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Future of India's old age income security

By: -

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White Paper

On

Pension

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Executive summary

This paper gives an insight in different types of pension plans i.e. Defined Contribution (DC) & Defined Benefit (DB). Pension systems around the world followed DB before 80's, and then it become difficult for the governments to sustain this expenditure. Pioneered by Chile DC became popular, in which there is no contribution from the government. On paper this looked like a knight standing in shining armour to save them. DC was adopted as the pension plan by many countries following the footsteps of Chile.

It turned out to be nightmare because of many reasons, the fund manager charged enormous commissions, invested in companies that will benefit the corrupt politicians. Many of the economies were doomed like Argentina & Chile itself. Most of the countries where this DC plan was adopted their pension system collapsed or started giving very miniscule returns.

Everybody is eager to know why the recent bill that UPA govt. is trying to get it passed in the parliament is on the same lines as Chile. When everyone has seen it go down in the past why India walking in the herd of sheep. Its because growing number of individuals entering the age group 18-60 yrs have risen and to maintain 8 % return for that many people has become so much that there is no other option left for the govt. but to switch to DC. This bill has been customised to the need for Indian population like

- The Govt will appoint fund managers.
- Each fund will have three different types of schemes to suit the risk appetite of every individual.
- Transparency in the working of the funds
- Even the unorganised sector can join the plan

But these are not enough to provide so called security to people of India. Govt. wants to chicken out from the current problem. In this paper many new ideas have been proposed which will help the income security to sink deep into the system of the country.

- Providing term insurance cover
- Hybrid plan (DC + DB), which is more suitable for Indian population
- Compulsory return if not met covered by insurance companies
- For better return investing in equities
- Investment in long-term infrastructure projects for the growth of the country etc.

About the Author

Tushar Falodia works as consultant with Ibexi Solutions. He did his MBA in finance from Sydenham Institute Of Management Studies. Worked as research analyst with a hedge fund. Specialize in System & business analysis and setting up process for insurance companies.

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Introduction

A **pension** is a steady income given to a person (usually after retirement). Pensions are typically payments made in the form of a guaranteed annuity to a retired or disabled employee.
Pension plans can be divided into two broad types: **Defined Benefit** and **Defined Contribution** plans.

Defined Benefit plans

A traditional pension plan that *defines* a *benefit* for an employee upon that employee's retirement is a defined benefit plan.
The benefit in a defined benefit pension plan is determined by a formula that can incorporate the employee's pay, years of employment, age at retirement, and other factors. A simple example is a **flat dollar** plan design that provides $100 per month for every year an employee works for a company; with 30 years of employment, that participant would receive $3,000 per month payable for their lifetime. Typical plans are **final average plans** where the average salary over the last three or five years of an employees' career determines the pension.
Defined benefit plans typically pay their benefits as an annuity, so retirees do not bear the investment risk of low returns on contributions or of outliving their retirement income.

Defined contribution plans

A defined contribution plan is a plan providing for an individual account for each participant, and for benefits based solely on the amount contributed to the account, plus or minus income, gains, expenses and losses allocated to the account. Plan contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) are credited to the individual's account. On retirement, the member's account is used to provide retirement benefits, often through the purchase of an annuity that provides a regular income.

Why to move towards Defined contribution

A growing challenge for many nations is population ageing. As birth rates drop and life expectancy increases an ever-larger portion of the population is elderly. This leaves fewer workers for each retired person. In almost all developed countries this means that government and public sector pensions could collapse their economies unless pension systems are reformed or taxes are increased.

Defined contribution plans have become more widespread all over the world in recent years, and are now the dominant form of plan in the private sector in many countries.

CHILE hosted a party

Up until 1981, Chile had a U.S.-style pay-as-you-go system. In 1981, workers already in the system were given a hard-sell "choice" of switching to a new, privatized system. All new entrants to the labour force after 1981 were required to enter the private system—with the exception of the military, which protected themselves by staying in the public system.

Personal Retirement Accounts in Chile

Chilean workers contribute about 12.5 percent of their wages to the old age, disability and survivorship program. Nearly 80 percent of the employee's contributions go towards personal accounts which are administered by privately owned pension management institutions; the remainder pays for disability and survivorship insurance (7 percent), administrative fees, and commissions (13 %). Net contributions are accumulated in personal accounts and earn investment returns.

Workers choose who they want to administer their personal retirement account. Investment choices are restricted to five investment funds. Among these funds, the default choice depends on the age of the worker, so that younger workers are assigned to a fund with more risk exposure than older individuals.

Chilean personal retirement accounts do not allow withdrawals before retirement. All workers can access their account if they reach the normal retirement age (65 for men, 60 for women).

Looking at the rosy picture of Chile most of the developed countries switched to Defined contribution.

What happened next?

For more than a decade, the returns on private accounts seemed spectacular, because of privatization of state enterprises and the interest rates were high from 1985 to 1991, which contributed to an average annual real return over fifteen years of 16.6 percent, peaking at 35 percent from 1989 to 1991. But once Chile’s economy cooled, so did returns on personal pension accounts.

How did it all happen?

- Contributors have not been able to make the required 240 monthly payments into a private fund over a 20-year period.

- Many low-wage earners registered with the private system evade the mandatory monthly payments by underreporting their income, assuming that the minimum pension will yield more than whatever their retirement accounts offer.

- A majority of participants only make an average of two to three monthly payments a year.

In 2004, the Chilean state was left with the responsibility of covering the private system's un-funded liabilities, to the tune of 7% of Gross Domestic Product $5.5 bn more than it spends on health and education combined.
It spent 41.5% of all of its social expenditures to cover the private pension system's deficit.
It must also cover the cost of the old system, to which the Armed Forces and the police still belong, together with half of public-sector employees.

Fund manager's fiesta

They charge gigantic commissions for their services, making the system unbelievably costly. Fund managers charge commissions on the order of $500 million annually. Between 1981 and December 2000, commissions totalled $6.2 billion. 25-32% of each mandatory deduction went to payment of commissions!

Funds managers had an average profit rate of 33.8% in 2001; and in 2002, under conditions of economic recession, that rate reached 50.1%— the real rate of return in the individual accounts has averaged only 5.1% since 1982

Important guests at the party

United Kingdom

History of the switch to private accounts almost 20 years ago under Thatcher, is titled, "A Bloody Mess". Thatcher's privatized system did indeed prop up the British stock and bond markets after 1988. But it was such a loss for most of the British workers who flocked into it like lemmings, that the Blair government of Britain has had to order those workers to be paid £12 ($20 billion) in compensation.

Thatcher's first government cut the old-age pension benefits— switching from wage indexing of benefits to inflation indexing. Thatcher's second government bribed (with expensive tax rebates from the public treasury) and hyped (with a huge advertising campaign) 4.3 million Britons by 1991 to shift from Social Security into private accounts. By the late 1990s, it became clear that most of those who switched, were doing much worse toward their retirement, than if they had stayed in the public system even with its benefit cuts. "On average, fees and charges [reduced] pension lump sums by up to 30% on retirement. The succession of stock collapses since the later 1990s has made their situation even worse.

Argentina

The partial privatization of Argentina's Social Security system in 1994 was a major contributing factor in the explosive debt crisis, default, and economic collapse of the country in December 2001.

Aside from the looting represented by the large and illegitimate foreign debt, the 1994 privatization deprived the government of a significant amount of tax revenue, which the privatization scheme diverted into private accounts, known as AFJPs. To make up the resulting deficit, the government was forced to borrow abroad—at very high interest rates—and accept the austerity conditionalities attached to IMF loans, in particular. By 2001, the deficit created by lost revenue was close to 3% of GDP.

In September 2001, three months before the debt default, the IMF forced the government to make a 13% cut in benefits in its old pay-as-you-go social security program—still functioning alongside the new private system—as a conditionality for a new agreement. The old program had been generous, offering a broad array of survivor and disability benefits, in addition to pensions.

By the late 1990s, 48% of AFJP funds were invested in bonds, on which the government defaulted in late 2001.

Other guest that joined later were

Peru (1993), Colombia, Costa Rica, Ecuador, Uruguay (1994), Bolivia (1997), El Salvador (1998), Panama (1999). Canada (1999).

What's India doing?

Employees' Provident Fund (EPF)

This is a defined contribution (DC) scheme. Individuals contribute to their account throughout their working life and take the benefit as a lumpsum at the time of retirement. Employees have to contribute at a rate of 12% of salary (basic + DA) of a maximum of Rs.6500.

Employees Pension Scheme (EPS)

The EPS is a defined benefit (DB) scheme is financed by diverting 8.33% of salary up to a maximum of Rs.6500 from the employers' contribution of 12% to the EPF; the balance contribution being credited to EPF. The central government contributes at the rate of 1.16% of employees' wages to EPS.

Pensionable salary is the salary drawn during the contributory period of service in the span of 12 months preceding the date of exit from the membership of EPF.

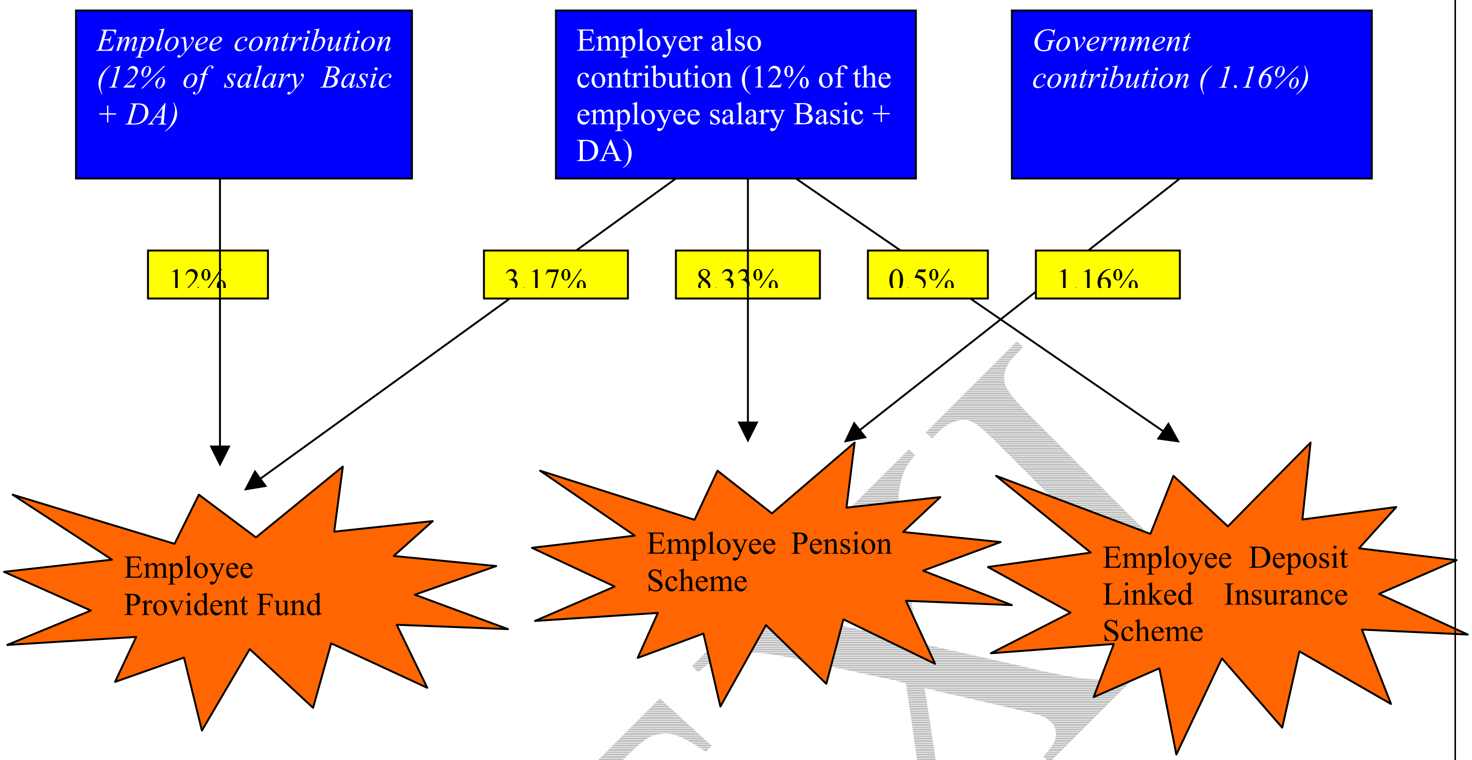
The EPS coverage has been steadily increasing, with a membership of 3,11,49,049 people as on March 2005.
The total contributions collected by the EPS stood at Rs.6511.85 crore as of 2004-05.
Thus even though EPS is a funded scheme, it tends to behave like a pay as you go DB scheme.

Employees Deposit Linked Insurance Scheme (EDLIS)

The EDLIS is an insurance scheme that offers a lump sum benefit on the death of the employee based on the provident fund balance to the credit of the deceased employee at the time of his death. It is financed by employer contributions of 0.5% of pay i.e. basic wages, dearness allowance including cash value of food concession and retaining allowance, if any. On the death of the subscriber, the persons entitled to receive the provident fund accumulations will be paid an additional amount equal to the average balance in the provident fund account of the deceased during the preceding 12 months wherever the average provident fund balance is less than Rs.35000. In case the average balance in provident fund exceeds Rs.35000, the amount payable is Rs.35000 plus 25% of the average balance in excess of Rs.35000 subject to ceiling of Rs.60000.
The administration of the three schemes is entrusted to the *Employees Provident Fund Organisation* (EPFO).

Gratuity

Gratuity is primarily a final salary related lumpsum benefit given to employees at the time of retirement or exit as an acknowledgement of their services.
A contribution of over 25% towards retirement benefits is among the highest in the world.



The Boards of Trustees of the relevant Provident Funds hand over 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. Individuals do not have any control or choice in the allocation of (and returns from) their savings.

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.

Unorganised sector

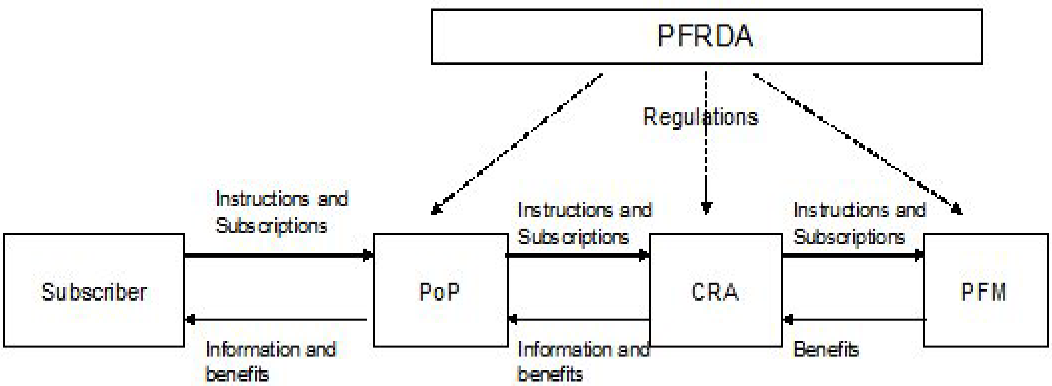
PPF account accepts accretions of a minimum of Rs.100 (fixed in 1968-69) and a maximum of Rs.60, 000 per member per year. The accretions, accumulations and withdrawals from PPF are fully tax exempted. A PPF account matures in 15 years. PPF allows partial withdrawals after 5 years of accumulations.

Pension reforms

In India first step towards pension reforms started by Project titled "OASIS", which was nominated to an 8-member Committee to examine old age income security in India.
New pension bill 2004 sets a framework for the development and regulation of pension funds in India in order to promote old age income security.

KEY features of the New Pension bill are: -

- It is *defined contribution* the investment risk is entirely borne by the employee. However, he is no longer exposed to the risk of default by the government.
- The system comprises one (or more) central record keeping agency (CRA), a set of pension fund managers (PFMs) and point-of-presence agencies (PoPs).
- The CRA will maintain records, accounts and effect all instructions regarding subscription, switching of options and withdrawals by the subscriber. The subscriber may access the CRA directly for information.
- The PFMs shall provide a set of schemes with varying risk-return profiles, 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. He can switch his funds across PFMs and schemes.
- 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 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 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.

Proposed system

In the table below I have given the 3 systems together (current, new bill & the Proposed system).

	Current system	NPS	Proposed system
Coverage	Organized sector employees through EPS, and government employees	Available to all subscribers, including the unorganised sector	#1 Compulsory for the organised sector, few profession & business in the unorganised sector
Eligibility requirement	Min. term of employment (typically 10-20 years)	None	None
Portability across job changes	None for govt. employees. Limited portability for those covered under EPS	Portable	Portable
Type of account	Pooled	Individual pension account (IPA)	Individual pension account (IPA)
Type of pension	Defined benefit	Defined contribution	#2 Hybrid. The fund managers will promise a portion of the return.
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 PFM's	#3 The risk is shared between the insurance company and the individual.

For Govt. employees	For existing central 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 govt. into a fund but this is paid out of the consolidated Funds of India	Govt. and the employee will each pay Max 12% 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	Govt. and the employee will each pay Max 12% of Basic + DA into a scheme of a PFM. Separate account for each employee will be maintained, and the amount invested.
Insurance cover for returns	No cover provided	No cover provided	#4 Part of the deposit in the fund will go towards buying term policy for the individual.
Not employed by the Govt	For those covered by EPS, the employer pays 8.33% of Basic + DA to the EPS (maintained by EPF), and the government pays 1.16%. EPS will pay pension after retirement at a rate based on the years of service and the last pay drawn.	No contribution from the employer. The employee selects a particular scheme	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. Govt pensions are unfunded	Each PFM will publish the performance of scheme managed by him at regular intervals. The subscribers can see the balance in his IPA	Each PFM will publish the performance of scheme managed by him at regular intervals. The subscribers 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	Each scheme has to follow a specified investment pattern. The subscriber chooses his portfolio of schemes
Investment Break up	Govt. bonds	Govt. Bonds and 5 % in securities market (it is not compulsory). Depend on the scheme the individual chooses	#5 25 – 30 percent investment in infrastructure & equities.
Management Fee	No proper percentage defined.	Fee of 0.2%	#6 Management fee of 0.1%

Explanation of the Proposed System

#1 The New 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 proposed system it should be made compulsory for the organised sector and some profession & business covered in the unorganised sector. Now the obvious question is, it will be difficult to bring unorganised sector under pension as they keep switching jobs. Answer to this would be, in pension system separate account would be maintained for each individual, so now the problem of switching jobs does not make any difference. The second question is around 50 % of the people are uneducated and they live less than 2$ per day. The objective of a pension system is to provide social security in old age, and people earning suppose 50 $ per day, pension to them does not make the same sense as the person earning less than 2 $ per day. So why all the energies of the governments are diverted towards getting people who are well off under the pension umbrella. Govt. has always concentrated on getting organised sector under this and it could bring only 13% of the workforce till date under pension schemes.

One cannot imagine how big this can be if unorganised sector is brought under this umbrella. Let me help you: - 18.5% of our GDP comes from agriculture, but 60% of the people depend on it. So, if we want to make a difference to this 60% 600 mn people, we will have to bring agriculture to its true potential. Still don't know how it can work!!

For example: - Suppose the govt. of India makes it compulsory for all companies involved in the organised agriculture retail business to deposit, on behalf a part of the payment made to the farmers and the people involved in logistic towards their pension. Reliance Retail one of the company run by the reliance group in India is investing Rs 250 Bn in the next 5 years. This sector is big enough to accommodate 6-7 players of the same size. As of date, organised retail accounts for only three per cent of the total retail pie. However, organised retail sector is expected to generate 10 to 15 million jobs over the next 5 years, and that the value of the organised retail sector in India by 2010 would be around Rs.2, 000 Bn or US $ 45 billion. Like this we can get the organized construction industry also in this.

#2 Advantages & disadvantages of both Defined Benefit & Defined Contribution

	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

The history of Defined Contribution is not bright either. Most of the places around the world it has failed (as mentioned at the starting of this paper). Defined Contribution has made a bloody mess of the pension systems.

Agreed that Defined Benefit is the best from the employee point of view, but what happens to the employer. 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 Rs 460 Bn is equal to 75% of our total defence expenditure or this is what India spends in 2 and half years on education. If India has this kind of expenditure it has to cut down on most of its development projects, which are essential to sustain 8% GDP growth. This is the only reason why govt. wants to shift to defined contribution.

However, the subscriber is exposed to two major risks at the time of exit in Defined Contribution.

- 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.
- 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.

To address these issues, the Proposed system will be a hybrid i.e. all the features of the Defined Contribution plus the fund manager will promise a return of 2 % on the funds at the time of retirements. Two questions arises one: - Why 3 percent? Second: - What happens if the fund managers not able to meet the 3 percent return.

Answer one: - When we look at the markets around the world and India. Their history tells us that it is totally feasible to sustain 3 % rate of return. To prove this point, look at the tables below, Barclays Capital Equity Gilt Study on returns by different asset class over a period of 105 yrs & 80 yrs for UK and US market

The UK data series begins in 1899 whilst the US series starts in 1926.

Real Investment UK Returns by Asset Class (% pa)					
Last	**2005**	**10 years**	**20 years**	**50 years**	**105 years**
Equities	18.9	5	7.4	6.6	5.2
Gilts	6	5.6	6.2	2.1	1.2
Corporate Bonds	9.8	8.1			
Index-Linked	6.7	5.2	4.7		
Cash	2.7	2.9	4.1	2	1

Real Investment US Returns by Asset Class (% pa)					
Last	**2005**	**10 years**	**20 years**	**50 years**	**80 years**
Equities	3.4	6.8	8.6	6.4	7
Bonds	3.6	4.9	6.4	2.4	2.3
Cash	-0.8	1	1.5	1.2	0.6

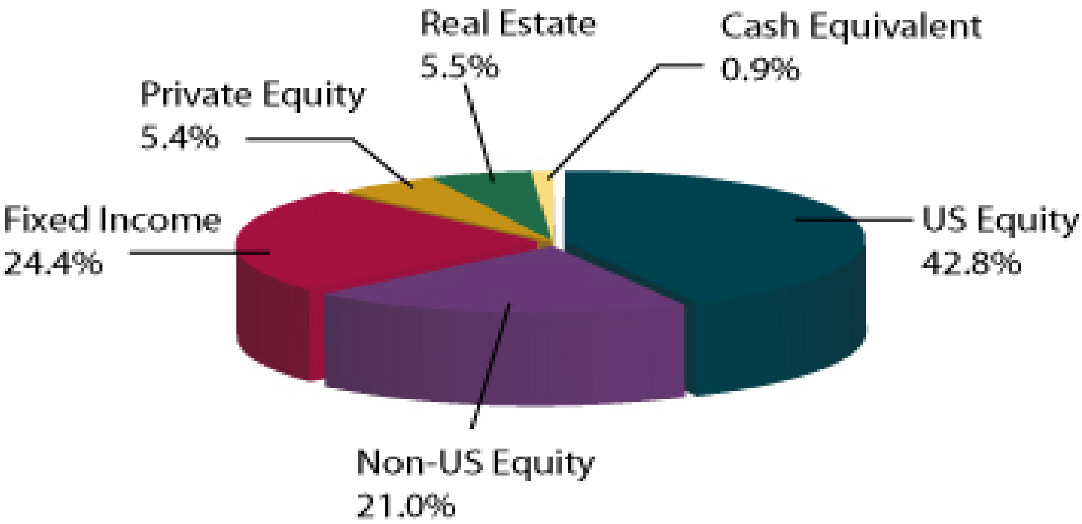
#3 The second part of the question "What happens when it falls below 3 %?"Answer is: - It will be covered by insurance. In Defined Contribution (DC) the whole investment risk is borne by the individual, this is one of the disadvantage of DC, In Proposed System (PS) this risk is borne by both individual and the insurance company. Yes, this can actually by done, as a miniscule part of the fund managers commission will go towards this type of insurance where the fund manager is unable to meet the 2% rate of return mark, it will become insurance companies liability to pay return up to the limit of 2%. *The payment to this type of insurance is not paid by the individual but by the fund managers.*

#4 Over all penetration of insurance in India stood at 3.28 per cent of the gross domestic product in 2003. It is expected to reach 5 % till 2008. I again repeat the main objective of social security is not only providing security in old age and only to the person himself. By giving term policies that is the cheapest insurance cover on life to the individuals help him cover his life, so that if anything happens to him at least his family can be supported. It will be given compulsory to all the account holders.

#5 This is the most controversial part of the paper. I recommend 25 – 30 percent of the funds should be invested in equities & long-term infrastructure projects. There was lot of hue and cry when the UPA govt. recommended 5 % investment in equity market in parliament on JAN 23 '07.
Currently all the pension monies are invested in govt. bonds. The same explanation of #2 goes here also. But for this lets look at the biggest pensions funds of the world

CalSTRS

The California State Teachers' Retirement System is the second largest public pension plan, the largest teachers' retirement fund in the United States and the 9th largest pension fund of the world. CalSTRS had a total membership of approximately 775,917 and assets of $153.2 billion as of October 2006.



It is a defined benefit pension fund. When we look at the pie, we see that of the assets of $ 152 Bn a staggering 48.2 % is invested in US & private equity.

The Government Pension Fund – Norway

It is the second largest pension fund of the world with asset size of $ 236 Bn.

- Equities account for 40% of the Fund's strategic benchmark portfolio, consisting of equities listed on exchanges in Europe (50%), America/Africa (35%) and Asia/Oceania (15%).
- Fixed income instruments account for 60% of the strategic benchmark portfolio, consisting of fixed income instruments issued in currencies from Europe (60%),
- America/Africa (35%) and Asia/Oceania (5%).

All the time I have been talking about US & UK equity markets performing better than the bond market. Lets look at the Indian market

Table No. 1 details the equity premium for India for the “post liberalization” period, using both the BSE 100 and the Sensex index as a proxy for the return on equity. Since participation in the T-bill market was highly regulated before 2000. I have reported the equity premium relative to the Bank Deposit Rate, using the later as a proxy for the return on a risk free security.

India Returns, 1991-2004			
	Relatively Riskless Security	BSE 100	Sensex
Mean Real Return %	1.28	12.6	11
Standard Deviation %	1.73	37.2	32.6

Table No. 2, Equity premium using the average annual stock price index as documented and reported by the Reserve Bank of India.

India Returns, 1984-1991		
	Relatively Riskless Security	BSE 100
Mean Real Return %	1.13	22.4
Standard Deviation %	0.74	28.1

While insurance pension plans offer equity exposure up to 100 per cent (under certain plans). Of the two pension funds in India, TIPP has posted an annualised return of 15.62 per cent since its launch in March 1997, whereas UTI RBP has returned 11.53 per cent since its inception (December 1994), as on April 11, 2007.
After understanding that equity markets perform better, it is true that there is a huge risk also as Peter Lynch said, “ In the long run, a portfolio of well-chosen stocks or mutual funds will always outperform a portfolio of bonds. In the long run, a portfolio of poorly chosen stocks won’t outperform the money left under the mattress.”
Some of the funds should be invested in infrastructure projects with along gestation periods, as India is short of long term funding.

According to a report by Ernst and Young (E&Y) and FICCI, an estimated investment of US$ 200 billion will be required to add 1,00,000 MW of additional generation capacity and bridge the supply deficit in the power sector by FY2012.

The Infrastructure sector including roads, power, railways, aviation require an enormous amount of $320-350 billion by 2012 to raise rate of investment in key areas at par with economic growth and 20 per cent of which will have to be chipped in by the private sector.

#6 How much does pension fund management have to cost?

In India mutual funds are allowed to charge maximum of 2.25% as management fee but it will not appropriate for pension funds as the sums are large and with a lock-in period. The Committee is talking of 0.2 percent for the New Pension System (NPS). These numbers have been criticised by mutual funds and insurance companies as being completely unrealistic and lacking in common sense.

But it is very much possible in India because of the following reasons: -

- Availability of cheap skilled labour
- Funds granted by auction method
- Investments using index funds

A remarkable recent development shows the possibilities for low cost fund management under Indian conditions: -

The Coal Mines Provident Fund Organisation (CMPFO) recently conducted an auction to pick fund managers for assets of Rs 20,000 crore ($4.6 billion). ICICI Securities and SBI quoted the lowest price of 0.01 per cent.

An apt Non Indian example for low management fee is of US civil servants pension, the Thrift Savings Plan (TSP), also uses an auction for recruitment of the fund manager for a fund of $186 billion. The winning bids in the most recent selection were from Barclays Global, for fees ranging from 0.02 per cent to 0.08 per cent of AUM per year depending on the asset class. The experiences of the US civil servants pension are, thus, quite meaningful in thinking about the New Pension System in India, even though the size of NPS assets are tiny when compared to $186 billion.

How can fees be much lower when compared with the gigantic charges of Indian mutual funds and insurance companies?

It is because of the following reasons: -

- Bulk fund management is highly cost efficient. Mutual funds and life insurers pay large commissions to agents to get customers and then spend even larger amounts in trying to retain them through their marketing and advertisement budgets.
- They also have to spend a significant amount in servicing retail customers. Fund managers' fees are drastically lower when the burden of an expensive distribution model and a large number of retail customers is taken out of the picture.
- Minimum lock-in period, as it is not so in most of the schemes of mutual funds and insurance companies.
- The cost function for a fund manager under an NPS-like situation is very different.

- The fund manager does not have to invest in fund collection infrastructure. He would get the investment funds daily through a single cheque from an agency called the Central Record keeping Agency (CRA)
- He would be required to invest the funds as per the specified investment pattern under each of the available schemes.
- There is no complicated stock picking to be done, as the fund manager would largely track benchmark equity indices.
- The fund manager under the NPS would not be required to service the customers, as that would be taken care of by the Point of Service (POS). In case of civil servants, the POS is the government itself. Once private sector POSs are envisaged, they would be working on behalf of the customers and not on behalf of the fund managers.
- Mutual funds agent's commissions are high because are paid not to grow the market and get new customers but to steal customers from other mutual funds or insurance companies. The NPS attempts to align the interests of the POPs to the customers'.

Conclusion

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.

Requirement of income security is mainly for 2 reasons. One is income, as when he retires he should have enough savings that he can live his retired life without spreading hands. The other is for his family after him.

It is essential for a country to have a stable income security system. The word "stable" should not be misinterpreted with DB. After so many years of the DB plan in the system we could only get 13% of the total work force under the pension.

An ideal pension system should have

- It should provide regular income after retirement with proper return on the funds invested.
- Insurance cover, as it is said; " The only one thing you can be sure of is your past"
- Govt. should be able to use the funds for the growth of the country.
- Wide coverage i.e. both organised and unorganised sector should be brought under pension.
- The asset manager should be able to deliver good returns at minimum cost.

It is most important to get the unorganised sector under the gamut of security cover, as they are the one who needs the most. The example of agriculture was given because still 60 % of the population is directly or indirectly involved in it, and unfortunately for them they fall under unorganised sector and not much heed is paid to get them into the system,

We have one of the lowest penetration of insurance 3.28 % of the gross domestic product. Sector like agriculture suffer from disguised employment. They mainly suffer from fluctuating income and risk covered, the male members are mainly income earners of the family are committing suicide, and there families have nothing left but to follow him. Ideally the security system should be targeted at providing benefits to them.