



Has the Indian retirement fund industry come of age? A critical analysis of NPS

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Executive summary:

The dissertation makes an attempt to understand what the critical factors that enable a successful penetration of pension reforms in India are, by taking new pension system (NPS) as the theme and analysing its critical success factors. In order to find out those successful factors, perspectives from the various stakeholders in the distribution network of NPS are taken into consideration.

We are a young population in India and hence the right time for reforms, through which we can realise the “power of compounding” and have a better life without depending on others in old age and thus ensure that the poverty levels decrease in the next 30 years. In order to do that, pension reforms have to be available to all. NPS is a scheme which targets approximately 300 million informal sector workers over time and thus a very important reform if not the ultimate one.

NPS is not a cure for all, it comes with its own set of limitations and they include the short term problem of EET, high transaction costs and the long term risk of higher investments in equities. Other limitations include the consumption pattern of individuals who prefer to withdraw their money from time to time-which is not possible through NPS. An analysis of NPS versus other pension schemes is made in which the comparison between NPS, UTI retirement benefit scheme, ICICI prudential Lifestage pension scheme, EPF, PPF reveals that NPS is better than other pension schemes with respect to management fees and custodian charges but loses out because of the current tax structure(EET) and the taxes on interest on annuity.

Other challenges involved in the distribution include low financial literacy and the risk of premature halting of distribution by PoPs, low incentive for distribution in case of NPS for an insurance agent and low penetration of IT infrastructure in small town and rural India.

Some of the ways in which pension fund industry and NPS in specific can be improved is by achieving a critical mass of workers, which would ensure economies of scale, improvement in capital market regulations, further improving the distribution through regional and nationalised banks and more importantly by improving the financial literacy levels among the youth in particular.

1 Introduction: Why pension reforms are important?

1.1 Current sound progress in poverty elimination:

India has experienced a substantial reduction in the headcount of the poor in the period after 1993. In years to come, it is likely that Indian GDP growth, and hence rising wages, will lead to the elimination of poverty among people in their working years.

1.2 Poverty amongst the elderly is the next frontier:

Poverty amongst the elderly will then become the dominant form of poverty in India, since the elderly do not work and thus do not benefit from higher wages. A parallel development of great importance is the rise in migration flows of labour, and the breakdown of the 'joint family', through which the elderly are less likely to cohabit with their children in old age.

1.3 This is the right moment:

India is at a remarkable point in its demographic transition. In the period from 2005 to 2030, a substantial decline in the dependency ratio is expected, with a large number of people coming into their working years. This constitutes an opportunity to create a pension system in time for them so that they can be empowered to enjoy decades of life in their elderly years using personal control of pension assets.

1.4 Every year lost hurts welfare:

An early effort in pension reforms is essential, so that sound institutions can be in place in time for young people coming into the labour force. The "power of compounding" implies that every additional year matters greatly in building up pension wealth. A person who loses an opportunity to put Rs.2,500 into a pension account at age 20 can lose pension wealth of Rs.25,000 at age 60. Every year of delay implies that millions of people will be unable to cross the poverty line in old age.

2 Evolution of pension funds in India:

In India, there are two types of Provident Funds, namely:

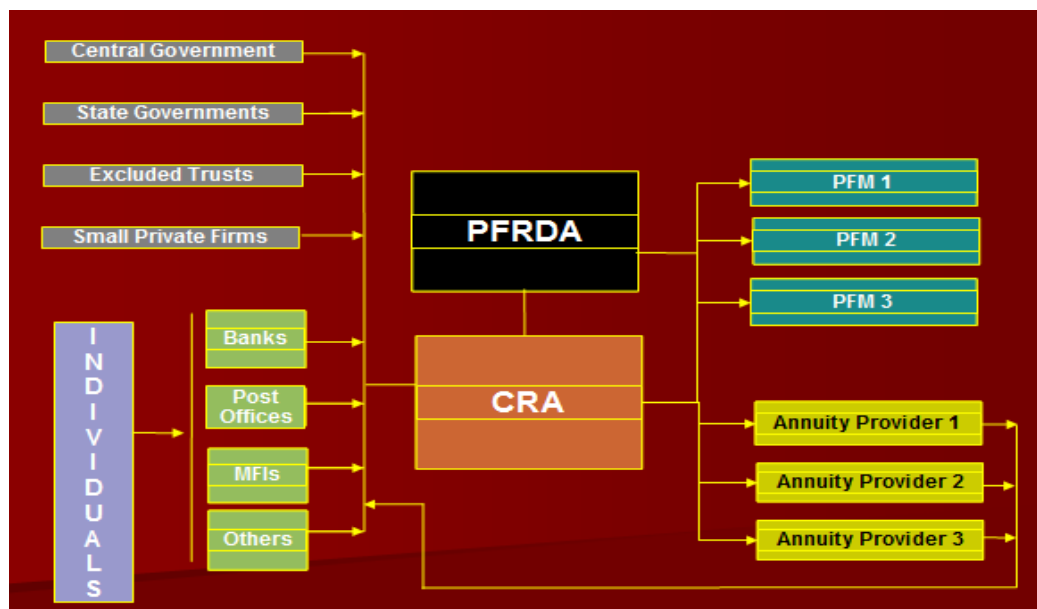
- Contributory provident funds
- Non contributory provident funds

The Contributory Provident Funds are applicable to industrial workers not working in Government sector. The following laws pertaining to Contributory Provident Funds are in operation in India.

1. Employees' Provident Funds and Miscellaneous Provisions Act, 1952 administered by the Employees' Provident Fund Organisation. This is meant for all workers engaged in industries and other classes of establishments as listed in the Schedule to the Act.
2. Coal Mines Provident Funds and Miscellaneous Provisions Act, 1948. This is meant for coal mines workers in the country.
3. Assam Tea Plantations Provident Fund and Pension Schemes Act, 1955. This is applicable only to the plantation workers in Assam State.
4. Jammu & Kashmir Provident Fund Act, 1961. This exclusively provides for Provident Fund and caters to workers in the State of Jammu & Kashmir.

With the introduction of new pension system (NPS), pension reforms have percolated into the rest of unorganized sector and the rest of the dissertation discusses the challenges, opportunities for the further penetration of pension reforms in India.

3 Distribution network of NPS¹:



A member will accrete savings towards his retirement into his Personal Retirement Account (PRA) through his working life. He will be able to use a nationwide network of competing pension service providers (PoPs) to access this system for opening a PRA, accreting new contributions, receiving account or system information and for obtaining retirement benefits.

A member will have complete control on how his contributions and savings in his PRA are managed. He will be able to select a professional Pension Fund Manager

(PFM) from a pool of competing pension fund managers. Each PFM in this system will offer a choice of three simple and standard pension schemes with different risk and return profiles. The most distinguishing feature of this architecture is seamless portability across jobs and across locations.

On retirement, the member will be able to use a part of the savings accumulated over the years in his PRA to buy an annuity as a way to obtain consumption for the rest of his life. In this process of accumulating retirement savings, the Pension Fund Regulatory and Development Authority (PFRDA) will provide the members of this scheme with a sound regulatory framework and an umbrella of safety with respect to prevention of fraud and malpractice.

Currently there are 21 PoPs which have 798 branches and 6 PFMs to manage the corpus of customers.

4 The Gap:

As per the ADB survey report², the following is the market size for NPS in India
Total size of the Indian labour force = 425 million and of these, 85% (363million) are paid workers. Of the 363 million 5.5% (20 million) are ready immediately to join the NPS based on three criteria:

- Financial capacity to pay adequate pension contributions
- High interest in the pension option
- Aged 30 to 50 years
- 20 million unorganised sector workers are ready immediately to join the NPS if effective sales and marketing tools are put in place

More importantly the composition of the 20 million includes significant numbers of rural workers as well as urban workers and includes workers on modest incomes (<Rs. 30000 a year) as well as higher income groups. Thus a gap of 403 million labours force!! The break-up of the 20 million is as follows:

Farmers	5.8 million
Small retailers	5.3 million
Street vendors	0.7 million
Self employed	3 million
Small/medium manufacturers	0.3 million
Skilled/semi-skilled wage earners	2.5 million
Salaried employees in small firms	1.5 million

Others	0.7 million
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- Over 50% of these have incomes of less than Rs. 100K a year.
- 19% have neither a bank or Post Office savings accounts
- 8% bank exclusively with the Post Office
- 56% bank exclusively with banks
- 17% have both Post Office and bank savings accounts and
- 44% are customers of life insurance institutions

5 Addressing the gap:

5.1 NPS: A critical analysis:

5.1.1 Tax—a necessary evil:

When thinking about the new pension system, the argument sometimes made is that it has to also use an EEE tax treatment, in order to be competitive in the eyes of consumers who have choices between alternative avenues. At the same time, it is important to design a fiscally responsible pension system, where the rule set would be consistent with sound principles of public finance, and yield stable institutions over many decades. Any new pension system which does not use an EEE tax treatment will be disfavoured today, when compared with EPF& PPF. Yet, if a new pension system uses an EEE framework today, it would be hard to bring back taxation at either entry or exit at a future date. From a long-term perspective, it appears to be useful to put the new pension system on a sound foundation by not using EEE tax treatment, and simultaneously work on improving the policies governing EPF & PPF.

5.1.2 Transactions costs:

In India we expect a large mass of pension system participants to do small transactions and to have small balances. This places new demands on the design of the pension system. If the cost of a money order is Rs.12, and if a participant contributes Rs.120 into a pension account, then the transaction involves an overhead of 10%, which is completely unacceptable.

The challenge in Indian pension policy consists of finding innovative design strategy through which these transactions costs can be controlled. The impact of pension reforms in India measured by the sheer number of households who stand to gain from a modern pension system will be defined by the extent to which a sound pension system design is able to support small value transactions and balances.

5.1.3 NPS versus other pension schemes:

Table 1 compares NPS with other pension schemes available in the market such as MF Pension Scheme, Insurance Pension Fund Scheme, EPF and PPF, on the basis of different charges.

NPS charges a flat Rs 470 per year plus 0.0084% which will go down further with an increase in the volume. In Mutual Fund product, let's consider UTI Retirement Benefit Pension. It provides a tax benefit of Rs 1,00,000. The entry load for the scheme has been put at 0% as per the SEBI ruling. For Insurance PF scheme, let's consider ICICI Prudential LifeStage Pension scheme, which comes with a total charge of 1.81%. While in EPF & PPF, there are no entry loads, transaction charges.

Table 1: Charges under Different Pension Schemes				
NPS	Mutual Fund¹	Insurance PF Scheme²	EPF	PPF
Flat Charge @ Rs 470	Entry Load @ 0%	FMC ³ @ 1.50%	Nil	Nil
Custodian Charge @ 0.0075%	Expense Ratio @ 1.25%	Policy Administrative Charges @ 0.25%	Nil	Nil
FMC @ 0.0009%	STT ⁴ @ 0.125%	STT ⁵ @ 0.125%	Nil	Nil
Rs 470 + 0.0084%	1.29%	1.81%	0	0
¹ UTI Retirement Benefit Pension, ² ICICI Pru LifeStage Pension				
³ Fund Management Charges, ⁴ Portfolio Turnover Ratio of 33%, ⁵ Portfolio Turnover Ratio of 50%				

If we consider an annual investment of Rs 1,00,000 for a tenure of 30 years across all the mentioned schemes, NPS will emerge as the best scheme in terms of maturity amount on account of its lower initial charges. Here, the rate of return has been pegged at 10 per cent considering the historical returns. In terms of maturity amount, as given in Table 2, NPS pays out Rs 1.801 crore, which is the highest among all pension schemes considered. It is followed by Insurance PF scheme and MF Pension scheme that give Rs 1.776 crore and Rs 1.785 crore, respectively.

But NPS loses when it comes to the mandatory investment of 40% of its payout in an annuity, for it follows the EET model. Moreover, the investor has to pay a tax on the remaining 60% of the payout, which he/she receives as a lump sum, as per the prevailing income tax slab. Even if the investor puts the entire maturity

amount in an annuity scheme, the interest received would be taxed at 20% with indexation (See Table 3). In comparison, Insurance PF scheme offers 33% tax-free payout. In case of Mutual Fund, EPF & PPF, the entire amount is tax-free.

Table 2: Returns on an annual investment of Rs 1,00,000 for 30 years			
	Rate of Return	Charges	Maturity Amount
NPS	10%*	Rs 470 flat + 0.0084%	18,007,779
MF Pension Scheme	10%*	1.291%	17,853,235
Insurance PF Scheme	10%*	1.813%	17,766,383
PPF	8%#	0.000%	12,234,587
EPF	8.5%#	0.000%	13,477,298
* Based on the past performance			
#The returns are fixed			
Table 3: Exempt, Exempt, Tax (EET) effect on the Maturity Amount			
	Tax Structure		
NPS	60% ¹ payout + 40% annuity ³		
Insurance PF Scheme	33% ² payout + 67% annuity ⁴		
MF Pension Scheme	Nil		
PPF	Nil		
EPF	Nil		
¹ Payout would be taxed at personal income slab.			
² Payout is tax-free.			
^{3 & 4} Interest on annuity would be taxed at 20 % with indexation.			

Thus, NPS is definitely the need of the hour. It provides a compulsory social security to the citizens as prevailing in the developed countries and also scores over other pension schemes in management fees and custodian charges. But the current tax structure (EET) and flexibility can mar the scheme because in NPS the maturity amount is taxed as per the individual income tax slab and the money is locked till the maturity, unlike in other schemes that come with an option to withdraw money. Moreover, interest on the annuity is taxable in the hands of investors.

5.1.4 Financial Implications:

The ability of the NPS to generate adequate replacement rates depends on future returns on assets and portfolio composition. In most cases, except for the portfolio of government bonds, the projected pension for civil servants is equal to or above 50 % of the last wage³.

Risk is also an important determinant of investment outcomes, especially when equity investments are allowed. While government bonds historically have had low volatility, equities show both higher returns and higher risk, making them better suited to investors with a long-term horizon.

5.1.5 Absence of first pillar:

The absence of first pillar could result in concentration of pension portfolios in government securities and higher-than-expected management fees as economies of scale are not realized early on.

5.1.6 Consumption:

Participants in this new pension system may be prohibited from premature access to their retirement savings. As a result, individuals will need to use alternate mechanisms to fund and protect their present consumption and other non-retirement needs. Knowledge of and access to credit and insurance markets will improve the ability and willingness of this segment to save for retirement⁵.

5.2 Challenges faced in the distribution:

- Low financial literacy leading to mistrust in the distributing agency
- The scheme is at a risk when any annuity provider imposes certain other terms and conditions. For example, the recent halting of distribution of the New Pension System to employees other than government staff following a directive from the sectoral regulator IRDA by LIC.
- Sales efforts based on agent sales forces are problematic for the NPS that must operate on small margins to promote participation by lower income groups
- The Points of Presence (PoP) or distribution agents of NPS will charge up to Rs 20 for every transaction. With four mandatory transactions every year, it

comes to Rs 80. An insurer gives 7.5 per cent of the annual premium to its agents. Clearly, the incentive for distribution in case of NPS is much lower. Thus, banks and others will prefer to sell you an insurance or mutual fund product that pays much higher commissions.

- Given the distribution channel structure, it's imperative that PoPs like postal offices have already implemented their IT infrastructure. This argument is especially true with regard to PoPs in small town and rural areas. If pension reforms are to be available for all, then IT implementation in small town and rural areas is the key.

6 Recommendations:

The following are some of the recommendations that could help generate more awareness and improve the distribution network.

6.1 Catch 'em young:

Given the inadequate financial literacy among the youth, there is an urgent need to incorporate basic financial terminology in the syllabus of junior college students. In this way, one can reap the benefits of financial education in the future. This would help attain Inter generation fairness and dominant preference.

6.2 Further distribution holds the key:

Given that the NPS is within reach for most of the workers thanks to post offices and nationalised banks, further distribution through regional and cooperative banks would lead to an increased awareness. Also proper distribution channels like regional banks and cooperative societies are to be used to make sure the workers are aware about the benefits of NPS.

This would help attain coverage, accessibility and efficiency by widening the distribution network and providing access to many new workers.

6.3 Achieve critical mass:

Critical mass could be achieved faster by granting permission for exempt workers to switch to the new system, and shift all assets to private PFMs. A less ambitious option could involve outsourcing of all or part of the management of accumulated reserves of partially funded schemes such as EPF to the private sector under competitive bidding procedures⁶. This would ensure economies of scale which would result in a sustainable process. This would help attain sustainability, efficiency through economies of scale.

6.4 Improvement in Capital market regulations:

Improvements in capital market regulations, laws, and infrastructure are necessary to foster the development of local securities markets. When such concurrent reforms are delayed, fast growth in pension AUM can generate imbalances between demand and supply of local securities and magnify asset price volatility. In particular, debt management agencies and regulators can support the provision of new instruments for retirement savings by ensuring liquid government bonds and issuing price indexed bonds.

A limited option for investments abroad can help PFMs diversify country risk, gain expertise and familiarity with new instruments, and relieve pressures in local markets, when the supply of securities is restricted in the short term⁷. While immediate liberalization of foreign investment restrictions may not be viable, over time it should be considered as the efficiency and effectiveness of PFMs improves. This would help attain Asset market valuation reliability, adequacy by providing sufficient return on the investments.

Conclusion:

The retirement fund industry has certainly begun to come of age in India. It is only certain push like incentive for distribution of NPS for PoPs, more PoPs, and improvement in capital market regulations and financial literacy which would ensure that the critical mass is reached and with that, an exponential increase in the number of beneficiaries from the scheme. 30 years from now on, the population below poverty line would be few if any, if we manage to capitalize on the current age demographics.

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Participants profile:

I am a 2nd year Post Graduate Diploma in management (PGDM) student from the Indian Institute of Management, Calcutta. Before joining this prestigious institute I did my BE in Electronics and Communications Engineering from Osmania University.

My current areas of interest include optimization theory and modelling of interconnection effects in a system. Some of my research works include the modelling of:

1. The influence of cost structures of mobile service providers on teledensity in India done under Prof. Anindya Chaudhury.
2. Estimation of customer lifetime value in Insurance: A case study of MetLife Insurance India Co Pvt. Ltd. done under Prof. Janakiraman Murthy.

My summer project was on “Design of Sales to cost Index of branches for cost efficiency calculations and Classification through AVK matrix” which received appreciation from the Managing Director of MetLife India and was implemented immediately.

I have keen interest in data analysis and learnt R language, Statistica, Vensim which would help me in professional life in future. I have been consistently good in mathematics with an aggregate of 95% in the eight Mathematics subjects I have had.

I have lived in different cultures ranging from village to a metropolitan over time in my life and learnt the positives in each culture while excelling in the task assigned to me.

I am an avid chess player, with a provisional FIDE rating of 2056 which is equivalent to a National Master and was among the top 3 positions in state championships for quite a few times.

Some of my position of responsibilities include: Batch representative of Class of 2007 in Engineering, Organizing committee member in many cultural festivals of college and Captain of Chess team in IIM Calcutta.