

The Project OASIS Report

(Old Age Social and Income Security Project)

11 January 2000

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Dear Ms. Gandhi:

I have great pleasure in submitting the Report of the Project OASIS Expert Committee for Devising a Pension System for India set up by your Ministry in 1998.

Yours Sincerely,

S.A. Dave

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1 Backdrop

1.1 Demographics

- (a) Populations world-wide are ageing. In India, while the total population is expected to rise by 49% between 1991 and 2016, the number of elderly (persons aged 60 and above) is expected to increase by 107%, to 113.0 million. In other words, the share of the aged in the total population will rise to 8.9% in 2016. Demographic projections further suggest that the number of the aged will rise even more rapidly to 179 million by 2026 – or to 13.3% of the population.
- (b) Males and females in India at age 60 today are expected to live beyond 75 years of age. Thus, on an average, an Indian worker must have adequate resources to support himself or herself for approximately 15 years after retirement. Demographic projections suggest that a forty year old today, who will be 60 in 2020, will have an expected life span of 20 years beyond 60, i.e. to age 80.
- (c) While we witness an increase in the number of aged, the traditional and informal methods for income security, such as the joint family system in India, are increasingly unable to cope with the enhanced life span and medical costs during old age. There is a growing stress on the joint family system and there is an immediate need for introduction of formal, contributory pension arrangements that can supplement informal systems. This problem is particularly important in India, which will enter its demographic transition, into increasing number of aged persons, at lower income levels than those seen in other countries which have long introduced systems to cope with the problems of an ageing population.
- (d) Traditionally, governments and societies provide economic security during old age through pension provisions and social safety nets. Sound pension systems form a social safety net for reducing poverty during old age. However, a rise in the number of older persons often causes a corresponding increase in government expenditure on non-contributory pensions and health services – since health and pension spending rise together. Higher government spending on old age security has often been at the cost of expenditure on other important public goods and services and has increasingly been a serious drain on government finances.

1.2 Labour Market & Old Age Income Security

- (a) Approximately 74.20% of India's population live in rural areas (1991 census). The per capita income in India (at 1997-98 prices) is Rs.13,193.

As per the 1991 Census data, India has an estimated 314 million workers. Of the working population, 15.2% (47 million) are regular salaried employees while over 53% (166 million) are self-employed and 31% (97 million) are casual/contract workers.

Of the salaried employees, approximately 23% (11.13 million) are employed by the Central, State and UT Governments and Departments (including post & telegraph, armed forces and railways) and are eligible to a non-contributory, indexed, defined benefit pension, funded entirely by the Government.

Approximately 49% (23.18 million) of the salaried (non-Government) workers are covered by a mandatory Employee Provident Fund and the Employee Pension Scheme.

Thus, barely 34 million (or less than 11%) of the estimated working population in India is eligible to participate in formal provisions meant to provide old age income security.

- (b) On the other hand, 28% (13 million) of the salaried workforce, and approximately 268 million workers in the unorganised sector (including farmers, shopkeepers, professionals, taxi-drivers, casual / contract labour, etc.) are *excluded* from participating in the existing provisions. Therefore, almost 90% of India's workforce are not eligible to participate in any scheme that enables them to save for economic security during their old age.
- (c) As a result, there is a serious threat that a majority of these workers, who may not be below the poverty line in their working lives, might sink below the poverty line in their old age, simply because they have not accumulated enough savings during their years in the workforce. This problem is further compounded since they will have to incur heavier expenditure on health during old age, neglect of which would only worsen their quality of life.

- (d) Demographic transition coupled with poor coverage by existing provisions suggests that we are inexorably moving towards an India with a gigantic number of destitute elderly. Faced with such huge numbers, a social safety net for retired workers or a poverty alleviation program which aims to pay even a modest subsidy would require a staggering expenditure – much beyond the capacity of the Government.

1.3 Existing Provisions for Government Employees

- (a) Government employees receive a non-contributory, indexed, defined benefit pension, funded entirely by the State. They also contribute 6% of wages into a provident fund scheme. Spending on such non-contributory pensions is an enormous strain on revenues and will only increase over time with an ongoing increase in benefits as well as increasing life expectancy of the population.
- (b) According to the latest published data released by the Department of Expenditure, Ministry of Finance, there were 5.2 million Central Government employees as on 31st March 1998. These include employees in railways, defence services, posts, and telecommunications. At the same time, the total number of Central Government pensioners as on 31st March 1998 was 3.54 million – reflecting a dependency ratio of around 66 per cent.
- (c) A simulation study to assess the increase in the number of Central Government pensioners and the related expenditure on pension payments over the next 30-40 years was carried out by the Tata Economic Consultancy Services, at the time of preparation of the Fifth Central Pay Commission Report. Assumptions made were that there is no rise in employment after 1992; that wages escalate at 2.5% per annum; that employees work for 33 years and enjoy 16 years of retirement; that the annual number of retirements are three percent of the total establishment; and, that the rate of inflation is 8% per annum. It has also been estimated that the successive pay commissions will grant increases in real wages of around 17% every 10 years. This study revealed that expenditure of the Central Government on account of its own pensions would increase from Rs.35,690 million in 1995 to Rs.2,71,830 million in 2015.
- (d) These estimates are based on conservative assumptions and do not consider two important facets of the problem: Expenditure on pensions to Defence Services

pensioners (where the current dependency ratio is over 110%) as well as expenses on pensions to employees of State Governments were not included in this projection. Further, the above figures do not account for the increase in pensions arising out of the Fifth Pay Commission's recommendations.

1.4 Mandated Provisions for the Organised Sector

- (a) 177 industries and classes of establishments notified by the Government and covered by the EPF & MP Act, 1952, and which employ 20 or more persons, are mandated to subscribe to the Employees' Provident Fund Scheme 1952, the Employees' Pension Scheme 1995, and the Employees' Deposit Linked Insurance Scheme 1976. These schemes are managed by the Employees Provident Fund Organisation (EPFO), Coal Miners Provident Fund, Seamen Provident Fund, Assam Tea Plantations Provident Fund, and the J&K Provident Fund.
- (b) The Employees' Provident Fund (EPF) Scheme is a defined contribution, publicly managed plan under which accumulations are paid to workers as a lump sum on retirement. The Employees' Pension Scheme (EPS) is a defined benefit, publicly managed plan that pays workers a monthly pension after retirement. It is further claimed that the EPS is also a defined contribution plan and is fully funded. The Insurance Scheme provides an additional payment in the event of death or permanent disability of a worker while in service. All employees in these establishments (except those drawing a salary of over Rs.5000 per month) are mandated to participate and contribute to these schemes.
- (c) Employers and employees are mandated to make equal contributions totaling between 20% and 24% of employee's wages towards the EPF and EPS. From the "employer's contribution" of 10% to 12%, 8.33% is diverted to the EPS while the balance is pooled into the provident fund account of the employees. The Government contributes 1.16% of wages into the EPS. A contribution of over 25% percent towards retirement benefits is among the highest in the world. High contribution rates leave little or no surplus income for savings for other contingencies by employees.
- (d) The Boards of Trustees of the relevant Provident Funds handover the funds thus collected for management to a single fund manager. The relevant fund manager is

strictly mandated to invest the funds as per the investment guidelines devised by the respective PF Boards. The funds are mainly invested in Government Securities or Special Deposits of the Government, which offer a fixed return to members. Each year, the Boards of PFs announce an annual rate of return to their members. Over the last decade, Provident Funds have announced a 12% nominal annual return (or a little over 2.5% annual *real* return on an average over the last decade) to their members. Individuals do not have any control or choice in the allocation of (and returns from) their savings.

- (e) As on March 1998, 2971 establishments, with approximately 4.5 million member-workers, were exempted by the EPFO and allowed to manage the funds on behalf of their employees. These exempted funds are mandated to equal or better the annual benefits announced by the EPFO. The pattern of investment by exempted funds is identical to the pattern prescribed in the investment guidelines issued by the EPFO.
- (f) Provident fund members are provided a facility to prematurely withdraw a part of their retirement savings on account of marriage of self and family members, insurance, education of children, housing and housing loan repayments, medical expenses, temporary unemployment, etc. Further, final settlement and withdrawal of full accumulations with interest are allowed on account of retirement, permanent disability, death, change of job to an uncovered establishment, or after 2 months of unemployment.
- (g) Despite extremely high contributions, and as a result of liberal withdrawals and poor returns, workers covered by the EPF are faced with highly inadequate terminal accumulations and potential destitution in their old age. For instance, the EPFO distributed average terminal accumulations of less than Rs.25000 per member during 1997-98 on retirement. In the same year, the EPFO allowed an average premature withdrawal of Rs.17000 per member.
- (h) The Employees' Pension Scheme (EPS) offers defined benefits of up to a maximum of 50% to the average of the last 12 month's salary. Despite standardised defined benefits, the contribution rates into the EPS vary across industries and classes of establishments. The Boards of Trustees invest the pension funds accreted by the members using the same investment pattern as prescribed by them for Provident Funds. The Boards of Provident Funds are also responsible for payment of the

benefits – i.e. of converting the lump sum accumulations under EPS into annuities and payment of pensions to individuals.

- (i) Actuarial calculations that compare the adequacy of contributions and returns on investments of the pension fund to meet the defined pension obligations of the Government are not readily available. There is also no indication that the benefits under this provision are inflation indexed. There is a risk that this provision may be underfunded, and promises an unsustainable benefit which will become a liability of the Government in the long run.
- (j) EPF contributions, returns on them, premature withdrawals and terminal accumulations are all fully tax exempted – while pensions are taxed. This provides workers an incentive for lump sum withdrawals, instead of opting for annuities during old age.

1.5 Provisions for the Unorganised Sector

- (a) The Public Provident Fund (PPF) was introduced in 1968-69 with the objective of providing unorganised sector workers (who are excluded from participation in mandated provisions) with a facility to accumulate savings for old age income security. This is an individual account system under which members are allowed to open PPF accounts either with some designated nationalised banks or with post offices. As on March 1998, State Bank of India had 1.84 million PPF accounts showing an outstanding balance of Rs.26 billion. As on March 1998, post offices had 0.92 million PPF accounts with an outstanding balance of Rs.24 billion. These accounts imply a combined coverage (bank and postal accounts) of less than 1% of the working population by this provision even after 3 decades of its existence.
- (b) The PPF account accepts accretions of a minimum of Rs.100 (fixed in 1968-69) and a maximum of Rs.60000 per member per year. The accretions, accumulations and withdrawals from PPF are fully tax exempted. A PPF account matures in 15 years – which is inadequate for generating meaningful accumulations for old age income security for younger workers. In addition, PPF allows partial withdrawals after 5 years of accumulations. As a result of premature withdrawal facilities and tax breaks, individuals largely misuse this scheme for legitimised tax evasion and it does not serve the intended purpose of old age income security.

- (c) The Government has no provision for professional investment of the annual accretions into this scheme. A corpus of assets (securities) is not visible. Instead, a part of the annual accretions into PPF are used for paying out the corresponding year's withdrawals from the scheme. In addition, 75% of the net annual accretions are distributed among State Governments at 14% interest while the balance accretions are diverted to the Public Account of the Government. The Government pays a fixed 12% interest on accumulations under PPF. The actual cost to the Government is even higher when forgone revenues from income tax collections are factored in. This is an expensive scheme with no assurance that its true objectives will be fulfilled.

1.6 Project OASIS (Old Age Social and Income Security)

- (a) The Ministry of Social Justice and Empowerment is entrusted with the nodal responsibility for care of older persons. The Ministry has been increasingly concerned with the issues of ageing, health and income security during old age as well as its close links to mental and emotional well being. However, the Ministry realises that poverty alleviation programmes directed at the aged alone cannot provide a solution to the income and social security problems of our elderly. For instance, providing a Rs.100 per month old age pension to the projected 175 million population of the elderly in 2025, would translate into an annual outflow of over Rs.210 billion (or Rs.21,000 crore) for the Government. Faced with such large numbers, it is apparent that the problem will have to be addressed through thrift and self-help, where people prepare for old age by savings accumulating through their decades in the labour force. The role that the Government can play in this enterprise is to create the necessary institutional infrastructure to enable and encourage each citizen to undertake this task.
- (b) As a culmination of this growing concern, and coincidentally with 1999 being declared the "*International Year of Older Persons*", the Ministry commissioned the national Project titled "OASIS" (an acronym for Old Age Social and Income Security) and nominated an 8 member Expert Committee to examine policy questions connected with old age income security in India. The Project OASIS Expert Committee was mandated to make concrete recommendations for actions that the Government of India can take today, so that every young worker can build

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up a stock of wealth through his or her working life, which would serve as a shield against poverty in their old age.

- (c) The research and recommendations under Project OASIS have a twin focus: that of further improving existing provisions, and, to devise a new pension provision for excluded workers who are capable of saving even modest amounts and converting this saving into an old age income security provision. The Report on reforms to the existing provisions was submitted to the Ministry of Social Justice and Empowerment in February 1999.
- (d) The objective of this Report is to recommend a pension system which is can be used by individuals spread all over India, which enables them to attain old age security at the price of modest contribution rates through their working career. It is simple and convenient to use and has the capability for converting modest contributions into reasonably large and comfortable sums in an almost risk-free manner for old age security.

2 Goals

- (a) Today, we in India face severe problems in the form of poverty amongst the elderly. In addition, three powerful forces are at work which ensure that the problem will worsen in the years to come:
- Improvements in health are increasing longevity, which means that more people are living to ever-longer lifespans. Present demographics suggest that a person who survives to age 60 has on average, 17 years ahead of him. This number may rise to 25 years in the coming decade. This would mean that a person who retires at the age of 60 has to plan to live for a quarter century without a wage income.
 - Families are becoming smaller as people have fewer children. Geographical labour mobility implies that children are increasingly likely to be geographically separated from their parents. Individual and social values are changing so that the joint family is increasingly considered unattractive. All these factors are leading to a situation where the young are increasingly unable or unwilling to have parents living with them.
 - Improvements in education and health are generating new expectations on the part of the elderly for the minimal level of consumption that is considered acceptable.
- (b) In the face of this problem, it is clear that anti-poverty programs will simply not suffice in addressing the problem. The sheer number of the elderly is too large, and the resources with the State are too small, to make anti-poverty programs the central plank in thinking about the elderly. International experiences, and common sense, suggest that Government dole is not sustainable on a significant scale, that economic security during old age should necessarily result from sustained preparation through lifelong contributions and the central values that a pension system should emphasise are self-help and thrift.
- (c) Hence, we need to establish an institutional infrastructure through which individuals can prepare for old age while they are in the labour force, i.e. an efficient pension system. The role of the pension system is to encourage and enable old age preparation on the part of a large fraction of individuals presently working in India.

- (d) Most individuals in India are outside the organised sector. Thus the concept of a “regular monthly salary” is alien to most of India, and hence the concept of a “monthly pension contribution” is equally alien. The large number of workers who are agricultural labourers or construction workers falls in this category. Unorganised sector workers may change jobs, opt for spells of self-employment, move from one location to another and also face temporary unemployment during their working lives. A pension system for India should thus be flexible and useful to this mass of individuals; not just to the small fraction of people in India who work in the organised sector, have a “regular monthly salary”, and undergo very little job mobility.
- (e) Tax incentives are more or less synonymous with old age income security savings in India. However, most individuals in India are not taxpayers, hence an exclusive focus on tax incentives as a vehicle to encourage pension savings is misplaced. Indeed, in a situation where the rich in India pay taxes while most do not, tax incentives which benefit the rich may often prove to be regressive, as the revenue forgone may be made good by some other form of commodity taxation.
- (f) From a financial perspective, sound pension planning can be achieved by two factors: (a) by obtaining continuous, uninterrupted accumulations and (b) by using sound fund management to achieve the highest possible rates of return. Once these two ingredients are in place, the arithmetic of compound interest over multiple decades generates remarkable income security from even modest flow of savings. A Rupee saved at age 25 turns into Rs.7.68 at the end of 35 years with a real rate of return of 6%. When either of these two features are absent, old age income security is lost. If the accumulation is broken by withdrawal, or if low interest rates are obtained through weak fund management, then a much higher savings rate is required in order to avoid poverty in old age.
- (g) The terminal wealth at age 60 is highly sensitive to the rate of return. An improvement of one percentage point in the rate of return – i.e. from 12% to 13% – has the potential to yield a 20% higher corpus at age 60. If the interest rate goes up from 12% to around 15%, it can double the terminal accumulations. Improving the rate of return by such percentage points, without sacrificing long-term safety of funds, is possible by appropriate modifications in investment guidelines, and by entrusting funds to professional managers.

- (h) From a political economy perspective, a large stock of pension assets is a dangerous thing. Pension programs face large political risk. Pension systems in all countries have faced pressures from a host of special interest groups who seek to obtain “minor” alterations of pension-related policies in order to benefit themselves. This has ranged from buying shares of public sector companies, financing the Government debt, transferring resources to states, financing infrastructure, subsidising inefficient financial sector entities all the way to directed credit to “priority” sectors. Regardless of the merits of any of these claims, the only goal that the pension system should serve is the wellbeing of individuals who are the contributors and hence preparing themselves for old age. This requires sound governance and sound pension system design. Individuals participating in the pension system should have incentives to take interest in the functioning of the system and block appropriation of their retirement savings by such special interest groups.
- (i) The challenge in building a pension system also lies in obtaining low administrative costs, nation-wide collection, and adequate simplicity for participation by millions of people with highly limited financial sophistication. The challenge also lies in obtaining freedom from fraud, and in resisting the pressures which seek to apply pension assets to further any agenda other than that of old age income security of members.
- (j) Research commissioned by Project OASIS shows that regular savings at the rate of between Rs.3 to Rs.5 per day through the entire working life easily suffice in escaping the poverty line in old age *provided the pension assets are invested wisely*. This is an extremely heartening feature of pension system design in India, since we can visualise an extremely large number of people in India today who can save between Rs.3 to Rs.5 per day and thus prepare themselves for old age income security. These numbers also remind us that low contribution rates are not the essence of the problem.
- (k) Systemic distortions and preferential treatment to certain provisions is undesirable and we need to strive towards creating an equitable environment and simplified provisions to encourage universal coverage both for salaried employees as well as self-employed persons.

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- (1) The pension system recommended in this Report can make an enormous difference in the form of removing millions of people from the ranks of the destitute elderly in the years to come. Each additional person who is able to plan for old age income security is one less from the ranks that require the minimum support safety net in old age.

This powerful motivation is the central inspiration for this Report.

3 A New Pension System

The new pension system should be based on *individual retirement accounts*. An individual should create this account; have a passbook where he can see a balance that is his notional wealth at that point in time; he should control how this wealth is managed; this account should stay with him regardless of where he is or how he works. He would make contributions towards his pension into this account through his working life (whether employed in the organised sector or not), and obtain benefits from it after retirement for the rest of his life. A heuristic sketch of the operations of this system may be offered here.

- (a) A person will open a single Individual Retirement Account (IRA) with the pension system at as early a point in his life as possible. The account will provide the individual with a unique IRA number that will stay with the individual through life. The individual would save and accumulate assets into this account in his working life, subject to a minimum of Rs.100 per contribution and Rs.500 in total accretions per year. Individuals would be free to decide the frequency of accretions into their accounts; there will be no pressure to make a fixed monthly contribution. The account would stay with the individual across job changes, spells of unemployment, and can be accessed at any location in India. The individual would always have access to an account balance statement showing his assets. All through, the individual would be empowered in having control of how his pension assets should be managed. Finally, upon retirement, the individual would be able to use his pension assets to buy annuities from annuity providers, and obtain a monthly pension.
- (b) In this entire process, a sound regulatory framework would give individuals an umbrella of safety with respect to problems of risk management and prevention of fraud.
- (c) A key feature of the system described ahead is a high ease of access to the pension system through myriad Points of Presence (POPs) which would be located all over India and will include post offices, bank branches, etc. The individual would be able to visit any POP in India (not just the POP where he had opened the IRA) and conduct transactions on his individual retirement account. Every POP would exhibit identical features, processes and procedures. These transactions would be extremely

simple and convenient, so as to require minimal knowledge about the financial sector.

- (d) Individual accounts imply full portability: i.e. the individual would hold on to a single account across job changes across geographical locations. Individual accounts will also give individuals the opportunity to alter their risk profile in the life cycle in an optimal fashion (from high-risk, high-return investments at a young age to a low-risk, low-return portfolio when approaching retirement) if they so desire, while allowing them full freedom and flexibility in making their own choices. Individual accounts also interpret individual accumulations as individual wealth; they eliminate the free-rider problem of collectivist programs. The accumulation of retirement assets, in a form which is manifestly visible as individual wealth, helps reduce the political risks that many pension systems have suffered from.

3.1 Service Delivery

- (a) Individuals should be able to access and operate their retirement accounts from “Points of Presence” (or POPs) located all over India. Any individual would be able to obtain identical services from any POP located anywhere in India.

The facilities that individuals should be able to access are extremely simple¹:

- Open an individual retirement account and obtain a permanent and unique IRA number,
 - Submit contributions into this account,
 - Obtain an account balance statement, and
 - Submit instructions governing pension fund management
- (b) We propose a two-tier system where POPs with good information technology and telecommunications facilities would offer better services than other technologically constrained POPs. At a POP that has IT and telecommunications facilities, all these transactions would be satisfactorily completed instantaneously. At other POPs, there

¹ It is useful to observe that in the accumulation phase – where the bulk of transactions of the pension system are likely to take place for the next 40 years – the risk of fraud is fairly limited, since there is no pay-out of benefits. A person has little to gain by fraudulently depositing a contribution into the pension account of another person.

would be delayed responsivity: for example, when the individual asks for an account balance statement, he would get it a few days later.

- (c) We need to harness the largest number of POPs possible, while preferring POPs which have IT and telecommunications facilities. The universe of POPs would include:
- Bank branches
 - Post offices
 - Depository participant offices
 - Any other location from which electronic connectivity into a central computer system is possible².
- (d) There are around 64,000 bank branches in India, all of which could be POPs. The postal system, in particular, is an ideal delivery mechanism that the pension system should harness. There are 153,000 post offices that are presently processing money orders. We can think of a pension contribution as a money order into the pension system; in which case the processes and success in preventing fraud which presently exist, in the context of money orders, are of great value. The postal system operates on the principle that the net funds at any branch post-office or sub post-office are cleared on a daily basis; only head post-offices maintain funds. This integrates efficiently into the pension system: the head post-offices can interact with the banking system to transfer funds to the pension system. The department of posts has also experienced significant success with a large-scale implementation of IT and telecommunications systems.
- (e) In summary, the existing number of potential POPs that can be immediately harnessed into the pension system is adequate to reach hundreds of millions of individuals in India. In addition, the rate of growth in the number of IT-equipped POPs is very high. Over the years, the spread of information technology and telecommunications would enable high quality service delivery through hundreds of thousands of locations.

² There are many private initiatives in constructing POP networks. For example, UTI, IDBI, ICICI, SHCIL, etc. have all built POP networks with hundreds of POPs, which could be harnessed into the pension system.

3.1.1 Centralisation of Record-keeping and Individual Access

- (a) The international experience with individual accounts suggests that the key concern is that of the administrative and transactions costs faced by individuals. Decentralised individual account systems tend to run up high costs when
- Multiple pension fund managers build proprietary collection machinery, and
 - Pension fund managers incur large marketing and distribution costs.
- (b) The environment with individuals facing complex choices between alternative fund managers with different customer interfaces would also inhibit participation by individuals with highly limited knowledge about finance. Further, all costs (including those on building multiple collection systems and of sales) are ultimately passed on to individuals and can significantly retard the accumulation of pension assets.
- (c) However, by building public infrastructure to support individual accounts, we can greatly impact on these costs.

Figure 1 Institutions for an Individual Retirement Account System

- (d) We recommend that the Government should obtain centralisation of record keeping and individual transactions through a centralised depository. The depository would be connected to the myriad POPs spread across the country. An individual would be able to access any POP and conduct all transactions. Individuals would be able to submit instructions with any POP which would transmit these to the depository, which would in turn implement them with the relevant Pension Fund Managers (PFMs). The accent on modern IT and communications, with a modern depository, would yield superior services and a reduced risk of fraud, at a lower cost.
- (e) The basic architecture of the system is hence one where individuals deal with POPs, which carry these instructions to the depository. The depository would maintain the database of all individual accounts as well as the instructions given by each individual. The depository would consolidate individual instructions into blocks of funds, which will be handed over to PFMs. In this system, PFMs would be able to focus purely on what they do best – i.e. Fund Management. They would only obtain a single instruction from the depository everyday, which will drive the assets under their management. This would make it possible to sharply drop the fees and expenses in fund management.
- (f) PFMs would be provided the database of individuals who have chosen them. This would make it possible for PFMs to understand their user profiles, optimise sales strategies, and offer improved services directly.
- (g) The Depository will provide an IRA balance statement to each individual once every six months. This Statement will be forwarded at no cost to the individual through the POP located closest to the individual's contact address.

3.1.2 The Role for IT in Lowering Transactions Costs

Technology-intensive solutions are often conceived to be expensive. However, an essential insight into the problem of transactions costs is that the deployment of computers and telecommunications is the essence of lowering transactions costs. We offer three examples that illustrate this further:

- (a) The experience of the Department of Posts is instructive. Their average transactions costs associated with money orders in the pre-computer world were Rs.32 per

transaction. For the post offices, which have adopted modern IT, this cost has dropped to Rs.12-16 per transaction. This experience is highly relevant for the purpose of pension system design, where contributions into a pension account can be seen as “money orders into a pension system”.

- (b) India's stock market has seen a ten--fold reduction in transactions costs owing to the deployment of technology from 1994 onwards. The total transactions costs used to be around 5% for retail transactions in around 1993; today they are around 0.5% on the National Stock Exchange.
- (c) Citibank's technology-intensive “*Suvidha*” bank account (in Bangalore) delivers high quality banking services while only requiring a minimum balance of Rs.500 in an account; this is in contrast with other banks which require a much higher minimum balance for comparable services.

3.2 Pension Funds Management

3.2.1 Entry of Pension Fund Managers

To begin with, six professional pension fund managers (PFMs) should be selected to manage the retirement funds under this system. The rationale and process associated with this is presented in Section 3.2.6³.

3.2.2 Styles

Every scheme offered by any PFM would have to fall into one of predefined *styles*. The pension system would offer three styles – “Safe Income”, “Balanced Income” and “Growth”. Each of the six PFMs would run one scheme each in the three styles, giving 18 schemes, in all, which individuals can choose from. The investment guidelines for these styles are specified in **Table 1**⁴.

³ There is one weakness of a system with a *small* number of PFMs: the problem that regulatory difficulties with a “very large” PFM would turn into difficulties for the State since the PFM is “too big to fail” (TBTF). If the average PFM has assets of Rs.300 billion – which is half the size of today's UTI – then six PFMs would have assets of Rs.1.8 trillion. Hence, there is a case for increasing the number of PFMs from 6 to 10 when the total assets of the pension system cross Rs.2 trillion.

⁴ The rationale for these may be summarised as follows: **Government of India Securities** – in general, the rates of return on securities issued by the Government of India offer the lowest price volatility and the

Table 1 Investment guidelines for three styles

	Safe Income	Balanced Income	Growth
Government Paper	>50%	>30%	>25%
Corporate Bonds	>30%	>30%	>25%
Domestic Equity	<10%	<30%	<50%
Of which, International Equity		<10%	<10%

3.2.3 Prudential Regulation

On one hand, asset classes such as corporate bonds or equities offer much higher returns and are clearly a desirable component of pension asset management. Yet, these asset classes throw up significant problems of prudential regulation. In India, we have experienced a variety of scandals in the financial sector. This has led to legitimate concerns about liberalisation of pension asset management. In order to obtain higher rates of return, and thus bring income security in old age within reach of individuals who can make small contributions such as Rs.3 to Rs.5 per day, we need to establish a mechanism for prudential regulation which (a) harnesses the rate of return of the asset class, while (b) avoiding the risks of fraud or scandal.

Towards this end, the strategy that should be adopted for three asset classes should be as follows:

- (a) For the first five years, all domestic equity investments should be implemented using index funds on the NSE-50 or the BSE-100 indices only. There should be no “active fund management” (where fund managers have discretionary control of which shares to buy). Pension funds should not engage in off—exchange transactions on domestic equities: this helps ensure a high degree of transparency in all transactions and a lower incidence of murky market practice. These rules would make it possible for pension assets to harness the “equity premium” (the higher return of equities)

lowest long-run rate of return. **Corporate bonds** – offer higher rates of return when compared with government paper, at the price of somewhat higher risk. **Equities** – offer the highest rates of return, over multi-decade horizons. A well-diversified international equity portfolio – offers a superior risk/return tradeoff when compared with the poor diversification implied by a portfolio which only contains Indian equities.

while suffering from none of the risks that flow from giving fund managers complete freedom in forming share portfolios.

- (b) Investments in corporate bonds should be limited to investment grade corporate bonds in India which are liquid. Liquidity helps ensure that the secondary market prices of bonds (which are used in valuation of pension assets) are reliable. The definition of a liquid bond should be as follows: the average impact cost (on the most liquid exchange in India) at transaction sizes of Rs.100,000 should be below 0.3%.. Pension funds should not engage in off—exchange transactions on corporate bonds: this helps ensure a high degree of transparency in all transactions and a lower incidence of murky market practice.
- (c) International equity investment should only be implemented using index funds.

3.2.4 Relative Returns Guarantee for “Safe Income” Style

In the “Safe Income” style, PFMs would have to supply a guarantee that they would not underperform the weighted average returns of all managers in that style by worse than 2 percentage points in a year. For example, if a PFM underperforms the weighted average returns under the “safe income” style by 5% in a year, he would be required to make good the 3% shortfall in returns to the individual subscribers.

3.2.5 Contribution Protection Insurance

An additional safety net in the pension system is that if, for any reason, the final pension assets of a participant are smaller than the sum total of all contributions, then the insurance cover would reimburse this difference. This would be applicable only for individuals who have contributed for at least ten years.

To a significant extent, the Government can purchase this insurance from insurance companies. The Canadian pension system uses a similar notion. There is a role for Government guarantees in overcoming some residual risks here.

3.2.6 Individual Control of Assets

- (a) When the individual goes to a POP with savings (which could be as little as Rs.100), he would need to fill out a form with 18 investment options where he can make a

choice. If he does not feel confident in making this choice, he could opt for the “default” allocation described ahead.

- (b) An individual would be able to go to a POP at any time, and submit a form with instructions for transfer of part or full assets from one scheme to another. The POP would send the instruction to the depository to this effect, which would pool individual instructions into a single consolidated instruction to the PFMs every day. If the POP lacks electronic connectivity, it would take a few days for the instruction to take effect.
- (c) A uniform exit fee (load) of 0.5% would be applied on all transfers across PFMs. Transfers of assets between schemes of the same PFM would carry a zero exit load.

3.2.7 Facilitating Individual Choice

It is extremely important to make it convenient for individuals spread all over India, most of whom have limited financial knowledge, to use the investment choices of this system. The focus on 6 fund managers offering 3 styles each is a part of that effort. Here, individuals would have exactly 18 schemes to choose from⁵.

There would be an institutional mechanism (described ahead) through which a *simple*, quarter-page advertisement would appear in all national newspapers, summarising the historical performance of all the 18 schemes. For example, it would be easy to choose the best scheme in the “Balanced Income” style by comparing the return obtained by the six competing PFMs. A poster containing this table would be prominently displayed at each POP’s office.

3.2.8 Allocation by Individuals with Low Financial Knowledge

For individuals who are incapable of deciding between schemes and fund managers, there would be an alternative choice titled “Default Allocation”. Under the default allocation,

⁵ A small number of PFMs is also superior from the regulatory standpoint. The media scrutiny of six PFMs would be much better than the media scrutiny on a large pool of PFMs. We can imagine the pension regulator running one inspection on each PFM every month when there are only six PFMs. For a comparison, SEBI today has an external auditor run an audit of each mutual fund once a year.

accretions would be placed into the “Safe Income” style, and with the scheme that has provided the highest return over the last one year⁶.

In the first year, and in the absence of historical performance data, funds accreted into the “Default Allocation” would be channeled to the PFM which has quoted the lowest consolidated expenses plus fees.

3.2.9 Retirement Advisors

A large pool of individuals with limited financial sophistication would participate in this system, and would need to make choices about asset management questions. Even though the basic design of the pension system is oriented towards making it simple, and not require financial sophistication, there will be an important role for sound advice on lifetime financial planning on the part of individuals.

Hence, the design of the pension system should include a Self Regulatory Organization (SRO) that will be registered with the Indian Pensions Authority. The SRO will facilitate training and certification of a large base of “retirement advisors”. These RAs will also be registered by the IPA and permitted to undertake advocacy as well as provide advice and assistance to individuals regarding lifetime financial planning.

3.2.10 Role for NGOs

In obtaining the transition of millions of individuals into the pension system, Non Governmental Organisations (NGOs) can play a key role in education and advocacy. Even after individuals have opened individual retirement accounts, NGOs can play an important role in (a) obtaining steady contributions, and (b) imparting knowledge in connection with the various choices that individuals in the pension system face.

3.3 Contributions

The pension system should require a modest minimum contribution rate of Rs.500 per year. Beyond that, mandatory contributions are not meaningful. The spacing of contributions across time should be left flexible, and the size of each accretion should be left flexible (subject to the requirement that each contribution should exceed Rs.100). This

⁶ In case there is a tie, funds will be invested in the scheme that has the highest returns since inception.

minimum mandatory contribution level (of Rs.500/year) should be periodically revised to keep pace with inflation.

Individuals who fail to meet this requirement (of contributing at least Rs.500 per year) would be penalised by halving the size of the micro-credit facility available to them (see Section 3.6).

POPs will provide individuals (like daily wage earners) with a facility to accumulate smaller accretions (less than Rs.100) in an interest-free pool that will stay with the POP. Once the individual's accretion in this pool becomes Rs.100, the POP will route the funds to the PFM of the individual's choice.

3.3.1 Individual, Voluntary Contributions

The Committee debated at length about the role for compulsion in obtaining uninterrupted contributions or in opening accounts, and is of the view that these should be voluntary and not mandatory. In a country of our size, it would be difficult to enforce a mandatory system, which may lead to harassment and corruption.

3.4 Benefits

The pension system design proposed here critically relies on annuity providers who convert the lump sum of assets (attained at retirement) into a regular monthly pension (or a variable annuity) until death. Annuities are a part of the life insurance industry. With the recent liberalisation of entry into life insurance, it is likely that we will see improvements in the extent to which annuities are efficiently priced. The Committee is of the opinion that the insurance industry will be willing to sell fair priced annuities to individuals who have joined this pension system. In addition, insurance companies will be expected to be innovative in applying age and demographic characteristics to vary the price of the annuity from one individual to the next.

3.4.1 Normal Withdrawals

At age 60, an individual would be able to derive benefits from his retirement account. The pension system would require that the first Rs.2,00,000 of accumulations be used for buying an annuity and thus obtaining a monthly inflation-indexed pension of roughly

Rs.1,500 – which is well above the poverty line. Beyond that, an individual would be free to decide how his assets should be deployed⁷.

This minimum mandatory annuitisation level (of Rs.2,00,000) should be periodically revised to keep pace with inflation. Premature cessation of accumulation (e.g. owing to retirement before age 60) would be possible only if 100% of the assets are annuitised.

3.5 Tax Treatment

- (a) The Committee is acutely conscious of the fiscal challenges faced by Government of India. At the same time it believes that the Government has an obligation to make the lives of senior citizens as comfortable as possible. It examined the current incentives available on various schemes for retirement income, and is of the opinion that they are adequate, provided the funds are invested in a manner which can earn higher returns. Rs.60,000 contributed for 35 years at the real rate of return of 5 percent would ensure a monthly annuity of about Rs.45,000 (at 1999–2000 prices). Even if the real rate of return were only 3 percent, a monthly annuity would be Rs.30,000.
- (b) The Committee is aware that some discrimination against self-employed persons would arise, since contributions totaling up to Rs.1,20,000 by employees and employers under mandated schemes are fully tax exempt whereas self-employed individuals – who are their own employers – will get only half this benefit. However, such differing tax treatment of contributions by employees and self-employed individuals is not uncommon in other countries as well since the employer contributions are considered a part of the overall “package” offered to employees. The Committee is deeply concerned about placing any additional direct or indirect

⁷ Research commissioned by Project OASIS reveals the following scenarios for the accumulation that is possible over a lifetime. We assume a contribution rate of Rs.10 per day from age 25 (Rs3600 per year) till age 60, growing at 3% per year. Then the terminal wealth proves to range from Rs.0.2 million (100% government bonds) to Rs.0.8 million (significant use of equity index). Hence, the minimum annuitisation of Rs.200,000 is reliably attainable under the most conservative investment strategies as long as Rs.10 is contributed into the pension account every day from age 25 till age 60; better investment strategies bring down this threshold to Rs.2.5 per day.

In the India of 2000 with an approximate average per capita GDP of Rs.20,000 per person per year (or Rs.80,000 per family of four per year), the universe of potential participants in a pension system, who can make contributions averaging between Rs.2.5 per day to Rs.10 per day, should be fairly large.

burden on Government finances and accordingly recommends that the tax-free limit for accretions into the IRA should continue to be a maximum of Rs.60,000 per annum.

- (c) Personal Income Tax in India is a maze of complex exemptions and needs to be highly simplified. Most existing exemptions should be withdrawn except perhaps those on long term savings, which should also be reviewed. Today pension income is taxable but lump sum withdrawals from Provident Funds are not. The Committee is of the view that all premature withdrawals as well as the terminal accumulations withdrawn as a lump sum from Provident Funds should be taxable at the rate of long term capital gains rate. However the amount which is used for buying annuities should be tax-free.
- (d) The income earned on Funds held in trust by PFM's and annuity providers, on behalf of contributors, should be exempt from any taxes. This does not imply that PFM's and Annuity Providers are 100% tax free entities. It only implies that income on their pension related assets should be exempted from tax.
- (e) Also income on Provident Funds should be made Income Tax free – without any ceiling on the tax-free rate of return.

3.6 Micro-credit and Withdrawals

- (a) The basic principle of pension saving is that contributions should be inaccessible to the individual until retirement. However, in India, most individuals have (a) highly variable incomes, and (b) highly limited access to formal credit. In this situation, an individual may be uncomfortable with being prevented from having access to his accumulations in his retirement account in the face of a practical exigency – especially in the absence of any other credit facility.
- (b) Hence, there is a strong case for integrating a micro-credit facility into the pension system whereby individuals can have access to funds in the form of a loan against their pension savings. Bank branches can disburse these loans. The rules used here should be as follows:

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- Loans of up to Rs.5,000 should be available provided the individual pension account has a balance in excess of Rs.10,000. The loan should be collateralised against the pension assets
 - Once the loan has been undertaken, all subsequent retirement contributions should first be allocated towards repaying the loan.
 - The minimum annual pension contribution of Rs.500 per year should be applicable over and above loan repayments,
 - Only one loan can be operative at a time
- (c) These limits (Rs.5,000 and Rs.10,000) should be periodically revised to keep pace with inflation. The implementers of the pension system should design the detailed modalities of how this micro-credit facility would work.
- (d) The Committee also debated at length whether individuals should be permitted to withdraw a part of their accumulations beyond this micro-credit facility before retirement. While the general consensus is that withdrawals should be discouraged except in cases of deserving premature retirements, a complete ban on withdrawals may deter many individuals from participating in the system. Therefore, the Committee recommends that premature withdrawals should be permitted once an individual accumulates Rs.2,00,000 in the IRA. This limit should be periodically revised upwards in keeping with inflation. Such withdrawals will however be allowed only thrice in the entire period of accumulation. A maximum of 33% of the accumulated balance above Rs.2,00,000 shall be permitted to be withdrawn. All such premature withdrawals will be subjected to a withdrawal tax of 10%. Withdrawals shall be allowed only for housing, medical expenses for serious illness or other grounds specified by the Indian Pensions Authority.

3.7 Estimated Costs

- (a) It is commonly observed that an increase in the rate of return by one percentage point over a lifetime of accumulations increases the terminal wealth of a pension accumulation program by over 20%. By that same argument, a reduction in administrative fees and expenses of one percentage point would have the identical effect, since all fees and expenses of the pension system are (ultimately) borne by

participants. Hence, an important perspective in pension system design is that of trying to obtain the lowest possible fees and expenses. International experiences have suggested that this is a nontrivial problem. The Indian experience with the EPFO also reveals large costs that are borne by participants.

- (b) Many features of the design proposed in this report have been tailored towards minimising the burden of fees and expenses upon pension system participants. The centralisation of record-keeping and collection of contributions by the depository is a powerful tool for reducing costs; many pension systems abroad which began as decentralised systems are now moving towards the depository structure which is proposed in this report. Finally, the accent on modern IT and telecommunications is a powerful tool for reducing costs, as has been proven by the computerization experience with money orders in the postal system.
- (c) The Committee has made preliminary estimates of the costs faced in the depository, transactions at the POPs, fees and expenses in fund management and the IPA. We find that under Indian conditions, it is possible to achieve all these functions using a total charge of 0.25% of pension assets per year.
- (d) A total expenditure of 0.25% would be one of the lowest levels of costs when compared with individual account systems elsewhere in the world. The impact of these costs on pension wealth accumulation can be measured using a simulation. Assume a contribution rate that begins at Rs.5 per day. Assume wage growth of 3% per capita and a real rate of return on pension investment of 6% per year. Then the final pension assets prove to be Rs.3,14,177 if transactions costs are ignored, and Rs.2,88,589 if transactions costs are paid for. Hence, transactions costs worsen the final accumulation by a factor of 8.8%⁸. This simulation is the most conservative case since it focuses on a low contribution rate of Rs.5 per day. The impact of costs and fees would be below 8.8% of the terminal wealth for contribution rates above Rs.5 per day.

⁸ Individual account pension systems without a depository are known to be highly expensive in terms of transactions costs. One estimate for UK (Mamta Murthi, J. Michael Orszag and Peter Orszag, 1999) reports that the typical accumulation ratio in UK is 25%; i.e. the final pension assets are 25% lower than what they would be in a world without transactions costs.

4 Regulatory Framework

The Indian Pensions Authority (IPA) is a new Regulatory Agency, which is required in order to perform a variety of important roles in the institutional arrangements of the pension sector. The primary roles of IPA are:

- (a) Oversight of functioning and growth of all aspects of India's pension sector.
- (b) Enforcement of mandatory contributions in the organised sector.
- (c) Registration of the Depository, POPs, PFMs, Annuity Providers and Individual Retirement Advisors.
- (d) Prescription of investment guidelines and accounting standards for PFMs.
- (e) Supervision and rules for micro-credit, premature withdrawals and taxation
- (f) Enforcement against fraud, dispute resolution and redressal.
- (g) Implementation of the relative return guarantee; including risk management to ensure adequacy of collateral.
- (h) Advocacy and education about the pension sector amongst citizens and policy makers.
- (i) Standardisation of information about fund performance and dissemination of easily comprehended performance measures about all PFMs to all individuals.
- (j) Research about India's pension system, and evaluation of policy initiatives that could yield improved functioning.

4.1 Oversight of Functioning and Growth

The core function of IPA is to oversee and supervise the functioning of the pension system, resolve problems and make incremental improvements on an ongoing basis, and to lead the growth of formal arrangements for post-retirement consumption by individuals in India.

4.2 Intermediaries

The pension system visualised here is comprised of four classes of intermediaries: the POP, the PFM, the depository and the annuity provider. The IPA would define the entry criteria for these intermediaries. These may initially be as follows:

- **POP:** Banks with a net worth above Rs.500 million who have scored 'C' or better on the CAMEL rating; Post offices; depository participant offices which have realtime connectivity to the depository and have a clean record in enforcement and inspections in the last three years
- **PFM:** This is discussed in Section 4.3
- **Depository:** Either or both of existing Depositories in India, or their subsidiaries, or a new depository promoted by the PFMs or their sponsors
- **Annuity Provider:** Banks or PFMs, which satisfy the above conditions, can become annuity providers. In addition, insurance companies authorised to be in life insurance by the IRDA and domestic financial institutions would also be permitted to sell annuities.

4.3 Entry of PFMs

Competition between private fund managers is widely viewed as a highly desirable feature of the pension sector. However, certain problems have been experienced in other countries:

- Owing to the low power of statistical tests of fund manager performance, even highly skilled workers are seldom able to correctly choose fund managers based on past performance. Fund managers who did well in the recent years do not necessarily outperform in coming years.
- Most workers are not comfortable with understanding and analysing performance, fees, loads and expenses. Individual account systems with multiple competing fund managers tend to have excessive fees, and tend to have pension funds expending enormous resources on sales and collection (which are passed on to workers as expenses).
- A plethora of fund managers increases the complexity of the information processing that workers have to do. Our proposal for standardising all funds into three styles, thus

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reducing the complexity of controlling for differences in risk, does not adequately ensure that it will be easy for workers to choose better fund managers.

- The problem of enforcement and prevention of fraud is harder with a large number of pension fund managers.

These concerns can be addressed using a system as follows:

- There should be six PFMs, to begin with.
- Each PFM should run three schemes, one in each style.
- The choice of the six PFMs should be based on an auction, where interested fund managers would compete in bidding the lowest management fees (inclusive of all expenses). The bidders with the six lowest fees (inclusive of all expenses) would get the PFM license for a period of five years. There would be no 'license fees'; the auction process would not generate revenues for the Government.
- All SEBI registered mutual funds with a net worth above Rs.250 million or their sponsors would be eligible to participate in this bidding. Winning PFMs should commit to obtaining atleast Rs.10 billion of assets within two years⁹.
- PFMs would need to be distinct entities exclusively doing pension asset management.
- Every five years, this bidding would take place afresh.

Auctioning based on fees+expenses ensures that individuals obtain low fees and expenses. Up-front setting of fees and expenses eliminates the constant monitoring that individuals have to do about expenses, and the possibility of large marketing expenses being passed on to participants.

Once a PFM has obtained one of the six slots, it does not ensure that it would obtain assets for management; the PFM would have to show good performance in order to attract assets. The control on sales and marketing expenses implies that PFMs would be forced to have a greater reliance on performance as a way to attract assets. The fresh auction every five years gives opportunities for relatively inefficient PFMs (who have lower

⁹ If a PFM fails to achieve this target, his fees should be dropped by 20% from the third year.

assets under management and are likely to bid higher fees + expenses) to be replaced by others¹⁰.

4.4 Enforcement

The proposed system involves individuals and four classes of intermediaries – the POP, depository, PFMs and the annuity providers. Each of these involves a potential for fraud and requires enforcement.

- POPs could defraud individual account holders when funds are paid into the system or withdrawn. Sometimes, the wealth of a worker could be switched from one PFM to another in the absence of adequate authority.
- PFMs could indulge in a variety of malpractices, including violation of investment guidelines, front-running, use of trading mechanisms which are not in the best interests of individuals, market manipulation, etc.

IPA would need enforcement machinery that imposes penalties upon errant economic agents, and evolve the regulatory framework on an ongoing basis to avoid a recurrence of these lapses.

IPA would have a window where any individual in the country would be able to obtain redressal of grievances in the context of pension intermediaries (POPs, PFMs, Depository or Annuity Providers).

Finally, the relationship between annuity providers and individuals could present a variety of problems. However, these would appropriately come under the jurisdiction of the Insurance Regulatory and Development Authority (IRDA).

¹⁰ It is possible to design a graceful handover of assets of exiting PFMs as follows. Suppose an investor has Rs.120 invested in the “Safe Income” style and Rs.240 invested in the “Balanced Income” style associated with PFM “A” who exits from the system after an auction. The depository would transfer these assets as follows: Rs.120 would be handed to the surviving PFM who has the highest performance in the “Safe Income” style in the preceding one year, and Rs.240 would be handed to the surviving PFM who has the highest performance in the “Balanced Income” style in the preceding one year. These transfers would take place at no cost to the participant. Further, the first time the participant chooses to modify his allocation in response to something that is closer to his preferences, away from this default reallocation, he would be exempted from the exit load.

4.5 Relative Return Guarantee

IPA would monitor the calculations and transfers of funds associated with the relative returns guarantee that is recommended above for the six schemes under the “Safe Income” style. In addition, IPA would ensure that PFMs maintain adequate collateral to support these transfers. This would require daily marking to market, and risk management, in a manner which is not unlike the risk management of the clearing corporation. If a fund has inadequate collateral, IPA would takeover the assets of the fund, remove the PFM from the system, and assign the individuals to other PFMs.

PFMs would have to maintain adequate collateral with IPA in order to ensure solvency in the event of under performance. The assets that a PFM can be safely allowed to manage would obviously need to be linked to the size of the collateral maintained. The Committee recommends that no PFM should enter the system with collateral below Rs.100 million.

Under normal circumstances, the relative returns guarantee is attainable through risk management by IPA. However, in the event of a crisis where the collateral pledged by PFMs is unable to cope with the payments which have to be made, there should be a guarantee from the Central Government that these would be made using Government assistance. This would impose a contingent liability on the State.

4.6 Advocacy and Education

IPA would be charged with the role of performing advocacy for the idea of saving for retirement. It would need to educate workers around the country about how the system works, about the choices between the three styles, and how workers can effectively choose fund managers.

The choices that workers face, in the context of pension planning, are numerous and challenging. Which PFM to choose? Which style to choose? How much to annuitise? If a worker ticks on the “default” allocation, the results may not be closely in line with his own tastes and goals. For hundreds of millions of workers in India to make independent choices on these questions requires a sea change in standards of literacy on financial matters.

4.7 Information Standardisation and Dissemination

IPA would require copious information disclosure by PFMs on a daily basis. IPA would work toward maximising the comparability of performance statistics across the PFMs.

All this information would be summarised in a simple and highly comprehensible manner. IPA would disseminate a *simple* one-page table of a performance comparison between all funds in the widest possible manner so that individuals can use this information to choose PFMs in an informed manner. For example, IPA could release the performance data in a quarter-page advertisement in all major newspapers, once a month. The education function of IPA would include the task of ensuring that individuals can understand this report.

4.8 Research

IPA would conduct or sponsor a research program about India's pension system.

4.9 Organisational Issues

IPA is a regulatory agency. The challenges that it will face in regulation and enforcement are much like those faced by other regulatory agencies in India.

- IPA should be an autonomous Government body. IPA should be located in Bombay. A Board comprised entirely of professionals should govern the IPA. Only individuals with a track record of excellence in relevant areas of expertise should be appointed on the Board.
- IPA should be interconnected with the rest of the pension sector using computer networking. This would reduce the cost of operations, improve ongoing data capture, and enable proactive regulation without always requiring a physical inspection.
- Fees charged to individuals who have accounts in the pension system would fund the IPA.

5 Reforms to Existing Provisions

The prime focus of the Committee has been on the great mass of individuals who are working outside the pension provisions that presently exist in the unorganised sector.

However, there is a unity in the basic insights into designing pension systems. An examination of India's pension system in totality reveals serious flaws in existing provisions for the organised sector. The individual retirement accounts (IRAs) described above can be an important part of the reforms agenda in the organised sector as well.

5.1 Reforms to Employees' Provident Fund

The flaws of EPF have been well documented: (a) inefficient asset management with low rates of return, (b) poor customer service, (c) a highly permissive approach towards premature withdrawals. This criticism is succinctly expressed in one fact: the average assets of individuals leaving the PF system is the tiny sum of Rs.25,000. In this sense, PF is failing on the core goal of accumulating pension savings for participants.

The Committee has the following recommendations on how these problems can be addressed:

- (a) Premature withdrawals should only be permitted in the event of permanent disability or death. Apart from this, premature withdrawal should entail mandatory annuitisation of the balance withdrawn.
- (b) Participants in EPF should be given the choice of having their contributions directed into the individual account system recommended in this report.
- (c) The existing notion of "exempt funds" is subsumed by the individual account system recommended in this report. Companies which are presently managing "exempt funds" should cease to manage these funds. They should give their employees the choice of 18 schemes where their mandated contributions would be deposited into an individual account.

5.2 Reforms to Employees' Pension Scheme 1995

The concerns about the EPS 1995 product may be summarised as follows:

- (a) The fund management that is presently in use with EPS 1995 is inefficient. Using superior fund management, participants could obtain much higher benefits at the same level of contributions.
- (b) There are persistent concerns about the extent to which the benefits that are promised by EPS 1995 are in line with the contribution rate required. There are also questions about the extent to which future benefits are inflation indexed. The fear is that the present EPS is grossly underfunded.
- (c) The Government presently contributes 1.16% towards pension accruals. This subsidy has no reason to exist.
- (d) The contribution rates and benefits for various establishments participating in EPS 1995 or similar pension plans (e.g. by nationalised banks) are different.

Hence, the Committee recommends the following actions:

- (a) EPS 1995 should standardise on a single set of benefits for all establishments, based on an employer contribution rate of 10%.
- (b) The Government's contribution of 1.16% towards pension accruals should be withdrawn.
- (c) The funds of EPS 1995 should be professionally managed.
- (d) The investment guidelines should be amended on the lines shown in this report.
- (e) Every year, an actuarial evaluation of EPS 1995 should be conducted, and the report should be publicly released. Benefits and/or contributions should be adjusted so as to ensure that EPS 1995 makes no claims on the Government, now or in the future.
- (f) Presently, the EPFO is charged with both fund management and annuity provision. There may be an important case for converting lumpsum assets into a monthly pension using the annuity market, once greater competition in the annuity market has appeared. Once this is done, the EPS 1995 should be based on outsourced asset

management (implemented by professional fund managers) and outsourced benefits (implemented by professional annuity providers).

5.3 Reforms to Public Provident Fund

The PPF scheme originated out of the desire to improve old age preparation in the unorganised sector. However, the existing PPF scheme has numerous well-documented flaws. We will refer to the existing PPF as the PPF-1 scheme, and recommend the creation of a new PPF-2 scheme as follows:

- (a) All fresh contributions into PPF-1 should cease, though PPF-1 should continue to meet all obligations for the future as originally promised to existing participants.
- (b) A new PPF-2 scheme should be announced, which accepts fresh contributions.
- (c) Withdrawals from PPF-2 should only be permitted at age 60, or in the event of death or permanent disability.
- (d) PPF-2 should be de-linked from small savings instruments. It should be professionally managed by an independent Board of Trustees. The funds that come into PPF-2 should not go into the public account. The entire assets of PPF-2 should be explicitly visible as securities held with a professional custodian.
- (e) In order to help obtain a transition out of existing transfer patterns, the investment guidelines of PPF-2 may stipulate that 40% of the assets be invested in State Government Securities.
- (f) The investment guidelines should be liberalised under the direction of the independent board of trustees – which will establish sound asset management policies and select professional fund managers to implement these policies, subject to the transitional qualification requiring a 40% allocation to State Government Securities.
- (g) The rates of return that PPF-2 comes out with should be driven purely by the investment return obtained by its fund managers; the Government should have no role in influencing the rate of return reported.

5.4 Government Pension Scheme

It is important that Central Government and State Government employees are covered by a pension provision that provides significant income security during old age. While the Committee does not have adequate information regarding the funding of this provision, it appears that this provision is not fully funded and could pose a serious problem. In light of increasing longevity in India, and possible decline in number of Government employees, this provision can impose a serious strain on future Government finances. The Government is seized of this problem and the Ministry of Finance has appointed a Working Group to look into the funding aspect of Government Pensions.

The Committee would only recommend that measures should be taken so that Government Pension liabilities become fully funded out of contributions made by employees. This goal can be achieved over a period of the next ten years.

5.5 National Senior Citizen's Fund

- (a) There is growing awareness and concern about the case of elderly persons in society. If at all, the problem is expected to worsen in the future if timely measures are not taken in the present. This should be a concern of all individuals, private sector companies, as well as the Government. The Government should take a lead in galvanising all these efforts. Towards this end, it is proposed that a National Senior Citizen's Fund be set up to encourage, catalyse, and complement all private sector efforts for the betterment of life of senior citizens in the country. The Fund can also be utilised for educating individuals about various security schemes, conducting research into areas concerning senior citizens and building infrastructure relevant to the social security industry.
- (b) The present contribution of 1.16% of wages by the Government to the Employees' Pension Scheme should be discontinued. Instead, this contribution should be channeled into the National Senior Citizen's Fund as initial corpus for the first 3 years of incorporation of this Fund. Thereafter, this contribution should be discontinued. In addition, 25% of the premature and lump sum withdrawal tax on provident funds under the new IRA system should be transferred to this Fund annually.

- (c) The fund should be monitored and administered by a professional Board of Trustees appointed by the Ministry of Social Justice and Empowerment.

5.6 Caring for Today's Old

- (a) There is a large existing population of destitute elderly – in the age group of 60 plus. There are no easy answers to providing them with income security given the financial position of Government and the large size of this population. At the same time given the significant magnitude of the problem, this issue cannot be ignored either.
- (b) Since August 1995, the Government of India is operating the National Social Assistance Program for the benefit of destitute persons aged above 65 years. There are three schemes under the program, one of which is National Old Age Pension Scheme. Under the scheme, a pension of Rs.75 a month is provided to eligible persons. States also operate similar schemes and supplement the Central Government. In the first two years the central Government disbursed about Rs.4 billion under the National Old Age Pension Scheme. The amounts could be large, if enough publicity is given to the scheme and eligible persons turn up to take the benefit of the scheme.
- (c) Though no information on the percentage of destitute among the elderly is available, estimates suggest that on the basis of current criteria, Central Government disbursement on this account are unlikely to exceed Rs.10 billion. Further, as the percentage of population below poverty line declines over time, this figure should gradually reduce.
- (d) The Committee is of the opinion that National Old Age Pension Scheme plays an important role despite its limitations, and it should be continued.

6 Implementation Path

The sequence of actions that would lead to an efficient implementation of the pension system proposed in this report would run as follows:

- (a) Establishment of the Indian Pensions Authority.
- (b) Development of a detailed blueprint of the processes in the pension system and how they would be implemented by various participating agencies (including banks, the postal system, etc).
- (c) Commencement of education effort.
- (d) Establishment of the depository. This can harness the institution building that has already taken place in India in this area.
- (e) Registration of POPs, the SRO for Retirement Advisors, and the PFM auction.
- (f) Full IT integration between IPA, Depository, POPs, PFMs and IRAs, and a detailed testing of this integration.
- (g) Commencement of the system.
- (h) Escalation of education effort; involvement of NGOs in education effort; pooling of contributions through employers or NGOs.

The capital expenditures involved here are fairly small. When the National Securities Depository (NSDL) was created in 1996, the initial capital was Rs.1.0 billion.

The Department of Posts has estimated that the incremental costs for technology and telecommunications at each post office, for implementation of computer and telecom technology, amount to Rs.80,000. Hence, if a post office needs to be hooked up into the pension system for high quality services, and even if the entire cost has to be borne by the pension system, the cost works out to Rs.80 million for each 1,000 post offices.

Once these systems are in place, the pension system described in this report is entirely self-supporting. The administrative and operational costs of the pension system are covered using the user charges paid to the depository, the regulator, the POP and the PFM. Hence, apart from the startup expenses, this system makes no direct claims on Government finances.

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This report does, however, ask for two contingent liabilities upon the Government:

- (a) A second-tier safety net in case the IPA is unable to implement the relative returns guarantee using collateral from the PFMs, and
- (b) A second-tier safety net for the contribution protection insurance to the extent that the guarantee cannot be implemented through insurance companies (Section 3.2.4).

Glossary

- **Annuity** There are various types of annuity schemes, with possible benefits to surviving spouse after death.
- **Benefits** The income (or lump-sum) that individuals obtain out of the pension account upon retirement.
- **Contributions** The funds that individuals pay into a pension account.
- **Contribution Rate** The fraction of income that an individual submits into the pension account every year. Example: if a person earns Rs.20,000 per year and contributes Rs.2,000 into the pension account, this is a contribution rate of 10%.
- **Equity Premium** The *risk premium* associated with investment in the equity index fund.
- **Exit Load** The fee charged by a scheme when an individual chooses to move funds out of the scheme. An exit load of 0.5% means that when Rs.1,000 is removed from the scheme, there is a fee of Rs.5, so that only Rs.995 are actually moved out.
- **Inflation-indexed Annuity** An annuity where the benefits are indexed to inflation. This would be a contract which pays Rs.1 per month from today until death, but the benefit (Rs.1/month) grows over time with inflation. Obviously, inflation--indexed annuities would be much more expensive than ordinary, unindexed annuities. See *annuity*.
- **Political Risk** The risk of malfunction in a pension system that derives from political pressures on the pension system.
- **Portability** The feature of a pension system which allows uninterrupted contributions despite mobility of an individual across jobs, and mobility of the pension assets in an individual account across fund managers upon request of the individual.
- **Risk premium** The enhanced rate of return that is obtained by investing in risk bearing securities. If the return on risk free long dated securities is (say) 12 percent, and long term on equity investment is 18 percent, the risk premium is 6 percent.

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Individuals who bear the fluctuations of investing in the equity index in India earn a long-run average risk premium of about 10 percentage points per year as a reward: i.e., the long-run average rate of return on the index fund in India is 10 percentage points higher than investments in Government securities. See *equity premium*.

- ***Variable annuity*** An annuity where the monthly benefit varies with asset returns.

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