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India's Pension Future

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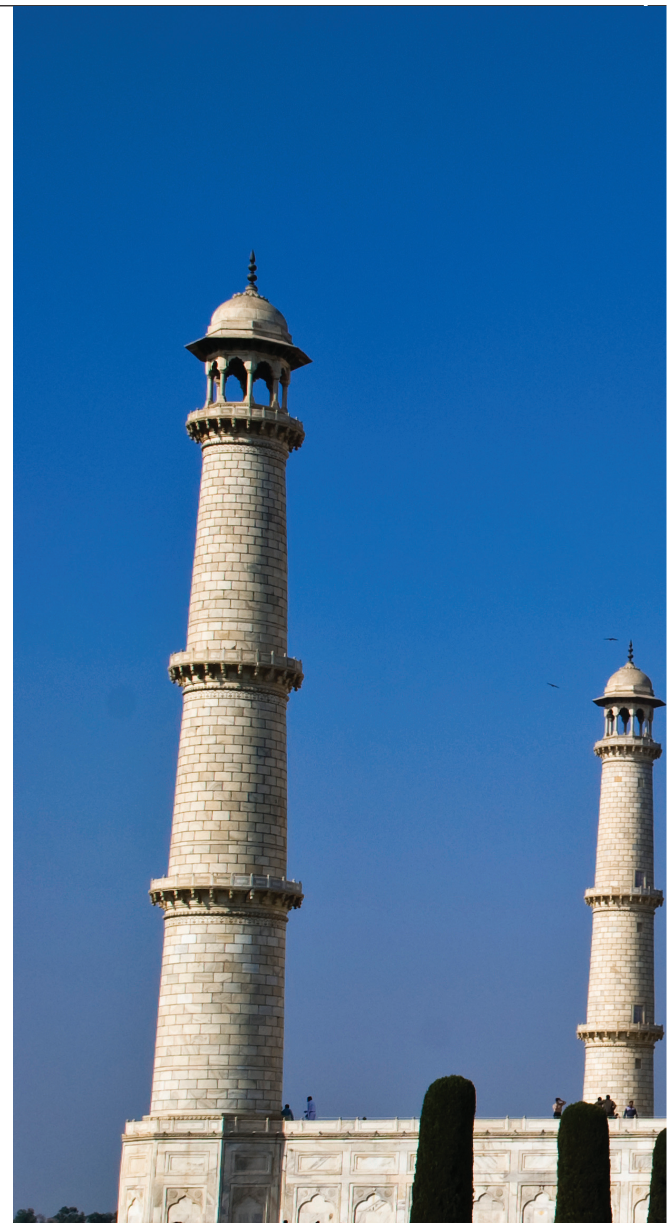

India is grappling with the complex issues surrounding the development of a pension strategy that can address the issues of the majority of the population, as well as the minority who are in formal employment in the public and private sectors. In this special report, IPA's India correspondent **Joseph Mariathasan** explains the issues and talks to those involved in mapping out India's pension future.

Fully 85% of the 450 million workforce does not have any access to a formal pension scheme, relying on their children who themselves may be too poor to carry the burden of aging parents.

The last few years have seen enormous progress in developing the framework for an all-encompassing strategy. The next few years will hopefully see many of the initiatives translated into actual pension provisions for tens, and possibly hundreds of millions, of the poorest segments of India's population. There is much to be positive about; India has a huge demographic advantage over most countries, in that the average age of its population is only 26 years. But as the proceedings of the 9th Invest India Economic Foundation (IIEF) Pension Policy Conference held in New Delhi in November, showed, there are still many hurdles to be overcome for the vision of adequate pensions for all to be achievable.

Backdrop

India does not have a comprehensive population-wide old age income security system. The vast majority of the population relies on support from their children in old age. As Ajay Shah, a Senior Fellow at the National Institute of Public Finance and Policy explains, prior to the reform process put in place in recent years, there were two narrow schemes available for pension provision. First of all, the civil servants' defined benefit pension which covered 26 million workers, and the second was the 'organized sector' system which was encompassed by the Employees Provident Fund Organisation (EPFO) which covers around 15 million workers.

> "The traditional civil service pension was indexed to wages and as a result, the growth in pension benefits was typically higher than inflation."

Ajay Shah

The traditional civil service pension was indexed to wages and as a result, the growth in pension benefits was typically higher than inflation. Shah's analysis showed that over a 14 year period to 2004, whilst nominal GDP grew by a compound rate of 14.3%, central government pensions grew at 16.37% and state government pensions at 19.6%. The combined outgoings as a percentage of GDP went from 1.46% to 2.31%.

As Shah points out, the scheme was designed in a world where most workers who retired at 60 were dead by 70. But the value of the embedded annuities have gone up dramatically as a result of increasing longevity, particularly for the upper echelons of government employees who now have mortality characteristics comparable to those of OECD populations. Moreover, Shah also points out that some public sector companies have DB pension funds that are likely to be underfunded. Their liabilities could cascade up to the central government exchequer at a future date, with no public data even available to assess the issue.

The EPFO has two main schemes, the "employee provident fund (EPF) and "the employee pension scheme" (EPS), which apply to firms with over 20 employees in defined industries. All activities required are undertaken by EPFO itself except for fund management which is outsourced to one external agency such as the State Bank of India.

Firms covered under the EPF can seek exemption for fund management and set up their own self administered funds. These "exempt funds" have to at least match the investment returns of the EPFO.

Whilst EPFO data indicates the presence of around 40 million members, Shah points out that many of these are dormant accounts which come through administrative difficulties in shifting an account from one employer to another. Independent estimates suggest a figure closer to 15 million members in late 2004. As Surendra Dave, the ex-Chairman of the Securities and Exchange Board (SEBI) pointed out in a 2006 paper, the EPFO was created in 1952, when there was very little understanding of pension economics: "A major role in the governance of EPFO was given to trade unions. These origins, and the governance structure, have been the root cause of a series of policy mistakes."

The EPF is an individual account defined contribution scheme based on a contribution rate of 16%. But as Shah points out, workers tend to retire with very small balances in the EPF. "In 2002-03, the mean pension wealth that came into the hands of a newly retired person was merely Rs.36,000. If this money was used to buy an annuity from LIC (Life Insurance Company of India), it would yield a pension of Rs.230 per month, or 9% of per capita GDP."

The EPS is a DB system based on a contribution rate of 8.33% with the government contributing an additional 1.16%. It was created in 1995 applying only to workers who started work after that date. It provides a defined benefit at a rate of 1/70 of the last 12 months earnings prior to retirement, for each year of service, subject to a maximum of 50%.

The EPFO has admirable objectives, but it has so far failed completely to deliver adequate pensions, despite the sums individuals put into it over their working lives. For employers, the EPF represents essentially a tax their employees have to pay out which would not be forced upon them in the informal sector. As a result, formal sector employers can struggle to compete with the informal sector, according to Manish Sabharwal, the Chairman and co-founder of Teamlease Services, India's largest temporary staffing firm. Around 95% of job creation is now in the informal sector he argued, and they do not deduct from wages to pay benefits, as with the EPF.

Moreover, he pointed out that the EPF seems to charge over 4% in fees to just invest in government securities. Yet even here, as Shah says, just one years contribution of Rs. 2,500 at age 20 can yield a pension pot of Rs. 25,000 at age 60 in a properly designed pension system. The failure of the EPFO schemes to provide adequate retirement income Shah attributes to administrative difficulties when accounts get closed or lost over job changes and also provisions for premature withdrawal of balances. There were also concerns over the funding status of the defined benefit EPS fund, which did not change contribution rates at all despite a dramatic change in bond yields from 13.4% in January 1997 to 5.1% in October 2003.

The EPFO has also been criticised strongly by many, including Shah, for being burdened with a complex mandate that encompasses record keeping, administration, supervision and regulation. Shah sees this as inconsistent with modern institutional architecture, where unbundling is favoured in the interests of transparency and competition, whilst regulatory functions are kept distinct from service provisions.

Perhaps one of the most pernicious aspects of both the civil service scheme and the EPFO is that the fiscal transfers are disproportionately captured by the rich. The EPF gains an explicit subsidy in the form of special deposits which are deposited with the government at above market rates of return. Shah points out that amongst EPF customers, as much as 83% of the assets are controlled by 15% of the accounts so that the bulk of the subsidy is being captured by the richest amongst them.

"India's largest temporary staffing firm. Around 95% of job creation is now in the informal sector he argued, and they do not deduct from wages to pay benefits, as with the EPF."

Manish Sabharwal

The defined benefit civil service scheme and the EPS also generate very different payouts for people in different income classes. As poorer people are likely to die sooner, the benefits obtained by the longer-lived wealthier individuals are much higher than those obtained by the poorer members if the scheme, which are thereby implicitly subsidizing their richer brethren!

The Reform Process and the Setting Up of The New Pension Scheme (NPS)

Given the drawbacks of the traditional provisions for pensions, India faced pressures for reform, which led a decade ago to two separate developments. The first of these was the OASIS report initiated by the Ministry of Social Justice in July 1998, written by a Committee chaired by Surendra A. Dave, a former Chairman of the Securities and Exchange Board of India (SEBI), with Gautam Bhardwaj of Invest India Economic Foundation serving as the Member-Secretary of the Committee. The OASIS report essentially put in place a framework for setting up DC pension provisions for the informal sector. The second development was a report undertaken independently of the OASIS project in October 1999 by the Ministry of Finance, on the reform of the Civil Service pension provisions.

Vested interests can always become entrenched within any bureaucracy, and India is notorious for its byzantine complexity. As Gautam Bhardwaj, one of the architects of the reform process says: "India needs to adopt a holistic approach to the provision of pension provisions for the poorest segments of society. The problem now is that responsibility is split between a number of Ministries, making it difficult to bring about the changes that are needed."

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Gautam Bhardwaj

What are the changes that should be the ideal? Shah outlines them as the following, all of which are incorporated in the National Pension Scheme and outlined in the original Oasis report:

Coverage: Pension provisions need to address the 85% of the 400 million workforce that does not have any access to a formal pension scheme.

Sustainability: Shah points out that India has had many instances of failures of guaranteed return savings schemes, such as the EPS and the assured-return products sold by UTI, which led to the central government having to intervene. A long term sustainable scheme must be based on a solid foundation of defined contributions, where the wealth of a participant is led purely by net asset value. It should avoid assured returns, subsidies, guarantees or liabilities for the central and state governments.

Moreover, Shah sees that: "A goal of pension reforms should be to separate government from the process, if making monthly pension payments to citizens, over and beyond the monthly contributions paid into the pension accounts of government employees participating in a DC system."

Scalability: The architecture of the pension schemes need to be suitable for Central, State and Local governments as well as the hundreds of millions of workers in the uncovered informal sector.

Outreach: The institutions and policies need to be designed to cater for the needs of a large mass of participants who are expected to be financially unsophisticated, who are presently not covered by financial services, engage in small value transactions and have small sums available for pension provisions.

Fairplay and low cost: The architecture should ensure the highest levels of transparency, competition and sound policy making.

Choice: The design has to be highly transparent, and give participants the choice between multiple competing pension fund managers, investment styles and competing annuity providers.

Sound regulation: There needs to be a regulatory framework focused in maximising the welfare of participants in old age.

The Civil Service report recommended a hybrid DC/DB pension provision for public sector workers. But as Dhirendra Swarup, the Chairman of the Pension Fund Regulatory and Development Authority (PFRDA) pointed out at the IIEF conference, civil service pension obligations were increasing at a compounded rate of 21% p.a.. The Central and State governments were paying out 70,000 crore of rupees ($15bn) out of their budgets for pensions, which in 10 years, would have meant that 50% of their total budgets would have been spent on pensions and salaries of their own employees. Not surprisingly perhaps, in the light of these statistics, the Indian Government did not accept the recommendations to continue with an element of DB provisions and ruled that Civil Service pensions would move onto a DC basis from January 2004, following the framework set out in the OASIS report.

The PFRDA bill was initially introduced in March 2005, and had the objective of setting in place a purely voluntary DC pension scheme (the New Pension Scheme or "NPS") that could be utilised by both the informal and as it turned out, the formal sectors as well. Whilst it may be thought that the creation of a voluntary pension scheme should not be a controversial issue, the bill did arouse some political opposition and as Swarup explains, it languished in government for 4 years, and will now be reintroduced in the coming session.

Despite the lack of formal legislation, the essential architecture was allowed to be put into place through contractual arrangements, with the creation of the PFRDA, and the framework installed for the provision of mass DC pension provisions in the National Pension Scheme (NPS). External fund managers in the form of SBI, UTI

Dhirendra Swarup

> "The NPS was extended to all citizens on a voluntary basis in the first half of 2009. So far, the results can only be said to be disappointing in terms of attracting individual participants, with just 3000 as of November 2009."

and 4 others have been selected for the Civil Service scheme, along with a custodian and other operational requirements finalized.

As of November 2009, there were 700,000 subscribers to the NPS, with 22 of the 28 State Governments agreeing to move onto scheme. However, as Swarup points out, it still took more than 4 years for the civil service to transfer funds to the NPS to be managed by professional fund managers.

The NPS was extended to all citizens on a voluntary basis in the first half of 2009. So far, the results can only be said to be disappointing in terms of attracting individual participants, with just 3000 as of November 2009. But Swarup declares that critics need to be patient. The education process is just beginning. As he pointed out, there are a number of reasons for the low take-up so far which include:

A lack of preparedness from the points of sale for pensions. In future, the PFRDA intends to monitor the performance of sales channels against their submitted business plans.

The lack of awareness of the products on offer. The PFRDA will be leading an awareness campaign.

The competition from the insurance and mutual fund industries. Swarup's view is that there is not currently a level playing field for the different providers of savings products.

The tax system currently places the NPS at a disadvantage vis a vis insurance products. Swarup sees the new tax regime as providing an incentive.

More fundamentally, the NPS was designed with a view to keeping intermediary costs at a minimum. As a result, the PFRDA has adopted a direct sales model, without any sales force. This avoids any danger of mis-selling and also radically cuts down the transaction costs. However, it does mean that alternative approaches need to be devised to educate and reach out to potential participants.

Swarup sees the advantages of the NPS over other savings and pension products as the following: A unique record for each individual and hence portability across employers; flexibility across investment classes; flexibility across fund managers; and very low transaction costs with no front end fees paid out to intermediaries. Ultimately, the success of the NPS will be based on the returns that are delivered to the participants. So far, the trend has been good, with Swarup indicating a return of 14% in the first year of provision for the NPS against the 8% delivered by the government scheme.

The NPS is clearly at a very early stage in its development, and the critical issue is how it can be rolled out on a voluntary basis to literally hundreds of millions of workers who have had no exposure to financial services. This issue will be a huge challenge for many years to come. Enthusing workers on saving for their pensions when they have little or no exposure to financial products and may be based in remote locations far from any bank is a non-trivial problem. - But it is the key to the eventual success of the NPS and the alleviation of old age poverty in India. The progress and ideas discussed at the IIEF Pension Policy Conference suggests that there is a way forward, albeit with many obstacles in the way.

The Plumbing for the NPS — the Unique Identification Authority of India (UIDAI)

One of the most difficult aspects of establishing a pension scheme for hundreds of millions of the poorest segments of India's society, is identifying who they are absolutely accurately over a period of a lifetime. Many of the potential participants in the NPS are illiterate, and there may even be no reliable records of their existence. The EPFO schemes have a recorded number of 40 million members but an actual number closer to 15m with the difference due primarily to an inability to track workers across multiple employers during their working lifetime. Achieving the NPS vision is predicated on utilising the latest technology, both in investment products and in the infrastructure required to deliver the products. Ajay Shah pointed out that unsophisticated consumers need sophisticated finance, but they also need extremely sophisticated mechanisms to deliver that finance in a mass market high volume, low cost environment.

India is embarking on a project that will have the most profound impact in the long term, on the nature of India's society, and will also be a key cornerstone for the widespread dissemination of the NPS to participants in the most remote areas of India. This is the establishment and provision of a unique number for every single individual in India, over 1 billion identities that will be able to be verified in real time. India is fortunate in having a vibrant and world class IT industry, and it has also been fortunate in gaining the services of Nandan Nilekani, to be Chairman of the Unique Identification Authority of India (UIDAI), established to develop and deliver the technology capable of doing this. Nilekani was a co-founder in 1981 of Infosys Technologies, now a world class IT company and one of India's brightest gems.

As Nilekani pointed out at the IIEF Pension Policy Conference, the challenge when delivering public services, is to be able to verify the identity of a person at the point of delivery. The intention of the UIDAI, is to establish a single database with one number to provide a unique identity (UID) and a very basic record for every individual in India. According to Nilekani, this may be just comprise a name, date of birth, address and the details of the parents. This will be established through using a unique biometric package which is currently being researched. Nilekani expects this to be finger prints with the additional possibility of using iris scans if they can be shown to be effective and unique. But as he points out, establishing unique identification data and hence a unique number is not sufficient. For the system to be effective, it must also be established that there are no duplicates. This process of "de-duplication" is a significant computational issue. If there were 500 million records and an extra 100 million were to be added, they would first have to be compared with all the existing 500 million and with each other before being recognized as not a duplicate and hence a single as well as being a unique identifier for an individual.

Nandan Nilekani

Once the technology of establishing the unique biometric data has been established, the issue is how it can then be applied in a cost effective manner across 1 billion people. Clearly, it cannot happen at once. The strategy that Nilekani outlines is based on using a variety of registrars who would be given the technology e.g. of taking fingerprints electronically and transmitting the information via mobile phones to a central database. These registrars would include banks, insurance companies and the usual financial intermediaries, so that existing users of such services would be easily able to be tested and assigned a unique number. But the technology of utilizing mobile phones with biometric assessment can be utilised by any agent involved in transactions with an individual, so it could encompass petrol stations etc. This then enables micro-payments of small amounts for an individual's pension provisions, to be incorporated alongside transactions associated with any day-to-day activities that utilize cash payments. The issue as Nilekani says, is to be able to combine the scale of coverage of mobile phones in Indian, with the prudential and regulatory aspects of finance. The UID provides an authentification program for service providers and should thereby continuously reduce transaction costs: "You just need a cell phone and say a fingerprint reader to get authenticated on line and then complete a financial transaction."

The only role of the UID is the establishment if identity and any two people by mutual consent, can establish each other's identity through such a system. Whilst the immediate application maybe the establishment of micro-pensions for the poor through the NPS, the ramifications of such a technology are likely to be much more far reaching.

Strategies and Incentives for Expanding Voluntary Pension Coverage

Recommendation of the OASIS report

The financial needs of an individual across their lifetimes are inevitably complex, whatever their wealth. Poor people lead lives with unpredictable cashflows, requiring risk management and the solution of complex financial problems. "As a result, consumers need sophisticated financial products", says Ajay Shah, a Senior Fellow at the Indian National Institute of Public Finance and Policy.

But as he adds, the typical consumer is bad at understanding fees, expenses and charges. The result is often an unsatisfactory outcome for the individual, although often not for the financial intermediaries supplying them with services. There are many failure stories of pension reforms, and the key proponents of pension reform in India are well aware of cases where 33% of a lifetime pension accumulation ends up with financial firms. In India, there are already serious problems with fees on mutual funds and insurance products according to Shah. Moreover, the tax legislation has become so complex that a salesman seems to be able to get away with almost anything when he promises "tax savings".

For the NPS to succeed in its objectives, the key question for Shah, is how to obtain mass scale outreach of distribution and access to financial products whilst ensuring consumer protection. The goal should be to ensure that neither consumer protection nor outreach are sacrificed. In some situations, public policy can solve the problem by enabling and encouraging commoditisation and bulk procurement. But for distribution, Shah argues that non-commoditisation is of the essence and artificially inducing standardisation in distribution will sacrifice scalability. But he adds: "Yet the arsenal of public policy has to play in favour of consumer protection."

Mass outreach of complex financial products such as pensions, can only be made possible using technology argues Shah. "Low tech solutions are elitist. Old fashioned policy makers want to force India to have a 19th century financial system. This is not the answer." Whilst consumer protection is often thought of as protecting the consumer from the Ponzi schemes associated with the likes of Bernie Madoff, the real problem as many would argue, lies with the fees and expenses charged to retail investors. Consumers are led astray by the allure of supposedly supernormal returns to invest in products with high embedded charges. Often there is a lack of comprehension of the fine print, and words such as shelters from tax, become a fig leaf to cover opaqueness. There can also be just plain apathy when it comes to discussing savings for pensions.

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The NPS was based on the recommendations of the 1999 Project OASIS report, which had as one of its prime drivers, the requirement to minimize intermediary costs in the mass provision of pensions. The key elements for doing this were expected to be:

A forced unbundling and transparency of the elements of pension provision in the form of: front end, record keeping, fund management and annuity provision.

The view that active fund management was unlikely to add much value, but would incur higher fees and expenses. As a result, the strategy was to use index funds to get the right asset allocation at minimum cost.

Economies of scale can be obtained in components such as fund management and record keeping.

Public procurement obtains minimum costs for components such as fund management and annuities.

The key insight of the OASIS report was to use unbundling combined with commoditization, combined with public procurement to address the market failures that stem from unsophisticated consumers.

Distribution strategy for the NPS

India is a very heterogeneous country. The average household income in March 2009 was around Rs. 500,000 in Abohar in the Punjab, and around Rs. 60,000 in Palanpur in Gujarat. Even in places relatively close to each other like Palakkad in Kerala, with around Rs360,00 and Vellore, in Tamil Nadu, with around Rs,66,000, the ratio of incomes was 5.4. As a result, distribution strategies to cover such disparities in income and geography need to be very heterogeneous themselves. Shah points out that the distribution costs varies with three factors: How much is the education/communication cost per consumer?; What are the wage and non-wage costs paid in that location?; How many customers or what is the size of assets under management (AUM) for that population?. In south Mumbai, education and AUM are good, but wage and non wage costs are high, whilst in Palakkad, education is weak. In Vellore, wages are low, but non-wage costs are high; education costs are high and AUM is low.

Shah argues that the problem with financial firms in India is that they have not reflected these issues in their strategies. Pricing and strategies need to vary by location. "State Bank of India pays the same salaries across India." Forcing standardisation of fees will sacrifice scalability since the cost of distribution of a financial product may vary by factor of 5 or even 10 between the best and worst locations. The provision of ATM terminals is a good example. The provision of ATMs is highly regulated with flat fees. As a result there is little incentive to place terminals in remote or poor locations such as Arunachal Pradesh or Vellore. Financial firms should look for internal formulas to do capital allocation and price setting in homogenous regions, which incorporate a measure of financial literacy, wage and non-wage costs and market size, according to Shah.

Currently there are two models in India for the distribution of old age pensions. In Karnataka, the government pays a 5% fee to the post office to distribute cash to recipients. In Mahdya Pradesh, the government pays cash directly into bank accounts, but as the banks and ATMs are only in urban areas, villagers have to walk 20kms to collect their payments.

Distribution strategies for the NPS still need to be developed and it is not clear what the successful approaches are likely to be. What is clearer, is that a one size fits all strategy is unlikely to succeed in fulfilling the objectives. But as Dhirendra Swarup, the Chairman of the PFRDA said: "The NPS is a brand new product. The primary concern has been on how to keep the costs low. Having 500 distribution agreements in place is not easy. As we mature though, we will develop. The model is robust, transparent and simple. We don't have a closed mind on distribution, but it takes time."

Civil Service Pension Reform

A major element of India's future pension strategy is the adoption by central and state governments of the NPS framework as the basis for future public sector pensions. The Indian central government introduced the New Pension System (NPS) with effect from January 1, 2004. Under the new pension system, the Central Record-keeping Agency (CRA) is required to maintain subscriber accounts and issue a unique Permanent Retirement Account Number (PRAN) to each subscriber. In this system, deductions towards an NPS pension are made from subscriber's salary on a monthly basis and an equal amount of contribution is made by the Indian central government.

The new pension system covers, at present, all new entrants to central government services but adoption by the State Governments can only be said to have been partially completed. However, Subhash Garg, the Joint Secretary, Ministry of Agriculture in India made the point at the IIEF Pension Policy Conference that the Indian State governments are recognizing that current and future salary and pension expenditure is the largest part of their fiscal expenditures and the DB pension entitlements expose them to highly uncertain pension liabilities. External factors can exacerbate their problems with a recent pay commission recommendation enhancing pensions in some cases by 100%. As a result, all India States barring just three, announced the adoption of the NPS very soon after the Government of India introduced it. Quite a few states have institutionalised the process of making deductions of employee contributions and making their own contributions. These states according to Garg, are now holding pension funds prior to passing them onto the NPS, and are paying interest on the funds accumulated.

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Subhash Garg

There is still some way to go before complete adoption of the NPS framework by the State Governments and progress has been slow according to Garg. Some States have not moved beyond announcements. Some States are faltering on contribution collections, accounting and data and some states are even regressing. Some States, mostly States getting technical assistance from the Asian Development Bank (ADB) have developed institutional mechanisms for collecting contributions, posting them to a ledger and providing individual accounts. Only a handful of States have succeeded in registering with the CRA and getting PRAN accounts even partially opened. Only two States have started uploading data regarding contributions to the CRA, whilst no NPS funds from any State have yet been invested by regulated fund managers.

There are a number of reasons as to why adoption of the NPS by the Indian States has been so slow despite the example of the central government. Garg finds that States are grappling with a number of issues. These include: Building in appropriate rules and systems to adopt and implement the NPS, and in particular, deciding on what should replace existing rules on pensions; a highly inflexible CRA architecture which has been designed for central government employees, with very different requirements from States; a limited understanding of the States' systems by the CRA; and agreements which the States find very different from what they are used to with external fund managers, trustee banks, custodians etc. As Garg points out, whilst States with centralized records are best placed to adopt the architecture of the NPS, they also have the least incentive.

To move forward at a State level, what is required is a recognition of the various systems the States already have in place, and a developmental role in building up their institutional capacity. As Garg points out, several States have weak IT and data collection capacity. The Government of India and the PFRDA need to adopt a developmental role, much as the ADB have in some states. Indeed, he argues that full implementation of the NPS by the States will have to be taken as a developmental challenge, the “D” part of the PFRDA.

This is a somewhat controversial role, since some would argue, as Gary Hendricks, a senior pension policy specialist does, that trying to combine regulatory activities with development within one agency does not work and leads to conflicts of interest. But for the NPS to be adopted, Garg argues States will have to be helped to develop institutional capacity to: Have the right set of rules and regulations; develop IT capacity and payroll systems to collect contributions and data; collect and compile data and contributions at one central location or at best, at regional and district levels; and have a fair and functioning arrangement with the CRA and fund managers.

“As he says, many States just do not have the knowledge to implement the NPS, and require significant technical and financial assistance. Indeed, some have not been taking contributions from employees for the past 4.5 years after agreeing to implement the NPS, which will lead to serious issues over funding once they eventually do.”

Gary Hendricks

Garg also argues the central government needs to work with multilateral agencies to help States develop databases and data management systems. Hendricks also argues forcefully that the awareness of a sense of urgency in implementing the NPS needs to be driven by the central government, and this needs to be a task that continues for at least 18 months. As he says, many States just do not have the knowledge to implement the NPS, and require significant technical and financial assistance. Indeed, some have not been taking contributions from employees for the past 4.5 years after agreeing to implement the NPS, which will lead to serious issues over funding once they eventually do.

Existing Precedents — The IIMPS "Micro-Pension" Model

Adopting the NPS for the mass of unregulated workers in the informal sector requires the ability to set up systems that enable small amounts of cash to be remitted at irregular intervals over long periods of time. Much of the NPS framework has been set in place to provide this facility, but with just a few thousand direct entrants to the NPS so far in the six months or so that it has been open to them, the system has still to prove itself. There are however, precedents in the "micro-pension" model of Invest India Micro Pension Services (IIMPS) that provide useful lessons and that may eventually become incorporated themselves into the NPS framework.

IIMPS was set up by Invest India Economic Foundation, with support from UTI and the Self Employed Woman's Association (SEWA), each of whom also own 10% of the equity. SEWA also owns a bank which itself has good IT and administrative functions, enabling IIMPS to work with groups of workers to collect multiple small contributions, pool them into significant amounts that can then be transferred to a fund management company such as UTI AMC. Not surprisingly, given this background, what has been common amongst many of the groups that have adopted the micro-pensions route is that they are women's organisations.

U.K. Sinha, the Chairman and Managing Director of UTI Asset Management, gave some insights at the IIEF Pension Policy Conference on the lessons to be learnt from a number of micro-savings that are already in existence in India including UTI's own one. These are all predicated on the fact that, as a recent IIMS Dataworks report suggested, 61mn of the 143mn lowest income earners (earning less than Rs. 3000 per month) are willing to save through a contributory social security arrangement. These workers have irregular income and the savings capacity is limited and hence the retirement payout is also limited. As a result, the cost for a service provider will be prohibitive. But social welfare is the responsibility of the State, and the Government needs to provide financial support for the retirement savings of these workers. The fiscal strain on the exchequer will be much higher if the Government looks to fund it at their retirement time.

Existing schemes that can provide precedents for the NPS include initiatives by State Governments such as those of Bihar, Karnataka and Rajasthan to provide savings for girls at birth that would be invested for them until they reach the age of 18. Other examples include Schemes set up by Andra Pradesh, Mahdya Pradesh and Rajasthan for workers, often women, to save small amounts with matching contributions from the State Governments up to a maximum of 1000 rupees a year. These schemes, even with maximum limitations provided by State Governments, are limited because the resources of the States themselves are limited. The NPS may well provide an alternative to them, but as Sinha argues, the Government may have to pay for recordkeeping and transfer charges for such moves to take place.

Bhardwaj's own experience of implementing micro-pension schemes in states such as Rajasthan, is that it takes four months or to convince State politicians to approve a scheme. Not surprisingly, there is often concern over what the implications of a scheme would be at the political level and how satisfied voters will be with the outcome. Benefits need to be seen to be spread fairly throughout the geographic region, and targeted at specific groups deemed to require such help.

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U.K. Sinha

UTI itself has been a pioneer in the provision of micro-savings using the IIMPS micro-pension model. Their scheme is implemented through IIMPS and is designed to address the retirement savings needs of unorganized workers in rural, semi-urban and urban areas. The contributions, which could be from workers, state governments and/or non-governmental organisations are invested into the UTI Retirement Benefit Pension Fund, and contributions can be as low as Rs. 100 a month. Each worker gets a unique number and periodic statements on his account. The worker is then entitled to make systematic withdrawals from the age of 60.

Whilst there was initial concern that there would be a large drop-off of contribution after the initial enthusiasm, the experience so far has been that 98% of contributions have continued after the 3.5 years of existence of the fund. UTI's route to provide micro-savings has been by finding a lead partner in each state. This could be a self help group, or some other organization which, through its normal activities, has a flow of payments to individuals, a small part of which could be diverted for pension provisions.

Robert Palacios

To succeed in persuading lowly paid workers to save for retirement requires education and also incentivisation. Robert Palacios a senior pension economist at the World Bank believes that it requires co-contributions by state or central governments to provide the necessary incentives and tax rebates. It also requires an outreach program argues Palacios, since the combined cost of an information program and getting to the end user is a huge burden. Channeling approaches through groups as UTI do, works well, but is limited in scope. Ultimately, individual households need to be approached in some way, similar to the Post Office offering life insurance.

Ultimately however, as Bhardwaj argues, the IIMPS micro-pension model of the type described cannot be a solution for India as a whole: "The problem is that even after saving for 30 years, the terminal amount is so small that it will not be able to provide a decent annuity for retirement for another 20 years. Moreover, as he points out, whilst workers are promised lump sums based on monthly payments that appear large in their eye, these figures are nominal amounts, which after 30 years of inflation, will turn out to be little in real terms.

The danger exists currently that many participants in the schemes may find that the promised terminal sums, whilst large from their standpoint, in today's money, will not have kept up with inflation and be unable to produce an adequate retirement income. As Bhardwaj explains, what is required are two things: firstly there needs to be an education process to disseminate the idea that contributions to micro-pensions do need to be raised each year in line with inflation; and secondly, the government needs to supplement the amounts paid in with co-investments of its own. As Bhardwaj argues, there is a population of 61m who may save if co-investments are made on their behalf. The key part then is to reduce the transmission costs – something that the NPS architecture was expressly designed to do.

Where Next for the NPS?

The New Pension Scheme framework is a tremendous concept, but turning the concept into a successful solution to the problems of old age poverty in India is a task that requires a level of commitment, organisation and resources that are still yet to be deployed. The experience of the past is not hopeful. Previous attempts by the government of India to alleviate poverty have been very haphazard. The National Rural Employment Scheme for example, guarantees 100 days employment a year for rural workers at a rate of Rs100 a day. It effectively means that with or without work, rural workers can expect Rs10,000 a year paid to them. But whilst the scheme is expensive from the Government's viewpoint, there is no record of who is getting the benefit and who is not, so whether the "leakage" of benefits is 10% or 50% is an unknown quantity.

In principle, the structure of the NPS and the development of technology such as the unique identification (UID) should enable any support from the government in terms of co-investments into pensions to be targeted at the most vulnerable segments of society. The NPS therefore does represent a new dawn for the alleviation of old age poverty in India. However, after six months of operation, the NPS itself had only recruited 3000 individual members, which would certainly not be seen as a success by any commercial operation, when the objective is to recruit tens if not a few hundred million participants!

Yet in its defence, the Chairman of the Pension Fund Regulatory and Development Authority (PFRDA) would argue that it is still early days and it will take time to get the infrastructure in place. What has been achieved since the 13 months or so (as of November 2009) since the creation of the PFRDA, has been the establishment of an infrastructure encompassing custodians, trustee banks, fund managers etc at a low cost without, they would argue, compromising on quality. As of November 2009, the NPS had 550,000 members from the central government civil service, and 100,000 from State governments. They are forecasting this figure from the States should rise to one million by 2010.

The PFRDA is not a statutory body as yet, and as a result, its powers are limited. Rules such as a 50% cap on investment in equities have been set by the central government and as a result, the PFRDA has no choice at the moment, but to accept them. Indian pension schemes currently have little exposure to equities with investments in the EPFO schemes predominantly bond based. Yet many pension funds in developed markets are looking to increase weightings to emerging markets above the 12% of the global equity market that they currently represent, on the grounds that they represent countries with younger populations and higher GDP growth rates. On this basis, India could find itself in 20 years time, with the situation that India's companies are paying more dividends to support the aging populations of the developed nations, than they are paying out to support the pensions of their own ex-employees and India's population more generally!

The PFRDA is tasked both with being a development agency for the introduction of the NPS as well as a regulatory authority. Yet until formal legislation is passed in Parliament, its role as a regulator is strictly limited, and it functions as an arm of the Ministry of Finance. Whilst it is in this position, it does however, carry much more clout in terms of persuading and pressurizing other arms of central government and indeed, State governments to move more quickly in realizing the aims of the NPS. Once legislation has been passed to formally incorporate the PFRDA as a separate legal entity, it will be seen as a narrow regulator, without the backing of a powerful ministry behind it.

"If the "D" in PFRDA is to stand for something other than the word "Defensive", the PFRDA needs to answer the issues raised by its critics and become much more proactive in developing the NPS, if the momentum is to be maintained."

The critical time for the eventual success of the NPS may actually be in the next year or so. During this time, the PFRDA and its supporters elsewhere need to build up the momentum and the enthusiasm of the States to actually implement the system they have already agreed in principle to accept; they need to find ways of incorporating existing micro-pension schemes within the NPS, and set up many more such group schemes; and much more progress needs to be made on the most difficult that of all, that of persuading individuals outside of any group, of the merits of saving for old age through the NPS.

Critics of the PFRDA's progress in recruiting members give the experience of Delhi's auto-rickshaw drivers as an example. The 85,000 auto-rickshaw drivers, steering their ubiquitous three-wheelers around India's capital, have their own trade union. The union approached the PFRDA directly with a view to joining the NPS. But the NPS required a minimum contribution of Rs.6000 a year, whilst the union felt its members could only afford Rs200 a month based on their income. Instead, the union went to UTI who happily took on all 85000 members using the micro-pensions route. From UTI's perspective, the auto-rickshaw union is totally responsible for the administrative burden of organizing the collection of small payments and pooling them together. As a result, UTI has only to manage the funds. It seems somewhat perverse that the PFRDA chose to turn the group away at a time when it needs to demonstrate the capabilities of the NPS.

If the "D" in PFRDA is to stand for something other than the word "Defensive", the PFRDA needs to answer the issues raised by its critics and become much more proactive in developing the NPS, if the momentum is to be maintained. The experience and success of the micro-pensions in India, with over 200,000 members across India, in essentially a series of private initiatives shows the potential of what can be achieved. Can these initiatives be integrated, as they should be, into the NPS, which could and should act as a catalyst for the convergence of the efforts to alleviate old age poverty across India? Or will the turf battles between the many ministries in the Indian Government give rise to another impasse in development, as they have so many times before.

Already the NPS itself has split into the two main strands of the Civil Service scheme and the private sector scheme, with different sets of fund managers. This itself reduces some of the benefits of scale and will make it more difficult for transferring pensions between the public and private sectors. The alternative scenario for the NPS is clearly already appearing over the horizon in the disappointing progress made by the State Governments in fully implementing the NPS , despite their initial enthusiasm for the idea. The crucial challenge over the next 18 months will be to develop sufficient momentum for the NPS to really become entrenched, across both the public and private sectors. The jury is still out as to whether its proponents will succeed in this aim.