

Pension Fund Management in India: Issues of Return and Accountability

G. V. Nageswara Rao
Managing Director, IDBI Capital Markets

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1 INTRODUCTION

Most pension fund managers in India see investment management as a simple exercise of deploying funds according to the pattern prescribed by the government. Some of them have an appreciation of the credit risk inherent in their investment decisions, but a large number believe that all eligible securities are equal. However, I have not come across a fund whose trustees have drawn up well-defined investment objectives and policy after having made a detailed analysis of the risks the fund is exposed to. Perhaps pension fund investment management is still in its infancy in this country and is constrained by regulations. Pension funds have not been in operation long enough and macro-economic parameters such as inflation and interest rates have been stable enough (well, in a very broad sense) to cause serious concerns of deficits in pension funds. While we talk of pension fund reform we need to simultaneously focus on establishment of systems, structure and regulatory framework that would promote efficient management of pension funds. It will be my attempt to explore some of these issues in this paper.

2 INVESTMENT CHARACTERISTICS

The investment and risk characteristics of a pension fund depend on the plan structure. Broadly, there are two types of pension plans: defined benefit plans and defined contribution plans.

2.1 Defined Benefit Plans

Defined benefit plans promise specified benefits to the plan participants, which are not directly related to the contributions made to the fund by them or by their employer on their behalf. The Employees' Pension Scheme, 1995 (EPS 1995), the pension plans implemented in RBI, IDBI and other commercial banks as well as those in several public sector undertakings are in the nature of defined benefit plans. Most of the pension funds in India are single employer defined benefit plans. EPS 1995 and Coal Mines Pension Scheme are examples of multiple employer defined benefit plans.

Benefits

Defined benefit plans in India usually offer the following types of benefits to participating employees.

1. Superannuation Pension: Superannuation Pension is payable on attaining the age of retirement and is usually dependent on the salary during the period immediately preceding retirement and the length of service. Under the Employees' Pension Scheme, 1995, the normal Monthly Superannuation Pension

would be Pensionable Salary * Pensionable Service * 70. Pensionable Salary is defined as the average monthly pay drawn during the 12 months preceding retirement, subject to a maximum of Rs 5000 per month. In RBI/IDBI, the rate of basic pension is 50% of the average of pay drawn during the last 10 months of service subject to a minimum of Rs 375 per month. Service of 33 years will qualify for full pension and for those who have put in less than 33 years of service, pension amount will be proportionate based on the number of years of qualifying service. In NTPC's Self-Contributory Pension Scheme, pension would be at the rate of 1.25% per year of reckonable service limited to 50% of salary last drawn, with capital being returned on death of the member to his nominee.

2. Monthly Pension payments by the fund or insurance company: Some of the pension funds such as EPS 1995 and RBI/IDBI also handle monthly pension payments. Others like NTPC purchase a life annuity from LIC on retirement of a participating employee by making a one-time lump-sum payment. The risk characteristics of both models would be different. In the former, the funds would remain with and be managed by the pension fund even after retirement of an employee. Whereas in the latter case the responsibility of the pension fund ceases on retirement and the funds are managed and risks assumed by LIC during the retirement period.
3. Cost of Living Adjustments: Some pension plans provide for increase in pension amounts to compensate for inflation, while others do not. For example, the RBI, IDBI and commercial bank pension schemes provide for dearness relief to the pensioners at rates as may be determined by the plan sponsors.
4. Premature Retirement Pension: Premature Retirement Pension is payable to an employee who retires before attaining the age of retirement but has put in the minimum period of service specified (e.g. 20 years of eligible service under EPS 1995). Premature Retirement Pension is usually computed in a manner similar to Superannuation Pension based on average salary prior to premature retirement and qualifying service at the time of premature retirement.
5. Disability Benefits: In the case of permanent disability, the plans generally provide for payment of pension without requiring minimum qualifying service.
6. Survivor Benefits: The plans provide for payment of Family Pension in the case of death of the participating employee while in service or after retirement. EPS 1995 provides for payment of pension to surviving spouse (until death or remarriage). It also provides for surviving children's pension until the children attain the age of 25 (payable for a maximum of two children). However, the RBI/IDBI Schemes restrict payment of Family Pension to only one person at a time. Family pensions are generally calculated as a percentage of the member's pension. For example, the NTPC scheme pays pension at the rate of 50% to a nominated beneficiary, in case of the death of the employee while in service. On death of a member after retirement, capital will be returned to the beneficiary nominated by him.
7. Withdrawal Benefit: Some of the plans provide for return of full or part of the contributions to the employee on resignation or otherwise leaving the plan without qualifying for pension. Plans such as RBI and IDBI do not provide for payment of pension in the case of resignation, dismissal or termination.

8. Commutation: The plans provide for commutation of a part of the pension at the option of the employee. The plans often specify the commutation factors without reference to the rates of interest prevailing at the time of commutation. For example, the Employees' Pension Scheme, 1995 lays down the proportion of pension that can be commuted and the commutable value of the pension. Similarly, the RBI and IDBI Schemes specify commutation factors in the Scheme.
9. Funding: Defined benefit plans may be funded out of contributions by the employees or the employer or both. The Employees' Pension Scheme, 1995 is funded by diversion of 8.33% from employer's share of contribution to the provident fund and the Central Government contributes 1.16% as Government contribution. RBI/IDBI schemes are funded by the full amount of employer's contribution to the provident fund.

The Coal Mines Pension Scheme is funded by 2% of the salary of the employee being the aggregate of the equal shares of the employer and the employee from their respective contributions to the provident fund, plus an amount of 1% of salary (subject to a maximum salary of Rs.1600) contributed by the Central Government. The Self-Contributory Scheme of NTPC is funded by contributions by the employees. Contributions in NTPC's Scheme are a flat rate plus a percentage contribution based on salary.

Who takes the risk?

As is evident, defined benefit plans specify the benefits as well as contribution ratios. As is also evident, they could differ in the benefits they promise and the way contribution ratios are specified. Then who takes the risk in case funding falls short of promised benefits? It depends on the plan structure. In Employees' Pension Scheme and RBI/IDBI Pension Schemes, the Central Government and RBI/IDBI respectively bear the full risk in case funding falls short of obligations. NTPC's Scheme gives powers to the trustees to require additional contributions from the employees or revise benefits in consultation with the actuary. The Coal Mines Pension Scheme also provides for revision in contributions or benefits with the approval of the Central Government. Defined benefit plans are in the nature of savings-cum-insurance plans. The plans, therefore, bear insurance risk as well as risk of investment performance. Defined benefit plans provide for stable retirement income based on salary. They provide insurance against longevity; therefore, an individual does not face the risk that his savings may run out before he dies. However, the employee takes the risk that his benefits may not be related to the contributions made by him. An employee who dies soon after retirement may draw by way of pension a sum far smaller than what he contributed through his working life. While another who lives long and leaves behind survivors may get by way of benefits more than what he contributed. Defined benefit plans do not generally provide for bequeathing of wealth. However, most plans in India allow commutation of a part of the pension; this makes it possible for an employee to take a lump-sum amount

on retirement and draw a reduced pension for life.

2.2 Defined Contribution Plans

Defined contribution plans are in the nature of individual retirement plan accounts. The contributions made by or on behalf of the employee are accumulated and paid on retirement along with such return as may be generated by the fund on the investments made. The Employees' Provident Fund Scheme as well as all the exempted provident funds in India are essentially defined contribution plans. The Group Superannuation Scheme of LIC is another example of a defined contribution plan.

Benefits

In defined contribution plans, the pension amount depends on the amount accumulated to the credit of the employee. In all the provident fund schemes, the accumulated balance at the credit of an employee is paid out on retirement and there is no monthly pension. Provident funds also allow withdrawal of balance for specified purposes such as acquisition of house, education of children, etc. The LIC Group Superannuation Scheme utilises the accumulated contribution along with interest to the extent of one-third to pay commuted value on retirement and the balance to purchase an annuity to provide monthly pension until death. LIC provides for several pension options such as life pension ceasing at death, life pension with return of capital and terminal bonus on death, life pension guaranteed for a minimum specified period and life thereafter, joint life pensions, etc. The amount of pension varies under each option. Under the Group Superannuation Scheme, on death of the participating employee before retirement, the accumulated contribution is used to purchase an annuity to pay monthly pension to the nominee. On withdrawal before retirement, the corpus can be used to purchase an annuity to start pension either immediately or after the normal age of retirement.

Funding

Defined contribution plans can also be funded by contributions of either the employee or the employer or both. Provident funds in India are funded by contributions of both the employee and the employer. The LIC Group Superannuation Scheme is funded by contribution by the employer of a fixed percentage of the salary of each employee. Provident funds declare interest annually based on the income they earn on investments made, which is credited to the employee's account. In the last few years, EPF has declared 12% interest; most exempted provident funds pay a similar rate. LIC declares interest on the accumulated contribution every year, which is a slab rate, based on the size of the fund.

Who takes the risk?

In defined contribution plans, the risk is usually borne entirely by the participating employee as his benefits are directly related to the accumulated contribution to his credit. If the pension or provident fund loses money in investments or earns lower than benchmark return, the employee bears the loss or opportunity loss. In defined contribution plans, each individual's contribution remains his and hence bequeathing of wealth is possible in case of premature death. However, the retirement income is less predictable as it depends on investment performance. There is no insurance element.

3 PENSION FUND'S MISSION

Successful management of a pension fund requires the ability to set long-term goals, policies and strategies. A formal statement of the fund's mission and investment policy goes a long way in focussing attention on issues critical to the fund's success and setting a clear direction. Setting of the fund's mission depends on the plan structure and what the plan sponsor wishes to accomplish. In a defined benefit plan, the mission of the pension fund, at the fundamental level, would be to invest the funds in a manner such as to secure the benefits promised to the plan participants. While some plans may make it possible to revise the benefits or contributions in case of shortfall in assets as compared to liabilities, it would usually be seen as the last resort. A secondary objective could be to generate adequate surplus (i.e. value of the plan's assets minus the value of expected obligations) so that future risks are reduced. Even if not promised, it is possible to define the fund's mission broadly such as to aim to provide additional benefits. For instance, a plan may define its mission as providing benefits adjusted for inflation and gains in productivity so that the relative living standards of the plan participants may be maintained during their retirement years. This could be even if the plan did not promise benefits adjusted for increase in cost of living. In defined contribution plans, as no benefits are promised, one approach is to define the fund's mission as maximisation of return at a specified risk level. Under this approach, the fund would be managed more like a mutual fund with several possible structures such as a bond-oriented fund, growth equity fund, index fund etc. This approach is adopted, for example, in US 401(k) plans. However, many defined contribution plans view their objective as replacing a targeted portion of a participant's income during his retirement years, which is what a participant would aim to achieve by joining the plan. In such an approach, the fund's mission would be defined as achieving a targeted replacement rate of participants' income. This would make the investment mission of a defined contribution plan similar to that of a defined benefit plan since the latter usually promise benefits

that are defined based on a replacement rate of the participant's income. Trustees of each pension fund will need to define their mission based on what the fund has been set up to accomplish. The fund's mission will determine the investment policy of the fund. The following mission statement of Minnesota State Board of Investment is an example (Source: Investment Policy: The Missing Link by Jeffery Bailey) "The BRF's mission statement reflects the broad pension goals pursued by the Minnesota State Board of Investment in the management of this fund. Specifically, the BRF's primary mission calls for the investment of employer/employee contributions to secure sufficient funds to finance promised benefits to participating public employees upon their retirement. Secondly, the BRF's investments should generate additional funds that permit either the reduction of contributions or the enhancement of benefits."

4 MISSION OF PENSION FUNDS IN INDIA

Pension funds in India do not have a well-articulated mission statement. Even if not articulated, trustees often see their primary mission as compliance with the myriad guidelines and regulations. With respect to investments, the primary objective is usually to achieve the investment pattern prescribed, while a secondary objective is to achieve at least the return declared by the government provident fund. The focus has rarely been on ensuring adequate funding levels, matching of assets and liabilities or target replacement rates. The reason is partially the limited flexibility in investment management under the regulatory framework and partially a lack of focus on pension fund risk and the risk tolerance of the plan sponsors.

Understanding Pension Fund Risk

Conventionally, the focus has always been on "return" rather than "risk". Pension fund sponsors and trustees tend to see themselves as "return maximisers" rather than as "risk controllers". Even in India, a pension fund manager may bandy the return he generated without reference to the risk of the underlying portfolio. A deeper understanding of risk is rare to find. Pension fund risk may broadly be defined as the possibility that the fund's mission may not be achieved. Precise delineation and definition of all risks that the pension fund is exposed to is vital to good risk management. However, this is not a simple, but a highly challenging process.

Time Horizon of Pension Fund

A pension fund has a very long time horizon considering the number of years an average person may remain in service and live thereafter in retirement. A person who joins the fund at the beginning of his career may remain a member of the fund for as long as 45-50 years. As a going concern, a pension fund would have an even longer time horizon. All parameters such as

inflation rates, interest rates and mortality rates could change in a significant manner over such long periods. Assumptions made at the time of plan structuring may not remain valid over a period of time. What is needed is a system in which these risks are understood and managed by the trustees on an on-going basis in order to maintain the solvency of our pension funds.

Conventional View of Risk

Traditional definitions of pension fund risk view it as a trade-off between risk and return on investments made. This is how most pension funds in India view risk. Some funds are highly risk averse and invest only in AAA rated bonds, while others may increase their return by investing in lower rated bonds thereby accepting more risk. Traditional views of risk seek to reduce the volatility in return from year to year. Investment in equity would, under this view, be seen as risky since variability in year-to-year returns can be significant even if over a long period equity could give higher returns than bonds. A portfolio of long-term bonds will minimise year-to-year fluctuations in return. These views of risk are focussed only on the “assets” side of a pension fund.

Asset-Liability Risk

The real risk a pension fund faces is asset-liability risk, because of the differing nature of assets and liabilities. The assets and liabilities of a pension fund need to be evaluated at regular intervals to ensure that the fund remains solvent and its assets would be adequate to pay for its liabilities. Even in the United States, it has taken Employee Retirement Income Act (ERISA) of 1974, Financial Accounting Standards Board Statement 87 (FASB 87) and the amendments made by Omnibus Budget Reconciliation Act (OBRA) of 1987 to bring this issue to the fore.

4.1 ERISA requirements on minimum funding

ERISA lays down minimum funding standards in defined benefit plans, for the protection of plan beneficiaries. The safeguards include acceleration of contributions in the case of underfunded plans, higher insurance premiums based on degree of funding, regulations aimed at computing funding surplus or deficiency in a prudent manner at the end of every plan year, taxes on underfunded plans and disclosure requirements in case of funding deficiency. In response to the persistent growth in pension underfunding, Congress strengthened the legislation over the years, the latest significant legislative initiative being the Retirement Protection Act (RPA) of 1994. The Internal Revenue Code also promotes adherence to minimum standards by laying down requirements of qualified plans on lines similar to ERISA. Pension plans are required to meet a minimum funding standard for each

plan year. In the case of a defined benefit pension plan, an employer must contribute an annual amount sufficient to fund a portion of participants' projected benefits determined in accordance with one of several prescribed funding methods, using reasonable actuarial assumptions. Plans with asset values of less than 100 percent of current liabilities are subject to additional, faster funding rules. A plan which does not meet the qualification requirements of IRC may lose its qualified plan status and consequently its tax-exempt status. Contributions to such plans may not be tax deductible. In the United States, the Pension Benefit Guarantee Corporation (PBGC) set up under ERISA, guarantees the benefits payable under defined benefit plans, subject to certain limits specified in law. An employer of an insured defined benefit plan is required to pay annual insurance premium per participant to PBGC. The insurance premium was initially a fixed sum per plan participant. OBRA 1987 introduced an additional variable premium related to the underfunding of the plan. The premiums were gradually increased and after the enactment of RPA in 1994 remain at \$19 basic per participant and a variable rate of \$9 per each \$1,000 of the plan's unfunded vested benefits RPA also changed the way underfunding is calculated by specifying that liabilities should be calculated using a standard mortality table and a market-related interest rate of 85 percent of the spot rate for 30-year Treasury securities. After the year 2000, plans will be required to use a new mortality table prescribed by the Secretary of Treasury. At the same time, the interest rate will rise to 100 percent of the Treasury spot rate and a requirement to use fair market value of plan assets (rather than actuarial value) will become effective. RPA requires most employers whose plans are less than 90 percent funded to provide a notice to participants regarding the funding status of the plan and the limitations of PBGC's guarantee of participants' benefits. ERISA provides severe sanctions against an employer who fails to meet the funding obligations. Any employer who fails to comply with the minimum funding requirements is charged an excise tax on the amount of the accumulated funding deficiency, unless the employer receives a waiver of the minimum funding requirements. This tax is imposed whether the underfunding was accidental or intentional. Certain actions can also be taken by the Department of Labour and the PBGC to enforce the minimum funding standards.

4.2 Impact of FASB 87

FASB 87 issued by the Financial Accounting Standards Board in 1985, after years of debate, has made a significant change in the way pension costs are accounted in an employer's balance sheet. The statement is based on the premise that the pension cost of an employer goes beyond what he contributes to the plan in a year. A major change introduced by the accounting

standard is the use of market interest rates on long term bonds for calculation of net present value of expected future obligations of a pension fund. In the past, the discounting rate was assumed by the actuary. This is based on the belief that markets undoubtedly have more accurate view as compared to the view of a single individual or organisation, however judicious it may be. An actuary's assumption of interest rate may be based on smoothness in change and hopefully conservative, but the market rates are far more objective. The result is a change in pension fund surplus or deficit due to changes in market interest rates. Assumptions of mortality and wage growth, however, remain the domain of the actuary.

The present value of pension benefits that have accrued to the present employees and retirees based on current wages and current interest rates is required to be calculated and termed Accumulated Benefit Obligation (ABO). Essentially, this is the size of the annuity to be purchased for these employees assuming immediate termination of the plan and based on the vested benefits as on the date. Any shortfall in the market value of pension assets as compared to ABO is required to be recorded as a balance sheet liability of the employer. Total pension expense in a given year is the sum of service cost, the net interest expense, and the amortisation costs for the year. Projected Benefit Obligation (PBO) should be calculated based on projected salaries, including any adjustments for projected increases in cost of living. Increase in any given year due to benefits earned in that year is the service cost for that year. Net interest expense is interest on PBO less expected return on plan assets. Amortisation costs result from (a) an initial balance sheet transitional surplus or deficit that is amortised over the future service life of active plan members, (b) prior service costs resulting from plan amendments are similarly amortised, and (c) actuarial gains and losses arise due to differences between actual plan experience and projected plan experience. Plan experience assumptions should reflect "best estimates". Specifically, the discount rates to determine service cost, PBO and interest thereon should be a market-related long-term interest rate. The expected plan assets return should represent management's best estimates, given the chosen asset mix policy. The salary growth projection should reflect productivity and inflation growth consistent with the discount rate and expected plan assets return. There has been debate on whether the methodology prescribed by FASB results in a fair statement of financial implications of a pension fund in an employer's balance sheet. The Statement itself admits that pension fund accounting is evolving and could change as experience is gained. Whatever could be the arguments about specific methodology, FASB has focussed the corporates' attention squarely on maintaining the funding levels of their pension funds by requiring deficits in funding balance of pension funds to be disclosed and recorded in sponsor's balance sheet. It has brought the realisation that in many companies, the size of their pension funds being so large, pension surplus or deficit can significantly affect their

earnings.

4.3 Minimum Funding Requirement in UK

In UK, the Pensions Act, 1995 lays down the minimum funding requirements for occupational pension schemes. As part of transitional arrangement, in the case of underfunding, it lays down provisions to meet the requirement over the next few years. Trustees are required to obtain an actuarial valuation every three years. The actuary must also provide a certificate stating whether or not in his or her opinion the contributions payable to the scheme are sufficient for the purposes of securing the Minimum Funding Requirement. This is a statutory requirement, which imposes a basic minimum that the value of the assets of the scheme is not less than the amount of the liabilities of the scheme. For this purpose, liabilities are to be calculated by reference to cash equivalents rather than the cost of buying deferred annuities. The actuary to the scheme will carry out the Minimum Funding Requirement calculations in accordance with professional guidance notes. The trustees will have to obtain an annual certificate stating that the contributions are adequate to ensure the Minimum Funding Requirement is met throughout the period. Where on a valuation, the value of the scheme's assets is less than 90 per cent of the scheme's liabilities, such a shortfall must be made up, under transitional arrangements, by the year 2003. Where the shortfall is between 90 per cent and 100 per cent, then it must be made up by the year 2007. Thereafter, where a valuation shows the assets at less than 90 per cent, the Principal Employer must secure the increase within one year of the date on which the valuation was signed. If at the end of any prescribed period the Minimum Funding Requirement is not met, the trustees must prepare a report giving prescribed information to the Occupational Pensions Regulatory Authority, which is the regulatory authority set up under the Pensions Act, 1995.

5 INDIAN PRACTICE

Most pension funds in India require actuarial valuation of the fund to be carried out at regular intervals. Some funds may do it every year while others may do it once in three years. There are no disclosure requirements, penalties or mandatory additional contributions in the case of underfunded plans. The reason perhaps is that underfunding has not yet become a serious issue in India and most pension plans are in the public sector where the sponsors are generally expected to discharge their obligations. However, we will need to set in place a framework on the lines of ERISA and FASB so

that adequate safeguards exist in the case of underfunding and trustees focus attention on the risks that can cause underfunding in their pension plans.

Pension Fund Risk

To the extent that assets and liabilities of a pension fund are not fully matched, the fund would be exposed to the following types of risk, which could cause underfunding.

1. Reinvestment risk: Pension fund liabilities normally have a longer average duration than its investments. This would expose the fund to reinvestment risk due to duration mismatch. In India, for instance, pension funds tend to invest in bonds of 5-7 years' maturity, while the average duration of their liabilities could be, say, even 30 years. At the time the investment is rolled over, interest rates could be lower or higher. Pension funds in India normally invest in regular coupon-paying bonds rather than cumulative or zero-coupon bonds, which also exposes them to reinvestment risk. Of course, it is important to remember that the investment decisions are often driven by the availability of instruments, the degree of development of capital markets and the prevailing regulations.
2. Inflation risk: As pension benefits are based on salary at the time of retirement, the pension fund is exposed to inflation risk as future wages can reasonably be expected to grow with inflation. Some funds also index pensions to inflation. Inflation indexed bonds would possibly best cover this risk. A portfolio of floating rate bonds may also cover this risk to a great degree since their coupons can be expected to have high correlation with inflation. Equity values may also be expected to move in line with inflation over a long period, though they would exhibit high short-term volatility. While the investment pattern in India does not allow investment in equities, it permits investments in fixed rate or floating rate bonds. Despite such instruments being offered by some of the financial institutions, no significant investment has been witnessed in floating rate bonds by pension funds based either on interest rate view or to manage risks. Funds in India are driven more by the need to achieve a return similar or better than their biggest "peer", the government provident fund.
3. Interest rate and price risks: Fluctuations in interest rates affect the returns of the fund and its asset values, while its future liabilities are fixed and do not vary with interest rates. Actuarial valuations in India carried out at the time of plan structuring often assume a return of 12% on the funds, which is reflective of the current interest rates, the current investment pattern and the benchmark return of the government provident fund. Changes in interest rates and changes in investment pattern could result in a return different from such assumption. In all marketable securities, there is price risk as values change. Funds in India are not required to mark their securities to market, which leads to a lack of appreciation of price risk in the marketable securities held by the fund. It also distorts interest rate view. For example, if a fund manager expects interest rates to go up, he should normally invest in a short-term instrument such as a treasury bill and then lock-in for a longer period after the rates firm up. However, since marking to market is

not required and the fund manager is judged by his current yield, there is incentive to invest in long-term paper even when interest rate view is bullish. The depreciation in asset value caused by the investment manager's decision is neither computed nor is he required to explain. Not marking the portfolio to market also exposes the fund to serious risk if the portfolio has to be liquidated for some reason (in the case of a large VRS, for example). Indian pension funds would possibly represent a unique situation where fixed income portfolios of thousands of crores of rupees are managed without having to take an interest rate view.

4. Credit risk: A pension fund would be exposed to default risk when it invests in fixed income securities. Since the investment pattern in India has been prescribed with a view to ensuring the safety of funds, this risk is manageable and no large-scale losses have been incurred by pension funds due to defaults. However, with several industries facing fluctuating fortunes and government finances coming under strain, management of credit risk is becoming increasingly important. However, few pension funds in India are equipped to carry out detailed credit evaluation. They are guided more by perception, name recognition and credit rating.
5. Real wage growth risk: Pensions would grow with increase in real wages, which may broadly move in line with gains in productivity. Usually, only equity values could be expected to move in line with gains in productivity in the industry and economy in general. Pension funds in India are not allowed to invest in equities.
6. Insurance risks: As defined benefit plans are also partly insurance schemes, they bear all the insurance risks. A cure for cancer, for example, could be a boon for all individuals, but could significantly increase life expectancy and put their pension plans in risk of insolvency. A fund is also exposed to risk to the extent that assumed mortality rates and birth rates are different from the actual rates for the group of people the plan covers.

Risk in relation to fund's mission

As risk is defined as the possibility of not achieving the fund's mission, it is important that the above risks be evaluated in the context of the fund's defined mission. A fund whose mission calls for minimising fluctuations in return may view high allocation to equities as very risky; while another whose mission requires benefit adjustments to maintain relative living standards of participants may view investment in equities as less risky.

Risk tolerance

Risk tolerance expresses willingness to bear adverse outcomes in the pursuit of the fund's mission. It reflects the trade-off between the probability of failing to achieve the fund's mission and the reward derived from achieving the mission in excess of expectations. Whose risk tolerance should the fund consider while determining the investment policy of the fund? Ideally, it should be that of the person(s) who bear the risk of the fund. In

EPS 1995, for example, since the Central Government bears the risk, the risk tolerance of the Government should determine investment policy. In RBI/IDBI schemes, since the sponsors bear the risk, they should ideally set the asset allocation and management strategy. In practice, however, it is difficult to specify a plan sponsor's risk tolerance as decision-makers often have trouble expressing their risk sensitivity. However, it is important to specify in writing the risk tolerance of the fund, which will serve as a guide to investment managers. Sometimes, questionnaire and simulation techniques are used to assist in expression of risk tolerance. The following is an example of Risk Tolerance statement of the Minnesota State Board of Investment (Source: Investment Policy: The Missing Link by Jeffery Bailey): "The Board views its tolerance for risk in managing the BRF's assets to be relatively high. Given the BRF's adequate funding and its middle-aged participant demographics, the Board takes a long-term view in establishing the BRF's risk-return exposure. As a consequence, the Board has adopted an aggressive, high expected return investment program consistent with the BRF's mission statement. The Board is willing to accept volatile short-term investment results with the expectation that the volatility will be more than compensated by superior long-term performance."

Risk tolerance and plan demographics

A sponsor's risk tolerance depends not only on his own assets, profitability and the ability to bear risk, but also on the demographics of the plan participants and the structure of the plan. For example, a defined benefit plan with a younger workforce has a longer time horizon and a much higher risk bearing capacity. It can assume more risk, expect to generate higher returns and its asset allocation policy can be more stable.

Risk tolerance in India

Funds in India have not had to define their risk tolerance in a formal way. Statements of risk tolerance have sometimes found expression in their investment policy where some funds have, for example, decided to invest in only AAA rated securities. This view of risk tolerance is, however, purely asset-side oriented.

5.1 Investment Policy

Specification of a clear investment policy is key to achieving good investment performance. It helps to define the investment objectives and long-term strategy of the fund and prevents ad-hoc shifts based on market conditions. Investment policy is a combination of philosophy as well as planning. Pension fund sponsors in the United States have, over the years, succeeded in bringing professional management and advanced technology to manage the

Objective	Target
Maximise expected return	12%
Maintain funding ratio	100%
Minimise expected return volatility	2.5%
Minimise funding ratio volatility	10%
Achieve real rate of return	3%
Minimise variance in return with reference to peers	3.5%
Minimise variance in return with reference to benchmark	5%

Table 1: Objectives of pension funds

large assets under their plans. From sophisticated valuation models to program trading, they have today access to an overwhelming array of investment management tools with which to compete in the highly complex global capital markets. With such a wide canvas, a well-defined investment policy will force conscious choices after proper evaluation of goals and risks. A good investment policy statement would specify the investment objectives, the broad asset classes in which funds would be invested, the target investment levels and permissible ranges for each asset class and the appropriate market benchmarks against which performance will be measured. The investment policy would naturally derive from the fund's mission, a comprehensive risk analysis and its risk tolerance.

Investment Objectives

A fund's investment objectives would comprise a specific list of quantifiable investment results expected to be achieved over a specified period. What could be the possible investment objectives of a pension fund? In an asset-only framework, the objective would be to maximise expected return on investment while minimising its variability (i.e. standard deviation). However, once liabilities are also considered, it becomes important to maintain a funding ratio. Another objective would be to minimise the level of variability in funding ratio as it would affect the sponsor's balance sheet. Further, a pension fund may have target real rate of return to cover inflation risk and evaluate performance with reference to peers as well as benchmark. A pension fund may, therefore, draw up multiple objectives in order of priority as shown in Table 1

A pension fund may specify investment objectives for the fund as a whole, for each asset class as well as for each investment manager.

Asset Class	Benchmark	Target (%)	Range (%)
US Equities	Wilshire 5000	30	16-44
Foreign Equities	Adjusted EAFE (50% Hedged)	39	14-53
US Fixed Income	Salomon Big	7	0-20
Foreign Fixed Income	Adjusted Hedged Salomon World	11	0-20
Corporates	SBHY Cash Pay	2	0-18
Private Equities	Brinson Partners	5	2-7
Real Estate	NCREIF Property	6	3-10
Cash	3 Month LIBOR	0	0-10

Table 2: Investment Policy of World Bank Pension Plan (1996)

Asset Class	Benchmark	Target (%)
US Equities	Wilshire 5000	60
US Bonds	Salomon Broad Bond Index	24
Real Estate	Wilshire Real Estate Index	10
Venture Capital	Not specified	2.5
Resource Funds	Not specified	2.5
Cash Equivalents	90-day Treasury Bills	1

Table 3: Asset mix of the Minnesota State Board

5.2 Target Asset Allocation

Research has shown that a fund's asset allocation determines its investment performance more than any other factor. Active management strategies such as stock picking, sector weightage and trading strategies have been shown to contribute relatively less to investment performance. How well a fund achieves its objectives is, therefore, determined by how well its trustees have drawn up a long-term asset allocation policy. The investment policy of the World Bank pension Plan for 1996 shown in Table 2 is an example of how target asset allocation could be stated (Source: Pension Investment Decisions by Sudhir Krishnamurthi and Arun Muralidhar, World Bank)

The Minnesota State Board has a policy asset mix given in Table 3. The Board targets a real rate of return of 3-5% over a 10-year rolling period and aims to exceed composite benchmark return over a 5-year rolling period, with active management. The fund maintains a high equity exposure to achieve targeted real rate of return and considering its high risk tolerance.

5.3 Active v. Passive Management

Once asset allocation is specified, trustees will need to further choose between active and passive asset management. An investment objective of beating the appropriate benchmark index would naturally entail active management. However, trustees often divide their assets between active and passive management. An active manager typically seeks to beat the benchmark by pursuing a distinct style (e.g. by sector weighting based on his research).

Managing Asset-Liability risk through Asset Allocation

Apart from being an expression of risk-return trade off on the assets side, a fund's target asset allocation also determines how the fund would hedge its risks. The relative advantages and disadvantages of each asset class would need to be weighed. Long-term bonds may provide the best hedge against variability of pension fund surplus, since the future obligations are discounted at current long-term interest rate. However, long-term fixed rate bonds are a poor hedge against inflation and productivity gains, which drive real wage growth. Treasury bills or floating rate bonds tend to provide better hedge against inflation, but cause high variability in income streams as well as funding ratio. Equities may provide a better expected rate of return over a long period, but cause short-term fluctuations. In asset-liability management, the aim should be to match fixed income assets with fixed amount obligations where the estimate of liability has a high degree of certainty and employ variable income assets to match variable amount obligations where the estimate of liability has a high degree of uncertainty.

Asset Allocation and Plan Demographics

A plan with a mature workforce lends itself to a more certain estimate of its liabilities and will usually have lower inflation and wage growth risks to cover. Such plans have an incentive to favour long-term bonds. A plan with a young workforce tends to have a higher degree of uncertainty in its future obligations. It will also have a longer time horizon and an incentive to hold a more aggressive asset mix with an emphasis on equities. But such a plan, while having a better chance of meeting its obligations in the long term, is exposed to short term fluctuations in funding ratio as equities are volatile and consequently affect the sponsor's balance sheet.

Asset Allocation in India

Pension fund managers in India do not need to worry about such dilemmas, since asset allocation is prescribed by the government.

a)	Central Government Securities	25%
b)	State Government Securities and securities guaranteed by Central or any State Government	15%
c)	Bonds/Securities of public financial institutions and public sector companies including public sector banks and certificates of deposit of public sector banks	40%
d)	In any of the above categories as may be decided by the trustees	20%
e)	Trustees may, subject to their assessment of risk-return prospects, decide to invest 10% out of d) above in bonds/securities of private sector companies rated as investment grade by at least two rating agencies	10% out of 20% in d) above

Table 4: Investment pattern prescribed for pension funds

At present, the investment pattern prescribed for pension funds is shown in Table 4

The investment pattern above should be followed as under:

1. Fresh accretions to the fund and redemption amounts of investments made earlier should be invested as per the proportions specified above.
2. Interest received under each category should be reinvested in the same category, without reference to the above pattern. More particularly, interest received on Special Deposit Scheme should be reinvested in the Special Deposit Scheme.
3. The prescribed asset allocation in India has two objectives:
To ensure safety of funds by disallowing investment in ‘risky’ assets such as equities. Investment in public sector undertakings is seen by the government as safer compared to investment in private sector companies.
4. To direct pension fund investments into channels desired by the government.

5.4 Safety of funds

Does the regulated investment pattern really ensure safety? The investment pattern seems to equate “public sector” with safety irrespective of the actual credit rating of the enterprise. The guidelines allows investment in any public financial institution or public sector company without reference to its rating. Even in the recently introduced 10% allocation to private sector, the minimum rating has been specified as investment grade which makes a wide spectrum of companies eligible for investment by provident and pension funds. Even greenfield projects are given minimum investment grade

rating of BBB- by the rating agencies. The guidelines actually place lot of responsibility on trustees to ensure safety of funds.

Asset allocation over the years

The government has been liberalising the investment pattern of pension and provident funds over the years. Table 5 shows the prescribed pattern at various points in time and gives an idea of the changes which have taken place in investment pattern over time.

The following observations emerge from an analysis of the liberalisation of the investment pattern:

1. The proportion of direct resource mobilisation by the government from the pension and provident funds has come down over the years, with a corresponding increase in flows to government enterprises. Direct pre-empting by the government has come down from as high as 85% in 1986 to a minimum of 25% today (the 15% state government allocation can also be invested in government enterprises carrying government guarantee).
2. The government has also gradually increased the proportion of funds raised by it at market-determined interest rates as compared to pre-emption at an administered interest rate. Investment in Special Deposit Scheme (which carries interest at a fixed rate of 12%) has come down from 70% in 1986 to zero today out of the fresh accretions.
3. The biggest beneficiaries have been all-India financial institutions and several central PSUs who have drawn from the larger allocation available to them. Many state government enterprises such as electricity boards, water and irrigation boards, road development corporations etc have also been making bond issues in the last few years targeted at pension and provident funds. After years of debate, just this year, the private sector has been able to get an allocation of 10% out of the fresh accretions.

Should asset allocation be regulated?

Case for regulation

If the primary purpose of pension and provident funds as compulsory savings devices is to ensure some minimum income for an individual in his post-retirement years, there is case for regulating investments so that the income is actually available during those years. A regulated investment pattern with emphasis on the highest safety and reasonable return on investments would be justified for this reason. This is particularly true of provident funds, where the benefits are not guaranteed. The system has worked well for over three decades. People feel confident that their provident fund is one of the safest avenues. There have not been cases of losses

	1963	1967	1985	1986	1995	1996	1997	1998
Central Govt. Securities	90%	Not less than 80%	Not less than 15%	Not less than 15%	25%	25%	25%	25%
State Govt. Securities		Not exceeding 20%	Not less than 15%	-	15%	15%	15%	15%
Govt. guaranteed bonds			Not less than 15%	Not less than 15%	Incl. 15% above	Incl. in 15% above	Incl. in 15% above	Incl. In 15% above
7 year National Savings Certificates or Post Office Time Deposits			Not exceeding 40%					
Special Deposit Scheme			Not exceeding 30%	Not exceeding 85%	30%	20%		
Bonds of public financial institutions and PSUs					30%	40%	40%	40%
In any of the categories as may be decided by the trustees							20%	20%
Private sector bonds/securities								10% out of 20% above
Cash	10%							

Table 5: Investment pattern of pension and provident over the years

among provident funds in these years. If a provident or pension fund is not confident of achieving the minimum return, it always has the option to hand the management over to the government. The government can channelise the funds into avenues desirable for national development while ensuring safety. Most of the pension and provident funds are managed in-house by the sponsoring companies. Professional fund management skills have not yet developed in these segments. Even professional fund managers have not been able to inspire public confidence as proven by the experience of mutual funds. Complete liberalisation in such a context could lead to adventurous management with potential loss of money and confidence.

Case against regulation

As we have seen, asset allocation is an involved process derived from investment mission, risk analysis and risk tolerance. It also depends on the particular characteristics of an individual fund. A regulated investment pattern may militate against the objectives of the fund exposing it to greater risk. A pension fund may not be able to pay promised benefits and a provident fund may not achieve an adequate replacement rate with respect to pre-retirement income. A regulated asset allocation is unfair to the sponsors who take risk. For example, in the pension schemes of RBI, IDBI and the commercial banks, the sponsors take the risk of making additional contributions in case of underfunding. But the sponsors do not have any control over asset allocation and have to bear the consequences of a regulated investment pattern. A regulated pattern may be dictated by the funding needs of the government and government enterprises rather than the interests of the plan beneficiaries. In a defined contribution plan such as the provident fund, there could be an argument that the individual should be able to determine his investment choice based on his own risk preference. In a regulated asset allocation system, there is only one right way to achieve a fund's objectives: the government's. A free system would promote different strategies for management of funds, which could be superior in achieving the fund's objectives.

6 IMPROVING YIELD WITHOUT SACRIFICING SAFETY

While there are merits and demerits of regulated investment pattern, it is important to remember that the only major classes of investments in India, which a pension fund is not allowed to invest, are:

Equities

Mutual funds

Real estate

Bank deposits (fund can invest in bonds of public sector banks)

International securities

Investment in international securities would involve macro-economic policy decision on capital controls. Bank deposits in India generally give lower return than institutional and PSU bonds or even long-dated government securities. Even if equities, mutual funds and real estate are permitted, many trustees may not necessarily view them as means to increase yield, without significantly increasing risk.

6.1 Unlocking Special Deposits

More scope exists for increase in yield within the present asset classes, by applying the investment pattern percentages on total corpus rather than on fresh accretions. Due to the historical investment pattern, most funds have large amounts locked up in investments such as Special Deposits which yield lower return (12% annualised) as compared to other categories. Funds such as EPF and CMPF are estimated to hold as much as 75-85% of their corpus in Special Deposits. Government has been extending the maturity date of Special Deposits and has been requiring the interest to be redeposited in Special Deposits. These deposits are also not tradable and hence cannot be sold. A significant yield improvement can be achieved by “unlocking” the Special Deposits. The government will need to draw up a plan for gradual repayment of these deposits. A possible plan could be: Annual interest on Special Deposits can be allowed to be invested as per the current investment pattern

Outstanding principal may be repaid over a period of seven years, partly by conversion into central government securities at market-determined interest rates and partly into other permitted securities.

Special Deposit Scheme could be retained as an optional scheme as an alternative to central government securities. In a mark-to-market system, a guaranteed return of 12% may not necessarily be a bad return in an uncertain government securities market.

It is difficult to address the issue of improvement in yield without addressing the issue of Special Deposits.

6.2 Increasing allocation to private sector

There is lack of good quality public sector paper, since the best rated PSUs are cash-rich and do not tap the market often. Only public financial institutions are in the market at all times. As a result, pension and provident funds have highly concentrated portfolios. Increasing the allocation to private sector is needed for the funds to diversify their holding. Private corporate securities tend to carry a higher yield, but also carry a higher risk as compared to institutional bonds.

Apart from the above, only active management can increase the yield on funds. Active management (discussed later below) also increases risk.

6.3 Institutionalising good pension fund management practice

More than liberalisation of the investment pattern, which exposes funds to more risks, it is far more important to institutionalise good pension fund management practice in India. A strong regulatory framework that would ensure efficient management of funds and provide for a high standard of supervision would, in fact, be a pre-requisite to freeing the investment pattern from regulation and possible privatisation of pension funds. All the regulatory changes in pension and provident fund area in the past years have focussed on the investment pattern rather than management practice. Some of the measures that are needed to be introduced in India are discussed below.

6.3.1 Statement of Investment Policy

Trustees should be required to draw up a Statement of Investment Policy which documents their investment objectives and strategy for risk management. The statement should cover such matters as risk tolerance of the fund and acceptable credit risk, diversification strategy and exposure limits, etc. The requirements in UK under the Pensions Act 1995 is a useful guide in this regard. In UK, the trustees must prepare, maintain and, from time to time revise, a written statement of the principles governing decisions about investments for the purposes of the scheme, called the Statement of Investment Principles. Before the statement is prepared or revised, the trustees must obtain the written advice of a person authorised under the Financial Services Act 1986 and with the appropriate knowledge and experience and consult with the employer. The statement must include the trustees' policy with regard to:

1. Ensuring compliance with the need for diversification of investments;
2. Ensuring regard to the suitability of classes of investment and individual investments within each class;
3. Taking advice, reviewing investments and following the principles set out in the Statement of Investment Principles;
4. The types of investments to be held and the balance between the different types of investment;
5. The risks and expected returns;
6. How investments are to be realised; and
7. Ensuring compliance, where relevant, with the minimum funding requirement

The Trustees Annual Report must include information concerning the Statement of Investment Principles and details of any investments not made in accordance with the Statement of Investment Principles. When selecting investments, the trustees or the investment manager acting on behalf of the trustees, must exercise their investment powers in compliance with the Statement of Investment Principles.

6.3.2 Principles of Accounting and Actuarial Valuation

India needs to introduce accounting standards for pension funds. Pension and provident funds need to mark their assets to market, which will focus attention on the nature of investments to hold and active management. Marking to market may cause higher fluctuations in yearly returns, which can be addressed through a Dividend Equalisation Reserve. Similarly, actuarial principles need to be made uniform. As we have seen, in the US, the law has laid down principles for adoption of discounting rate and mortality tables.

6.3.3 Benchmark Returns

At present, a pension fund cannot evaluate its investment performance in the absence of a benchmark with which to compare. Development of benchmarks for bonds and government securities will possibly happen with the development of those markets. In the meantime, it would be useful for EPFO to take initiative in regard to development of performance benchmarks. EPFO should publish uniform guidelines on computation of asset yields, average returns and portfolio risk. All provident and pension funds should be required to report their yields to EPFO, which may publish summary information. This would serve as benchmark for trustees to evaluate the performance of their own funds.

6.3.4 Minimum Funding Requirement

A minimum funding requirement of 100% needs to be introduced for defined benefit plans. A sponsor of a defined benefit plan should be required to make additional contributions in the case of underfunding and recognise the underfunding as a liability in his balance sheet. An underfunded plan needs to make adequate disclosures to plan participants and report to the regulatory authority, say, the EPFO.

6.3.5 Target Replacement Rate

Provident funds hold larger assets compared to pension funds in India. Provident funds in India aim to generate a return comparable or better than the government provident fund. They do not have any target replacement rate. It would be useful to require provident funds to disclose the replacement rate of participants' income they are likely to achieve based on an actuarial evaluation. This disclosure can be made every two years and will give a clear indication of how well the funds are able to achieve their objective of providing for a participant's retirement years.

6.3.6 Active Management

At present, pension and provident funds in India are not allowed to sell securities excepting when they have settlement liabilities greater than their monthly contributions. The funds, therefore, hold all securities they purchase till maturity. There is no concept of active management. As a result, funds are unable to restructure portfolios based on interest rate view (e.g. shifting from long-dated securities into short-dated or vice versa) or to manage exposure (e.g. a company's profitability may start to deteriorate, but the fund cannot reduce exposure to the company by selling some securities). Funds need to be given choice as to whether they would like to manage their assets passively or actively. Even in markets where the trustees have complete freedom to determine investment policy, it is usual to find a part of the assets being managed passively. Active management also exposes a fund to "active risk" which is the risk that through active management, a fund may achieve better or worse results as compared to passive management.

6.3.7 Disclosure Requirements

Indian pension funds are not subject to strict disclosure requirements to their members. Basic information about the scheme should be made available to all members at the time of joining. An annual statement of the fund's operations including its investment performance and funding status should be prepared and communicated to all members. A statement of benefits vested should be given to each employee at the end of every year. As in UK, the actuarial valuation report and the Statement of Investment Principles should be open to inspection by members.

6.3.8 Standards of Efficient Administration

Trustees should be required to lay down standards for administration, such as the time within which a claim is processed. A procedure should also be established for handling complaints.

6.3.9 Leadership Role

Funds such as EPF, which have the government's backing and the ability to take risks, need to assume leadership role in setting in place good fund management practice in India in areas such as declaration of investment policy, risk management strategies, active asset management, ensuring minimum funding levels, customer service standards etc. Provident and pension funds in India are driven by EPFO guidelines, the way commercial banks are driven by RBI guidelines.

Pension Funds where the sponsors take full risk and are financially strong (such as RBI, IDBI and commercial banks) can straightaway be given full freedom to invest including in equities and, to a limited extent, in overseas securities. These funds should, however, be required to adopt high standards of management and disclosure practices.

However, it is critically important to set in place a strong regulatory framework including a clear definition of fiduciary responsibilities.

6.3.10 Fiduciary Responsibilities

Pension and provident funds in India are set up as trusts and are subject to the Indian Trusts Act. Organisational set-up as a trust ensures that the assets of the fund are maintained separate from the employer and the trustees are bound by the general provisions of trust law contained in the Indian Trusts Act.

While examining whether fiduciary responsibilities in India are adequate, it would be useful to study the relevant provisions in the US and UK.

Fiduciary Duties in US under ERISA

The Employees' Retirement Income Protection Act 1974 (ERISA) lays down the governing framework for employee benefit plans in US. The Pension and Welfare Benefits Administration under the Department of Labour is responsible for administration of ERISA. The following are the ERISA provisions relating to fiduciary duties.

Who is a fiduciary?

ERISA lays down the duties and responsibilities of fiduciaries of employee benefit plans. ERISA defines a fiduciary in a much broader context as compared to India. ERISA defines a fiduciary as anyone who exercises discretionary control or authority over plan management or plan assets, anyone with discretionary authority or responsibility for the administration of a plan, or anyone who provides investment advice to a plan for compensation or has any authority or responsibility to do so. Plan fiduciaries include, for example, plan trustees, plan administrators, and members of a plan's investment committee.

Power to engage advisors and investment managers

Any employee benefit plan may provide that

any person or group of persons may serve in more than one fiduciary capacity with respect to the plan (including service both as trustee and administrator)

a fiduciary may employ one or more persons to render advice with regard to any responsibility such fiduciary has under the plan

a fiduciary with respect to control or management of the assets of the plan may appoint an investment manager(s) to manage any assets of the plan.

Prudent man standard of care

ERISA requires of plan fiduciaries prudent man standard of care as follows:

1. A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.
2. A fiduciary shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
3. A fiduciary shall diversify the investments of the plan so as to minimise the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
4. A fiduciary shall discharge his duties in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with law.
5. It may be particularly interesting to note that ERISA specifies diversification, which would normally be considered to be in the purview of investment management strategy, as a duty of a prudent fiduciary.

Liability for breach of fiduciary duty

A fiduciary who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries shall be personally liable to make good to the plan any losses to the plan resulting from such breach, and to restore to the plan any profits which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. Any provision in an agreement or instrument which purports to relieve a

fiduciary from liability for any responsibility, obligation, or duty shall be void. However, it is permissible for

1. A plan to purchase insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary
2. A fiduciary to purchase insurance to cover liability under this part from and for his own account
3. An employer or an employee organisation to purchase insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan.

ERISA also specifies limitation period with respect to action against a fiduciary for breach of duty. No action can be initiated six years after violation, or three years after the plaintiff had actual knowledge of the breach or violation, whichever is earlier. In the case of fraud or concealment, such action may be commenced not later than six years after the date of discovery of such breach or violation.

Liability for breach of co-fiduciary

ERISA provides for liability upon a fiduciary for breach by their co-fiduciaries in certain circumstances. A fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan

1. If he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach
2. If, by his failure to comply with fiduciary duties in the administration of his specific responsibilities, he has enabled such other fiduciary to commit a breach
3. If he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.
4. If the assets of a plan are held by two or more trustees, each shall use reasonable care to prevent a co-trustee from committing a breach. They shall jointly manage and control the assets of the plan.

A trust instrument may expressly provide for allocating fiduciary responsibilities among fiduciaries, or for them to designate other persons to carry out fiduciary responsibilities. In such a case, a fiduciary shall not be liable for acts or omissions of other persons.

Investment managers

If an investment manager has been appointed, no trustees shall be liable for the acts or omissions of such investment manager, or be under an obligation

to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.

Conflict of interest

A fiduciary with respect to a plan shall not

1. Deal with the assets of the plan in his own interest or for his own account,
2. In his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or
3. Receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

Fiduciary Duties under the Pensions Act in UK

Duties of trustees of the occupational pension schemes in UK are governed by both the general trust law as well as the law relating to pensions. The principal legislation affecting the pensions is the Pensions Act 1995 which lays down the governing framework for occupational pension schemes. These schemes are regulated by the Occupational Pensions Regulatory Authority (OPRA) set up under the Act.

Duty to act in accordance with law and trust deed

Trustees are required to act both within the framework of the law, and in accordance with the trust deed and rules.

Duty to act in the interest of the beneficiaries

The fundamental duty of a trustee is to serve all the different classes of beneficiary fairly. It is not the role of a trustee to represent the interests of any particular group or party, such as the employer, pensioners or a trade union. Trustees' duties relate to the provisions of the trust and its beneficiaries. Separate issues such as negotiations about pension benefits between the employer and workforce representatives are not the business of the trustees or trustee meetings, even though some trustees may be involved in these issues in different roles.

Duty to act prudently, conscientiously and honestly

Trustees have a fundamental duty to act prudently, conscientiously and honestly. Trustees must act in good faith and not make any personal profit at the expense of the trust fund. In order to avoid any conflict of interest, trustees are forbidden from buying assets from or selling assets to the fund. The duty to act prudently is particularly relevant when dealing with the

scheme's investments. It means acting in the way that a prudent person would in relation to their own affairs, such as considering the risks involved, obtaining and acting upon appropriate professional advice, and diversifying the scheme's investments

Trustees duties include the taking advice on any matters which they may not understand and on technical issues which may affect the scheme.

The trustees must consider the circumstances, having taken account of all the relevant facts, without prejudice, seeking professional advice if necessary. But care should be taken in recording and announcing the reasons for the decision, which could be challenged in the courts. Trustees may find it helpful to set standards of service for themselves and their advisers. Trustees cannot absolve themselves of responsibility by delegating their duty to make decisions to professional advisers.

Administrative duties of trustees

Trustees have the duty of appointing the professional advisers to the scheme, in particular the auditor, actuary, legal adviser and fund manager. Where trustees are required to take advice, they should do so only from the advisers they have appointed. Any trustee placing reliance upon advice taken from a professional adviser not appointed by the trustees can be suspended, removed or penalised by the Occupational Pensions Regulatory Authority. Trustees must establish procedures for dealing with disputes and nominate a person to hear complaints and make decisions. Details of internal dispute procedure must be communicated to all members. If the internal procedure does not solve their complaints, members can apply to the Ombudsman or to the Occupational Pensions Advisory Service.

Appointment of investment managers

Trustees have a duty to take expert advice on matters where they need help. This will normally apply to the duty to invest. For investments which are covered by the Financial Services Act 1986, trustees will need advice from a person who is properly authorised to carry out investment business. For other investments not covered by the Financial Services Act 1986, the trustees will need to be satisfied that the person from whom they take advice has appropriate knowledge and experience.

Under the Financial Services Act 1986 it is a criminal offence for a person who is not properly authorised to carry on investment business. This means that anyone involved in the day to day management of the pension scheme's investments, or anyone giving advice on investments, must be authorised to do so. It is unusual for a board of trustees to seek authorisation under the Financial Services Act 1986. In practice, most trustees delegate the work of investment management to an authorised investment manager. Usually the investment manager will be authorised by the Investment Management Regulatory Organisation (IMRO). As with other professional advisers, the investment manager must be appointed by the trustees in writing. In addition, the Financial Services Act 1986 requires the trust to have a formal

agreement with the investment manager setting out the investment needs and responsibilities.

The trustees will not be held responsible for any mistake made by the investment manager, provided you have made sure that they:

1. Are authorised under the Financial Services Act 1986;
2. Have the appropriate knowledge and experience for managing the investments of the scheme; and
3. Carry out their work competently and in accordance with your instructions regarding suitable investments.

This delegation of decisions about investments covered by the Financial Services Act 1986 is an exception to the general law of trust that trustees cannot delegate their responsibility to make decisions.

Although the trustees may delegate the day-to-day investment decisions to the investment manager, they remain responsible for:

1. The investment strategy with which the manager must comply; and
2. Ensuring that the manager is a suitable person to carry out the investment business of the scheme on their behalf.
3. Other duties which the trustees must carry out

In addition to the general duties of trusteeship, trustees have a number of specific duties and tasks. The Pensions Act 1995 clarified a number of the trustees' tasks. The main tasks include ensuring that:

1. The right benefits are paid out at the right time;
2. Accurate records of past and present members are maintained;
3. Full and proper accounts are kept, and reported to the Inland Revenue for any tax which is due or has to be deducted from the benefits paid;
4. Having taken actuarial advice, the level of contributions to the scheme is sufficient to meet the liabilities;
5. The pension fund is properly invested;
6. Suitable professional advisers are appointed;
7. Obtain expert advice in the matters where help to carry out these duties is required;
8. Suitable banking arrangements, separate from the employer, are in place;
9. Members have a procedure through which to resolve queries or disputes about their benefits;
10. The member nominated trustee or member nominated director requirements are met; and
11. Members and others are told about the scheme and about their personal benefits.

Trustee liability

A trustee could be personally liable for any loss which he or she causes to the scheme as a result of a breach of trust.

A breach of trust arises when:

1. A trustee carries out an act which he is not authorised to do under the trust deed and rules;
2. A trustee fails to do something which he is required to do under the trust deed and rules; or
3. A trustee does not perform duties under trust law or pensions legislation.

A trustee can also be responsible for co-trustees' breaches of trust if he fails to stop them committing their breach. The rules of most pension schemes will protect trustees from personal liability for a loss in the event of an unintentional or negligent breach, unless it is wilful or deliberate. However, if a trustee is fined by OPRA as a result of a breach, it is forbidden to pay the fine out of the scheme's assets. In some cases, the employer will provide indemnity insurance for trustees. These provisions are generally effective, but their limits have not yet been tested in the courts.

Do we need an Act like ERISA or Pensions Act?

Certainly we need a legislative framework to set in place a modern pension management practice. The existing law under the EPF Act has ensured growth of a strong provident and pension fund industry. This law will need to be strengthened to regulated a liberalised and expanded system of provident and pension funds. Several of the issues that will need to be addressed by the legislation have been discussed in this paper. EPFO, which has established a system of supervision of pension and provident funds, will need to be equipped to administer new legislation. EPFO has so far assumed the roles of regulator as well as a player since it also has management and administration responsibility of the EPF. These roles will need to be separated over time.