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The Case For A Regulatory Authority for India's Pensions System

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As the Indian policy makers begin to focus on reforming the pension system, one of the major issues concerns who should regulate the pensions industry.

This column argues that there is a strong case for setting up a separate regulatory agency, provisionally called the Provident and Pension Funds Authority (PPFA). The main argument for the PPFA is that it will be in a better position to address the limitations of the current, rather fragmented, pension system and help develop a robust pensions industry than either the status quo or entrusting the task to an existing agency.

Let me focus on two major limitations of the current system and how the PPFA could assist in addressing them.

I. Lack of System-wide Perspective:

Among the important insights emerging from the pension reform debates is that a given level of financial security (as measured by total retirement income divided by pre-retirement income, i.e. the replacement rate) is better obtained from a variety of sources rather than from a single source. Thus, if the desired replacement rate, as experts suggest, is about two-thirds for a middle income person, then it can be obtained from provident fund type defined contribution (DC) arrangement, a defined benefit (DB) arrangement such as occupational or other pension schemes, voluntary savings, support of family and community, and others. Moreover, accumulated savings need to be translated into an income stream during retirement. Such a stream may involve some form of phased withdrawal, including, but not confined to annuities.

It is therefore essential that the different components of the pension system, whether in terms of different sources of retirement income, or in terms of different sponsors of the provident and pension fund plans as is the case in India, must be viewed not in isolation but from a system-wide perspective.

The Indian pensions industry is currently divided into four major components, which are not integrated.

First, the Employees Provident Fund Organization (EPFO), which is under the Ministry of Labor, is the primary organization for retirement income for private sector employees. It administers a mandatory savings DC scheme (Employees Provident Fund Scheme or EPF Scheme) and a DB pensions scheme (Employees Pension Scheme or EPS), with survivor's benefits. The EPF has 26 million members, while the EPS has 23 million members. The combined assets of the EPFO schemes are about 7% of GDP. If even simple parametric reforms, such as tightening liberal pre-retirement withdrawals, are implemented, the total assets will increase rapidly.

The EPFO is also empowered to decide on the companies that may be permitted to administer their own provident and pension schemes. It also supervises the exempted firms, and essentially regulates itself through its own Board of Trustees.

Since the EPFO is in essence a part of a larger pensions industry, combining administration, regulation and supervision powers under one organization is not consistent with good governance practices, particularly as the industry develops and becomes more complex and diversified. The proposed PPFA would assist in addressing this anomaly.

The *second* component of the pensions industry consists of various occupational schemes; prominent among them are the schemes of public sector financial organizations such as banks, insurance companies, and the state owned enterprises. These are currently stand-alone schemes, which need to be integrated into the pension system as a whole, a task, which the PPFA would perform.

The *third* component of the current pension system concerns the civil servants at the Center and in the States. Their retirement benefits include a non-contributory, indexed, DB pension, with survivors' benefits, mandatory provident fund savings scheme of the DC type, and a gratuity. These schemes have their own structures, and there are no regulations concerning their design, financial viability, and investment patterns. The civil servants are the beneficiaries, but for the pensions, the liability burden is on the government, i.e. population as a whole. It is essential that the beneficiaries be not entrusted with framing the rules and also administering and supervising them. The proposed PPFA will be in a better position to insist on appropriate practices by those in charge of these schemes.

The *fourth* component consists of tax advantaged voluntary saving schemes most of which are administered by India's Post Office Savings Bank (POSB). The POSB is the largest financial institution in the country, controlling deposits equivalent to 9% of GDP, larger than the assets of the EPFO. Both the interest rates on them and their end use have been administratively determined. As the interest rate regime in India becomes more market-based, and as pre-funding becomes more widespread for retirement (including for those in the informal sector), there will be a need to view such tax-advantaged savings from a system-wide point of view. The tax treatment of the retirement savings instruments and of the providers of pension products will need to be made more consistent so as to protect tax revenue and minimize allocation distortions. A recent Government Report (Reddy Committee Report on Small Savings) has recommended this, but no decisions have been made concerning the implementation.

As in other countries, the savers will also need to learn about the investment fundamentals.

As the pensions industry grows in India, the role of insurance companies in providing pension products, including annuities, and of mutual funds is likely to grow. The other elements of the pensions industry, such as custodial services, human resource training, pension management and consultancy services, and others will grow.

It is clear from the above that only a professional specialized regulatory agency such as the proposed PPFA will be able to take a system-wide perspective. The Insurance Regulatory and Development Authority (IRDA), and Securities and Exchange Board of India (SEBI) are in charge of only a part of the some of the components of the pension system. Their current tasks are quite challenging and it may be useful for them to concentrate on them fully. The proposed PPFA of course would need to closely liaise with the IRDA and SEBI, and with the Reserve Bank of India.

The EPFO, under this proposal, will essentially concentrate on administering its schemes professionally and under the regulations set by the PPFA.

II. Limited Degree of Professionalism:

What most often distinguishes a successful from a non-successful reform is a sustained professional level attention to details of design and

implementation. In the current pension arrangements, the limited degree of professional level attention to details can be found in many areas, ranging from record keeping, management information systems, design of withdrawal schemes, design of pension formula and for commutation benefits, member empowerment; and investment regulations and management.

The EPFO alone has investments of Rs.1256.6 billion as at end march 2001 (equivalent to about 7.0 per cent of GDP), but its investment guidelines have so far been not updated to reflect modern concepts of portfolio management. All the investments of the EPFO are in debt instruments, predominantly in government and public sector securities. This provides insufficient opportunities to translate such long-term savings into growth enhancing economically productive investments.

The current arrangements also do not encourage professional approach in the occupational pension schemes and in managing investment portfolio of those firms exempted by the EPFO.

The occupational schemes are governed by the respective Board of Trustees appointed by the plan sponsor, but with no uniform requirements on funding norms, tax arrangements, service quality, fiduciary responsibility of the trustees, etc. It is desirable to ensure that good governance practices, internationally benchmarked, prevail in the operations of these schemes, and that they are supervised more effectively. This is essential if these enterprises are to be competitive in the domestic and international arenas, and if they are to provide the promised pensions to the employees.

There is therefore a need to develop professional manpower, including actuaries who understand the special nuances of the pension system, which are quite different from those in life and non-life insurance. The Indian actuaries in this area, as in others, should be globally competitive.

Transition from a rather ad-hoc to a professional approach will not be achieved quickly or without commitment to enhancing regulatory capacity. The proposed PPFA can draw on private and public sector human resources, and with appropriate governance structure and mandate, enhance professionalism with which the pension industry as a whole is managed and further developed.

Such a transition is essential for the long term financial security of estimated 180 million elderly by year 2030, and by extension for the quality of life of the non-elderly.

As a by-product, professionalization of the pension system will generate opportunities for India to export pension related services to other countries making a similar transition. The more varied the services, which enter India's export basket, the greater the probability of attaining India's export revenue objectives.

A frequent argument against setting up more specialized regulatory agencies in India is the lack of regulatory capacity, and the probability of such agencies becoming avenues for retiring bureaucrats to continue to secure power and income.

The remedy however does not lie in not emphasizing supervision and regulation. These functions must be performed well if pensions industry is to develop along the desirable lines. It lies instead in enhancing regulatory capacity, including changing the recruitment and remuneration policies to ensure that services of professionals and technocrats and not just general administrators are obtained by the regulatory agency. The experiences of the pension regulatory agencies in such Latin American countries as Chile and Mexico may be instructive for India.