NEW PENSION SCHEME (NPS)
- the road ahead and future challenges

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Chapter 1

INTRODUCTION

India supports 18% of the world population with 2.6% of the world landmass. In terms of the age profile of the population, majority are in 25-61 years of age bracket and facing the triangle at the top that is increasing faster than the base supporting it. For example against the total number of employees of 45 lakh in the central Government the number of pensioners is 38.4 lakh showing pensioners to employee's ratio of 0.85. (S*ource: Report of High Level Expert Group on New Pension System, Feb 2002).*

1.1 The people above age 60 years are growing at a much rapid pace- annual rate of growth of 3.8 percent per annum (75.9 million in 2001 and 55.3 million in 1991).Life expectancy at birth for females is 66.91 years while for male it is 63.87 years which was 59 years for males and 59.7 years for females in 1991-92.

1.2 Retirement benefits in India, in one form or the other, are available to only about 11% of the working population, and the financial burden on the Government and the employer is rising to very high levels. The total pension liability on account of the Central Government employees has risen from 0.6% of GDP (at constant prices) in 1993-94 to 1.66 of GDP (at constant prices) in 2002-03 and the actual outgo has increased from Rs.5206 crore in 1993-94 to Rs. 21927 crore in 2002-03. As a percentage of net tax revenue the total pension liability has increased from 9.7% in 1993-94 to 12.68% in 2002-03.

1.3 The pension payments at the State government level have also risen sharply during the last 10 years. The annual average increase in pension expenditure in the period 1995-96 to 2000-01 was 27.1 percent. In the year 2000-01 more than 10% of the revenue receipts of the States were pre-empted by pension expenditure which was 5.4 % in 1990-91. According to figures available for 2002-03 (BE), 11 States have pension expenditure, which is higher than the expenditure on administrative services. These States are Andhra Pradesh, Bihar, Goa, Gujarat, Himachal Pradesh, Karnataka, Kerala, Orissa, Rajasthan, Tamil Nadu, and West Bengal. (Source: RBI's Report of State Finances 2002-03). The details in this respect may be seen in annex I. The situation may further deteriorate if systemic changes are not carried out. Some of the above mentioned State Governments are increasingly finding it difficult to meet the liabilities and there are reports of delay creating worry in the minds of the pensioners.

1.4 Therefore, in view of high financial burden on account of pension expenditure, reforms of the pension system becomes critical in order to gradually move towards a contribution based pension system. Some of the States have proposed to introduce a new contribution based pension scheme for their newly recruited employees. The following table shows the steps initiated by some of the State Governments:

State Governments	Steps initiated
Chhattisgarh	Setting up pension fund
Rajasthan	New pension scheme for new recruits of the State Government
Tamil Nadu	Introduction of a new contributory pension scheme for all employees recruited from December 2001.

Source: RBI Report on State Finances 2002-03.

1.5 The savings behavior in India has undergone remarkable changes in recent years in view of the structural changes. The present savings behaviour in term of preferred financial instruments is given at Annex-II.

Chapter 2

STRUCTURE OF THE PENSION SYSTEM IN INDIA

2.1 India, like most other developing countries, does not have a universal social security system to protect the elderly against economic deprivation. Perhaps, persistently high rates of poverty and unemployment act as a deterrent to institute a pay-roll tax financed state pension arrangement for each and every citizen attaining old age. Instead, India has adopted a pension policy that largely hinges on financing through employer and employee participation. This has however restricted the coverage to the organized sector workers - denying the vast majority of the workforce in the unorganized sector access to formal channels of old age economic support.

Prevalent/existing Pension system in India:

2.2 Presently, following are the components of the main pension schemes in the country :

A) Government Employees

- i) Civil Services Pension Schemes
- ii) Civil Services Provident Fund
- iii) Gratuity to Civil Servants

B) Workers in the organised sector

- i) Employee Provident Fund
- ii) Employee Pension Scheme
- iii) Gratuity to employees
- iv) Special Provident Funds such as Coal Miners Provident Fund, Assam Tea Plantation Provident Fund, Jammu & Kashmir Provident Fund and Seaman's Fund

C) Voluntary Schemes -.

- i) Public Provident Fund
- ii) Private Pension plans
- iii) Personal Pension plans from annuity providers

D) National Social Assistance Programme for Poor and Elderly- transferred to States from 2002-03.

E) Pilot scheme for the unorganized workers- scheme has been launched recently in 50 districts. Workers in the unorganized sector or self-employed can contribute between Rs 50/ to Rs 100/ per month (employer makes matching contribution or the workers pays the matching contribution as well in case of self employed. At old age pension @ Rs 500/ per month will be paid to the worker. The Scheme is being implemented by EPF and has also got component of insurance cover.

2.3 The details in respect of the above-mentioned schemes are at annex III.

Chapter 3

GLOBAL MODELS OF PENSIONS:

3.1 The prevalent models of pension system around the world is based on PAY-AS-YOU-GO (PAYG) and defined benefit schemes. However, recent international experience in some countries, e.g., OECD (9 out of 15), is indicating that the difference between the future pension outlays and tax revenue are going to be as high as 150 to 300% of the GDP by the year 2050. In Europe, with the possible exception of U.K and Netherlands, almost all countries face pension crisis in terms of under funding of the system, with Germany and Italy potentially facing the biggest problem.

3.2 In order to address the problems on account of rising pensions liability which are mostly based on defined benefit, there are two options, which are being exercised internationally to bring in reforms in the pension system viz. parametric (minor) reforms and systemic (major) reforms. While major reforms include moving from pay-as you-go (PAYG) to defined contribution, provident fund to PAYG, conventional PAYG to notional PAYG etc. the minor reforms are related to changing contribution structure, benefit structure and administration etc.

3.3 Some of the countries which have gone in for major pension reforms (systemic) are Sweden, Poland, Mexico, Australia, Hungary, Kazakastan (moved from PAYG to defined contribution), Indonesia and Nigeria have moved from provident fund system to PAYG.

3.4 In the category of minor reforms, New Zealand, Ireland, Italy etc. have changed the eligibility criteria in terms of changing the retirement age whereas Brazil, Latvia, Greece etc. have changed eligibility criteria in terms of changing the service years. Other minor reforms of changing the contribution structure has been carried out in Japan, Malaysia, Taiwan, Korea, Bulgaria, Sudan etc. Benefit structure in terms of changing the pension formula has been carried out in Iran, Congo, Senegal, Armenia etc. and indexation has been changed in France, Russia, Malta, Germany etc.

Chapter 4

RECENT TRENDS IN PENSION REFORM

4.1 Two parallel sets of initiatives have been undertaken during the last 2-3 years. Regarding Government employees, it was envisaged in Budget 2001-02 that a new pension scheme based on defined contribution basis would be launched for the new entrants in the Government service. Accordingly, a High Level Expert Group (HLEG) was set up by the Department of Pension and Pensioners' Welfare (DPPW), Ministry of Personnel, Pension and Public Grievances. The HLEG suggested a new hybrid scheme that combines contributions from employees and the Union Government on matching basis, on the one hand, while committing to the employees a defined benefit as pension. The objective of the Government was to design a scheme for new entrants in Central Government service where the contribution is defined, where no extra infrastructure is sought to be created in Government and which is capable of serving other groups like State Government employees, middle class self-employed people and even those in the lower income bracket amongst the unorganized sector subsequently.

4.2 The second initiative was for the unorganised sector. OASIS (Old Age Social and Income Security) project was commissioned by the Ministry of Social Justice and Empowerment under the Chairmanship of Shri S.A.Dave which submitted its report in January, 2000. OASIS report recommended a scheme based on Individual Retirement Accounts to be opened anywhere in India at the price of modest contributions through the working career of the worker. Banks, Post Offices etc., could serve as Points of Presence (POPs) where the accounts could be opened or contributions deposited. Their interconnectivity could ensure portability as the worker moves from one place/employment to another. There should be a depository for centralised record keeping, fund managers to manage the funds and annuity providers to provide the benefit after the age of 60. A central regulatory authority, India Pension Authority was recommended. Minimum contribution of Rs. 500 per annum was expected to have an accumulation of around Rs. 2 lakhs at the age of 60 years. The first Rs. 2 lakhs was to be used for buying an annuity, beyond which one would be free to deploy.

4.3 In the Budget 2003-04 a new pension system has been announced based on defined contribution, shared equally in the case of Government employees between the Government and the employees. Under the scheme there will be no contribution from the Government in respect of individuals who are not Government employees. The new pension scheme will be portable, allowing transfer of the benefits in case of change of employment, and will go into 'individual pension accounts' with Pension Funds.

4.4 The Ministry of Finance will oversee and supervise the Pension Funds through a new and independent Pension Fund Regulatory and Development Authority. The present proposal integrates the issues and goals of the above two initiatives. The existing scheme of pension, GPF and Gratuity would cease for new entrants to the Central civil services.

4.5 The following are the details in respect of the New Pension Scheme (NPS):

4.5.1 NPS would be available for the central government employees appointed on or after 1st January 2004 on a mandatory basis and to those in the unorganised sector on voluntary basis. All participants will have individual pension account which would be portable.

4.5.2 An amount equivalent to certain percentage of the basic salary has to be contributed towards the pension by the employee and a matching amount is to be contributed by the employer i.e. Government of India. No premature withdrawal from the pension fund will be allowed during the service time. At the time of retirement there will be compulsory annuitisation of the accumulated sum so as to achieve a replacement rate of atleast 25%. Beyond that, the individual would receive a lumpsum of accumulated pension wealth, which he would be free to utilise in any manner. The contribution and accumulation would be tax exempt upto a limit, but benefits would be taxed as normal income (EET)

4.5.3 In order to promote savings for expenditure during service time there will be a second tier to the new pension scheme which would be a voluntary scheme with no contribution from Government. Employees can make withdrawal from the second tier on the same lines as is permitted from GPF. Persons in the unorganised sector, especially those who are self employed and educated can avail of this second tier scheme right since the beginning. However, Government would not be contributing for individuals in the unorganised sector. The assets of the second tier scheme would be managed through exactly the procedures applicable for the first tier scheme. However, the employee would be free to withdraw his money anytime. This withdrawable account does not constitute pension investment, and would attract no special tax preference.

4.5.4 As with civil servants, individuals in the unorganised sector will be able to ask for investment protection guarantees on investments in the 'Safe Income' scheme. However, this guarantee would be implemented using private financial markets, and the cost will be fully passed on to the participant. There would be no fiscal impact in any fashion.

4.5.5 Persons being covered by Employee Provident Fund Scheme and Employee Pension Scheme would not be mandatorily covered under this scheme but they can join the second tier voluntarily.

4.5.6 There would be an independent Pension Fund Regulatory and Development Authority (PFRDA). The authority would be located in New Delhi. The Government will support the Authority for its finances. The Authority would also be responsible for drafting of the legislation for statutory position of the regulator. PFRDA has started functioning from 1st January 2004.

4.5.7 Government would not be required to create any additional infrastructure for collection, accounting, record-keeping etc. Its job would be limited to making the contribution on behalf of the employer towards pension of individual employees to the fund manager. Existing infrastructure of banks, depositories etc. can be used for collection, accounting, record keeping etc.

4.5.8 There could be a number of pension fund managers (one of which will be in public sector called Pension Corporation of India) licensed by pension fund regulatory authority and choice would be with the individual employee to decide which fund manager he would like to go with. Pension assets could also include investment in overseas market in order to take advantage of the reducing volatility through diversification.

4.5.9 PFRDA will permit the fund managers to float 3 types of schemes i.e. safe, balanced and growth and ensure transparency and disclosure of information regarding investments. Portability will be allowed and an employee can transfer his scheme from one fund manager to another. Portability from one Government service to another or from private to Government and Government to private will also be permitted. The infrastructure is more or less on the lines suggested by OASIS report and involves no extra expenditure on the part of Government.

4.5.10 The scheme in its concept and infrastructure is capable of being replicated to other Government departments like Railways or Defence Services. State Governments can join in the scheme as and when they like.

Chapter 5

MAJOR ISSUES

5.1 In view of the fact that pension liabilities are creating a stress on Government finances and also creating worry in the minds of the pensioners, it is important that pensions are funded and separately accounted for and payment responsibility is taken away from the Government. Of course, in the long run it will also result in freeing the resources for development purposes including providing much needed long term funds for country's infrastructure development. However, the initiatives involve immense challenge in terms of devising a system which without jeopardizing the interests of the existing beneficiaries, takes care of long term interest of all new participants in the labour force. The 5 pillars of the new pension system could be coverage, return, simplicity, portability and tax neutrality.

5.2 Central Record Keeping Agency (CRA) has a primary role in NPS as it would have records of all contributions and directions from the participants. It will also have the mandate to effect client instructions regarding switching from one fund to another or from one scheme to another of the same fund. Besides, facilitating implementation of individual choice, the CRA is also expected to help in big way in reducing fees and costs because every fund manager will not be required to set up an elaborate fund collection, transfer, record keeping and marketing infrastructure. However, what should be eligibility criteria for a CRA or type of contract between PFRDA and CRA or the relationship between CRA and pension fund mangers, (PFMs) etc are issues still being sorted out by PFRDA. A discussion document on these issues has been put up for debate and suggestions on behalf of PFRDA.

5.3 Similarly, the eligibility and selection criteria for PFMs, whether these should be a limit on the numbers of PFMs, whether the PFMs should be separate entities or existing companies in the financial sector can *ipso facto* be eligible and what should be relationship between the PFMs and PFRDA on the one hand and other regulators on the other hand are issues which are required to be addressed with due care and attention to detail.

5.4 One issue being raised in various fora is rationale for having a separate regulator and the role of the insurance industry in the new system. In this connection, I would like to clarify that PFRDA will concern itself with the stage of contribution and accumulation of pension wealth. Since pension fund are long term fund having large impact on the capital markets, it is the intention to offer the best possible option to the investor for the growth of the pension wealth and allow international diversification to meet this end. At the age of 60 at least 40 % will have to be compulsorily unitized through an IRDA regulated annuity provider.

5.5 Initially, the pension funds will be small in size and intending companies as PFMs, CRA or POPs, may not break even. But over the next 3-5 years this industry is likely to see an explosive growth. Companies with deep and long term commitment can not only survive but also make their contribution in this field.

Chapter 6

CONCLUSIONS

While providing old age income security to uncovered 89% of Indian population is certainly an esteemed goal in the long run, albeit provision of such income security on a voluntary basis could certainly be taken as an intermediate achievable goal. The recent initiatives in term of NPS as announced in budget 2003-04 is a litmus test for future course of action on pension reforms and provision of old age income security.

6.2 Systemic reforms are the need of the hour as opposed to parametric reforms: In recent years, growing realization about these deficiencies has prompted the government to take reformatory steps to overcome these problems. However, most of these reforms are initiated in a piecemeal manner. A mix of policies like austerity on benefit promises, reliance on greater funding, relaxation of investment norms, encouraging private participation, enhancing system efficiency and developing regulatory capacity could help avert the looming pension crisis and promote better economic security for the aged. The benefit of such a pension regime is also likely to foster aggregate rate of savings and accelerate capital market development necessary for financing infrastructure and other long term projects.

6.3 So far as the insurance industry is concerned they will have the right to participate in the Scheme along with other financial companies of required minimum capital, track record and efficiency in matters of costs/fees etc. It will also be the effort of the Government to ensure smooth co-ordination between IRDA and PFRDA. It is also proposed to enact a separate law shortly so as to provide complete clarity about roles, duties and rights of various stakeholders. It will be the aim of the Government to create a system whereby the best pension fund managers in the world are enthused towards joining the system. Similarly, the aim is also to create an investment climate for the pension funds so that the investor is not denied the benefits of the opportunities in the world market keeping in view the best global practices.

ANNEX I

PENSION LIABILITY OF STATE GOVERNMENTS.

(In Rs. crore 2002-03 BE)

States	Expenditure on Admn. Services	Pension expenditure	Ratio pension to total Admn. Expenditure.
Andhra Predesh	1779	2560	1.44
Arunachal Pradesh	187	49	0.26
Assam	1053	649	0.62
Bihar	1432	2038	1.42
Chhattisgarh	552	361	0.65
Goa	99	140	1.41
Gujarat	1193	1435	1.20
Haryana	682	603	0.88
Himachal Pradesh	324	507	1.56
J&K	1262	626	0.50
Jharkhand	859	750	0.87
Karnataka	1467	1943	1.32
Kerala	848	1819	2.15
Madhya Pradesh	1572	1177	0.75
Maharashtra	3655	2307	0.63

PENSION LIABILITY OF STATE GOVERNMENTS.

(In Rs. crore 2002-03 BE)

States	Expenditure on Admn. Services	Pension expenditure	Ratio pension to total Admn. Expenditure.
Manipur	195	179	0.92
Meghalaya	259	76	0.29
Mizoram	162	49	0.30
Nagaland	372	107	0.29
Orissa	720	1451	2.02
Punjab	1533	1027	0.67
Rajasthan	1148	2027	1.77
Sikkim	78	28	0.36
Tamil Nadu	1982	3175	1.60
Tripura	271	216	0.80
Uttaranchal	449	251	0.56
Uttar Pradesh	3904	2661	0.68
West Bengal	1819	2095	1.15
Delhi	229	80	0.35
All States	30085	30386	1.01

Source: RBI's report on State Finances,

ANNEX II

SAVINGS OF HOUSEHOLD SECTOR IN FINANCIAL ASSETS					(RS. CRORE)
	1996-97	1997-98	1998-99	1999-00	2000-01
SAVINGS (GROSS) OF THE HH SECTOR IN FINANCIAL ASSETS OF WHICH	158518	171740	209664	244143	264699
CURRENCY	13643	12780	21846	20822	16901
IN %	8.6	7.4	10.4	8.5	6.4
BANK DEPOSITS	50902	74099	75670	90190	109400
IN %	32.1	43.1	36.1	36.9	41.3
NON-BANKING DEPOSITS	25980	6733	7663	6351	8979
IN %	16.4	3.9	3.7	2.6	3.4
LIFE INSURANCE FUND	16121	19410	23428	28678	34455
IN %	10.2	11.3	11.2	11.7	13.0
PROVIDENT AND PENSION FUND	30390	32267	46350	54762	53937
IN %	19.2	18.8	22.1	22.4	20.4
CLAIMS ON GOVERNMENT	11783	22162	28220	28951	34806
IN %	7.4	12.9	13.5	11.9	13.1
SHARES AND DEBENTURES	6631	4464	5625	13706	8579
IN %	4.2	2.6	2.7	5.6	3.2
UNITS ON UTI	3776	595	1887	1811	(-) 1343
IN %	2.4	0.3	0.9	0.7	
SOURCE : HANDBOOK OF STATISTICS ON INDIAN ECONOMY, RBI, 2001.					

Annex III

Existing system of pension in India

Program	Legal coverage/eligibility	Effective coverage	Financing
COMPULSORY			
Employee's provident fund (EPF)	Employees in firms with more than 20 employees	About 5.8 % of the labour force	Employer and employees contributions
Employees Pension Scheme (EPS)	Same as above with some exemptions	About 5.4 % of labour force	Employer, government contributions
Civil services pension scheme	Civil servants at state and federal level	About 3.5% of the labour force	State of central government budgets
Government provident fund	Civil servants at state and federal level	most civil servants	employee contribution
Special provident funds	Certain occupations and employees in J&K	About 0.5% of the labour force	Employer and employee contribution
VOLUNTARY, TAX PREFERRED			
Public provident Fund	All individuals	About 0.8% of the labour force	Contributions
Superannuation plans	All employees	About 0.2% of the labour force	Contributions
Personal pensions	All individuals	About 0.2% of the labour force	Purchase of annuity like products
SOCIAL ASSISTANCE			
State level social assistance	Varies by State	Varies by state	State budgets
National Old age pension scheme	Destitute persons above age 65	About 15-20% of population over 65 years	State budgets
Pilot scheme for unorganized sector workers	Unorganised sector workers	50 districts	Contributions and Government

Source: World Bank (2001) and other reports