisms.

6. On coverage front, many countries have faced challenges. For example, as discussed above, still only a small number of households contribute to the voluntary funds in the US. On the other hand, countries like Hungary have a fairly high percentage of coverage, with the voluntary pension funds far surpassing the mandatory public pension funds. It would be useful to study in detail how countries increased outreach of such funds, because that will be a key challenge for NPS. There are some insights from behavioural economics that suggest strategies for improving enrolments and contributions. For example, auto enrolment increased membership by 30% in 401K plans. Also, default allocations matter a lot, because very few people actually reallocate after the initial allocations.

7. Since many of the funds usually come with tax subsidies, there is also a considerable challenge to ensure tax subsidies reach the right people. For example, in the US, bulk of the tax subsidies for pensions are cornered by the richer half of the population, with only a small portion trickling to the poor. There is a risk of this happening for NPS-Lite as well, because of the subsidy involved.

8. Many of these funds are now paying out, and have built systems for this. Though this is not of immediate pertinence for NPS, it would be useful to review payout systems to ensure that some architectural foundations are in place for the time when payouts will begin in a few years.

9. The recent financial crisis exposed the vulnerabilities of many investment strategies of pension funds, especially because it came along with an increasing demographic pressure in

many ageing countries. It would be useful to study the fund management strategies in some of these countries, and take steps to avoid such tail events that may have a significant impact on the value of the funds, especially because consumption protection is the key objective of such funds. Many funds in Europe have faced significant loss of value due to the financial crisis.