India is aging. One response of Indian policy makers has been the introduction of the New Pension Scheme (NPS), a defined contribution pension scheme which is mandatory for civil servants and voluntary for the rest of the population. Given the size of the target population, even if take-up is modest, NPS savings may soon provide huge amounts of capital to India’s economy. However, challenges abound. What governance structure will best achieve the ultimate policy goal of serving the needs of savers? What business processes and information technology design will serve members best? How effectively will the NPS attack the problem of old-age poverty?

In this book, a multi-disciplinary international team, comprising economists, lawyers, pension management experts, and capital market experts, explore these and other questions. The book proposes significant legal, regulatory, and governance reforms for the NPS and other existing pension schemes, as well. It finds that current NPS business practices cannot keep pace with potential growth of the system and makes suggestions on how to take better advantage of information technology. Based on a review of experience elsewhere and state-of-the-art economic-demographic modeling, it warns that the NPS in its current form does not address the retirement income needs of the lifelong very poor, suggesting that it is only one in a range of responses needed to cope with the challenges of population aging in India.

Cheolsu Kim, an economist, is currently lead financial sector specialist, South Asia Department at the Asian Development Bank (ADB), Manila, Philippines. He has served various posts in ADB, including in the India Resident Mission and the Private Sector Operations Department where he was responsible for financial sector and capital markets development and reforms in various developing member countries.

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Implementing an Inclusive and Equitable Pension Reform

Lessons from India’s New Pension Scheme

Cheolsu Kim, Landis MacKellar, Russell G. Galer, and Gautam Bhardwaj

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Foreword

The Government of India is at the forefront of pension reform in the South Asia Region. The pension reform drive originally stemmed from ballooning unfunded pension liabilities under the defined benefit system for civil servants, which was not fiscally sustainable for both central and state governments. The occupational pension system currently in place for civil servants and salaried employees in the private sector covers barely 14% of India’s paid workforce. Most of India’s workforce is employed in the unorganized or informal sector, and are excluded from the benefits of a regulated retirement income arrangement.

Though the Indian population is still relatively young, it is aging at an accelerating rate. Data from an Asian Development Bank (ADB)-funded national household-level retirement, incomes, and savings survey conducted with the Indian Ministry of Finance and the Pension Fund Regulatory and Development Authority (PFRDA) in 2005, clearly demonstrates a high level of anxiety among unorganized sector workers in India about their old age security, as well as increasing uncertainty about support in old age from their children. The rapid growth in nuclear families that are now the norm in India, an increasingly mobile workforce, and expanding urbanization of the population suggests that this assessment is in all probability accurate. Unlike in the past therefore, Indians, as also informal sector workers in other developing economies, increasingly will need to self-provide for their own retirement.

Fortunately, India’s deep financial markets, strong economic growth, and rising incomes allow the government to redirect pension policy now, in the hope of mitigating future fiscal problems which will otherwise arise. The country can also take advantage of this opportunity to expand the coverage of the old-age income security system for workers in the unorganized sector.

In 2004, the government of India took the first steps towards establishing a self-sustaining and broad-based pension system for the country when it moved away from unfunded defined benefit pensions for government employees in favor of a contributory arrangement. The New Pension Scheme (NPS) is a defined contribution, individual accounts-based pension program that is mandatory for civil servants. In 2009, the NPS was made available to all other Indian citizens including informal sector workers on a voluntary basis. The success of the NPS ultimately depends on the level of voluntary participation it can mobilize,
which in turn will be determined by public awareness and confidence, savings capacity, and the willingness of individual subscribers to make pension contributions over a long-term horizon. The credibility of the system and its appeal to prospective subscribers is contingent on its design, management, infrastructure, regulation, and supervision – tasks that are housed at PFRDA, India’s new pension sector regulator. This book includes a unique field-based analysis of these issues.

Even with growth of the NPS, existing and reformed occupational pension schemes will continue to play an important role in India. This book therefore devotes attention to these established instruments, as well as the NPS.

Going forward, the importance of establishing a vibrant pension sector cannot be underestimated. Doing that, and doing it well, will be one of the determinants of the health and stability of India’s capital markets because of the boost in long-term savings that pension contributions bring. Importantly, capital markets can make a very significant contribution to producing high real returns and converting modest savings into meaningful retirement incomes in order to reduce longevity risk, especially for low-income informal sector workers with modest, intermittent incomes. Therefore, this book includes comprehensive legal and regulatory and demographic and economic analysis.

I am confident that the findings and policy recommendations included in this book will assist policy makers and pension practitioners in the South Asia Region and elsewhere to devise inclusive, equitable, and sustainable pension policies, products and infrastructure to meaningfully address the income security needs of an aging population. As such, this book can be a valuable resource to address old-age poverty, particularly among informal sector workers.

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Acknowledgments

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Our shared vision of promoting pension reform as a tool to enhance the financial inclusion of informal sector workers was the catalyst for this project.

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Acronyms and abbreviations

ADB  Asian Development Bank
AFP  Administradora de Fondos de Pensiones (Pension Funds Administrators)
AMC  Asset management company
BJP  Bhartiya Janta Party
CBDT  Central Board of Direct Taxes
CDS  current daily status
CGMS  CRA Central Grievance Management System
CPFC  Central Provident Fund Commissioner
CRA  central record-keeping agency
CRIISP  Committee to Review Implementation of Informal Sector Pension
CWS  current weekly status
DB  defined benefit
DC  defined contribution
DDOs  Drawing and Disbursing Offices
DEA  Department of Economic Affairs, Ministry of Finance, Government of India
DEMAT  Dematerialized Account
DFS  Department of Financial Services, Ministry of Finance, Government of India
EAG  Expert Advisory Group
E0  life expectancy at birth
EDLI Scheme Employees’ Deposit Linked Insurance Scheme
EDMS  Electronic Document Management System
EEE  “Exempt-Exempt-Exempt”
EET  “Exempt-Exempt-Taxable”
EOIs  Expressions of Interest
EPF  Employees’ Provident Fund
EPFO  Employees’ Provident Fund Organization
EPIP  Export Promotion Industrial Park
EPS  Employees’ Pension Scheme
FGDs  Focus Group Discussions
Acronyms and abbreviations

FPU  File Processing Utility
FVU  File Validation Utility
GDP  gross domestic product
GOI  Government of India
GRC  Grievance Resource Cell
HRTC Himachal Road Transport Corporation
HSA  Hemant Sahai Associates
IMPS Invest India Micro Pension Services
IFA  Individual Financial Advisors
IMR  Infant Mortality Rate
IPD  implicit pension debt
IRDA  Insurance Regulatory and Development Authority
IT  information technology
ITA  Indian Trusts Act, 1882
ITAct  The Income Tax Act, 1961
KIOC  Kudremukh Iron Ore Company Ltd
KPCARDB Kangra Primary Co-operative Agriculture and Rural Development Bank Ltd
KYC  Know Your Customer
LIC  Life Insurance Corporation of India
MCC Mangalore City Corporation
MCF  Mangalore Chemical and Fertilizers Ltd
MFI  micro-finance institution
MIS  management information system
MRP  Mangalore Refinery and Petrochemicals Ltd
NAV  net asset value
NBFC  non-bank financial company
NCIS  NPS Contribution Instruction Slip
NGO  nongovernmental organization
NPS  New Pension Scheme
NPSCAN  NPS Contribution Accounting Network
NREG  National Rural Employment Guarantee
NSDL  National Securities Depository Limited
NSE-NCFM  National Stock Exchange of India—Certification in Financial Markets
PAO  Payment Account Office
PFMs  pension fund managers
PFMCs  pension fund management companies
PFRDA  Pension Fund Regulatory and Development Authority
PGA  Payment of Gratuity Act, 1972
POP  Point of Presence
POP-SP  Point of Presence—Service Provider
PPF  Public Provident Fund
PRAN  Personal Retirement Account Number
RBI  Reserve Bank of India
RFPs  Request for Proposals
RPFC  Regional Provident Fund Commissioner
Rs   rupee
SEBI  Securities and Exchange Board of India
SEZ   Special Economic Zone
SHCIL Stock Holding Corporation of India Limited
SHG   self-help group
SRS   Sample Registration System
TA    Technical Assistance
TFR   Total Fertility Rate
UN    United Nations
UPS   usual principal activity status
UPSS  usual principal and subsidiary status
UVOPSS unregulated voluntary occupational pension schemes
WHOSIS World Health Organization Statistical Information System
Part I

Introduction, background, and context
1 Introduction

Less than 14% of India’s 321 million paid workforce is covered by formal retirement programs. Traditionally, access to retirement savings arrangements in India has been restricted to salaried employees of the federal and state governments and of larger private and public sector companies. Most of India’s workforce is employed in the informal or unorganized sector and does not have an “employer” and is therefore excluded from access to formal retirement programs.

The roughly 26 million federal and state government employees are covered by a tax-funded, wage- and inflation-indexed, defined benefit pension program that provides a 50% replacement wage at retirement. The annual fiscal cost of this traditional civil service pension program has grown from less than $0.5 billion in the mid-1980s to nearly $30 billion today. By 2006, the civil service pension program had resulted in an estimated implicit pension debt (IPD) of over $600 billion.

India also has a number of mandatory and voluntary retirement benefit programs established by employers for private and public sector salaried employees. About 20 million salaried workers contribute nearly a quarter of their annual wages towards their retirement on a mandatory basis through these programs. These savings are publicly managed and administered by the Employees’ Provident Fund Organization (EPFO) under the Indian Ministry of Labour and Employment. Around 2,700 employers additionally offer voluntary superannuation, pension, and provident fund benefits to employees who are excluded by legislated, mandatory retirement programs delivered by the EPFO.

On 1 January 2004, faced by the growing fiscal cost of civil service pension payments and the huge pension coverage gap, the Government of India embarked on an ambitious pension reform agenda. India’s pension reform aimed at replacing the traditional defined benefit civil service pension scheme with a defined contribution New Pension Scheme (NPS) for new government employees and to cover India’s 284 million unorganized sector paid workers under the same scheme on a voluntary basis over time. Simultaneously, the Government notified the Pension Fund Regulatory and Development Authority (PFRDA) to establish the NPS administrative and institutional architecture and to regulate NPS service providers.

A key policy objective of the NPS is to achieve broad-based social protection to reduce vulnerability in old age for India’s unorganized sector workers.
Concomitantly, the arrangements are expected to reduce potential future budgetary pressures by increasing self-provision, contribute to economic growth by increasing aggregate long-term savings, provide greater depth and liquidity in Indian financial markets, facilitate labor mobility through fully-vested portable pension accounts, and help in the fight against old-age poverty. By August 13, 2011, 1.62 million new government employees who joined service on or after 1 January 2004 were enrolled under the NPS on a mandatory basis.²

In August 2008, the Indian Ministry of Finance instructed the PFRDA to extend the NPS to all Indian citizens, including informal sector workers on a voluntary basis, with a view to achieve a unified pension arrangement that is mandatory for government employees and voluntary for others. The PFRDA has put in place the necessary institutional capacity by outsourcing the administrative tasks associated with the NPS to the commercial sector under a system of licensing and registration arrangements. In this process, the PFRDA appointed the National Securities Depository Limited (NSDL) to serve as the central record-keeping agency (CRA) for both mandatory and voluntary NPS accounts and appointed six private and public sector pension fund management companies (PFMCs) sponsored by regulated financial institutions to manage the voluntary retirement contributions to NPS. The PFRDA has also established the NPS Trust (under the Indian Trusts Act, 1882) and appointed a board of trustees. To date, 35 banks and third-party distributors have been appointed by PFRDA as Point of Presence (POP) for NPS. These 35 POP institutions have established 12,226 Service Provider (POP-SP) outlets responsible for enabling enrollments and public interface with the NPS. As on September 03, 2011, 55,611 application forms for the voluntary NPS were collected by these POP-SP branches.³

The degree to which the NPS fulfills the government’s public policy objectives and bridges India’s pension coverage gap will depend in large part on the level of voluntary participation that is achieved by the scheme. The size of the private pensions market that is achieved among unorganized sector workers will depend fundamentally on public awareness and the financial capacities and willingness of workers to defer current consumption in favor of old-age income security over a multiple-decade savings horizon. International experience from Asia, analyzed in this book, however, suggests caution. Voluntary retirement saving plans for the informal sector elsewhere in the region have not achieved the coverage that is being attempted by the NPS.

However, two pan-India household surveys—the Indian Retirement, Savings and Earnings Survey, 2005, commissioned by the Asian Development Bank and the Indian Ministry of Finance, and the subsequent Invest India Incomes and Savings Survey, 2007—estimated that there is substantial demand for private pensions; that India’s private pension market could achieve aggregate savings as high as US$300 billion by 2019–2020. This potential can be reached, however, only if there is a marked change in behavior. Due to the absence of a broad-based retirement savings program, a majority of India’s informal sector workers have given no thought to their retirement needs, including more than half of those over 40 years old and for whom old age income security should be a pressing issue.
Part of the explanation is that over a third of these workers expect their children to support them when they are no longer able to work. This strategy is risky at best since traditional reliance of the elderly in India on children and extended families for old-age income support is being rapidly eroded by labor mobility and economic hardship. This presents a bleak outlook for the next generation of India’s elderly and suggests that old age poverty will continue to be an intractable public policy challenge for India.

To address old-age poverty effectively, the PFRDA will therefore need to resolve a range of challenges, including financial illiteracy, sustained and adequate voluntary contributions, structure and adequacy of commercial incentives for service providers, market-linked investment returns and volatility risk (not unrelated to governance), longevity risk in the face of mortality improvements, and exit rules including mandatory annuitization. The experience with the voluntary NPS coverage also suggests that broad-based access will need to be dovetailed with a nation-wide promotions and public education campaign, and active field-level implementation management and monitoring by the PFRDA.

Whatever the success of the NPS in providing pension coverage for the unorganized sector, existing occupational schemes will continue to play a vital role. The current compulsory pension programs in which organized sector employers and their employees are required to participate, as well as supplemental schemes which employers may establish on a voluntary basis, will remain the key manner in which the government intends to provide for the retirement income security of the organized segment of the Indian workforce. Whether policy objectives are attained for organized workers thus relies on the extent to which the compulsory and supplemental schemes are properly designed, managed, and regulated. Particular concern has been expressed about the extent to which the voluntary occupational schemes are regulated and supervised. As this study evolved, it became clear to us that a thorough analysis of the existing occupational schemes was needed.

This book aims to support Indian pension policy makers in (i) developing a national implementation strategy for NPS that will achieve broad-based voluntary coverage among informal sector workers across geographical, income, and occupational segments, and (ii) establishing an effective and uniform regulatory environment for voluntary occupational pension schemes, including provident funds, pension schemes, and similar schemes established by private sector employers for their employees. It is based on a broad and multidisciplinary effort involving legal and regulatory analysis, field work on marketing and business practices including information technology, and advanced economic and demographic modeling.

Part I of this book contains the introduction (Chapter 1) and presents the demographic and economic background context, especially as they relate to the labor market.

Part II analyzes the NPS from an institutional, legal, and regulatory point of view. Chapter 3 describes various aspects of the ongoing NPS reform designed to supplement existing arrangements and thereby provide pension coverage for the
unorganized sector. Chapters 4 and 5 present analysis, findings, and recommendations addressing weaknesses in product design, regulation, and governance.

Part III deals with communications, marketing, and business practices. Initial take-up of the voluntary NPS was very low. In Chapter 6, based on field work in the Mangalore and Hamirpur districts, innovative strategies to market the scheme are presented. Chapter 7 presents findings and recommendations related to business practices and information technology. A major conclusion is that significant improvements in both are needed if the NPS is going to be able to cope with rising membership and assets under management.

Part IV turns to economic and demographic aspects of the NPS. Chapter 8 presents the results of a modeling exercise aimed at projecting the potential future size of the NPS. It concludes that, under conservative assumptions, NPS will account for a substantial share of the Indian capital market, increasing the urgency of implementing the legal and regulatory reforms called for in Part II. Chapter 9 presents a microsimulation model analysis of the experience of individual savers within the NPS. It validates the conclusion gained from looking at experience elsewhere in the world, especially Asia, that voluntary saving schemes such as the NPS may be insufficient in and of themselves to effectively address old-age poverty. The policy conclusion is that NPS needs to be part of a broader strategy to address this problem; that it is complement to, not a substitute for, other broad-based policies to help the poor cope with aging.

Part V deals with existing occupational pension issues. Chapters 10 and 11 deal with compulsory occupational schemes, and Chapter 12 deals with unregulated voluntary occupational schemes. In both cases, legal and regulatory issues are identified and recommendations are offered.

Finally, the concluding Part VI consists of a chapter synthesizing findings and offers a transition strategy for inclusive pension reform in India, particularly its extension to cover the unorganized sector.
The need for pension reform in India arises from two main factors: demography and the nature of the labor market. In this chapter, we set the stage for the reforms analyzed in the remainder of this book.

India’s changing demography

Population and age structure

The UN Population Division estimated India’s population at 1.2 billion in 2009, with a growth rate of 1.43% per year from 2005 to 2010. It is projected to increase to 1.6 billion in 2050 according to the UN medium variant scenario; the corresponding estimates in the low and high variant are 1.4 and 1.9 billion. Given the uncertainties inherent in demographic projections, these scenarios are consistent with analysis done in the context of the 2001 Census of India. For comparison, in 2025, the UN projection (1.431 billion) and the Census of India projection (1.399 billion) differ by only 31 million. The higher population projection of the United Nations is largely the result of a larger estimated baseline population. In addition, the Census assumes a higher sex ratio at birth than the United Nations, and its life expectancy assumptions are more optimistic. Both projections are based on assumptions of rapid fertility decline to and below replacement level.

Figure 2.1 illustrates population projections through 2030 from a variety of sources using a variety of assumptions. There is a significant range of variation, but the momentum or inertia of population growth—the fact that much future population growth is “locked into” by past trends—means that even radically different assumptions on mortality and fertility give rise to only modestly different scenarios in the near and even medium terms (say, out to 20 or 30 years). To put it differently, experience and sensitivity analysis alike show that, while long-term (say, 50-year plus) population projections are highly sensitive to assumptions on mortality and fertility (the role of migration is secondary), projections over the range of 10–25 years are quite robust.

The projected aging of the Indian population is similarly robust to the assumptions made. Figure 2.2 gives age pyramids, taken from UN Population Division
estimates and the Census of India, for the Indian population in the early years of this century. Like other developing countries, the population in India is young today, with one-third of the population below 15 years in 2005. This proportion is projected by the UN Population Division to decrease to less than one-fifth (18.2\%) in 2050.

This decline is mostly due to past and continuing fertility decline; it also to some extent reflects declines in adult and elderly mortality rates.

International demographic convention defines a country as “aging” where the proportion of people over 60 reaches 7\%. Aging may also be measured as an increase in the median age of the population. Today, India ranks second after the People’s Republic of China, or the PRC, in the absolute numbers of its elderly population. The proportion of elderly (60 years and older) is projected by both the UN Population Division and Indian authorities to quadruple by 2050. In the case of the UN Population Division, the increase is from 79.4 million (7.4\% of total population) to 315.6 million (19.6\% of total population).

The transition from a situation in which less than 1 in 10 to a situation in which over 1 in 5 persons is elderly will be momentous. Rapid fertility decline, as in India, is often compared to the opening of a “demographic window of opportunity” because a relatively large cohort of productive workers coexists with relatively small
economically unproductive cohorts of the elderly (their parents) and the young (their children). There is much opportunity to invest, whether in physical or in human capital via the education of their children. Eventually and ineluctably, though, the window of opportunity must close, as a small cohort of economically productive workers will eventually coexist with a large cohort of the economically unproductive elderly. This, in a nutshell, is the economic challenge of population aging.

Figure 2.2 Baseline population in 2005 and 2001 for India (population in 1,000)
In an aging society, the ratio of economic producers to consumers decline. The key goal of pension reform, in addition to helping persons to cope with old age on an individual basis, is to help society as a whole make the transition to this new demographic regime.

Concern over population aging is not limited to increase in the proportion of the elderly as regards the population as a whole. Many Indians over 60 are still economically active and, while the historical record has been that the demand for leisure in old age (i.e., retirement) rises sharply with development, it would be unwise to assume that this will be the case in India. Perhaps India will follow the path of Japan, where a high proportion of the elderly are still economically active.

However, a significant period of economic inactivity prior to death is inevitable, and in all countries, improvement in mortality at older ages is giving rise to an increasing share of the “oldest old,” often defined as the population over 80. Disability, inability to engage in productive work, living alone, the death of children, and outliving accumulated assets—all causes of elderly poverty—are closely correlated with advanced age. Women are particularly affected because they are much more likely than men to live into extreme old age.

In 2005, according to the UN Population Division (2009), India ranked third in the world in population over 80: 15.4 million (1.2%) of the world’s oldest old lived in the PRC, 11.0 million (3.6%) in the USA, and 6.5 million (0.6%) in India. In 2050, the UN Population Division estimates that India will be home to 42.6 million persons over 80. This represents 13.5% of the population over 60, as opposed to only 8.2% today. The growth of the oldest-old population through 2026 as projected by Indian authorities is given in Table 2.1.

An often-used index of population age structure is the dependency ratio, conventionally defined as the ratio of the population under 15 and over 65 to the population aged 15–64. This can be expressed as the sum of child and old-age dependency ratios, trends in which are shown in Table 2.2. The Indian old-age dependency ratio is expected to triple in 2005–2050. However, because of decline in the child dependency ratio, a result of continuing fertility decline, the total dependency ratio is expected to decline. The question of whether a decline in the child dependency ratio can offset the economic impacts of an increase in the elderly dependency ratio is an empirical one and fraught with controversy. However, as pointed out above, eventually the working population will be small relative to the elderly population.

**Fertility and mortality**

The population and age structure trends described above are driven by past and ongoing trends in fertility and mortality. The aging of a population can be decomposed into two sub-processes: aging at the base and aging at the top of the population pyramid: the former results from a decline in fertility, while the latter results from mortality reduction among the elderly. In India, both processes are comparatively recent phenomena.
Table 2.1 Population number and proportion of population aged 80 and above, and 60 and above, and the ratio of the oldest-old to the elderly

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Males</th>
<th>Total Females</th>
<th>Total</th>
<th>Males</th>
<th>Females</th>
<th>Ratio 80+/60−79</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>3,176</td>
<td>1,651</td>
<td>70,687</td>
<td>35,743</td>
<td>0.05</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>4,760</td>
<td>2,411</td>
<td>83,580</td>
<td>42,834</td>
<td>0.06</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>9,632</td>
<td>5,163</td>
<td>98,470</td>
<td>50,332</td>
<td>0.11</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>13,239</td>
<td>7,391</td>
<td>118,099</td>
<td>59,986</td>
<td>0.13</td>
<td></td>
</tr>
<tr>
<td>2021</td>
<td>16,660</td>
<td>9,558</td>
<td>143,245</td>
<td>72,651</td>
<td>0.13</td>
<td></td>
</tr>
<tr>
<td>2026</td>
<td>19,877</td>
<td>11,465</td>
<td>173,183</td>
<td>88,560</td>
<td>0.13</td>
<td></td>
</tr>
</tbody>
</table>

Proportion of total population in %

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Males</th>
<th>Total Females</th>
<th>Total</th>
<th>Males</th>
<th>Females</th>
<th>Ratio 80+/60−79</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>0.31</td>
<td>0.33</td>
<td>6.87</td>
<td>6.57</td>
<td>7.20</td>
<td></td>
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<tr>
<td>2006</td>
<td>0.43</td>
<td>0.45</td>
<td>7.51</td>
<td>7.08</td>
<td>7.98</td>
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<tr>
<td>2011</td>
<td>0.81</td>
<td>0.90</td>
<td>8.26</td>
<td>7.80</td>
<td>8.75</td>
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<tr>
<td>2016</td>
<td>1.04</td>
<td>1.21</td>
<td>9.31</td>
<td>8.84</td>
<td>9.80</td>
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<tr>
<td>2021</td>
<td>1.24</td>
<td>1.48</td>
<td>10.69</td>
<td>10.17</td>
<td>11.25</td>
<td></td>
</tr>
<tr>
<td>2026</td>
<td>1.42</td>
<td>1.70</td>
<td>12.37</td>
<td>11.67</td>
<td>13.13</td>
<td></td>
</tr>
</tbody>
</table>

Source: Census of India, 2006.


Demographic and economic context

Table 2.2 Dependency ratios in India, 1950–2050

<table>
<thead>
<tr>
<th>Year</th>
<th>Medium variant</th>
<th>High variant</th>
<th>Low variant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Child</td>
<td>Old-age</td>
</tr>
<tr>
<td>1950</td>
<td>68</td>
<td>63</td>
<td>5</td>
</tr>
<tr>
<td>1955</td>
<td>73</td>
<td>68</td>
<td>5</td>
</tr>
<tr>
<td>1960</td>
<td>78</td>
<td>72</td>
<td>5</td>
</tr>
<tr>
<td>1965</td>
<td>82</td>
<td>76</td>
<td>6</td>
</tr>
<tr>
<td>1970</td>
<td>79</td>
<td>73</td>
<td>6</td>
</tr>
<tr>
<td>1975</td>
<td>77</td>
<td>71</td>
<td>6</td>
</tr>
<tr>
<td>1980</td>
<td>75</td>
<td>69</td>
<td>6</td>
</tr>
<tr>
<td>1985</td>
<td>73</td>
<td>67</td>
<td>6</td>
</tr>
<tr>
<td>1990</td>
<td>71</td>
<td>65</td>
<td>7</td>
</tr>
<tr>
<td>1995</td>
<td>69</td>
<td>62</td>
<td>7</td>
</tr>
<tr>
<td>2000</td>
<td>65</td>
<td>58</td>
<td>7</td>
</tr>
<tr>
<td>2005</td>
<td>60</td>
<td>53</td>
<td>7</td>
</tr>
<tr>
<td>2010</td>
<td>56</td>
<td>48</td>
<td>8</td>
</tr>
<tr>
<td>2015</td>
<td>52</td>
<td>44</td>
<td>8</td>
</tr>
<tr>
<td>2020</td>
<td>49</td>
<td>40</td>
<td>9</td>
</tr>
<tr>
<td>2025</td>
<td>47</td>
<td>36</td>
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<td>2030</td>
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<td>33</td>
<td>12</td>
</tr>
<tr>
<td>2035</td>
<td>44</td>
<td>30</td>
<td>14</td>
</tr>
<tr>
<td>2040</td>
<td>44</td>
<td>28</td>
<td>15</td>
</tr>
<tr>
<td>2045</td>
<td>45</td>
<td>27</td>
<td>18</td>
</tr>
<tr>
<td>2050</td>
<td>47</td>
<td>27</td>
<td>20</td>
</tr>
</tbody>
</table>


Life expectancy at birth (E0) increased steadily from 37.9 years in 1950–1955 to 63.5 years in 2005–2010, and is estimated by the UN Population Division to increase further to 73.3 years in all of its three projection variants. Before the 1980s, women died on average earlier than men, with the strongest gap in the 1950s to 1970s, when the difference was roughly 1.5 years. Today, men have, at birth, on average, a shorter life expectancy than women by almost 3 years. This “female advantage” is in line with the pattern observed in almost all countries.

India’s total fertility rate (TFR) decreased steadily in the last five decades according to the United Nations (2009), from 5.91 children per woman in 1950–1955 to 2.75 in 2005–2010 (Figure 2.3). Dependent on the UN projection variant, the TFR is assumed to decline further in the high variant to a TFR of 2.35, in the medium variant to a TFR of 1.85 (a bit lower than the replacement level of 2.1), and in the low variant to a well sub-replacement level TFR of 1.35.
The regional dimension

There are likely to be considerable regional variations in population growth, as different regions in India are at different stages of demographic transition (Table 2.3). For example, the model of population growth for the state of Kerala is different from the rest of India. Unlike other states, Kerala has already achieved lower birth and death rates, lower infant mortality, higher literacy, and higher age at marriage. The expectation of life at birth is higher both for men and women and this is the only state in India at present with sex ratio at birth favorable to women.7

Urbanization and migration

Urban areas in India are of two main types. The most important are “statutory towns”, which are deemed to be urban because of their form of local self-government.
### Table 2.3 Fertility and mortality indices, India (2001)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Male</td>
<td>Female</td>
</tr>
<tr>
<td>India</td>
<td>3.2</td>
<td>61.8</td>
<td>64.1</td>
</tr>
<tr>
<td>Himachal Pradesh</td>
<td>2.3</td>
<td>67.3</td>
<td>70.9</td>
</tr>
<tr>
<td>Punjab</td>
<td>2.4</td>
<td>66.2</td>
<td>68.9</td>
</tr>
<tr>
<td>Uttaranchal</td>
<td>3.3</td>
<td>60.0</td>
<td>64.0</td>
</tr>
<tr>
<td>Haryana</td>
<td>3.2</td>
<td>64.4</td>
<td>66.3</td>
</tr>
<tr>
<td>Delhi</td>
<td>2.1</td>
<td>69.6</td>
<td>72.8</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>4.1</td>
<td>62.1</td>
<td>65.2</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>4.7</td>
<td>59.5</td>
<td>59.4</td>
</tr>
<tr>
<td>Bihar</td>
<td>4.3</td>
<td>63.6</td>
<td>62.7</td>
</tr>
<tr>
<td>Assam</td>
<td>3.1</td>
<td>57.6</td>
<td>58.8</td>
</tr>
<tr>
<td>West Bengal</td>
<td>2.4</td>
<td>64.7</td>
<td>67.4</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>3.7</td>
<td>62.0</td>
<td>60.0</td>
</tr>
<tr>
<td>Orissa</td>
<td>2.7</td>
<td>58.3</td>
<td>59.8</td>
</tr>
<tr>
<td>Chhattisgarh</td>
<td>3.5</td>
<td>56.0</td>
<td>60.0</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>4.0</td>
<td>58.0</td>
<td>59.3</td>
</tr>
<tr>
<td>Gujarat</td>
<td>2.9</td>
<td>62.6</td>
<td>66.7</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>2.5</td>
<td>64.4</td>
<td>68.1</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>2.3</td>
<td>61.4</td>
<td>65.9</td>
</tr>
<tr>
<td>Karnataka</td>
<td>2.4</td>
<td>62.5</td>
<td>68.1</td>
</tr>
<tr>
<td>Kerala</td>
<td>1.8</td>
<td>69.3</td>
<td>75.2</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>2.0</td>
<td>64.1</td>
<td>67.1</td>
</tr>
<tr>
<td>NE States (Exc. Assam)</td>
<td>2.4</td>
<td>65.1</td>
<td>69.1</td>
</tr>
</tbody>
</table>

Source: Census of India, 2006.

In 1991, statutory towns contained 87% of urban population. In addition, there are so-called “census towns,” so-defined because they meet several basic demographic and employment criteria. India’s true level of urbanization may be somewhat higher than the official figures.

Table 2.4 summarizes the level of urbanization in 2001 and the projected trends in urbanization as estimated by Census of India (2006). The overall impression is of a relatively low level and slow pace of urbanization. The table shows that Tamil Nadu and Maharashtra were the most urbanized states in 2001, with Gujarat not far behind. Levels of urbanization are particularly low in Assam, Bihar, Orissa, and to a lesser extent, Uttar Pradesh. In 2001, despite the presence of Kolkata, even West Bengal was only slightly more urban than the national average.
Figure 2.4 illustrates that the UN Population Division expects the rural population to peak and begin to decline around 2025, with the growing urban and shrinking rural population equalling each other in about 2040.8

The population of urban areas can grow by three mechanisms: (i) natural increase (births minus deaths) of the urban population, (ii) net in-migration from rural areas; and (iii) reclassification of rural areas as urban. During recent decades, the natural increase of urban population has accounted for most of the

| Table 2.4 Projected proportion of urban population, 2001–2026 |
|----------------|-------|-------|-------|-------|-------|-------|
|               | 2001  | 2006  | 2011  | 2016  | 2021  | 2026  |
| India         | 28.0  | 29.0  | 30.1  | 31.1  | 32.4  | 33.6  |
| Himachal Pradesh | 9.9  | 10.5  | 11.1  | 11.8  | 12.5  | 13.3  |
| Punjab        | 34.4  | 36.5  | 38.9  | 41.3  | 43.8  | 46.3  |
| Chandigarh    | 90.1  | 89.8  | 89.8  | 89.8  | 89.8  | 89.8  |
| Uttarakhand   | 25.8  | 27.1  | 28.5  | 29.9  | 31.4  | 32.9  |
| Haryana       | 29.3  | 31.5  | 33.9  | 36.4  | 39.0  | 41.6  |
| Delhi         | 93.7  | 94.5  | 95.5  | 96.4  | 97.0  | 97.6  |
| Rajasthan     | 23.4  | 23.7  | 23.9  | 24.2  | 24.5  | 24.7  |
| Uttar Pradesh | 20.9  | 21.4  | 21.9  | 22.6  | 23.2  | 23.9  |
| Bihar         | 10.5  | 10.5  | 10.5  | 10.6  | 10.6  | 10.6  |
| Sikkim        | 11.8  | 12.3  | 13.5  | 14.9  | 16.4  | 18.2  |
| Ngaland       | 17.2  | 17.2  | 17.3  | 17.3  | 17.4  | 17.4  |
| Manipur       | 26.7  | 26.1  | 25.6  | 25.2  | 24.7  | 24.3  |
| Mizarom       | 48.8  | 51.6  | 53.4  | 55.1  | 56.9  | 58.6  |
| Tripura       | 16.9  | 18.1  | 19.1  | 20.1  | 21.2  | 22.3  |
| Meghalaya     | 19.7  | 20.2  | 20.7  | 21.1  | 21.8  | 22.4  |
| Assam         | 13.0  | 14.0  | 15.1  | 16.2  | 17.4  | 18.7  |
| West Bengal   | 28.0  | 28.3  | 28.5  | 28.8  | 29.0  | 29.3  |
| Jharkhand     | 22.4  | 22.8  | 23.4  | 23.9  | 24.4  | 25.0  |
| Orissa        | 15.1  | 16.0  | 16.9  | 17.8  | 18.8  | 19.9  |
| Chhattisgarh  | 20.3  | 21.7  | 23.3  | 24.9  | 26.6  | 28.3  |
| Madhya Pradesh| 26.5  | 27.1  | 27.8  | 28.4  | 29.0  | 29.7  |
| Gujjarat      | 37.5  | 39.0  | 40.5  | 42.0  | 43.6  | 45.1  |
| Maharashtra   | 42.7  | 44.6  | 46.5  | 48.4  | 50.3  | 52.3  |
| Andhra Pradesh| 29.2  | 27.5  | 27.7  | 28.0  | 28.2  | 28.4  |
| Karnataka     | 34.3  | 35.8  | 37.4  | 39.0  | 40.7  | 42.4  |
| Goa           | 50.2  | 54.7  | 59.0  | 63.3  | 67.3  | 71.1  |
| Kerala        | 25.5  | 25.7  | 25.5  | 25.3  | 25.1  | 24.9  |
| Tamil Nadu    | 45.2  | 49.8  | 55.0  | 60.1  | 65.1  | 69.9  |

Source: Census of India, 2006.
Demographic and economic context

urban growth. But there are signs that urban growth attributable to natural increase is beginning to slow due to the fall in birth rates. This suggests that the contribution of rural-to-urban migration is on the rise. Finally, the reclassification from rural to urban has played a fairly significant role in urban population growth. Its role, given the phenomenon of “urban sprawl,” may become relatively more important in the future.

The Indian Census of 2001 included questions on people’s last residence and their duration of the residence at the place of enumeration. Analysis of these data shows that about 60% of migrants had made intra-district moves, over relatively short distances. The next most common migrants were those who had moved between districts. About 11% of migrants had crossed state borders, and a much smaller proportion reported their place of last residence as in another country.
For the projections given in Table 2.4, it was assumed that the migration rates remain constant throughout the projection periods for all the states (except Goa).

While the Indian diaspora is a prominent global phenomenon, international migration has always been small compared to the size of India’s population (Table 2.5). Therefore it has had, and will have, only marginal influence upon the country’s future population. Starting from the 1960s, there was an increased out-migration from India to the UK, the USA, Canada, and Australia, mainly in search of better employment and, more recently, educational opportunities. From the late 1970s, there has also been considerable out-migration to the oil-producing countries of the Gulf, about two million workers. International migration is difficult to foresee; however, with increasing awareness of overseas employment and easier air travel, it seems reasonable to expect a rise in the number of better-educated young people who leave India for North America, Europe, and

Table 2.5 Net migration rates, 1991–2001

<table>
<thead>
<tr>
<th>Net migration rate (per 100) 1991–2001</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>Himachal Pradesh</td>
<td>0.04</td>
<td>(0.06)</td>
</tr>
<tr>
<td>Punjab</td>
<td>0.20</td>
<td>0.07</td>
</tr>
<tr>
<td>Uttaranchal</td>
<td>(0.03)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>Haryana</td>
<td>0.40</td>
<td>0.35</td>
</tr>
<tr>
<td>Delhi</td>
<td>1.93</td>
<td>1.57</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>(0.08)</td>
<td>(0.05)</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>(0.25)</td>
<td>(0.16)</td>
</tr>
<tr>
<td>Bihar</td>
<td>(0.39)</td>
<td>(0.17)</td>
</tr>
<tr>
<td>Assam</td>
<td>(0.06)</td>
<td>(0.09)</td>
</tr>
<tr>
<td>West Bengal</td>
<td>(0.04)</td>
<td>(0.04)</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>(0.08)</td>
<td>(0.02)</td>
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<td>(0.10)</td>
<td>(0.04)</td>
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<td>Chhattisgarh</td>
<td>(0.06)</td>
<td>(0.07)</td>
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<td>Madhya Pradesh</td>
<td>(0.01)</td>
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<tr>
<td>Gujarat</td>
<td>0.22</td>
<td>0.09</td>
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<td>0.37</td>
<td>0.21</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>(0.03)</td>
<td>(0.03)</td>
</tr>
<tr>
<td>Karnataka</td>
<td>0.04</td>
<td>0.00</td>
</tr>
<tr>
<td>Kerala</td>
<td>(0.08)</td>
<td>(0.08)</td>
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<td>NE States (Exc. Assam)</td>
<td>0.07</td>
<td>(0.03)</td>
</tr>
</tbody>
</table>

Source: Census of India, 2006.
Australia. Finally, there are significant immigration flows, mainly from Bangladesh and Nepal.

**Labor market and employment**

Labor force, employment, and unemployment in India vary greatly depending on the measure used. For purposes of this book, it is important to keep in mind a stylized fact from development economics: in low-income settings, only the rich can afford to be unemployed. The practical implication is that even persons defined as unemployed according to conventional measures are usually involved in some form of productive income-generating activity.

Indian labor statisticians have identified a number of concepts for use in assessing labor market status. The usual principal activity status (UPS) measure defines labor force participation as having been employed or unemployed (out of work but looking for it) for at least 6 out of the last 12 months. In order to cover those who were outside the labor force most of the time but nonetheless employed on a regular basis, the wider concept of usual principal and subsidiary status (UPSS) was introduced. Yet another concept, current weekly status (CWS), classifies a person as in the labor force if he or she has worked or is seeking and/or available for work at least 1 hour during the reference period of 1 week preceding the date of the survey.

Finally, current daily status (CDS) rates are computed on the basis of the information on employment and unemployment recorded for the 14 half-days of the reference week. It is CDS that is now the generally preferred measure. The Report of the Task Force on Employment Opportunities stated in 2001 that “the CDS measure of unemployment is widely agreed to be the one that most fully captures open unemployment in the country.” In its Tenth Plan (2002–2007), India’s Planning Commission decided to switch over to the CDS for purposes of projecting labor force and unemployment. This was justified on the ground that “(a) CDS was a better measure than the UPSS to capture unemployment and under-employment and (b) it took into account seasonal variations the samples were surveyed uniformly over the year.”

The Eleventh Plan identified the following specific weakness on the employment front:

- An increase in unemployment among agricultural labor households from 9.5% in 1993–1994 to 15.3% in 2004–2005.
- A rise in under-employment.
- While non-agricultural employment expanded at a robust annual rate of 4.7% during 1999–2000 to 2004–2005, this growth was largely in the unorganized sector.
- Despite healthy GDP growth, employment in the organized sector actually declined.
• Although real wages of casual labor in agriculture continued to rise during 2000–2005, growth decelerated strongly as compared to the previous five-year period, almost certainly reflecting poor performance in agriculture.
• Growth of average real wages in non-agriculture employment in 1999–2000 to 2004–2005 was negligible.
• Real wages stagnated or declined even for workers in the organized industry.

The statistical summary of the Planning Commission provided in Table 2.6 refers to “Labor force” as labor force participants, while “Workforce” refers to persons actually employed.

The unorganized sector and unorganized workers

As discussed in Chapter 1, there is in India an urgent need to provide old-age income security for the vast majority of workers outside the civil service and large urban establishments that comprise the organized sector. In all countries, the identification of informal workers has given rise to definitional challenges and controversies. These problems reached their peak, for example, in some formerly socialist economies, where “informal” was both linguistically and legally indistinguishable from “illegal.” Yet, labor economists and statisticians have made considerable progress in recent years in coming to grips with the slippery concept of informality.

In 1993, the Fifteenth International Conference of Labor Statisticians (15th ICLS) defined the informal sector in terms of characteristics of the enterprises (production units) in which the activities take place, rather than in terms of the characteristics of the persons involved or of their jobs. Persons were defined as employed in the informal sector if they were employed in at least one production unit of the informal sector, irrespective of their status in employment and whether it was their main or a secondary job. This approach might be expressed simply as follows: “It is the place of work, not the person; that marks a worker as being in the informal sector.”

So, the issue becomes how to define an establishment as informal. According to the UN Economic and Social Council, the term “informal sector” denotes (i) all private unincorporated enterprises owned by individuals or households (informal enterprises) engaged in the production of sale of goods or services, and (ii) with employment size below a predetermined threshold (UN System of National Accounts 1993). “Informal workers” (or employment) include persons whose employment relationship is not subject to labor legislation, social protection, and employment benefits (e.g., maternity leave, workers compensation, paid vacation, etc.). Again, to simplify, an establishment is informal if is relatively small and does not employ its workers on the basis of a legal labor contract (which would require the forms of social protection and benefits stipulated in the latter words of the definition). Labor relations within the informal sector depend mostly on social relations and custom, not on statute or legislation."
Table 2.6 Past and present macroscenario on employment and unemployment—rural and urban

<table>
<thead>
<tr>
<th></th>
<th>Currently daily status basis</th>
<th>Growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>('000 person-years)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>All India</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population</td>
<td>718,101</td>
<td>893,676</td>
</tr>
<tr>
<td>Labor force</td>
<td>263,824</td>
<td>334,197</td>
</tr>
<tr>
<td>Workforce</td>
<td>239,489</td>
<td>313,931</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>9.22</td>
<td>6.06</td>
</tr>
<tr>
<td>No. of unemployed</td>
<td>24,335</td>
<td>20,266</td>
</tr>
<tr>
<td><strong>Rural</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population</td>
<td>546,642</td>
<td>658,771</td>
</tr>
<tr>
<td>Labor force</td>
<td>206,152</td>
<td>252,955</td>
</tr>
<tr>
<td>Workforce</td>
<td>187,899</td>
<td>238,752</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>8.85</td>
<td>5.61</td>
</tr>
<tr>
<td>No. of unemployed</td>
<td>18.253</td>
<td>14,203</td>
</tr>
<tr>
<td><strong>Urban</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population</td>
<td>171,459</td>
<td>234,905</td>
</tr>
<tr>
<td>Labor force</td>
<td>57,672</td>
<td>81,242</td>
</tr>
<tr>
<td>Workforce</td>
<td>51,590</td>
<td>75,179</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>10.55</td>
<td>7.46</td>
</tr>
<tr>
<td>No. of unemployed</td>
<td>6,082</td>
<td>6,063</td>
</tr>
</tbody>
</table>

Source: Planning Commission, 2008, p. 73.
To combine establishments and workers, the International Labor Organization proposed the term “informal sector” which may be defined as follows:

In brief, the set of unorganized/informal sector *enterprises* constitutes the *informal sector*, while the set of people whose employment can be characterized as “informal,” because of certain characteristics of their jobs, constitute the set of *workers in informal employment*.¹²

The term generally used in India to denote the “informal sector” is “unorganized sector” and “informal workers” are referred to as “unorganized workers.” A matrix approach (see Table 2.10) is used. Although they represent a distinct minority, workers in the organized sector who are working without formal labor contracts or social coverage are considered informal workers. An even smaller number of workers who are in the unorganized sector but benefit from formal labor contracts and social protection are considered formal workers. Such “crossover” workers, however, constitute only about 7.5% of the Indian work force. The vast majority of informal workers work in the unorganized sector and the vast majority of formal workers work in the organized sector.

Though the above definition does not make any distinction between agricultural and non-agricultural enterprises, the concept of enterprise is generally used in India only in the context of the non-agriculture sector. Since such a restrictive meaning would exclude a large number of workers in agriculture, the Planning Commission has considered each operational holding as an enterprise for the purpose of applying the definition.

In the Indian national accounts, the unorganized sector includes production units whose activity is not regulated by statute or legal provision, and/or those which do not maintain regular accounts. For instance, in the case of manufacturing, this covers all manufacturing units using electrical power and employing less than 10 workers or not using electrical power and employing less than 20 workers. Within each unorganized sector, three categories of enterprises are distinguished.¹³ Own account enterprises (OAEs) are those owned and operated without the help of any regularly employed, hired workers. These enterprises, run by family workers, constitute the majority of all unorganized sector units. In 1994–1995, for example, about 85% of unorganized sector manufacturing enterprises were OAEs. Non-directory establishments (NDEs) which constitute the second largest group, are defined as enterprises which employ five workers or fewer (including family workers), of which at least one is a regularly employed hired worker. Directory establishments (DEs) are those employing six or more workers of which at least one is hired.

In rural areas, unorganized workers fall mostly into the following categories: landless agricultural laborers, small and marginal farmers, sharecroppers, persons engaged in animal husbandry, fishing, forest workers, toddy tappers, workers in agro-processing and food-processing, and artisans such as weavers, blacksmiths, carpenters, and goldsmiths. In urban areas, informal workers are mainly manual laborers in construction, carpentry, trade, transport, and small manufacturing
Demographic and economic context

Table 2.7 Indian labor force, 1999–2000 (in millions)

| Sector       | Employment category
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Formal</td>
</tr>
<tr>
<td>Organized</td>
<td>30.66</td>
</tr>
<tr>
<td>Unorganized</td>
<td>4.02</td>
</tr>
<tr>
<td>Total</td>
<td>34.68</td>
</tr>
</tbody>
</table>


enterprises, street vendors and hawkers, head load workers, garment makers, rag pickers, and others.

Table 2.7 gives the number of persons in the various segments of the Indian labor force according to the definitions above. Viewed from the point of view of the sector, 85.8% of total employment in the Indian economy during 1999–2000 was accounted for by the unorganized sector. This was around 340 million, including 4 million workers whose job status can be characterized as formal. From the point of view of the nature of employment, 336 million workers, accounting for 91.3% of total employment, were informal, of which some 26 million workers were in the organized/formal sector. Sixty-five percent of unorganized workers were engaged in agriculture, indicating the prominence of the rural segment in the informal economy.14 Almost all the non-agricultural unorganized sector is composed of unorganized trade, hotel and restaurants, unorganized transport, storage and communications, and unorganized services of all types.

Labor force development

Many observers take a dim view of the informal sector: for example, Remesh (footnote 14) has listed as follows, the developments that comprise the rapid structural transformation of the Indian labor force: shrinking employment in the organized sector and unprecedented growth of informal sector activities; deterioration in the quality of employment (in terms of job security, and terms and conditions at work); weakening of worker organizations and collective bargaining institutions; and decline in social security.

Admittedly, the unorganized sector is characterized by relatively low productivity, with output per worker only one-eighth that generated per workers in the organized sector. Nevertheless, by the late 1990s, Indian workers employed in the unorganized segment produced roughly 60% of national income, as measured by net domestic product, while the organized sector generated about 40%. Table 2.8 provides estimates of the employment and income contributions of agricultural and non-agricultural activities within the organized and unorganized segments, which reveal the inter-sectoral, as well as the inter-segment, disparities. The productivity
gap between the organized and unorganized sectors is especially striking in agriculture.

Estimates of formal and informal employment as of 1 January 2000, based on the above definition of unorganized employment, are given in Table 2.9.

As shown by the data in Table 2.10, there is not much regional variation around the national average. Only a small number of states or union territories have a share of around 80% or below: Delhi, Kerala, Goa, Nagaland, and Sikkim.

The size of India’s future labor force will depend on the size and age structure of the population, and the age-specific labor force participation rates (LFPRs). The population in the most active working ages increased over the last decades and will continue to increase in absolute numbers, as shown in the population projections above. In addition, India’s 60+ population, many of whom are also in the labor force, will also increase both absolutely and as a proportion of total population. The share of the population under 15 will decline. Thus, age structure changes are acting to boost the labor force.

Table 2.11 shows past and projected future trends in the male and female overall LFPRs together with the absolute size of the labor force. The data in Table 2.11 reflect both changes in age-specific LFPRs and changes in the population age distribution. The overall trend expected by these researchers is stability in the proportion of adult men in the labor force and an increase in the proportion of women.

As shown by data in Table 2.12, the dominant long-term trend in the Indian labor force has been the decline in the share of employment accounted for by agriculture, from about two-thirds in the early 1980s to half in the early years of this century. Manufacturing, construction, and services have all increased in importance.
### Table 2.9: Estimates of workers in formal and informal employment (million)

<table>
<thead>
<tr>
<th>Sl. no.</th>
<th>Category</th>
<th>Rural</th>
<th>Urban</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Male</td>
<td>Female</td>
<td>Total</td>
</tr>
<tr>
<td>1.</td>
<td><strong>Total employment</strong></td>
<td>196.74</td>
<td>104.02</td>
<td>300.75</td>
</tr>
<tr>
<td>1.1.</td>
<td>Agriculture</td>
<td>140.48</td>
<td>88.79</td>
<td>229.26</td>
</tr>
<tr>
<td>1.2.</td>
<td>Non-agriculture</td>
<td>56.26</td>
<td>15.23</td>
<td>71.49</td>
</tr>
<tr>
<td>2.</td>
<td><strong>Organized employment</strong></td>
<td>10.60</td>
<td>2.04</td>
<td>12.64</td>
</tr>
<tr>
<td>2.1.</td>
<td>Agriculture</td>
<td>1.80</td>
<td>0.73</td>
<td>2.53</td>
</tr>
<tr>
<td>2.2.</td>
<td>Non-agriculture</td>
<td>8.80</td>
<td>1.31</td>
<td>10.11</td>
</tr>
<tr>
<td>3.</td>
<td><strong>Unorganized employment</strong></td>
<td>186.14</td>
<td>101.97</td>
<td>288.11</td>
</tr>
<tr>
<td>3.1.</td>
<td>Agriculture</td>
<td>138.68</td>
<td>88.06</td>
<td>226.73</td>
</tr>
<tr>
<td>3.2.</td>
<td>Non-agriculture</td>
<td>47.46</td>
<td>13.92</td>
<td>61.38</td>
</tr>
</tbody>
</table>

### Table 2.10 Informal employment by State, 1999–2000 (million)

<table>
<thead>
<tr>
<th>State</th>
<th>Informal workers</th>
<th>Total employment</th>
<th>Percentage of informal employment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Male</td>
<td>Female</td>
<td>Total</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>21.03</td>
<td>14.41</td>
<td>35.44</td>
</tr>
<tr>
<td>Assam</td>
<td>5.60</td>
<td>1.33</td>
<td>6.93</td>
</tr>
<tr>
<td>Bihar</td>
<td>23.35</td>
<td>7.28</td>
<td>30.63</td>
</tr>
<tr>
<td>Goa</td>
<td>0.27</td>
<td>0.08</td>
<td>0.35</td>
</tr>
<tr>
<td>Gujarat</td>
<td>12.72</td>
<td>7.23</td>
<td>19.95</td>
</tr>
<tr>
<td>Haryana</td>
<td>4.55</td>
<td>1.59</td>
<td>6.14</td>
</tr>
<tr>
<td>Himachal Pradesh</td>
<td>1.32</td>
<td>1.26</td>
<td>2.58</td>
</tr>
<tr>
<td>Karnataka</td>
<td>13.92</td>
<td>8.05</td>
<td>21.97</td>
</tr>
<tr>
<td>Kerala</td>
<td>6.36</td>
<td>2.77</td>
<td>9.13</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>20.97</td>
<td>12.32</td>
<td>33.30</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>22.93</td>
<td>14.02</td>
<td>36.95</td>
</tr>
<tr>
<td>Manipur</td>
<td>0.38</td>
<td>0.19</td>
<td>0.57</td>
</tr>
<tr>
<td>Meghalaya</td>
<td>0.42</td>
<td>0.31</td>
<td>0.73</td>
</tr>
<tr>
<td>Mizoram</td>
<td>0.13</td>
<td>0.10</td>
<td>0.22</td>
</tr>
<tr>
<td>Nagaland</td>
<td>0.12</td>
<td>0.10</td>
<td>0.22</td>
</tr>
<tr>
<td>Orissa</td>
<td>9.19</td>
<td>4.89</td>
<td>14.08</td>
</tr>
<tr>
<td>Punjab</td>
<td>5.96</td>
<td>2.36</td>
<td>8.32</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>11.71</td>
<td>7.53</td>
<td>19.23</td>
</tr>
<tr>
<td>Sikkim</td>
<td>0.10</td>
<td>0.04</td>
<td>0.14</td>
</tr>
</tbody>
</table>

*Continued*
### Demographic and economic context

<table>
<thead>
<tr>
<th>State</th>
<th>Informal workers</th>
<th>Total employment</th>
<th>Percentage of informal employment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Male</td>
<td>Female</td>
<td>Total</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>16.71</td>
<td>10.16</td>
<td>26.87</td>
</tr>
<tr>
<td>Tripura</td>
<td>0.70</td>
<td>0.08</td>
<td>0.78</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>40.93</td>
<td>14.41</td>
<td>55.35</td>
</tr>
<tr>
<td>West Bengal</td>
<td>19.69</td>
<td>5.48</td>
<td>25.17</td>
</tr>
<tr>
<td>Delhi</td>
<td>2.80</td>
<td>0.36</td>
<td>3.17</td>
</tr>
<tr>
<td>Pondicherry</td>
<td>0.20</td>
<td>0.09</td>
<td>0.29</td>
</tr>
<tr>
<td>Chandigarh</td>
<td>0.24</td>
<td>0.03</td>
<td>0.27</td>
</tr>
<tr>
<td>Dadra &amp; Nagar Haveli</td>
<td>0.05</td>
<td>0.03</td>
<td>0.07</td>
</tr>
<tr>
<td>Daman &amp; Diu</td>
<td>0.04</td>
<td>0.01</td>
<td>0.05</td>
</tr>
<tr>
<td>A &amp; N Islands</td>
<td>0.06</td>
<td>0.02</td>
<td>0.08</td>
</tr>
<tr>
<td>Lakshdweep</td>
<td>0.01</td>
<td>0.00</td>
<td>0.01</td>
</tr>
</tbody>
</table>

### Table 2.12 Sector-wise share of employment by current daily status

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>65.42</td>
<td>61.03</td>
<td>56.64</td>
<td>52.06</td>
<td>50.19</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>0.66</td>
<td>0.78</td>
<td>0.67</td>
<td>0.63</td>
<td>0.61</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>11.27</td>
<td>11.1</td>
<td>12.13</td>
<td>12.9</td>
<td>13.33</td>
</tr>
<tr>
<td>Electricity, water, etc.</td>
<td>0.34</td>
<td>0.41</td>
<td>0.34</td>
<td>0.35</td>
<td>0.33</td>
</tr>
<tr>
<td>Construction</td>
<td>2.56</td>
<td>3.63</td>
<td>4.44</td>
<td>5.57</td>
<td>6.10</td>
</tr>
<tr>
<td>Trade, hotel, and restaurant</td>
<td>6.98</td>
<td>8.26</td>
<td>11.2</td>
<td>12.62</td>
<td>13.18</td>
</tr>
<tr>
<td>Transport, storage, and communication</td>
<td>2.88</td>
<td>3.22</td>
<td>4.06</td>
<td>4.61</td>
<td>5.06</td>
</tr>
<tr>
<td>Financial, insurance, real estate, and business services</td>
<td>0.78</td>
<td>1.08</td>
<td>1.36</td>
<td>2.00</td>
<td>2.22</td>
</tr>
<tr>
<td>Community, social, and personal services</td>
<td>9.10</td>
<td>10.5</td>
<td>9.16</td>
<td>9.24</td>
<td>8.97</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Demographic and economic context

Wages

Wages have grown more slowly than both output and employment in India, evidence that productivity gains are not being passed on to workers. There is a large and persistent gap between wages in the unorganized sector and wages in the organized sector, with casual agricultural workers earning the lowest wages. As the economy has liberalized, this gap between organized and unorganized sectors has widened; however, there is declining wage disparity within more disaggregated sectors (e.g. within informal manufacturing, within formal manufacturing, etc.).

Table 2.13 shows that, in urban India, the wages of regular workers have grown more rapidly than those of casual workers in key sectors such as construction, trade, transport, and services.

Table 2.13 Annual growth rates of sectoral wages of regular and casual workers in urban India

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regular</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>8.91%</td>
<td>(10.20%)</td>
<td>(0.24%)</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>9.27%</td>
<td>2.02%</td>
<td>5.91%</td>
</tr>
<tr>
<td>Manufacturing (15–22)</td>
<td>1.56%</td>
<td>(2.11%)</td>
<td>(0.13%)</td>
</tr>
<tr>
<td>Manufacturing (23–37)</td>
<td>4.75%</td>
<td>(2.32%)</td>
<td>1.48%</td>
</tr>
<tr>
<td>Public utilities</td>
<td>7.22%</td>
<td>1.76%</td>
<td>4.70%</td>
</tr>
<tr>
<td>Construction</td>
<td>2.86%</td>
<td>0.89%</td>
<td>1.96%</td>
</tr>
<tr>
<td>Trade, hotels and restaurants</td>
<td>6.03%</td>
<td>(3.57%)</td>
<td>1.55%</td>
</tr>
<tr>
<td>Transport, etc.</td>
<td>4.96%</td>
<td>0.99%</td>
<td>3.14%</td>
</tr>
<tr>
<td>Services (65–74)</td>
<td>4.79%</td>
<td>1.38%</td>
<td>3.23%</td>
</tr>
<tr>
<td>Services (75–93)</td>
<td>7.71%</td>
<td>(0.61%)</td>
<td>3.84%</td>
</tr>
<tr>
<td><strong>Casual</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>3.20%</td>
<td>(2.54%)</td>
<td>0.55%</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>8.67%</td>
<td>(4.98%)</td>
<td>2.24%</td>
</tr>
<tr>
<td>Manufacturing (15–22)</td>
<td>4.70%</td>
<td>(4.23%)</td>
<td>0.54%</td>
</tr>
<tr>
<td>Manufacturing (23–37)</td>
<td>5.58%</td>
<td>(3.03%)</td>
<td>1.57%</td>
</tr>
<tr>
<td>Public utilities</td>
<td>2.71%</td>
<td>(2.44%)</td>
<td>0.34%</td>
</tr>
<tr>
<td>Construction</td>
<td>2.41%</td>
<td>(0.17%)</td>
<td>1.23%</td>
</tr>
<tr>
<td>Trade, hotels and restaurants</td>
<td>3.20%</td>
<td>(2.76%)</td>
<td>0.45%</td>
</tr>
<tr>
<td>Transport, etc.</td>
<td>2.34%</td>
<td>0.59%</td>
<td>1.54%</td>
</tr>
<tr>
<td>Services (65–74)</td>
<td>5.74%</td>
<td>1.34%</td>
<td>3.72%</td>
</tr>
<tr>
<td>Services (75–93)</td>
<td>0.40%</td>
<td>1.95%</td>
<td>1.10%</td>
</tr>
</tbody>
</table>

* Figures in parenthesis in Sectors column are NIS codes; others are negative numbers.

In concluding this, as well as other, chapters, we offer a brief synthesis of the major issues and findings that have emerged and offer some recommendations for dealing with them.

<table>
<thead>
<tr>
<th>Findings</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>The proportion of elderly (60 years and older) is projected by both the UN Population Division and Indian authorities to quadruple by 2050. The Indian old-age dependency ratio is expected to triple in 2005–2050. The proportion of the population below 15 years will decrease due to assumed fertility decline to replacement or below replacement level by 2050.</td>
<td>While pension reform can serve a number of goals, the key goal, in addition to helping persons to cope with old age on an individual basis, is to help the society as a whole make the transition to a new demographic regime.</td>
</tr>
<tr>
<td>Improvements in mortality at older ages are giving rise to an increasing share of the “oldest old”, defined as the population over 80. In 2050, the UN Population Division estimates that India will be home to 42.6 million persons over 80.</td>
<td>Saving-based schemes in India will need to pay particular attention to the problem of the elderly outliving their savings. A complementary basic minimum income scheme or a universal demogrant approach may be needed. Particular attention will need to be paid to the concerns of women, who are disproportionately represented among the very elderly. The rising share of “oldest old” requires special attention to the anti-poverty aspect of pensions, as poverty rates rise rapidly with age due to disability, inability to work, and loss of spouse and children.</td>
</tr>
<tr>
<td>It is expected that rural population will peak and begin to decline around 2025, with the growing urban and shrinking rural populations equaling each other in about 2040.</td>
<td>Urbanization is a cross-cutting theme that needs to be mainstreamed in all areas of Indian policy.</td>
</tr>
<tr>
<td>India has been facing several problems on the employment market: increase in the rate of unemployment; a rise in under-employment; non-agricultural employment growth concentrated in the unorganized sector; declining employment in the organized sector; and stagnating or declining real wages even for workers in the organized sector. Under these considerations, it cannot be assumed that the share of the unorganized sector will decline with economic growth and development.</td>
<td>The persistence of informality heightens the priority for the Indian government to provide vehicles to help unorganized workers ensure their old-age income. It is important that approaches to social protection in the informal sector do not deter growth and employment. At the same time, pension provision in the organized sector should not encourage informality.</td>
</tr>
</tbody>
</table>
Part II

The pension system reform
3 The New Pension Scheme
Design, governance, and institutions

The New Pension Scheme (NPS)
The New Pension Scheme (or NPS), the design of which we describe in this chapter, is one response to the demographic challenges described in the preceding chapters. The government introduced the NPS for its civil servants in 2004, and issued a directive in 2008, expanding the scheme on a voluntary basis to all Indian citizens. The latter program opened in May 2009 but has developed very slowly. Recent developments, described at the end of the chapter, may accelerate scheme participants. In the two chapters which follow, we provide analysis and offer recommendations pertaining to the scheme’s design (Chapter 4) and its institutional and regulatory framework (Chapter 5).

The NPS civil service scheme is a two-tiered defined contribution scheme that replaces a defined benefit pension scheme for all individuals recruited by the federal and state governments since 1 January 2004. Accumulations in individual defined contribution accounts under the scheme are invested in diversified investment funds managed by regulated private sector pension funds (pension fund managers or PFMs). The program is managed and supervised by the Pension Fund Regulatory and Development Authority (PFRDA), which was established for this purpose.

The government’s extension of the NPS to all other citizens of India is focused on providing a low-cost vehicle by which individuals working in the smaller private sector firms, as well as the larger self-employed workforce, may voluntarily accumulate pension savings. The primary targets of the program are individuals working in the unorganized sector, which accounts for nearly 90% of the Indian workforce. This group includes entrepreneurs, small business owners and their employees, agricultural workers, and daily wage laborers among others. None of these individuals are covered by existing, compulsory pension programs, which reach only employees in organized sector workplaces.1 Additionally, those individuals who have accrued pension benefits in a compulsory or voluntary occupational scheme, or who have pension and long-term savings in retail financial instruments, may supplement those benefits and investments by participating in NPS.2
The New Pension Scheme

By providing long-term saving opportunities, NPS seeks to improve the income security of the elderly. There are also a number of secondary policy goals that the NPS design seeks to satisfy. These include the following:

- Reducing fiscal obligations. The NPS may help reduce potential future budgetary pressures on the government by increasing the self-provision of pension and reducing the fiscal strain on social safety net programs, while not replacing them.\(^3\)
- Increasing access to and participation in the financial sector. The NPS may introduce unbanked individuals and those unfamiliar with formal investment products to the workings of the capital markets, financial institutions, and financial products.
- Deepening, and providing a source of stable capital to, the financial markets. The NPS may contribute to economic growth by increasing aggregate long-term savings and thus provide greater depth and liquidity in Indian financial markets and stimulate the development of financial institutions.
- Enhancing labor markets. The NPS may facilitate labor mobility through fully vested, portable pension accounts.\(^4\)

The expansion of the NPS to workers in the unorganized sector and to the general public should be considered in the context of the savings and investment opportunities already available to individuals in addition to those provided via the workplace. These saving and investment opportunities include existing government-sponsored programs such as the Public Provident Fund (PPF) and post office savings accounts, as well as a growing array of retail products offered by the financial services sector, such as personal pension plans offered by life insurance companies, pension funds established by the mutual fund industry, and various bank deposit products. Existing voluntary pension arrangements in India, however, have failed to capture significant interest among unorganized sector workers. Less than 5% of unorganized sector workers presently participate in such schemes. This experience underlines the need for the NPS to differentiate itself from the existing alternatives if it is to succeed.

Success of the NPS will depend, in large part, on the ability of the government to address the most significant reasons why great numbers of people are not presently participating in the existing savings and investment opportunities. Many individuals and households do not currently participate in pension and other long-term savings programs because they lack the financial capacity to do so. Others, however, may have the capacity to accumulate long-term savings, but may not have sufficient financial knowledge or may be unwilling to place trust in financial institutions and markets or in information provided about a particular product. Other individuals may have a need to maintain liquidity for precautionary purposes and, as a result, be unwilling to lock their assets in long-term instruments, the rules of which prohibit, limit or penalize early access or withdrawals. Or they may be unwilling to bear the market risk associated with certain financial products. Finally, cultural preferences may act as barriers to participation in a
pension fund or account. For example, many households in India continue to prefer to store wealth in the form of gold.\textsuperscript{5}

In short, the success of the expansion of the NPS will depend on the level of voluntary participation that is achieved by this scheme, which, in turn, will depend on PFRDA’s choices in program design and its ability to respond to anticipated challenges. Developing appropriate marketing schemes and establishing a trusted branding based on transparency and user-friendly business processes will be important. Additionally, success will depend on establishing an operational structure that is administratively feasible and appropriately governed, adequately protecting the rights of individual subscribers and their pension assets, and aligning subscriber expectations with program design. These factors are somewhat less relevant to the success of the civil service NPS, because civil service participation is compulsory and contribution collection is automatic and payroll-based.

\textit{Scope of coverage, participation, and contribution requirement}

\textit{Civil service NPS.} The NPS for civil service employees is compulsory for all new recruits to the central government from 1 January 2004. Individuals contribute 10\% of salary including dearness allowance and dearness pay to the scheme. This contribution is matched by the central government. Contributions and returns are deposited in a non-withdrawable pension account (“Tier I account”). An individual who opens a Tier I pension account also may establish a voluntary “Tier II” account, the balance of which may be withdrawn at any time.

In addition to covering the central government’s new recruits, the NPS is also open to employees of states that elect to participate. Twenty-six state governments have decided to participate, of which several have signed agreements with the NPS Trust and its central record-keeping agency (CRA). Over 1.6 million central and state government employees are already covered by the NPS and have been issued individual accounts by the CRA.

\textit{The citizen’s NPS.} The citizen’s NPS, often referred to as the “unorganized sector scheme”, was introduced by the PFRDA on 1 May 2009. It is intended to provide individuals outside the formal sector with an easy, low-cost mechanism to voluntarily accumulate and invest savings intended to provide a pension. Unlike the civil service NPS, informal sector workers and other individuals participate in the citizen’s NPS on a purely voluntary basis. Although the government’s main policy focus in developing the scheme is to provide those uncovered by other extant pension schemes with a way to accumulate pension savings, the scheme is open to any Indian citizen who is aged 18–60, who chooses to open an NPS account, and who is not a government worker already covered by NPS.

Although individuals join the scheme on a voluntary basis, those individuals who open accounts agree to make a minimum annual investment of Rs6,000 and to make contributions a minimum of four times per year. Contributions must be no less than Rs500. Accounts are charged Rs100 in each year that the annual minimum is not satisfied. Similarly, individuals are charged Rs100 if they fail to
make contributions at least four times per year. Inactive accounts remain until eroded by fees and penalties.

In December 2009, PFRDA introduced a Tier II saving account to the scheme for the unorganized sector. Unlike the Tier I pension account, the balance of which is essentially non-withdrawable prior to attaining age 60, the Tier II savings account has no limits on withdrawals. A person, however, must have an active Tier I account to open and maintain a Tier II account. The account is available with no extra CRA charges for account opening or annual maintenance. However, subscribers are charged a per transaction fee identical to that levied on Tier I account transactions and must satisfy the following minimum contribution and balance requirements:

- Minimum contribution to open Tier II account = Rs1,000
- Minimum amount per contribution = Rs250
- Minimum account balance at year’s end = Rs2,000
- Minimum number of contributions per year = 4

A penalty of Rs100 is assessed on a subscriber for failing to maintain the minimum balance or make the minimum number of contributions. Although the targeted population has limited capacity to save, it is hoped that access to a Tier II savings account will prove attractive and mitigate the concerns of potential subscribers regarding the Tier I limitations on withdrawals.

The PFRDA has shown itself ready to adjust the scheme’s design. For example, in response to the low number of subscribers to the citizen’s NPS after its 2009 rollout, the PFRDA developed and introduced a simplified version of the NPS account, often referred to as “NPS-Lite”, which is being offered at a lower cost to low-income workers through a “group” model. Similarly, the central and state governments have recognized the need to improve financial incentives to increase scheme participation, especially among the very poor. Both of these developments are discussed in more detail later in this chapter.

**Tax treatment of contributions, earnings in NPS accounts, and withdrawals**

An “EET” tax regime applies to both the civil service and unorganized sector schemes of NPS:

- contributions to the NPS are tax exempt;
- earnings accruing in an individual’s account are tax-exempt; and
- account assets are taxable at time of withdrawal.

EET tax treatment is in line with the prevailing international practice for taxation of pension assets, but it is inconsistent with the EEE tax regime applicable to many other pension and long-term savings vehicles in India. Under the EEE tax regime, an exemption from tax is provided for amounts drawn at retirement (or when permissible, under the vehicles’ rules), in addition to exempting contri-
butions and accruing earnings from taxation. (The annual amount exempted is limited under the Income Tax Act, 1961.) A new, draft Direct Tax Code recently circulated for public comments by the Ministry of Finance proposes to apply an EEE treatment to NPS contributions and accumulations. This new tax treatment, if implemented, will bring the NPS at par with other existing long-term savings provisions. It could serve as a major inducement to join the system.

**Exit at retirement and form of benefit**

Both the civil service and citizen’s permit an individual to exit Tier I at or after attaining age 60. At withdrawal, at least 40% of the Tier I account balance must be used to purchase an annuity from an Insurance Regulatory and Development Authority (IRDA)-regulated life insurance company. The remaining account value may be received as a lump sum payment, paid and utilized without restriction, or withdrawn as phased withdrawals between ages 60 and 70. Individuals are required to withdraw from the system upon attaining age 70.

In the case of the civil service scheme, the annuity must be a joint and survivor annuity providing a pension over the lifetime of the employee, his dependent parents, and spouse at the time of retirement. In the case of the citizen’s NPS the annuity selected may be in the form of a survivor annuity that will pay a survivor pension to the subscriber’s spouse.

**Early exit**

Both NPS schemes permit individuals to exit the scheme prior to attaining age 60, in which case 80% of the Tier I account must be annuitized. The remaining 20% may be withdrawn as a lump sum. There is no option to partially withdraw account balances.

**Death of subscriber**

In cases where a subscriber dies, regardless of cause, the balance in the subscriber’s account may be transferred to the NPS account of a nominee or taken as a lump sum by the nominee.

**Investment of account assets**

The pension contributions in the civil service scheme are invested by professional asset managers in accordance with the investment guidelines of the government applicable to non-government provident funds, and in accordance with the mandates of the PFRDA.

Civil service NPS. PFRDA has hired three public sector investment managers in a competitive bidding process to manage civil service scheme assets in segregated “pension funds” established for this purpose. PFRDA allocates investments to these funds in a manner it determines annually. At this time, there is no civil
servant choice in selection of a pension fund. Prior to the establishment of the pension funds, the NPS contributions had been held in the Public Account of India on a temporary basis and earned an administered return of 8.5% per annum.

Citizen’s NPS. The PFRDA has hired six professional investment managers in a competitive bidding process to manage the assets accumulating in the citizen’s scheme. The scheme requires individual subscribers to select one of the six PFMs with whom to invest his or her account assets. Each PFM is required to offer three different diversified portfolios, the composition of which is regulated by PFRDA. These funds include:

- “E”: “High return, High risk”, which invests up to 50% of its assets in equity instruments using index funds;
- “C”: “Medium return, Medium risk”, which invests in predominantly fixed-income-bearing instruments; and
- “G”: “Low return, Low risk”, which invests in purely fixed-income instruments.

Once a PFM is selected by the subscriber, he or she can make an “active choice” to direct the investment of his or her account balance and divide the balance among the three asset allocation options that are managed by the PFM he or she has selected. The funds of an individual, however, must remain with only one PFM. Alternatively, after selecting a specific asset manager, an individual can elect the “auto choice” option. In this case, the investment of the account balance is automatically invested across the three portfolios managed by the selected PFM in a proportion established in accordance with the age of the individual.7

The NPS obviously provides greater investment choice in the unorganized sector scheme than in the current civil service scheme. The age-adjusted default investment option is also a more precise mechanism than the single pool approach currently provided to the civil servants who, in effect, are defaulted into a single asset allocation. On the other hand, the unorganized sector scheme limits the individual subscriber to one PFM, whereas the civil service scheme provides (mandated) exposure to all PFMs selected by the PFRDA.

Switching investment choice

After making initial investment decisions, a subscriber in the NPS’s unorganized sector scheme may reallocate account assets among the funds offered by the PFM he has selected, but may do so only once annually in April of each year. (As noted above, there is no choice in the civil service scheme.) Eventually, the subscriber will also be permitted to switch from one PFM to another.

Program access and administration

Civil service scheme. NPS civil service scheme account administration is intended to be integrated with civil service payroll processes and contributions are paid on
an automated basis via payroll. Civil servants are automatically enrolled in the program when hired. In effect, from the perspective of a newly hired civil servant, the process will require no decision on his or her part.

Citizen’s NPS. Unlike the NPS civil service scheme, the unorganized sector scheme relies on voluntary participation. Individuals must open an account at a POP-SP. POP-SPs, which are financial institutions (generally bank branches) that are authorized by the PFRDA to act in such capacity, serve as “collection points and extend a number of customer services to NPS subscribers.” Individuals who have established an account may make contributions on a voluntary basis at any POP-SP nationwide, regardless of which financial institution processed the establishment of the NPS account.

Account portability

An individual opening an account is assigned a Personal Retirement Account Number (PRAN), as well as a Telephone Password (TPIN) and an Internet Password (IPIN), from CRA. The PRAN remains the same regardless of where an individual resides. Under NPS, an individual is not permitted to establish an account if he or she already has one. This feature of NPS is designed with the intent of avoiding problems reportedly undermining account portability provided in the Employees’ Provident Fund (EPF). Although the EPF is intended to provide account portability to individuals moving from one employer to another, it has been plagued by inactive, orphaned accounts and multiple accounts established by individuals over the course of a lifetime of employment with different employers.

As of this writing, some dimensions of NPS account portability remain unclear. First, it is not clear whether accounts are portable between the civil service and unorganized sector schemes. Second, it is also unclear whether an individual retains the same PRAN if he or she seeks to open a new NPS account after closing an account (early exit).

Grievance redress

Citizen’s NPS. Subscribers may register grievances and complaints by calling the CRA call center at a toll-free telephone number after following authentication procedures, registering the grievance online at a specified website, or by submitting the grievance in a prescribed form to a POP, which would forward it to the “CRA Central Grievance Management System” (CGMS). Each grievance is assigned a token number, regardless of the manner in which it is registered or submitted. This enables an individual to check the status of its consideration either at the CRA website or through the call center. The grievance process is designed to handle and respond to complaints within 30 days.

There is an appellate process. Individuals who are not satisfied with the CRA’s resolution of their grievance may refer their complaint in writing to the “Grievance
“Redress Cell” (GRC) of PFRDA. The GRC will review complaints received directly from a subscriber or from an advocate, agent or third party if such person is formally authorized by the subscriber to act on his or her behalf.

In addition to the two-tiered grievance process, the PFRDA has made great efforts to ensure that NPS architecture is “transparent” and “web-enabled” in order to allow a subscriber to monitor his or her investments, investment returns, and choice of PFM.

**Governance and institutions**

*Establishment of PFRDA and scope of authority*

The Ministry of Finance (DEA) established the PFRDA as an “interim body” by Executive Order in October 2003, pending establishment of the PFRDA legislatively. Despite the efforts of the government, the Parliament has yet to take such action. While Parliamentary approval is awaited, the PFRDA continues to operate on the basis of the 2003, which was renewed by resolution in November 2008. The PFRDA was established to “regulate and develop the pension market.” Consistent with the purpose for which it was established, the PFRDA is provided with authority sufficient to “enable it to effectively regulate, promote and ensure the orderly growth of the pension market.” Its authority includes the ability to “provide itself with suitable supporting staff and raise adequate resources” by developing its own funding stream based on user fees. It has explicit authority to determine its own procedures and power to obtain records and documents relevant to its operation from official and non-official bodies.

In December 2003, the Ministry of Finance instructed the PFRDA to establish a mandatory defined contribution system for new entrants to the Indian Civil Service - the NPS. The Ministry’s Notification provided only an outline of the “architecture of the New Pension System.” In addition to identifying who would be covered by the NPS civil servant scheme, the contribution rates, and distribution rules, the December 2003 mandate also established in general terms the operational “architecture” for the New Pension System, requiring that it include:

- central record keeping and accounting infrastructure (CRA);
- several pension fund managers (PFMs) to offer three categories of schemes; and
- disclosure rules under which the CRA and the PFMs would “give out easily understood information about past performance so that the individual would [be] able to make informed choices about which scheme to choose.”

In January 2007, in the face of continued parliamentary inaction, the government instructed the PFRDA to move forward with the implementation of the NPS for the civil service and appoint a CRA and PFMs. In November 2008, the Ministry of Finance announced that the NPS would be expanded and made
available “to all persons, including self-employed professionals and others in the unorganized sector.” There is no additional text or direction regarding the implementation of the unorganized sector scheme.

**Key NPS institutions**

The PFRDA is headed by a chair appointed by the central government and no more than two full-time and two part-time members selected by the central government from amongst persons “having experience and knowledge in economics, finance, legal and administrative matters with one person from each discipline.” The chair and members serve 5-year terms and are eligible for reappointment.¹⁴ The salary, allowances, and other matters related to the terms of employment of the chair and members are set forth in the 2003 and 2008 notifications issued by the ministry.

The specific entities involved in the governance and operation of the NPS are the following:

- *Pension Fund Regulatory and Development Authority (PFRDA)*;
- *NPS Trust and NPS Board of Trustees*;
- *Trustee Bank: Bank of India*;
- *Central record-keeping agency (CRA):* National Securities Depository Limited (NSDL) serves as the CRA for both the civil servant and unorganized sector schemes;
- *Custodian: Stock Holding Corporation of India Limited*;
- *Pension fund managers (PFMs):¹⁰*
  - ICICI Prudential Pensions Fund Management Company Limited
  - IDFC Pension Fund Management Company Limited
  - Kotak Mahindra Pension Fund Limited
  - Reliance Capital Pension Fund Limited
  - SBI Pension Funds Private Limited
  - UTI Retirement Solutions Limited
  - *Points of Presence (POPs)* include 35 banks, brokerages, and third-party distributors, and 12,226 POP-SP branches.¹¹ ¹²
- *NPS subscribers:*
  provided with proper disclosure and transparency, NPS subscribers may provide a vital policing function, ensuring service quality, accuracy of accounts, and the timely execution of transactions.

**Recent developments**

*Introduction of co-contributions*

Several notable innovations were introduced after the 2009 rollout of NPS to the public recently. During the 2010–2011 Union Budget meetings, the Indian
Finance Minister announced an annual co-contribution of Rs1,000 for 4 years for every citizen who voluntarily opens an NPS account during 2010–2011. In 2011, the Indian Ministry of Finance has extended this co-contribution benefit by another year. This benefit, which is aimed at low-income workers, is limited to those who save between Rs1,000 and Rs12,000 per year, including those made to an NPS account. Apart from the social policy attractions of this approach, there is an important vertical tax equity issue involved. Higher-income earners in India enjoy benefits of up to Rs30,000 tax deduction per year for retirement contributions. Low-income workers are excluded from such tax benefits. From a tax expenditure point of view, there is little difference between tax-funded subsidies and forgone tax revenues. On the face of it, therefore, this “Swavlamban Initiative” seems to be a prudent policy measure. Moreover, from a social policy perspective, co-contributions may be a necessity if the NPS is to have any chance of generating adequate retirement income for low-income workers, especially those in the unorganized sector. Indeed, it has been established that the low, intermittent incomes of most unorganized sector workers may not produce an above-poverty annuity, even if they diverted a significant part of their consumption towards long-term savings over multiple decades. However, model simulations reported on in Chapter 9 of this book do not show a strong poverty impact of the initiative, as the sum involved is simply too low.

The main impact of the move may be, rather, to encourage membership. The government anticipates this co-contribution will motivate the poor to join the NPS and inspire savings discipline in the current voluntary environment. Although the government was targeting voluntary coverage of 1 million low-income informal sector workers by March 2011 and had committed a co-contribution budget of Rs1 billion from the Union Budget for this purpose, only 30,227 NPS-Lite accounts had been opened by early February 2011 (see below for description of NPS-Lite).

In parallel, the state governments of Karnataka and Haryana have announced a similar co-contribution based incentive for their low-income unorganized sector workers. Both states have decided to co-contribute Rs1,200 per year (over and above the annual Rs1,000 co-contribution by the central government) for workers who join the NPS starting 2010–2011. With this, the number of state governments that have decided to offer pension co-contributions has risen to five. The other three states are Rajasthan, Madhya Pradesh, and Andhra Pradesh.

The policy interventions at the level of the federal government and states are guided by the following priorities:

- to achieve early, inclusive, and mass-scale voluntary enrollments in the NPS, cutting across occupations, geography, and incomes and especially among the vulnerable low-income informal sector workers in remote locations;
- to achieve a stable, secure, and efficient grassroots-level transactional and administrative environment under which modest, periodic old-age savings of the poor are collected and transferred to PFRDA-regulated fund managers;
- to deliver identical rights and choices and easy access to standard high-quality services to every citizen and especially to the poor; and
to encourage adequate contribution levels and sustained savings discipline by the poor.

It is too early to fairly assess the long-term impact on membership of the introduction of co-contribution incentives. Prior to its introduction, subscription rates had been quite disappointing. Although the PFRDA had appointed 35 banks, brokerages, and large third-party distributors as POPs, which make NPS available through 12,226 POP-SP branches, voluntary coverage by the NPS had only reached 55,611 subscribers by August 2011—or an average of just 2 customers per branch a year after this Scheme was opened up to the public in May 2009. India’s experience with the voluntary NPS rollout between 2009 and 2011 has demonstrated that in addition to providing access to the NPS, the following may be needed to achieve a greater impact on coverage: (i) active promotions; (ii) sound commercial incentives; and (iii) active, field-level implementation. Marketing strategies and improved business processes are discussed in Chapters 6 and 7.

NPS-Lite: simplifying accounts, reducing costs, and introducing grassroots intermediaries

To implement the co-contributions-based NPS under the new Swavlamban Initiative and deliver on the Government of India’s policy objective of mass-scale, early coverage of NPS, especially among the working poor in remote locations with low banking penetration, the PFRDA has launched an “NPS-Lite Model” based on low administrative and transactional costs and charges. At the front end of customer interface, the PFRDA has announced an NPS-Lite implementation based on a “group” model to harness the outreach and grassroots-level enrollments and service delivery capacity of the micro-finance, cooperative, and self-help group (SHG) movements in targeting and servicing the old-age saving needs of low-income workers. Pilot activities in Mangalore and Hamirpur on outreach, which are discussed in Chapter 6, suggest considerable scope for such interventions.

Service providers for the poor under this model are expected to perform a number of key tasks, including (i) delivering pension literacy training and actively promoting retirement planning among their membership, (ii) cross-selling the NPS to their customers or members, (iii) providing individual subscribers with a single-window interface for efficient access to transactional services (account opening, channeling contributions to selected PFMs and schemes, channeling instructions regarding switches across PFMs and schemes), (iv) providing a single-window interface for transparent access to objective informational services (periodic account statements, PFM performance data, complaints resolution, changes in personal contact information or nominees), (v) addressing problems of dormant accounts by motivating inactive NPS-Lite subscribers to continue periodic contributions into their NPS-Lite accounts, and (vi) delivering terminal NPS-Lite benefits to retirees.
The ability of grassroots-level entities, including cooperatives, micro-finance institutions (MFIs), non-bank financial companies (NBFCs), SHGs, and worker associations, to undertake secure, accurate, and swift transmission of information, instructions, and funds to authorized NPS service providers, as well as to provide standard, high-quality, uninterrupted services to subscribers in remote locations is of paramount interest to the government and the PFRDA. If the NPS-Lite is unable to provide easy access to all potential subscribers in India, or if subscribers face frauds, delays or errors, or if they do not receive a standard high quality of uninterrupted services and objective information, the NPS-Lite will fail to gain inclusive coverage and traction among the poor and will, thus, fail to meet its core public policy objective of effectively mitigating the longevity risk of the poor.
4 NPS analysis, findings, and recommendations I

Design

In the previous chapter, we presented the design, governance, and institutions of the NPS, focusing on the NPS’s unorganized sector scheme or “citizen’s NPS.” In this and the following chapter, we present analyses of these features from a structural and institutional point of view, in the first case, and a legal and regulatory point of view, in the second.

In the discussion below, we identify a number of concerns regarding the design and structure of the citizen’s NPS scheme. These concerns can be addressed, and at the end of the chapter we summarize some recommendations to do so. It is important, however, to first put in proper perspective the challenge of designing a successful voluntary pension program that focuses on the unorganized sector and low-income workers. Providing adequate pensions to workers in the informal or unorganized sector has proved to be an extremely difficult social policy goal in both developed and developing countries. Taken as a whole, experiences internationally, whether in the form of compulsory or voluntary schemes, have been somewhat discouraging. Significant success in achieving adequate pension coverage for the unorganized sector in developing countries is a “holy grail” that has yet to be attained.

The mainstay of pension provision in much of Asia, dating from the colonial period, is provident funds, sometimes ostensibly mandatory, but whether officially or in practice, voluntary for the informal sector. This has been the approach taken in India, as well as in Sri Lanka, Malaysia, Singapore, and Hong Kong, China. Provident funds have also been utilized in Thailand. Although we save a discussion of India’s Employees’ Provident Fund for later chapters, at this juncture in our analysis, it is sufficient to focus on the fact that India’s EPF, like other provident funds internationally, effectively covers only employers and employees in the organized sector. In fact, any sort of mandatory, long-term savings program targeting the unorganized sector has seen little success. Among the reasons discussed in Appendix 1, two stand out.

First, individuals in this sector have modest, intermittent incomes. Under these circumstances, individuals are unable to make adequate and regular contributions or satisfy compulsory obligations that may be imposed upon them. Similarly, the owners of small, formally registered businesses are likely to seek ways to evade compulsory pension contribution obligations by underreporting wages and
numbers of employees, or simply ignoring their legal obligations. Those small businesses that do comply with contribution obligations may seek to offset the cost of doing so by reducing other expenses—for example, by limiting wage increases or refraining from making marginal hires of new employees. Moreover, those small businesses that are only marginally profitable may elect to close and, at best, begin to operate on an informal basis. For those small employers that are already operating on an informal basis, the introduction of compulsory pension contribution obligations will reduce their incentive to formalize their businesses and comply with other basic, legal requirements associated with entering the formal economy, such as registration or licensing.

Second, the imposition of compulsory pension obligations in this sector creates almost insurmountable enforcement challenges for the government. In developing countries with large informal sectors, such as India, the state is likely to have insufficient capacity to enforce contribution obligations among this population.  

The ineffectiveness of mandatory schemes has resulted in many countries and their policy experts exploring two distinct approaches to achieving higher levels of coverage. One alternative is to establish universal non-contributory coverage for basic social security, especially pensions (often referred to as citizens’ pensions or demogrants). This alternative has attracted significant support in the developed world.  

Citizens’ pensions are typically small, thus fiscally affordable, indexed to inflation and funded from general tax revenues. Their goal is to prevent poverty, providing an income foundation from which citizens can build via voluntary retirement saving. The approach has also attracted adherents in developing countries (Sri Lanka, Lesotho, Brazil, Maldives, and others). The main concern cited against the approach is fiscal cost—while the cost of a modest pension program may be small relative to GDP, it may be large relative to tax revenues in a setting where direct taxes are low and revenue collection is weak.

The second alternative is to encourage voluntary savings. Studies of voluntary pension schemes in developed countries have shown that, in addition to an effective taxation regime, two factors can increase the likelihood of voluntary saving for old age: an arrangement where people opt out instead of opting in, and the ability to retrieve some assets if necessary.  

In the case of India, tax incentives will have little effect for most of the population, and a mandatory opt-out is neither administratively feasible nor readily enforceable. The remaining design lever, then, may be permissive, pre-retirement access to pension account assets. While there is a significant risk that allowing withdrawals will leave insufficient amounts for retirement, it appears that for many people the possibility of taking their funds out increases likelihood of participation. As we describe below, the NPS rules are designed to provide pre-retirement access and, at the same time, prevent the dissipation of long-term savings by splitting NPS savings into a Tier I account, to which pre-retirement access is limited to closing out the account, at which time 80% of the account value is paid in the form of an annuity; and a Tier II account, the balance of which is accessible to the subscriber at any time.
Voluntary nature of program and impact on participation

As is the case with any voluntary pension scheme, in order for the NPS’s unorganized sector scheme to succeed, its design (and the publicity of the scheme) must engage potential subscribers and induce them to participate in the scheme, keep to a minimum the impediments that may prevent them from doing so, and avoid inadvertently creating new barriers. The scheme’s design therefore must attract the interest of individuals who are disinclined to participate in the scheme and encourage them to take the steps necessary to participate—and to continue to participate. Prospective subscribers must (i) open an account, (ii) make contributions on a periodic basis in amounts and with a frequency satisfying the scheme’s minimum contribution rules, and (iii) select an asset manager for account assets. Each of these steps could inhibit initial and/or continued participation in the program. For example, whether an individual will open an account depends on a number of factors, including his or her knowledge of the program (successful publicity), sufficient engagement or interest in the program to overcome inertia or trepidation (in the case of individuals with little financial knowledge or experience with banks and other financial institutions), ease of access to a POP, the individual’s ability to understand the program, its rules, and its benefits in comparison to other alternatives, and its affordability.

The PFRDA has tried to tackle dimensions of this challenge. For example, the PFRDA has sought to reduce barriers to scheme participation by developing an online application system and e-payment facility with the assistance of the CRA. 5 A web-based strategy may become quite important in the long term, but in the immediate future, focusing on this strategy will preclude much of the population that the program had initially envisioned reaching, as they lack internet access. Similarly, NPS design has focused on tax incentives. As we have already noted, tax incentives are frequently used to encourage individuals to participate in voluntary schemes, but they will not likely be effective for most of the Indian population. Both of these strategies fail to take account of the practical and financial constraints on most of the NPS’s target population.

By comparison, the PFRDA’s more recent actions to launch the “Lite” version of the NPS and to use intermediaries as “aggregators” for collecting, pooling, and transferring modest individual contributions, including those of persons without banking access, are more appropriate interventions. Each of these measures, which were described in the previous chapter, focuses on the elements of the NPS design that deter large portions of the Indian population from participating in the NPS. Similarly, the introduction of co-contributions creates a financial incentive appropriately aimed at the individuals of the NPS’s target population: in effect, providing them with a monetary incentive in lieu of the tax incentive that is relevant to only those individuals in higher-income categories.

Other factors that shape the savings patterns and behaviors of the Indian population also should be considered, and, if possible, addressed. For example, the saving rate of Indians is relatively high, but savings are traditionally held in bank accounts and gold, not in long-term financial instruments. For NPS participation
to grow, policy makers must identify and address the underlying reasons for the prevailing cultural attitudes towards financial institutions and products and other impediments to financial inclusion and access, including the low level of financial literacy among the general population. Similarly, they must focus more sharply on understanding the day-to-day needs of much of the population, which make it improbable that many people will have the financial wherewithal to “lock up” savings for retirement purposes.

Because the NPS’s unorganized sector scheme has experienced extremely low uptake rates in its first years of operation, it is important to quickly assess the reasons for the low level of public response. Assessing the “buy side”—the potential subscriber—will be a key to the NPS’s ability to increase subscribers. It may make sense for the PFRDA to consider launching a survey of the current, voluntary subscribers to better understand who they are and what factors motivated them to establish an NPS account. Similarly, the PFRDA should conduct an assessment of the sales efforts and outlook of the roughly 12,200 branches of POPs responsible for distributing the NPS product, as well as the incentives necessary to align their interests with that of the NPS and its subscribers. The continued gathering of empirical data, such as that we describe in Part III, will enable PFRDA and the POPs to continue to adjust the product’s design and address the remaining impediments to NPS participation.

Having identified some of the many challenges that the PFRDA confronted, and which it will continue to confront, in designing the rules and mechanics of the NPS for the unorganized sector, we will now focus our analysis on various aspects of the product design. There are four contribution-related limitations to consider. First, there are the minimum contribution requirements imposed by PFRDA; second, the extent of the incentives to contribute; third, the cost of contributing and maintaining the account; and fourth, the limitations on access to the contributions accumulated in the account. Each of the limitations represents a design decision that could affect an individual’s decision to participate in the NPS.

**Contribution limitations**

The NPS today requires minimum contributions of Rs500 per transaction and Rs6,000 per year to Tier I pension accounts. The impact of these minima clearly will be more relevant to low-income earners. Individuals with less financial flexibility, low wages, or intermittent income, may find it difficult to commit to making the required minimum contributions of Rs500 per transaction and Rs6,000 per year. This ongoing, prospective commitment could be a substantial barrier to entry. Similarly, because such individuals will have smaller balances, the flat fees paid to open and maintain an account, discussed in more detail below, will be a greater concern to them and may not compare as favorably to the service and transaction fees of competing products.

By comparison, for more highly paid individuals, the annual, minimum contribution requirements should not be a barrier to participation in NPS. Indeed, assuming the NPS product is sufficiently attractive to them, these individuals may
be more concerned with maximum contribution limitations than with the NPS’s minimum contribution requirements. Although there is no maximum limitation on amounts that individuals may contribute to their NPS account, the tax rules provide only a limited incentive to contribute and may act as an implicit cap on the amounts that individuals in this cohort may elect to contribute annually. Specifically, under the “EET” tax structure of the NPS account, only up to Rs100,000 contributed to the account is deductible from income annually under section 80CCD of the Income Tax Act, 1961.

**Tax treatment**

The “EET” tax regime under which the NPS operates is the predominant tax regime used for pension products internationally. However, an EET tax regime puts the NPS at a distinct disadvantage when compared with the EEE tax regime applied to other long-term savings and pension products in India. Currently, an EEE tax regime applies to other state-run plans such as the Public Provident Fund (PPF), Government Provident Fund (GPF), and Employees’ Provident Fund (EPF). Retail pension plans, like the NPS scheme, are usually taxed at withdrawal under an EET tax regime. This disparate treatment has been widely recognized, and it is likely to be addressed. The new draft Direct Tax Code proposed to become effective on 1 April 2012, and which aims to bring the NPS into the EEE category and at par with other long-term and retirement savings plans, is a significant development for the NPS.7

There is also a significant technical distinction to be observed in the tax treatment accorded the NPS’s civil servant scheme and that accorded its unorganized sector citizen’s scheme. Contributions to the NPS’s civil servant scheme are clearly deductible under section 80CCD of the Income Tax Act, 1961, up to 10% of salary (including dearness allowance) earned in the previous year. Additionally, amounts plus interest withdrawn and received from the scheme are taxable if received as a result of account closure or opting out of the scheme, or if paid as a pension from an annuity plan purchased with scheme assets. However, whether section 80CCD applies to the NPS’s citizen’s scheme is less clear. According to its title, section 80CCD applies to “pension schemes of Central Government.” However, the text of the section permits the deduction for contributions only of any individual “employed by the Central Government or any other employer on or after the 1st day of January, 2004… under a pension scheme notified or as may be notified by the Central Government.” At a minimum, therefore, in order to ensure the applicability of section 80CCD, the government may be required to notify the scheme.

The language of section 80CCD, however, may be read quite narrowly, so that such notification might not be sufficient to clearly establish the provision’s applicability to NPS’s citizen’s scheme. Section 80CCD arguably contemplates the deductibility of contributions made *only by employed persons* (and, perhaps only *to occupational, rather than individual, schemes*). While such an interpretation of the scope of the provision may be too literal, it is unclear whether the provision
can be said to be applicable to the NPS’s unorganized sector scheme at all. Obtaining clarification of its scope is important because most competing pension and long-term savings products are deductible under section 80C of the tax law.\(^8\)
According to news reports, the PFRDA has recognized there is, at a minimum, a need to clarify the matter, and it is seeking to address the issue.\(^9\)

Tax rules, however, should not be overemphasized. Although tax treatment may be a key driver that will result in some individuals deciding to invest in an alternative long-term savings product, the NPS holds some distinct advantages—including its low asset management fees, as well as the imprimatur of government management and oversight, and the scheme’s similarities to the NPS’s civil servants scheme, which create a halo effect for those individuals inclined to be concerned about the safety and security of their assets. Moreover, it is unlikely that the intended, core target audience for the NPS’s unorganized sector scheme will act primarily on the basis of the tax treatment. On the other hand, individuals with the most financial ability to participate in NPS will take the tax rule into consideration—and they will compare other long-term savings and investment opportunities with which the NPS should be able to compete on a level playing field. Furthermore, over the long term, tax treatment will become an increasingly relevant consideration for an ever-growing portion of the Indian population, as individuals’ incomes and their exposure to tax liabilities increase. Moreover, it may still be argued that these tax considerations are relevant even today to the success of the NPS among the target population: if the group for which tax treatment is most directly relevant, eagerly and in great numbers, open NPS accounts, it may have an important signaling effect on the rest of the market.

### Fees and expenses

Fees and expenses are important to individuals assessing long-term savings products. The current NPS fee structure does not compare advantageously to the fees charged by other competing programs and products—especially for low-income workers making modest contributions. As previously described, the NPS subscriber must pay a flat annual fee, transactional fees, and investment management fees, in addition to a fee to open the account. In the short term, these fees may put the NPS account at a disadvantage in a competitive market—and, in fact, some financial institutions have developed comparative charts to demonstrate that their own proprietary products may be a lower-cost option in the initial years after account establishment. The micro-simulation analysis presented in Chapter 9 concludes that the ultimate anti-poverty impact of NPS is sensitive to the fee structure.

In the long run, however, the combination of NPS’ flat annual fees and its low investment management charges should be beneficial. As an account grows, the flat fees will diminish relative to growing account balances. Additionally, assuming fee levels remain constant, inflation will erode the actual cost over time. As the relative importance of the flat annual fees diminishes, the asset-based investment management fee will become the more significant factor when comparing
the NPS’s costs to those of other products. Assuming it does not increase, the investment management fee should compare favorably: the PFMs providing investment management services to the NPS earn 0.0009% on assets under management, which is extraordinarily low by any measure, and a good deal lower than charges levied by mutual funds and other investment products. Unfortunately, fee levels are not guaranteed under NPS program rules, so it is unclear whether this assessment will remain accurate over time. In fact, there are already indications that asset managers will eventually demand a higher fee. Nor is the low cost of asset management likely to sway smaller account holders.

In addition to the possibility that the NPS fee structure could change is the fact that the current terms under which the fees are set are not transparent to the public. Neither the terms of the contractual agreements that the PFRDA have reached with the PFMs nor the banks serving as POPs have been publicly disclosed. As a result, little is known about the duration of the contracts or the extent to which the contractual terms permit the parties to reset or renegotiate fees. Moreover, although it is assumed that the PFRDA has developed a standard agreement for all similarly situation parties, it could be the case that PFRDA has entered into one-off agreements with each PFM and POP, or permitted variances and amendments to the standard document on a party-by-party basis. By contrast, although there are similar issues regarding the lack of disclosure of the contractual arrangements that PFRDA has entered with CRA, the terms relating to fees have been disclosed: CRA has agreed to reduce the annual maintenance fee and charges per transaction when the number of NPS accounts reaches 1 million and to further reduce fees when the number of accounts reaches 3 million. These breakpoints are disclosed in the Offering Document and Welcome pamphlet provided to the public.

For individuals with small accounts, the start-up and ongoing annual fees assessed against accounts may seem quite expensive. The total first year’s cost for an NPS account is Rs560, and the annual cost, assuming four transactions per year, is Rs470. For an individual who saves the minimum of Rs6,000 per year in NPS, this translates to 9.7% and 7.6% of the first year’s and subsequent annual contributions, respectively. Many of the individuals that the government hopes would participate in the NPS will be very sensitive to price. The start-up and annual costs will be a larger percentage of their new accounts, because their account values will be quite small in initial years. Moreover, many in this population may seek to make modest, monthly contributions to their accounts—and, as a result, the transaction fee will affect them more substantially than a person making only the annual, minimum number of four contributions to his or her NPS account. Moreover, assets spent on costs will likely come from assets that such an individual may have saved. The PFRDA’s introduction of an “NPS-Lite” scheme with relatively modest fees and charges, and the government’s introduction of co-contributions for NPS-Lite are efforts to address these concerns. Other potential actions could include the introduction of a governmental subsidy to pay all or a portion of the fees assessed during the year in which the account is established (or over the first several years, perhaps on a declining basis).
developed in Chapter 9, significantly reducing fees can substantially increase the proportion of low-income savers who are able to attain a poverty-level income in old age by participating in the NPS.

**Composition and disclosure of investment portfolio allocation**

Each of the six PFMs participating in the NPS’s citizen’s scheme offers three diversified portfolios to a subscriber, the composition of which is regulated by PFRDA. The Offering Document provided to subscribers includes a description of the asset allocation parameters within which each fund is managed. A review of the Offering Document reveals inadequacies in the disclosure it provides. On the one hand, the Offering Document provides a sophisticated explanation of the funds; on the other hand, it leaves some fundamental questions unanswered.

The Offering Document fails to address some of the most basic concerns an investor may have about the construction of each fund’s portfolio. For example, it is not clear whether a PFM is permitted to invest fund assets in affiliated funds it may also manage. Although PFMs are required to segregate their NPS asset management operations from those of their other, similar asset management businesses, it is not clear whether the PFMs may invest in affiliated funds. There are reasons both to permit and to prohibit such investments: although investing in affiliated funds gives rise to substantial self-dealing and conflict of interest concerns, it may be an appropriate way to achieve economies of scale and reduce investment management costs, especially in the early years of the NPS. Requiring separate infrastructure has imposed unnecessary operational redundancies and costs on the investment firms that are participating as PFMs—costs which are not accurately reflected in the current asset management fee. One option would be for the PFRDA to permit the PFMs to make greater use of existing infrastructure on a temporary basis; and rules requiring the wholesale segregation of operations could be re instituted once the NPS matures and economies of scale are more readily achievable.

The PFRDA and NPS Boards of Trustees may be able to adequately address the issue of self-dealing and conflicts of interest by setting explicit guidelines, appropriately monitoring investment decisions, and ensuring proper public disclosure. Unfortunately, it may be difficult to adequately explain the level of fees that a PFM would earn in such circumstances to investors, because a PFM investing in affiliated funds would be (indirectly) earning substantially more than the stated asset management fee. Moreover, PFMs engaged in such investments would each earn different fees above the flat, universal fee now earned by each PFM, depending on the percent of its portfolio it invested in affiliated funds and the level of fees it earned as the investment manager of those funds. In short, such arrangements would undermine several policy priorities: complete transparency, low fees, and the simplicity and universality of the fees charged.

The Offering Document also fails to clearly describe the asset composition rules applicable to the funds. The Offering Document’s description of the “E” asset class provides a good example of the deficiencies. As described in the
Offering Document, up to 50% of the assets in an E fund may be invested in equities. More specifically, it states that these assets are invested in “index funds” replicating the portfolio of particular indices, such as BSE Sensitive index and NSE Nifty 50 index. The Offering Document, however, does not state what limitations are applicable to the remaining 50% of the assets. Second, it does not explain how the index funds are constructed. Is a PFM permitted to invest E fund assets in existing index funds that an affiliated entity or a third party manages, or is it required to directly invest E fund assets in a manner which replicates various indices, i.e., to construct its own portfolio of stocks included in the reference indices? In the former case, the PFM would be operating a “fund of funds” for one-half the assets it is managing. In the latter case, the asset management function, at least in the early years of the program, may be quite expensive to manage given the relatively small size of the fund. Moreover, assuming that E fund assets are permitted (or required) to be invested in index funds, there is no clear requirement that the index funds be those of asset management companies (AMCs) regulated by SEBI, a requirement that is explicitly imposed on the “C” fund.

The Offering Circular needs to be revised to provide a more complete explanation of the investment portfolio rules for each asset class available to subscribers, so that they are better able to understand how their retirement savings will be invested. At the same time, the PFRDA must strike the proper balance between full disclosure and comprehensibility, taking account of the level of financial literacy of the intended audience. It is unclear, however, that the Offering Document succeeds on this level. Although in our judgment the descriptions provided in the Offering Circular are incomplete, they may also be too sophisticated for many prospective NPS subscribers to comprehend.

**Pricing of pension fund units—net asset value**

The disclosure material available to subscribers also inadequately describes fund pricing. According to the informational pamphlet, “net asset values” (NAVs) of funds are released on a regular basis so that investors may be able to take informed decisions.” But it is unclear what constitutes a “regular basis.” Arguably, a PFM could be in full compliance with this standard and, yet, at the same time a subscriber would not necessarily have an up-to-date NAV when opening an account or deciding whether to re-allocate investments among a PFM’s funds or to switch PFMs. It may be desirable for NAVs of NPS schemes to be published in newspapers alongside NAVs of mutual funds and equity prices. This will achieve the desirable transparency of NPS NAVs, and simultaneously create more visibility for the NPS as an investment option. Importantly, NPS funds may then be easily compared to retail AMCs.

**Switching—annual PFM and investment option choice**

NPS subscribers have only a limited ability to change their asset allocation by switching PFMs and shifting their asset allocation among the “E”, “C,” and “G”
NPS account design

funds. Given the long time horizon for which assets are invested, the administrative and transactional costs that can arise if individuals elect to constantly reallocate their NPS portfolios and the desire to discourage market timing strategies among asset classes, efforts to limit such activity are appropriate.

Nonetheless, there may be adverse consequences to the limitation. First, there will be an unusual amount of activity in the 1 month in which switching is permitted, and the unusual activity may unnecessarily strain NPS administration. For example, in a mature program with millions of accounts, a POP could be overwhelmed by subscribers seeking to change their investments. Second, the PFMs could determine that the funds they manage need to hold a larger cash position to ensure the liquidity necessary to accommodate an anticipated uptick in subscriber activity. As a result, the funds will be “out of the market” unnecessarily. Moreover, PFMs will have incurred market transaction costs that, arguably, could be avoided under a different rule. Finally, once the NPS matures, the bunching of the switching decisions of subscribers may result in unusually large trades, which could have an impact on the wider market.13

In reviewing the limitation placed on subscribers’ ability to change PFM, it is relevant to consider the behavioral response to similar rules imposed elsewhere. Two notable cases are that of the United States and Chile. When US 401(k) schemes first introduced an element of choice in investments for participants, the choice was frequently limited to an annual, quarterly, or monthly choice. The limitations imposed on investment reallocation were often a reflection of the administrative burden anticipated and limitations on asset valuation, which was, in many cases, monthly, rather than daily. As those limitations became less relevant, schemes began to permit participants to change investments on a daily basis. In many cases, rather than experiencing increases in portfolio reallocation, many schemes experienced little overall change, or decreased activity. If an individual is told that he or she must reallocate his or her investments within a specific period of time, and failing to do so, must wait until next year, then he or she will tend to make a change in his or her portfolio. However, if an individual knows he or she can reallocate investments at any time, then he or she will not feel pressured to do so. Moreover, individual decisions to switch PFMs or reallocate among funds and concomitant administrative activity will be spread more evenly throughout the year, rather than bunched into one short, annual period, thus avoiding some of the potential problems discussed above.

In Chile, large numbers of individuals participating in the Chilean pension program were often prodded to change their “AFP (Administradora de Fondos de Pensiones or Pension Funds Administrators” fund selection by an aggressive sales force hired by each AFP. The resulting transactional costs were substantial. In the case of Chile, the switching was unnecessary because the portfolios of each AFP were highly regulated (essentially, they invested in government bonds), and there was little real divergence in performance. This type of problem should not be a substantial one for NPS, because the program is designed so that little direct pressure can be placed on individual subscribers.
Portability

One of the most significant features of the NPS design is that it provides a foundation for a completely portable pension program. The PFRDA should consider the full possibilities of this aspect of the NPS.

One aspect of portability arises from the fact that the NPS now has two separate schemes. For example, as noted in the description of plan design features above, it is not clear whether a civil servant can transfer his or her assets from the civil service scheme to an account in the NPS’s citizen’s scheme. Because both accounts are maintained by the CRA, such transfers presumably would not be administratively difficult to execute. This portability would be useful in the case of a civil servant who severs service with the government and takes up private sector employment, or vice versa. On the other hand, it is unclear whether a former civil servant would have incentive to do so, because he or she may be required to pay certain transactional and other expenses in the unorganized sector scheme, which are paid by the government in the civil servant scheme.

The opposite scenario also raises similar questions. If a subscriber to the NPS’s unorganized sector scheme were to become a civil servant, would his or her NPS account automatically transfer to the civil servant scheme? If so, how is the difference in investment options and choice to be addressed? Some individuals may want to maintain their account in the unorganized sector scheme in order to retain access to investment choice and a broader array of investment managers. Could (and should) the individuals retain an active account in each scheme? If he or she were permitted to maintain the two accounts, would the civil servant be permitted to transfer assets on a regular basis from the civil servants’ scheme account to the citizen’s scheme account? To the extent that the PFRDA expands the choice available to civil servants, the motivation for individuals to utilize the citizen’s scheme rather than the civil servants’ scheme will be reduced substantially.

Perhaps more significant than the interplay between the two NPS schemes is the potential for moving assets into the NPS schemes from other individual account-based schemes and pension plans, and vice versa. The most obvious situation, which is one that some Indian policy makers have contemplated, is the relationship between an individual’s EPF account(s), or his or her account in an employer-managed provident fund, and the NPS. There are significant opportunities for permitting individual choice within these government programs. (PPF is another example.) Before such portability can be introduced, however, a number of issues would need to be considered. For example, the risk borne by NPS subscribers is quite different from the risk borne by individuals in the EPF (or PPF), because the EPF has an administered rate of return. Second, the exit rules are completely different. Enabling individuals to move assets from one program to the other could result in confusing some people and could be an invitation for others to “game” the rules, unless identifiable subaccounts were established. Establishing subaccounts, however, could result in undesirable record-keeping difficulties and increased administrative costs—and confuse the participants. Regardless of potential implementation challenges of providing portability
between various government pension and provident schemes and the NPS, this option should be considered seriously by Indian policy makers in consultation with the PFRDA, CRA, EPFO, the CBDT, and the Ministry of Finance.

An even more ambitious portability program would permit individuals to move assets to and from the NPS and other private sector pension plans and long-term savings vehicles without incurring withdrawal or tax penalties. It is unclear whether financial institutions would see this type of portability as advantageous to their business or not. Financial institutions trying to assess how this type of portability would affect their business would need to estimate the value of assets flowing to their products from NPS and out of their products to the NPS. The overall desirability of such expansive portability rules would need to be carefully considered from a policy perspective. This type of portability exists in one form already: at retirement, a significant portion of the assets an individual accumulates in his or her NPS account are required to be used to purchase an annuity in the private marketplace at pensionable age.

Portability could also be considered at the employer, rather than participant, level. For example, an employer might prefer to invest the assets of its Exempt, or Excluded, Provident Fund in the NPS, rather than manage the scheme assets itself, or seek outside asset managers or investment advisers. We discuss this possibility more fully in Part V.

Positioning the NPS among other financial products for long-term saving

The NPS account program competes with other programs and products available to the public. When one compares it in terms of cost, taxes, investment return, and exit rules, it is unclear that it will be competitive with all of them all of the time. Although some of the products that potential subscribers may compare with the NPS have not been overwhelmingly popular to date, an interest in NPS may spur a renewed interest in them. A good example may be the PPF, which has features that some people may see as beneficial – including its tax benefits, more liberal exit rules, risk-free return, and cost structure. Another good example is the “Micro-Pension” scheme designed by Invest India Micro Pension Services (IIMPS) and UTI Asset Management Company Limited, which targets the working poor with a contributory pension arrangement and has achieved a voluntary coverage of nearly 400,000 subscribers over the last 3 years.

Some people could end up saving via competing products instead of the NPS. From a public policy perspective, this is a good result—even if it means that fewer people join the NPS, so long as each person has made a rational investment decision—especially if it results in the participation of the previously unbanked and novice investors in regulated, formal financial products.

The PFRDA should accept the fact that the NPS has no natural monopoly on the unorganized sector. NPS is competing in a diverse marketplace diverse in terms of financial institutions and products, and diverse in terms of the segments
of the population it is attempting to reach. The NPS should try to focus, at least initially, on those market segments in which it appears to have some inherent advantages. It might also clearly identify the segments of the market in which it appears to perform poorly and consider product design and communications efforts that might improve uptake in those segments over time. The Indian Retirement, Earnings and Savings (IRES) Survey 2005, which was conducted for the Ministry of Finance, identified the following three potential markets for the NPS:

1. Unorganized sector workers with a capacity to pay regular pension contributions and who are interested in saving for their retirement. These workers are concentrated in three groups: traditional and mechanized farmers; small retailers; and self-employed persons including professionals.
2. Persons in salaried employment who are excluded from the Employees’ Provident Fund Organization (EPFO) membership by virtue of working in firms with less than 20 employees and who are not confident that their present savings efforts for retirement are adequate.
3. Salaried workers covered by excluded (and unregulated) pension and provident fund arrangements offered on a voluntary basis by large employers under income tax exemptions provided by the Central Board of Direct Taxes (CBDT).

Although NPS is available to almost all individuals in India, the PFRDA should not lose sight of these core markets and others it may identify. It should also maintain its focus on the key policy goals underlying the Government of India’s decision to establish the NPS.

Aligning financial sector interest in NPS: “loss leader” or cannibalizing business?

In its efforts to better understand market activity and the extent to which individuals are choosing to open an NPS account or, instead, to invest in another product, it is essential that the PFRDA understand the behavior and attitude of the POPs and their employees at the branch level. It is possible that POP-SPs may try to sell their own products to customers seeking information about the NPS irrespective of any prohibitions or limitations to doing so. It will be quite difficult for the PFRDA to police branch-level activity. Because of the difficulty of effectively policing the POPs’ local activities, the NPS should consider how best to align the interest of the POPs with that of the PFRDA and NPS target subscribers.

In interviews conducted with individual representatives of financial institutions serving as POPs, two distinct points of view emerged. Some view the NPS as a “loss leader”—a product that may bring new profitable business to financial institutions in the long run, but on which they will likely lose money in the short run. These institutions view the NPS as an opportunity to reach out to the large, untapped, nascent market of the unbanked. For many NPS subscribers, establishing an NPS account may be one of the first interactions they have
with a formal financial institution. If such individual have a positive experience with the NPS and the POP, they may be more willing to consider other financial services and investment. Other POP representatives view the NPS product as a necessity, rather than a desirable addition to their “product line.” In their view, they have to offer what their competitors have “on their shelves” to accommodate customers, who expect their banking institution to make all potential products available to them.

In neither case, however, does the banking community consider the introduction of the NPS likely to substantially erode other business. For example, bankers do not expect that money will flow out of their customers’ current accounts and into NPS. Nor do they expect that the typical NPS subscriber would otherwise have opened a different type of account or invested in a different product. Whether such substitution or “cannibalization” will occur, or whether financial institutions might perceive it to be the case in the future, remains to be seen.

Summary of findings and recommendations

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<th>Findings</th>
<th>Recommendations</th>
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<tr>
<td>There has been slow uptake of the NPS product in the unorganized sector since it first became available in May, 2008. Deficiencies in various aspects of the NPS product’s design may undermine the uptake of the product and should be addressed. Until the introduction of NPS-Lite, PFRDA had appeared to insufficiently focus on individuals who may be able to make only the minimum contribution amounts.</td>
<td>Certain elements of the NPS product rules should be reviewed and revised. For example, the level and frequency of required contributions, as well as the associated penalties imposed on subscribers for not satisfying mandated contribution requirements, may deter many individuals from subscribing to the NPS. The PFRDA should consider recalibrating these requirements and penalties. Second, strategies should focus on impediments to account uptake of those individuals with lower incomes and less predictable cash flow, and adjust minimum contribution rules accordingly. The introduction of a “Lite” version of the NPS product is a step in the right direction, and its effectiveness should be closely monitored. Third, when focusing on the core segments of the unorganized sector, the PFRDA should realistically assess the non-financial, as well as the financial, barriers to opening and maintaining an NPS account. For example, web-based access to accounts, in the short run, will have little effect on much of the population. By comparison, the PFRDA’s recent focus on non-bank intermediaries that regularly interact with this population may be a more effective means of attracting them to NPS.</td>
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Fourth, although tax incentives will not be relevant for much of the NPS’s target population in the short term, a growing portion of the Indian population may be motivated by tax incentives over time. The NPS should be accorded identical tax treatment (whether “EEE” or “EET”) as products with which it is competing. The extent to which the current tax law provides for the deductibility of contributions to the NPS unorganized sector scheme, should be clarified.

Fifth, fees and expenses must be reassessed. Although investment management fees are extraordinarily low, the flat fees associated with opening accounts and conducting account transactions may be too high. The flat fees have a greater impact on smaller accounts. The PFRDA’s introduction of a simplified “Lite” version of the product may address this issue for many individuals. Other potential actions could include the introduction of a governmental subsidy to pay all or a portion of the fees assessed during the year in which the account is established.

The manner in which portfolio assets are invested is not sufficiently disclosed to subscribers. The manner in which portfolios may be constructed could present significant conflicts of interest concerns and undermine the transparency of fees earned by the PFMIs. It is also unclear how frequently the shares of PFMIs are priced.

The Offering Document should clearly explain how assets are invested within each investment option made available by the PFMIs. Second, the Offering Document should clearly disclose how often the net asset values (NAVs) of funds are calculated, and where the prices are published.

Third, the PFRDA should more explicitly regulate portfolio composition by clearly defining the manner in which the PFMIs may (or must) construct indexed portfolios. Because the PFRDA has not issued rules and has relied on contractual arrangements, it is not clear whether there are sufficient limitations imposed on the PFMIs. For example, there should be a more explicit explanation of the extent to which a PFM is permitted to invest in affiliated funds which it (or an affiliate) manages. To the extent that such investment is permitted (and it may be more cost-effective, especially in the early years of NPS when the economies of scaling may be lacking), there should be rules addressing potential conflict of interests and ensuring the transparent disclosure of fees earned by the PFMIs.
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<td>Current account rules limit a subscriber’s ability to switch PFM or</td>
<td>PFRDA should re-examine the limitations imposed on</td>
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<td>reallocate investments to only one time annual. International experience</td>
<td>subscribers’ ability to move funds among investment</td>
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<td>suggests that adverse consequences may result from this limitation,</td>
<td>options and from PFM to PFM.</td>
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<td>including a negative impact on fund portfolios and returns (as a result</td>
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<td>of the need to maintain increased liquidity in the portfolio at one</td>
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<td>specified time of the year), market impact (as a result of a bunching</td>
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<td>of subscriber transactions), and more (rather than less) transactional</td>
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<td>activity by subscribers.</td>
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<td>The extent to which former civil servants can move account balances</td>
<td>PFRDA should clarify the extent to which monies may</td>
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<td>from the civil servant to the unorganized sector scheme should be</td>
<td>move from the NPS civil servant scheme to the NPS</td>
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<td>clarified. Similarly, it is not clear whether someone entering the</td>
<td>unorganized sector scheme, and whether it is possible</td>
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<td>civil service can consolidate balances. Nor has PFRDA considered the</td>
<td>to further broaden the ability of individuals to move</td>
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<td>extent to which NPS balances and those of other pension accounts are</td>
<td>monies among different schemes and the NPS. (The latter</td>
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<td>transferrable one to the other.</td>
<td>is addressed in more detail at Chapter 12.)</td>
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<td>The PFRDA has not adequately addressed the extent to which POP-SPs may</td>
<td>To the extent that there are limitations on the ability</td>
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<td>cross-sell other products to individuals seeking to open, or transact</td>
<td>of POP-SPs to cross-sell products to individuals seeking</td>
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<td>business in, a NPS account.</td>
<td>to open, or transact business in, a NPS account, the</td>
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<td>limitations should be clearly disclosed to the public.</td>
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<td>If such limitations are in place, the PFRDA should</td>
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<td>assess the extent to which they can be adequately</td>
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<td>enforced, or whether a better strategy may be to permit</td>
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<td>properly supervised cross-selling activity. More broadly,</td>
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<td>the PFRDA should make greater efforts to establish a</td>
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<td>more active role for the POP-SPs in selling the NPS</td>
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<td>product. One way to do so would be to better align the</td>
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<td>economic interest of the POPs with that of the NPS.</td>
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In the previous chapter, we reviewed NPS account design. In this chapter, our analysis focuses on the governance of the NPS program and its institutions. We believe that there are many areas in which the Government of India can make substantial improvements that will benefit the program and subscribers as participation and assets under management increase. The projected increase in assets and participation analyzed in Chapter 8 underscores the importance of taking these governance reform steps. Recommended reforms range from a realignment and clarification of the roles and responsibilities of the PFRDA and the NPS Trustees to enhancing the transparency of the contractual relationships established with the private sector institutions participating in the program and improving disclosure materials provided to subscribers.

Several factors give rise to the concerns discussed in this chapter. First, because the PFRDA was not established by legislation, it has not been able to develop a body of regulations. In lieu of regulations, it has relied on establishing standards contractually. Second, true to its “developmental” mandate, the PFRDA has focused its resources on developing and implementing the NPS programs for the civil service and the unorganized sectors, rather than its regulatory and supervisory responsibilities. Finally, as it developed the NPS and its governing structure, there was a natural need for the PFRDA to work closely with the fledgling NPS Board of Trustees, but one result of this regular consultation and coordination has been an overlapping and unclear division of responsibilities.

Limitations and effects of the PFRDA’s legal status

Because the PFRDA lacks legislated authority, it is unable to issue regulations to promulgate standards of practice for entities participating in the NPS or to effectively levy penalties and fines on NPS intermediaries. The PFRDA therefore, has entering into contracts with entities that it would otherwise have been able to regulate, license and supervise, including the CRA, POPs, and PFMs. All were selected by a contracting process that included issuing requests for Expressions of Interest (EOIs) and Requests for Proposal (RFPs), obtaining and assessing responses to RFPs, and negotiating contract terms. There has been a resulting lack in transparency regarding various aspects of program design, the scope of
Governance of the NPS program and its institutions

responsibilities assigned to various parties, and the extent of their liability to the NPS and to subscribers. Some of the design issues discussed in the previous chapter are a consequence of the contractual construction of the program.

It is unclear whether the contractual process would have been necessary if there had been the ability to issue regulatory standards, or whether a combination of both approaches would have been used. For example, the criteria for POPs could have been established by regulation and licensing. On the other hand, given the nature and role of the CRA and the fact that its functions would be carried out by one entity rather than many competing entities, it could well be the case that contractual arrangements would have been most appropriate in any event. PFMs, like the CRA, are presently limited in number and a selection process would likely have been more useful in addition to any regulation or licensing the PFRDA could have established.1 The PFRDA would almost certainly have developed regulations if it had had the authority to do so. In fact, it had begun to draft regulations to address the “registration of intermediaries” during the years in which its authorizing legislation had been pending. Similarly, the PFRDA has issued a RFP seeking an adviser to provide technical input on framing regulations on a wide range of issues including fees and charges, investment, grievances and intermediary keeping of accounts.2

One way to resolve this issue, of course, is to provide the PFRDA with clear regulatory authority. In its absence, however, the PFRDA should take measures to make its contracts readily available to the public. The public currently has no way to understand what obligations have been imposed on participating private sector institutions or whether they are third-party beneficiaries to whom the institutions may be directly liable. As this book goes to press, the only documents upon which subscribers can rely are the Offering Document and Welcome pamphlet issued by the PFRDA. The Welcome pamphlet does not provide any useful information regarding institutional obligations, and although the Offering Document describes the affirmative “functions of POP”, it does not identify safeguards that would address a number of concerns that potential subscribers may have, such as the following:

- protections regarding conflicts of interest, for example, when a POP is an affiliate of a PFM;
- ability or restrictions on a POP to solicit other business from individuals seeking to open an NPS account or to provide comparisons of price and performance with other products;
- limitations on, or entitlement to, a POP’s provision of assistance regarding the selection of a PFM or investment portfolio; and
- duration of agreements with the PFRDA or NPS Trust, including the extent to which prices are “locked in.”

Absent the availability of the contracts that the PFRDA has entered with various entities, we cannot know the extent to which the POPs, PFMs, and CRA are permitted to subcontract with third parties to perform contractual obligations,
and, if they are permitted to so, whether the arrangements first must be approved by the PFRDA and disclosed to the subscribers. If such subcontracts are permitted, to what extent will liability for performance remain with the entity that has contracted with the PFRDA? The CRA, for example, as discussed in Chapter 7, already has outsourced the digitalization and processing of account applications, the mailing of Welcome kits and assignment of Permanent Retirement Account Numbers (PRANs), Internet Passwords (IPINs), and Telephone Passwords (TPINs).

Selection and obligations of trustees

The PFRDA has established a trust under the Indian Trusts Act, 1882 (ITA) and appointed a Board of Trustees to manage the trust and oversee the functions of the PFMs. The following assessment of the board and its obligations relies on brief descriptions appearing on the PFRDA’s website, in an RFP for POPs issued by the PFRDA, and in the Offering Document made available to the general public.4

According to the PFRDA website, the NPS Trust is established for the purpose of “taking care of the assets and funds under the NPS in the interest of the beneficiaries (subscribers). In fulfillment of its objectives . . . it supervises the PFMs and interacts with other intermediaries like the trustee bank (Bank of India), CRA (NSDL), and the Stock Holding Corporation of India Limited (custodian of investment instruments).” It also has authority to enter into agreements with other intermediaries to discharge its obligations. (Apparently the PFMs, CRA, and trustee bank and custodian are supervised by, but do not contract with, the trust.)

According to the PFRDA’s description in a recent RFP, the focus of the trust’s activity is the PFMs. That document states that the trust conducts a quarterly review of PFM performance and ensures that the PFMs are properly utilizing brokers to execute transactions, not giving undue or unfair advantage, or dealing with associated parties to the detriment of the beneficiaries, managing the funds “independently of other activities,” and acting in accordance with all PFRDA rules.5

The Offering Document suggests that the NPS Board of Trustees has expansive responsibilities for the “administration” of the NPS, although the specific “functions” it ascribes to the trust indicate that its duties are much narrower. On the one hand, the Offering Document states that “the administration of the “New Pension System” vests [in the Board] under India Law” and that “[t]he Trust is responsible for care of the funds under the NPS.” On the other hand when describing the “functions of the NPS Trust”, it focuses primarily on the PFMs and identifies the following specific responsibilities:

- to call for any information, reports, etc., from PFM(s), trustee bank, and custodian;
- to issue directions to PFM(s) for protecting the interest of subscribers;
- to appoint a panel of independent auditors to undertake a compliance audit;
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- to verify that trustee bank is performing its functions as per the provisions of the Agreement with the NPS Trust; and
- to verify that PFM(s) are strictly following the terms and conditions of the Investment Management Agreement (IMA) with the NPS Trust.6

In reality, then, the NPS Trustee Board is responsible for overseeing asset custody and investment management. It is not responsible for “administration” writ large. Administration of the NPS, which would include responsibility for the daily operations and performance of the CRA and the POPs, therefore, apparently remains the responsibility of the PFRDA.

Because key documents, such as the trust deed, the governing bylaws of the Board, Board minutes, its agreement with the trustee bank, and the trust’s MOU with the PFRDA, are not readily available for review, it is difficult to assess whether trust governance is robust and the scope of the Board’s authority and responsibilities are clear. One would expect these documents to address the following matters:

- the manner in which the Board members are selected and the terms of office;
- the extent to which the Board is independent of the PFRDA;7
- the extent to which conflicts of interest with obligations are addressed;8
- the formalities of trust board management, including decision-making processes and record-keeping;9
- the assigned scope of the Board’s authority and purview;
- the contracting authority of the Board, including the extent to which it determines the contents and terms of Investment Management Agreements (IMAs), whether it executes these agreements on behalf of the trust at the instruction of the PFRDA or exercises discretion, and the extent to which it similarly exercises discretion with respect to its monitoring of the PFMs and their compliance with the terms of the IMAs;
- the types of decisions the Board has made regarding the NPS civil servants’ scheme, as well as any decisions it has made regarding the NPS citizen’s scheme;
- the role the Board plays in making annual asset allocation decisions in the NPS civil servants’ scheme;
- the extent to which the Board has a fiduciary obligation to the NPS subscribers, and whether NPS subscribers and/or the PFRDA are the beneficiaries of the trust;10 and
- the level of care required of the trustees under the trust deed or the ITA.11

Some of these issues are addressed in the trust law, as indicated in the accompanying footnotes. However, the governance documents should address these issues in greater detail.

Because the NPS Trust Board was established under the PFRDA, and both entities are relatively new, it is understandable that there may be some lack of
clarity in their respective roles and responsibilities. Going forward, it will be important to better define their relationship. Currently, the role of the Board is too limited, and the responsibilities of the PFRDA too great. The PFRDA should assume broader regulatory, supervisory, and policy functions, but it should step back from day-to-day operations now that the NPS architecture has been developed. It should not be both the manager of the NPS program and at the same time its regulator and supervisor. The responsibility for all day-to-day operational management and oversight of the NPS should be ceded to the Board of Trustees, including the responsibility to negotiate and manage contracts with many of the entities involved in NPS operations, such as those distributing product (POPs), in addition to their current responsibilities for overseeing asset custody and PFM performance, and the PFRDA should focus on regulating the NPS and supervising the Board.

Absent this realignment of responsibilities, there is even the appearance of a conflict of interest in the grievance process that PFRDA has established for subscribers, because it adjudicates complaints arising from the performance of a program over which it has day-to-day management responsibilities.

Once this separation is achieved, it would enable the PFRDA to take on additional regulatory and supervisory functions. For example, it could play a significant role in the oversight of occupational schemes, which is discussed in Part V.

**Selection and obligations of CRA**

In January 2007, the PFRDA invited Expressions of Interest (EOIs) from public sector entities with experience developing and managing technology-based central administration and record-keeping systems, for functioning as a central record keeper responsible for opening and maintaining the personal retirement accounts of NPS subscribers and providing related services. Public sector entities expressing interest were required to satisfy the following conditions:

- 5 years of experience in central record keeping and administration functions;
- minimum net worth of Rs500 million; and
- experience in managing over 500,000 individual accounts per year over the prior 3 years.

After reviewing six EOIs, four entities were invited to respond to the PFRDA’s Request for Proposal (RFP), of which three responded. An evaluation committee recommended the National Securities Depositary Limited (NSDL) as the most suitable entity to perform the CRA function based on RFP requirements, and NSDL is now under contract to provide the services.

According to the Offering Document, CRA performs the “recordkeeping, administration and customer service functions for all subscribers of the NPS” and provides “periodic, PRAN statements to each subscriber.” The Offering Document enumerates the following “services provide by CRA to subscribers”:
Governance of the NPS program and its institutions

- Annual Account Statements: CRA sends annual account statements to subscribers detailing the total contribution, time-wise credits into the account, and other relevant information.
- Grievance Redress: subscribers are able to register grievances through the web interface or through other channels, and CRA registers all complaints in electronic form and informs the subscriber of complaint status.
- Executing Investment Option Changes: CRA acts on transmitted instructions of subscribers regarding investment option selection, switching options, and providing confirmation reports.
- Provision of Other Account Information: CRA provides account balance information, including information regarding amounts that may be withdrawn in a lump sum.
- Web-enabled Services: CRA provides subscribers with a web interface to view a history of their transactions and to permit subscribers to send switching instructions to CRA.

The Offering Document enumerates those CRA functions that are subscriber-focused. It does not describe back-office functions of CRA. For example, in addition to the enumerated subscriber services, the CRA has developed and is responsible for the maintenance of information technologies and systems, hardware and software, interface with PFMs, the trustee bank, and POPs. CRA consolidates NPS member contributions and instructions, which are typically received from POPs and their local branches, and it then transmits them to the relevant PFMs, reconciling transactional orders and money flow, and recording all transactional activity on an individual account basis. Eventually, the CRA will also be called upon to work with annuity providers when NPS accounts build up in value and individuals either retire and withdraw account balances, or exit from the NPS prematurely.

A comprehensive description of what was anticipated to be the range of CRA responsibilities and functions is discussed in a draft consultative paper, “Central Recordkeeping and Administration of Individual Pension Accounts under the New Pension System,” which was produced by IIEF for the Ministry of Finance and the PFRDA in July 2006. As the paper states,

The choice of agency which is entrusted with the task of establishing the CRA is of paramount importance and interest to policymakers and the PFRDA. The full operational and member service framework, as well as the core principles of the pension system rest on the ability of the CRA to efficiently and accurately discharge its responsibilities and enforce the service and functional obligations on service providers over multiple decades.

As with the NPS Trust, the extent to which the governance, operation, and oversight of the CRA can be fully analyzed is limited because key documentations is unavailable, including, most crucially, the contract between
the PFRDA (or the NPS Trust) and the CRA. Because the CRA is the backbone of the entire NPS operation, it is crucial that it be properly designed, its software robust and secure, and the operation properly managed and supervised. It is also important that the NPS have the capacity to readily move to another record keeper if the current vendor, NSDL, underperforms, has capacity issues, or experiences regulatory difficulties (for example, with another of its key regulators, such as the Securities and Exchange Board of India [SEBI]). Business process issues, such as those relating to the account establishment, transaction, and information processing, are discussed in later chapters.

Selection and obligations of PFMs

In May 2007, the PFRDA invited EOIs from public sector entities for sponsoring pension funds for the civil service scheme. To be eligible, sponsors were required to satisfy the following conditions and additional requirements identified in a preliminary information memorandum:

- 5 years of experience of fund management; and
- average assets under management of not less than Rs10 billion.

After reviewing seven EOIs, four entities were determined to meet stated requirements and were invited to respond to the PFRDA’s RFP. An independent selection committee evaluated the proposals and identified the three “best value bidders,” each of which entered into an Investment Management Agreement (IMA) with the NPS Trust. A similar process was undertaken for the selection of the six PFMs now providing asset management services to the unorganized sector scheme.

Pension funds are required to be separate legal entities, appropriately capitalized, and to establish administration and investment management processes separate from those of their parent firms. It has been suggested that the requirements for such separation resulted in the duplication of various functions performed by the parent or an affiliate, undermined the ability to achieve economies of scale, and added administrative cost. As noted in the previous chapter, it is unclear whether the PFMs may invest NPS assets in other collective investment schemes, such as indexed mutual funds, including those that the parent or an affiliate manages.

The structural requirements currently in place are intended to keep NPS assets separate and distinct and prevent various forms of self-dealing. Given the slow uptake of NPS by the unorganized sector, however, it may be necessary to review these constraints, so that, failing economies of scale in operation, participating asset managers can continue to offer (extraordinarily) low-cost services to NPS subscribers. If there is a need to take such steps, the PFRDA could more precisely identify its policy concerns and provide more focused regulatory limitations and prohibitions.
Selection and obligations of POP-SPs

The PFRDA has entered into contracts with banks and other financial institutions on a national basis to serve as Point of Presence—Service Providers. POP-SPs are critical for the success of the NPS unorganized sector scheme, because they act as the customer interface for individuals seeking to open an NPS account or conduct account transactions. Those individuals who do not open an NPS account online, which is to say the vast majority of potential subscribers, will open their NPS accounts through the authorized branches of the POP-SPs, typically at branch banks, and they will conduct NPS transactions (making contributions, switching PFMs, reallocating assets among a PFM’s investment options, etc.) through that, or any other, authorized POP-SP.

The POP-SPs functions include the following:

- opening NPS account and related activities,\(^{16}\)
- maintaining and reporting records of transactions,\(^{17}\)
- servicing subscribers,\(^{18}\) and
- handling grievances.\(^{19}\)

In addition to having the capability to handle required services and perform the functions described above, POPs must be:

- regulated by the Reserve Bank of India (RBI), the SEBI, or the IRDA and not have had any major strictures imposed by any financial sector regulator or court of law within the 5 years preceding the application;
- have a minimum of 25 branches covering at least 25 districts over three or more states, with each branch conforming to IT requirements and having capacity to link electronically to the CRA and transmit subscriber and transaction information on a T+1 basis;
- have a minimum net worth of Rs100 million; and
- be in the business of marketing or selling retail financial services and have experience selling such products over the counter.\(^{20}\)

Although most POPs are banks, they need not be. For example, non-bank financial institutions that are authorized to serve as a POP include:

- Computer Age Management Services;
- IL&FS Securities Services;
- Reliance Capital; and
- UTI Asset Management Company.

One of the attractive features of the NPS is that NPS accounts are not tied to a particular POP-SP. Subscribers may conduct their NPS-related business at any authorized POP-SP.\(^{21}\) This design feature, however, may have the effect of weakening the incentive for a financial institution to service NPS accounts. We previously discussed various perspectives of the financial institutions on the business
rationale for becoming a POP. One incentive is the fact that, while the fee income that a POP is likely to generate from NPS activity is low, participating in the NPS may bring potential new customers to the institution. The fact that individuals opening NPS accounts are not “captured”, however, may reduce the ability of the institution to generate additional business from NPS subscribers.

This concern, however, may not prove to be a significant one for the following reasons: first, many of the individuals opening an NPS account will do so at a POP-SP with which they already conduct business. Second, the other significant segment of NPS subscribers—individuals with no current business with the POP-SP—may continue to present a business opportunity, regardless of the NPS’s open architecture. Assuming such subscribers are properly assisted and obtain good service, they may continue to utilize that POP-SP, even if they could go elsewhere to execute NPS transactions. Third, absent particularly poor service, a person may simply remain with the same POP-SP for ongoing business, consistent with the inertia that often accompanies such relationships.

The PFRDA has yet to issue clear guidelines regarding the POP-subscriber relationship. For example, there are no express limitations on a POP’s marketing and advertising activities or the cross-selling of NPS and other financial products and services offered by the POP. Nor are there explicit rules regarding the protection of the information subscribers provide when establishing an account. Because many NPS subscribers will be unfamiliar with banking and other institutions, PFRDA should establish sufficient safeguards—and make the subscribers and the public aware of them. (There may be constraints and limitations placed in the POPs’ contracts with the PFRDA, but the contractual terms have not been made public.)

Similarly, the PFRDA has not imposed any training obligations on POP employees. POP branch staff must be ready to answer the questions that potential subscribers might have about the NPS and the product rules. They must also understand the scope of their responsibilities and the limitations and prohibitions, if any, that the PFRDA has instituted on their conduct. Second, the staff must be sufficiently trained in the technical and mechanical aspects of the program so that they can properly take applications and contributions, open NPS accounts, and process account transactions. A number of press reports in the initial months of the NPS’s operation had indicated that in fact most POP employees were not sufficiently aware of the NPS when individuals entered a bank branch to open an account.22 As the assessment of business process in Chapter 7 suggests, this may remain an ongoing concern. The PFRDA (or NPS Trust) should consider imposing a formal certification process upon either institutions (POP), their branches (POP-SP), or their individual employees, to ensure there are properly trained individuals working with NPS product and subscribers.

Subscribers’ role in NPS governance, disclosure, and transparency

Properly empowered, NPS subscribers can play a critical role in the governance and success of the NPS. Provided with clear, complete, and readily understandable
information about the NPS, account rules, fees, transactions, and investment options, as well as an effective grievance process, NPS subscribers can provide a vital oversight function and help to ensure that POP and CRA service quality is maintained, individual account records are accurate, and transactions are timely executed. Absent transparent disclosure and a well-functioning grievance process, subscribers will less ably perform this policing function. Moreover, inadequate disclosure and opaque rules and pricing could discourage participation in the NPS or result in subscribers making poor investment decisions. Similarly, ineffective redress of grievances and complaints could quickly tarnish the NPS’s reputation. The Ministry of Finance recognized the importance of disclosure and transparency when it set out the “architecture” for the NPS, particularly with respect to the investment decisions. Among the few specific design parameters and policy goals it set forth, it required that CRA and PFMs “give out easily understood information about past performance so that the individual would [be] able to make informed choices about which scheme to choose.”

The PFRDA has made two disclosure documents available to individuals subscribing to the unorganized sector scheme, which we have previously discussed: A “Welcome” pamphlet and an “Offering Document.” There is some additional material and information available on the PFRDA website. Both documents provide a comprehensive explanation of the NPS, account rules, fees, and investment choices. They also identify the entities involved in operating and overseeing the program, and describe their functions and the services provided to subscribers. The documents even provide comprehensive and sophisticated explanations of the types of risks involved in NPS participation.

Nonetheless, the disclosure documents are inadequate for a number of reasons, each of which the PFRDA should take steps to address. These include an inadequate presentation of the investment choices, which may be relevant to some subscribers, and an absence of any discussion of the benefits of participation in NPS. We discuss each of these issues below. Perhaps ironically, however, the most notable inadequacy is that the documents are too sophisticated for their target audience. The PFRDA has used technical language that will not be understood by large segments of the Indian population.23

The sophisticated language used is compounded by the length of the document and its design. The Offering Document will appear dense, unfriendly, and unapproachable to many potential subscribers and, as a result, it may act as a deterrent to their opening an account. The document uses a small font; there is little “white space”; and it makes little use of graphic and pictorial presentation techniques. Likewise, the accompanying application form looks complicated, onerous, and off-putting, when, in fact, the form asks for very little information, most of which will be easy to provide. Many individuals reviewing these materials are likely to seek third-party assistance, thus increasing the prominence of the POPs and increasing, rather, than reducing, the time POP staff may need to spend with new NPS subscribers in the application, contribution, and investment decision-making processes.

The Offering Document, by its nature perhaps, requires a certain amount of detail, formality, and precision, inevitably making it more difficult for the layperson to read and comprehend. The PFRDA has tried to design the Welcome
pamphlet in a manner accessible to a broader population with lower levels of financial literacy and reading skills. It uses shorter sections, FAQs, and informational tables. However, even this document, which is aimed at a wider audience, is not properly targeted to the broad Indian population that the NPS seeks to attract.

There are a number of ways in which the documents might be revised—primarily by reducing the amount of information, assuming a lower level of financial literacy, and using more visual images to convey various concepts and details, such as a flowchart to display and describe the activities and services of, and the relationships among, the POPs, CRA, PFM, and the NPS Trust. The discussion of the various types of risk, for example, might be greatly simplified and conveyed in a form more likely to be read. Information that is less central to the program, but legally necessary, such as information and declarations related to KYC requirements and the Prevention of Money Laundering Act, could be explained in brief; and some information, such as a description of the “back office” operations that are required to operate the NPS, could probably be eliminated.

The PFRDA also should consider developing a range of disclosure and informational documents, each targeted at different levels of financial literacy. The informational document may be shortened by dividing it into more than one document. For example, the FAQs section of the Welcome pamphlet, which contains 33 questions and answers, could be a separate, stand-alone informational pamphlet. Similarly, one document could describe the workings of the NPS and the relationships and roles of the various entities in the program, and another could present the investment options, portfolios rules, and identify risks.

**Disclosure relating to investment choice**

Because investment choice is one of the most significant features of the NPS’s unorganized sector scheme, subscribers must be provided with an appropriately understandable and detailed explanation of their options. However, the presentation of the options is insufficient. All investment option descriptions would benefit from pie graphs, as well as an explanation of how the portfolios of each PFM could differ given the constraints imposed by the investment guidelines.

The life-cycle portfolio concept and the shifting allocation of account assets is well explained, but similarly might benefit from a visual aid, such as a graph demonstrating the shift in asset allocation along the investment option’s “glide path” as a person ages.

**Fee disclosure**

The PFRDA has tried to transparently disclose all fees associated with the opening and maintenance of an NPS account by presenting the fees in a completely unbundled manner. Unfortunately, the PFRDA’s efforts are foiled by the very complexity of the product’s design and fee structure: There are nine separate charges paid to the various entities performing services for the NPS, and the type of charge varies. For example, the CRA charges for opening an account and also
imposes an annual maintenance fee per account. These two fees are paid by the “cancellation of units.” The POP collects a registration fee and a contribution upload fee, as well subsequent transaction fees. These fees are “collected upfront.” Additionally, the following charges are paid through a deduction to the net asset value (NAV): the trustee bank imposes a charge for any transaction originating from a non-RBI location; the custodian charges for assets under custody, at a rate which varies depending for “electronic” and “physical” assets; and the PFM charges an investment management fee. As a result of this complexity, there is a rather long list of fees for a subscriber to review and understand - a list accompanied by close to a half of page of footnotes.

Clearly, the PFRDA needs to simplify its presentation of the fees associated with an NPS account and reduce the “small print.” In fact, most subscribers will be most concerned with the total “all-in” fee per year. Because the fees imposed annually will vary with the number of transactions executed by the subscriber, as well as with the size of the account, the PFRDA cannot provide an exact “all-in” fee. However, it should consider providing some examples of the total, projected or average, annual fee for a typical range of subscribers.

**Explanation of tax rules**

The Offering Document provides no explanation of the tax regime applicable to NPS contributions, accumulations (earnings and capital gains), or withdrawals. In fact, the disclosure documents appear to intentionally avoid the issue of taxes by providing only the following general statement under the heading “Tax Benefits”: “Tax benefits would be applicable as per the Income Tax Act, 1961, as amended from time to time.” The evasion may simply be prudent, because the tax regime applicable to the NPS may change from “EET” to “EEE”, as discussed elsewhere in this book. On the other hand, tax information is critical to a number of people who will be considering the NPS and comparing it to other investment opportunities. Furthermore, even if the tax on withdrawals is changed under the tax law, contributions to NPS accounts will likely remain tax-exempt up to permitted annual contribution limits under Section 80C of the IT Act.

**Information regarding the anticipated benefits of NPS participation**

It is always tricky to provide estimated projections of the anticipated benefits of an investment, especially a long-term investment in which the investment allocation will change, the investment pools have no prior track record (itself of course no guaranty of future results), and the contributions may be irregular, aside from the other factors for which assumptions must be made. Nonetheless, it would be useful to potential subscribers if the PFRDA provided an indication of the range of outcomes over different time horizons, contribution patterns, and investment outcomes in its disclosure documents.
## Summary of findings and recommendations

<table>
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<th>Findings</th>
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<tr>
<td>Despite a well-articulated institutional and regulatory structure established for the NPS, additional articulation of, and greater transparency regarding, the roles of the various entities involved in the market development, design, management, and oversight of the NPS is needed.</td>
<td>Currently the role of the NPS Board of Trustees is too limited, and the role of the PFRDA too great. The operational aspects of the NPS should be clearly segregated from the regulatory and pension sector development responsibilities of the PFRDA. The NPS Board of Trustees should manage both the NPS civil service scheme and its unorganized sector scheme at an operational level and establish suitable capacity for ongoing grassroots-level monitoring and evaluation of NPS implementation, administration, and intermediary behavior. The nature and scope of the fiduciary responsibilities and obligations of the NPS Trustees should be made explicit. The role of the PFRDA should be to provide regulatory and supervisory oversight and policy analysis. For the PFRDA to more effectively perform these tasks, it must become fully endowed with the legal authority and functionality, as well as the budget and capacity, necessary for it to effectively carry out its mandate. The government should consider providing the PFRDA the responsibility of regulating and supervising the compulsory EPFO-managed schemes, voluntary occupational pension schemes, and gratuity schemes, once its operational responsibilities for NPS are transferred to the NPS Trust. To the extent that the PFRDA is to take on additional regulatory and supervisory responsibility for occupational schemes, as recommended, legislation will be necessary.</td>
</tr>
<tr>
<td>The contractual terms under which the POPs, CRA, and PFMs operate are not fully disclosed to the public. As a result, it is unclear precisely what constraints and limitations are placed on their behavior—and it is not possible to assess whether these limitations are adequate.</td>
<td>Contracts should be readily available to the public so that the scope of obligations imposed on intermediaries is transparent. Second, the PFRDA should develop a rule-based framework applicable to all intermediaries that is transparent and available to the public. The rules (or regulations, if the PFRDA is empowered to issue them) should establish safeguards addressing aspects of market-based behavior, including, for example, the sales and subscription process, cross-selling opportunities, advertising, and the use of subscriber information.</td>
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Similarly, the PFRDA should develop guidelines and prohibitions addressing conflicts of interest, self-dealing, and similar concerns, which are applicable to all intermediaries involved in the distribution and sale of NPS product, the management of NPS assets, and the maintenance of NPS accounts. Such rules are vitally important elements contributing to the ongoing soundness and stability of the NPS, and the development and maintenance of public trust in the program. If PFRDA is to revise the structure of POP incentives, encourage cross-selling activities, and reduce the segregation requirements imposed on PFM operations (per recommendations made above), these rules take on increasing significance.

Unlike insurance, banking, and mutual fund distributors and agents, POP-SPs and other NPS intermediaries are not required to undergo a formal certification training to provide services and information to subscribers and the public at large. Although there have been some efforts to ensure that the staffs of NPS intermediaries are sufficiently trained, the efforts have been informal and insufficient and do not result in certification.

Although the PFRDA uses only SEBI-, RBI-, and IRDA-regulated service providers for NPS, the sales of retirement savings products and the provision of related services create the need for new, specialized knowledge of NPS products and processes. The PFRDA should mandate that only qualified persons be permitted to participate in NPS operations. The NPS Trust should impose a formal certification for NPS operations and products. This should become a prequalification for all front-office and back-office staff of POP-SPs and other NPS intermediaries.

The subscription contract executed when opening an NPS account does not adequately explain the extent to which the subscriber has legal recourse against the PFRDA, NPS Board, and NPS intermediaries.

Offering Document and subscriptions contracts should more clearly distinguish between the PFRDA and the NPS Trust, and a subscriber’s potential legal recourse against them and intermediaries should be clarified. Although the PFRDA has established a process whereby complaints may be filed, the range of actions available to subscribers should be more clearly identified.

The disclosure materials, subscription contracts, and other written materials provided to subscribers and potential subscribers are too complicated for most individuals in the NPS’s target population.

The design, rules, and operation of the NPS must be more readily understood by those persons to whom the scheme is targeted. Most of the disclosure and other explanatory materials currently made available by the PFRDA— albeit generally comprehensive—are drafted in a language that is too technical and detailed for many of the individuals targeted. Second, these materials should be simplified and made available in a variety of languages. Third, the physical appearance of the materials (overall style, format, font, etc.) should be redesigned, so that the materials appear more approachable. Fourth, the target audience should be further segmented, and the materials specifically designed for various market segments.
Part III

NPS communications, marketing, and business practices
A central challenge for the government of India as well as for the PFRDA is to achieve meaningful pension inclusion while demographic conditions remain relatively favorable. PFRDA’s ability to rapidly build a mass market for the NPS will depend largely upon its ability to locate and address the existing latent demand for retirement savings products and its capacity to direct the sales behavior of NPS distributors.

An important related issue that the PFRDA must address is of encouraging millions of individual workers, most of whom earn modest intermittent incomes, to begin saving for their old age while they are young, and to contribute both regularly and adequately towards their old age over multiple decades. This is especially challenging as most informal sector workers in India are unable to easily relate to the concepts of “retirement” or “pensions” and are also not presently exposed to long-term savings products with market-linked returns.

A sustained and visible grassroots-level effort is therefore needed to both inform and educate potential subscribers about the NPS and to encourage them to voluntarily defer a meaningful part of their present consumption towards retirement savings. This is a gigantic problem for India as over 85% of its workforce is excluded from formal pension provisions and is therefore highly vulnerable to the risk of old-age poverty. A combination of low literacy, low financial literacy, and modest intermittent incomes has traditionally put both retirement planning and qualified advice out of reach of most of these workers and barely 5% of workers are presently saving for their old age.

The linkages between financial illiteracy and retirement savings behavior are also evident from an analysis of the national-level household surveys commissioned by the ADB and the Indian Ministry of Finance, and the subsequent survey by IIEF and IIIMS Dataworks. Data from both surveys show that nearly a third of India’s low-income workforce believe they will need to work well into their old age as they would be unable to accumulate enough savings to otherwise support themselves. Most, however (nearly 60%), have given no thought to their retirement needs, including more than half of those over 40 years old and for whom old-age income security should be a major concern. Part of the explanation is that over a third of these workers expect their children to support them when they are no longer able to work. However, the reality is that traditional reliance
of the elderly in India on children and extended families for old-age income support is being rapidly eroded.

Even for the 5% of India’s working poor who are actively saving for their old age, the savings accumulations are very modest. The average savings corpus of those above 45 years is Rs25,000 or less. Hence, the best-case scenario, even for those presently saving for their old age, is that they will manage enough pre-retirement savings to support themselves for no more than 2 years when they decide to stop working or are unable to work. This presents a bleak outlook for the next generation of India’s elderly and clearly suggests that old-age poverty will continue to be a public policy challenge.

The global financial crisis of 2008 has further highlighted the importance of, and linkages between qualified financial advice, financial literacy, and financial behavior. The PFRDA must therefore ensure that potential customers of the NPS receive objective, accurate, and adequate information to allow them to make informed decisions, are not subjected to unfair or deceptive practices, and have access to recourse mechanisms to resolve disputes. Qualified and objective retirement advice would also arm individuals with appropriate knowledge, skills, and confidence to better understand the information they receive and match their retirement needs with appropriate products. Advisory services therefore can both drive and distort financial behaviour and the composition and direction of demand for the NPS as well as for a variety of other risk management tools. Qualified advice and customer knowledge is also the single most important raw material for effective retirement planning as pension benefits, especially in a voluntary, individual accounts-based Defined Contribution (DC) retirement savings program like the NPS, will largely depend on the financial behavior of individual subscribers. Hence, two NPS subscribers with identical demographic and income characteristics can achieve very different retirement outcomes.

Effective retirement planning using voluntary DC pension programs is also the most complex behavioral finance challenge as it often involves a multiple-decade savings horizon while imposing important choices and responsibilities on individual subscribers in the form of questions regarding market, longevity, and inflation risks. Questions and choices governing NPS product options, savings frequency and adequacy, replacement rates, and annuities will appear daunting to even high-income urban audiences. They are even more challenging for urban and rural low-income workers in the informal sector who form a major share of India’s workforce and are exposed to the risk of outliving their savings due to life expectancy improvements and the corrosive impact of inflation on terminal accumulations.

If the NPS target customers do not adequately understand their options and rights, they will tend to exercise inefficient choices, or contribute insufficiently, or stay away entirely. A significant input of human capital among both potential and existing NPS subscribers will therefore be required in terms of retirement planning and the role for disciplined retirement savings in order to achieve mass-scale voluntary coverage and sustained savings discipline by individual subscribers. A key strategy to overcome this challenge would be to design communications
and processes that are simple and easy for ordinary people to understand. As discussed towards the end of Chapter 5, existing PFRDA material has not succeeded in this.

The target customers for NPS are also unlikely to save voluntarily for their old age unless a high level of public confidence in the scheme is established and maintained. Greater confidence can be best achieved by enabling customers to become better informed about their own rights and responsibilities. In this situation, PFRDA’s strategy to bring in complete transparency where a customer can clearly see the direct relationship between NPS contributions and benefits may have a positive long-term impact on both voluntary coverage and savings discipline. This strategy should, however, be supplemented by an appropriately designed and widely distributed communications and public education strategy and tools that accurately, objectively, and effectively convey information regarding the NPS product, key financial concepts, and the importance of retirement savings to India’s vast informal sector workforce.

Going forward, the challenges of mass-scale generic education and concept promotions, and of encouraging voluntary enrollments and disciplined retirement savings by millions of workers will be further compounded by the geographical spread of the initiative, the number of target beneficiaries, as well as by their knowledge and demographic heterogeneity. Achieving effective customer protection, sustained public confidence, and optimum retirement savings behavior in this situation will require simultaneous, innovative actions on field promotions, simple and objective information disclosure, effective complaints resolution, and easy access to qualified, grassroots-level retirement advisory services.

The PFRDA has already made important progress with addressing some of these issues by ensuring that the NPS is a secure, simple, and widely available product. The use of existing branches of the postal network, banks, and other large, well-regulated third-party finance distributors for NPS cross-sales, enrollment, and ongoing service delivery should reap rich dividends in the form of broad-based scheme coverage. This should especially be the case as the current 35 POPs already deliver a range of financial services to over 100 million Indians from some 200,000 branches.

However, available statistics on NPS and NPS-Lite enrollments, at least over the first few years, are far from encouraging. According to data available on PFRDA’s website, barely 56,000 individual subscribers have voluntarily opened NPS accounts since May 2009 although 12,226 outlets presently offer the product to the public. Voluntary coverage of the NPS-Lite, despite the Rs1,000 co-contribution by the federal government and similar levels of fiscal transfers by at least two state governments since early 2010, was around 750,000 by August 2011. It is obvious, therefore, that NPS and NPS-Lite distributors and service providers will require adequate commercial incentives to approach the tasks of cross-sales, enrollment, and ongoing service delivery with sustained energy, innovation, and commitment.

To build a mass market for the NPS and achieve early, measurable success with bridging India’s huge pension coverage gap, the PFRDA should (i) embark
Communications and marketing for the NPS

on an innovative and sustained effort to create public awareness regarding the importance of disciplined retirement savings as well as regarding the NPS, (ii) direct the cross-sales efforts of existing POPs through an incentive compatible distribution model, and (iii) facilitate the availability of a large base of qualified retirement advisors to objectively guide individual subscriber decisions governing NPS products and service providers. In parallel, the PFRDA should establish appropriate capacity to closely monitor subscriber and intermediary actions and to actively manage NPS implementation and coverage of expansion efforts of regulated entities.

In this direction, the PFRDA notified the constitution of a Committee to Review Implementation of Informal Sector Pension (CRIISP) on 10 August 2010. Among other things, this PFRDA committee is expected to investigate the underlying causes for the tenuous beginning of the NPS and suggest remedial steps required to make the NPS a viable pension system for all stakeholders. The committee is expected to specifically address issues related to NPS marketing and promotions and recommend suitable stakeholders, or groups thereof, that may be best suited to perform this role. In this process, the committee will also examine the NPS incentive model, against national and global best practices, and recommend viable commercial incentives for each category of NPS service provider.

Regardless of the solutions prescribed by this committee, and especially in the context of medium- to long-term implementation planning, PFRDA will need to design a communication and marketing strategy that competes successfully in an increasingly consumer-oriented economy. Banking and insurance product providers in India traditionally rely heavily on sales and distribution effort based on commissioned agents and cross-selling new products to existing clients to achieve market penetration. As a result, there is very little marketing data based on consumer preferences, perceptions, capabilities, and characteristics that can guide the PFRDA in crafting successful NPS marketing approaches. In this situation, a useful strategy for the PFRDA may be to invest adequately in building a high-quality management information system (MIS) coupled with suitable research capacity to analyze quantitative and qualitative data on the needs, preferences, and behavior of both existing and potential customers. In addition to directing policy and regulatory response, such analysis would also encourage informed investments in communications and sales by NPS service providers.

A key lesson, not only from Asia, but worldwide, is that voluntary saving schemes depend for their success on successful communications and marketing strategies, as well as on efficient, user-friendly business practices. Evidence to date in India suggests that there is considerable need for improvement in these areas.

NPS take-up following rollout in May 2009 had proven extremely slow. As of 3 September, 2011, the PFRDA had registered 35 POPs and some 12,226 POP-SPs. As of the same date, the NPS had registered 55,611 members indicating an average pan-Indian enrolment rate of less than 2000 new NPS subscribes per month and less than 5 subscribers per POP-SP over a 2.5 year period.
This “accounts per POP-SP” estimate dropped substantially over the final 6 months of the first year of operation, but this is largely explained by the recent dramatic increase in the number of POP-SPs.

Based on these data, market penetration in the first year following rollout was minimal. This reflects low awareness of the NPS on the part of the general public, lack of promotion of the new system, as well as the insufficient number of distribution points and incentive problems. This chapter explores the marketing and communications side of the issue, and then looks at the role and incentives for POP-SPs.

The analysis below is based on pilot initiatives tested in two pilot districts: Hamirpur (a rural district in Himachal Pradesh) and Mangalore (an urban district at Karnataka). In 2009–2010, a team of pension sector and communications experts applied a segmented direct marketing and sales approach to encourage voluntary NPS enrollments in the two districts. The team worked closely with the district administration officers and private sector finance providers on preliminary demand evaluation surveys and project implementation at both districts.

Armed with a range of new communication tools and a direct outreach strategy, the team enrolled roughly 500 informal sector workers for the NPS within a short, 4-week window. In one of the districts, communications and enrollment efforts were concentrated and directed at all potential NPS customers within a small geographic area through direct contact camps and road-shows. In the second district, coverage and communication efforts were largely directed at individual members of certain occupational groups. During this period, the consultants also had an opportunity to directly observe the impact of PFRDA-prescribed commercial incentives on the NPS marketing and sales behavior of POPs.

Marketing strategies

In addition to their role in scheme promotion and front-end service and information delivery to the public at large, POP-SPs were expected to play an important role in cross-selling the NPS to their existing financial services customers. The following strategies were recommended:

- **Targeted coverage based on geography**: local service providers would direct their coverage efforts to deliver the NPS at specified locations in each district. Local POP-SPs would concentrate on reaching potential subscribers through innovative outreach and coverage interventions concentrated on recognized administrative classifications.

- **Targeted coverage based on occupations**: local POP-SPs would target homogeneous groups of workers through innovative communication and promotional strategies. The groups would be identified in consultation with the district administration, POP-SPs and other local stakeholders. In this process, the team would also monitor the impact of PFRDA-prescribed commercial incentives for POP-SPs on their marketing and sales budgets and
behavior with regard to the NPS as well as in relation to the marketing and sales of other financial and insurance products.

Results of promotional activities

In the two pilot districts, a range of public education and information dissemination initiatives were implemented through workshops, meetings, and camps targeting unorganized sector workers and key stakeholders, including groups, employers, worker associations, trade and industry bodies, government offices, and the media in a pilot district. A range of media were employed for dissemination of information and knowledge regarding the NPS, including local cable television networks, radio, mobile publicity vans, seminars, and road shows.

Results were dramatic: within 3 weeks, the district’s three POP-SPs had enrolled 140 new voluntary NPS subscribers, thereby growing voluntary coverage to 10 times the coverage achieved in the previous 11 months.

It appears that intense use of both traditional and non-traditional marketing and communications methods can substantially increase enrollment. Two marketing modalities appear especially promising: cell phones (mobile phones) and street events.

Cell phones

Surveys indicated that 85–90% of respondents in both pilot districts use or have used cell phones and 90–95% of the current 300,000 members of the IIMPS scheme promoted and administered have registered a cell phone contact number. India has a population of approximately 1.1 billion; the workforce in India is perhaps 300 million workers; and telecommunication companies estimate that 15% of the workers are using cell phones, amounting to 45 million cell phone users.

If the targeted population for an NPS publicity campaign was cell phone users, it would require only 10% of that population to reply positively to the campaign in order to subscribe 4.5 million new NPS members. Even a 2% hit rate (the traditional hurdle in mass mail campaigns) would result in close to a million members. In the months following, social and family networks, word of mouth, etc., would likely result in a strong multiplier effect. At first estimate, the costs of such a campaign appear modest. If the cost of one SMS for cell phones is Rs0.01 (a fee which could be further negotiated between government and the telecommunication companies), five SMS messages per person would give rise to a cost per person of Rs0.05. Accordingly, if the target population were 45 million, the campaign cost would be estimated at Rs2.25 million.

Specifically, a communication campaign using SMS messaging on cell phones may be conducted as follows:

- Telecommunication companies in pilot districts should be contacted to negotiate access to and use of the customer database. The customer database would constitute the target population.
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- Primary SMS messages to be transmitted to the target population might include:
  - Do you want to work until the day you die?
  - Who will look after you when you stop working?
  - Are you saving for that day when you stop working?
  - NPS is the individual saving account that will ensure your future after you stop working!
  - The Indian Government promotes (supports) the NPS saving account for your retirement needs.

- The messages would ideally be sent out to the target population at defined intervals, the spacing of which should be determined by a marketing team to ensure maximum impact. Each SMS message sent would be connected to a title message that would ensure the reader opens the message, i.e., “Indian Government community message” or a similar phrase. The response from the SMS communication campaign should be documented into electronic reports, for each pilot district, and used in the subsequent district survey. The person would respond to the initial SMS campaign message in the same manner using SMS, Yes/No. The responses would be recorded together with the mobile phone number of the person. The mobile number would provide information of the person, name, surname, address, etc. This same information should be drafted in a report format that can be taken into the field when doing the subsequent district survey. When surveying a person in the field, the team would then have available information on previous answers.

Street events

Local street events can also be used to promote and market the NPS. According to baseline survey results, 40% of all respondents participate in such events. Additionally, each stall or location used in the street events to promote NPS should be able to survey the persons that inquire about NPS in order to gather additional information and maximize the future subscription of NPS members. It would be desirable to have POP-SP representatives participate in these events to provide assistance to persons wishing to sign an NPS application form. The effectiveness of the communication campaign and the local street events can be measured via the number of enquiries and the number of effective application forms.

The role of POP-SPs

Promotional strategies will work best when POP-SPs are eager to sell the product. Yet, field visits (Table 6.1) revealed a low level of effort to promote the NPS has been observed among POP-SPs.

The lack of promotion suggests that there are few incentives for POP-SPs to invest effort in promoting the NPS. Aspects of this include:

- The low costs chargeable by the POP-SP for registering a new NPS member or administering subsequent contributions.
Communications and marketing for the NPS

Table 6.1 POP-SPs’ role in marketing the new system

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<th>POP-SP name</th>
<th>Address</th>
<th>Observation</th>
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| POP-SP 1    | Sector 4, Noida | • No promotional information visible.  
|             | (a large global bank) | • The bank official was not aware of NPS, and asked what the account would be used for.  
|             |                | The bank official also appeared not to be aware that a user digital certificate had been issued to the office, and that they were on the PFRDA list of official NPS providers.  
|             |                | • The bank official offered to send documentation by email.  
|             |                | • No members had been registered and no one had inquired about NPS.          |
| POP-SP 2    | Sector 2, Noida | • No promotional information visible.  
|             | (a large PSU bank) | • There was a desk designated for NPS, but the bank official explained that training was still in process and that although he recognized that a user certificate had been issued, it was not being used.  
|             |                | • No members had been registered, and no one had inquired about NPS.        |

- The existence of other POP-SP proprietary investment saving products. None of the current registered POP-SPs, including the State Bank of India with its enormous number of account holders, are cross-selling the NPS product to their current clients/account holders.
- The fact that the member is not tied to any one service provider, i.e. that the member can use any registered POP-SP for subsequent contributions.

The first two points can be addressed by adjusting incentives properly. The third point is a difficult problem to address because the flexibility of utilizing different POP-SPs is a major selling point for the potential member.

At a minimum, the low level of effort observed, as well as stakeholder interviews, suggests that closer monitoring by the PFRDA is needed. Two steps might include:

- POP-SP offices should be visited and certified by the PFRDA via direct visit to the POP-SP premises or via a questionnaire directed to trained and registered users from the POP-SP. This should occur before the POP-SP is officially authorized by the PFRDA and published or promoted on the PFRDA website as an official POP-SP.
- PFRDA should develop and convene a one-day workshop with the POP-SP institutions (marketing managers and CEOs) to discuss cross-selling techniques that could boost the number of NPS members. The workshop should
discuss the impact of the large volume of new members and include a segment that explains any legal limitations on cross-selling practices.

**Outcome of stakeholder interviews**

Stakeholder information and awareness meetings, workshops, seminars, and camps were conducted targeting employers, associations of commerce and industry, and workers’ groups. Based on their inputs, expanding NPS will require:

1. Improved capacity for ongoing market development, research, strategic planning, stakeholder consultations, documentation, and grassroots-level supervision and enforcement.
2. Appropriate budgets and strategies for producing and delivering a range of public goods, including mass direct-contact pension literacy and promotional campaigns to raise awareness of the importance of old-age savings, especially among the poor.
3. Sound commercial incentives for proactive, targeted, mass outreach, and active sales and enrollment efforts.
4. Sound commercial incentives and retail capacity for secure, error-free, grassroots-level, periodic collection and reconciliation of contributions, data and transactional information, and ongoing services and information delivery to individual NPS subscribers.
5. Improved capacity for ongoing field-level monitoring and evaluation, audits, impact assessment, and complaints redress.

**Summary of findings and recommendations**

The following recommendations flow from the field-level experience with NPS implementation.

<table>
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<th>Findings</th>
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<tr>
<td>Field assessment indicates significant unmet demand for retirement saving among unorganized sector workers; yet traditional marketing approaches are not well-suited to the task. There has been insufficient innovative use of non-traditional marketing strategies for the NPS also.</td>
<td>The NPS, with the cooperation of the POP-SPs, should develop an integrated marketing strategy involving community networks, civil society organizations, direct contact outreach programs, and the use of nontraditional media to actively promote NPS. Specific interventions could include the use of cell phones and street events.</td>
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<tr>
<td>NPS promotional material, while comprehensive, is pitched at too high a level for the average consumer.</td>
<td>Deficiencies in promotional materials are a serious concern from both the regulatory and communications perspectives. The PFRDA and the POPs should pursue a more user-friendly information strategy to promote transparency and consumer trust.</td>
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<tr>
<td>Most unorganized sector workers are unable to easily relate to the concepts of “retirement” or “long-term savings” and are inadequately aware of the NPS.</td>
<td>There is need for a nation-wide pension literacy and promotional campaign aimed at informing low-income workers regarding the importance of old-age savings, the role for thrift and self-help, the NPS features and operations, rights and responsibilities of NPS subscribers, and important financial concepts including compounding and time-value-of-money. The outreach of NPS POP-SPs and grassroots-level institutions should be harnessed in delivering a mass-scale NPS promotion and public education campaign.</td>
</tr>
<tr>
<td>Financial knowledge, income levels and periodicity, savings behavior and capacities, as well as access to formal financial services and sales channels, differ greatly between urban and rural locations. Similarly, large differences in attitude, needs, and capacity were observed across occupations and age profiles. As a result, latent demand for the product has been untapped.</td>
<td>A one-sized-fits-all approach will not work for India. The PFRDA should adopt different communications, coverage, and service access strategies for rural and urban target populations. The population should be segmented based on survey results and other objective inputs, in order to more effectively reach the rural and urban workforces. For example, the population could be segmented by occupation, income, and education levels so that appropriate information, communications, and public education strategies are targeted in order to achieve maximum impact. There should be a particular focus on increasing coverage among lower-income workers located in remote areas with limited banking and financial services access. (The NPS-Lite model developed by PFRDA is a good example of a segmented approach to delivering the NPS to the poor.)</td>
</tr>
<tr>
<td>Although the PFRDA uses only SEBI-, RBI-, and IRDA-regulated service providers for NPS, the sales of retirement savings products and provision of related services create the need for new, specialized knowledge of NPS products and processes. Staff knowledge, sales processes, intermediary behavior, the quality of information, and transactional services at the level of individual POP-SP branches, along with corresponding savings behavior and satisfaction levels with NPS products, performance, and information at the level of individual subscribers need to be monitored on an ongoing basis.</td>
<td>The PFRDA or the NPS Trust should commission periodic consultations with NPS subscribers and ongoing monitoring and evaluation of the NPS implementation at the grassroots level. The PFRDA should mandate that only qualified persons be permitted to participate in NPS operations. The NPS Trust should impose a formal certification for NPS operations. This should become a prequalification for all front-office and back-office staff of POP-SPs and other NPS intermediaries. The certification examination should be conducted through the NSE-NCFM program. Existing intermediary staff should be provided with a 90-day window within which such certification requirements are implemented.</td>
</tr>
</tbody>
</table>
Unlike insurance, banking, and mutual fund employees, distributors and agents, the staff of POP-SPs and other NPS intermediaries are not required to undergo a formal certification training to provide services and information to subscribers and the public at large. Although there have been some efforts to ensure that the staff of NPS intermediaries are sufficiently trained, the efforts have been informal and insufficient and do not result in a formal certification. Although all POPs registered with PFRDA have extensive marketing and distribution experience and the capacity to increase coverage, most POP-SPs appear to have adopted a passive outlook to NPS sales. They have devoted inadequate energy and investment on NPS cross-sales to their existing customers and have not sought to encourage the public more generally to subscribe to the NPS scheme.

<table>
<thead>
<tr>
<th>Findings</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>The PFRDA should take measures to encourage (or require) POPs to actively market the NPS product. In this context, the PFRDA should review the extent to which the current fees and charges paid to POPs provide sufficient incentives for NPS distributors to market or cross-sell the NPS, taking into account the costs associated with NPS sales and service delivery and the distribution models and incentives associated with other (competing) long-term savings and insurance products being offered by POPs. PFRDA could consider establishing reasonable level-of-effort and coverage outcome requirements for POPs with which it contracts.</td>
<td></td>
</tr>
<tr>
<td>PFRDA should explore the viability of linking NPS accounts with other welfare benefit products (such as life and disability), and it should encourage POPs (and other financial institutions) to develop and propose such combination products. The regulation and supervision of these products would be the responsibility of both PFRDA in cooperation with other relevant regulators, such as the IRDA.</td>
<td></td>
</tr>
</tbody>
</table>
Government can also consider additional distribution channels, including government programs in which the core target population participates. The PFRDA has already taken some steps in this direction by engaging NGOs, microfinance, and similar institutions to introduce NPS-Lite accounts. These organizations will need proper incentives to ensure that they actively encourage NPS subscription. Other existing government programs could be an additional, effective point of entry for many potential subscribers. For example, the National Rural Employment Guarantee (NREG) program could be utilized to offer participating individuals the opportunity to open NPS accounts or, alternatively, the government could require individuals participating in the program to open NPS accounts. The government could provide a matching contribution via the program. Similarly, individuals participating in government-sponsored health insurance initiatives (RSBY) could be provided similar access.

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<td>Government can also consider additional distribution channels, including government programs in which the core target population participates. The PFRDA has already taken some steps in this direction by engaging NGOs, microfinance, and similar institutions to introduce NPS-Lite accounts. These organizations will need proper incentives to ensure that they actively encourage NPS subscription. Other existing government programs could be an additional, effective point of entry for many potential subscribers. For example, the National Rural Employment Guarantee (NREG) program could be utilized to offer participating individuals the opportunity to open NPS accounts or, alternatively, the government could require individuals participating in the program to open NPS accounts. The government could provide a matching contribution via the program. Similarly, individuals participating in government-sponsored health insurance initiatives (RSBY) could be provided similar access.</td>
<td></td>
</tr>
</tbody>
</table>
Better promotion and improved incentives for POP-SPs will increase NPS membership. However, better business processes, especially improved use of information technology (IT), will be needed to make the NPS a trusted brand. As part of the technical assistance that is the backdrop to this book, the administrative and IT systems currently implemented in the POP-SPs to support the operation of the NPS were assessed. The key finding is that the established systems and processes rely too heavily on manual activities. From initial customer contact, the business process chain is characterized by manual record-entry and physical registers. As the system grows, so too will the number of human errors experienced. Current practices are therefore not sustainable as the system expands. Overloading the POP-SP network in its current state could result in a public relations fiasco. New business processes, together with their software requirements, are suggested in this chapter.

Step 1: Subscription and payment of first contribution business process

In this subsection, the initial stage of NPS membership, processing of the NPS subscription form and the first contribution payment, is assessed.

CRA software for POP-SPs

The CRA software provided to the POP-SP is derived from the NPS software designed by the CRA for the Payment Account Offices (PAOs) to handle the periodic NPS transactions of government workers. The software was not specifically designed for an individual voluntary subscription process. The decision to adapt it to POP-SP requirements was not a wise one, because it does not sufficiently automate operations and increases the need for POP-SP manual controls. These concerns will become increasingly evident when a POP-SP experiences an increase in the number of subscriptions.
Physical documents

POP-SPs do not have the capacity to digitalize subscription documents or any other physical documents involved in the NPS subscription processes. Currently, all physical documents involved in the membership process are scanned and loaded into the CRA-controlled Electronic Document Management System (EDMS) by a third party. The CRA does not have offices in all Indian states, and its main offices are located in Mumbai. CRA has contracted an intermediate institution, Karvy Group (KARVY), to handle the digitalization process. It is understood that the CRA has contracts with other third party providers similar to KARVY in other districts where KARVY is not present.

The POP-SP initiates the digitalization process by taking two photocopies of the original application and proof documents. One copy is sent to KARVY for digitalization and data capture. The POP-SP archives the other photocopy for internal control purposes. The original documents are returned to the applicant after being signed and stamped by the POP-SP. In accordance with this procedure, all POP-SPs throughout India would have a physical NPS archive.

Once the physical documents have been digitalized, the CRA acts as a central electronic folder for the entire NPS system and provides services to registered members (via personal user password). All registered POP-SPs can access individual folders and review the electronic archived documents.

Physical administrative registers

The POP-SP does not have online electronic records of the application form or the registration payment. Therefore, the POP-SP has no alternative but to establish physical registers in which the application and payment information are recorded. The POP-SP physical register is the backbone of the subscription process. The POP-SP currently administers two physical registers because of the numeration of the receipt numbers, one for the registration process, and the other for contribution payments. (The two-digit prefix of the receipt numbers is different.) Although there are only two physical registers, an increase in the number of persons processing NPS application within the same POP-SP would increase the risk of human error and increase the difficulty of monitoring and controlling the subscription process.

This process, unacceptably prone to error, should be replaced by a more efficient and secure one. One possible approach would be to require the digitalization of records at the POP-SPs. This approach is not recommended, however, because it would require the installation of scanning equipment and result in additional costs and additional operations for the POP-SPs. Moreover, unless the PFRDA mandates such functionality in the registration and authorization process of POP-SPs, the system would not be able to impose a standard form of operation for all POP-SPs. Therefore, the digitalization of physical documents in the CRA through third parties should be continued. However, as discussed next,
the issuance of the Personal Retirement Account Numbers (PRANs) should not remain linked to this digitalization process.

**Assignment of PRAN numbers**

The POP-SP cannot release the registration payment until a PRAN number has been assigned to the applicant. The PRAN number is only allocated by the CRA to the applicant when all information from the application form is validated and registered into the CRA system and all physical documents have been validated and digitalized. Because the physical documents are processed by KARVY and then the CRA, it currently takes between five and seven calendar days to allocate a PRAN when an account is established, according to POP-SP estimations. Considering that current NPS membership is low, this does not bode well for the future, should the number of application forms increase dramatically.

In order to know when it is allowed to process the registration payment, the POP-SP must monitor the daily PRAN allocation process. In order to monitor the allocation of a PRAN number to an applicant, each POP-SP assigns to the application form an internal receipt number (each POP-SP has its own sequence of receipt numbers, concatenated to a pre-registered POP-SP number registered in CRA), and for each POP-SP receipt number, KARVY assigns an acknowledgement number. These two numbers, taken together, are the only key to monitoring the application form and the PRAN allocation process.

The two numbers are manually registered into the POP-SP physical register, as is the PRAN number once allocation is detected. The transfer number for the registration payment is also manually written into the physical register. When the registration payment is booked and matched into the individual account of the member (status reflected in the CRA system), the POP-SP can then complete the subscription process for an individual member and manually close the physical register. It takes between eight and ten calendar days to complete the cycle from subscription to closure, and it could be more, depending on the cashing of the payment document.

**POP-SP core systems**

There have been suggestions that POP-SPs should incorporate the NPS as part of their operations. Incorporation of the NPS as part of the POP-SP core operations would mean that the NPS product would be recognized by the POP-SP as part of its standard operations. Given the current dependency on PRAN allocation, the POP-SP core systems would need to connect automatically to the CRA systems, for both subscription and payment processes. This would require system development and synchronization with the CRA. Because POP-SPs are serving only as a service point for membership and contribution payments, it is not imperative to integrate the NPS into POP-SP core operations. In lieu of such integration, it is recommended that the CRA provide POP-SPs with online services that allow the POP-SP to operate, and the CRA to automate, the subscription and contribution operations.
NPS business processes and IT needs

This is described as part of the proposed, new business process discussed below. The only reason for a POP-SP to be required to incorporate the NPS into their core system would be where the POP-SP is actually cross-selling the NPS product by utilizing its current client base and the member is a permanent client of the POP-SP. In other circumstances, it is not recommended that POP-SPs incorporate the NPS into their core systems.

Current business process map: subscription and payment of first contribution procedure

The current process for subscription and payment (Figure 7.1) is highly dependent on POP-SP capacity to monitor the application and release the contribution payment to PFM s via the CRA and trustee bank once the application form has been accepted and the PRAN number issued to the applicant. This process is dependent on the existence of a physical register, which is written and updated manually by POP-SP personnel. The physical register contains personal information of the applicant, and amounts related to taxes, fees and net contributions. All the following control numbers are written manually into the physical register:

- POP-SP receipt number for the application form
- POP-SP receipt number for the NPS Contribution Instruction Slip (NCIS)
- Acknowledgement number issued by KARVY
- PRAN number issued by CRA
- Fund Transfer Number composed of transaction ID number
- Matched and Booked contributions (i.e., reconciliation or “matching” of money by the CRA with the trustee bank, and allocation or “booking” to the individual account of the member followed by closure of the cycle).

The manual operation of the physical register and the POP-SP’s dependency on the physical register as a tool to monitor an application form creates an unacceptably high risk of human error.

In the current business process, the POP-SP is dependent on the capacity of the data entry group KARVY and the processing of the information by the CRA to receive notice that the PRAN has been assigned to the applicant. This results in a delay in the issuance of the PRAN. Because of this delay, the POP-SP must physically archive the contribution payment document associated to the subscription process until the PRAN has been allocated. Not only does this delay give rise to risk of physical loss or destruction, it translates into the loss of potential investment gains.

Proposed new business process: subscription procedure

Overall, the current business process is characterized by a high level of manual operations and a low level of automation, thus creating a high risk for
Figure 7.1 Current POP-SP subscription business process map
human error within the POP-SP. The fact that the POP-SP has implemented manual approaches as a tool to monitor the status of an NPS application form without modifying the core computer systems of the POP-SP is a critical barrier to the future success of the NPS reform. As the number of application forms increases, the complexity of the administration will increase, as will the number of human errors, and the time frame for allocation of contributions into the individual NPS accounts will extend further than the current eight to ten calendar days.

The physical registers in the POP-SPs should be eliminated and replaced with electronic records. The POP-SPs cannot be expected to modify their core systems, therefore the CRA should provide an automated process that ensures quality control of the POP-SP information, and which allows the POP-SP to eliminate the physical registers and operate solely via CRA software. In order to accomplish this, the CRA must provide the POP-SPs with the services required for NPS subscription and contribution payments.

In the proposed business process (Figure 7.2), the CRA will provide each POP-SP with online services that will process a minimum set of information entered by the POP-SP from the NPS application forms. The POP-SP will enter only the essential information that will allow the CRA to allocate a PRAN online or reject immediately the application form based on existing NPS accounts. In this manner, the POP-SP operates the system and provides an immediate response to the applicant on his/her application status. Data capture of the remaining, non-essential information and digitalization of documents will continue to be the prime function of KARVY. The cornerstone of the new process is that a PRAN will be issued (or denied) immediately. The issuing of the PRAN online will allow the POP-SP to process the contribution payment without delay.

The online CRA application that captures the essential data from the application form and issues a PRAN or rejects the application should be in HTML data entry format and include only 13 fields of information. The application would do the following:

- HTML data entry format
- Only 13 fields of information
- Identify POP-SP, and calculate receipt numbers for subscription and payment
- Validate applicant information with existing CRA master registers or third party registers
- Check conformity of tax and fee values, and calculate net contribution
- Validate Pension Fund and asset distribution
- Return rejection messages
- Return PRAN
- Generate completed NCIS form (pdf format) and show automatically in browser
- Calculate payment transfer date according mode of payment, show date
<table>
<thead>
<tr>
<th>Subscriber</th>
<th>POP-sp</th>
<th>KARVY</th>
<th>CRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fills in NPS application form and attaches proof documents</td>
<td>Receives registration form and helps subscriber complete mandatory or missing sections of the form</td>
<td>Checks proof documents and photograph of applicant are compliant and attached</td>
<td>Checks mandatory data on form is presence and valid</td>
</tr>
<tr>
<td>Form is rejected for correction</td>
<td>Verifies correctness of the form data with proof documents - name of subscriber - present address - date of birth</td>
<td>Data correct</td>
<td></td>
</tr>
<tr>
<td>Signs NPS Application form</td>
<td>Requests initial amount to open account and mode of payment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Applicant indicates amount and mode of payment - attaches payment document</td>
<td>Receives Payment Document (first contribution)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Figure 7.2** Proposed POP-SP subscription business process map
• Store applicant information
• Store contribution values for daily closure and invoicing

The increase in the workload of the POP-SP related to the data entry of information will be more than compensated for by the elimination of manual operations and physical registers. The difference for KARVY is that the information will be associated to a PRAN, eliminating the need for KARVY to allocate acknowledgement numbers for each POP-SP receipt number and, correspondingly, eliminating the need for the POP-SP to monitor the acknowledgement number on a daily basis in order to track the issuing of the PRAN.

The online issuing of the PRAN will increase the automation of the business process. The new business process will include the automatic calculation of receipt numbers for subscription and payment and the automatic generation of a complete NCIS form ready for signing. The fact that essential information is entered into the CRA system in the initial operation will place the onus on the CRA, not the POP-SP, to expedite the payment process.

The proposed new business process will include a CRA daily closure and the automatic generation of payment invoices, both for taxes and fees, as well as the net contribution value. In the new process, the POP-SP will not be required to generate and validate a contribution file for subscription, because the information entered in the initial online operation will provide all the information needed to package and generate the invoices.

Additional CRA services should allow the POP-SP to view the completed cycle of the application forms through the vision of “work trays”:

• Work tray 1 – Submitted forms pending data entry KARVY
• Work tray 2 – Submitted forms with problems detected by KARVY (clicking shows list of problems) for customer solution
• Work tray 3 – Application forms booked and matched in last three days

All work trays should be visible to the POP-SP at the same moment, and scroll bars should allow the POP-SP to view additional application forms. Each work tray should have a search option to locate an individual application form within specified work trays, or by searching over all work trays.

Table 7.1 describes the characteristics of the proposed new business process and provides a comparative analysis between the current and the new process.

In order to evaluate the costs and risks of the recommended, new business process, as compared to the current business process, a point value was assigned to items affecting the business process. The point system, which is subjective, is based on the following assessment of risk levels: high = 0.80, medium = 0.50, low = 0.20. Using these values, the cost/risk level of the current process is calculated to be 18.1 and the proposed new process if 4.8. Based on this measure, the new process represents a substantial improvement over the current process. Any reasonable, subjective assignment of values to risk would also result in an estimated improvement.
<table>
<thead>
<tr>
<th>Item</th>
<th>Current business process (A)</th>
<th>New business process (B)</th>
<th>Error risk level</th>
</tr>
</thead>
<tbody>
<tr>
<td>POP-SP Subsc. Receipt number</td>
<td>Manually calculated</td>
<td>Automatic</td>
<td>Low</td>
</tr>
<tr>
<td>POP-SP Payment Receipt number</td>
<td>Manually calculated</td>
<td>Automatic</td>
<td>Low</td>
</tr>
<tr>
<td>Physical Register – Subsc. information</td>
<td>Manually updated</td>
<td>N/A</td>
<td>Medium</td>
</tr>
<tr>
<td>POP-SP Payment Receipt number</td>
<td>Manually calculated</td>
<td>N/A</td>
<td>Medium</td>
</tr>
<tr>
<td>Applicant and NCIS payment information sent online to CRA (0)</td>
<td>Manually</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Taxes and fees calculated by POP-SP</td>
<td>Manually</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Online validation of applicant information (check for duplicity)</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>PRAN issued online by CRA</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Transcribe receipt number onto application form</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Transcribe receipt number onto NCIS form</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Transcribe tax and fees onto NCIS form</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Transcribe receipt number onto NCIS payment form</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>PRAN issued online by CRA</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Photos of signed documents archived in POP-SP</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Scanned documents available online</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>POP-SP proceeds immediately to cash payment document of first contribution</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>POP-SP waits for PRAN to be issued before the cashing process begins</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Payment documents archived in physical folder in admin area</td>
<td>No</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>CRA FPU (1) local software procedure for registering subscription receipt number</td>
<td>Yes</td>
<td>Low</td>
<td>N/A</td>
</tr>
<tr>
<td>Item</td>
<td>Current business process (A)</td>
<td>Error risk level</td>
<td>New business process (B)</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>------------------------------</td>
<td>-----------------</td>
<td>--------------------------</td>
</tr>
<tr>
<td>CRA FVU local validation software procedure for (1)</td>
<td>Yes</td>
<td>Low</td>
<td>N/A</td>
</tr>
<tr>
<td>POP-SP register subscription receipt numbers into CRA via FVU (1)</td>
<td>Yes</td>
<td>Low</td>
<td>N/A</td>
</tr>
<tr>
<td>Generate Check list of application forms for sending information to third party data entry KARVY</td>
<td>Manually</td>
<td>Medium</td>
<td>Automatic generation</td>
</tr>
<tr>
<td>Acknowledgement number issued by data entry KARVY for each receipt number required by POP-SP to locate application form</td>
<td>Manually</td>
<td>High</td>
<td>N/A</td>
</tr>
<tr>
<td>Transcribe Acknowledgement number into physical register</td>
<td>Manually</td>
<td>High</td>
<td>N/A</td>
</tr>
<tr>
<td>Dependency on third party data entry KARVY for issuing of PRAN</td>
<td>Yes</td>
<td>High</td>
<td>N/A</td>
</tr>
<tr>
<td>Dependency on PRAN to release subscription payment</td>
<td>Yes</td>
<td>Medium</td>
<td>Yes; Issued online</td>
</tr>
<tr>
<td>Transcribe PRAN into physical register</td>
<td>Yes</td>
<td>High</td>
<td>N/A</td>
</tr>
<tr>
<td>CRA FPU (2) local software procedure for registering contribution payment</td>
<td>Yes</td>
<td>Medium</td>
<td>N/A</td>
</tr>
<tr>
<td>CRA FVU local validation software procedure for (2)</td>
<td>Yes</td>
<td>Medium</td>
<td>N/A</td>
</tr>
<tr>
<td>POP-SP register contribution payments into CRA via FVU (2)</td>
<td>Yes</td>
<td>Medium</td>
<td>N/A</td>
</tr>
<tr>
<td>Invoice for payment of taxes and fees</td>
<td>Manually</td>
<td>High</td>
<td>Automatic generation (0)</td>
</tr>
<tr>
<td>Invoice for payment of net contributions based on (2) Transaction number</td>
<td>Automatic generation(2)</td>
<td>Low</td>
<td>Automatic generation (0)</td>
</tr>
<tr>
<td>Separate CRA menu option to print invoice</td>
<td>Yes</td>
<td>Low</td>
<td>N/A</td>
</tr>
<tr>
<td>Transcribe payment transaction number into physical register (2)</td>
<td>Yes</td>
<td>High</td>
<td>N/A</td>
</tr>
<tr>
<td>Closure registered into physical register</td>
<td>Manually updated</td>
<td>High</td>
<td>N/A</td>
</tr>
<tr>
<td>Number of days to CLOSE subscription cycle</td>
<td>8–10</td>
<td>High</td>
<td>2–3</td>
</tr>
</tbody>
</table>
Summary of recommendations

- Eliminate the POP-SP physical registers and manual operations.
- Eliminate the acknowledgement number for each receipt number issued by KARVY. Change the KARVY key for data submission from acknowledgement number plus receipt number to PRAN.
- Implement the online service to capture essential data from the NPS application form and issue immediately the PRAN or generate rejection report.
- Implement the automatic generation of the NCIS payment form.
- Implement the concept that the CRA expedites the contribution payment process, via the daily closure concept, and the automatic generation of invoices for the transfer of funds to PFMs, as well as payment of taxes and fees to the POP-SP accounts.
- Require the CRA to implement an electronic archive network where all physical documents are stored in digital format and a storage area where all physical documents are archived. The CRA should implement a request procedure to provide access to the original physical document for any legal requirements. The CRA should implement online web services that allow both the member and all registered POP-SPs to access the electronic folder and the respective documents, with member access controlled by the password issued in the welcome kit.
- Eliminate the requirement that the POP-SP with access to the electronic folder retain and archive the physical photocopy of the member’s documents.
- Require the POP-SP to retain a physical photocopy of the original documents until the CRA confirms digitalization according to the PRAN number. Once confirmed, the POP-SP should be expected to destroy the photocopies and continue to work only with the electronic images provided by the CRA electronic archive network.
- Automatically generate and load into the electronic archive periodic statements on the balance of the individual account. Members and POP-SP should be able to retrieve historical documents from the archive and print.

Step 2: Payment of subsequent contributions business process

The following is an assessment of the processing of NPS contributions subsequent to enrolling in the system and paying the first “sign-up” contribution.

CRA software for subsequent contribution payments

The CRA software provided to the POP-SP is batch based. The POP-SP declares all contribution payment documents that, during the day, have been cashed into the “parking” account, i.e. the intermediate account in the POP-SP from which the money is transferred to the trustee bank and individual account. The CRA is
not aware of payments that have not been cashed by the POP-SP. Under this approach, the POP-SP is responsible for expediting the CRA current payment process, not the CRA that ultimately must take action.

**Physical administrative registers**

The POP-SP currently administers one physical register for contribution payments. This contribution physical register is different from the subscription register because of the numeration of the receipt numbers (the two-digit prefix of the receipt numbers is different). Currently, only one physical register exists for contribution payments.

Each payment form is assigned a unique receipt number. Each POP-SP has its own sequence of receipt numbers that are concatenated to a pre-registered POP-SP number registered in the CRA. The receipt number is manually calculated, allocated and registered in the POP-SP physical register. In the payment process, the CRA generates a transaction identification (ID) number that batches together a group of contribution payments. This transaction ID number is manually entered into the physical register alongside the corresponding receipt number that is included in the package of payments. Only when the contribution payment is finally booked and matched into the individual account of the member (status reflected in the CRA system) is the contribution payment process for that individual member manually closed in the physical register. The complete cycle from payment to closure is estimated between three and four calendar days including the cashing process of the payment document.

The POP-SP physical register is the administrative backbone of the NPS payment process, providing historical records of receipt numbers and payment transactions. An increase in the number of persons processing contribution payments within the same POP-SP will increase the number of human errors and the difficulty of monitoring the payment process. Physical registers, manually updated, are risky and this process should be replaced by a more efficient and secure one.

**Current business process map: payment of subsequent contributions**

The current business process for dealing with subsequent contributions (Figure 7.3) is dependent on the existence of a physical register, written and updated manually by POP-SP personnel. The physical register contains identification of the member and amounts related to taxes, fees and net contributions.

The following control numbers are written manually into the physical register:

- POP-SP receipt number for the NCIS contribution payment form
- PRAN of the member
- Fund Transfer Number or payment transaction ID number
- Matched and Booked contributions, closure of cycle
NPS business processes and IT needs

Figure 7.3 Current POP-SP contribution business process map
The manual operation of the physical register and the POP-SP dependency on the physical register as a tool to monitor contribution payments creates a high risk of human error. Moreover, the POP-SP receipt numbers are not system generated but manually calculated.

Although the time frame for processing the NPS contribution payment (three to four calendar days) is not excessive, the fact that a physical register exists and is updated manually constitutes a low level of automation and efficiency. As the number of contribution payments rises, the administration will become increasingly burdensome for the POP-SP, and the potential of human errors increases in the maintenance of the physical register, which could directly affect the process timeframe, extending time further than the current three to four calendar days.

The fact that the POP-SP has implemented physical registers as an administrative tool for NPS contribution payments without implementing electronic records by modifying the core computer systems of the POP-SP could prove significant to the future success of the NPS reform.

Proposed new business process map: payment of subsequent contributions

The proposed new business process (Figure 7.4) does not require a radical change in the manner the contribution payments are processed. The principal change is the elimination of the physical registers in order to enhance automation. The other change corresponds to synchronizing the contribution payment with the same procedure used in processing the subscription contribution payment.

The CRA should provide the POP-SP with services designed to handle subsequent contribution payments to established NPS accounts. Contribution payments should be registered online, as the payments occur. The contribution payment process should consist of two stages. The first stage is registering member identification, recording the amount of contribution and generating a NCIS printed document for signature. The second stage is confirming the effective payment of the NCIS, i.e., the teller confirming that the member has effectively paid the amount printed on the NCIS form. The second stage confirmation would simply flag the contribution as ready for the daily CRA invoicing process, which is described in the new business process maps.

The current CRA local software utilities (the File Processing Utility or FPU and the File Validation Utility or FVU) for registering payments would be replaced with a CRA online web service. With this web service, each individual payment would be registered into the CRA system. The receipt number would be calculated automatically, and an automatic NCIS payment form would be printed. The POP-SP would operate the system, and it would immediately be able to detect discrepancies, such as where the member is not readily identified on the CRA system. In such cases, payment documents would be returned immediately to the payer, eliminating custody of documents in the POP-SP.

The online CRA software application that would capture the essential data related to the contribution payment should be in HTML data entry format
Figure 7.4 Proposed POP-SP contribution business process map
NPS business processes and IT needs

and include only nine fields of information. The application would do the following:

- Identify the POP-SP, and calculate payment receipt number
- Validate the applicant identification PRAN with the existing CRA master register
- Check conformity of tax and fee values, and calculate net contribution
- Generate completed NCIS form (pdf format) and show automatically in browser
- Calculate payment transfer date according mode of payment, show date
- Store payment information (work trays)
- Store payment values for daily closure and invoicing.

The increase in the workload of the POP-SP related to online data entry of the payment would be minimal and compensated for by elimination of the physical register and manual updating.

Under this approach, the contribution payment can be cashed immediately due to the fact that the payment has been previously validated. The fact that payment information was entered into the CRA system places the responsibility for expediting the payment process on the CRA where it belongs, not on the POP-SP where it currently rests.

The new business process includes a CRA daily closure and the automatic generation of payment invoices, both for taxes and fees, as well as the net contribution value. The initial online operation provides all the information needed to package and generate the invoices.

Additional CRA services should allow the POP-SP to view the complete cycle of the contribution payments through the vision of work trays.

- Work tray 1 – Contribution payments according to date of payment
- Work tray 2 – Contribution payments according to date of invoice

All work trays would be visible to the POP-SP at the same moment, and scroll bars would allow the POP-SP to view more contribution payments. It should be possible to select the contribution payments of each work tray according to a range of dates, with a default of the current date minus five days inclusive. However, the user would be allowed to modify and have different selection criteria values in each work tray. Each work tray should have a search option to locate an individual contribution payment within the work tray, and there should be a search facility over all work trays, using the PRAN or receipt number.

Table 7.2 describes the characteristics of the proposed new business process and provides a comparative analysis between the current and the new processes.

To evaluate the costs and risks of the recommended, new business process, as compared to the current business process for payments to pre-established NPS accounts, the same method applied to the recommendation for the establishment of NPS accounts was used. Using the business process chart, a point value was
<table>
<thead>
<tr>
<th>Item</th>
<th>Current business process (A)</th>
<th>Error risk level</th>
<th>New business process (B)</th>
<th>Error risk level</th>
</tr>
</thead>
<tbody>
<tr>
<td>POP-SP Payment Receipt number</td>
<td>Manually calculated</td>
<td>Medium</td>
<td>Automatic</td>
<td>Low</td>
</tr>
<tr>
<td>Physical Register–Payment information</td>
<td>Manually updated</td>
<td>High</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Taxes and fees calculated by POP-SP</td>
<td>Manually</td>
<td>Medium</td>
<td>Manually</td>
<td>Medium</td>
</tr>
<tr>
<td>NCIS payment information sent online to CRA (0)</td>
<td>No</td>
<td>High</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Online validation of member information</td>
<td>No</td>
<td>High</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>Transcribe taxes and fees onto NCIS form</td>
<td>Manually</td>
<td>Medium</td>
<td>NCIS generated automatically (0)</td>
<td>Low</td>
</tr>
<tr>
<td>Transcribe receipt number onto NCIS payment form</td>
<td>Manually</td>
<td>Medium</td>
<td>NCIS generated automatically (0)</td>
<td>Low</td>
</tr>
<tr>
<td>Photocopies of signed documents archived in POP-SP</td>
<td>Permanent</td>
<td>Medium</td>
<td>Permanent</td>
<td>Medium</td>
</tr>
<tr>
<td>POP-SP proceeds immediately to cash payment document</td>
<td>Yes</td>
<td>Low</td>
<td>Yes</td>
<td>Low</td>
</tr>
<tr>
<td>CRA FPU (2) local software procedure for registering contribution payment</td>
<td>Yes</td>
<td>Medium</td>
<td>N/A</td>
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<tr>
<td>CRA FVU local validation software procedure for (2)</td>
<td>Yes</td>
<td>Medium</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>POP-SP register contribution payments into CRA via FVU (2)</td>
<td>Yes</td>
<td>Medium</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Invoice for payment of taxes and fees</td>
<td>Manually</td>
<td>High</td>
<td>Automatic generation (0)</td>
<td>Low</td>
</tr>
<tr>
<td>Invoice for payment of net contributions based on (2) Transaction number</td>
<td>Automatic generation (2)</td>
<td>Low</td>
<td>Automatic generation (0)</td>
<td>Low</td>
</tr>
<tr>
<td>Separate CRA menu option to print invoice</td>
<td>Yes</td>
<td>Low</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Transcribe payment transaction number into physical register (2)</td>
<td>Yes</td>
<td>High</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Closure registered into physical register</td>
<td>Manually updated</td>
<td>High</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Number of days to CLOSE contribution cycle</td>
<td>3-4</td>
<td>Low</td>
<td>2-3</td>
<td>Low</td>
</tr>
</tbody>
</table>
assigned to items affecting the business process. The point system, which, again, is subjective, is based on the following assessment of risk levels: high = 0.80, medium = 0.50, low = 0.20. A point value is accumulated only if the item has an impact on the business process. Using these scores, the current business process has a risk/cost profile of 8.0 while the proposed new one has a risk/cost profile of 3.9. Based on this measure, the new process represents a substantial improvement over the current process.

Summary of recommendations

- Eliminate the POP-SP physical registers, and manual operations.
- Implement the online service to capture NPS contribution payment data.
- Implement the automatic generation of the NCIS payment form.
- Implement the concept that the CRA pushes the contribution payment process, via the daily closure concept, and the automatic generation of invoices for the transfer of funds to Pension Funds, and payment of taxes and fees to the POP-SP accounts.

Information technology issues

CRA transfer of funds to the pension fund managers

As originally rolled out in May 2009, the NPS had only one tier, from which no withdrawals were permitted until annuitization. As of December 2009, a Tier II was launched, from which withdrawals are permitted. Only individuals who already have Tier I accounts can open Tier II accounts.

The pension funds that administer NPS accounts are required to create separate investment portfolios for each tier, according to each type of investment, Equity (E), Corporate (C) and Government (G), with its own NAV. Therefore, each pension fund has a minimum of six investment portfolios. Each portfolio has a separate income contribution account into which contributions are paid.

The CRA transfers the contribution payments from the trustee bank to the PFMs as one lump sum to an intermediate “holding” account of the PFM. In order to detail the contribution values for each of the investment portfolios, the CRA generates an electronic file with individual records, detailing values for each tier and portfolio. The sum of the detailed values balances with the total amount transferred from the trustee bank to the PFM.

The PFMs have to process the electronic file generated by the CRA in order to identify the individual values for each portfolio, and once identified, transfer electronically the values from the intermediate income account into the income accounts of the respective portfolios.

It should be noted that PFMs could avoid this intermediate transfer of money procedure, if the CRA processed and transferred the individual values from the trustee bank account directly into the individual portfolio income accounts of the Pension Fund.
Kiosk/electronic banking approaches

The NPS model promotes saving via periodic and continued contribution payments. Although the business process for subsequent contribution payments has been reviewed and improved, the amount of paperwork necessary for subsequent contributions can be reduced further.

The following three proposals, two involving kiosks and the third consisting of electronic banking, should be evaluated. In evaluating them, two points need to be kept in mind. First, all of these alternatives must connect automatically to the CRA in order to register the contribution payment into the system. Second, the alternatives are not required to connect to the core systems of the POP-SP.

Kiosk-A

Kiosks are mobile units that can be positioned in strategic locations, the basic requirement being that they must be connected to Internet. Kiosks can be co-financed between CRA, POP-SPs, and financing from project sponsors. Each kiosk is configured as a POP-SP with automatic coding and connectivity to the NPS Contribution Accounting Network (NPSCAN).

Alternative A corresponds to the basic kiosk approach, which provides the NPS member with a touch screen through which he or she can specify the PRAN, amount and mode of payment, following which an NCIS form is generated. The NCIS form should be turned in, and the contribution paid, at any registered POP-SP. The Kiosk-A approach provides autonomy to NPS members and simplifies the payment process for the POP-SP. Information would flow automatically to the CRA with no need for POP-SP staff to register the NCIS into the CRA system for the daily invoicing process. In this approach, once the NCIS form has been generated and printed, the member would simply go to a POP-SP and pay the amount. The POP-SP teller would confirm payment and the NCIS information would immediately be available for invoicing.

The Kiosk-A approach is consistent with the new business process described below (see New POP-SP Contribution-Process/Subscription-Process), because the amounts submitted to the CRA system are validated; a NCIS form is automatically generated; and the values are stored in the CRA system, pending confirmation of payment and invoicing.

Kiosk-B

Kiosk-B is a more advanced type of kiosk approach that operates in the same manner as Kiosk A, with the same operative requirements, connection to CRA, etc. The difference is that in Kiosk B, the NCIS form will include a receipt stamp, indicating that the money has been paid.

The Kiosk works in the same manner as automatic teller units used in banks and parking areas, where the amount is paid in cash by the payer directly to the automatic teller.
The kiosk ensures that the total amount declared by the member is effectively paid before printing the NCIS form. Security issues should be reviewed, but with Kiosk B, the member is totally autonomous. At the end of each day, a designated POP-SP would deposit the amount of money collected by the Kiosk into a “parking” account. The CRA would process the daily invoice as described in the new business process below.

Electronic banking

According to the results of the baseline survey carried out in the two districts identified in Chapter 7, between 60 and 80% of the households interviewed have active bank accounts. The elevated number of bank accounts suggests that one of the best approaches for future subsequent contribution payments is to put in place the technology to allow the member to do electronic banking or automatic debiting.

The CRA or a third party provider should be contracted to provide an electronic debiting service. The POP-SP should provide electronic debiting services to their own client data base that have opened an NPS account.

Due to the increase in online web-based operations defined in the new business processes, it is recommended that the CRA review and increase the bandwidth of the NPSCAN network in order to ensure adequately rapid response to the POP-SP with the new functionalities. It is also suggested that the project review the Service Level Agreement between the CRA and KARVY to ensure on-time delivery and the quality of information digitalized.

Summary of findings

<table>
<thead>
<tr>
<th>Findings</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current NPS business processes are too paper-oriented and do not reflect international good practices in the application of IT, particularly with respect to the establishment and maintenance of accounts at the POP-SP. Overuse of manual procedures and overreliance on physical registers raise the risk of human error, a risk which will become more serious as the system grows.</td>
<td>The detailed recommendations in this chapter seek to reduce the risks associated with physical registers and manual operations. Implementing these recommendations will require revamping of the CRA software and architecture at the level of the POP-SP interface.</td>
</tr>
<tr>
<td>The centrality of front-end processes to the successful administration of NPS accounts reinforces the need to ensure proper training of POP-SP personnel. NPS is unlikely to succeed unless it can become a trusted brand, and much of that trust needs to be formed at the customer-interface level.</td>
<td>As also discussed in Chapter 7, POPs should be held responsible for properly training POP-SP personnel. A formal certification process should be established.</td>
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</tbody>
</table>
Part IV

The economics and demography of the NPS
Successful design and implementation of the NPS reform requires quantitative estimates that can serve as a basis for policy discussions. In this chapter, a modeling and simulation exercise is presented estimating the number of contributors and the asset base of the NPS under transparent assumptions and using a transparent model structure. The numbers presented below should not be interpreted as a projection, but as a scenario in which demographic, labor market, economic, and system participation assumptions are combined.

To estimate the dimensions of the NPS system, the Macro_NPS simulation model has been constructed, modified from a model previously applied in the USAID-financed Armenia Social Protection Systems Strengthening (SPSS) project. This model is a large but simple spreadsheet that:

- produces a cohort population projection;
- combines this with assumptions about the labor market to estimate the potential contribution base for the NPS and the wage bill;
- applies assumed NPS system participation and contribution rates to estimate contributions; and
- based on an assumed rate of return and fees as a share of total assets, estimates the path of total assets in the system over time.

The Macro_NPS model is implemented in Excel and runs on an annual basis. As a “cell-based” model, it tracks age/sex cohorts, not persons. For this reason, it is not well-suited to analyze the experience of an average individual. For this purpose, an agent-based model has been developed of the Micro_NPS, which is presented in the next chapter.

Macro_NPS model structure

This model consists of a set of linked Excel workbooks (linked in the sense that changing an assumption in one workbook may lead to a change in numbers calculated in another). What is called a model is, in fact, a series of modules consisting of individual workbooks.
The workbook “Structure of employment” breaks down all base-year employment by age and sex into urban and rural, organized and unorganized sectors. These shares can be changed by assumption over the projection period.

“Population” performs a cohort-component projection of the population, on the basis of the United Nations World Population Prospects, 2008 Revision, by single-year age group, sex, and urban–rural residence. In “Population,” separate worksheets deal with the urban and rural fertility, mortality, and rural–urban migration. International migration is not dealt with. The gist of the cohort-component approach is:

\[
\text{Pop}(a,s,t) = \text{Pop}(a-1,s,t-1) - \text{Deaths}(a-1,s,t-1) + \text{Net in - migration}(a-1,s,t-1)
\]

i.e. the population aged \(a\) (say 40) of sex \(s\) (say, female) in year \(t\) (say, 2020) is equal to the number of females aged 39 in 2019 minus those who die plus net in-migration.\(^1\) The number of births is calculated by multiplying the number of women in age cohorts 15–49 by assumed age-specific fertility rates and an assumed sex ratio at birth.

Based on the population projection, “Labor force”—actually two workbooks, “Labor force urban” and “Labor force rural”—calculates labor force and employment (thus, unemployment as well) by single-year age group, sex, and urban–rural residence. This is done by multiplying population by age, sex, and place of residence by assumed labor force participation and unemployment rates. These workbooks then apply the distribution from “Structure of employment” to allocate employed workers across the organized and unorganized sectors.

“Wages,” which like “Labor force,” consists of separate urban and rural workbooks, projects the average real wage in the organized and unorganized sectors; it also imposes an assumed male–female differential. Wage rates times number of persons employed gives the wage bill. A Full-time Equivalent (FTE) coefficient allows the user to take account of the fact that not all employed workers are working all the time.

In “NPS Contr,” the number of contributors to the NPS system is calculated as an assumed share of workers by category—age, male/female, urban/rural, and organized/unorganized sector.\(^2\) The total wage bill earned by each type of worker, from “Wages” is multiplied by the proportion of workers participating in the system; then by an assumed contribution rate (proportion of gross earnings saved) to calculate the annual contribution in a given year. No allowance is made for contributions before 18 or after 60, although these would be simple to allow for.

In “NPS Accum,” the accumulation of each age /sex cohort is calculated, again with distinction between urban and rural workers. The basic calculation for a cohort aged \(a\) of sex \(s\) in year \(t\) is
Potential size of the NPS

Accum(a, s, t) = Accum(a - 1, s, t - 1) \((1 + r - f)\) + Contr(a, s, t)

where \(r\) is the rate of return and \(f\) is costs expressed as a proportion of assets under management. In words, the assets of the cohort, e.g., males aged 50 in 2020 will be the assets of the cohort of males aged 49 in 2019 times one plus the rate of return net of fees expressed as a share of assets, plus contributions in 2020. There are several important simplifying assumptions. One is that assets cannot be removed until 60, at which point they are annuitized in their entirety, leaving the NPS system. In the event of death, assets are assumed to remain in the system, i.e. are either assigned to another member as a supplement to their own account, or, if the deceased’s beneficiary is not a member, a new account is opened for him/her. The NPS design is more nuanced than this regarding early withdrawal, death, and the annuitization process, but these nuances are better dealt with in the Micro_NPS agent-based model presented in the next chapter.³

NPS simulation results

A rough model scenario has been constructed with the goal of illustrating a possible path of asset accumulation. This is meant to serve as a basis for discussion, not as a projection for planning purposes. Major assumptions are as follows:

Population and demography

Population was initialized by single-year age group, sex, and urban–rural residence using the most recent World Population Projections of the United Nations.⁴ UN data were used because they are based on national data sources but have been processed to eliminate “age heaping” in the raw Census data.

Base-year age-specific fertility rates, corresponding to an average (rural and urban combined) total fertility rate of about 3, were taken as reported by the Census of India.⁵ Assumptions on fertility decline have been made roughly in line with those from the UN Population Division illustrated Chapter 2. To be more specific, urban fertility is assumed to decline from 2.18 in 2001 to 1.7 in 2030, after which it remains constant, while rural fertility is assumed to decline from 3.24 in 2001 to 2.1 in 2035, after which it remains constant. Given urbanization trends described below, this is consistent with a decline in the average total fertility rate (TFR) from 2.9 in 2001 to 1.9 in 2050, marginally higher than the assumption underlying the UN Population Division medium variant.

Age-specific mortality data for males and females were taken from the World Health Organization Statistical Information System (WHOSIS); despite applying to 2006, these were used to initialize the model in 2001.⁶ Sex-specific rates were adjusted in line with estimated life expectancy differences to give a reasonable urban–rural gap; 60.9 for both sexes combined in rural areas and 67.1 in urban areas. Age-specific mortality rates were assumed to decline at a rate
of 1% per year (more or less in line with international experience), leading to rural/urban life expectancies of 69.5/74.4 in 2050. Again applying the urban share, this amounts to an increase in average life expectancy for both sexes combined of 62.4 in 2001 to 72.0 in 2050. This does not differ significantly from the UN Population Division medium variant described in Chapter 2.

Rural–urban migration rates (net rural-to-urban flow as a proportion of rural population) were assumed to equal 2% per year for males and females aged 15–49 and zero for all other age groups. When combined with assumptions on rates of natural increase, this results in a scenario in which the urban share rises from the present 28.5% to 52.5% in 2050. This is consistent with the UN Population Division urbanization scenario (see again Chapter 2).

The overall result is a scenario in which population rises from its present level to 1.571 billion in 2050. The old-age dependency ratio (population over 65 divided by population 15 to 64) increases from an estimated 6.5% in 2005 to 19.4% in 2050.

A quick comparison with the information given above in Chapter 2 will confirm that all these results are consistent with the UN Population Division medium variant and, by extension, in line with the various projections reported. Figures 8.1–8.5 summarize the main assumptions and results.

**Labor market and economy**

Age, sex, and rural/urban labor force participation and unemployment rates were kept constant at their last observed values. Differences between Census data and data from the Planning Commission (see Table 2.6) make for some non-trivial differences between labor force and employment estimates—rural labor force in 2005 is estimated by the Planning Commission to be 303 million, as opposed to 265 million in the model scenario based on the United Nations World Population Prospects Data, 2008 Revision; urban labor force at 116 million, as opposed to 133 million. Differences of similar magnitude apply to employment: 278 million
Figure 8.2  Life expectancy at birth, 2005 and 2050

Figure 8.3  Total population, 2005–2050

Figure 8.4  Old-age dependency ratio, 2005–2050
Potential size of the NPS

in rural areas according to the Planning Commission, as opposed to 248 million according to the model; 107 million in urban areas according to the Planning Commission, as opposed to 124 million according to the model.

The share of the formal sector in total employment was assumed to be 5% and 2%, respectively, for rural males and females, and 25% and 15%, respectively, for urban males and females. These shares are consistent with the combined rural–urban data for 1999/2000 in Table 2.7.

No hard data on wages were discovered, so the estimates used are ad hoc: average 2005 annual earnings in the urban informal sector were estimated to be Rs54,000 for men and Rs36,000 for women; the corresponding numbers in the rural informal sector were assumed to be Rs30,000 and Rs25,000.\(^7\) Nominal GDP growth was assumed to be 10% per year; wage growth in both formal and informal sectors was also assumed to be 10% per year. The nominal rate of return after fees and costs was assumed to be 8% per year, which would correspond to a real rate of return on the order of 2%.

**NPS pension system start-up**

A major publicity and awareness-raising campaign will be needed to effectively market the NPS. Here, it is assumed that membership rises from its current negligible base to 0.5% of the unorganized workforce in 2012 and 1% in 2013, after which it increases by one percentage point per year, reaching 38% by mid-century. This scenario would be consistent with the introduction of promotions, together with introduction of NPS-Lite and government co-contributions. We assume that in 2010, unorganized sector workers aged 18–39 contribute; in 2011, those aged 18–41; in 2012 those aged 18–52; and so on, until workers aged 18–49 are contributing (Figure 8.6).
The average contribution rate is assumed to be 8% of gross income. It is assumed that there are no early withdrawals and that, in the event of death, the assets remain in the system (i.e. are transferred to another member or a new membership is created). On reaching age 60, contributions cease and the accumulation is paid out to the saver, who presumably will use it to purchase an annuity. No effort is made to model the annuity market or, another option, phased withdrawal.

Under these assumptions, total assets under management rise to approximately Rs550 trillion in 2050 (Figure 8.7), amounting to about 186% of gross domestic product (GDP) by the end of the simulation (Figure 8.8). Since we have only covered the unorganized sector, it is possible that the NPS might amount to 20% or more of GDP by mid-century. In the medium term (out to 2020), the estimates presented here are more conservative than the $300 billion cited in Chapter 1. They amount to approximately $50 billion in the early 2020s. There are two reasons for the difference: the later assumed start-up of accumulation and the more conservative assumptions that are mandated by the very slow-startup that has been observed.

Discussion

In this chapter, demographic and labor market trends were reviewed and, based on a model projection, the potential size of the NPS was estimated. A middle-of-the-road demographic scenario was constructed which, not surprisingly, is in line with the work of other experts, e.g. in the United Nations Population Division and the Census of India work described in Chapter 2. Despite ongoing fertility decline, the population of India will continue to grow, albeit at
a progressively slower rate. As extensively analyzed here, it will also age, as the cohorts entering the elderly age groups will be significantly larger than the cohorts entering the labor force.

Likely labor market trends were not analyzed, and the work reported in this chapter simply extrapolates current labor market structures—proportion of the labor force in the formal sector for men and women, urban and rural. One may argue that, with rapid economic growth and structural transformation (including urbanization and the rapid growth of industry and services relative to agriculture),
the share of the unorganized sector should decline, yet the experience of recent decades shows little sign that it will decline. This underpins the importance of providing vehicles to help unorganized sector workers ensure their old-age income security.

Surveys have identified strong demand for a retirement saving vehicle among unorganized sector workers. Intentions reported in surveys can, of course, be biased. As brought out in Appendix 1, experience in developed countries strongly indicates that voluntary retirement saving is driven by tax incentives, and even if the NPS system is adjusted to an “EEE” tax regime (contributions, capital returns, and annuity income all tax-exempt), the tax rules will be irrelevant to a vast majority of the population. The success of the NPS scheme—and the resulting buildup of assets—is not assured, notwithstanding the confidence expressed by many stakeholders interviewed.

However, under reasonable assumptions, NPS will generate a very significant pool of assets. This scenario is, of course, entirely dependent on the assumed growth of membership, the rate of NPS savings out of gross income, the assumed rate of return, and the assumed rate of growth of GDP. Even with limited success though, it appears likely that NPS will become a major player in the Indian economy. This presupposes, however, effective marketing and building of a solid brand by business practice improvements. The heavy weight of NPS assets in Indian capital markets increases the importance of addressing the legal and regulatory issues that have been identified in Part II, particularly those related to asset management.

Summary of findings and recommendations

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<tbody>
<tr>
<td>Assumed fertility and mortality declines will lead to a population of 1.571 billion in 2050, which leads to an increase of the old-age dependency ratio from 6.5% in 2005 to 19.4% in 2050 (for more details on demography see Chapter 2).</td>
<td>The fast-growing population and in particular the old age groups calls for government action to provide pensions to guarantee healthy and adequate life after retirement also for unorganized workers.</td>
</tr>
<tr>
<td>Most research suggests that the urbanization rate, currently about one-third, will rise to one-half.</td>
<td>While current efforts to provide an adequate standard of living are focused on rural poverty, the face of poverty in India and elsewhere will increasingly be an urban one. As NPS strategy is developed, the long-term nature of the scheme demands that adequate attention be paid to labor markets, income, saving, and poverty in the urban setting.</td>
</tr>
</tbody>
</table>

(Continued)
Potential size of the NPS

<table>
<thead>
<tr>
<th>Findings</th>
<th>Recommendations</th>
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<tbody>
<tr>
<td>Under a reasonable scenario, total assets under management will rise to approximately Rs crore 51 million in 2050, amounting to about 16% of GDP. Since this estimate covers only the unorganized sector, the total NSP might amount to 20% or more of GDP. It is likely that NPS will become a major player in the Indian economy.</td>
<td>In Part II, a number of NPS legal and regulatory issues were identified that call for government action. The fact that the NPS will occupy a rising and significant share of the Indian capital market underscores the importance of dealing effectively with these issues.</td>
</tr>
</tbody>
</table>
International experience

International experience, summarized in Appendix 1, suggests that policy makers should be cautious before assuming that voluntary retirement schemes will effectively address the problem of old-age poverty in and of themselves; that they are only an important part of a broader policy package. In order to analyze the situation more closely, a model of the experience of various individuals saving in the NPS needs to be analyzed. That is the purpose of this chapter.

Model overview

From the point of view of input into the policy process, the Macro_NPS model presented in the last chapter should be seen as focusing policy makers’ thoughts on basic demographic, economic, and labor market trends. Since it is based on the average behavior of age cohorts, it is not suitable for estimating the life course for an individual: for example (and of particular importance), the annuity that a single individual would receive. One approach to accomplishing this is to construct actuarial estimates for a single individual with given characteristics. While traditionally, such estimations have been deterministic in nature, stochastic extensions can be done as well. More powerful still though, is tracking the life course of a large set of individuals whose characteristics and behaviors are not only stochastic but also who may interact with each other by marrying, having children, co-residing, and so on.

For that reason, the Micro_NPS model has also been applied. This is a dynamic, continuous time micro-simulation model. It simulates the individual life courses and contribution histories of participants of the NPS plan. Saving behaviors at a given point in time depend on individual characteristics like age, sex, health, employment status, and income. In addition, household characteristics are accounted for, i.e. income of spouses and presence of children in the household.

Micro_NPS allows distributional analysis of expected payouts and annuities by age, year, education, urban–rural residence, education, and income decile at entry into the pension plan. In this way, it can be estimated for whom the NPS is
a sound investment, as well as the extent to which it will need to be complemented by other sources of income to prevent old-age poverty. The size of the simulated population can be set by the user with simulation outputs automatically scaled to a target population size. A simulation of 1 million agents takes about 30 minutes on a standard PC. Micro_NPS is implemented in the Modgen programming language developed and maintained at Statistics Canada, a non-proprietary package for micro-simulation and agent-based modeling.

**Model assumptions and parameters**

This subsection describes the modeling assumptions and parameterizations employed in these simulations.

**NPS membership and contributions**

We assume that all eligible persons join NPS, i.e. we are modeling the experience of members, not comparing their experience with that of persons who are eligible but choose not join. Individuals become eligible for joining the plan when the minimum contribution is below the normal saving rate for the first time, and stay in the plan once enrolled.

Members of the NPS make a monthly contribution according to a saving rate defined as a percentage of labor income. Pension saving is subject to two restrictions. First, no contribution is made if the remaining household income (adjusted for household composition) would be below the “existence minimum” described below. Second, a minimum NPS contribution level is set, as well as a maximum saving rate. All savings are converted to an (individual) annuity at the 60th birthday.

In the case of death before retirement, the surviving partner inherits the NPS pension savings and these are annuitized at 60; if the partner has reached retirement age 60 already, savings are annuitized immediately. When an annuitant dies, the annuity ceases; there is no survivor’s pension.

Assumptions made are as follows:

- Pension saving rate: 10% of labor income
- Maximum pension saving rate: 15% of labor income
- Minimum contribution: Rs500
- Rate of return (real): 4% p.a.
- Probability to join if eligible: 100%
- Annuity factor: the monthly pension is set at \((0.004413 \times \text{total accumulation at retirement})\); the factor is set to pay an annuity which would deplete savings after 25 years at a real interest rate of 2.5% p.a.

In setting the probability of entry at 100%, no attempt is made at this stage to realistically model the development of the NPS system in terms of number of members.
and assets under management. In the simulations below, only the accumulation and annuity experience of persons who do join the system if they qualify are looked at.

**Fees**

Four types of fees are included in the model: an account-opening fee, a monthly maintenance fee, a transaction fee at each contribution, and a funds management fee as a proportion of total savings. Fees can deplete inactive accounts over time; in case total savings fall below zero, the account is closed.

- Opening account fee: Rs90
- Account maintenance: Rs30 per month
- Transaction fee: Rs30 per transaction
- Management fee: \((0.000007 \times \text{total NPS savings})\) per month

The parameterization corresponds to the current NPS regulations for Tier I accounts; it is assumed that all pension savings are made in this account and no withdrawals are made until retirement. Tier II, accounts from which early withdrawals will be possible, are not modeled.

**Labor income and income distribution**

Potential labor income (assuming good health and being employed) is drawn from a log-normal income distribution with a Gini coefficient of 0.36. The mean income in the reference year 2010 can be set by the user. Income mobility is restricted: agents usually remain in the same income decile, but move up or down one decile with a given assumed monthly probability. Each month a new random income is drawn under these restrictions. An agent’s initial decile is determined by a random draw at age 18. It is assumed that partners start in the same income decile; from there on, the random walk income processes of spouses are assumed to be independent of each other.

Median monthly incomes can be parameterized separately by sex, urban–rural residence, and education. No labor income is received during spells of sickness or disability. The lengths of these spells can be assumed to be shorter than the monthly accounting cycle.

Income histories are simulated from age 18 and the year 2010 onward until death; thus, elderly persons are permitted to supplement their annuity income with labor income. An “existence minimum” is set as reference value for distributional output. The existence minimum also enters the calculation of payments to the pension scheme; see below. For the existence minimum, the purchasing power parity of $2 per day, Rs1,825 per month is used.

The income scenarios have been created based on data from the pilot district survey in Mangalore (see Chapter 6).
Parameterization

Initial monthly income is shown in Table 9.1.

Table 9.1 Mangalore scenario of mean and median monthly income (Rs)

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>3,730</td>
<td>3,020</td>
</tr>
<tr>
<td>Female</td>
<td>2,100</td>
<td>1,700</td>
</tr>
</tbody>
</table>

Assumptions are:

- Real income growth: 4% per annum.
- Monthly income mobility between deciles: 0.5% probability of a change.
- Existence minimum: Rs1,825 per month.
- Consumption equivalence scale: 1 for adults, 0.5 for dependent children.

Employment and productivity

Individual income is subject to labor productivity, which can vary over the life cycle in accordance with an age-specific productivity coefficient, typically decreasing at older ages. Mean income relates to a reference productivity level of 1. If labor productivity is parameterized as being 0, employment is lost automatically. Labor force participation is dependent on age, sex, and residence (urban/rural). A parameter of the proportion of the population (of a given age, sex, and rural/urban residence) is set, which changes labor force participation status in each period, subject to the imposed consistency condition that the assumed aggregate rate is unaffected.

Parameterization

- Labor productivity: a flat 100% productivity level for ages 20–54 is assumed, which diminishes stepwise thereafter, until reaching zero at age 90 (Figure 9.1, no sex differential).
- Labor market participation (Figure 9.1): sex- and age-specific rates peak at 95% for men and 50% for women. (Note that disability decreases these rates, which refer to the healthy population).
- The labor force mobility factor is set to 0.01, leading to fast shuffling at high participation rates (men move back into the labor force quickly) and high persistence at lower participation rates (women and the aged remain in the same labor market state for long time intervals).
Sickness and disability

Agents in Micro_NPS are subject, throughout their lives, to risks of sickness and disability. Sickness and recovery are parameterized through hazard rates by age and sex, and no labor income is received during spells of sickness. The possibility of partial income reduction as a result of illness via the duration parameter (illness may last less than 1 month) was taken into account.

Parameterization

- Risk of sickness and recovery from sickness are modeled using piecewise constant hazard rates by age; the current parameterization is ad hoc and does not distinguish by sex. Risks of sickness and sickness duration are assumed to increase with age. Table 9.2 displays the hazard rates (and mean waiting times based on these hazards) of falling sick and recovering from sickness.

Table 9.2 Hazard rates—risk of sickness and recovery

<table>
<thead>
<tr>
<th>Age</th>
<th>Sickness hazard</th>
<th>Mean waiting time (years)</th>
<th>Recovery hazard</th>
<th>Mean duration of sickness (days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–44</td>
<td>0.50</td>
<td>2.00</td>
<td>48.00</td>
<td>7.6</td>
</tr>
<tr>
<td>45–64</td>
<td>1.00</td>
<td>1.00</td>
<td>24.00</td>
<td>15.2</td>
</tr>
<tr>
<td>65–84</td>
<td>1.50</td>
<td>0.67</td>
<td>18.00</td>
<td>20.3</td>
</tr>
<tr>
<td>85+</td>
<td>2.00</td>
<td>0.50</td>
<td>12.00</td>
<td>30.4</td>
</tr>
</tbody>
</table>
NPS and the individual saver

- Risks of disability and recovery from disability are also set by age and are not distinguished by sex. Disability risks increase with age: at age 50, 5% have experienced disability; at age 65, 10% have experienced disability; at age 100, 40% have experienced disability. The recovery rate is set to 0.1 (average time in a state of disability is 10 years) for ages below 50 and 0 for 50+ (Figure 9.2).

Costs are assigned to sickness periods, lowering household budgets in months during which there is a sickness episode in the household. In other words, sickness not only lowers labor income but also it imposes health expenditures and, through this, has an impact on NPS contributions. However, borrowing or divestiture of assets as a means of coping with catastrophic health expenditure are not taken into account.

Parameterization

- Scenario 1: no health expenditures considered.
- Scenario 2: Rs1,000 medical costs are assigned to 50% of sickness episodes. In addition to the sickness hazards for the simulated agents and their spouses, a monthly probability of 10% that a dependent child gets sick is additionally assumed.

Mortality

Age-, sex-, and urban/rural-specific mortality rates were calculated from SRS data (Office of the Registrar General, 1999, based on deaths 1997) and then lowered by 1% p.a. (an ad hoc adjustment) to more closely reflect 2010 rates.

Figure 9.2 Simulated percentage of time spent sick or disabled by age
It is assumed that mortality keeps declining at 1% per year, a rate of decline in line with international experience. Under such a scenario, life expectancy at age 18 increases by 5 years over the next 50 years and the probability at age 18 to survive until age 60 increases from 85% to 89%. Figure 9.3 illustrates simulated life expectancies by sex and place of residence.

Figure 9.3 Life expectancy at age 18 and at age 60 and probability at age 18 to reach age 60
Education

The educational composition of the population can be parameterized by year of birth, sex, and rural/urban setting. The model distinguishes three levels of education. It is assumed, that the level of education can be assigned—thus is known—at age 18. The educational composition is parameterized based on data of the Family and Health Survey 2005/2006. Future scenarios are based on extrapolations of recent trends, as in the case of fertility below. Figure 9.4 depicts the parameterization.

General demography

The parameterized population distribution refers to the population alive in 2010—the starting year of the simulation, and the population entering the simulation at age 18 in each of the following years. With the exceptions of fertility and disability events, lives are tracked in detail from the 18th birthday onwards. Urban/rural characteristics are those at age 18, after which model users can set an age-specific rural–urban migration rate.

Parameterization

- Population: numbers correspond roughly to UN data and projections. One-third of the population, independent of age, is assumed to be urban in the initial year.
- Rural–urban migration: the net urban–rural migration rate is set to 1% per year for ages 18–60. In such a scenario, the urban population share will increase to above 50% around 2050, in line with UN projections.

1. Urban

**EDUCATIONAL COMPOSITION - FEMALE URBAN**

![Graph showing educational composition by birth cohorts for female urban population]

**EDUCATIONAL COMPOSITION - MALE URBAN**

![Graph showing educational composition by birth cohorts for male urban population]

*Figure 9.4* Education composition by birth cohorts
2. Rural

EDUCATIONAL COMPOSITION - FEMALE RURAL

EDUCATIONAL COMPOSITION - MALE RURAL

Figure 9.4 Cont’d
**Family demography**

Micro_NPS uses a “typical family” approach, in which users can parameterize a list of typical family structures. Family types are distinguished by the ages at partnership formation and dissolution (currently only assuming one partnership), the age difference of partners, and the ages at birth of up to eight children. Parameterization is from the female’s point of view.

A second parameter table specifies population composition by family type, by year of birth, education level, and rural–urban residence. Population, in other words, is distributed among family types. In the simulation, each person is matched to a virtual partner according to the given probability distribution of family patterns. Partners are created as attributes of the simulated “dominant” person. Consistency of family types is maintained by using the same family parameter table independent of sex. (Thus, from a male’s perspective, staying single means being linked to a woman who stays single—i.e., to a partner actually never met).

**Parameterization**

The scenarios of parity distributions by birth cohort and rural/urban residence are based on data of the Health and Family Survey 2005/2006 and geometrical extrapolations of trends (assuming half the speed of the previous 3-year average change in proportion). While such an extrapolation can only produce an ad hoc scenario, overall fertility matches data of UN Population Division projections well. For birth cohorts 2021–2025, cohort fertility is assumed to be 2.13 in rural, and 1.6 in urban settings (Figure 9.5).

**Parameterization**

- Family types: 10 basic family types have been defined, one without partnership and children, and the others with partnership and 0 to 8 children; partners are assumed to stay together until death.
- Age at leaving home /economic independence is set to 16.5 years.

**Results**

**Life-course earnings and income**

For Figures 9.6 and 9.7 of life-course income trajectories, the 6th initial earning decile has been chosen, as it closely resembles the average income (which, given the assumption of a log-normal distribution with a Gini coefficient of 0.36, is around 2% above the median).

The discussions starts with the birth cohort 1992, i.e., the cohort currently entering the labor market aged 18 in 2010. For the average male of this earning decile, household income stays above the poverty line over his whole life,
Figure 9.5 Parity distribution and cohort fertility rate (CFR) by birth cohort and education level
Figure 9.5 Cont’d
Parity distribution and CFR: rural, 5–9 years of education

Parity distribution and CFR: urban, 5–9 years of education

Figure 9.5 Cont’d
although the distance is narrow in young and old age. However, the average individual male NPS pension of around Rs3,000 replaces only about 25% of average individual labor income at age 60. Total household NPS pension income (for the average male in the cohort) is close to the poverty line; thus, for more than half of the population, the assumed 10% saving rate, combined with the assumptions detailed above on rate of return and fee structure, is not sufficient to secure a minimum subsistence income in retirement by NPS benefits alone. This suggests that, even for the average member, NPS income is a complement to, not a substitute for, other forms of income in old age.
Note that the poverty line or existence minimum is invariant over time: that is, it reflects absolute, not relative, poverty or, equivalently, a fixed consumption basket. Since the poverty line is fixed while incomes and thus savings grow, there is pronounced increase in the real value of pensions over time. For example, under the same assumptions as above, including real income growth rate of 4%, for the 2002 birth cohort of the 6th entry decile, pensions reach Rs5,000 for men. However, because pensions and incomes have grown pari passu, the replacement rate is still about 25% of labor income at 60.

Figure 9.7 Lifetime income history, 2002 birth cohort, 6th earning decile at age 18
Internal rate of return (IRR) on NPS savings

The IRR is calculated as the rate of return that, when applied to NPS savings up to age 60, would give rise to total savings observed at that point. Due to fees and maintenance costs, not all of the assumed 4% real rate of return is passed on to the saver. As fees are dominated by flat-rate costs, the difference between the IRR and the interest rate depends heavily on the size of contributions. As illustrated in Figure 9.8 for the 1992 birth cohort, in lower entry deciles, up to one-third of savings accounts have a negative rate of return, or savings are consumed by fees altogether. For those receiving a positive rate of return, the IRR ranges from 2.5% to 3.5%.

Figure 9.8 IRRS on NPS savings
Fees, like the minimum subsistence income, are assumed to remain the same over time. Economic growth leads to higher real savings and thus lower fees in relative terms. Negative IRRs virtually disappear from the 2012 birth cohort onwards; for this cohort, the rate of return is above 3.25% in 75% of all cases.

**Pensions by initial earning deciles**

Figure 9.9 displays pensions by year of birth and initial earning deciles. The first part of the figure refers to individual pensions in absolute terms; the second part depicts the percentage of persons attaining a household pension income above the poverty line. On average, individual pensions above the $2 PPP threshold are not reached for those born before 2002 in the case of females and before 1985 in the case of males. From a household perspective, this threshold is met starting from the 2000 female and 1992 male birth cohorts. The implication is that NPS pension saving under the parameters adopted will not provide a minimum income, in and of itself, for many of those now being born into lower-income deciles. This underscores the need to put in place social safety nets to address the challenge of old-age poverty.
Inclusion of health expenditures

Just as it is considering the provision of old-age income insurance, India is considering improving its system of healthcare provision and financing. Experience elsewhere in Asia suggests that episodes of illness, especially those involving catastrophic out-of-pocket health expenditure (sometimes defined as expenditure in excess of 25% of annual income) are a major cause of poverty.

Figure 9.10 illustrates results for a simple scenario that assumes fixed out-of-pocket health expenditures of Rs1,000 arising in 50% of all sickness episodes. In the central deciles, the inclusion of health expenditure in the calculation of NPS pension savings reduces the proportion of the population with a pension above the minimum subsistence line by 5 percentage points (from about 80% to about 75%), with similar impacts for the lower-income deciles. These are significant impacts. They suggest that improved public health and healthcare financing have synergies with the NSP, especially on the old-age poverty front.

![Graph showing Average individual Pensions by Initial Earning Decile and Year of Birth](image-url)

Figure 9.9 Pension income by initial income decile and year of birth
The government’s matching grants

In 2010, the Government of India instituted a “top up” or matching contribution program to encourage NPS saving. This amounts to Rs1,000 per year over 3 years for persons joining NPS in 2010 and 2011. Simulations indicate that that duration of the program is too short to significantly change poverty outcomes. The grants may serve their primary goal of increasing scheme membership, but are unlikely to affect poverty outcomes.

Eliminating or subsidizing fees

By contrast, poverty outcomes are sensitive to the fee structure. As a reference case, a scenario was run in which all fees were eliminated. As shown in Figures 9.11 and 9.12, the proportion of participants receiving an NPS annuity in excess of the minimum subsistence income increases by 5 percentage points. Moreover, the increase is greatest for the lower-income deciles. In the no-fees scenario, 18 year olds entering the system will now receive a pension 10% higher than in the baseline; 18 year olds in the lowest-income decile joining now will receive a pension 25% higher.
Figure 9.10  The impact of health expenditure

Figure 9.11  The impact of eliminating fees
The question arises, “What is the optimal level of subsidy”? This is essentially a question of political economy, not model analysis. As discussed in Appendix 1, the well-to-do, who are able to save, benefit more from the existence of the NPS than the poorest, who cannot afford to save. Heavy subsidies to the NPS are regressive unless they can somehow be targeted to the poor, a difficult goal to achieve. There is also the issue that international experience shows that governments who are subsidizing a pension scheme develop a feeling of entitlement to direct the asset management strategy of that scheme, often with results that are not in the best interest of the beneficiary.

**Discussion**

In this chapter, micro-simulation modeling has been applied to estimate the potential experiences of individual NPS savers, with particular emphasis on income distribution. This has bolstered the evidence from experience elsewhere in Asia that a voluntary saving scheme such as NPS needs to be complemented by social protection schemes that directly attack old-age poverty. On a brighter note, these simulations confirm that, over time, economic growth will significantly improve the ability of NPS to deliver a poverty-level income to the elderly. If the debate is couched in terms of increasing the replacement ratio, or maintaining the ratio of the average income of the elderly to the average income of the working population, economic growth will, of course, have much less impact on performance of the scheme because wages will rise as well as pensions.
Summary of findings and recommendations

<table>
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<tr>
<th>Findings</th>
<th>Recommendations</th>
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<tr>
<td>Model simulations suggest that, for over half of the male population born into the middle-income cohort in 1992 and joining the NPS when eligible, total household NPS pensions received on retirement will not exceed the minimum subsistence income adjusted for household structure. These results confirm the note of caution regarding the role of voluntary retirement saving schemes in Asia.</td>
<td>The Government of India should continue to explore alternative options for addressing old-age poverty, even while developing the NPS, and even for persons in the middle range of the income distribution. In developing the NPS, the Government of India should also give attention to existing and potential basic social protection floors related to old-age income security.</td>
</tr>
<tr>
<td>A significant reason for failure to deliver a minimum income to the poor is the heavy toll that large fixed fees place on low-income savers. Although the situation will improve over time as incomes grow (and assuming the fees remain fixed), a significant proportion of lower-income persons now joining the NPS will experience a negative rate of return on their savings. Reducing or subsidizing fees can significantly improve the NPS’s impact on poverty: so, too, can policies to reduce out of pocket health spending.</td>
<td>The fee structure of NPS should be carefully reviewed to increase the effectiveness of the scheme and improve outcomes. Targeted fee reductions are an attractive option if reliable, cost-effective targeting is possible. However, poorly targeted subsidies will be regressive, since NPS savers will not come from the poorest levels of society, subsidy schemes may be regressive. Another, indirect approach to alleviating old-age poverty is improved healthcare finance. Potential links between NPS and health insurance should be explored.</td>
</tr>
<tr>
<td>Introduction of Tier II accounts will make the NPS scheme more attractive to middle-income savers; it will have no impact on NPS’s poverty performance because the poorest will not be able to afford to save in Tier II accounts. Model simulation results indicate that government co-contributions now in place are not of sufficiently long duration to substantially affect ultimate accumulations, although they may boost participation. International experience suggests that tax incentives are an important inducement to save, yet these will not be of much impact on the poor, who fall outside the tax system.</td>
<td>Policy makers should keep in mind that measures to promote membership in the NS do not necessarily affect the scheme’s ability to address the issue of old-age poverty. A broader spectrum of policies is required for this. On a brighter note, strong economic growth will substantially improve the NPS’ ability to reduce old-age poverty.</td>
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Part V

Occupational pension schemes
10 Compulsory occupational schemes

Important as is the NPS reform, reform of existing occupational schemes that cover the organized sector is also needed in India today, even though today’s organized sector represents only a small part of the Indian workforce. If the size of the organized sector grows, occupational pension schemes will play an increasingly important part of India’s social protection framework and could be used as a tool by which to support financial inclusion goals. In the following chapters, we present an overview of both compulsory occupational pension schemes in which employers and employees are required to participate and voluntary occupational pension schemes that employers may establish. We identify shortcomings in their design, regulation, and supervision, and make recommendations for reform.

India’s compulsory pension program has its roots in the establishment of the Employees’ Provident Fund (EPF) in the 1950s. It currently includes three schemes in which most employers with 20 or more employees are required to participate. These schemes are:

- The Employees’ Provident Fund Scheme (EPF), which is a defined contribution scheme with an administered rate of return.
- The Employees’ Pension Scheme (EPS), which is a defined benefit scheme.
- The Employees’ Deposit Linked Insurance Scheme (EDLI Scheme), which provides a life insurance benefit to survivors of EPF members.

These schemes are managed, regulated, and supervised by the Employees’ Provident Fund Organization (EPFO). They are each established under the same enabling legislation, the Employees’ Provident Funds and Miscellaneous Provisions Act, 1952 (“the EPF Act”). Covered employees are required to contribute 12% of their wages (currently up to a maximum wage base of Rs6,500) to fund these schemes. Employers contribute an identical amount. According to EPFO data, there are over 573,000 employers and more than 42.6 million employees covered by the EPF Act.

Employers may apply for an exemption from participation in any of these three schemes under Section 17 of the EPF Act and, in lieu of their participation, operate their own schemes under rules promulgated by the EPFO. These “exempt” schemes are usually established by large employers and, almost universally, are “Exempt Provident Funds” operated in lieu of participation in the EPF.
In addition to these EPFO-managed schemes, employers have two additional compulsory benefit obligations established by legislation:

- The Payment of Gratuity Act, 1972 ("the PGA Act") requires employers to pay a gratuity, which is a lump sum severance payment, to qualifying employees when they sever employment.
- Employers are generally required to pay the lump sum value of accrued leave encashment entitlements to employees who leave their employ.

The discussion of compulsory schemes below is limited to the EPF, EPS, and employer obligations under the PGA Act. A brief description of the EDLI Scheme is provided in the accompanying footnote. Three summary comparative charts of key legal and scheme provisions, which include EPF, EPS, Exempt Provident Funds, and gratuity obligations, are included at the end of this chapter. In Chapters 11 and 12, we identify a number of design, operational, and policy issues relating to the compulsory schemes and make recommendations for reform.

In addition to these compulsory obligations, employers may establish additional retirement schemes on a voluntary basis. These include the following:

- defined contribution pension schemes,
- defined benefit pension schemes,
- superannuation funds, and
- “excluded” provident funds.

These schemes are described and analyzed in Chapter 12. To date, there has been little attention paid to their regulation and supervision and, in fact, with little exception, these voluntary schemes are weakly regulated and are not actively supervised or monitored.

**Structure and scope of the EPF Act**

The EPF Act and the three schemes promulgated under it generally cover all employers in India that have 20 or more employees. In the case of each scheme—the EPF, EPS and EDLI Scheme—the EPF Act provides that the central government “frame” the scheme within the boundaries, and in satisfaction of, the requirements set forth in the Act. This structure permits the modification of each scheme’s rules upon notification in the Official Gazette without the need to amend the underlying legislation. The EPF Act, however, also specifies the matters for which provision may be made in each scheme in schedules to the Act.

**Employers and employees covered**

The EPF Act applies to those “factories” and “establishments” which employ 20 or more persons if the factory or establishment is engaged in an industry specified in a schedule ("Schedule I") to the Act, which the government may amend.
In 1952, the Act applied to six industries, and it now applies to 186 industries. The central government also has authority to extend the Act’s application to establishments employing less than 20 persons, in addition to expanding covered industries. The reach of the EPF Act seems clear enough, but, in fact, its scope has been subject to litigation. For example, employers have challenged whether they are within the definition of a particular Schedule I industry, are an “establishment” under the Act, and whether a particular unit is a branch or department of their firm and is part of an “establishment” or is by itself a separate and distinct “establishment.” These challenges are significant, because they demonstrate the inclination of employers to evade the application of the EPF Act. For example, some employers have tried to restructure their businesses into separate, smaller entities, each with less than 20 employees. On the other hand, employers who are not compelled to participate in the EPF schemes may elect to do so on a voluntarily basis, and, according to EPFO data, over 4% of the covered establishments are in this category.

The EPF Act applies to employees working at covered factories and establishments whose salaries do not exceed the maximum wage base for coverage (Rs6,500). Furthermore, once an employee qualifies for the scheme as an “employee” earning below Rs6,500, he remains covered even if his wages later exceed the maximum wage base, and he remains covered until either his death or his withdrawal of his EPF account accumulations. In 1988, the definition of “employee” was amended to extend coverage to workers employed through contractors.

Exclusions and exemptions

Certain employers (“establishments”) are excluded from the reach of the EPF Act. These include certain cooperatives and governmental establishments that already had other schemes in place. Provident funds maintained by employers under this exclusion are commonly referred to as “excluded provident funds,” which we discuss in greater detail later in this chapter.

In addition to these exclusions, an employer employing 100 or more employees may apply for an exemption from participation in the EPF scheme, in which case, it is required to maintain its own provident fund scheme, an “Exempt Provident Fund.” Similarly, although employers rarely elect to do so, they may seek the permission of the EPFO to opt out of the EPS and EDLI Scheme and manage their own similar schemes. “Exempt Provident Funds” are discussed in more detail later in this chapter. As of 31 March 2009, there were 2,755 Exempt Provident Funds and 3 Exempt Pension Funds, covering an estimated 4.4 million employees—approximately 10.7% of covered employees.

EPFO Governance and organization

The EPF Act provides for the establishment of a Central Board, the members of which are appointed by the central government, which acts as a board of trustees
for the EPFO and its programs. A Central Provident Fund Commissioner (CPFC), also appointed by the central government, serves as the Chief Executive of the Central Board. The Central Board is audited annually by the Comptroller and Auditor General of India, and its audit report accompanies an Annual Report the Central Board prepared for the review of the central government. In 1997, the central government was provided the authority to establish Appellate Tribunal(s). Aggrieved individuals may appeal notifications and orders of the central government to the tribunal within 60 days.

In addition to this central organization, the EPF Act empowers the Central Board to appoint Regional Provident Fund Commissioners (RPFCs). The RPFCs have an important role in the administration and enforcement of the EPF Act, including collection of contributions, making an initial review of exemption applications, facilitating transfers of members employed in one region to another, and recovering damages from employers. This organizational structure has led to some inefficiencies in operation.

The EPF scheme

The EPF Scheme is a provident fund financed by compulsory contributions of employers and employees remitted to the EPFO, which are accumulated in individual accounts for each employee. The accounts are maintained by the EPFO, although employers retain certain record-keeping obligations. The EPFO invests the assets. Accounts are credited annually with an administered rate of return announced by the EPFO, which may or may not match the actual investment return on the assets. Benefits are paid out as a lump sum payment either at pensionable age or prior to pensionable age in a number of different circumstances described below.

Contribution requirements

Each employer is required to contribute a total of 12% of each employee’s basic wages to the EPFO. The maximum wage base for the calculation is Rs6,500 per month. Over two-thirds of this 12% contribution, 8.33 percentage points of the 12%, is diverted to fund the Employees’ Pension Scheme (EPS). The government has increased the maximum monthly wage base upon which the contribution is calculated by notification several times.

Each employee also pays a contribution equal to 12% of his basic wages, up to the maximum monthly wage base of Rs6,500. All of the employees’ contributions remain in the EPF.10

Scheme administration, record keeping, and enforcement

The EPFO is responsible for scheme administration and recordkeeping. Although it has had a poor reputation for timely processing and record maintenance, in recent years, it has undertaken to overhaul its information systems and digitize records.
Recent press reports indicate that EPFO has almost completed the digitalization of all subscriber records. Employers also have monthly information reporting requirements and record maintenance responsibilities assigned under the scheme, and they are subject to inspection. The employer is responsible for remitting both its contribution and its employees’ contributions, which are withheld from each employee’s pay, and the accompanying documentation.

There is a penalty payment for employer contributions in arrears that ranges from a rate of 17% to 37% of the arrears per annum. The rate assessed on employers depends on the duration of the default. Various acts in contravention of contribution, reporting or other obligations, or prohibitions of the scheme are punishable with imprisonment of up to one year, or a fine of Rs4,000, or both.

**Asset custody and investment management**

The following three accounts are established under the EPF scheme rules:

- a Central Administration Account, which reflects all administrative expenses of the Fund,
- the Provident Fund Account, which contains all aggregated employer and employee contributions; and
- the Interest Suspension Account, which holds all interest, rent, and other income, net profits and losses from sale or investments and from which earnings are credited to member accounts.

Under the EPF Act, all monies belonging to the Provident Fund Account may be deposited with either the Reserve Bank of India, State Bank of India or any scheduled bank approved by the central government. The accounts of the fund are audited in accordance with instructions issued by the central government in consultation with the Comptroller and Auditor-General of India.

The Provident Fund Account assets are invested, subject to the direction of the central government, in securities identified as permissible investments under Sections 20(a)-(d) of the Indian Trusts Act, 1882. In 2008–2009, the EPFO engaged four private sector asset managers to manage the investment of scheme assets under mandates it established. In conjunction with the outsourcing of the investment management function, the EPFO set up a new “Investment Monitoring Cell” to oversee the accounting and monitoring processes and took steps to build in-house capacity.

In recent years, the Ministry of Finance has liberalized the Investment Pattern, which it develops for nongovernment provident funds, superannuation funds, and gratuity funds, and it has encouraged both the EPFO and private sector provident and pension funds to increase their investment exposure to private securities, including equities. Effective 1 April 2009, funds operating under the 2008 Investment Pattern announced by the Ministry may invest up to 15% of contributions in the stock markets. The EPFO has followed the more constrained approach of the 2003 Investment Pattern, which does not permit the investment of assets in
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the stock markets.\textsuperscript{16} Most recently, the EPFO relaxed their investment allocation constraints to permit the investment of larger amounts of the bonds of state-owned companies and banks.\textsuperscript{17}

\textbf{Member accounts and earnings on account balances}

Member account balances are credited with their own contributions, those of their employers, and interest paid on the account. The interest is credited on a monthly basis on the amount in each member’s account. The central government, in consultation with the EPFO’s Central Board of Trustees, determines the interest rate credited. This administered rate is announced prior to the year in which the interest is credited. The rate is constrained by the limitation that the amount of interest credited may not exceed amounts in the scheme’s Interest Suspense Account.\textsuperscript{18} The account, in essence, acts as a buffer between the account balances of individual accounts and the net value of the underlying assets, thus enabling the EPFO to smooth the rate of return, reduce its volatility, and reduce the exposure of scheme members to market risk. EPFO representatives have indicated that limiting volatility is particularly important for scheme members approaching retirement. These members are especially vulnerable to a sudden drop in their account value, from which their balances would not have time to recover, prior to withdrawal.

The current rate of return on EPF account balances is 9.5\%, which was announced in September 2010. The rate over the previous 5 years had been 8.5\%. The decision to raise the rate is anticipated to result in a deficit of about Rs16 billion, which will be paid from the scheme’s Interest Suspense Account.

Under the EPF Scheme provisions, members’ account balances are protected from assignment to, or attachment by, their creditors or receivers in the event the employee is in insolvency proceedings. Nor are account balances liable to attachment by order of any court for any reason.\textsuperscript{19}

Notwithstanding these protections, the account balances of EPF members, if dormant, may be subject to future action by the EPFO. Specifically, the EPFO is currently considering whether to stop crediting interest to inactive accounts, such as those accounts which have not received contributions for 36 consecutive months.\textsuperscript{20} Thus, an EPF member who has moved from employment covered by the EPF Act, to employment with a smaller employer or an unorganized sector work environment, may be subject to a loss of income—or delayed application of interest owed. The EPFO has been plagued with administrative and record-keeping problems, one result of which is numerous dormant accounts, which continue to be credited with interest—and which may never be claimed.

\textbf{Benefits paid}

An EPF member may receive a lump sum pension payment of his account balance upon retirement at age 55, or take the lump sum before age 55 in a number of other circumstances described in the scheme rules. Specifically, Section 69 of
the scheme rules permits a member to withdraw the full amount standing to his credit in the fund in the event of:

- retirement after attaining the age of 55 years;
- retirement on account of permanent and total incapacity;
- migration from India for permanent settlement abroad;
- termination of service in the case of retrenchment; or
- termination of service under a voluntary scheme of retirement under mutual agreement by the employer and employee.21

Additionally, a scheme member also may withdraw up to 90% of the account balance any time after attaining age 54 or within 1 year before his actual retirement or superannuation.22 Account balances withdrawn at retirement or resignation are tax free, irrespective of the number of years of membership in EPFO.

**Permitted pre-retirement withdrawals and advances**

Any EPF member is permitted to withdraw assets or take an advance from his account prior to retirement or the events described in Section 69 of the scheme rules for a number of reasons specified in the scheme rules. Usually, the rules require the employee to have been a scheme member for 5 (and in some cases 10) years, and there are explicit limits on the amounts permitted to be withdrawn or advanced. These limitations vary with the purpose of the withdrawal or advance and may be expressed in relationship to the member’s years of service, as a percentage of his EPF account balance, or in relation to annual basic wages. For example, an EPF member who has completed 5 years’ membership in the EPF and whose own contribution is more than Rs1,000 (including earned interest) may take a withdrawal of his account balance for purchase or construction of a home or flat, including land acquisition, or for improvements to the home.23 Similarly, advances are permitted in “special cases,” such as the shutdown of a factory or other establishment resulting in unemployment, illness, marriage, force majeure conditions or events, electricity cuts, and where a member becomes physically handicapped.24

**Treatment of survivors of employees**

A deceased EPF member’s account balance is payable to nominee(s) selected by the member. If the member has not named a nominee, the account balance is payable to the member’s family members in equal shares.25

**Tax treatment of contributions, withdrawals, and payments from EPF**

The relevant tax rules26 provide the following:

- Employer contributions to the EPF are eligible for a rebate.
- Employee contributions to the EPF are excluded from income.
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- Receipt of payment of pension from the EPF is excluded from income.
- Withdrawals from the EPF prior to retirement for permissible purposes are permitted, although certain types of withdrawals are required to be repaid in accordance with the schedule set forth in the tax provisions.
- Failures to repay certain withdrawals are subject to income taxation.

Employees’ Pension Scheme (EPS)

The EPS is a defined benefit pension scheme that pays a member’s pension to a member upon his superannuation or retirement, or disability, and in the event of his death, to the surviving spouse and children. More specifically, the EPF Act requires the scheme to provide for “superannuation pension, retiring pension or permanent disablement pension” and pensions for an employee’s beneficiaries, including the surviving spouse, children, and orphans. Participation in the EPS is compulsory for the same employers and employees that are required to participate in the EPF scheme.

Contribution requirements

The EPS is financed by the employers’ contributions, assets of the former Employees’ Family Pension Scheme, which the EPS replaced, and “such sums as the Central Government may . . . specify.”27 There are no employee contributions required. The employers’ contribution obligation is included in the 12% contribution discussed above. Specifically, of the 12% of each employee’s wages (up to the maximum wage base of Rs6,500) payable by each employer under the EPF Scheme, 8.33 percentage points of the 12% is diverted to support the EPS. The central government contributes an additional 1.16% of the employee’s pay (also up to the maximum wage base of Rs6,500).

Scheme administration, record keeping, and enforcement

EPS, like the EPF, is administered by the EPFO, which may issue rules pertaining to the scheme. Sections 18 to 24 of the EPS scheme rules impose various recordkeeping and information reporting obligations on employers. An employer that defaults on its contribution obligations may be assessed a penalty ranging from 17% to 37% of arrears per annum, set in accordance to the length of time in arrears.28

Asset custody and investment management

The EPS establishes an “Employees’ Pension Fund Account” opened by the Commissioner as instructed by the Central Board. All assets in the account, except contributions of the central government, are held in custody and invested in
the same manner and, within the same limitations, as the assets of the EPF Scheme.  

**Annual reports, audit, and actuarial valuation**

The Central Board is responsible for preparing an annual report on the EPS under the same provisions applicable to its reporting obligation for the EPF. Annual valuations are conducted by a “valuer”—a term that is not defined in the Act—who is appointed by the central government. The provision requiring the annual valuations also permits the central government to alter the required contribution rate, levels of benefits paid, or the period for which benefits are given. Such changes to the scheme design, however, may be made only “when the Employees’ Pension Fund so permits.” The link to the EPF is necessitated by the fact that the contributions paid to the EPS are being diverted from the employers’ EPF contributions.

**Benefits paid**

The EPS provides the following benefits:

- pension payment for life at retirement/superannuation paid monthly;
- pension payment for life if the individual is disabled during employment;
- optional lump sum payment to the member by commutation of the benefit for up to one-third of the pension amount; and
- option for early exit and return of capital at severance of employment prior to age 58.

The basic rules for calculating an EPS pension are presented in Box 10.1. An individual is entitled to a full pension benefit from EPS only upon completing 10 years of pensionable service and reaching age 58. Benefits are based on the employee’s average salary during the final year of employment and the total years of employment. The formula used to calculate the benefit is “pensionable salary” multiplied by “pensionable service” divided by 70.

A reduced early retirement benefit is available for individuals who have completed 10 or more years of service and retire, or cease to be in employment, before reaching age 58. The pension benefit of individuals who qualify for early retirement is reduced by 4% per year for each year below age 58, but not earlier than age 50. Different calculations account for individuals who were existing members in the prior scheme.

The member may elect alternative forms of pension that provide either a return of capital to a nominee or widow and a survivor’s pension to the widow, or a guaranteed payment over 20 years (payment over a certain period to widow or nominee if the member dies prior to 20 years in pay status). If the member elects one of these options, the pension calculation described above is reduced to 90% or 87.5% of the pension payable, depending on which option is elected.
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**Box 10.1** Formula for calculations of a member’s superannuation pension under the EPS, 1995

Monthly Pension = \[ \frac{(\text{Pensionable Salary} \times \text{Pensionable Service})}{70} \]

where:

\textit{Pensionable Salary} = \text{the average monthly pay during the contributory period of service in the 12 months preceding the date of exit, but no more than Rs6,500, unless the employer has remitted contributions for the higher salary amount.}

\textit{Pensionable Service} = \text{the years of service for which contributions have been received or are receivable.}

- If Pensionable Service < 10 years, no pension is paid.
- For members age 58 or more who have rendered 20 years of Pensionable Service, 2 additional years are added.
- For members age 50–57, the Monthly Pension is reduced by 4% for each year less than age 58.

\*Special rules apply for pre-1995 accruals under the preceding scheme

*Treatment of survivors of employees*

The EPS pays survivor benefits in addition to those described in the preceding paragraph. There are a number of rules regarding survivor benefits, accounting for a variety of different circumstances. Under the most typical circumstances, a survivor’s pension is paid to the widow upon death of the member until death or remarriage, and an additional pension may be paid to children up to age 25. The amount paid to the widow depends on when the member dies and the salary earned prior to death. If the member dies (i) while still working (“in service”) or (ii) after the date of exit from service, but before attaining age 58 and prior to commencing pension payment, then the widow is paid the greater of:

- the amount the member would have received if he had retired on the date of death,
- Rs450 per month, or
- a scheduled amount linked to the member’s salary at the date of death (ranging from Rs300 to Rs2,051).
If the member dies after commencement of payment of the monthly pension, then the widow receives a monthly pension equal to the greater of 50% of the member’s pension or Rs450. The children’s pension is based on the amount of pension the widow receives (or would have received, if she has already died). Specifically, surviving children (for up to two children) are each paid the greater of Rs150 or 25% of the value of the widow’s pension up to the age of 25. If there is no widow, the children receive 75% of what the widow would have received. Finally, in the event the scheme member is unmarried or has no eligible family member, then the pension is paid to a nominee or dependant parents for life.\(^{34}\)

**Tax treatment of EPS contributions and payments**

The pension paid under the EPS is tax exempt. However, EPS members receiving a commuted pension are entitled to a tax exemption for only one-half the commuted value. If the individual receiving the commuted pension also received a gratuity, then the tax exemption is reduced further, and he is entitled to a tax exemption for only one-third of the commuted value.

**Exempt provident funds**

The EPFO may exempt an employer from any of the three schemes promulgated under the EPF Act, or from any of the provisions of one of the schemes. The vast majority of the exemptions issued are exemptions from the EPF (provident fund). In all three cases, the employer must provide benefits equal to or better than those provided under the particular EPFO Scheme.

Exemptions are conditionally granted on the basis that the conditions and standards of operation that served as the basis for the exemption continue to be maintained by the employer. For example, there are 31 separate conditions imposed on employers maintaining Exempt Provident Funds, many of which relate to the governance of the scheme, including trust, custody, and disclosure requirements. Employers and employees are required to make contributions to the Exempt Provident Fund at rates no less favorable than those they would have made to the EPF.\(^{35}\) Some of the key conditions are identified in Box 10.2. Employers granted an exemption from the EPF Scheme remain subject to the Act itself.

Employers seeking an exemption make application through the proper regional office of the EPFO. In recent years, the EPFO has tried to simplify this process, by reducing required documentation, prioritizing a fund’s satisfaction of essential conditions in its review of applications, and placing an emphasis on expeditious processing.\(^{36}\)

**Administration, custody, and investment of trust assets**

Four requirements limit the manner in which the assets of an Exempt Provident Fund trust may be invested. First, the assets must be invested in accordance with
the same investment pattern prescribed by the EPFO for the EPF. The EPFO follows the conservative Investment Pattern issued by the Ministry of Finance in 2003.\textsuperscript{37} Second, because all Exempt Provident Funds are required to be tax qualified, the limitations in the tax law and rules apply. As a result, the investment pattern at Rule 67 of the Tax Rules is also applicable, although this appears generally to follow the Ministry of Finance’s declared investment pattern.\textsuperscript{38} Third, each employer sponsoring an Exempt Provident Fund is liable to make up the difference between the annual, declared rate of return of EPFO for the EPF and its actual return, if less. As a result of this “guaranty”, which employers are required to extend to their employees, Exempt Provident Fund trustees have almost uniformly sought to match the composition of the EPF portfolio. Finally, trustees are required, as one of the conditions of the grant of an exemption, to obtain the EPFO’s approval prior to restructuring an Exempt Provident Fund’s portfolio or selling portfolio securities—even if the transactions would not violate the EPFO’s mandated investment pattern.

\begin{boxed_text}
Box 10.2 Key conditions for operating an Exempt Provident Fund

The employer must:

- establish a Board of Trustees, to meet no less than quarterly, under his Chairmanship to manage its Provident Fund, which is accountable to the EPFO for the proper accounting of the assets in its custody, contributions and benefit payments and full compliance with conditions set forth;
- maintain detailed accounts of transactions within each employee’s account;
- ensure all employees who would be eligible for the EPF are members;
- make contributions at a rate at least as favourable as that which would have been made to the EPF;
- credit interest to the monthly balance of each member that is no lower than the rate declared by the central government for the EPF;
- provide benefits that are “on the whole not less favorable to the employees than those provided under the Act, or those provided by any other employer (establishment) of a similar character”;
- invest the PF’s assets in accordance with EPFO investment guidelines;
- bear the expenses of administration;
- hold the liability for any loss to the fund due to theft, burglary, defalcation, misappropriation.
\end{boxed_text}
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**Form of benefit**

Under section 17 of the EPF Act, benefits provided under the rules of the Exempt Provident Fund “on the whole” may not be less favorable to employees than those they would receive from the EPF. To date, the EPFO has interpreted the “on the whole” standard quite narrowly, and it has restricted the benefits provided by Exempt Provident Funds to only those that precisely match those provided by the EPF. The language in the Act arguably could allow for some flexibility in the design of, and forms of benefit provided by, the Exempt Provident Funds.

**Exemptions from the EPS and EDLI scheme**

An employer may request the EPFO to issue it a similar exemption from the EPS or EDLI Scheme. Exemptions from the EPS are rare, and employers do not readily seek them. The lack of employer interest is a reflection of the nature of the obligation they would be required to assume. Employers contributing to Exempt Provident Funds are liable on an annual basis for contributions based on salary, any difference between the administered rate of return on the EPF Scheme’s assets and the return the employer has earned for its Provident Fund, and the costs of administration. In the case of the EPS, the employer is similarly liable for an annual contribution and the cost of operating its scheme. However, it is also liable for the outstanding defined benefit obligation over the long term and, thus, would be at substantial financial and actuarial risk.

**Gratuity funds**

Under The Payment of Gratuity Act, 1972, employers with 10 or more employees are required to pay a gratuity to eligible employees at termination of employment. Although employers need not make provisions for the pre-funding of this obligation, some employers do so. The PGA applies nationally in all states. It is enforced by both the central and state governments, the jurisdictions of which are defined in the Act.

**Employers and employees covered by the PGA**

The PGA covers employers of every “shop or establishment” in which 10 or more persons are employed, or were employed, on any day in the preceding 12 months, as well as every factory, mine, oilfield, plantation, port, and railway company. Once the Act has become applicable to a shop or establishment, it remains applicable regardless of whether the number of persons employed falls below 10. Employers must cover all “employees,” a term which is defined broadly in the act. 39 The government may exempt an employer from the application of the PGA if the employer provides employees “gratuity or pensionary benefit not less favorable than the benefits conferred under this Act.” 40
Contribution requirements: the employers’ funding obligations

An employer’s only obligation under the PGA is to pay gratuities when due. The employer has no obligation to fund (or pre-fund) its accruing gratuity liabilities. However, tax rules, which are described below, provide employers with some incentive to do so. The current accounting standards (AS-15), which require employers to recognize their gratuity payment obligations as accrued liabilities on the company’s balance sheet also provide an incentive to pre-fund. Although there are no comprehensive data available, anecdotal evidence suggests that these incentives have not resulted in the adequate funding of these outstanding liabilities. Moreover, because the cap on gratuity payments was recently raised from Rs350,000 to Rs1 million, the liabilities that employers must recognize under AS-15 have increased. In the absence of a legal requirement to pre-fund gratuity obligations, there is a real risk that employers under financial strain will not be able to pay gratuities at precisely the time when they may be likely to reduce their workforces. It is especially unlikely that employees would receive their gratuity payments from an employer in bankruptcy. Employers who do pre-fund these liabilities may do so in several different ways, which are discussed below in the section on custody and investment.

Employee eligibility for gratuity benefit and amount paid

Every employee is entitled to a gratuity payment from his employer at termination of employment if he has “rendered continuous service for not less than five years” on his superannuation, or retirement or resignation, or on his death or disablement due to accident or disease. The 5-year requirement is waived for cases of death and disability. Employees who have been terminated for causing damage or loss to the employer as a result of a willful or negligent action forfeit the gratuity to the extent of the damage or loss, and those terminated for disorderly or violent conduct or offences of moral turpitude committed during the course of employment may forfeit the gratuity in whole or part.

An employer must pay each eligible employee 15 days’ wages for every completed year of service (or part thereof in excess of 6 months), based on the rate of wages last drawn at termination up to a maximum gratuity of Rs1 million (Box 10.3). An employer and employee may enter into a contract that would pay more than this amount, but they are prohibited from entering into a contract to reduce it.

Benefit payments on death of employee

In cases of death, the gratuity is payable to the employee’s nominee, or if he does not have a nominee, to his heirs, with special provisions for minor heirs. The nominee is required to be a family member if the employee has a family at the time of nomination.
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Tax treatment of contributions to pay and payments of gratuity

The relevant tax rules provide the following:

- Employer payments to satisfy gratuity obligations are deductible as a business expense.
- Employer contributions to an “approved” Gratuity Fund are tax deductible.
- The income received by a Gratuity Fund trust of an approved Gratuity Fund properly registered and maintained in accordance with tax requirements is exempt from taxation.
- Receipt of gratuity payment is excluded from an individual’s income up to limits described in the PGA.
- Receipt of gratuity payment other than a gratuity paid under the PGA is excluded from income up to limits described in the tax provisions.

An employer makes application to obtain tax authority approval of its Gratuity Fund under Tax Rules no. 98–111 and Part C of the Fourth Schedule of the tax code. These rules are similar to those applicable to approved Superannuation Funds, which are discussed in Chapter 12. The rules include a trust requirement, investment limitations, and alternatively, permit the employer to establish a “group gratuity scheme” with the LIC or another insurer.

Custody and investment of assets

Employers who elect pre-fund gratuity obligations may do so by establishing a trust or by making contributions to group gratuity scheme managed by a

Box 10.3 Formula for calculations of an employer’s gratuity obligations for an employee being paid on a monthly basis under the payment of gratuity act, 1972

\[
Gratuity = \left( \frac{Wage}{26} \right) \times 15 \times Years
\]

where:
\( Wage \) = the monthly wage paid at termination (Basic Wage and Daily Allowance)

\( Years \) = the number of years of continuous service at termination, (except if years of continuous service is less than 5 years, then \( Years \) equals zero).

\( Gratuity \leq Rs1 \ million \)
life insurer. The investment of gratuity fund assets is subject to limitations: The trustees may deposit the gratuity fund monies in a Post Office Savings Account, a current account, or a savings account at scheduled bank, or invest the assets within the investment pattern specified in the Tax Rules. Assets in a Gratuity Fund established under the Tax Rules are protected from employer access and access of creditors or attachment.

An employer may fund its gratuity obligations by establishing a group gratuity scheme with an insurer. Group gratuity scheme products are typically unit-linked investment vehicles, regulated by the Insurance Regulatory and Development Authority (IRDA), in which employers can invest from among a list of unitized, pooled investments. The employer, not the insurance company, continues to bear investment risk. These products may also provide insurance in the form of a small death benefit for an employee, which is priced separately and for which a separate premium is charged. These products are designed to satisfy the tax rules and enable an employer to take his section 36(1)(v) deduction annually for contributions to the scheme. As part of the services it provides to employers establishing group gratuity schemes, insurers, such as LIC, may also offer assistance to them in managing the impact of gratuity scheme obligations on their balance sheets under AS-15.

**Enforcement**

Enforcement of the PGA is a shared responsibility among the central and state governments. The PGA provides that the “appropriate Government” is responsible and has authority to enforce the Act. The central government enforces the Act in the case of “establishments” (i) belonging to or under its control, (ii) having branches in more than one state, and (iii) major ports, mines, oilfields or railway companies. In all other cases, the state governments enforce the PGA as applied to the shops and establishments within its state. In effect, excepting larger employers with businesses in more than one state, the state governments have the lion’s share of the burden in enforcing the Act. The effect of this is uneven enforcement and some divergence in standards. The fact that establishments in one state may have the Act applied and enforced in a different manner than those in another state appears to have been an acknowledged and accepted result of the way the act was intended to be enforced.

Disputes about amounts of gratuity payable are addressed to the “controlling authority”, which is any officer the appropriate government appointed to be responsible for the administration of the Act, and may be appealed. For non-payment of gratuity, an employer may face imprisonment for no less than 3 months to 1 year, or pay a penalty of no less than Rs10,000 and up to Rs20,000, or both.

**Summary comparative tables**

See Tables 10.1–10.3
Table 10.1 Compulsory schemes—legal basis, governance and asset management

<table>
<thead>
<tr>
<th>Legislative basis</th>
<th>Employees’ provident fund</th>
<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
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<tr>
<td>Employees’ Provident Funds and Miscellaneous Provisions Act, 1952 (as amended) (“the EPF Act”) and scheme rules promulgated thereunder</td>
<td>Employees’ Provident Fund Organization (EPFO)</td>
<td>1995 amendment to the EPF Act and scheme rules promulgated thereunder</td>
<td>Section 17 of the EPF Act</td>
<td>The Payment of Gratuity Act, 1972, (“PGA”)</td>
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<td>Indian Trusts Act, 1882</td>
<td>Indian Trusts Act, 1882</td>
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<td>Employers participating</td>
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<td>Same as EPF</td>
<td>Employers with 10 or more employees</td>
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<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
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<td>Employer and employee contributions</td>
<td>Employer and government contributions(^{51})</td>
<td>Employer and employee contributions; additional employer liability where investment of assets fails to match administered rate of return</td>
<td>No funding requirement; employer may establish a trust and invest assets or purchase an insurance product</td>
<td></td>
</tr>
</tbody>
</table>

**Investment manager**

<table>
<thead>
<tr>
<th>Employees’ provident fund</th>
<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPFO both manages assets itself and retains and monitors private sector asset managers</td>
<td>EPFO both manages assets itself and retains and monitors private sector asset managers</td>
<td>Employer (trustee) or asset managers it retains and monitors</td>
<td>Tax rules</td>
</tr>
</tbody>
</table>

**Limitations on investment**

<table>
<thead>
<tr>
<th>Employees’ provident fund</th>
<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 20 of the Indian Trusts Act and the Investment Pattern issued by Ministry of Finance</td>
<td>Section 20 of the Indian Trusts Act and the Investment Pattern issued by Ministry of Finance</td>
<td>Section 20 of the Indian Trusts Act and the Investment Pattern issued by Ministry of Finance</td>
<td>Tax rules</td>
</tr>
</tbody>
</table>

**Rate of return applied to member accounts**

<table>
<thead>
<tr>
<th>Employees’ provident fund</th>
<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administered rate of return, the amount of which may not exceed balance in the EPF’s Interest Expense Account</td>
<td>Not applicable</td>
<td>Required to match administered rate of return of the EPF</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

**Regulator/supervisor (Ex. CBDT, pertaining to tax-related matters)**

<table>
<thead>
<tr>
<th>Employees’ provident fund</th>
<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPFO enforces employer requirements</td>
<td>EPFO</td>
<td>EPFO</td>
<td>The “Appropriate Government” appoints the controlling authority. Generally, the central and state-level labor authorities are responsible for enforcement</td>
</tr>
<tr>
<td></td>
<td>Employees’ provident fund</td>
<td>Employees’ pension scheme</td>
<td>Exempt provident funds</td>
</tr>
<tr>
<td>----------------------</td>
<td>---------------------------</td>
<td>---------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td><strong>Compulsory contribu-</strong>&lt;br&gt;<strong>tions</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Employer</strong></td>
<td>The remainder of a total contribution of 12% of the monthly wage base, after 8.33% of the 12% is diverted to EPS. (Est. 3.67% of the monthly wage base.)</td>
<td>8.33% of the 12% contribution made to EPF is paid into the EPS trust</td>
<td>Same as would have paid to the EPF (3.67% of the monthly wage base).</td>
</tr>
<tr>
<td></td>
<td>Employer pays 1.10% administration charge</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Employee</strong></td>
<td>12% of monthly wage base</td>
<td>None</td>
<td>12% of monthly wage base</td>
</tr>
<tr>
<td><strong>Government</strong></td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Voluntary contributions</td>
<td>Employees’ provident fund</td>
<td>Employees’ pension scheme</td>
<td>Exempt provident funds</td>
</tr>
<tr>
<td>-------------------------</td>
<td>---------------------------</td>
<td>---------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td><strong>Employee</strong></td>
<td>Employee may contribute additional amounts under section 29 of EPF scheme rules</td>
<td>NA</td>
<td>Employee may contribute in same manner as to EPF</td>
</tr>
<tr>
<td><strong>Employer</strong></td>
<td>Employer may contribute additional amounts under section 29 of EPF scheme rules.</td>
<td>Employer may contribute additional amounts for salaries above the maximum wage base under section 11(3) of the EPS rules</td>
<td>Employers may contribute additional amounts, or establish an independent “excluded” provident fund for contributions on salaries above the maximum wage base</td>
</tr>
<tr>
<td><strong>Government</strong></td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>
Table 10.3 Compulsory schemes—eligibility for and payment of benefits

<table>
<thead>
<tr>
<th></th>
<th>Employees' provident fund</th>
<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pensionable age</td>
<td>55</td>
<td>58</td>
<td>58</td>
<td>NA</td>
</tr>
<tr>
<td>Conditions of benefit eligibility</td>
<td>Attainment of pensionable age; permanent and total incapacity; permanent migration from India; termination of service as a result of retrenchment; or voluntary retirement agreed between employer and employee</td>
<td>Attainment of pensionable age of 58, or early pension at ages 50–57. Accumulation of 10 years of service</td>
<td>Same as EPF</td>
<td>5 or more years of continuous service at the time of termination of employment; superannuation; retirement; or resignation</td>
</tr>
<tr>
<td>Form of benefit</td>
<td>Lump sum</td>
<td>Monthly benefit payment till death or 1 of 3 options offering reduced benefit and survivor’s benefit</td>
<td>Lump sum</td>
<td>Lump sum</td>
</tr>
<tr>
<td>Amount of benefit</td>
<td>Lump sum equal to account balance</td>
<td>Monthly benefit = (pensionable salary of final average monthly pay up to Rs6,500) * (pensionable service of no less than 10 and no more than 20 years) / 70. Years of service greater than 20 years are additionally credited</td>
<td>Lump sum equal to account balance</td>
<td>15 days’ pay for every year of service up to a limit of Rs1 million</td>
</tr>
</tbody>
</table>

Continued
<table>
<thead>
<tr>
<th>Pre-retirement access</th>
<th>Employees’ provident fund</th>
<th>Employees’ pension scheme</th>
<th>Exempt provident funds</th>
<th>Gratuity obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible EPF members with 5 years of participation may have a withdrawal from account: to finance construction, purchase or improvement of home, or purchase land upon which to build, or pay associated loan obligation.</td>
<td>Early pension payable at ages 50–57. Pension reduced 3% by each year less than age 58. Pension is payable on account of disablement.</td>
<td>Same as EPF</td>
<td>5 year requirement is waived if termination is due to disablement.</td>
<td></td>
</tr>
<tr>
<td>Advances from account permitted for eligible purposes, including: loss of employment resulting from factory shutdown; medical need (hospitalization for 1+ months, major surgery, specific illnesses of family member identified in the act); abnormal conditions such as natural disasters; marriage; education; physical handicap.</td>
<td>Commutation of benefit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefits payable at death</td>
<td>Balance in the account is paid to member’s nominee or family member.</td>
<td>50% survivor’s benefit if elected with reduced monthly pension, and, additionally, widower’s benefit generally equal to 50% of monthly pension and children’s benefit of 25% of widow’s benefit for up to 2 children until age 25.</td>
<td>Same as EPF</td>
<td>5 year requirement is waived if termination is due to death. Benefit is paid to a nominee, or if no nominee, to heirs. Special rule applies for payment to minors.</td>
</tr>
</tbody>
</table>
Forfeitures of benefit

Account balances are nonforfeitable and not attachable by creditors, or by court order. EPFO may cease to apply interest to the account if no contributions have been made to it for 36 or more months. (Policy remains under consideration and has not been implemented.)

Gratuity forfeited to extent of damages or losses if reason for termination was an act of willfulness or negligence causing damage, loss or destruction of employer property; riotous or disorderly conduct or other violent acts; or an offense of moral turpitude in the course of employment.
11 Analysis, findings, and recommendations on compulsory occupational pension schemes

In this chapter, we highlight deficiencies in the compulsory occupational schemes described in the previous chapter and make recommendations to address them. The recommendations are summarized in the following Chapter 12, together with those pertaining to the voluntary occupational schemes. Our concerns generally fall into two categories. The first category includes matters of scheme design and finance. As a result of a wide range of design flaws, the compulsory schemes generate insufficient retirement incomes for those individuals they are intended to cover. The second category includes administrative and operational deficiencies in the management and oversight of the schemes, which result in suboptimal performance, growing frustration among employer and employees, negative public opinion, and an incentive to evade scheme participation. In addition, we discuss three matters that do not neatly fall into either of the categories and which raise distinct policy issues: investment policy; small employer coverage; and the compulsory nature of gratuity provision.

Beyond these issues, however, looms a larger one: the absence of a clear set of policy objectives. India’s compulsory programs were developed in a patchwork manner over almost six decades. While the patchwork has its own logic, the overall goals and the manner in which each scheme is to contribute to attaining policy goals needs to be more clearly articulated. In the absence of a clear statement of policy objectives, it is difficult to fairly assess the schemes’ design and performance. Presumably the goal, stated broadly, is to provide retirement income security for Indian workers in the form of adequate and sustainable pensions. But this formulation gives rise to the question in another form: What is an “adequate and sustainable pension?” Moreover, the question can be answered only by taking into account the entire panoply of pension schemes, accounts, and programs available in India, including the compulsory occupational schemes, the voluntary occupational schemes, and other individual opportunities for long-term savings and investment, including the NPS. Because the issue of policy must be considered holistically, we will return to the subject in Chapter 13, after our discussion of the voluntary occupational pension schemes, which provide retirement income supplementing the benefits provided by the compulsory schemes.
Deficiencies of compulsory retirement schemes

Even absent a full articulation of the government’s pension policy goals or a definition of pension adequacy, it is nonetheless apparent that the compulsory schemes, as presently designed, do not provide “adequate” pensions by almost any measure. The average final claim paid out by the EPF to members, for example, was less than Rs29,000 in 2008–2009. The failure of the compulsory schemes to produce an acceptable level of pension income is the result of the following key factors, among others:

• insufficient contributions (most notably, as a result of the low maximum wage base upon which contributions are calculated);
• generous pre-retirement access to account balances (EPF) and early pensions (EPS); and
• lump sum payments of benefits (EPF, gratuities).

Another measure of “adequacy” is the number of people the schemes cover. Because the EPFO schemes are limited to employers with 20 or more employees, many workers, even in the organized sector, are not covered by the EPFO-managed schemes.

Moreover, the current compulsory program is not financially sustainable. The EPS, as we shall discuss in more detail, is substantially underfunded. Similarly, the gratuity benefits that employers owe their employees may be paid on a pay-as-you-go basis with no pre-funding. The EPFO’s current investment policy also contributes to the fiscal weakness of the EPS and the small account balances of member accounts in the EPF. Although the conservative investment policy embraced by the EPFO may reduce the volatility of the provident and pension fund assets it manages, it is likely producing suboptimal investment returns. The investment performance has been reflected in EPFO declaring an “administered rate of return” that sometimes has been below the rate of inflation, resulting in a loss of value in the EPS trust and EPF accounts, and which at other times has been set artificially above the actual rate of return achieved.

Deficiencies in scheme design

Both the EPF and the EPS have deficiencies in design that limit the value of the pensions the EPF and EPS are currently providing. We discuss the most significant of these issues here:

• insufficient contribution levels;
• actuarial instability of the Employees’ Pension Scheme;
• excessive pre-retirement access;
• lump sum forms of benefit;
• the “administered rate of return”; and
• early pensionable age.
Insufficient contribution levels to fund both EPF and EPS benefits

The level of required contributions to compulsory schemes, of course, is one of the key factors determining the value of pensions. The EPF’s contribution requirements should produce the range of income replacement outcomes desired by the government based on its policy objectives. The current contribution requirements are set as a percentage of wages (12% from the employer and the same from the employee) up to a limit established as the maximum wage base, which is currently Rs6,500. Of the total value (24% of compensation), 15.67 percentage points of the 24% fund the EPF; the remaining 8.33 percentage points fund the EPS. The main culprit behind the inadequacy of contribution levels is not the contribution rate, but the maximum base.

Currently, the maximum wage base is fixed and adjusted on only an ad hoc basis. As a result, it tends to lag in value behind the inflation rate and wage growth, and contributions shrink as a percentage of the overall wage. The government should consider whether both variables (the percentage of wage and the maximum wage base) should be adjusted. On way to address this problem would be to establish a mechanism to automatically adjust the maximum wage base. For example, the maximum wage base could be established using average salaries as a reference point. The wage base could then be indexed to the rate of inflation or wage growth, or a combination of the two. This approach would eliminate the need to reset the wage base on an ad hoc basis.²

When establishing contribution obligations, various factors must be considered, including the expected investment return, average years worked and the continuity thereof, the pattern and rate of salary growth (up to the relevant maximum wage base), and the availability of early withdrawal opportunities. The actual outcomes, i.e., the resulting account balances and pensions supported by the contribution levels, should be reviewed from time to time to ensure that the underlying assumptions remain accurate.

The EPS’s contribution requirements can be properly set (and adjusted) in accordance with a proper actuarial valuation that takes into account a number of factors, including employment patterns, wage growth, and investment returns on the scheme’s assets, as well as changes in life expectancy among pensioners. These factors will need to be carefully analyzed, because the government will ultimately be responsible for making up any shortfall in the ability of the EPS to pay the defined benefit pension when due. As we discuss in the following paragraphs, actuarial reviews conducted for the EPFO have already determined that the EPS is substantially underfunded, a problem that can be resolved only by some combination of an increase in contribution levels and a reduction in the benefits paid by the scheme.

Actuarial instability of the employees’ pension scheme

Actuarial valuations conducted for the EPFO have stated as early as 2003 that action was required to control a growing deficit.³ The EPFO, however, has failed
to take the necessary action. In fact, the scheme has run deficits since its inception in 1995, which indicates fundamental flaws in the assumptions used to determine that the mandated contributions could support the promised benefits when the scheme was established. In 2005, actuaries estimated the scheme to be underfunded by Rs220 billion.4

As early as 1998, a team of reviewing actuaries, recognizing the precarious funding situation, recommended that enhancements to EPS benefits if any, should be paid only out of emergent surplus. In 2003, the reviewing actuaries similarly warned that increasing pensions paid by the EPS on an ad hoc basis was not sustainable. According to the EPFO Annual Report, the actuaries were vehement in their opposition to a proposed 4% increase in pensions, stating that such an increase “cannot even be imagined.” They recommended taking the following steps to reduce benefit liabilities:

- delaying implementation of changes in the wage ceiling (which would lead to increase in benefits owed) until the associated liability was funded from an identified “viable system of funding”;
- redefining pensionable salary to be average salary over final 36 or 60 months rather than over final 12 months; and
- increasing the reduction factor used to calculate reduced pensions from 3% to 5% annually or greater.5

Some measures to reduce the deficit position of the EPS have been implemented, but these steps are insufficient. They have included changing the reduction rate applied to early pension calculations from 3% to 4% (as opposed to the more aggressive 5% recommended by the actuaries), eliminating the ability to take the payment of pension in the form of a commuted benefit (lump sum), and reducing optional forms of benefit providing guaranteed return of capital.

Unfortunately, these measures have not been sufficient to place the EPS on an actuarially sound footing. The EPFO’s strategy has been to address the EPS’ underfunding problem by reducing the scheme’s more marginal benefits in an effort to preserve the scheme’s core benefits. A fundamental design flaw—the fact that the core benefits cannot be adequately funded at the current contribution rates - cannot be addressed at the margins. Additionally, the reforms have focused exclusively on benefits. Contribution requirements have not changed, nor has the manner in which the EPFO invests the scheme’s assets which are invested solely in government debt. The central components of the scheme design—including its core defined benefit pension and the asset-side of the ledger (level of contributions, source of contributions, and the manner in which assets are invested) must be reassessed in order to achieve fiscal sustainability. In this context, the following steps should be considered:

- Shifting a portion of existing contributions used to fund other schemes to support the EPS, for example, by eliminating compulsory gratuities paid under the PGA, which is suggested below.
Deficiencies of compulsory retirement schemes

- Clarifying the extent to which various stakeholders, including employers, employees, current pensioners (to the extent anticipating adjustments in pensions paid), and the government share liability for scheme obligations, including unanticipated liabilities in a manner which takes into account the fiscal constraints of all parties and the expectations of older scheme members. All stakeholders should expect to bear their share of the cost of ensuring the EPS is actuarially sustainable through increases in contribution rates and reductions in benefits.

- Limiting or eliminating scheme features and rules which undermine the fiscal strength of the scheme and yet do not substantially enhance pension outcomes, such as lump sum payment of pension benefits, the payment (return) of contributions to nonvested participants, and early retirement benefits. At a minimum, such opportunities should be realistically valued and, arguably, they should be discouraged by employing more aggressive, but transparent, discounting rules.

- Eliminating, or reducing the generosity of, the survivors’ benefits provided by the EPS, for example, by limiting the benefit to the spouse and eliminating additional benefits paid for children.

- Revising the scheme’s investment strategy to diversify asset allocation, including increasing exposure to equities and internationally to enhance potential return at acceptable levels of volatility and risk.

Notwithstanding these and similar reforms, which taken together could restore fiscal stability to the scheme, they do not reach the broader policy issues that the government should simultaneously address. Specifically, the appropriate design of the EPS cannot be determined without more explicitly defining the role the EPS defined benefit is to play in the provision of adequate retirement income security of those individuals working in the organized sector.

Excessive opportunities for pre-retirement withdrawals and access to EPF accounts

The EPF scheme rules permit individuals to obtain pre-retirement access to their account balances. Eligible individuals may withdraw account balances to finance housing, in certain cases of unemployment, to finance a marriage, in the event of natural disasters, and for other reasons. Additionally, individuals may obtain access at severance of employment with an employer. As international evidence summarized in Appendix 1 shows, this access substantially reduces the ability of individuals to accumulate meaningful pension income in the provident fund. Although there may be some countervailing policy justifications for permitting this pre-retirement access to PF accumulations, the primary purpose of the EPF should be the accumulation of pension income. Given the manner in which the EPF is currently structured, however, pension accumulation is not prioritized sufficiently. It takes second or third place, in operation, if not as a matter of articulated policy. In part, it is a result of the multiple purposes for which provident
Deficiencies of compulsory retirement schemes

funds have historically been established and utilized.\footnote{For the EPF to generate substantial retirement income for its members, these rules will need to be changed and pre-retirement leakage substantially reduced. Consequently, the government should simultaneously explore the extent to which means outside of the scheme are available to address the financing of housing, income needs resulting from job loss, and the costs imposed by natural disasters. The elimination of pre-retirement access to EPF accounts surely will be greeted unenthusiastically if the public is not provided alternative sources of capital. The developing retail banking sector, credit institutions, micro-lending organizations, and similar entities should be able to step into the breach.}

Lump sum form of benefit payments from the EPF and EPS

The problem of lump sum payments also features in the international experience summarized in Appendix 1. Individuals participating in the EPF are paid their provident fund benefit (the account balance) in the form of a lump sum, rather than as an annuitized (or other) stream of income. Similarly, although the EPS generally pays pensions in the form of monthly pension payments, eligible members may receive a lump sum payment of up to one-third the pension amount. In fact only about 1 in every 9 EPS claim settled annually is a claim for a monthly pension.\footnote{In each case, the lump sum payment reduces the long-term, retirement income security provided by the schemes. The government should eliminate or reduce the availability of lump sum payments of pension, whether in whole or in part, to ensure that pension accumulations are rationally spent down over the projected life expectancies of pensioners.}

The “Administered Rate of Return” on EPF account balances

Currently, the EPFO announces the rate of return on EPF account balances. Although this administered rate relates to investment return, the EPFO essentially orchestrates some smoothing. This technique substantially reduces members’ exposure to the volatility of purely market-based returns. The EPFO believes the smoothing is appropriate in the case of defined contribution accounts in which volatility would otherwise be borne directly by individual members and that it is especially appropriate for members approaching pensionable age and preparing to take their lump sum “pension.” The “administered rate of return”, however, has the following more pernicious effects:

- It creates the misimpression that the government is providing or underwriting a guaranteed return, when, in reality, the scheme members are bearing the cost of the smoothing of the investment return. Members bear the cost, because investment return in a good year may be retained in the EPF’s Interest Suspense Account and then used to subsidize the lower return that may be earned in a later year. The cost of the smoothing is not transparent to scheme members.
Deficiencies of compulsory retirement schemes

- The implicit promise of an annual rate of return that displays little volatility may contribute to the EPFO’s desire to maintain a conservative investment portfolio for the EPF. In turn, the conservative investment portfolio results in lower relative returns over time. In recent years, this approach has resulted in EPFO crediting member accounts with a rate of return less than the inflation rate.\(^8\)

- Because employers sponsoring Exempt Provident Funds are required to match the administered rate of return,\(^9\) their portfolios mimic the EPF’s portfolio, reducing the potential return that Exempt Provident Fund members could earn. When the EPFO raises its declared rate by using its Interest Rate Suspense Account, employers sponsoring Exempt Provident Funds, which do not have similar reserves, must bear the cost of the increase—in effect, acting as guarantors of an EPF-equivalent rate of return for their employees.

- The exposure of the accounts of those members who are nearing retirement to market volatility—one of the main reasons why the EPFO has asserted that it would be unwise to invest the EPF assets in equities—may be addressed in other ways that would not impose the (most likely) lower returns on the account balances of those members who have a longer time horizon to retirement. For example, the EPFO could establish two different portfolios or consider using a life-cycle approach, such as that which is employed by the NPS.

Pensionable age

The current pensionable age for both the EPF (age 55) and the EPS (age 58 and early pension available at age 50) enables members to receive a pension payout at a relatively early age. The government should consider linking adjustments to the pensionable age to changes in life expectancy, so that pensionable age will rise automatically. This approach would eliminate the need to raise the pensionable age on an ad hoc basis and reduce the risk of confronting a hostile political environment whenever the government proposes an increase.

There is no ‘right’ or ‘best’ pensionable age. Many factors must be taken into account in determining what the “normal retirement age” of a particular society should be. The pensionable age set by the government should reflect cultural expectations, the fiscal capacity of its pension system and its stakeholders, as well as projected changes in life expectancy and dependency ratios. Pensionable age may also reflect the particular labor market conditions of a country. Much of the relevant data is recited in Chapter 2, and we will not repeat it here. In the case of India, there are a number of compelling reasons why the pensionable age should be raised:

- Life expectancy is projected to increase in India, and years spent in retirement also will increase. It follows that the cost of financing retirement
Deficiencies of compulsory retirement schemes

will increase too, because of the need to support longer periods of retirement. Raising the pensionable age would result in individuals working longer, providing more time for them to finance their pensions, and there also would be a corresponding reduction in the number of years that the same individuals would spend in retirement, thus lowering the total cost of financing it.

- India’s dependency ratio is expected to triple over the next 40 to 50 years: India will have far fewer workers supporting a growing elderly population. It therefore makes good policy sense for the current workforce to accrue pensions and accumulate the assets during their working lives that are sufficient to support themselves in their retirement years. Doing so will reduce their reliance on pay-as-you-go funding and intergenerational transfers of wealth.

- From a political perspective, it will likely be easier to increase the pensionable age now rather than later. There are relatively low cultural expectations for “retirement” in India today; but expectations may change as the Indian economy develops and the population ages. Additionally, the political constituency for which pensionable age is an important matter—those individuals approaching retirement—will grow in size relative to the overall population, reflecting demographic trends. The recent political turmoil in countries with relatively old populations, such as many in Europe, provides a timely illustration of how politically difficult increasing the pensionable age can be.

- The changing nature of work in the organized sector and expanding employment opportunities support an increase in the pensionable age(s). Encouraging retirement at earlier ages may be appropriate in economies where jobs are scarce and in those industrial sectors requiring physically demanding work. It may be less appropriate, however, for countries in which economies are growing and where employment opportunities are shifting towards service-related (less physically demanding) work.

Administrative and operational deficiencies

Although the EPFO has recently tried to improve the quality of its operations, there has been insufficient improvement to date. As a result of administrative deficiencies, examples of which we provide below, stakeholders almost uniformly express their frustrations about EPFO performance, and the EPFO’s public reputation has been damaged. Rather than addressing each particular deficiency one by one, however, they should be considered as symptoms of broader structural issues. At bottom, the deficiencies are the result of the fact that the EPFO is a self-regulatory entity with little effective third-party oversight. Perhaps, more importantly, employers have little alternative to using its services, and over the years, EPFO has had little incentive to improve its administration. As we discuss in more detail below, the administration of the EPF Act schemes should be restructured to introduce incentives to encourage improved performance.
and to introduce independent oversight. Additionally, to the extent that the EPFO cannot manage its workload, some of it should be transferred elsewhere, thus enabling the EPFO to focus on its core administrative and operational obligations.

The following are some examples of the deficiencies in EPFO performance.\(^{11}\)

- **Account statements.** The EPFO has been unable to deliver annual statements of account to more than 40% of EPF members, and members have not yet been provided with online access to up-to-date account information.\(^{12}\) (Ironically, EPFO has had little trouble requiring employers sponsoring Exempt Provident Funds to provide online access to account information as a condition of the grant of an exemption.)

- **Benefit claims.** The EPFO itself reports that, in 2008–2009, less than 66% of all claims it received were settled within 30 days, a performance target that it established.

- **Transfers.** Only 57% of the transfer requests the EPFO received in 2008–2009 were settled within 30 days, which, again, is the EPFO’s own performance standard. At the close of the reporting year, there were approximately 76,500 pending transfer applications representing over 11% of the transfer workload.

- **Dormant EPF accounts.** Although the numbers are not readily ascertainable, many of the individual accounts in the EPFO’s records are dormant, inactive accounts, many of which likely have stale member information. Many of these are small accounts that are not consolidated with new accounts as individuals move from one employer to the next.\(^{13}\) Improved processing of transfer requests and the implementation of unique identification numbers for members should reduce the number of dormant accounts.

To be fair, although the EPFO’s levels of efficiency and productivity neither satisfy its own standards nor win any applause from the Indian public, its performance should be assessed against the backdrop of an increasingly mobile workforce and a corresponding increase in its workload.\(^{14}\) Moreover, the organization in recent years has taken steps to reduce processing delays, increase record-keeping capacity and accuracy, update its IT systems, and improve its responsiveness.\(^{15}\)

One of the structural impediments to increasing EPFO’s administrative performance is its bifurcated, centralized and regional organizational structure, which results in the dispersion of information among regional offices, and the two layers of decision making and processing which often result. For example, employer applications for an exemption are processed and reviewed by a Regional Provident Fund Commissioner (RPFC) only to be forwarded to the Central Provident Fund Commissioner for further review and determination—and then to the government for its final approval. It may be time to review this structure, which was established with the enactment of the EPF Act in 1952. To effectuate such changes, legislation may be needed.
As was noted at the outset of this section, it is possible to offer one-off solutions to address each of the identified deficiencies. Indeed, the EPFO has already started to address some of them. The underlying cause of the EPFO’s poor performance, however, should also be a focus of the government’s attention. Thus, in addition to ensuring that the EPFO has the resources available to fix specified deficiencies, the government should also take a broader approach and consider taking the following steps:

- **Establishing independent, supervisory oversight of the EPFO.** The government should consolidate the regulation and supervision of the EPFO-managed schemes, NPS—and voluntary occupational schemes—under a single “Pension Regulator,” possibly designating the PFRDA. We discuss this recommendation in chapter 12.

- **Reducing the scope of EPFO responsibilities.** The government should eliminate EPFO functions that reduce its focus on its core administrative and operational functions, and assign them elsewhere, including for example, the exemption process and its supervision of Exempt Provident Funds.

- **Introducing incentives and competition to stimulate improvements in the EPFO’s performance.** Under the current framework, the EPFO maintains a near-monopolistic position: (1) employer and employee participation in the EPFO-managed schemes is compulsory; (2) the EPFO has authority to grant or deny employer applications to opt out of its schemes and establish their own Exempt PFs; and (3) Exempt PFs must be managed in accordance with rules issued by EPFO. By controlling the manner in which they can operate, the EPFO also limits the ability of the Exempt PFs to “compete” against it. The government should consider ways to provide greater incentives for the EPFO to improve its performance, including, for example:
  
  - Eliminating the restriction requiring employers sponsoring Exempt PFs to match the EPFO’s administered rate of return and liberalizing the applicable Investment Pattern.
  - Enabling employers to opt out of the EPFO and participate in the Exempt (and Excluded) PFs, of other employers or the NPS. This would provide smaller employers a way to take advantage of the exemption process and help the Exempt and Excluded PFs (and the NPS) to attain economies of scale. (Secondarily, it also would disperse capital and potentially create a number of large institutional investors.) Along the same lines, smaller employers could be permitted to federate in order to feasibly form their own Exempt PFs.\(^6\)
  - Removing the responsibility for issuing employer exemptions from the EPFO and assigning it to the Pension Regulator, thereby eliminating the presence of any conflicts of interest in the exemption process, especially in light of the proposed, heightened competition among the PFs, and between the PFs and the EPFO.
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Investment policy

The EPFO invests EPF and EPS assets in accordance with the Investment Pattern promulgated by the Ministry of Finance in 2003, which provides no exposure to the equities markets. As a result, only modest rates of return are generated. In turn, this investment performance is reflected in the administered rate of return credited to members’ EPF accounts. We have already identified our concerns with the use of an administered rate. In the case of the EPS, the lower the rate of return, the more pressure to either reduce benefits or increase contributions, given the current funding difficulties of the scheme. Recently, the credited rate of 8.5% has been lower than the inflation rate. Over the same period, there have been significantly larger gains in the Indian equity markets, although, as the EPFO points out (and considered by market performance in 2011), volatility accompanies the overall gains.

As noted in our discussion of the “administered rate of return,” above, the EPFO’s investment management practices have a direct impact on Exempt Provident Funds, because employers sponsoring Exempt Provident Funds are required to match the EPFO’s administered rate of return for their scheme members. If the Exempt Provident Fund’s investment performance fails to match the EPFO’s administered rate of return, the employer is required to make up the difference. Employers have little incentive to construct an investment portfolio in their Exempt PF trusts that would include equities and outperform the EPFO in the long run, if the resulting volatility could require them to increase contributions in any given year usually adopt an investment strategy and portfolio similar to that of the EPFO in order to minimize the risk that they will be required to make additional contributions. Employers face the additional challenge of taking into consideration the higher transactional costs they likely bear for asset management, as well as the fact that the EPFO may set its rate above or below the actual annual investment return on the EPF portfolio.

Looked at from another perspective, the EPFO has created a set of rules that frustrate any potential competition with it based on investment return in comparable funds. Under these rules, the Exempt Provident Funds are unable to serve as a benchmark against which to compare the EPFO’s performance as the investment manager for the EPF (as well as the assets of the EPS). In fact, the EPFO has the advantage, because it is able to set the rate and use its Interest Rate Suspense Account to top up when investment performance misses the declared return. The government should consider taking the following actions:

- **Eliminating the requirement that the Exempt Provident Funds’ annual return not be lower than the EPFO’s administered rate of return.**

By eliminating this requirement, employers and Exempt Provident Fund trustees should be able to better diversify their investments and exercise their fiduciary responsibility to make affirmative, prudent investment
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decisions on behalf of the trust and its members. This issue could be addressed without legislation. It merely requires amending the conditions the EPFO has established for Exempt Provident Funds.  

- **Permitting greater latitude to employers investing the Exempt Provident Fund assets.** Employers should be permitted to diversify the portfolios of Exempt Provident Funds beyond limitations established by the EPFO. There are several specific steps the government can take; First, at a minimum, employers should be permitted to invest fund assets within the more liberal constraints of the most recent Investment Pattern issued by the Ministry of Finance. Second, the Ministry should continue to liberalize the Investment Pattern, at least as applied to the Exempt PFs and other pension funds.  

Third, the investment limitations in the trust law should be reviewed. Rather than imposing a list of permissible investments, the trust law, at least as applied to pension funds, should rely more fully on the general fiduciary obligations established in the law.

Trustees of Exempt Provident Funds have a fiduciary obligation under the Indian Trusts Act whereby they are “bound to deal with the trust property as carefully as a man of ordinary prudence would deal with the property if it were his own. . . .” The pension laws of many countries rely more heavily on this standard than on permitted lists of investment to ensure that pension assets are properly and prudently invested. The government should take under consideration the extent to which adopting such an approach is feasible and appropriate for India. Proposals that would expand the list of investments permissible under the trust law have, in fact, already been introduced.

**Small employer coverage**

Regardless of how one defines the amount of “adequate” pension that should be provided by the EPF Act schemes, it is clear that the individuals who work for small employers of less than 20 employees do not receive it, because their employers are not required to participate in the current compulsory schemes. Individuals working for small employers, therefore, must rely on their own voluntary efforts to accumulate long-term savings, by enrolling and regularly contributing to NPS or another savings product. The government should consider extending the reach of the EPFO’s compulsory programs to small employers who employ 10 or more employees. Because of the way that the EPF Act is drafted, the EPFO could lower the 20-employee threshold to 10 employees without legislation.

There are a number of factors to consider when assessing the viability of such an expansion of the EPF schemes, including whether it would impose an undue financial or administrative burden on small employers. In making this determination, the government should consider the following factors:
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- The availability of computer and electronic technologies, which could reduce the cost and simplify administration and compliance for small employers.
- The extent to which the administrative and financial burdens that would be imposed obligations are similar (or dissimilar) to those already imposed under the Payment of Gratuity Act. For example, the PGA, at least under current law, does not require employers to prefund their gratuity obligations or to withhold and remit employee contributions from employee pay.
- The extent to which the new obligations would result in evasive behavior on the part of both small employers and their employees, and result in many retreating to informal employment arrangements. It is inescapable that this step would encourage informality. 20
- The feasibility of adopting different contribution requirements for small employers and their employees.
- Whether the gratuity obligations will be eliminated and the PGA repealed, as recommended below.
- Whether there are suitable alternatives, such as mandating participation in the NPS.

Prior to undertaking any expansion of coverage, the government should determine that the EPFO has adequately resolved its administrative deficiencies and has sufficient capacity to manage an expansion of coverage of this magnitude. It should also consider whether a small employer program is best managed elsewhere, for example, by NPS. Finally, in either case, it should consider phasing in the program so that the influx of new entrants is manageable.

Issues pertaining to gratuities

When the study of occupational pensions described in the latter part of this book commenced, the scope of the work plan did not include a review of gratuity obligations. However, as work proceeded, it became clear that it was important to take gratuities into account. First, the gratuity obligations imposed on employers are long-term defined benefit liabilities and, from the perspectives of actuarial and accounting standards, should be treated in the same manner as other defined benefit liabilities, such as the liabilities of the EPS and those of employers who sponsor voluntary defined benefit pension schemes. Second, compulsory gratuity obligations use employer assets that employers (and policy makers) could choose to reallocate. This is an important consideration when the compulsory pension schemes (the EPF and EPS) are neither delivering adequate pensions to the individuals they now cover, nor accumulating sufficient assets with which to do so. Third, it follows that if there is limited available capital to allocate to the provision of long-term benefits—regardless of whether the source is the employer, employee or government—then the available assets should be used to finance the most important policy objectives.
Elimination of the compulsory gratuity payments

It is unclear what distinct policy purpose supports the compulsory provision of gratuities. The chief purpose of the Payment of Gratuity Act when it was enacted was to achieve some uniformity of rules and standards, rather than to compel the provision of gratuity benefits, by reducing the legal complexities confronting those employers who were already providing gratuity benefits to workforces in more than one state. Second, gratuity benefits paid to long-term employees (in the form of lump sum payments) merely replicate the payment of lump sum benefits under the EPF. Third, because the Indian workforce is becoming more mobile with shorter, average job tenures, gratuity will be earned less frequently (for failure to satisfy the 5 years of continuous service requirement), and when it is earned, mobile short-tenured employees will be the recipients of multiple, small lump sum payments over the course of their working lives. There may be little justification for maintaining a compulsory program that yields these outcomes and imposes costs on employers, including small employers (those with 10 to 19 employees) who are not yet required to participate in the EPFO-managed compulsory schemes.

Inadequate funding of gratuity obligations

If the employers’ obligation to pay gratuity benefits is to remain, it should be properly funded in the same manner as other defined benefit obligations. However, as we have described in the previous chapter, gratuity benefits are unfunded liabilities, which employers may satisfy on a pay-as-you-go basis. Because the obligations are often unfunded, employers may be unable to pay gratuities, especially when they are under economic duress, experiencing cash flow problems and reducing their workforces. Ironically, it is precisely these circumstances under which the compulsory payment of gratuity would be most needed. Finally, unfunded gratuity obligations may have a significant impact on a company’s balance sheet under accounting principle AS-15.

To address these concerns, the government should consider taking the following action:

- **Establishing a legal obligation to fund gratuity obligations on an actuarially sound basis.** Regardless of whether or not the compulsory obligation imposed under the PGA is retained, the government must ensure that employers sponsoring gratuity funds—including those established on a voluntary basis—fund their obligations in accordance with the same actuarial principles, standards, and practices, which apply to other defined benefit obligations.

- **Establishing proper transition rules in the event gratuity obligations are eliminated and new funding obligations are imposed.** In the event that compulsory payment of gratuity is eliminated and the PGA repealed, employers would need to recognize their accrued liability and fund the
accrued rights of employees. The rights would need to be valued and funded on a sound actuarial basis, and employees with accrued rights made whole.

If compulsory obligations are eliminated, the obligations could be satisfied either by paying lump sums to employees, or by transferring the accrued benefits into another employer-sponsored scheme. The payment of the accrued benefits directly to employees is not advisable, because it would result in lump sum payments to individual workers, many of whom will be many years from retirement. The value of the accrued benefits could be paid into the EPF, the employer’s Exempt or Excluded Provident Fund, or a voluntary pension (or gratuity) scheme established by the employer. (It could also be paid into the EPS, but this may be less transparent to employees.)

**Inadequate regulation and supervision of gratuity schemes**

Regulatory and supervisory oversight of gratuity schemes and PGA obligations to pay gratuity is limited. The responsibility for the administration and supervision of the PGA is delegated under the act to the “appropriate Government”—to State and Central governments—which may appoint “different controlling authorities . . .for different areas.” The PGA also grants inspection authority to the governments, which may appoint inspectors who, in turn, have generally broad authority to obtain information and documents from employers, and perform onsite and offsite inspections. As a result of this legislated dispersion of authority there is no clear central authority issuing regulations or managing the supervision of gratuity obligations. In addition to this legislative delegation of authority and responsibility, the CBDT has authority to regulate and supervise “approved” Gratuity Funds, but, as we discuss in more detail in the following chapters, it has not been an active supervisor.

The Indian Trust Act would apply to a trust that an employer may elect to establish. However, this may only add another layer of inadequate regulation and supervision as no regulatory body directly oversees a Trust’s implementation or management. Finally, it is not clear how vigorously IRDA regulates or supervises the insurance products that may be used to fund gratuity obligations. To address the inadequate regulation and supervision of the PGA and gratuity schemes, the government should subject the schemes—and employers sponsoring them—to the same regulatory and supervisory oversight we propose for the EPF and EPS, as well as for the voluntary schemes discussed in the following chapter: the PFRDA, or another entity responsible for the oversight of compulsory and voluntary pension schemes, should also be delegated the responsibility for gratuity schemes.
In this chapter we both describe and assess the voluntary occupational pension schemes that employers may elect to establish for their employees. These voluntary schemes provide benefits that supplement the benefits provided by the compulsory schemes. They are a surprisingly understudied—and under-regulated—part of the Indian pension system.

Voluntary occupational pension schemes currently cover only a minority of all Indian workers. They could nonetheless become an increasingly important part of the pension landscape and a vital source of retirement income security for millions of Indian workers, because it is unlikely that India’s compulsory pension programs, as currently designed, will adequately serve the needs of its growing organized sector workforce. Indeed, even with substantial reform, the compulsory schemes likely will provide only a modest level of income replacement. To address this deficiency, the Indian Government will need to consider increasing the role of supplemental, employer-based schemes in addition to introducing reforms to the compulsory programs. Whatever their future role, the voluntary schemes existing today require robust regulation and supervision to ensure that they are properly operated and funded, and that employers are able to make good on their contractual promises to provide supplemental pensions to their employees.

These schemes present a particular challenge to the government and policy makers, because there is so little regulation and supervision. One result of the absence of governmental oversight is that there is little information available upon which to base policy or recommend regulatory action. For example, there are very few aggregate data, except for the proprietary information developed by service providers, such as consultants and actuaries, which may have data based on information collected from their clients. Similarly, information about operational and management practices must be regarded as only anecdotal. On the other hand, given the lack of regulation and supervision, the initial steps that the government should take are clear.
Types of voluntary occupational pension schemes

There are four types of unregulated, voluntary occupational pension schemes, or UVOPSs, which are described and analyzed below:

- defined contribution schemes,
- defined benefit schemes,
- Superannuation Funds, and
- Excluded Provident Funds.

Of these four, the Superannuation Funds and the Excluded Provident Funds are regulated under the Indian tax law, but only to the extent that an employer seeks tax recognition of the schemes to take advantage of the tax benefits associated with maintaining and funding them. There are also tax provisions addressing the extent to which contributions to, and distributions from, defined contribution and defined benefit schemes are exempt from taxation, which we describe below. In addition to these schemes, employers also may voluntarily establish Gratuity Funds to fund the gratuity obligations imposed by the PGA; these, too, are unregulated and unsupervised, except to the extent the employer seeks tax recognition.

Defined contribution and defined benefit schemes

Employers may establish a defined contribution or defined benefit scheme for the benefit of their employees. Little is known about the number of these schemes, the typical benefits offered under them, the extent to which they are funded, or the unfunded liabilities of the sponsoring employer. The key distinctions between defined contribution and defined benefit schemes are well-known, and the manner in which the DB–DC terminology is used in India does not depart from international practice. Defined contribution pension schemes are those in which a pension is determined by the amount of assets accumulated and invested in the scheme member’s name. DC schemes are financed by employer or employee contributions, or a combination of the two. The scheme member bears the investment risk associated with the management of the assets, although he or she may or may not have control over the manner in which the assets are invested.

DB schemes are those in which the pension is determined as a function of a worker’s history of pensionable earnings under a formula that considers three factors: a benefit accrual rate, the worker’s wages (using final salary, or average wages over a specified period or over the worker’s full career), and his or her length of service. In a DB scheme, the scheme sponsor, who is typically the employer, remains responsible for paying pensions when due and bears the liabilities and risks associated with that responsibility. The employer is obligated
to pay the pensions to scheme members as they come due when eligible employees retire. The risks the employer sponsoring a DB scheme assumes include the following:

- **Financial risk:** the risk that it will not have sufficient assets set aside to pay the benefits, or, if it has not set aside assets, the risk that it will not be able to pay benefits from its current cash flow.
- **Investment risk:** the risk associated with managing the scheme’s assets (assuming the scheme is funded).
- **Actuarial risk:** the risk that the actual behavior of the covered population diverges from the actuarial assumptions used to estimate liability.
- **Longevity risk:** the risk that pensioners will live longer than anticipated is a type of actuarial risk borne by the scheme and its sponsoring employer if pensions are paid directly by the employer or the DB scheme trust (essentially on a self-insured basis), rather than by the purchase of a group or individual annuity from a life insurance company.
- **Inflation risk:** if the scheme provisions provide for inflation-adjusted benefit payments, the risk that pensions paid will be larger than anticipated if the pensions are paid directly by the employer or the DB scheme trust, rather than by the purchase of an inflation-adjusted group or individual annuity from an insurer.
- **Political risk:** the risk that changes in law or regulations could alter the extent of its liabilities and payment obligations.

Because there are no funding requirements under Indian law, employers may fund their defined benefit scheme obligations on a pay-as-you-go basis, in the same manner that they may fund their compulsory gratuity obligations under the PGA.

The following provisions of the Income Tax Act, 1961 are applicable to defined benefit and defined contribution pension funds:

- An individual’s contributions to a pension fund are deductible under section 80C(2)(Vii).
- Amounts received or receivable at the time of a voluntary retirement or termination of service in accordance with any scheme of voluntary retirement up to Rs500,000 are excluded from income under section 10(10C).
- Any payment in commutation of pension received under any scheme of any employer up to the commuted value of one-half of the pension is excluded from income, and in the case where gratuity is also paid, the commuted value of only one-third of the pension is excluded from income under section 10(10A)(ii).

**Superannuation funds**

Although a Superannuation Fund may be either a type of DC or DB scheme, depending on its design, it is generally treated as separate and apart from either,
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Perhaps because there are specific tax rules that are applicable to it. According to Tax Rule 82, which establishes rules for “approved” Superannuation Funds, Superannuation Funds are “established or constituted for the sole purpose of making payment of pension or family pension by the employer to his employees.” A Superannuation Fund is funded by contributions invested in trust or, alternatively, in a pension fund managed by an insurer under a group superannuation scheme contract. The general practice among employers appears to be to establish a defined contribution scheme using a group contract issued by an insurer and under which the payment is paid out as an annuity.

To obtain tax recognition (“approval”) of a Superannuation Fund and enjoy the resulting tax benefits, an employer must apply to the CBDT, providing it with information about the classes and types of employees entitled to the benefits of the fund, where the accounts of the fund are maintained, and how the fund is invested. The information statement must be verified by the scheme’s trustees. If the Superannuation Fund satisfies the tax requirements, then contributions, gains on the Fund’s assets, and benefits paid from the Fund are treated as exempt from taxation (“EEE”). The tax treatment of contributions to, and payments from, an “approved” Superannuation Fund are the following: 2

- Employer contributions to an approved Superannuation Fund are treated as a deductible business expense for amounts within the contribution limits. The total annual contribution for each employee to the Superannuation Fund may not exceed 27% of salary, reduced by the employer’s contribution to any provident fund in that year. In effect, assuming that the employer also is making contributions to the EPF or an Exempt Provident Fund, the contribution to the Superannuation Fund will be a maximum of 15% of salary.

- Employer contributions for past service liability are treated as deductible business expenses spread over the years of payment.

- Employer contributions to an approved Superannuation Fund are excluded from income up to the cap established in the tax law.

- Income received by an approved Superannuation Fund’s trust is exempt from taxation.

- Receipt of payments from an approved Superannuation Fund in the form of an annuity are exempt from taxation; employees entitled to receive the annuity (at retirement) may receive up to one-half the commuted value of the annuity as a lump sum payment (reduced to one-third the value if the employee also receives a gratuity) on a tax-free basis; benefits paid to nominees at an employee’s death or to the employee upon incapacitation prior to retirement are tax-free.

Additionally, an employer’s contributions to an approved Superannuation Fund are treated as “fringe benefits” under the tax law. As a consequence, any contribution by an employer to an approved Superannuation Fund for employees above Rs100,000 is subject to Fringe Benefit Tax. This is a relatively new tax rule, and it has reduced the popularity of these funds. Under the FBT regime, an employer
pays the FBT at the rate of 30% on its contribution to an approved Superannuation Fund for employees in excess of Rs100,000 for each employee.3

There is only one limitation addressing the inclusion or exclusion of employees in a Superannuation Fund: the scheme is prohibited from covering a company director, unless the director is also a full-time bona fide employee of the company and owns less than 5% of the company. Aside from this limitation, an employer has the ability to determine the extent to which the scheme will cover all or part of its workforce. As insurer LIC states on its website:

It is not obligatory or statutory on the part of the employer to provide for pension to all employees. It is entirely up to him to decide to which class/classes of employees he desires to extend the scheme. The eligibility conditions may be defined on the basis of designation or salary. (However, after the categories are specified, the employer cannot discriminate between the employees and thus extends the scheme uniformly.)

Distribution rules are similar to those imposed on DC and DB schemes. At least 50% of the value of the benefit paid to a member from a Superannuation Fund must be in the form of an annuity paid at the time of retirement, death or incapacity. The remaining 50% of the benefit may be paid to the member in a lump sum. If the person paid the lump sum is also receiving a gratuity, the permissible lump sum amount is reduced to one-third of his or her accumulated account balance in the fund. The scheme trustees are required to enter into a “scheme of insurance” or accumulate contributions for each beneficiary of the fund and purchase an annuity from an insurer. Certain bank funds established to pay pension under banking legislation are excluded from the requirement to provide annuities issued by a life insurer (Tax Rule 89).

The tax rules impose some rules on trusts formed in conjunction with the funding of a Superannuation Fund. If an employer elects to establish its Superannuation Fund in the form of a trust, under Tax Rule 84 the trust is required to have at least two trustees, neither of which may be a “company” (as opposed to an individual person), unless the employer has obtained the prior approval of the tax authority. Second, the trust assets may not be returned to the employer “under any circumstances” nor a lien placed on the fund to satisfy an employer debt or other obligation (Tax Rule 91(2)). Similarly, no scheme member is permitted to hold an interest in any insurance policy of the trust, and employees are prohibited from assigning or creating a charge upon their interests in the fund (Tax Rule 92).

Excluded provident funds

The term “Excluded Provident Fund” is not defined in law or regulation, and, as a result, the term is used imprecisely. Stakeholders, when asked under what circumstances a fund would be considered to be an “Excluded PF,” will offer somewhat inconsistent or incomplete definitions. Generally, an Excluded Provident Fund is a provident fund that is not regulated or supervised under the
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EPF Act. There are at least six reasons why a provident fund might not be covered by the EPF Act:

- the employer (or “establishment”, using the terminology of the act) has less than 20 employees;
- the employer has more than 20 employees, but none of the employees is a member of the EPF, and each earns more than the maximum wage base of Rs6,500 per month;
- the employer does not operate in a Schedule I industry covered by the EPF Act;
- the EPF Act does not apply because the establishment is identified in the act’s exclusions at section 16(1);
- the EPFO has excluded it consistent with its authority to do so under section 16(2); or
- the employer has established the fund to provide employees with provident fund benefits linked to wages above the maximum wage covered by the EPF, which imposes contribution obligations only on wages up to the upper wage base of Rs6,500.

Often, other types of funds are included in the informal definition of “Excluded Provident Fund”, including, for example, provident funds established under the Provident Fund Act, 1925.

Excluded Provident Funds are subject to section 36(1)(IV) of the Income Tax Act and the relevant Tax Rules provisions, which establish the criteria under which an employer may apply to the tax authority to recognize its Excluded Provident Fund (or any provident fund) so that it can claim an annual exemption for its contributions to it. This is the same sub-paragraph of the Income Tax Act under which employers claim deductions for contributions to Superannuation Funds. In the case of Excluded Provident Funds, however, the applicable conditions under which the fund is “recognized” are more extensive and include the following:

- Employer contributions to a “recognized” Provident Fund are treated as a deductible business expense for amounts within the contribution limits.
- Employer contributions for past service liability are treated as deductible business expenses spread over the years of payment.
- Employee contributions to a “recognized” Provident Fund are excluded from income up to limits established at section 75 of the IT Act.
- Each employee’s contributions are required to be a definite proportion of his salary and are deducted by the employer from the employee’s salary in that proportion in each payment period and credited to the employee’s individual account in the fund. The employer’s contributions to the individual account of an employee may not exceed the amount contributed by the employee and are credited to the employee’s individual account at intervals not exceeding 1 year.
• Income received by a “recognized” Provident Fund is exempt from taxation.
• Receipt of a payment from a “recognized” Provident Fund is deductible from income so long as the payment is made within the limitations on distributions provided under the tax rules.

The contributions of an employer and its employees to a recognized PF must be credited to the employee’s individual account in the PF, and the assets held in a trust managed by two or more trustees or an “Official Trustee.” The PF’s assets must be segregated, and the trust is generally irrevocable, unless employees consent to its revocation. The employer, however, may recover money from the trust if an employee is dismissed for misconduct or voluntarily leaves employment before the contributions (and earnings thereon) vest.  

The tax rules also require that an employer send to each member an account statement showing the opening balance at the beginning of the period, amounts contributed during the year, the total amount of interest credited at the end of the period or debited and the closing balance at the end of the period (Rule 74(6)).

The distribution rules are similar to those applicable to both Exempt Provident Funds and the EPF. The accumulated balance in an employee’s provident fund account is payable to him on the day he ceases to be an employee, or as otherwise provided in rules issued by the tax authority (Tax Rules 68–73). In accordance with these provisions, a scheme’s rules may permit an employee to withdraw up to 90% of his account balance prior to retirement, if the withdrawal occurs no more than 12 months prior to retirement.

The scheme rules may permit an employee to nominate one or more persons to receive the balance in his provident fund account in the event of his death. However, surviving family members will take priority over any such nominee (Tax Rule 67A). The rules also permit employees to obtain access to accumulated account balances while still working for the employer sponsoring the scheme. These withdrawal rules are extensive and are liberally drawn. Members are permitted to initiate withdrawals for a multitude of purposes. However, many permitted withdrawals come with conditions and requirements to repay the withdrawal to the fund. Amounts not repaid are treated as taxable income.

The tax rules provide for portability among provident funds when an individual severs employment and changes employers. It is unclear how often the provision is used for Excluded Provident Fund accumulations.

Excluded Provident Funds are distinguishable from the “Exempt Provident Funds” established by employers. However, Excluded Provident Funds are now subject to an important new requirement enacted in 2006, which may substantially erode the distinction. As we have previously discussed, employers who are covered by the EPF Act may apply to the EPFO under section 17 of the Act to operate their own “exempt” provident funds in lieu of participating in the EPF. The EPFO conditions its grant of an exemption upon an employer maintaining its “exempt” PF in accordance with a number of requirements, some of which are quite appropriate (such as some of its governance-related requirements),
and some of which are problematic (such as the investment rules it has imposed). The Finance Act of 2006 requires employers with provident funds previously accorded tax recognition on or before 31 March 2006 to submit to the jurisdiction of the EPF Act on a voluntary basis (under section 1(4) of the EPF Act) and apply to the EPFO to obtain a section 17 exemption from the application of the EPF Act to their provident fund. The scope and full effect of this provision remain unclear and controversial. In effect, employers seeking to maintain the tax recognition of their heretofore “excluded” PFs must transform their funds into an “Exempt” Provident Fund—and presumably comply with the applicable rules set forth as conditions for obtaining a section 17 exemption. Many of the employers subject to this provision have strenuously opposed it, and the compliance deadline has been extended several times. The full effect of this requirement is not yet clear.

Analysis of and recommendations regarding the UVOPSs

Even in the absence of a policy decision to increase the nation’s reliance on the UVOPSs, it nonetheless remains very likely that these schemes will grow as a result of the increasing formalization of the Indian workforce. Additionally, demand-side pressure on wages and benefits, which may develop in some sectors of the labor market in the future, could lead to a greater utilization of voluntary schemes to provide compensation and benefits. Thus, whatever the long-run policy decisions about the shape of the Indian pension system, schemes will probably continue to be established and maintained by employers on a voluntary basis, which in itself provides adequate reason for the government to take action and ensure that the “unregulated” UVOPSs are in fact properly regulated and supervised.

Secondarily, policy makers should consider the role of pension fund capital in the financial markets, and the significant contribution that pension funds could make in the area of corporate governance. Properly financed, prudently managed schemes will accumulate large pools of “patient” capital to invest. Trustees and asset managers, acting on behalf of pension scheme trusts, could be substantial shareholders who take an active and responsible role in the development and maintenance of robust corporate governance practices.

The following analysis is undertaken keeping in mind the same principles underlying our review of the compulsory schemes: the policy goals of pension “security”, “adequacy,” and “sustainability.” In the context of voluntary, occupational schemes, the issue of “security” focuses on the regulatory and supervisory environment within which employers establish and operate pension schemes for their employees. Generally, the rules relating to “security” are structural and procedural in nature. We focus our attention below on two deficiencies that substantially undermine the security of pension assets and benefits: the weak and fragmented regulatory and supervisory oversight of voluntary schemes, and the absence of comprehensive governance requirements.

“Adequacy” focuses on the level of benefits provided by schemes and to whom they are provided. The “adequacy” of benefits may be addressed by establishing
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substantive legal requirements and limitations in scheme design. For example, regulations could specify the extent to which a scheme is required to include all or a certain percentage of an employer’s workforce, the distribution of benefits paid among different groups of workers, and the level of benefits a scheme member would accumulate over the course of his or her career. The “adequacy” of the benefits the UVOPs provide can be defined only by reference to the supplemental role they are intended to fulfill, and the government can develop detailed regulations pertaining to adequacy only after it has determined what benefits the compulsory schemes are to provide. The key concerns we discuss below are similar to those discussed in the context of the compulsory schemes: scope of coverage, pre-retirement access to assets, portability, and form of pension paid.

The concept of “sustainability” overlaps with the concepts of both “security” and “adequacy.” A scheme’s “sustainability” is a matter of both substantive obligations (such as contribution and funding requirements) and procedural rules (such as rules regarding the manner in which contributions are deposited, the custody and investment of assets, and the accounting and audit of these functions), which ensure that the scheme is able to pay future benefits when due. Two of the key elements associated with “sustainability” are funding levels (especially in the case of defined benefit schemes) and the prudent investment of scheme assets, each of which is addressed in our analysis.

The following analysis of the deficiencies in India’s regulation of voluntary occupational pension schemes includes the topics identified above:

- regulatory and supervisory oversight,
- scheme governance,
- scope of coverage,
- pre-retirement access to assets,
- portability,
- form of pension paid,
- funding of defined benefit schemes, and
- prudent asset management.

**Regulatory and supervisory oversight**

Although there are substantial weaknesses in the current regulation and supervision of NPS and the EPFO-managed schemes, the voluntary occupational pension schemes are certainly the most dangerously neglected. Currently, there is no regulatory or supervisory body that has been clearly designated as the entity primarily responsible for oversight, and, to the extent that an entity is responsible for an aspect of regulation or supervision, that responsibility is only one among its many responsibilities—and not a high priority. If there can be said to be a primary or lead regulatory and supervisory body responsible for the oversight of the UVOPs, it is the tax authority, the CBDT, but it has not actively regulated or supervised the schemes, and its reach extends only to those schemes for which employers seek to claim a tax exemption.11
In those cases where the employer does not seek tax recognition of its scheme, however, the scheme is subject to no active regulatory or supervisory oversight, and the applicable legal framework is minimal:

- If the employer chooses to fund the scheme and establishes a scheme trust to do so, the trust must comply with the Indian Trust Law.
- Certain financial products in which the employer (or trustee) elects to invest pension assets may be regulated by either SEBI or IRDA.
- The government issues an investment pattern that identifies permitted categories of investments and related portfolio limitations.

The consequences of this regulatory and supervisory vacuum are the following. First, little protection is available to employees and scheme members. The only recourse they may have is the courts. The ability to institute a lawsuit, however, assumes that the employee or scheme member has some access to scheme rules (the written disclosure of which is not required), can state a legitimate cause of action, and is able to provide adequate factual support for the claim. It also assumes the employee or scheme member has the wherewithal to take such action. Because of the substantial asymmetries of information, financial wherewithal, and power between employers and their employees, such protection is surely inadequate.

Second, the government has very little information upon which to base policy analysis, regulatory intervention or supervisory action. A robust regulator would require annual reporting, and a proper supervisor would be regularly engaged in inspection activities. Moreover, if there is no governmental entity to which employees and scheme members can report complaints, including suspected mistreatment or malfeasance in scheme management, many significant problems in scheme management will remain undiscovered. Furthermore, if employees and scheme members themselves have inadequate information about their scheme rules, they themselves may not even understand when they are being improperly denied pension or pension accruals. Put another way—one might argue that there is a silent crisis, because there is little likelihood that any improper pension scheme management would come to the attention of policy makers, scheme participants, or the press.

It is imperative that the Indian Government implement a robust regulatory and supervisory framework for the UVOPSs to address this glaring deficiency. Because there are so many similar and overlapping concerns among the various pension schemes, a single, consolidated regulator could be charged with the oversight of the voluntary occupational schemes established by employers—as well as supervision of the NPS and EPFO. The primary responsibilities of the “Pension Regulator” would be to:

- establish and implement regulations to ensure the proper establishment, governance, and administration of employer-sponsored schemes;
- implement relevant legislation and the government’s pension policy;
• ensure that employees and other scheme members receive proper information about their scheme and their rights thereunder and have access to a grievance procedure;
• ensure the schemes are prudently funded and assets properly held and invested;
• establish and implement reporting requirements for employers and schemes;
• supervise employers and schemes to ensure compliance with laws and regulations;
• coordinate with other relevant regulatory and supervisory bodies, such as the tax authority and financial regulators and supervisors; and
• support the collection and assessment of data, research, and analysis necessary to implement and amend regulations, adjust supervisory priorities, and inform government’s future policy considerations.

The government should consider assigning the regulatory and supervisory responsibilities described above to the Pension Fund Regulatory and Development Authority (PFRDA). The government may assign these responsibilities to other, existing Indian authorities, of course, but none of these authorities has any greater expertise in pensions and, more importantly, none would be able to make pension regulation and supervision its priority. For example, as we have already discussed, the CBDT has not been able to devote proper resources to pensions. Although a case could be made that SEBI or IRDA could be assigned these responsibilities, in each case, the tasks of regulating and supervising pension schemes would take second place to their primary missions. Therefore a “new” independent body is the best choice, so long as it is adequately funded, imbued with sufficient authority, and mandated to develop the resources and knowledge necessary to successfully regulate and supervise. The PFRDA is a new authority that has largely completed its “developmental” mission with respect to NPS and which already has some basic infrastructure in place. Earlier in this book, we recommended that the PFRDA reduce its role in the operation, administration, and implementation of NPS by delegating the responsibility for daily functions to the NPS Trustees, so that it could function as NPS’ supervisor. The supervision of NPS alone, however, may be a rather narrow remit. It would make a good deal of sense for the PFRDA to also take responsibility for the oversight of the EPFO and related schemes, as previously recommended, and the UVOPs, which supplement the benefits the EPFO schemes provide. This proposed expansion of the PFRDA’s responsibilities, in fact, is consistent with the purpose for which it was established (to “regulate and develop the pension market”) and the scope of its current authority (sufficient to “enable it to effectively regulate, promote, and ensure the orderly growth of the pension market”).

**Scheme governance**

One of the most significant gaps in the regulation of India’s voluntary occupational pension schemes relates to scheme governance. The permitted scope of the
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Substantive provisions of a pension scheme can be debated among policy makers and stakeholders, taking into account social protection needs, pension policy, and the realities of the labor market. The required minimal levels of coverage and contribution, the extent to which employers will establish voluntary schemes, and the value of the benefits they provide may each be adjusted over time in response to the successes and failures of policy decisions, the ebb and flow of labor market supply and demand, and a number of other, similar factors. But regardless of the substantive rules—whatever the bundle of benefits developed in this cauldron of political, policy, and business imperatives—all is meaningless unless the schemes are properly set up and operated. Without a proper, structured set of governance rules, schemes are destined to be mismanaged and subjected to abusive practices. Occupational pension schemes are particularly vulnerable to potential abuse for a number of reasons. First, when properly funded, there can be a great deal of capital associated with a scheme, and, without proper regulation, supervision, and governance, pension assets are a tempting target. Second, an employer’s interests and those of their employees and the pension scheme are not always sufficiently aligned, nor are those of other parties involved in pension fund management.

A breakdown in the basic elements of governance can be utterly devastating to a pension scheme or similar enterprise. In the case of pensions, the failure may result in enormous difficulties for older workers and pensioners relying on the income their pension schemes were to provide. More broadly, one substantial, newsworthy scandal could taint the entire occupational pension system and undermine employee confidence in it. By contrast, proper governance protects pension assets and the rights of scheme members. Studies have suggested that well-governed pension funds can enjoy investment returns of between 100 and 300 basis points per annum above other funds.

The Indian law, however, does not currently impose sufficiently robust standards of governance, and the minimal standards imposed fall below international norms. There are at least two sets of “recommended practice standards” for pension scheme governance that have been used widely—the OECD guidelines on pension fund governance, which have also been embraced by the International Organization of Pension Supervisors (IOPS),15 and the set of guidelines issued in the UK in its “Myners’ Report.”16 These standards are useful benchmarks against which to measure the current governance of the UVOPSs. Similarly, corporate governance practices, by analogy, may also provide a useful reference for the development of governance requirements for pension schemes. Because India has a long-standing trust law dating from the 19th century, growing financial services and securities industries, and substantial professional capacity, there is little reason that such standards cannot be satisfied if policy makers and law makers choose to require employers sponsoring schemes and scheme trustees to do so.

In the analysis below, the topic of governance is divided into two areas: the “internal” and “external” aspects of governance. The “internal” aspects of governance include the basic internal structure of a pension scheme organization,
including the scheme document (sometimes referred to as the scheme rules, or the scheme’s constitution), the assignment of responsibilities among the employer sponsoring the scheme, scheme trustees and other parties, and the legal standards under which these parties are expected to act. The “external” aspects of governance include the roles of scheme members, who should be empowered to take action on their own behalf or on behalf of the scheme; the custodians, who hold scheme assets; the asset managers whom trustees may retain to invest scheme assets; and the independent, qualified accountants and, in the case of defined benefit schemes, actuaries, who review the operations and finances of the scheme.

**Internal governance**

There are few and wholly inadequate rules and regulations addressing the “internal” scheme governance of the UVOPSs. The governance-related rules that do exist appear in the following contexts:

- Exempt Provident Funds must adhere to rules established by the EPFO;
- tax-recognized Provident Funds, approved Superannuation Funds (and, similarly, approved Gratuity Funds) must adhere to tax rules; and
- schemes which employers otherwise fund by establishing a trust adhere to the provisions of the Indian Trusts Act, 1882.

But these rules are limited in scope, fail to adequately address a number of key areas of “internal” governance matters, and do not apply to all voluntary schemes, regardless of type and regardless of tax status. For example, rules in the following areas are deficient:

- the establishment of the scheme rules in writing,
- the segregation of scheme assets from those of the employer,\(^{17}\)
- trustee qualifications and rules for addressing conflicts of interests,\(^{18}\)
- fiduciary standards of conduct applicable to a person with authority to operate the scheme and/or manage its assets, including but not limited to trustees,\(^{19}\) and
- financial and procedural audits of the scheme.\(^{20}\)

The failure to impose uniform rules to ensure the safekeeping of scheme assets is one of the most troubling gaps in current regulation. Thus, assuming an employer elects to fund its pension scheme, it need not necessarily clearly segregate the scheme’s assets from its own funds, unless it has also elected to comply with the applicable tax rules, which, in most (but not all) cases, require that the scheme assets be held in a trust established for this purpose.\(^{21}\)

Notwithstanding the deficiencies in current regulation, a new pension regulator responsible for promulgating proper governance rules for the UVOPSs has available two solid foundations upon which to build a comprehensive, sound, and
uniform regulatory structure: the EPFO’s requirements for the Exempt PFs and the standards imposed under the Indian Trusts Act. For example, the Indian Trusts Act includes specific provisions addressing the following important topics:

- Fiduciary obligations: sections 11, 12, 13, 15, and 36 of the act.
- Conflict of interest and self-dealing prohibitions: sections 14, 23, 51, 52, 54, 60, and 88 of the act.
- Fit and proper requirements for trustees: sections 10 and 60 of the act.22

Overall, regulations addressing “internal” scheme governance should ensure that the schemes are properly governed in a prudential manner for the exclusive benefit of their members. This may be achieved by developing regulations that would:

- require that all schemes have written scheme rules, which are to be followed and maintained by scheme trustees, and which are to be understandable to the average scheme member and properly disclosed to them;
- require the establishment of a trust to hold scheme assets, the trustees of which are to implement and maintain the scheme in accordance with its rules and manage the scheme’s assets, which are to be held under the trust instrument;
- ensure that the trustees charged with the overall management and administration of the scheme and its assets will be fit, proper, and qualified, by establishing standards pertaining to their prerequisite skills and qualifications, responsibilities, and liabilities;
- apply the highest fiduciary standards and obligations to employers, trustees, and other persons with any discretionary control over scheme assets, or other substantive aspects of scheme administration, such standards and obligations to be tailored specifically to the context of pension fund administration and asset management, and which should include conflict-of-interest rules and prohibitions; and
- impose further requirements that provide third-party oversight of scheme management, including annual reporting requirements to enable the efficient and effective supervision of employers and schemes to ensure that they remain in full compliance with regulations, and other measures addressed below under “external governance.”

One of the key aspects of scheme governance that the government and policy makers will need to address is the extent to which employers may, or should, remain in control of scheme administration and asset management (including by acting as the sole trustee of the scheme), and the extent to which control should be delegated to unaffiliated third parties. They should also consider the feasibility and value of requiring employee and scheme member representation on a scheme’s board of trustees. If employers are to play a role in governance,
their potential conflicts of interest must be adequately considered and properly addressed. Similarly, if the employer is permitted to control its scheme’s board of trustees, for example, by appointing its own corporate officers as trustees, then, at a minimum, the regulations should require that an unaffiliated custodian be appointed to hold scheme assets.

It can be difficult to adequately address employers’ conflicts of interest in the context of schemes that they establish voluntarily. An employer involved in scheme governance has an inherent conflict of interest, because its self-interest in establishing, maintaining, and funding a pension scheme will not always coincide with its legal obligations as a trustee or other fiduciary with obligations to the scheme and its members. In the United States, this troubling conflict has been acknowledged by the courts, and an uneasy doctrinal accommodation made: the so-called “two hat rule.” The litigation, which arose as a result of the bankruptcies of the Enron and Worldcom firms in the United States, which is briefly discussed in the accompanying footnote, highlights the fundamental conflict between an employer’s fiduciary duty to a pension scheme and its members, and its duty to its business and its shareholders.23 One of the most infamous demonstrations of this fundamental conflict occurred in the United Kingdom in the early 1990s, when Robert Maxwell, a newspaper publishing magnate, embezzled money from his companies’ pension funds to keep his businesses afloat. The recent Madoff scandal in the United States did not directly concern pension schemes, but schemes were investors in Mr Madoff’s investment funds, among many other investors; it too provides a cautionary lesson.24

When considering this issue, policy makers should keep in mind the fact that voluntary occupational schemes are, in fact, voluntarily established by employers, who legitimately will desire some control. Employers, of course, will retain important aspects of control over the schemes they establish, because they will retain the authority to define and amend scheme rules and to terminate their schemes, within the framework of proper regulations. Boards of trustees provide independent and objective oversight, and strong, independent trustee boards can add substantial value to a scheme for scheme members—and for the employer sponsor. A responsible board can reduce an employer’s financial and legal exposure, mitigate risks of imprudent investment decisions, mismanagement, and improprieties, and increase their employees’ feelings of security in the benefits the employer has promised to provide.

External governance

In addition to employers and scheme trustees, a number of other parties should play an important role in scheme governance. Not least of these are a scheme’s members themselves, who have an interest in monitoring pension fund trustees and pension scheme operations. In addition to the oversight role that members may perform, the role of others is equally important. These include the accountants who audit scheme finances, the actuaries who evaluate
defined benefit liabilities, and the other third-party service providers to schemes, such as investment managers and custodians. Each is vital to ensuring that various aspects of scheme operations are regularly reviewed by disinterested, nonaffiliated professionals. Any reformation of the current regulatory framework should consider improving scheme governance by taking the following steps:

- providing fundamental rights and protections for scheme members, including disclosures, grievance processes, and the protection offered by imposing fiduciary obligations on trustees and other relevant parties;
- requiring the third-party custody of scheme assets;
- requiring the audit of scheme finances and operations by qualified, independent auditors, and similarly, requiring the actuarial valuation of a scheme’s accrued and projected benefit obligations by qualified, independent actuaries in the case of schemes providing defined benefits.

We address each of these in turn.

SCHEME MEMBER RIGHTS AND PROTECTIONS

Armed with proper information and a fair grievance process, members would be more likely to understand their rights and obligations and take action to protect their right to participate and accrue benefits in voluntary occupational schemes. Under current Indian law, however, employers are under no legal obligation to provide adequate information to their employees about the schemes that they sponsor for their workforce, or to ensure that their employees obtain promised benefits under their schemes. Specifically,

- Information currently provided to scheme members is insufficient. 25
- There is no requirement to provide a grievance process to scheme members.
- Because employers do not have an obligation to establish a scheme trust, not all employers do so; absent the formation of a trust (and the corresponding appointment of trustees), there are no fiduciary obligations imposed on those responsible for managing the scheme to do so for the exclusive benefit of scheme members.

All three elements—disclosure of information, availability of a grievance process, and the protection of scheme members that is provided by trustees with a fiduciary obligation to do so—are critical for the successful protection of scheme member rights.

First, without information about the scheme, it is difficult for members to understand the extent of their right to participate in the scheme or how their benefits accrue, and difficult to monitor the operation of the scheme. 26 Second, without a fair and accessible grievance process, employees, scheme members and
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pensioners are not able to register complaints, challenge the determinations of scheme managers, raise questions about the scheme’s operation or management, and enforce their rights under the scheme rules, including rights pertaining to their eligibility to participate in the scheme, the rate at which benefits accrue or contributions are made to individual accounts, the timely remittance of contributions, and other similar matters. In addition to having access to a grievance process, scheme members should have the ability to submit complaints to the governmental authority charged with overseeing voluntary schemes, and standing to bring a civil action to the courts on behalf of himself, the scheme, and other scheme members.

Members themselves, if armed with sufficient access to information and an accessible grievance process, can play a significant role in scheme governance by monitoring the performance of the scheme. For example, the provision of an annual benefit statement enables a member to monitor his benefit accrual, the value of contributions made to the scheme on his behalf and the timeliness of remittance and, in the case of a defined contribution scheme, the investment return on his account balance. Access to the scheme’s annual reports, audit reports and opinions and, in the case of a defined benefit scheme, actuarial valuations, provides members with the opportunity to review the overall health of the scheme and its operations. Because it is unlikely that supervisory authority could review all schemes on a frequent basis, the ability of members to do so is an important aspect of ensuring the stability, security, and sustainability of pension schemes.

Notwithstanding the important role that scheme members themselves can play in protecting their own rights and entitlements even when armed with information and accessible avenues to pursue grievances, scheme members do not always feel they are able to protect their own interests under an employee benefit scheme as a result of the asymmetries of power and knowledge between employers and their employees. Therefore, it remains crucial that the law also clearly impose fiduciary obligations on scheme trustees (and other persons with authority to take decisions on behalf of the scheme) to act exclusively in the interest of the scheme and its members.

INDEPENDENT THIRD-PARTY CUSTODY OF SCHEME ASSETS

None of the tax rules applicable to the various voluntary occupational schemes address the custody of scheme assets. (By contrast, the NPS employs a custodian, in addition to the NPS trustees.) Qualified, unaffiliated custodians provide an additional level of protection to assure the safekeeping of scheme assets. The previously referenced Maxwell and Madoff scandals, which are discussed in Appendix 1, are each compelling illustrations (in the breach) of how independent custody can play an important role in preventing the misappropriation of scheme assets and potential trustee malfeasance. Neither of these scandals would have occurred if there had been properly trained, attentive custodians holding scheme assets. Indeed, absent third party custody and regularly conducted third
party audits, discussed below, the misappropriation of scheme assets may simply go undetected.

INDEPENDENT, THIRD-PARTY AUDIT AND ACTUARIAL VALUATION

At present, in India, there are no regulations in place that require all voluntary occupational schemes to obtain an audit annually from an independent, qualified auditor. The tax rules applicable to “registered” Provident Funds, for example, require only the timely preparation of accounts and establish reporting requirements (Rule 74). By contrast, the conditions the EPFO has established for Exempt Provident Funds are more stringent. Exempt PFs are subject to audit annually by a qualified independent chartered accountant; the Exempt PF’s Board must submit the audited balance sheets to the EPFO; and the Board must retain a different auditor every 2 years (Conditions Nos 16, 24).

Similarly, there is no explicit requirement that the scheme trustees (or employer) of defined benefit schemes engage an actuary to conduct an actuarial valuation to determine the scheme’s long-term liabilities and funding obligations. (Except in the case of a scheme registered under the tax law, of course, there are no funding requirements imposed at all, an issue discussed below.) The establishment of standards and methodology has been left to the accounting and actuarial professionals. On the whole, this is an appropriate and sound approach, but there needs to be something more than self-regulation by the two professions, and clear legal obligations established for employers, auditors, and actuaries.

The only “requirements” currently in place pertaining to defined benefit liabilities arise under the accounting standards. Accounting Standard AS-15(Revised) requires employers to accurately reflect defined benefit scheme liabilities on their balance sheets. The rule requires an employer sponsoring schemes to record the net pension assets and liabilities on its balance sheet using a method that includes a valuation of the long-term liabilities, rather than only the annual, pay-go obligations. By reflecting these long-term liabilities on the firm’s financial statement, AS-15 provides important information to a firm’s shareholders and investors and is an incentive for some employers to improve their schemes’ funding status. Because the application of AS-15 can have a significant impact on a firm’s balance sheet, its implementation has been controversial. Prior to its introduction, scheme liabilities could be kept off the balance sheet and amortized over a number of years.

Audit requirements and, in the case of defined benefit schemes, also actuarial valuations, are crucial components of robust pension scheme governance and critical to ensuring the security of pension assets. Without well-articulated audit and actuarial standards, and a requirement that schemes be audited on an annual basis, this security could be compromised. For this reason, the trustees of pension and similar schemes should be required to obtain independent financial audits of the schemes and assessments of the scheme’s assets and liabilities annually, utilizing independent, licensed professionals, including properly credentialed accountants and actuaries, who are unaffiliated with the trustees or sponsoring employer.
When implementing regulations to address these concerns, the following requirements should be considered:

- The audit client should be the scheme, not the employer, and the auditor should be engaged by the scheme trustees.
- The auditor should be retained for no more than 2 or 3 consecutive years.
- Trustees of schemes with defined benefit liabilities should retain an actuary to produce actuarial valuations of liabilities.
- The audit should include a procedural audit that would assess the extent to which IT systems, standardized workflow, and risk management processes are in place, are sufficiently robust, and are implemented.
- The accountants and actuaries retained by scheme trustees should be appropriately trained and licensed.
- The regulator should establish proper parameters and uniformity in methodologies and assumptions used by accountants and actuaries, taking note of professional rules, standards, and standard-setting bodies within professional organizations and the importance of enabling the proper exercise of professional judgment and guidance to clients.
- Auditors should produce clean, unqualified opinion letters to accompany annual reports that scheme trustees are required to submit to the regulator; if unable to obtain a clean opinion, scheme trustees (or, upon their failure to do so, the auditor) should be required to immediately inform the regulator.
- Annual reports should include the opinions and reports of the auditor and actuary.
- There should be sufficient supervisory resources dedicated to the review and analysis of reports and audit opinions, enforcement of reporting obligations, and any related inspection and investigative functions.

**Scope of coverage**

Currently, there are no coverage, participation or “nondiscrimination” rules that would require employers to ensure their voluntarily established schemes reach beyond a narrow band of the workforce, such as company executives and managers. There are many different ways to design such rules. For example, the government could require that a minimum percentage of an employer’s total workforce be included in its pension schemes, or that the percentage of employees who are eligible for scheme membership be similar to the percentage of managerial and highly paid employees who are eligible for membership. Similarly, the government could institute rules regarding the relative value of benefits accruing to, and earned by, each group.

Determining whether the government should impose such coverage requirements on schemes that are voluntarily established by employers requires the consideration of a number of different factors, including the extent to which voluntary occupational schemes will be relied upon to provide retirement income security, whether employers use schemes as a labor management tool
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(the effectiveness of which could be compromised by coverage rules), the value of the tax benefits which employers obtain for establishing and maintaining schemes (and, correspondingly the government’s loss of tax revenue), the cost such rules would impose on employers, and whether the rules would discourage employers from maintaining schemes. Policy makers will need to balance the costs and benefits of different types of coverage rules, in order to derive an outcome that results in covering as much of the workforce as possible in voluntarily established occupational schemes at a reasonable cost. Because employers may provide coverage on a tax-advantaged basis, the government, by foregoing revenues in exchange for an employer’s establishment of a pension scheme, is, in effect, “buying” coverage. On the other hand, the cost imposed on an employer of covering more employees, rather than only its preferred groups of employees, may exceed the cost the employer is willing to pay, resulting in less scheme formation.

Pre-retirement access to assets

Pre-retirement uses of account balances significantly undermine the ability of schemes to generate pensions. It follows that if the purpose of pension schemes is to provide pension income, then payments at termination of employment (prior to pensionable age) should be eliminated, or extremely limited. Similarly, the opportunity for scheme members to take pre-retirement withdrawals or loans from their scheme account balances should be prohibited or limited to exceptional situations. Pre-retirement access to accrued account balances merely reduces pension accumulations and defeats the purpose of the schemes. However, in setting policy and developing regulations addressing pre-retirement access, it may be appropriate to distinguish compulsory schemes from supplemental voluntary schemes. In the case of supplemental schemes—and especially voluntary employee contributions—the rules regarding pre-retirement access could be more flexible than the rules for compulsory schemes and compulsory contributions.

Under the current tax rules, members participating in Exempt and Excluded Provident Funds registered with the CBDT may take pre-retirement withdrawals from their PF accounts for a number of different purposes. This pre-retirement access is similar to the access permitted under the EPF rules. Applying the EPF standards may make sense, in the case of the Exempt PFs, because their very purpose is to provide benefits in lieu of those provided by the EPF. (Consistent with their purpose, under section 17 of the EPF Act, the benefits provided on the whole must be equal to those provided by the EPF.) In the case of Excluded Provident Funds, however, it is less clear as a matter of policy that the rules should necessarily be identical to those of the EPF, because the Excluded PFs are usually providing a supplemental benefit, for example, by topping up EPF contributions based on employees’ income above the EPFO’s maximum wage base of Rs6500. The policy decision regarding how much pre-retirement access to permit must balance the extent to which the supplemental schemes
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will be relied upon—in conjunction with the compulsory schemes—to generate “adequate” pension income with other policy imperatives addressed by pre-retirement access to account balances. The greater the assigned role of the supplemental schemes in producing “adequate” pensions, the lesser the pre-retirement access that should be tolerated. As we suggest above, voluntary employee contributions could be subject to a different rule than employer contributions; similarly, it may be possible to design a provident fund with dedicated subaccounts similar to the Tier II savings account provided by the NPS.

Portability

As we have already noted in the context of the EPF and Exempt Provident Funds, portability of pension accruals is an important matter, especially in an environment where workers are increasingly mobile. The tax rules currently permit—but do not require—a tax-recognized Provident Fund to accept assets transferred from other similarly tax-recognized PFs. If the PF of an individual’s new employer does not permit the transfer of assets, the job-changer will either leave his or her account balance in his or her prior employer’s scheme or take a distribution of the balance at severance of employment. In the latter case, the former scheme member will simply spend the assets—a result contrary to the primary purpose of the scheme. In the former case, the person’s pension savings will be scattered across employers during the course of his or her career. It is probable that many individuals will forget about the smaller account balances over time, even as their accounts accrue decades of investment returns. Similarly, the former employers and the scheme trustees may lose track of the whereabouts of the departed employee and scheme member. It is vital that the law ensure better outcomes. There are a number of steps that the government should take, as well as others that it should consider taking.

First, the government should require schemes to accept, rather than permit them to accept, transfers from the PFs maintained by an employee’s previous employers. Correspondingly, former employers (and scheme trustees) should be required to effectuate a timely transfer upon the request of a former employee. Second, employers or scheme trustees should be required to fully inform individuals (both at the commencement and the termination of employment) of their right to transfer vested benefit amounts and explain the transfer process. Third, if a former employee does not elect to transfer pension assets, the employer and scheme trustees should be required to retain the accounts and records, make reasonable efforts to maintain a current address for the former employee, and provide him or her with an annual account statement. Fourth, standardized operational and communication protocols should be established to ensure that such transfers are completed without administrative difficulty. Fifth, employees should not be permitted to take a distribution of the pension benefit upon severance of employment. (If severance is the result of
employer bankruptcy or workforce reductions, the necessary social protection measures should be taken outside of the schemes.)

In addition to these rules, policy makers should consider the feasibility of requiring portability among defined benefit schemes. In the case of defined benefit schemes, the regulator would need to define the manner in which the present value of a member’s accrued benefit is determined. (Permitting a former member the opportunity to transfer assets from a DB scheme, of course, assumes the DB scheme is sufficiently funded.) Finally, the extent to which portability may be limited by the distinctions among types of pension schemes should be assessed. Ideally, portability rules should permit individuals to transfer assets from one type of scheme to another. For example, perhaps former employees should be permitted to transfer assets from an Excluded or Exempt PF to the NPS or EPF, or from a DB scheme to a DC scheme or Superannuation Fund. If such transfers are permitted, it will be important to make sure that those individuals who elect to effectuate such transfers understand the extent to which scheme rules differ.

Form of pension paid

Currently, pensions paid from voluntary occupational pension schemes are often paid as lump sums. There is no prohibition against making such payments from UVOPPs, except to the extent limited by the tax recognition requirements. As we have discussed in the context of the compulsory schemes, the payment of pensions in the form of lump sum payments reduces the long-term, retirement income security provided by the schemes. Individuals handed a lump sum may spend the amounts down too quickly, failing to account for their potential longevity. Generally, annuities or periodic payments provide a more sustainable pension. The government should eliminate or reduce the availability of lump sum payments of pensions in order to ensure that pension accumulations are rationally spent down over the projected life expectancies of pensioners.

Scheme funding

Today’s UVOPPs are unsustainable, because there are no minimum funding or financing requirements imposed upon employers that voluntarily sponsor and maintain pension schemes. As a result, many schemes, whether defined contribution or defined benefit, may be substantially underfunded, or not funded at all. Furthermore, even if an employer chooses to fund its scheme, there are no requirements that the assets contributed to the scheme be segregated from the employer’s own assets. In the case of a defined contribution scheme, the lack of minimum funding standards may result in employees accumulating small account balances and, thus, being paid inadequate pensions. In the case of a defined benefit scheme, the failure to promulgate minimum funding standards will likely result in the substantial underfunding of the scheme’s liabilities, undermining the sustainability of the scheme.
**Defined contribution schemes**

Under current Indian law and regulations, an employer has no obligation to fully fund its defined contribution obligations. Because of the absence of regulations, the only legal obligation, if any, would be a contractual one. Whether there is a contractual obligation depends on the language in the scheme rules or the employer’s employment contracts with its employees. Because employers control the drafting of these documents, they can limit the extent of any contractual commitment to fund a scheme. In addition to their contractual obligations, employers who choose to obtain tax recognition of their schemes must comply with the tax rules. However, neither the tax rules for “recognized” Provident Funds nor those for “approved” Superannuation Funds require employers to make timely contributions to their scheme.³⁸

Similarly, to the extent the tax rules require scheme assets be held in a trust, there are no requirements that the trust deed contain conditions relating to an employer’s obligation to properly fund the scheme; nor are there requirements that the trust deed include provisions relating to the timely remittance of the employees’ contributions to the trust for those schemes that are funded, in whole or in part, by employees’ contributions withheld from pay. Moreover, in those cases where an employer elects to voluntary fund its defined contribution pension scheme, there is no requirement that the contributions be made to an “irrevocable” trust, except in the case of a “recognized” Provident Fund.³⁹ Thus, the employer could always use the assets contributed to the scheme (an all accumulated earnings) for its own benefit, and, presumably, the assets would be available to the employer’s creditors.

**Defined benefit schemes**

The tax law provides little guidance for the funding of defined benefit pension schemes. Absent any legal obligations, many employers may find it convenient to manage their liabilities on a pay-go basis. As is the case for an employer sponsoring a defined contribution scheme, an employer sponsoring a defined benefit scheme may have a contractual obligation to fund its scheme, arising from provisions of the scheme rules or employment contracts. If there is a contractual obligation, however, it would likely take the form of a legal obligation to pay the owed benefit, rather than to pre-fund the benefit obligation, similar to the obligation to pay gratuity imposed under the PGA.

Estimating an employer’s liability for defined benefit scheme benefits (the actuarial valuation of a scheme) requires the professional assistance of an actuary, but there is no legal requirement to engage a qualified actuary to do so—and no regulation of the methods and assumptions the actuary may use. Thus, even if an employer is committed to properly funding its defined benefit scheme, the scheme, nonetheless, could be underfunded if the employer has not consulted with an actuary to estimate the liabilities—or if the actuary has used unreasonable assumptions. (Indeed, even with the assistance of a properly-trained actuary making appropriate assumptions, the assumptions may need to
be reviewed, compared against the scheme’s actual experience, and adjusted on a regular basis.) The methods and assumptions an actuary uses have a direct bearing on the calculation of an employer’s funding obligations.\textsuperscript{40}

\textit{MINIMUM FUNDING REQUIREMENTS}

Regardless of the type of scheme an employer has established, whether a defined contribution scheme (including all Provident Funds and Superannuation Schemes) or defined benefit scheme (including Gratuity Funds and Superannuation Schemes designed as DB schemes), employers must be required to remit due and owing contributions on a timely basis to a trust. Regulations could additionally require the employer to explicitly state in the scheme rules the amount of contributions that it expects to make annually to the scheme. The regulations could include provisions providing limited relief to employers who may not be able to fund the scheme in a given year. Without any regulations, however, it is likely that many schemes will be inadequately funded. In the case of defined benefit obligations, the regulations should include a requirement to obtain an actuarial valuation on a regular basis (annually may not be necessary) from an actuary who is determined to be “fit and proper” by the regulator, in order to make a prudent determination of annual funding obligations under guidelines developed with the assistance of the actuarial profession.

\textit{IRREVOCABILITY OF AMOUNTS EMPLOYERS CONTRIBUTE TO SCHEMES}

As we have previously emphasized, hand in hand with any funding requirements imposed on employers sponsoring DC and DB schemes, it is vital that employer (and employee) contributions to the schemes be irrevocably paid, clearly segregated from the employer’s own assets, and inaccessible to the employer and its creditors. A trust is an ideal legal form for this purpose, but there may be other instruments that achieve the same result, such as properly structured insurance contracts.

\textit{RECORD-KEEPING REQUIREMENTS}

Scheme trustees, should have access to complete and accurate records and information necessary to maintain individual account records (and to credit account balances with contributions in the case of defined contribution schemes, and to calculate accrued benefits in the case of defined benefit schemes). In the case of defined contribution schemes, interest, and earnings should be required to be credited on a regular basis. In the case of defined benefit schemes, actuaries will require access to different records, including the data needed to make actuarial assessments, such as work and salary histories, turnover rates, and dates of birth. Much of this information is controlled by the employers sponsoring the schemes, who should be required to provide it to trustees (and to other persons responsible for record keeping for the scheme). In turn, the trustees and record keepers should
be required to properly retain the information for a specified period of years so that it is both secure and accessible to those persons who are required to use it to fulfill their obligations to the scheme.

**TRANSITION RULES TO ADDRESS FUNDING AND RECORD-KEEPING DEFICIENCIES**

In the absence of regulations requiring employers to do so, it is likely that many of them have not been properly funding the pension schemes that they have established voluntarily. If funding rules are imposed under new regulations, as recommended, the rule should explicitly address the manner in which the outstanding obligations that accrued prior to their effective date are to be funded. Requiring an employer to make a single lump sum payment of its outstanding liabilities to its scheme(s) will likely be unrealistic and onerous—and it is certain to be viewed as unfair. Given the voluntary nature of these schemes, unreasonable rules will discourage employers from maintaining their schemes and result in their electing to terminate them. Therefore, employers should be required to make their schemes whole for these previously accrued liabilities by amortizing the obligations over a reasonable number of years. In the case of employers with defined benefit liabilities, the reduction of the outstanding obligation over time will substantially improve the sustainability and security of the schemes. In the long run, imposing a requirement to fund these outstanding liabilities should also improve the balance sheets of the sponsoring employers. In the case of defined contribution schemes, there will need to be some assumptions made about the rate of return that should be used when calculating liabilities for unpaid contributions arising in this period. Presumably the liability would then be treated in the same manner as a fixed defined benefit obligation to the scheme for accounting purposes.

Undoubtedly, there will be cases in which record keeping by employers has been deficient, making the calculations of outstanding liabilities difficult to calculate. For example, those employers who have failed to make proper contributions to their defined contribution schemes are unlikely to have maintained individual account records for scheme members recording the amounts owed. In fact, in such circumstances, it is unclear how a scheme member’s benefit (the account value at retirement) is currently being calculated. In theory, contributions and interest earned could be calculated from historical data, but it is difficult to imagine that an employer that has not regularly been funding its defined contribution scheme is currently using a defined methodology to calculate the value of the (notional) account balances when it pays benefits under the scheme. Nor is the employer likely to have the records available to do so. Similar issues will need to be addressed in the defined benefit context as well. Regulations should include guidance on how these situations are to be addressed.

**Prudent asset management**

Once assets are contributed to a scheme, they must be properly and prudently invested. There are at least four fundamental issues that must be adequately
addressed to successfully ensure the proper investment management of scheme assets. First, the investment management function should be assigned only to fit and proper individuals who are properly licensed and suitably knowledgeable about asset allocation and investment products, and who are required to understand the scheme rules and the short- and long-term needs of the scheme and its members.

Second, the law should impose a robust legal obligation on investment managers to act in a fiduciary capacity for the sole and exclusive benefit of the scheme and its members when investing scheme assets or advising scheme trustees. Neither of these requirements is explicitly set forth in current law or regulation.

Third, the governance framework within which the investment management function is conducted must support prudent behavior and reduce the likelihood of imprudence. For example, the law should require the scheme trustees to be responsible for selecting, monitoring, and overseeing the investment managers, and require that the trustees establish a written process by which they do so, such as an investment policy. Similarly, contractual arrangements between the trustees on behalf of the scheme and investment managers, advisers, and other consultants should be written and transparent. The governance framework should also provide rules and processes to address any conflicts of interest that any of the parties involved in scheme asset management may have. Although those schemes that utilize trusts may include provisions in their trust deeds that address these matters—and the trust law may impose a broad fiduciary obligation on trustees the scope of which would require them to develop an investment policy, monitor investment managers they hire, and so forth—the regulations should address these matters directly.

Fourth, the regulator should impose appropriate substantive limitations on the range of permitted investments for scheme assets to reduce the risks associated with the investment management function by requiring that the scheme assets be invested in a diversified portfolio of investments and prohibiting particularly risky and unsound investments and investment practices. At the same time, the regulations should be designed to permit scheme trustees to design investment policies and select the investment managers that they determine are best suited to the needs of their scheme and reflect best practices in the investment management industry. The regulations should support a competitive market environment for investment management services in which scheme trustees can hire investment managers on the basis of performance and price.

Under current Indian law, the investment management decisions of the trustees of voluntary occupational pension schemes are subject to the following limitations:

- the Investment Pattern issued by the Ministry of Finance,
- the Indian Trusts Act, 1882, and
- the relevant tax rules.

The most important of these limitations is the Investment Pattern issued by the Ministry of Finance. The Ministry has cautiously liberalized the Investment
Recommendations on UVOPs

Pattern in recent years (e.g., 2005 and 2009) and begun to permit limited exposure to private sector securities, including equities. This method of investment regulation is sometimes referred to as a “permissible list” (or “legal list”).

The Indian Trusts Act establishes a defined list of permitted investments at section 20 of the act, but it is not a significant impediment to the investment of assets in trusts formed under the law, because it acts as a default provision: The terms of the trust deed may explicitly provide for investment other than in accordance with section 20. The tax rules, where relevant, essentially incorporate the trust law standards to the extent they require the establishment of a trust, or reference the Investment Pattern.41

The debate in India regarding the Investment Pattern’s applicability to pension assets has focused in recent years on its applicability to the compulsory schemes managed by the EPFO, which we discussed in a previous chapter. The EPFO maintains that the Investment Pattern most recently promulgated by the Ministry of Finance introduces too much volatility and risk, and it has refused to embrace it. The debate should be expanded so that the issue of how the assets of the UVOPs should be invested is squarely addressed. Like the need for adequate funding, ensuring the most effective investment of pension assets is important because, like contributions, earnings (or losses) on scheme assets directly affect outcomes in terms of both the adequacy of pensions that schemes provide and the long-term sustainability of the schemes.

The current Investment Pattern, despite recent liberalization, remains quite restrictive. Because of the limitations it imposes, it sacrifices potential, long-run average investment return in order to reduce the likelihood of short-term volatility and produce more predictable annual returns. Under these restrictions, scheme trustees are unable to implement investment strategies to prudently diversify the asset allocation of their schemes’ portfolios (in accordance with the fundamental principles of modern portfolio theory and practice) and obtain the maximum, prudent investment return (consistent with their schemes’ liquidity constraints and their investment policies and objectives). Scheme trustees are unable to take full advantage of the Indian (and, if desired, international) securities markets. Given the development of a deep and liquid securities market and professional asset management capacity in India, such an approach would be beneficial to scheme members in voluntary occupational schemes, even if it introduces a degree of volatility not experienced under the Investment Pattern.

In the aggregate, the investment constraints currently imposed doubtlessly result in the UVOPs producing less investment return than they should. The Ministry of Finance, at a minimum, should continue to liberalize the permitted investments available to scheme trustees under its Investment Pattern. Its incremental approach to this issue is consistent with the increasing skill and capacity of scheme trustees and Indian asset managers and the increasing opportunities in the Indian securities markets. The Ministry (in conjunction with a new regulator, if one is established for pension schemes), however, should...
take a more aggressive approach, which includes a stronger emphasis on the procedural or governance-related aspects of scheme asset management. Reducing reliance on a “permissive list” and increasing the role of prudential rules is in line with current practice in countries with well-developed securities markets. Consistent with this approach, the following reforms should be considered: first, increase the level of fiduciary responsibility imposed on scheme trustees; second, require trustees to develop and implement a written investment policy; and, third, require trustees to use professional, properly licensed asset managers when investing scheme assets. We briefly discuss each of these recommendations below.

The prudent person standard

If the Ministry of Finance liberalizes the Investment Pattern (at least as applied to the UVOPSs), trustees will have increasingly more discretion to define their scheme’s investment policy, determine the scheme’s overall asset allocation strategy, and make specific investment decisions. In light of the greater discretion in managing scheme assets, there should be a concomitant increase in the standard of care imposed on scheme trustees. Specifically, the traditional “prudent person” standard imposed on trustees under the Indian Trusts Act should be replaced by a “reasonable expert” standard, which requires scheme assets to be invested in the same manner as would an expert in portfolio management. This standard would enable scheme assets to be managed in accordance with the current standards of practice in the asset management industry.

Written investment policy

Trustees should be required to establish a written investment policy consistent with the purposes, objectives, and needs of the scheme and its members, including the need for liquidity to pay pensions and which sets forth appropriate guidelines by which investment decisions are made. An investment policy is a governance tool that reduces the extent to which a scheme’s trustees will take investment decisions on an ad hoc basis by establishing a decision-making process for investments, developing an asset allocation strategy for the scheme’s portfolio, identifying benchmarks by which to measure performance, and setting forth a schedule for reviewing performance and the investment strategy and, from time to time, the policy itself.

The use of professional asset managers

To the extent that scheme trustees may not have sufficient expertise to make investment decisions, especially with respect to stock and bond selection in specified asset classes, they should be required to engage professional asset
managers or, at a minimum, an investment adviser to assist them in designing their investment policy and implementing it. In doing so, care should be taken not to unnecessarily drive up the cost of scheme administration. Good practice in asset management should yield returns which, in the long run, outpace any reasonable cost of obtaining professional assistance.
There is no statement of the policy objectives of India’s occupational pension system or of the roles that the compulsory and voluntary schemes play in the provision of pensions and retirement income security for Indian workers. India’s occupational pension system is in need of a substantial, policy-driven review, in addition to the regulatory and supervisory review that is the primary focus of this portion of the book. Although most regulatory and supervisory deficiencies identified can be addressed without undertaking such a sweeping review, the underlying effectiveness of the “system” to deliver adequate and sustainable pensions cannot be fully assessed in its absence. As part of its review, the government should develop a comprehensive national pension policy that clearly defines its objectives and goals and establishes a corresponding framework within which to implement the policy. The national pension policy and its implementing framework should be communicated to all relevant stakeholders and to the public.

The current pension system for the organized sector workforce provides inadequate pension income. The government should consider undertaking a substantial reform of occupational pension provision in order to improve outcomes (as measured by the number and value of pensions provided). Any such reform, of course, must be based on the establishment of a national pension policy. Because there is no such policy in place, there is no policy-based benchmark by which to measure the extent to which today’s occupational schemes are performing as had been intended. It is clear, however, that the compulsory pension schemes are delivering smaller pensions than they feasibly could generate as a result of flaws in their overall design and operation. Because there is insufficient data, in part, a result of the absence of reporting requirements, it is not possible to assess the extent to which the voluntary schemes are currently providing valuable, supplemental pensions. The Government of India should make explicit the income levels it expects the pension system to generate for individuals in retirement and clarify the extent to which the compulsory programs and supplemental occupational schemes should share the burden of providing adequate pensions.

The government could address a number of deficiencies, but retain the current overall systemic framework, by introducing a combination of parametric and procedural reforms. Parametric reforms could include measures such as increasing the pensionable age, adjusting contribution levels, expanding coverage requirements, revising benefit eligibility rules, as well as restricting access to lump sum payments and pre-retirement withdrawals.

Procedural reforms could include measures such as imposing reporting requirements, establishing supervisory oversight, instituting governance standards, requiring transparency and written disclosures to scheme members, imposing fiduciary obligations on those involved in scheme management, and ensuring the proper custody and prudent investment of scheme assets.

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<td>There is inadequate regulatory and supervisory oversight of both the compulsory schemes (including the three EPFO-managed schemes and gratuities) and the voluntary occupational pension schemes.</td>
<td>The government should establish an independent, third-party regulatory and supervisory body (&quot;Pension Regulator&quot;) to regulate and supervise the EPFO, the UVOPSs, and gratuity schemes. The government should consider appointing the PFRDA as the Pension Regulator.</td>
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<td>There are a number of design and structural deficiencies that undermine the ability of the EPF and EPS to generate pension income for members.</td>
<td>The government should identify and address the particular design and structural deficiencies that undermine the value of the pensions the EPF and EPS are currently providing. Its review should include consideration of the following steps: adjusting the contribution levels, linking pensionable income to changes in life expectancy, reducing or eliminating lump sum benefit payments and pre-retirement access to account balances and benefit accruals, and eliminating the &quot;administered rate of return&quot; methodology used to credit EPF accounts. The reform of the EPS should ensure the actuarial and fiscal sustainability of the scheme.</td>
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| The EPFO has recently undertaken to address key concerns regarding the quality of its operations, including its record-keeping capacity and the manner in which funds are invested. However, there has been insufficient improvement in operations, a continued inability of members to access information regarding contributions to their accounts and their account accumulations, and increasing stakeholder frustration. Because employer and employee participation in the schemes that the EPFO manages is compulsory and the EPFO controls the ability of employers to opt out and establish their own Exempt Pension Funds, the EPFO has insufficient incentives to address administrative deficiencies more aggressively. | The government should require the EPFO to substantially improve administrative processes, record keeping, and related operations, including stakeholder relations, and provide incentives for the EPFO to improve its performance. It should consider:  
  
a) clarifying the source(s) of the administrative issues plaguing EPFO and providing necessary resources to resolve them,  
b) introducing incentives and competition to stimulate improvements in the EPFO’s performance, such as eliminating the restriction requiring employers sponsoring Exempt Pension Funds to match EPFO’s administered rate of return, and enabling more employers to opt out of the EPFO and participate in Exempt (and Excluded) Pension Funds, including smaller employers,  
c) removing the responsibility for issuing exemptions from the EPFO and placing it with a separate regulator, such as the PFRDA, and  
d) ensuring portability for a mobile workforce, including the reduction of dormant accounts. |
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<td>The EPFO’s conservative investment policy produces suboptimal results.</td>
<td>By requiring the EPFO to compete against other alternative funds on the basis of performance (including both service and investment return), the EPFO may acquire incentives to alter the EPF’s investment portfolio. This can be achieved by enabling more employers to participate in Exempt and Excluded PFs, eliminating the imposition of the administered rate of return on Exempt PFs, permitting greater latitude to employers investing Exempt PF assets, liberalizing the applicable investment pattern, and permitting employers (or employees) to elect to invest assets with the NPS, rather than the EPFO.</td>
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<td>The Employees’ Pension Scheme (EPS) is underfunded and has significant actuarial deficiencies.</td>
<td>The benefits promised under EPS and the contribution rates must be adjusted to ensure that the scheme is actuarially sound, based on generally accepted, reasonable actuarial assumptions and assumptions regarding the expected investment return on scheme funds. Several specific measures may help to improve the scheme’s funding status, including the elimination of the ability of members to take lump sum payments of pension benefits or early payments, increasing the equity allocation in the scheme’s investment portfolio, and considering an increase in contribution rates by reducing other contribution requirements (e.g., eliminating the compulsory payment of gratuity benefits).</td>
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<td>The current compulsory schemes do not cover smaller employers.</td>
<td>The government should consider extending the reach of the compulsory programs to smaller employers, keeping in mind the costs that might be imposed and the challenges of enforcement. For example, it should consider using the 10-employee standard established for gratuities. Such expansion of the EPFO programs should occur only after administrative and record-keeping deficiencies have been eliminated. The expansion of coverage could be phased in so that the EPFO can properly manage new entrants.</td>
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<td>There is little value provided by the compulsory funding of gratuity benefits paid as a lump sum to employees when severing employment. The value of the benefit is further reduced by increasingly short-job tenure.</td>
<td>The government should review the extent to which the policy underlying the compulsory payment of gratuities remains appropriate in the context of the increased mobility of today’s workforce, and it should consider its elimination. The assets used to fund gratuity obligations should be used to fund “true” pensions. If retained, the government should clarify that employers are obligated to pre-fund gratuity payment obligations and treat them as defined benefit liabilities.</td>
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There are no substantive rules that would require employers to ensure their voluntarily established schemes reach beyond a narrow band of the workforce, such as company executives and managers.

The government should consider the extent to which it is feasible and appropriate (in light of the voluntary formation of schemes) to impose coverage requirements. For example, the government could require that a minimum percentage of an employer’s workforce be included in its pension schemes. The precise parameters depend on the extent to which voluntary occupational schemes are relied upon to provide retirement income security and the extent to which the employer obtains tax and other benefits for maintaining a pension scheme.

There is little regulation establishing the minimum features required to be included in the rules of voluntary, occupational schemes. In today’s environment, private sector employers have complete discretion to design schemes as they desire, except to the extent they accede to the tax requirements necessary to obtain “recognition” of their schemes. As a result, pension scheme and provident fund schemes established on a voluntary basis may suffer from some of the same design flaws that plague the EPF and EPS.

There are a number of scheme design elements that will directly affect the pension benefit that schemes are able to provide. The most significant of these are those addressing pre-retirement access to benefits, vesting, and portability, and the form of the pension paid. Regulations should address these and other design elements.

There are few and wholly inadequate rules and regulations regarding the proper governance of schemes.

Both the “internal” and “external” aspects of scheme governance should be regulated and supervised in accordance with standard international practices. At a minimum, regulations should require that scheme rules be in writing and properly disclosed to scheme participants and that scheme assets be held in a trust managed by qualified trustees. Employers, trustees, and other persons with any discretionary control over scheme assets or scheme administration should be held to the highest fiduciary standards. Furthermore, scheme members should have access to fair and expeditious grievance procedures. Custodians independent of scheme trustees should hold scheme assets. The trustees should obtain an audit of the scheme on an annual basis from an independent, qualified auditor and, in the case of defined benefit schemes, the trustees should obtain an annual valuation from an independent, qualified actuary.
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<td>Today’s voluntary schemes are financially unsustainable, because there are no funding or financing requirements imposed upon employers sponsoring the schemes. Many schemes, whether defined contribution or defined benefit, may be substantially underfunded.</td>
<td>There should be clear funding requirements that employers are required to satisfy. In the case of defined benefit schemes (including Gratuity Funds), the regulator should establish minimum funding standards. Employers should be required to obtain independent assistance from a qualified actuary to determine the extent to which its scheme is underfunded and contributions owed. Employers should not be permitted to pay benefits on a pay-go basis from their own corporate funds. Once contributed, defined contribution and defined benefit scheme assets should be segregated from those of the employer and held in trust under the trust law. Trustees should be required to establish a formal, written investment policy that is consistent with the purpose and needs of the scheme and its members, including the need for liquidity to pay pensions. Trustees should be required to obtain professional asset managers to invest scheme assets. The government should consider liberalizing the applicable Investment Pattern and increasing its reliance on a “reasonable expert” standard under which scheme assets would be invested prudentially. Such liberalization could be phased in, consistent with the increasing capacity of trustees and asset managers to design and implement investment portfolios with increased exposure to short-term volatility.</td>
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<td>Scheme assets, to the extent segregated from the employer’s own assets, are invested with little regulation, but for the limitations imposed by the Investment Pattern.</td>
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Part VI

Towards an integrated policy
India’s pension sector is extensive in its breadth, and yet, it has neither generated sufficient levels of coverage, nor, for those who are covered, delivered adequate retirement outcomes. In large part, this is because the foundation of India’s pension system is based on formal employment arrangements in the organized sector of the economy that captures only a small percentage of the paid workforce. Policy and regulatory efforts aimed at expansion of the New Pension Scheme (NPS) to the unorganized sector workforce on a voluntary basis are intended to address this coverage gap, at least in part.

Importantly, voluntary pension products such as the Public Provident Fund (PPF) have been available in India for many decades. New retirement saving products offered by mutual funds and life insurance companies have entered the market in only more recent times. Both traditional and new voluntary pension products, however, have failed to capture a significant market. Given time, the NPS has potential to fare better but the early signs are not encouraging.

The NPS reform

On the basis of the pan-India Income, Retirement, and Savings Survey, 2005 commissioned by the ADB and the Indian Ministry of Finance, and the subsequent Invest India Incomes and Savings Survey, 2007 results, three broad potential markets for the NPS exist at the present time:

1. Unorganized sector workers with a capacity to make regular pension contributions and who are interested in voluntarily saving for their old age. These workers are highly concentrated in three groups—traditional and mechanized farmers, small retailers, and self-employed persons including self-employed professionals.

2. Persons in salaried employment who are excluded from formal pension and provident fund arrangements including EPFO schemes by virtue of working in firms with less than 20 employees.

3. Government and private sector salaried employees who are covered by mandatory pension and provident fund arrangements but are not confident that their present retirement benefits will provide an adequate income.
replacement and are interested in voluntarily contributing to a supplementary retirement savings program like the NPS.

In Chapter 8, we estimated that even given fairly conservative labor force and actuarial assumptions, the number of persons covered by the NPS and the assets under management, could be considerable.

The PFRDA, which is charged with the development and regulation of the NPS market, has already established an institutional framework to enable and encourage such workers to voluntarily participate in the NPS. Early, broad-based success with voluntary coverage among these target segments, and India’s ability to rapidly achieve a mass-market status for the NPS, will however hinge critically on effective implementation planning and management by PFRDA.

The experience with limited marketing success and poor coverage of voluntary pensions in India and elsewhere suggests that attempting national implementation from a cold start may not produce optimum policy outcomes. Instead, phasing in the NPS may have higher appeal as this would enable a learn-as-you-go approach and the opportunity to test scheme architecture, evaluate different marketing and communication techniques, and review coverage outcomes and subscriber behavior in selected locations. The merit of this approach is demonstrated by the recent ADB-funded study of NPS implementation in two Indian districts. In these pilot districts, marketing and communications interventions based on experience elsewhere substantially increased NPS membership in only a few weeks. This experience was described in Chapter 7. However, as described in Chapter 8, current business practices and underutilization of good-practice information technology are creating a risk that, as the NPS expands, it will not cope well with rising volume. The result would be consumer dissatisfaction and an impression, easy to create but difficult to dispel, that NPS is a “bad brand.”

Sustained high economic growth will further improve the capacity of India’s unorganized sector workforce to accumulate sufficient savings for self-support in retirement. However, as shown in Chapter 9, a large proportion of unorganized sector workers may not be in a position for the foreseeable future to self-provide for retirement. This includes unorganized sector workers who actually join NPS, in addition to those who do not join; the lifetime poor who may not be able to save anything for their old age; unpaid workers who have no cash incomes to support pension contributions; those suffering from sickness, disability, or unemployment; and those workers with meager and intermittent incomes. Equally, the NPS will be unable to address the retirement savings needs of informal sector workers who are presently nearing retirement or those who are already aged 60 or above. For each of these groups, the government would need to design and implement effective social assistance policies and programs that adequately support them in their old age.

The absence of a meaningful and efficiently delivered old-age pension benefit also imposes a significant social transfer burden on younger low-income workers.
The ability of poorer households to support the elderly is an issue that requires closer analysis and more policy attention in India. The presence of an aged member in households may of itself cause all persons in the household to be in measured poverty. This would in turn further depress the capacity of low-income earners to save for their own retirement. In this eventuality therefore, lifting aged persons out of poverty through fiscal transfers may offer the possibility of lifting the entire household out of poverty. Evidence from elsewhere has also illustrated how the receipt of a pension, in whatever form, substantially raises the status of the elderly within the household, as well as having spillover effects such as increased expenditure on children’s schooling.

Although the NPS may not be a universal solution to India’s pension coverage gap, its success can dramatically reduce the size of the workforce that must rely on a combination of fiscal and social transfers to combat old-age poverty. Equally, the underlying design considerations that form the basis of the NPS architecture may present a useful benchmark to assess the efficacy of other existing retirement arrangements, as well as a basis for their reform.

In this direction, the government and the PFRDA are already using the NPS framework to drill down the income distribution with conditional cash transfers aimed at encouraging voluntary enrollments and disciplined retirement savings by low-income workers. Existing incentives are not sufficient to increase terminal savings, but may significantly encourage the working poor to join. However, the lack of liquidity in NPS, especially in the absence of affordable and easy access to emergency credit by the low-income workers, may depress coverage and sustained savings discipline. The irony, of course, is that elsewhere in Asia, ease of withdrawal for non-retirement purposes has frustrated provident funds’ goal of ensuring adequate old-age income. A difficult balance must be struck. Moreover, a significant communication and public education effort will be required therefore to produce adequate, regular savings for old age by a population that largely faces modest intermittent incomes.

As the PFRDA succeeds in generating broad-based public awareness and interest in retirement savings among unorganized sector workers, many “aware” individuals may elect to join the PPF or other existing programs where government subsidies are higher and there is greater flexibility in terms of contributions “lock in” than is the case with the NPS. Going forward, the government will need to evaluate the merit of merging traditional products such as the PPF with the NPS.

A similar issue is the linkages between tax and pension policies. Existing voluntary and mandatory pension arrangements attract a number of generous tax concessions. However, similar concessions are available on a range of other short- and long-term investment choices. Voluntary pension programs including the NPS are therefore competing with a range of other tax-preferred savings vehicles. The issue of tax subsidies is further complicated by the fact that most Indian workers’ incomes presently are too low to attract tax, rendering the issue of tax concessions irrelevant for a majority of the informal sector workforce. Nonetheless, reviewing the relativities between tax-supported savings
Implementing pension reforms

instruments and voluntary pension tax arrangements will be important if a high take-up of voluntary pensions for workers in the tax net is to be achieved.

The PFRDA has continued to demonstrate a willingness to adjust its course in line with emerging implementation challenges and the needs and constraints of potential subscribers. The launch of the innovative NPS-Lite version, with a different distribution methodology, conditional cash transfers, and lower fees and charges, should help improve participation rates by low-income workers. In the medium term as well, the PFRDA would need to continue this approach in order to attract subscribers at levels policy makers had first intended.

Reforming occupational schemes

As pension schemes are vehicles for the long-term accumulation of assets, it will be equally important for the government to maintain a long-term policy perspective on pension reforms. Under this assumption, and in parallel with policy and regulatory interventions related to the NPS, it would be advisable for the Indian Government to also review present policy in relation to the objectives and operation of occupational schemes to ensure that they conform with old-age income security objectives in ways that both meet the needs of the workers concerned and protect the fiscal positions of future governments.

The current occupational pension system, including compulsory and voluntary schemes offered through employers, requires a combination of parametric, procedural, and systemic reform. Parametric reforms could aim to increase the number and value of benefits paid to “adequate” levels. Procedural reform would aim at improving administration, operations, governance (including member rights and entitlements), and the manner in which investment decisions are taken to strengthen the security and sustainability of the programs. Systemic reform may include questions of regulation as well as fundamental changes in the design of benefit arrangements.

Mandatory occupational programs deliver inadequate terminal accumulations as a result of outdated investment policies, suboptimal returns, inefficient administration, liberal pre-retirement withdrawals, and poor information and service quality to subscribers. Voluntary occupational pension and provident fund programs suffer from similar administrative and management challenges. Importantly, voluntary occupational programs suffer also from a perilous lack of regulation and supervision. The coverage and outcomes provided by voluntary programs suffer from similar administrative and management challenges. As a consequence, the number of employees covered by such arrangements is unknown but thought to be large enough to be of interest to the government. Assigning a proper regulator to oversee them is therefore imperative. One aspect of this regulation should be to establish basic protections for participating employees and arm them with the information and grievance redress processes necessary to better protect their rights and entitlements. In parallel, the governance of schemes should be radically improved. Contrary to the case in many countries, India already has a well-established body of financial
Implementing pension reforms

sector regulations and many of the key regulatory concepts are already present within its legal framework. As a result, there is sufficient capacity to rapidly evolve a robust regulatory and supervisory framework for occupational pension schemes.

Towards an integrated pension policy

A fundamental issue in improving existing occupational retirement programs is the absence of a comprehensive national pension policy. In this scenario, there is no policy-based benchmark by which the performance of existing occupational schemes, or the nascent unorganized sector NPS, can be evaluated. For example, several current occupational schemes fail to deliver an “adequate” retirement income. Yet, subscribers are unable to demand a different outcome simply because there is no clear definition of “adequacy.” There is no statement of the policy objectives of India’s pension system or of the specific responsibilities of administrators and trustees of both compulsory and voluntary programs in targeting or ensuring adequate retirement income security for Indian workers.

In this context, the government should aim to develop an inclusive and equitable national pension policy that provides equal opportunities and identical rights to all citizens, regardless of their employment status, to achieve a dignified retirement in a secure and well-regulated environment. This policy should enable individual portability across jobs and locations, as well as across a range of pension programs. The design and performance of existing and new pension programs, as well as the underlying actions of regulators, administrators, and trustees, should be guided by this proposed national pension policy. The process of designing this national pension policy should be preceded by a comprehensive review of existing arrangements as well as a broad-based survey of labor markets. Although several regulatory and supervisory deficiencies can be addressed without undertaking such a sweeping review, the effectiveness of the “system” to deliver adequate and sustainable pensions cannot be fully assessed in its absence.

The national pension policy should identify the government’s objectives and goals, including:

a) the value of retirement income it seeks to provide and the percent of income it expects the pension system to generate for individuals in retirement (expressed, for example, as a flat amount relative to the poverty line and/or as a percentage of salary),

b) the level of coverage it seeks to attain (expressed in terms of the percentage of the organized and unorganized sector workforce, the minimum percentage of employees of a given employer, and which employers by size),

c) the relative extent to which pension provision is to rely on the compulsory and voluntary employer-sponsored pension schemes, individual savings and investment, and other government programs, and
Implementing pension reforms

d) the means of financing pension provision, including for persons who will be unable to participate in contributory retirement programs.

An important first step towards a unified and inclusive pension policy framework for formal and informal sector workers was taken in 2004 when the government decided to bring new government employees into the NPS. There is considerable consensus already that the NPS is well suited to serve as a genuinely national pension scheme as it protects subscriber interests through an incentive-compatible architecture and a dedicated regulator, promotes ease of access, and provides flexible and attractive investment options and low transaction costs. This initiative of using the NPS as a policy tool to implement civil service pension reforms, can be further broad-based and strengthened by similarly extending the NPS to salaried private sector employees covered by legislated pension and provident fund arrangements on a mandatory basis, as well as to salaried workers participating in voluntary, employer-sponsored superannuation and provident fund arrangements.

At an institutional level, existing pension and retirement saving programs should be mandated to outsource scheme administration and the management of individual subscriber records to the central record-keeping agency (CRA) regulated by the PFRDA. Similarly, the management of aggregated, voluntary and compulsory retirement contributions by salaried workers should be managed by PFRDA-regulated pension fund managers. Salaried workers should be able to use their employers or PFRDA-regulated Points of Presence (POPs) to access information on their retirement account balances as well as periodic account statements. Through this strategy, salaried employees in large private or public sector firms would begin to enjoy the same portability rights, as well as product and fund manager choices that are already available to civil servants and Indian citizens participating in the NPS. As a result, salaried workers will be able to switch employers or locations, or move from formal to informal or self-employment without any administrative overhead related to their individual retirement accounts.

Policy implementation may be phased-in by providing such employees with an initial voluntary option to switch their existing retirement savings from publicly or privately managed, DC pension, provident fund, and superannuation plans to NPS products. These employees may be provided also with a right to continue using the existing funds management services of EPFO or other pension and PF administrators. The task of enforcing mandatory contributions by both employees and employers should continue to rest with the EPFO and other pension and PF administrators. There are obvious social equity benefits of this policy option as it would provide India’s formal and informal sector workers with a uniform and well-regulated retirement savings arrangement, and identical rights and choices to maximize their retirement incomes.

The implementation of a larger reform will need to be carefully staged so that the government, the PFRDA, and pension sector stakeholders can effectively adopt and implement the reform. Special attention should be paid to stakeholders,
Implementing pension reforms

upon whom much of the success or failure of the reforms will rest—especially with respect to schemes that are established on a voluntary basis. These stakeholders include financial institutions and other service providers that may assist employers in managing their schemes and scheme assets, as well as the employers themselves and their employees. An effective communication and education campaign would be required to inform and educate salaried workers regarding new product options, as well as their rights and responsibilities as subscribers to market-linked retirement products with variable returns.

To make determinations based on the recommendations in this book, the government will need to collect additional data, especially with respect to the voluntary occupational schemes. As a transitional step, it may be appropriate to impose initial reporting requirements on sponsoring employers. This will enable the government to more clearly understand the number of such schemes, types of benefits, number of employees, number of pensioners who have received or are receiving benefits, and the extent to which, and the manner in which, the schemes are governed and funded. This will achieve two initial goals. First, it will provide the necessary data upon which to make policy decisions. Second, it will provide an initial database for the PFRDA on existing practices and enable it to develop suitable regulations to effectively protect the beneficial rights and interests of scheme subscribers.

Particular reform recommendations will require special transition rules. For example, the reform may require employers to fund their unfunded benefit obligations. To implement this mandate, the regulations will need to include reasonable amortization schedules so that employers are able to make the schemes whole over a period of years, rather than immediately. This is especially true for employers with unfunded defined benefit obligations, including gratuity obligations. However, it may also include sponsors of defined contribution schemes that have not been properly funded. Similarly, employers may be required to submit static data of their employees as well as historical information on individual contributions to the CRA.

It is likely that in the process of designing or implementing a new, national pension policy, along with an overarching, uniform regulatory environment for the pension sector, some existing scheme, such as Gratuity, may be either terminated or merged with other programs. The process of terminating or merging some existing programs should occur within a transparent timeline and framework established by the government and the PFRDA to ensure that all outstanding liabilities are satisfied and scheme assets are used only for the benefit of scheme subscribers.

India’s pension sector regulatory and supervisory infrastructure would need to be radically reorganized also to establish a robust, consolidated authority to oversee the entire pension area, including the NPS, compulsory legislated programs, and voluntary occupational pension schemes. The PFRDA would be the logical place to locate this authority. In the context of implementing a national pension policy and an effective and uniform regulatory environment for India’s pension sector, the government should undertake a comprehensive review
Implementing pension reforms

of the draft PFRDA legislation to ensure that the regulator would indeed have the ability to regulate and supervise the full range of existing retirement programs. This review should similarly assure that potential conflicts with existing legislation are resolved ahead of a broad-based administrative, procedural, and systemic reform.

Finally, the integrated pension policy must be placed in the broad context of a population that is aging, while poverty (although diminishing with growth) is still widespread. Substantial numbers of elderly Indians will remain outside the pension umbrella, and broad policy will need to take them into account, as well.
At heart, the NPS reform is an attempt to put in place a voluntary retirement saving instrument adapted to the needs of the unorganized sector. This appendix, which should be regarded as background material for Chapters 4 and 9, summarizes lessons learned from international experience with voluntary retirement savings as applicable to the unorganized sector. Social protection is increasingly recognized as improving competitiveness and well-being. Informal sector workers suffer from relatively low productivity and are disproportionately poor. On both counts, then, the NPS reform is an attractive policy initiative. However, social protection is not costless, and international experience teaches that there are advantages and disadvantages to different approaches.

International experience with public old-age income security schemes can be divided into two categories: that of the developed economies, which have had public pension schemes in place for over a century; and the developing economies, where such schemes are still relatively new apart from limited instruments inherited from the colonial past (e.g., provident funds). The globalization of financial services and capital, and the increasing fragmentation and informality of labor in the developing world, has led to some convergence of developing and developed economies in this area, but distinctions still remain.

In this section, three different approaches to pension policy are discussed. The first is compulsory contributory social protection, along the lines that figured most prominently in the development of social security in the developed world in the 20th century—what economic historian Carmelo Mesa-Largo has termed the “Golden Age” of social security. The second is the non-contributory, universal coverage approach identified with Denmark, New Zealand, and a number of other countries, including a growing number of developing countries. In some countries (e.g., Brazil), the universal benefit is targeted to specific groups such as the rural poor. The third, still in its emerging state, is the approach by which voluntary retirement savings become not only a supplement to other approaches but also backbone of income provision in old age. This is the approach that the NPS hopes to implement in India.
Voluntary approaches to retirement saving in perspective

In countries such as the USA and the UK, voluntary retirement savings were initially an instrument for upper-middle and upper classes, not a mainstay of old-age income security available to all. Voluntary savings were stimulated by preferential tax treatment and this was primarily an advantage for persons paying significant amounts of taxes. Such persons were certainly not in the informal or agricultural sector and were not at high risk of old-age poverty.

At the same time, in the developed economies, beginning in the late 19th and through the 20th century, social security and/or insurance for the broad (or at least the industrial) workforce was provided through mandatory contribution-financed arrangements and governed primarily by tripartite institutions composed of labor, employer, and government representatives. This is often referred to as the Bismarck model, where the term “Bismarckian” refers to the German social insurance model, which began in 1889 and consisted of a long sequence of laws providing for differentiated group social insurance inclusion based on contributions. A quarter century after these initiatives, the USA introduced an old-age income security system based on contributions, but with income-leveling adjustments. The contribution-based model is often distinguished from the one adopted by the Nordic countries, with more universal old-age income benefits and the larger goal of “freedom from want” for the entire population. These approaches aimed to provide a comprehensive social safety net.

However, whether based on differentiated programs or on universal inclusion, most countries based pension programs on mandatory contributions paid by workers and their employers. Social insurance was therefore only provided to workers with formal employment, generally those who were employed through formal labor contracts. These social and economic context in which this model took root must be kept in mind. Among the implicit assumptions were:

- independent nation-states provide social insurance for citizens,
- employment is binary—workers work full time or not at all,
- international mobility is limited,
- the stable nuclear family is the norm,
- skills last a lifetime and workers remain in one profession,
- labor contracts are the norm,
- industrialization leads to a decrease in informality, and
- the age structure is generally constant.

These assumptions, relevant only for some industries of selected developed and industrialized countries in the beginning and of decreased relevance overall in recent years, were never applicable to the developing world. Nonetheless, these assumptions governed the establishment of social security programs, even in the developing world, based on the premise that development will lead to social, economic, and institutional convergence. As the 20th century ended, however,
it was clear that significant changes had weakened the assumptions that the original model was based upon:

- Globalization of production is the norm and countries have limited economic autonomy.
- The nature of work has changed, with a decline in full-time stable employment, more part-time work and informal work.
- The mobility of capital has increased.
- Informal employment increased in both the industrialized wealthy countries and in the developing world, enabled in part by information technology, and now encompasses high-income workers as well as those with limited skills.
- Family structures are more fluid.
- Skills become outdated quickly in the information age.
- Populations worldwide are aging.

The current situation in the developing world is that labor markets continue to be characterized by part-time work, unpaid family work, underemployment, and a preponderance of agricultural and unorganized sector work. A minority of the population has long had access to mandatory contributory pension schemes. However, it is estimated that 90% of the population in the poorest developing countries is outside social security and has no prospect of coverage by such programs.

The existence of the unorganized sector is often viewed negatively and the suggestion is made that the workers in that sector are somehow illegitimate, work in illegal industries, or remain outside the law in order to avoid taxes, or that their employers are miscreants. However, as documented in the case of India, the informal sector and the agricultural sector employ the majority of the population in many developing countries. Workers are informal because the economic imperatives of globalization and poverty permit no other choice to both workers and employers. Most unorganized sector workers produce legal products and are not criminals. It is extremely unlikely, for example, that employers will offer all workers a labor contract and formalized employment, because in order to remain flexible and competitive in a global market, they cannot afford to do so. They must be able to respond to changing global markets by increasing or reducing their workforce on very short notice; their goods must be internationally and domestically competitive.

In light of these developments, the alternative approach of universal non-contributory coverage for basic social security, especially pensions (often referred to as citizens’ pensions or demogrants) has attracted significant support in the developed world. Citizens’ pensions are typically small, thus fiscally affordable, indexed to inflation, and funded from general tax revenues. Their goal is to prevent poverty, providing an income foundation from which citizens can build via voluntary retirement saving. The approach has also attracted adherents in
developing countries (Sri Lanka, Lesotho, Brazil, and others). The main concern cited against the approach is fiscal cost—while the cost of a modest pension program may be small relative to GDP, it may be large relative to tax revenues in a setting where direct taxes are low and revenue collection is weak.

In the context of the global financial crisis, the International Labor Organization (ILO) has strengthened its commitment to achieving a “global social protection floor,” the major component of which is a basic pension available to all citizens over an age to be decided. Considerable analysis has been devoted to estimating the cost of such packages in different countries, with the overall conclusion that, provided conditions for eligibility are sufficiently tight and benefits modest, the cost is affordable.

**Asian experience with voluntary savings as a social safety net**

The mainstay of pension provision in Asia, dating from the colonial period, is provident funds, sometimes ostensibly mandatory, but whether officially or in practice, voluntary for the informal sector. Provident funds have been studied repeatedly and their principal flaws are known to be:

- In most cases, there is lump sum payment at retirement and therefore no regular income.
- Irregular payment of contributions limits accumulations and increases management costs.
- Public control has typically led to poor investment returns as assets were allocated to state-run development funds.
- The ability of participants to withdraw funds prior to retirement—for purchase of a home, for the education of children, in the event of sickness or unemployment—results in inadequate levels of resources available at retirement age.
- Disability or survivor protection is limited.

Because provident funds effectively cover only the formal sector, there has been increasing interest in policy approaches to extend pension programs to cover the informal sector. The use of voluntary savings to protect the poor has been particularly advocated and attempted in Asia. A recent World Bank study examined the experience of several Asian countries in expanding coverage to the informal sector. This paper, which reviewed the experience of India, Thailand, Sri Lanka, the People’s Republic of China, Viet Nam, the Philippines, the Republic of Korea, Indonesia, and Bangladesh, concluded that expansion of coverage through a mandatory savings system is unlikely to succeed (this refers to the so-called “second pillar” pension systems which began with Chile and were implemented on a large scale in transitional Central European countries, such as Poland, Hungary, Croatia, and Bulgaria).
Lessons learned from voluntary retirement savings in developed countries

In addition to these lessons derived from a study of Asian countries, some aspects of experience in developed countries are relevant.

Studies have shown that, in addition to a good taxation regime, two factors increase the likelihood of voluntary savings in developed countries: the ability to retrieve some assets if necessary; and an arrangement where people opt out instead of opting in.

For example, the US 401(k) instrument provided by employers is voluntary. The possibility of loans and withdrawals allows people to take out loans that must be repaid with interest. In the case of hardship, permanent withdrawals can be made. Permanent withdrawals can also be made in the New Zealand Kiwi Saver scheme. A recent UK study estimated that allowing loans and withdrawals could result in a substantial increase in participation in voluntary arrangements. While there is a significant risk that allowing withdrawals will leave insufficient amounts for retirement, it appears that for many people the possibility of taking their funds out increases likelihood of participation.

Based on this, it is likely that, as assets and participation in the NPS increase, there will be political pressure to allow early withdrawal.

Based on this, it is worthwhile to explore whether, and how, voluntary arrangements can be made routine for unorganized sector and agricultural workers. Chapter 7 on information technology and business processes illustrated some examples of this.

Discussion

Taken as a whole, experience in expanding pension coverage to the informal sector, whether in the form of compulsory or voluntary schemes, has been discouraging. This raises the question of how the NPS reform may fare better. Several points specific to the Indian context emerge:

- There is a relatively dense financial infrastructure in India, making it easier than in some other countries to reach unorganized sector workers.
- All of the schemes instituted so far in the region have been targeted specifically at the unorganized sector. The fact that unorganized sector workers are being asked to join a scheme that also covers the civil service is a unique and deft strategic maneuver that should increase the level of interest and confidence in the scheme.
- Indian expertise in information technology may help to address the challenges of collecting contributions, keeping records, and paying benefits. However, this will require addressing the serious IT problems identified in Chapter 7.
- The addition of Tier II accounts helps to address the issue of early withdrawals, but it must be kept in mind that the very poor will not have sufficient income to contribute to Tier II accounts.
Appendix 1: Voluntary retirement pension schemes

This leaves two challenges to be surmounted:

- Guaranteeing good governance, especially in the management of assets. This is, in significant part, the subject of the design and legal and regulatory analyses.
- The enduring problem of how to generate sufficient retirement income for the very poor. Subsidies can boost the scheme’s anti-poverty aspect, but raise the issue that, unless properly targeted, they are regressive.
Appendix 2  The Maxwell and Madoff frauds

The Maxwell and Madoff cases identified in the text demonstrate the importance of imposing a proper governance structure on pension schemes, their trustees, and those appointed to manage the investment of pension assets. In particular, each case illustrates the importance of “external governance.” It is vital that pension scheme supervision harnesses independent third parties such as financial institutions to serve as custodians of pension assets and professional accountants and conduct annual audits. These unaffiliated entities provide additional layers of security for schemes and their members. In Box A1.1, we provide a brief description of the Madoff scandal, in which a well-known investment manager’s “Ponzi scheme” could have been prevented if he had been required to use an unaffiliated financial institution as custodian of the assets of the investment fund he managed, or if the audit firm conducting the annual audit of his investment funds had been a truly independent entity, rather than one whose independence was undermined by its long-standing relationship with its client. Similarly, trustees, if required to act independently of the employer, or the presence of a robust, independent custodian, could have prevented the employer’s misuse of pension assets in the Maxwell case (Box A1.2).

In the wake of the Madoff scandal, the US Securities and Exchange Commission amended its regulations, introducing new rules to encourage investment advisers to use independent, unaffiliated custodians of assets under management. In the event an adviser continues to use an affiliated custodian that is not operationally independent, the SEC introduced new audit requirements, including “surprise audits” (see Table A1.1). Rather than requiring pension fund trustees to use an independent, external third-party custodian, the UK reforms undertaken in the aftermath of the Maxwell scandal, including legislation enacted in 1995 and 2004, have emphasized trustee independence from the employer, greater employee representation, and minimum funding and guaranty insurance for defined benefit schemes.
Box A1.1 The Madoff scandal

The Madoff scandal involved Mr Madoff’s investment of assets for clients, many of which were large, institutional investors, such as charities, foundations, and pension funds. Clients invested in investment funds managed by Madoff, who provided false statements of account to them on an ongoing basis over a number of years. The statements showed false investment returns. Records of transactions in the investment fund were also completely fraudulent. Mr Madoff was running a Ponzi scheme, relying on the “buy and hold” strategy of many of his clients. When many of Madoff’s clients suddenly and simultaneously began to liquidate their accounts in response to market volatility, the Madoff funds collapsed.

Many factors contributed to Madoff’s ability to continue his fraudulent activity over many years, two of which are relevant to the issues of governance addressed in this book:

- The custodian of the Madoff funds’ assets was an affiliated broker-dealer controlled by Madoff, who was a registered investment adviser under US securities laws.
- The external accountant was captive to his client. He had been the auditor for the Madoff businesses for a number of years, and Madoff was his sole significant client.

Box A1.2 The Maxwell scandal

In 1991, the British newspaper magnate Robert Maxwell misappropriated over £450 million from his companies’ pension funds to shore up shares of his failing corporate empire in a desperate effort to avoid bankruptcy, a fraud that was not discovered until Mr Maxwell’s death. Maxwell, who was also the schemes’ trustee, borrowed cash from the pension funds of firms within his business empire, and he used the assets to support his debt-laden companies by injecting capital into the companies and by purchasing company shares in order to present healthy financial statements and to artificially support the share prices. Maxwell was able to do so without discovery, as a result of a fundamental breakdown in the governance of the pension funds.

As trustee, Maxwell was able to control the investment of the pension assets without oversight or additional signature on transactional instructions. Moreover, the schemes’ custodians failed to question obviously unusual investment activity, and the unaffiliated accounting firm that was
responsible for auditing the Maxwell businesses and schemes failed to perform adequate due diligence. For example, the audit firm accepted management’s explanations for irregularities without further probing, and it issued unqualified audit opinions for Maxwell businesses, which had not maintained proper records, could not reconcile their books, and had maintained inadequate internal control systems.

Table A1.1 The “Madoff Amendments” regarding investment adviser custody of client assets

<table>
<thead>
<tr>
<th>The arrangement</th>
<th>Surprise exam</th>
<th>Custody controls review</th>
<th>Concerns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client assets are in the physical custody of the adviser</td>
<td>Yes</td>
<td>Yes</td>
<td>A risk that the adviser could misappropriate assets since there is no separate custodian</td>
</tr>
<tr>
<td>Client assets are in the custody of a custodian that is affiliated with the adviser and not operationally independent.</td>
<td>Yes</td>
<td>Yes</td>
<td>A risk that the adviser could misappropriate assets because of its affiliation with the custodian</td>
</tr>
<tr>
<td>Client assets are in the custody of a qualified custodian that is affiliated with the adviser but operationally independent because the affiliate and adviser operate as distinct entities with no overlap of personnel, office space or common supervision</td>
<td>No</td>
<td>Yes</td>
<td>If the adviser does not have access to the client’s assets, then a surprise exam is less meaningful, but a check on the affiliated custodian’s custody controls will focus on the effectiveness of custody protections</td>
</tr>
<tr>
<td>The assets are in the custody of an independent, third-party custodian, but the adviser has authority to withdraw client funds—such as by a power of attorney</td>
<td>Yes</td>
<td>No</td>
<td>The ability to withdraw client assets heightens the risk that an adviser could misappropriate those assets and go undetected, so the annual surprise exam will serve to verify client assets</td>
</tr>
<tr>
<td>The assets are in the custody of an independent, third-party custodian and the adviser either has no control over the funds or merely has the authority to withdraw agreed-upon fees</td>
<td>No</td>
<td>No</td>
<td>There is no indication that this type of arrangement has resulted in fraud that would warrant additional safeguards</td>
</tr>
</tbody>
</table>
Notes

1 Introduction
2 http://www.pfrda.org.in
3 Source: http://www.pfrda.org.in

2 Demographic and economic context
3 Life expectancy at birth is a synthetic index giving the number of years that would be lived by a hypothetical individual who passed through life subject to the age-specific mortality rates observed in a given year. It is not to be confused with cohort life expectancy, which is the average age of death for the members of an actual historical cohort as they aged.
4 The replacement level fertility rate is that at which eventually population would stabilize, neither increasing nor decreasing in size. In most populations, it is a bit below 2.1 births per woman, assuming that she survives from 15 to 49. See below for the definition of the total fertility rate.
5 In Japan, for example, the population of centenarians (aged 100+) is growing in excess of 13% per year, and a substantial majority of women now aged 60 are likely to survive into their nineties.
6 The total fertility rate, another synthetic index, gives the number of children who would be born to a woman who lived from 15 to 49 subject to the age-specific fertility rates observed in a given year. It is not to be confused with, and can in fact differ substantially from, actual fertility as experienced by a cohort of women.
Notes


3 The new pension system: design, governance, and institutions

1 The most significant, compulsory program is established under the Employees’ Provident Funds and Miscellaneous Provisions Act, 1952. Generally, “establishments” employing 20 or more persons are subject to the act. The act establishes three separate schemes: the Employees’ Provident Fund Scheme (EPF), the Employees’ Deposit-Linked Insurance Scheme (EDLI Scheme), and the Employees’ Pension Scheme (EPS). In addition to the schemes established under the act, the Payment of Gratuity Act, 1972 requires “shops and establishments” in which 10 or more persons are employed to provide a gratuity benefit to eligible employees. Formal sector employers may also establish other schemes, such as a defined benefit or defined contribution benefit scheme or a superannuation fund, for their employees. These schemes are described in Part V.

2 The fact that the NPS can be used to supplement extant pension provision should not be overlooked, because it remains unclear that current programs, whether compulsory or voluntarily established, will provide adequate income to many individuals who retire from organized sector employment. The extent to which savings in the NPS unorganized sector scheme is additional savings or merely substitutes for other forms of savings is an important question.

3 It is interesting to note that the EPF has a similar goal, as stated in the EPF Act, of “cultivat[ing] among workers a spirit of saving something regularly.”

4 The EPF also is set up to provide pension portability and, putting aside some substantial design flaws and administrative and record-keeping deficiencies identified in this book, continues to operate as a portable program.

5 Market conditions may inhibit the ready conversion of savings stored in gold. The rationalization of this market may increase liquidity and lower barriers to the conversion of these savings: see, e.g., “Online trading of gold bars to start by June-end” in The Economic Times, 18 June 2009; “India gold dealers tap vast domestic stocks” in Financial Times, 29 June 2009.

6 PFRDA revised the allocation of pension fund assets among the three asset managers effective 1 May 2009. PFRDA has indicated, according to press reports, that allocations are based on the competitive yield of the funds, using a mark-to-market method of calculating final return in accordance with SEBI norms. (By contrast, EPFO uses a yield-to-maturity method in its calculations.) The three funds generated returns varying from 12% to 16% in 2008–2009. The weighted average return was over 14.5%.
Notes


7 The auto choice option moves individual allocation from a high-risk to a low-risk strategy over time. Thus the account balance of an individual age 18 to 35 will be invested as follows: 50% E fund, 30% C fund, and 20% G fund. At age 36, the allocation automatically is shifted annually by decreasing the percentage of the account invested in the E fund and C fund and correspondingly increasing the percentage of the account invested in the G fund until the allocation reaches 10% E fund, 10% C fund, and 80% G fund at age 55. The auto choice portfolio remains the same for those aged 55 to final distribution at ages 60 to 70.

8 NPS informational pamphlet, “Welcome to the New Pension System” at p. 2. NPS terminology differentiates the POP, which is the bank or other financial institution agreeing to so serve, and the “Point of Presence Service Providers” (POP-SPs), which are authorized branches of a POP.

9 The process by which an account is established is reviewed in Chapter 7.

10 There are three different PFMs for the civil service scheme, which are sponsored by the State Bank of India (SBI), UTI AMC, and the Life Insurance Corporation of India (LIC).


12 LIC was also one of the first POPs but, following LIC’s appointment as a POP, IRDA issued guidance prohibiting insurance companies from serving as a POP. As a result, LIC ceased its POP activities. The IRDA guidance also addressed other aspects of life insurance companies’ potential role in the NPS program. In addition to the prohibition on serving as a POP, IRDA stated that life insurers may set up fully-owned subsidiaries to act as PFMs, subject to approval by IRDA on a case-by-case basis. Non-life insurance companies are prohibited from doing so. Specifically, IRDA requires a life insurance company setting up a PFM subsidiary to:

1 Satisfy the capital requirements of the subsidiary through the Shareholders’ Funds;
2 Treat investment in the subsidiary as a non-admitted asset in the insurance company’s accounts and not consider it when computing solvency margin;
3 Carry the investment in the subsidiary at its book value for purposes of the financials of the insurance company;
4 Provide no guarantees on the pension funds managed and base the returns to NPS subscribers solely on NAV of the units of the PFM;
5 Satisfy any losses arising from “extraordinary lapses and contingencies” that affect the interest of NPS subscribers through the Shareholders’ A/c, not through the Policyholders’ Funds; and
6 Obtain specific, prior IRDA approval of any PFM considering management of guaranteed products.


14 As initially established, the chair and members were each appointed for a 2-year term, or until the statutory PFRDA was in place, whichever was earlier, and were then to be appointed for additional terms of 3 years under the statutory PFRDA, or if earlier, until age 65 (chair) or age 62 (members).

4 NPS analysis, findings, and recommendations I: design

1 International experience, especially in Asia, is summarized in Appendix 1.

2 A recent World Bank study examined the experience of several Asian countries in expanding coverage to the informal sector. This paper, which reviewed the experience of India, Thailand, Sri Lanka, the PRC, Viet Nam, the Philippines, the Republic of Korea, Indonesia, and Bangladesh, concluded that expansion of coverage through a mandatory savings system is unlikely to succeed (this refers to the so-called “second pillar” pension systems which began with Chile and were implemented on a large scale in transitional Central European countries, such as Poland, Hungary, Croatia, and Bulgaria). MacKellar, Landis Ed. SP Discussion Paper No. 0903, The World Bank, “Pension Systems for the Informal Sector in Asia,” March 2009.

3 This section is based, in part, on the speech of Nicholas Barr, Professor of Public Economics, London School of Economics and Political Science, entitled “Strategic Policy Directions for Social Policy,” 5 March 2007 at the International Social Security Association conference in Warsaw, Poland. See also Keeping the Promise of Social Security in Latin America, by Indermit S. Gill, Truman Packard, and Juan Yermo, for a discussion of poverty targeted pensions, especially Chapter 9 “Preventing Poverty in Old Age.” 2005 The International Bank for Reconstruction and Development/World Bank.

4 For example, the US 401(k) instrument provided by employers is voluntary. The possibility of loans and withdrawals allows people to take out loans that must be repaid with interest. In the case of hardship, permanent withdrawals can be made. Permanent withdrawals can also be made in the New Zealand Kiwi Saver scheme. A recent UK study estimated that allowing loans and withdrawals could result in a substantial increase in participation in voluntary arrangements. “Would allowing early access to pension savings increase retirement incomes?” Pension Policy Institute, www.ipe.com/articles/print.php?id=29808.


7 This book does not account for any potential change in tax rules that may come into effect in 2011, as a result of legislation enacted in 2010.
Generally, section 80C of the Income Tax Act, 1961, permits the deductibility of up to a maximum, aggregate contribution of Rs 1 Lakh contributed to qualifying investments annually. (Deductions under section 80CCD are aggregated and included in the annual limit.) Qualifying investments are those specified in section 80C and include contributions to: provident funds, Public Provident Funds, life insurance premiums, equity-linked savings schemes, approved superannuation schemes, certain annuity plans, unit-linked insurance plans (ULIP) of UTI or LIC mutual fund, pension funds established by mutual funds, 5-year term deposit bank accounts, post office time deposit accounts of 5-year terms and, pursuant to section 80CCC, contributions to annuity plans of LIC or another insurer which, for the purpose of receiving pension, are deductible.

See “Budget may provide tax benefit to NPS holders at entry” in Business Standard, dated 12 June 2009. Another issue which appears unresolved is how to treat non-deductible contributions made to an NPS account. Arguably, there will be very few people who would contribute after-tax dollars to an NPS account, but if someone were to do so, the contribution would be taxed a second time at withdrawal under an “EET” regime, unless this after-tax basis were accounted for.

The initial charge of opening the account is Rs470, which includes Rs410 in charges paid to the CRA (annual maintenance fee [Rs350], plus account opening charge [Rs50], plus transaction charge [Rs10]) and Rs60 in charges paid to the POP (initial subscriber registration and contribution upload fee (Rs40 plus transaction charge of Rs20) assessed by the POP. After an account is established, there is an annual account maintenance fee charged from the second year onward by the CRA (Rs350) and two transaction fees are charged for each transaction (Rs10 to the CRA and Rs20 to the POP). Transactions for which the transaction fees are assessed include: (i) the regular subscriber’s contribution, (ii) a change in subscriber details, (iii) a change in investment scheme or fund manager, (iv) the processing of withdrawal requests, (v) the processing of a request for subscriber shifting, (vi) the issuance of a printed account statement, and (vii) any other subscriber service as may be prescribed by PFRDA.

The government already bears these costs for civil servants.

In the short term, this is unlikely to be a concern, and if the overall size of the Indian markets grows at a pace similar to NPS over time, it may never be a substantial concern. On the other hand, one could imagine a case in which a large number of subscribers decide to reduce equity exposure in a volatile market, or to change PFMs after a year in which there is a significant difference in PFM performance. The concern is exacerbated where most of the equity exposure is in identical indexed portfolios across PFMs.

It may follow from the stated rules that a former civil servant, having already established an account in the civil servants’ scheme, is prohibited from establishing one in the unorganized sector scheme, but the language in the Offering Document appears to refer to only active “Government employees.”

As we discuss in the following chapter, the PFRDA, rather than licensing and regulating the POPs, has entered into individual contracts with each institution. Unfortunately, the contracts are not readily available to the public, and, there is little publicly available information available regarding the nature of the contractual arrangements, the scope of the POPs’ obligations to the NPS, and the extent to which they are permitted to cross-sell their own products to customers seeking information about the NPS.
5 NPS analysis, findings, and recommendations II: governance and institutions


2. Absent proper legislative authority, however, the manner in which the “regulations” would be released and the ability to enforce them, is open to some question.

3. PFRDA’s RFP for POPs provides for a 5-year term of registration, after which a POP would be expected to re-bid to be considered for subsequent appointment. See Section 8.1,”Renewal of Registration After the Five Year Term” at page 31 of “Request For Proposal For Appointment of Additional Points of Presence (POP) For Expansion of New Pension System (NPS) Delivery Network For All Citizens,” issued by the PFRDA and available on its website (2009 FRP for POPs).

4. Very little information regarding the legal duties and obligations of the Board of Trustees is readily available. For example, the authors were unable to obtain a copy of the trust deed establishing the trust and board or a Memorandum of Understanding between the PFRDA and the Trust executed on 1 July 2009.


7. The 2009 RFP for POPs states that the Board of Trustees is “constituted by the PFRDA,” suggesting little independence. See section 1.1.5 at page 10 of the RFP.

8. Section 14 of the ITA provides that “a trustee must not himself or for another set up or aid any title to the trust property adverse to the interest of the beneficiary.” It should be noted that Bank of India serves in three capacities: trustee bank, POP, and PFM.

9. Subsection (a) of section 19 of the ITA provides that a “trustee is bound to keep clear and accurate accounts of the trust property.”

10. Sections 23–30 of the ITA provide the extent to which a trustee is liable for breach of trust and the extent of liability imposed under various circumstances. Chapter VI of the Act provides for the rights and liabilities of beneficiaries, including the right to inspect the trust accounts subject to the provisions of the trust instrument (section 57), “the right that the trust property shall properly be protected and held and administered by proper persons. . . .” (section 60), and the right to compel the trustee to perform any particular act of his duty and restrain the trustee from committing any contemplated or probable breach (section 61).

11. Section 15 of the ITA states that a “trustee is bound to deal with the trust property as carefully as a man of ordinary prudence would deal with such property if it were his own; and, in the absence of a contract to the contrary, a trustee so dealing is not responsible for the loss, destruction, or deterioration of the trust property.”

12. One indication that there is insufficient separation of the PFRDA and the NPS Trust Board can be found in the Section D of the Subscriber Registration Form in which the two entities are referred to as “the PFRDA/NPS Trust.”

13. The discussions of CRA and PFM selection and obligations are limited to a review of the narrative provided on the PFRDA website and in the Offering Document.

14. For the NPS civil service scheme, the CRA works with the Pay and Accounts Offices (P&AOs) and Drawing and Disbursing Offices (DDOs) of the government to open NPS accounts and process mandatory contributions.

15. Notwithstanding the costs involved in establishing a pension fund and managing it in accordance with the requirements of the PFRDA market participants were eager to participate in the NPS at its establishment, aggressively bid for the opportunity to do so, and in the bidding process, offered exceptionally low asset management fees in order to assure a place within the NPS program. All PFMs selected were required
Notes to operate at the lowest proposed asset management fee of 0.0009% p.a., which the PFRDA describes in the Offering Document as “perhaps the world’s lowest cost money managers.” Expert commentators, as well as other stakeholders, are unanimous in their belief that such fees will be unsustainable in the long run, even as PFM achieve economies of scale, or within the contract tenure of the current PFMs. See Sidhartha, “Loss-wary pension fund managers bet on fee hike” in Business Standard, 1 May 2009 at www.business-standard.com/india/news/loss-wary-pension-fund-managers-bettee-hike/356745/

16 These activities include (i) receiving filled application forms and required “Know Your Customer” (KYC) documentation, and verifying KYC documentation; (ii) collecting and verifying contributions received as cash, check or demand draft; (iii) submitting complete and accept forms to CRA on a daily basis; and (iv) uploading subscriber contribution files into the CRA system and arranging for transfer of the funds into the account of the NPS Trust maintained with the Trustee Bank.

17 This responsibility includes (i) uploading regular subscriber contributions; (ii) verifying PRAN card details on deposit slips; (iii) collecting and verifying contributions received in cash, check, demand draft or by electronic clearing system (ECS); (iv) uploading subscriber contribution details online into the CRA system; (v) remitting clear funds into the account of the NPS trust maintained with the trustee bank on at least a T+1 basis; and (vi) maintaining hard copies of deposit slips.

18 Servicing subscribers includes (i) carrying out changes in subscriber details on subscriber’s request, subject to PFRDA conditions; (ii) receiving switch request for change in PFM and/or investment option from the subscriber and transmitting to CRA; (iii) receiving a withdrawal request from a subscriber and transmitting to CRA; (iv) attending to subscriber’s request for shift to another POP; and (v) providing any other such services that the PFRDA may prescribe.

19 Handling grievances includes receiving grievances against the POP or a particular branch thereof, or any other intermediary that are submitted by a subscriber by (i) uploading the grievance in the “Central Grievance Management System” (CGMS) of CRA and (ii) receiving grievances raised by the subscriber against the POP or its branch through the CRA call center or the CGMS.

20 See Section 2, “Functions of POP(s)” in “Request For Proposal For Appointment of Additional Points of Presence (POP) For Expansion of New Pension System (NPS) Delivery Network For All Citizens,” issued by the PFRDA and available on its website.

21 Although this feature of the NPS program is widely discussed, language in the Offering Document seems to suggest that an individual’s ability to use different POPs to conduct business may be limited. For example, one of the subscriber services that POPs provide is “[a]ttening to subscriber’s request for shift to another POP-SP.” See Offering Document at page 10. Similarly, the 2009 RFP for POPs states that subscribers cannot yet shift from one POP to any other, but that the ability to do so will be implemented “in due course of time (as stipulated by PFRDA).” 2009 RFP at section 2.7.


23 The informational pamphlet refers readers to the PFRDA website for additional information on a number of items, including information on auto choice (i.e., the default portfolio option) and each fund option. It is unclear the extent to which individuals seeking answers to more questions will readily go the website and find it, and, more importantly, it is unclear how many of the individuals for whom the program has been established will have computer access at all.

6 Communications and marketing for the NPS

1 Analysis from the Report titled “Towards a Financially Inclusive Financial System: Financial Services Demand and Utilisation by India’s Low Income Workforce”
The potential size of the NPS

1 Technicalities such as deaths of in-migrants, which are also dealt with in the model, need not detain us here.
2 The calculations presented here deal only with the unorganized sector component of the NPS, which is by far the largest component.
3 Equally easy to model would be the polar opposite, in which upon death, assets leave the system—this would mean simply adjusting cohort accumulations downward by mortality in each year. Death between 18 and 60 is not rare in India, but it should also be noted that the great majority of persons who reach age 18 will, in fact, survive to age 60 and beyond.

Compulsory occupational schemes

1 The EPF was established under the EPF Act in 1952. The EPS was established in 1995 and the EDLI Scheme in 1976, by amendment to the EPF Act.
3 The EDLI Scheme (referred to in the EPF Act as the “Insurance Scheme”) pays a lump sum death benefit to the survivor(s) of a deceased EPF (or Exempt PF) member upon his or her in-service death. If no specific person was nominated by the scheme member, the benefit is paid to the members of the member’s family in equal shares. The lump sum benefit paid equals the average balance in the member’s EPF account for the 12 months preceding death, up to a maximum of Rs35,000 plus 25% of the balance amount, up to a maximum of Rs60,000. The EDLI Scheme is funded by employers and central government. employees are not required to contribute. The EPFO governs the scheme in the same manner as it does the EPF.
4 See section 5 and Schedule II (EPF Scheme), section 6A and Schedule III (EPS), and section 6C and Schedule IV (EDLI Scheme). Section 7 provides for modification of each scheme by notification.
5 In 1960, the Act was amended to address employers’ efforts. Section 2A thus provides the following: “For the removal of doubts, it is hereby declared that where an establishment consists of different departments or has branches, whether situated in the same place or different places, all such departments or branches shall be treated as parts of the same establishment.” These scope-of-coverage provisions, however, continue to be extensively litigated. Determinations are often based on the specific factual situation presented in each case.
6 EPFO Annual Report at 4.3.
7 Section 2(f) of the EPF Act states that an “employee” means “any person who is employed for wages in any kind of work, manual or otherwise, in or in connection with the work of an establishment, and who gets wages directly or indirectly from the employer, and includes any person (i) employed by or through a contractor in or in
connection with the work of the establishment; (ii) engaged as an apprentice, not being an apprentice engaged under the Apprentices Act, 1961 (52 of 1961), or under the standing orders of the establishment.”

8 Exempted entities include certain cooperatives registered under the Co-operative Societies Act, 1912 employing less than 50 persons; government establishments with other schemes in place; and “any other establishment set up under any Central, Provincial or State act and whose employees are entitled to the benefits of a contributory provident fund or old age pension in accordance with any scheme or rule framed under that Act governing such benefits.” Section 16 of the EPF Act. This provision should be read in conjunction with the provisions of the Provident Funds Act, 1925, which provides for the establishment of a statutory provident fund for scheduled government, and semi-government organizations, local authorities, railways, universities, and educational institutions.

Additionally, there are specific scheme rules providing specific definitions for the employees of newspaper establishments and cine-workers working in the film production industry. See sections 80 and 81 of the EPF Scheme rules.

9 EPFO Annual Report at 1.1.

10 All compulsory contribution calculations are based on the “basic wages” of each employee. The term “basic wages” means all emoluments which are earned by an employee while on duty or on leave with wages in accordance with the terms of the employment contract, and which are paid or payable in cash to him. Section 2(b) of the EPF Act. In 1995, courts determined that amounts paid as leave encashment were included in the basic wages for purposes of calculating the contribution. *Hindustan Lever Employees Union v. Regional Provident Fund Commissioner*, 1995 LLR 416.

11 See “EPFO says no to investment in equity in absence of guarantee”, Deccan Herald, dated 15 February 2011.

12 See section 32 of the EPF Scheme.

13 See section 52 of the EPF Scheme. Section 20 of the Indian Trusts Act, 1882 permits investment in (a) securities issued by the Central or any State Government, the United Kingdom or Ireland, (b) bonds and debentures and annuities secured by the United Kingdom prior to the establishment of the country on the revenues of India or any province, (c) securities issued by railway and other companies guaranteed by the Central Government, and (d) securities issued under the authority of any Central or State act on behalf of a municipal body or other similar entity described in the Act.

14 Current managers include SBI, HSBC Asset Management, ICICI Prudential AMC, and Reliance Capital AMC.

15 Source: EPFO Annual Report at 4.23–4.27.


18 Sections 51, 59, and 60 of the scheme rules.

19 Section 10 of the EPF Act.

20 “Interest on PF savings hiked to 9.5pc” Deccan Herald, dated 15 September 2010.

21 Section 69 of the scheme rules.

22 Section 68NN of the scheme rules.

23 Detailed rules are provided in section 68B of the scheme rules. In the case of the purchase of a site for construction of a house, the amount of withdrawal is limited to the lesser of: the member’s basic wages (including dearness allowance) for 24 months, the total value in the account, or the actual costs of the acquisition of the dwelling site. In the case of the purchase or construction of the house, an additional withdrawal is permitted, which is limited in the same manner as the withdrawal for site purchase,
except the 24-month wage limitation is increased to 36 months. In the case of home improvements, the withdrawal may be no more than 12 months’ basic wages (including dearness allowance) and may be taken only 5 years after the initial completion of the home construction. The EPF member is permitted two such withdrawals. Under section 68BB, members who have completed 10 years’ membership in the EPF may take an additional withdrawal to repay any loans issued under section 68B.

See the following scheme provisions: sections 68H (“non-recoverable” and/or interest-free advances for factory closings), 68J (“non-refundable” advance for illness of the EPF member or a family member that either requires hospitalization of one month or more, is deemed major surgery, or is one of an enumerated list of illnesses, including, for example, TB, leprosy, cancer, mental derangement, paralysis, or heart ailment), 68K (advance for marriages and education of children, and 68L (natural disasters and calamities).

Section 70 of the scheme rules.

See the following provisions of the Income Tax Act, 1961: section 88—employer contributions, section 88(2)(v)—employee contributions, section 10(11)—payment from the EPF. For tax rules regarding early withdrawals, conditions for withdrawals, requirements for paying certain withdrawals back to the fund, see sections 68–72. For tax treatment of default on obligations to repay certain withdrawals, see section 73.

Section 6A of the EPF Act.

Section 7Q of the EPF Act and section 5 of the EPS rules.

Sections 25 and 26 of the EPS rules. See also section 7 of Schedule III of the EPF Act.

There is considerable concern that the EPS is actuarially unsustainable. Reported actuarial valuations estimate a deficit of Rs540 billion. See “Pension fund deficit swells to Rs. 54k cr” in The Economic Times, dated 1 September 2010. Actuarial reports summarized in the EPFO Annual Report indicate that significant changes should be made. The issue is discussed in the following chapter.

Sections 30 and 31 of the EPS rules.

See sections 12, 12A, 13, 14, and 15 of the EPS rules.

This discount factor was originally set at 3% and increased to 4% (effective September 2008) to discourage members from taking early pension.

Section 16 of the EPS rules.

Employers may deduct contributions to their Exempt Provident Funds as a business expense under section 36(4) of the Income Tax Act, 1961 so long as the Fund is a “recognized provident fund” under the tax law. See Rules 67–81 of the Tax Rules. The EPFO will require an Exempt Provident Fund to be “recognized” under the tax law. See Part A of the Fourth Schedule pertaining to Recognized Provident Funds.

This effort is a direct response to legislation that tied the ability of an employer to obtain and maintain tax recognition of an Excluded Provident Fund to its having been granted a section 17 exemption from the EPFO. Under the Finance Act 2006, an employer sponsoring an Excluded Provident Fund is now required to register it with the EPFO in order to obtain favorable tax treatment for its scheme, contributions to it, and earnings thereon. These funds are to be distinguished from the Exempt Provident Funds that are established under section 17 of the EPF Act, and which are approved and actively supervised by the EPFO.

The Ministry of Finance, however, has issued two updated versions of this Investment Pattern, each one more liberal and less constraining than its predecessor. As mentioned above, the most recent Investment Pattern, which took effect on 1 April 2009, expands the investment discretion of trustees and permits them to invest scheme assets in equities and actively managed portfolios.
Because the EPFO currently adheres to a more constrained investment pattern, the trustees of Exempt Provident Funds cannot take advantage of the flexibility provided under the Ministry’s 2009 Investment Pattern. For further discussion, refer to the analysis and recommendations in the following chapter.

An “employee” is any person other than an apprentice employed in a covered workplace, excepting persons employed in central or state government. Section 2(e) of the PGA.

Section 5 of the PGA.

In 1987, there was an attempt to amend the Payment of Gratuity Act to impose on employers an obligation to fund their gratuity obligations, but the amendment (section 4A) was never notified. Section 4A would have required each employer to obtain “insurance for his liability for payment to wards the gratuity” from LIC or another licensed insurer. The “appropriate Government” would have been authorized to exempt employers “who had already established an approved gratuity fund” and every employer employing more than 500 employees who establishes an “approved gratuity fund.” The amendment also would have required all gratuity funds to satisfy tax rules for “approved gratuity funds,” under the Income Tax Act, 1961.

The increase in booked liability has caused some consternation, especially among banks, because the increase in outstanding liabilities reported under AS-15 results in a reduction of reserve capital. See, e.g., “Higher pension, gratuity outgo to hit banks’ net”, The Economic Times, 1 September 2010, page 15.

See, e.g., “Employees exiting Satyam may have to give up gratuity”, The Economic Times, 28 January 2009. According to the article, Satyam, a software service company which collapsed after significant misstatements of its finances were discovered, had a projected gratuity obligation of Rs705 million and a leave encashment obligation of Rs263 million at the end of the fiscal year prior to its collapse.

The Act provides special rules for calculation of wages and years of service in the case of seasonal workers and miners. See section 2A of the PGA.

The following provisions of the Income Tax Act, 1961 are applicable: section 36(1)(v) regarding employer contributions, section 80(2)(v) regarding employee contributions, section 10(10)(ii) regarding gratuity payments up to prescribed limits in the PGA, section 10(10)(iii) regarding gratuity payments up to prescribed limits other than PGA-required payments. See also the provisions of Part C of the Fourth Schedule pertaining to Approved Gratuity Funds.

Under section 40A(7), an employer must actually set aside a contribution in an “approved” Gratuity Fund in order to take a deduction and is prohibited from taking a deduction if merely making an accounting provision for the estimated accrued liabilities. The amount of deduction is limited under Tax Rule no. 103: the employer’s “ordinary annual contribution” must be made on a “reasonable basis… having regard to the length of service of each employer” and may not exceed 8.33% of the salary of each employee. The employer may make additional contributions to account for past service liability under Tax Rule no. 104, as part of its initial contribution to the fund, but again, these payments may not exceed 8.33% of the employee’s salary for each year taken into account.

The assets and liabilities of the ceased Family Provident Fund were assumed by the EPS.
11 Analysis, findings, and recommendations on compulsory occupational pension schemes

1 This figure was derived from data reporting in the EPFO Annual Report 2008–2009 (“EPFO Annual Report”). In the year of which data is reported, there were Rs3.47 million claims settled and a sum of Rs. 10038.57 crore paid out on those claims. See EPFO Annual Report at 4.44.

2 The government has previously increased the wage base by notification on several occasions: from Rs3,500 to Rs5,000 in 1994 and Rs6,500 in 2001.

3 Section 32 of the EPS scheme rules requires an annual valuation of the fund and authorizes the government to alter the rate of contributions required or the scheme’s benefit structure. The EPFO Annual Report for the period 2008–2009 indicates that valuations have been completed on a regular, if not annual, basis. Reports were made in 1998, 1998, 2001 (2 reports), 2003 (2 reports), 2004, and 2005. In addition, two review reports by a panel of actuaries on the valuation reports were completed in 1998 and 2003.

4 Actuarial reports issued in the initial years of the scheme operation indicated an initial surplus in the scheme (presumably the result of the transfer of the Family Pension Scheme’s assets and liabilities). By the time the August 2001 valuation was conducted, the initial surplus of Rs1.70 billion had already been reduced to a mere Rs700 million. The trend continued unabated, and the scheme moved from a surplus position to one of a continually growing deficit. The underfunded position of the EPS has climbed steadily ever since. The 2005 actuarial valuation (based on 2003–2004 data), estimated that the deficit was equal to Rs220 billion.

5 In the same time period (2003–2005), the valuating actuary was making similar suggestions aimed at controlling the cost of benefits, and recommended the following steps: revising the reduction rate from 3% to 5% for calculation of early pension payments to those members commencing monthly pension payments prior to age 58 (ages 50 to 57); increasing the retirement age from 58 to 60; reducing the withdrawal opportunities permitted under the scheme rules; and liberalizing the investment pattern to generate an increase in investment return.

6 The provident funds of many countries historically were designed to serve more purposes than pension provision. To some extent, this is an artifact of an era during which there was a lack of a developed financial services infrastructure, a dearth of banking and lending opportunities available to individuals, and a need to use the accumulating funds as a source for government financing and infrastructural development. Singapore’s provident fund is the most notable example. Individual accounts in the Singapore Provident Fund have also been used to finance housing and to pay medical insurance premiums. But this approach requires an explicit, and frequently revisited, policy decision, as well as a contribution rate than can provide sufficient capital to finance the multiple purposes for which it is intended, including the provision of an adequate pension. The Singapore Provident Fund, at one time, had a contribution rate about twice the EPF/EPS contribution rate.

7 See section 12A of the EPS rules. According to the EPFO Annual Report, the EPFO paid out 3,762,070 EPS pension claims for all benefits other than monthly pensions during the reporting year 2008–2009. By contrast, the EPFO settled only 410,376 claims for EPS monthly pensions and was paying monthly pensions on an ongoing basis to 3,246,131 pensioners and their nominees (including widows and widowers, other family members, and nominees) in the same period. See EPFO Annual Report, Tables 6-8 at 6.24–6.31.

8 The EPFO raised the rate of return for the EPF from 8.5% to 9.5% for the 2010—2011 year, an apparent response to the Ministry of Finance, which has been exerting pressure on the EPFO to increase the equity position of the fund. It appears that the EPFO is using the Interest Rate Suspense Account to finance
the increase. The EPFO also changed its method of accounting from a cash-based to an accrual-based method and, in doing so, was able to identify surplus assets that it also used to finance the increase in the administered rate of return. See “New accounting norms for retirement benefits” in The Economic Times Bangalore, 9 November 2010 at p. 9.

9 See paragraphs 7 and 9 of the “Revised Conditions for Grant of Exemption Under Section 17” at Appendix 1 of the scheme rules.

10 Conclusions are drawn from interviews with employers and other stakeholders, including insurance companies, mutual funds, banks, and actuarial and benefits consultants, as well as from discussion and comments obtained at a series of stakeholder workshops that were conducted in Delhi and Bangalore in August and early September 2010. The negative opinion of the EPFO, whether justified or not, is uniformly held.

11 Unless otherwise cited, data is derived from the EPFO Annual Report.

12 In the 2008−2009 reporting year, EPFO issued only 58% of annual statements of account to its members. By any objective measure, this is quite disconcerting. The only mitigating factor is that many of the accounts may be small, dormant accounts, which arise as the result of other administrative shortcomings.

13 In many cases, the employee simply withdraws the balance on his old account and begins afresh with a new account with his new employer. An employee may withdraw the full balance in his EPF account when he severs service with an employer in a variety of situations, such as termination of service or retrenchment, voluntary retirement, upon closure of a factory and transfer to an uncovered establishment, as well as in the event of permanent migration, and permanent and total incapacity to work (section 69 of the EPF scheme rules). However, if a person withdraws his account balance before completing 5 years of employment with his employer, the withdrawal is treated as taxable income. The tax, as well as the administrative barriers, discourages some people from taking the withdrawal.

14 The number of transfer requests that the EPFO receives annually is not inconsequential: in the 2008−2009 reporting year, the EPFO completed 280,000 transfers, up from 230,000 in the previous year. Similarly, claims applications have increased. For example, in the period 2008−2009, the EPFO settled 3,473,000 EPF claims, up from 2,930,000 in the prior year. The number of monthly pension claims made under the EPS increased from approximately 597,000 (2006−2007) to over 663,000 (2008−2009), and “other” pension claims increased from about 2,696,000 to 3,762,000 in the same period. EPFO Annual Report at section 4.44, Table 18 at section 4.50, and Tables 7 and 8 at sections 6.27 and 6.29.

15 It has also worked to reduce the time from the collection of contributions to their deposit from 3−5 days to 1 day and eliminating the float period, although the Annual Report describes the effort as only a trial process in one region. The State Bank of India, which is responsible for receiving and processing collections, has been earning float on the days during which the transfer of funds to EPFO is processed. This modification of operational processes would ensure the timely credit of deposits to the EPFO and the immediate availability of the funds for investment on the members’ behalf. See section 4.17 of the EPFO Annual Report. Although this is a significant EPFO initiative, the question must be asked why the issue had not been addressed much earlier.

16 When this idea was presented in meetings with stakeholders in August, 2010, they reacted enthusiastically. They were particularly interested in the idea of moving assets to the NPS. There are a number of administrative challenges to effectuating this systemic change. If not carried out properly, it could exacerbate the EPFO’s recordkeeping and transfer problems. One approach is to develop a centralized record keeper, perhaps based on the functionality built for the NPS. Another option, especially if the focus is on asset management, could treat the alternatives to EPFO as alternative
asset management choices for either employers or members, in which case the EPFO’s competencies, operational processes and systems would need to be redesigned and enhanced. Finally, the recordkeeping function could be dispersed among the larger entities (including large Exempt and Excluded PFs) that may wish to gather assets, scale up operations, and lower costs. If employers could move their contributions and employees from the EPF to “competing” employers managing schemes, the competition may result in lower costs, a wider range and the improved quality of services, as well as competition based on investment performance.

17 The authority to issue exemptions and many of the conditions of exemption are established in section 17 of the Act. Subsection (1)(a) of section 17 states that an exemption may be granted if, among other conditions, “in the opinion of the appropriate Government, . . . the employees are . . . in enjoyment of other provident fund benefits which on the whole are not less favorable to the employees than the benefits provided under this Act . . .” (emphasis added). The phrase “benefits which on the whole are not less favorable” to the employees than benefits provided under the EPF would suggest that although contribution rates must be equal to, or greater than, those of the EPF (in accordance with other language appearing earlier in the same subsection), the benefits provided need not be identical. Benefits provided by Exempt PFs need only be “on the whole. . . not less favorable.” Presumably, if the legislation was intended to require identical or equal benefits, it would have so stated. It follows from this analysis that the investment return on accounts need not be the identical to that of the EPF, because section 17 explicitly tolerates different outcomes.

In further support of this reading of section 17, subsection (1A)(d)(iii) of that provision requires the Board of Trustees of an Exempt PF to “invest provident fund monies in accordance with the directions issues by the Central Government from time to time. . . .” This provision suggests that investment practices were the focus, not the investment return.

18 See section 17(1)(a) of the EPF Act with respect to the EPF and section 17(1A)(d)(iii) with respect to the EPS.

19 See, e.g., Bill No. 14 of 2009.

20 As discussed previously in chapter 5, the extensive case law addressing the extent to which various work situations are covered under the EPF Act is a clear indication that small employers will in fact seek to avoid the costs imposed.

21 The statement accompanying the introduction of the bill stated that the “objects and reasons” for the Act were “to ensure a uniform pattern of payment of gratuity to employees throughout the country”, a need which arose because various states were passing their own legislation. Thus, the Act’s intent was “to avoid different treatment to the employees of establishments having branches in more than one state when, under the conditions of their service, the employees are liable to transfer from one state to another.”

22 Analysis suggests that gratuity benefits provide little social protection, if any, and perhaps in only limited circumstances, such as retrenchment. Even in the case of retrenchment, a portion of a person’s EPF account balance may be a suitable substitute.

23 The increase of the maximum gratuity payment obligation from Rs3,500 to Rs10,000 has heightened the private sector’s awareness of this issue. For example, the banking community estimated that the industry’s the annual cost imposed by this increase would be Rs40 billion, and the increase in outstanding gratuity liabilities, as accounted for under the AS-15 accounting standard, would have a negative impact on their reported reserves, which, in turn, would reduce the banks’ capital adequacy ratios and their reported profits. See “Higher pension, gratuity outgo to hit banks’ net” in The Economic Times, 1 September 2010 at page 15. More recent reports indicate that AS-15 will be modified to permit firms to record assets and liabilities of all post-retirement balances in a reserve account and enable them to reduce and smooth the charges for
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retirement benefits that are reflected on their balance sheets. See “New accounting norms for retirement benefits” in The Economic Times Bangalore, 9 November 2010 at p. 9.

24 As we have already mentioned, there have been previous efforts to impose an obligation to pre-fund gratuity liabilities by amending the PGA, which have caused some confusion among stakeholders. Under proposed section 4A of the PGA, which would have amended the PGA, an employer would have been required to fund its gratuity obligations either by purchasing an insurance contract or establishing and contributing to a trust. The provision, however, was never notified.

12 Analysis, findings, and recommendations on unregulated voluntary occupational pension schemes

1 The obligation to finance the scheme’s benefits, of course, can be shared between employer and employees, but in such cases, the employees’ obligation is usually in the form of a compulsory contribution set as a fixed percentage of salary—essentially a defined contribution to the scheme—and thus, the risks of underfunding, poor asset management, and changing actuarial assumptions and conditions continue to reside with the employer.

2 See Tax Rules at Part XIII Rules 82–97 issued under the Income Tax Act, 1961. The relevant IT Act provisions are the following: section 36(4) (see also Tax Rules 87 and 88) regarding employer contributions, section 80C(2)(vii) regarding employee contribution, section 10(25) regarding income received by the Superannuation Fund trust, and section 10(13) (see also Tax Rules 89 and 90) regarding payment from an “approved” Superannuation Fund.

3 See section 115WA and 115WB of the IT Act, 1961.

4 See the relevant Tax Rules 67–73. The following provisions of the Income Tax Act, 1961 are also applicable: section 88—employer contributions, sections 75 and 80C(2) (vi)—employee contributions, section 10(25)—income received by the “recognized” Provident Fund, section 10(12)—accumulated balance due from a “recognized” Provident Fund. See also Part A of Schedule IV, Rule 4(b), (c), and (g).

5 See Schedule IV, Rule 4(c), (d), and (f).

6 Under provisions established in accordance with the Finance Act, 2006, the withdrawal rules set forth at Rules 68–71 no longer apply to withdrawals made after 1 April 2007 (Rule 71A) to those Excluded PFs which become “Exempt” Provident Funds in accordance with Rule 4(ea). See discussion of the Finance Act, below.

7 See Schedule IV, Rule 5(c).

8 The Finance Act, 2006 instructs the tax authority to withdraw its recognition of any provident fund previously excluded from the EPF Act, 1952 by sections 1(3) and 1(4) of the EPF Act unless the employer sponsoring the fund obtains an exemption from the EPFO under section 17 as a condition of retaining tax recognition. It is not clear whether the EPFO may require the Excluded Provident Funds to comply with the same conditions that it has established for Exempt PFs under section 17. See also the provision codified at Schedule IV, Rule 4(ea).

9 If the Finance Act requires Excluded Provident Funds to comply with the EPF Act, including the requirements associated with EPFO-issued exemptions, then the analysis of Exempt Provident Funds presented in previous chapters may apply to the Excluded PFs. Some of the conditions imposed on Exempt PFs, however, do not seem relevant for Excluded PFs and, although the general intent of the Finance Act provision—to strengthen the existing regulatory and supervisory framework applicable to Excluded PFs—is laudable, its full effect does not appear to have been properly considered. Its enactment is an example of the ad hoc approach to pension policy, regulation, and supervision that is currently prevalent.
10 For example, in the United States, pension regulations require pension fund trustees to prudently invest and to attend to all rights accruing to shares, including voting rights. As a result, pension funds have been a key factor in the rise of a more activist shareholder community and the related proxy advisory services industry. The participation of pension funds in these aspects of corporate governance has had significant, positive effects on corporate governance, for example, by contributing to the reduction of the use of poison pills, an increase in majority voting, and changes in the composition and role of corporate boards. See New York Stock Exchange’s Commission on Corporate Governance Report at p. 15 et seq.

11 The CBDT collects and approves initial applications for recognition or approval, but typically only reviews schemes as part of a much broader audit of an employer. Although applications for tax recognition are filed, the CBDT has not retained an active database of schemes that could be used to assemble aggregate data regarding the characteristics of the schemes. There are a number of reasons for CBDT’s inactivity and ineffectiveness. First, its jurisdiction is dependent on the voluntary filings of scheme sponsors. Second, the current tax rules provide only minimal standards. Third, the penalties for failure to comply with the relevant tax rules are currently too weak (and weaker still because there is little threat of enforcement). Fourth, the schemes are not a high priority for CBDT, in light of its other responsibilities—and, indeed, CBDT’s implementation of India’s new Direct Tax Code will surely reduce any possibility that its activity in the pension area will increase.

12 There may be a number of legal claims available. For example, aggrieved employees and scheme members may be able to raise contract claims against employers who are in breach of contract, raise a claim in equity for promissory estoppel or some similar claim. Presumably, the cause of action would be based on either the employment contract or the contractual agreement to provide pensions, the written pension scheme rules, if any, or oral representations upon which the individuals may have relied. Additional claims may be available against the scheme’s trustee, if the employer has established a scheme trust.

13 In the case of SEBI, pension assets will be invested in the Indian securities markets (to the extent permitted by the applicable legal standards and Investment Pattern) and the administration of pension schemes (especially defined contribution schemes) may require operational and IT infrastructure and rules, including disclosure rules similar to those of mutual funds. In the case of IRDA, products regulated and supervised by IRDA may be used to fund pension schemes; benefit payments might be in the form of insured annuities; and defined benefit schemes may find it beneficial to use insurance products as part of a funding strategy. The regulation of DB schemes also requires actuarial capacity, which IRDA may already have in place.

14 For citation, see the discussion of the PFRDA and scope of its authority in Chapter 3.

15 See http://www.oecd.org/document/23/0,3746,en_2649_34853_42193431_1_1_1_1,00.html.

Although those employers seeking tax recognition for their schemes are required to segregate scheme assets in a trust, it is not clear whether common practice satisfactorily ensures the safe custody of scheme assets. Presumably, an employer either may hire an independent, third-party trustee, or, alternatively, it itself may act as trustee of its scheme’s assets. It is also unclear whether third-party custodians are being used to hold the assets.

The tax rules applicable to the “approved” Superannuation Funds, for example, require only that there be more than one trustee and that trustees be individuals, rather than companies. There are, however, no minimum fit and proper standards, no qualification standards requiring certain types of skills, and no explicit rules to address conflicts of interest. Thus, for example one or both trustees could be a director or senior executive of the employer. The tax rules applicable to “registered” Provident Funds have a similar lack of standards.

To the extent that an employer sponsoring a scheme elects to establish a trust, the fiduciary principles in the Indian Trusts Act would apply, but the standards in the Act may not be sufficiently focused on the specific functions of pension scheme trustees. Discussed below, for example, is the proposal that the prudent person standard be modified in order to require trustees and other scheme fiduciaries to act in the manner expected of a “prudent expert.”

The tax rules applicable to “registered” Provident Funds require the timely preparation of accounts and establish reporting requirements, but these requirements are not sufficient (Rule 74).

As we have already noted, employers establishing tax-recognized provident funds, including Exempt and Excluded PFs, and Superannuation Funds, are required to form scheme trusts. In the case of Exempt PFs, the EPFO also imposes this requirement as a condition of the exemption. The tax rules do not explicitly require the more general scheme types (defined contribution and defined schemes) to establish trusts or segregate assets.

The tax rules permit employers establishing Superannuation Funds to use contracts with insurance companies, rather than establishing a trust. If the goal of establishing a trust is to ensure that there is a third-party fiduciary with clear legal obligations to the scheme and its members, it is not clear that the mere use of an insurance contract is adequate to the task in the absence of additional regulations regarding the terms of the contract. Regulators also should provide guidance on what constitutes an “insurance contract” for these purposes. Currently, the “insurance contracts” funding many Superannuation Funds are actually only agreements to administer the scheme (individual accounts), to hold and invest assets, and annuitize pension payments. The contracts do not transfer the investment risk of the scheme assets to the insurer.

The Indian Trusts Act provides that trust beneficiaries should have “a right (subject to the provisions of the trust) that the trust property shall be properly protected and held and administered by proper persons . . . .” The explanation accompanying the provision identifies those persons who would not be proper trustees, including, for example, persons having interests inconsistent with that of the trust beneficiaries, and persons who are insolvent.

The US law generally recognizes that neither an employer’s establishing of a pension scheme, nor its design decisions regarding the scheme parameters, is a fiduciary function; rather, an employer, when acting in these capacities, is analogous to the settlor of a trust. Similarly, a corporate officer who is also a scheme fiduciary is only liable for a breach of fiduciary duty to the pension scheme and its members if he violates his fiduciary duty when he is, or should be, acting in a fiduciary capacity on their behalf. The US law, thus has made a practical accommodation to the fact that employers and their executives will often be responsible to the firm sponsoring a pension scheme and the
pension scheme - or in the words often use in US case law, they will “ware two hats”. Determining which hat is worn when, is not always an easy task.

For example, what happens when a corporate officer has inside information regarding poor earnings or a brewing company scandal? As a corporate officer, the person’s duty is to the corporation and its shareholders, and to act on the information, even on behalf of the scheme, would violate the securities laws (insider trading). During the collapse of the Enron Corporation, a US energy firm, corporate officers who were also fiduciaries to the firm’s pension scheme were unable to take action on behalf of the scheme based on “insider information” obtained when acting in their corporate capacities. Their inaction resulted in enormous losses for the scheme and its members—and thereafter resulting in extensive litigation. Although US courts continue to embrace the two-hat rule, they do not necessarily permit employers or company officers to err on the side of the company rather than the pension scheme. See e.g., In re Worldcom, 263 F. Supp. at 765 (Court declined to dismiss claims against Bernie Ebbers, the company’s CEO, observing that “[w]hen a corporate insider puts on his ERISA hat, he is not assumed to have forgotten adverse information he may have acquired while acting in his corporate capacity.”).

24 See the discussions of the Maxwell and Madoff scandals at Appendix 2.

25 Employers sponsoring “recognized” Provident Funds are required to provide annual statements to scheme members (Tax Rule 74(6)). The tax rules for “approved” Superannuation Funds and Gratuity Funds are silent on the issue. The Payment of Gratuity Act requires employers to determine the amount of gratuity owed a former employee as soon as it becomes payable and to notify the person in writing (section 7(2) of the PGA).

26 Written disclosures should include a number of documents and topics, including, for example, statements of benefit accrual (or account balance) and contribution history, provided with appropriate frequency, the scheme rules, and an easy-to-understand summary of the rules. The rules and summary should address the following: conditions under which an employee qualifies for participation in the scheme (eligibility), the manner in which benefits accrue or accumulate, the vesting of benefits, how and when the pension benefits will be paid, the manner in which the accumulated, vested value of the benefit may be transferred to another scheme (portability), the process by which members may make inquiries about the scheme or file a grievance with respect to their rights under the scheme, and the names of persons responsible for the maintenance and operation of the scheme (generally the trustees and the senior officer of the employer who is delegated responsibility on behalf of the employer). Scheme members should also have access to the annual reports of scheme trustees, audit reports, and opinions, and actuarial valuations in the case of defined benefit schemes.

27 The area of member rights and protections is fully explored in the OECD’s work in this area. The OECD, in conjunction with the International Organization of Pension Supervisors (IOPS), has issued best practice guidance for policy makers, regulators, and supervisors. See http://www.oecd.org/document/23/0,3746,en_2649_34853_42193431_1_1_1_1,00.html. See also Galer, R. “Guidelines for the Protection of the Rights of Members and Beneficiaries in Occupational Pension Plans,” OECD Financial Market Trends, Volume 87, October 2004.

28 Custody services should be performed by only “fit and proper” financial institutions, such as licensed and regulated banks, insurance companies or other financial institutions. Rather than imposing standards on the institutions seeking to perform custodial functions for pension schemes, the regulations could require the scheme trustees to obtain third-party custodians who satisfy standards established by the regulator.

29 The rule’s most noteworthy aspects include the following:

- using a “projected unit credit method” to value the liabilities, which involves projecting salaries to the time of retirement, death, disability or severance from the
company, taking into account any terms of the scheme that promise benefit increases or indexation of benefits, using prescribed interest rates to value the liabilities;

- valuing scheme assets at fair value, using market values whenever they are available (“mark-to-market”);
- requiring that annual actuarial gains and losses that exceed a defined amount be reflected on the balance sheet and amortized in accordance with the details of AS-15; and
- limiting the extent to which a scheme’s surplus assets can be claimed to be assets of the employer (for accounting purposes) to those instances when the terms of the scheme permit the employer to use the assets in order to reduce future contributions or to be taken as a refund.

30 Recently, Indian firms, particularly banks, have voiced concern that an increase in compulsory gratuity obligations (by raising the amount permitted to be paid from Rs350,000 to Rs1 million) would result in a large increase in liability, which would need to be reflected on the balance sheet under AS-15. Recent press reports indicate that AS-15’s methodology may be modified to address these concerns. AS-15 is consistent with the approach taken in the UK and USA, where its impact on corporate balance sheets is also somewhat controversial. In times of significant financial volatility, the obligations and assets reported under the rule can change substantially from year to year. This translates into an unpalatable degree of volatility on employers’ balance sheets. The mark-to-market requirements, in particular, have caused substantial concern, and some people have advocated a return to an approach that would permit the “smoothing” of asset (and liability) valuations over a period of years, rather than utilizing a “snapshot” approach to valuation and assessment of a firm’s outstanding liabilities. Further discussion of AS-15 can be found later in this chapter in the discussion on “scheme funding.”

31 Implementation of the licensing requirement could include the establishment of a supervisor-maintained register of qualified accountants and actuaries and educational, training or certification programs specific to pensions and other employee benefits, which could be implemented in coordination with the relevant professional organizations.

32 An employer often uses a pension (or other employee benefit) scheme as a labor management and compensation tool. For example, an employer may decide to establish a pension scheme to attract workers with specific skills in a competitive labor market, to retain trained workers and maintain a stable workforce, or to signal concern for its workers’ overall welfare. Pension schemes and other compensation devices, such as severance schemes (and voluntary gratuity schemes), may become increasingly important to employers in India as their workforces age, and there is a need to control payroll costs (senior employees tend to be more expensive) or to effectuate a change in the composition and skill sets of their workforce.

33 We have made a similar point earlier in our discussion of the voluntary nature of the NPS unorganized sector scheme and its Tier I and Tier II NPS accounts. To the extent that voluntary employee contributions are expected or desired, it has often been the case that employees will not participate in the scheme unless there are either incentives to do so (e.g., an employer’s matching contribution or a tax benefit) or the ability to take assets out of the pension scheme, at least in the case of exigent circumstances. In fact, studies have shown that in addition to a good taxation regime, two factors increase the likelihood of voluntary savings in developed countries: the ability to retrieve some assets if necessary, and an arrangement where people opt out instead of opting in. For example, the US 401(k) instrument provided by employers is voluntary. The possibility of loans and withdrawals allows people to take out loans that must be repaid with interest. In the case of hardship, permanent withdrawals can be made.
Permanent withdrawals can also be made in the New Zealand Kiwi Saver. Similarly, a recent UK study estimated that allowing loans and withdrawals could result in a substantial increase in participation in voluntary arrangements. While there is a significant risk that allowing withdrawals will leave insufficient amounts for retirement, it appears that for many people the possibility of taking their funds out increases likelihood of participation. See “Would allowing early access to pension savings increase retirement incomes?” Pension Policy Institute, www.ipe.com/articles/print.php?id=29808.

34 Our analysis of the EPF’s pre-retirement withdrawal rules is provided in Chapter 11. Rules permitting pre-retirement access to EPF account balances have substantially reduced the value of pensions the EPF provides to its members.

35 Rules 5(c)(3) and 8(iii) of Part A of the Fourth Schedule.

36 Similarly, there needs to be a clear vesting principle, so that an employee may readily know when he becomes entitled to his pension benefit under an employer’s scheme and can take this into account when deciding whether to continue to work for the employer. There is a vesting concept in the PGA (5 years of continuous service), and, in other cases, 5 years of service is used as a milestone at which certain rights under a scheme accrue. For example, an employee who has rendered 5 years or more of service with an employer retains his tax exclusion for a distribution from a recognized Provident Fund. Rule 8(i) of Part A of the Fourth Schedule.

37 In the case of a tax-recognized Provident Fund, for example, the tax rules state that “the accumulated balance due shall be payable on the day he ceases to be an employee of the employer maintaining the fund.” Schedule IV, Rule 4(g). In the case of Superannuation Funds, up to one-half of the commuted value of the benefit may be paid as a lump sum.

38 The one possible exception applies to “recognized” Provident Funds. The tax rules state the following: “[T]he contributions of an employer to an individual account of an employee in any year shall not exceed the amount of the contributions of the employee in that year, and shall be credited to the employee’s individual account at intervals not exceeding one year.” (section 4(c) of Part A of the Fourth Schedule) (emphasis added).

39 If the fund were a “recognized” Provident Fund, the contributions would be required to be made to an irrevocable trust. Section 4(d) of Part A of the Fourth Schedule.

40 For example, a mark-to-market approach, such as that which is required for accounting purposes under AS-15, may yield a very different result than a “corridor” or “amortization” rule, which would smooth funding obligations. If regulations were to introduce an AS-15 approach to the actuarial valuation of liabilities, employers could react by adjusting their scheme’s portfolios to obtain more predictable investment performance—and likely reduce the scheme’s equity exposure. This, in turn, may affect future contribution obligations. Additionally, these calculations are extremely sensitive to interest rate assumptions, often linked to corporate bond yields. Under one estimate, a 50 basis point fall in discount rates results in an estimated 10% increase in liabilities. Mercer Consulting, “Global Defined Benefit Pension Liabilities Hit New Highs” (press release), 22 September 2010.

41 Scheme trustees investing the scheme assets may also be required to comply with the “Investment Pattern” Table set forth in section 67 of the tax rules. This provision applies to all “recognized” Provident Funds and “approved” Superannuation Funds (by reference in its relevant tax provisions). The CBDT should continue to coordinate its Investment Pattern with the Ministry of Finance, which may be better placed to assess the extent to which pension scheme assets should be permitted to be invested in a broader range of investment opportunities.

42 Section 14 of the ITA states that a “trustee is bound to deal with the trust property as carefully as a man of ordinary prudence would deal with such property if it were his own...”.

Appendix 1

3 This section is based on the speech of Nicholas Barr, Professor of Public Economics, London School of Economics and Political Science, entitled “Strategic Policy Directions for Social Policy,” 5 March 2007 at the International Social Security Association conference in Warsaw, Poland. See also Keeping the Promise of Social Security in Latin America, by Indermit S. Gill, Truman Packard, and Juan Yermo, for a discussion of poverty-targeted pensions, especially Chapter 9, “Preventing Poverty in Old Age.” 2005. The International Bank for Reconstruction and Development/The World Bank.

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