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NATIONAL PENSION SYSTEM (NPS)

"A generous basic state pension is the least a civilized society should offer those who have worked hard and saved through their whole lives."

The Government had introduced the National Pension System (NPS) from 1st January, 2004 for new entrants to Central Government service, except for the Armed Forces. This Defined Contribution scheme was then opened to all citizens from 1st May, 2009 on a voluntary basis. The Government constituted an interim regulator, the Pension Fund Regulatory and Development Authority (PFRDA) through a Government Resolution as the precursor to the statutory regulator. The NPS architecture consists of, the National Securities Depository Limited acting as a **Central Recordkeeping and Accounting Agency (CRA)** for maintaining the data and records, **Pension Fund Managers (PFMs)** for generating and maximizing returns on investments of subscribers, Stock Holding Corporation of India Limited functions as a **Custodian** to take care of the assets purchased by the Fund managers, Axis Bank functions as **Trustee Bank**, responsible for the day-to-day flow of funds and banking facilities in accordance with the guidelines/ directions issued by the Authority under NPS, the **NPS Trust** which is entrusted with safeguarding subscribers interests, **Point of Presence (POP)** as the first point of interaction between the subscriber, **Aggregator** as a primary point of interaction between the subscriber and the NPS - Swavalamban architecture and **Annuity Service Providers (ASPs)** who are IRDA licensed and are empanelled by PFRDA for servicing the annuity requirements of the NPS subscribers.

Features

- The NPS account Permanent Retirement Account Number (PRAN) remains the same irrespective of change of employment or geography.
- NPS is comparatively advanced in the technology it uses. On joining NPS, each Subscriber gets log in ID and Password of NSDL system for accessing NPS details online.
- It offers a choice of Service Providers, Funds, Investment Options, Pension Fund Managers, Annuity Service Provides and Annuity Plans to Subscribers.
- It offers Subscribers freedom to switch the Service Providers, Fund, Investment Option and Pension Fund Manager.
- Amount and frequency of contribution can be changed as per the Subscriber requirement.
- NPS is regulated by PFRDA, with transparent investment norms and regular monitoring and performance review of fund managers by NPS Trust.
- Efficient grievance management through CRA / PFRDA Website, Call Centre, Email or Postal Mail.
- Investment Portfolio under each asset class can be viewed on respective Pension Fund Manager's website.
- NPS as a product, has very low cost.

Accounts

Under NPS there are two types of accounts available to the subscribers viz. Tier-I, where contribution will serve saving for retirement in a non-withdrawable account and are subject to tax benefit and a Tier-II account which is a voluntary saving account that allows withdrawal where tax benefits are not applicable. In case of a Corporate Model, the account charges can be borne either by the Corporate or Subscriber, at the discretion of the Corporate. Tier-II account can be activated along with the Tier-I account or at a later date.

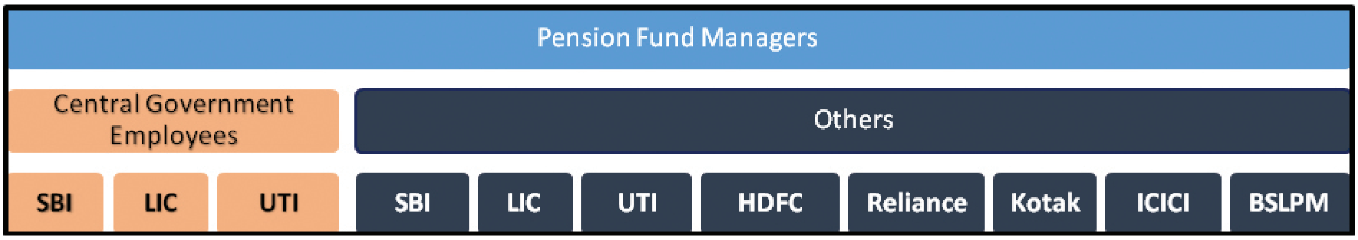
Models

Government Sector

NPS is mandatory to all new recruits in Central Government, State Government, Central Autonomous Bodies (CABs) and State Autonomous Bodies (SABs) from 1st January 2004 (except the armed forces). The monthly contribution under this model is 10% of the Basic Salary and Dearness Allowance (DA) which is to be paid by the employee and the same amount is contributed by the Government also. The contributions and investments are deposited in the non-withdrawal Tier-I account of PRAN. In the default scheme for Tier-I account, the contribution is allocated to three PFMs, viz. SBI Pension Funds Private Limited (SBI), UTI Retirement Solutions Limited (UTI) and LIC Pension Fund Limited (LIC) in a predefined proportion. Each of the PFMs invest the funds in accordance with the prevailing investment guidelines. In Tier-II, the only difference is that the subscriber can select any one of the existing PFMs and the ratio in which his/ her money can be invested in one or more asset class viz. Equity, Corporate Debt and Government Bonds.

Corporate and All Citizen

The NPS Corporate Model allows three variations of contributions, viz. equal contributions by employer and



Birla Sun Life Pension Management Limited (BSLPM) is yet to commence its business based on last update as on 14-07-2015. Source – PFRDA employee, unequal contributions by the employer and employee or the employee contribution from either the employer or the employee. Particulars of the available NPS accounts are given below:

Particulars	Tier-I	Tier-II
Option of selection of the Account	Manda-tory	Optional
Withdrawal Facility	No	Yes
Minimum Contribution at the time of account opening	INR 500	INR 1000
Minimum amount for Subsequent Contribution	INR 500	INR 250
Minimum Contribution Required per year	INR 6000	INR 2000*
Minimum Number of Contribution per year	1	1
Frequency of Contribution Permitted	Unlimited	Unlimited

**Total Corpus of INR 2000 is required at the end of Financial Year*

NPS-Lite (Swavalamban)

In the Union Budget 2010-11, the Government of India introduced a temporary subsidy, the Swavalamban benefit as an incentive to unorganised sector for providing the retirement benefit such that the Govt. of India will contribute INR 1,000 per year to every Swavalamban account, provided that the contribution is between INR 1,000 to INR 12,000 per year.

Atal Pension Yojana (APY)

A new initiative called Atal Pension Yojana (APY) is announced in Union Budget for 2015-16. The APY focussed all citizens in the unorganised sector, who join the National Pension System (NPS) administered by the Pension Fund Regulatory and Development Authority (PFRDA) and who are not members of any statutory social security scheme. Under the APY, the subscribers would receive the fixed pension of INR 1000 – 5000 per month, at the age of 60 years, depending on their contributions, which itself would vary on the age of joining the APY. The minimum age of joining APY is 18 years and maximum age is 40 years. Therefore, minimum period of contribution by the subscriber under APY would be 20 years or more. The benefit of fixed pension would be guaranteed by the Government. The Central Government would also co-contribute 50.00% of the subscriber's contribution or INR 1000 per annum, whichever is lower, to each eligible subscriber account, for a period of 5 years, i.e., from 2015-16 to 2019-20, who join the NPS before 31st December, 2015 and who are not income tax payers. The APY would be launched from 1st June, 2015. The existing subscribers of Swavalamban Scheme would be automatically migrated to APY, unless they opt out. All Points of Presence (Service Providers) and Aggregators under Swavalamban Scheme would enrol subscribers through the architecture of the National Pension System.

Investment Choice & Guidelines

In addition to the option that a subscriber has with reference to choosing their PFMs out of available 8 PFMs (including BSLPM) in order to manage their fund, they are also eligible to choose amongst the two approaches with respect to investment choices in order to invest their money. The two approaches to invest subscriber's money are as follow:

A) Active choice - Individual Funds (Asset Class E, Asset Class C, and Asset Class G)

Subscriber will have the option to actively decide as to how his/her NPS pension wealth is to be invested in the following three options:

Asset Class E - Investments in predominantly equity market instruments.

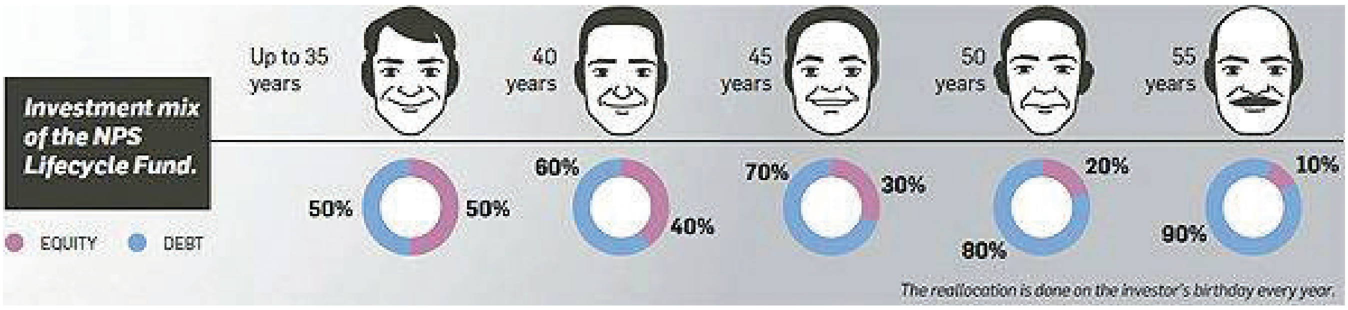
Asset Class C - Investments in fixed income instruments other than Government securities.

Asset Class G - Investments in Government securities.

Subscriber can choose to invest his/her entire pension wealth in C or G asset classes and up to a maximum of 50.00% in equity (Asset class E) or can also distribute his/her pension wealth across E, C and G asset classes, subject to such conditions as may be prescribed by PFRDA.

B) Auto choice - Lifecycle Fund

In case subscribers are unable/unwilling to exercise any choice as regards asset allocation, their funds will be invested in accordance with the Auto Choice option. Under this option, if the subscribers age is upto 35 years then, 50.00% of contributions and thereby accumulation will be allocated to asset class, "Equity", 30.00% of contributions and thereby accumulation will be allocated to asset class, "Corporate-Debt" and 20.00% of contributions and thereby accumulation will be allocated to asset class, "Government-Debt". At each birthdate of the subscriber, the Equity allocation will reduce by 2%, Corporate will reduce by 1% and after reducing the contribution to asset classes Equity & Corporate-Debt, a remainder will be allocated to asset class Government at each subsequent years. The allocated proportion to asset classes Equity, Corporate & Government at the age of 55 years and thereafter will remain constant, that is 10%, 10% and 80% respectively as illustrated below.



Asset Allocation under Auto Choice – Lifecycle Fund

**Applicable to Scheme CG, Scheme SG, Corporate CG, NPS-Lite Schemes and Atal Pension Yojana (w.e.f. 10th June 2015). Reference: - Circular, PFRDA/2015/16/PFM/7, dated 03-06-2015.*

Schemes

Government Sector	Private Sector
Central Government (CG)	❖ Scheme E (Tier I & Tier II)
Scheme State Government (SG)	❖ Scheme C (Tier I & Tier II)
	❖ Scheme G (Tier I & Tier II)
	❖ NPS-Lite*
	❖ Corporate-CG Scheme**

**Follows investment rules as applicable in case of Government employees.*

***Corporate CG Scheme has been discontinued for new enrolment w.e.f. 12th February 2013.*

Schemes Returns

The weighted average returns (since inception) of NPS Schemes are tabulated below.

Name of Scheme	Compound Annual Growth Rate (since inception) in %
Central Government (CG) (w.e.f. April 01, 2008)	9.10
State Government (SG) (w.e.f June 25, 2009)	8.59
Equity (E) (w.e.f. May 1, 2009)	9.20
Corporate (C) (w.e.f. May 1, 2009)	10.53
Government (G) (w.e.f. May 1, 2009)	7.93

The above returns are calculated based on scheme NAVs and the securities held under the schemes portfolio are valued on Mark-to-Market (MTM) basis. Source: - PFRDA Annual Report 2013-14

Exit/Withdrawal

(a) Exit from NPS upon attaining the age of Normal Superannuation (for govt. employees only) or upon attaining the age of 60 years (for all subscribers other than govt. employees): At least 40.00% of the accumulated pension wealth of the subscriber needs to be mandatorily utilized for purchase of an annuity providing for the monthly pension of the subscriber and the balance is paid as a lump sum payment to the subscriber.

(b) Exit from NPS before attaining the age of Normal Superannuation (for govt. employees only) or before attaining the age of 60 years (for all subscribers other than govt. employees): At least 80.00% of the accumulated pension wealth of the subscriber needs to be utilized for purchase of an annuity providing for the monthly pension of the subscriber and the balance is paid as a lump sum payment to the subscriber.

(c) Upon Death of a subscriber: The entire accumulated pension wealth 100.00% would be paid to the nominee / legal heir of the subscriber.

(d) For withdrawals arising out of NPS-Swavalamban accounts under (a) & (b) above, there is an overriding condition on the lump sum payment payable due to which the entire accumulated pension wealth would be annuitised in case if the monthly pension obtained by using the 40.00% / 80.00% of the pension wealth is below INR 1000/- per month.

Annuities and Annuity Providers

The subscriber has to mandatorily buy the annuity as specified in the exit rules of NPS. Annuity Service Providers (ASPs) are IRDA licensed and regulated Life Insurance companies, transacting annuity business in India and who are empanelled by PFRDA. Currently there are 7 types of annuities available with the 7 ASPs, viz. Life Insurance Corporation of India, SBI Life Insurance Co. Limited, ICICI Prudential Life Insurance Co. Limited, HDFC Standard Life Insurance Co. Limited, Bajaj Allianz Life Insurance Co. Limited, Reliance Life Insurance Co. Limited and Star Union Dai-ichi Life Insurance Co. Limited.

Default ASP is Life Insurance Corporation of India and the default annuity scheme is for life with a provision of 100.00% of annuity payable to spouse during his/her life on death of annuitant. Payment of annuity ceases once the annuitant and the spouse die or after death of the annuitant if the spouse deceased before the annuitant, without any return of purchase price.

Performance

How NPS Funds Have Performed

Pension fund manager	1-yr returns (%) Equity funds	1-yr returns (%) Corp debt funds	3-yr returns (%) Equity funds	3-yr returns (%) Corp debt funds	5-yr returns (%) Equity funds	5-yr returns (%) Corp debt funds
HDFC Pension Fund	24.28	14.98	-	-	-	-
LIC Pension Fund	22.7	15.07	-	-	-	-
SBI Pension Fund	24.15	15.12	18.73	11.45	10.47	11.54
ICICI Prudential Pension Fund	24.36	16.2	19.16	12.06	11.48	11.35
Kotak Pension Fund	24.14	14.93	18.57	11.65	11.03	11.23
UTI Retirement Solutions	24.54	14.35	18.66	11.09	9.93	10.6
Reliance Capital Pension Fund	24.1	14.85	18.33	11.79	10.05	10.28
Average	24.04	15.07	18.69	11.61	10.59	11.00

3-year and 5-year returns are annualised
Data on government bond plans not included
Source: Value Research Data as on 28 April, 2015

The equity funds of NPS strike an average return of 10.60% in the past five years, corporate debt funds delivered 11.00%. The third NPS category of gilt funds yielded average returns of 9.80% over the same period. The only exception is the ICICI Prudential Pension Fund that's part of the NPS, where the equity fund has consistently done better than the corporate bond and gilt funds.

Historically, it has been proven that equities are able to generate much better returns. Also retirement planning is a very long-term process, which necessitates having a healthy equity exposure. It can be observed that since its inception in May 2009, the equity plans of the NPS have outperformed the other two fund options. The underperformance of equity plans was probably a result of higher stock market volatility during the past five years. Even though corporate bonds will continue to perform well, they may not always beat the equity plans.

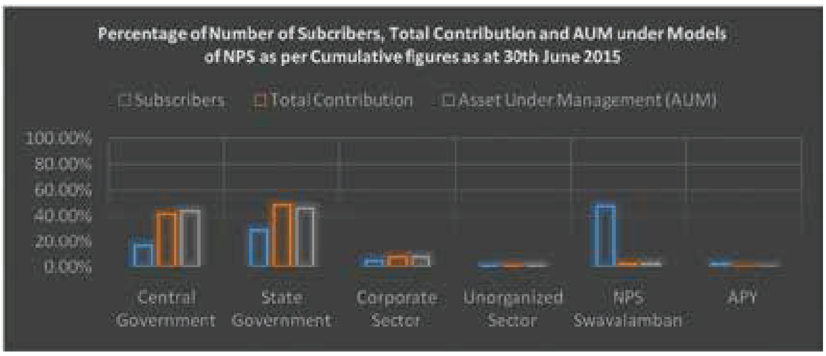
Growth

The summary of Growth in Number of Subscribers, Total Contribution and Asset Under Management when compared with Cumulative NPS Statistics as on 31-03-2014 and 31-03-2015, is provided in the table below.

NPS Model	Growth in Subscribers	Growth in Contribution	Growth in AUM
Central Government	12.6%	36.7%	51.9%
State Government	31.1%	67.1%	80.4%
Corporate Sector	42.3%	95.4%	116.0%
Unorganized Sector	10.2%	43.1%	62.6%
NPS Swavalamban	47.3%	71.5%	91.3%
Total	34.5%	55.1%	68.1%

Central Government includes CABs, State Government includes SABs and the AUM provided for Unorganised Sector include Tier-II also.

NPS-Lite is a different way of distributing the scheme and it has different investment rules targeting people at an economic disadvantage. The highest growth in number of NPS Swavalamban subscribersis observed may be due to Government reliefs to unorganised sector in terms of co-contribution. The next highest growth is observed in the corporate sector which could be mainly due to the available tax benefit to both employer and employee. Since the corporate model exist for the organised sector the reason for observed growth in AUM is due to the facility available for choice of PFMs and Investment options. The above table suggest that NPS is gaining popularity and sooner it may become the most popular pension product in India.



**Central Government includes CABs, State Government includes SABs, The AUM provided for UOS include Tier-II also.*Source: - Available on website of National Pension System Trust

All employees of the Central Government and of Central Government autonomous bodies, with the exception of the armed forces, are now covered by the NPS. Besides, 29 State Governments have also joined NPS in respect of their employees. As on 31.03.2015, over 4.1 million Government employees, from Central and State Governments, have already joined the NPS and the corpus (of their contributions & returns) has crossed INR 73,000 crore.

Net Replacement Ratio (NRR)

It is important for each investor to save enough money during his working life in order to provide for life after retirement depending upon the pattern of spending which could be as follows

- Property loan, are repaid prior to retirement.
- Fall in savings ratio, as people usually save for post-retirement.
- Reduction in travel costs, contributions to pension arrangements and the State scheme.
- More money may be required for leisure activities and healthcare after retirement.

Theoretically, NRR should vary by income with the less well-off needing a higher NRR and the wealthy a lower NRR. Usually the NRR is less than 100.00% since there are fewer expenses to be borne after retirement as explained above.

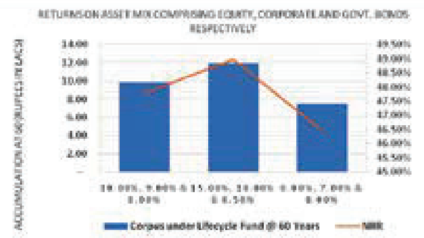
By definition, "Net Replacement Ratio" (NRR) is,

After-tax income in the year after retirement/After-tax income in the year before retirement

Consider an example where Mr. Common Man, who is hired by a company called ABC Limited, a month ago. Mr. Common Man is thinking to start saving for his retirement by joining NPS on his 35th birthday that falls on the first day of next month and continue contributing at each birthday to Tier-I account until he exit from NPS. The current salary of Mr. Common Man is INR 300,000 per annum, net of all taxes, needs assistance in understanding the net replacement ratio that justifies the continuity between his pre- and post-retirement standards of living, if he chooses to invest with aninitial contribution of INR 6,000 on his 35th birthday and increasing subsequent contribution in line with expected salary growth of 7.00% for all future years. Mr. Common Man is poor at understanding investment and hence has decided to opt for "Auto Choice Investment Option" as available under NPS. Assuming the pension corpus will bereceived on his 60th birthday (i.e. when he will retires from his job), his accumulation at 60th birthday is then determined by further assuming that the returns under equity, corporate debt and government securities that leads to investment earning and the contribution that is payable at the beginning of each subsequent year are restricted in regards to age wise asset allocation as prescribed under Life Cycle Fund. For simplicity, here we will ignore expenses at retirement (if there are any). The additional assumptions towards returns on investment under each scenario, viz. base, optimistic and pessimistic, expected income on retirement and annuity rate for life are mentioned in the below table.

Assumptions	Base - Scenario	Pessimistic - Scenario	Optimistic - Scenario
Age-Exact (in years)	35	35	35
Current Pay (p.a.)	300,000	300,000	300,000
Salary Increase (p.a.)	7.00%	7.00%	7.00%
Initial Contribution	INR 6,000	INR 6,000	INR 6,000
Increase in subsequent contribution (p.a.)	7.00%	7.00%	7.00%
Returns on Equity, Corporate Debt and Government Securities	10.00% p.a., 9.00% p.a. and 8.00% p.a. respectively	00.00% p.a., 7.00% p.a. and 8.00% p.a. respectively	15.00% p.a., 10.00% p.a. and 8.50% p.a. respectively
Annuity Rate at Retirement	10.905466	10.905466	10.905466
Income on Retirement From PF -(A)	5,000,000	5,000,000	5,000,000
Income on Retirement From Gratuity – (B)	1,000,000	1,000,000	1,000,000
Income on Retirement From Other Sources – (C)	1,500,000	1,500,000	1,500,000
Results	**Base - Scenario**	**Pessimistic - Scenario**	**Optimistic - Scenario**
Projected Salary at Retirement	1,628,229.79	1,628,229.79	1,628,229.79
NPS Accumulation at Retirement – (D)	986,588	750,269	1,197,911
Total Available Income to Invest (A+B+C+D)	8,019,581	7,857,441	8,167,184
Annual Income at Retirement in w.r.t.: assumed Annuity Rate	735,372.66	720,505	748,907
NRR	**47.79%**	**46.46%**	**48.98%**

The graph below shows Mr. Common Man's corpus at retirement, assuming different rates of return on Equity, Corporate Debt and Government Debt under base, optimistic and pessimistic scenario respectively and his corresponding Net Replacement Ratio.



It is clearly observed from the graph above that the higher the returns, the higher will be the accumulation and corresponding NRR. As per the Fixed Income Money Market and Derivatives Association of India (FIMMDA), the annualised par yield on Government Securities maturing in 25 years as on 30-06-2015 is 8.33%. Therefore, even if one does not want to take more risk and desires the minimum guaranteed return on his investment, then he can invest 100.00% in Government Securities. This approach of investors will not bring any material changes to the NRR in reference to above stated example and will produce little less accumulation at retirement but NRR will remain closest to the above determined NRR under the base scenario, subject to the fact that the reinvestment risk falls on investor.

Secondly, the annual contribution of INR 6000 is only 2.00% of the current annual salary, for example, if Mr. Common Man increases his saving ratio to 10.00% keeping all other assumptions constant, the corresponding NRR under base, pessimistic and optimistic scenarios will be 70.02%, 63.36% and 75.97% respectively.

The NRR depends largely on the lifestyle we want to maintain once we retire. If one plan to travel and live an expensive lifestyle compared to a simple life at home, you will have to save more. It depend on the timing when an individual is planning to retire, the level of saving of an individual, marital status and number of dependent at retirements, in case, if married, then the level of income of the partner etc. It is commonly believed and quoted that a pension of 50.00% to 75.00% of final salary is required to sustain the same lifestyle enjoyed up to retirement. There is no quantitative research that supports such and one should be careful to suggest a blanket NRR for all investors ignoring their individual needs and circumstances. It is tempting to think that a suitable NRR is 100.00% on the grounds that nobody will want to suffer a reduction in income after retirement.

The limitations of using a Net Replacement Ratio, on its own in order to set a retirement benefit target will only consider the income one year before retirement and thus can be distorted by variable pay, change in working patterns resulting in different remuneration just before retirement such as commission or overtime. Further NRR does not reflect any future appreciation/ depreciation of the post retirement income such as indexation relative to inflation and it also does not consider any allowance for survivor benefits attached to the post retirement income. Most important, NRR does not actually consider the change in expenses in the crude formula.

Advantages of NPS

- NPS is a well regulated, transparent, highly innovative and sophisticated product. It is based on the world's best practices in the pension sector involving disciplined saving, vigilant investment and its judicious draw down on retirement.
- NPS charges just 0.25% as fund management fee making it one of the cheapest pension products in the world. Mutual funds can charge up to 2.25% and life insurers can charge up to 1.35%.

- Private sector NPS subscribers have the choice of 8 fund managers and they are allowed to switch from one to another giving them the option of choosing the best fund manager. NPS subscribers are given the freedom to decide their asset allocation depending on the risk they can bear.
- The market linked returns are actually an uncertainty. But the subscribers also have the choice of investing 100.00% funds in Government securities wherein returns are more or less assured and may not be real.
- The availability of Auto choice or Life Cycle Fund comes as a big positive for those who do not want the asset allocation decision headache.
- It is a win-win situation as the employer and the employees both avail tax benefit from the NPS and this can be done by merely restructuring the Cost to Company without incurring additional cost.
- The addition of Tier-II account in December 2009 was a welcome move as it allowed unrestricted withdrawal.

Disadvantages of NPS

- NPS has both, rigidity issues when it comes to premature withdrawal from Tier-I account and liquidity issues due to applicable limit on lump sum withdrawal amount and mandatory annuitisation.
- The exposure to equity investment is restricted at 50.00%. People in the young age group who can take higher risks may see this as a disadvantage, as they might be losing an opportunity because equity investments can give good returns. Also, equity investment is restricted to index funds which replicate the BSE SENSEX or NSE NIFTY which means losing out on opportunities to get good returns from other stocks.
- As per prevailing Income Tax Rules, the funds will be taxed on lump sum withdrawal and on annuity returns.
- The returns are market linked and there is no guarantee of getting good returns.
- The levels of pension increases from DC provision such as flat, fixed, index-linked, etc., usually depend on the benefits from any annuity the member chooses to buy at retirement. The higher the expected pension increases, the lower the initial pension amount purchased from a given DC fund.
- Due to lack of understanding of the risks involved and how the pensions may differ now and in the future, may lead members to give up inflation protection, which may be valuable, particularly if actual inflation turns out to be significantly higher than expected and dependants are also likely to be affected by this.
- There are risks for a pension scheme investing in cash or short-term Government debt. These assets may be a poor match for the liabilities.

To conclude, NPS has the two main features that a pension scheme should have – one, it instils disciplined retirement planning by putting restriction on withdrawal during the accumulation phase and two, it leads to cautious withdrawal in the post-retirement phase, investing in an annuity plan being an effective way to do so. 50.00% restriction on equity exposure appears to be a fair when compared to traditional retirement schemes such as EPF (Employee Provident Fund) and PPF (Public Provident Fund), which do not allow equity investments at all. If NPS is brought in the EEE tax regime, making withdrawal as well as annuity tax free, it could become a very good pension product.

Pension Policy in India has traditionally been based on the employment contracts/ service conditions and financed through employer and employee participation. As a result, the coverage has been restricted to the organized sector and a vast majority of the workforce in the unorganized sector has remained outside the formal channels of old age financial support. As per the recent census, around 2.96 crore people are employed in organized sectors, which is around 8 per cent of the main workforce of the country. The remaining working population is engaged in the unorganised sector and majority have no access to any formal system of old age economic security.

In terms of assets under management, EPFO funds hold two-thirds of the share and private pensions and annuities one-third. Although NPS is still very small, it is gathering acceptance due to higher returns under the NPS schemes compared to all other options. The recent budget announcements relating to provision of choice to employees between PF and NPS, singular Income Tax rebate up to INR 50,000 to NPS in addition to rebate available to other investments and general awareness will hopefully swing the preference to NPS schemes.

The National Pension System (NPS) launched by Government of India and supervised by the Pension Fund Regulatory & Development Authority (PFRDA) has evolved out of this very need to provide old age security to the vast multitude of Indian population, without unduly straining the fiscal fabric of the Government and simultaneously enabling long term investment funds for the development of economy.

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