Legislative Brief

The Pension Fund Regulatory and Development Authority Bill, 2011

The Pension Fund Regulatory and Development Authority Bill, 2011 was introduced in the Lok Sabha by Mr. Pranab Mukherjee, Minister for Finance on March 24, 2011.

The Bill was referred to the Standing Committee on Finance (Chairperson Mr. Yashwant Sinha) on April 8, 2011. The Committee submitted its report on August 30, 2011.

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Highlights of the Bill

- The Pension Fund Regulatory and Development Authority Bill, 2011 seeks to give statutory powers to the interim authority set up in 2003. It also alters the name of the New Pension System to National Pension System (NPS).
- NPS is a 'defined contribution' scheme for all central government employees who joined after January 2004. It is implemented through a combination of retailers, pension fund managers, and a record keeper. This scheme is different from the earlier 'defined benefit' scheme.
- Under the NPS, every subscriber will have an individual pension account, which will be portable across job changes. The subscribers will choose fund managers and schemes to manage their pension wealth. They will also have the option of switching schemes and fund managers.
- The NPS was extended to all general citizens through central government notification in May 2009.

Key Issues and Analysis

- The Bill provides a structure (NPS) to plan for old age income security. However, it is optional for those in the unorganised sector. This differs from the system in countries such as the United States, which have a mandatory system to ensure that all persons have old age income security.
- The NPS is a defined contribution scheme. It is different from existing pension schemes in the organised sector such as the EPS, and the GPF. Both the EPS and GPF are defined benefit schemes.
- In the NPS, the investment risk is entirely borne by the employees. They are no longer exposed to the risk of default by the government as was the case under the defined benefit system.
- There will be no explicit or implicit guarantee on the pension wealth, except in cases where the subscriber purchases market based guarantees. This rule is different from the case of bank deposits, where deposits up to Rs 1 lakh are guaranteed.
- The total corpus and number of enrolments to the NPS have been lower than expected. Recommendations have been made by different committees to the government to make efforts to popularise the scheme.

PART A: HIGHLIGHTS OF THE BILL

Context

Till 2009, old age pension was available only to government employees and individuals in the organised sector. In 2000, the Old Age Social and Income Security (OASIS) Report, under the chairmanship of Dr. S.A. Dave, recommended that pension schemes be extended to the unorganised sector as well. In October 2003, an interim Pension Fund Regulatory and Development Authority (PFRDA) was constituted through a notification to develop and regulate the pension sector.

In December 2003, the central government (through a notification[1]) implemented the New Pension Scheme (NPS) for its employees appointed from January 2004 onwards. The NPS shifted the pension scheme for government employees from the defined benefits (DB) system to a defined contribution (DC) system.[*] In order to give statutory powers to the interim body, a Bill was introduced in Parliament in March 2005. This Bill defined the architecture of the pension system. However, it lapsed with the dissolution of the 14th Lok Sabha in 2009.

In the meantime, the interim PFRDA appointed 22 retailers (Points of Presence - PoPs), seven pension fund managers (PFMs), and a central record-keeper (CRA). In May 2009[2] the NPS was extended to all citizens (including workers in the unorganised sector, on a voluntary basis). In March 2011, the PFRDA Bill, 2011 was introduced in the Lok Sabha. It seeks to give statutory status to the interim PFRDA, and changes the name of the New Pension System under the previous bill to the National Pension System (NPS). As of July 2011, the NPS had 24 lakh subscribers, and managed funds of Rs 10,000 crore.[3]

Key Features

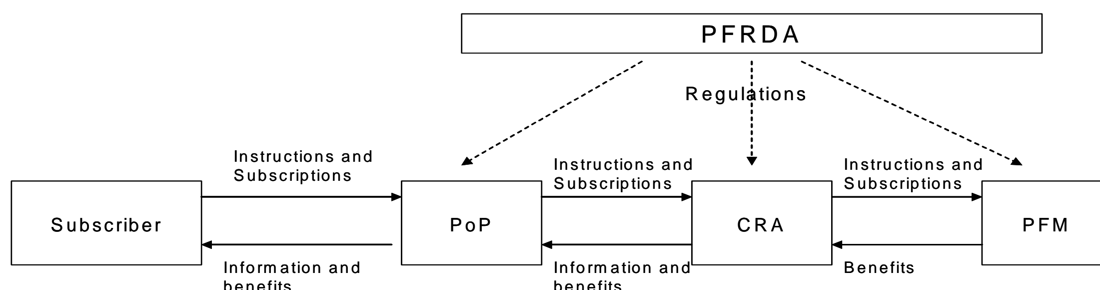
The Bill gives statutory recognition to the PFRDA, defines its powers and duties, and sets the broad contours of NPS.

The NPS Architecture

The NPS is a DC pension system set up by the PFRDA. It comprises the following:

- **Central Recordkeeping Agency (CRA) -** The CRA shall maintain records and accounts, and execute all instructions regarding subscription, switching of options, and withdrawals by the subscriber[4]. The subscriber may obtain information about his account directly from the CRA.
- **Pension Fund Manager (PFM) -** The PFMs shall provide a set of schemes with varying risk-return profiles (i.e., balance between risk taken and returns expected), and manage assets of subscribers.
- **Point of Presence (PoP) -** The PoPs shall function as the retailers of the NPS. They shall receive instructions and contributions from subscribers, transmit these to the CRA, and pay out benefits to subscribers. They will be the initial point of contact between subscribers and the system.

Chart 1: The NPS Architecture



Source: PRS

[*] In the Defined Benefit (DB) system, pension payable at the time of retirement is fixed on the basis of the last pay-scale drawn. In the Defined Contribution (DC) system the pension payable is determined by the funds accumulated through contribution, and investment gains during the service of the employee.

Working of the NPS

The working of the NPS can be explained under the following heads:

- **Eligibility norms** - The PFRDA shall prescribe norms on matters such as minimum capital requirement, past track-record (including ability to provide guaranteed returns), costs and fees, information technology capability, and customer base.
- **Foreign investment** – Subscribers' funds may not be invested abroad by PFMs.
- **Individual Pension Account** - Every subscriber shall have an individual pension account (IPA). The subscriber has the option of selecting the PFMs and schemes[5]; he can switch his funds across PFMs and schemes. The IPA will be portable in case of change of employment.[6] The subscriber cannot exit from the system except as specified by the notification. The current notification specifies two options: (a) if the subscriber chooses to exit at the normal age of retirement (60 years), he shall use at least 40 per cent of accumulated pension wealth to purchase an annuity[7] from a life insurance company. This annuity will provide pension for the lifetime of the employee, his dependent parents and spouse; (b) if the subscriber chooses to exit prior to retirement, 80 per cent of the accumulated pension wealth shall be converted to an annuity.
- **Permanent Retirement Account Number (PRAN)** – Every subscriber on registering with the NPS gets a unique PRAN issued by the CRA.
- **Two tier structure** - The notification mentions a two tier structure for government employees under the NPS. In Tier-I both the employee and the government will contribute 10 per cent of (basic+DA)[8], and there will be no withdrawals till exit. The employee can opt to contribute a further amount into a Tier-II account, which will not have any contribution by the government and from which he can make withdrawals.[9]

Establishment, powers and duties of the PFRDA

- The PFRDA shall perform promotional, developmental and regulatory functions relating to the pension system. It shall also impose penalties in case of any regulatory violations.
- The PFRDA comprising a Chairman, three whole time members, and three part time members shall be appointed by the central government for a five year term, and may be removed from office only under specified conditions.
- The PFRDA shall regulate the NPS, and all intermediaries including the CRA, PFMs and PoPs. It shall approve the schemes and norms (including investment guidelines) for management of the investments by PFMs. It shall be responsible for protecting the interests of subscribers and establishing a mechanism for redressal of their grievances. It shall standardise dissemination of information about performance of pension funds and performance benchmarks.
- The PFRDA may establish a Pension Advisory Committee, with a maximum of 25 members. This committee would represent the interests of employee associations, commerce and industry, subscribers, intermediaries and organizations engaged in pension research. It would also advise the PFRDA on matters referred to it.

Extent of the Bill

- The Bill exempts certain schemes and funds. These include the Coal Mines Provident Fund and Miscellaneous Provisions Act 1948, the Employees' Provident Funds and Miscellaneous Provisions Act 1952, the Seamen's Provident Fund Act 1966, the Assam Tea Plantations Provident Fund and Pension Fund Scheme Act 1955, and the Jammu and Kashmir Employees' Provident Funds Act 1961, and contracts covered by the Insurance Act 1938. It also exempts employees of the central government and All-India Services appointed before January 1, 2004.[10] Any person governed by any of these exempt schemes may voluntarily choose to join NPS in addition to their mandatory cover.
- The Bill permits state governments and union territories to extend the NPS to their employees. Any employee in the excluded category can opt to join the NPS in addition to his mandatory cover.

PART B: KEY ISSUES AND ANALYSIS

EPS versus NPS

Employees who joined the central government after January 2004 are covered under the NPS. Those employed with the government before 2004 are covered by the General Provident Fund (GPF). Employees in the organised sector subscribing to the Employee Pension Scheme (EPS) also have a pension facility. In Table 1, we compare the NPS with other pension schemes such as the EPS, and GPF.

Table 1: Comparison of features of EPS and NPS

Feature	EPS / GPF	NPS
Coverage	Organised sector employees through EPS, and government employees before 2004 under GPF.	Available to all subscribers, including the unorganised sector.
Eligibility Requirement	Minimum term of employment (typically 10 -20 years).	None.
Portability across job changes	None for government employees. Limited portability for those covered under EPS.	Portable.
Type of account	Pooled.	Individual pension account (IPA).
Type of pension	Defined benefit.	Defined Contribution.
Risks	The employee carries no investment risk. However, there is a risk of default/delay in pension payments by GPF/EPS.	The employee carries the entire investment risk. There is no risk of default by PFMs.
For government employees (covered by GPF)	For existing central government employees, the government pays 50% of the average of last 10 months' pay (Basic+DA) if employee has 33 years' service. There is no contribution by the employee or the government into a fund but this is paid out of the Consolidated Fund of India.	Government and the employee will each pay 10% of Basic+DA into a scheme of a PFM. Separate account for each employee will be maintained. At the time of exit, a part (40%) of the pension wealth will be used to buy an annuity, and the remaining paid as a lump sum amount.
For those not employed by the government	For those covered by EPS, the employer pays 8.33% of Basic+DA to the EPS (maintained by EPFO), and the government pays 1.16%. Pension after retirement will be paid based on the years of service and last pay drawn.	No contribution from the employer. The employee selects a particular scheme.
Disclosure of Performance	Not mandated. There is no regular update on performance of the EPS. Government pensions are unfunded.	Each PFM will publish the performance of schemes managed by him at regular intervals. The subscriber can see the balance in his IPA.
Investment strategy	The EPS board decides the strategy. This strategy and the investment portfolio are not disclosed to the employee.	Each scheme has to follow a specified investment pattern. The subscriber chooses his portfolio of schemes.

Sources: PFRDA website, EPS-1995, PRS

Defined Benefit versus Defined Contribution

The DB system, applicable to government servants appointed before 2004, and EPS subscribers, promises a fixed monthly pension. This amount is linked to the pay drawn, number of years of service etc., and has no direct linkage to the contribution of the employee or employer towards a pension fund. The entire investment risk is borne by the pension fund manager and the government. The total benefits liable from such a scheme could amount to be higher than the funds available, which can lead to delays and defaults. Traditionally, a large proportion of pension funds around the world have been of the DB type[11]. However, many have been under funded, and some have collapsed[12]. This has led to a debate in a number of countries regarding the sustainability of their pension and social security systems.[13]

In the DC system (as proposed in the NPS), each employee contributes a proportion of his monthly income to an individual account. The funds in this account are invested in one or more schemes offered by pension fund(s). The balance in the account belongs to the employee, which will be accessible at the time of exit. The employee bears the entire investment risk and there is no risk of default by the fund as the liability of the fund to its subscriber equals the assets owned. Table 2 lists some advantages and disadvantages of the DB and DC system.

Table 2: Defined Benefits versus Defined Contributions

	Defined Benefits	Defined Contribution
Advantages	- Guaranteed retirement income - Employees do not bear investment risk - Flexibility for inflation and wage adjustments - Independent of participant's savings	- Participants have more choice in investing - Participants can benefit from better returns - Plans are easily portable across job changes - Option to switch fund managers and schemes - No risk of default by fund managers
Disadvantages	- Not beneficial to employees who leave before minimum eligible service - Less portable in switching employers - Fund manager could default if funds are not invested appropriately	- Returns are subject to market performance - Participants bear investment risk and may make misinformed choices - Difficult to build a fund for those who enter late - Shifts administration costs to employees

Source:PRS

Coverage

The Bill excludes employees of the central government who joined before January 1, 2004. Those who joined from this date must be part of the NPS. State governments may mandate NPS for their employees by issuing a notification. Sixteen state governments[14] have notified NPS for their employees. The Bill excludes all schemes covered by EPF Act. Thus, employees covered by the EPS are exempt from the provisions of this Bill.

The Bill makes the NPS available to the unorganised sector. However, there is no compulsion to join the system. Many countries (e.g., the social security system in the US) require a mandatory contribution from individuals to ensure that they have old age income security. According to the Standing Committee Report submitted in August 2011, approximately 51,000 individuals have joined the voluntary part of the NPS as of July 2011.

The government extended pension schemes to the unorganized sector in May 2009. However, according to a committee[15] report, the scheme has drawn few subscribers as of May 2011. In order to attract more subscribers in the unorganized sector, the government initiated new schemes such as the NPS Lite[16] and Swavalamban[17], which provide additional facilities and benefits.

Risks

Under the NPS, PFMs offer an array of schemes[5] with differing risk-return profiles. The subscriber divides his contribution (as well as existing pension wealth) into these schemes, and has the option of changing this combination at any time. The final pension wealth will depend on the performance of the schemes chosen by the subscriber. Thus, the subscriber takes the entire investment risk. The premise is that fluctuations in market value will smooth out over the working life of the subscriber.

However, the subscriber is exposed to two major risks at the time of exit. If there is a major market shock at the time of retirement (say, an incident such as a terror attack or financial crisis), leading to a fall in asset prices, the entire accumulated wealth is at risk. A subscriber with a few years remaining before exiting would be more likely to ride over this shock but a subscriber retiring at that time will be affected adversely. Second, the subscriber has to purchase an annuity at the time of exit, and is similarly exposed to any sharp downturn in the annuity market at that time.

The Bill states that there will not be any explicit or implicit assurance of benefits except market based guarantees to be purchased by the subscriber. This rule is different from the case of bank deposits, where deposits up to Rs 1 lakh are guaranteed by the Deposit Insurance and Credit Guarantee Corporation.

Committee recommendations

Standing Committee Report, 2011

The PFRDA Bill, 2011 has incorporated a number of recommendations made by the Standing Committee in its 2005 report. Two key recommendations of this committee are not incorporated. These were:

- More flexibility in the Tier 1 account to allow subscribers to withdraw funds in case of any exigency.
- Restrictions on foreign investment in pension funds, bringing it in line with the restrictions in the insurance sector; (26% cap on foreign investments).

The Standing Committee on Finance submitted its report on the PFRDA Bill, 2011 in August 2011. It reiterated the above two recommendations made in 2005. In addition, the Committee made other recommendations. These include:

- Need for efforts to popularise the different schemes.
- Stringent monitoring and implementation of the schemes.
- Insuring funds of subscribers and giving minimum guaranteed returns to ensure safety of their deposits.
- Making the schemes more broad based and flexible.

Report of the Committee to Review Implementation of Informal Sector Pension (CRIISP), 2011

This Committee was constituted in August 2010 under the chairmanship of Mr. G.N. Bajpai to look into the implementation of the NPS, especially in the informal sector. The report was released in July 2011. The recommendations include:

- Removing entry barriers – Minimum requirement of Rs 6000 for the NPS should be removed.

- Rationalise CRA charges - CRA charges for the NPS members should be made the same as those for the members of NPS Lite.
- Change the structure for subscription – A new structure with a charge at the rate of 0.5 per cent of the subscription raised by the PoPs from each subscriber. This maximum amount of subscription at which this rate is charged by the retailer (PoP) is Rs 50,000. This is to prevent the PoPs from chasing high value clients only.
- Customer ownership – PFRDA should set up a marketing division to ensure proper branding of the schemes and the different products.

Notes

1.Notification number F. No. 5/7/2003-ECB&PR dated December 22, 2003.

2. PFRDA Press Release dated April 30, 2009.

3. According to the report of the Standing Committee on Finance on PFRDA Bill, 2011 submitted in August 2011.

4. A subscriber is an individual who joins NPS.

5. The current notification specifies that 3 types of schemes of various risk-return combinations shall be offered through investments in differing combinations of government securities, corporate bonds, and equity shares.

6. As in the case of a bank account, the IPA is independent of employment details.

7. An annuity is a contract by which one receives fixed payments on an investment for a lifetime

8. Basic+DA: Basic salary + Dearness Allowance

9. This is more like a savings account or a liquid mutual fund.

10. Referred to as "existing government employees" in this Brief

11. The High Level Expert Group on New Pension System, 2002 (Chairman BK Bhattacharya) lists Canada, Japan, Denmark, Germany, France and the US among countries following the DB system.

12. Delphi Corp, an auto parts maker, which filed for bankruptcy in October 2005, had an estimated pension liability of $14.5 billion. See http://news.bbc.co.uk/2/hi/business/4323854.stm

13. A recent paper suggests that in 25 years the pension liability for the UK government could amount to 3.1 trillion pounds http://www.economicpolicycentre.com/2010/04/19/government-pension-liabilities-understated-by-1trillion/

14. Andhra Pradesh, Assam, Bihar, Chattisgarh, Gujarat, Goa, Himachal Pradesh, Jharkhand, Madhya Pradesh, Maharashtra, Manipur, Orissa, Rajasthan, Tamil Nadu, Uttarakhand, and Uttar Pradesh

15. Committee to Review the Implementation of Informal Sector Pension (CRIISP)

16. The PFRDA introduced a new scheme called the NPS Lite for the economically disadvantaged sections of the society in 2010. The scheme is operated through aggregators such as the Self Help Groups and has a very low cost structure. The beneficiary of this scheme shall invest any amount every year.

17. Under the Swavalamban scheme, for every new account opened during 2010-2011 the government shall contribute Rs 1000 every year. The subscribers to the scheme would have to contribute a minimum of Rs 1000 every year (maximum of Rs 12000). The contribution from the government would continue for the following five years for all those who join the scheme during the years 2010-11 and 2011-12.

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