Chapter 1

Rethinking Pension Provision for India

S.A.Dave *Robert Palacios* *Gautam Bhardwaj*

Despite the inherently long time horizon of pension systems, changes to these important programs are observed to be quite frequent over the course of the last century. In some sense, this should be expected given the difficulties of predicting what the world will look like when a young worker today joins the ranks of the elderly tomorrow. Changing demographic structures, income levels, technology and even cultural changes can and have forced policymakers throughout the world to reconsider the intergenerational equation.

1.1 How Pension Reform Evolved in India

It should not come as a surprise then, that India is among a growing number of countries considering important changes to the institutions and policies that aim to provide their workers with a measure of income security in old age. Rather, what is surprising is how little the two main pension schemes currently operating have changed since Independence. For the private sector, the basic structure outlined in the Employees Provident Fund Act of 1952 remained unquestioned for almost four decades while the inherited British pension scheme for civil servants still operates essentially as it did under colonial rule.

A major change did occur in 1995 however, with the conversion of part of the defined-contribution, EPF scheme to a defined benefit scheme in the form of the Employees' Pension Scheme. This was an important break with previous policy in two ways: First, it extended the concept of a mandated annuity to the private sector for the first time. Second, it added a new pension liability to the one that already existed with regard to civil servants. In doing so, India became one of the last countries to join the century-long

march to dependence on publicly-managed, defined benefit schemes that are financed on a pay-as-you-go basis.

Perhaps the last to join the club will be India's close neighbour, Bhutan, where a similar conversion took place in 2001. Their reforms in some way mark the end of an era of expansion of the traditional model. For decades, pension liabilities in the form of promises made by governments to the early generations have been accumulating. Now, however, the pendulum is swinging in the other direction; the prudence of not having set aside savings specifically meant to pay off these pension promises is being seriously questioned and 'traditional' public DB schemes are being pruned. In a growing number of countries, they are being shut down or converted into defined contribution schemes with substantial private sector management of the retirement funds.

India, however, can exhibit stark contrasts at times. Satellites and firms producing the cutting edge of information technology are juxtaposed with brown-outs in the capital and hugely inefficient state enterprises. While reforms open the insurance sector for the first time in five decades to competition and set up a new insurance regulator, the government is forced to bail out a quasi-public sector mutual fund. The introduction of a new, public DB pension scheme in 1995 is followed a few years later by proposals for introducing the first privately-managed, defined contribution pension provision in South Asia. The latter pension reform was first proposed in 1998 by a special commission known as the Old Age Security and Income Security (OASIS) Project.

1.2 The OASIS Project

The OASIS Project was commissioned as the first comprehensive study of India's pension sector by the Ministry of Social Justice and Empowerment, Government of India, to Invest India Economic Foundation (IIEF) in August 1998. The Government constituted an eight-member expert committee with representatives from the Ministries of Finance, Labour and Social Justice under the chairmanship of Dr. S.A. Dave to undertake the study. The OASIS Committee commissioned over 25 research papers and studies to domestic and overseas experts and conducted several technical consultations to elicit opinions and create policy awareness and consensus on the core principals of pension system design. During the process, the OASIS

Committee also received inputs from a team of experts from The World Bank. The final OASIS report was submitted to India's Prime Minister on January 14, 2000 at New Delhi.

While the original mandate and focus of the Project OASIS Expert Committee's report was on the ninety-percent of workers that are not covered by any pension scheme in India, it eventually raised awareness regarding the overall state of the pension system. Its proposals are now seen as an option to be considered beyond the informal sector. Specifically, as the pressure on government finances due to an aging civil service grew, the paradigm shift advocated by the OASIS report gained support.

Part of the awareness that was created by the OASIS Project and other efforts was recognition of the deficiencies of the existing system that provided strong rationale for reform. Low coverage, flaws in the benefit formula and indexation procedures that produce inequities between and within generations, and most notably, the risk that promises could not be kept in light of projected pay-as-you-go deficits were found to undermine the social objectives of the existing system. In fact, it was not clear that those social objectives had ever been clearly defined and in this way, the OASIS Project helped raise fundamental questions as to the objectives of the system itself.

Importantly, the OASIS Project brought the debate on pension system design and reform into the public domain. However, even from the outset, the policy discussion was not limited to the internal workings of the pension system. The fact that fewer than one in ten workers are covered by a pension system in a country with high levels of absolute poverty makes the indirect impact of the pension system on the economy more important than usual. Such indirect effects could be positive – for example, when a pool of long term savings is created and is effectively channelled into projects that increase economic growth, or when pension funds contribute to greater liquidity and depth in domestic capital markets. However, these indirect effects can also be negative, as is the case when governments use the savings to increase wasteful public consumption or when high contribution rates add to the incentives for small firms to remain in the informal sector. In the case of civil service pensions, the program may also begin to crowd out other social programs as the pension bill eats up a rising share of tax revenues.

As the national dialogue on pension policy progressed, it was also important to recognize the opportunities and constraints for pension reform created by changes in other parts of the economy. There were important developments in the financial sector that improved the prospects of a funded pension system including the end of the 50 year monopoly of the Life Insurance Corporation of India and the introduction of modern technology in India's securities markets. The growth of the private mutual fund industry, including partnerships with foreign firms, is especially relevant to the proposed reform. Meanwhile, the presence of new, voluntary private pension products provided additional rationale for the creation of a specialized pension regulator. These developments made it more likely that a defined contribution scheme of the type advocated by OASIS could succeed.

On the other hand, the short term fiscal pressures – partly due to pension payments – made it more difficult to move quickly from an unfunded to a funded pension scheme. The Union government as well as state governments have grown dependent on an automatic source of deficit finance by way of the EPFO schemes, and the introduction of an employer contribution to the new civil servants scheme would require additional resources.

After several years, the rationale for pension reform, the cost of inaction and the constraints to be taken into account, have percolated to the higher levels of government and public awareness has increased. Even so, the reform announced by the Minister of Finance in March 2003 represents but the first step in the proverbial thousand mile journey.

1.3 The Indian Pension Reform of 2003

In his annual budget speech in February 2003, India's Union Finance Minister, Mr. Jaswant Singh, announced a bold and progressive pension reform initiative with the core elements of a privately-managed, defined contribution scheme that would eventually replace the non-contributory, defined benefit scheme of the civil service. In his Budget speech, the Finance Minister said

> "My predecessor in office had, in 2001, announced a road map for a restructured pension scheme for new Central Government employees, and a scheme for the general public. This scheme is now ready. It will apply only to new entrants to

> Government service, except to the armed forces, and upon finalisation, offer a basket of pension choices. It will also be available, on a voluntary basis, to all employers for their employees, as well as to the self-employed. This new pension system, when introduced, will be based on defined contribution, shared equally in the case of Government employees between the Government and the employees. There will, of course, be no contribution from the Government in respect of individuals who are not Government employees. The new pension scheme will be portable, allowing transfer of the benefits in case of change of employment, and will go into 'individual pension accounts' with Pension Funds. The Ministry of Finance will oversee and supervise the Pension Funds through a new and independent Pension Fund Regulatory and Development Authority."

The key feature of this new system is the individual, defined contribution account. This is a fundamental change and the first system of its kind in South Asia. The details of the proposal began to emerge in the following months and included:

- Reliance on private asset managers to be selected through a bidding process
- Centralized recordkeeping and administration of individual retirement accounts
- Limited choice among investment portfolios
- Contribution rates set with the intention of providing roughly the same replacement rate as current levels to a central government worker with a full contribution history

Also important is the population targeted for coverage by this new pension system. To start with, only new entrants to central government service would be obliged to join the new DC scheme while other workers would be allowed to do so on a voluntary basis, but without contributions from the state. While this strategy avoids difficult issues related to those civil servants that already have acquired pension rights in the old system, it also

prolongs the transition period and results in relatively small numbers of contributors in the early years of the scheme.

Another significant element in the new system is the new pension fund supervision agency. The first of its kind in the region, the Pension Fund Regulatory and Development Authority (PFRDA) would be responsible for enforcing a set of regulations which have yet to be issued. Presumably, the rapidly growing voluntary private pension sector as well as the enterprise-based schemes that operate in parallel, such as the electricity board pension plans, would also fall under the new regulatory framework. Finally, following recommendations by The World Bank and the Asian Development Bank in two major studies, this new agency may eventually be charged with oversight of the schemes currently supervised by the EPFO. In short, the PFRDA could bring the entire pension sector under one supervisory umbrella for the first time in India's history.

While the broad policy framework of the reformed civil service scheme has been described, a plethora of design and implementation questions remain. Among the most pressing are the following:

- How soon can the appropriate information technology for collection and recordkeeping be constructed?

- What is the required size and budget of the new supervisory agency?

- What regulations must be issued and how are these to be coordinated with those falling under the securities and insurance sectors (SEBI and IRDA, respectively.)

- How will the fund managers be selected and on the basis of what criteria?

These are only a few of the several challenging issues facing public officials responsible for implementing the reform, and the list of policy decisions to be made is much longer. For example, the final contribution rate to be required has not been determined and the rules regarding the payout period have yet to be defined. Each of these questions requires discussion about policy objectives as well as analytical work to spell out the possible solutions.

While a daunting task, there is ample international experience that shows systemic reform is possible. Roughly a dozen Latin American countries have already introduced individual account schemes and have managed (some better than others) the transition from an unfunded, DB scheme to a funded, DC scheme. Another half a dozen countries in Eastern Europe have also succeeded. With regard to civil service schemes in particular, most of the Latin American reformers have integrated their civil service pension schemes with those of the private sector. In Eastern Europe, special schemes for civil servants had already been eliminated during the socialist period.

While India will become the first South Asian country to introduce a privately-managed, defined contribution scheme for its civil servants, there is some precedent elsewhere. A similar arrangement to the one proposed, known as the Thrift Savings Plan (TSP), was introduced for federal government workers in the United States after 1984 and has been deemed a success after almost two decades. More recently in 2000, Hong Kong required new civil servants to join the Mandatory Provident Fund system, a privately-managed, employer-based, DC scheme that covers the entire labour force. Interestingly, the pension scheme being replaced is essentially the same type of scheme as that found today in India having been inherited from the colonial period.

In short, while this is a bold reform with far-reaching implications, it is a reform that is demonstrably feasible. However, the task is huge and will take some time to implement even under the best of circumstances.

1.4 Embarking on the Path of Reform

The motivation for the conference that produced the series of papers collected in this volume was the need to begin to answer some of the key policy questions mentioned above. A unique feature of the event and of the material that it generated was the conscious attempt to combine local and international expertise wherever possible.

This volume includes the *Project OASIS Report* and recommendations. This report highlights the demographic transition, low coverage by existing provisions and the consequent policy compulsions for pension reforms in India. It encapsulates the policy framework for a new, privately manage-

ment, DC provision for informal sector workers who constitute over ninety percent of India's workforce.

In the following chapter, *Challenges of Pension Reform in India,* Robert Palacios reviews the current situation in India and provides a starting point for pension reform. The author draws on and updates a major research paper produced by The World Bank after three years of close interaction and significant time spent in India. (The final report was presented to the Government of India in April 2001). The paper reviews every component of old age income security including informal arrangements within the family, social assistance programs targeted to the elderly, tax-favoured products offered on a voluntary basis and of course, the main schemes mandated for formal sector workers.

These policy proposals provide a backdrop for the focused chapters which follow and that examine several key policy concerns and issues which would arise in the context of implementing the new fully funded defined contribution pension scheme. These include effective governance and regulation; funding and investment of retirement savings; adequacy of benefits and the role of annuities; the need for, role and costs of guarantees; mechanisms for efficient collection and administration of pension contributions as well as the impact of fees and charges, especially in the face of potentially modest contributions; and, the impact of financial literacy on voluntary contributions and effective selection of products, fund managers and annuity providers.

Given the importance of private pension funds from both a social as well as economic policy perspective, as well as to maintain public confidence in the system, development of effective infrastructure and policies for supervision and regulation of private pensions has gained increasing importance across the world. However, unlike banking and securities regulations that have evolved over long periods in response to a series of crises, regulatory frameworks to promote safe, efficient and orderly functioning of private pension systems are yet evolving and exhibit more diversity among nations. These frameworks have attempted to identify the unique regulatory risks and objectives of pension systems, and integrate them with the core principles of supervision and best practice.

In the chapter on *Approach to the Regulation of Private Pension Funds in India and Application of International Best Practices*, Richard Hinz and Nageswara Rao provide an excellent overview of the existing pension systems in India, their regulatory frameworks, and an assessment of their efficacy. The authors also examine the potential role for private pension funds in India, the core principles of supervision, as well as international best practices in this area and their possible application to India, particularly in the context of the current reform initiatives. They suggest that the main challenge for India will be to balance 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. The paper indicates that reliance on restrictive entry requirements, initially restrictive investment regimes, proactive oversight and intervention, and the establishment of restrictive but viable rules governing potential conflicts of interests should be high priorities for India's policy-makers. A focus on transparency of performance measures and market competition are key complements to these basic attributes. The paper argues that the legal and regulatory framework should explicitly contemplate a process of evolution to a more flexible and open market based regime in order to attain the maximum benefits of a funded private pension system in the long term.

A close study of existing formal systems of retirement income provision in India also provides some important lessons and directions for policies that will govern new private pension systems. Existing pension systems suffer, in varying degrees, from three major weaknesses – problems of funding, problems of investment restrictions combined with administered rates of return, and mismanagement of funds. The ultimate impact of these three problems is to increase the probability of taxpayer-financed bailouts – a solution that is not sustainable in an already difficult fiscal situation.

Several entities in India offer defined benefit plans which suffer from lack of adequate funding. Unless solutions are found soon, these liabilities will threaten the viability of the entities involved. For defined contribution plans, a poorly structured investment regime can impose costs on contributors in terms of lost returns. On the other hand, a relatively small increase in risk-adjusted returns can significantly enhance total asset accumulations of contributors and improve the security of their retirement income. Finally, irrespective of the type of plan, good governance of pension funds is critical.

Passive regulation, such as defining the class of investments that pension funds can invest in, or defining the fraction of funds which can be invested in each class is not a sufficient condition to ensure that the fund is invulnerable to theft and fraud. Close monitoring and well defined lines of accountability have to be built into the investment process.

In their chapter on *Institutional Mechanisms in Pensions Fund Management,* P.S. Srinivas and Susan Thomas discuss policy issues raised by the problems of poor funding, inadequate diversification, and weak governance in the context of three case studies – the Indian Railways Pension Fund, the Employees Provident Fund, and the Seamen's Provident Fund. The authors examine means to reform these pension funds, drawing upon both Indian and international evidence, and offer some general principles which could be useful in pension reforms in India.

Today, there is a considerable consensus and international evidence that over the multi-decade horizons encountered in pension investment, enormous gains can be obtained through portfolios that include private securities such as corporate bonds and equities. However, such investment strategies do impose greater uncertainty upon workers about post-retirement consumption. Guarantees are one mechanism through which this investment risk can be contained.

In his paper on *Investment Risk in the Indian Pension Sector and the Role for Pension Guarantees*, Ajay Shah sees the role of guarantees as one mechanism to protect the worker from this investment risk. In his paper, he describes the investment risks present in pensions and works out the costs of different guarantee structures. His results indicate that the poor would have some chance of escaping poverty in their old age if they see equity investment, while the rich would be comfortable with riskless assets. Shah also cross-examines the role of policy in providing the guarantees. He concludes that the most attractive policy strategy appears to be one where individuals make choices about the three fundamental facets of old age planning – contribution rates, equity exposure and guarantee structure and individuals pay the full price of purchasing the guarantees from private markets. Valuation exercises, such as those undertaken in this paper, should play an important role in public policy and should help more informed decision making on the part of the State. Shah suggests that if the State chooses to take on such liabilities, it should be done with full

awareness of the off-balance sheet consequences which flow from a stated guarantee structure. India's unfortunate experiences with assured returns should not be repeated in the context of the new pension system.

Sound management and security in the accumulation period should lead to significant accumulations in workers' individual accounts. Public policy however, does not end at this point. Rather, the objective is to provide income security throughout old age and as a result, to provide, either on a mandated or at least voluntary basis, effective longevity insurance. For this reason, the success of any defined contribution scheme depends therefore on how well it translates accumulated funds into a stream of retirement income. This ultimately depends on a well-regulated and competitive insurance sector. With the reforms in the private pension plans and social security systems, annuities markets in India are likely to grow. The paper entitled *The Annuity Market in India: Do Consumers Get their Money's Worth? What are the Key Public Policy Issues?* by Estelle James and Renuka Sane studies the annuities market in India and points to several key weaknesses that need to be corrected to enable the development of a health annuity industry in India. The authors identify the reasons behind the underdevelopment of the annuity industry relative to other kinds of insurance. They also identify constraints such as the lack of well-developed mortality tables and the absence of long-term financial markets to immunize risks. James and Sane identify institutional gaps that have to be addressed immediately in order for annuities to play an important role in the pension reform. They also discuss some issues in the various policies related to the insurance industry and the special regulations that are needed.

Administrative fees and charges can also have a significant impact on terminal benefits as seemingly small levies on consumers in a pension system can significantly reduce retirement wealth. Accordingly, recent pension reform proposals for India have stressed the importance of administrative costs and charges for consumers. Administrative charges are also of central interest to policy-makers, for whom adequacy of pension benefits is an important goal, especially when private pensions are expected to provide a large part of retirement incomes. The paper on *Cost of and Charges for Administering Individual Pension Accounts in India* by Edward Whitehouse draws on evidence from the international experience and from data on Indian mutual funds as it investigates policies that would limit administra-

tive charges and the tradeoffs involved in their implementation. The paper looks at how administrative charges affect pension values on the basis of a formal model of different measures of charges and empirical evidence from a range of countries with large private pension sectors. Whitehouse also examines the policy options and choices of the institutional and fee structure of funded pensions and their effect on costs of provision and on administrative charges. He points out that regardless of the charge being based on assets or contributions, it is essential to ensure clear disclosure of the charges levied by different providers.

Each of these papers were presented at the IIEF conference and the core issues in implementing the new pension system were debated by over 100 participants representing government departments, regulators, fund managers, annuity providers, multilateral agencies, intermediaries, journalists and economists from domestic and overseas markets. Following this meeting, IIEF conducted an opinion poll to assess the outlook of participants on implementing pension reforms, and on a variety of contemporary policy concerns. A summary of the response to this poll and its analysis is presented by Gautam Bhardwaj in his chapter titled *Issues in Implementing Pension Reforms in India: Evidence from the IIEF Survey.* The issues that this survey broadly chose to explore included an assessment by participants of the core design principals and features of the new pension system as well as their views on some parametric reforms that could improve the efficacy and impact of existing provisions.

While the new pension system will provide significant freedom to every participant in making choices governing products and fund managers, it will also prohibit them from premature access to their retirement savings. As a result, individuals will need to efficiently use alternate mechanisms to fund their present consumption and other non-retirement needs and commitments. For millions of workers in India to make independent decisions on the questions related to financial savings and retirement planning will require a sea change in standards of financial literacy. In order to assess the knowledge, attitudes and behaviour of individuals towards retirement, risk, investments, savings and debt, as well as their expectations from the manufacturers, distributors and regulators of financial products and services, IIEF conducted a financial literacy survey in July 2002. This survey was run on an admittedly non-random sample of 1832 persons based in 106 dis-

tricts in India. The results of this survey are encapsulated in the last chapter titled *The IIEF financial literacy survey 2002* by Gautam Bhardwaj. While this survey is only a starting point for the discussion of financial literacy and its relation to pension reform, it does highlight the need for a quantum improvement of financial knowledge among potential participants. Within the scope of the risk-return possibilities allowed in the new pension system, workers' choices on asset allocation will largely determine the adequacy of the benefits they will derive. The author argues that people are not likely to save voluntarily in a system unless they feel confident about it and greater confidence can be best achieved by enabling the public to become better informed about the system. In this situation, a useful strategy for increasing coverage and motivating participation is to focus on simplicity in system design and to bring in complete transparency where a worker can clearly see the direct relation between contributions and benefits.

1.5 Conclusion

Pension reform is squarely on the agenda in India and the stakes are high.

Paramount of course are the dual objectives of consumption smoothing and alleviation of poverty in old age. By providing a safe vehicle for long term savings, a well-designed pension system can improve the lives of millions of Indian citizens in the decades to come. As such, it is a key area of social policy for the Government of India.

The nature of the system that has been proposed involves new institutions, in particular regulators, recordkeeping agencies and of course, pension fund managers. Setting them up properly is a great challenge. But a well regulated and efficient pension system can achieve two important things under the right conditions: First, it can effectively channel resources from savers to the increasingly dynamic private sector firms that can promote economic growth. Second, it will result in demand for longer term instruments including government and even mortgage-backed bonds. Together, the impact on government finances and capital market liquidity can generate indirect benefits for the rest of India's vast population.

In order to reap these rewards, the system must be based on a sound design and be well implemented. Both will require a concerted effort and support from stakeholders. In the coming months, the new Pension Regulatory and

Development Authority will begin to operate, policy-makers will finalize the design of the new system and the administrative apparatus will be constructed.

This volume is a modest attempt to contribute to this process.