Pension Reform
by Renuka Sane

All over the world, ageing has proved to be a major factor influencingsociety. While India's immediate future benefits from a demographicdividend, UN population projections indicate that India too, will facean ageing population in the coming decades. Policy actions in thefield of pensions have to be taken many decades ahead of thedemographic transition, as the key strategy of the field – ensuringthat individuals build up adequate wealth over their working life tofinance consumption in old age - requires decades of saving byhouseholds. Hence, the events that can be envisaged from 2030 till2100 need to shape our actions right now.

India's strategy on pensions should rest on two pillars. The first isa funded, individual account, Defined Contribution (DC) system whichensures substantial creation of personal pension wealth. For thepoorest people, there is a role for a means-tested pension which isimplemented as a cash transfer. Both the systems exist in some form.

The funded pillar broadly consists of three programs. This includesthe National Pension System (mandatory for civil servants recruitedafter 1 January 2004, and voluntary for others) under the Pension FundRegulatory Development Authority (PFRDA). The next set of schemes arethe DC Employees Provident Fund and a Defined Benefit (DB) EmployeesPension Scheme (mandatory for those in firms with 20 or moreemployees) managed by the Employees Provident Fund Organisation(EPFO). There exist other provident funds such as Assam TeaPlantations Provident Fund, Coal Miners Provident Fund, Seamen'sProvident Fund for different categories of workers.

The means-tested transfer program is in the form of schemes under thecentrally sponsored National Social Assistance Program such as theIndira Gandhi National Old Age Pension Scheme (IGNOAPS) and the IndiraGandhi National Widow Pension Scheme (IGNWPS) which provide cashtransfers to the destitute elderly.

In addition, there exist unfunded pensions for civil servantsrecruited prior to 2004, and the one-rank-one-pension (OROP) for thearmed forces.

The problem

There are seven problems with the existing pension system.

1. There is no arm of government which takes a view of the overallpension system. For example, the NPS is under the Ministry ofFinance, while the EPFO schemes are under the Ministry ofLabour. This has led to gaps in information about how all parts ofthe system operate, andinconsistent pension policy.

2. Provident fund organisations play a dual role of administering theprogram as well are regulating it. This has lead to seriousgovernance failures in several of the provident funds, the costsof which have ultimately been borne by the tax-payer. Someexamples of these include the Coal Miners Provident Fund (netshortfall estimated to be about Rs.1782 crore in August 2016 bythe CAG), Seamen's Provident Fund (which made losses of aroundRs.93 crore in securities trading), and under-supervision ofexempt funds under the EPFO (Standing Committee Report oninadequacy in governance).

3. The EPF allows for early withdrawals during the working career of the member. This has meant that members retire with low balances diminishing the purpose of having a vehicle for retirement saving. The portability of the EPF account across jobs is said to have improved in recent times, but leaves a lot to be desired. The investment guidelines are restrictive and do not allow for international diversification. The actuarial valuation of the EPS is not put out in the public domain regularly, and the true extent of the funding gap remains unknown.

4. The National Pension System (NPS) that arose out of Project OASIS, was a big step forward in the establishment of a sound pension system with a focus on simplicity and low costs. In numerous aspects, such as fund management, multiplicity of schemes, the NPS has diverged substantially from the design of Project OASIS. Mandatory annuitisation of 40% at retirement may give sub-optimal outcomes if the annuity market is not well developed.

As well, there are concerns about the implementation of the NPS for civil servants with alleged complaints of mismanagement on transferring the contributions to the accounts of employees. There is also an uneasy tension between the role of PFRDA as a regulator and the role of PFRDA as an administrator of the NPS.

5. The coverage of the existing system remains at about 8-10% of the workforce. Despite several attempts by the government in the form of a co-contribution DC scheme such as the NPS-Swavalamban (NPS-S), and the more recent DC-DB Atal Pension Yojna (APY), coverage has remained low.

6. There exist problems of implementation of the IGNOAPS and IGNWPS cash transfers. The government machinery that is able to provide welfare transfers to the poor needs improvement.

7. There is an increased fiscal burden owing to the setting up of the OROP for the armed forces. Uniformed armed force personnel are a tiny slice of the economy, and the OROP is likely to be quite expensive, as the pension starts at a young age and life expectancy of the group is higher owing to better health than the general population. The fiscal stress from the OROP is likely to manifest itself over the coming decades.

The proposed solution

What is needed is a coordinated effort which pulls various elements ofthe pensions story together, and harmonises them into exactly twopillars -- a funded pillar and a poverty pillar. The followingmeasures may be undertaken towards pension reform.

1. *Governance*: The Government should set up an expert committee to undertake a review of the governance mechanisms of all the provident funds. The medium term plan should be to entrust the PFRDA as the regulator of the pensions sector. This would imply:

- Provident Fund organisations (such as the EPFO) would onlyadminister the schemes (such as the EPF and the EPS). That is,they would serve as the collection mechanism for the EPF andEPS. At the outset the EPF may choose one fund manager(regulated by the PFRDA) to manage contributions of itsmembers. Eventually EPF members should be given the choice ofchoosing the EPF fund manger or other PFRDA regulated fundmanagers. Over time, DB plans such as the EPS should be closed for new members.

- Statutory pension systems such as the Coal Miners Provident Fund, Seamen's Provident Fund, exempt funds under the EPFO would also come under the PFRDA. As with the EPFO, these funds would serve as a collection entity for their respective members.

- The NPS Trust would become an independent entity and would be the administrator of the NPS.

2. *Fund management*: There are four broad changes on fund management that need to be made.

- The fund management function of the provident funds should be handed over to the Pension Fund Managers (PFMs) licensed and regulated by the the PFRDA. The mechanism of the hand over, and the implications for the current system of administered rate of return in the provident funds needs to be developed. If the EPF wishes to continue to use its current fund manager, it should be possible after the licensing of the manager by the PFRDA such that it is subject to PFRDA regulations.

- Investments should be regulated through the use of the "prudent person principle" and not through the current mechanism of detailed and prescriptive investment guidelines. This wouldinclude investment of pension assets in international markets that helps in diversification. It is important to have a structured monitoring of investment performance vis-a-vis benchmark returns and risk management at the level of pension fund managers, trustees and pension supervisors. Valuation norms w.r.t to bonds need to be revisited with a focus on moving towards a mark-to-market valuation of all funds.

- For existing DB funds such as the EPS, or DC-DB schemes such as the APY, or for those DC funds that offer guaranteed returns, there should risk-based capital and liquidity requirements, as well as a requirement of an actuarial valuation (for schemes with a DB component) on an on-going basis, that is published in the public domain.

- Policy should re-orient itself to the Project OASIS vision - that of a few funds managing large volumes, that focus on passive management and result in low fees through auction-based procurement. One of the visions of the OASIS report was the separation of fund management from other functions such as collection and record-keeping. This basic design of the NPSshould be maintained as the other provident funds get regulated by the PFRDA.

3. *Exit Policy*: Currently provident funds provide a lump-sum withdrawal at retirement, while the NPS mandates 40% annuitisation. There needs to be a coherent exit policy for all pension funds. This is important in the context of under-developed annuity markets, where mandating annuitisation might actually work against the interest of the member. A policy of phased withdrawal should be considered, while in parallel measures to develop annuity markets undertaken. The current policies of allowing premature withdrawals from pension funds should be discontinued.

4. *Review of the NPS*: The Ministry of Finance needs to undertake areview of the NPS so as to improve its functioning. This involves

- An evaluation of the features on which the NPS has moved away from the Project OASIS vision, and the reasons for the same. This should be followed by an implementation plan to bring back the NPS to its original vision where the reasons for divergence may not appear entirely justified.

- An evaluation of the problems in the current processes forgovernment employees to ensure smooth implementation of the scheme. It is important to understand all the reasons for the dissatisfaction of government employees in order to make the system work for them.

- Benchmarking the NPS against global best practice, such as the Thrift Savings Plan of the US, to compare costs and performance.

5. *Distribution strategies*: The Ministry should continually innovate on distribution strategies, i.e. the mechanisms used by the Points of Presence under the NPS, aiming to achieve the level of diversity required to address all strata of the population in all locations. A commissions led retail strategy for coverage isunlikely to lead to high coverage, and runs the risk of pensions being mis-sold. This can be very damaging not only in terms of money lost, but in terms of the trust deficit that might get created. The possibility of engaging with organisations (such asunions, other co-operatives) that might help enroll members should be considered. Solutions through fintech players should be leveraged to improve coverage.

A sustained awareness campaign should be undertaken to spread the message of the NPS. Governments should only introduce policies for the informal sector after extensive thought and deliberation. Instances such as the abrupt shutting down of the NPS-S and its replacement by the APY create uncertainty in the minds of potential customers, and disincentivises participation.

Finally, it is important to make the NPS work for civil servants because when satisfied they will become key flag bearers of thescheme.

Ultimately voluntary coverage of pensions has to be seen in the context of the overall financialisation of savings in the country. Even today, most Indian households prefer saving in real estate and gold over financial assets. It is important to acknowledge that in this environment, huge success in voluntary coverage of pensions which remain illiquid till retirement, is going to be challenging, and pensions policy must work with overall policy that improves participation in financial products.

6. *Review of social pensions*: A review on the adequacy and efficiency of the IGNOAPS and IGNWPS program should be undertaken. Different states provide for an additional top-up on the basic pension provided by the Centre. In addition, different states have different eligibility ages. The impact of these provisions on elderly well-being should also be studied. An analysis of the gaps in the design and implementation of the program should motivate changes to the program.

7. *Expert Group on Pensions*: Pension reform requires a unified view at the Ministry of Finance, as pensions policy requires actuarial, securities market and risk management expertise, along with an appreciation for fiscal prudence. The Ministry of Finance should constitute working groups that:

- Construct and release a comprehensive information base about allpension mechanisms in India.
- Manage the release of anonymised administrative data, for research about the existing pension system both aggregate and micro-data.

- Undertake continuous fiscal analysis of the liabilities on account of DB pensions that include the EPS, the old civilservices pensions, the recent one-rank-one-pension for the armed forces, and the IGNOAPS. This will serve as useful information for times when governments get tempted to make generous pension promises.

- Engage with the best researchers outside government to study thefunctioning of the pension system and establish a steady flow ofanalytical and policy papers in the field.

- Co-ordinate with agencies such as the RBI, IRDAI, SEBI on issuesrelated to bond markets, capital controls, annuities markets,that are relevant to the functioning of the pensionsystem. Similarly, co-ordinate with the National SocialAssistance Program which runs the IGNOAPS on the design, andimplementation of the program. Co-ordination with the Ministry of Labour and EPFO to obtain access to statistics on theprovident fund schemes will also be required.

Conclusion

In conclusion, pension reform is an important part of economic policymaking as the demographic transition in India unfolds. The separateand disparate pieces of the pensions sector need to be brought together. There is also a need to locate pension issues in the largerstory of ageing in society - this would weave together issues such asliving arrangements of the elderly, health care, longevity insurance,and labour supply.