Pension System in India : A Central Banker's Perspective *

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At the outset I wish to compliment the Asian Development Bank Institute and others who are sponsoring this policy Conference. The Conference is rightly addressing the policy issues as well as practical skills involved in examining and improving the pension systems in South Asian countries. The approach of enabling of sharing of experiences and views among South Asian countries and, with multilateral institutions is commendable. My comments today will be in two parts. The first part will contain a description of initiatives taken and involvement by the Reserve Bank of India (RBI) in the recent past, say the last three years, in matters relating to Pension System in India. The second part will narrate issues that are required to be addressed in the context of pension reform, from the perspective of a central banker.

RBI's Interests

While pension system as well as its regulation is not of direct concern to the RBI, there are several areas of interest to the RBI. In fact, the Reserve Bank as far back as 1996-97, encouraged a resident consultant of the RBI to undertake a study of the pension system and this pioneering but comprehensive study highlights the dimensions of the problem, though the RBI does not necessarily share the solutions offered by the study.

Second, the RBI in its contribution to recommendations of the Working Group on Domestic and Foreign Savings for the consideration by the Steering Group on Financial Resources for the Ninth Plan emphasised the importance of contractual savings of which pension system is an important element.

"The Group was of the view that increase in contractual saving is essential and should be ensured by appropriate policy actions and the estimates of domestic savings are based on the premise that there would be a significant increase in contractual savings and if this did not materialise, the domestic savings are likely to be significantly lower and they would affect investment and overall growth". The Report further states "The household sector saving rate is contingent on a significant increase in contractual saving and that necessary policy actions during the Ninth Plan would be taken to ensure that the targetted saving rate of the household sector is achieved".

In this regard, the Reserve Bank has also articulated the importance of contractual savings in funding infrastructure from time to time.

Third, the Reserve Bank was associated with Project OASIS both during the preparation of the report in 1999 and in consideration of it at later stages. It is an excellent report and perhaps no other report has contributed as positively to the debate on the issue of pensions. The Reserve Bank Board had expressed interest in the subject and noted the report in view of its criticality for the developments in the financial sector. The Reserve Bank had also rendered some advice to Government on the fiscal implications of this report.

Fourth, the RBI has been active in developing financial markets, mainly money and government securities markets. The Provident Funds have special interest in Government securities for well-known reasons. Development of funded or private pension systems need to be supported by a simultaneous strengthening of the financial market infrastructure, since the ability of the pension funds to take care of the interests of contributors depends on the performance of the financial markets.

It will be useful to place on record the measures taken by the RBI in the last two years in this regard that should be of interest to Provident Funds (PFs). Provident Funds are now allowed to have constituent

Subsidiary General Ledger (SGL) accounts with banks, Primary Dealers, Depositories, etc., all of whom are having SGL accounts with the RBI. Bidding in the primary auction of government securities can be done by PFs through such entities or even directly. Non-competitive bids can be placed by PFs in auctions of Treasury Bills. For many years, the maturity structure of market loans had shortened. Using skilful debt management, the Reserve Bank was able to place longer-term issues of 15 and 20 year Government paper. On the open market window, we have been making available papers of different maturity including those with tenor longer than 10-year paper and of late this has attracted interest from PFs. Zero coupon bonds and inflation (capital) indexed bonds, which ought to be of special interest to PFs have been issued. Tax Deduction at Source on government securities has been abolished.

There are several other initiatives under contemplation, the most important being the satellite linkage as part of computerisation of the RBI's Public Debt Office. With such a linkage, it should be possible for a PF anywhere in the country to put in a bid at any office of the RBI in a primary auction or buy from the open market window from any place, as also be able to transact with intermediaries like Primary Dealers and banks. It is also proposed to introduce order driven trading with guaranteed settlement for small lots and PFs should be able to take advantage of this facility. Further, the legal changes proposed by the RBI in regard to Public Debt combined with the institutional developments already put in place by the RBI should help build vibrant markets, thereby enabling PFs to actively manage their portfolio in order to maximise returns.

Fifth, the Reserve Bank has received the *Report of the Informal Group to Study the Role of Bank Deposits in Savings Mobilisation (Chairman Shri A.P.Kurien)*. The report is under examination but I will share with you an observation in the report that while all saving instruments showed wide year-to-year variations during 1990-91 to 1998-99, not surprisingly, contractual savings showed relatively less fluctuations. There has also been some steady improvement in the relative importance of contractual savings. The Reserve Bank intends to explore further measures for increasing the attractiveness of contractual savings.

Sixth, A study of Public Accounts in India under the ageis of *Development Research Group* of the RBI was presented at the seventh meeting of State Finance Secretaries on November 3 and 4, 2000 convened by the RBI. The stark realities of growing liabilities under the existing Provident Fund arrangements was of great anxiety to State Finance Secretaries, but it was recognised that it is really an All-India phenomenon and indeed a national level problem warranting an in-depth study and a viable approach chalked out by the Government of India.

Issues

It is not my intention to go into the issues relating to the less than active management of Provident Funds in India or even inadequate incentives to do so. Similarly the relative advantages of funded as against pay-as-you-go or the dangers of privately managed funds, etc. are not addressed here. There are also vital issues relating to supervision and administration of the provident funds in India, though these are not of direct concern to the RBI. As a central banker, however, issues relating to macro-economic stability and growth, savings, especially contractual savings, development of financial markets to enable pension funds to invest efficiently, tax treatment pertaining to different forms of savings, fiscal implications of pension

system and the overall regulatory framework in the financial sector are of concern to the RBI and relevant to the pension systems.

There are five dimensions to a comprehensive approach to reform of the pension system in India. They are (a) social dimension in terms of inter-generational equity and humanitarian considerations (this needs to be discussed as some analysts claim that this is only an *intra-generational* issue); (b) economic dimension in terms of implications for growth and stability, especially with regard to incentive framework favouring contractual savings; (c) fiscal dimension in terms of the fiscal impact of payment of pensions to government employees, financing the borrowing programme, payment to poor as part of social safety net, and contingent liabilities that may arise due to the nature of regulatory prescriptions pertaining to provident funds and pensions; (d) financial dimension in terms of the functioning of financial markets which enables appropriate safety and return for savings meant for payment of pensions in future; (e) the regulatory dimension in terms of prescriptions governing operation of pension funds in particular and, overall financial sector in general. The regulatory dimension will have to encompass issues relating to regulatory gaps and overlaps. It may be desirable to consider pension fund regulatory issues in this broader perspective also, and priorities in policy actions should reflect the importance of each dimension in the specific country context.

In any comprehensive review of social security, especially pension system in India, it will be useful to differentiate various segments, since the workforce is significantly segmented at the current stage of development and may remain so, though in a less differentiated way in the near future. The first segment is the employees in the Government system (Centre, State and local), where the stock of liabilities is huge and it is a fiscal problem and an "overhang" which can at best be insulated from perpetuating itself in future. The second consists of employees in the public enterprises in industry, who are mostly covered by Central Provident Fund Scheme or Employees Provident Fund Scheme. The third comprises employees in the private corporate sector and related entities. A significant part of this work force is also covered under Central Provident Fund and pension schemes. All the above three categories of workforce account for about fifteen per cent of total workforce in the country. Of the remaining 85 per cent, about one-third are too poor to afford any contributory scheme. The rest have several avenues, but only few among them, forming about one per cent of workforce, currently use the avenues of individual provident fund instruments. Most of these are in effect subserving the major objective of funding the debt of public sector, especially Government through postal savings, public provident funds/small savings and life insurance.

It is essential to recognise the implications on the pension system, of relevant realities of current reform process in India. First, lifetime employment which was virtually a legal requirement and a moral norm is yielding place to contracted tenures and outsourcing. Second, labour markets are becoming more flexible, which implies that institutional arrangements for individuals seeking financial security, must be provided. Third, mobility of labour is increasing and pension systems should remove penalties or irritants in regard to such mobility. Fourth, self-employment is increasing relative to employment in organisations, especially when services sector is growing very rapidly, which again calls for a review of the institutional arrangements. Fifth, marketisation of pension system by itself will thus be an inadequate response to the problem. In fact, existing stipulations under the prevailing schemes need to be reviewed on a priority basis to enable them to cope with new realities. There is a perception that the provident fund/pension schemes are serving primarily the objective of funding fiscal deficit and a review of guidelines is sought. This approach of reviewing and redesigning, feasible in the immediate future, is necessary and in

any case a pre-condition for any reform. In doing so, we should recognise that this approach of redesigning existing schemes is only one element of the pension reform.

Fiscal dimension is perhaps the most critical in pension reform in many respects. First, the pension liability as per present pay-as-you-go is very difficult to sustain in the medium to long term. The Finance Secretaries of States, in a meeting earlier this month, described it as an explosive situation and the problem for Government of India is not any less severe. Merely changing the systems of administration of liabilities will not solve the problem of "overhang" though a review is useful for the future. Second, the government budgets are dependent to a significant degree on sources such as small savings, and these are not part of market borrowings. Third, "involuntary" contribution to market borrowings is currently available to Government through regulatory prescriptions on banks and provident funds. Reform of pension systems, rationalisation of taxes and financial sector reform would require elimination or at least significant reduction in such involuntary subscriptions to government's borrowing programme. Thus, reduction in fiscal deficit would be essential as an enabling factor for effective reform of the pension system. Finally, any relief for large sections of the poor and the vulnerable in regard to pension is possible mainly through budgetary support and unless the fiscal position improves no succour is possible to large sections of the poor. Indeed, all subsidisation, and even acceptance of contingent liabilities as part of any pension system on a contributory basis to those who can afford will seriously undermine the capacity of governments to take care of pension needs of the vulnerable sections. Thus, fiscal reform and prioritisation of pension expenditures (including tax expenditures) are essential for meaningful pension reform. Where proposals for contributory pension system involve contingent liabilities on the Government, as a central bank, the Reserve Bank has advised against them. The Reserve Bank had cautioned about the need for realism in estimating the returns on investments and the need to avoid contingent liabilities through pension assurances by Government in respect of private pension sponsors in regard to the design of any new pension system.

The long-term objective of the Reserve Bank in regard to financial sector is to ensure that savers have a range of institutions and instruments to choose from to suit their risk/ return preferences. In fact, in the interests of financial stability, excessive dependence of financial intermediation through the banking system needs to be avoided in the medium to longer-term, while recognising that banks will continue to be special. In this regard, mutual funds and pension funds will have a greater role to play in financial intermediation. In pursuance of the objective of multiple types of financial intermediaries providing larger choice and competition, the Reserve Bank would seek reductions in preemptions of banks resources and level playing field among the intermediaries, and such a level playing field would necessitate appropriate equitable tax treatment, as explained separately, and more importantly appropriate equitable regulatory induced financial burden such as differentiated reserve requirements. Thus, a comprehensive review of the regulatory induced financial burdens, including on the savings schemes, may be needed as part of medium-term actions, that would clearly set apart pension funds and contractual savings on the one hand and all other market based financial intermediation with level playing on the other. While contractual savings could have preferred-status in tax-treatment, all others ought to have an assured level playing field.

Tax treatment is an important aspect of pension system. As explained in the Kurien Committee report, an important explanatory factor in movement of household savings from one category, say banks, to another, say mutual funds has been tax exemptions. The host of tax concessions tabulated in the report show that they address different sets of priorities, which are also changed

very frequently depending on specific problems of institutions. Tax exemptions are given depending on entities or end-use or instruments. There is need for an immediate review of all taxes relating to financial intermediation, and announcing a time bound plan to remove all tax concessions except those relating to long term contractual savings, essentially covering life insurance, pensions and provident funds. The Reserve Bank has a direct interest in this subject of tax reform and involuntary subscriptions to government's borrowing programme in the context of the overall reform of the financial sector, and the needs of pension systems should be recognised in the reform of relevant tax system and financial sector.

Among the tax measures that ought to be reviewed in the interest of promoting contractual savings and avoiding misuse of facilities are those already highlighted by Dave Panel. The foremost relates to abolition of tax on earnings of over 12 per cent in Provident Fund and levy of tax, at least of a 10 per cent, on early withdrawal from Provident Funds.

A few words on the regulatory framework for the pension system in India would be in order. It has to be recognised that there are four broad areas that need attention. First, given the magnitudes, pension system for government employees which is linked to fiscal management needs to be tackled separately though in the medium to long run, there can be shift from pay-as-you- go to funded system. Second, pension system for the vulnerable sections which has significant fiscal implications would also need to be addressed separately though in the medium to long run, there can be a funded system with some governmental support. Third, and an area crying for reform, relates to the current provident fund/ pension schemes - both centralised and decentralised - covering organised labour. Although a legal framework and institutional arrangements exist, they appear to be somewhat outdated. The main emphasis would have to be on focussed reform of the existing systems. Fourth relates to devising pension systems that synchronise with the changing needs of labour markets, labour mobility, self-employment and service sector growth. New systems would have to be put in place for this area and this may require an enabling regulatory framework that encourages pension funds. It must be recognised that a new regulatory framework does not necessarily mean a new regulator or additional bureaucracy.

Briefly stated, from the view point of the Reserve Bank, we advocate (a) increased mandatory contractual savings from the organised sector, both public sector including Government, and private sector; (b) enabling environment and regulatory framework for voluntary contributions to contractual savings, especially pension funds; and (c) changes in the tax regime and regulatory prescriptions in financial sector to promote contractual savings with favourable treatment to them and less favourable but *inter se* equal treatment to all non-contractual savings. This approach coupled with improvements in fiscal management and financial markets provides perhaps an optimal approach.

Perhaps, my comments would be incomplete without a reference to the case for and against mega-regulator or super regulator. If a view is taken in favour of mega regulator, regulation of pension system gets subserved in mega approach. If we persist with separate regulators, two issues would arise *viz.*, whether there should be a separate regulator for pensions and, a much broader issue of handling regulatory gaps or overlaps. In August 1999, I had given a keynote address on Universal Banking in which I had referred to the issue of new bureaucracies as well as regulatory coordination. Let me reproduce what was stated then.

"Since there is no point in creating new bureaucracies, there are practical difficulties in massive redeployment of personnel, and expertise for regulation cannot be created overnight, some ways

of filling up the regulatory gaps and overlaps should be found without disrupting the existing regulatory structures. The proposal is to explore the feasibility of an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the existing jurisdiction. The features of the proposal are : The Board for Financial Supervision of the RBI can continue to supervise banks and non-banks but with the Deputy Governor as Chairman; the insurance regulating authority will supervise insurance companies and Securities and Exchange Board of India will continue with its regulatory jurisdiction. The apex financial regulatory authority may be constituted, by statute with the Governor of the Reserve Bank of India as Chairman and the members could be Chairmen of the three regulatory agencies. The apex body should also include some outside experts on a part-time basis. The Finance Secretary could be a permanent special invitee or a regular member without voting rights as in the case of the RBI Board. The apex authority could have by law, jurisdiction to assign regulatory gaps to one of the agencies; arbitrate on regulatory overlaps and ensure regulatory co-ordination.

The apex authority could be serviced by a part-time secretariat of the RBI. In a way, the proposal improves and formalises the present informal arrangement into a legislative based authority."

Let me conclude by emphasising the importance of enhancing contractual savings for growth, improving fiscal situation and bringing about financial sector reforms in the context of pension reform. An optimal approach from the RBI's point of view has been articulated here. There is a need and scope for improving the existing provident fund and pension schemes in the country. Caution is advocated against instituting any large-scale changes in the pension system or regulatory regimes without ensuring appropriate reforms in other areas. In particular, the introduction of private sector in managing funded pension should take into account not merely system of regulation and supervision or accounting standards or risk management systems, but also financial market infrastructure, including clearing and settlement systems, and the microstructure for trading in securities. We are still in the process of developing financial market infrastructure. Above all, fiscal impact, including dangers of assuming contingent liabilities should be assessed in devising pension reform measures.

*** Comments by Dr.Y.V.Reddy, Deputy Governor, Reserve Bank of India, in the Session on Governance and Regulatory Issues in Pension Reforms in South Asia, of the Pension System Reforms Conference, orgnaised by Asian Development Bank Institute at New Delhi on November 24, 2000**.