Pension Pay-out

India has introduced partially mandatory annuitization programme in the post accumulation period to provide regular retirement income to the pension investors, explains H Sadhak

An emerging trend in pension reform is to switching over from Defined Benefit (DB) to Defined Contribution (DC) system pension. A DC pension system is broadly divided into two phases namely Accumulation Phase covering collection of Contribution & Funds Management and Decumulation Phase/ Pay out phase covering pension payment to the pensioners. Accumulation has a time limit, normally up to the date of retirement, but pay out period normally till the survival of the pensioner Fund Management at accumulation phase is more glamorous and attractive business proposition than managing funds at the pay out phase since investment risks are borne by the investors and funds managers virtually bear no such risk, but mortality and other risks are borne at pay out phase by the pension providers.

This is the phase when a pension investor has to protect the risk arising out of over stressing longevity, expenses for medical care, may be some money for repayment of debt or building a house for living etc. India has introduced NPS in the form of Defined Contribution Pension and all the attention has been focused on Fund Management , Collection etc, , though Pay out phase is the core to the survival and success of NPS.

The main forms of pay outs in DC Pension system are Lump-sum Payments, Programme Withdrawal, and Life Annuity. Each of these options have strength and weaknesses. However a general trend is to have a combination of two or three options. However, Life

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Table -1: In force Annuity & Pension Policies under non linked Life & Annuity business

	2004-05	2005-06	2006-07	2007-08
A.In force Policies('000)				
(i) Life Assurance	165359	183109	194164	198168
(ii)Annuity & Pension	3114	3186	3193	3135
(iii) Annuity as % Life Assurance	1.80	1.73	1.64	1.58
B. Sum Assured & Bonus (Rs in crore)				
(i) Life Assurance	1133136	1374364	1513876	1620876
(ii)Annuity & Pension	681	68425	91557	51867
(iii) Annuity as % Life Assurance	6.0	5.0	6.0	3.2

(Source: Annual Report, IRDA, 2005-06, 2006-07, 2007-08)

Annuity has become the most accepted pay out method world over. But pay out through annuitization is a critical business because of unlimited amount of risks involved in annuity payment which arises out mortality and demographic risk due to improved mortality.

Mortality forecasting to assess enhanced longevity which could guide the annuity providers to assess long term risks often prove wrong. The problem is further compounded by undeveloped long term securities market to invest retirement savings by the annuity providers. Therefore there is an indifference even among the licensed annuity providers to sale annuity products eg in UK of around 240 authorised life companies in 1999 , only about 10 are at any time serious providers of life annuity in Argentina out of 217 , only 21 companies were doing purely retirement business companies in 2001.

Pay outs in NPS: The Government of India has introduced New Pension System (NPS) in January 2004 which is mandatory for employees joining services wef January 2004. NPS has been extended to all citizens as a voluntary pension wef 1 May 2009. However two different types of pay out mechanisms have been introduced by PFRDA

Pay out in NPS for Central Govt Employees: At the time of retirement / age of 60, when accumulation period ends an employee has the option to invest at least 40% accumulated wealth in purchasing an annuity plan from a life insurance company approved by IRDA and to take maximum 60% of as lump sum.

Pay out in NPS for all citizens: Voluntary NPS allows an investor, withdraw before age 60 at any point of time but has to invest at least 80% of accumulated wealth to purchase an annuity from a life insurance company approved by IRDA and 20% as lump sum withdrawal.

However, under voluntary NPS , when an investor exit at the age 60 from the system has to invest at least 40% of wealth in annuity and the remaining amount can be withdrawn as lump or as a phased withdrawal between the age 60 and 70 This Phased withdrawal is an additional facilities in voluntary NPS.

Mandatory Annuitization and Implementation Constraints: India has introduced partially mandatory annuitization programme in the post accumulation period to provide regular retirement income to the pension investors. Mandatory annuitization has several advantages. It forces the employees to invest full or a part of accumulated savings to ensure regular income during retirement period, reduce the risk arising from unwise spending of accumulated funds and thus to face adverse financial consequence, it enables the employees to transfer mortality and in some cases market risks to the annuity providers. It also works on insurance principles of pooling risks and providing avenues for low cost risk management.

However several institutional constraints come in the way of efficient implementation of annuity programme. Most significant are: Constraints related to annuity service providers such as Adverse selection and Financial Risks. Adverse selection risks are mortality and longevity risks arises from those who volunteer to purchase annuity are people who believe that they would live longer. Further continued improvement in mortality, which an insurance company unable capture fully also a risk factor. Financial Risks arising out of Inflation Risk, Investment Risk, Reinvestment Risk. Shortage of long term financial instruments to hedge long term due to these factors.

Market related constraints include absence of sufficient number of annuity provides with sound track record and experience in managing annuity business, absence of annuity products to serve a cross section of investors having different level of risks and to serve different retirement income etc. These constraints

Table 2: General Annuity & Pension Business (Non Linked)

	No of Policies ('000)		Sum Assured (Rs Crore)	
	01-04-07	31-03-08	01-04-07	31-03-08
A. Private Sector				
Bajaj AZ Life	6	7	239	226
HDFC Standard Life	74	75	1485	1434
ICICI Pru Life	53	55	559	1538
ING Vysa Life	38	44	NA	NA
Kotak OM Life	6	6	260	248
Max NY Life	8	7	157	145
Met Life	1	1	15	145
SBI Life	77	92	331	526
TATA AIG Life	22	21	475	460
Total Private Sector	284	306	4530	4598
B. Public Sector				
LIC of India	2909	2829	87027	47269
C. Total (A+B)	3193	3135	91557	51867

Source : Annual Report, IRDA, 2005-06, 2006-07, 2007-08 need careful attention of policy makers and regulators.

Annuity Market in India: Till the opening of life insurance industry to the private sector, LIC of India was the only provider of life annuity. After the life insurance market was opened up in 2000, private companies entered the life insurance business and started launching pension and annuity products, though LIC remained the major and dominant player in the market. At the time of nationalization of life insurance business there was hardly any annuity business. The first Annual Report of LIC for the period September 1956 to Dece mber 1957 , total annual payment of Rs 9.95 lakhs under 575 annuities. Since then Indian life insurance industry traveled a long way , witnessed a significant growth in life insurance business, moved from monopoly to competitive market environment, but the annuity market remained virtually non starter and dormant, when compared with growth of life insurance industry.

An analysis of in force non linked life assurance and annuity policies which includes pension policies would indicate that annuity business indicate that annuity market remain dormant in spite of tremendous market potential in absence of universal social security and insignificant coverage by formal pension system. It is alarming to note that non linked pension and annuity policies as a percentage of life assurance has significantly declined from 1.80% in 2004-05 to 1.58% in 2007-08 .

Life Insurance Corporation of India with over 90% in annuity sum assured and 90% in policies dominate the annuity. Data in table- 2, on in force non linked pension and annuity would reveal the relative position of LIC and other private companies. With the entry of private sector companies market share of LIC in the annuity market has declined, yet it is the major provider of annuity. Though the market share of private sector life insurance companies in assurance business increasing since their entry, not many of them launched Annuity plans and LIC is still fulfilling the annuity demand in the market, though it is more risky and less lucrative insurance business.

Why Annuity business is not growing in India?

In addition to the institutional constraints mentioned earlier the growth of annuity market was hampered by the following factors in India.

Over emphasis on ULIP business: Whatever may be the reasons, Indian life insurance companies focused more on unit linked pension rather than annuity products.

Reduced Tax incentives: Since 1992, tax incentives for investment in gradually became unattractive. During 1987-92, annuity investment attracted tax incentives under section 88 of the income tax act 1969 was available. Under section 88, entire premium amount paid for annuity plans were fully exempted for income tax. Tax benefits under section 88 was withdrawn from 1992 onwards and there was a decline in sales of annuity policies by LIC. Subsequently tax incentives under section 80CCA was introduced and exemption was available for annuity/pension investing but restricted up to Rs 10000 only. This benefits was available up to 2005-06 . Even this was withdrawn subsequently. At present tax incentives available, under section 80CCC, which seems to be unattractive . During 1987-92 LIC launched Jeevan Dhara , Jeevan Akshay and Jeevan Suraksha with huge market response. Even under 80CCA tax regime LICs annuity plans like New Jeevan Dhara , New Jeevan Akshay, New Jeevan Suraksha and Jeevan Nidhi was quite well received.

Narrow Product Market: Indian annuity market is quite narrow in respect of product range, most plans launched are participating and non participating Deferred Annuities. Immediate annuities are few and mostly launched by LIC. This trend noted in terms of annuity pay out of LIC . Deferred annuity as percent of total annuity payment was 55.2% in 2000, 91% in 2002 and 72.13 % in 2003. In developed market a new generation annuity products are available for retirement investing, namely Variable Annuity , Equity Indexed Annuity, Inflation Indexed Annuity, Impared Annuity , Enhance Annuity, in addition to Fixed and Guaranteed Annuity

A Proposal for Annuity Development Programme (ADP)

Success of New Pension System in India would be significantly determined by effective and efficient implementation of annuity programme. This can, however, happen if actions are initiated in a cohesive and strategic manner under a broad Annuity Development Programme (ADP) with a holistic view. A broad outline of such a programme provided below:

Annuity Providers: One of the most important aspects of Annuity programme is to decide who should be the annuity providers. While deciding the annuity providers, a caution is called for since many life insurance companies may not have necessary experience and required solvency capital and risk management experience to protect retirement capital of the annuitant. Therefore, a selectivity criteria may be followed to authorize life insurance companies to sell retirement annuity. In most of the countries abroad a license is required to sell retirement annuity eg Life insurance companies need to obtain a authorization license from the regulator to sell retirement annuity in UK, Chile, Mexico, Uruguay etc . For selection certain criteria like experience in annuity business (say min 10 years), profit earning records (say min. 10 years), risk capital base (need special provision), claims settlement experience, certain technical and financial criteria etc to be fixed for such authorization.

Annuity Products: Certain guidance are required to ensure that the pension investors do not go for wrong in selecting an annuity and put their retirement income at stake. The most crucial objectives of an annuity is to transfer longevity risk to annuity providers, ensure regular and guaranteed income The importance of such guidance become essential because of low level financial literacy in India. More over, need and risk tolerance of pension investors in the post accumulation phase differ with their savings and financial position.

In this respect the experience of some

countries abroad may be of help to us. For example, Argentina law restrict the choice of annuity products only to a Joint and Survivor annuity certain benefits. In Brazil, annuities paid by life insurance companies are basically escalating annuities with revaluation at least equal to inflation. In Chile, only indexed annuities with death benefits are allowed as pension annuities. In Mexico, Consumer Price Index linked life annuity can be offered as retirement annuity.

Cost/Pricing of Annuity Products: Pricing has a significant implications on retirement payment through annuity. Pricing is a complex matter and an annuity providers consider several long term aspects related to the cost of annuity service and various kinds of risk associated with pricing. Distorted market forecasting, interest rate scenario, mortality forecasting, longevity of particular group may create an imbalance between imbedded value and imbedded cost.

Tax incentives: Tax incentives play an important role in annuity market development. The Government should consider this aspect and introduce liberal tax regime for annuity market as it does to promote some other sectors of economy.

Capital Market instruments: One of the reasons of under development of annuity market is the absence required long term debt instruments to hedge future capital market risks. Indian debt market yet to develop to support the requirement of long term instruments for an emerging pension industry like ours. In many develop market , financial innovations are taking place and supply of long term instruments like Deferred Income Government Security, Limited Price Index Bonds, Inflation indexed Bonds , Survivor Bonds etc are proposed and available.

Timing Risk: Mandatory annuitization suffers from timing risk, which arises due to strictly stipulated timing of annuitization. For example NPS mandated annuitization of at least 40% accumulated amount at the time of exit / retirement by an investors. However, market at that point of time may not be favourable and the price of annuity may be high resulting into lower regular income during the rest of the life of the annuitant.

The problems of timing can be tackled by introducing Flexibility in Annuity Entry. For example, instead of mandatory purchase of annuity at the time of retirement, an employee may be allowed to by annuity within a given Annuity Time Range (ATR) period according to her/his choice. If an employee retire at the age of 60, she / he may be allowed to purchase annuity from age 55-60, with staggered vesting age. Thus an employee can take advantages of market movement and purchase, required annuity at a price beneficial to her/him.

These are only few of the many issues need to be carefully considered for developing an annuity market and promoting a well meaning annuity programe for NPS. To design, a meaningful annuity programme active initiatives and participation of all the regulators of Financial sector are required, since it involved a whole range of issues like regulating annuity business in pension pay outs phase , designing annuity products , designing new financial instruments , overseeing the interest of pensioners in post accumulation period etc.

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Pension Power

The pension market in India has huge potentials

Opening up the New Pension Scheme (NPS) for the unorganized sector and almost taking the final step to usher in the new pension scheme in the country, Pension Fun Regulatory & Development Authority (PFRDA), after two rounds of bidding, selected six players as pension fund managers for tapping resources for pension.

PFRDA, which had earlier short-listed 15 leading players which either have life insurance or mutual fund business, has finally zeroed on six players on the basis of the lowest fund management cost.

The players which have been chosen are Reliance MF, ICICI Prudential Life Insurance, IDFC MF, SBI Pension Fund, Kotak MF and UTI MF.

UTI MF quoted the lowest price of Rs 9 for managing Rs 10 lakh which will be cost of managing funds for the NPS.

UK Sinha, chairman & managing director, UTI AMC, said the earlier biddings for EPFO funds which were quite low had already set some kind of a benchmark for the cost of managing pension funds.

“Somewhere, we never wanted to take any chance this time after witnessing the criteria for selecting the fund managers for EPFO finds and had quoted competitive pricing. I think this kind of cost to manage NPS funds may be unremunerative,” he said.

However, he said the cost structure managing NPS money may set a benchmark for other fund management businesses as well as life insurance and mutual fund companies.

Sinha said it was high time for PFRDA to popularize and raise awareness about the NPS so that the common man could take advantage of the new system.

Unlike the life insurance industry, the