Pension Industry in India

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Much has been written about the demographic dividend of India. We have one of the youngest populations in the world, which properly harnessed, will take India to the top notches of developed nation. However, this demographic advantage will start graying from about next 25 years onward and then this segment, which would have contributed to the national prosperity, will require old age security. We should learn from the current travails of the various economies, which are now grappling with the issues of old age care and institutionalize an effective pension system in place in our country.

Old age security is the uniform concern, from the times immemorial, of any civilization in world and has found many society specific solutions. Indian joint family system is a unique example of providing old age security. With changing social norms, nuclear families are replacing joint families of yesteryears. This calls for a different model of old age security and this is where we need a Pension framework supported by a robust Pension Fund industry. The classical Pension Architecture is based on three pillars:

Pillar-1: Public pensions
Pillar-2: Occupational pensions
Pillar-3: Personal pensions

The first pillar is an anti-poverty pillar that is noncontributory and guarantees a minimum income in old age. This is normally funded by the State and is noncontributory. The other two pillars are contributory. The second is a forced savings pillar that provides benefits only to contributors, and, in general, provides the most benefits to those who contribute most. Pillar 3 is a voluntary savings pillar, available to anyone who cares to supplement the retirement income provided by the first two pillars. In practical situation, hybridization of these pillars occurs in most of the countries. Pension Industry, worldwide, is the largest in fund mobilization. As per a recent study, the AUM for the 13 major Pension markets is about US $ 32 Trillion with the US market itself account for about 59% of its share (US$ 18.9 Trillions). South America, especially Chile leads in Pension reforms and successfully running an effective pension system.

India has been a late starter in the field of Pension Reforms. A universal Pillar I pension providing a country-wide social security system is present only in parts scattered over various schemes. The coverage in the organized sector is about 12% of the working population. The Pillar II, representing auto enrolment covers the Government Employees and certain PSUs, especially the Banks and those covered by the EPFO Act. A large number of companies and organizations also run their own superannuation fund, which also form part of Pillar II. Introduction of NPS has put a real pension product in the Indian markets for Pillar III.

Pension Reforms in India were also a result of the fiscal stress caused by burgeoning Pension Bill of the Government Employees, who were hitherto covered under the 'defined benefit' system. The Government of India initiated the pension reforms in right earnest in the year 2004, when PFRDA was constituted as an interim regulatory body for the pension sector in India. PFRDA was also mandated by the Government of India to implement the National Pension System (NPS), a 'Defined Contribution' scheme, initially for the new entrants to Central Government services, excepting the Armed Forces; and later extended to the State Governments and the all citizens of the country. The PFRDA Act was finally passed by the Indian parliament in the year 2013, thereby giving statutory powers to the interim body.

A distinct feature of the current Indian Pension market is that there is no single regulatory structure for all the players. The PFRDA Act 2013 provides for exemption for certain bodies, notably (*i*) the Coal Mines Provident Fund and Miscellaneous Provisions Act, 1948; (*ii*) the Employees' Provident Funds and Miscellaneous Provisions Act, 1952; (*iii*) the Seamen's Provident Fund Act, 1966; (*iv*) the Assam Tea Plantations Provident Fund and Pension Fund Scheme Act, 1955; and (*v*) the Jammu and Kashmir Employees' Provident Funds Act, 1961. These exemptions take out a very large corpus of superannuation funds from the ambit of regulatory supervision of PFRDA.

A number of differing estimates have been made for the size of Indian Pension market – both for the current size and the future estimates. Helene K. Poirson of IMF, in his paper of April 2007 estimates that Indian retirement market will grow from Rs 1.5 lac crore in 2010 to Rs 4 lac crore in 2025. Estimates of FICCI-KPMG report of April 2007 indicates that the market will grow from Rs 56,100 crore to Rs 4.06 lac crore in 2025. Study of the industry body ASSOCHAM estimates that the market will grow from the present level of about Rs 15.4 lakh crore to about Rs 20 lakh crore by 2015. This underscores the need for a detailed and authoritative study on the Indian Pension Market characteristics, size, market segment and their needs, growth strategies etc. This study can be undertaken with the active involvement of PFRDA,

Government, industry & the various reputed specialized institutions.

Normally, the Pension Regulators, in other international jurisdictions have regulation and development functions. However, in respect of Indian Pension sector, National Pension System (NPS) has been mandated by the PFRDA Act with its basic features and key components detailed in the Act. As per the Act, PFRDA's function is to register intermediaries for the Pension Sector as well as appoint intermediaries for the NPS, thereby introducing a high element of operational role for PFRDA vis-à-vis NPS. The NPS follows an Unbundled Architecture, which implies that all the intermediaries are not appointed by the Fund Manager, unlike in the MF industry, where the AMC selects all the intermediaries and offers a 'bundled' product to the investors. In NPS, each intermediary is separately appointed by PFRDA and charges separately, hence the subscriber has multiple charges – Fee of the Fund Manager; fee of Point of Presence (PoP), which accepts the applications / subscription amount; and fee of the Record Keeping agency. The unbundled architecture is in line with international practice followed by many countries, especially in Latin American countries. 401(k) plans of the US also have this feature.

The current corpus of NPS exceeds Rs. 50 thousand crore with more than 67 lac subscribers. There are two distinct categories of subscribers to NPS, based on mode of contribution – Compulsory or auto enrolment in NPS and voluntary enrolment. The former category consists of employees of Central & State Government employees, Central & State Government autonomous bodies, PSU Bank employees and very few private sector corporates.

The segment of subscriber with voluntary contribution is a large untapped segment – both in terms of numbers as well as many affluent segments like the professionals with large surplus investible income. The current unbundled structure of NPS raises 'subscriber ownership' issues as this segment has to be persuaded to invest, thereby making NPS a Push product for this segment. Unbundled Architecture is a loose structure, in-so-far as consumer focus is concerned, an essential pre-requisite for 'Push' products. In the entire Architecture, it is the Pension Fund Manager (PFM), which has the maximum stake and therefore, PFM has to be the pivot for marketing for the voluntary contribution segment of subscribers to NPS. Currently, the framework of NPS does not permit the PFMs to directly undertake marketing or act as a PoP; they are required to float a separate subsidiary for marketing and have to tie up with PoPs. This structure has been prompted by concerns on mis-selling by the PFM; however, this does not address the basic issue of development of the sector in the voluntary segment, where the growth has still not taken off.

There has been an understandable sensitivity on issues of various Costs of NPS, insofar as it involves a corpus earmarked for old age security. There is a view that auction at periodic intervals is the best for selection of PFMs through competitive bidding for ensuring and maintaining low fee. As against this, there is a different view that PFMs should have an ongoing registration process with flexibility to charge fee subject to a cap being fixed by the regulator. There are plusses and minuses in both the alternative.

Auction at periodic intervals can be the most efficient for discovering lowest price, thereby giving an ostensible advantage for the subscribers but it does suffers from certain pitfalls like predatory pricing, which may lead to monopoly by a single or few players. Auction route to determine fee / commission, is also not followed in any other comparable finance sector industry like Mutual Fund, Insurance and even Banking. In all such industries, the regulator fixes a cap on the fee. The rationale is that market forces will determine the correct level of fee, in other words, the market does operate an ongoing 'auction' for fee, thereby adjusting the same to the demand.

Pension is a long term product with tenures in the range of 20 to 40 years, limiting the tenure of a PFM through auction, therefore, may not be in the best interest of subscribers because if a particular PFM does not succeed at the next round of bidding than its subscribers will have to shift to another player. PFMs, presently, are single product companies and fund management is a highly sophisticated and skill intensive industry with high salary levels. Setting up a PFM company, working to the highest professional standards to ensure best returns and safety of Pension Funds; will be highly capital intensive. Therefore, in all fairness, PFMs should be assured of continuity of operations for delivering results. Low level of fees can also tempt the PFMs to cut corner and save cost, which affects the subscribers' interest in the long term.

The major issue in fixing fee cap is the fear of overcharging the subscriber. The current cap of 0.25% per annum of AUM in the private sector pension industry is nowhere near the levels of fee in MF & insurance industry. An important measure of cost of a Pension scheme is 'Charge ratio'; normally calculated over a 40 year period. As per a recent study done by OECD, *Private Sector NPS Scheme is the second lowest cost product in the world* with a charge ratio of 6.54% over a forty year period calculations. The charge ratio for some other international jurisdictions goes even higher than 50%.

A possible solution will lie in recognizing the difference in marketing effort involved in Auto (Compulsory) and Voluntary enrolment in NPS, where higher marketing effort is required. In case of Govt. Employees, the fee is already set by the auction process. There may be a case for fixing differential fee cap for the Auto Enrolment & Voluntary Enrolment segments in the private sector NPS.

We should now adopt a multi-pronged strategy to accelerate the growth of Pension sector in India. There is a need to take a relook at the structure of various products under NPS. The scheme has been kept quite simple; however, there is a room for improvement in the

bouquet of the NPS products. Based on consumer preferences and requirements, Separate NPS Products may be required for Auto Enrolment and Voluntary Subscriber in NPS. In fact the need of Auto enrolment subscribers in Government, public and private sector may also be different.

PFM is the entity in the entire architecture with a maximum stake in growth of AUM, therefore, the solution is not to deny marketing role to PFMs on the apprehensions of mis-selling but to have effective guidelines for marketing, stringent supervision and swift penalization in cases of violations. Marketing of NPS will be key to its growth till such times, it remain a voluntary product for a large segment of the population. The Youngsters of today and for that matter those of older vintage also, do not have a propensity to make long term saving. The belief is to live a full life today and future will take care of itself somehow. With such a philosophy of life, it is not surprising that making compulsory long term savings, which are locked up for 20 year plus, is the last priority, mostly put off for another day. In such a scenario a massive marketing effort is needed to bring the youngsters to the fold of pension plans. As a long term strategy, a variant of auto enrolment may be brought in by making legislative changes to make auto enrolment in certain specified pension plans, compulsory for all employees of all establishment with say more than 50 staff.

The regulator and the industry also need to plan beyond NPS. India is a large market and there is a need for a larger range of products under the NPS umbrella as well as other tailor made products by the PFMs – covering both unbundled & bundled architecture. This will go a long way in growth and expansion of the pension market in India. At some stage in future, there is a case for extending the Pension regulatory framework to the funds, which are currently exempted under the PFRDA Act. This will require some imaginative thinking and planning with all the stakeholder, including the concerned ministries and entities and PFRDA working together – the basic objective being improving returns and security of the subscribers of these funds

The Pension sector in India is the sunrise industry in the financial sector and going by the precedent of world pension industry, there is no reason as to why the Indian pension industry should not emerge as the largest player in the Indian financial markets in the coming decade. The growth of the NPS scheme, so far, has been rapid, but, given the size of our working population, the potential for this sector is unlimited making Pension industry as sunrise sector in the country. Like all sunrise industries, Pension sector in India is also been having its own share of multiple issues and startup hiccups. A very rough analogy would be the telecom industry in India in its earlier days – everyone appreciated the immense potential of the telecom sector but kick starting growth was a very painful and long process and required immense innovation & out of box thinking by the industry and sustained positive support by the government. Pension Industry in India requires a similar treatment to become the top financial sector industry in the country. The Telecom Industry has played a leading role in all spheres of life, be it social development or facilitating expansion of our economy, similarly Pension Industry, worldwide, contributes to nation building. Pension industry in India will be fulfilling two fold objectives of providing old age security as well contributing in the nation building initiatives. The long term funds of Pension Industry will be an important source of financing for long gestation project, especially in the infrastructure sector. A rapid growth of the Indian Pension industry is, therefore, a key requisite for all round accelerated growth of Indian economy.