Chapter 4

Approach to the Regulation of Private Pension Funds in India Application of International Best Practise

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4.1 Introduction

In order to provide income security for citizens during old age and driven by fears about the unsustainability of their social security programmes, many countries have initiated the development of multi-pillar pension systems which seek to integrate both public and private components. This has lead to a rapid growth of mandatory as well as voluntary privately managed pension funds and reduced the reliance on public social security systems. These new private retirement systems are often supported by the state with tax incentives. When mature they will control a substantial portion of the financial assets in an economy and exercise considerable influence over the allocation of capital, corporate governance and the financial well being of a large section of the populace. Anticipation of the importance of private pension funds from both a social as well as economic policy perspective has naturally turned attention toward the development of effective systems for their supervision and regulation. Effective supervision and regulation are also recognised as necessary to maintain public confidence in a private pension system.

Over time, regulatory frameworks have evolved around the world to promote safe, efficient and orderly functioning of private pension systems. These frameworks have tried to identify regulatory risks and objectives, and integrate within them principles of supervision and best practices. Unlike banking and securities regulations that have evolved over long periods

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in response to a series of crises, practice in the area of pension funds is yet evolving and exhibits more diversity among nations. As part of an effort to codify best practice, in April 2001, the International Network of Pension Regulators and Supervisors (INPRS) adopted a set of fifteen principles of supervision for private occupational pension schemes designed to safeguard the interests of the beneficiaries and ensure the efficient running of such plans.[2]

The Indian pension system is largely publicly managed and tightly controlled. Proposals have been made in the recent past suggesting introduction of private participation, in order to expand coverage, increase returns and improve efficiency. This paper provides an overview of the existing pension systems in India, their regulatory frameworks, an assessment of the efficacy of the system and the potential future role for private pension funds. It provides a discussion of the principles of supervision of private pension funds, international best practices in the area and their possible application to India, particularly in the context of the proposals for reform made in the recent past.

4.2 Pension Systems in India

India does not have what has become commonly referred to as a "first pillar" social security programme that provides significant income replacement rates for the majority of the population as is common in most OECD countries. The central government operates a variety of poverty alleviation programmes funded out of its general tax revenues targeted at people below the poverty line. However, there is no public PAYGO system run out of the government's budget to which citizens contribute and receive benefits.

Mandatory occupational plans forming what is typically termed a "second pillar" are the mainstay of retirement income security in India. These plans, however, cover only the salaried workers employed in specified industries and classes of establishments that are notified by the government.[3] The

[2]The International Network of Pension Regulators and Supervisors consists of representatives from regulatory and supervisory agencies from 60 countries. A complete statement of the principles can be found on their web site at http://www.inprs.org/data/publications/files/fifteenprinciples.pdf

[3]The mandatory coverage provisions for provident and pension funds, contained in the EPF Act of 1952, are discussed later in the paper

notified industries and classes of establishments cover most of the organised sector. Such occupational arrangements utilise a dual benefit structure, with each employee generally being a member of a DC plan that is not annuitised and allows early withdrawals for some specified purposes (called a provident fund), as well as a DB plan that pays life pension (called a pension fund). Contribution rates are high, ranging from 20 percent to 24 percent of salary. In addition, most of the salaried workers in the organised sector[4] are also entitled to a lump-sum retirement gratuity generally computed at half-month's salary for every year of completed service. However, the majority of the labour force consisting of self-employed workers, casual workers and most of those employed in the unorganised sector do not have mandatory coverage. For them, voluntary individual saving (the "third pillar" in a multi-pillar system) is the only means of providing for income in old age. The government and the insurance companies offer long-term savings plans that are aimed at enabling such workers to save for their retirement. These individual voluntary plans as also the mandatory occupational plans are supported in India with strong tax incentives.

4.2.1 Labour Market in India

India is the second most populous nation in the world with a population of 1025 million as per the 2001 Census. The total labour force is 403 million, or 39 percent of the total population. The labour force is predominantly rural and engaged in agriculture. Although only 26 percent of the national income comes from agriculture, 77 percent of the labour force lives in rural areas and 58 percent is engaged in agriculture. By type of employment, 53.6 percent of the labour force is self-employed, 31.2 percent comprises casual workers without regular employment, while only 15.2 percent is in regular salaried employment.[5]

The Census figures suggest the total number of regular salaried workers in the country to be about 61 million. Mandatory coverage for retirement plans in India extends only to salaried employees and can be categorised as follows:

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[4]The mandatory coverage provisions for gratuity, contained in the Payment of Gratuity Act of 1972, are discussed later in the paper

[5]Based on 1991 Census. Corresponding data based on 2001 Census not yet released.

- Government employees who are covered under the government's pension system,
- Salaried employees in establishments covered by the EPF Act,
- Salaried employees in establishments covered under special Acts and
- Salaried employees in establishments not covered under the EPF Act but have equivalent voluntary arrangements (such establishments are mostly in the public sector).

Employees of the central and state governments numbered 10.8 million as of March 31, 2000.[6] Mandatory coverage under the EPF Act extended to 26.30 million workers as of March 31, 2001.[7] Coverage under the Special Acts is estimated at 1.74 million.[8] While there are no estimates of employees not covered under the EPF Act but covered under similar voluntary arrangements, a guesstimate would be about 1 million. Total coverage is thus estimated at about 39.84 million,[9] which is about 65 percent of regular salaried workers and about 9.9 percent of the total labour force. Considering the paucity and quality of data, these numbers are best considered indicative, with a reasonable margin for error.

Self-employed and casual workers (who together constitute 84.8 percent of the labour force) are not covered for mandatory plans. The majority of the self-employed workers (about 59 percent) are cultivators, while the majority of casual workers (about 85 percent) are agricultural labour.[10]

[6] Economic Survey 2001–02, Table 3.1, Government of India.

[7] EPFO Operational Statistics 2000–01, www.epfindia.org

[8] Comprising 0.8 million of coal workers, 0.76 million of plantation workers in Assam, 0.03 million of merchant navy and 0.15 million workers in Jammu & Kashmir.

[9] The Economic Survey 2001–02 (Table 10.7) estimates the total employment in organised sector at 28 million for 1999–2000, as reported in the Employment Market Information System of the Ministry of Labour. The Survey estimates 70 percent of organised sector employment to be in public sector and 30 percent in private sector. The number is stated to include all establishments in the public sector irrespective of the size of employments and non-agricultural establishments in the private sector employing 10 or more persons. This estimate of the Survey semms to be at variance with the estimate of the coverage of the occupational plans, since most establishments where mandatory coverage is required can be considered to be in the organised sector

[10] Data based on 2001 census

There are no estimates of the number of workers who can potentially contribute to a pension system, but are not subject to mandatory coverage at present. Because 26.1 percent of the population lives in poverty,[11] a large proportion of uncovered workers can be assumed to be able to barely meet their daily needs and hence not have the ability to save for the future. The fact that provident and pension funds account for 20.7 percent of total household financial savings[12] of the country does indicate that the penetration of these plans among the population that has savings potential is fairly high. At the same time, the absolute number of new workers that can be brought under the coverage of a pension system is thought to be large. Proposals have been made in the past to lower the threshold of employment for mandatory coverage of an establishment from twenty or more workers at present to ten or more workers. A large number of self-employed workers including well-to-do farmers, practising professionals such as doctors, lawyers or accountants and small business owners are not covered under the mandatory pension system at present.

4.2.1.1 Government Employees Pension System

The government and its enterprises constitute the biggest employer in India, with 70 percent of organised sector employment being in the public sector and only 30 percent in the private sector. The central government employed 3.3 million workers and the state governments an additional 7.5 million workers as of March 31, 2000.[13] Direct employees of the government receive a different set of retirement benefits including indexed pensions, in contrast to other public sector employees (such as those in government-owned companies) who are covered under the mandatory occupational plans on par with private sector workers. Employees of aided institutions and local bodies, however, receive retirement benefits similar to the employees of the government.

Government employees are entitled to three major retirement benefits

1. A lump-sum gratuity,

[11] For the year 1999–2000, Economic Survey 2001–02, Table 10.4, Government of India

[12] For the year 2000–01, Reserve Bank of India, Annual Report 2001–02, Table II.4

[13] Economic Survey 2001–02, Table 3.1, Government of India. The Working Group on Pension Liabilities gives a number of 11.13 million as against 10.8 million given by the Survey

2. The General Provident Fund and
3. A Defined Benefit pension plan.

The gratuity, governed by the Payment of Gratuity Act of 1972, is paid on retirement or death as a lump-sum. It is based on final salary and is usually computed as a half month's salary for each year of service, subject to a ceiling of Rs.3.5 lakhs. A minimum qualifying service of five years is necessary to receive retirement gratuity. The General Provident Fund (GPF) is a defined contribution plan with a minimum 6 percent contribution from the employee and no matching contribution from the government. The GPF is not separately invested but instead constitutes a part of the Consolidated Fund of India, to which the government pays interest at an administratively determined rate which varies from year to year. Advances and withdrawals can be made out of the GPF for specified purposes such as housing, medical, educational or marriage expenses and acquisition of consumer durables. The accumulated balance is paid to the employee on retirement or on leaving government service. The government also operates a Deposit Linked Insurance (DLI) Plan under which a subscriber to GPF, in the event of death, is paid an amount equivalent to the average balance over the past three years, subject to a ceiling of Rs.60,000.

The most significant retirement benefit to the government employees, however, is a defined benefit pension plan, to which the employees do not contribute but is paid out of the current revenues in the government's budget. The maximum replacement rate is 50 percent of the average salary in the last ten months before retirement, for a full qualifying service of 33 years. A shorter qualifying service entitles to a proportionately reduced pension. A minimum qualifying service of twenty years is necessary to receive superannuation pension. Family pension is payable on death of a pensioner to the eligible family member at 30 percent of last pay. Provisions for short service pension, disability pension and commutation into a lump-sum are available. Pension benefits are indexed in two ways, through inflation indexing of benefits post retirement at the same rates of cost of living adjustments applicable to serving employees, and through indexing of basic pension to changes in the salary structure of the serving employees based on pay commission recommendations. The government's pension plan is not portable and an employee forfeits rights to a pension if he or she leaves service before completing twenty years. These arrangements are unfunded

and the pension payments are a direct charge to the government's budget. The government's pension system is not exactly a PAYGO system as there are no contributions from the employees. In total, the replacement rate for government employees from all the retirement benefits is estimated to reach 100 percent in many cases, a high rate by any standards.[14]

There is no independent supervision as these are government plans and essentially unfunded. A complex set of rules directed toward benefit administration govern these plans which cover various classes of employees such as railway employees, postal workers, civil servants, armed forces, and others.

The annual pension liability of the central government to its retired employees for the year 2001–02 was Rs.22,410 crore, or 9.7 percent of the government's total revenues and 1 percent of the country's GDP. The pension liability increased sharply since the implementation of the Fifth Pay Commission recommendations with effect from 1996–97. More than 50 percent of the pensions are on account of defence forces, with other categories in order of size being railways, civil servants, postal and telecom workers. The annual pension liability in 1990–91 was only Rs.3,271 crore (0.6 percent of the GDP), indicating a seven fold increase over a decade.[15] The number of current pensioners is 3.4 million, more than the number of active workers.

The state governments face a similar predicament. Pension payments of 29 large Indian states for 2001–02 amounted to Rs.26,790 crore, which was 8.05 percent of their revenue expenditure.[16] For the states, pensions have been the fastest growing item of their expenditure in their budgets, alluded to as a 'ticking time bomb' by the Eleventh Finance Commission. Total annual pension liability of the central and state governments are, in aggregate, about 2.3 percent of the GDP.[17]

The outstanding liabilities on account of the provident fund, which the governments maintain as a sort of a book reserve, constituted 15.1 percent of total outstanding liabilities in the case of the central government and 15.5 percent in the case of state governments. On these liabilities, the

[14]Report of the Working Group on Pension Liabilities, Ibid
[15]Economic Survey 2001–02, Box 2.1, Government of India
[16]Economic Times, Pensions burn hole in states' pockets, July 29, 2002
[17]Business Standard, September 26, 2001

governments paid interest at 9.5 percent for 2001–02, compared to average market borrowing rate of 8.76 percent for 15-year maturity bonds, making them one of the most expensive sources of funding for the government.[18] Besides the provident funds, there is a large implicit pension debt that has not been quantified. While presenting the budget for 2001–02, the Union Finance Minister expressed concern that the government's pension liability 'has reached unsustainable proportions'.

Certain state governments such as West Bengal's have had to delay pension payments due to financial problems.[19] Several other states face similar problems.

The central government appointed a Working Group on Pension Liabilities under the chairmanship of A. M. Sehgal, Controller of General Accounts, to estimate the government's pension liability over the short and medium terms. The exercise was aimed at aiding fiscal planning. The Working Group, which submitted its report in June 2001, made serious disclaimers owing to the lack of adequate data. No actuarial valuation could be made due to non-availability of age profiles, as the government did not have reliable and collated databases of its serving employees and pensioners. The Group thus based its estimates on heuristic methods. The Group expects the pension liability to go up further over time due to several reasons, chief of which are increased life expectancy, indexation of pensions to inflation as well as salaries of serving employees, increase in average salaries of government employees after successive pay revisions, and increase in retirements over the next ten years due to a fifty-seven percent rise in employment during 1957–71. The Group estimated the annual pension liability in 2009–10 to be in the range of Rs.29,891 crore to Rs.33,558 crore under different scenarios. The liability as a percentage of GDP is projected to fall from 1 percent at present to 0.47 percent by 2009–10. It is, however, important to underscore that the estimates of the Group are based on inadequate, unreliable data and a conservative, unrealistic assumption that there would be no change in the salary structure of government employees over the next ten years.

The Working Group recommended that the government should consider introducing a defined contribution plan for new employees in full or partial

[18] Data from Reserve Bank of India, Annual Report 2001–02, Box 12
[19] Economic Times, July 29, 2002

substitution of the present defined benefit plan. It recommended transition of existing employees to defined contribution plans in part, through appropriate incentives. It recommended transition to funded systems in order to make the liability of the government explicit and transparent.

The government appointed an Expert Group under the chairmanship of B. K. Bhattacharya, a former civil servant, to redesign the pension system for government employees. The Group submitted its report in February 2002, which is not made public. News reports suggest that the Group has recommended a two-tier system of pensions for new employees based on a combination of defined benefits and defined contributions. The Group is also reported to have suggested a private manager for the fund and an independent regulator. Although the government had, after several postponements, announced October 1, 2002 as the date on which a new system would come into force, the deadline has been missed yet again.

Capping the ballooning pension liability, transition to defined contributions and a funded system, paring the high cost paid by the government on the funds and the approach to enhance returns to the employees in a defined contribution system are thus key dimensions of pension reforms that require attention in the government pension system in India.

4.2.2 Mandatory Occupational Plans

The pension system for non-government employees is governed by the Employees' Provident Funds and Miscellaneous Provisions Act of 1952 ("EPF Act"). The Act makes it mandatory for employees of notified establishments[20] to participate in three funded plans operated by the Employees' Provident Fund Organisation (EPFO). The central government has the power to notify any industry or class of establishments for mandatory coverage under the Act. Any establishment that operates in a notified industry or class, and employs twenty or more workers is then required to establish retirement plans for its workers by joining the EPFO. Over time, the central government has increased mandatory coverage by notifying an increasing number of industries and classes of establishments. As of April 2001, 180 industries and classes of establishments have been notified for mandatory

[20]Under Sec 4 of the Act, the central government has the power to notify any industry or class of establishments for inclusion in Schedule I, which specifies the industries and establishments to which the Act applies.

coverage, which cover most of the organised sector. All categories of employees including employees engaged through contractors and hourly-rated workers are covered for mandatory participation. Non-discriminatory access, a key regulatory principle, is thus ensured by the EPF Act.

EPFO is a government body constituted under the EPF Act and managed by a board of trustees appointed by the central government with representatives from the central and state governments, employer associations and employee unions. The Union Labour Minister acts as the chairman of the board of trustees. The Central Provident Fund Commissioner (CPFC) appointed by the central government, usually a government civil servant, acts as the chief executive of the EPFO. The Ministry of Labour exercises administrative supervision over the EPFO. EPFO has set up a network of offices across the country that handle record keeping and benefit administration while fund management has been contracted out to an independent manager. EPFO uses the banking system for collection of contributions from employers all over the country and for disbursal of pensions.

Each covered employee becomes a member of three plans, all of which are funded - the Employees' Provident Fund Scheme of 1952 ("provident fund"), the Employees' Pension Scheme of 1995 ("pension fund") and the Employees' Deposit-linked Insurance Scheme of 1976 ("DLI scheme"). The employee and the employer contribute 12 percent of salary each, a total of 24 percent.[21] Out of the total contribution, 8.33 percent on a maximum pensionable salary of Rs.6,500 per month goes to the pension fund and the balance to the provident fund. Employees are allowed to make additional voluntary contribution to the provident fund, which is not matched by the employer. An unusual feature in India is that the central government contributes an additional 1.16 percent (subject to the ceiling of Rs.6,500 per month) to the pension fund from out of its tax revenues on account of every covered employee. The DLI scheme is funded out of only the employer's contribution, which is an additional 0.5 percent of the salary, subject to the ceiling of Rs.6,500 per month.

[21]In five industries and in loss-making companies under the purview of the Board for Industrial and Financial Reconstruction, the mandatory contribution rate is 10 percent each. Salary, for the purpose of contribution, is defined as basic pay, dearness allowance and certain specified benefits

Administrative charges are payable separately by the employer to the EPFO to cover costs. Employees' returns on their contributions are thus unaffected by costs. Administrative charges are 1.10 percent of salary, which translates to 4.58 percent of new contributions taking that the contribution rate is 24 percent of salary. Applying the approximate new contributions to assets ratio in the recent past, costs work out to about 0.45-0.50 percent of assets. Additional administrative charges at 0.01 percent of salary are payable for the DLI scheme.

The provident fund is a defined contribution plan, the accumulated balance of which is paid out to the employee as a lump-sum on retirement. There is no mandatory annuitisation. The plan allows withdrawals before retirement for specified purposes such as purchase of a house, major medical expenses and education or marriage of children. Pre-retirement withdrawals are popular, particularly for housing. Aggregate pre-retirement withdrawals in a year account for over 60 percent of new contributions to the plan. The provident fund is, therefore, more of a long-term savings plan than a pure retirement plan. Average accumulated balance paid out on retirement is low at about Rs.23,900[22] (in comparison, India's per capita income at current prices was Rs.16,487 in 2000–01 and the per capita emoluments of public sector employees was Rs.1,66,592 in 1999–2000).[23] The fund is invested according to investment regulations prescribed by the government. Interest is declared every year by the board of trustees of the EPFO out of the investment earnings, and credited to members' balances.

The pension fund is a defined benefit plan, which pays monthly superannuation pension for life. Pension rights vest after a minimum service of ten years. The retirement age is 58 years. The full service pension amount comes to about 50 percent of the average salary in the twelve months before retirement, for a person with a service of 33 years. The maximum pensionable salary is Rs.6,500 per month. A shorter service than 33 years entitles to a proportionately reduced pension. The plan allows premature retirement after twenty years of service, but in India, not many employees opt to retire early unlike in the western countries. A member with service between ten and twenty years is eligible for short service pension. A member who has not completed ten years of service does not get pension

[22]EPFO Operational Statistics for 2000–01. www.epfindia.org
[23]Economic Survey 2001–02, Tables 1.1 and 3.4, Government of India

but a withdrawal benefit representing return of his contributions. The plan pays disability pension in the event of permanent and total disablement. On death of a participating member, survivor pension is paid to the spouse (at 50 percent of the member's pension) and children below the age of 25 (at 25 percent of the member's pension for each child). A member may commute up to a maximum of one-third of pension amount and receive 100 times the monthly pension as commutation value. There are also options to draw a reduced pension and receive a capital sum on death so as to leave a legacy. Commutation values are pre-defined in the plan, exposing the fund to interest rate risk.

An important lacuna in benefit adequacy is that pension payments are not indexed to inflation, exposing the beneficiary to risk of inflation. EPFO announces ad hoc increases in pension after biennial actuarial valuations. Increases of 4 percent and 5.5 percent were announced in the last two biennial valuations in 1996 and 1998. It is reported that actuarial valuations are pending since then. EPFO does not make these actuarial valuations public. An equally important regulatory weakness is that there are no rules on minimum funding, an aspect dealt in detail later in this paper. Under the DLI scheme, an additional amount equivalent to the balance in the provident fund is paid to an employee in the event of death while in service, subject to a limit of Rs.60,000.

Employers can seek exemption from joining the EPFO-administered plans by setting up their own plans, called the Exempted Funds. Employers are granted exemption if their plans are funded and not inferior to the EPFO plans in contribution and benefit structure. In practice, the exempted plans are almost identical to the EPFO plans. Exempted Funds are, in effect, employer-specific plans that are privately managed. These funds are set up as independent trusts with representatives of the employer and the employees as trustees. The Exempted Funds are governed by the provisions of the EPF Act and are supervised by the EPFO. The expenses of operating an Exempted Fund are required to be borne by the employer. In addition, the employer also needs to pay 0.18 percent of the salary to the EPFO towards inspection charges to cover costs of supervision. Setting up an Exempted Fund involves a long-drawn and difficult process that includes obtaining written consent from a majority of the workers in the establishment. Employers are heard complaining that the process is made even more difficult

by the EPFO, which is interested in protecting its turf as the largest operator of retirement plans. It is gathered that no fresh exemptions have been granted by the EPFO for the past several years.

The EPF Act covered 340,013 establishments with 26.30 million employees for mandatory participation as on March 31, 2001. Of these, 2,624 establishments with 4.26 million employees opted to set up their own Exempted Funds.[24] EPFO managed assets of Rs.65,514 crore, while the Exempted Funds managed assets of Rs.28,691 crore as on March 31, 2000.[25] The publicly managed funds of EPFO cover 99 percent of the establishments, 84 percent of the employees and 70 percent of the assets. It is the larger employers who pay better wages that have chosen to set up Exempted Funds. These Funds, which are technically privately managed, cover only 1 percent of the establishments, but 16 percent of the employees and 30 percent of the assets. Most of the Exempted Funds carry out record keeping, benefit administration and fund management in-house, although contracting out these functions to professional providers is on the rise.

To encourage retirement savings, the Indian government provides tax benefits to mandatory occupational pension plans. India grants tax-free status to retirement fund contributions in contrast to tax-deferral prevalent in many countries. Contributions of an employee are eligible for a tax rebate, wherein the income-tax otherwise payable by the employee is reduced by an amount equal to 20 percent of the contributions made. The matching contributions made by the employer are treated as tax-free income in the hands of the employee, while they continue to be eligible deductible expenditure for computation of the employer's taxable income. Interest credited to the funds annually as also the accumulated balance paid on retirement is tax-free for the employee. Monthly pension payments are, however, taxed as normal income without recognition of the components of principal and interest. Tax treatment is thus anomalous between provident and pension funds. Capital returned and investment earnings in a provident fund are tax-free while the same when paid as monthly pensions are taxed. Nevertheless a salaried employee saves a substantial amount of income-tax by participating in the mandatory occupational plans.

[24]EPFO Operational Statistics for 2000–01, IBID
[25]Ministry of Labour, Annual Report, 1999–2000

To qualify for the tax benefits, a provident fund or pension fund is required to obtain recognition under the Income Tax Act of 1961. A recognised fund is required to comply with the provisions of Schedule IV of the Income Tax Act, which is a further source of regulation in addition to the EPF Act. Chief among these regulations is the pattern of investment prescribed by the Ministry of Finance, which directs where the funds can be invested.

Another important mandatory retirement benefit to salaried workers in India, besides provident and pension funds, is retirement gratuity which is payable under the Payment of Gratuity Act of 1972. The Act applies to every factory, mine, plantation, shop or establishment where 10 or more persons are employed. Gratuity is payable on resignation, retirement or death, to all employees who have completed at least five years of service, at the rate of half-month's salary for each year of completed service. A gratuity fund can be maintained in India in one of three ways

1. Under a book reserve system,
2. By buying an insured plan, or
3. By managing an independent fund.

Accounting standards require an employer to charge the liability for gratuity against profits. An employer is allowed create a reserve on his balance sheet for the purpose. Valuation on actuarial basis or on the assumption that all employees retire on the balance sheet date are both acceptable. Tax laws, however, do not allow such provision made as deductible expenditure but only the actual payment for gratuity to the employees or to funded plans. Thus for tax-efficiency reasons, employers prefer to fund the gratuity plan by buying an insured plan or by managing assets in an independent trust. The government-owned Life Insurance Corporation of India (LIC), the sole insurer in the country till recently, offers a Group Gratuity Plan which is the most popular insured plan. Some of the private insurers, who have been allowed into the business recently, have just started to offer similar plans. Contributions are assessed by the insurer based on actuarial valuation, which are tax-deductible for the employer. Employers with over 500 employees are allowed to set up independent gratuity trusts that operate fully funded plans. Such gratuity funds need to obtain approval under the Income Tax Act of 1961 and comply with Schedule IV provisions, including investment regulation. As of March 31, 1998, more than 30,000

schemes with 3.84 million employees and Rs.4,400 crore in assets were covered under insured gratuity funds with LIC.[26] No data is available on self-managed gratuity funds. However, a fairly large number of companies are known to operate self-managed gratuity funds. Employer's contribution to the gratuity fund, as well as the gratuity received on retirement is tax-free for the employee.

4.2.3 Voluntary Pension Plans

In addition to the mandatory plans, several employers also operate voluntary occupational plans, called superannuation funds. Indian income-tax law treats employer's contribution to provident and pension funds (up to 12 percent of salary) as tax-deductible expenditure while, at the same time, it is tax-exempt in the hands of the employee. A similar treatment is also given to additional superannuation contributions of up to 15 percent of salary. To take advantage of this provision, many employers have set up voluntary superannuation plans (which are usually defined contribution plans that are annuitised on retirement) in addition to the plans under the EPF Act, particularly for senior employees. In such cases, the aggregate contribution rate to retirement plans may be as high as 39 percent of salary (24 percent to mandatory plans and 15 percent to voluntary superannuation plan).

A superannuation fund is set up as an independent trust which can either manage the assets itself or buy an insured plan from the LIC or any private insurer. Book reserve system is not possible since the plans are required to be funded to avail the tax benefit. There were a total of 5,537 superannuation funds in 1998 of which 4,719 subscribed to the LIC plan and 818 were self-managed. The total corpus of the LIC plans was Rs.4,972 crore while the corpus of the self-managed plans was estimated at Rs.1,200-1,500 crore.[27] The only regulation affecting the superannuation funds is Schedule IV of the Income Tax Act under which they are required to obtain approval to qualify for tax benefits. Common investment regulation applies in India to all funded provident, pension, gratuity and superannuation funds under Schedule IV of the Income Tax Act.

[26] P C Gupta: LIC's experience with management of Pension and Superannuation Funds, OASIS paper, 1998

[27] P C Gupta, IBID

Non-salaried employees can participate in voluntary retirement plans that are offered by the government, the LIC and mutual funds. These are long-term savings plans aimed at enabling saving for retirement. The government's plan is the Public Provident Fund (PPF), which is available to any citizen. It is a DC plan that is not annuitised and supports flexible contributions. A subscriber can deposit every year any amount from Rs.100 to Rs.60,000. Early withdrawals are possible after a mandatory lock-in period of six years. PPF is not strictly a retirement plan but a long-term savings plan, as the subscriber can withdraw the accumulation fully fifteen years after the account is opened. PPF qualifies for all the tax benefits of a mandatory occupational provident fund in that contributions are eligible for a tax rebate at 20 percent and interest earnings as well as the accumulated balance withdrawn from the fund are tax-free. It is by far the most popular voluntary plan among the self-employed, who see it as a tax-saving device. Collections under the PPF were Rs.11,500 crore[28] for the year 2000–01, which is about as much as the annual contributions under all the mandatory provident funds. The PPF is not separately funded or managed but instead forms part of the government accounts. The government declares an interest rate payable on the account balances, which varies from year to year. The interest rate is usually the same as that credited the Government Provident Fund (GPF) and the Employees' Provident Fund (EPF).

LIC's individual pension policies are an important avenue for the self-employed and those who want to top-up their occupational pension. A total of 670,375 policies were in force in 1998 with annual pension payment of Rs.1,454 crore.[29] Some of the private insurers, who have recently been permitted to enter the business, have also started to offer pension products. A few mutual funds such as the Unit Trust of India and Templeton offer pension funds. The mutual funds pay out the accumulation on maturity without annuitisation. These, however, have not been popular with investors because of their variable returns. The corpus under these funds is not large. Pension products from the insurance companies and the mutual funds are both supported by tax benefits on contributions. Contributions to these individual pension plans are also eligible for tax rebate at 20 percent, in the same manner as the mandatory retirement plans. However, the pension payments are taxed as income (which is also the case with mandatory

[28]Union Budget Papers, 2001–02
[29]P C Gupta, IBID

occupational pension funds). The insurance products come under the regulatory purview of the Insurance Regulatory and Development Authority (IRDA) while the mutual fund products come under the regulatory purview of the Securities and Exchange Board of India (SEBI). Banks in India are not permitted to run pension products on their balance sheets.

Retirement plans in India are thus fragmented, consisting of mandatory DC, DB and gratuity plans besides possible voluntary superannuation plans. There is need to consolidate these benefits under a unified framework that ensures benefit adequacy.

4.3 Regulation of Private Pension Funds in India

The government dominates the retirement funds industry in India. As discussed previously, within the mandatory occupational plans, the government-owned EPFO covers 99 percent of the employers, 84 percent of the employees and 70 percent of the retirement assets. The employer-administered exempted funds, which are privately managed, account for the rest. In voluntary plans, the government's Public Provident Fund is popular as a flexible, tax-efficient plan and there are no equivalent products from private providers. Among insurance companies, the other providers of group and individual pension products that are supported by tax benefits, the government-owned LIC was, until two years ago, the sole life insurer. The private insurers who have started to operate recently are yet to have any significant presence.

Pension and provident funds in India, the EPFO as well as the Exempted Funds, operate under a highly regimented structure. The same rules generally apply to both the EPFO and the Exempted Funds. There has been little change in the regulatory framework of these funds in the past fifty years since the EPF Act became law in 1952. Unlike in the banking and securities markets, there have not been any major crises, cases of fraud or losses among provident and pension funds, which focused attention on regulation.

4.3.1 Recent Events

This absence of attention, however, is likely to rapidly change. In May 2002, a serious fraud came to light in the Seamen's Provident Fund, a re-

tirement fund for the employees of the merchant navy, which has been set up under a special Act of the Parliament. Central Government Bonds of about Rs.93 crore (nearly 20 percent of the total corpus of the fund) were reported lost, not having been delivered by a broker from whom they were bought. Police arrested the broker and his associates who had similarly duped several co-operative banks by failing to deliver securities for which payment had been received. The commissioner of the Seamen's Provident Fund was removed on charges of negligence and suspected participation in the fraud. Investigations are continuing. Agitated seamen were assured by the government that their retirement savings would be protected, although how the losses would be made good has not been disclosed.

The EPFO was concerned that several Exempted Funds were also dealing with the broker and has ordered an audit of Exempted Funds to ascertain if any of them have incurred similar losses as has been suggested in several recent news reports. No information is yet available on the results of the audit.

Provident and pension funds had hitherto not suffered investment losses on account of defaults by issuers of bonds. However, that began to change as well in the year 2002. IFCI, a public financial institution, defaulted on bonds held by the EPFO, the Coal Mines Provident Fund and a number of Exempted Funds due to liquidity problems. The problems of the institution are engaging the attention of the central government. It is expected that taxpayers' money or government guarantees will be used to bail out the institution on the same lines as the Unit Trust of India (UTI). In the meantime, the defaults have continued for nearly a year. Some state government enterprises are also reported to have delayed payments or defaulted on bonds held by provident and pension fund trusts. While concerns about the quality of the portfolios held by provident and pension funds have been known for some time, the official acknowledgement has come from the Reserve Bank of India (RBI) which has stated in its latest annual report that 'provident funds have also been invested in state government guaranteed bonds, state electricity boards, irrigation projects and state financial institutions which may carry default risk'.[30]

These developments have raised for the first time the spectre of serious losses for provident and pension funds in India although the full import of

[30]Reserve Bank of India, Annual Report 2001–02, Box 1.2

these events is yet to be grasped. No concerns are as yet heard on the risks facing the pension system and no clamour seen for reforming regulation and supervision. But these are sure to come up once the full dimensions of recent events become clearer.

4.4 Current Regulatory Framework

Regulation of provident and pension funds in India comes out of three sources - the Income Tax Act of 1961, the EPF Act of 1952 (or other special Act governing the fund) and the Indian Trusts Act of 1882.

Every provident and pension fund trust, as also every gratuity and superannuation trust, is required to obtain approval under the Income Tax Act for its income to be treated as tax-exempt. Such an approved trust is required to comply with the provisions of Schedule IV to the Income Tax Act. The chief requirement under Schedule IV is compliance with the investment limitations prescribed by the Ministry of Finance. The effect of this provision is that a common investment pattern applies to all types of provident, pension, superannuation and gratuity funds in India, whether or not they are governed by the EPF Act.

The EPF Act governs the EPFO and is also the chief source of regulation for the Exempted Funds. The EPFO is a government body that operates the largest retirement funds in the country but is not subject to supervision by an independent regulator. The EPFO also exercises supervision over the Exempted Funds. While the EPF Act is the main legislation governing mandatory retirement plans, there are other Acts[31] governing retirement plans for specific categories such as coal mine workers, plantation workers, merchant navy and workers in Jammu and Kashmir. Another important legislation is the Provident Funds Act of 1925 which applies to government and other provident funds. The Act has been extended to several public sector and aided institutions which have set up voluntary provident funds. The Act is much less extensive than the EPF Act in scope and provides for some rights of beneficiaries and nominees.

[31]The major pieces of special legislation are the Coal Mines Provident Funds and Miscellaneous Provisions Act, 1948, Assam Tea Plantations Provident Fund and Pension Schemes, 1995, Jammu & Kashmir Provident Act, 1961 and Seamen's Provident Fund Act, 1966.

The Indian Trusts Act applies to all trusts and deals with the rights and obligations of the trustees and the beneficiaries.

The legislation governing supervision of provident and pension funds is thus fragmented and there is no one regulator who supervises all funds. Pension reforms in India need to establish unified regulation affecting all retirement funds and an independent regulator with jurisdiction over all funds.

The regulation of the Exempted Funds, which are the only type of privately managed funds that operate in India, is at present founded on four basic principles

1. Trust organisation, which ensures independence from the employer,
2. Standardised plans, which ensure uniformity of benefit structure and vesting rights,
3. Highly prescriptive investment regulation, and
4. Minimum return guarantee by the employer.

4.4.1 Trust organisation

All provident, pension, superannuation and gratuity funds are required to be set up as independent trusts. Exempted Funds are set up as irrevocable trusts sponsored by the employer. Trust deeds are required to be registered and filed with the EPFO for obtaining exemption. Although there are no legal rules on the contents of the deed, they tend to be standardised to pass the review by the EPFO. Trust organisation ensures segregation of assets from the sponsor and requires full funding for all DC plans. The rules require representatives of the employer and the employees to be appointed as trustees. Representatives of the employees are elected by ballot. In practice, employees who are perceived as credible and capable of protecting the members' interests usually get appointed as representatives of both the employer and the employees. These are typically full-time employees who also act as the trustees. As the retirement benefits of the senior management also form part of the fund, the management and the workers are seen to have common interest in effective administration of the trust.

The Indian Trusts Act of 1882 governs all trusts, addressing many of the agency issues. The fiduciary duties, powers and liabilities of a trustee and

the rights of a beneficiary are defined in the Trusts Act. Duties of trustees include the duty to execute the directions of the trust documents, to keep himself informed of the state of the trust property, to protect the title to the trust property, not to set up a title adverse to the beneficiary, to keep accounts, to be impartial among multiple beneficiaries, etc. There is also an important 'prudent person' rule that requires a trustee to deal with trust property as carefully as a man of ordinary prudence would deal with such property if it were his own. The liability of a trustee in event of breach of trust is to make good the loss. Besides the duties defined under the general trust laws, trustees of Exempted Funds have under the EPF Act the duty to maintain accounts and to invest the funds according to government directions.

Although duties and liabilities of trustees are fairly well-defined, lawsuits against the trustees or any action against them for breach of obligations is unheard of, perhaps because there have been no instances of major frauds or losses. As a result, having in place processes that protect them against charges of fraud or negligence had never been on top of the agenda for the trustees. Trustees tend to have a rather simplistic understanding of their responsibilities and are almost never covered by professional indemnity insurance. It will be interesting to see whether the recent events discussed earlier in the paper that resulted in losses to the funds have any effect on liabilities of trustees or on the way they discharge their responsibilities. The usual approach of the EPFO to problems in Exempted Funds has been to withdraw the exemption and require the employer to make good losses, if any.

A major weakness in regulation is that there are no rules on minimum funding, or on how the funding levels are to be determined and maintained. However, most of the Exempted Funds are provident funds, which being DC plans are in any case fully funded. Most employers,[32] even if they operate an Exempted Provident Fund, prefer to join the EPFO as far as the pension plan (which is a DB plan) is concerned. Thus the provident fund contributions go to their self-managed Exempted Fund while the pension fund contributions are remitted to the EPFO. The result is that employers are insulated from the liabilities attached to the DB plans of their employ-

[32]Only one employer is reported to have set up an exempted pension fund under the EPF Act.

ees, because employers have no further liability once they make defined contributions to the EPFO's pension plan. The problems that are seen in western countries from the corporate final-salary based DB plans and the effect they have on corporate profitability and solvency thus do not apply to India.

The liability for the DB plans of all employees thus shifts to the EPFO. EPFO's DB plan is also not required to ensure full funding as per regulation, and its actuarial valuations are not made public. The government has implicitly assumed responsibility for any deficit in the plan. It is significant that the Working Group on Pension Liabilities has expressed concern about the potential contingent liability to the central government, on account of EPFO's pension plan, due to contributions and investment earnings not being adequate to pay the liabilities. The scheme, however, empowers the central government to alter the contribution rates, the scale of benefits or the duration for which benefits are paid.

Most of the voluntary superannuation plans are DC plans, although there is no data available in this regard. There are, however, no rules on minimum funding governing such DB plans as do exist. In the case of insured DB superannuation plans offered by the LIC, full funding is ensured by the LIC through actuarial valuations carried out every year. In the case of self-managed DB superannuation plans, it is left to the trustees to ensure full funding.

There are some pension funds (DB plans) outside the purview of the EPF Act which are mostly in public sector enterprises and banks. Although there are no rules, the employers in these cases generally ensure full funding based on actuarial valuations carried out either annually or every two years. There are, however, no guidelines on how the actuarial valuations are carried out. Assumptions do indeed differ among actuaries, particularly in regard to discounting rates. But as these DB plans are mostly in the public sector, there have hitherto been no serious concerns that pension obligations would not be met. As the financial health of many public sector enterprises deteriorates and the government's support to them becomes uncertain, such concerns would become real in the future.

The EPF Act contains some very tough provisions that protect the contributions receivable from an employer by a provident or pension fund trust.

The contributions payable by an employer are treated as statutory liabilities and given priority over all other debts if the employer becomes insolvent. Directors of an employer face criminal liabilities for non-payment of contributions in time. In the event of non-payment, the trustees can apply to the Central Provident Fund Commissioner (CPFC) who has the power to direct any debtor of the employer to make payment to the fund, in full discharge of obligations to the employer. CPFC also has the power to recover dues through attachment and sale of property in the same manner as land revenue due to the government, the fastest and the most robust recovery process in India. Employees are thus well-protected against insolvency of the employer, a key objective in pension regulation.

Despite these provisions, non-payment or delay in payment of contributions by employers has been a serious problem for several years. Arrears in contributions were Rs.766.51 crore for the EPFO and Rs.417.59 crore for the Exempted Funds as of March 31, 2001.[33] Arrears are usually from loss-making companies, which are often given some leeway in payment of contributions but are required to pay interest for the delayed period.

Unlike pension funds overseas that contract out fund management and record keeping functions, funds in India generally manage them in-house. Pension fund regulation does not, therefore, specifically address the relationships of the fund with external service providers. No specific obligations and liabilities of service providers are defined in pension fund regulation. The general prudent person principle under the trust laws and the general contract law govern these relationships. Providers of fund management services, however, require a licence from the Securities and Exchange Board of India (SEBI) and are governed by the SEBI (Portfolio Managers) Rules, 1992. Providers of benefit administration and record-keeping functions are not licensed or regulated, excepting for supervision by professional bodies if the provider happens to be an accounting firm.

In contrast to mutual funds in India, there are no rules requiring appointment of an independent custodian. Most of the Exempted Funds maintain direct custody of and the title to their investments. Exempted Funds generally do not implement internal controls in investment management such as counterparty exposure limits or segregation of front-office and back-office

[33] EPFO Operational Statistics for 2000–01, IBID

functions. There are also no obligations imposed upon the auditors of provident or pension fund accounts, unlike in the case of companies in India, where they are required to evaluate and comment upon the adequacy of internal controls and internal audit systems. Loss of securities that came to light recently in some funds is beginning to focus attention on these limitations.

4.4.2 Standardised Plans

Employers are granted permission, by the government in consultation with the EPFO, to set up Exempted Funds if their contribution and benefit structure are not inferior to the EPF plans. In practice, the contribution rates, benefits and the rights of beneficiaries including vesting rights are almost identical across the country. Due to the restrictions imposed by the investment regulations there is no choice portfolios to the employers or the employees.

Portability is an important principle of pension regulation; it is made easy in India by the dominance of the EPFO. As 99 percent of the employers subscribe to EPFO plans, relocation of workers among these is handled by a simple declaration to the EPFO. Both DC and DB plans of the EPFO are thus portable within the employers who subscribe to the EPFO. Transfer of balances between the EPFO and the Exempted Funds and among the Exempted Funds are also uncomplicated, as the Exempted Funds are basically provident funds which are DC plans. Problems in portability are usually the result of the administrative inefficiency of the EPFO. In India, it is relatively easy to withdraw the accumulation in a provident fund when an employee resigns from the services of the employer by making a declaration that he or she does not intend to take up employment for at least six months. Employees often misuse this provision thus portability not being effectively achieved. The DB plans, which are mostly in the public sector enterprises and banks, are not portable.

4.4.3 Investment Regulation

Investment requirements and limitations are the core of the regulation and control of provident and pension funds in India. Current law imposes what has often been viewed as a highly restrictive or “draconian” investment regulation regime. Asset classes as well as percentages that are to be invested

in them are specified and the interest earnings from investment classes are required to be reinvested in the same categories. Control of asset allocation is maintained by dictating the distribution of new contributions and maturity proceeds rather than requiring that the overall portfolio be rebalanced to achieve a required profile.

Funds in India cannot invest in real estate, gold or other physical assets. Nor can they invest in stocks or mutual funds. No investments are also permitted in non-tradable investments such as loans or deposits (including bank deposits).[34] Investments are mostly directed to the government and its enterprises, with only 10 percent being allowed to be invested in the private sector at the option of the trustees. India enforces strict capital controls and no overseas investments are permitted. Recently, the government made a beginning by granting mutual funds limited allocations for investment in overseas bonds. Provident and pension funds are, however, required to invest in only domestic bonds.

Table 4.1 Investment Regulation

Categories	Proportion
Bonds of Central Government	25%
Bonds of State Governments or Bonds of public sector enterprises guaranteed by Central or State Governments	15%
Bonds of public financial institutions or public sector enterprises	40%
In any of the above categories as decided by the trustees	20%

New contributions and redemptions of old investments are required to be invested in the following categories in the proportions specified

The investment requirements for the year 2002–03 are:

- Out of the 20 percent, if the trustees so choose, 10 percent can be invested in bonds of private sector companies.
- Interest earnings from bonds in each of the categories are required to be reinvested in the same category. Specifically, interest earned on Special Deposit Scheme is required be reinvested in the same Scheme.

[34]Central Government's Special Deposit Scheme is the only exception.

While the objectives of prescribing investment regulation have never been explicitly articulated, they would appear to be three-fold. First, the central and the state governments run large fiscal deficits and are constantly looking for captive investors to buy their bonds. Over time, the financing need has extended to government enterprises as well, which also benefit from captive investors to maintain the flow of funds and keep rates low. Second, bonds of the government and its enterprises are perceived to be safe for the investment of retirement savings. Protection of subscribers' funds is ostensibly a major motivator for the investment limitations. Third, captive investments are an indirect means to ensure that provident and pension funds always receive a reasonable rate of return and are thus effectively perceived to be an indirect form of a government guarantee. This is reinforced by the fact that the rate credited by the government to provident and pension funds has often been above the returns that the investors could earn on their own voluntary savings.

The percentages specified for each asset class apply to new flows of funds. Investments made in prior years (as per the pattern in force at that time) are carried till maturity. Funds are not permitted to trade in bonds. Sale of investments can only be made with the prior approval of the Provident Fund Commissioner, which is granted if the fund has settlement liabilities exceeding its new contributions. All investments are defined as long-term for accounting purposes, and there is no practice of marking-to-market based on current prices.

There are no specific diversification requirements among issuers for each required category of investments. As there are only a limited number of eligible issuers of bonds, funds tend to have high concentrations of a small number of issuers in their portfolios. Most funds have high exposures to public financial institutions, which are the largest domestic issuers of bonds. There are also no rules limiting investments in the securities of the sponsoring employer and some provident and pension funds in public sector enterprises are known to have invested large amounts in the bonds of the employer.

The basic framework of investment regulation such as fixed percentages for asset classes, pre-emption of investments by the government and passive management has never changed since it was first introduced fifty years ago. Although India pursued a programme of economic reforms in the 1990s,

provident and pension funds were least affected by these. Over the years, only two major changes occurred in the investment regulation–a shift from investments directly with the government to investments in government enterprises, and a shift from investments with administratively determined interest rates to investments with market determined interest rates.

From 1952 until 1975, provident and pension funds were required to invest 100 percent of their moneys in central government bonds. Interest rates on these bonds were administratively determined, as were all interest rates during the period. Funds often had difficulty in sourcing bonds due to the lack of a well-developed distribution network and cumbersome paper-based settlement systems. In July 1975, the central government introduced the Special Deposit Scheme, which was operated through select government banks. This was a non-tradable deposit account, in which the outstanding balances earned interest at a rate administratively determined by the central government from year to year. Due to the convenience of the Scheme, allocation to the Scheme was increased steadily and reached a peak in 1992–93, when 85 percent was required to be invested in central government's special deposits and the balance 15 percent in central government bonds.

After the economic reforms were set in motion in 1991, the funding pattern of public financial institutions and government enterprises changed in favour of market borrowing at market-determined interest rates. To provide captive sources of borrowing, the central government gave up some of its pre-emption on provident funds in favour of government enterprises, including public financial institutions. In 1993–94, the investment regulation was changed to require provident and pension funds to make 15 percent of their new investments in bonds of government enterprises. This was progressively raised to 40 percent, where it remains today. Public financial institutions, viz., IDBI, ICICI and IFCI were the principal beneficiaries of this change, and most funds today have large exposures to these institutions.

State governments' budget deficits also soared in the 1990s leading them to seek captive funding sources as well. Several state governments also set up independent corporations to implement infrastructure projects in irrigation, road development and power sectors. These state enterprises issued bonds guaranteed for repayment by the respective state governments. To

facilitate funding of the states, since 1995–96, provident and pension funds are required to make 15 percent of new investments in the bonds of state governments or in bonds guaranteed by central or state governments. The allocation to this category has remained unchanged since introduction. In the past few years, state enterprises implementing infrastructure projects have issued large amounts of bonds that have been bought by provident and pension funds.

Allocation to government enterprises and the states came at the cost of the central government. By 1996–97, the allocation to central government's special deposits had declined to 20 percent while the allocation to central government bonds was at 25 percent, for a total of 45 percent. The government discontinued the Special Deposit Scheme in 1997–98, and placed the 20 percent at the discretion of the trustees to be invested in any of the three categories - central government bonds, state/guaranteed bonds, or government enterprises. The EPFO as well as many of the Exempted Funds, chose to invest the 20 percent in the bonds of government enterprises as yields on those bonds were higher, making an aggregate investment of 60 percent in that category. Several Exempted Funds, however, chose to invest the 20 percent in state/guaranteed bonds where the bonds carry even higher yields but lower credit rating.

An important side effect of these changes is also a shift to market determined interest rates. Since 1993, the central government bonds are issued at market determined interest rates in auctions conducted by the Reserve Bank of India, although many categories of captive investors such as banks, insurance companies and provident funds were required by law to invest in government bonds. Government enterprises were free to determine interest rates on their bonds. New investments in Special Deposit Scheme, the interest rate on which was administratively determined, stopped in 1997–98. Since then, all new investments by provident and pension funds were made at market determined interest rates, with the exception of interest received on special deposits which was required to be reinvested in special deposits.

In his budget speech for 1998–99, the Union Finance Minister announced a major decision to allow provident and pension funds to invest in bonds of private sector enterprises, up to 10 percent of new investments. This 10 percent was carved out of the 20 percent placed at the discretion of the trustees in the previous year. Unlike other asset class allocations, which

were non-discretionary and needed to be adhered to, investment in private sector was at the discretion of the trustees who can, in the words of the Finance Minister, "invest in these securities subject to their assessment of the risk-return prospects of each security". Also, while bonds of public sector enterprises bought by the funds did not require rating, private sector bonds were required to carry investment grade rating by two credit rating agencies.

However, in the past three years since the provision was introduced, very few funds have chosen to invest in private sector. The EPFO as well as a vast majority of the Exempted Funds, most of which are set up by private sector employers, do not invest in private sector bonds. This is an indication that even private funds believe that investment in government enterprises is safer and carries an 'implicit government guarantee' unlike private enterprises which are subject to market forces.

Investment regulation for provident and pension funds comes from two sources - the Ministry of Finance under the Income Tax Act, and the Central Board of Trustees of EPFO (under the administrative control of the Ministry of Labour) under the EPF Act. Usually, the same regulations are notified under both Acts, but differences could arise. In 1999, the Ministry of Finance approved gilt funds as eligible investments under the 25 percent allocation for central government securities. The EPFO, however, did not implement a similar revision with the result that gilt funds remain ineligible investments for Exempted Funds as of today.

4.4.4 Minimum Return Guarantee

Exempted Funds are required to declare an interest rate not less than that declared by the EPFO. The employer is required to make good the shortfall, if any. Most funds manage to achieve the minimum benchmark return. A few very small funds sometimes have a problem in earning the minimum return due to the difficulties in sourcing small lots of securities at good prices. The liability on the employer in such cases is, however, not significant.

It is relatively easy to earn at least as high a return as the EPFO due to the limited flexibility given by the investment regulation. The mandated asset classes and passive management meant that sophisticated fund management skills were not required. Employers were thus motivated to set up

Exempted Funds even at the risk of providing a minimum return guarantee in order to provide better service to their employees in benefit administration, as the EPFO is notoriously inefficient. It must be noted that the EPFO contracts out investment management to a professional fund manager while most Exempted Funds choose to manage investments in-house. The Exempted Funds thus do not have the same advantages as the EPFO, of size or professional management. Yet the Exempted Funds are able to match the returns made by the EPFO which is indicative of the limited leeway the investment restrictions give a professional manager in pursuing superior returns.

4.4.5 Returns on Provident Funds

A key difference between the Indian provident fund and other DC plans usually seen in the western countries is that the Indian provident fund works like a deposit account which pays interest year after year, although the fund carries an underlying portfolio of securities. DC plans that invest in funds or portfolios of securities are usually marked to market at current values and the Net Asset Value (NAV) is determined, often every day. In India, however, the provident fund treats its bond holdings like a portfolio of deposits, as the bonds are required to be held till maturity. The average yield on the portfolio then becomes the investment return for the provident fund. Out of the return earned, the trustees declare an interest rate (it is not called dividend) to be credited to the members' balances. Members are thus unaffected by changes in the market values of the bond portfolio. For 2001–02, the EPFO paid an interest rate of 9.5 percent p.a. on members' monthly running balances, a minimum return that the Exempted Funds have to meet.

The strict rules that effectively mandate passive investment imposed few requirements or potential liability on the investment management process. Trustees had few concerns about credit, market or liquidity risks, matters that would normally be foremost in the minds of fixed-income portfolio managers. Investment management is essentially a process of selecting from among the few available alternatives within the required categories and only applies to new flows of funds. Until recently, investment losses were never a concern to provident and pension funds as most of the funds were invested with the central or state governments or their enterprises. While bonds of some enterprises, especially those sponsored by the state

governments, carried explicit government guarantee, others were thought to be backed by 'implicit support' from the sponsoring government. None of the funds have, therefore, found it necessary to develop processes or expertise for credit evaluation. Private placement markets in bonds are unregulated and little information is available to the investors in any case. Over the past few months though, provident and pension funds have begun to experience delays in payments and defaults. However, the sponsoring governments are seen to be striving to meet obligations using tax-payers' money if required, and the funds do not expect to write-off losses as yet. Provident and pension fund returns have thus far not been affected by credit losses. This may change in the future as the fiscal situation of several state governments has become a cause of concern recently and their ability to back up the debts of their enterprises is being increasingly questioned.

Passive management does not require periodic reconsideration of the entire portfolio or the kind of special expertise or complex research usually associated with managing large portfolios. Most funds felt competent to manage their investments and did not see a need to engage a professional manager. The regulatory framework provides few opportunities or incentives to pursue differential returns through superior management. Most funds have also so far managed to achieve the minimum guaranteed return with relative ease.

In this scenario, returns depended principally on two factors - the age of the fund and the credit risk profile. Old funds tend to have nearly 75-80 percent of their corpus invested in the Special Deposit Scheme (SDS)[35] and their returns are driven primarily by the administratively fixed interest rate on the SDS. EPFO, being the oldest fund, falls in this category. Newer funds that were started after the economic liberalisation tend to have higher returns because they would have little exposure to SDS and have invested at the high interest rates in the 1990s. More recent funds started after year 2000 tend to have the lowest returns, since the interest rates declined during that period. Returns also depend upon the credit risk the fund assumed within the category of government enterprises. Credit ratings differ among government enterprises as the rating agencies take into account the inherent financial strength of the issuer, the likely government support available and

[35]Fresh deposits in SDS stopped in 1997 and the old deposits were to mature in 1998. But the central government unilaterally extended the maturity to 2003.

the fiscal situation of the sponsoring government. Credit ratings are lower and yields higher in the case of state government enterprises compared to most central government enterprises. While the central government is rated AAA for domestic issuances, most state governments carry ratings in the range of A- to A+. Funds which have invested in such lower rated bonds tend to have higher returns. These funds have placed more reliance on government support than on credit rating and thus carry higher risk.

Provident Fund interest rate is one of the few remaining rates administratively determined in India although it functions in a rather convoluted way. The central government determines the interest rate on SDS from year to year, the current rate applicable from April 1, 2002 being 9 percent p.a. As the EPFO and all of the old Exempted Funds, which account for the bulk of the assets, have substantial investments in the SDS, the government indirectly controls their investment earnings. The government has adopted a policy of fixing the same interest rate on the SDS, the government provident fund (GPF), the public provident fund (PPF) as well as the government savings certificates that are sold through the post offices. Thus the government seeks to ensure that the members of the EPFO's occupational plans, the government employees who participate in the unfunded GPF and the self-employed workers who hold PPF accounts, all get the same return. The return is also the same on government's savings certificates. These certificates, however, have inferior tax status because interest on them is not tax-free.

As all of these rates affect a large portion of the population, their determination has become a politically sensitive issue. In the past few years, the government has consistently paid a higher rate on these savings than the interest on its market borrowings. Concerned about the high cost of borrowing and the rigidity it brought to the whole interest rate structure, the government appointed an Expert Committee to Review the System of Administered Interest Rates under the chairmanship of Dr Y. V. Reddy, Deputy Governor of the Reserve Bank of India, which submitted its report in September 2001. The Committee recommended linking of these administered rates to a market benchmark such as the yield on traded government bonds. While the government has expressed its intention of moving to market determined benchmarks, no decisions have been announced yet.

There is an added dimension to the EPFO's provident fund rate. While about 75 percent of the EPFO's corpus is invested in the SDS, the other investments are made at market-determined rates. In the declining interest rate scenario witnessed over the past three years, the yield on the total corpus is higher than the government-determined SDS interest rate. This is because the SDS interest rate varies from year to year while the other investments made in earlier years carry a fixed rate. EPFO thus has investment earnings adequate to pay members higher than the administered rate. But the EPFO's provident fund scheme requires the interest rate to be determined by the central government in consultation with the Central Board of Trustees (CBOT) of the EPFO, which is how the government's administration of the rate comes into effect. This has become a politically contentious issue in the past few years between the Union Labour Minister who chairs the CBOT and the Union Finance Minister whose ministry is responsible for all administered interest rates. The CBOT has been recommending a higher rate for credit to members on the basis of its higher earnings that has been turned down by the ministry of finance. For 2002–03, the CBOT has recommended 9.5 percent p.a. while the finance ministry has approved 9 percent p.a. in line with its policy of equating the SDS, the GPF and the PPF rates. The Labour Minister has threatened to take the issue to the Cabinet for resolution, and has even received media support for the higher rate as it is justified by the higher earnings. If CBOT has its way, it would be a departure from the past policy of the government of equating the various provident fund rates that are administratively determined.

The Exempted Funds are, of course, free to declare any interest rate so long as they meet the EPFO's rate that is their minimum guarantee. But the income-tax law treats such excess as taxable income of the members of Exempted Funds, while the minimum return is tax-free. So most Exempted Funds pay only the minimum required return and build reserves out of excess earnings, just as the EPFO does.

The Exempted Funds are not required to disclose their investment returns to either the participating members or to the EPFO. The actual declared interest rate although known to their members, is not made public. Likewise, the EPFO also does not disclose its investment returns to the public. The only public information available is the interest rate credited by the EPFO to its provident fund members, which can also be taken to be the rate de-

clared by most of the Exempted Funds. The interest rate on the provident fund and a comparison with other benchmark rates over the past twelve years is given in Table 4.2

Table 4.2 Returns on Provident Funds in India

Year	Provident Fund Rate∗	Bank Deposit Rate (above 5 yrs)	PF rate minus Bank Deposit rate	Long term Govt. bond yield (above 15 years)†	PF rate minus Govt. Bond yield†
1990–91	12.00%	11.00%	+1.00%	10.86-12.04%	+0.55%
1991–92	12.00%	13.00%	-1.00%	9.91-12.38%	+0.86%
1992–93	12.00%	11.00%	+1.00%	8.82-12.47%	+1.36%
1993–94	12.00%	10.00%	+2.00%	12.85-13.43%	-1.14%
1994–95	12.00%	11.00%	+1.00%	11.77-13.47%	-0.62%
1995–96	12.00%	13.00%	-1.70%	11.84-13.02%	-0.43%
1996–97	12.00%	12.00-13.00%	-0.50%	9.00-14.20%	+0.40%
1997–98	12.00%	11.50-12.00%	+0.25%	9.00-13.17%	+0.92%
1998–99	12.00%	10.50-11.50%	+1.00%	10.00-13.46%	+0.27%
1999–2000	12.00%	10.50-11.00%	+1.25%	9.79-13.11%	+0.55%
2000–01	11.25%	9.50-10.00%	+1.50%	10.58-11.89%	+0.01%
2001–02	9.50%	8.25-9.00%	+0.87%	7.41-8.32% +1.64%	
2002–03#	9.00%+	7.75-8.25%	+1.00%	6.71-8.17%	+1.56%

***Source**: Reserve Bank of India, Handbook of Statistics on Indian Economy, 2000–01. The provident fund rate is the same for the EPF, the GPF and the PPF; **& Source**: EPFO Operational Statistics. At 12 percent from April 2000 to June 2000 and at 11 percent for July 2000 to March 2001; **$ Source**: RBI Monthly Bulletin, April 2002; **Source**: RBI Weekly Statistical Bulletin, August 3, 2002; † Average value taken where a range has been indicated; **+x** Rate approved by MOF

The provident and pension funds could achieve attractive returns if the comparison benchmark is what the subscribers could earn on their voluntary savings. The two major investment avenues for individual investors in India are bank deposits and government savings certificates distributed through the Post Offices. Provident and pension funds matched or even exceeded the returns on these instruments by investing in bonds. Adjusted for tax benefits, returns on provident and pension funds are even higher. Provident and pension funds have been able to earn higher returns than members' voluntary savings due to the nature of financial markets in India.

4.5 State of Development of Financial Markets in India

Indian economy was tightly controlled until reforms were initiated in 1991. The public sector dominated the economy. Interest rates were administratively determined and financial markets were underdeveloped. Interest rates were gradually liberalised and became market driven, with very few rates remaining administratively determined today. The market infrastructure and the institutions required for development of the financial markets were created in the 1990s.

A key component of this development was the government bond. With increasing fiscal deficit financed by market borrowing, the primary issuances of central government bonds increased rapidly from Rs.8,989 crore in 1990–91 to Rs.11,6314 crore in 2001–02. The government bond market became fairly liquid over the past five years with traded volumes rising from Rs.29,530.62 crore in 1995–96 to Rs.2,45,9674.74 crore in 2001–02. The RBI created the institution of primary dealers in 1995 to bring more liquidity to this market. Market infrastructure saw similar progress in the period. DVP settlement was instituted in 1994; a clearing corporation and electronic settlement of deals established in 2002. A Real-time Gross Settlement System (RTGS) for payments is presently under implementation.

The corporate bond market developed since about 1995. The private placement market has grown quickly with corporate bond issuances increasing from Rs.10,035 crore in 1995–96 to Rs.62,462 crore in 2000–01.[36] Issuances from the public financial institutions fueled a lot of this growth. Innovation is limited as yet and most bonds are plain vanilla instruments. Floating rate bonds are not popular and inflation-indexed bonds are nearly non-existent. A retail bond market has not yet developed, with just a couple of financial institutions making public issues of bonds. Corporate bond market remains illiquid with traded volumes of just Rs.14,486 crore reported on the National Stock Exchange (NSE) in 2000–01.[37]

During this period of bond market development the government liberalised investment guidelines for provident and pension funds. Allocation to bonds of government enterprises that started at 15 percent in 1994 increased to a

[36] Prime Annual Report, 2000–01

[37] National Stock Exchange: Indian Securities Markets, A Review, 2000–01

maximum of 60 percent at present, while a similar fall has been mirrored in the allocation to government bonds. Private sector bonds are permitted up to 10 percent since 1998. Bonds of financial institutions and public enterprises tend to have longer maturities and pay higher coupon rates compared to bank deposits. Provident and pension funds were able to earn higher returns by investing in bonds, as the funds had access to the wholesale private placement markets. As the retail bond market has not developed, individual investors invested mainly in bank deposits rather than bonds.

The stock market started to develop in mid-1980s when foreign companies were required to dilute their shareholding, but the market boomed after the liberalisation started in 1991. A major scam, however, hit the market in 1992. Securities and Exchange Board of India Act was passed in 1992, which established the capital market regulator. Over the next few years, India modernised its stock markets with the introduction of nationwide electronic trading in 1994 and dematerialisation of share certificates in 1996. India also shifted from account period settlement to rolling settlement in 2002. Trading volumes recorded phenomenal growth with the average daily traded volumes on the stock exchanges increasing from Rs.150 crore in 1990 to about Rs.3,500 crore in 2001–02. However, the stock market witnessed scams and crises at regular intervals reflecting gaps in supervisory capabilities. While global markets experienced a decade-long bull run, Indian markets went through cycles of boom and bust. The meltdown in tech stocks and the more recent fall in global markets on the back of corporate accounting scandals added to the woes. The BSE Sensex, which reached a high of 4467 in April 1992, stood at 2991 on September 30, 2002 recording a fall of 34 percent over a decade. At present, the market is in a phase in which investor confidence has been shaken and individual investors have shied away from the market.

A mutual fund industry is yet to develop to a significant degree in India although a large number of international firms have established operations in the country. Most of the funds have been set up only in the past 3 - 4 years. The industry remains in the early stages of development with insufficient experience to judge its likely scope or viability. With the recent turmoil in the stock markets, most funds have reported losses and investor confidence in equity funds is not particularly high. Debt funds have succeeded in attracting some investor interest. However, the state-owned Unit Trust

of India (UTI), which is the largest mutual fund, is in the throes of a major crisis at the moment. UTI had launched several funds that had explicit or implicit assured returns and was unable to meet obligations. The government has recently structured a bail-out package to restrict investor losses. The crisis, which affected several million investors, has shaken public confidence in the mutual fund industry.

Capital account controls in India do not permit citizens to invest overseas. Though there has been debate on capital account convertibility and potential future reform has been proposed, progress has been limited. Recently, as a first step, the government has permitted mutual funds to invest in the highest-rated overseas bonds subject to a countrywide limit that is distributed among the funds. Mutual funds are yet to operationalise the allocations.

The result is that household savings are conservatively invested. India has a high household savings rate at 20.9 percent of GDP in 2000–01, of which 11.0 percent is invested in financial assets and 9.9 percent in physical assets. The total financial savings of the households was distributed as shown in Table 4.3

Table 4.3 Distribution of Household Savings in India

	2000–01	1996–97	1993–94
Currency	6.4	8.6	12.2
Deposits	44.3	48.2	42.6
Of which Bank Deposits	38.8	25.6	27.9
Other Deposits	5.5	22.6	14.7
Shares and Debentures	1.4	3.8	8.0
UTI and other mutual funds	1.3	2.8	5.5
Government Savings Certificates and securities	13.1	7.4	6.3
Insurance	12.8	10.1	8.7
Provident and pension funds	20.7	19.1	16.7
Total Household Financial Savings	100.0	100.0	100.0

Source: RBI, Annual Report, 2001–02

Bank Deposits are the most popular investments for households in India, followed by provident and pension funds. Provident funds have generally provided higher returns compared to bank deposits, as shown by Table 4.2. The only period when it did not occur was during the high interest rate pe-

riod of 1995–97, when the provident fund rate remained frozen at 12 percent. Yet during these periods, the provident funds did invest at higher rates although they did not distribute higher earnings. Other deposits shown in the Table 4.3 include mainly deposits of non-banking financial companies (NBFCs), manufacturing companies and co-operative banks. Specifically, NBFCs witnessed rapid growth in India in mid-1990s and became popular with investors by raising deposits at high rates (often higher than the provident fund rate). The bubble burst quickly within a few years, with depositors losing money due to defaults leading to loss of investor confidence. Co-operative banks do pay a premium on commercial bank deposit rates, but do not generally match the provident fund rate. These banks have also been hit by a series of failures over the past year, leading to concerns among depositors. As a result, the share of bank deposits in household financial savings has gone up over the past five years, as evidenced by the data above.

Government's savings certificates and insurance are the next most popular investment options for the Indian households. As mentioned, the government has a policy of equating the savings certificates rates with the provident fund rate. Insurance, being a risk cover, is not exactly comparable but the returns are lower than the provident fund.

Retail moneys flowing into stocks, bonds and mutual funds actually declined over the past decade. The stock market witnessed a string of scams and crises, with the small investors burning their fingers time and again. The IPO market that boomed in the mid-1990s is all but dead, although showing some weak signs of revival in the past few months. The retail bond market has not developed in India to any meaningful size, despite the persistent efforts of a couple of financial institutions. The private mutual fund industry is nascent and yet to become an option of any significance to individual investors.

Investors are thus not unhappy with the returns on provident and pension funds when compared to the returns on alternate investment avenues. In fact, they earned more on the retirement funds compared to their voluntary savings. Investment in the bond market, which is primarily a wholesale market and the policy of the government in paying a higher interest rate on this channel of borrowing were the main reasons why the provident funds could earn higher returns.

4.5.1 Are the Returns Adequate?

Although provident and pension funds may have given returns higher than members' voluntary savings, the key question to ask is whether the returns are adequate. The ultimate objective of the pension system is to achieve a target income replacement rate for citizens in old age. On this criterion, the Indian system fails on two counts. First, the large pre-retirement withdrawals do not ensure adequate savings for the retirement period. Second, the returns which are below the real wage growth in the economy do not ensure that the replacement rate can be maintained.

Pension funds in developed countries have been able to achieve income replacement targets by generating high returns with global investing. They have been able to provide inflation-indexed returns that matched or exceeded wage growth. Providing old age income security thus goes beyond pension reforms. They need to be accompanied by developments in the financial markets that promote productivity of capital. The International Network of Pension Regulators and Supervisors recognised the same when they stated in their principles, A productive, diversified investment of retirement savings which spreads risk requires well-functioning capital markets and financial institutions. The development of advance-funded pension systems should go hand-in-hand with a strengthening of the financial market infrastructure and regulatory framework (including the development of new financial instruments and new markets such as inflation-indexed markets and the improved functioning of retirement annuity markets). The Reserve Bank of India echoed the same view when it stated in its Annual Report, *'Pension fund reforms are considered an integral part of financial sector reforms and fiscal consolidation. Development of a funded private pension system needs to be supported by a simultaneous strengthening of the financial market infrastructure'*.

Access to global investment markets for provident and pension funds would be an important consideration for India to increase returns on retirement savings to international levels. The Indian government has made a beginning by granting limited allocations to mutual funds to invest overseas. Extension of such liberalisation to provident and pension funds may be the key in the long-term to increase returns and thus retirement income levels.

4.5.2 Public Confidence in the System

All of the options to increase returns would likely be associated with increased risk and variability in returns. But in India, members perceive their retirement funds, which often represent a major portion of life savings, as 'fixed-income' investments. This is in line with public preference for fixed investment returns. Members have no knowledge of how the fund is invested, but believe their savings to be 'safe' with the government somehow behind the system. They have never been educated that their provident fund is subject to investment risk. They receive an annual statement of account, showing their monthly contributions adding to the accumulated balance as in a deposit account, along with a credit of interest at the end of the year. They expect to receive the amount shown to their credit, when they retire. They do understand that the rate of interest varies from year to year, in line with the movements in market interest rates. India has witnessed a sharp decline in interest rates over the past three years and the EPFO's provident fund rate has fallen from 12 percent p.a. in 1999–2000 to 9.5 percent p.a. in 2001–02. Members deem such decline as normal, having witnessed similar fall in the rates on popular investments such as banks deposits.

The upside of the system is the confidence of the public built over fifty years. Every new employee joining service contributes to an occupational plan secure in the belief that he would get his money back at the end of a long career, with no loss of principal and along with a reasonable return. Unlike the banking system and the stock market that have witnessed several crises in India, the provident and pension funds have been spared of any confidence-shaking crises. However, for the first time in fifty years, prospects of defaults and losses have become real over the past few months raising questions about the sustainability of the system.

4.5.3 Sustainability of the System

While the model may have worked in the past, a virtually publicly managed system with administered returns cannot be supported in the liberalised era that India has chosen to unveil over the past decade. The government has so far implicitly assumed responsibility for all retirement savings by directing such savings to be channelled to itself or its enterprises and paying what would be considered an attractive return. In effect, the government has underwritten the pension system with tax-payers' money. The govern-

ment has also assumed fund management responsibility, with more than 70 percent of the corpus of provident and pension funds being under the EPFO plans.

Over the past few years, the government has increased the allocation for public financial institutions and public sector enterprises. There is an implicit assumption in the minds of the trustees and members that these investments are backed by the government. But many of these enterprises have started to face financial problems and the ability of the government to bail out such enterprises is being increasingly tested. IFCI's default is a case in point where a bail-out package is yet to be structured. The problem is particularly acute among state government enterprises. Several state governments have extended guarantees to their enterprises indiscriminately and, owing to their fiscal profligacy, have witnessed downgrading of their credit ratings. Provident and pension funds have made large investments in such state government enterprises. The quality of this portfolio has become a matter of concern. Several enterprises have defaulted or delayed on payments calling in question the value of a state government guarantee.

If government enterprises are unable to meet their debt obligations, either the members will need to accept losses or the tax-payers' money used for bail-outs. The problem of defaults has just started and is only likely to get worse with time. With the retirement savings of millions being involved, it is also a politically sensitive issue. The solution to remove the huge contingent liability on the government budget is to transition to a privately managed system functioning under an effective regulatory framework. The responsibility for safety of funds needs to lie with the trustees where it belongs. Trustees need to be able to define a clear investment policy, choose a competent fund manager and invest based on an assessment of risk. Plan participants need to understand that their retirement funds are subject to investment risk. The investment regulation needs to become sufficiently flexible for the funds to choose an appropriate risk-return profile ranging from low-risk bank deposits to high-risk stocks.

While the Indian economy was built with a dominant public sector in the first four decades after the Independence, the government is now committed to a policy of shrinking the public sector through privatisation and exit from non-strategic businesses. New investments in public sector have already fallen sharply. Competition from private sector has also affected the

profitability of public sector enterprises, which has deterred further investments in public sector.

The ability of the public sector to absorb large amounts of retirement savings and generate an adequate return on them is thus in doubt. Already, provident and pension funds face a dearth of investment options resulting in concentration in their portfolios. The only viable solution is the broadening of investments in private sector and overseas securities. Without a greater capacity to diversify, the risk to the pension system from portfolio concentration and exposure to low-rated enterprises will increase. With the shrinking of the public sector, the government enterprises will need less captive sources of funding, lending more capability to the government to liberalise investment regulation.

There are concerns about a potential ‘debt trap’ of the government, with combined debt of the central and state governments reaching 63.7 percent of the GDP at the end of March 2001. Interest payments constituted more than 38 percent of the governments’ total tax revenues in 2000–01. Concerns are regularly heard from official agencies, domestic experts as well as international credit rating agencies on the fiscal situation of the government. Pension and provident funds, with their high concentration to government debt, are in a similar trap. In its present fiscal position, the government is in no position make net repayments to the funds unless the fiscal deficit reduces or other categories of investors take up more of its debt. Thus when the Special Deposit Scheme matured in 1998, the government unilaterally extended maturity of the scheme to 2003. It remains to be seen whether the government would indeed be able to redeem these large deposits in 2003.

The longer the present system continues, the deeper and tighter the trap becomes. Provident funds’ investments with the government have thus nearly become a Ponzi scheme, and major withdrawals due to retirements or systemic reform could potentially cause distress. The situation is not very different from the social security systems of the OECD countries and phenomena that made them unsustainable such as ageing of the populations would cause similar problems in India. However, the government announced plans to rein in fiscal deficit some time ago, and has proposed enactment of a fiscal responsibility law. If these measures succeed, the government’s need for captive sources of funding should gradually diminish.

In addition to the capacity of the government to maintain the size of the debt load, paying higher than market-determined returns on pension and provident funds is similarly unsustainable, as it amounts to subsidising the plan participants at the cost of the tax payers. The high rates of return on the provident and pension funds in the past were due to the few remaining administered rates of interest, particularly on small savings schemes of the government. The government has already moved towards dismantling them, as they result in high cost of borrowing. A committee under the chairmanship of the Deputy Governor of the Reserve Bank of India has recommended relating these rates of interest to market benchmarks although due to political sensitivities decisions are not made yet.

Earning higher returns without assuming higher risk goes against the basic principles of finance and is sure to end. When returns drop to market levels, it will be difficult to enforce investment regulations that direct virtually all of the assets of pension fund into government debt and demands for relaxation are sure to be made. Lower returns on retirement funds compared to voluntary savings would be unacceptable to members. Provident funds, their trustees and members would then need to make careful risk-return choices. Much of the financial sector development has taken place over the past decade to make this process feasible. As markets mature and supervision becomes more effective, markets would play a more efficient role in capital allocation. Returns on provident and pension funds in the present paradigm would no longer look attractive and employees would demand higher returns. Stocks and mutual funds would then become more popular with the households and would be acceptable investments to hold in retirement funds.

The government has also taken on the responsibility as the trustee and fund manager for most of the country's retirement savings by setting up the EPFO. As long as most of the investments were made with the government or its enterprises and they met their obligations on time and gave good returns, it works. But questions arise when there are private sector alternatives, competitive investment management, variable returns and investment losses. The government is unsuited to be a plan administrator or manager in such an environment due to the political sensitivities and is likely to be at odds with the needs of an open, competitive market.

The government has also assumed the huge contingent liability for any deficit in the DB pension plan of the EPFO, which is unsustainable. Pension plans all over the world have tended to migrate to DC plans from DB plans. Where DB plans do exist, the liability for them rightfully belongs to the employer and not the tax-payer. Inevitably, the DB plan of EPFO will need to be reformed into a DC plan or a privately managed DB plan for which the employer assumes liability.

The government's own pension system is evidently in need of reform, as acknowledged by the committees appointed by the government. The apparent solution is a gradual transition to privately managed, funded plans based on defined contributions. A privately managed system with liberalised investment guidelines can potentially earn higher returns that can reduce the government's future liability for pensions.

In this context, pressures for the establishment and rapid growth of private pension funds appear to be inevitable. As the Indian economy continues to develop and modernise, higher levels of employment in the organised sector will substantially increase pressure for pension coverage in the absence of other means to provide income security to the aged. The long period of development of the current system has lead to widespread acceptance of pension funds and the seeds of an independent and more varied system have been sown with the gradual emergence of funds organised and operated by individual enterprises. Perhaps most importantly a widespread expectation of benefits has been created and continues to be reinforced by the steady expansion of the provident funds. Robust levels of household savings among expanding sectors of the population will strengthen these demands.

Over the past fifty years, the government has focused on increasing coverage of the occupational plans by gradually bringing more industries and classes of establishments under the purview of the EPF Act. The number of covered establishments increased from 1,400 in 1952–53, to 46,504 in 1969–70, to 194,961 in 1989–90 and to 340,013 in 2000–01. There has been a similar increase in the number of covered employees from 1.2 million in 1952–53, to 5.6 million in 1969–70, to 14.66 million in 1989–90 and to 26.30 million in 2000–01.[38] However, private pension funds with

[38]Data from Ministry of Labour Annual Reports and www.epfindia.com

aggressive marketing capabilities may be necessary to increase coverage to non-salaried segments.

These pressures for the wider introduction of private funds are complemented by developments in capital markets. Explicit policies to diminish the size of the public sector require the expansion of private sources of stable and efficiently managed long term capital. The emergence of private debt markets and their supporting infrastructure and the development of equity markets should shortly provide the potential for professional portfolio management and diversification and risk management techniques able to support the rapid emergence of private funds. The convergence of these supply and demand forces are poised to provide the impetus and financial market synergism required to accelerate the widespread introduction of a truly private pension system.

4.6 Future of Private Pension Funds in India

The role of private pension funds in India has hitherto been limited. Though Exempted Funds are technically privately managed, the framework under which they operate limits their effectiveness. The strict investment regulation does not allow any scope for differential returns compared to the EPF plans. As a result, no professional service providers emerged either for fund management or administration that could consolidate the large number of small Exempted Funds. Less than 1 percent of the employers have chosen to set up self-managed funds although, of course, they cover 18.8 percent of the covered employees. The motivation for setting up an Exempted Fund was to provide better service to the employees in benefit administration as the EPFO is perceived to be notoriously bureaucratic and inefficient, than to generate higher returns.

In 1998, the government set up an expert committee under the chairmanship of Dr. S. A. Dave for devising a pension system for India. The project was titled OASIS for 'Old Age Social and Income Security'. The committee submitted its report in January 2000. The committee recommended introduction of Individual Retirement Accounts (IRAs). A centralised record keeping and servicing network was proposed to expand reach and minimise costs. Six fund managers that would each offer three standardised portfolios would be chosen through a competitive bidding process focussed on fees and expenses. The competing investment managers and multiple port-

folios would be expected to enable participants in the system the capability to align their individual investment pattern to their unique and evolving requirements. Annuities would be purchased from insurance companies. An insurance fund to guarantee principal has also been proposed. The committee recommended that EPF subscribers be given the choice to switch to the new system and Exempted Funds close and their subscribers be transferred to the new system.

Recognizing the distinct requirements, importance and scope of responsibilities required to effectively supervise and regulate an extensive new private pension system the committee also recommended establishment of India Pensions Authority (IPA) to undertake these responsibilities.

The IRDA, which examined implementation details of Project OASIS, made its recommendations in November 2001. The IRDA endorsed the idea to permit private pension funds to offer IRAs. The differences from the OASIS report related to licensing criteria for the pension fund mangers and the centralised record keeping and servicing network. The IRDA did not recommend any limit on the number of fund managers and did not endorse the idea of a centralised network. The IRDA report also did not endorse the concept of a separate regulatory authority for pensions. Instead the committee's report noted that "since insurance and pensions are regulated by the same regulator in most countries, due to similarities in the sectors, there should be total synchronous development of regulation in both these areas? This would, therefore, mean that it would be ideal if we have one regulator who looks after both the pensions and insurance areas."

Notwithstanding some differences of opinion on the form of implementation, underlying the work of both committees is the acceptance of the need for private pension funds in the country. Both committees also recognised that a key pre-requisite for the effective development of private pensions is a reliable and secure system for its regulation and supervision. Regardless of where this responsibility is ultimately resident, the more critical design issues are whether the regulatory regime is adequately formulated and sufficiently robust to addresses the basic requirements inherent to a private pension system and properly aligned with the main aspect of its design and functions. This requires a careful consideration of the nature of private pension funds, the evaluation of the objectives and requirements of the design, and the alignment of these needs to the environment within which the pension system will operate.

4.7 The Unique Character of Private Pension Funds

The foundation for any system of regulation is the recognition of the nature and requirements of private pension funds. Pension funds are essentially specialised financial intermediaries that collect and manage capital accumulated through contributions made by many individuals.

Pension funds, and consequently their regulation, are distinct from other financial intermediaries because they combine these financial functions with a significant role in advancing social policy objectives. Private pensions are a primary source of retirement income in many countries and of rapidly increasing significance in the developing world. This affords them a far broader base of participation and a unique set of purposes and constraints relative to other financial institutions. In India, despite coverage being limited mainly to the salaried workers, contributions to provident and pension funds constitute 20.7 percent of the nation's household financial savings indicating their high penetration among the population that has the potential to save.

Pension funds typically reach far more deeply through socio-economic strata than do other types of financial intermediaries and represent a much greater portion of the household wealth of the average participant. This characteristic is especially relevant in circumstances in which participation in a privately managed funded system is mandatory as in India or where the private pension system replaces public retirement income programs such as occurred in Chile during the 1980s. Even in a mixed system in which participation in a private pension is essentially voluntary such as the United States, households in the lower income groups typically have a large proportion of their accumulated wealth in the private system and will depend on it substantially for their economic security in old age.

Pension funds consequently serve a largely unsophisticated clientele with a very high degree of dependence and vulnerability. In India, this is particularly relevant as the financial sophistication of the participants is limited due to lower education levels and due to the underdeveloped nature of the financial markets. A deposit is the most commonly understood investment concept in India and risk appreciation is limited. Understanding of concepts such as mutual funds, or even bond-investing fundamentals such as yield-to-maturity is limited as yet to a small section of the population.

Pension regulation would need to bear in mind such realities and evolve regulation in response to growth in financial sophistication.

Pension funds function with substantially longer time periods than other intermediaries with the typical participant having a relevant investment horizon measured in decades rather than months or years. They are also prohibited, with relatively few exceptions, from borrowing and leveraging their portfolios. Both of these tend to minimise the liquidity requirements. Pension funds are, therefore, almost exclusively engaged in portfolio optimizing strategies which focus on diversification, selection and exploiting time period premia rather than those directed toward interest rate spreads, inter period arbitrage strategies or the management of liquidity exposure.

This creates a relatively narrow corridor to which investment practices may be appropriately confined. Pension regulation thus needs to address a subset of possible investment styles. In India though, complex investment strategies and issues in their regulation have not yet engaged attention due to the state of development of the financial markets and the nascent growth of fund management industry. Funds that implement arbitrage, speculative or leveraging strategies or those that have the ability to go short are yet to make their appearance in India. But as markets develop and overseas investments become allowed for investment, this is bound to change. It will, therefore, be important that any legislative basis for a new pension system define with considerable specificity the range of acceptable investment practices to enable any regulator to ensure adherence to appropriate practices and avoid exposing participants to inappropriate or unwarranted risks.

While pension funds operate under a variety of governance structures the overwhelming majority of the arrangements involved the payment of fixed fees for asset management and services. Fee based compensation arrangements impose a different set of agency issues and financial incentives than those in which the equity holders of an intermediary gain or lose in direct proportion to the profits and losses of the enterprise. Pension fund regulations are particularly focused on the agency issues associated with this type of incentive structure, which range from conflicts of interest related to the allocation and level of administrative expenses to managing incentives for adding marginal risk to investment portfolios. Again, India does not yet have experience in these regulatory issues as most fund management arrangements today are based on fixed fees and not performance linked.

Pension funds are also somewhat unusual in their potential to function as second and third tiers rather than primary sources of financial intermediation. Funds established in the trust/foundation model often simply act as a conduit or nexus for the purchase of asset management services on behalf of employees. They invest through bank instruments, trust departments, the purchase of insurance products or through shares in investment companies or mutual funds which are subject to regulation and control through separate legal and institutional authorities which will often have differing priorities and imperatives. The coordination of these authorities and reconciliation of varying approaches and imperatives impose some of the more complex problems in a pension regulatory regime. As India has multiple regulators for insurance (IRDA), capital markets (SEBI) and banking (RBI), the coordination of these authorities and their interactions with the pension funds will be essential to the successful operation of any system.

The significant direct tax subsidies given to pension funds also contribute to their distinctive status. The tax preferred status of retirement savings vehicles in which contributions are often afforded what approximates a consumption tax treatment effectively makes public fiscal authorities among the major stakeholders in a pension fund. Ensuring the equity of the distribution of these subsidies and protecting the value of the public investment contributes to the perceived need for greater security in the regulatory approach. Establishing the conditions for access to this subsidy, although outside of the scope of this paper, is one of the primary tools in the regulation of pension funds. India already has the necessary regulatory framework as the private pension funds require recognition under the Income Tax Act, which lays down the regulations that need to be followed for the tax-benefits to remain in force.

Finally, their role as an instrument of social policy through income support of the elderly further contributes to the acceptance of more restrictive regulatory approaches and perhaps more significantly leads to a variety of guarantees. Guarantees directed toward social policy objectives which establish government backed promises of rates of return or future benefit levels can create complex incentive structure and moral hazard problems. Establishing a regulatory framework in conjunction with guarantees originating in political imperatives or social policy objectives is one of the more complex and vexing problems in regulating pension funds. While there are

no explicit guarantees in India at present, the deep involvement of the government creates implicit guarantees. In a privately managed system, these guarantees would require to be reviewed, made explicit and appropriate institutional structure and safeguards established.

4.8 Approaches to the Regulation of Private Pensions

Although private pension regulatory regimes are consistent in their attempt to address the distinctive requirements of pension arrangements and address a common set of risks, there is considerable variation in the manner through which this is accomplished. This variation originates with a number of factors including the historical evolution of the system, the state of economic development as well as unique political and cultural environments. No simple descriptive framework can encompass the richness of this variation. Key elements of design and function can, however, be illustrated through two stylized models and consideration of a number of key areas in which their attributes vary.

From the perspective of their role as financial intermediaries pension funds can be viewed as falling within two basic models,

1. Special purpose management companies characteristic of Latin American and Eastern European system and

2. The Trust/Foundation model characteristic of Anglo/American and Western European approaches.

The Indian system of occupational plans and Exempted Funds follows the second model. The reforms suggested by Project Oasis and the IRDA envisage the first model. It is likely, therefore, that India will need to incorporate elements of both models in achieving a solution appropriate to the design and conditions faced by a new private system. While the two models are exemplary in delineating key attributes hybrid approaches have become quite common as various countries seek to establish systems which address particular conditions or objectives. Motivations for hybrid arrangements include the need to function in the very early stages of capital market development, an attempt to evolve from highly restrictive regimes to a market

oriented approach or to reconcile a new design with existing institutional arrangements, issues likely to be relevant considerations in India.

Special purpose management companies operate in virtually the same manner as investment companies or mutual funds in their investment management activities but wrap a number of other functions related to collection of contributions and benefit pay-outs around these. They are usually sponsored or effectively managed by parent entities engaged primarily in financial services. Their primary purpose is investment management and maintenance of individual accounts. Typically they invest directly in instruments offered on primary markets or by issuers, making strategy and selection decisions in-house. They usually perform all individual account maintenance functions, arrange for the transfer of balances and often serve as intermediaries in the sale of annuity contracts. Participants are generally permitted to switch accounts among a limited set of companies resulting in a sort of managed competition type of market discipline. In some circumstances they are permitted to underwrite annuities. Although they are not specific to mandatory defined contribution systems in which employer's role is constrained to the collection and forwarding of predetermined contributions, they are generally associated with what have become known as second pillar systems.

Regulation of these systems is characterised by narrow structural requirements related to the organisation of the sponsoring entities, highly specific limits on portfolio composition, imposition of specific constraints on fees and marketing in conjunction with highly regimented systems of accounting and disclosure. The underlying regulatory philosophy is highly prescriptive and emphasises uniformity to achieve safety over flexibility to achieve efficiency.

The approach has been termed by some observers as draconian because of the rigidity of the structural and operational requirements it imposes. Investment requirements are designed to manage systemic economic risks through very specific portfolio regulations. Regulatory and supervisory activities are directed toward control of the contributions flows, immediate accountability of management companies for the value and custody of assets and the availability of standardised investment performance data.

Project OASIS suggests several features that are characteristic of this model. Project OASIS suggests managed competition among a limited number of pension fund managers; in fact, it suggests six managers chosen by bidding on fees. It suggests three standardised portfolios with specific asset allocations characterising conservative, balanced and aggressive styles that would be offered by all the managers although it does not recommend specific issue or asset allocation limits that are typically characteristic of the regulatory model. The OASIS proposal would also impose limits on expenses and require investment performance to be presented in a standardised format to facilitate comparison and competition. Switching would be possible among the different managers at specified intervals. The report also suggests a centralised collection and record-keeping system that the committee believes saves on cost and enables nation-wide coverage, a design feature that is often used in conjunction with a special purpose investment management company approach. The IRDA report did not endorse the limit on the number of managers and the centralised record-keeping system.

Usually, trust/foundation pension funds primarily provide a basis for the organisation and accountability of activities rather than to directly perform investment management functions. They are characteristic of voluntary employment based arrangements in which the trust serves to separate the pension fund from the sponsor's other business activities. The direct role of the fund's trustees and administrators is typically limited to oversight of administrative functions and formulation of general investment strategy. There is a greater reliance on employers to be responsible for the collection and forwarding of contributions. With the exception of the largest entities (for which economies of scale prevail) investment management activities are typically obtained on a contractual basis.

These types of pension funds commonly utilise other intermediaries such as banks, insurance companies and mutual funds to obtain bundled investment management services, or engage specialised fund managers who are delegated considerable discretion regarding strategic and selection and trading decisions. Both defined benefit and defined contribution arrangements are organised in this form resulting in a broad and complicated array of strategic investment problems. These include asset-liability management and concerns about limiting the volatility of sponsors' contributions

in addition to the narrower issues of mean variance portfolio optimisation. These arrangements more typically provide benefits supplemental to public social insurance systems (first pillar) or mandatory public funded arrangements (second pillar) and consequently often have greater risk tolerance in their investment strategies.

Regulatory regimes applied to this model are more characteristically directed toward controlling the nature of the relationships and transactions among the various parties and imposing standards of conduct rather than assessing compliance in terms of outcomes or investment results. Rather than dictating portfolio content they are based on standards of diligence and suitability oriented toward the process of decision. They tend to focus on prohibiting conflicts of interests in terms of incentives, relationships and functions rather than organisational categories or structural definitions. Transparency and competition are often secondary considerations to adaptability and operational efficiency, derivative of the association with voluntary systems and employer sponsorship. There is a greater emphasis in compliance activities on deterrence, assignment of liability and compensatory sanctions than pre-emptive enforcement. These regimes have therefore been classified as flexible in contrast to the more prescriptive models.

However, India has adopted the trust/foundation model for the mandatory occupational plans, unlike the western countries where such employer-sponsored plans are usually voluntary. The regulatory regime for these trusts, discussed earlier in the paper in detail, is prescriptive rather than flexible. The Indian trusts also tend to manage investments and carry out record-keeping and benefit administration in-house, rather than contract out these functions to professional providers. Indian pension fund regulation does not address these relationships, which are today governed by the general contract law. However, engagement of professional providers by the trusts is on the rise and the regulation would need to be reformed to address organisational and liability issues, and provide more flexibility.

4.9 What Risks Must Pension Regulation Address

As with any type of financial institution, the regulation of pension funds originates with the assessment of risks. Pension funds impose essentially the same risks as other financial institutions such as banks or mutual funds but add to these a number of considerations resulting from their role as an

instrument of social policy and the distinctive nature of their membership. Elements of their regulation are generally aligned with these risks. The major categories of risk and associated aspects of regulation are discussed below.

4.9.1 Inefficient Capital Allocation

Mature private pension systems control a significant portion of the financial capital of economy. In the United States private pensions represent 20 to 25 percent of the financial capital with aggregate assets that exceed those of the banking and insurance sector and are now the majority owners of the equity shares of the largest publicly traded corporations. Pension funds have been estimated to hold a third of stock market capitalization in the U.K., a quarter in the U.S. and 11 percent in Chile and Denmark. In India, total pension assets are estimated at about 7 percent of GDP. About 20.7 percent of total household financial savings in India flow into provident and pension funds every year, their investment resulting in a significant impact on the efficiency of capital allocation in the economy.

Pension regulatory regimes attempt to address the risk of inefficient capital allocation by imposing standards for investment management that either subjects asset managers to a market standard of decision making (the prudent expert) or imposes specific parameters through portfolio composition requirements. They may also impose an implicit hurdle rate for investment decisions via minimum return requirements and placing sponsors capital at risk. Others implicitly achieve the result through book reserve funding systems which effectively permit the assets to be comingled with those of the sponsoring company presumably subject the same market discipline via corporate governance mechanisms and share prices. The tension between subjecting pension assets to market forces to achieve allocative efficiencies while simultaneously achieving high levels of security and fiscal integrity is the most fundamental issue in the design of pension regulatory systems.

The present regulation in India that involves a highly regimented investment prescription and the complete absence of competition among funds with no option to the employee or the employer to choose plans or portfolios, militates against allocative efficiencies in the economy. Healthy competition among pension fund managers and the availability of reliable comparative information that enables members to make the right switch de-

cisions should be key dimensions of private pension regulation that India needs to establish.

While a prudent person rule with total freedom to the funds to determine investment policy may have maximum allocative efficiencies this can only effectively be achieved within mature and efficiently operating financial markets. Although progress toward this development has been substantial in recent years, as discussed earlier, India remains in the formative stages of the development of its investment markets and is therefore likely to require the continuation of a system of portfolio composition requirements for some time. Due to the considerable vulnerabilities of the populations served and the extent of public fiscal exposure, private pension funds are generally the last major type of financial intermediaries for which the more relaxed market oriented investment regimes are appropriate, although any approach is well advised to explicitly consider an eventual evolution is this direction.

The concept of three standardised portfolios suggested by Project OASIS is worthy of consideration in this context. It constrains portfolios within three relatively specific categories without precisely specifying asset allocation. This provides a modicum of safety while representing a significant transition from the single portfolio prevailing at present and creates a relatively simple structure within which effective competition among providers can be facilitated. Project OASIS has suggested safe, balanced and growth portfolios representing increasing levels of risk. The standardised portfolios make it easier to understand risk-return tradeoffs and compare across funds. Project OASIS also suggests a simple, standardised quarterly report of performance returns that makes it easier for the members to make switch decisions. Considering risk-bearing capacity and levels of financial sophistication, there is a case for limiting the balanced and growth portfolios only to employees above a certain income level, at least in the initial stages. Multiple portfolios increase administrative complexity, which Project OASIS has tried to address through a centralised depository keeping records. Countries have also often imposed restrictions on the number of times such switches can be made.

Competitive pressures among pension companies work towards enhancing returns to investors and improve allocation of capital in the economy. Project OASIS recommended six managers, with the aim of achieving rea-

sonable size for each company and to reduce confusion among investors. The licensing procedures need to balance conflicting considerations. A small number of reputed, large players are easier to regulate and supervise. At the same time, entry barriers should not be such as to limit competitive pressures. Faced with similar concerns other countries have sought to limit market entrants in the initial years of a reform in anticipation of a gradual broadening of the market when sufficient depth is attained and the supervisory and licensing system are established and well functioning.

Latin American countries have adopted minimum guarantee related to the average return achieved by the industry. This has often been criticised for causing herd behaviour among the funds. In India, a guarantee related to a fixed income benchmark, such as the average 3-year fixed deposit rates of five big banks, would be appropriate to build investor confidence. Shortfalls may come from the pension companies that can be recouped in good years. This would ensure that a minimum return is achieved over the long term that would be a hurdle rate for the pension system.

A book reserve system that depends primarily on corporate governance and market discipline is not appropriate for India since these pressures are as yet not strong enough. A book reserve system also does not ensure funding of the pension plans and remains vulnerable to financial difficulties of the employer. Under the present regulation, book reserve system is allowed in India only for gratuity funds.

4.9.2 Vulnerability to External Economic Shocks

Pension funds are vulnerable to several types of external factors. Although they have minimal liquidity concerns related to a "run on the bank" they are subject to solvency issues resulting from general economic downturn or in the case of defined benefit plans mismatches between asset and liability interest rates. The main vulnerability derives from the status of sponsors. Fundamental or cyclical economic fluctuations may threaten the viability of sponsors coincident with low returns among funds. Among employer sponsored arrangements (both single and multi) sectoral losses in employment leading to early or bunched retirements may result in payout requirements that are coincident with negative investment returns and a loss of contributions.

These types of risks are typically addressed through two mechanisms. Portfolio restrictions and diversification requirements partially hedge systemic economic risks. Sponsor specific risks are mitigated by requirements that title to the pension funds assets be segregated from the other assets of the sponsor, explicit positioning of pension funds in bankruptcy cases and the establishment of reserve and minimum capital at risk requirements for sponsors. Legal frameworks which impose personal liability on designated individuals are an additional means of limiting these risks both through their incentive effects and by providing recourse for damages.

In India, underperformance of investment markets due to economic downturns would need to be hedged through diversification, particularly international diversification. At present, mutual fund regulation in India stipulates diversification requirements while pension regulation does not. To insure against the possibility that an employee retiring during depressed markets could be at a disadvantage, annuitisation should be spread over the last few years before retirement. Bunched retirements due to lay-offs is not a serious concern in India, but the recent voluntary retirements introduced in several companies do point to the possibility. Bunched retirements would again need to be addressed through structuring of pay-outs and annuitisation over a few years.

Indian laws already have strong provisions to cover employer specific risks. Employers are not allowed to run pension funds under a book reserve system. An independent trust with title to the assets isolates the fund from sponsor's insolvency. Insolvency laws already provide priority to the dues of provident and pension funds. The EPF Act gives power to the commissioner to recover dues to the funds in a procedure on par with recovery of dues to the government, with priority attachment of assets. The Act also imposes liability on the directors of the employer for failure to discharge responsibilities under the Act.

Among employer specific risks, the risk of underfunding in DB plans has not been specifically addressed in the Indian laws at present. The new plans suggested in the reform initiatives are DC plans. However, where DB plans exist, funding rules need to be defined to insulate the fund from employer specific risks. Rules need to also specify the principles governing actuarial valuation and asset valuation in order to determine funding levels. Minimum funding requirements should specify the acceptable funding levels that are required to be maintained at all times.

4.9.3 Negligence of Responsible Parties

As noted above, pension plans involve the investment of significant capital on behalf of populations which typically have low levels of legal and financial sophistication. The complex portfolio strategies associated with long term investment horizons create a high potential for negligence on the part of asset managers and informational asymmetries in the transactions between members and funds. Defined benefit arrangements impose special problems in actuarial measures.

Regulation of these risks is achieved through a broad range of measures. Specific licensing requirements for entry into the market are common in Latin America and Eastern Europe. Explicit fit and proper requirements typical of many systems and the prudent expert standards which typify Anglo-American system incorporate similar standards although generally in a retrospective rather than prospective manner. The U.K has recently developed regulatory programs to enhance the education of trustees. Extensive systems of information disclosure and marketing standards are the usual approach to the potential for informational asymmetries. Liability arrangements and bonding requirements further address these risks although they are primarily directed toward the problem of fraud.

For India, or any other country in the early stages of developing market oriented financial institutions, licensing criteria that restrict entry to credible, reputable companies is the only reliable method to insure against negligence and lack of performance. Essential criteria for entry are capital adequacy, well established internal controls, transparent governance structure and reliable independent external audits. A prudent person rule already exists for trustees under the Indian Trusts Act. This needs to be extended to asset managers and other responsible parties associated with pension funds. Establishing duties, standards and liabilities of responsible parties such as trustees, directors, auditors, actuaries and custodians will be a critical initial priority in the promulgation of regulations.

Over the past few years, India has developed extensive disclosure standards for mutual funds and IPOs. This experience can be used to develop disclosure standards for pension funds, including the performance of funds as well as portfolio composition. Pension regulation should specify disclosure standards to be complied at the time of selling and on an on-going

basis to reduce information asymmetries between the fund and the members. India has recently introduced a certification programme for distributors and salespeople of mutual funds. A similar programme for pension funds would insure against mis-selling.

4.9.4 Fraud and Malfeasance

The most immediate and obvious risk of pension funds is the potential for fraud, malfeasance or outright theft of assets. Incidents such as the Maxwell case in the U.K., the diversion of union pension funds in the U.S. by organized crime syndicates in the 60's and early 70's and more recently the extensive fraud among self designated pension funds in a number of transition economies in Central and Eastern Europe continue to highlight this vulnerability.

Regulatory regimes address these risks through both structural requirements as well as pro-actively though examination and intervention. The title to assets is usually required to be held separately from those of the sponsor within a framework (a trust or separate incorporation) that assures a higher standard of responsibility. Custody arrangements often augment this approach. Governance structures that rely on the independent appointment and authority of boards of directors or trustees impose internal controls and oversight on those with discretionary authority or who handle funds. Extensive specific prohibitions of transactions among parties with potential conflicts of interest are another common means to prevent the diversion of funds.

The structural requirements are supported through accountability and liability provisions that usually significantly exceed those applicable to other commercial arrangements. Trust laws typically impose a greater reach of personal liability for responsible parties than do commercial codes often penetrating corporate liability shields and permitting the attachment of personal property. Broader application of criminal penalties is also used for deterrent and remedial purposes. Pension funds may be subject to specific bonding requirements or require that reserves or minimum capital provisions be met as a condition of licensing. Periodic financial reporting requirements supported by the requirement for independent audits to verify the veracity and completeness of financial statements are nearly universally required although they vary widely in their frequency.

Active oversight and intervention programs by supervisory authorities supplement structural requirements and enforce compliance with fraud prevention measures. They include periodic and unscheduled on site inspection, the authority to demand production of documents and records and access to substantial sanctions. The nature of these activities varies widely and is discussed in further detail in a later section.

Indian laws have experience in fraud prevention provisions, which can be extended to pension funds. Mutual funds in India are required to appoint independent custodians, who are licensed and regulated by SEBI, to hold assets. There are several well-established custodians operating in the country. Pension fund regulation should impose a similar mandatory requirement of independent custody arrangements.

Risks arising from self -dealing and conflicts of interest will pose some of the more difficult challenges in India. One of the most difficult threshold problems will be the development of a legal framework that defines the scope of relationships among pension fund managers and service providers that will give rise to the applications of restrictions that seek to preclude inherent conflict of interest situations. This fundamental problem is one of the most commonly overlooked issues on the formulation of the legal framework in which nascent private pension system operate. This is one area where their may be much to be learned from the Anglo-American Trust based systems whose protections are substantially based on these relationship defined prohibitions and safeguards.

The sweeping prohibitions incorporated in some regulatory systems are likely to be impractical in the earlier stages of financial market development in which a limited number of institutions will dominate certain sectors and trading venues. The added costs that would be associated with requiring asset managers to execute trades through unaffiliated brokers, for example, may be prohibitive in relation to the protection they afford. Regulatory approaches which craft structural protections such as reserve or collateral requirements, fixed fee arrangements or prohibitions against principal transactions in dealer markets when relationships between asset managers and market execution institutions exist offer one potential middle ground.

The current Indian system of restrictions on mutual fund investments and other transactions with the sponsor or his associated companies offers one alternative approach. Transactions with associates are required to be disclosed to investors. Restrictions may include specific board approval and disclosure to plan participants. Governance arrangements should include provisions for independent directors with relevant experience and knowledge. Oversight responsibilities of the board such as institution of adequate internal controls should be defined and penalties enforced for failure. The requirement of independent audit already exists. To ensure independence, the appointment of the auditors may be made by the pension regulator in a system similar to what is followed by the RBI for banks.

4.9.5 Inefficient Operations and High Administrative Costs

One of the primary agency risks, which is compounded by the fee based nature of the pension fund management business, is the potential for operational inefficiencies when overhead costs are charged directly from accounts or separated from fees. There are more opportunities for this problem in pension fund management because of the multiple types of overhead and fees that may be charged including administrative and accounting, asset management and transaction fees as well charges associated with annuitisation. In addition to the absence of incentives for sponsors to limit overhead there are significant transparency issues in regard to fees because they are often netted against investment returns and therefore concealed in standard financial reports or bundled with other services obscuring the ability of members to make relevant comparisons to similar financial services.

Regulatory regimes utilise two basic approaches to this agency and efficiency risk, by explicitly imposing ceilings or other limitations on fees or attempting to utilise market competition by establishing standard disclosure requirements to facilitate members' capacity to bring pressure on sponsors or enhance competition among funds. Each of these has its attendant limitations and unintended effects. Limits tend to result in minimising competition as funds cluster at the maximum. The design of a disclosure regime that enables participants or even employers to fully grasp the subtleties of trading costs, asset management fees and administrative overhead to make meaningful comparisons has proven to be elusive.

For mutual funds, India has put in place limits on various types of expenses. Particularly due to the low asset base at present, asset management companies have chosen to take a hit by absorbing a part of the marketing, brand-building and distribution costs. Media and investment analysts have generally evaluated fund performance based on NAVs, net of expenses. Funds rarely compete on the basis of expenses. On balance, a disclosure regime which separately discloses gross returns and expenses may be appropriate for pension funds in India. Any approach such as that proposed by project OASIS which controls entry on the basis of competition on fee levels will necessitate the presentation of fees in a clear and transparent manner. Disclosure of the financial statements of the asset management companies should also be made mandatory, which would bring pressure on reduction of expenses in cases where excessive profits are perceived by the market.

The question also needs to be addressed whether only fixed fees should be permitted or they could be related to performance. Performance related fees create an interest for the asset management company to maximise long term performance of the fund. The costs of management for the asset management company are also often related to the performance of the fund due to staff bonus plans. There is a case for India to allow asset management fees to be related to performance. In the regulations for portfolio managers, SEBI has allowed only fixed fees to be paid to the managers on the basis that performance-related fees may encourage 'reckless' behaviour. In an environment in which portfolio composition is likely to be tightly controlled the potential for irresponsible risk taking in the pursuit of performance fees in less immediate. Most pension systems severely limit the application of performance based fees, permitting them only in narrowly constrained circumstances in which they reference a performance standard which cannot be manipulated by the manager and limiting them to a relatively small part of the overall investment management costs.

4.9.6 Benefit Inadequacy

Private pension systems are ultimately directed toward achieving a targeted level of income replacement for the participating populations, a characteristic that distinguishes them from financial entities solely directed at maximising shareholder wealth. Shortfalls in expected investment returns or higher than anticipated costs therefore have broader social and fiscal ram-

ifications particularly when government backed guarantees are provided. This risk often initially manifests itself in problems with mismatching investment portfolios, suitability and mis-selling of pension products and is therefore closely intertwined with issues of efficiency.

Contributions to provident and pension funds is one of the highest in India. The employer and employee contribute 12 percent of the salary each, making a total of 24 percent. In companies which also have a superannuation fund, a further 15 percent is contributed by the employer leading to as much as 39 percent of the salary going towards retirement savings. In addition, there is retirement gratuity which is half-month's salary for each year of service (coming to about 4 percent of the salary).

The likely source of risk to benefit adequacy are, therefore, likely to be related to investment returns and preservation of savings for retirement income purposes rather than contribution levels. As discussed previously, administratively determined interest rates are unsustainable. However, equity markets are yet to develop the depth or stability to support the standard practice of pension funds to achieve high long term returns through equity premia while managing asset specific risk through portfolio diversification.

The critical balancing act in formulating an investment regulation framework will be providing the necessary safety through asset allocation limits and diversification requirements without inducing fund managers to forgo the liquidity and time premiums that (in addition to tax treatment) afford pension funds their main advantage over other intermediaries. The most effective means to accomplishing this is likely to be through measures that ensure transparency in the presentation of returns to facilitate competition among funds to counter the tendency of managers to target performance to return guarantees.

More immediate risks arise from the tradition of using provident fund assets for non retirement purposes. Provident funds permit early withdrawals for purposes such as building a house, marriage or education of children, medical expenses and so on. Early withdrawals constitute about 60 percent of the new contributions. Almost everyone withdraws from provident fund for purchasing a house. The provident fund works more like a savings plan rather than a retirement plan. Pay-outs on retirement are low. India needs to target a replacement rate rather than focus on contribution rate.

The salary for the purpose of contributions does not include certain special allowances and bonus. The effective contribution rate is, therefore, lower. For achieving a target replacement rate, the contributions need to consider all allowances. The multiplicity of retirement schemes makes it difficult to assess benefit adequacy. A consolidation of schemes and benefits is required.

4.10 Key Dimensions in Regulatory Systems

Major distinctions in regulatory systems can be illustrated by considering variation along several key dimensions. These are best interpreted as a set of axes along which various systems occupy different positions in a continuum. Although the two general models are represented as ends of each dimension, actual regulatory systems are best perceived as a matrix comprised of varying combinations of attributes rather than uniformly occupying the extremes of each dimension.

4.10.1 Investment Regulation

This area represents the most significant divergence of the two basic regulatory models. One approach, nearly exclusively applied to systems based on the trust model is known as the prudent person rule. It simply requires that those responsible make investment decisions while exercising diligence and expertise and taking into account the specific circumstances of the fund. The usual adjunct is a general dictate for diversification and a duty of loyalty (sole consideration of the beneficial owners' interests). This rule is usually construed to permit consideration of individual investments in the context of their role in the larger portfolio thus permitting assets with high risk characteristics to be included in a pension portfolio so long as the risk is hedged elsewhere in the portfolio.

The alternative, the prescriptive or legal list approach, is to specify the maximum amount that pension funds can invest (by asset class and in individual instruments as a share of the portfolio). This is the approach adopted in most European countries, and in Latin America. The investment results under the prudent person rule have generally been superior to those achieved under the prescriptive approach. This has largely been achieved by investing a greater proportion of the fund in equities than is permitted under the

prescriptive approach. It has therefore been suggested that the differential largely represents a risk premium.

From a supervisory point of view, the advantage of the prescriptive approach is that it is simple and easy to police. It is also more naturally evolutionary in response to innovations in financial products and practices. The prudent person approach requires a greater element of judgement by the supervisor and necessitates a substantial interpretive effort to assist practitioners in understanding how the general principles will be applied. It is consequently associated with considerable uncertainty for all parties. While in principle it should preclude outlying investment behaviour, in practice the courts in the United States, however, have been reluctant to reverse even highly risky investment behaviour solely on the basis of prudence unless losses have been realized.

At present, India, as do most countries, incorporates elements of both approaches. Strict asset allocation guidelines for pension funds are imposed; however, within the confines of the guidelines, a more general prudent person rule applies to the activities and decisions of the trustees. In the case of mutual funds, India relies upon a disclosure regime that requires disclosure of investment objectives including asset allocation. Mutual fund law also specifies diversification requirements.

For pension funds India needs to aim for a gradual move along the spectrum towards a more liberalised asset allocation, with the eventual aim of full liberalisation. In the intervening period, which is likely to constitute a decade or more, significant asset allocation and categorical restrictions (eg prohibitions against non-investment grade private debt issues, limited partnerships, currency speculation) will need to be imposed. A robust formulation of a general prudence standard and some experience and judicial precedent in its application will eventually open the door for more relaxed decision process oriented standards and their attendant efficiency gains. This, however, can only be attained with a fully developed legal framework, efficient and transparent financial markets and an experienced and effective supervisory authority.

The mandated asset allocation may be supplemented by a disclosure requirement. U.K. law, for instance, requires pension funds to prepare, based on professional advice, a Statement of Investment Principles which is dis-

closed to the plan participants. A similar approach would be appropriate for India. The statement would address issues such as selection, active/passive management and diversification.

4.10.2 Governance

In much of Latin America, there are strict governance rules applying to the pension fund management companies. They must be exclusively dedicated to pension fund management; they cannot delegate or sub-contract their management functions; and they can each manage only one pension fund. Boards of directors, to the extent they exist, are appointed by the management companies and have very direct responsibility for operational issues. Others such as Hungary, Switzerland and Australia have joint or elected boards which largely serve an oversight role. In the United States pension fund trustees are appointed by employers (where they are often officers of the sponsoring corporation with substantial other responsibilities within the firm) or employee organisations. Trustees largely perform strategic and oversight functions delegating responsibility for the management of funds to a range of service providers and investment managers. Legal governance requirements are more directed toward assignment of oversight and liability than the a priori designation of specific fund management responsibilities.

For mutual funds, India has a system of separate trusts in which the assets are held and an asset management company which formulates and executes investment strategy. A board of trustees or a trustee company manages the trust, while a board of directors manages the asset management company. Responsibilities of the trustees and the asset management company and its directors are defined in law. Qualifications of directors and a requirement of a minimum number of independent directors unrelated to the sponsor have also been specified. This arrangement has worked well, has the benefit of familiarity in the country, and can be adopted for the pension fund companies.

4.10.3 Licensing and Barriers to Entry

The management company oriented regulatory environments seek to limit entry and enhance security by imposing extensive licensing procedures in conjunction with capital and reserve requirements. This limits entry to

relatively small number of entities making in-depth oversight practical, achieves de facto economies of scale in operations and provides a significant source of security, albeit at the cost of the implicit rents on capital. In marked contrast, systems utilising the trust/foundation approach impose less stringent qualification requirements for fund managers (subsuming these instead under the prudence standards) and rarely require capital or reserves. This approach is a reflection of the voluntary employment based nature of the system which relies on minimising costs and entry barriers to attract participants. It also represents an implicit reliance on the capital of sponsoring employers to secure assets. Other methods such as bonding requirements in the U.S. for parties handling assets and requiring approval by a regulatory agency to manage funds as is common in Europe are less intrusive than the stringent financial requirements common in Latin America.

In India, SEBI adopted the approach of relatively less stringent entry requirements for intermediaries such as merchant bankers, brokers and mutual funds. This resulted in a large number of small intermediaries many of which could not survive. It also made regulation and oversight more difficult. In contrast, RBI and IRDA adopted the approach of more stringent entry criteria for banks and insurance companies respectively.

More stringent criteria limiting entry to a smaller number of credible players is more appropriate for pension funds. Capital requirement may be related to assets under management, particularly if a minimum guarantee is required from the pension companies with sponsor's capital at risk. Limiting entry to well capitalised entities provides a crucial margin of safety in the early period of operation and make the scope monitoring and oversight feasible for the regulatory authority in the start up period. Latin American countries have typically limited market entrants to a handful of firms in the early periods consistent with the close supervision required for more restrictive investment regimes, an approach India could do well to emulate. Among Central and Eastern European countries a somewhat larger number of initial entrants have been permitted. A period of consolidation typically resulting in the survival of a similar number to the Latin American arrangements would seem to lend credence to the wisdom of a more restrictive approach in the early period.

4.10.4 Fee Limits

Specific restrictions on fees are a common feature Latin American and Eastern European systems. Some, Chile for example, permit only certain categories of fees, prohibiting exit charges, asset based management fees and performance fees. Commissions for selling agents and annuity conversions on the other hand are held to a prescribed level. Hungary places limits on the fees that the fund may charge for administration but places no specific limits on what it may pay asset managers. Trust based systems generally do not explicitly regulate fees. In the United States fee levels are regulated indirectly through the general prudence requirements through a provision in the law which specifies only that they be reasonable.

Both approaches have their critics. Prescribed limits tend to result in a clustering of expenses at maximum and have been perceived as anti-competitive. They also may lead to shifting costs to other unregulated categories and a loss of transparency. The reasonableness approach on the other hand is difficult to enforce especially because it is associated with system with many funds (700,000 in the U.S.) and is a weak constraint on the inherent agency problems of an employment based system.

As already discussed, utilising fee levels as the basis for competition for market entry may should serve as an effective controlling device. This will need to be buttressed with a disclosure regime that requires gross returns and expenses to be disclosed separately and a requirement for the financial statements of pension companies to be made public, even if unlisted. In combination this approach may serve as appropriate measures for India to bring market pressure on expense levels.

4.10.5 Compliance Interventions

Latin American systems are often characterised as pro-active in regard to their compliance activities in contrast to the more re-active basis of regulation in Anglo-American systems. A small number of large funds permit regulators to take a pre-emptive approach to compliance, conducting on site reviews on a regular basis, maintaining continuous interaction with funds in an attempt to prevent deviations from proscribed standards, taking a more directive, interventionist stance. Enforcement in other envi-

ronments is more remedial in nature, seeking to compensate funds for the consequences of violations of the law.

This fundamental difference originates in many aspects of the two models, including the number of funds, a greater concern with less intrusive practices in voluntary systems and the level of the development of capital markets and financial institutions. Of particular significance is the management of assets via other highly regulated financial intermediaries (banks, insurance companies, brokerage houses) in trust based systems which enable regulators to be reliant on other primary regulators as well as to be more sensitive to the need for coordination of authority and operations.

A pro-active regulatory regime supervising a limited number of funds is strongly recommended for India. The experience in capital markets highlights the problems of supervision of a large number of smaller players with uncertain reputations. A smaller number of players permits a more liberal regulatory approach as against the highly prescriptive approach that would be needed when there are a large number.

4.10.6 Reporting and Valuation

Both systems rely to a high degree on regular reporting of the financial status and where relevant actuarial status of pension funds and providing this information to members as well as regulatory authorities. Differences arise in the frequency of reporting and valuation methods. Regulators in Chile and Argentina require daily reports of the financial status of funds with assets carried on a mark to market basis and account statements made available to members several times a year. European and Anglo-American regulators are more likely to require annual reporting and permit greater discretion in terms of valuation. Latin American systems are able to rely on the direct verification of the regulators for the accuracy of financial statements. Others impose external independent audit requirements to ensure the reliability of reports because it is not feasible to review all of the regulated entities.

Mandatory accounting and valuation standards will be necessary in India to ensure uniformity and facilitate comparison across funds. A system of accounting and valuation standards specifically applicable to pension funds will need to be in place before any system can effectively operate. Perhaps even more important is the development of standards and practices for the

auditing of the pension funds. A requirement for the periodic independent audit of pension funds to verify the completeness and accuracy of financial and performance presentation is perhaps the most central preventive aspect of any regulatory system. This should be undertaken by the supervisory authority in the formative period but may be supplemented by independent private audits if standards of integrity and independence can be established.

4.10.7 Institutional Placement of Regulatory Authority

While all approaches necessitate political independence in the regulation of pension funds there are systemic differences in the placement of this authority. Latin American countries have established what are effectively completely independent institutions reflecting the underlying construct of pension funds as effectively stand-alone special purpose financial institutions. Most other systems place the authority as a distinct unit within a larger public institution, placing regulators under the broader auspices most commonly of Finance Ministries, Labor Departments or Insurance Regulatory Authorities. Two recent Eastern European reforms (Poland and Hungary) have essentially split the difference creating largely independent authorities more loosely within other government agencies although each of these has moved toward greater consolidation of pension regulation with that of other financial services in recent years. Consolidating regulators is a greater imperative in systems that are more interactive with other regulated financial intermediaries. The U.K. represents perhaps that furthest extent to which this concept has been advanced with the creation of the new Financial Services Authority (FSA) in an attempt to better coordinate regulation.

Two somewhat divergent, but potentially reconcilable, proposals regarding the location of the pension regulator in India have been proposed. Project OASIS suggests a new independent authority while the IRDA Committee proposes subsuming the responsibility within the existing insurance regulatory institutions. Compelling arguments exist for both perspectives. Pension fund regulation, for the reason enumerated in the preceding sections, is distinctive from other types of financial institutions and requires a distinct dedicated institution. This is particularly important when there are significant interactions with other financial products such as annuities where the regulators may face conflicting priorities. Insurance regulators, especially in the presence of guarantee funds, place a high priority on maintaining

company solvency. This imperative may be indirect conflict with interests of pension fund beneficiaries purchasing these products. However, the essential problems and inter-actions among various types of financial institutions are generally more convergent than in conflict and can only be effectively administered with a high degree of coordination.

These considerations argue for a separate, and highly independent authority to address the distinctive requirements of pension funds. There are, however, compelling arguments to house this institution within a broader financial services authority to ensure coordination on both a policy and operational level. India should carefully consider the experiences of the U.K, Australia, and Hungary and others in seeking an optimal distribution of regulatory and supervisory authority and its placement in relation to other public organisations with similar responsibilities for the control of financial institutions.

4.11 Conclusion

India has now moved beyond consideration of whether a market oriented private pension is necessary to evaluation of the best design and operational characteristics to guide its implementation. A rapidly increasing salaried and formal sector workforce and increased dependency rates resulting from longer life expectancy will continue to increase the demand for efficient means for retirement savings. The imperative to establish a well functioning private system is accentuated by the absence of existing public social insurance programs and the lack of fiscal capacity to finance their development.

The introduction of a private pension system is broadly supported through the widespread acceptance of individual account based retirement savings arrangements resulting from the long history and success of the Provident Funds and more recent introduction of employer sponsored exempt funds. The ability of these to meet future needs is significantly limited by the inherent constraints imposed on public institutions capability to undertake the type of portfolio management methods that enable private pensions to achieve the market returns that provide their essential advantages in relation to public pay as you go approaches.

The financial market infrastructure required to support the development of a private pension system is rapidly developing in India. Fixed income markets are approaching the depth and stability of returns to absorb substantial new sources of funds. This will permit a transition from the administratively determined interest rates that have until recently characterised pension financing in India. Equity markets, which in mature private pension system typically afford the greatest long-term investment advantages, are not stable yet but should develop in response to the expansion of private pension funds as well as other factors.

A basic framework for the organisation and regulation of private pensions has been established by the Provident funds and Exempt funds that utilize a trust based form of governance and adhere to a highly structured and limited form of investment regulation. A main challenge ahead will be to adapt and extend this framework to enable a private system to flourish. This requires balancing the need for flexibility and market based criteria with the inherent need of any pension system to afford a high degree of stability and security to its participants.

This process is best undertaken through an evaluation of the particular characteristics of private pension systems and considering the types of risks against which they need to be protected. Two basic models of system design and regulation, the Latin American Model based on specialised investment management firms and the Anglo-American Trusts provide important insights on the choices to be made and guiding principles in effectively regulating private pensions.

In making these choices India is well advised to consider approaches which incorporate aspects of both models and which recognize the current stage of development of its financial markets. A high reliance on restrictive entry requirements, initially restrictive investment regimes, pro-active oversight and intervention and the establishment of restrictive but viable rules governing potential conflicts of interests should be high priorities. A strong reliance on transparency of performance measures and market competition are key complements to these basic attributes. The legal and regulatory framework should, however, explicitly contemplate a process of evolution to more flexible and open market based regimes as financial markets mature in order to attain the maximum benefits of a funded private system over the long term.

There are a range of feasible combinations of alternatives to the design and regulation of a private pension system. Recent proposals from Project OASIS and the IRDA have provided a good start to this process but much work remains to expand these into a complete and viable system design. The only certainty to this process is that to be successful it will have to be unique to the cultural, political and economic conditions of India today.