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Changing Landscape of Indian Pension Fund Management System

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ABSTRACT

This paper is an attempt to assess the Indian pension fund management system and its importance in present day scenario. It discusses the problems associated with present Indian pension fund management system like low coverage and underperformance of schemes. It then discusses the present system prevalent in India and the various schemes on offer presently and in the past. Finally paper concludes with some recommendations to the stakeholders in the industry.

Keywords: Pension Fund Managers, Pension Funds, Pension Reforms, Investment Alternatives, Inflation Indexing.

INTRODUCTION

A reform in the pension system handles the key problem of financial sector in twofold approach. First of all, introduction of private pension fund managers will make sure the large-scale mobilization of savings. It will enhance rate of saving leading to a higher rate of capital accumulation, significant for a developing country like India. Pension fund managers may even take to Instruments such as index funds if provided with the opportunity to do so. It is proved that investment in an index fund and diversification can result into a rate of return over and above the rate of inflation.
As per the latest report by government of India pension payment is one of the largest contributor of government expenditure and will keep on increasing with increasing longevity and life expectancy. To save the best for the last, the consequences of pension reform that touches each person's life is its extremely human aspect. Private pension fund managers provide the individual what he never had before--the power of exercising his choice. An individual can choose between competing Pension fund managers, between the growth type or secure income type of schemes and may even plan to save more in the initial stages and retire early! He can decide for himself as to who would be the best agent to manage his money for him and act accordingly. Such options are not provided under a system administered by the government.

Problems with Present system

The deficiencies of the current pension system administered under government of India are as follows:

- low coverage
- under performance of Provident Fund schemes
- investment restrictions
- administrative difficulties
- underdeveloped private annuity market
- The differences in pensions between public and private sector employees as compared to the public sector are wide.

Current Systems in India
Types of Pension Fund prevalent in India

Defined-contribution plan: workers build up either explicit or implicit retirement accounts that fund retirement

***Defined-benefit system*:** "Benefits are usually determined by multiplying a replacement rate by a pension base. R*eplacement rate* is typically an accrual factor times the years of service, and the pension base is a function of a worker's earnings history. Since this type of system often ignores the time path of contributions in calculating the replacement rate and the pension base, the tie between benefits and contributions can be quite loose".

Pay-as-you-go system: Payment of pension is done with the taxes collected from the younger taxpaying generation.

Funded System: pension payments are used in different financial assets. Funding paves an opportunity to benefit from investment in financial markets, where the rate of return is likely to be higher than the implicit rate of return.

Examples of schemes in India

A. Employees' Provident Fund (EPF) – 1952

It provides benefits deriving from retirement, resignation or death, depending on the accumulated contributions plus interest, ranging from employers and employees. It is more used as medium of tax evasion. The effect of scheme can be seen as follows:

Workers covered	**24 million**
Contribution rate	12 % employers' share and 12 % employees' share
Total contribution	24 per cent
Diverted as under	• Provident Fund - 15.67 per cent • Pension Fund - 8.33 per cent
Government contribution in pension fund	1.16 per cent

B. Employees' Pension Scheme (EPS) – 1995

"EPS members are eligible for two benefit streams on superannuation – a lump sum EPF accumulation upon retirement and a monthly pension from the EPS. However workers alleged that the pension from the EPS was substantially inferior compared to the public pension schemes and that the return from the scheme was even lower than the provident fund arrangement. The debate surrounding the EPS continues unabated till today, with many trade unions filing litigations against the scheme".

C. Employees' Deposit Linked Insurance Scheme (EDLI) – 1976

"The scheme provides lump sum benefits upon the death of the member equal to the average balance in the member's EPF account for the 12 months preceding death up to Rs. 25,000 plus 25 per cent of the amount in excess of Rs. 25,000 up to a maximum of Rs. 60,000. The effect of the scheme can be seen below".

Insured persons	**8.8 million**
Beneficiaries	34.2 million
Contribution rate	4.75 per cent employers' share and 1.75 per cent employees' share
Total contribution	6.5 per cent

D. OTHER SCHEMES

The Public Provident Fund (PPF) scheme provides facility to unorganized sector workers to accumulate savings for old age income security. Under the scheme, amounts ranging Rs 100 to Rs 60,000 per annum can be deposited into the PPF account. These investments are eligible for tax rebate. The scheme was unpopular due to ineffective marketing and improper service delivery.

Changes Recommended

Structure of the new pension system

The basic architecture of the system should be one where PFMs would be able to focus purely on fund Management. Hence individuals should deal with Point Of Preference (post office or bank), which carry these instructions to the depository. The depository consolidate individual instructions into blocks of funds, which would be handed over to PFMs.

Private management of accretions through Pension Fund Managers

"The model of private pensions should be implemented using private Pension Fund Managers (PFMs). Even if individuals themselves do not possess the knowledge of financial instruments, the market forces would enable them to decide to employ a PFM who would make these choices on their behalf. Hence, this number should be determined by the free interplay of market forces. The most efficient fund managers would survive while the rest would be weeded out and hence there should be no cap on their number. In Chile there is complete free entry for Pension fund providers, even if they are foreign companies, provided certain capital requirements are met"

Different investment alternatives

***Active Fund Management* (AFM)** increases value when fund managers make efforts to exploit market inefficiencies and pay to cover for transaction costs and management fees.

Passive fund management harnesses the equity premium reliably by investing in Index funds. These are not vulnerable to volatility and are easier to regulate.

"While international diversification sharply reduces risk, it also reduces rates of return accessible to unleveraged investments since equity premium internationally is lower than that of India. The lower volatility of the world stock market index as compared to the much less diversified NSE-50 index will ensure higher rates of return".

To conclude: Foster experimentation and learning

"A reform in the pension system is a long drawn out process, which requires ideological commitment in the first place. Ironically, it is the largest communist country of today that stands as a shining illustration to such commitment. The key word for pension reform is flexibility. This implies that maximum room needs to be provided for local experiments. Rules need to be laid down clearly, but their number and level of stringency should not be overwhelming. In the long run, there needs to be a commitment to phase out most of the detailed rules, leaving only a broad framework to act upon".

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