Pensions - Is the time bomb ticking away?

“Will there be enough to live on when I retire?” Increasingly, this question of old age financial security is being asked across the world. To quote Leon Trotsky, old age is the most unexpected of all things to happen to man. India is no exception in living upto this home truth.

The OASIS report of 1999 draws heavily upon the World Bank’s recommended multi-pillar system to provide for old age financial security. The three pillars are:

1. A mandatory, publicly managed, tax-financed pillar for social insurance
2. A mandatory, privately managed, fully funded pillar for old age savings
3. A voluntary pillar for those who want more protection in their old age

The **first** pillar resembles public pension plans, providing a social security net for the old and poor, particularly for those whose lifetime income was low or who cannot afford to pay for building a reasonable retirement income. These are based on the principles of social insurance and are wholly financed by the state either out of general tax revenue or by some kind of special tax or cess. The United States, for example, levies a social security tax on all working people to finance this pillar.

The **second** pillar requires that people save mandatorily for old age and benefits are actuarially linked to contributions. It should preferably be privately managed, fully funded, and managed competitively.

The **third** pillar, voluntary savings and annuities, is meant to provide supplemental retirement income for people who want more generous old age pensions. The World Bank suggests that the first pillar providing basic security needs must be publicly managed, and only the second and third pillars are to be privately managed.

Multi-pillar system in India

In India, the first pillar is almost non-existent. The government does have some poverty alleviation programmes but they are too insignificant as compared to the country’s needs and their implementation is mostly political in nature.
Some mistakenly believe that pensions paid by the government to its employees constitute the first pillar since they are paid on ‘pay as you go’ basis (PAYG) from current tax revenue. Pension to civil servants are more akin to deferred wages paid by the employer and according to the World Bank’s guidelines should be included in the second pillar of the multipillar pension system.

The second pillar is found mostly in the organised sector and is in the form of employment-linked schemes. Against a working class population of 400 million, only 35 million have access to a pension system. Of these 35 million, 11 million are in civil service (central and state governments) and 24 million are members of various employees’ provident fund and pension schemes”. - *Ramesh Gupta of IIM – Pension Reforms in India: Myth, Reality & Policy Choices.*

The third pillar, that is voluntary contribution for extra protection is found in a wafer thin segment of the population. This is that class of society that has surplus funds at their disposal—and there are no prizes for estimating the number of such people.

Global Update on Pension Norms

a) Developments in the USA

A December 2005 study of 85 big public pensions in all 50 states in the USA covering three-fourths of public employees nationwide -- found that governments continued to enhance benefit formulas, ease early retirement and improve other benefits from 2000 through 2004 despite states' financial problems. The increases were enacted on top of even larger benefit changes approved from 1996 to 2000. The study, conducted by the Wisconsin Legislature, is one of the most comprehensive on the issue.

The New Jersey Legislature has approved 17 benefit enhancements since 2000 that increased the unfunded obligations of public pensions in the state by $6.8 billion, according to a task force studying the issue.

Average annual benefits for retired state and local workers grew 37% to $19,875 from 2000 to 2004, the most recent data available, according to the Census Bureau. The rising payments reflect the early retirement of baby boomers, who started to qualify for full benefits in 2001, at age 55, under most government pensions.

"These pensions are unaffordable," says Alaska state Rep. Bert Stedman, a Republican. "If we don't act now, we're going to have social conflict in the future between the haves and the have-nots -- those with government pensions and those without."

b) The European Pensions and Savings Revolution

The rapid ageing of the European population over the next 30 years will, other things being equal, reduce the size of labour force and so decrease trend economic growth rates and put severe strain on existing pay-as-you-go (PAYGO) state pension schemes;

These strains will be particularly severe in countries such as Germany and Italy where state pensions are relatively high as compared to average earnings at present and where previous pension reforms, in contrast to the UK, have not fully defused the potential impact of the demographic time bomb on the public finances; pressure from global capital markets and the EMU Stability Pact to keep budget deficits low will also require governments to make state pension schemes more affordable in these countries;

Despite political opposition from interest groups, future pension reform efforts in these countries are likely to result in less generous state pension schemes paid from a later statutory retirement age; this will lead to an increasing demand for private pension provision, like in the USA, whether from employers or by individuals purchasing pensions and other long term savings products from financial services providers.

Existing Pension Mechanisms in India and their analysis

In India, we do not have a comprehensive population-wide old age income security system. The vast majority continues to rely on support from their children as the main means of obtaining consumption in old age. This is rapidly changing due to breakdown of the joint family system.

There is the civil servants' defined benefit pension (TCSP)– which covers roughly 2.7 million workers – and the 'organised sector' system run the Employees Provident Fund Organisation (EPFO) – which covers roughly 15 million workers. In a population of over 1 billion and having a work force of over 400 million including agricultural workers, this is abysmally low.

Traditional civil servants pension (TCSP)

The 'traditional civil servants pension' is the pension program that existed for employees of the central government who were recruited prior to 1/1/2004. The TCSP is a pay-as-you-go defined benefit pension. It is an integral part of the employment contact for government employees. There is a minimum requirement of 10 years of service before a worker is entitled to this pension. There is no attempt at having contributions or building up pension assets, i.e., it is unfunded. The benefit promised by the TCSP is a pension which is roughly half of the wage level of the last ten months of employment.

The TCSP is indexed to *wages.* There is a 'one rank, one wage' principle, whereby all retired persons of a certain rank get the same pension. Through this, pension payments are steadily revised to reflect the growth in wages. Hence, the growth in pension benefits in old age is typically higher than inflation. The government can only meet the increasing cost of such pension with a growing population at the cost of the rest of the population.

In management of this scheme, the core issue has been that of fiscal imbalance. The pension payout of the centre and states has risen at a compound average annual growth rate of 18% over the period 1990-2004. The TCSP was designed with an assumption where most workers who retired at 60 would be dead by 70. In recent times, employees have mortality indices comparable to those of OECD countries. All these have made the base assumptions inappropriate leading to fiscal imbalance.

EPFO (Employees Provident Fund Organisation)

"The EPFO runs two main schemes, the 'employee provident fund' (EPF) and the 'employee pension scheme' (EPS). Both schemes are mandatory for workers earning below Rs. 6,500 a month, in establishments with over 20 workers in 177 defined industries. As of 31/3/2003, there were 344,508 such establishments. EPFO data show the presence of 39.5 million members. However, many of these are dormant accounts, which come about through administrative difficulties in shifting an account from one employer to another. Independent estimates, based on the *Indian Retirement Earnings and Savings* (IRES) database, suggest that there are roughly 15 million workers in late 2004". *– A Sustainable and Scalable Approach in Indian Pension Reform by Ajay Shah.*

The Leftist parties and trade unions primarily look after the interests of such a small population. The balance population including those "below the poverty line" would end up funding this cost. Moreover, during every corporatisation or getting government employees to join public sector, for example, employees of DoT joining BSNL or MTNL, the government normally buys peace with the trade unions by guaranteeing the pension payments from the government treasury. This creates a huge snowball effect as retirement costs of employees get increased as normally ex-gratia is given to sweeten the change over together with an increase in DA. Public sector gets their DA linked with the industrial indices while government employees get a consumer indices linked DA . The snowball is as a result of these increases of pension payouts from the date the employee joined the government, which in such cases would be a substantial number of years calculated at current pay after these revisions. In MTNL, the retirement benefit costs for about 40,000 employees was Rs. 270 crores and in the year 2001, they asked for Rs. 1,100 crores from the government to cover the payments. BSNL, which is much bigger than MTNL has not been able to quantify such liabilities yet. The government in power rarely analyses all costs before such commitments are made.

The EPFO has **several shortcomings** which undermine its service provision, financial soundness, and hence effectiveness as a pension mechanism:

1. The existing rules governing EPF do not cater to matching of pension wealth over the work life span. If the accumulated EPF balance at retirement were used to buy an annuity, it yields a pension which is 9% of per capita GDP. This is way beyond the current accumulations at about 2.4% of GDP.

2. In the case of EPS, concerns have been expressed about the funding status. The 10-year interest rate fell dramatically from 13.4% on 1/1/1997 to 5.1% on 18/10/2003, and some modest improvements in mortality took place over this period. However, there was no change in either the contribution rate or the benefit rate for EPS. This suggests that EPS was either overfunded in 1998 or underfunded in 2003. While the law requires that an actuarial report should be produced every year, no such recent reports have been released into the public domain.

3. There are difficulties of implementation and administration with EPFO's programs that were established in the 1950s. The issues are not integrated with the transformation in technology and knowledge about pension policies and processes. There are weaknesses in the mechanisms of funds management, transparency and governance. Even if a participant does not exploit windows of opportunity to withdraw assets, the fund management of the EPFO yields low rates of return.

4. The lack of use of IT in dealing with databases relating to employee information from the entire country has led to difficulties in reconciliation. More importantly, the valuation framework used is one where all bonds are valued at cost, regardless of market price.

Accounting for Change in Pension Regulations

Current global pension accountings standards are fairly incomprehensible—and India is no different. Most readers of accounts probably do not get beyond the number for the deficit. You would need a highly skilled actuary and accountant sitting next to you to understand the rest of it.

So how did we get here? It started with a view that assets and liabilities should be measured at their market value. The difference is either a surplus or a deficit and under international rules, this number initially goes on the balance sheet. So far so good.
It became complicated when the accounting standard setters in the international arena realised the annual change in the surplus or deficit could be huge. For some companies

this number would swamp all the other numbers appearing in the profit and loss (P&L) account. The instinctive reaction was that such huge numbers don't look good so the accounting standard setters decided companies could either ignore most of this impact or put it somewhere less high profile than the income statement.

But the economic reality is that pension funds are often a huge risk so the reflecting numbers must necessarily be huge. Where else can you get away with financing highly leveraged debt with mostly equity investments and then not reflect the impact in the income statement? Some companies are only waking up to this now. By virtue of their pension liabilities, many of Britain's largest and most famous companies have the risk profile of an insurance company and not a widget maker.

Firstly the standards should mandate that pension fund assets are treated as if they were investments and accounted for as such separately from the liabilities. Some would consider this heresy as most pension funds control their assets through independent trusts. The reality is the performance of pension fund assets directly impacts contributions and hence shareholder value. This approach ends the idea of creating profits from the expected return on equities, an unusual concept with quite bizarre outcomes – some entities show their entire profits from this source.

Secondly, pension liabilities should be accounted like any other liability of the company and reflected in full on the balance sheet. Entities do not have a liability for future pay rises so these should be excluded. Discounting at a high quality bond rate seems a reasonable compromise for dealing with the complex risk profile of pensions. Annual movements in other liabilities whether they come from changes in estimates or otherwise are normally reflected as income.

Government of India accounts for its pension and EPFO obligations on cash basis and hence no projected obligations and payment liabilities over the workers' life get accounted for. It would be next to impossible without a comprehensive system of information warehouse to determine the total payment obligation of the government over a period of time.

In the light of commitments made by successive governments relating to enhanced pensions of government employees by raising their pay and DA or their refusal to align rates of interest of provident fund to markets, pensions will simply become unaffordable as our young population ages. In Europe and USA this is already beginning to show up and pension cut back by government is a reality. We need to wake up to the truth that unless reforms in retirement benefits are swift and rapid, we will drive the meager social security system in India into an era of insecurity for our aged.

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