Annex 2

B. RETIREMENT SCHEMES AND PENSION FUNDS IN INDIA

B.1. Why are Pension funds important to the bond market?

International experience shows that pension funds have indeed provided the much-needed boost to the development of corporate debt markets both in terms of demand for corporate bonds as also liquidity apart from improving the market microstructure. Pension funds have also been major stimulators of financial innovation as they have directly or indirectly supported product innovation by supporting the development of asset backed securities, structured finance, derivative products and so on.

Pension fund presence in the bond market is likely to increase the availability of long term funds in the market, which in turn will improve the asset liability mismatch that often arises in projects with long gestation periods. As a matter of fact, globally the pension industry has been a key component of the financial infrastructure of an economy. It is one of the few sources of long term funds, which have null, or least risk associated with maturity of assets and liabilities. Thus, its viability and strengths have far-reaching consequences for not only the money and capital markets but also for each and every facet of the economy. Funds raised from pension fund placements can specifically help infrastructure financing.

The ever-increasing longevity makes any retirement provision based on inter-generational income transfers faces difficult to sustain. Defined benefit schemes are giving way to defined contributory schemes. While India makes up about 16.3 per cent of the world population, its elderly population is only about 12.5 per cent of the world's elderly population. India's population is currently relatively young but this will change as health and other social initiatives lead to continuous improvement in birth and death rates. There are currently 70 million people over the age of 60 in India and fewer than 10 per cent of them have their pension; the others have to work or rely on transfers, mainly from their children. Hence the potential or the development of pension fund industry and its benevolent effects on the debt market are immense.

B.2. Retirement Planning and Pension Funds in India:

Existing pension schemes in India are limited in their coverage and are poor in their design. First, there is a pension scheme for civil servants and employees of autonomous bodies such as universities, which is fully funded by the Government. Second, there is the Employee's Provident Fund Organization（EPFO）, which is mandatory for the organized sector and which offers a provident fund[6] and a pension scheme.[7] A small scheme is also run by the EPFO for workers in the unorganized sector. Finally, about 50 insurance companies and mutual funds offer over 700 financial products to all citizens though only 1% of the population buys such products.

B.3. Recent Government Initiatives and Pension Fund Reform

Two parallel sets of initiatives have been taken during the last 4-5 years. The first initiative was for the organized sector and the second initiative was for the unorganized sector. OASIS (Old Age Social and Income Security) project was commissioned by the Ministry of Social Justice and Empowerment, which submitted its report in January 2000. OASIS report recommended a scheme based on Individual Retirement Accounts (IRAs) to be opened anywhere in India. Banks, Post Offices etc., were identified to serve as "Points of Presence" (POPs) where the accounts could be opened or contributions deposited. Their electronic interconnectivity would ensure "portability" as the worker moves from one place/employment to another. There would be a depository for centralized record keeping, fund managers to manage the funds and annuity providers to provide the benefit after the age of 60.

The OASIS report brought forth important reforms in the field of pension fund investments and paved the way for later initiatives like the announcement of the New Pension System in the Budget of 2003-04, which got introduced on 1 January 2004.

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[6] Under a provident fund, the full amount of the benefit available at retirement may be taken as a lump sum cash payment, irrespective of whether the benefit is calculated on a *defined benefit* or a *defined contribution* basis.

[7] Under a pension fund at least two-thirds of the final benefit must be paid as a pension for the rest of the pensioner's life. A maximum of one-third of the final benefit may be taken as cash.

B.4. The New Pension System

The New Pension System (NPS) is a pension system that is intended to initially cater to newly recruited Central Government employees (except the armed forces) and to workers in the unorganized sector. Even within unorganized sector, the NPS will cater to only workers who are taxpayers and can be motivated to join the scheme through tax incentives. As with Government employees, they can ask for investment protection guarantees on investments under various pension schemes offered by Pension Funds. However, this guarantee would be implemented using private financial markets. Persons being covered by schemes offered by the EPFO and other provisions administered under any statutes would not be covered under this NPS scheme. Thus, no existing arrangement of pension provision applicable to already existing persons are proposed to be changed, only new/additional persons are going to avail the benefit of the NPS.

Although the NPS has started with covering Central Government employees who joined service after 1 January 2004, State Governments are likely to join this NPS scheme going forward. In due course, private sector employees too may join the NPS scheme.

The uniqueness of the NPS is two-fold:

(i) It creates a system where both the Government employees as well as workers in the unorganized sector are covered by one scheme and supervised by one regulator and

(ii) The choice about fund managers or about different schemes of a fund manager can be exercised independent of the fund manager through the mechanism of the Central Record-keeping Agency (CRA).

B.5. Investment guidelines according to the New Pension System:

(i) Non-Government provident funds are allowed to invest 5% of assets in blue-chip shares and 10% in corporate debt and equity-oriented mutual funds

(ii) Relaxation of norms for superannuation and gratuity funds to invest in the Gilt fund. Provident funds can have a maximum exposure of 5% in gilt funds at any point in time.
(iii) Provident Funds can invest in bonds of financial institutions and companies having investment grade[8] from at least 2 credit rating agencies.
(iv) There would be multiple pension fund managers licensed by Pension Fund Regulatory and Development Authority (PFRDA) and the choice would be with the individual employees to decide which fund manager they would like to go with.
(v) Under the NPS, it is proposed that there would be four broad categories of pension scheme (scheme A, B, C and D). While in scheme A, investments will be made in Government securities only, scheme D would have relatively higher weighing for equity while retaining the dominance of fixed income instruments. Schemes B & C will provide a balanced investment option with equity and fixed income instruments.
(vi) On the issue of guarantees on principals and/or returns, market based guarantees are proposed under the NPS scheme. This means that the subscriber has to bear the cost of the guarantee. However, the scheme with 100% Government Securities would be totally risk free in terms of capital protection and assured returns if the securities are held to maturity.

B.6. Why is pension Fund investment in corporate bonds so low?

The above discussion illustrates that the bulk of pension fund investment in capital markets is dominated by bonds. Further, within bonds, Government securities form the major proportion of bond investments. Pension funds hesitate to invest in corporate bonds for fear of exposing their portfolio to unnecessary risk. However, they fail to maximize returns in the process of giving primacy to risk mitigation. Financial repression during the period of administered interest rates caused returns on Government bonds to be significantly lower than the returns on safe investments in informal markets. Although, deregulation has improved the situation, returns on Government bonds are still significantly lower than returns on other assets with close to or zero default risk.

[8] Investment grade consist bonds with a rating of BBB and above

Provident funds and pension funds are required to invest in accordance with prescribed guidelines that are orientated towards safety of the funds. As a result, the preference has been for Government securities and PSU Bonds. A very small proportion (10% of accruals to the fund in a year) is available on a voluntary basis for investment in private sector bonds. Of the total corpus of statutory provident funds (including the Employees Provident Fund) amounting to Rs.1,750 billion as on 31 March 2004, only Rs. 490 billion[9] was invested in corporate bonds (mostly those issued by public sector entities). It is because of the current pension fund norms that returns on pension funds are so low. Perhaps it is time now that prudential norms governing pension funds should change. Consequently, the return-risk maximization paradigm should also be given due consideration as compared to only risk minimization.

Thus, the dominance of Government bonds in the pension fund portfolio leads to thinking whether one should be looking at a quantitative increase in bond exposure or one should be looking at a qualitative increase by way of increasing pension fund holdings of bonds with higher return-risk ratios like corporate bonds. Corporate bonds may be preferred over equity investments because investors may neither be willing to accept the low returns which gilt-edged bonds provide, nor accept the high risk that comes along with equity investment. The aim therefore is to attain the most optimum debt-equity mix and within debt exposure the most optimum balance between safety and return.

Following are the some of the countermeasures suggested for optimizing returns from Pension funds and expanding their presence in the corporate debt market:

1. Pension funds, by their very purpose of establishment, are risk averse and this moves them away from corporate bonds. However, in reality many of the AAA/AA+ corporate bonds have close to 0 default rates and offer a substantially higher spread over gilts (see table B1, B2 and B3; Figure B4)thereby increasing the return profile of the portfolio without adding to its risk structure

[9] Source: EPFO Balance Sheet and IDBI Capital Markets Ltd.

Table B1: Default Statistics of Corporate bonds

CRISIL Average Cumulative Default Rates in %(2000-2004)				
RATING	**SAMPLE SIZE**	**1-year**	**2-year**	**3-year**
AAA	262	0.00	0.00	0.00
AA	456	0.00	0.30	0.76
A	279	0.72	1.80	3.50
BBB	108	4.63	8.37	12.19
Investment Grade(AAA-BBB)	1105	0.63	1.28	2.07
Speculative Grade(BBB and below)	173	12.71	29.08	31.70

Source: CRISIL Default Study, 2004-05

Note: Default rate of a rating category measures the likelihood of a rating in that category to default during a given time horizon. It is measured by the proportion of total defaults to total outstanding ratings in a particular time horizon.

Table B2: Stability of Ratings

CRISIL One-year Average Stability Rates in %(1992-2004)	
AAA	96.64
AA	89.26
A	82.40
BBB	73.27
Overall	83.64

Source: CRISIL Default Study, 2004-05

Note: Stability rate can be looked upon as the likelihood of no transition. For instance, during the period 1992-2004, 96.64% of the AAA rated corporate bonds continued to remain the AAA category. Only 3.36% of the bonds were downgraded.

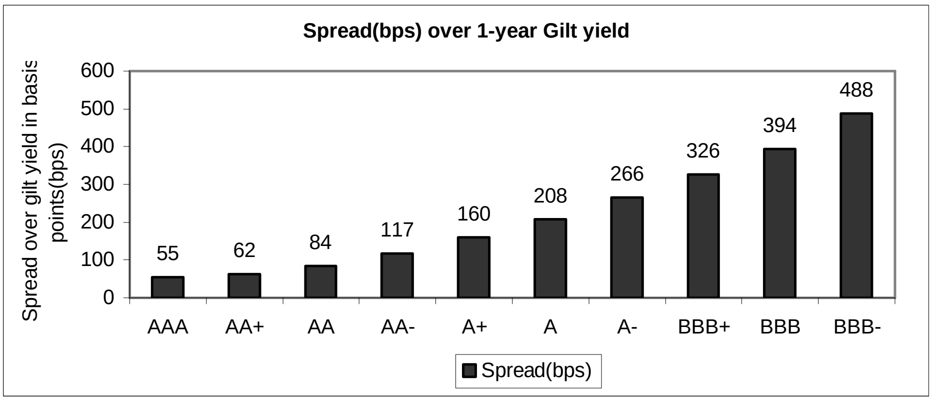
Table B3: Measuring Return-risk ratio of Corporate Bonds

RATING	SPREAD OVER 1- YEAR GILT YIELD(bps.)	DEFAULT RATE(%)
AAA	57	0
AA	76	0
A	178	0.72
BBB	337	4.63

Source: CRISIL Default Study, 2004-05

The above analysis reveals that many AAA/AA bonds have returns significantly higher than gilt-edged securities. For instance in Table B3, we see that the return on a 1-year AAA corporate bond is at least 57 basis points higher than the return on a gilt-edged security of a similar tenor and the default on both the types of bonds is zero. Thus, a rational study should be undertaken to determine the correct return risk measure from corporate bonds and Government Securities. Fund managers and investors alike should be made aware of this return risk measure and the advantages of investing in corporate bonds should be highlighted.

Figure B4: Pattern of Spreads over 1-year Government securities, 2005-06



Source: FIMMDA（Fixed Income Money Market and Derivatives Association of India

An Indian insurance/pension fund company is constrained by the fact that the market for fixed income securities is very illiquid such that only government securities and AAA/AA+ rated corporate bonds have liquid markets. Further, absence of a market for liquid Mortgage Backed Securities denies these companies the opportunity to enhance the yield on their investment without significantly adding to portfolio risk. If pension fund industry is liberalized and is engaged in active portfolio management, the liquidity of the bond market will increase significantly. This will enable pension fund companies to invest in bonds of lower rating and thereby add to the average yield of their investment without adding significantly to their portfolio risk.

2. Private sector participation in pension funds should be encouraged as state monopolies have generally been found to be laggard in terms of innovation or in terms of offering a wider range of products to the individuals they cover. Greater innovation in financial instruments adds to the diversity and efficiency of a capital market.

3. Also the restrictions on investments undertaken by pension funds require a fresh look. For instance, Provident Funds need to park at least 25% of their funds in central Government securities and another 15% in either State Government securities or debt

mutual funds approved by the SEBI. The discretionary component of portfolio allocation is very small. This should be increased so that investment in other instruments of investments that offer higher returns can be increased.

4. A fully functioning Pension Fund Regulatory and Development Authority (PFRDA) would go a long way in instilling confidence in investors. Although PFRDA was set up in December 2004 as regulator for Pension Funds, it is still in a transition phase and has not been able to make much headway.

B.7. Conclusion:

It is evident from this study that pension fund investment in India is heavily biased in favor of Government securities. While investment restrictions imposed by the Government may be partially responsible for this investment pattern, strict prudential norms dominated by the concern for safety over return may have only exacerbated the situation. However, with the implementation of the New Pension System, while the pension fund exposure to corporate bonds has been rising, the private participation in pension scheme offers has also increased. Improvements in the corporate bond market have also facilitated this process.

With the choice of pension fund investment structure shifting in the hands of individual, pension fund investment in India is poised to move in to a new trajectory that is consistent with the risk bearing abilities of individual constituents. This may lead to greater demand for good quality corporate bonds. However, the path to this optimum is likely to take a few more years in view of slow progress on policy reformulation and pension reforms.