

OCCUPATIONAL PENSIONS **AGENDA, FRAMEWORK AND REFORM**

Cynics have begun to call the pension reform debate the issue of the future; always has been and always will be. It's time to build consensus around a realistic agenda and get some progress rather than idealistically wait for the best solution.

Pension reform is like ice cream; the more you wait the more it melts. The glacial pace of reform in the last few years has meant that interest groups have hardened positions and making any progress is becoming difficult.

I would urge all sides involved in the delivery of occupational pension to graciously consider some give and take so that a start can be made. Insurance deregulation had many compromises (most glaringly the 26% cap on foreign equity) but things have moved forward rapidly and we have a strong platform for the next generation of insurance reforms.

Whatever we do, pensions are becoming a hot issue because of multiple factors:

- Differential pace of financial and pension reform (lower interest rates, more expensive annuities)
- Tax reform (perk valuation, enforcement)
- Labor market trends (move to cost-to company, increased mobility, portability demands, lower desirability and unsustainability of defined benefit plans)
- Monopoly of PF commissioner (low service to cost ratio, lack of choice in compliance, bad service, etc)
- Time bomb in government pensions (unfunded, indexed, nothing but off balance sheet debt)

Despite pressures, pension reform is stuck and it might be time to try a different strategy. Demonstrating progress on less controversial issues would build a platform before taking on the difficult issues. Nothing cemented popular support for telecom deregulation than the race to the bottom in STD rates.

A high level listing of issues related to occupational pensions could be:

STRATEGIC ISSUES

- More to reform than Investments; sequencing is key
- Don't blur objectives for the Provident Fund; let it be a retirement benefit
- Conflicting, dual role of the PF commissioner; regulatory and administrative
- Role and Responsibility of Plan Trustees
- Funding and Sustainability of Government pensions
- Avoid Guaranteed Returns

TACTICAL ISSUES

- Scrap EPS
- Give companies a choice for PF compliance at entry
- Low terminal PF accumulation
- Tax issues and rationalization
- Portability; transfer between different PF trusts

STRATEGIC ISSUES

More to reform than investments; sequencing is key

The pension reform debate always sinks around the argument of equity investments by provident funds. It is a tricky issue and there is no right answer. Nobody argues about the long run desirability of equity investments by pension funds but capital market reform is needed in the short term.

Equity markets may be ready for pension money but pension money is not ready for the volatility and lack of transparency of Indian equity markets. It may be prudent to attack other issues and come to the issue of investment deregulation issue in the next phase. A possible sequencing could be first marking investments to market, allowing some investing in passive index funds, employer choice and finally employee choice. Most importantly, employer choice should precede employee choice.

Reforms need to be carefully crafted for early success. The deregulation of industries like telecom, airlines, etc. is not comparable because some of the early entrants in airlines and telecom have rightly closed down. But that is unacceptable in an industry like pensions that is built on trust and fiduciary responsibility.

Don't blur objectives for the Provident Fund; it should provide retirement income

Socrates said that a slave who has three masters is free; the current lack of accountability of the EPFO is rooted in multiplicity of goals. Social Security, coverage, retirement accumulation, liberal insurance, liquidity during accumulation, mandatory participation, actuarial soundness, etc. are conflicting objectives.

There is disturbing news that the government is planning to layer an unemployment benefit onto the Provident Fund. Its objectives are already confused by death insurance (EDLI), Social security (EPS) but we should return the PF to its roots; a well-designed, individual account defined contribution retirement benefit.

Conflicting and dual role of the PF commissioner

All companies that cross twenty employees have to pay 24% of salary to the EPFO. This monopoly position does not subject charges or service to competition and employers pay an additional 4.4% of contributions as asset management and administration fees (probably the highest in the world) with service levels that, mildly put, and could do with improvement.

Nobody disputes the complexities of creating competition in a mandatory contribution pension plan but that cannot be an argument against it. The first phase of reform needs to separate the regulatory and administrative roles of the EPFO and subject the administrative part (which is nothing but an asset management and IT services operation) to open competition. This will mean giving free choice to companies in

choosing an administrative and/ or investment service provider for Provident Fund compliance and scrap the current convoluted and bizarre exemption process.

Role and Responsibility of Trustees

Plan trustees currently have no liability for plan performance or actions. The highest leverage in any reform program would be the creation of fiduciary and criminal liability for plan trustees as individuals.

The current lack of a framework has creates a sometimes incestuous relationship between trustees and financial intermediaries which leads to decisions that are not always taken in the interests of plan participants. The role needs to be clarified and the downside needs to be amplified.

Funding and sustainability of Government pensions

Unfunded government pensions are estimated to be \$ 120 billion; almost 35% of GDP. Most are defined benefit and liberally indexed to inflation. This is nothing but off balance sheet debt of the government and is an issue that needs immediate attention. Biggest pocket are the civil services, defense and the railways. It is hard to image but the number of pensioners for railways (the largest employer in the world) is now larger than the number of active employees!

The government has made a bold decision to move from defined benefit pensions but the past liability needs to be funded and the indexation needs to be discontinued. The whole issue has to be very carefully handled because it could have wide implications for interest rates, credit rating, the privatization agenda and much else.

Guaranteed Returns

Volatility in financial markets is here to stay and any structure that attempts to remove uncertainty only redistributes risk. Government finances cannot be the dumping ground for bad investment calls (UTI, Indian Bank and the future EPS) and we need to recognize that there is no asset in the world that can escape the risk/ return trade-off

A sustainable pension framework is not built on investment guarantees; it ensures the availability of multiple assets to suit different needs. Some may have guarantees with lower returns and some will not. This is not discriminatory; people at different stages of their life have different needs, wants and risk propensity.

TACTICAL ISSUES

Scrap EPS

Not many people with a Provident Fund account know that 8.33% of their salary is sent to a badly designed Employees Pension Scheme (EPS) that doesn't come back as a lump sum and is probably not worth much unless you die in the first two years. It was introduced with no debate, employers oppose it, employees don't like it, the Supreme Court has heard arguments, but the Employees Provident Fund Organization (EPFO) won't back down.

The details of the Employee Pension scheme are heavy but a Mother Nature design flaw is fixed benefits and contributions (one has to be variable). Other issues include a defined benefit plan with individual balances, early withdrawals that destroy pooling effects, opening balances that may not cover past service liability, a committed central government subsidy, etc.

Most importantly, the EPS is actuarially unsound and probably unsustainable; an asset shortfall will require a government bail-out (ala UTI, Indian Bank, et al) sometime in the next ten years. It is nothing but a contingent liability on government finances that will surely be called on.

Key arguments against EPS reform are that choices are limited and operational unwinding will be too complicated. An elegant operational and structural solution to unwind EPS would be returning the past and future 8.33% to where it came; the defined contribution account of individual subscribers.

Give companies a choice for PF compliance at entry

The default position of the Provident Fund commissioner means that all companies who cross twenty employees have to comply with them. It is important that companies be given other options because the current process of complying with them first and then pulling out to form your own exempt trust gives them a chance to block any exemptions (as they have for the last two years).

This is closely linked to the dual role of the PF commissioner and addressing that issue would substantially allay the frustration of corporate with new exemption applications or restructuring proposals arising from corporate changes.

Low terminal PF accumulation

Liberal early withdrawal options from the Provident Fund account have created a situation where the terminal accumulation value is on average only Rs 25,000. A number of leakages need to be plugged but this may not be possible given the high rates of contribution.

We strongly believe that any plugging of leakages should be accompanied by a reduction in the rates of contribution from 24% to somewhere in the range of seventeen or eighteen percent.

Two other important changes that could increase terminal accumulations could be a) the application of provision of tax deducted at source for withdrawals before five years by the provident fund commissioner (as applicable to exempt trusts) b) the free transfer of PF balances between excluded and exempt trust as it would preempt any motives for early withdrawal.

Tax issues and rationalization

The Income tax Act needs to attack three immediate issues. The most important one is the cap on tax deductibility of company contributions to defined benefit plans at 15%. This tends to encourage under funding and it is important that contributions made under advice from a registered actuary be fully tax deductible.

The other important issue is the taxing of investment returns beyond the rate credited by the PF commissioner. This removes all incentives for prudent fund management and has created a large reserve account in some well-managed funds. The distribution of this reserve at some point in the future will create unfair cross-subsidies for the current members at that time and all investment earnings should be tax-free.

Uniform applicability of tax deducted at source is also important. Currently the PF commissioner does not deduct any tax at source on withdrawals before five years and this encourages depletion of the terminal amount.

Portability; transfer between different PF trusts

The Provident Fund commissioner currently prohibits the free transfer of accumulations between exempt trusts and excluded trusts (not covered by the PF Act and participants with base salary above Rs 6500).

This prohibition completely defeats the intent of portability and is purely driven by the PF organization trying to stifle the growth of schemes outside their purview.

CONCLUSION

- It is much more important to make some progress than wait for a perfect solution to India's pension problems
- Let us tackle controversial investment deregulation in the next phase and focus on other structural issues in Phase One.
- The largest pension scheme in the country is the Provident Fund and any reform program that wants to make a difference has to include it.
- Separation of the dual and conflicting role of the Provident Fund organization would be base camp for any reform program
- A important long term step needs to be convergence of government and occupational pension plans