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**Pension Regulatory Issues: A Framework for India**

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**1. Background**

1.1 The Hon. Finance Minister, while presenting the union budget for the year 2003-04 on 28<sup>th</sup> February 2003, announced that the Government had decided to set up a separate regulatory authority to be named as Pension Fund Regulatory and Development Authority (PFRDA) to regulate and supervise the pension funds and also develop pensions in India, a specific developmental role being envisaged for the PFRDA. Government officials have subsequently gone on record to say that the Pension Fund Managers (PFMs) licensed by the PFRDA would be regulated and supervised by the PFRDA and the pension products offered by the life insurers would be regulated and supervised by the Insurance Regulatory and Development Authority (IRDA). Further details about the scope of regulation and supervision are as yet not available in the public domain. This paper, in this context, attempts to outline a suitable framework for the pension regulation and supervision in India.

1.2 For consistency, and following normal English usage, this paper uses “regulation” to refer to the process of making laws, whether it be through principal legislation (Acts) or subordinate legislation (Regulations or Rules) and “Supervision” is used to refer to the process of checking whether the regulatory provisions have been complied with, and intervening as necessary, in accordance with powers made available in the legislation.

**2. Building up of Assets for Old Age Income - Pension :**

2.1 The two reports of the Expert Committee (called the OASIS Committee) constituted by the Ministry of Social Justice and Empowerment under its project Old Age Social and Income Security (OASIS) for devising a pension system for India, for the first time created awareness about the need to provide for old age income and initiated debate on the need to reform India’s pension system.

2.2 In the Chapter titled “Problems and Diagnosis” of its first report released in February 1999, the OASIS Committee had observed that “ Economic security during old age should necessarily result from sustained preparation through lifelong contributions. The government should encourage fully funded old age income security systems that emphasis the values of thrift and self-help. The government should step in only in the case of those who do not have sufficient income to save for old age.” This enunciates

the basic philosophy of reforms that the old age income has to be self financed by the individuals except those who do not have sufficient income to save for old age.

2.3 It is now generally accepted that any arrangement that builds up the assets for old age income can be termed as 'pension'. The pension system, thus, encompasses all vehicles that build up assets for old age income, like Employee Provident Fund, Public Provident Fund, Occupational Pensions, Gratuity and Personal Pensions. ( In India , we do not have any state pension except the small assistance provided by the government to the destitute aged 65 and above.).

### **3. Pension Segments:**

3.1 'Pensions' in India could generally be segmented as follows:

- Means tested and tax financed state assistance to the destitute aged 65 and above - (Defined Benefit) ;
- Pension of the government employees who have joined the service before 1<sup>st</sup> January 2004 - (Defined Benefit);
- Complementary pensions like the proposed defined contribution fully funded individual account pension with universal access - (Defined Contribution);
- Provident fund – Employee and Public – (Defined Contribution);
- Employee Pension Scheme 95 – (Hybrid, but essentially Defined Benefit);
- Occupational Pension – (Both Defined Contribution and Defined Benefit);
- Gratuity or Severance Pay benefit (Defined benefit); and
- Personal pensions offered by life insurers and mutual funds – (Essentially Defined Contribution) .

3.2 The current regulatory and supervisory framework for these benefits is discussed in paragraph 5.1. The details of regulations and supervision vary by the type of pension, i.e. whether defined benefit or defined contribution, but the basic aim is to protect the interests of the members / subscribers and ensure that they receive a fair deal.

### **4. Pension Reforms and Regulatory Frame-work**

4.1 It might be useful at this stage to outline the purpose of pension reforms as well as the influence of the regulatory frame-work on the reforms initiatives. The pension reforms, through both partial or systemic changes, must ensure removal of deficiencies in the existing pension system and create a new system for pension saving and provision. In specific terms, pension reforms must ensure:

- increased coverage for old age income;
- reduction in unfunded pension liability;
- reduction in the role of the government as a pension provider, except as the provider of the means tested and tax financed pension;
- better return and protection to the subscribers; and
- higher availability of funds for means tested tax financed pension.

4.2 In order to ensure the above, it is necessary to have a clear regulatory and supervisory frame-work. If we look at the lessons to be learnt from countries which have initiated pension reforms, one significant aspect that stands out is the need for a clear regulatory frame-work and a strong regulatory authority.

## **5. Current Pension Regulatory Frame-work in India**

5.1 The current regulatory frame-work in India for pensions arrangements is outlined here with reference to the pension segments mentioned in paragraph 3.1.

- the means tested and tax financed assistance being provided by the government , does not require any supervision by a regulatory authority;
- pension of the government employees, who have joined service before 1<sup>st</sup> January 2004, is not funded and is paid on Pay As You Go (PAYG) basis out of the current revenue. It is managed by the government and as such is not supervised by any regulatory authority;
- the complementary pension in the form of the proposed defined contribution fully funded individual account pension would require a regulatory frame-work for supervision which is proposed to be provided by the PFRDA;
- Public Provident Fund (PPF) is managed by the government with 75 per cent of the net accretions being given as loans to the states and balance credited to public account of the government and as such does not require supervision by a regulatory authority. Further, this fund is most likely to be closed once the proposed individual account pension system is introduced;
- Employee Provident Fund (EPF) is both administered and regulated / supervised by the Employee Provident Fund Organization (EPFO). This is not a very satisfactory arrangement as the body that administers it also regulates and supervises it. Sooner than later, for the benefit of the system, this arrangement will have to be changed with the regulatory and supervisory functions being separated from the EPFO;
- Employee Pension Scheme (EPS) 95 is again administered and regulated/ supervised by the EPFO. This would also benefit from separating the regulatory and supervisory functions from the EPFO;
- occupational pensions set up through approvals from the Commissioners of Income Tax (CIT) under the provisions of the Part B of the Fourth Schedule of the Income Tax Act, 1961 are envisaged to be supervised by the relevant CITs but this supervision remains confined only to ensuring adherence to the prescribed investment pattern. The other aspects are left to self regulation through auditors and actuaries and any self-regulation to be effective has to have the legislative frame-work. In India there are no minimum funding requirements;
- as in the case of occupational pensions, the gratuity funds set up through approvals from the CITs under Part C of the Fourth Schedule of the Income Tax Act, 1961 are envisaged to be supervised by the relevant CITs but this supervision also remains confined only to ensuring adherence to the prescribed investment pattern. This being a defined benefit scheme, other aspects are left to self regulation, again through auditors and actuaries; and

- personal pensions and group pension products offered by the life insurers are regulated and supervised by the IRDA and those offered by the MFs are regulated and supervised by the SEBI;

As can be seen, the regulation and supervision of pensions is fragmented and this needs total review.

## **6 Pension Regulatory Body for India**

6.1 With the various initiatives on pension reforms being on the anvil, the government has announced that the PFRDA would be set up to regulate and supervise the pension funds.

6.2 In keeping with the parliamentary mandate to IRDA to not only regulate and supervise the insurance business but to play a role in its development, the government has sought to give a similar mandate, in respect of pensions, to the PFRDA. This is very significant, since considerable developmental work will have to be done to make the community at large understand the need and importance of self financing of old age income.

**6.3 Scope of Work of the Regulatory Body :** - To date, scope of the PFRDA's proposed authority has not been announced, beyond that it would regulate and supervise the PFMs licensed by it for providing the proposed defined contribution fully funded individual retirement account pension.

6.3.1 As mentioned earlier, government officials have also gone on record to say that the pension products offered by the life insurers would be regulated by the IRDA . This leaves the occupational pension and gratuity funds not being supervised by any regulatory body other than the CITs. Here it is necessary to clarify that the IRDA would regulate the group pension and gratuity products offered by the life insurers and chosen by the trustees of the pension / gratuity funds to administer the pension / gratuity benefits, but the IRDA is not envisaged to regulate the pension / gratuity funds as such.

**6.4 Regulatory Objective:** - The aim of any regulation and supervision is to protect the subscribers and this protection does not remain confined to ensuring the financial viability of pension arrangement. It encompasses control on costs, good value for money, rules of pension arrangement, trust deed, expeditious settlement of claims and disputes and adequate choice to the subscribers as also controlling competition amongst the different providers.

6.4.1 The first objective is to avoid failures. When the regulations and supervision aim at avoiding failures, it would be useful to examine what are the factors that could endanger the financial viability of a pension arrangement. These could be improper investments, incorrect pricing either of the products or the charges, inadequate control on expenses , frauds and mismanagement, inadequate safeguarding of assets and a few others.

6.4.2 It is a generally accepted premise that the funding of retirement benefits should be independent of the government and the employers. This is how the concept of trusteeship has been introduced for such arrangements and this has led to a structure based on this concept. The trust structure for funding of retirement benefits ensures that the contributions that are collected and invested are held in trust for the benefit of persons who have contributed or for whom the contributions are collected.

6.4.3 In this context, what is important is to get the regulatory structure right which sets out the basic rights and obligations of the relevant parties – the pension scheme members, the trustees, the employer, the service provider and the advisors.

6.4.4 Having said this, it is important to emphasize that no regulatory system can be 100 percent certain of preventing failures, in every situation. However, what is important is that the integrated package of legislation, both principal and subordinate, along with self regulation through the actuaries, auditors and other professionals should help in achieving a fairer and more secure framework for the pension system, for the benefit of those who are entitled to receive pensions now and in future.

**6.5 Regulatory Structure:** - The Government of India having decided to set up an independent Pension Fund Regulatory and Development Authority (PFRDA) with a secretary level official as its Chairman and a four member board; have by an executive order, on 1<sup>st</sup> January 2004, established an interim PFRDA with an interim Chairman and two non executive board members. The PFRDA would have to be established through an Act of Parliament. The interim PFRDA would draft the Bill for establishment of the statutory authority and frame the regulations that would be required for licensing and regulation and supervision of the Pension Fund Managers. It is not clear at this stage whether the PFRDA would also supervise occupational and other pensions, but it is necessary that the government addresses the issue of regulation and supervision of occupational and ‘other pensions’.

6.5.1 While the profile of the occupational pension structure is well established, the profile of the structure for the proposed DC individual retirement account pension has yet to evolve. There is a general consensus (and government officials have gone on record to say) that the life insurance companies, banks and mutual fund companies with foreign participation could seek to be the PFMs for this pension.. However, the details of structure of the PFM is yet not known in the public domain. The possible structure of the vehicle could be one of the following:

- an entity seeking to be an PFM is required to set up a separate entity that would function as PFM;
- an entity is allowed to function as PFMs from within its existing business with a Chinese Wall separating the two businesses, the way SEBI requires the mutual funds to separate its mutual fund scheme business and portfolio management business; or
- an entity is allowed to function as PFMs from within the existing business.

6.5.2 What are the cost implications of these structures ? A separate entity would require capital and that would add to the cost. However, the other two alternatives have also cost implications, though on a lesser scale. If a life insurance company offers this pension within its existing set up, with or without Chinese Wall, this pension would be treated as unit linked business and the solvency margin would go up by 1 % of assets under management since no guarantees are envisaged and this would have its cost. In the case of a bank or an NBFC, I guess, the pension accumulation would be treated as a deposit for determining capital adequacy.

6.5.3 The other issues that would have to be addressed if the life insurers were required to set up a separate company for providing this pension are:

- the capital for the separate entity would have to come from the Shareholder Fund as an “other than approved investment” with a ceiling of 15 %, presumably of the Shareholder Fund;
- how this investment would be valued at the time of placing value on the assets of an insurer;
- the expense overrun of the new entity would be a charge on the P & L Account of an insurer;
- the extent of admissibility of this asset for solvency of the insurer.

6.5.4 If the life insurers function as PFM within its existing set up it would lead to a situation that the pension product would be as approved by the PFRDA but the responsibility of overall solvency of the life insurer would be with the IRDA.

6.5.5 The regulations for the proposed DC individual retirement account pensions could be structured drawing on the basic philosophy followed for the regulations for Stakeholder Pensions in the UK. The stakeholder pension regulations are somewhat complex because of the legacy issues in the UK pension system. In India, we could have a simpler system as there are no legacy issues.

6.5.6 Since the IRDA is and would be regulating and supervising the group pension and gratuity products it would be logical to also entrust the regulation and supervision of occupational and affinity group pensions funds and gratuity funds to the IRDA. This aspect is extensively analyzed in section 9 of this paper.

6.5.7 It might not be feasible to immediately address the issue of separating the regulation and supervision of the EPF and EPS 95 from the EPFO but this would have to be addressed at an opportune time once the pension system reasonably settles down.

**6.6 Role of the Pension Regulatory Body:-** The PFRDA would license the Pension Fund Managers under the proposed pension scheme and such licensing should be made a prerequisite for approval of the pension arrangement by the tax authorities. For licensing it is necessary to lay down the governance structure and if a separate entity is required to be set up by the provider, the capital structure requirement, minimum capital

and issue of ceiling on foreign equity will have to be addressed. If an alternate structure is stipulated, then the governance norms would have to be prescribed.

6.6.1 It is important that the pension regulatory body be given both power and resources to carry out spot checks and detailed investigations independent of any complaint. The very existence of such power would act as an encouragement to sound administration and a deterrent to improper conduct on the part of those involved in running of pension arrangements.

6.6.2 The task of the regulatory body should be to ensure that security of pensions is not put at risk and that management systems are sound. It should not be required to prescribe how this should be done through the imposition of minutely detailed regulations but a broad framework be so laid down that the objective is achieved through self regulation and minimum regulation through legislative processes.

6.6.3 The office of the regulatory body should be held on a full-time basis by a person who has detailed understanding of the working of pension arrangements and the personal and institutional authority not only to enforce statutory requirements, but to develop voluntary standards which would receive wide support.

6.6.4 The regulatory body will have to have an advisory committee with membership covering a wide range of skills and interests.

6.6.5 The regulatory body should be required to make an annual report of its activities, including the general survey of developments during the year in matters falling within the regulatory body's remit, to the Ministry of Finance. A copy of the report should be required to be laid before both the houses of the Parliament and be made available in the public domain. The role of the IRDA has evolved on similar lines and replicating the model for the PFRDA would not pose much of a problem.

6.6.6 There, however, is a difference in the role of the pension regulatory body and role of the regulatory bodies in the other areas of financial services sector; the difference being that the pension regulatory body would be somewhat less proactive, particularly in the area of occupational pensions. This is because, in contrast to insurance companies and asset management companies, which are relatively homogeneous and few in number, there are a large number of occupational pension arrangements and there exists great diversity in the way these are set up and managed. It would therefore be impracticable for the pension regulatory body to keep all occupational pension arrangements under active review. This is the case with OPRA in the UK, and is the source of much of the criticism of it. In this context, the role of professionals associated with the pension arrangements, in particular the auditors and actuaries, will have increased importance.

6.6.7 However, the UK Government Green Paper released in December 2002 – “Simplicity, security and choice: Working and saving for retirement” - envisaged that the new pension regulator (or a redefined OPRA) would focus on protecting the benefits of scheme members. It would operate proactively to anticipate problems, concentrating its

effort on schemes where it assesses that there was a high risk of fraud, bad governance or maladministration.

## **7. Immediate Tasks Before the Pension Regulatory Body**

7.1 The immediate tasks before the interim PFRDA would be to prepare the Bill for establishment of the Pension Fund Regulatory and Development Authority (PFRDA) through an Act of Parliament as also the regulations for supervision of PFMs and the DC individual account pension. The frame-work of this legislation to establish the PFRDA could be based on the following :

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- role and responsibility of the regulatory body in supervision of the pension business and in development of the pension market;
- powers and functions of the regulatory body to frame regulations;
- the finances of the regulatory body;
- profile of the provider of the proposed defined contribution individual retirement account pension; any financial services provider could possibly be the provider; and
- deciding the profile of the Pension Fund Managers as outlined in paragraph 6.5.1, and if a separate entity is to be set up, the shareholding structure and minimum capital requirement and ceiling on foreign equity.

7.2 The interim PFRDA would have to simultaneously frame regulations for supervision of the proposed defined contribution individual account pensions and this would include;

- evolving the process of selection of Pension Fund Managers (PFM);
- fixing the eligibility criteria for entities seeking registration as PFM;
- drawing up the fund management regulations, possibly based on the SEBI regulations, as the operations would essentially be investment operations;
- determining 'minimum standards' for the scheme as mentioned hereinafter; and
- other relevant matters.

7.3 As mentioned earlier, for framing the regulations of this scheme, we could draw on the philosophy and important features of the Stakeholder Pension regulations in the UK. These features are summed up herein:

**7.4 Stakeholder Pension – Philosophy and Important Features** - One of the important features of the Stakeholder Pensions is the 'minimum standards'. As a part of its commitment to encourage more people to save for their retirement, the UK government felt that personal pensions needed to be made less difficult to understand. There existed wide variation between the terms and conditions offered by different schemes and as a result, comparisons between them were difficult. The introduction of 'minimum standards' for stakeholder pension was considered necessary to ensure a level of standardization across schemes which would allow individual consumers to compare more easily what was on offer. It was felt that 'minimum standards' would mean that people could have confidence that their pension was flexible, portable and that any



stakeholder pension scheme would give them a good basic deal. Specifically ‘minimum standards’ were set for the amounts of fees which could be charged, minimum contributions allowed, freedom to stop and start contributions and freedom to transfer between pension providers. There were also minimum standards to cover investment choices and the information which PFMs should give to their customers.

**7.4.1 Charging structure** – The basic objective was to adopt a simple and transparent charging structure so that the individual consumers could understand what charges they would pay and could make comparisons. To facilitate this, the Government decided to specify the maximum fees which could be charged. They allowed no initial or exit charges, no charges for reducing or increasing contributions (other than that the individual needed to contribute a minimum of GBP 20 per month) and only an annual management charge on the individuals’ funds under management of 1 per cent. A percentage charge on fund value:

- produces little revenue in the early years of a scheme, or when a subscriber joins the scheme; this increases the length of time needed to recoup the initial capital invested in setting up the scheme;
- means some cross-subsidy from those with larger individual funds to those with smaller funds;
- produces an incentive to PFM to maximize the value of their funds;
- continues to provide PFMs with some revenues from dormant accounts

7.4.2 Levying charges in this manner have been challenging for the UK companies and would be so in India also, as costs involved in setting up and running a scheme are likely to be weighted towards the early years of the scheme’s operations. There will clearly be need for some initial capital investment by the sponsors, which may take some years to recover.

**7.4.3 Limit on charges** – As has been mentioned, the prescribed limit on charges was seen as a valuable safeguard for the subscribers and was envisaged to provide an important degree of confidence in the scheme. However, a charge limit has to be set up taking into account the overall costs.

**7.4.4 What the charge limit covers** – When specifying the limit it was considered important to be clear about what the charge covers and, by extension, what services may be charged for separately. The following costs associated with scheme administration were expected to be covered by the charge limit:

- costs associated with establishing and running the scheme administration, including payments and administrative / professional support to the trustees;
- the investment of funds;
- providing required basic information to subscribers;
- other costs incurred in promoting the scheme;
- providing basic information and advice;
- setting up of individual accounts
- receiving contributions;

- processing and payment of transfers both into and out of the scheme;
- making report to the regulatory authority;
- tax administration; and handling disputes and complaints.

Should the cost of advice be included in the charge limit or should it be outside the charge limit ? If it is outside the charge limit, and the subscribers are required to pay for it, people who need it most will not take it.

**7.4.5 Charges outside the limit** – The schemes can charge separately for additional services in such manner as is considered fit. It may be mentioned here that in the Chilean model, the PFMs are not allowed to make any deduction for costs or profits from the 10 % contribution paid by the subscribers. The subscribers pay additional 2-3 % contribution to cover the PFMs expenses and profit margin and the cost of other benefits like death and disability cover.

**7.4.6 Minimum level of contribution** - This limit ensures that people who can only make modest contributions are not ruled out from joining a stakeholder pension scheme, but equally that pension providers do not have to provide stakeholder terms for very small contributions. This was defined in the UK as being below GBP 20 per month, recognizing that contributions below this level would be insufficient to enable companies to provide Stakeholder Pensions profitably. Minimum level of contribution has to be dealt with in this perspective.

## **7.5 Investment choice**

**7.5.1** All through the debate on the proposed pension scheme in India, there has been a consensus that three fund choices could be offered to the subscribers, viz, Income, Balanced and Growth with Income Fund as the default option. It may be considered whether “Lifestyle Fund” could be the default option. While the regulations need not go into the micro management issues, the regulations in respect of the kinds of investments to be held, balance between different kinds of investment, risk, exercise of rights attaching to the investments, valuation norms, calculation of net asset value and the extent to which social, environmental or ethical considerations are taken into account in selection, retention and realization could be similar to the SEBI MF regulations in this behalf allowing for the long term nature of pension fund investments.

**7.5.2** Maybe the authorities could consider providing option of “with profits fund” subject to the conditions that the fund conforms to the minimum standards laid down for the pension scheme and the life insurer setting up a separate fund and maintaining a separate set of accounts for this fund. Minimum Standards would require that with profits investments should allocate all funds to subscribers and not create a smoothing fund.

## **7.6 Information**

**7.6.1** It is essential that subscribers receive regular, clear and good quality information on their pension accumulations. This may include the basics of how the scheme operates, the benefits offered, tax rules and contribution limits. It should also Include regular

information on the value of the subscriber's fund, the contributions paid in and the charges which have been levied .

7.6.2 In December 1998, the UK Government published a Green Paper : *A New Contract for Welfare : Partnership in Pensions* containing references to:

- education issues;
- proposals to provide integrated annual benefit statements; and
- requirements for illustrations of benefits from DC schemes.

The Green Paper proposal on DC Scheme Illustrations was : “ We are proposing immediate improvements to help people understand their private pension position. At the moment, members of money purchase pension schemes (both occupational and personal) must be given a benefit statement every year, but schemes are not required to give members a projection of their likely future level of pension. Some give illustrative projections, but this is not widespread . In contrast, members of salary related schemes can have statements which show how much pension has accrued to date and forecast how much members can expect to accrue by the time they reach pension age if they continue in the same job. We are proposing that :

- all money purchase schemes should be required to provide annual statements showing the projected value of the individual's fund at retirement age and the amount of pension it might buy at today's prices;
- the statement must be as simple and straightforward as possible. It must also be clear that it is only an estimate which depends on unknown variables that will invariably change over time; and
- there will also have to be clear and evident warnings about the actuarial and economic assumptions used in the projections.”

After four years of public debate and consultations with the actuarial profession on this issue, with effect from 1<sup>st</sup> April 2003, the Department for Work and Pension has introduced pension forecasts for all those who request it. This will give an indication of the State benefits which an individual can get when he retires. To make the pension picture more complete, the department has also specified that those with occupational, personal or stakeholder pensions can expect to receive an annual illustration of the value of their future benefits. The legislation has – for the first time- placed a legal requirement on trustees and managers of defined contribution pension arrangements to illustrate future benefits. Illustrations have to conform to the guidelines drawn up by the actuarial profession, in consultation with the Government.

## **7.7 Other matters for Indian Pension regulations**

7.7.1 The other matters would include:

7.7.2 **Transfers** – The single charge structure does not envisage exit charge at the time of change of pension fund manager. Would this lead to frequent changes ? The regulations will have to address the issue of charges for transfers in or out of the scheme.

**7.7.3 Clearing House Operations** – it is envisaged in the scheme that there would be a Central Record-keeping Agency (CRA) that would receive the contribution collected by the collecting centers, pass those to the appropriate PFMs and keep the relevant records. The regulations would have to lay down guidelines for these operations.

**7.7.4 Annuitisation** - The schemes of this nature being essentially vehicles of investment, regulations for such schemes do not address the annuitisation issue but it would be desirable to do so in India.

**7.7.5 Marketing and Distribution** – If the proposed pension system were to have some form of limit on charges, the reduced margin, both for the provider and distributor, would require large volumes to make the system viable for pension companies. The distribution of this pension is expected to ride on the existing distribution channels with the government employee pension being handled directly. It could happen in the case of other employee/affinity groups as well. In this context, the regulations may not go into micro management by stipulating the ceiling on distribution costs. It could perhaps be best left to the provider to work this out within the overall expense cap or the cost offered by the provider in his bid, if bidding process for licensing were to be followed..

**7.7.6 Withdrawals** – The regulations would have to ensure that the funds are not easily accessible to the subscribers during their working life and aim at preserving the accumulations to the date of retirement. Yet, for many of the subscribers this being the only saving, the regulations may have to provide for allowing withdrawal in exceptional circumstances, that too limited to a few in number, for the contingencies laid down in the regulations with ceiling on the amount to be withdrawn. The thinking in this regard is to have two types of contributions, “ tier I” ( dedicated contribution of retirement benefit) and “ tier II “ ( other savings), and easy withdrawals will be allowed from accumulations of “tier II” contributions.

**7.7.7 Winding up** – The regulations will have to lay down the requirements as regards winding up, the procedure for discharging the rights of subscribers on winding up and other associated issues.

**7.7.8 Resolution of Disputes** – The regulations will have to lay down the framework of the mechanism for resolution of disputes.

7.8 This in very broad terms could be the regulatory framework for the proposed pension scheme.

## **8. Central PF Board, Singapore – Proposal:**

8.1 Singapore has a Central Provident Fund (CPF) with various investment options. The Economic Review Committee (ERC) had recommended that the Government should facilitate the provision of low-cost, privately managed pension plans (PPPs) as additional investment option under the CPF Investment Scheme. In response to the ERC recommendations, the CPF Board has reviewed the possible approaches and developed a proposed framework for the PPPs and a Consultation Paper on this issue was released by

the CPF Board on 6<sup>th</sup> January 2004. Since the design issues are similar to the ones under debate in India it was felt that it might be useful to outline the CPF Board, Singapore , proposal.

8.2 The CPF Board proposes to facilitate the introduction of PPPs structured as unit trusts with key features of a well-diversified portfolio and low investment cost. The desirable features of PPPs as listed by the CPF Board are:

- simple choice by members with PPP providers offering appropriate number of fund options;
- no front-end sales charges;
- redemption fees for early withdrawal, except for death, permanent incapacity, etc.
- rebalancing of invested money according to the changing needs through switching . a small fee, especially for switching between PPP providers is proposed;
- option of converting PPP savings into an annuity from age 55, annuity being proposed to be provided at best possible group annuity rates;
- low fees, through an optimum number of PPP providers during initial years for economies of scale and having PPP providers serviced by a single master administrator;
- PPP providers expected to comply with the CPF Investment Guidelines
- proper disclosures;
- Trustee-ship of PPPs., i.e. a trust is expected to be set up for the PPPs.

It would be seen from this that the features of this type of pensions are similar, focussing on transparency, flexibility, portability, low cost, value for money, investment choice, and adequate disclosures

## **9. Occupational Pensions**

9.1 While the pension reforms are on the anvil, it is necessary for the government to address the issue of regulation and supervision of pension and gratuity funds. The current position in respect of regulation and supervision of these funds has been outlined in para 5.1. While self-regulation is good, it has to have a legislative framework.

9.2 The occupational pensions can be of three types;

- defined contribution;
- defined benefit; and
- hybrid, i.e. where both the contributions and benefit are defined. However, such schemes are essentially defined benefit as the employers have make good the deficit in the fund periodically.

and the funding modalities followed are that the trustees :

- manage the fund and buy annuities from life insurers;
- manage the fund and also pay out annuities, e.g. as in respect of public sector bank employees' pensions;

- go in for a scheme offered by life insurers.

The occupational pension regulations would have to cover all types of funded pensions and gratuity.

9.3 The inadequacies of supervision of the pension funds and the gratuity funds have been outlined in para 5.1 and there have been concerns expressed in different quarters, in particular, about the adequacy of funding of these benefits. However, in the absence of any regulatory framework for this purpose, these issues have never come to the fore. In this context, it is necessary that these funds are brought under the purview of some regulatory authority. Since the IRDA is the regulatory and supervisory authority for group pension and group gratuity products offered by the life insurers, it would be logical to entrust this work to the IRDA. It may be mentioned here that for regulation and supervision of retirement benefit scheme with defined benefit, be it pension or gratuity, actuarial skills are required for ensuring adequate funding. In view of this, similar to the system of Appointed Actuary in insurance business, the system of Scheme Actuary has been evolved for DB pensions in some of the jurisdictions. In a DB pension arrangement the Scheme Actuary is responsible for:

- valuation of the pension fund;
- monitoring compliance with the Minimum Funding Requirement (MFR);
- advising the trustees on a schedule of contributions and recommending transfer values;
- asset liability management;
- quantifying the benefit cost for company account purposes; and
- certification for tax purposes.

In the context of the requirement of actuarial skills for regulating and supervising the DB pensions and gratuity funds, the IRDA, which will always be equipped with actuarial skills, would be the most appropriate regulator for this business. Further, as the annuities are regulated by the IRDA, this arrangement will enable the IRDA to have complete regulation and supervision of these pension funds.

9.4 The important features of the regulations for supervision of these pension / gratuity funds are outlined herein:

9.5 **Pension promise** - The trust law provides considerable freedom to the settlers of the trust and it exposes the members to the risk that their interests in the scheme might not always be sufficiently protected. In this context, the members of occupational pension schemes have certain reasonable expectations that the legislation should protect. These include the expectations that the rights will accrue with service and, once accrued, will be protected and that benefits will be provided in accordance with the scheme rules and any legal requirements. These reasonable expectations ( which are not strictly legal rights , as trust deeds, as mentioned above, usually provide wide powers of amendments to the employers and trustees) form the core of what might be termed the 'pension promise'. It is this promise that the pension legislation should seek to protect, particularly in respect

of accrued rights. The primary duties of the trustees in relation to the pension promise should be set out in the legislation.

**9.6 Funding** – Funding is critical in a pension arrangement under which the benefits are defined. Appropriate funding of pension scheme’s accrued liabilities is fundamental to the pension promise as it provides means whereby the accrued benefits are protected even if the sponsoring employer becomes insolvent. In order to achieve this, funding needs to be set at a level which ensures that the scheme is in a position to meet the liabilities as they fall due. This requires a minimum statutory solvency or funding requirement in a funded defined benefit scheme to secure the pension rights of members.

9.6.1 All schemes subject to minimum solvency requirements should be required to establish and keep in place a funding plan adhering to not less than the hundred percent level. In the event of a drop below this level, but at or above the base level, say ninety percent, the trustees should be required to submit a plan to the pension regulatory body providing for restoration of the fund to hundred percent level within specified time.

9.6.2 The trustees and the scheme actuary should be required to report any shortfall, whether at the hundred percent level or base level, to the regulatory body, as soon as they become aware of it.

**9.7 Interests in Pension Fund and Surpluses** – The surplus in a defined benefit scheme has to be viewed in two perspectives, viz. surplus in an on going scheme and surplus on winding up. The regulations should specify the manner of treatment of surplus in an ongoing scheme such as the extent to which contribution holidays can be taken by the employer or both the employer and the employees.

9.7.1 The surplus on winding up should generally be dealt with in accordance with the scheme rules and where the rules are silent, the most satisfactory course would be for the trustees to be given statutory discretion as to the application of unallocated surplus.

**9.8 Pension Fund Trustees** – As all the pension schemes approved by the income tax authorities have to be trust based, the role of the trustees is of crucial importance in the administration of the schemes. The issues that need to be addressed include the qualification and disqualification of the trustees, the extent of employer control over their appointment and removal, the composition of the trust board, the distribution of powers between the employer and the trustees, trustees’ conflict of interests and issues connected with the powers of the trustees.

9.8.1 The scheme auditor and scheme actuary should not be allowed to act as trustees and the employer shall not have sole power to appoint trustees and should not be able to veto a trustee selected by the scheme members.

9.8.2 Schemes should not be required to appoint pensioner trustees but should be encouraged to consider including them on the trustee board.

9.8.3 Certain rights need to be reserved to the trustees, irrespective of what the trust deed provides. Decisions on the following matters should be reserved for the trustees by legislation:

- to appoint scheme auditor, scheme actuary, fund manager and other professional advisors;
- to decide, in consultation with the employer, on the investment strategy of the fund;
- to decide on the any unallocated surplus on winding up.

**9.9 Amendment and Winding up** – Schemes can be amended in accordance with the rules of the scheme and the provisions of the trust deed. In addition, they can be wound up in various circumstances. In order to protect the rights of members (active, deferred, pensioners) the regulations should ensure that the regulatory authority is involved in overseeing the process.

9.9.1 Amendments which detrimentally affect the accrued rights of a scheme member should not generally be permitted and the approval of the regulatory authority should be required before such an amendment is made to the scheme.

9.9.2 Where winding up of the scheme is planned, and not precipitated by insolvency of the employer, the trustees should be required to give scheme members a reasonable period of notice prior to winding up. On winding up of a scheme, benefits should be calculated on the basis of cash equivalents, but if additional assets are available, those should be allocated in accordance with the scheme rules.

**9.10 Early Leaving** – There are number of reasons why members might leave their occupational pension scheme before the normal retirement age, as a result of individual choice or bulk transfer from one employer’s scheme to another on sale or merger of companies.

9.10.1 The actuarial certificate should provide adequate protection for scheme members affected by bulk transfers, and the individual consent of those members should not be required.

9.10.2 If the scheme is fully funded, transfer values should not be calculated on a basis which is more favorable to the departing member than that used in assessing minimum solvency of the scheme. Where the scheme’s solvency level is less than hundred percent, the transfer value should be reduced proportionately.

9.10.3 The regulatory authority should have the right to impose a penalty on the scheme administrator if, without good cause, the transfer value is not paid within the period specified in the regulations.

**9.11 Scheme Administration** : In the administration of pension schemes the role of administrator and the professional advisors like actuaries, auditors, lawyers are of vital importance and the duties that they have to take on behalf of the scheme need to be



clearly defined. Further, their relationship with the trustees and with the employer also need to be defined.

9.11.1 Every defined benefit scheme should have a Scheme Actuary appointed by the trustees. The scheme actuary should be required to certify scheme solvency annually on the minimum solvency basis and the solvency certificate should be required to be furnished to the regulatory authority. Scheme Actuary should have a duty to report serious or persistent irregularities to the regulatory authority. The scheme auditor should also be appointed by the trustees.

9.11.2 The trustees should be required to make an annual return to the regulatory authority consisting of

- a copy of the audited scheme accounts;
- a copy of the scheme administrator's audited statement of payment of contributions; and
- a copy of the actuarial certificate of scheme solvency in relation to the minimum solvency requirement.

9.12 **Fund Management** : Flexible guidelines for investment should be prescribed in the regulations. The annual report of the trustees should contain a statement by the trustees that they have carefully considered the investments and are satisfied that they conform to the statutory criteria. The regulations shall also prescribe prudential and exposure norms for investments.

9.13 **Safeguarding the Assets** : The regulations shall require segregation of pension fund assets from the employer including the issue of self investment, custody of scheme assets by an independent custodian, designation of assets as belonging to the pension scheme and supervisory control of fund managers.

9.13.1 Investment, if any, in the employer's business should be required to be excluded in determining compliance with the minimum solvency requirement.

9.14 sue of arrears of regular contribution and contribution to meet the deficit by the employer in the case of insolvency of an employer.

9.15 **Information for the Scheme Members** : The basic information about the scheme should be provided to everyone before joining the scheme. All active members and pensioners should be required to be provided an annual statement showing both their individual benefits and key information about the scheme, including its solvency level, the basic distribution of assets and fund movements.

9.15.1 The regulations should also provide for the process of approving the annual report and accounts.

9.16 **Dispute Resolution** ; All schemes should be required to establish a formal internal dispute resolution procedure of a nature approved by the regulatory authority, and to

make the details of this known to scheme members. The Ombudsmen should be given powers to enforce their decision directly.

#### **10. Scheme Actuary :**

10.1 The actuaries have played a significant role in the financial management of defined benefit pension schemes. In the UK, the widespread use of actuaries by funded pension schemes was probably a significant factor in the reluctance of governments to legislate significant statutory requirements for pension schemes, other than tax approval, until 1973, when the Occupational Pension Board was established by the Social Security Act 1973.

10.2 The Scheme Actuary is accountable to the trustees, and is, therefore, required to keep in balance the interests of all participants in the trust, including beneficiaries, as well as employees of the employer. Traditionally there is, however, a fundamental difference between the role of an Appointed Actuary in life insurance business and a Scheme Actuary in pension business. The role of Appointed Actuary is proactive, whereas that of a Scheme Actuary is reactive. A Scheme Actuary has to report non compliance, if he comes across it, whereas an Appointed Actuary has to ensure compliance. This perhaps could change with the role of the occupational pension regulator becoming more proactive.

10.3 The IRDA has introduced the system of appointed actuary for life insurance and general insurance sectors in India. It would be appropriate that when taking up the task of supervision of occupational pensions, the system of Scheme Actuary is introduced in India.

#### **11. Need for Enlarging the Scope of Regulation and Supervision by PFRDA**

11.1 In paragraph 5.1 hereof the different arrangements for building up assets for old age income are listed. It is necessary that all these arrangements, except those where the government makes payment of old age income, and those regulated or are sought to be regulated by the IRDA, are brought under purview of the PFRDA. As mentioned earlier, it might not be feasible to immediately separate the regulation and supervision of EPF and EPS 95 from the EPFO but that should be the ultimate objective.

11.2 When the regulation and supervision of the EPF and EPS 95 is to be separated from the EPFO, the PFRDA perhaps could be the most suitable regulatory body to be entrusted with the regulation and supervision of the EPF and EPS 95. In order to ensure smooth functioning, it might be necessary to entrust the regulation and supervision of EPS 95 also to the PFRDA even though it is essentially an occupational pension scheme.

11.3 For regulation and supervision of these arrangements, it might not be necessary to frame separate legislation. The PFRDA could adopt the exiting regulations applicable to these schemes with necessary modifications.

#### **12. Legislation Influencing Pension Arrangements:**

12.1 The pension arrangements and the member's relationship and rights therein are governed by a number of different areas of law. These include trust law, contract law, tax law, social security law, employment law, financial services law and other general law.

12.2 The trust law provides the underlying legal principles governing establishment of pension arrangements under trust structure. The contract law governs the rights and duties of pension providers and members. The tax law protects and control tax relief available to pension arrangements. The social security law regulates various pension arrangements. The employment law primarily regulates the relationship between employer and employee. The financial services regulations regulate the asset management functions of pensions when the management of occupational pension fund assets are entrusted to the AMCs. The general laws would influence other aspects of pension arrangements.

12.3 The authorities will have to ensure that the tax treatment of the proposed pension is uniform and does not vary with the type of the provider.

### **13. Role of Various Regulatory Bodies:**

13.1 In the last paragraph, the various legislation influencing the pension arrangements have been mentioned. The regulatory authorities which regulate these areas and their responsibilities in respect of different aspects of pension arrangements are covered herein.

13.2 The approval to the pension funds for tax relief is granted by the Income Tax authorities. The Ministry of Labor regulates the social security arrangement for workers. The pension reforms initiatives have been taken by the Ministry for Social Justice and Empowerment which commissioned Old Age Social and Income Security (OASIS) project. The Finance Ministry oversees the overall functioning of the financial services sector. The Securities Exchange Board of India (SEBI) regulates the capital markets which have a strong bearings on the pension business. The insurance regulatory authority regulates the pension products, both personal and group, offered by the life insurers. The Ombudsman system also has a role of adjudicating on the complaints of injustice due to mal-administration by the pension providers and it may be necessary to set up separate dedicated Ombudsman system for pensions .

### **14. Role of Actuaries in the Evolving Pension Scenario**

14.1 The role of actuaries in defined benefit pension has been outlined in section 9 hereof. In this section, attempt has been made to outline the significant role the actuaries can play in the current environment in which the DB pension arrangements are being replaced by DC pension arrangement for new employees and a DC public pension with universal access would soon be introduced.

14.2 The change over from DB to DC seeks to transfer the whole or part of investment risk from the employer to the employees. In this process, it is necessary to make people understand that the traditional final salary and DC pension represent the polar extremes

and that there are intermediate options. It is necessary that the actuarial profession responds to the challenges of pension design and communication needs, e.g. moving from final salary to career average in a DB scheme could provide substantial relief to the employers in terms of costs. This is just one example and there would be many more.

14.3 As DC pension arrangements become the main source of retirement income for greater part of the population, the ability to plan for retirement income with a reasonable degree of certainty will become more important.

14.4 Planning for retirement is not well understood by the majority of the population because the normal perception is that retirement is a long way off for many and partly because of its complexities. The actuarial profession, in the cause of serving the public interest, has an important role to play in facilitating better understanding of pension issues by the general public.

14.5 The actuarial profession needs to identify effective ways of influencing government and debate on pension issues, so as to ensure that the shift from DB to DC arrangements is the subject of informed debate. The actuaries should have an opportunity to comment on :

- the pros and cons of different types of benefit delivery systems; and
- how existing DB arrangements can be made simpler to understand.

14.6 The actuarial profession, which essentially means the Actuarial Society of India, needs to identify ways of helping the Government of India and the community at large to comprehend many complex issues in pension area, such as the risk / reward analysis related to the choice of pension type.

14.8 It is also important to realize that the changing environment may need a change in the skill set required by a pension actuary.

## **15. Public Education on Pension Matters**

15.1 Because of the social structure, social psyche and nature of the economy, an average Indian was never much concerned about making provision for old age income. But with the ever increasing longevity and changes in the social structure a need is increasingly being felt for self financing of old age income. In order to make people understand the importance of building up assets for old age income, a massive awareness and education program needs to be undertaken. This will have to be done by the government, the pension regulatory body and the providers, and the education must start from the school level. This is particularly important in the context of the introduction of the proposed defined contribution individual retirement account pension with universal access. The Document of the World Bank – India The Challenge of Old Age Income Security - released in April 2001, has expressed concern in respect of this pension scheme that “ There is little evidence that a significant number of individuals in the informal sector will voluntarily save with a multi-decade horizon if not encouraged by direct subsidy.” ( which is very unlikely). The public education and initiatives to create awareness would address the concern expressed by the World Bank. The developmental role assigned to the PFRDA by the government has to be viewed in this perspective.

15.2 In India, further tax incentives would lead to increase in pension savings but would not lead to increase in coverage. It would only make privileged people more privileged. Educating people and creating awareness amongst them would only lead to increased coverage.

## **16. Summing up**

16.1 All regulations aim at protecting the consumers of various products and services and this protection assumes greater importance when dealing with the long term financial contracts such as pensions. Because of the complex and long term nature of the pension business, this business needs closer supervision. The detailed regulations would vary by the type of pension arrangements but the basic philosophy of the regulations should remain the same.

16.2 The regulation and supervision of the pension and gratuity funds be brought under the purview of the IRDA. While the actuaries have played a significant role in supervision of pension business, in a defined benefit pension arrangements a statutory role in the form of Scheme Actuary needs to be created as it exists in many jurisdictions.

16.3 The regulations for the proposed defined contribution individual account pension, which is envisaged to be offering universal access, need to focus on 'minimum standards' in respect of the various facets of the pension scheme. Such an approach would provide fair deal to the public.

15.4 Looking to the complex nature of pension business, a suitable frame-work for regulation and supervision of all pensions is necessary. It is also essential that all the arrangements for building up of assets for old age income, other than those regulated and supervised by the IRDA, are brought under the control of the pension regulatory body, if not immediately, then over a period of time, so that all issues are addressed in a holistic manner. This would bring cohesiveness to the pension system, its regulation and supervision.

15.5 The actuarial profession would have to be proactive to influence the government and the community at large to facilitate understanding of the implications of different pension choices

15.6 There is an urgent need to initiate consumer education and awareness programs so that people gain greater knowledge about the need to and means of saving for their retirement.

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**Disclaimer:** Views expressed in this paper are strictly those of the author

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Subhedar has a honors degree in Mathematics from the Mumbai University. He is an Associate of the Institute of Actuaries, London, and has passed three of the four Fellowship papers of the Institute in 1970s. He is a Fellow of the Actuarial Society of India and an Associate of the Insurance Institute of India.

He joined Oriental Govt. Security Life Insurance Co. Ltd. in 1955 and retired as the Managing Director of LIC in October 1995. During his tenure with LIC, he has worked as in charge of Division and Zone. He was associated with setting up of LIC's off-shore life insurance company in Bahrain and was its first CEO.

He was the President of the Actuarial Society of India from 1995 to 1997 and the President of the Insurance institute of India from 1993-95.

In November 1995, he joined Prudential Corporation Asia Ltd., Hongkong, as Sr. Advisor based in Mumbai and was associated with setting up of Prudential ICICI MF and ICICI Prudential Life Ins. Co Ltd. He is a Director of Prudential ICICI MF Trust Co. and Prudential Process Management Services (India) Pvt. Ltd. He is an Alt. Director of ICICI Prudential Life Ins. Co. Ltd.

During the process of insurance sector liberalization, he was associated with many Committees of Actuarial Society of India(ASI) that worked with the IRDA and was Chairman of the ASI's Insurance Law Review Committee. He is a Member of the IRDA's Insurance Advisory Committee, CII Insurance Committee and FICCI Insurance and Pensions Committee. He is a visiting Faculty at the National Insurance Academy, Pune.