Pension Reforms Set to Tap Huge Indian Market

The LIC Pension Fund Ltd was the first pension fund company to receive the Certificate of Commencement of Business from the Registrar of Companies, Maharashtra, in January 2008, after receiving approval from the Pension Fund Regulatory and Development Authority (PFRDA). In an exclusive interview with *Asia Insurance Review*, **Dr H Sadhak**, CEO of the company, talks about pension reforms and why they are critical for India.

Why is pension reform so important for India?

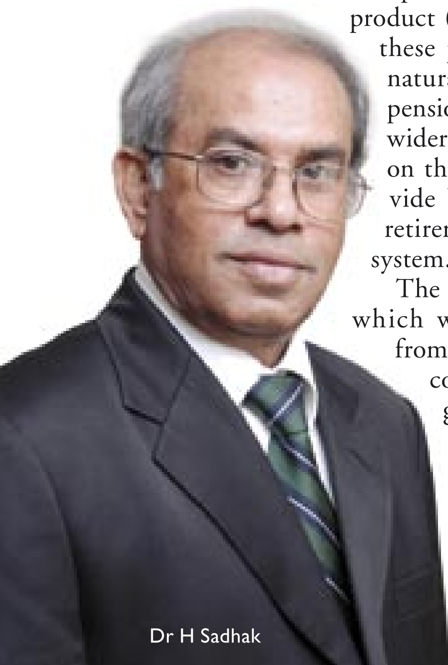
The debate on social security and pension reforms has taken centre stage as one of the most critical policy issues in developed and emerging countries.

Policymakers and researchers are intensely debating for an appropriate mechanism to tackle the problem arising out of increased longevity, and on the unfunded Defined Benefit Pension System which is unsustainable in the long run. The introduction of a funded defined contribution pension system will be able to solve this problem.

In order to understand the necessity for the immediate need for pension reforms in India, let us look at the challenges ahead. Firstly, India has a large population of young people – the average age being 26 – but this is changing very fast due to the rapid growth rate of the elderly population segment of 3.8%, as against the general population growth rate of 1.8%.

Secondly, the rate of pension coverage is very low. Only 11% of workers are covered by a formal pension system. The remaining 89% stay uncovered. Studies have shown that there is no formal pension system in place for informal sector workers, which means about 370 million workers are uncovered.

Thirdly, the current system has become financially unviable for the Central and State Governments. According to some estimates, pension payments by the Central and State Governments in India made up only 1.8% and 2.53%, respectively, of the gross domestic product (GDP) in 2004-5. In view of these pressing problems, it is only natural that we move towards a new pension regime which will provide a wider coverage, reduce the burden on the Government, and also provide better returns and sufficient retirement wealth through a funded system.


Dr H Sadhak

The New Pension System (NPS), which was introduced with effect from January 2004 as a mandatory contributory system for central government employees and was subsequently widened to include employees from 19 State Governments, is a most appropriate step for India. Presently, the NPS provides mandatory coverage for central government employees (excluding Armed Forces) who joined the government service on or after 1 January 2004. Once the pension bill is passed by the Indian Parliament, the NPS will be available to all citizens of India.

What are the salient features of the new pension system?

The NPS established by the Government of India is fully funded by the Defined Contribution (DC) system. The individual account-based NPS is a two-tier system:

- Tier I: This is a mandatory and non-withdrawable pension account. According to NPS rules, the employee is required to contribute 10% of the salary, while another 10% contribution will be made by the Government, bringing the total contribution to the employee's pension fund to 20%.
- Tier II: This is a voluntary withdrawable savings account to which no contribution is made by the Government.

Mandatory annuitisation: Individuals can normally exit at the age of 60 or at superannuation from Tier I of the pension system. At the time of exit, the individual would be required to invest at least 40% of his pension wealth in the purchase of an annuity from an Insurance Regulatory and Development Authority (IRDA)-regulated life insurance company. Every subscriber under the NPS will be issued a unique Permanent Retirement Account Number (PRAN) by the Central Record-Keeping Agency (CRA). The NPS is portable and subscribers will be entitled to switch from one scheme to another, as well as from one fund manager to another. The pension fund managers will offer multiple schemes to the subscribers. There will be four to five schemes – Debt-oriented Scheme; Equity-oriented Scheme; Balanced Scheme; G-Sec Scheme; and probably, one called the Default Scheme.

However, at present, there are two schemes. Scheme 1, which is already operational, will have 85% of its assets invested in debt instruments and 15% in equity and equity mutual funds. Scheme 2, yet to be operational, will invest 100% of its assets in government securities.

In order to provide a wider choice and to introduce competition, there will be multiple fund mangers. The subscriber will have the choice of selecting from multiple pension fund managers and multiple schemes. There will be no implicit or explicit assurance of benefits except for a market-based guarantee mechanism to be purchased by the subscriber. At present, there are three fund managers including the LIC Pension Fund Ltd.

What is the potential of the pension market in India?

There is a huge potential in emerging pension and retirement markets in India. However, at present, the market is very small. The Organisation for Economic Co-operation and Development (OECD) data indicated that in 2005, pension fund assets in India made up only 5.3% of the GDP, compared with 64.9% in Chile, 62.6% in Singapore, 56.7% in Malaysia and 33.9% in South Africa. This indicates the tremendous room for growth for the pension fund industry in India, as borne out by a study on the potential pension market under the NPS, conducted by the Asian Development Bank (ADB) in 2004. The study indicated that only 52 million workers were covered under the formal pension system, while 310 million were uncovered. According to another study conducted by FICCI-KPMG, the post-reform pension market in India will grow to Rs4,064 billion (US$90 billion) in 2025.

What would be the impact of pension reforms on the annuity market in India?

Annuity solves the major problems of wealth allocation in post-retirement life and has become an integral part of pension reforms globally. There is a very significant relationship between pension reforms and expansion of the annuity market. India has introduced an annuity-based pension system. The NPS has an inbuilt mandatory provision of annuitisation where at least 40% of the pension wealth on retirement/exit of a member will be used for purchasing an annuity from a life insurance company approved by the IRDA. This will also provide a boost to the annuity business.

How will the capital market in India benefit from the pension industry?

In recent years, the Indian capital market has witnessed tremendous transformation in trade, technology and infrastructure. Due to strong economic fundamentals since 2003, the stockmarket has risen sharply accounting for about 40% of the Indian GDP, while capital markets (bonds and shares) account for about 130% of the country's GDP. Development of the pension industry will further increase institutional participation in capital markets which will provide strong support to enhance depth in the market. Further, it will also support the mutual funds industry, which is a fast-growing industry in India.

Though recent reforms in Indian financial markets have brought transparency, promoted the fund management industry, induced competitive asset allocation and investors' protection mechanism, the market still lacks depth and suffers from a shortage of adequate financial instruments, particularly in the debt segments. Pension reform will provide impetus to these areas, while the presence of the Pension Fund Regulatory and Development Authority (PFRDA) will also strengthen the existing regulatory mechanism to support the healthy growth of the pension industry.

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