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Legislative Brief

The Pension Fund Regulatory and Development Authority Bill, 2005

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Highlights of the Bill

- The Pension Fund Regulatory and Development Authority Bill, 2005 establishes an authority to develop and regulate the new pension system (NPS) which seeks to provide old age income security for all individuals, including those in the unorganised sector.
- NPS will be implemented through a combination of retailers, pension funds and recordkeeper(s).
- Every subscriber will have an individual pension account, which will be portable across job changes. The subscriber will choose the fund managers and schemes to manage his pension wealth. He also has the option of switching schemes and funds.
- The NPS has already been operationalised for new central government employees through a notification. This is a 'defined contribution' scheme unlike the 'defined benefit' scheme for existing central government employees.

Key Issues and Analysis

- The Bill provides a structure to the private and unorganised sectors to plan for old age income security. It is not compulsory for these sectors to take part in this system. Those not participating may still have to fall back on public resources in old age.
- In the system for new government employees, the investment risk is entirely borne by the employee. However, he is no longer exposed to the risk of default by the government.
- There will be no explicit or implicit guarantee on the pension wealth unless through purchase of market based guarantees. This is unlike the case of bank deposits where deposits up to Rs 1 lakh are guaranteed.
- Any unfavourable event affecting market prices at the time of retirement could lower both pension wealth and the annuity rate. Subscribers may have to stay on in the system beyond their retirement date in order to ride over such a shock.
- PRS estimates that given current market rates for annuity, Rs 1,000 per month subscribed to NPS for 35 years will result in lifetime annual pension for self of Rs 47,000 to Rs 77,000 under different scenarios of returns.

PART A: HIGHLIGHTS OF THE BILL[1]

Context

This Bill sets a framework for the development and regulation of pension funds in India in order to promote old age income security. It defines an architecture consisting of retailers, pension funds and record-keeper(s), and establishes a statutory body to regulate the sector. The pension scheme for new government employees has been changed from the existing defined benefits (DB) system to a defined contribution (DC) system[2]. That is, the pension payable at the time of retirement is not fixed on the basis of the pay-scale (DB) but will be determined by the funds accumulated through contribution and investment gains during the service of the employee (DC). This new system will be governed by the architecture proposed in this Bill.

Only 13% of the workforce is currently covered by pension schemes[3]. These are government employees and those in the organised sector covered by the Employees Pension Scheme 1995. Schemes offered by insurance companies and regulated by the Insurance Regulatory and Development Authority (IRDA) are also available, but these are a combination of pension and insurance. This Bill provides a regulatory framework for a new pension system (NPS) which will be available to any individual.

High budget deficits have reduced the government's ability to continue the current system. A number of state governments have reportedly delayed pension payments[4]. Total government (centre+states) pension cost has increased from Rs 6,400 crore in 1991 to Rs 46,569 crore in 2001, which is a growth from 7.3% to 14.6% of total tax revenue. An estimate suggests that the implicit pension debt of centre and states on account of pension liabilities to current employees is 55% of GDP[5]. The NPS tries to address these issues. The central government has implemented NPS for its employees appointed from January 1, 2004[6] through a notification[7] issued in December 2003. Currently, all the contributions in this scheme are being parked in the Public Account, and the government is paying interest at 8% p.a. These funds will be moved to schemes managed by Pension Fund Managers after implementation of this Act.

Key Features

The Bill is in the nature of an enabling legislation. It establishes the Pension Fund Development and Regulatory Authority (PFRDA), defines its powers and duties, and sets the broad contours of NPS. The particulars of NPS (such as selection of intermediaries, types of schemes etc) are not detailed, and shall be determined by PFRDA through regulations.

The New Pension System (NPS)

- The system comprises one (or more) central recordkeeping agency (CRA), a set of pension fund managers (PFMs) and point-of-presence agencies (PoPs).
- The CRA shall maintain records, accounts and effect all instructions regarding subscription, switching of options and withdrawals by the subscriber[8]. The subscriber may access the CRA directly for information.
- The PFMs shall provide a set of schemes with varying risk-return profiles (i.e., balance between risk taken and returns expected), and manage the assets of subscribers.
- The PoPs shall receive instructions and contributions from subscribers, transmit these to the CRA, and pay out benefits to the subscribers. They will be the "windows" for subscribers to the system.
- Every subscriber shall have an individual pension account (IPA). He has the option of selecting the PFMs and schemes[9]. He can switch his funds across PFMs and schemes.

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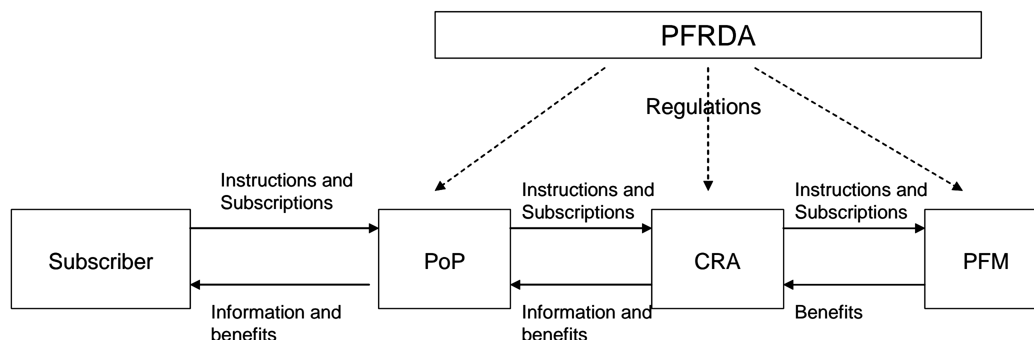
[1] This Brief has been developed on the basis of the Pension Fund Regulatory and Development Authority Bill, 2005 introduced in the Lok Sabha as Bill No. 36 of 2005 on March 21, 2005. We have also noted the recommendations of the 21st Report of the Standing Committee on Finance (Chairman BC Khanduri) while preparing this Brief. The main recommendations include inclusion of (a) 26% cap on FDI in pension fund intermediaries; (b) prohibition of overseas investments by PFMs; (c) at least one PFM from the public sector; (d) one scheme invested only in government securities; (e) part withdrawal from the scheme for emergencies by forming a Tier II account; (f) specific reference to matters relating to protecting subscribers' interests; (g) preference to companies offering guarantee on returns; (h) selection criteria for CRA and PFMs; (i) formation of a pension fund advisory committee, etc. Newspaper reports (eg. The Telegraph dated 22 Nov, 2005) suggest that the first five of these recommendations will likely be adopted by the government as amendments.
[2] See page 4 for a discussion on these systems.
[3] Source: Standing Committee Report.
[4] Maharashtra, Bihar and Uttar Pradesh have delayed salary and pension payments, according to BusinessWeek online dated January 27, 2003 (available at http://www.businessweek.com/magazine/content/03_04/b3817170.htm)
[5] Bhardwaj G and SA Dave, "Towards estimating India's IPD on account of civil service employees", July 2005 (available at http://www.iief.com/thursdays/sl_BhardwajDave2005_ipd1.pdf).
[6] Also referred to as "new government employees" in this Brief.
[7] Notification number F. No. 5/7/2003-ECB&PR dated December 22, 2003.
[8] A subscriber is an individual who joins NPS.

- The IPA will be portable in case of change of employment. (As in the case of a bank account, the IPA is independent of employment details). The subscriber cannot exit from the system except as specified by notification by the central government. The current notification specifies two options. (a) If the subscriber chooses to exit at the normal age of retirement (60 years), he shall use at least 40% of accumulated pension wealth to purchase an annuity[10] from a life insurance company. This annuity will provide pension for the lifetime of the employee, his dependent parents and spouse. (b) If the subscriber chooses to exit the scheme any time prior to retirement, the minimum amount to be converted as an annuity is 80% of the accumulated pension wealth.
- The notification mentions a two tier structure for government employees. Tier-I will be the core level with the employee and the government each contributing 10% of basic+DA, and there will be no withdrawals till exit. The employee can opt to contribute a further amount into a withdrawable Tier-II account, which will not have any contribution by the government.

Chart 1. The NPS Architecture



Establishment, powers and duties of the PFRDA

- The PFRDA shall regulate the NPS and other pension schemes under its purview. It will register and regulate all intermediaries including CRAs, PFMs and PoPs. It shall be responsible for protecting the interests of subscribers and establishing a mechanism for redressal of their grievances. It will approve the schemes and norms (including investment guidelines) for management of the investments by PFMs. It shall standardise dissemination of information about performance of pension funds and performance benchmarks.
- The PFRDA comprising a Chairman and up to five members shall be appointed by the central government for a five year term, and may be removed from office only under specified conditions.

Scope of the Bill

- The Bill does not cover any scheme or funds under the Coal Mines Provident Fund and Miscellaneous Provisions Act 1948, the Employees' Provident Funds and Miscellaneous Provisions Act 1952, the Seamen's Provident Fund Act 1966, the Assam Tea Plantations Provident Fund and Pension Fund Scheme Act 1955, and the Jammu and Kashmir Employees' Provident Funds Act 1961, or contracts covered by the Insurance Act 1938. It also exempts employees of central government and All-India Services appointed before January 1, 2004[11]. Any person governed by any of these exempt schemes may voluntarily choose to join NPS in addition to their mandatory cover.
- NPS is mandatory for central government employees who have been appointed from January 1, 2004. It permits state governments and union territories to extend the NPS to their employees. Thirteen state governments have notified NPS for their employees[12].

[9] The current notification specifies that 3 types of schemes of various risk-return combinations shall be offered through investments in differing combinations of government securities, corporate bonds and equity shares.
[10] An annuity is a contract by which one receives fixed payments on an investment for a lifetime or for a specified number of years. In this case, a lifetime annuity has to be purchased.
[11] Referred to as "existing government employees" in this Brief
[12] Andhra Pradesh, Assam, Chattisgarh, Gujarat, Goa, Himachal Pradesh, Jharkhand, Madhya Pradesh, Maharashtra, Manipur, Rajasthan, Tamil Nadu, Uttar Pradesh

PART B: KEY ISSUES AND ANALYSIS

Existing System versus the NPS

Currently, pension schemes are available to employees of central and state governments. Employees in the organized sector subscribing to the Employee Pension Scheme also have a pension facility.

Table 1. Comparison of features of the existing system and NPS

	Current system	NPS
Coverage	Organised sector employees through EPS, and government employees	Available to all subscribers, including the unorganized sector
Eligibility Requirement	Minimum term of employment (typically 10 -20 years)	None
Portability across job changes	None for government employees. Limited portability for those covered under EPS.	Portable
Type of account	Pooled	Individual pension account (IPA)
Type of pension	Defined benefit	Defined Contribution
Risks	The employee carries no investment risk. However, he is faced with the risk of default/delay in pension payments by the government or EPS.	The employee carries the entire investment risk. There is no risk of default by PFMs.
For government employees	For existing central government employees, the government pays 50% of the average of last 10 months' pay (Basic+DA) if employee has 33 years' service. There is no contribution by the employee or the government into a fund but this is paid out of the Consolidated Fund of India.	Government and the employee will each pay 10% of Basic+DA into a scheme of a PFM. Separate account for each employee will be maintained, and the amount invested. At time of exit, a part (now 40%) of the pension wealth will be used to buy an annuity, and the remaining paid as a lump sum amount.
For those not employed by the government	For those covered by EPS, the employer pays 8.33% of Basic+DA to the EPS (maintained by EPFO), and the government pays 1.16%. EPS will pay pension after retirement at a rate based on years of service and last pay drawn.	No contribution from the employer. The employee selects a particular scheme
Disclosure of Performance	None. There is no regular update on performance of the EPS. Government pensions are unfunded.	Each PFM will publish the performance of schemes managed by him at regular intervals. The subscriber can see the balance in his IPA.
Investment strategy	The EPS board decides the strategy, and this strategy and the investment portfolio are not disclosed to the employee.	Each scheme has to follow a specified investment pattern. The subscriber chooses his portfolio of schemes.

The Role of PFRDA

The Bill defines the basic structure of NPS and leaves it to the PFRDA to specify details. This will permit the system to evolve with time. Critics argue that given the significant power vested in PFRDA, the selection and appointment of suitable persons to the Authority is critical to the success of the sector. The central government shall make this appointment (and does not need to consult the opposition). This appointment rule is similar to that of the top management of regulators such as RBI, SEBI and IRDA.

Defined Benefit versus Defined Contribution

The defined benefit (DB) system, currently applicable to government servants appointed before 2004, and to EPS, promises a fixed amount to be paid per month as pension. This amount is linked to the pay drawn, number of years of service etc., and has no direct linkage to the contribution of the employee or employer towards a pension fund. Thus, the employee faces no direct risk, and the entire investment risk is borne by the pension fund manager and the government. However, the employee is exposed to the risk that the total benefits liable from the pension scheme manager is higher than the funds available, which can lead to delays and defaults. EPS was reportedly underfunded to the extent of Rs 22,000 crore as on March 31, 2004[13]. Even in cases where the benefits are paid out by the exchequer, limited resources can lead to delays, as witnessed by pensioners of several state governments.

In the defined contribution (DC) system as proposed in the NPS, each employee (and his employer in the case of government servants appointed since 2004) contributes a proportion of his monthly income to an individual account. This account is invested in one or more schemes offered by pension fund(s). The balance in the account belongs to the employee, which will be accessible at the time of exit. The employee bears the entire investment risk. However, there is no risk of default by the fund as the liability of the fund to its subscriber equals the assets owned by it.

[13] Indian Express, December 7, 2005 (available at http://www.indianexpress.com/full_story.php?content_id=83448).

Traditionally, a large proportion of pension funds around the world have been of the DB type[14]. However, many of these have been under funded, and some have collapsed[15]. This has led to a debate in a number of countries regarding the sustainability of their pension and social security systems.

Table 2. Defined Benefits versus Defined Contributions

	Defined Benefits	Defined Contribution
Advantages	- Guaranteed retirement income - Employees do not bear investment risk - Flexibility for inflation and wage adjustments - Independent of participant's savings	- Participants have more choice in investing - Participants can benefit from better returns - Plans are more portable across job changes - Option to switch fund managers and schemes - No risk of default by fund managers
Disadvantages	- Not beneficial to employees who leave before minimum eligible service - Less portable in switching employers - Fund manager could default if funds are not invested appropriately	- Returns are subject to market performance -Participants bear investment risk and may make misinformed choices -Difficult to build a fund for those who enter late in life -Shifts administration costs to employees

Risks

Under the NPS, PFMs will offer an array of schemes (the current notification specifies 3 types) offering differing risk-return profiles. The Standing Committee has recommended that at least one scheme should be fully invested in government securities. The subscriber divides his contribution (as well as existing pension wealth) into these schemes, and has the option of changing this combination at any time. The final pension wealth will depend on the performance of the schemes chosen by the subscriber. Thus, the subscriber takes the entire investment risk. The premise is that fluctuations in market value would smooth out over the working life of the subscriber.

However, the subscriber is exposed to two major risks at the time of exit. If there is a major market shock at the time of retirement (say, an incident such as the attack on Parliament on December 13, 2001), leading to a fall in asset prices, the entire accumulated wealth is at risk. A subscriber with a few years to exit would likely ride over this shock but a subscriber retiring at that time will be affected adversely. Second, the subscriber has to purchase an annuity at the time of exit, and is similarly exposed to any sharp downturn in the annuity market at that time.

The Bill states that there will not be any explicit or implicit assurance of benefits except market based guarantees to be purchased by the subscriber. This rule is different from the case of bank deposits, where deposits up to Rs 1 lakh are guaranteed by the Deposit Insurance and Credit Guarantee Corporation.

Coverage

Employees of central government and those in the organised sector covered by EPS

The Bill excludes employees of central government who joined before January 1, 2004. Those who joined from this date have to be part of NPS. State governments may mandate NPS for their employees by issuing a notification. The Bill excludes all schemes covered by EPF Act. Thus, employees covered by the EPS are exempt from the provisions of this Bill. However, any employee in the excluded category can opt to join the NPS in addition to his mandatory cover.

New government employees will have to contribute 10% of their Basic+DA to the NPS. Thus, their disposable income will be lower than that of those who joined before 2004. Some critics contend that their salaries were determined by the fifth pay commission which took account of pension benefits. They say that withdrawal of such benefits should be compensated by the government. They also claim that the government used up the funds in the former contributory provident fund scheme, and that is the reason for the fiscal stress[16]. However, others challenge this view and state that terms of employment of existing employees have not been changed. New recruits joined service with full knowledge of their salary package, including the NPS, and have no case to complain.

[14] The High Level Expert Group on New Pension System, 2002 (Chairman BK Bhattacharya) lists Canada, Japan, Denmark, Germany, France and the US among countries following the DB system.
[15] A recent case is that of Delphi Corp, the world's largest auto parts maker, which filed for bankruptcy in October 2005, and had an estimated pension liability of $14.5 billion. See http://news.bbc.co.uk/2/hi/business/4323854.stm
[16] See comments by W R Varada Rajan, Secretary, CITU (available at http://www.rediff.com/money/2005/may/05debate.htm)

Unorganised sector and others not currently covered

The Bill makes the NPS available to the unorganized sector. However, there is no compulsion to join the system. Many countries (e.g., the social security system in the US) require a mandatory contribution from individuals to ensure that they have old age social and income security.

Financial implications

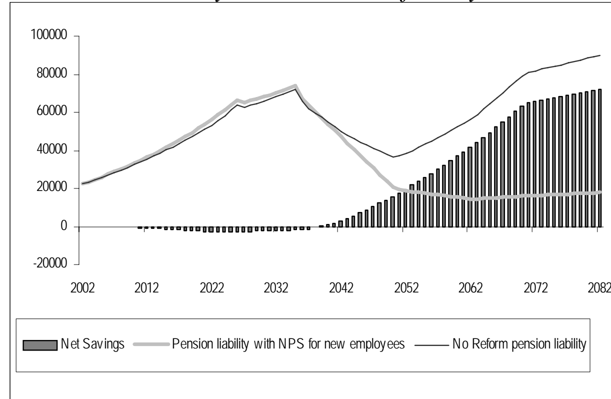
Government finances

The NPS is mandatory for government employees appointed since January 1, 2004. Most of these employees will retire about 30-35 years from now. During this period, the government will continue to pay pension to retiring employees under the old regime as a DB plan. The government will also contribute 10% of the Basic+DA of new government employees to the DC plan. Thus, the actual costs to the government will rise. This will reverse as the proportion of new employees among pensioners rises.

Computations presented to the Standing Committee suggest that the incremental cost to the government will peak at Rs 2,900 crore in 2021-22, and then decline. Savings will be apparent after 2038-39, and will rise from Rs 1,000 crore in 2039-40 to Rs 37,000 crore in 2059-60 and Rs 72,000 crore in 2081-82. However, these estimates must be viewed with caution as they make several simplifying assumptions owing to lack of detailed data. These include assumptions about age profile of existing pensioners and serving employees, downsizing central government employment, gender profiles etc.[17]

Chart 2. Projected pension cost of central government

Gains under new system will occur from year 2038-39



Source: 21st Report of Standing Committee on Finance on PFRDA Bill 2005, which quotes the High Level Expert Group (Chairman: BK Bhattacharya)

Pension expectations under NPS

Under differing scenarios of return, PRS has estimated the likely annual pension if Rs 1000 is invested in a subscriber's IPA for 35 years. PRS assumes that the entire pension wealth will be converted to an annuity and the annuity rates at that time will be the same as currently available. PRS cautions that the actual annuity could be lower if the average life expectancy increases over the next 35 years, leading to lower annuity rates.

Table 2. Estimated pension per Rs 1000 invested per month in an IPA for 35 years

(Rs)

Scenario	I	II	III	IV
Inflation adjusted annual return on pension corpus	1.50%	2%	3%	4%
Pension wealth (inflation adjusted)	551,540	606,413	737,282	902,862
(a) Annual pension for only self, OR	47,212	51,909	63,111	77,285
(b) Annual family pension for self and spouse	42,855	47,118	57,287	70,152

Notes: (1) The return has been assumed to be net of inflation, and at a constant rate throughout the period. (2) The entire pension wealth at the time of retirement (age 60 years) is invested in an annuity. (3) Life annuity currently offered by LIC is 8560 per lakh for self and Rs 7770 for self and spouse (in which spouse will get 50% of the amount as annuity after death of self). (4) The assumption of flat contribution are simplistic, as the monthly investments would typically rise with wage growth. (5) The annuity is NOT inflation adjusted after its first year.

Source: PRS estimates

Acknowledgements: PRS has drawn upon, and gratefully acknowledges, a number of experts and stakeholders who generously shared their opinions on this draft Bill. Written comments on the Bill from Rajiv Kumar (Confederation of Indian Industry), Ajay Shah (Independent scholar and former consultant to Finance Ministry) and SK Vyas (Confederation of Central Government Employees and Workers) are available with PRS.

[17] See Mukesh Anand and Rajeev Ahuja, "Government pensions: Liability estimates and assumptions", Economic and Political Weekly, June 19, 2004.

List of Government Bills Pending in Parliament[18]

Rajya Sabha		Lok Sabha	
Title of the Bill	**Ministry**	**Title of the Bill**	**Ministry**
The Indian Medical Council (Amendment) Bill, 1987.	Health and Family Welfare	The Contempt of Courts (Amendment) Bill, 2004	Law and Justice
The Constitution (Sixty-first Amendment) Bill, 1988.	Human Resource Development	The National Tax Tribunal Bill, 2004	Law and Justice
The Participation of Workers in Management Bill, 1990.	Labour and Employment	The State Emblem of India (Prohibition of Improper Use) Bill, 2004	Home Affairs
The Cinematograph (Amendment) Bill, 1992.	Information and Broadcasting	The Andhra Pradesh Legislative Council Bill, 2004	Law and Justice
The Atomic Energy (Amendment) Bill, 1992.	Atomic Energy	The Government Securities Bill, 2004	Finance
The Constitution (Seventy-ninth Amendment) Bill, 1992.	Health and Family Welfare	The Constitution (One Hundred and Third Amendment) Bill, 2004	Social Justice and Empowerment
The Indian Boilers (Amendment) Bill, 1994.	Commerce and Industry	The National Commission for Minorities (Repeal) Bill, 2004	Social Justice and Empowerment
The University Grants Commission (Amendment) Bill, 1995.	Human Resource Development	The Merchant Shipping (Amendment) Bill, 2004	Shipping
The Private Universities (Establishment and Regulation) Bill, 1995.	Human Resource Development	The Actuaries Bill, 2005	Finance
The Delhi Rent (Amendment) Bill, 1997.	Urban Development	The Pension Fund Regulatory and Development Authority Bill, 2005	Finance
The Constitution (Eighty-seventh Amendment) Bill, 1999.	Rural Development	The Commission for Protection of Child Rights Bill, 2005	Human Resource Development
The Lotteries (Prohibition) Bill, 1999.	Home Affairs	The Admiralty Bill, 2005	Shipping
The Coal Mines (Nationalisation) Amendment Bill, 2000.	Coal	The Small and Medium Enterprises Development Bill, 2005	Small Scale Industries and Agro and Rural Industries
The Foreign Trade (Development and Regulation) Amendment Bill, 2001.	Commerce and Industry	The Taxation Laws (Amendment) Bill, 2005	Finance
The Provisions of the Municipalities (Extension to the Scheduled Areas) Bill, 2001.	Urban Dev. and Poverty Alleviation	The Banking Regulation (Amendment) Bill, 2005	Finance
The Constitution (Scheduled Tribes) (Union Territories) Order (Amendment) Bill, 2003.	Tribal Affairs	The Reserve Bank of India (Amendment) Bill, 2005	Finance
The Companies (Amendment) Bill, 2003.	Company Affairs	The Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institution Laws (Amendment) Bill, 2005	Finance
The Criminal Law (Amendment) Bill, 2003.	Home Affairs	The Cess Laws (Repealing and Amending) Bill, 2005	Commerce and Industry
The Cantonments Bill, 2003.	Defence	The Factories (Amendment) Bill, 2005	Labour and Employment
The Arbitration and Conciliation (Amendment) Bill, 2003.	Law and Justice	The Khadi and Village Industries Commission (Amendment) Bill, 2005	Small Scale Industries and Agro and Rural Industries
The Chartered Accountants (Amendment) Bill, 2003.	Finance	The Prevention of Insults to National Honour (Amendment) Bill, 2005	Home Affairs
The Cost and Works Accountants (Amendment) Bill, 2003.	Finance	The Punjab General Sales Tax (As in force in the Union Territory of Chandigarh) Repeal Bill, 2005	Home Affairs
The Company Secretaries (Amendment) Bill, 2003.	Finance	The Food Safety and Standards Bill, 2005	Food Processing Industries
The Seeds Bill, 2004.	Agriculture, Food and Civil Supplies, Consumer Affairs and Public Distribution	The Juvenile Justice (Care and Protection of Children) Bill, 2005	Social Justice and Empowerment
The Prevention of Child Marriage Bill 2004	Law and Justice		
The Scheduled Castes, Schedules Tribes and Other Backward Classes (Reservation in Posts and Services) Bill, 2004.	Law and Justice		
The Standards of Weights and Measures (Enforcement) Amendment Bill, 2005.	Agriculture, Food and Civil Supplies, Consumer Affairs and Public Distribution		
The Standards of Weights and Measures (Amendment) Bill, 2005.	Agriculture, Food and Civil Supplies, Consumer Affairs and Public Distribution		

[18] This list does not reflect the proceedings of the ongoing winter session of Parliament.

The Homoeopathy Central Council (Amendment) Bill, 2005.	Health and Family Welfare
The Indian Medicine Central Council (Amendment) Bill, 2005.	Health and Family Welfare
The Manipur University Bill, 2005.	Human Resource Development
The Drugs and Cosmetics (Amendment) Bill, 2005.	Health and Family Welfare
The Disaster Management Bill, 2005.	Home Affairs
The Indian Medicine and Homoeopathy Pharmacy Bill, 2005	Health and Family Welfare
The Labour Laws (Exemption from Furnishing Returns and Maintaining Registers by Certain Establishments) Amendment and Miscellaneous Provisions Bill, 2005	Labour and Employment
The National Commission for Minority Educational Institutions (Amendment) Bill, 2005.	Human Resource Development
The Indian Medical Council (Amendment) Bill, 2005.	Health and Family Welfare
The Central Silk Board (Amendment) Bill, 2005.	Labour and Employment

Sources: Lok Sabha Bulletin Part II (Nos. 1637-1639) dated September 9, 2005; Rajya Sabha Bulletin Part II (No. 42550) dated November 9, 2005

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