SOME REFLECTIONS ON PENSION REFORMS IN INDIA

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Pension policy in India has been characterized by the dominance of the orgainsed sector based on financing through employer and employee participation. As a result the coverage has been limited to the organised sector and the employees in the unorganized sector needs to be brought into purview of the formal channels of old age financial support. Further, the existing mandatory and voluntary private pension system needs uniform regulatory framework for transparency and improved service. There is an imperative need to manage the pension funds through fund managers as is the practice in some of the developed countries to derive the positive spin-offs in terms of investment options and making available the resources for improving growth. In view of the experience with the current pension system in India, efforts have been made by the Government in the recent years towards the direction of reforms in pension policy with the introduction of a new pension system in 2004. The present paper focuses on the recent initiatives and reforms in the pension system in India in the light of international experience as also the compulsions due to demographic factors and attendant implications for finances of the Government both Central and State Governments. The policy initiatives include setting up of the Interim Pension Fund Regulatory and Development Authority (October 2003), introduction of a New Pension System and introduction of the Pension Fund Regulatory and Development Authority (PFRDA) Bill in Parliament in March 2005. Against this backdrop the paper also highlights some of the policy challenges and imperatives to be addressed in the medium term.

The pension reforms initiatives have emerged as one of the important tenets of public policy in the recent past, although these are yet to take off on account of the pending of the passage of the PFRDA Bill. The introduction of pension is an integral component of the refining the social security system in India. The paper is organised as follows. Section 1 briefly deals with the international experience with regard to pension reforms. Section 2 presents necessity of pension reforms in Indian context and also focuses on the demographic factors having bearing on pension reforms. It also presents the salient features of the New Pension System and its architecture. A brief description of the role of private sector in pension also discussed in this section. Section 3 deals with the recent policy initiatives including some of the issues flagged by the PFRDA based on the recommendations of the Expert Group on investment guidelines for pension in the informal sector released recently. Section 4 concludes with emerging challenges and policy issues.

1 Brief review of international experience on pension reform

Many countries are grappling with the problem of how to reshape their onerous, tax-financed pension schemes. Latin America, however, has been a laboratory for pension reform. Starting with Chile in 1981, several countries such as Peru, Argentina and Mexico embarked on pension reforms. The details have varied across the region but, overall, pension provision has shifted decisively to a privatised model. What can the rest of the world learn from Latin America? A study by Gill *et al.*, *Keeping the Promise of Social Security in Latin America*, from the World Bank, presented a

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comprehensive analysis of the Latin American experiment. The World Bank set out a model of pension reform based on three "pillars": first, a tax-financed public safety-net; second, compulsory saving by workers, generally into individual pension accounts; and third, voluntary saving for retirement. The study found that main success of Latin American pension reform aimed at improving the governments' finances. The reform also galvanised the development of capital markets and helped to modernise the financial system, both by improving the quality of regulation and by generating services such as risk-rating.

According to the World Bank report, *Old-Age Income Support in the 21st Century*, most pension systems in the world "do not deliver on their social objectives, they contribute to significant distortions in the operation of market economies, and they are not financially sustainable when faced with an ageing population". Pension reform must take account of workers in the informal economy, who often make up more than half the labour force in developing countries. And it must also cater for people who will be poor throughout their lives.

Chile has been considered to be model country for implementation of pension reforms. Its pension system is based on obligatory individual accounts and private administration. In Chile, the debate has focused on the people who remain outside the system – a problem that the Chilean government says it would fix broadening Social Security coverage. Overall, the consensus is that the system of pension fund administrators has more strengths than weaknesses. That explains why, from Central and South America to Eastern Europe, the Chilean system has served as the inspiration for 17 countries that have decided to get rid of their underfinanced systems of distribution. The main attraction of the Chilean pension system was that it was created at the beginning of the 1980s as the successor to the old state-run system, which went bankrupt. A second factor was that the Chilean reform included the concept of individual capital accounts. "This feature appeals to many people who believe that governments are often unable to maintain sufficient assets to finance a retirement system." Individual accounts can be better protected against political risks. Its system incorporates a "security network" in the form of minimum pensions and old-age benefits guaranteed by the government (Olivia Mitchel).

According to a study by the AFP Association (which comprises Chile's seven private-sector pension administrators), the first foundation of the Chilean model is the country's government. In its subsidiary role, the government finances a portion of the minimum pensions and all of the public-assistance pensions provided for the aged poor. The second foundation consists of the private-sector pension administrators who administer the obligatory Social Security savings. They help to relieve the burden on the government. The third pillar is Chile's workforce, which voluntarily saves, either to increase its pensions or in order to take early retirement. The mechanism for doing this is called "voluntary provisional savings".

Individual accounts permit the establishment of a direct link between those contributions that people make to the system and the benefits they derive from it. This creates incentives for people to assume responsibility for their own pensions and can lead to a range of positive results for savings, the development of capital markets, and higher worker productivity. These factors, in turn, stimulate economic growth. Its impact on economic growth is a key "virtue" of the Chilean model.

According to the OECD report, *Pensions at a Glance: Asia/Pacific, a Joint OECD/World Bank Report*, many Asian countries would need to reform their pension systems in order to deliver sustainable and adequate retirement incomes for today's workers. In order to prepare for the rapid population ageing forecast over the next two decades, it is vital to act now to avoid future problems and repeating many of the mistakes made in Europe and North America. The report analyses the retirement income systems of 18 Asian countries, including Australia, China, India, Indonesia, Pakistan, the Philippines and Vietnam. It says that reform is needed because:

- coverage of formal pension systems is relatively low;

- withdrawal of savings before retirement is very common;
- pension savings are often taken as lump sums and often do not provide people with adequate income over their lifetime;
- pensions payments are not automatically adjusted to reflect changes in the cost of living.

In order to improve the pension systems in Asia Pacific region including India, the pension report by OECD relating to this region makes three key recommendations: Asian countries with defined-benefit schemes based on workers' final salaries should shift to calculating pension entitlements using lifetime average earnings, as most OECD countries do. This would make them more financially sustainable and fairer; final salary plans tend to favour the higher paid whose earnings tend to rise more rapidly with age compared to lower paid manual workers; and many countries allow people to withdraw their pension benefits before retirement or pay lump-sum benefits, rather than a regular retirement income. Allowing people to take out their savings only on retirement *via* regular payments, known as annuities, would reduce the risk of people's savings running out in retirement.

In OECD countries, an average of 70 per cent of the working-age population is eligible for a pension. However in South Asia, just 7.5 per cent of the working-age population are eligible and in East Asia 18 per cent. Furthermore, few countries in Asia/Pacific have social pensions to provide safety-net retirement incomes for people who are not members of formal schemes. Only in India are social pensions significant, with around 10 to 15 per cent of older people covered.

2 Demography and importance of pension reforms in India

Nearly one eighth of the world's elderly population lives in India. The vast majority of the population is not covered by any formal pension scheme. Instead they are dependent on their own earning and transfer from their children. Pension policy in India has traditionally been based on financing through employer and employee participation. As a result, the coverage has been restricted to organised sector and vast majority of the workforce in the unorganised 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 from 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 would be accentuated by the sharp increase in the financial burden on the Government and other employers on account of pension liabilities. The working age population is likely to increase in the next two decades at a brisk pace, thereby pension reform is vital to provide support at the old age without having any adverse effect on finances of the Government (Table 1).

The total pension liability on account of the Central Government employees has increased from 6 per cent of its revenue receipts in 1990-91 to 11 per cent in 2000-01, sharp rise possibly reflecting the impact of Fifth Pay Commission, before falling to 5.8 per cent in 2008-09 (budget estimates). In respect of State Governments, the same ratio has increased from 5.4 per cent in 1990-91 to 11.3 per cent in 2001-02 before sliding to 8.7 per cent in 2008-09 (budget estimates) (Table 2). There is an imperative to need reduce the burden on the Governments in view of the likely rise in these payments in future.

India is one of the youngest country in the World today with an average age being only 26 years. The dependency ratio in India is also one of the lowest in the World. However, old-dependency ratio during 2000-25 is estimated to increase almost 1.5 times (8.1 in 2000 to 12.2 in 2025); the next 25 years is likely to witness a sharper increase of around 2 times (from

Table 1

India's Labor Force and Demographic Indicators

	Indicator		**Time Period**
1	Life expectancy at birth *(years)*		2000-05
	Male	63.2	
	Female	64.6	
2	Life expectancy at age 60 *(years)*		2001
	Male	15.7	
	Female	17.1	
3	Total fertility rate (No. of children)	2.85	2001
4	Population *(millions)*	1028	2001
	Females *(millions)*	496	
	Males *(millions)*	532	
	Sex Ratio *(females per thousand males)*	933	
5	Population above age 65 *(millions)*	46.6	2000
		129.3	2030
	Old Age Dependency Ratio (percent)	11.9	2001
6	Total workforce *(millions)*	424.6	2001
	Urban workforce *(millions)*	97.7	
	Rural Workforce *(millions)*	326.9	
7	Working age population *(millions)*		
		619.7	2000
		921.5	2025
		1048.2	2050

Source: Asher and Vasudevan (2006).

12.2 in 2025 to 22.6 in 2050). The policy imperative under these circumstances is to a establish a strong and sustainable social security network in the country. At the same time India is growing old at a very fast rate and the population of people above 60 years of age, constitute 80 million in 2008 would double in the next 18 to 20 years. In order to reap the advantages implementation of pension reforms is vital. The coverage of old age constitute about 12 per cent of the total workforce in the formal social security system. The remaining 88 per cent do not have access to any formal scheme. New Pension Scheme is aimed at 88 per cent of the workforce.

The pension scheme in operation in India can be broadly divided into the Civil Services Pension schemes (12 million), Employees Provident Fund (40 million), Empoyees' Pension Scheme (28 million), Special Provident Funds (2.1 million) and New Pension Scheme (0.3 million). The Civil Servants' Pension (CSP) is a traditional defined benefit scheme which runs on the basis of pay-as-you-go system, for employees of Central Government who were

Table 2

Pension Payments
(billion rupees)

Year	States	*as percent of revenue receipts*	Centre	*as percent of revenue receipts*
1	**2**	**3**	**4**	**5**
1990-91	35.93	5.4	32.72	6.0
1991-92	37.16	4.6	37.48	5.7
1992-93	43.79	4.8	45.85	6.2
1993-94	51.07	4.9	52.06	6.9
1994-95	61.46	5.1	57.34	6.3
1995-96	78.13	5.8	69.28	6.3
1996-97	98.27	6.5	82.52	6.5
1997-98	115.99	7.0	113.76	8.5
1998-99	161.66	9.4	153.46	10.3
1999-00	226.79	11.2	194.46	10.7
2000-01	254.53	10.9	211.17	11.0
2001-02	282.19	11.3	218.26	10.8
2002-03	310.05	11.3	221.02	9.6
2003-04	330.24	10.7	236.29	9.0
2004-05	373.78	10.3	249.7	8.2
2005-06	406.48	9.4	271.96	7.8
2006-07	468.61	8.8	295.2	6.8
2007-08 RE	560.02	8.9	324.44	6.2
2008-09 BE	627.29	8.7	346.75	5.8

BE: Budget Estimates. RE: Revised Estimates.
Source: Union Budget documents, various issues, State Finances, *A Study of Budgets* and Swarup (2007).

recruited up to December 31, 2003 and employees of State Governments recruited up to the effective date mentioned in notifications issued by those Governments. CSP is an unfunded scheme and there has been no attempt at building up pension assets through contribution or any other provision.

2.1 New Pension System

There was a marked shift in pension policy during the period 2000 to 2007 in India which culminated in introduction of new pension system. A High level Expert Group and Old Age Social and Income Security (OASIS) project commissioned by the Government were two milestones on the road to pension reforms for the Government employees and the unorganised sector respectively. These efforts culminated in setting up of the Pension Fund Regulatory and Development Authority (PFRDA) in October 2003, introduction of New Pension System in January 2004 and introduction of PFRDA Bill in March 2005. In order to reduce the liability, the Central Government has introduced the defined contributory system for the new employees. Similar schemes have been undertaken by nineteen State Governments. The remaining State Governments are expected to opt the Defined Contribution (DC) based New Pension System (NPS). The NPS contributions of the employees of the Central Government and 19 State Governments would be transferred to these fund managers by the respective Governments in the beginning of 2009-10. The NPS has been implemented for Central Government employees (excluding defence personnel) recruited on or after April 1, 2004. The NPS is designed for scalability, outreach, fair play and low cost, and provides choices to individual. For such a system sound regulatory framework is an imperative. The NPS envisages individual retirement based accounts, with the worker empowered to exercise investment choice.

The salient features of the NPS are that it provides seamless portability across jobs and across locations, unlike all current pension plans, including that of the EPFO. It would provide hassle-free arrangement for the individual participants and a pure DC product with no defined benefit element, returns being totally market-related. NPS also provides various investment options and choices to individuals to switch over from one investment option to another or from one fund manager to another subject to certain regulatory restrictions. At present there shall be only two investment choices – investment of entire contribution in Government securities alone or adopting the investment guidelines applicable to non-government provident funds. The current government guidelines provide that up to 15 per cent can be invested in equities and the balance 85 per cent in fixed income instruments. After the passage of the PFRDA Bill by Parliament, the Regulator would provide more investment choices. NPS will have comparatively lower costs. Low costs will enhance pension wealth and bring in more customers. The main challenges are: providing safety and high returns; extending coverage to as many people as possible and to improve financial literacy levels. There is an imperative to make efforts to educate potential participants about benefits and advantages of saving for retirement. According to an estimate made by a FICCI-KPMG study the assets under management will be US$ 95 billion in less than 20 years. One important element which would greatly incentivise pension savings is the tax treatment given to it. At present, NPS is subject to the EET tax regime. On the other hand, Employees Provident Fund (EPF), General Provident Fund (GPF) and Public Provident Fund (PPF) have more favourable tax treatment. EEE benefit is available to them. This goes against the basic philosophy of encouraging contractual savings, which provide long-term funds for investment.

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 January 1, 2004 participate in the GPF scheme which is again an EEE tax regime whereas NPS is subject to EET regime and the withdrawable 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. The main challenges in the development of this sector include: covering the unorganized sector; empowering the subscribers to take appropriate investment decisions based on their risk and return profile, provide safety and optimum returns, and to improve financial literacy levels.

2.2 NPS architecture

The Pension Fund Regulatory and Development Authority (PFRDA) and National Securities Depository Limited (NSDL) entered into a formal agreement on November 26, 2007 relating to the setting up of a Central Recordkeeping Agency (CRA) for the New Pension System (NPS). The CRA is a first of its kind venture in India and is critical to the successful operationalisation of the NPS. The main functions and responsibilities of the CRA are: (i) Recordkeeping, Administration and customer service functions for all subscribers of the NPS; (ii) Issue of unique Permanent Retirement Account Number (PRAN) to each subscriber, maintaining a database of all PRANs issued and recording transactions relating to each subscriber's PRAN; (iii) Acting as an operational interface between PFRDA and other NPS intermediaries such as Pension Funds, Annuity Service Providers, Trustee Bank etc. An important feature of the PRAN to be issued by CRA is that it shall be portable across jobs and geographical locations.

The NPS architecture consisting of a Central Recordkeeping Agency (CRA) and competing pension fund managers along with the NPS trust, custodian, Trustee bank, Retirement Advisers and other players. Based on the systems prevalent in both developing and developed countries, PFRDA devised a system that meets Indian conditions and needs. PFRDA had attempted to design an architecture which is simple, cost effective and robust.

PFRDA has completed the process of putting in place the full NPS architecture. The selection of the Central Record Keeping Agency (CRA), Pension Fund Managers (PFMs) and Trustee Bank was made. State Bank of India (SBI), UTI Asset Management Company (UTI-AMC) and Life Insurance Corporation (LIC) have been appointed as Pension Fund sponsors under the NPS.

As these intermediaries were selected through a bidding process, the fees/charges are very competitive *vis-à-vis* the prevalent fee/charges in the mutual fund and insurance industry. A Custodian of NPS assets and an NPS Trust have also been appointed. Once the volumes increase, these costs can only move southwards. Low costs will enhance pension wealth and bring in more customers. Once the volumes increase, these costs can only move southwards. Low costs will enhance pension wealth and bring in more customers.

2.3 Private sector

Three private sector groups – Reliance (ADAG), ICICI and Kotak Mahindra – were among the six bidders shortlisted by the Pension Fund Regulatory & Development Authority (PFRDA) for managing pension funds for citizens other than government employees. The other three are UTI, SBI and IDFC. As per the Government plan, the New Pension System for all citizens will be rolled out from April 1 2009. The six parties were shortlisted by PFRDA from more than a dozen participants in the competitive bidding. Under the NPS, fund managers, besides incurring the operating expenses, will have to pay PFRDA Rs 10 lakh a year as marketing expenses. There was aggressive bidding from private parties who feel that the corpus would be large as the scheme is

Table 3

Investment Pattern of Pension Funds

Instrument	Revised Investment Pattern	Investment Pattern Dated January 2005
Government securities and mutual funds dedicated to government securities, regulated by the Securities Exchange Board of India (SEBI)	up to 55%	minimum 40%
Debit securities (issued by corporate bodies, including banks and public financial institutions); term deposit receipts (issued by scheduled commercial banks) and rupee bonds	up to 40%	minimum 25%
Money market instruments, including units of money market mutual funds	up to 5%	previously not allowed
Equities	up to 15%	up to 5%
Equity-linked schemes of mutual funds regulated by the SEBI	up to 15%	up to 10%

open to all. Analysts, however, think it may not be the case, going by the investor response to some of the existing pension schemes. Private sector entities were barred from bidding for the New Pension System for government employees launched last year. However, they were allowed to bid when it came to managing funds for citizens other than government employees. The NPS for the government employees is currently managed by three public sector institutions – LIC, SBI and UTI. Under the new NPS – which is a voluntary scheme – an individual can join any one of the funds and would have a permanent Retirement Account Number (PRAN). The records of subscribers are run by a central record keeping agency.

3 Recent policy initiatives

As a sign of increasing confidence in the expansion of private pension systems in India, the Ministry of Finance had increased the flexibility in the pattern of investment. This would be effective from 1 April 2009 for non-governmental provident funds, superannuation and gratuity funds. In line with the practice in many developing countries, there have always been significant restrictions on how these funds could be invested, with a considerable bias toward local investments and toward government securities. The latest revision to the investment pattern provides an avenue of investment options and will give more flexibility for investment management within the revised ceilings available for different categories of investment (Table 3).

Within the above instruments, it should be noted that investment in equities is limited to shares of companies for which derivatives are available on the Bombay Stock Exchange or the National Stock Exchange. However, this does cover more than 250 stocks, which would now be available. Concerning debt securities, these should have a duration of at least three years, and at least 75 per cent of investments need to be investment grade. Bonds denominated in Indian currency and issued by multilateral agencies such as the International Finance Corporation, a member of the World Bank Group or the Asian Development Bank must also have a maturity of at least three years. The required duration for term deposit receipts has been changed from a maximum of three years to a minimum of one year. Overall, this is a significant extension of flexibility in creating a range of bond portfolios.

Apart from a specific limit on exposure to mutual funds, which is not to be more than 5 per cent of the portfolio at any time, there are some further significant relaxations around trading and the monitoring of the investment pattern. While the investment pattern must be in place at the end of each year, movement is allowed during the year provided that each category does not exceed the investment pattern limit by more than 10 per cent. Also, the entire portfolio can be treated as tradable and exposed to active management. Rather than the old limit of 10 per cent of the portfolio being tradable, the only limit now is that the overall turnover ratio (that is, the value of securities traded during the year divided by the average value of the portfolio during the year) should not be more than 2 per cent.

3.1 Investment guidelines for pension funds in informal sector

PFRDA had constituted an Expert Group (Chairman: Shri Deepak Parekh) to recommend investment norms for the New Pension System for all citizens other than Government employees covered by NPS. The Report submitted by the Group to PFRDA on February 17, 2009. The recommendations of the Group have been considered by PFRDA. Comments/views of the public on the recommendations of the Expert Group and modifications proposed to be made in the investment norms by PFRDA are invited. The major recommendations of the Group and the modifications proposed to be carried are shown in Table 4. A set of questions raised for evaluation relate to administrative choices were made at PFRDA as features of NPS. These are: how frequently ought a contributor be allowed to change his investment allocation? What are the valuation guidelines to be adopted to calculate the NAV of the funds under management? How are the PFMs to be evaluated on their fund management performance? What would be the frequency of NAV disclosure to PFRDA and to the contributors? What is the action to be taken on evaluating their performance? How are the "auto choice" funds to be allocated for fund management? Also see Annex 1 for investment guidelines for pension funds in the informal sector submitted by the Expert Group to the PFRDA.

3.2 Valuation guidelines to calculate the NPS funds NAV

Pension funds are invested for long-horizon, it is important that there is no ambiguity about the NAV or the assets that the funds are invested in. In addition, the NPS is a new pension system . In order to build the credibility of the system, it is even more important to have clarity on what the NAV is with as much accuracy as possible. Thus, it would be commendable to have the NAV at each PFM reported to the PFRDA on a daily basis. However, a problem with the NPS funds is that the three proposed asset classes "E" , "G" , "C" have very different characteristics in terms of their frequent valuation. "E", the index funds have an extremely high level of valuation accuracy – these are the most liquid stocks traded on electronic exchanges showing as accurate a price as possible from minute to the next. "G" contain some ambiguity in valuation (on the older Government of India bonds, which are hardly traded and thus , is very difficult to find a recent market price for). Both E and G are not problems when it comes to standardised valuation guidelines, as described above. The problem lies in valuing funds invested in "C": here, there is very little trading of these securities; most of them are bought in over the counter trades; and often are held to maturity.

Table 4

Suggestions on Investment Pattern for NPS for All Citizens

Schemes	**Expert Group**	**PFRDA**
“E”	100%	100%
“G”	100%	100%
“C”	100%	100%
Auto Choice (till 35 years of age)		
“E”	65%	60%
“G”	10%	10%
“C”	25%	30%
at age	**60 Years**	**55 Years**
“E”	10%	0%
“G”	80%	80%
“C”	10%	20%
Asset Class/Scheme	Expert Group	PFRDA
“E”	Nifty 50	Index Funds that replicate the portfolio of a particular index such as BSE Sensitive index, NSE 50 index, etc. These schemes invest in the securities in the same weightage comprising of an Index.
“G”	**Government of India bonds** Liquid Funds of Asset Management Companies with following filters: - AMCs are SEBI regulated, with Average total assets under management (AUM) for the most recent six-month period of, at least, Rs 5,000 crores. - All assets that are permitted for investment into liquid funds by SEBI. Fixed Deposits of banks with following filters: - Net worth of at least Rs 500 crores and a track record of profitability in the last three years, - Capital adequacy ratio which is not less than 9% in the last three years, - Net NPA of under 5% as a percentage of net advances in the last year, - Be a participant in the RTGS system, - The price-to-book ratio of the bank Must exceed 1.25	**Government of India bonds** **State Government Bonds**
“C”	**Govt. bonds/Credit rated State Govt. bonds** **Credit rated Public Financial Institutions/PSU bonds** **Credit rated Municipal bonds/infrastructure bonds** **Bonds of all firms (including PSU/PSE) that have shares listed on a stock exchange with nation-wide terminals,** and: 1 Have a market capitalisation of over Rs 5,000 crore (as on 31st March), 2 Which have been traded for at least three years, 3 Whose shares have an average trading frequency of at least 95% for a period of the last one year on the exchange, 4 Whose top management as well as the board of directors of the company have no legal/regulatory charges against them	**Liquid Funds of AMCs regulated by SEBI with filters suggested by the Expert Group**. **Fixed Deposits of scheduled commercial banks with following filters:** - Net worth of at least Rs 500 crores and a track record of profitability in the last three years, - Capital adequacy ratio of not less than 9% in the last three years, - Net NPA of under 5% as a percentage of net advances in the last year. **Debt securities with maturity of not less than three years tenure issued by Bodies Corporate, including scheduled commercial banks and public financial institutions [as defined in Section 4 (A) of the Companies Act]** Provided that at least 75% of the investment in this category is made in instruments having an investment grade rating from at least one credit rating agency. **Other categories/requirements as recommended by the Expert Group**

4 Emerging challenges and issues

There are certain policy issues which need to be addressed for the success of New Pension System. The voluntary nature of NPS along with poor financial literacy and attitude of households towards financial savings pose challenge to achieving optimum coverage of NPS. Designing an effective, efficient and accessible system, which caters to the heterogeneous workforce should be priority in the success of NPS in India (See Annex 2). According to ADB survey, there is transition from family support to self-support in retirement. Therefore corrective measures are essential at an appropriate time. A major challenge in 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 payment. The DC system does involve capital-market risk during the accumulations phase when contributions and returns on investment build up in the fund.

NPS architecture for Government employees has already started functioning in terms of investment of NPS corpus and the CRA started functioning from June 1, 2008. The real challenge will be in seeing that the entire system functions smoothly. In this regard, issues relating to safety and high returns, extending coverage to as many people as possible would be important. It is only when the system is made available to all citizens that its full potential will be realized in terms of economies of scale and the subscribers will gain substantially in terms of even lower fees and charges and high returns. Pension savings would provide the much needed funds for infrastructure development. NPS would provide an opportunity to every citizen to save for retirement in a regulated environment and thus help in promoting inclusive growth. In order to address the issue of investment of pension contributions under NPS through a mechanism of consensus, a conference of Chief Ministers on pension reform was held in January 2007, which was chaired by the Prime Minister. Except three state governments, all were in favour of the guidelines applicable to non-government PF prescribed by the Ministry of Finance for investing accumulations under NPS.

India has the world's youngest and fastest growing working-age population. In contrast to the rise in the median age of population in the industrialised countries from early 30s to early 40s over the last two decades, the median age in India has increased from 20 in 1980 to 24 in 2005. According to the projections made by the United Nations, the median age in India would cross 30, only by 2025 and would remain around 35 till 2040. In 2020, the average Indian will be only 29 years old, compared with the average age of 37 years in China and the US, 45 in West Europe and 48 in Japan. The demographic process would create a large labour force. However, the window of opportunity provided by a relatively large and young workforce in India needs a conducive social policy environment for getting realised. Therefore, to reap the rewards of demographic dividend, public-policy has a critical role to play. The evolving demographic characteristics, in view of the coverage of pension to the mainly to organised sector efforts need to be made in bringing the unorganised sector into purview of pension system in the coming years.

ANNEX 1
INVESTMENT REGULATIONS FOR THE NEW PENSION SYSTEM FOR THE INFORMAL SECTOR

What assets classes should be offered in NPS investment choices?

Recommendation: The simpler structure of the “E”, “G”, “C” investment choices is easier to understand, provides clear choices to the contributors and lowers the cost to the contributor, the regulator as well as the CRA. Thus, the Group recommend that investment choices offered in NPS be the “E”, “C” , “G” asset classes.

Asset Class “E”

Given the need for prudence and simplicity in the initial stages of NPS, the Group argue that equity participation be done through a standardised portfolio across all PFMs, implemented through an index fund only (Nifty index fund). This should be approach adopted in the first stage of the NPS implementation. This can be expanded to include a wider set of alternative index funds after the first five years of the NPS to allow more choices to the fund managers to deliver better returns. As regulatory experience with NPS increases and regulatory capacity expands, NPS equity funds may even include active management of equity portfolios. This should include more sophisticated products such as derivative portfolios, hedge funds, and international investments as the capacity of both the contributor and regulator expand to accommodate these.

Asset Class “G”

All investments into asset class G assets should be either in Central Government bonds or the securities/instruments listed as follows:

1) liquid funds of mutual fund companies funds, where the AMCs satisfy the criteria of: having AMCs that are regulated by SEBI, with, average total assets under management (AUM) for the recent six-month period of , at least, Rs 5,000 crore;
2) all assets that are permitted for investment into liquid assets by SEBI. If this channel is used, the fees and expenses of the liquid fund do not become an issue;
3) fixed deposits of certain specified banks, where the banks must satisfy the following criteria: net worth of at least Rs 500 crore and a track record of profitability in the last three years; CAR of not less than 9 per cent in the last three years; net NPA of under 5 per cent as percetange of advances in the last year; be a participant in the RTGS system; the price to book ratio of the Bank must exceed 1.25;
4) NPS funds invested by any PFM in a liquid fund or FD of a bank should be under 10 per cent of the total “G” funds held by the PFM.
5) the total NPS funds invested in any single asset management company ought to be under 5 per cent of the total AUM of the AMC;

Limits on funds invested in any single FD or liquid fund should not exceed 5 per cent of the total funds invested in asset class “G”.

Asset class “C”

1) all State Government bonds that are explicitly guaranteed by the state government;

2) all State Government bonds that are rated by a rating agency. There is no restriction on an acceptable minimum credit quality – the choice of investment is left up to the PFM to decide;
3) all bonds/securities of: 1. public financial institutions as specified under Section 4 (A) of the Companies Act, and 2. public sector companies as defined in Section 2 (36-A) of the Income Tax Act, 1961; the principal whereof and whereon is fully and unconditionally guaranteed by the Central Government that have credit rating;
4) all municipal bodies/infrastructure funds bonds that are rated by a credit rating agency. There is no restriction on an acceptable minimum credit quality in the case of municipal bonds as well – investment choice is left up to the PFM to decide;
5) bonds be permitted for NPS investment of all firms (including PSU/PSE) that have shares listed on a stock exchange with nationwide terminals, and: 1) have market capitalization of over Rs 5,000 crore (as on 31st March); 2) which have been traded for at least three years; 3) whose shares have an average trading frequency of at least 95 per cent for a period of the last one year on the exchange; 4) whose top management as well as the board of directors of the company have no legal/regulatory charges against them.

The stock market-based filters for selection of corporate bonds for NPS "C" asset investment also implies that the stock market indicators can be used for valuation of the "C" assets. This will be an improvement in the current valuation framework that is based on credit rating downgrade since the stock market price can be a more real-time measure of credit quality compared to the credit rating.

- Besides, exposure to any single bond of an entity should not exceed more than 5 per cent of the total funds invested by the PFM in asset class "C".
- The total exposure to bonds by any single entity should not exceed more than 10 per cent of the total funds invested by the PFM in asset class "C".
- The total credit exposure of all the NPS funds invested in the debt of any permitted entity should be limited to a concentration of less than 5 per cent of the total debt of the company.

Limits on an individual contribution in a specific asset class

Recommendation: Contributors making an active choice of NPS investment 9Class A contributors) can choose how much they wish to invest in "E", "G" and "C" asset classes. The se contributors have no limits on what fraction of their investment can go into any of the asset choices. Class A contributors have to choose their PFM. As well. NPS contributors who do not actively choose their NPS investment (Class S contributors) are invested into the "auto choice" scheme. Class S contributors do not have to choose their PFM.

The auto choice investment scheme

Recommendation: The auto choice investment is made in the form of a life cycle fund. Here, the fraction of funds invested across "E", "G" "C" are determined by eth age of the contributor. In this scheme the maximum amount permitted for investment in the "E" asset class is proposed to be set at 65 per cent of the contributions. The maximum amount permitted for investment in the "C" asset class is proposed to be set at 25 per cent of the contributions. There will be the choice of "E" and "C" investment for any auto choice contributor whose age is under 35 years.

As the contributors grow older, the amount invested in "E" and "C" start being draw down automatically to reduce the amount of risk exposure in the contribution portfolio. This will also automatically reduce the expected return to the contributors portfolio. The risk of the portfolio becomes the lowest when the person nears retirement at age 60. The lowest risk of the portfolio is proposed to be set for an 80 per cent investment in “G” , 10 per cent in “E” and 10 per cent in “C” assets.

What are the valuation guidelines to calculate the NPS funds NAV?

Recommendation: Since the “E” class has components that are actively traded on the exchange, valuing AUM invested in “E” is not a problem. However, PFMs must have a third party valuation of the AUM in “G” and “C” investments. Given the difficulty with valuation , the Group recommend that the “G” and “C” AUM should be valued and reported to the PFRDA quarterly.

How frequently should the contributor be allowed to change investment choice, or PFM choice?

Recommendation: Contributors have to hold their choice of investment and PFM constant for the period of a year during the initial stages of NPS.

What is the framework to use for evaluating the performance of NPS PFMs?

Recommendation: If more than 605 of the NPS AUM is in “E” assets, PFRDA might consider the tracking error of the AUM invested in index funds for the different PFMs as a relative measure of their performance. Since costs of fund management is strongly related to the AUM,, it is recommended that NPS starts with a small group of PFMs.

How should the selection of the “auto choice” funds in PFM be done?

Recommendation: The auto choice funds should be split equally among all PFMs who offer to manage these funds at the cost quoted by the lowest bid in the PFM auction.

ANNEX 2
APPOINTMENT OF POINTS OF PRESENCE AND SPONSORS OF PENSION FUNDS/PENSIONS FUNDS UNDER THE NEW PENSION SYSTEM FOR ALL CITIZENS OTHER THAN GOVERNMENT EMPLOYEES COVERED UNDER THE NPS

I. The following entities have been approved by PFRDA for appointment as Sponsor(s) of Pension Fund/Pension Fund under the New Pension System for all citizens other than Government employees covered under NPS:

1) ICICI Prudential Life Insurance Company Limited
2) IDFC Asset Management Asset Management Company Limited
3) Kotak Mahindra Asset Management Company Limited
4) Reliance Capital Asset Management Company Limited
5) SBI Pension Funds Limited
6) UTI Retirement Solutions Limited

II. The following entities have been approved by PFRDA for appointment as Points of Presence (POPs) under the New Pension System for all citizens other than Government employees covered under NPS:

1) Allahabad Bank
2) Axis Bank Limited
3) Bajaj Allianz General Insurance Co Limited
4) Central Bank of India
5) Citibank N.A.
6) Computer Age Management Services Private Limited
7) ICICI Bank Limited
8) IDBI Bank Limited
9) IL&FS Securities Services Limited
10) Kotak Mahindra Bank Limited
11) LIC of India
12) Oriental Bank of Commerce
13) Reliance Capital Limited
14) State Bank of Bikaner & Jaipur
15) State Bank of Hyderabad
16) State Bank of India
17) State Bank of Indore
18) State Bank of Mysore
19) State Bank of Patiala
20) State Bank of Travancore
21) The South Indian Bank Limited
22) Union Bank of India
23) UTI Asset Management Company Limited

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