Pension Fund Management in India: Government Role and Regulatory Issues

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Abstract—This Pension funds nowadays in India play a huge role in development of the economy and it play active role in the Indian equity markets. A change both in their investment attitudes and in the regulatory climate, encouraging them to increase their investment levels in equities and would have a massive impact on capital market and on the economy as a whole. This paper examines the potential and actual role played by government in pension fund management. It is shown that government played important role in investment performance in terms of risk and return, and pension funds are well placed to take advantage of the benefits, but pension fund typically hold low proportions equity on their portfolios which hamper its growth but at the same time low equity proportions means more safety for pension funds. Whereas some degree of “home bias” is likely to occur naturally, it is undesirable for regulations to enforce tighter limits on proportion of equities and there is thus considerable scope for improvement in the current system and other issue which needs attention for making the new pension scheme equitable is the tax treatment.

Keywords- Pension, Economy, Investment, Risk, Return, Portfolio, Equities

I. INTRODUCTION

Public pension schemes (or social security schemes as they are known in some countries) have long been recognized as having major economic and social implications. In addition to their obvious social welfare objective of providing adequate retirement incomes for the aged, public pension schemes can influence economic performance and capital accumulation through their effect on taxes and intergenerational transfers. For many countries, the implicit liability to fund public pensions is by far the most significant unrecognized liability in their public accounts. Pension funds are a unique situation where individuals invest over multi-decade horizons, in order to obtain consumption in old age. All pension investment works with the fundamental pension equation" (Ambachtsheer & Ezra 1998):

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\text{Contributions + Investment returns = Benefits paid}
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Pension Policy in India has primarily and traditionally been based on financing through employer and employee participation. As a result, the coverage has been restricted to the organized sector and a vast majority of the workforce in the unorganized sector has been denied access to formal channels of old age financial support. Only about 12 per cent of the working population in India is covered by some form of retirement benefit scheme. Besides the problem of limited coverage, the existing mandatory and voluntary private pension system is characterized by limitations like fragmented regulatory framework, lack of individual choice and portability and lack of uniform standards. High incidence of administrative cost and low real rate of returns characterize the existing system, which has become unsustainable. Non-sustainability of the existing pension system is highlighted by the sharp increase in financial burden on the Government and the other employers on account of pension liabilities. While the total pension liability on account of the Central Government employees has increased at a compound annual growth rate of more than 21% during the 1990s, the comparable rate for the State Government was 27% per annum.

India has nearly eighty million elderly people, which is one eighth of world’s elderly population. This segment of population is growing at a rate of 3.8% per annum as against a rate of growth of 1.8% for the overall population. A vast majority of this population is not covered by any formal old age income scheme and is dependent on their earnings and transfer from their children or other family members. These informal systems of old age income support are imperfect and are becoming increasingly strained. Poverty and unemployment may have acted as deterrents to provide a tax financed state pension arrangement for each and every citizen attaining old age. Therefore, in the organized sector (excluding the Government servants) a pension policy has been adopted based on financing through employer and employee participation. This has, however, denied the vast majority of the workforce in the unorganized sector access to formal channels of old age economic support.

II. PENSION FUNDS: MEANING

A fund established by an employer to facilitate and organize the investment of employees’ retirement funds contributed by the employer and employees. The pension fund is a common asset pool meant to generate stable growth over the long term, and provide pensions for employees when they reach the end of their working years and commence retirement. Pension funds are commonly run by some sort of financial
intermediary for the company and its employees, although some larger corporations operate their pension funds in-house. Pension funds control relatively large amounts of capital and represent the largest institutional investors in many nations.

Pensions broadly divided into two sectors:

A. Formal sector Pensions
   - Employees Provident Fund
   - Employees Pension Scheme
   - Employees Deposit Linked Insurance Scheme

B. Informal sector Pensions
   - Coal mines provident fund
   - Coal mines pension scheme
   - Coal mines linked insurance scheme

C. Voluntary Pensions

Superannuation schemes: Plans sold in the market. These are typically plans sold by Mutual funds and Insurance companies. Also from Life Insurance & Postal Life Insurance

Informal sector pensions: The Government has stepped up its efforts to extend coverage of formal pension arrangements to the nearly 350 million informal sector workers. In this direction, the Department of Economic Affairs, Ministry of Finance, India has recently finalized a technical assistance project with the Asian Development Bank (ADB) to formulate appropriate policies and institutional arrangements to motivate these excluded workers to voluntarily participate in formal retirement plans. This project (awarded to a consortium of UNSW and IIEF) will assist the policymakers and the PFRDA in achieving greater clarity on the specific needs and constraints of this audience and in designing appropriate products, access and delivery mechanisms as well as benefit and exit policies which can serve India's huge, widespread and diverse informal sector workforce. This project targets self-employed professionals, contract and casual labor, agricultural workers, farmers, women workers, etc. and includes a nationwide random survey of 42,000 households.

Existing arrangements applicable to informal sector as Senior Citizens Saving Scheme, NOAPS and Public Provident Fund.

III. Role of Social Factors

As the investment horizon of pension funds is of a long-term nature, integrating ESG factors into their investment practices has the potential to enhance their long-term returns. The pension funds accumulate vast financial resources on behalf of ordinary workers and are therefore expected to employ integrated, forward-looking investment practices to earn more consistent long-term returns. This means identifying sources of risk and creates a "win-win" situation between societal impact and investment performance. In fact, investment choices based solely on short-term financial views would not be considered even appropriate for pension funds, given their risk-reward profile and the needs of the funds' shareholders.

Realizing this link between ESG factors and long-term returns, governments and regulatory bodies in the developed markets particularly in European continent have intensified their focus on this area. As pension funds are in a unique position to influence market participants, principally their fund managers, to value ESG factors appropriately and integrate them into the investment process, several governments have launched regulations to establish ESG disclosure requirements for pension funds over the last decade.

The first such initiative to put a formal obligation on pension funds to make ESG disclosure was in United Kingdom (UK). Since July 2000 the trustees of a pension fund in UK are required to declare “the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments” and “the policy (if any) directing the exercise of the rights (including voting rights) attached to the investments”.

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Following this pioneer initiative, many other countries have put similar rules in place.

IV. LESSONS FOR INDIA

The New Pension Scheme (NPS) in India allows 50 per cent of the pension fund contribution to be invested into the stock markets and one of the mandates of PFRDA (Pension Fund Regulatory and Development Authority) is to oversee the functions of pension fund managers.

Therefore, by bringing in ESG criteria into the investments guidelines of fund managers, PFRDA could enhance the accountability and transparency of pension investments.

Mandating such disclosure would help clarify the potential materiality of ESG issues for fiduciaries and also encourages pension fund investment managers and other capital market agents to improve investment practices by integrating ESG factors into their investment decision.

A. Impact of pension system on economy

There are two ways of looking at the potential indirect impact of the pension system on the economy. The first involves a scenario in which the current situation is allowed to continue indefinitely. In this ‘no reform’ case, the main indirect impact is through fiscal policy. Pension liabilities grow, raising deficits or diverting funds from other programs. The fiscal problem is due to burgeoning civil service pensions as well as current and future subsidies to the EPS. In addition, there is an opportunity cost to the extent that positive indirect impact of pension reform on labor and capital markets are foregone. On the other hand, reforms that combined cost reduction with the introduction of well-designed funded schemes would reduce the fiscal burden, reduce or eliminate certain labor market distortions and possibly contribute to the development of capital markets. These gains could generate higher economic growth rates raising living standards for those not participating directly in the pension system. The next section looks at possible ‘systemic’ reform options aimed at reaping these indirect benefits while achieving basic public policy goals for old age income security.

B. Pension Market in India

The existing system of pensions which leaves more than 88 percent of Indian workforce uncovered is unlikely to act as a social security umbrella for the ageing Indians. Even for those that the system covers, the defined benefit is strictly not guaranteed as most DB schemes are either wholly unfunded or under-funded schemes. Improvement in healthcare facilities leading to increase in life expectancy, evolution of nuclear family systems and rising expectations due to increase in per capita income, education etc. are some of the factors likely to compound the problem in future. The new pension system, based on defined contribution and funded liability is a significant step in the direction of addressing this problem. Spread of NPS is seen by many as the direction in which the pension reforms need to move to find a viable and sustainable solution to the problem of old-age income security.

In 2001, Government of India appointed a group of experts to study the various aspects of extending an organized system of pension to the unorganized sector. The group submitted its report in October 2001. According to this report, the pension market (which includes pensions, provident funds and other small savings i.e. NSC, NSS) would grow to about Rs.4064 billion by 2025. The growth would largely be due to normal growth of economy in terms of growth in income and population and does not consider the significant increase in coverage that would arise because of reforms in the insurance and pension sectors. A more conservative estimate is that the pension market will be worth about Rs.1808 billion by 2025.

V. THE NEW PENSION SYSTEM & GOVERNMENT ROLE AND REGULATORY ISSUES

During the last seven years, from 2000 to 2007, a marked shift in pension policy in India was witnessed which culminated in introduction of a new pension system. A High level Expert Group (HLEG) and the Old Age Social and Income Security (OASIS) Project commissioned by the Government were the two initial milestones on the road to pension reforms for the Government employees and the unorganized sector respectively. These efforts culminated in setting up of the Pension Fund Regulatory and Development Authority (October 2003), introduction of a New Pension System (December 2003), and introduction of the PFRDA Bill in Parliament (March 2005). HLEG suggested a new hybrid scheme that combines contributions from employees and the Union Government on matching basis, on the one hand, while committing to the employees a defined benefit as pension. The objective of the Government was to design a scheme for new entrants in Central Government service where the contribution is defined, where no extra infrastructure is sought to be created in Government and which is capable of serving other groups like State Government employees, middle class self-employed people and even those in the lower income bracket amongst the unorganized sector subsequently.

OASIS report recommended a scheme based on Individual Retirement Accounts to be opened anywhere in India. It was envisaged that Banks, Post Offices etc., could serve as “Points of Presence” (POPs) where the accounts could be opened or contributions deposited. Their electronic interconnectivity will ensure “portability” as the worker moves from one place/employment to another. There will be a depository for centralized record keeping, fund managers to manage the funds and annuity providers to provide the benefit after the age of 60.

The New Pension System (NPS) which has its origin in the two reports mentioned above, was made operational through a notification dated 22nd December, 2003. It has been made mandatory for new recruits in the Central Government (except Armed Forces) from 1st January 2004. It marks a shift from the defined benefit to a defined contribution regime. It is based on the principles of defining upfront the liability of Government, giving choice to subscribers, facilitating portability of labour force and ensuring transparency and fair-play in the industry. About 100,000 Central Government employees (excluding employees of autonomous organizations) are already covered.
under the new pension system and contribute 10 percent of their salary and dearness allowance towards pension with a matching contribution from the government. Nine States have also notified and implemented a defined contribution pension system for new employees. Many other State Governments have made significant strides in this direction. NPS will also be available to all individuals in the unorganized sector on a voluntary basis. Under the NPS, for all subscribers, at the time of retirement there will be compulsory annuitisation of at least 40 percent of the accumulated pension wealth and the balance will be paid as a lump sum. There will be multiple pension fund managers licensed by PFRDA and the choice would be with the individual subscriber to decide which fund manager to go with.

There would be four broad categories of pension schemes offering investment options with varying ratio of equity and fixed income instruments. The choice of a scheme would rest with the subscriber. Full transparency and disclosure of information regarding investments will have to be provided by the intermediaries. Portability will be provided to the participants along with the option to transfer accumulations from one fund manager to another. To bring the new pension system within a statutory regulatory jurisdiction, an ordinance was promulgated on 29 December 2004 setting up a statutory Pension Fund Regulatory and Development Authority. Subsequently, a Bill was introduced in the Parliament to replace the ordinance. The Bill provides for establishing a statutory Authority to promote old age income security by establishing, developing and regulating pension funds and protecting the interest of subscribers to schemes of pension funds. Once the Act comes into force the Authority shall regulate all intermediaries under the new pension system including pension funds, central record keeper, points of presence, etc. It will approve the terms and condition of the scheme, lay down norms for the management of the corpus of the pension funds including investment guidelines under such schemes. The Bill envisages that the pension supervisor will provide robust regulatory umbrella essential to sustain member confidence and to protect the interests of the participants and to develop the pension system by inculcating saving habits for long term. The Bill also provides adequate safeguards to take care of the subscribers to the NPS and stringent penalties for contravention of the provisions of the proposed Act and the Rules and Regulations framed there under. In accordance with Parliamentary conventions in India, on introduction in the Lower House the Bill was referred to the Parliamentary Standing Committee on Finance. The Committee, having considered the evidence and clarifications placed before it, opined that “...the reform process in the pension sector involving the setting up of the PFRDA as a Statutory regulatory body for managing the NPS is an urgent necessity mainly on account of burgeoning fiscal stress of pension payments on the Central and State revenues and the need to provide a viable alternative to the populace at large to save for old age income security”. The Committee approved the PFRDA Bill for enactment subject to certain modifications, which are under consideration of the Ministry of Finance, Government of India. The Bill is yet to be taken up for further consideration by Parliament. Meanwhile, in view of one of the recommendations of the Standing Committee that the initial or broad contours of the regulations governing the implementation of the NPS under the infrastructure of PFRDA be framed and put in public domain, PFRDA has prepared the broad contours of Regulations on registration of intermediaries and put them in public domain for comments of stakeholders. The NPS has been mainly designed to fill the gap of old age income security to the unorganized sector. The scheme is envisaged to be a voluntary one for this segment of the population. Given a high savings rate of 35% of GDP, Indian workers are encouraged in respect of their capability to contribute towards a self financed old age income security scheme. In this framework, the New Pension System will provide them with the opportunity to fulfil their needs of old age income support in the most productive way. Further, the system will also be capable of providing a delivery mechanism for the other segments of population viz. Pillar-I (population vide mandatory pension system) and Pillar-II (mandatory occupational pension system). The low cost structure of the architecture will enable Governments to utilize this infrastructure to deliver any scheme of old age income support to any segment of the population in the most efficient manner. While the introduction of the New Pension System for new recruits of the Central Government/ State Governments is a positive step in the direction of reforming the pension sector in India, the road ahead has many challenges. The level of financial literacy and preponderance of rural aged make the task daunting. Sex ratio of the workforce and economic status of women pose special problems in the design of pension systems. Designing an effective, efficient and accessible system, which caters to the requirement of a heterogeneous work force, nearly 88 percent of which is not covered by any pension or old age security scheme, is the immediate priority of those concerned with pension reform process in India. The challenges of translating the design into reality will arise thereafter and will take a while to overcome.

The new pension scheme is an attempt to move away from the defined benefit pension plans to defined contribution based schemes. But, this change would be applicable only to the new entrants. The problem of financing the pension liability of those already under unfunded or partially funded schemes is like to cause fiscal stress for the next two or three decades. Some parametric changes will, therefore, become necessary for effective and efficient discharge of this liability. Thus, apart from spread of the new pension scheme, introduction of parametric changes in the existing defined benefit mandatory pension systems is equally necessary for reducing the fiscal stress. Attempts to estimate the future pension liability arising out of the existing unfunded pension plans are at a nascent stage in India.

Recently, some private researchers have tried to undertake a limited exercise in respect of the defined civil service pension scheme. One such study puts the implicit pension debt liability of the Central and State Governments arising out of three components of civil servants pensions at Rs.20034 billion or 64.51per cent of GDP. While the methodology and/or the results can be questioned, the magnitude of the problem that this estimate suggests cannot be ignored. The enormity of the problem becomes even more apparent when this liability is compared with the explicit internal public debt of Government of India, which is 84.86% of GDP (2004-05).
Recognizing the fact that pension reforms are an urgent social priority, policymakers in India are working hard to evolve suitable pension systems.

A major challenge of the New Pension System is to provide the individual subscriber with an adequate retirement income. Public sector pension schemes involve ‘policy risk’ in as much as the Government of the day may not be able to accommodate required pension outlays leading to delays in pension payments or defaults in some cases. On the other hand, private pension schemes are less subject to this ‘policy risk’ because Governments are less prone to confiscate private property.

One issue which needs attention for making the new pension scheme equitable is the tax treatment. Pension savings in general and the NPS in particular is a very long term saving instrument having a time horizon of 30-35 years. Therefore, the treatment of this instrument from a tax perspective, if not the most preferential, should at least be at par with other medium or short term financial instruments. This is especially important at the nascent stage of the new pension system development. In this context, example of Public Provident Fund (PPF) and other such instruments are worth mentioning. PPF having a life cycle of 15 years is under an EEE (exempt exempt-exempt) tax regime and is not taxed at any point whereas NPS being a 30-35 years instrument is taxed at exit. Therefore, subscribers to NPS are at a disadvantage compared to the PPF especially when seen in the context that NPS is a mandatory scheme whereas PPF is a voluntary scheme. The Government employees appointed before 1.1.2004 participate in the GPF scheme which is again an EEE tax regime whereas NPS is subject to EET regime and the withdraw able tier-II account of NPS (a substitute to GPF) is envisaged to get no preferential tax treatment. Further, a common ceiling for contributions of both the employees and Government under the Income Tax Act, 1961 may be a disadvantage for the subscribers of NPS. Accordingly, a need is felt to treat all long term savings instruments equitably and provide the same tax treatment to NPS as being given to PPF and other similar schemes. The tax treatment merits a review so as to take care of the distortions across financial instruments and giving right fiscal incentives for the development of the pension sector.

Governance Structure & Administrative Structure

The three mandatory plans are administered by Employees’ Provident Fund Organization and set up under the EPF Act and Central Provident Fund Commissioner appointed by the Federal Government is CEO who is usually a civil service bureaucrat and supported by Assistant and Regional Provident Fund Commissioners.

Central Board of Trustees is the supervisory authority and Minister of Labour is the Chairman and there is Central Provident Fund Commissioner, five Federal Government Representatives, fifteen State Government Representatives, ten Employer Representatives and ten Employee Representatives and all trustees are appointed by Federal Government after consultation.

EPFO carries out Benefit Administration and Record keeping set up an extensive administration network with offices all over the country.

Fund Management is contracted out to a professional fund manager and State Bank of India is presently the fund manager and there is no change in fund manager for several years.

VI. PENSION FUND MANAGEMENT

Pension Funds are managed by Pension Fund Administrators and they are responsible for taking investment decisions but in some jurisdictions, pension fund management can be by asset management and insurance companies and some management decisions may be the responsibility of Boards of Trustees in some corporate organisations. Pension Fund Custodians are those who keep custody of pension funds.

Regulations of pension funds require the appointment of a custodian, depository institution or trustee, standards of conduct and minimum suitability of the operators of pension funds, the rights of investors to withdraw funds and the right of investors to full, timely and accurate information disclosure. Regulations required promoting both the performance and the financial security of pension assets.

Main goals of pension investment are to ensure adequate, affordable and sustainable benefits to contributors, secure safety & security of funds and ensure adequate liquidity to pay all pension benefits of contributors as and when due risk management for pension assets established on quantitative limits which is maximum limits for individual, class or class of assets. Achieve an optimal trade-off of risk and return through strategic asset allocation.

Investment Guidelines for pension fund management

Funds are required to follow Investment Pattern prescribed by the Government according to the New Pension System:

(i) Non-Government provident funds are allowed to invest 5% of assets in blue-chip shares and 10% in corporate debt and equity-oriented mutual funds

(ii) Relaxation of norms for superannuation and gratuity funds to invest in the Gilt fund. Provident funds can have a maximum exposure of 5% in gilt funds at any point in time.

(iii) Provident Funds can invest in bonds of financial institutions and companies having investment grade from at least 2 credit rating agencies.

(iv) There would be multiple pension fund managers licensed by Pension Fund Regulatory and Development Authority (PFRDA) and the choice would be with the individual employees to decide which fund manager they would like to go with.

(v) Under the NPS, it is proposed that there would be four broad categories of pension scheme (scheme A, B, C and D). While in scheme A, investments will be made in Government securities only, scheme D would have relatively higher weighing for equity while retaining the dominance of fixed income instruments. Schemes B & C will provide a balanced investment option with equity and fixed income instruments.

(vi) On the issue of guarantees on principals and/or returns, market based guarantees are proposed under the NPS scheme. This means that the subscriber has to bear the cost of the
guarantee. However, the scheme with 100% Government Securities would be totally risk free in terms of capital protection and assured returns if the securities are held to maturity.

No investments allowed in

- International Securities – Strict Capital Account Controls exist in India. No Indian citizen or corporate can invest overseas.
- Stocks – India has a large stock market
- Real Estate – Only Financial Assets allowed
- Gold – Only Financial Assets allowed
- No investments permitted in Bank or Corporate Deposits
- Investment allowed only in marketable securities
- No loans to individuals or Corporate
- Only exception is Central Government’s Special Deposits

CONCLUSION & SUGGESTIONS:

Suggestions for the pension reform process in India are as follows:

- Pension savings should not be a source for financing government deficits,
- A large portion of pension savings should be invested in equities,
- Equity exposure should be obtained using index funds,
- International diversification should be harnessed to reduce the investment risk to the extent possible, and
- Wealth accumulation through equity oriented investment strategies is quite remarkable, even at fairly low contribution rates like Rs.10 per day.
- Introduction of Retirement Funds
  - NAV based funds
  - Different investment objectives and management styles
  - Capital preservation funds
- Option to Employees to shift fully or partially to Retirement Funds managed by approved pension companies
  - Employees may take time to get used to variable returns
  - Marketing and administration costs will increase
  - Strict Regulation and Disclosures required
- Requires distribution and servicing infrastructure to be set up
  - Common infrastructure as suggested by OASIS may be a good option

Basic pension reform is a complex undertaking. It requires a sound technical plan of action that ideally harmonizes provisions across the country and across sectors. Such a plan must take into account fiscal and financial sector constraints. It must also include a transition strategy for phasing out existing provisions while respecting commitments already made. Finally, the system must be designed in such a way as to be able to adapt to economic and social changes for decades to come. While the task is difficult, the impact of pension reform can be far-reaching. The stakes are high not only for the relatively small fraction of the labor force directly affected, but also for the rest of the population through a series of indirect economic effects more difficult to quantify. A growing body of research is showing that a vital pension system can boost stock market liquidity, extend the yield curve, lower borrowing costs and improve corporate governance. And reducing pension liabilities in the public sector reduces future budgetary pressures, allowing more spending in other needed social areas. Labor markets may also function better with reduced distortions in the labor markets.

It is concluded from this study that pension fund investment in India is heavily biased in favor of Government securities. While investment restrictions imposed by the Government may be partially responsible for this investment pattern, strict prudential norms dominated by the concern for safety over return may have only exacerbated the situation. However, with the implementation of the New Pension System, while the pension fund exposure to corporate bonds has been rising, the private participation in pension scheme offers has also increased. Improvements in the corporate bond market have also facilitated this process.

With the choice of pension fund investment structure shifting in the hands of individual, pension fund investment in India is poised to move in to a new trajectory that is consistent with the risk bearing abilities of individual constituents. This may lead to greater demand for good quality corporate bonds. However, the path to this optimum is likely to take a few more years in view of slow progress on policy reformulation and pension reforms.

On the other hand, as far as pension fund managers are concerned, efforts should be made to give up the closed approach and allow them freedom to function within a broad regulatory framework. Pension reforms which have been set into motion in the last five years need to be taken forward immediately if India wishes to take advantage of the edge that its demographics offer over similarly placed economies. Average age of Indians in 2005 was about 26 years with 31% of Indians being younger than 15 years, and nearly 64% of Indians in the working population. Thus, the time for undertaking the reforms in the pension sector could not be more appropriate, but the need of the hour is to push the reforms further without delay in terms of offering this system to the unorganized sector workers. The demographic advantage is not going to last forever because India’s elderly are growing at a much higher rate than the total population, as a consequence of which the current dependency ratio of 15 is likely to shoot to 40 in the next four decades (dependency ratio here defined as
the number of persons over age 60 years to number of persons between age 20-59 years). The implications of demographic dynamics for pension planning in India become more evident when one takes into account the fact that average life expectancy at age 60, which is currently 17 years, is likely to rise to more than 20 years in the next three decades and that the population over 60 years of age will approach 200 million in 2030. However, India is still at an early stage of the demographic transition. This is the right time, therefore, to roll out the NPS to all segments of workers. The New Pension System is designed to use the 21st century Information Technology so as to achieve portability, competition and coverage. However, poor financial literacy and the attitude of the households towards financial savings, risk and retirement planning, pose a challenge to achieving optimum coverage of NPS. Creating awareness about these reforms and gaining the confidence of the people to encourage them to be a part of this movement is the single most important challenge faced by policymakers today.

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