Pension Reforms and the Emerging Annuity Market in India

India is a young country with the average age of its population being 26 years. But this may not continue for long as the growth rate of an elderly population (those above 60 years of age) is 3.8%, higher than the general population growth of 1.8%. **Dr H Sadhak**, CEO of LIC Pension Funds tells *Asia Insurance Review* that with the average life expectancy increasing and there being no universal social security in India, the New Pension System is seen as a welcome solution as it requires mandatory annuitisation at withdrawal. He also examines if India has a vibrant annuity market to support this mandatory requirement.

Available study indicates that the 2006 1.114 billion population is going to reach 1.411 billion in 2026, while average life expectancy will increase from 63 years to 67 years for male and 68.8 years for female in 2016.

Acute Unemployment

However, along with the population explosion, India also suffers from acute problem of unemployment. According to 2001 census, only 402 million people were employed. Out of the total employment of 402 million, 7% was in organised sector and 93% in unorganised sector. Further out of 27.79 million employed by organised sector, 19.14 million was employed in Public Sector and 8.65 million in Private Sector.

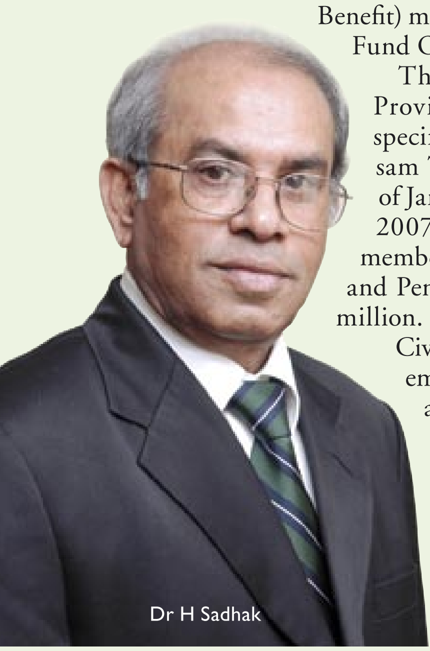
However, the current Social Security and Pension which exist mainly for organised sector covers only 11% of workers leaving 89% without any formal Social Security and Pension coverage.

Different Coverages Existing

While Civil Service and Public Sector employees enjoy the benefits of Pension (Defined Benefit) Provident Fund and Gratuity, organised Private Sector employees are covered by Provident Fund (Defined Contribution) Pension (Defined Benefit) managed by Employees Provident Fund Organisation (EPFO).

There are some other statutory Provident funds for employees in specific sectors like Coal mine, Assam Tea Plantation, Seamen's, State of Jammu & Kashmir etc. By March 2007, EPFO, Provident Fund had membership of 44 million employees and Pension fund membership was 35 million.

Civil Services pension, which covers employees of Central Government and State Governments and provides defined benefit pension is critically unsustainable as annual pension payments increasing steadily by 425% for Central Government and 650% for State Governments during 1993-1994 to 2004-2005. Increased pension costs put tremendous pressure on the government finance.


Dr H Sadhak

New Pension System

New Pension System (NPS) that has been introduced in India, is a self financing Defined Contribution (DC) System made mandatory for employees of Central Government who have joined services on or after 1st April 2004. Subsequently 21 State Governments also joined the NPS. This is a Two Tier System – Tier 1 being Contributory, Tax deferred System under which employees contribute 10% of her/his salary and a matching contribution is made by the employer while Tier 2 is a voluntary savings scheme. There are multiple funds and fund managers. NPS is also a portable system.

The Pension System, particularly the DC, has two distinct phases, i.e. accumulation and decumulation. Accumulation is the phase when an employee/member accumulates savings and creates pension wealth for future. Decumulation is a payout phase. Under NPS, accumulation phase is managed by the fund manager approved by the Regulation, Pension Fund Regulatory and Development Authority (PFRDA). Decumulation phase will be managed by a life insurance company approved by Insurance Regulatory Development Authority (IRDA).

Annuitisation

Decumulation or pay out under Defined Contribution pension system can be managed through various methods like annuity, systematic or lump sum withdrawals etc. However, the most important and widely accepted method is annuity.

Most of the countries which have reformed their pension systems and introduced DC pension opted for Annuitisation. Annuitisation, no doubt is a difficult institutional proposition but relatively more effective to provide retirement income to a member, comparing to lump sum or programme withdrawal. Most of the Latin American countries linked their pension reforms to mandatory Annuitisation.

India has also linked to its New Pension System (NPS) to mandatory annuitisation. According to the NPS Provision, any member can exit from NPS at age 60 (Retirement age in India). However the member has to mandatorily spend at least 40% of his/her pension wealth to purchase an annuity from a life insurance company approved by the IRDA .

Pension and General Annuity Business by Life Insurance Companies in India				
Policies sold	**2004-2005**	**2005-2006**	**2006-2007**	**2007-2008**
1. Pension & General Annuity	1792417	2116188	6760697	9924705
2. Total Life insurance	26187789	35440430	46128425	50848922
3. (1) as % of (2)	6.84	5.97	14.66	19.5
Premium (Rs. In Crore)				
4. Pension & General Annuity	3150.71	13059.18	21935.96	31741.43
5. Total Life Insurance	20962.07	30888.03	61468.5	78552.7
6. (4) as % of (5)	15.03%	42.28%	34.05%	40.41%
Sum Assured (Rs Crore)				
7. Pension & General Annuity	1582.69	594.79	1895.67	6265.17
8. Total Life Insurance	236762.75	378270.95	485918.33	569759.05
9. (7) as % of (8)	0.67	0.16	0.39%	1.1%

Source: Calculated by the author from data in IRDA Journal Vol IV, No. 9, August 2006, & IRDA Journal Vol VI. No. 7 June/July 2008. May not be actual but an approximation. Rs 100 Crore = Rs 1 Billion

Effective implementation of mandatory annuitisation will however, depend on a vibrant and dynamic life insurance market to supply appropriate annuity products. Annuitisatin will also need support of a Debt Capital Market to facilitate long term investment of pension assets like long term inflation linked bonds. Since the development of annuity markets need the support of a vibrant life insurance market, let us examine the state of recent life Insurance and annuity market in India.

Life Insurance Market in India

The Indian economy since 1990s has witnessed steady growth rates and emerged as one of the fastest growing economies of the world which registered GDP growth of 9% in 2007-2008 and average growth in GDP during 2000-2001 to 2007-2008 at 7%.

Similarly the rate of gross domestic savings in 2006-07 went up significantly from 23.4% in 2000-01 to 34.8% in 2006-07. Growth in household savings in India has been the single most important contributor to domestic savings and its contributions steadily increased from 19.8% in 1999-00 to 23.8% in 2006-07. Though Indian households still prefer to put a large part of its savings in bank deposits (54.3% in 2006-07), life insurance savings has been steadily increasing.

The share of Life Fund in household financial assets increased from 11.8% in 1999–2000 to 14.9% in 2006-2007. In terms of GDP Life Fund, the share went up from 1.5% to 2.8% during the same period.

However, a reverse trend has been noted in respect of household savings through Provident and Pension Fund (P&PF). The share of P&PF in household financial savings declined from 22.2% in 1999-2000 to 9.2% in 2006-2007 and in terms of GDP it declined from 2.8% to 1.7% during the same period.

This decline was probably due to transfer of sizeable funds from this segment to life insurance, increased investment in mutual funds and stock markets etc, in spite of the need to save more for retirement income. This also indicates the psychology of savings and priority assigned by the Indian investors to retirement savings. It is therefore necessary to strengthen the institutional mechanism to spread financial literacy and awareness to retirement investing without hindering the overall growth in domestic financial savings.

Annuity Business

Though retirement savings through P&PF has declined during the past few years, a noticeable increase of such savings has taken place in the life insurance market in the form of growth of Pension and General Annuity business of life insurance companies.

The annuity market, though very small at present, has been showing a trend of increased growth during recent times, particularly since the opening up of Indian insurance market. This trend can be noted from data in the table showing the number of Pension and General Annuity (P&GA), premium incomes and sum assured during 2004-2005 to 2007-2008.

It can be noted from the Table that the growth in sales of Pension and General Annuity (P&GA) policies increased by 82% as against growth in sales of total life insurance policies (including Life, health and P&GA) by 94% during 2004-2005 to 2007-2008.

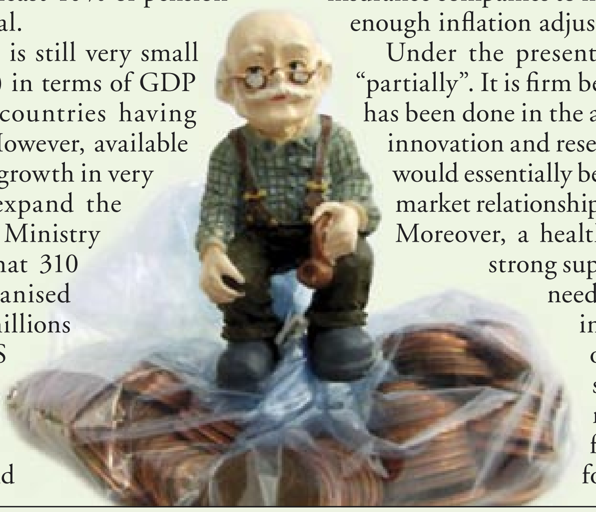
But, the share of P&GA policies in total policies sold went up significantly from 6.84% to 19.5% during the same period. However, growth of premium under P&GA policies was much higher at 909% as against growth of premium under total policies sold (274%) during the same period.

Also most significant is the share of P&GA in total premium income which went up from 15.03% in 2004-2005 to 40.4% in 2007-2008. Similar trend in Sum Assured (SA) growth was also noted during the same period and SA under P&GA Policies as a percent of SA under all the Life insurance policies under written went up from 0.67% in 2004-2005 to 1.1% in 2007-2008.

NPS – A Further Boost to Annuity Business

The small annuity market in India has witnessed a significant growth during the last few years (2004-2005 to 2007-2008) but it is expected to witness manifold growth once the New Pension System becomes fully operational and is opened to all section of citizens in India, because of mandatory annuitisation of at least 40% of pension wealth at retirement/withdrawal.

The Indian pension market is still very small at only 5.3% in 2005 (OECD) in terms of GDP when compared with other countries having similar GDP pension assets. However, available estimates indicate a significant growth in very near future since NPS will expand the coverage. A survey by ADB and Ministry of Finance in 2004, shows that 310 million workers in the unorganised sector are uncovered and 20 millions are able and willing to join NPS immediately. In addition to that, all the new employees in Central and State Governments are to join NPS. This will expand scope of annuity market in India and provide a significant boost to annuity Business.



Further, there are some estimates of growth in pension assets in the post-reform period. According to a study conducted by FICCI – KPMG, pension assets in India, after the reform, would increase to Rs4,064 billion (US$83.8 billion) in 2025. Another estimate of Helen K. Poirson of IMF shows that pension assets would grow from Rs1,500 billion in 2010 to Rs3,000 billion in 2020 and further to the Rs4,000 billion in 2025.

Is there Enough Annuity Product Innovation?

But a natural question one would ask is – Is the life insurance market ready to provide necessary annuity products to the prospective buyers of annuity? Is the Indian market innovative enough to supply preference oriented annuity products that would create enough regular income to the pensioners? Whether there are enough financial instruments in the capital market that would enable the life insurance companies to invest retirement funds to generate enough inflation adjusted income?

Under the present circumstances one would say "partially". It is firm belief of this author that not much has been done in the area of insurance market product innovation and research on buying behaviour. These would essentially be because of the changing product market relationship in the emerging annuity market. Moreover, a healthy annuity market would need strong support of the capital market which needs to provide long term financial instruments like index-linked and other types of bonds/fixed income securities. The emerging annuity market would also call for a more focused regulatory mechanism for annuity market.