Market crisis & pension funds

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Global financial crises originating from subprime problems virtually brought the financial sector to a near collapse, which was rescued by huge packages of costly stimulus funds. In a normal economic environment, the money would have created jobs for millions, taken consumption demand to new heights and boost production and growth of the world economy. Rarely was there a country and economy which had not been adversely effected. The menacing impact of financial market crisis was most felt in the global pension fund industry, and more acutely in mature economies.

The OECD Market Focus (December 2008) noted that the total pension assets of OECD declined by $3.3 trillion or nearly 20% from December 2007. Including other pension assets like assets in personal pension plans this loss was about $ 5 trillion. The crisis in the financial market also impacted the return on pension fund investment, which marked a decline of more than 30%.

Further this decline was significant in countries having higher investment in equities, for example a country like Ireland having 66% exposure in equities witnessed a more than 30% decline in return.

However, the decline in assets and returns would have been much higher, but for the shift in asset allocation patterns which was taking place in mature economies.

A study by Watson Wayatt (2009 Global Pension Study) indicated that that there had been a significant shift in asset allocation since 2005 . During the period 2005 to 2008 Equity investment declined from 59.7% to 41.4% and bond investment increased from 24.5% to 40.2%.The increased weight in favour of bond portfolios in pension funds restrained the decline in overall return.

However, the NPS in India could remain isolated from the crisis due to the cautious and prudent investment guidelines of PFRDA which reduces the risk content of fund management operation.

Therefore the fund managers namely LIC Pension Fund , SBI Pension Fund and UTI Retirement Solutions, which stated investment management operations from April 2, 2008, could beat the crisis on the street to deliver reasonably higher return on NPS funds. These three funds could withstand the market pressure and generate returns of 12%-14% by March 30 2009. This has been possible due to the prudent allocation pattern prescribed by regulator PFRDA : 85% investment in debt market instruments, upto 10%

in corporate bonds or equity mutual funds and upto 5% in equity for the pension assets of government employees.

There were huge arguments across the country and pressure on the pension regulator to allow 100% equity investment in NPS for the unorganised sectorm but the PFRDA has prudently put a cap of 50%. This was a very right decision particularly in view of global pension fund debacle and even in mature economies, equity investment is somewhere near 42% of the total pension portfolio.

Indian regulator PFRDA, within a very short time, could put in place a well meaning regulatory mechanism to monitor activities and performance of fund managers. Fund management regulation is basically quantitative in nature — predetermined pattern of asset allocation. Though often it is argued that quantitative regulation imparts rigidity and constrained performance, experience indicates that it has so far not created any constraints for good performance. However, there is a scope for adding further regulatory measure by introducing prudent person rule as prevalent in many European market and being adopted by many other. The Prudent Person Rule, which focuses more on fund managers knowledge, expertise and accountability would strengthen risk management practices.

The global financial crisis and its impact on pension-fund assets and returns also focuses on the need for careful design of pension-fund products and choice of investment option by the investors for pension savings. There will be greater demand for the Default Option (called Auto Choice in NPS).

The Default Option has several varieties and the most suitable would be the 'Target Dated Funds'— which an investor can select to match her retirement date. The Default Option and Target Dated funds are in the order of the day and even in most developed market like the USA, the UK and Sweden, more than 8% investors opt for Default Option with a predetermined asset allocation pattern.

However, greater awareness needs to be created among pension-fund investors about the Default Optionand Target Dated Funds. Often the investors are either led by short term gain or loss of stock market and change their outlook on investment risk. However, pension investing is a long term option or objective and patience is required to achieve investment objective which calls for the spread of financial literacy which at present, seems to be very low in India.

The financial crisis also brought to the fore, funding crisis in the Defined Benefit Pension System. It has been reported in an OECD study that average funding levels down by 10% which created a funding gap of $ 2 trillion.Unfunded Defined Benefit Pension is already a strain on fiscal system in India. Such a financial crisis and market volatility in asset prices may create an unsustainable crisis in the DB system. Therefore, Defined Contribution Pension like our NPS, needs to be extended further. After all, the Indian model of pension reforms implemented by introducing well-structured NPS has been able to protect the assets of investors with good returns.

Another area of consideration to promote a well defined pension system in any country is the unification of pension market structure under a single regulatory authority. In our country , due to historical reasons, heterogeneity has been developed in the areas of pension products, cost structure, monitoring the fund performance and supervision.

Often these are loosely integrated. It is because there was no unified pension market and a number of entities launched some pension or pension-like products as their rider products . However, to day we have national policy on pension and a national regulator, which has come out with a successful pension model for both the organised and unorganised sector of the country . The model is low-cost, highly transparent and technology-led, providing flexibility and option of active choice to the investors for pension savings.

It is therefore natural, that the all the scattered segments of pension market be unified under one single regulator i.e the PFRDA which is focusing its attention only on pension funds. This will bring more clarity on regulation, save regulatory Costs, put in place a uniform cost structure for funds management, introduce uniform risk management practices in the pension industry , speed up pension-fund research, and bring near equality in investment returns. These will ultimately benefit the millions opf deserving people who need retirement income through pension savings in a non-discriminating pension-fund market.

—*Views expressed here are the personal views of the author. The author can be reached at hsadhak@rediff.com.*