Evolution of investment instruments in South Asia

Susan Thomas
http://www.igidr.ac.in/˜susant
susant@mayin.org

IGIDR
Bombay

Features of a modern pension system

- Self-funded
- Focus on highest returns, lowest costs
- Focus on flexibility of investment
- Focus on good governance and regulation

India’s New Pension System (NPS)

- DC scheme, market determined rates of return
- Individual accounts
- Central record-keeping agency, CRA
- Competing fund managers
- Independent pension fund regulator
- A two-tier system:
  1. Tier I: currently available only to Central Govt. employees, mandatory 20% contribution
  2. Tier II: available to anyone, voluntary, no tax benefits

Linking NPS with Indian capital market reforms

- DC scheme
- Individual accounts
- **Central record-keeping agency, CRA**
- **Competing fund managers**
- **Independant pension fund regulator**
- A two-tier system:
  1. Tier I: currently available only to Central Govt. employees, mandatory 20% contribution
  2. Tier II: available to anyone, voluntary, no tax benefits

Central record-keeping agency, CRA

Motivation for a CRA

The CRA solves the problems of:

1. Uniform services to end customer
2. Reduce costs in the pension system by
   - Unbundling the cost of record keeping/maintenance, fund collection/distribution from fund management.
   - Exploiting economies of scale in record keeping.
   - Facilitating efficient movement of the individual account across jobs and fund schemes.
3. Easier to monitor and regulate.

Lessons from the securites depository, NSDL

- Prior to 1993, there were several problems with settlement in the equity market:
    1. fraud paper,
    2. high cost of transfer across large geographical distances.
- These problems disappeared with:
    1. Dematerialisation of equity,
    2. Centralisation of the settlement process.

Tangible outcomes

- Before depositories, the cost of equity settlement was typically 1.25% of the transaction value.
- After depositories, this cost dropped to 0.03% of the transaction value.
- Reusing the CRA infrastructure at NSDL:
  1. Tax Information Network (TIN) system.
  2. Central warehouse receipt record keeper for the gold derivatives market.
  3. CRA for the NPS.

Electronic funds transfer (EFT)

- EFT can be used to reduce the cost and improve the efficiency of funds collection and disbursement.
- The focus is not so much on a real-time service.
- The focus is on improving access of *reliable* fund collection/disbursement for a large population spread over a wide geographical area.

EFT in India

- The securities market accessed IT to provide wide-spread access to rapid securities transactions and settlement.
- The Indian banking sector has been slow to provide similar services for funds transactions.
- Today, the foreign and the private sector banks compete to provide electronic funds transfer all over the country within their own networks.

Fund management

Focus on the best return on investment

- By definition, DC systems collect and accumulate funds very quickly from inception.
- The fund manager needs to be focussed on **the highest return, at the lowest cost of investment**.
- The investment products ought to be **flexible** to suit a heterogeneous set of risk preferences.
- Internationally, the consensus is that the pension fund management industry ought to focus on offering **simple** choices.
- This requires a cadre of fund managers who are knowledgeable about the business of investment in the domestic markets.

Fund management in NPS

- The number of fund managers for the NPS is limited to ten managers.
- The fund managers will be selected through an auction where primary selection criteria is the lowest cost of fund management offered.

Pension fund product choices

- In addition, the schemes that the fund managers can offer are also limited to three basic combinations of bond and equity exposure:
    1. **safe**: 70% of the funds in Govt. of India (GOI) bond portfolio, the rest in equity.
    2. **medium**: 50% of the funds in GOI bonds.
    3. **risky**: 40% of the funds in GOI bonds.
- There is a strong preference for index portfolios as the choice of portfolio.

The fund management industry in India

- The fund management industry in India started with one state owned entity (the Unit Trust of India) in the eighties.
- This sector was opened up in early 1990's to both domestic as well as international competition.
- Today, there are around 35 fund managers in India, with a heterogeneity of fund types.
- The industry today has around USD 50 billion of funds.
- However, the fees charged by these funds are still quite high by world standards.

Regulation for fund management

Pension fund regulation

- Pension funds are invested over long time spans of over 30-35 years.
- An overarching concern is ensuring the safety of the funds collected and invested from deliberate fraud and malpractice.
- This is especially important in emerging market countries where governance is a big concern.

Pension fund regulation in India

- There is an independant pensions regulator, Pension Fund Regulatory and Development Authority (PFRDA).
- Pension fund management regulation will draw on principles and lessons from mutual fund regulation.
- A key aspect is self-monitoring by an individual of their own cumulated funds. This is faciliated by:
    1. ease of account access at the CRA
    2. transparent and liquid markets enabling frequent mark-to-market valuation, in the case of equity markets in India. This is difficult for the less transparent bond markets.

Indian mutual fund regulation and governance

- The Securities and Exchanges Board of India (SEBI) is the mutual fund regulator.
- SEBI tightened the regulation of the mutual fund industry after the CRB scam of 1998.
- The most significant policy actions were
  1. increased transparency about a scheme's portfolio, and
  2. more frequent disclosure from Indian mutual funds.
- Since then, the Indian mutual fund industry has been remarkably free of problems.
  (Cases in contrast: UTI, Seamen's Provident Fund)

Indian mutual fund regulation and governance

There are several layers of governance in an Indian mutual fund management company:

1. A trustee board which sets the accounting standards and portfolio valuation for a given mutual fund scheme.
2. A board of directors for the mutual fund company.
3. A statutory auditor for the company, from company law.
4. An internal auditor.
5. Lastly, there is the SEBI auditor.

Investible universe of assets for pension funds

Pension funds require diverse and liquid asset markets

- The long term horizon nature of pension funds imply that these funds can benefit most from returns out of diversified investments.
- World-wide, most pension funds have a home-country bias.
- Pension funds have also been the primary drivers for international investments.

Investible assets in India

The assets span:

- Equity, spot and derivatives
- Debt, mainly central govt. bonds
- Commodity derivatives, including both agricultural and non-agricultural commodities

Are the domestic markets enough for the NPS investment?

- The stock of GOI debt today is approximately USD 11 trillion. The market cap of the set of tradeable stocks is USD 550 billion.
- There is no good measure of the size of the pension fund stock in India. However, estimates place it between USD 40-60 billion.
- When the NPS starts scaling up in size, it is likely that domestic markets will **not** provide sufficient size and liquidity.
- One solution is to use international assets and markets.
  India still has very limited convertibility, which limits the NPS ability to access global assets.