INTERVIEW • H SADHAK, chief executive officer, LIC Fund

'Pension funds are expected to be more efficient in delivering better returns and higher wealth creation'

The development of a professional pension fund industry is gathering steam. After establishing a separate regulator, the Pension Fund Regulatory & Development Authority (PFRDA), and allowing three professional fund managers to manage the retirement funds of civil servants (those who have joined after January 2004), the Centre is now expanding the existing system to include the unorganised sector and retail. H Sadhak, chief executive officer, LIC Fund, in an exclusive interview with FE's **Sitanshu Swain**, *highlights how the one-year-old pension fund industry is fast taking shape in the country. Excerpts*

How do you see your performance since inception?

We have completed one year since incorporation, but not one year of operation. We have started investing the NPS Fund from April 2, 2008 onwards. Our company has performed exceedingly well, particularly in view of the fact that the capital market is undergoing a volatile phase and our funds size was very small. You will appreciate that managing a fund with restriction of investing 85% assets in debit instruments is very difficult, since small size funds do not have much scope for rebalancing the assets portfolio with a strategic asset allocation perspective. However, we have done very well and our performance is much better if compared with such debt-oriented funds in the market. Managing pension funds for retirement income is something different from managing some assets for growth, since a pension fund manager has to ensure maximum risk-adjusted return.

Further, assets of an employee remain with a pension fund company for 30-35 years and passes through four to five business cycles. It is therefore critical to understand the long-term risk-associated with a fund. This problem however can be talked through quality management, risk management, fund management skill, active compliance and governance system. Keeping these in view, we have focussed on developing the required management skill and structure, active compliance and governance systems, etc, under the guidance of our board, consisting of eminent experts in finance and administration.

We have also put in place an independent fund management system, fund management infrastructure and fund accounting system.

Pension fund regulator, the Pension Funds Regulatory and Development Authority (PFRDA), is planning to launch universal pension schemes in the country. Are you also keen to participate in the new framework?

We are a PFRDA-approved pension fund management company and can manage PFRDA-approved funds. If such pension schemes are introduced by PFRDA, we would be interested in managing such funds with our experience in managing long-term assets.

We would go by the regulatory requirement at that time. So far, we have not come across any such communication. For us, no new things are required to be done, since we are a fully operational organisation, with all the required fund management skill and infrastructure support under the PFRDA framework.

Do you think you are able to offer something very different or better than what the existing life insurance players are providing as part of their pension policies?

Life insurance companies in India are offering some pension as it happened globally. But these products basically focus on insurance needs of the policy holder, though the annuity products offered by them aim at retirement income. Life insurance companies manage accumulation to decumulation ie pay outs. Pension funds on the other hand manage accumulation and investment of such assets as specialised retirement fund managers with greater clarity and focus, and therefore concentrate on fund management with greater specialisation. Secondly, pension funds basically concentrate on age-based investing, particularly in respect of the default option, but there is no such option in life insurance investing, which is basically guided by risk-based investing.

Moreover, NPS schemes are dedicated retirement funds, while life insurance plans do not have such provisions. As per the present guidelines, once the employees reaches the age of retirement, he has to spend at least 40% of his pension wealth for purchasing annuities, which will take care of his need of his regular retirement income. Moreover, under NPS, all participants will be allotted permanent a Retirement Account No enabling him/her to switch over from one pension plan to another pension plan or to switch over from poor performing funds to better performing funds.

These flexibilities are not available under the pension plans offered by the life insurance companies. Moreover, pension funds under NPS are dedicated to managing only the retirement business and expected to be more efficient in delivering better returns and higher wealth creation.

The importance of dedicated pension funds in the retirement market may be noted from the Chilean experience. Chile introduced the defined contribution (DC) system in 1981 and at that time, pension funds assets in terms of the gross national product (GNP) was only 0.92% as against life insurance assets of 2.25%. In the year 1997, pension assets in terms of GNP was 42.19% as against 13.40% of life insurance assets. At present, the pension asset in Chile is about 64%. This indicates that pension funds products have greater appeal for retirement savings.

How do you see the demand for pension products in the country?

Demand for pension products depends on a variety of factors like the changing demographic profile, alternative social security arrangements like universal social security, increased purchasing power to buy retirement products, etc.

Though India is a young country with the average age of Indians being 26 years, the growth rate of the elderly population is 3.8%, as against the general population growth rate of 1.8%, and ageing and increased longevity can be taken care of by retirement savings.

In India, virtually there is no universal social security. About 11% workers are covered under formal social security provision. A study conducted by the ministry of finance (MOF) and Asian Development Bank (ADB) in 2004, indicates that 52 million workers are covered under formal pension and 310 million workers are uncovered. This shows the extent of potential in the pension market.

Further, according to a study by Ficci-KPMG, the post reformed pension market will grow to the extent of Rs 4,06400 crore in the year 2025. Incidentally, it may be mentioned here that Chile reformed its pension system and introduced a defined pension system in the year 1981.

How do you see resources out of pension funds impacting the stock markets and the larger economy?

Pension funds have an immense and multi-dimensional impact on the stock market. Some recent OECD data shows that in 2003, pension assets as a percentage of stock market capitalisation was 152% in Iceland, 120% in Canada, 55% in the US, 48% in the UK. With such huge assets sizes, the pension fund can impact the market to check volatility, influence corporate governance, reduce the cost of capital, which would be in the interest of investors and the economy. Pension funds would also impact the debt market, provide depth, induce innovation of long-term debt instruments, which the Indian market desperately needs.

Is it safe to invest pension money in equities, as the ongoing financial crisis shows the equity market can be badly impacted at the time of a crisis and thereby create a huge loss for investors?

One should remember that pension fund investing is a long-term proposition and such funds would undergo several stock market cycles. Investing in equity is basically not risky. Research has shown that the adverse impact of market volatility declines over a long period of time and provides better returns. What needs to be done is to avoid fund management activism. Fund managers and investors must have a long-term perspective and should not be guided by only short-term cost and return.

One must remember that a myopic view may wipe out short-term gain and put the fund in distress. Therefore, active implementation of regulatory guidelines, a robust system of risk management, compliance and governance, are very critical to the safety and growth of pension funds.

Don't you think you will have to compete with other life insurance players, including your own parent company LIC, for retail pension plans?

Yes, there will be some competition in the retirement product market, since about 20% life insurance policies and about 40% of first year premium (2007-08) came under pension and general annuity products. Once dedicated pension funds enter into this market, a percentage of such business is bound to go to them. However, there is so much untapped potential and both can compete and grow, which would be in the favour of customers.

Further, most of us are ignoring one alarming fact. Over a period of time, there is a gradual decline in household financial savings in provident and pension funds.

In the year 1999-2000, Indian households saved 22.2% of their financial assets in provident and pension funds, which in the year 2006-07 has declined to 9.2%. In terms of GDP, the share of provident and pension funds declined from 2.8% to 1.7%, though the household savings during this period have gone up from 20.9% to 23.8% and household financial savings had gone up from 11% to 11.3%.

This is alarming because Indian households are ignoring the retirement income need inspite of increasing longevity. Therefore, a special vehicle for retirement savings through pension funds are emerging as a priority.

How do you see the regulatory framework for the domestic pension fund industry? Is it comparable with the best in the world?

The regulatory mechanism for the pension fund is in the process of evolution and I think in the course of time it is going to be a robust system. As far as the system design is concerned, our system is in many ways better than many countries, which have opted for systemic pension reforms.

We have introduced a very low cost system in the world. It is a technology-driven sophisticated accounting and administrative system. More significant is the regulatory support as a developer to the NPS, fund managers and other entities. I personally believe that NPS, in the course of time, would emerge as a most cost-effective, well-regulated pension system of the world.