New Pension System: Changing the way India thinks tomorrow

India is confronted with severe challenges like a growing population, increased ageing, decline in organised public sector employment, the absence of formal social security for informal sector employees and high cost of existing defined benefit (DB) pension. **Dr H Sadhak**, CEO, LIC Pension Fund Ltd, gives us an overview of the Indian population, how the New Pension System aims to help the financial needs of the citizens when they retire and what challenges still lie ahead.

While India has a young population, the average age being 26 years, this is changing very fast. The growth rate of elderly population in India is 3.8% as against general population growth rate of 1.8% and the number of elderly population will be more than double in the next 20 years. Further, life expectancy has been steadily increasing, and is estimated to go up from 63.7 years at present to 67 yrs for men and 68.8 years for women in 2016.

The population of India reached 1.09 billion in India in 2004-2005 and the size of the labour force was 419.65 million. Growth of the labour force (2.84%) was at a much higher rate than the population (1.69%) during 1999-2000 to 2004-2005.

Most workers not covered by formal pension system

According to the National Sample Survey 61st round (2004-2005), out of the total work force of 457.5 million, organised sector employed only 62.5 million ie 13.66%, leaving 395 million (86.34%) to be employed by the unorganised sector.

It has been estimated that only 11% of workers are covered by formal pension system while 89% still remain uncovered. Study has shown that there is no formal pension system for informal sector workers- about 310 million workers are uncovered. It is obvious that the unorganised sector constitutes the bulk of the labour force in the country and there should be certain avenue to provide them pension/ social security.

India is still lagging behind the developed and many emerging countries. In terms of pension assets as percentage of GDP, it was observed that in 2005, pension assets as a percentage of GDP was only 5.3% as against 64.9% in Chile, 62.6% in Singapore, 56.7% in Malaysia, 33.9% in South Africa, 125% in Netherlands, 99% in the USA, 66% in the UK etc.

To tackle the challenges posed by the high cost, low coverage pension system in the country, the Government of India introduced the contributory and funded pension system in January 2004, which is called New Pension System (NPS).


Dr H Sadhak

Structure of NPS

The Structure of NPS: The NPS mandatory is for central government employees (except the armed forces) who joined services on or after 1st January, 2004. NPS is not mandatory for the State government employees, though already 21 State and Union Territory have joined the NPS. The NPS was further extended to all citizens of India with effect from 1 May 2009.

The Individual Account based NPS is a Two Tier system:

- **Tier-1**
  It is a mandatory and non-withdrawable pension account. As per the NPS rules, the employees will contribute 10% of the salary and an identical matching contribution will be made by the Government, totalling 20% contribution to the pension account of the employees.

- **Tier-11**
  Tier 11 is a voluntary, withdrawable savings account. No contribution will be made by the Government.

Portability: NPS is portable and the pension benefits will never cease even if she/he changes job and moves from one place to another. Subscribers will also be entitled to switch over from one scheme to another scheme as well as from one Fund Manager to another Fund Manager.

Multiple investment options: Under the NPS, the pension fund managers will offer multiple schemes to the subscribers. At present, however, schemes offered to the central government employees and other citizens are bit different.

Payouts in NPS: At the time of retirement/age of 60, when accumulation period ends, a government employee has the option to invest at least 40% accumulated wealth in purchasing an annuity plan from a life insurance company approved by IRDA and to take a maximum 60% as lump sum withdrawal. However under the voluntary NPS for all citizens, a member can withdraw the accumulated amount before age 60 at any point of time but has to invest at least 80% of accumulated wealth to purchase an annuity from a life insurance company approved by IRDA and 20% as lump sum withdrawal. If he/she exits at the age 60 from the system, he/she has to invest at least 40% of the amount in annuity and the remaining amount can be withdrawn as lump or as a phased withdrawal between the age 60 and 70. This phase withdrawal is an additional facility in voluntary NPS.

Tax benefits: There are tax benefits for participating employees. Currently EET Tax is applicable for mandatory contribution to NPS.

The architecture: NPS is a well structured Defined Contribution pension system under a well thought out architecture with defined roles of various entities.

Some areas of concern

The New Pension System is one of lowest cost but highly technology driven defined contribution pension system in the world. This has opened the avenue for retirement savings, particularly for the informal and unorganised sector which was hitherto beyond the purview of formal social security.

NPS regulator, Pension Fund Regulatory and Development Authority (PFRDA), has also put in place a regulatory mechanism which is highly transparent and NPS Trust (see *Side Bar*) has also designed a very sound system of monitoring and performance review of the fund managers.

However, certain structural and generic issues need to be addressed for better performance of the system. Some of them are indicated below:

Timing risks: Timing risks basically arise due to the strictly stipulated annuitization timing. For example, NPS-mandated annuitization requires at least 40% of the accumulated amount at the time of exit/retirement by investors. However, the market at that point of time may not be favourable and the price of annuity may be high resulting in lower regular incomes for the rest of the life of the annuitant.

Underdevelopment of the annuity market: The Indian annuity market is very narrow in terms of products and market size. Life insurance companies, particularly LIC of India, are the main annuity providers in India.

An analysis of the annuity market indicates that non-linked pension and annuity policies as a percentage of life assurance has significantly declined from 1.80% in 2004-05 to 1.58% in 2007-08. Though life assurance policies increased by about 20% during this period, annuity and pension policies increased only marginally by 0.7%.

Moreover, most of the annuity products are Immediate or Deferred Annuity – the new generation products like Variable Annuity, Inflation Indexed Annuity, Equity Linked Annuities are not there in India.

Short supply of long term debt instruments: Mortality and financial risks associated with pension and annuity business comes in the way of the growth and development of annuity market.

The major risk factors associated with annuity market are mortality risks, investment and reinvestment risks. Absence of required technical knowledge to investigate and forecast mortality increases indirect financial risks, while the absence of well regulated and developed debt market deter the life insurance companies from entering the annuity market.

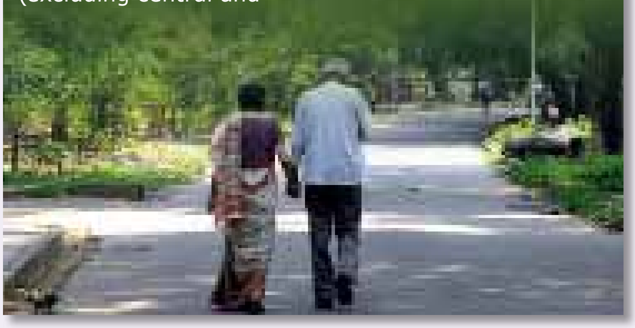
Players in Indian pension market

Pension Fund Regulatory and Development Authority (PFRDA): The PFRDA is entrusted with the responsibility to regulate and develop the pension market in India.

New Pension System (NPS) Trustee: The NPS Trust is responsible for taking care of funds under NPS.

Pension Fund managers: In order to introduce competition and to provide wider choices to the subscribers, PFRDA has allowed multiple fund mangers. The subscriber will have a choice to select from multiple pension fund managers and multiple schemes.

PFRDA has appointed three pension fund managers, namely LIC Pension Fund Ltd., SBI Pension Fund and UTI Securities Ltd to manage the funds of the central government employees and will also manage state government funds. Further, PFRDA has appointed six fund managers to manage funds of all citizens (excluding central and



Since annuity covers an annuitant for an unknown long period, asset liability matching becomes a critical factor an annuity company. Unless there are financial instruments for investing funds to earn that guaranteed return, there will be long term liability mismatch.

Low level of financial literacy: Financial literacy is quite low and there is low level of awareness about the necessity of retirement savings.

The study conducted by NCAER-Max New York Life (2008) threw some light on the savings behaviour of Indian households. About 83% of the households save for emergency including marriages and social events, children education and gifting and nearly 69% of households in India save for old age financial security. However, this means that about 31% of household do not have any provision for old age financial savings.

All these put immense responsibility on the NPS to educate the households about the necessity for old age savings through financial literacy programme and to offer suitable financial products to channel savings into old age pension.