Surviving the Age Quake - Pension Reforms in India

Dr. H. Sadhak, CEO of LIC Pension Fund Ltd, is a well known economist and financial sector expert, and a recipient of 12 awards for his contribution in research and policy Papers. He has occupied many important positions in the Indian financial services industry including Pension Funds, Mutual Funds, and Life Insurance and Banking sectors. V.S Girish, Managing Editor of the BFSI World spoke to Dr. H. Sadhak, on the relevance of pension funds, management of pension assets, and future prospects. Excerpts from the interview:

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Relevance of Pension Funds

India has the world's youngest population. By 2050 our population will be the highest in the world. People living above the age of 60 will rise from a current 8% (2002) to an estimated 21% and people living above the age of 80 are likely to INCREASE FROM 8% IN 2002 TO 15% levels. As our population increases, with longevity nudging 63 years as on date, and with declining fertility rates, there will come a time when we will also face the same problems that Japan or the Western World is currently facing today. The percentage of people who are in the working age – 20 to 60 years - will move downward. Dependency ratio will increase significantly. With the break down of the joint family system, and a lack of a social security system, the aged will have a challenge in meeting their basic survival needs and this may lead us to a situation to what some economists call the "Age Quake". Unless we plan today, the costs of taking care of a large aged population can undo much of the progress we will make.

The introduction of the New Pension System (NPS) is a step in the right direction to defuse the crisis arising out of a large ageing population.

On New Pension System (NPS)

NPS is a pension system wherein an investor invests throughout his/her working career and reaps the benefit after retirement. It is mandatory in NPS that at the withdrawal stage atleast 40% of accumulated wealth is used for purchasing life annuity which will provide regular retirement income. And 60% of accumulated income can be withdrawn for meeting other economic needs. The NPS, which is basically a Defined Contribution System, will go a long way in tackling the emerging crises of ageing and need for retirement incomes.

The attractiveness of the NPS is that it is focused only on retirement benefits; first, the pension fund has an exclusive regulator – the Pension Fund Regulatory Authority (PFRDA) exclusively for regulation and development of the pension industry, there is also a centralized pension trust namely NPS Trust, which owns pension assets of NPS and monitors the fund management performance. Secondly, the pension funds fully focus on investment of pension assets and investment management get full attention of fund managers. Third, the cost of NPS is very low compared to other investment schemes. Fourth, you have the option of changing the pension fund manager - under the NPS, you can change the fund manager; or you can switch over from one product to other products. You have a PRAN, which provides you to monitor your account, fund performance etc. And last but not the least – the returns under NPS are high.

Managing Risks in Pension Funds

Risk management takes a larger role here. There is a framework for risk management in NPS but a National Level Risk Standard needs to be put in place for better risk management and risk monitoring and probably an outline of accountability of decision makers. Pension funds are exposed to credit risk, market risk and inflation Risk. To manage risk there should be a market which can supply financial instruments long term debt instruments to hedge the risk arising out of inflation. Pension funds invest 85% funds in debt instruments – and for this

Intermediaries:

- Pension Fund Regulatory and Development Authority (PFRDA): Promotes old age income security by establishing, developing and regulating pension funds, to protect the interests of subscribers to schemes of pension funds and all matters connected to it.
- NPS TRUST: Administers the "New Pension System" and is responsible for taking care of funds under the NPS.
- Central Record Keeping Agency (CRA): To maintain subscriber accounts and issue a unique Permanent Retirement Account Number (PRAN) to each subscriber; undertakes Record Keeping,
- Administration and Customer service. National Securities Depository Ltd (NSDL) has been appointed as the CRA for the NPS in this system.
- Pension Funds Managers (PFMs): Manages investment of Retirement Savings of NPS. PFRDA has appointed three pension fund managers, namely LIC Pension Fund Ltd., SBI Pension Fund (Pvt.) Ltd. and UTI Retirement Solutions Ltd. for managing pension funds of Central and State Government, and six fund managers for managing the funds of unorganized sector.
- Trustee Bank: NPS Trust has appointed Bank of India as the Trustee Bank. Bank of India branches are authorized to collect NPS Trust contributions from contributors.
- NPS Custodian: Is responsible for holdings of the NPS Trust. NPS Trust has appointed Stock Holding Corporation of India Ltd as the custodian for the new pension system.
- Annuity Service Providers (ASP): To offer annuity schemes to the Subscribers; receive funds from CRA and pay regular monthly annuity at the time of exit at retirement or earlier. The member has to purchase an annuity from one of the Life Insurance Companies regulated by IRDA.
- Points of Presence (PoPs): Does the registration of subscribers, undertakes Know Your Customer (KYC) verification, receives contributions and instructions from subscribers and transmission of the same to designated NPS intermediaries.

there is a need for quality long term instruments, something which is absent in India.

For hedging inflation risk, we need inflation-protected extra-long debt instruments like those in developed countries and Capital protected bonds. In the absence of such instruments, it will be difficult to manage these risks. And since there are no good long-term instruments, there is a serious amount of reinvestment risk. For example, in 2008 the bank interest rates were between 10 to 11 % which today are between 7 to 7.5percent. To hedge these risks, there is a crying need for innovative instruments.

On the Distribution Mechanism

Agents play a crucial role here. When an agent approaches a person the conversion is higher. They are the first-line financial educators in the country. In the insurance industry, our agents have contributed very significantly and it has not been easy on them to carry the message of retirement benefit, which is anything but an easy task. Financial literacy programme in five star hotels and conference for elite investors do not fulfill the real need. We need to take it to the grass root level to educate people about the importance and need for retirement savings to avoid old age hard ship.

The Pension Assets as a Percentage of GDP

The pension assets in India is just 5% of GDP, while in Chile it is 65%, in Netherlands 120%, Switzerland 113%, and UK at 80%. In most Latin American countries it is around 40% to 50%, while the global pension fund assets have reached 70% of the global GDP. Hence, we will be able to see a tremendous scope for growth in India now.

On Financial Literacy

Today the critical factor is in educating the average Indian on the need for retirement savings, on issues such as - the features of NPS, how NPS will help etc. You need to manage costs at a reasonable level and fix a reasonable management fee. The industry is striving to educate Indians on the sanctity of

retirement savings. Many people withdraw their savings mid-way through for some reason or the other. We need to inform them that they are committing a grave mistake and make them realize that they need to focus on their post retirement income.