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RIFM

Study Notes

Retirement Planning and Employee Benefits

Forward

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CHAPTER

2

WEALTH CREATION

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A. WEALTH ACCUMULATION AND EROSION

B. EARLY RETIREMENT, LIVING LONGER THAN EXPECTED, DELAYING RETIREMENT

C. EFFECT OF INFLATION

[A.] WEALTH ACCUMULATION

Wealth accumulation is the process whereby the savings of an individual is used for the purpose of building up capital that will result in a source of revenue over the next several years. Wealth accumulation means increasing the amount of capital with the individual so that the amounts here are used more effectively and this becomes a corpus that one can expect support from in the days ahead.

The wealth accumulation process is not a short term exercise where there are some fixed steps taken over in a couple of years. This is a steady process that has to be undertaken over a long period of time and it has its own characteristics as the results will be evident only over this long time frame.

- A large amount is required at the end of the process
- This cannot be generated overnight
- A long time span is required to arrive at this wealth
- Market conditions where investments are made are not smooth
- Things do not move in a straight line
- There are tumbles and shocks in between
- This will create problems in the wealth accumulation process
- Continuous efforts will pay the required dividends
- The ups and downs will be taken care of by the long time frame

There is another reason why slow accumulation is a necessity. The wealth generation process required use of different assets. Several of these earn steady returns. Not all of them have features like equity. This means that the time required for wealth creation is also going to be long. The long period also gives a chance to use the power of compounding.

A successful Wealth Creation strategy needs to have the following:

Safety – Safety of the wealth is very important for wealth creation. Investor must look for safety in the first place for deciding on a investment.

Liquidity- Though the liquidity requirement is needed the most 3-5 years before retirement, to convert the assets as and when required for meeting the retirement outflow. Even in earlier period of life, liquidity nature in an investment commands a premium in the market over liquid assets.

Yield- Earning suitable return on the investment is also very important to beat inflation, otherwise the inflationary pressure will eat up the asset and the corpus will have a shortfall.

Investment vehicles for wealth Creation

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Following investment avenues can be considered and used as investment vehicles to reach the target goal.

a. Real estate
b. Bullion
c. Shares
d. Small Saving Schemes
e. Pension Funds
f. Mutual Funds
g. Life insurance

[A] WEALTH EROSION

The word “wealth erosion” means a “wearing off or the gradual decline of the wealth of a person. If the wealth is kept lying idle, it is likely to be eroded over a long period of time, irrespective of its quantum. Therefore, prudent steps need to be taken to make an optimum use of such wealth so as to generate a regular income stream.

During the pre retirement stage, the effect is not much as the individual continues to earn income during his working life plan. However, after retirement with the discontinuation of a regular income, the individual will have to solely depend upon the pension benefit or the invested corpus income, which in many cases is a reduced amount.

Additionally, there is a gradual reduction in purchasing power due to inflationary conditions. As a consequence, it leads to a steep fall in the value of money.

In the spending phase individual spends his/her retirement corpus and corpus keeps reducing due to inflation and most conservative investments in this phase.

Reasons of wealth Erosion

a. **Fall in Interest Rates**
In India during the period between 1980-2000, Indians had witnessed a very high rate of interest ranging form 14% (Available on government administered schemes) to 20% (offered by corporate India).In just last 5 years the interest rate scenario has totally reversed, with it ranging from 8% to 9%. Any retirement corpus is always at risk with this kind of fall in interest rate. The fall in interest rate reduces the yield on investment, thus creating a mismatch in income stream and expenses stream, which in turn needs to be bridged by liquidating the capital assets.

b. **Taxation**
Tax has the tendency of eating away a good part of income generated. Taxation is thus an area, which needs careful evaluation viz a viz to investment vehicle and time of withdrawal.

c. **Preference of present consumption over future consumption**
The tendency of the human being for current consumption over future consumption can be devastating, as any deviation from the set goal can only reduce the surplus

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available for saving for retirement. Individuals must be made aware of the fact that the financial discipline must be followed.

d. **Shift in Government Policies**
In India, we do not have only the market risk but we also have a very high risk of wealth erosion, considering the shift in government policies too often. What is required is a progressive and long term policies dealing investments and taxation, while we are exposed to the changes every fiscal. Thus it becomes very difficult to take a long term view from the government legislation point of view:

For eg: Long term Capital Gain on Equity Mutual Fund and on stocks traded on a recognized stock exchange, on which Securities Transaction Tax is paid, is free of income tax, thus incentivizing the investor to invest in equity for long term. Any change by the government to the above, will adversely affect the return.

[B] RETIRING EARLY REDUCES THE EXPECTED BENEFIT

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An individual can begin receiving full pension benefits at the retirement age However, if he retires early, the pension benefits or the retirement corpus will be less because of the less time given to the investments for compounding.

Thus for an early retirement, greater saving is required to fund the retirement, as the compounding of return will not be in favor, as also the retiree will have a longer retirement years, because of early retirement, which will need more corpus to sustain full term.

Let us consider the following example. Person A saves Rs. 5000 every year from the age 25. If he can manage a return of 12% on his investments. His investments will grow to.

At the age of 50 = Rs. 6, 66,670

At the age of 58 = Rs. 17, 12,147

Thus saving Rs. 40000 more (5000*8) and allowing extra 8 years to the investment, the corpus is nearly tripled. Now if the retirement has been proponed to age 50, then additional investments are required to match the projected expenses.

Living longer than expected

One of the most astounding success stories of the 20th century was arguably the sheer extension of human life spans. Advances in science and medical research have driven this success by increasing the likelihood that more infants will survive into adulthood and the probability that 65- years-olds will have a greater chance of living into their 80s and even 90s. But when it comes to retirement income planning, life expectancy figures can be seriously misleading. Many people born at any given time will outlive their own "life expectancies." This means that most people ought to think hard about "longevity risk"-the real possibility of living 20, 30 or even 40 years past retirement age. Without planning, a longer than expected life could easily lead to a person, or couple, outliving their savings. Though it really boils down to a simple sentence," You need to plan for the possibility that you will live longer than you think," longevity risk is probably the least-understood variable in

lifetime income planning, very few people have any clear sense of the distinctions between the life expectancy of their own age group and the probability that they will live many years beyond their life expectancy once they reach age 65.Fewer still realize that if they are in good health, even people who have reached age 80 or 85 still have quite high probabilities of living 10 or 15 more years.

As a result most people underestimate the length of time they need to plan for living in retirement. A study shows, an American man who has reached age 65 in good health, for example, has a 50% chance of living twenty years to age 85, and one chance in four of living to 92. For a 65-year-old woman, those odds rise to a 50% chance of making age 88 and one chance in four of living to 94.The odds that at least one member of a 65-year old couple will live to 92 are 50%. And there is one chance in four that one member of that couple will live to 97.

As medical research and technology continue to push that lifespan envelope, more and healthier individuals just entering retirement will have to make plans for the very real possibility of needing 30 to 40 years of post-retirement income.

As it is evident from the table given hereunder, that based on a constant outflow every month, a person living longer will need higher corpus than a person having shorter life.

The below table shows the need of retirement corpus for withdrawal of Rs.10000 per month for a period of 20 years, 25 years and 30 years.

Monthly Requirement	10000	10000	10000
No. of Month	240	300	360
Interest per Month on Investment	0.50%	0.50%	0.50%
Present Capital Required	1,395,807.72	1,552,068.64	1,667,916.14

DELAYING RETIREMENT INCREASES THE EXPECTED BENEFIT

This is just the opposite of retiring early, as we have seen herein above, under this the retirement corpus as planned earlier can get even better with the extra time allowed, as the magic of compounding works. A corpus of Rs. 10,00,000, if invested at 10% can add Rs. 1,00,000 in the first year, Rs. 1,10,000 in the second year , Rs. 1,21,000 in the third year taking the corpus to Rs. 13,31,000. A delayed retirement allows that extra year of working to give extra compounding benefit to the saving nest and builds up more capital.

[C] Effect of Inflation

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Inflation means a general and progressive increase in prices. It is a proverbial saying that “in inflation everything gets more valuable except money’; also “too much money chasing too few goods’.

The excess of money supply in the country also causes inflation. The Reserve Bank of India, which is the Central Monetary Authority in India manages and controls the money supply by issuing directions regarding the fixation of interest rates for banks, fixing of CRR (cash reserve ratio), SLR (Statutory liquidity ratio), reserve repo rate etc.

With the rising inflation, the goods and services get costlier and hence, the purchasing power per currency unit gets reduced.

Inflation also affects the prices besides the forces of demand and supply. There are many other economic factors that may affect the price levels considerable.

These factors are static supply or short supply despite growing demand in respect of certain commodities, Government distribution policy, indirect taxation level measures such as grant of subsidy, different levels of excise duty, protected market (custom tariff) etc. The application of Deficit Financing by the Government in its budget also adds to the cause of inflation. The government sometimes tries to fill in the deficit gap i.e. the difference between planned expenditure and total receipt (revenue plus capital) by following additional money into the economy.

The inflationary trend affects the cost of living of the citizen of a nation, as there is a fall in the value of currency.

At the micro level, inflation has an impact on an individual’s financial planning. With a sharp rise in the cost of living there is a general demand for wages and salary to be linked to the wholesale price index and wholesale price index is considered as a direct determinant of the variation in the cost of living. To calculate the wholesale price index and consumer price index, a base year is selected and made equal to 100 points. Dearness allowance paid to the employees working in industry, civil service and public sector undertaking, banks and others specified industries is marked to the wholesale price index through the cost of living index.

When inflation creeps higher, your investment money has to work even harder to retain its spending power. Instead of trying to predict where inflation is headed, investors should focus on their portfolios, ensuring their investments are best-positioned towards off inflation’s effects over time. That becomes even more important given the expectation that various returns could slow down from the hectic pace witnessed in the last few years.

Inflation has remained pretty high in India over the past decade and a half. The rise is particularly strong in a few years in between when the price jumps have been in double digits, which is far more than the average figure. If you are working and you receive dearness allowance then the rise in inflation will be affected through the regular revision of the figure and thus, you end up earning a higher sum. The same principle needs to be applied when one has retired and in this case, the retirement fund has to earn this kind of higher sums in order to tackle inflation.

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The first place to start is asset allocation. Stocks tend to outperform bonds during inflationary periods, so investors need to have enough exposure. (Of course, other factors, like one's age, time horizon, risk tolerance and goals need to come into consideration, too.)

Many financial advisors also recommend putting 5-10% of a portfolio in commodities-even a mutual fund that invests in a broad-based basket of commodities-which also tend to work well as inflationary hedges. Gold is another classic hedge, moving independently of stocks and other asset classes. Again, the size of~ allocation depends on the individual.

That said, advisors caution investors against putting too much money into assets like gold and commodities because, over the long term, returns don't keep up with more traditional investments like stocks.

Real estate is also considered a good inflation hedge. Other tangible assets, like' vacation and commercial properties, can provide exposure, though real-estate investment trusts are probably the easiest way to enter the market. Indians do not have this option yet but as the market develops, this kind of opportunities is likely to be present in increasing numbers in the coming days.

There has also been talk about issue of inflation-linked bonds. Their interest payments tend to be levered to inflation, so these bonds might pay interest based upon the movement of the price index selected for tracking purposes. Since these offerings are smaller than traditional corporate offerings, they can be less liquid.

Dividend-paying stocks also provide an extra cushion. Whatever you do, don't overreact. This calls for careful monitoring of the overall plan but there is no need to panic every time the inflation figures rise by a bit, or spikes up in the short run.

What adjustments must be .made for Inflation?

The cost of retirement will likely go up every year due to inflation - that is, Rs 35,000 won't buy as much in year 5 of your retirement as it will in the first year because the cost of living usually rises. Although pension benefits are adjusted for inflation, any other estimates of how much income you need each year and how much you'll need to save to provide that income - must be adjusted for inflation. When planning for your retirement it is always safer to assume a higher, rather than a lower, rate and have your money buy more than you previously thought. Retirement calculators should allow you to make your own estimate for inflation.

Many financial experts feel it is important to save at least a portion of your retirement money in higher risk-but potentially higher returning-assets. These higher risk assets can help you stay ahead of inflation, which eats away at your nest egg over time.

Which assets you want to invest in, of course, is your decision. Never invest in anything you don't thoroughly understand or don't feel comfortable about.

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Exercise Ch 2

1. In post retirement period, many investment principles and strategies that people rely on while accumulating wealth remain valid with significant differences in how they may be applied tactically

A. **True**
B. False

2. In the process of building lifetime wealth through financial assets, consistency factor implies investing as early in life possible; whereas time factor implies keep investing regularly.

A. True
B. **False**

3. For longer investment time horizon, volatility of the market can be a significant risk factor because the value of an investment may be down at the time when funds are withdrawn.

A. True
B. **False**

4. A risk tolerance profiling of the client must be done based on certain pre-made_______

A. **Questionnaire**
B. Financial Plan
C. Invoice
D. Draft Plan

5. Which of the following statement(s) is/are correct?

I. Income means current stream of cash inflow from various sources.
II. Wealth is the income invested for growth in investment vehicles

A. Only I is correct
B. Only II is correct
C. **Both I and II are correct**
D. Neither I nor II is correct

6. Without planning, a longer than expected life could easily lead to a person, or couple, outliving their savings. This risk is rightly defined as_____.

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A. Inflationary Risk
B. Longevity Risk
C. Deflationary Risk
D. Asset Allocation Risk

7. Which of the following statements/s regarding “ultra-conservative” strategy is/are correct?

I. An “ultra-conservative strategy is the one where retirees aim to meet lifetime income needs solely with cash and fixed-income instruments.
II. Retirees with insufficient cash resources relative to their needs should also adopt ‘ultra-conservative strategy.

A. Only I
B. Only II
C. Both I and II
D. Neither I nor II

8. Overly generous and optimistic withdrawals in the early retirement years can have the effect of downsizing retirees’ budgets and lifestyle expectations, and some may even be forced to go back to full-time jobs.

A. True
B. False

9. Which of the following factors make health care costs a critical challenge for retirees and pre-retirees, and can pose very real risks of throwing lifetime income plans of track if they are not provided for?

I. Longer Life Spans
II. Inflation
III. Declining retiree medical coverage
IV. Deflation
V. Shortfall of medical plans

A. Only I and II
B. Only I,II,III and V
C. Only II and III
D. Only I,II and III
E. All of the above

10. Factors affecting wealth erosion includes all of the following, except_________.

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A. Fall in interest rate
B. Taxation
C. Government policies shift
D. Preference of future consumption over current consumption
E. Inadequate plan for contingencies and emergencies

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CHAPTER

12

REFORM PROPOSALS

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- ***A. Project OASIS and its recommendations***
- ***B. World Bank's recommendations, multi pillar reforms, Chilean model***
- ***C. Pension Authority***
- D. ***The role of state developmental state (East Asia),welfare state (Europe and North America),minimalist state (Europe and North America)***

[A] PROPOSALS FOR PROJECT OASIS

The Ministry of *Social* Justice *and Empowerment, Government* of *India had* commissioned a national Project tilted "OASIS" (Old Age Social and Income Security) in 1999 under the chairman ship of Dr. S.A. Dave to examine policy questions connected with old age income security in India and create necessary institutional infrastructure and to make concrete recommendations for actions. The committee, which submitted its Report in February 1999, was entrusted with the twin task of further improving existing provisions, and, to devise a new pension provision for excluded workers who are not capable of saving even modest amounts and converting this saving into an old age income security provision.

Summary of Recommendation

The OASIS Report recommended a structure based on individual retirement accounts (IRA). The Individual accounts to have full portability: i.e. the individual would hold on to a single account across job changes across geographical locations.

The pension system would constitute:

1. Points of presence (POPs): A two-tier system with POPs with good infrastructure facilities is proposed, which would offer better services.
2. Depository corporation: which would handle the database part of the Individual accounts namely choices of schemes and convey them to PFMs
3. Pension fund Managers (PFMs): which would perform the task of fund management?
4. Annuity Providers: The pension system design proposed by the here critically relies on annuity providers who convert the lump sum of assets (attained at retirement) into a regular monthly pension (or a variable annuity) until death.

Major recommendations of the Committee were:

Pension System Structure

To develop an institutional infrastructure, through which individuals can prepare for old age while they are in the labour force, in an efficient pension system. As most individuals in India are outside the organized sector and face temporary unemployment, a pension system for India should thus be flexible and useful to the unorganized sector. Government role is not sustainable on a significant scale and old age economic security should necessarily result from sustained lifelong contributions by emphasizing self-help and thrift, and for sound pension planning, there should be sound fund management to achieve the highest possible rates of return.

Individual Retirement Account

An individual would be required to open an Individual retirement account with the POP. The IRA account will have unique 10 numbers, which will not change in the entire life span of the individual.

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Minimum Contribution and Annual Accretion

The Committee recommended a simple and convenient pension system where a person opens a single Individual Retirement Account (IRA) as early in his life as possible with a minimum of Rs.100 per contribution and Rs. 500 in total accretions per year. No limit on the frequency of accretions or fixed monthly contribution.

Point of Presence

The pension system would work through a myriad Points of Presence (POPs), which would be located all over India including banks branches, post office etc; with full portability across job changes and across geographical locations. It would be a two-tier system where POPs with good information technology and telecommunications facilities would offer better services than other technologically constrained POPs and in turn would reduce administrative and transactions costs.

Private Pension Fund Managers

The professional pension fund managers (PFMs) should be selected to manage the retirement funds under this system. The pension system would offer three styles - Safe Income, Balanced Income and Growth. Each of the six PFMs would run one scheme each in the three styles, giving 18 schemes In all, which individuals can choose from.

Safety Net through Insurance

An additional safety net in the pension system is that if the final pension of a participant is smaller that the sum total of all contributions then the insurance cover would reimburse this difference for individuals *who have contributed for* at *least* ten years. To a significant extent, the Government can purchase this insurance from insurance companies.

Regulatory Body

The design of the pension system should also include a Self Regulatory Organization (SRO) that will be registered with the Indian Pension Authority. The pension system relies on annuity providers who convert the lump sum of assets (attained at retirement) into a regular monthly pension (or a variable annuity) until death.

The Indian Pensions Authority (IPA) would oversee the entire working of the system and handle the administration.

Tax Incentive

The tax-free limit for accretions into the IRA should continue to be a maximum of RS.60,000 per annum. Premature withdrawals as well as the terminal accumulations withdrawn as a lump sum from Provident Funds should be taxable at the rate of long-term capital gains rate, However, the amount that is used for buying annuities should be tax-free.

The income earned on Funds held in trust by PFM's and annuity providers, on behalf of contributors, should be exempt from any taxes, There is a strong case for

integrating a micro-credit facility into the pension system whereby individuals can have access to funds in the form of a loan against their pension savings.

Role of government guarantees

To reassure the people to switch to the new system government guarantees play a vital role. These guarantees may depend upon the level of 'welfare' functions that the government takes upon itself to perform:

Removal of subsidies

The present contribution of 1.16% of wages by the Government to the Employees' Pension Scheme should discontinue. Instead, this contribution should be channeled into the National Senior Citizen's Fund as initial corpus for the first 3 years of incorporation of this Fund. Thereafter, this contribution should be discontinued. In addition, 25% of the premature and lump sum withdrawal tax on provident funds under the new IRA system should be transferred to this Fund annually.

Early withdrawals

One of the main problems of the Pension Schemes in India is the problem of premature withdrawals, which more than often results in poverty during old age. As of now there is no incentive to compel people to keep their savings till the maturity period and the tax incentives provided are the same even if withdrawals are made. The OASIS report suggests the 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.

Financing the transition cost

The transition cost for a new pension system may be three-fold:

a. Cost of paying the workers who chose to remain within the old system.
b. Cost of reimbursing those who chose the new system.
c. Cost of the 'safety net' provided by the government.

This cost can be best borne in India by privatizing the State Owned Enterprises. In such a case, Pension Fund Managers may also participate actively in buying shares of the companies being privatized.

This would give workers the possibility of benefiting handsomely from the enormous increase in productivity of the privatized companies by allowing them, through higher stock prices that increases the yield of their PSAs, to capture a large share of the wealth created by the privatization process.

Reform Suggested In Existing Schemes by Oasis Report

Empowering the Employee Pension Scheme

1. The system of using competing professional fund managers, prudently liberalized investment guidelines, and improved governance covered in the previous chapter, should also be applied for pension funds. This will introduce

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specialized agencies for fund management (professional fund managers registered with SEBI) and for annuity provision (annuity providers registered with the insurance Regulatory Authority).

2. The presently limited, assured returns should be replaced by market-determined rates of return.

3. The Government's contribution of 1.16% towards pension accruals should be gradually withdrawn over a period of maximum three years. In the interim, this contribution should be credited to the National Senior Citizen's Fund.

4. The vesting period for pensions should be 10 years. Breaks in contribution should be permissible provided they are made up later with the correct interest penalty. Lump sum topping-up by individuals, in case of a shortfall in the minimum contribution period, should be permitted.

Empowering the Public Provident Fund

1. The "Public Provident Fund" should be renamed "Individual Retirement Account (IRA)" to focus on its objective.

2. The provident fund system of using competing professional fund managers, prudent liberalization of investment guidelines, and improved governance should also be applied to the Public Provident Fund. A professional Board of Trustees should be appointed to oversee the investment and administration of the fund.

3. The 10% tax on early and final withdrawals on provident funds should be applied to all permissible withdrawals from the PPF as well. As in the provident funds, this tax should not be levied on the portion of accumulations retained in the IRA for purchasing an annuity at age 60, or invested in approved instruments under Section 54E.

4. The rate of return should be market determined and there should be no tax on it.

5. The limit on the tax-free annual contribution should be raised to RS.1, 20,000 less contribution from an employer, if any. This would make the PPF equitable with PF (which allows RS.60,000 tax-free contribution from the employee and a matching tax-free contribution from the employer. In fact, tax-free contribution from the employer could even be higher). This would remove discrimination in tax-treatment of self-employed persons vis-a-vis employed persons.

6. Branches of all commercial banks should be allowed to serve as PPF collection centres. A comprehensive publicity programme should be initiated to enhance awareness regarding the details and benefits of the revised scheme.

7. PPF should provide for an optional contribution for insurance against death and permanent disability.

8. A Public Pension Scheme (PPS) should be initiated under the Public Provident Fund. 10% of contributions to the PPF should be mandatorily earmarked for this new Public Pension Scheme with a minimum contribution of Rs.500 a year.

The first Rs.500 contribution to PPF every year will go towards the mandatory Public Pension Scheme. Those desirous of contributing higher percentages can contribute more. As in the case of the Employee Pension Scheme(EPS).the vesting period should be 10 years. Breaks in contribution should e permissible and lump-sum contributions in case of short-fall in the minimum contribution period, should be permitted. Those who are members of any other pension scheme, on submission of documentary evidence, may be exempted. The quantum of pension would be determined by the accumulation to the credit of the subscriber at the time of retirement, death or permanent disability.

Annuities

1. Presently, the function of accumulating wealth and selling annuities are both bundled into provident fund institutions.
2. Annuity provision will be more efficiently achieved by a market with competing annuity providers registered with the Insurance Regulatory Authority. The Government should work towards obtaining a thriving, competitive annuity market where private, public and foreign firms compete in selling the cheapest annuities to India's citizens.
3. At age 60, the worker would accumulate a stock of wealth. On the principle of avoiding double taxation, the part which is put into an annuity should be tax exempt. The remainder, subject to the exemption limit, should be taxed at a 10% rate. The annual income obtained from the annuity should be a part of taxable income.

National Senior Citizen's Fund

There is growing awareness and concern about the case of elderly persons in society. If at all, the problem appears to worsen in future if timely measures are not taken in present. This should be a concern of all. The government should take a lead in galvanizing all these efforts. Towards this end, it is proposed to set up a National Senior Citizen's Fund with a view to encouraging, catalyzing, and complimenting all private sector efforts for the betterment of life of senior citizens in the country. The Fund can also be utilised for educating individuals about various security schemes, conducting research into areas concerning senior citizens and building infrastructure relevant to the social security industry.

The present contribution of 1.16% by the Government of India to the Employees Pension Scheme should be channeled into this fund as initial corpus till this contribution is gradually withdrawn. A part of the withdrawal tax on provident funds may also be transferred to this fund annually. The fund should be monitored and administered by a Board of Trustees appointed by the Ministry of Social Justice and Empowerment.

[B] WORLD BANK RECOMMENDATIONS

World Bank had undertaken a study on India and Its Pension Sector. The title of the study paper was

INDIA

The Challenge of Old Age Income Security

Following is the executive summary extracted from the said report, which speaks about the current pension structure, its deficiencies and recommendation

Executive Summary

1. One eighth of the world's elderly population lives in India. The vast majority is not covered by a formal pension system. Relying instead on their own earnings and transfers, mostly from children. But informal systems are imperfect and increasingly strained. As the population ages, the challenge of providing old age income security mounts. This report is about reforms that can help India address this challenge.

2. The first step is to assess current public policy in this area. The starting point is a review of the main formal schemes sponsored by Government This includes the mandatory pension schemes that cover formal sector workers in the public and private sector as well as tax incentives that are designed to encourage retirement savings on a voluntary basis. It also includes public transfer schemes directed at the poor elderly that operate at both the state and national level. The analysis presented in this report is preliminary, but the findings underline serious deficiencies in these programs.

3. Having recognized many of these problems already, the Government of India has recently assigned a high priority to pen 'on reform. In fact, while this report was being drafted, several key initiatives were under way. An ambitious proposal for reform was submitted by an expert committee known as the Old Age Social and Income Security (OASIS) project under the guidance of the Ministry of Social Justice and Empowerment and is now to be implemented by the Insurance Regulatory Development Authority (IRDA). The 2001 budget includes a major reform of the civil service pension scheme. These steps signal the willingness to tackle the pension problem in India.

4. Pension reform is a complex undertaking, especially in the Indian context. This report contributes to the policy discussion that is unfolding by taking a holistic view to see how the seemingly separate elements of the system are actually interdependent. The report recognizes the current tendency, correct in our view, to undertake fundamental reforms, rather than making marginal changes to existing schemes. In this spirit, several systemic reform scenarios are illustrated and relevant international experiences are cited. Finally, the subtle but important interactions between pension reform and other parts of the economy are highlighted. Specifically, the report discusses the potential synergies between pension reform and reforms in the enterprise and financial sectors as well as emphasizing the need to provide a conducive environment for a new pension system, especially in the fiscal arena.

World Bank Report on

The Old Age Social and Income Security (OASIS) project.

The OASIS project is the most important recent pension reform initiative in India. While the primary goal of the initiative was to promote voluntary participation of the vast informal sector in a cost effective private pension system, the reform proposed by Dr. Surendra Dave and the team working under the auspices of the Ministry of Social Justice and Empowerment necessarily touched upon broader polity issues.

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A series of conferences and consultations led to the publication of the first OASIS report in 1998 and a subsequent report in January 2000. The commission consulted closely with relevant government agencies such as the Ministry of Labor, researchers, multilateral Institutions like the World Bank and the domestic firms involved in financial services and insurance. Their report has raised awareness of the failings of the existing system for old age income security and the need for reform.

The crux of the OASIS proposal is to establish a system based on privately managed, individual accounts with low costs and widespread accessibility. The new system. Would rely on a limited number of private asset managers each offering three investment portfolio options to individual savers. The three options would range from a more conservative portfolio with a greater weighting in government bonds, to a more aggressive equity-based portfolio. The managers would be selected through a competitive bidding process that used, among other things, a criterion of low administrative costs. Government would facilitate access to the system through a network of 'points of presence' (POPs) that would take advantage of the postal and banking systems throughout India and keep costs low. A new entity, the Indian Pensions Authority would be created and would select the asset managers.

While OASIS focused on extending coverage to new groups in the informal sector, the reports also included an important diagnosis of the problems with the mandatory schemes and proposed changes that would affect the EPF/EPS. These included:

- Encouraging larger accumulations and annuitization through tax incentives and limiting withdrawal options before retirement age. Also, allowing accumulation to continue after the normal retirement age and educating workers as to the need for long term savings.

- Increasing rates of return by (a) Liberalizing investment rules including allowance of 10 percent of new accretions to be invested in equity index funds (b) hiring professional asset managers for exempt funds and changing EPF governance structure (c) moving to market-based returns and eliminating the tax on returns higher than 12 percent.

- Increasing coverage by (a) removing industry type distinctions for mandatory membership (b) reducing the number of employees a firm must employ before being obliged to join the EPF from 20 to 10 (and eventually 5) and (c) eliminating the 5000 rupee per month ceiling on' covered earnings.

- Allowing private insurance firms to eventually participate in the provision of annuities promised by the scheme.

- Phasing out the government subsidy of 1.16 percent of the wage bill.

- Setting the minimum vesting period at 10 years and allowing for broken contribution history and lump sum contributions to the scheme for missed years.

OASIS also proposed similar reforms to the Public Provident Fund (PPF) to convert it into a modern, funded system of individual retirement accounts or IRAs.

Importantly, OASIS proposed allowing workers covered by the EPF Act voluntarily switch to the new, privately managed defined contribution scheme. Thus, the proposal provides a foundation for the eventual convergence of pension provision within a single framework and including a significant role for the private sector. The government role would concentrate on education, infrastructure (collection, record keeping, and accessibility) and supervision.

Aside from the reform proposal itself, the OASIS project was important for two reasons. First, it raised awareness regarding the need for reform at a critical juncture in the evolution of India's pension system. Second, for the first time, it framed the debate over pension reform in broad terms that brought together all elements of the system. This was, in fact, the first time that many of the government agencies connected to public policy in this area interacted. It brought together diverse

experts ranging from finance to social assistance. They have provided an important forum for discussion of pension policy, an area that requires a broad interdisciplinary approach.

[B] MULTI-PILLAR REFORMS: WORLD BANK (REFORMING THE FORMAL PENSION SYSTEM)

Multi Pillar Reform

Pension schemes across countries can be categorized into three pillars based on the need they address and the funding nature. Each of these pillars has some combination of the five features *(viz.*Voluntary vs. mandatory; savings vs. redistribution; DB, DC and NDC; funded vs. PAYG; and private vs. publicly managed)

The first pillar schemes, which are mandatory and redistributive, offer defined benefits that are largely financed on a PAYG (Pay As You Go) basis and are publicly managed.

Basic pension (Old Age Pension) - characterized by redistribution, PAYG, mandatory, defined benefit and collective risk - e.g. public pension plans.

The second pillar schemes or defined contribution schemes, in which contributions are placed in individual or group funds, could be managed either by private sector pension companies or by the public sector.

Compulsory Superannuation (Forced/contractual savings) - characterized by vertical equity (income smoothing), funding, mandatory, defined contribution and individual risk- e.g. occupational pension plans.

The third pillar schemes comprise voluntary personal pensions. The three pillars can be complementary to each other. While some countries avail of only one or two of the pillars, there are several advantages in adopting multi-pillar system.

Voluntary Superannuation (voluntary savings) - characterized by voluntary, income smoothing, funding and individual risk - ego Personal pension plans and additional contributions made by individuals to occupational scheme.

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The three pillars can be complementary to each other. While some countries avail of only one or two of the pillars (either Pillars I and III or Pillars II and III), there are several advantages of adopting multi pillar system. The pension reform and related developments during the nineties in both the developed and developing countries observed that, although there is a definite tendency towards schemes incorporating-funded component, State managed first pillar schemes augmented by contribution

related components would continue to stay.

Multi Pillar Reform is advantageous for the following reason:

Affordability of PAYG systems given population aging

Better rates of return through private sector investment

Need for increased savings to bolster economic growth

Need for capital market development

Need to reduce the impact of inefficient management

Pension Fund Regulatory and Development Authority (PFRDA)

Pension Fund Regulatory and Development Authority was established by the Government of India on 23rd August 2003 to promote old age income security by establishing ,developing and regulating pension funds, to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental thereto.

Composition of Authority

The Authority shall consist of a Chairperson and not more than five members, of whom at least three shall be whole-time members, to be appointed by the Central Government.

[C] PENSIONS AUTHORITY

An interim regulator, the Pension Fund Regulatory and Development Authority (PFRDA) was constituted through a Government resolution dated October10, 2003 as a precursor to a statutory regulator and became operational from January 1, 2004.

Till the architecture is fully in place, the Central Pension Accounting Office (CPAO) under the Controller General of Accounts is acting as the interim Central Record-Keeping Agency(CRA).Contributions are currently being credited into the public account earning a return equal to the GPF rate. As per data available, about 137,952 employees are covered under the NPS.

Approximately Rs.200 crore, including Government contribution, has been credited into the pension account. The Pension Fund Regulatory and Development Authority Bill,2005 was introduced in Parliament on March 21,2005.The Bill proposes that the main mandate of PFRDA is to regulate the NPS, as amended from time to time by the Central Government. Pension schemes already covered under the Employees'

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Provident Fund & Miscellaneous Provisions Act, 1952 and other enactments would be specifically excluded from the regulatory jurisdiction of PFRDA. However, individuals covered under such mandatory programmers under other Acts can voluntarily choose to additionally participate in the NPS.

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PFRDA will establish the institutional architecture of the NPS including the CRA and pension funds. It will also frame investment guidelines for pension funds.

PFRDA is empowered to impose stringent penalties for any violation of the law. The regulator will also create a special fund, which will be used for educating and protecting the interests of subscribers to schemes of pension funds. The Bill was referred to the Standing Committee on Finance. The Committee presented their report in Parliament on July 26, 2005 recommending:

i. Allowing withdrawal from Tier I account also;
ii. Specifying in clear terms in the Bill that one of the pension funds would be from the public sector;
iii. Giving preference in selection to such pension fund managers that gurantee returns and spelling out the pre-requisites relating to capital structure and experience criteria for selection of pension funds and other intermediaries in the Bill;
iv. Making available to subscribers an option of 100 per cent investment in Government securities and indicating this in the Bill;
v. Implementing any decision relating to permitting FDI in the pension sector only by way of suitable amendments in the legislation; and not allowing such decisions and decisions relating to deployment of pension funds outside the country to be at variance with related provisions applicable to the insurance sector;
vi. Setting up a Pension Advisory Committee similar to the Insurance Advisory Committee of IRDA;
vii. Rephrasing clause 4 of the Bill to clearly depict the composition of the Authority; selecting members of the Authority only from amongst professionals having experience in economics or finance or law; and having a Central Government nominee as one of the part-time members;
Including the differentiation between Tier-I and Tier II accounts as a part of the basic or essential features of the New Pension System in clause 20 of the Bill; and
viii. Bringing forward a comprehensive legislation in order to cater to the social security of the unorganized sector, inclusive of pension coverage of the workforce, simultaneously with the setting up of PFRDA as a statutory body.

[B] THE CHILEAN MODEL

The Chilean pension system has been a role model for the countries of the world after its successful implementation. World Bank has been an avid advocator of Chilean Model for other countries. The pension reforms in Chile (called as Chilean Model) have attracted other countries attention.

The model was successful in

a. Transferring from a pay-as-you-go system to one based on individual capitalization, which is sustainable in time and consistent with the rapid, irreversible aging process in the population.

b. Generating positive performance of the pension funds' yield during more than two decades of operation of the reforms.

c. Reducing the contribution rates, which were reduced to half than the level, it used to be, which. Resulted in increase in the net salary and productivity of the workforce.

d. Making significant impact of the pension funds on the development of the Chilean capital market and on the country's levels of savings, investment and growth.

The Chilean pension system is based

a. On the capitalization of social security savings in individual accounts,
b. On professional management of the resources by private Pension Fund Administrators devoted exclusively to that end,
c. On individual ownership of the contributions, and
d. On a system whereby the processes of collection, investment and payment are strictly regulated and supervised.

The principles outlined above have been included in social security reforms passed in dozens of countries in the past two decades and have given rise to what is increasingly known as the “Chilean model" of social security in pensions.

The Change in 1981

During the late 1970s, it was clear that the pay-as-you-go system had to be reformed. The military government finally decided to switch to a totally new system. The opposition to abolishing the old system was not strong because 93 percent of the pensioners could receive only the **minimum** benefits set by the government. The new system to be introduced was the *Administradora de Fondos de Pensiones* (AFP), or Privately Managed Pension Fund. Finally the Chilean mode was introduced in the year 198.

The Main Aspect of the model:

Chile's legislative Decree No. 3500 of November 1980 established the AFP, which became operative in May of the following year.

a. Participants in an AFP are required to pay 10 percent of their earnings into a privately managed pension fund.
b. An additional contribution from the employee is needed for providing the disability and survivors' benefits.
c. The contribution is invested by AFP on behalf of the participants. Old age benefits depend on the amount accumulated in his account plus interests accrued. Money in the AFP is both portable and transparent. Workers can move freely from one AFP to another. They can find out at any time the current valuation of their account and the commission charges.
d. The private sector AFPs are regulated by the *Superintendencia de Administradoras de Fondos Pensiones* (SAFP), which is a state organization.
e. According to current regulations, workers who have a reasonable history of contributions are guaranteed a minimum pension when they reach the age of 65 for men and 60 for women.

f. In case a worker's accumulated fund in the AFP is not big enough for this minimum, the State will make up the difference.

g. To prevent the State from being struck by the shortfall, the AFPs are required to generate for each month a return averaged to market based on a formula

Achievement of the Chilean Model

a. Total funds accumulated in the individual accounts have been growing at an average rate of 40 percent per year.

b. By July 1994, the total stock was USD 22.3 billion, or 43 percent of the GDP. It has also become a major source of private savings.

c. By July 1994, it accounted for 35 percent of national savings (World Bank, 1996,).

d. By September 1993, 93.4 percent of the workforce, or 4,553,988 people, were already members of the AFPs (International Labor Office, 1994).

The attractiveness of the Chilean system has probably been due mainly to the high rate of returns.

Rate of Return for Chilean Pension Funds

	Year	**ROR** (%)	Year	ROR%
h.	1981	12.5	1982	26.8
i.	1983	22.7	1984	2.8
j.	1985	13.4	1986	12.0
k.	1987	6.4	1988	4.7
l.	1989	6.6	1990	17.6
m.	1991	28.6	1992	4.0
n.	1993	16.7	1994	17.8
o.	Average	14.0		

Source: World Bank (1997, p. 80)

Real Rate of Return for Private Pension Funds in Several Countries (1970-90)0

Country	**ROR** (%)
Canada	2.2
Denmark	4.1
Germany	5.1
Japan	4.4
Netherlands	4.2
Switzerland	1.2
UK	6.1
USA	3.3
Average	**3.8**

The success of Chile's pension reform has made it a role model for many other countries to follow.

There seem to be several factors accounting for the success.

a. Large pool of pension funds were created with small contributions from private savings, which can take advantage of other investment opportunities, which otherwise were not available to individuals. Appointment of AFP opened new investment opportunities, which were previously not available to small investors. A number of investment strategies, such as hedging for currency risks, diversification and taking advantage of economy of scale, are now possible.

b. The pension reforms were complimented by the economic reform in Chile. In particular, economic efficiency appears to have been significantly enhanced since the reform started.

c. The PAYG system was obviously in trouble before the introduction of the AFP. The large implicit debt of the former and the falling support ratio made it less certain that people could get the expected pension benefits after retirement. A change was called for

d. The system was able to provide good insulation against political risks, such as the pressure to use it as a means for income redistribution, or as a source to fund government budget deficits.

e. The Chilean government was able to resolve one of the most difficult problems of the reform, i.e., financing the compensations to those who had already paid taxes for the PAYG system.

[D] THE ROLE OF STATE DEVELOPMENTAL STATE (EAST ASIA), WELFARE STATE (EUROPE AND NORTH AMERICA), MINIMALIST STATE (EUROPE AND NORTH AMERICA)

The Role of the State

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Europe & North America

The social protection systems in Euromerica were similarly remarkable by the standards of their time but not worth emulating for developing countries today. With acceleration of pace of industrialization and urbanization in the Western Europe during 18th and 19th century, there were several efforts to enact "poor laws" to provide for help to the destitute in terms of food, health, and housing. However the organized efforts for state provision for broad-based welfare can be said to have originated with

Bismarck in Germany who in 1883 introduced the first old age, invalidity and work injury schemes.The Bismarckian social security system was characterised by compulsory, individual provision based on the principle of mutual aid. This form of insurance was born by the bodies established under public law which were self-administered and were built around the provision of statutorily fixed entitlements of individuals in employment. These entitlements were calculated in relation to the contribution paid. In modern language, the Bismarmarckian system was one of "defined contribution" rather than "defined benefit".

Japan. For nearly two decades after the Second World War, the Japanese public policy was characterised by emphasis on high growth and restraint on social expenditures by the government. A balanced budget policy kept the government slims and controlled inflation. Tax policy distributed the benefits of high economic growth to tax payers through tax cuts which also allowed a higher rate of private expenditures on health and education services. Social expenditures by the government were kept low with the local governments playing a more important role in delivering basic social in a relatively equitable fashion.

By the early seventies however, the euphoria of rapid growth was beginning to affect public policy on social welfare in Japan. In response to the public mood, Euromerican style of welfare state was gradually introduced for old age security. Public pension system was modest in coverage and benefits until the early 1970s. But after 1973,the fiscal burden of the pension system grew rapidly for three reasons: (a) coverage and benefits were expanded substantially in response to rising political demands for public provision of social security; (b) the growth rate of the economy slowed down substantially in response to oil shocks in the 1970s; and © an accelerating demographic transition created a larger cohort of ageing dependants relative to workers. As in most Euromerican countries, Japan now faces the problem of an insolvent public pension system unless the pension contribution rates are increased dramatically.

Singapore. Singapore has been able to simultaneously achieve economic and social progress. This can be attributed to the policies and paternalistic attitude of the government. Though the main focus of government policy has been to promote economic growth, generous social subsidies have also been given in the past. Mainly, in the areas of education, and health. However, to avoid excess demand created by the free rider by the free rider problem, the government aims to reduce these subsidies. This policy is reflected in the words of Mr. Rajaratnam, former Senior Minister: " We want to teach the people that the government is not a rich uncle. You get what you pay for. We want to reduce welfare the minimum, restrict it only to those who are handicapped or old. To the others, we offer equal opportunities."

Hence, Singapore's welfare policies concentrate on providing basic services to the needy so as to not dampen general work incentives. Welfare expenditure is limited to the aged, disabled, single mothers and orphans. As a consequence of individuals being largely left to themselves to fulfil their social security needs, public expenditure on welfare services in Singapore is low relative to high-income countries. Singapore has not moved towards becoming a welfare state, as has Japan, even though they both share a similar level of development. It has thus been able to avoid some of the problems experienced by the Japanese social security and welfare system.

China. In the euphoria of communist victory, a nationally unified social welfare system covering pension, health and housing was introduced in China in the 1950s for urban workers. This system fell apart during "Cultural Revolution" and the social welfare responsibilities were assumed by individual enterprises. This enterprise based welfare system naturally proved a major impediment to labour mobility and enterprise reform during the 1980s and for the last ten years various experiments are being conducted in various localities to design a more viable system which meets the needs of a market economy but also has some elements of social protection for all urban workers. During this period, the Chinese authorities have studied extensively the systems of pensions and healthcare in various developed and developing countries and conducted various experiments in China to design a system that learns from others' experiences but is grounded in the realities of China.

After years of study and experimentation, the Chinese authorities issued in July, 1997 a policy statement on the new pension system for urban enterprise workers in China. The system is to be implemented over the next two years and many refinements will be needed as implementation proceeds. However the basic design is in place and it has many laudable features.

Lessons from Euromerica and East Asia

Before trying to draw lessons of experience, it is worthwhile to consider the nature of "lessons" that one country can learn from other countries' experiences. Every nation, like every individual, is placed In a unique situation and it has to design policies that are congruent with its social, political, economic circumstances. Thus, it is generally not possible to get ready-made models and replicate them elsewhere. Even within one country, it has been found that a strategy that worked at one time in one locality did not work at other times in other localities. There are, therefore, no "magic bullets" to be transferred from Euromerica or East Asia to other countries in the field of social security as in other areas.

While it is not possible to get mechanically replaceable models, it is not appropriate to be nihilistic and assert that everything ids situation dependent and there is nothing one can learn from others. Instead, it is worth looking for and gets "insights" about policies from the experiences of other countries. In this connection, it is useful to note the Chinese approach .on learning from other countries. The phrase "policy insight" is often used by the Chinese officials in their discussions of learning from other countries' experiences and it has the advantage of suggesting a subtle qualitative rather than-a mechanical approach in looking for lessons. In general, the Chinese policy makers study experiences in other countries but do not try to replicate them. Their approach is one of trying to get insights from experiences of various countries and then conduct

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experiments in particular localities to see how a proposed set of policy reforms will work. The Chinese also put a lot of emphasis on consensus building before launching nation-wide reform programmes. It is in the light of such an approach of learning from others that we present below some thoughts on what other countries can learn from Euromerican and East Asian experiences. In our judgment these are broad lessons to be useful in most circumstances.

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Exercise Ch 12

1. This report has been the center of all pension reforms and activity in the country.

A. Project Report
B. Old age report
C. OASIS Report
D. Water Report

2. OASIS stands for________

A. Old age social and income security
B. Over age security for individuals in society
C. Old age security for individuals in society
D. Over age social and income security

3. In India the pension reforms will have to be accompanied by changes in the ______.

A. Company Laws
B. Income tax laws
C. Foreign Exchange Laws
D. None of the above

4. In the growth scheme under the OASIS plan more than 50% of the investment will be in:

A. Equities
B. Debt
C. International Equity
D. 1
E. None of the above

5. In the balanced scheme under the OASIS plan more than 50% of the investment will be in:

A. Equities
B. Debt
C. International Equity
D. None of the above

6. The reforms in the pension sector will lead to funds being managed by________

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A. Mutual fund Managers

B. Pension Fund Managers

C. Portfolio Managers

D. Insurance Fund Managers

7. The OASIS report talks of opening an account for the individual called_______

A. Investment Account

B. Individual Retirement Account

C. Individual Account

D. Retirement Account

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