Pension scheme has miles to go

Jayant Pai Posted online: Mon Jan 02 2012, 03:39 hrs

There is considerable angst among reformists that the revised Pension Fund Regulatory and Development Authority (PFRDA) Bill was not passed during the current winter session of Parliament.

However, I believe both the amendments therein were irrelevant due to the following reasons :

26 % foreign holding

Even under the current regime, there are partly foreign owned entities serving as fund managers (such as ICICI Prudential Life Insurance). Also, even though the pensions sector may be nascent, our financial sector superstructure is fairly evolved. Hence it is unlikely that foreign players will bring in radically superior processes/technologies which will transform our sector.

Also, as seen in other arenas, such as mutual finds and banking, foreign shareholding is not really a big advantage to the end consumer as the best practices they bring are quickly adopted by all the players.

Fixed returns

The second proposal, concerning fixed returns is regressive and seeks to pull us back into the era of guaranteed returns. This is anachronistic in a world in which there is hardly any refuge from price volatility. Even the Government is admitting this by partly deregulating the returns on Postal Small Savings Schemes.

No doubt, investors will flock to such a variant within the New Pension Scheme (NPS) but this could actually prove detrimental to everyone concerned in the longer term.

While the powers that be are engaged in a tussle to decide what is good for us, here is a snapshot of the retirement investment scene that prevails in other parts of the world today. While there are myriad programmes, I have chosen USA and Brazil, one a developed market and the other an emerging market. Though specifics vary, there are a few common threads running through :

There is a definite shift from the “Defined Benefit” (DB) to “Defined Contribution” (DC) mode. Hence the onus of generating an adequate retirement corpus is shifting from the employer/ Government to the employee/citizen.

Unfavourable demographic changes and precarious Government finances are the primary reasons behind this trend gathering momentum.

This shift is faster in those countries where financial markets are relatively more robust.

In the USA, the most popular retirement savings program is a defined contribution plan known as the 401(k) program. Employer contributions with the 401(k) vary and fund withdrawals are permitted when the employee attains the age of 59.5 years. There is a wide selection of stock, bond and money market funds for employees to choose from.

In fact, this section has spawned an entire industry of pension fund managers which includes all the well known mutual funds and insurance companies. Many companies' 401(k) plans also offer the option to purchase the company's stock. In 2011, about 60 per cent of American households nearing retirement age have 401(k)-type accounts.

In Brazil, the old-age pension consists of three parts: the age pension, contributory pension and proportional pension. They are following a mix of DB and DC with a plan to eventually move towards DC.

The age pension is a defined benefit plan which also involves some contribution from the intended beneficiaries. For the contributory pension, the insured must have contributed at least 35 years (men) and 30 years (women). The monthly benefit is equal to a fixed percentage of average earnings.

For the proportional pension, the age limit is age 53 with 30 years of contributions (men) or age 45 with 25 years of contributions (women). Once again, the monthly benefit is again equal to a fixed percentage of average earnings plus 5 per cent of average earnings for each additional year of contributions.

The second feature across most countries is that the retirement proceeds are usually taxed. In other words, rarely does any citizen enjoy the Exempt-Exempt-Exempt (EEE) benefit. In India Public Provident Fund and Employee Provident Fund holders (and NPS holders, as per the proposed new Direct tax Code) enjoy this benefit.

There is an index known as the Melbourne Mercer Global Pension Index which objectively compares and assesses the retirement income systems of 16 countries (including India) based on their adequacy, sustainability and integrity.

While no country's system has an index value above 80 (considered to represent an A-grade system) six countries have an index value between 65 and 80. India ranks at number 15, with a value of merely 43.40. Holland tops the list with a value of 77.90.

This shows that we have miles to go, thereby increasing the urgency to resolve all the related issues on a war footing.

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