The way forward for India's National Pension System

Renuka Sane Susan Thomas*

July 2014

Abstract

This paper examines the existing implementation of the National Pension Scheme against the goals with which it was created. It finds that there are certain critical areas in which the NPS has deviated. These include multiplicity of schemes, lack of investment choice, low transparency of the system, and a lack of focus on keeping asset management fees low. These gaps are well-understood and can be corrected with regulatory interventions. There remain other policy issues that need to be addressed. These include well designed payout policies, and occupational pension systems that will leverage the institutional development of the NPS to include the informal workforce.

Keywords: investment choice, intermediation fees, intermediaries, distribution channels, pension payout, annuitites, occupational pension systems
JEL classification: G28.

*Renuka Sane is with the Indian Statistical Institute, New Delhi. Susan Thomas is with the Finance Research Group, Indira Gandhi Institute of Development Research (IGIDR), Mumbai. This work has been supported by project funding from ICSI-CCGRT. Email: renuka@saner.org.in, susant@igidr.ac.in

Contents

1 Introduction

Pension reform in India was conceived in the context of an economy where large expenditures were incurred on pensions of central government employees,[1] a parallel mandatory system existed for private sector firms with 20 or more employees,[2] while a large part of the country remained outside of the two programs. There was growing concern about an ageing population that lacked formal means of income security in old age. As part of the policy response to these problems, the Ministry of Social Justice and Empowerment set up the Committee for Old Age Social and Income Security (OASIS Committee) in 1998.

The committee identified three problems. The civil servants system was unaffordable. The mandatory system for private workers was failing to deliver meaningful replacement rates and also had a bankrupt component. The large informal sector had no formal pension provisions. A strategy to solve all three problems over time was devised and presented in their report, OASIS (2000).

The committee's view was that a contributory system that encouraged the build up of wealth should be the central strategy for pension reform. Shah (2006) summarises the reform goals as designing a system that: (a) increases coverage on the large area, population and diversity of India; (b) is low cost; (c) is accessible to unsophisticated participants; (d) provides choice of investment; (e) is backed by sound regulation; and (f) has long-run sustainability. The recommendations of the committee took the form of the National Pension System (NPS)[3] when it was implemented.

The NPS became operational in 2004, and has since grown to having assets under management in the NPS family of schemes of Rs.422 billion (under USD 7 billion) in under 6 million individual accounts. It is mandatory for new recruits to the central government, and voluntary for all citizens of India. After a decade of existence, there is need to examine the existing NPS and compare the performance of this system to the goals with which it was created. In this paper, we revisit the NPS from this perspective.

[1] Bhardwaj and Dave (2005) estimate an implicit pension debt of roughly 56 per cent of GDP on account of the civil service, under fairly conservative assumptions. Thus, even though civil servants made up only 6-10% of the paid workforce, their pension provisions were proving to be extremely expensive.

[2] These are the schemes under the Employees' Provident Funds and Miscellaneous Provisions Act, 1952. They are called the Employees Provident Fund (EPF) and the Employees Pension Scheme (EPS).

[3] The NPS was first called the New Pension System and was later renamed as the National Pension System.

We find that while several of the key features of the existing system are consistent with the original design features, there are certain critical areas in which the NPS has deviated. Thus, while there continues to be an attempt to reduce transactions costs in the system, with a central record keeping agency and a limited number of pension fund managers, the NPS has several flaws at the level of accessibility of the system as well as the choice of investments to the pension contributor.

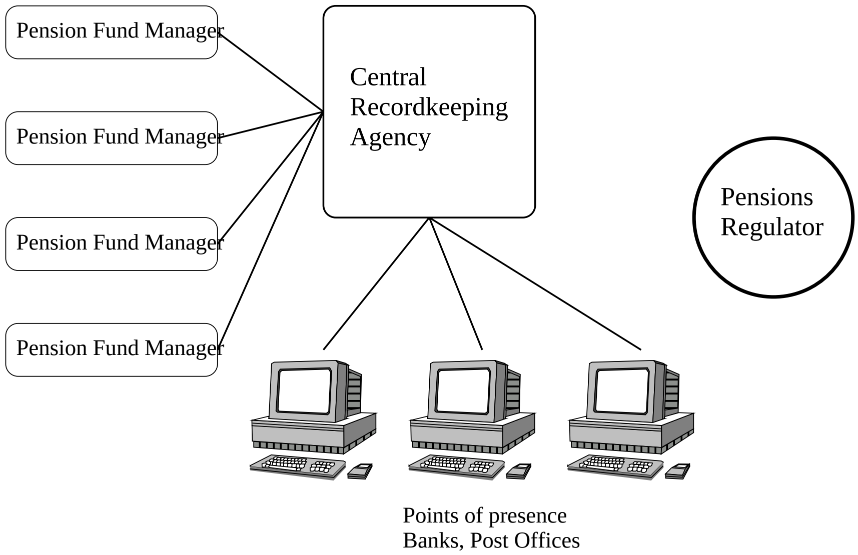
One, the NPS has fragmented into a multiplicity of what is available as schemes, none of which provide investment choices that explicitly maximise long-term returns to the contributor. Second, a key feature where NPS was to make progress over the Employees Provident Fund Organisation (EPFO) was on transparency. However, this has not taken place. Third, the combination of lack of transparency, low investment choice and inconsistencies of tax treatment across the NPS and the traditional pension systems, biases the choice of the contributor towards the latter.

All these, and other factors such as a reduced focus on fees charged on asset management, widen the gap between the NPS implementation as of date and what the NPS was originally designed to achieve. There remain other policy issues that need to be addressed to achieve the end goal of coverage across the breadth and length of India that the OASIS project started with. These go beyond the scope of what the original NPS design targeted to achieve and include: well designed payout policies and occupational pension systems that will leverage the institutional development of the NPS to include the informal workforce.

One of the key bottlenecks has been the lack of a sound regulatory framework, put in place by an empowered and independent regulator. The PFRDA Bill that had been pending since 2002 was passed in 2013. This enables the formal institutionalisation of the PFRDA as the regulator of the NPS. The PFRDA can now take on the task of both the relatively short term agenda of closing the gap between the current NPS and the original design. It can also initiate the research analysis required for the medium and longer terms goals of ensuring a pension system with universal coverage in India.

This paper analyses the outlook on NPS – past, present and future. It is organised as follows: Section 2 describes the implementation history of the NPS and what are the existing features of this system today. Section 3 describes the elements of the gaps between the existing and the original design features in OASIS (2000). Section 4 lists policy action that the PFRDA needs to undertake, over the short-term horizon to get the NPS back on track with the original goals, as well as some areas for a longer-term policy thinking.

Figure 1 NPS Architecture



Section 5 concludes.

2 The National Pension System, NPS

The NPS in India today is a pension system based on individual accounts, where the key participants (See Figure 1) are:

Points of Presence (PoPs) PoPs make up a network of access point to the NPS for all customers. These include banks, post-offices and depository participants. In the case of civil servants, the existing administrative framework that disburses salaries and other benefits function as the PoPs.

Central Record-keeping Agency (CRA) The CRA is the agency that is connected to the PoPs spread across the country at one end, and to the fund managers managing the investments on the other. Every day, the CRA receives funds from individual accounts at PoPs, calculates the aggregated value of funds that need to flow to each respective fund manager.

The key contribution of the CRA to the design goals is to lower transactions costs by lowering costs of record keeping and funds flows. This is expected to result in a higher return of the NPS to contributors.

Pension Fund Managers (PFMs) PFMs are freed from the role of collection of contributions from individuals and maintenance of records, since they receive a single instruction and cheque from the CRA. They can thus focus purely on fund management.

Fund managers are only required to do passive management, which is another approach to lower fund management costs. The number of pension fund managers are limited, as are their product offerings. This simplifies the product offerings, making the NPS universally accessible to both financially sophisticated and unsophisticated customers.

Regulator An independent regulator, the PFRDA, is visualised to set rules and regulation, and carry out the monitoring and supervision function over the NPS.

2.1 The implementation

After the submission of the OASIS report, the central government made the decision, in 2002, to place all new recruits from 1 January 2004 onward into the NPS. The employee contribution was set at 10 percent of wages[4] while the government would contribute an additional 10 percent as the employer. As of March 2014, the NPS is operational in all accounting formations of Central Governments, and 117 Central Autonomous Bodies (CABs). In addition, 25 State Governments have joined the NPS, out of which 18 have operationalised transfering funds into NPS as of March 2014 (Department of Financial Services, 2014).

On 27th August, 2003, the Government, through a Press Release, informed about setting up of an interim Pension Fund Regulatory and Development authority (PFRDA). PFRDA was constituted through a Government Resolution notified in the Extra-Ordinary Gazette dated 10th October, 2003. This Resolution was reissued on 14th November, 2008. The PFRDA Bill, 2005 was introduced in March, 2005 in the 14th Lok Sabha. Since this was a Money Bill, on the dissolution of the 14th Lok Sabha, the Bill lapsed. The PFRDA Bill, 2011 was again introduced in the 15th Lok Sabha in March, 2011.[5] The Bill was finally passed in Parliament in 2013.[6]

[4]This includes salary and dearness allowance (DA)

[5] The two Bills were different and the 2011 Bill contained two major deviations from the 2005 Bill. These related to stipulating the foreign investment policy for pension funds in the PFRDA Act itself and permitting floating of a minimum assured return scheme, to be notified by PFRDA, as part of NPS.

[6]Dave (2006) provides a detailed account of the political economy of NPS implementation.

Table 1 NPS Membership as of August 2013

	Number of contributors	Assets under Management (Rs. billion)
Central Government	1,201,636	192.3
State Governments	1,776,973	133.3
Private sector	257,754	17.7
NPS-Lite	2,046,849	6.4
Total	5,283,212	349.6

Source: Department of Financial Services

The NPS for citizens of India was introduced with effect from May, 2009. A variant of the NPS for those in the informal sector called NPS-Lite was introduced in April 2010. Further, a separate scheme called *Swavalamban* was launched in which the government contributes Rs.1000 to the account of every informal sector worker who manages to contribute Rs.1000 or more in the NPS-Lite account in each financial year.[7] A network of non-banking financial companies and NGOs, called aggregators under the scheme, were licensed to undertake outreach, marketing and enrollment functions. Finally, the NPS Corporate sector model was introduced in December 2011 for all employees of the corporate entities including public sector undertakings. The total membership and the assets under management of the NPS in August 2013 is presented in Table 1.

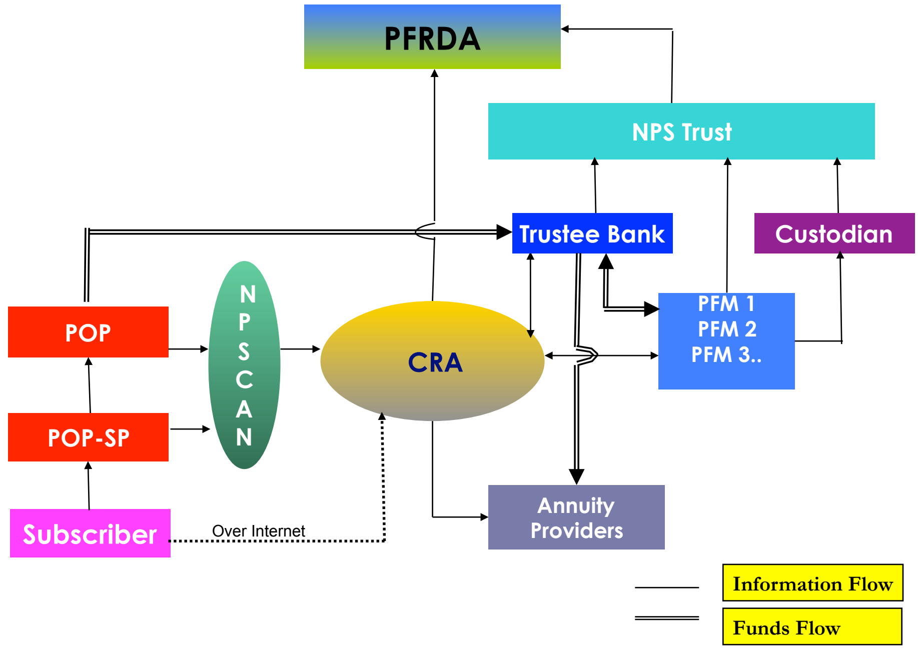
2.2 NPS infrastructure

The NPS became operational for new recruits to the civil services in 2004. Since the PFRDA Bill had not yet been passed by Parliament the Government of India decided to set up private contracts between the various institutional elements of the pension system, which included several service providers including:

1. Points of Presence (PoPs for those outside of central government and PoP-SP for central government departments)
2. A Central Record-keeping Agency (CRA).
3. Pension Fund Managers (PFMs).
4. A Custodian.

[7] The scheme is valid until 2016-17.

Figure 2 NPS Architecture



5. A Trustee Bank to facilitate flow of funds between the central government and the CRA.

6. The NPS Trust set up under the Indian Trusts Act, 1882 to oversee the functions of the PFMs, Trustee Bank and the Custodian.

7. Annuity service providers.

Employee contributions are transmitted from the PoPs to the Trustee Bank, and the information about the contributions is sent to the CRA. The CRA then directs the Trustee Bank to forward contributions to the respective PFMs who invest the proceeds according to the investment guidelines laid down by the PFRDA. The Trustee Bank plays a key role in the flow of funds between the various entities. At retirement, it is expected that the member will buy an annuity from one of the annuity providers licensed by the PFRDA.

At present, all NPS variants have two accounts: the first which does not allow any withdrawals until retirement age (*Tier-I*) and a second which does allow for pre-retirement withdrawals (*Tier-II*) An active Tier I account is a pre requisite for opening a Tier II account. Government employee contributions are mandated to go to the Tier-I account. In addition to the mandated 20 percent, they may make contributions into the Tier II account.

2.3 Variations in NPS products

Despite the NPS variants sharing a common infrastructure, the choices offered to members across these variants differ, particularly on investment choice, and rules for taxation and withdrawals.

2.3.1 Investment guidelines

The contributions of central government employees are invested in the default schemes of three public sector Pension Fund Managers (PFMs).[8] Each of the PFMs invest the contributions in the proportion of 85 percent in fixed income instruments and 15 percent in equity and equity linked mutual funds. The contributions of Swavalamban customers are invested in the pension fund manager chosen by the aggregator.

Contributions of voluntary customers of the NPS (except for Swavalamban contributors) can be invested in any of the three asset classes:

- *Asset class E* are investments in equity market instruments. This is the high risk return asset class. The contributions are invested in index funds that replicate the portfolio of a particular index (for example, the BSE Sensex and NSE Nifty indexes qualify as candidates for these). The maximum investment in this class is 50 percent of total contribution.
- *Asset class G* are investments fixed income instruments, mostly central government bonds. This is the low risk return asset class.
- *Asset class C* are investments in fixed income instruments issued by state governments, municipal bodies, state government PSU/PSE like electricity boards, and private corporations. This is the medium risk return asset class.

Central government employees can invest in these assets only through their Tier II account.

The NPS also offers a default option called *auto choice* in which investments are made in a *life cycle fund* across all the three asset classes in a pre-defined portfolio that is based on the age profile of the investor. For example, the portfolio of an employee who is less than age 35 has 50 percent weight in equity, 30 percent weight in corporate bonds and 20 percent weight in Central Government securities. The allocation towards risky assets (such as E and G)

[8] These are LIC Pension Fund Ltd., SBI Pension Funds Pvt. Ltd. and UTI Retirement Solutions Ltd.

decreases as the employee comes closer to retirement, while the weightage to less risky assets (such as C) increases. The auto-choice option is not available to central government employees or Swavalamban customers.

2.3.2 Tax rules

Tax benefits under NPS for employees are given in section 80CCD of the Income-tax Act, 1961. An individual can claim tax deduction of upto 10 percent of the salary contributed towards NP. For those contributing through the corporate scheme, an employee can claim tax deduction on contribution made by the employer, not exceeding 10 percent of his basic salary plus dearness allowance (if any) Under Section 80 CCD (2). This is above the overall limit of Rs.1 lakh offered under Section 80C. The employer can claim tax benefit for its contribution by showing it as business expense in the profit and loss account.

Interest income is exempt in the NPS. Withdrawals at retirement, however, are taxed as income. The NPS thus follows an EET tax structure.

2.3.3 Draw-down policies

The retirement age for all NPS members is set at 60. Members are required to annuitise 40 percent of their terminal accumulations using the products of the empanelled annuity service providers. If members retire before the age of 60, then they are required to annuitise 80 percent of terminal accumulations. The lump-sum withdrawal is subject to both an income tax, as well as a service tax (in the case of the annuity purchase).

3 Problems in implementation

It has been a decade since the NPS has been operational for government employees, and half a decade since those outside of the civil services have been allowed to access the NPS. A lot of progress has been made in setting up the infrastructure of the system. As described earlier, the goal of the NPS was to provide for a system that:

1. Increases coverage on the large area, population and diversity of India;
2. Has long-run sustainability;

3. Is low cost;
4. Is accessible to unsophisticated participants;
5. Provides choice of investment;
6. Is backed by sound regulation.

Several of the decisions regarding NPS implementation have taken the system away from this goal.

3.1 Multiple variants

The fragmentation of what was originally intended as one single NPS has fragmented into four variants has four damaging consequences.

First, fragmentation damages economies of scale. The essential idea of the NPS is to harness scale economies and deliver low costs.

Second, fragmentation reduces the quality of policy analysis. It can be argued that many mistakes in policy have been made because of reduced policy analysis time per unit variant. If there was only one NPS, all research and policy analysis, and all criticism, would focus on only that variant. This would generate improved thinking, given the paucity of policy analysis in India.

Third, fragmentation has greatly escalated the complexity of household financial choice. An essential feature of the NPS was *simplicity* in the eyes of the user. The average citizen of India is not able to comprehend complex financial decisions. The idea of the NPS was to give a very simple environment which can be easily learned, and where mistakes are unlikely. NPS is now, however, a complex system and is beyond the cognitive reach of most households. Private citizens would gain confidence if the NPS they were signing up into was the same NPS that civil servants are using. This channel has been blocked by separating out civil servants from other users.

Finally, NPS held out the promise of a single pension account across government or non-government employment. This would reduce frictions in the labour market. But this benefit remains elusive with the presence of multiple separate NPS variants.

3.2 Investment guidelines

The original NPS design envisaged that Pension Fund Mangers would offer three scheme options viz. A, B and C. The asset allocation in the three options would be as follows:

- *Option A*: 60 percent of the assets would be held in Government paper, 30 percent in investment grade corporate bonds and 10 percent in equity.
- *Option B*: 40 percent of the assets would be held in Government paper, 40 percent in investment grade corporate bonds and 20 percent in equity.
- *Option C*: 25 percent of the assets would be held in Government paper, 25 percent in investment grade corporate bonds and 50 percent in equity.

The design also allowed for investments in international equity subject to regulatory oversight. The Expert Group set up by the PFRDA in 2009 further recommended that the maximum exposure allowed for equity be set to 100 percent (Parekh, 2009).

These guidelines, and the auto-choice scheme described in the previous section, have not been made available to government employees. All three public sector fund managers offer only one investment choice, which resembles Option A. This will inevitably lead to lower expected terminal wealth at retirement, relative to what would have been achieved with a higher equity exposure in early working life.

Investment in international markets is not permitted under the current regulations. This reduces the ability of the fund manager to achieve lower risk through higher diversification by allowing international exposure.

3.3 Lack of choice: fund manager and instruments

The original design of the NPS provided for choice in investment across asset classes and fund manager. In the current implementation, government employees are not given freedom of choice in investment. They are also not allowed to choose the fund manager as the contributions are divided in a pre-specified ratio among the three PFMs.

3.4 Inconsistent tax rules

The NPS follows an EET tax framework i.e. contributions are exempt, accumulations are exempt, but withdrawals at retirement are taxable income. This is an inferior tax treatment when compared with participation in other pension programs such as the Contributory Provident Fund (CPF), Employees Provident Fund (EPF), superannuation, Public Provident Fund (PPF) all of which are EEE, i.e. contributions are exempt, accumulation is exempt, and withdrawals are exempt. This inhibits a higher participation into the NPS.

There are further complications in how the tax varies at different levels of contributions. For example, within the exempt framework for contributions, tax deductions are available up to the limit of Rs.1 lakh for the contributions made by employees to the EPF scheme, recognised provident funds, approved superannuation funds and NPS.[9] However, in the case of NPS, there is also a requirement that the deduction cannot exceed 10 percent of the employee salary in the previous year.[10]

The tax-deductibility of employer contributions is restricted to 10 percent of the employee's salary in the case of the NPS.[11] This is also an inferior tax treatment when compared to EPF and other recognised funds where the employer's contribution is exempt from tax up to a limit of 12 percent of the employee's salary.[12]

The revised draft of the Direct Taxes Code (DTC) proposes that the lump sum withdrawal under NPS would be tax exempt, subject to some ceiling, on par with superannuation funds, as there is no tax on commutation under those funds. However, the annuity income would be part of the normal income and would be taxed. Therefore, the tax treatment proposed by the Code is EEe (exempt-exempt-partial exempt). However, until this is implemented, the PFRDA needs to address the inconsistent tax treatment.

3.5 Decreasing focus on costs

The goal of a pension system is to facilitate the build up of wealth across several decades. This is best achieved with a low cost system. The expe-

[9] Section 80C and 80CCD read with Section 80CCE, IT Act.
[10] Section 80CCD(1), IT Act.
[11] Section 80CCD(2), IT Act.
[12] Rule 6, Part A, Schedule IV, IT Act.

rience of early reform countries such as Chile has pointed to the pitfalls of private-sector fund-management leading to extremely high charges on beneficiaries (Mesa and Mesa-Lago, 2006). It is in this context that the NPS was designed to achieve low cost by using economies of scale and auction-based procurement of pension fund managers and annuity service providers, and passive investment.

Several of these principles have been violated by the current PFRDA guidelines. PFRDA has done away with the system of bidding to be a fund manager. Now any eligible company can become a fund manager. Annuity service providers have also been appointed without the auction process.

The PFRDA has also extended the role of pension fund managers to market NPS. The fund management charge was increased from 0.0009 percent to 0.25 percent from 1 November 2012 i.e. Rs.250 on an investment of Rs.100,000 against Re.1 charged earlier.

3.6 Missing transparency

PFRDA has, so far, offered limited transparency about the NPS. There is no systematic dissemination of statistics about the scheme. Regular updates to information on the number of members, assets under management, performance of funds, and fees and expenses are not available.

While the Swavalamban scheme is an important pillar of the NPS, little is known about participation of customers and performance of various aggregators. Lack of access to anonymised data about individuals and aggregators inhibits the understanding of the performance of the system, and consequently any suggestions for reform.

Grievance redress is an important function of the regulator. Such a facility is not easily found on the PFRDA website, and there is very little information on where complaints can be registered in person or at a call centre. Statistics on the aggregate complaints against the various service providers, as well as action taken to remedy such complaints are consequently unavailable. For example, anecdotes suggest that there are considerable delays in account opening of the NPS, and the allocation and dispatch of the Permanent Retirement Account Number (PRAN) card, and other procedural delays. Anecdotes also suggest that several government employees do not receive account statements and are not entirely clear about their choices.

Better data will enable better analysis about how the NPS is faring, which in turn will lead to more informed policy changes.[13] Full aggregate data from the NPS about all aspects of the operations should be released at a daily frequency, so that all stakeholders are kept updated about the NPS is working for them.

3.7 Low focus on consumer protection

The PFRDA has been concerned about the low sales of NPS achieved by point of purchase (PoP) agents. Low participation is seen to be a result of no intermediary owning and taking responsibility for marketing the scheme. The costs of the NPS are also seen to be high in percentage terms, though they are low in absolute terms. The PFRDA has therefore been considering moving the PoPs from an absolute cost structure to an *ad valorem* one, and re-evaluating the annual maintenance charge of the CRA.[14] The focus has thus exclusively been on the incentive structure of sales intermediaries.

Experience from the mutual fund and insurance industries in India shows that a combination of high-powered sales incentives without any liability for mis-selling does not lead to an increase in retail participation.[15] In recent times, several instances of mis-selling have led to huge financial losses to consumers.[16] In the case of low income households, similar concerns led to the shutdown of the micro-finance industry in the state of Andhra Pradesh in 2010 (Sane and Thomas, 2013b).

It would, therefore, be imprudent for the PFRDA to incentivise the sale of the NPS in an environment characterised by a lack of strong consumer protection. The PFRDA needs to re-orient its strategy towards an explicit goal of consumer protection, with a clear enumeration of the rights of consumers, and obligations of sellers. The current focus of the PFRDA on remuneration of agents is one-sided, and incomplete without concurrent regulations that can actively prevent mis-selling.

[13] The importance of a daily MIS about these facts was also raised by TAGUP (2011).

[14] These recommendations were made by the The Committee to Review Implementation of Informal Sector Pension (CRIISP, 2011)

[15] For example, only 1.5 percent of Indian households have outstanding investments in mutual funds, and 38 percent in insurance. (Source: Pattern of Investments, March 2013, Consumer Pyramids.)

[16] Mis-selling episodes have been documented by (Anagol, Cole, and Sarkar, 2012; Anagol and Kim, 2012; Halan, Sane, and Thomas, 2013).

4 Solving the problems

4.1 Policy response for a course correction in the short term

There are some very clear policy responses that can be taken in the immediate short-term to close the gaps listed in the previous Section. They are:

1. **De-fragmentation.**

   There should be only one NPS for the entire country. All existing variants should be consolidated into this over a one-year horizon.

2. **To improve investment choices.**

   The choice of investments and fund managers should be made available to central government employees. For those contributors who are unable to choose, the default should be set as the life cycle investment option as offered in Parekh (2009).

3. **Rationalise investment and tax guidelines to deliver robust performance over multi-decade horizons.**

   Investment guidelines must incorporate inflation indexed instruments, or higher exposure into securities such as equities as a hedge against inflation. Tax policies must be made consistent across all available pensions schemes.

4. **To improve transparency.**

   Every NPS participant must receive communication each month with the latest contribution and the current accumulation. Detailed information about the number of members, returns of fund managers, costs of switching between fund managers should be made available on the NPS website, and regularly updated.

5. **To improve economies of scale and to lower costs.**

   In addition to a single CRA, the NPS should have a limited number of fund managers and annuity providers in order to harness economies of scale. This will help to keep down costs. An area where expansion is required is a larger base of PoPs, where there is a case for larger fees and a different approach to contracting.

6. **To empower consumers and protect their rights.**

   The PFRDA needs to look to the Indian Financial Code[17] as a benchmark to provide for various protections against misleading conduct by sales agents.

[17] Srikrishna (2013)

The PFRDA requires to conduct suitability studies before embarking on a full-fledged policy initiative at improving the distribution of the NPS.

4.2 Looking beyond to longer term policy thinking

In the previous section, we discussed the several aspects of the NPS that can be fixed within the existing framework. In this section, we turn to policy issues that require fresh thinking from the government and the PFRDA.

4.2.1 Designing payout policies

A pension scheme is judged by its ability to provide for an adequate consumption in retirement. In most modern DC systems, such as the NPS, an individual accumulates wealth over her working life, and draws down this wealth over retirement. Since the accumulated wealth has to provide for a meaningful consumption for the lifetime of the individual, how this wealth is drawn-down becomes important.

There are three main choices.

1. A lump sum withdrawal where the retiree is free to use the accumulations in any way.
2. Annuity purchase from an insurance company, where the annuity pays a fixed regular income for life.
3. Program withdrawals where the retirement fund is used for a draw-down (as income withdrawal or short-term annuity) while leaving the rest of it invested.

Antolin (2008) describes the various trade-offs in the design of payout policies. If the individual takes a lumpsum, and runs out of money, then the state has to bear the burden using tax-payer funds as it is difficult for governments to not provide for destitute elderly. If the individual is made to annuitise her entire wealth, there is no flexibility in case of emergencies or the possibility of bequest. If the individual takes out a programmed withdrawal, she bears considerable investment risk, and may still run out of money in old age. How then should the payout policy be designed?

Different countries have approached this differently, and are largely influenced by the existence of a state funded pension which offers protection from poverty in retirement.[18] The Chilean approach, for example, has been to restrict lump-sum distributions, and mandate the use of fixed inflation-indexed annuities or lifetime phased withdrawals. The Australians, are more flexible in allowing lump sums. Most recently, the UK has done away with its rule of mandating the purchase of an annuity by the age of 75, and allows for programmed withdrawals. The US has very little mandatory annuitisation.

In India, the NPS has mandated individuals to annuitise 40 percent of their wealth, and take the remainder as a lump sum.[19] There is no option of programmed withdrawals. As NPS members mature towards retirement, several details about this policy require attention:

1. What level of mandatory annuitisation is optimal?

   The question of mandatory annuitisation needs to consider how much choice the individual is allowed to exercise over her own accumulations. If the objective of the PFRDA is to ensure a minimum consumption, then annuitisation can be mandatory only to the extent that is required to buy the minimum annuity.

   Annuities can be expensive for the poor as they have a lower life expectancy than the rich. If they die early, they effectively end up subsidising the rich. A stark difference between the mortality experience of Swavalamban customers and government employees may lead to pricing that does not work in the interest of the informal sector workers. The PFRDA should consider an option of a programmed withdrawal, with or without a deferred annuity that begins in late old age. In this case, mandatory annuitisation of 40% may not be optimal.

2. Should mandatory annuitisation be extended to mandatory inflation-indexed annuity purchase?

   The nominal annuity may not be able to buy a minimum consumption basket if inflation rises over the lifetime of the retiree. If the objective of mandatory annuitisation is to ensure adequate retirement consumption, then the PFRDA may consider mandating the purchase of an inflation indexed annuity instead of a nominal annuity. The formula for programmed withdrawals could also be set appropriately.

3. Should there be a default option for those unable to choose the payout product?

[18] Rocha, Vittas, and Rudolph (2010) describe the payout policies of five countries.

[19] Government employees with superannuating with less than or equal to Rs.2 lakh as their pension wealth can withdraw the full amount.

On the investment front, the PFRDA has provided for a life-cycle default option for those unable to make investment decisions. This should be extended to the payout option as well. The PFRDA should invest in the design of a default pay out policy.

4. Life insurance companies are often reluctant to enter into annuity markets because of the lack of availability of good mortality tables as well as instruments for hedging longevity and inflation risk.

   The PFRDA needs to set up processes for solving market failures that may impede the functioning of annuities markets. For example, enabling the development of mortality tables, or enabling policy that leads to markets for inflation indexed bonds, or instruments to hedge longevity risks.

5. If annuities are expensive, then the accumulations will buy a very small pension. How should the NPS ensure low-cost annuities?

   The procurement of annuity service providers should be done via an auction, which leads to the lowest prices. This was the approach taken for the appointment of pension fund managers and has led to some of the lowest fund management costs in the world. The PFRDA has already appointed annuity service providers. However, details of the appointment process and the charges levied by the companies need to be re-examined once again.

A payout policy is fundamental to the success of the NPS. While most attention so far has been to the development of the accumulation phase, the PFRDA needs to turn its attention towards the design of the payout phase.

4.2.2 Integrating occupational pensions with the NPS

Firms with 20 or more employees in India fall under the Employee's Provident Fund Act, 1952. They are mandated to contribute towards the Employees Provident Fund (EPF) and Employees Pension Scheme (EPS).[20] Even though the scheme is legally binding only for those employees who earn upto Rs.6,500 per month[21], in practice, all employees end up with the EPFO. This implies that employees who earn more than Rs.6,500 per month can legally choose

[20]Under the EPF Scheme, the employer and employee have to contribute an amount equal to 12% of the employee s basic salary. From out of the employer s share of contribution, 8.33% is remitted towards the EPS. In addition, the Central Government also contributes 1.16% of the employees wages to the EPS fund, subject to a wage ceiling of Rs. 6,500 per month.

[21]Employees earning more than Rs.6,500 per month are called excluded employees. All employees, other than excluded employees are required to become members of the EPF. See Paragraph 2(f) and 26(1)(a), EPF Scheme

to not be part of the EPFO and request employers to transfer contributions to the NPS instead. While there is a possibility of an increase in the existing wage ceiling of the EPFO, until such time that it is, the PFRDA should actively consider setting up mechanisms for employees to participate in the NPS.

In addition, companies often set up superannuation funds for their employees as a voluntary top up to the EPF and EPS. Employers can be encouraged to set these up via the NPS.

5 Conclusion

The NPS has evolved as a credible individual account, low cost, long term savings product. It services almost 6 million individual accounts. This includes government employees as well as low income households in the informal sector, who previously have had limited access to formal finance.[22]

The passing of the PFRDA Bill at the end of 2013 has empowered the PFRDA with the necessary statutory authority to supervise and monitor the institutions of the NPS. Such a regulator can build trust in the system by ensuring that the interests of the NPS customers is the primary focus.

Some of the immediate steps that the PFRDA can take include: (a) establishing portability, (b) improving investment choices, (c) rationalising investment guidelines for returns over the long-term, and making tax policies consistent, (d) improving transparency, (e) reverting to a strict focus on low costs of managing the NPS, (f) increasing the visibility and access of this product while ensuring that protection of customer rights against mis-sales and fraud.

In addition, the PFRDA can also set in motion the next step of policy initiatives to ensure that increased coverage of the wider informal workforce. With this, the NPS will move the country closer towards providing social and income security for citizens in their old age.

[22] Sane and Thomas (2013a) describe the participation of the low income households in the Swavalamban scheme of the NPS, using proprietary data from a financial services firm. This paper finds that there is considerable interest among these households in a state-run long-term savings product, where otherwise access to finance is poor.

References

Anagol, Santosh, Shawn Cole, and Shayak Sarkar (2012): "Understanding the Incentives of Commissions Motivated Agents: Theory and Evidence from the Indian Life Insurance Market," Working Paper 12-055, Harvard Business School.

Anagol, Santosh, and Hugh Hoikwang Kim (2012): "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," *American Economic Review*, 102(1), 576–93.

Antolin, Pablo (2008): "Policy Options for the Payout Phase," Working Papers on Insurance and Private Pensions 25, OECD, OECD Publishing.

Bhardwaj, Gautam, and Surendra A. Dave (2005): "Towards estimating India's implicit pension debt on account of civil service employees," Working paper, Invest India Economic Foundation.

CRIISP (2011): "Report of the Committee to Review Implementation of Informal Sector Pension," Discussion paper, PFRDA.

Dave, Surendra A. (2006): "India's Pension Reform: A Case Study in Complex Institutional Change," in *Documenting Reforms: Case Studies From India*, ed. by S. Narayan. Macmillan India and Observer Research Foundation.

Department of Financial Services (2014): "Pension reforms in India," Discussion paper, Department of Financial Services, `http://financialservices.gov.in/pensionreforms_index.asp`.

Halan, Monika, Renuka Sane, and Susan Thomas (2013): "The case of the missing billions: Estimating losses to customers due to mis-sold life insurance policies," Working Paper WP-2013-007, IGIDR.

Mesa, Alberto Arenas De, and Carmelo Mesa-Lago (2006): "The Structural Pension Reform In Chile: Effects, Comparisons With Other Latin American, And Lessons," *Oxford Review of Economic Policy*, 22(1), 149–167.

OASIS (2000): "Project OASIS Report," Committee report, Ministry of Social Justice, Government of India.

Parekh, Deepak (2009): "Report of the Expert Group on Investment regulation for the New Pension System for the informal sector," Committee Report, PFRDA.

Rocha, Roberto, Dimitri Vittas, and Heinz P. Rudolph (2010): "The Payout Phase of Pension Systems: A Comparison of Five Countries," Policy Research Working Paper 5288, The World Bank.

Sane, Renuka, and Susan Thomas (2013a): "In search of financial inclusion: informal sector participation in a voluntary, defined contribution system," Working Paper WP-2013-022, IGIDR.

——— (2013b): "Regulating microfinance institutions," *Economic and Political Weekly*, XLVII(5), 59–67.

Shah, Ajay (2006): "Indian pension reform: A sustainable and scalable approach," in *Managing globalisation: Lessons from China and India*, ed. by D. A. Kelly, R. S. Rajan, and G. H. L. Goh. World Scientific.

Srikrishna, Justice B. N. (2013): *Financial Sector Legislative Reforms Commission*, vol. I and II. Ministry of Finance.

TAGUP (2011): "Report of the Technology Advisory Group for Unique Projects," Committee report, Ministry of Finance, Government of India.