

# India's Pension System: A Critique and an Agenda for Reforms

Basudeb Sen  
Executive Director, Unit Trust of India

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## 1 INTRODUCTION

The objective of this paper is to identify and apply principles/criteria for evaluating the existing pension system in India and for outlining a pension system for the next century. In Section One, we list certain principles/criteria. In Section Two, we evaluate the existing system in terms of the principles and criteria set out in Section One. In Section Three, we discuss possible reforms for the future.

## 2 PRINCIPLES & CRITERIA

Of the 960 million Indians, about 9% or about 87 million are above the age of 54. They have either retired or are going to retire soon (from employment in organizations or from self-employment). All of them would be very happy if decent post-retirement pension income every month is assured to them, besides free or low cost but good health care for them and their spouse as well as a home to live. Some of them are fortunate in that they enjoy/will enjoy these benefits or are/will be wealthy enough to take care of their old age needs. Most of them, however, are not or will not be as fortunate. A post-retirement pension income may be of little value if the retiree has no shelter (home) or no access to minimum health care at affordable cost. It is difficult to assess the adequacy of pension without reference to the availability of other component of old age security. This is the principle of adequacy.

### 2.1 Sustainability

Survival of senior citizens on the basis of taxes paid by younger people may not be a self-sustaining mechanism if the proportion of senior citizens to working citizens continues to rise over time unless productivity gains are large enough for the working citizens to share these gains with the old. The citizens may contribute during their working life towards a pension saving plan. But if the benefits are not fully funded by contributions (and earnings generated by contributions), a pension system will not be self-sustaining. This principle of sustainability is important.

### 2.2 Dominant Preference

Differences in preferences among individuals within a generation or across generations may also influence the nature of the pension system a society adopts. It is possible that a 25 year old of 2000 slated to retire in 2035

may prefer not (rather, hate) to depend during his old age on his future generation's subsidies. If most 25 year olds have strong preference to depend on their own savings for the old age, and if this 'dominant preference' is accepted as an explicit social choice, the system pension may reflect this principle of 'dominant preference'.

### **2.3 Intergeneration Fairness**

Whether or not the dominant preference is for dependence on subsidy by younger generation for senior citizens, there may be an issue of 'intergeneration' fairness. A generation of senior citizens may have a claim on the income generated by productive younger generations. It is necessary to find a mechanism to fairly determine the value of transfers younger generations could make by way of taxes to senior citizens. A part of the transfer may be viewed as sharing of the higher levels of income enjoyed by the younger generations in a growing economy with the senior citizens irrespective of the contributions the latter may have made to by laying the foundations of economic growth and social development. Moreover, a part of the senior citizens' contribution may not have been fully paid for during their working lives. If the dominant preference is against dependence on younger generations, the unearned (interest, dividend, capital gains and rental) income accruing to senior citizens have to be valued on a fair basis. This warrants a fair valuation of the assets owned by the senior citizens.

### **2.4 Reliability of Asset Market Valuation**

It is not easy to design a mechanism that would satisfy this principle of 'intergeneration fairness' through the valuation of the financial and physical assets owned by senior citizens (or valuing the claims senior citizens should have on the national income). One possible mechanism is valuation of assets based on market price. If the market for physical assets and financial assets are stable in reflecting the fundamental strengths of an economy and the productivity of assets, all generations could consider accepting market valuation of assets as acceptable. If asset market valuation/pricing behavior is too erratic or the asset market pricing process dynamics is grossly imperfect, the problem of valuation is difficult to resolve. This principle of 'Asset Market Valuation Reliability' is therefore important for any pension system.

## **2.5 Freedom of Choice**

Preferences of individuals within a generation as well as over generations are likely to vary: two persons of equal capability (in terms of life time income and savings) may like different types of retirement life. These preference or choice differences may demand providing a degree of freedom for each person in influencing his pre-retirement savings/investment decisions. Since income and savings capabilities differ across individuals and the risk-return attributes of different financial assets also differ, the principle of “Freedom of choice” becomes all the more important.

## **2.6 Basic Minimum**

Societies may be reluctant to give unlimited freedom of choice to avoid situations where certain individuals do not save for the future and decided to depend on alms after retirement. The society may fix a basic minimum post-retirement income level that may vary over time. So long as a person earns, society may require him of a minimum rate of savings towards post-retirement provision. This is the principle of basic minimum.

## **2.7 Entitlement**

Some citizens in poor countries may not have income enough to save for the post-retirement life. Survival needs are the first charge on current income. Those who are handicapped or disadvantaged to earn more than one requires to survive, may be supported even after they have grown old. The voluntary associations, religious and charitable societies and the State generally endeavor to take care of these needs based on donations or a charge to the exchequer. A citizen may be considered to have an entitlement to opportunity for earning in accordance with the ‘principle of basic minimum’ post-retirement income or a post-retirement help. This reflects the principle of entitlement.

## **2.8 Coverage**

The principles of ‘basic minimum’ and ‘entitlement’ together reflect the principle of coverage. This implies that the society likes to ensure that as many senior citizens as possible are covered by some measure of post-retirement income security. The society could target to cover under a pension system all senior citizens whether or not they could earn and save for the old age.

A	Adequacy	Post-retirement Income is meaningful only if one has a ‘home’ and a health insurance cover.
B	Dominant Preference	Post-retirement income flows may not be funded by income flows of earning citizens, if the latter citizens themselves are not willing to depend for their post-retirement life on their future generations’ contribution.
C	Inter-generation Fairness	Both senior citizens and younger generations must perceive that the senior citizens are being compensated for the latter’ contribution on fair basis.
D	Basic minimum	Post-retirement income should not fall short of a basic minimum.
E	Entitlement	Society wants to ensure a ‘basic minimum’ post-retirement income to those who were handicapped to earning enough during their working life.
F	Coverage	No potential senior citizen is left out by post-retirement pension income system.

Table 1: Those related to Societal choice/value

## 2.9 Accessibility

Post-retirement life cannot be planned or implemented without an institutional mechanism that provides adequate accessibility. All earning citizens need to be able to access with ease an appropriate institutional mechanism that accumulates the retirement-targeted savings and delivers the pension income on retirement. ‘Accessibility’ is important if the principle of ‘coverage’ and ‘freedom of choice’ have to be operationally meaningful.

## 2.10 Efficiency

Accessibility to an inefficient institutional mechanism may not be meaningful. Efficiency is to be understood in terms of the cost and ease of access during pre-retirement life as well as the quality of post-retirement service provided by the institutional mechanism. This is the principle of ‘cost and service efficiency’.

To summarize, we have referred to 11 principles that may be relevant to developing a retirement income/savings or pension system. These principles may be regrouped and restated as shown in Table 1 and Table 2

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G	Sustainability	Post-retirement income flows to senior citizens to be sustainable may need to be funded out of pre-retirement income of the same set of citizens (except for the handicapped and disadvantaged)
I	Freedom of Choice	For post-retirement income in excess of a basic minimum, citizens should be able to exercise their own choice as to the post-retirement income-flows and therefore their pre-retirement savings/investment decisions.
J	Accessibility	The institutional mechanism for delivery of pensions service should be easily accessible by as many potential senior citizen as possible.
K	Efficiency	The institutional mechanism for pensions should be efficient both in terms of cost and service to the citizens.
L	Asset Market Valuation Reliability	Asset markets should be reliable in valuing the assets owned by the senior citizens.

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Table 2: Those related to Economic Viability & Efficiency

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We are not suggesting that all these principles are universally acceptable or they are exhaustive. These principles reflect a wide variety of views or expectations and some of them may be interrelated. Yet, each principle may stand out on its own if the society so chooses. Not all may agree to the way these principles have been stated in the paper. But the analytical framework adopted here may be used even with alternative statement of the principles.

### 3 AN EVALUATION

#### 3.1 Current System

We need to know the existing system before we can attempt an evaluation. In this Section, we begin with an outline of the existing system. For our purpose, we define the system more broadly as it really exists, and therefore do not limit ourselves to only those components which are formally recognised as pension system in India. In view of this, we are not inclined to leave out components of long-term savings (e.g. provident funds) that ultimately generate post-retirement income flows for individual citizens. The existing pension system in India is briefly described in Tabel 3:

Components	Compulsory/ Optional	Funding Status
a) Pension and Provident Funds for Government employees	Compulsory-restricted membership	Defined Benefit Pension—not funded (pay-as-you-go). Defined contribution provident fund with defined return
b) Pension and Provident Funds for employees of establishments covered by the Employees Provident Fund Act, 1952 and Employees Pension Scheme 1995 or other Acts (like Coal Mines Provident Fund Act)	Compulsory – restricted	Defined Benefit Pension contributory but - Funding status unclear. Defined contribution Provident fund with defined return.
c) Employer-sponsored superannuation funds / pension funds – over and above (a) & (b)	Optional – restricted	Mostly defined benefit plans, often contributory, some are clearly funded
d) Public Provident Funds	Optional – open to all citizens	Flexible contribution, return defined.
e) LIC's pension schemes like Jeevan Suraksha/Akshya/Dhara and annuity plans	Optional – open to all	Funded, defined return/annuities
f) UTI's Retirement Benefit Plan (RBUP) and Kothari Pioneer Pension Plan	Optional – open for all	Funded and without guaranteed return
g) Individual specific plans	Optional	Many individuals before retirement build up portfolio of investments in financial assets for old age security
h) Select Group Specific Pension Plans (e.g. For Freedom fighters, free old age homes, legislators)	Restricted	Unfunded or donation based (non-contributory)

Table 3: A bird's eye-view of existing system

The components (a) to (g) are tax-advantaged to varying extent, but all are not accessible by all citizens. The first two, (a) & (b), are compulsory for citizens who are covered under the relevant statutes. The third (c) is an arrangement offered by certain employers generally to a section of their employees. The next three, (e) to (g) are available to all citizens. Component (g) is not an insignificant component. Many individuals start building up their savings in the form of bank deposits, postal deposits, Unit Trust of India's (UTI's) units etc. On retirement, they put those investments along with provident fund and gratuity monies into bank deposits, UTI's Unit Scheme 1964 and Monthly Income Schemes and other instruments for post-retirement (regular) income.

All Provident Funds provide assured growth in value. Contributions, accumulations and return of balances on retirement are all tax-advantaged. However, pensions of Government employees are not funded. Pensions on retirement are subject to usual income tax. Pensions under Employees Pension Scheme are funded in the sense that employees (and employers') contributions are defined but their actuarial relationship to benefits are not clear. Exempt category establishments set up their own trusts and may be using actuarial valuation services and/or purchasing annuities from LIC to meet their obligations on pension payments.

In the case of employer-sponsored pensions (additional to those under EPS Act, 1995), the defined benefits are most probably fully-funded on actuarial basis or based on annuities purchased from LIC. Public Provident Fund (PPF) as well as LIC, UTI and Kothari Plans are funded. UTI's Retirement Benefit Unit Plan (RBUP) is essentially a fund management product structured to facilitate savings by individuals to satisfy post-retirement income need.

Provident fund permits withdrawal/borrowings for various reasons as part of the system. At present, the investible funds with provident funds under Employees Provident Fund Organisation (EPFO) and exempt establishments, aggregate to about Rs.1,00,000 crore while employees pension schemes investible funds may not exceed Rs.8,000 crore. Provident funds are a large source of savings that gets converted into bank fixed deposits and UTI units for generating monthly/annual incomes for retired citizens. If it were possible to empirically determine the percentage of bank fixed deposits, postal savings deposits and UTI units that serve the needs of post-retirement income, we would have got a better picture of the present pension system in India. Individuals in large number make their own savings plans to meet their post-retirement income using various 'safe' financial assets. The corpus under LIC's Jeevan Series policies is reportedly close to Rs. 200 crore. Even Employer-sponsored superannuation schemes are estimated to have investible funds of Rs.15,000 crore, while balances with public provident funds

are estimated at Rs.12,000 crore.

### **3.2 Impressionistic Evaluation**

We may now examine how far the above System satisfy the principles/criteria listed in the Part One. At the outset, however, we must admit a rigorous test is constrained by inadequate availability of relevant information. Therefore, the evaluation may have to be largely impressionistic.

### **3.3 Adequacy Test**

To test for the first principle of Adequacy, we need to use more information than we have provided in this paper. More information may be available in the papers on health insurance and housing finance presented at this conference or elsewhere. We suspect that the current system may not fully meet the criterion of Adequacy. While the citizens covered by provident funds also enjoy the facility of soft loans for housing from the employers or withdrawal facility from provident funds, in the absence of housing mortgage finance market, the current system severely restricts employee freedom (to change jobs once a large housing loan is taken). The cost of owning a house is high and increases with the age of a citizen. On the other hand, the size of the housing loans available is relatively small for most young employees with a few years of service to their credit.

Inadequacy may arise also on account of health facilities. Many corporate employers provide some health service facility to retired employees. Retired employees of Government have some access to low cost health services from Government hospitals. But the service available from Government hospitals is often difficult to access because of inadequate capacity in relation to demand and does not often meet the quality standards offered by private hospitals/doctors whose charges are very high. Medical insurance offered by insurance companies are gradually getting popular. Unit Trust of India manages a Senior Citizen Unit Plan (SCUP), which allows building up savings to assure funding of hospitalization expenses subject to maximum ceiling for the entire post-retirement life of a Plan member (and the spouse). This insurance cover is provided through an arrangement with the New India Assurance Company. A Senior Citizen member receives a card against which specified hospitals provide the service and bills the insurance companies. The scheme has not become as popular as one would have wished for three reasons - the insurance premium implicit under the SCUP is high, the coverage of hospitals is not countrywide and the reluctance of individuals to save at an early age for post-retirement medical expenses.

### **3.4 Dominant Preference & Intergeneration Fairness**

Under our current pension plans, a pay-as-you-go defined benefit plan the benefit is related to the last pay drawn and may not be fully funded by the contributions made prior to retirement. This reflects a dominant preference to risk the future generations' income to protect the retirement income needs of the earlier generations. Again, from the point of view of future generation or younger citizens, it is in their interest to limit the burden that they will be called upon to bear based on post-retirement benefits defined for, as well as, by the earlier generations. While an annual return of 12% on special deposits and on Public Provident Fund is assured, it is not clear if the savings of the current generation (in the form of public provident fund or special deposits in which provident funds continue to have large exposure) are really invested in creating assets that generate atleast 12% annual return. If not, the shortfall compounds overtime and shifts to future generations in the form of higher tax incidence. From the point of view of the present generation of employees, the concern is whether their savings are generating or capable of generating more than 12%. Are their savings deployed in creating assets whose value represents more than 12% growth or in public/government consumption or creating low productivity assets or financing inefficiently executed productive projects? In the absence of detailed information on what use is made of the resources available to the Government from special deposits, public provident funds and investment in government securities by provident funds and pension funds, it is difficult to say with certainty that the intergeneration fairness test is met by the existing system.

### **3.5 Coverage: Basic Minimum & Entitlement**

All government employees are covered by pensions and provident funds. EPFO covers about 215 lakh citizens employed with 3 lakh establishment (including exempt category). Thus, the entire organised sector is not covered. Even if we had covered the entire organised sector, the total coverage would have been about 3 crore persons or 10% of the working population. For most citizens outside the organised sector employment, basic minimum pension is not available. The public provident and LIC's Jeevan brand policies are yet to cover many citizens. Citizens with income below the poverty line, have no entitlement to pension at old age. Clearly, the current system does not meet the criteria of 'basic minimum', 'entitlement for the handicapped' or "coverage". Most potential senior citizens are destined to depend on their sons/daughters/relatives and charitable institutions when they retire: their dependence will be for longer periods than their parents and grandparent's dependence on them.

### **3.6 Sustainability Test**

So long as the rate of interest assured is realistic and earned, the provident fund component of the existing system is sustainable as this is based on defined contributions. However, one is not sure about the impact of 10% - 12% employers' contribution plus administrative charges incurred (and, where required, paid to EPFO) by employers, on employers' ability to sustain their businesses in an increasingly competitive market environment. Also, when Governments are under pressure to reduce taxes and fiscal deficit, and expand expenditure on social infrastructure, a pay-as-you-go method for payment of interest on provident funds to Govt. employees on retirement leaves the risk of unsustainability open.

There could also be a concern about the sustainability of the Pension system which are defined benefit in nature. At present, there are 8 working persons per retired person. Life expectancy has increased significantly in the past decade and will increase in future as well. The elongated life span would tend to reduce the number of working person per retired person. With a rising old age dependency ratio (number of 59 year plus citizens to number of citizens in 20-59 age group), the tax incidence on younger generation may progressively rise. For EPS (non-exempt category), the sustainability is dependent on whether the contributions and the growth in their values exceed the future liabilities of pension payment on an actuarial basis. It may be observed in this connection that the experience of many advanced countries show that pension schemes did become unsustainable as demographic profile changed. As a result, many countries are moving away from State-funded pension regimes to private pension fund management systems.

### **3.7 Freedom of Choice**

Very little choice is currently available. Most citizens cannot choose from alternative managers for managing all their savings for retirement. The provident/pension fund manager is either the State Bank of India/EPFO or the LIC. There is no alternative accredited/approved pension fund manager. A person himself has to manage his savings for pension (beyond what is statutorily managed by SBI/EPFO) or he can join LIC plans. He has very little choice in the way he can draw the pensions after retirement : it is defined as per EPS, 1995 or LIC plan. Defined benefit is as per a standardised formula for the citizens covered under different schemes.

The citizens do not have alternative service providers for fund accounting and administration. The service providers are monopolies like EPFO or public sector banks. Citizens cannot influence the investment deployment pattern. Provident/Pension funds have largely a standardised investment

pattern to follow. Even where a person himself wants to be the fund manager for his additional savings or retirement money (provident fund/gratuity), he has limited choice. He cannot put his money in an ill-functioning equity market and debt market. His choice is primarily limited to banks, UTI's US-64 scheme or Monthly income schemes, other mutual fund schemes, IDBI, ICICI, IFCI or other corporate bonds or deposits. The current system therefore provides very limited freedom of choice.

### **3.8 Accessibility Test**

The current system provides high accessibility so far as public provident fund and LIC's schemes are concerned. Public Sector commercial bank branch network is fairly wide. LIC also has a fairly big and dispersed branch and agency network. However, banks have little incentive (at the branch-level) to actively market and service public provident fund accounts. Monopoly service providers may be content with limited business expansion. Since the freedom of choice (in relation to service providers) is low, accessibility remains limited. In the absence of a competitive and contestable pension fund management and service industry, social awareness about savings for retirement and the access of rural population to professional service will be limited.

### **3.9 Efficiency Test**

The current system may not be regarded as efficient. Information on the number of government employees engaged (and the cost they incur) in administering the pension/provident fund scheme for Govt. employees is not available. But there is no reason to believe that the efficiency level in government pension administration is any higher than the general efficiency standard of government offices. Even if service efficiency is reasonably good (especially as pension can now be received through dedicated commercial bank accounts), cost efficiency is suspect. EPFO has a manpower strength of over 17,000 to service 215 lakh members. It has an aggregate investible funds of Rs.55,000 crores and its annual collection is Rs.9,000 crore. Compare this with Unit Trust of India's 2,500 employees dealing with Rs.60,000 crore of funds owned by 480 lakh investors and annual unit sales of Rs.10,000 - Rs.15,000 crores. Admittedly, this is a crude comparison. EPFO does not manage the funds themselves, while UTI does. EPFO has no marketing costs like UTI. But EPFO has to ensure that establishments deposit the contributions and the employers do not violate the EPF Act Provisions. Yet, even these crude statistics leave room for doubt about the cost efficiency of EPFO (Table 4). We do not have information on total expenses of

		EPFO	UTI
1	No. of accounts/members handled per employee (000)	1.25	20.00
2.	Size of funds managed per employee (Rs. crore)	3.20	23.0
3.	Per employee annual collection (Rs. crore)	0.50	4 to 5

Table 4: Relative Efficiency Indicators

EPFO, but it charges over 65 basis points of the employee-income base on which the provident fund contributions are calculated. This roughly works out to a receipt of about Rs.160 crore in 1997-98 to EPFO implying a realisation per employee of less than Rs.1 lakh, while an employee alone is likely to cost as much per year. The employee compensation bill itself would be in the range of Rs.170 crore for EPFO. If we take into account the cost of electricity, rent, stationery, travelling, guest houses, maintenance, communication, computers, asset management fee 0.025% to SBI etc., the annual expenditure of EPFO may be higher.

For other components of the current system, it is further difficult to assess the cost efficiency. Public Provident Fund (PPF) services are provided through the commercial banks. It is not known whether the banks get fully compensated for the costs. But the level of efficiency of PPF is unlikely to be higher than the overall level of banking efficiency in terms of both service levels and costs.

### 3.10 Asset Market Valuation Reliability

Participation in risk capital of financially strong and better managed companies and projects is generally expected to yield (on an average) higher return than (a) the return on participation in debt capital of such companies/projects or (b) the return from participation in equity/debt capital of weaker or inefficiently managed companies/ projects. We are required to believe that investment in risk (equity) capital in any Indian company (private or public sector) is really less rewarding than government securities and special deposits in order to justify the investment pattern specified for provident funds and pension funds. We are also required to believe that investment in the equity capital of MTNL or VSNL or Hindustan Lever or ITC or Infosys or Gujarat Ambuja is less rewarding than investment in bonds/debt paper issued by IDBI, IFCI, MTNL and SAIL. Government

can own shares in MTNL, it can divest such shares to domestic investors and foreign investors including foreign pension funds. But Indian provident funds and pension funds cannot invest in MTNL shares. Such beliefs do not appear rational and the relative valuation of financial assets implicit in the specified investment pattern (even with the latest modification allowing 10% investment in private sector securities) does not appear reliable.

The current system therefore does not appear to be consistent with the Principle of Asset market Valuation Reliability. Even if there were no specified investment pattern for provident and pension funds, the problem of asset valuation reliability would still remain. It is generally argued that the long-term return is high for commercially-driven infrastructure projects (power, ports, roads, telecom, etc) and for strong, efficiently managed public and private sector companies. Do the stock markets reflect this rational expectation? Unfortunately, in the recent period, share prices in general indicate very poor returns from the equity of such projects and companies. If the financial asset market cannot generate rationally expected valuations, no citizen can agree to channelise savings for retirement into market-valued financial instruments. It is difficult to recommend provident funds and pension funds to invest in equity and corporate bonds unless we have established financial markets which are capable of valuing assets rationally. Liberalisation, globalisation, privatisation, regulation and prudential guidelines by themselves cannot establish reliable market mechanisms. The mere existence of buyers, sellers, regulators, trading infrastructure and trading does not imply the existence of markets capable of discharging the desired economic function of discovering prices that reflect the economic value of assets adjusted for risk. Processes of competition, contestability and mobility of financial resources are key to the economic role of market mechanism. Our financial markets need to be strengthened so that they can effectively discharge this role. One possible reason for the dominance of government securities, special deposits and PSU bonds in Indian Provident Fund investments, may be that the government or the Central Board of Trustees are not confident of the reliability of the valuation in markets for financial assets. The 12% rate on special deposits probably reflects this difficulty to satisfy the principle of Asset Market Valuation Reliability.

If the reliability of financial asset markets is enhanced, provident funds/pension funds managements to gain considerably. Equity shares and mutual fund products account for a dominant share (40% - 70%) of the pension fund investments in advanced countries (Table 5). Equity accounted for 8% - 11% of Government-owned pension funds investments in Malaysia, South Korea and Phillipines.

In USA, even the citizens can choose their individual pension fund portfolios.

Equity Component (%)	Countries
40 - 45	Japan, Canada, Germany
60 - 70	USA, UK

Table 5: Equity in Foreign Pension Fund Asset Mix

	1964	1974	1984	1991
Government Pension Funds	6.5	18.7	27.1	39.9
Private Pension Funds	52.4	48.3	44.4	64.3

Table 6: Share of Equity in US Pension Fund Investments

Over the years, the share of equity investments in US pension funds has increased substantially (Table 6).

Clearly, the pension funds abroad have tried to gain from investing in equity shares. Over the longer-term, equity tends to give higher return than alternative investments. Investments made in Bombay Sensitive Index portfolio in April 1980 has generated 22% annualised return for the period 1980-1990 as well as 1980-96. Since 1996, the stock market has seen a sharp fall in the index levels and continued to be in bearish state till December 1998. Even then the annualised return for the period 1980-1998 is higher than 19%. Unit Trust of India's Mastershare scheme which was introduced in 1986 has given an annualised return of 30% for the period 1986-96 and over 25% for the period 1986-98. Had provident funds invested in Mastershare scheme in 1986, they would have earned much better return than 12%.

It is unfortunate that provident funds could not capture the prosperity of the Indian equity market during 1980-1998 or 1986-1998. The entry of provident funds and pension funds into the Indian stock market could have also contributed to the growth and reliability of the stock market. It may be mentioned in this context that pension funds have emerged as a major force in financial markets internationally. In USA pension funds accounted for 36% of the total financial assets. As long-term investors, these funds have imparted greater degree of stability to the financial markets and large pension funds have become active in improving corporate governance practices. There is no reason why such trends should be discouraged in India.

We need to progress fast in removing process deficiencies in equity markets and introduce greater contestability by (a) allowing freer share buy-back by companies, (b) by allowing easier creeping acquisition by promoters, (c) by

	Test for	Result	Need
1	Adequacy	Suspect- To be assessed	To improve
2	Dominant Preference	Dependence	To reduce
3	Integration Fairness	Suspect	To clarify
4	Sustainability	Doubtful	To ensure
5	Coverage	Extremely low	To increase
6	Freedom of choice	Limited	To widen
7	Reliability of valuation	Low	To enhance
8	Accessibility	Limited	To increase
9	Efficiency	Doubtful	To improve

Table 7: System Evaluation

completely banning sale of shares in the stock market by traders/persons who do not own stock or do not commit to deliver each share sold with guarantee evidenced by borrowing stocks and putting up fifty percent cash margin, (d) by completely eliminating paper based trading, (e) by shifting over to T+2 Rolling Settlement for Crisil-500 shares and (f) by introducing options and futures in financial assets. If we are committed to carry out these reforms, with speed, the time is so opportune now for entering the stock markets for provident funds and pension funds, especially as shares are currently available at attractively low prices in the stock markets.

We do not, however, intend to suggest that entry of provident funds and pension fund into the equity market is as simple as investing in government securities and special deposits. Equity investing would demand considerable degree of risk management expertise. We need to evolve a system that ensures availability of such expertise, at reasonable cost, to provident fund and pension fund trustees as well as individuals (who plan to save more for retirement than compulsory contribution to provident fund/pension fund).

The summary results of the evaluation in this section are set out in Tabel 7.

#### 4 AGENDA FOR REFORMS

The direction in which the Pension System in India could proceed follows from the analysis presented in Section Two. We first state the broad objec-

	Objectives	Actions
1	Reduce cost to Govt	Allow commercial operation
2	Phase out Unfunded plans	Allow reliable funded plans
3	Ensure basic minimum to more	Induce more into the net
4	Expand Network	Allow new entry/commercial operation
5	More service providers and products	Allow new entry
6	Generate higher Returns	Revise pattern, allow competition

Table 8: Objectives to Action

tives that we may consider worth pursuing.

#### Objectives

1. Increase the coverage of senior citizens,
2. Encourage citizens to put more savings for retirement under pension plans at early phases of working life,
3. Reduce the cost to the exchequer on account of subsidy to meet (i) guaranteed return on citizen's savings for retirement, (ii) defined benefit to pensioners and (iii) cost of pension administration,
4. Gradually move away from subsidised or unfunded or partly funded pension plans/schemes for citizens earning incomes (above a minimum level).
5. Encourage the development of an efficient and competitive retirement savings industry comprising specialised financial service firms for fund management, accounting and administration, product marketing and distribution, actuarial service, etc.
6. Impart and strengthen competitive and contestable processes in the capital market to improve its reliability and thereby facilitate flow of long-term savings dedicated to retirement purposes into capital market instruments, particularly those investments which represent long-term investments like risk capital and infrastructure finance.

#### 4.1 Increasing Coverage

There are three components to increasing coverage: (a) uplift income levels of people to generate savings capability, (b) bringing those with savings capability into the formal system of savings for pension and (c) providing pension

benefits to those remaining disadvantaged/handicapped. It is unlikely that India will achieve such rapid economic growth that it would be possible soon for 90% of the Indian working population to have income adequate enough to save for retirement. However, as we progress over the decades towards higher economic prosperity, it is necessary that each generation subsidises the handicapped/disadvantaged sections of the senior citizens population during their old age. While charities and donations channelised through voluntary organisations may continue, state funding for compulsory retirement benefit to disadvantaged people is the only alternative for increasing the coverage of pension systems till high economic growth is able to bring in larger percentage of the working population into higher income groups capable of saving adequately for basic minimum post-retirement income. Much, however, will depend on the fiscal situation of the Government at any point of time as to what extent the Government can target to reduce the incidence of senior citizens not covered by any form of retirement income.

#### **4.2 Retirement Planning at Early Age**

To bring more people into the net of formal arrangement of pension, it is necessary to encouraging savings for retirement among those who have incomes to save but not yet covered by formal/informal retirement planning. Currently savings for retirement is encouraged through compulsory contribution schemes only for employees in the organised sector and though the tax incentives for such savings as also savings under PPF and schemes /plans managed by LIC and UTI. But there is very little educational or publicity campaign to make citizens conscious of the need for higher savings for retirement and the advantage of such saving at early phases of working life. It is necessary for EPFO, corporate employees and the government to conduct appropriate retirement planning education seminars, not for those going to retire soon, but for the younger generation of employees. The network of offices and agents of the banks, post offices, LIC and UTI are readily available infrastructure that can be utilised to strengthen continuous awareness programme. PPF, RBUP and Jeevan Series policies need to be marketed aggressively all over the country (and not limited to urban areas, however, continuous and rapid progress can be made in this area if we allow competing pension fund organisations market their products.

#### **4.3 Restructuring Tax Incentives**

The tax incentives also need to be geared to encouraging early savings or higher savings for retirement income. At present, in the case of both Provident Fund/Public Provident Fund, early withdrawals for specified purposes

are allowed without any tax disincentive. We may need to have a tax incentive structure that creates disincentives for withdrawal of savings from pension/provident fund plans before retirement except for low-cost single home and critical illness. In the case of UTI's Retirement Benefit Unit Plan (RBP), we have provided for 10% loss for withdrawals before the age of 58. It is suggested that any withdrawal from tax-advantaged long-term savings plan like provident funds/public provident funds (except for purposes of acquisition of only the first house or meeting medical expenses for critical illness) should be subject to some tax penalty. A new series of fully tax-advantaged PPF may be launched in replacement of the old one. The new PPF should prohibit withdrawal, except under circumstances of death or critical illness. Also, all children irrespective of the age may be allowed to save under tax-advantaged provident fund/pension plans that do not allow withdrawal before the age of 55 or death or critical illness, whichever is earlier. Contributions by any person on behalf of a child into such plans may be made completely tax exempt.

#### **4.4 Reducing Cost to the Exchequer**

To reduce the cost to the exchequer, the extent of compulsory investment in Government securities and special deposits may be drastically reduced. High comfort on Govt. paper for safety should be available only at low cost to the Govt. The interest rate on govt. securities and special deposits could be much lower than what is currently available. Also, the interest rate on provident funds should be based only on the net rate of return actually realised from the funds deployed.

The defined benefit to pensioners should be actuarially valued and the gap in the investible funds to be bought in by the employer, (including the Government) should be assessed annually. Proper gap analysis will help Government to assess the implications on the fiscal/future budgets of the Govt. This may help measure the extent of sustainability of the present system, revise the investment pattern restrictions in favour of investment in corporate equity and debt, and thereby reduce the burden on the Government (and therefore on future generations).

#### **4.5 Raising Return Efficiency**

It may be irrational to set the interest rate in risk-free government securities and special deposits by pension/provident funds equal to or higher than the return on investment in a carefully chosen diversified portfolio of corporate equity and debt securities. If the return on investments in corporate equity or debt is higher, the portfolio return can be increased by reducing

	Phase I (2000)	Phase II (2002)	Phase III (2005)
Govt. or Govt. Guaranteed securities	Upto 75%	15%	20% or more
Special Deposits		30%	Nil
Public Sector Debt instruments	Upto 20%	20% or more	40% or more
Private Sector Debt instruments	Upto 10%	15% or more	
Mutual Fund Schemes/ UTI Schemes	Upto 5%	10% or more	Upto 25%
Listed Company Shares		Upto 5%	Upto 15%
Offshore Investments			Upto 10%

Table 9: Proposed Revision in Investment Pattern (% of Cumulative Investment Outstanding)

the proportion of government securities in the portfolio. The investment restrictions for pension/provident fund may be revised to enhance returns by allowing investment in mutual fund schemes, unit schemes of UTI, corporate equity and debt securities as also money-market securities. In three phases, the investment pattern of outstanding investments of Provident Funds and Pension Funds may be revised as given in Table 9.

The Trustees may lay down quality norms for each specific investment.

#### 4.6 Enhancing Cost Efficiency

It is also necessary to assess the actual cost of administration of pension, both for Government employees as well as employees covered under EPF Act 1952 and EPS 1995. It may be possible to make efficiency gains and take immediate and effective cost cutting measures.

#### 4.7 Developing a Competitive Industry

EPFO has played a great role in establishing pension/provident fund system, despite its inadequacies or inefficiencies. In the emerging scenario, the role of EPFO needs to be reviewed. It is suggested that EPFO may be turned into a commercial entity with share capital provided by Government of India (but delinked from Government Department). In its new role, EPFO may

act only as a pension fund administrator for Govt. employees and employees covered under EPF/EPS for non-exempt category of establishments. A new Central Trustees Organisation (CTO) with fewer members (less than 20 instead of 43 as at present), may be set up by the Labour Ministry. CTO and Trusts set up by exempt category establishments may be allowed to entrust the funds management responsibility to one or more independent and accredited Asset Management Companies (AMCs) and UTI as they may like to choose.

For the development of a competitive and contestable market for pension fund management and pension fund administration services, it would be necessary to give exemption option to all member establishments (to start with to establishments employing more than 100 persons). Once an option is given, the number of exempt establishments will increase. These exempt establishments have to seek the services of accredited macs/firms engaged in providing pension funds management and administration services.

We may also consider giving options to individual provident/pension fund members to stop further contribution under EPF/EPS to EPFO/SBI and directly contribute to the retirement fund plans offered by competing AMCs. For example, a member who has already been contributing under EPS/EPF may from (say) the 16th year onwards be allowed to join an approved and accredited (therefore fully tax-advantaged) retirement fund/provident fund introduced by competing accredited AMCs with/without transferring existing balances with EPFO.

The Public Provident Fund scheme would need to be restructured. The banks collecting PPF may set up separate Boards of Trustees/Trustee Companies and transfer the fund management work to accredited AMCs sponsored by them or by others.

#### **4.8 Regulation**

We also need to set up a separate Retirement Regulatory Authority to license and oversee the functioning of all Board of Trustees/Trustee Companies, AMCs, EPFO and its other competing organisations as well as their products and services. The Regulatory Agency may lay down the standards of conduct, obligations and responsibilities of each agency connected with the retirement savings/income plans (including provident fund and pension funds of Govt. employees and employees covered under EPF, 1952 and EPS,1995). While it is possible to consider the insurance regulatory authority for the responsibility of regulating retirement /pension /provident fund businesses, it may be desirable that this area is handled separately and not mixed up with pure insurance regulation. Insurance business and

pension fund businesses may look similar and may involve synergies or inter-relation, but these are preferably treated as distinctly different businesses and therefore regulated by different agencies.

The regulatory reforms need to reflect the importance of trusteeship and fiduciary responsibilities. The concept of Trusteeship and the rights and responsibilities of Trusts/Board of Trustees/Trustee Companies need to be clearly spelt out. The eligibility criteria for Trustees may be laid down. Qualifying Professional Trusteeship examinations have to be introduced. Professionally qualified and accredited Trustees should form 50% or more the Board of Trustees (Board of Directors of a Trustee Company). To ensure that we have adequate supply of professionally qualified trustees for pension funds and provide for funds, it may be necessary to provide for adequate compensation for professionally qualified and accredited trustees and introduce trustees' liability insurance facility.

The Asset Management companies (AMCs) to which Trustees may assign the retirement/pension/provident funds for management also need to be accredited by the Regulatory Authority. An accredited AMC will be allowed to (a) manage funds entrusted to it by CTO/EPFO and Trustees of any exempt category establishment and (b) offer retirement savings plans directly to citizens. For the latter (b), AMCs may be allowed to join hands with insurance companies to offer products that combine fixed/variable annuities on retirement. The regulatory provisions should lay down the fiduciary obligations on the AMCs. The fact that an AMC is approved by SEBI may not be adequate for retirement fund management and related services. However, the retirement/pension / provident funds may choose to invest in any scheme of SEBI approved mutual funds to the extent permitted by the investment restrictions referred to in para 3.7 and approved by the Trustees. Services relating to retirement/pension/provident funds may be offered only by accredited agencies. Regulatory guidelines on marketing, accounting and administration have to be issued. Since it is possible that a single agency may engage in marketing, accounting and administration and fund management, regulatory guidelines should cover requirement of chineewalls among divisions dealing with different activities of the same accredited firm. Capital Adequacy norms may be laid down for AMCs and these firms.

Guaranteed-return provident funds may be entrusted to accredited AMCs for management, but any shortfall in income or values have to be funded by the employer organisations (including the Govt). Where citizens contribute independently to a plan promoted by an accredited AMC, there should not be any guaranteed return. Board of Trustees or Trustee company may, however, indicate the minimum annual return expected of the AMC entrusted to manage funds. The return performance of an AMC should be evaluated every year. Unless an AMC has recorded much higher return performance (than the minimum return performance) in the preceding three

years, any shortfall in the latest year should attract regulatory review and action. While reviewing such cases of shortfall in any particular year, if the Regulator finds that the return prospects for the future of the Fund to be poor, the AMC and the Trustees will be required to stop further collections. The Trustees and the Regulatory Agency may undertake efforts for transferring the funds to another AMC based on appropriate valuation. If necessary, the Regulatory Agency may provide monetary relief to the contributors to a certain extent from a Reserve Fund which the Regulatory Agency builds up from a part of the annual fees payable by all accredited AMCs.

In case in a particular year, there is a general and widespread decline in the prices of financial assets due to market aberrations, the Regulatory Agency may have to make a special industry-wide review and advise the retiring citizens to defer their withdrawals for one or two years (without loss of any tax benefit) from the Retirement Fund Plans sponsored by AMCs. This may not seriously affect the retiring employees as they would still be getting the benefit of that part of their retirement savings placed with the employer - sponsored funds.

Under the Regulations, contributing members of any retirement / pension / provident funds may be allowed the option to transfer balances from one AMC to another AMC at Net Asset Value without loss of tax benefits. This should apply also to transfers from PPF and CPFO to other AMCs. If the EPFO desires to introduce products on the lines that independent AMCs may do, EPFO may for this purpose set up its own subsidiary AMCs accredited with the Regulatory Agency.

In summary, the reform action points are :

- Commercialise Operation
- New Entry
- Revise investment Pattern
- Induce more into the Net
- Develop Competitive Industry & Contestable Market
- Reform Regulation
- Restructure tax incentives.

For creating a contestable industry and competitive markets, it would be necessary to:

- Decompose Activities/Players (Contributors, Trustees, Fund Management, Administration & Accounting, Marketing & Distribution)
- Introduce Comprehensive Legislation to protect interest of contributors and to specify roles, responsibilities, obligations, standards of conduct and disclosure.

Implementing the above suggestions may require changes in the extant legislations including the EPF Act, 1952, EDLIS, 1976 (Employees' Deposit Linked Insurance Scheme), EPS 1995, the Indian Trusts Act and The Insurance Act. Equally important, there is a need to design appropriate restructuring of EPFO employing over 17,000 employees. A part of EPFO employees may be absorbed by the corporate form of EPFO, a part may be required in the Regulation Authority and a smaller part retained in Labour Ministry to assist the CTO. It may be advisable to have a comprehensive legislation 'Citizens' Retirement Income Security Act' (CRISA) on the lines of Employees' Retirement Income Security Act, 1974 (ERISA) in USA. CRISA should protect the interests of employed, self-employed persons, children and unemployed persons covered by any retirement income/savings plan/scheme and ensure the development of a retirement savings management and service industry that is healthy, efficient, competitive and sustainable.

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