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***Outline of the operational framework and
selection process for Pension Fund Managers***

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Important: *This document evaluates the various policy options and outlines a draft operational environment and selection process for PFMs. Public comments, inputs and ideas on this document from domestic and international experts are invited and will be carefully considered and evaluated by the Government while drafting the final policy framework for PFMs including the detailed investment guidelines, performance measurement process, operational and functional obligations, eligibility criteria and selection procedures, etc.*

1. Background

1. A new pension system for India, and the establishment of a new dedicated pension sector regulator was proposed during the Union Budget for 2003-04 and was approved by the Union Cabinet on 23 August 2003. The new pension system came into effect from 01 January 2004. The new regulator for India's pension sector, named the interim Pension Fund Regulatory and Development Authority (PFRDA), was set up on the same date.
2. Participation in this new pension system is mandatory for Central Government employees (excluding Armed Forces in the first stage) who join service on or after 01 January 2004. This system will replace the existing PYGO DB pension scheme and the DC General Provident Fund (GPF) for these new employees. After a few months, this new pension system will be opened to all other citizens of India including employees of State Governments and other public and private employers, as well as self-employed professionals, informal sector workers, NRIs, etc.
3. Each individual who joins this new pension system will be allotted a unique *personal retirement account* (PRA) number. This pension system will offer two types of sub-accounts created by individual members:
 - a) a Tier-I non-withdrawable and tax deferred *pension* account, and
 - b) a Tier-II withdrawable *savings* account with no tax advantages (and subject to certain minimum contributions per year into the Tier-I account)

The Tier-I account will be EET – where a member's contributions will be exempted from tax at entry, exempted from tax while they stay invested and earn returns, and only taxed (at a rate decided by the GOI) at the time of withdrawal at retirement. Contributions to the Tier-II account may be permitted only after achieving some minimum annual accretion (to be specified by the PFRDA) into Tier-I accounts. Withdrawals from the Tier-I account will be permitted only at retirement. A part of the terminal accumulations in Tier-I accounts will be annuitized on a mandatory basis¹.

¹ *The specific exit policies for mandatory and voluntary members (for Tier-I and Tier-II accounts) including benefit structures, exit age, tax treatment, protection against death and disability and operational restrictions and services are being framed. IIEF will circulate a separate document on exit and benefit policies.*

4. In this system, a member will accrete savings towards his retirement into his PRA through his working life. This PRA will stay with the member regardless of where he stays or works – including spells of unemployment, self-employment, changes in jobs or location. He will be able to use a nation-wide network of competing pension service providers (POPs) to access this system for opening a PRA, accreting new contributions, receiving account or system information and for obtaining retirement benefits.
5. A member will have complete control on how his contributions to his PRA are managed. He will be able to select a professional Pension Fund Manager (PFM) from a pool of competing pension fund managers registered with the PFRDA. Each PFM in this system will offer a choice of three simple and standard pension schemes with different risk and return profiles. If a member is unable to select a PFM, his savings will be directed to a 'Default' scheme. If he desires, the member will be able to allocate his savings across multiple PFMs and schemes. He will also be able to seamlessly switch his savings between fund managers and products. With individual accounts and complete freedom of choice, a member will be able to easily alter his risk profile in an optimum fashion over time – he will be able to move from a high return scheme with relatively higher risk at a young age, to a low or near zero risk, modest returns portfolio when approaching retirement if he desires. Each member will receive periodic, consolidated statements of his PRA which will reflect his notional wealth in his PRA across various products and PFMs. This will be the sum total of his contributions at that point in time and the returns that these contributions have earned.
6. On retirement, the member will be able to use a part of the savings accumulated over the years in his Tier-I PRA to buy an annuity which will provide him and his spouse a pension for the rest of their lives.
7. In this process of accumulating retirement savings, the PFRDA will provide members with a sound regulatory framework for maximizing their retirement benefits and an umbrella of safety with respect to prevention of fraud and malpractice.
8. The Department of Economic Affairs, Ministry of Finance, has been charged with the responsibility of setting up the PFRDA and for establishing the legislative, regulatory and institutional framework for the new pension system. While the institutional

capacity is being put in place, the 20% monthly contribution by each new employee who has joined service after 01 January 2004, is being individually recorded and credited into the Public Account under an 'Interim' arrangement managed by the Controller General of Accounts (CGA) and the Central Pension Accounting Office (CPAO). These contributions will receive a rate of interest decided by the Government during this interim phase. Once the institutional capacity is in place, this pool of savings and the interest accrued on them will be credited into the personal retirement account of each employee.

1.1 Roles of participants in the new pension system

1. This scheme will target two categories of individual participants (**members**):
 - a) It is applicable to all employees of the central government (excluding Armed Forces) who join service after 01 January 2004. For these employees, participation and contributions to the Tier-I (pension) account is mandatory. Every month, the government will deduct 10% of the salary (basic plus DA) of these new employees, match it with an identical contribution from its side, and transfer this full 20% contribution into the relevant employee's Tier-I pension account. The employee will select the PFM(s) and scheme(s) to which this 20% monthly contribution will flow. The cost of opening this account and the fees and charges of service providers for the twelve depositions in a year may be borne either by the employer or by the employee as per the terms of employment.

These employees will also be eligible to open and operate the Tier-II savings account (which will allow withdrawals) on a voluntary basis. The amount and periodicity of contributions into this Tier-II account will be decided by the employee and will be over and above the mandatory contributions into the Tier-I pension account. The government will not contribute to this Tier-II account. If a government employee decides to resign from service, he will be able to leave with the full balance in his Tier-I pension account (which will be the total of the government's contribution, his own contributions and the investment earnings on them as on that date). He will not however be permitted to withdraw these savings till he reaches age 60. Also, once he ceases government service, he will no longer be eligible for the 10% government contribution and will thereafter be free to contribute voluntarily into his Tier-I account. The status of the Tier-II account, however, shall not change.

b) The second category of members will include all other citizens of India including employees of state governments, corporates and PSUs, self-employed professionals, contract and casual labour, farmers, non-resident Indians (NRIs), etc. who will participate in this scheme on a voluntary basis. In some cases (including State Government employees) this scheme may replace the existing pension system and participation may be mandated by the employers (as in the case of new central government employees). This category of members will also be able to operate the Tier-I and Tier-II accounts. These members will be free to decide the amount and periodicity of contributions into these accounts. For these members, there will be no matching contribution by the Central Government. However, employers will be free to make contributions into the PRAs of their employees if they wish. Unlike in the case of the Central Government, these contributions by employers may not be mandatory². The members who choose to open Tier-II accounts may do so after they have invested at least Rs.3600³ (2003-04 prices) into their Tier-I accounts (implying a contribution rate of Rs.10 per day).

In both categories of members and account types, the members will receive a unique account number, accrete contributions into this account, select a PFM and product, switch between PFMs and products, and receive consolidated account statements.

2. The electronic recordkeeping, administration and reconciliation functions for all members of this pension system will be centralized and performed by the **Central Recordkeeping Agency (CRA)**⁴. The CRA will issue the unique account number (PRA) to each member, maintain a master database of all personal retirement accounts and record the transactions related to each member's PRA. The CRA will receive, reconcile and consolidate member contributions and instructions and transmit them to the relevant PFM and scheme on a daily basis. The CRA will periodically provide each member with a consolidated PRA statement reflecting the member's contributions, allocation across various PFMs and schemes, fees and charges of the various PFMs, growth of assets, etc. The CRA will also monitor and report to the

² The tax treatment of contributions by employers to the voluntary Tier-I accounts of their employees and whether this can be treated as a deductible expense from the employer's income may be examined in a separate note.

³ This is only an indicative figure. The precise limits and treatment of contributions to Tier-I accounts is being examined in more detail and the final policies on this account will form a part of a separate document being produced for the DEA / PFRDA.

⁴ A detailed note (in PDF format) on the CRA and the administrative and recordkeeping arrangements under this new pension system can be downloaded from the 'Interim PFRDA' section on the Ministry of Finance website (<http://www.finmin.nic.in>)

PFRDA on the functioning of the service provider network as well as compliance on mandatory contributions by government employees.

3. **Points of presence** (POPs) will be the network of service providers and will offer a host of services to members. POPs will assist members in opening new PRAs; collect, verify and transfer contributions and/or instructions regarding PFMs and schemes to the CRA with relevant and correct member account information; collect and transfer complaints from members to the CRA; provide performance data as well as account information and statements to members; and communicate changes in personal information of members to CRA. Once a member retires, the CRA may use this service network to deliver the lumpsum terminal accumulations to the bank account of relevant members. Banks, post offices, depository participants and other secure entities which are capable of electronic connectivity with the CRA will serve as POPs.

For central government employees including Civil Services, Railways and Department of Posts, the relevant Pay & Account Offices (P&AOs) and DDOs which manage the government's payroll process, will perform some of the POP functions. The P&AOs and DDOs will be responsible for the initial services to government employees including (a) handing over of a system information brochure on joining service, (b) account opening, (c) deducting and transferring the 10% employee contribution and 10% government contribution to the CRA on behalf of each employee as per the choice of PFM and scheme, and (d) deduction and transfer of employee contributions to Tier-II accounts to the CRA as per the choice of PFM and scheme. Once this initial contribution reaches the PFM and the units are credited into the PRA of the relevant employee, he will be able to avail of all other services (switching PFMs and schemes, account statements, NAV information etc.) by opening a service account with a POP or by directly accessing the CRA over the Internet or phone.

4. The retirement savings under this pension system will be managed by competing, specialized professional **pension fund managers** (PFMs) registered with the PFRDA. Every day, the CRA will receive several payments and/or instructions regarding (a) new contributions to PFMs and schemes, (b) changes (switches) in PFMs or schemes, and (c) terminal withdrawals. The CRA will reconcile and collate all such instructions and funds received from members through the POP/P&AO/bank network or the Internet. For each scheme of each PFM, the CRA will arrive at a single amount which will include the sum of fresh contributions as well as incoming transfers

from other schemes. From this, the CRA will deduct the total outflow from the specific scheme (which may be on account of transfers or terminal withdrawals) to arrive at a *net* amount payable to (or receivable from) each scheme of each PFM. Once all such balances are determined, the CRA will remit a single, netted amount to each PFM (which be the sum total of the netted amounts across all three schemes of the PFM) along with a statement specifying the exact amount to be invested under each of the 3 schemes on a daily basis. PFMs will comply with the investment guidelines issued by the PFRDA for allocating these assets under each scheme. Firms with requisite fund management experience and which satisfy the eligibility criteria specified by PFRDA will serve as PFMs.

5. When a member retires, he will be mandated to use a specified part of his terminal accumulations in his PRA to buy an annuity (with survivor benefits) from a pool of competing **annuity providers** who will be responsible for delivering a regular monthly pension to the member for the rest of his life. Life insurance firms which are registered with the IRDA will serve as annuity providers. The retirement age for non-government employees, which is the age at which they will be able to withdraw their savings and buy an annuity will be decided by the PFRDA⁵.
6. **Authorized Retirement Advisors** (ARAs) will help in marketing the new system to potential members. ARA's will advise and assist members with opening retirement accounts, as well as with selecting appropriate pension fund managers and products. The ARAs will conform to a uniform code of conduct and ethics and will have to pass a certificate examination prescribed by the PFRDA in order to obtain a periodically renewable work license. Existing agents and financial intermediaries of mutual funds and insurance firms will also be able to serve as ARAs by passing this certification examination. ARAs will receive a commission specified by the PFRDA⁶.
7. In this entire process of accumulations and withdrawals, a **sound regulatory framework** would give individuals an umbrella of safety with respect to problems of risk management and prevention of fraud. The PFRDA will regulate the charges, entry and exit, quality and provision of service of POPs, ARAs, CRA and PFMs during the the accumulation phase of this pension system. The PFRDA shall also approve periodic investments on account of CRA system upgrades. The process of delivery of

⁵ A further discussion on Exit Rules is provided in Section 2.2

⁶ The specific qualifications, responsibilities, guidelines, restrictions, fee structure and payment processes, etc. for IRAs are being examined separately and will be notified by the PFRDA

pensions to members by annuity providers will be regulated by the IRDA. However, if a member chooses to not withdraw his savings as a lump sum and decides to instead phase out his withdrawals from his PRA, he will continue to interact with the POPs, CRA and PFMs and will thus remain the responsibility of the PFRDA as well.

2. Policy questions and alternatives

Pension benefits in a DC system depend primarily on contributions and the accumulated investment earnings on them. Efficient management of retirement savings can thus generate larger benefits for members. Returns from investment of retirement savings with individual accounts will be an important tool for motivating new members to enter the system and existing members to continue their contributions. On the other hand, poor returns, inability of pension asset managers to honor their commitments, institutional failures and regulatory lapses will have an equally significant impact on lowering public confidence in the system, and consequently on the entry and continued participation by members. Therefore, the primary concern of policymakers will be to provide an environment for members to maximize their retirement benefits in a fraud-free environment. As a result, stringent entry and selection criteria for pension asset managers with adequate asset management experience and capabilities, standardized and regular information disclosure, effective supervision of investment processes and strict adherence to prescribed investment and business rules will be of paramount interest to policy makers.

Competition between fund managers is widely viewed as a highly desirable feature of the pension sector. Standard, simple and regular disclosure of performance, fees and costs, in an environment where fund managers compete to attract pension assets, offers two key benefits to members – (a) it provides a powerful motivation for efficient management of retirement savings, and (b) it lowers asset management costs.

The PFRDA proposes to appoint competing professional pension fund managers (PFMs) for this system. These PFMs will be allowed to offer their services for managing the retirement savings under the new pension system. These PFMs may also be allowed to offer fund management services to other pension, PF and retirement plans in the country.

The Government and the PFRDA are evaluating several policy choices and questions which will have an important bearing on the incentives, performance and actions of pension fund managers and hence on member benefits. Some of these questions and choices include:

1. Should the number of pension fund managers be limited? If so, how can the

number of PFMs be limited and how should this number increase over time?

2. Should existing or only new firms serve as pension fund managers?
3. Should the database of members / customers of each PFM be disclosed to the relevant PFM?

We can draw on the international evidence and experience with management of retirement savings to evaluate the pros and cons of these policy choices. The same is summarized below.

2.1 Should the number of PFMs be limited?

The number of PFMs that participate in a pension system with individual accounts will have an important impact on coverage, charges and benefits. Countries with a large number of pension fund managers have experienced the following issues with governance and customer service:

1. Individual account systems with a large number of competing fund managers tend to have excessive fees, as pension funds spend enormous resources on sales and marketing (which are passed on to members as expenses);
2. Most individuals are not comfortable with understanding and analyzing performance, fees, loads and expenses. Even highly skilled individuals are seldom able to correctly choose fund managers based on past performance. A plethora of fund managers increases the complexity of the information processing that members have to do. This may deter targeted individuals, most of whom may be financially unsophisticated, from readily entering the system;
3. Fund managers who did well in recent years do not necessarily outperform in coming years. The Government's proposal for standardizing all funds into three styles reduces the complexity in performance evaluation and product selection. However, this does not ensure that it will be easy for members to choose better fund managers;
4. The problem of enforcement and prevention of fraud is larger with a large number of pension fund managers.

There are also some weaknesses in a system with a very limited number of PFMs.

These include:

1. The problem that regulatory difficulties with 'very large' PFMs could turn into difficulties for the State when a PFM becomes 'too big to fail' (TBTF) – this could happen in an environment where very few PFMs are managing very large assets;
2. The problems of potential collusion between a handful of PFMs;
3. Mergers amongst an already limited number of PFMs may lead to a dampening of competition;
4. A few PFMs may not be able to cope efficiently with millions of potential members; and
5. Political pressures from a limited number of PFMs may lead to a continuation of the restrictions on entry of more players.

From a PFM's point of view, a limited number of competitors for a specified period provides a larger (and perhaps guaranteed) market share and makes the pension fund management business more attractive in the short term.

Also, as the estimated size of assets in a new pension system is likely to be small in the initial years, it may be prudent to (initially) limit the number of PFMs. If many PFMs compete for a tiny asset, they may find the business unattractive in the short term. This can cause a PFM to either fail or surrender its license which would in turn lower the confidence of the other players and also cause administrative problems for its customers.

Hence, while there may be a case for initially limiting the number of PFMs selected to manage retirement savings, there also is a case for increasing their number over a period of time. Fresh applications from new, prospective PFMs can be invited when some system milestones are achieved. These could include a specified period after launch of the new system, or when the total assets of the pension system cross a certain figure, or when coverage exceeds a specified number of members, or on a gradual basis.

2.2 How can the number of PFMs be limited?

If the Government and the PFRDA decide to limit the number of PFMs in the new pension system, this decision can be implemented through the selection process. A limited number of PFMs can be selected using either of the following process:

1. auction of a limited number of PFM licenses, or
2. self selection and approvals based on prescribed eligibility criteria

a) **Bidding or Auction Process for Selection of PFMs**

In this process, the regulator 'auctions' a 'license' for a limited period and specifies the eligibility criteria for bidders as well as the maximum number of licenses that will be auctioned at a point in time. Entities which satisfy the prescribed eligibility criteria are invited to bid on the basis of a pre-committed consolidated number which covers the asset management fee and any other charges for the duration of the license. The pre-specified (limited) number of firms which bid the lowest fees and charges are granted a license for a specified period. The regulator may also prescribe a ceiling on the charges that can be levied by PFMs. In this situation, the Government would need to decide the exact number of PFM licenses that it would (initially) issue.

An auction or bidding process has the following key *advantages*:

1. This is a transparent and objective selection process and fits the Government's procurement procedure; and
2. Competitive bidding is a transparent and market determined process of determining the fees and charges and it does not impose the risks of regulated caps / ceilings on fees and charges on the PFMs.

The auction or bidding process also has the following *disadvantages*:

1. Even with strict and standard eligibility criteria, this process does not always guaranty that the *best* firms will be selected as PFMs and can lead to suboptimal benefits;
2. Some PFMs may quote unrealistic (near zero) fees in order to enter the market

early. This may cause them to fail or exit early and thus undermine the credibility of the system; and

3. If the PFMs have pre-committed very low fees, they may not have the incentive or capacity to undertake any marketing or sales actions.

b) **Self-selection Process for PFMs**

This is an alternative selection process where the regulator notifies a set of strict and objective eligibility criteria and other pre-conditions (including service and functional obligations) for PFMs. Any firm which satisfies these criteria, agrees to the pre-conditions and service obligations, and wishes to serve as the PFM under the prescribed rules is free to apply for an approval. Once the regulator verifies that the firm satisfies the pre-conditions, it approves the firm to serve as a PFM. This is similar to the process adopted by SEBI and IRDA for mutual funds and insurance firms respectively.

Here, a limit on the number of PFMs can be achieved mainly by focusing on the *eligibility criteria*. Importantly, the fees and charges that can be levied by PFMs are determined by the regulator.

The self-selection process has the following *advantages*:

1. As the markets evolve, economies of scale would promote consolidation and lead to an optimal number of firms in the market over time, as has been the case in several other countries; and
2. Since there is no explicit entry barrier (except the eligibility criteria), this at the outset does not exclude an efficient player from the market.

The self-selection process also has the following *disadvantages*:

1. Despite strict entry norms, policymakers will be unable to accurately estimate the number of PFMs who will enter the market – and a larger number of PFMs may increase regulatory and administration costs as well as the complexity of information processing for customers;
2. As PFMs will be uncertain about the size of their potential market share, they may

spend large sums on marketing and sales which will in turn increase the costs to customers; and

3. The limits on fees and charges will have to be determined by the regulator. These limits could be inaccurate and can prove too liberal or too restricted – in the former case it will impact accumulations and benefits, and in the latter case it will cause the business to appear unattractive to the PFMs in the long run.

2.3 Should existing or only new firms serve as PFMs?

There are no existing entities which are registered as pension fund managers in India. It is likely that domestic and foreign banks, financial institutions, asset management companies, insurance firms, NBFCs, etc. will be interested in the newly opened pension fund management business. A decision regarding the structure and ownership of PFMs is essential as it will have an important bearing on their operations, costs and governance. The two approaches that policymakers can consider in this regard are:

- (a) allowing existing firms to serve as PFMs
- (b) allowing only specialized, new entities to serve as PFMs

In general, allowing existing entities to serve as PFMs can cause cross subsidies between pension and non-pension assets, spillover of risks between pension and non-pension businesses, as well as regulatory overlaps leading to potential conflicts and governance inefficiencies. On the other hand, establishment of new entities will increase the cost of pension fund management. Most countries across the world have chosen the route of establishing new dedicated pension fund managers. However, there are also instances (as in the case of Sweden) where existing asset management firms have been permitted to offer pension scheme which are subject to some additional regulations and reporting obligations. The benefits and trade-offs of allowing existing firms to serve as PFMs are outlined below.

(a) Existing firms as PFMs:

The *advantages* of allowing existing firms to serve as PFMs are:

1. Existing firms will harness existing fund management experience and infrastructure which will lower the PFM costs and therefore fees; and

2. Using existing firms will reduce the time-to-market for PFMs.

The *disadvantages* of allowing existing firms to serve as PFMs are:

1. While regulations can require the existing firms to *ring-fence* the accounts, assets and operations of the pension schemes, there may be considerable cross-subsidy across pension and other assets. This may lead to either predatory pricing in the pensions market or charging of higher fees in case the other market is highly competitive;
2. The assets of various potential PFMs (banks, insurers, AMCs, etc.) face varying types and degrees of risks. Despite ring-fencing and appropriate governance structures (including a separate Board of Trustees), there is a chance that these risks of their traditional businesses may spillover to the pension assets; and
3. Existing firms (banks, AMCs, insurers, etc.) from India and abroad would be required to report to multiple regulators – this can drive up the costs of compliance and cause regulatory overlaps and lapses.

(b) New, specialized PFMs

The *advantages* of mandating that specialized new entities to serve as PFMs are:

1. It ensures complete financial transparency for PFMs;
2. It facilitates effective regulation of pension fund management activities by clear definition of service delivery as well as identification and attribution of costs;
3. It provides the Regulator with detailed, clear and accurate information to undertake price reviews; and
4. Avoids the risks and anti-competitive effects of cross subsidies between pension and other (MF/ Insurance/ any other financial) activities.

The *disadvantages* of mandating that only specialized and new entities can serve as PFMs are:

1. This puts a burden on charges as the new firms may require to set up systems and processes ab initio; and
2. This might increase the lead time in the establishment of PFMs.

2.4 Should the list of members be given to PFMs?

Market mechanisms for the new pension system envisage a role of inter-alia the clearinghouse for the CRA, wherein the CRA records the contributions, aggregates contributions of many members and moves them in omnibus accounts to the PFMs chosen by the members. All the fund switches are processed by the CRA. This feature (known as “blind allocation”) discourages sales expenditure by the PFMs and helps to keep transaction costs low.

However, regulating institutional mechanisms to reduce costs may not be the best policy choice. Alternatively, the policy makers could rely on competition among PFMs to keep transaction costs low. This could be enabled by providing the PFMs with a list of consumers along with the netted contributions. This will provide incentives for active sales and marketing efforts to increase coverage. However, the ceiling on PFM fee could be regulated (and decreased exogenously over time) to leave little room for excessive sales and marketing expenditures.

The policy makers thus need to:

- a) Weigh the pros and cons of blind allocation, where the PFMs are not allowed access the list of their customers;
- b) Weigh the pros and cons of allowing the PFMs to access the list of their customers;
- c) Decide on mechanisms to manage and regulate sales and marketing expenses in both the above cases and increase coverage; and
- d) Prevent potential sales and marketing malpractices.

a) **Blind asset allocation**

The advantages of blind allocation are:

1. The mechanism of ‘blind allocation’ provides an incentive for lower expenses on sales and marketing and hence helps lower transaction costs and fees;
2. In the case of de-licensing of a PFM, this makes the exit less costly for the PFM as no (or negligible) ‘intangible assets’ by way of sales and marketing have been created; and

3. This mechanism reduces the regulatory burden as the regulator is required to deploy less resources for monitoring sales and marketing conduct of PFMs.

The disadvantages of blind allocation mechanism are:

1. This may result in ‘socially suboptimal marketing’ and the regulator will need to ensure that members have public access to the minimum information to take informed financial decisions;
2. The burden of increasing the system’s coverage is mainly on the regulator. (The CRA and POPs may also invest in sales and marketing efforts since their fees are linked to member transactions. However, the regulator will need to determine the prudence of all sales and marketing expenses. Normally such expenses would be approved on cost basis in the absence of any benchmark);
3. The investments by PFMs in sales and marketing would have ‘free rider’ problems as other PFMs may benefit from their competitors’ sales and marketing efforts;
4. Importantly, this can cause significant cross-subsidies from existing to potential customers as existing members would have to directly bear the burden of all sales and marketing expenses.

b) Providing PFMs with a list of their customers:

The advantages of providing the PFMs with the list of consumers along with the netted contributions are:

1. This institutional mechanism facilitates the offering of loyalty discounts and other special benefits to customers as the PFM can keep a track of its base of customers – and hence lower the overall transaction charges or offer additional benefits to its customers; and
2. This institutional mechanism also provides an incentive to the PFM to undertake marketing and education efforts within the charge ceilings approved by the regulator.

The disadvantages of providing the PFMs with the list of consumers along with the netted contributions are:

1. In case of limited competition and product differentiation (if PFMs club their products with non-pension products), the marketing costs may lead the overall charges to be higher than those under the blind allocation mechanism;
2. Enforcing of guidelines for market conduct will entail deployment of large regulatory resources – to monitor malpractices in sales and marketing and mis-selling; and
3. In case of inadequate monitoring, this mechanism might lead to 'sub-optimal' financial decisions by the members.

3. Proposed operational and policy framework for PFMs

The international experience provides a broad direction for establishing a suitable operational and policy framework for pension fund managers. In addition to the international evidence, India's policymakers may choose to derive their conclusions and frame an appropriate policy direction for PFMs also on the basis of the following core objectives of this new pension system for India:

- a) **Simplicity:** This pension system is targeting over 300 million workers with low literacy, low levels of financial literacy, diverse demography, savings capacity and attitudes towards retirement, risk and savings. To achieve significant voluntary coverage, this pension system should be very simple and easy for ordinary people to understand. To the extent that customers are not aware, they will tend to either exercise inefficient choices, or contribute insufficiently, or enter the system late, or stay away entirely, or fall prey to fraud or miss-selling. Workers are also unlikely to save voluntarily in this pension system unless they feel confident about it. Greater confidence can be best achieved by enabling the public to become better informed about the system. In this situation, a useful strategy for increasing coverage and motivating participation is to focus on simplicity in system design and to bring in complete transparency where a person can clearly see the direct relation between contributions and benefits. A limited number of standard products offered by an initially limited number of pension fund managers will make it easier for ordinary people to compare and select a product or PFM of their choice.
- b) **Nationwide access:** A key aspect for driving coverage will be the ease with which consumers spread across 3.3 million square kilometers will be able to participate in this pension system. Outreach and easy access to the pension system from remote locations across the country, as well as channeling modest, infrequent contributions from millions of workers at the lowest possible transaction costs is an essential objective for policymakers. In this direction, it is essential to harness a variety of non-proprietary distribution channels into the pension system.
- c) **Consumer choices and rights:** Each individual's needs, risk appetite and product preferences will change over his or her lifetime and that person is best suited to pinpoint and act on these changes. This also counters the potential risk of agency conflict. A mix of 3 simple products (safe, balanced and growth) and the 'default'

option for people who are unable to take a decision will be able to cater to persons of every age, education, income or risk profile. In addition to offering a limited number of standard products, the system should make it easy for a member to exercise his choice and empower each member to alter his or her allocation with changes in age, income, risk profile, etc. with the least cost and administrative overhead.

- d) **Low fees and charges:** Fees and charges on assets have a significant impact on terminal accumulations and are thus of special interest to policymakers. We can achieve lower fees and charges through (a) competition – where PFMs compete on fees and charges, (b) non-proprietary distribution and access – where PFMs are not required to spend huge resources on establishing proprietary nationwide distribution and access mechanisms, (c) wholesale asset management – where PFMs are not required to deal with thousands of small value checks on a daily basis and are able to focus only on efficient, wholesale funds management, and (d) passive asset allocation strategies where PFMs do not incur the excessive transaction costs of active funds management and instead track a pre-specified index. Passive funds management also enables policymakers, regulators and customers to assess and benchmark the performance of PFMs against the underlying market index.

- e) **Maximum returns:** Retirement savings can be maximized through a variety of prudent strategies including (a) investment into equities with some international diversification, (b) competition between multiple PFMs, and (c) regular reporting of fees and performance in a standard and simple format to customers.

- f) **Sound governance:** Proactive regulation and sound governance will be essential to protect the interests of each consumer in India's pension sector over multiple decades. Passive funds management strategies by a limited number of PFMs coupled with swift enforcement and stiff penalties for malpractice will lower regulatory costs, improve regulatory efficacy and increase member confidence in the system. Appointment of the best pension fund managers in the world and clear regulatory and supervision control of the PFRDA over the PFMs will improve the governance and regulatory efficiency of the system.

The following sub-sections provide the outline of a draft policy framework for PFMs under this new pension system. This includes a synopsis of PFM functions, operations and restrictions, the eligibility criteria and selection process for PFMs, as well as their obligations and terms of engagement. The policy framework for PFMs will be finalized by

the DEA and the PFRDA and will be based on (a) comments and ideas received on this draft document, and (b) the final entry, exit and benefit policies governing individual members.

3.1 Operations and restrictions for PFMs

1. Each PFM will offer *three standard schemes or products* – which can be broadly categorized as 'Safe', 'Balanced' and 'Growth'. In each of these three schemes, PFMs will be able to invest (as per the investment guidelines prescribed by the PFRDA) in equity, corporate debt and government bonds. The allocation in each asset class may not be rigid and instead based on 'bands' prescribed by the PFRDA. Some international diversification under each asset class shall be permitted. The investment guidelines proposed under the Project OASIS Report are provided below which may serve as an indicative guide on asset allocation to potential PFMs:

	Safe/Default	Balanced	Growth
Government Paper	>50%	>30%	>25%
Corporate Bonds	>30%	>30%	>25%
Domestic Equity	<10%	<30%	<50%
<i>Of which, International Equity</i>		<10%	<10%

2. The 'safe' scheme will also serve as the '*default*' scheme of the pension system. Every day, the CRA will transfer new contributions under the 'default' option to the safe scheme of the PFM which is offering the lowest fee for this scheme on that day.
3. PFMs will not receive, reconcile and invest thousands of small value contributions. They will instead only undertake *wholesale asset management* – every day, a PFM will receive a netted, consolidated amount from the CRA which will be the sum of all new contributions to the three schemes of the PFM *minus* the withdrawals from these same schemes (due to terminal withdrawals at retirement, switching, or withdrawals from Tier-II accounts). The CRA will instruct the PFM regarding the exact percentage or amount which should be invested under each of the three schemes. If on any day, the netted amount is negative (where withdrawals exceed new contributions) for a

⁷ The final investment guidelines for PFMs will be prescribed by the PFRDA

PFM, the PFM will be required to transfer the difference to the CRA on the same day.

4. Only *passive investment* (using a PFRDA approved index) will be permitted for all domestic and overseas equity investments under each of the three products. No off-exchange transactions on equities will be permitted. Active management will be allowed only for corporate and government bonds if no standard benchmark indices for these assets exist. However, only investment grade paper will be considered for corporate bonds. While asset allocation will be passive, the PFMs will be able to 'select' the country(ies) for international diversification. Over a period of time, the PFRDA may permit active funds management in equities.
5. PFMs will be able to undertake *sales, marketing and communication activities* to encourage new members to join the system and existing members to optimize their allocation across the three schemes. PFMs will also be free to engage and compensate individual retirement advisors (IRAs), distributors and agents if they wish. The PFMs will be required to disclose the sales commissions payable and paid to these intermediaries (all of whom will be required to pass a certification examination mandated by PFRDA). All new contributions (including those that result from agent sales) will necessarily flow to the PFMs only through the POPs and CRA.

To assist this sales and marketing process, the CRA will provide each PFM with a list of its new customers (based on new contributions or switches) on a daily basis. The PFRDA will decide when this process of sharing the customer data with the PFMs will begin. PFMs will be free to use this data to design and assess their marketing strategies. This database will not have any commercial value and be considered a Regulated Asset (and will be the property of the GOI).

Any malpractices in sales (including rebating of commissions, inadequate disclosure of commissions, misinformation or incorrect advise, etc) will be viewed as a serious offense and a PFM license may be terminated on these grounds. The PFRDA will monitor the disclosure and prescribe an advertising, communication and disclosure code for PFMs and their agents.

3.2 Broad pre-qualifications and pre-conditions for PFMs

1. PFMs will be new, separate entities which will be required to be registered with the PFRDA. These PFMs will offer pension fund management services based on

- investment guidelines prescribed by the PFRDA. Only these registered PFMs will be permitted to manage the assets under the new pension system and of other retirement schemes which are under the jurisdiction of the PFRDA.
2. PFMs will be granted a license by the PFRDA on the basis of a competitive and transparent bidding process. This process of granting licenses as well as the proposed license terms and conditions for PFMs are described in more detail in the subsequent sections.
 3. Initially, the PFRDA will issue 6 PFM licenses. One (1) of these 6 PFMs will be a publicly owned, domestic public sector PFM.
 4. The PFRDA will issue the 7th PFM license when the total AUM of the pension system becomes Rs.15,000 crore. Thereafter, a fresh PFM license will be issued whenever the AUM of the system grows by Rs.2,500 crore. The criteria for granting new PFM licenses on the basis of AUM growth will be regulated (and may be changed over time) by the PFRDA.
 5. The following categories of firms will be allowed to sponsor a new pension fund management company and bid for a PFM license:
 - a) *Domestic mutual funds* registered with SEBI with an AUM of Rs.4500 crore on the date of bidding
 - b) *International mutual funds, pension funds or insurance firms* with an AUM of Rs.100,000 crore and experience of minimum 20 years in financial services
 - c) *Life insurance firms* registered with the IRDA before December 2003
 - d) *Domestic or foreign banks or financial institutions* registered with the RBI with a minimum investment portfolio of Rs.4500 crore
 6. A bidder for a PFM license with majority shareholding by a domestic firm will be considered a *domestic bidder* and will need to satisfy the eligibility criteria (AUM, experience, etc.) for domestic firms. Similarly, a bidder for a PFM license with majority shareholding by an international firm will be considered an *international bidder* and will need to satisfy the eligibility criteria (AUM, experience, etc.) for international firms.
 7. An international firm which decides to sponsor a PFM and bid for a license will be

allowed to participate in the bidding process without setting up an office in India. However, if the firm is granted a license to set up a PFM, it will be required to incorporate a company in India. This may be set up as a 100% subsidiary of the international sponsor or in collaboration with domestic person(s) or firm(s). In either case, the sponsor will be required to comply with the rules of the PFRDA, the Companies Act, the regulations of the RBI, FIPB rules and other Government regulations.

8. A PFM will be required to maintain a minimum capital of Rs.25 crore. This capital requirement may be changed by the PFRDA in keeping with the AUM of the system and/or the structure for fines that may be applicable for PFMs.
9. A firm which has been indicted or de-licensed in any regulatory or legal proceedings by any domestic or overseas regulatory or legal body will not be eligible to bid for a PFM license.
10. Other pre-conditions:
 - a) The Sponsor(s) of a PFM shall at no time hold more than 10% of the equity stake in any other PFM
 - b) The Sponsor shall at no time hold more than 10% of the equity stake in the CRA
 - c) A PFM will not be permitted to obtain custodial services from a custodian in which it holds more than 5% equity stake
 - d) No audit firm shall hold any equity stake in a PFM

3.3 Outline of the selection process for PFMs

1. The PFRDA will initiate the PFM selection process by issuing an Expression of Interest (EOI). This EOI will specify the eligibility criteria for firms which wish to sponsor / setup a pension fund management firm. The EOI will also articulate the bidding and selection process for PFMs. The responses to the EOI will be examined by a Selection and Evaluation Committee of the Government and PFRDA. This Committee will short-list the firms which satisfy the eligibility criteria.
2. Firms which satisfy the eligibility criteria for sponsoring / setting-up a PFM will be invited to submit a simultaneous technical and financial bid to the Evaluation and

Selection Committee. These firms will also have an opportunity to participate in a joint meeting with the PFRDA and the members of the Evaluation and Selection Committee to seek clarifications, information and any other details on the bidding process and the license terms.

- a) The *technical bid* will include the information and qualifications of the sponsor(s) including years of existence, track record, market share, capital structure, profitability in its existing business, etc. as well as the business projections and prospects in the pension sector.
 - b) The *financial bid* will be a single number which shall be the pre-committed, consolidated sum of fees and charges as a percentage of assets under management (AUM). This fee will include the capital costs and operational expenses including those on sales and marketing, infrastructure, IT, regulatory costs, etc. Outside of this fee, a PFM will be allowed to charge only entry and/or exit loads prescribed by the PFRDA on account of transactions costs including brokerage fees and custodial charges.
3. The technical and financial bids of all PSU bidders will be considered separately to select one PSU PFM. The bids of all other bidders (including domestic and international sponsors) will be considered separately to select 5 private sector PFMs.
 4. First, only the technical bids will be evaluated. Here, each bidder will be awarded a *rank* on a pre-specified and transparent set of technical qualifications. The lowest score (Rank 1) will be considered the best technical bid. Then the financial bids of all bidders will be opened and similarly ranked. The technical bids will have a weightage of 40% while the financial bids will have a weightage of 60%. The combined weighted average of the technical and the financial ranks will be used to select the best 5 firms which will be granted PFM licenses. The process of 'ranking' the proposals and selecting them on the basis of the weighted average of the technical and financial scores will help overcome problems of a 'tie' in the financial bids.
 5. The infra marginal fee (the highest fee quoted by the 6 selected PFMs) will serve as the ceiling of the fees for all PFMs which are granted these licenses. While no PFM will be allowed to charge a fee which is higher than this ceiling (which is established through a transparent, market-based and competitive process), each PFM will be free to charge a fee which is lower than this prescribed ceiling.

6. Any 'predatory' pricing (as defined under The Competition Act, 2002) will lead to disqualification of the relevant PFM(s) from this bidding process and their financial bids will not be considered even though their technical and financial bids may have been opened.
7. The firms which are granted a license to set up a PFM will be required to comply with certain obligations, license conditions and time-frames prescribed by the PFRDA.

3.4 PFM license terms and conditions

1. The license for a PFM will not have any specified tenure and a PFM will be able to continue in business and charge any fee which is equal or less than the infra marginal bid. However, this fee ceiling will change on the basis of future infra marginal bids (when the next round of bidding for new licenses is undertaken).
2. A PFM license may be terminated by the PFRDA for any material violation of the license conditions. Termination of a PFM license for breach or violation of the license conditions by a PFM will disqualify the PFM from participating in any future bids for a PFM license. If a PFM license is revoked, the PFRDA will auction this license using the same bidding process described above.
3. A PFM will be able to surrender its license with a specified advance notice to the PFRDA. In this situation, the PFM will not be allowed to reenter this market as a PFM for a period of 3 years. The customers of the PFM and their assets will be transferred to other PFMs on the basis of customer choice. The exiting PFM will bear the transaction costs of this transfer. The assets of customers who are unable to (or do not) select any other PFM and/or scheme will be transferred to the 'default' scheme. In this case also, the PFRDA will auction this license using the same bidding process described above.
4. PFMs will also be allowed to merge or buy out other PFMs. This process will be regulated by the PFRDA. In this situation also, customers will have certain choices and rights prescribed by the PFRDA.
5. Each PFM will be required to pay an annual license renewal fee of Rs.2 crore to the PFRDA. The first year's license fee will be payable to the PFRDA 15 days after the

grant of the PFM license. Thereafter, this fee will be payable in advance at the beginning of each financial year.

6. If the AUM of any PFM falls below 5% of the total AUM of the system, the PFM license will be terminated and a new PFM will be appointed through the bidding process. In this situation also, the PFM will not be allowed to reenter this market as a PFM for a period of 3 years. This floor (of 5% of AUM of the system) may be revised by the PFRDA from time to time.