

Pension Reform: Needed, right here, right now!

The debate about pension reform continues to rage, as the **Pension Fund Regulatory and Development Authority (PFRDA) Bill** awaits parliamentary approval. Barring some political opinion, there is near unanimous agreement that an overhaul of the pension system is long overdue. A look at management of retirement funding in other countries holds many lessons for India. This paper attempts to highlight possible innovations, and their potential benefits.

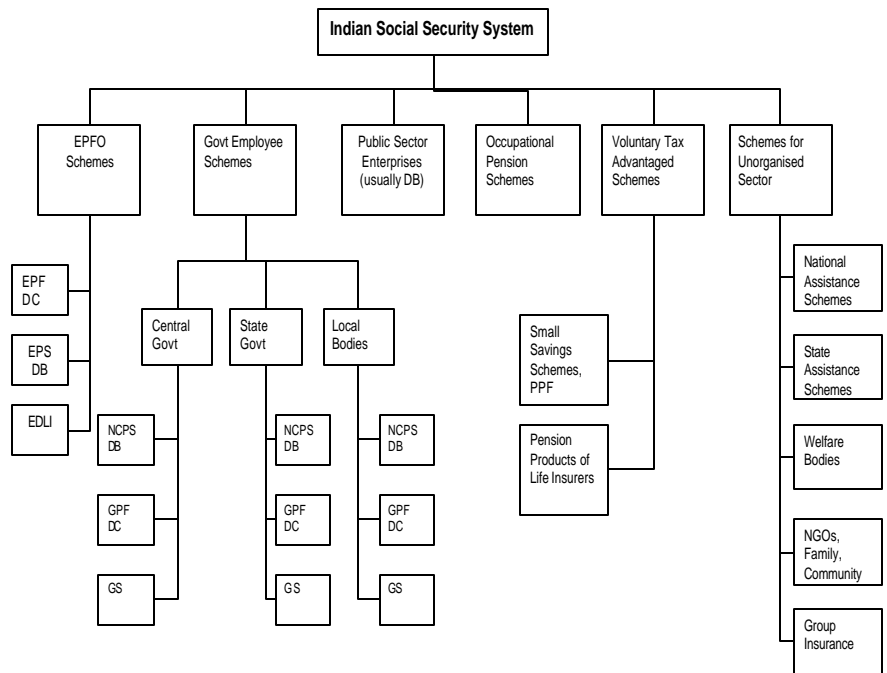
A need for change

Rising life expectancy and the resultant ageing in population means that India's elderly (above 60 years of age) who numbered 72 million constituting 7.1% of the total population in 2001, will touch 177 million or 13% of the total in 2025. If that's a worry, consider the fact that even now barely 10% of the working population has some form of retirement funding. This means that there is an alarming dependency of the aged on their families to care for them post retirement.

Government's pension burden is a disaster in the making

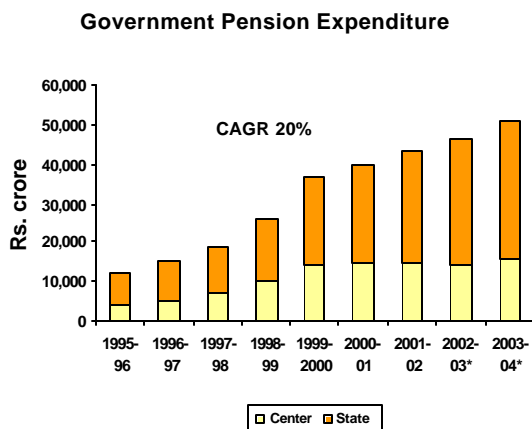
Ironically, despite its minimal coverage, India's pension system is fraught with complexity and a lack of cohesiveness. Multiple schemes administered by different entities co-exist, and there is no single regulator. The major constituents are the schemes for Civil Servants run

by the respective central and state government departments, Employee Provident Fund (and the Employee Pension Scheme) for private sector employees, and Occupational Schemes of employers like banks, insurance companies and public sector corporations. Barring the Employee Provident Fund, which is regulated by the Employee Provident Fund Organisation, all other schemes are either managed by the employers or left unsupervised. Pension funds are invested as per statutory guidelines and are almost exclusively restricted to safe but low yield, government paper. There is no requirement of disclosure of investments, neither do subscribers have a say.



Abbreviations:

- | | | |
|--------------------------------|----------------------------------------|-------------------------------------------|
| DB: Defined Benefit | DC: Defined Contribution | EDLI: Employees' Deposit Linked Insurance |
| EPF: Employees' Provident Fund | EPS: Employees' Pension Scheme | GPF : Government Provident Fund |
| GS: Gratuity Scheme | NCPS: New Civil Service Pension Scheme | NGO: Non-Government Organizations |



The bulk of pension schemes in India follow a Defined Benefit model, with the government picking up the tab. Significantly, pension expenditure is growing at 20%, as against a 14% growth in receipts. As a result, the burden on the exchequer has reached alarming proportions, with the total liability estimated at 55% of GDP. The country faces a very real possibility of the government's pension spending exceeding revenues in the not too distant future.

The writing on the wall is clear – India needs large scale reforms quickly, to prevent a pension crisis. In response, the authorities instituted a New Pension Scheme (NPS) for central government employees joining after 1st January 2004, which is based on the principle of Defined Contribution. The scheme is also open to those in the unorganized sector, who may join on a voluntary basis. Analysts estimate that this system will bring in substantial savings starting in another 30 years. A crucial aspect of the NPS is that subscribers will be allowed to choose between various investment schemes with different risk / return profiles. Management of funds will be thrown open to a limited number of professional fund managers including those from the private sector.

The Pension Fund Regulatory and Development Authority is the designated regulatory body, but still awaits formal parliamentary clearance to begin operations. Despite the pressing need for reforms, onward progress has been stalled by the usual bottlenecks, including political opposition.

Assuming that the reform process will eventually surmount these obstacles, let us take a forward look at some innovative investment options and their potential benefits.

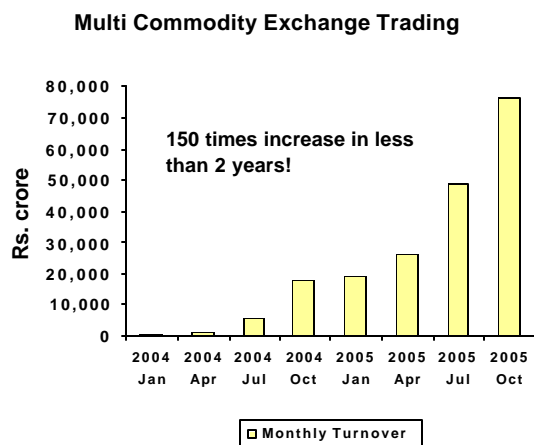
A case for innovation

Improved returns

Due to the restricted investment options open to it (read government bonds), the Employees Provident Fund Organisation has achieved an average real rate of return of only about 2.5% between 1990 and 2004. Moreover, the Employee Provident Fund assures a tax free 8.5% return to subscribers, while earning a meagre 6% nominal return on investments. This works out to a whopping loss of about Rs. 2,000 crores each year.

In contrast, over a long-term investment horizon that is typical of pension funds, there is a 99% chance that equities will outperform bonds! Specifically, Indian stock markets offer a long run return of about 18.5%.

The California Public Employees Retirement System (CalPERS) is a classic example, which has nearly 70% funds invested in equities and real estate and has consistently posted a double digit return since 1995, barring the years 2000 - 2002. Incidentally, CalPERS has invested over US\$ 100 million in the Indian stock market and is now considering investment in real estate funds.



The alternatives are not restricted to equities alone. In fact, Europe is seeing a shift away from equities and bonds towards higher yielding asset classes like commodities, which are booming thanks to soaring demand from manufacturers in China and India. Institutional investors, such as pension funds and assurance groups, are increasingly including commodities in their portfolios alongside more traditional investments. One look at the burgeoning business of a leading commodity exchange in India only underscores the point.

Stability

Since they are essentially long term investors, pension funds play a balancing role in the equity markets. In the United States, they control over 36% of all financial assets, and estimates are that, when permitted, Indian pension funds could bring as much as Rs. 400,000 crores to the stock markets. This kind of financial muscle can help counter the weight of domestic and foreign financial institutions on India's bourses, and thereby mitigate risk of flight of capital.

Allowing pension funds to invest in capital markets will also bring about development of the corporate debt market which is still plagued by low liquidity and lack of depth, in terms of quality of paper and participants. International experience shows pension funds have provided the impetus to corporate debt markets by way of demand, liquidity and improved market microstructure. Chile is one such example where pension funds hold

Allowing professional management of funds and easing investment restrictions will bring multiple benefits

about 70% per cent of assets in debt securities including corporate bonds.

Accountability

Governments in India have been known to use the pool of retirement savings for developmental purposes and for financing budgetary deficit. The project Oasis report on old age income security reforms recommends that the government desist from using these funds to finance fiscal deficit and instead use them to create wealth for the poor. Professionalising the management of pension funds and imposing requirements such as daily declaration of net asset value and marking investments to market, will force greater accountability.

Governance

Globally it is seen that when pension funds are major shareholders in a company, they improve corporate governance by taking an active role on the board - CalPERS is known to be one of the most powerful shareholder activists.

Momentum

We have already mentioned that permitting pension funds to invest in equity instruments can play a crucial role in developing the capital market. In 1995, Wilshire Associates, a consulting firm under contract with CalPERS examined the performance of 42 target companies. The study revealed that the stock price of these companies

which trailed the S&P 500 Index by 66% in the five-year period before CalPERS' involvement, outperformed the Index by 52.5% in the following five years. Again, the U.S. venture capital industry owes its development to the backing of pension funds, which made available a vast pool of risk capital.

The conclusion is simple

It is apparent that liberalising the operations of pension funds will result in several benefits. That it happens sooner rather than later is a fervent hope.

Resources:

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- *The Pros of Pension Funds*, Rediff, Oct 28th 2004
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