Pension Fund Regulatory and Development Authority

Discussion Paper on Pension Reforms and New Pension System (NPS)

1) Current provision of Pensions in India
2) Why review Pension Systems?
3) Governments' Initiatives
4) New Pension System (NPS)
5) Present Status
6) Why PFRDA Bill?
7) Some clarifications
8) Recent International Experience
9) Road Ahead- issues, challenges and opportunities

1. Current provision of Pension

India, like most other developing countries, does not have a comprehensive social security system to protect the elderly against economic deprivation. Poverty and unemployment may have acted as a deterrent to institute a pay-roll tax financed state pension arrangement for every citizen attaining old age. Instead, India has adopted a pension policy based on financing through employer and employee participation. This has however restricted the coverage to the organized sector workers - denying the vast majority of the workforce in the unorganized sector access to formal channels of old age economic support.

2. Why review Pension Systems?

2.1 While retirement benefits in India, in one form or the other, are available to only about 11% of the working population, the financial burden on the Government and the employer is rising to very high levels.

2.2 The people above age 60 years are growing at a rapid pace- annual rate of growth of 3.8 percent per annum (75.9 million in 2001 and 55.3 million in 1991) in the period 1991-2001 as against the annual growth of 1.8% for the general population.

2.3 The total pension liability on account of the Central Government employees has risen from 0.6% of GDP (at constant prices) in 1993-94 to 1.66 of GDP (at constant prices) in 2002-03. As a percentage of net tax revenue the total pension liability has increased from 9.7% in 1993-94 to 12.68% in 2002-03.

2.4 The break up of the different sectors within the Government are given below:

Pension Expenditure (in Rs. cr)

	1993-94	2004-05
Civil	818	4,712
Defence	2,531	11,245
Railways	1,488	6,400
Posts	227	1,215
Telecom	142	1,155

2.5 The dependency ratio within the Central Government has also reached levels which are worrisome. The following table gives detail in this regard.

Sector- Wise Comparison of pensioners and employees

Ministry	pensioners (in lakh)	employees (in lakh)	ratio of P to E
Defence	19.40	11.50	1.68
Railways	10.18	15.80	0.68
Postal	1.58	2.94	0.54
Telecom	1.42	4.21	0.34
Civil	5.83	10.54	0.55

Source: Bhattacharya Report.

2.6 The pension payments at the State government level have also risen sharply during the last 10 years. The annual average increase in pension expenditure in the period 1995-96 to 2000-01 was 27.1 percent. State Pension payments: Rs. 5,107 cr in 1993-04; and Rs. 38,370 cr in 2004-05 (RE) (an increase of Rs. 33,263 crore).

2.7 In 2000-01 more than 10% of the revenue receipts of the States were pre-empted by pension expenditure which was 5.4 % in 1990-91. According to figures available for 2002-03 (BE), 11 States have pension expenditure, which is higher than the expenditure on administrative services. These States are Andhra Pradesh, Bihar, Goa, Gujarat, Himachal Pradesh, Karnataka, Kerala, Orissa, Rajasthan, Tamil Nadu, and West Bengal. (Source: RBI's Report of State Finances 2002-03). The situation may further deteriorate if systemic changes are not carried out. Some of the above mentioned State Governments are increasingly finding it difficult to meet the liabilities and there are reports of delay creating worry in the minds of the pensioners

2.8 Other major problems faced by the pension system in India in both organized and unorganized sector include

(i) Inadequate coverage for old age income security

(ii) Fragmented regulatory framework

(iii) Lack of individual choice and portability

(iv) Lack of multiple pension providers and coverage

(v) Lack of uniform standards and non-compliance with international best practices on regulations

(vi) Non-sustainability of the pension schemes such as EPS and civil services pension schemes.

(vii) High incidence of administrative cost and low real rate of returns.

(viii) Management issues in some of the funds (like Seamen's PF), promise of unsustainable returns by funds, defaults by PFI's.

(ix) Lack of a reliable and comprehensive data-base.

3. Governments' Initiatives

3.1 Two parallel sets of initiatives were taken during the last 4-5 years. Regarding Government employees, it was envisaged in Budget 2001-02 that a new pension scheme based on defined contribution basis would be launched for the new entrants in the Government service. Accordingly, a High Level Expert Group (HLEG) was set up by the Department of Pension and Pensioners' Welfare (DPPW), Ministry of Personnel, Pension and Public Grievances. The HLEG suggested a new hybrid scheme that combines contributions from employees and the Union Government on matching basis, on the one hand, while committing to the employees a defined benefit as pension. The objective of the Government was to design a scheme for new entrants in Central Government service where the contribution is defined, where no extra infrastructure is sought to be created in Government and which is capable of serving other groups like State Government employees, middle class self-employed people and even those in the lower income bracket amongst the unorganized sector subsequently.

3.2 The second initiative was for the unorganised sector. OASIS (Old Age Social and Income Security) project was commissioned by the Ministry of Social Justice and Empowerment which submitted its report in January, 2000. OASIS report recommended a scheme based on Individual Retirement Accounts to be opened anywhere in India. Banks, Post Offices etc., could serve as "Points of Presence" (POPs) where the accounts could be opened or contributions deposited. Their electronic interconnectivity will ensure "portability" as the worker moves from one place/employment to another. There will be a depository for centralised record keeping, fund managers to manage the funds and annuity providers to provide the benefit after the age of 60.

3.3 In the Budget 2003-04, a new pension system was announced based on defined contribution, shared equally in the case of Government employees between the Government and the employees. Under the scheme there will be no contribution from the Government in respect of individuals who are not Government employees. It was announced that 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.

3.4 The new pension system was made operational through a notification dated 22nd December 2003 applicable only to new recruits in the central government from 1st January 2004. An interim Pension Fund Regulatory and Development Authority (PFRDA) was also set up through a Resolution of the Government dated 10th October 2003 and the Authority started functioning from 1st January 2004.

3.5 In Budget 2004-05, it was announced that the new pension system would be brought within a statutory regulatory jurisdiction. Accordingly, an Ordinance was promulgated on 29th December 2004 setting up a statutory Pension Fund Regulatory and Development Authority. Subsequently a Bill was introduced in the Lok Sabha during the Budget Session of the Parliament to replace the Ordinance. The Bill provides for establishing an Authority to promote old age income security by establishing, developing and regulating pension funds and also protect the interest of subscribers to schemes of pension funds. The Authority would regulate all intermediaries under the new pension system including pension funds, central record keeper, points of presence etc. It will approve the terms and conditions of the scheme, lay down norms for the management of the corpus of the pension funds including investment guidelines under such schemes.

After the introduction in the Lok Sabha, the Bill has been referred to the Parliamentary Standing Committee on Finance.

4. New Pension System

4.1 Guiding Principles of NPS

- Define upfront liability of Government on pension payment
- Give choice to subscribers
- Facilitate portability of labour force

- To ensure transparency and fair-play in the industry
- To build a model which is capable of handling large numbers in unorganized sector.

4.2 The following are the details in respect of the New Pension Scheme (NPS) as currently being implemented under the executive set-up:

- NPS would be available for the central government employees appointed on or after 1st January 2004 except those in the armed forces on a mandatory basis. The scheme shall be made available to all individuals in the unorganised sector on voluntary basis. All participants will have individual pension account which would be portable.
- An amount equivalent to certain percentage of the basic salary has to be contributed towards the pension by the central Government employee and a matching amount is to be contributed by the employer i.e. Government of India.
- It is proposed that at the time of retirement there will be compulsory annuitisation of the 40% of the accumulated pension wealth so as to achieve a reasonable pension. The balance 60% will be paid as a lumpsum, which he would be free to utilise in any manner.
- The contribution and accumulation are tax exempt upto a limit, but benefits may be taxed as normal income.
- The existing scheme of pension, GPF and Gratuity would cease for new entrants to the Central civil services.
- In order to promote savings for expenditure during service time there will be a second tier to the new pension scheme which would be a voluntary scheme with no contribution from Government. The second tier shall be operationalised once the full architecture of the NPS is ready. However, no Government contribution shall be made in the second tier. The employee would be free to withdraw her Tier II money anytime. This withdrawable account will not constitute pension investment, and would attract no special tax preference.
- As with civil servants, individuals in the unorganised sector can ask for investment protection guarantees on investments under various pension schemes offered by

Pension Funds. However, this guarantee would be implemented using private financial markets.

- Persons being covered by schemes offered by Employee Provident Fund Organization (EPFO) and other provisions administered under any statutes would not be covered under this scheme. Thus, no existing arrangement of pension provision applicable to already existing persons are proposed to be changed, only new/additional persons are going to avail the benefit of the new pension system.
- There would be an independent Pension Fund Regulatory and Development Authority (PFRDA) to regulate, monitor and supervise the new pension scheme.
- Government would not be required to create any additional infrastructure for collection, accounting, record-keeping etc. Existing infrastructure of banks, depositories etc. can be used for collection, accounting record keeping etc.
- There will be multiple pension fund managers licensed by PFRDA and the choice would be with the individual employee to decide which fund manager she would like to go with.
- Under the New Pension System it is proposed that there would be four broad categories of pension scheme. While in scheme A, investments will be made in G-secs only, scheme D would have relatively higher weightage for equity while retaining the dominance of fixed income instruments. In between, i.e. schemes B & C will provide a balanced investment option with equity and fixed income instruments. The choice of a scheme would rest with the subscriber alone and it would also be possible for the subscriber to also allocate her assets across the three schemes. Further, we are also looking at a default option, which could be scheme A or B, and a default fund manager which could be a public sector fund manager. Full transparency and disclosure of information regarding investments shall be provided. Portability will be allowed and a participant can transfer her accumulations from one fund manager to another. Portability of individual pension account while being transferred from one Government service to another or from private to Government and Government to private will also be permitted.

5. Present Status

5.1 More than 90,000 new central government employees are already covered under NPS since 01 January 2004. As an interim arrangement all contributions – employees and Governments'- are being credited into the Public Account earning an 8% return.

5.2 Many States have formally decided to adopt the same system for their own new civil servants. Nine States have already notified the scheme and implemented a defined contribution pension system for new employees. The following are the details in this regard:

	State	Date of Notification	Effective From
	Himachal Pradesh	**15.5.2003**	15.5.2003
	Tamil Nadu	6.8.2003	1.4.2003
	Rajasthan	27.3.2004	1.1.2004
	Andhra Pradesh	22.9.2004	1.9.2004
	Chhattisgarh	27.10.2004	1.11.2004
	Jharkhand	9.12. 2004	1.12.2004
	Manipur	31.12.2004	1.1.2005
	Gujarat	18.3.2005	1.4.2005
	Madhya Pradesh	13.4.2005	1.1.2005

Many other State Governments including Assam, Orissa, Kerala and Punjab are considering introduction of a defined contribution (DC) based pension systems.

6. Why PFRDA Bill?

The following are the main reasons for having a statutory Regulator which is envisaged to be created through the PFRDA Bill:

- A subscriber joining at age 25 will stay in the new pension system for about 35 years till retirement and 20 years thereafter. Robust regulatory umbrella is essential to protect the interests of workers over half a century.

- A statutory regulatory body with penal powers is essential to sustain member confidence and to protect the interests of participants.
- Increasing public confidence in the new system with a focused regulator is necessary which is adequately empowered through a legislative backing.
- Developing the pension sector by inculcating saving habits for long term in order to smoothen the consumption of citizens require a robust architecture under a statutory regulator.

7. Some clarifications

7.1 Costs and fees - is it going to be high?

– NPS design is based on unbundling of activities and use of existing infrastructure (banks, post offices etc.) and netting through central record keeper (CRA), which will lower costs. Further, use of existing infrastructure in terms of points of presence, fund management capabilities, record keeping capabilities would lower costs.

7.2 Investment Options- do the contributions of participants under the new pension system will necessarily be invested in equity market/stock market?

– Participants under the new pension system have full choice of putting their contributions (including matching Government's contributions) in different schemes i.e. A, B, C or D. Further, there will also be a default pension scheme to which all contributions would automatically go if the participant does not prefer any choice of scheme. To start with this scheme could be Scheme A with only Government securities under its portfolio. A suggestion has been made that a public sector fund manager shall be selected for functioning as default fund manager i.e. if no choice is preferred by any participant for functioning as her fund manager; the said public sector fund manager could function as her fund manager. On the issue of default scheme, the international experience suggests that about 80 to 85 % of the subscribers go to the default option.

7.3 Guarantees- Are there going to be any guarantee on principals and/or returns?

- Market-based guarantees are proposed under NPS meaning subscriber has to bear the cost of guarantee. However, as indicated earlier, the scheme with 100% Government securities would be totally risk free in terms of capital protection and assured returns if the securities are held to maturity.

8. Safeguards for subscribers :

8.1 There are adequate and robust safeguards provided in the Bill so that the interests of the subscribers to the NPS are taken care of; for example in case of any lapse on part of recordkeeping agency or pension fund, the Authority can make a report to the Central Government which could appoint an Administrator to take over the management of the organization concerned.

8.2 Further, the Bill provides for stringent penalties in case of violations of certain provisions of the Bill. The Bill has made provision for penalties of upto Rs. 1 lakh per day and upto Rs. 1 crore in case of carrying out activities without obtaining certificate of registration, violating terms and conditions of certificate etc..

8.3 In case of any offence committed by any person or any person attempts to contravene or attempts or abets the contravention of the provisions of this Act, Rules or Regulation, the punishment in terms of and imprisonment could go upto 10 years or with a fine which could be imposed upto Rs. 25 crores or with both.

8.4 The Bill also provides for appeal against the order of the Authority which could be made before the Securities Appellate Tribunal (SAT).

****

The above discussion paper is circulated for soliciting comments from the public and other stakeholders. The comments could be sent to the following address:

e-mail: gyanbhushan@hub.nic.in