Financial Institutions and Markets
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Lecture – 26
Provident Fund and Pension Fund

So, in the previous class, we discussed the different issues related to commercial banking, which deals with the financial statement, performance of the commercial bank, then we also discussed the autonomy, then we went to the Basel norms. Then finally, we discuss certain things related to risk management of the commercial bank or the measures of the risk of the commercial bank.

Today, we will be discussing about another important institution what we can say or important instrument, which is available in the market or always we are much more concerned about that is basically your Provident Fund and the Pension Fund, because that is a buzzword or maybe common things, what always people are concerned about whenever anybody works or anybody started earning the income.

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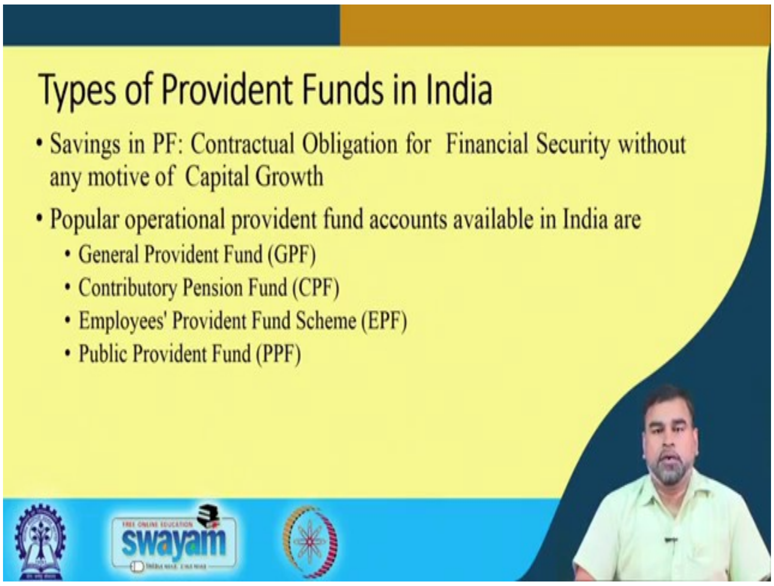

So, let us see that what exactly this pension fund and provident funds are and how those things work in the Indian financial system. So, whenever we talk about the provident fund, it is basically what, it is basically the contractual obligation for financial security without any motive of the capital growth. What does it mean? It means that why the people basically go for a provident fund or the government ensures that we should have a provident fund, it is not to maximize the return or we are not expecting that a regular flow of income, what we can expect from this.

But, we always go for the provident fund, the basic reason is the provident fund is basically financial security for you and as well as for your family members. So, we go for small savings through this provident fund, and end of the retirement. Once your job will be superannuated or you will be getting your retirement, then that particular money can be accumulated to a certain amount, and finally, that can be useful for your retirement life for you and as well as for your family.

So, the basic objective of the provident fund is, it is a forced kind of savings that the investor or the person always does, to get certain kind of security, after the retirement. So, if you talk about India, in India mostly there are different types of provident funds work. One is your GPF-General Provident Fund which was there before, but nowadays it is not existent, but still, there are certain employees, who are coming under this GPF scheme.

And we have the Contributory Pension Fund-CPF, then we have the Employees Provident Fund scheme that is EPF, then finally the Public Provident Form that is PPF. One by one if you see, what do you mean by the general provident fund? The general provident fund feature is basically dealt with after the person gets superannuated or maybe gets his retirement. Then whatever existing salary he was getting, every year or every month some amount of salary was deducted from that particular monthly salary, generally, it is 10 percent, and that money is deposited in the account which is called the GPF account.

And after the retirement, he gets that particular money or all the accumulated money with a certain interest. And that interest rate is basically decided by the government. In between the GPF, money can be withdrawn for some specific reasons some either it is health-related issues or any social issues if you have that is already defined. So, the GPF money also can be withdrawn, if the particular person wants.

Within that, we have another scheme, which was available that is called CPF contributory pension fund. What this contributory pension fund is and in the contributory pension fund after retirement, the person does not get the pension on the basis of his or her last salary. In the contributory pension fund, the person contributes certain money or certain percentage of the monthly salary, and the minimum matching amount a 10 percent or 12 percent that will be contributed by the employer, and that money will be kept in a particular account which is called the CPF account. And that also carries certain interest. And after retirement, that person will get back that particular money with a certain interest, whatever money they have accumulated.

An employee provident fund, it is basically a small income group. So, everybody should have the EPF account. And whenever the particular person gets his or her salary, a certain percentage of the total salary of that particular month will be deposited in the EPF scheme. And the accumulated money can be withdrawn, whenever this person gets his retirement.

And public provident fund, this is basically a way of making your investment or maybe tax saving instrument. Some of the commercial banks are entitled to provide these public provident fund services like the state bank of India. And the maximum amount, what you can save through the public provident fund that is 150,000 per month. And the person can deposit that money in one go or they can deposit the money also two in a different installment basis, but that has to be deposited within that particular time gap, so that is basically a tax-saving instrument what people call it. And it is a very long term instrument, generally, it is kept for 15 years.

And the money cannot be withdrawn, before that or before the maturity of that particular fund which is basically 15 years time period, so that is basically you call at the PPF scheme of the public provident fund. So, these are the different provident fund schemes, which are existing in the Indian market. And different people are coming under maybe falls under that particular scheme, depending upon that reference or depending upon the type of the job, what they are doing, and as well as whether they are the lower income group or they are the higher income group.

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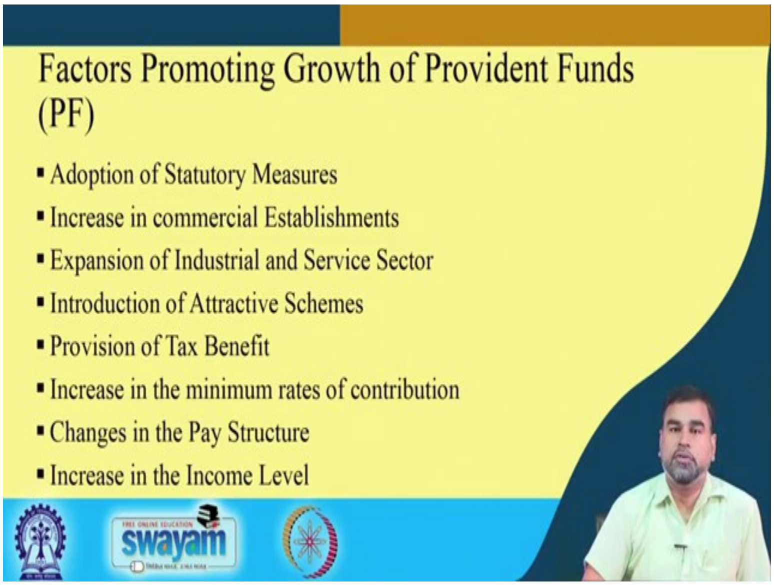

So, if you talk about why the provided fund is very important or it is very growing because there are different reasons for that. One is your, that is adaptation of statuary measures, because it is a mandatory, it is a force saving kind of thing, it is mandatory for everybody to open the provident fund account, because to make that particular retirement life safer and as well as your family protection.

And another one is increase in the commercial establishment because of development in the business sector. Nowadays, there are some organized and unorganized employees, which are available. For both organized and unorganized employees, this particular provident fund services are available or may be mandatory, so because of that thing is basically growing in the Indian market now.

Then we have the expansion of industrial and service sector, which is growing rapidly. Introduction of the different type of schemes because we have just now, discussed the four type of schemes. There are different schemes available under this; the people can always go for depending upon their characteristics. And also the provident fund provides the tax benefits.

So, whatever money is deposited in the provident fund scheme, that basically is a tax deductible instrument whenever we are giving the income tax in a particular financial year. And also increase in the minimum rate of contribution, the government time to time make it mandatory that how much money has to be deposited towards the pension or provident fund, so because of that also that amount are available to the money in the circulation above in terms of the provident fund account is also increasing.

Changes in the pay structure, because time to time the pay revisions are happening. One is the income level of because a particular person increases, then automatically the amount availability towards this provident fund also increases. And increase in the income level. So, these are the major factors, which drive the growth of the provident funds in India or the amount of money which is circulated through the provident funds in India. So, these are the things, not the ultimate things, but these are the some of the major factors, which drive the growth of provident funds in the Indian financial sector.

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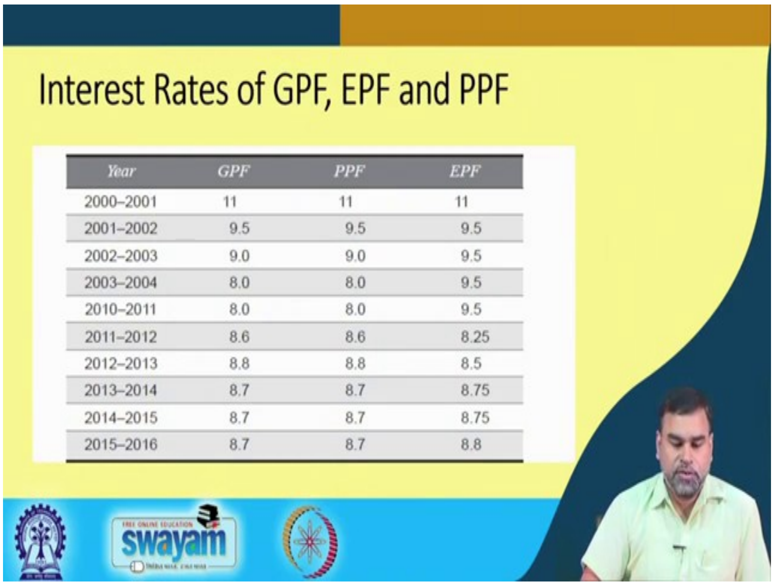

Year	GPF	PPF	EPF
2000–2001	11	11	11
2001–2002	9.5	9.5	9.5
2002–2003	9.0	9.0	9.5
2003–2004	8.0	8.0	9.5
2010–2011	8.0	8.0	9.5
2011–2012	8.6	8.6	8.25
2012–2013	8.8	8.8	8.5
2013–2014	8.7	8.7	8.75
2014–2015	8.7	8.7	8.75
2015–2016	8.7	8.7	8.8

Then we have if you see that, we have some data related to the rate of interest what we get. If you see the GPF, PPF, and EPF rates, there is not much fluctuations in comparison to all these three types of funds which are available, but more or less it varies between eight percent 8.7 or 8 percent to 11 percent. But, if you see there is a trend in 2000, it was 11, but after that this particular rate has come down 9.59 9, then it has come down even 8, then there are some in there is a fluctuating trend.

But, when up to 2000, if you see 2000 to 2001, the rate was quite high 11 percent interest; but, in the year 2015, 16 data, whatever we have now. If you see that GPF provides 8.7 percent interest PPF 8.7, and EPF provides the 8.8 percent interest, and that always subject to change depending upon the government policy.

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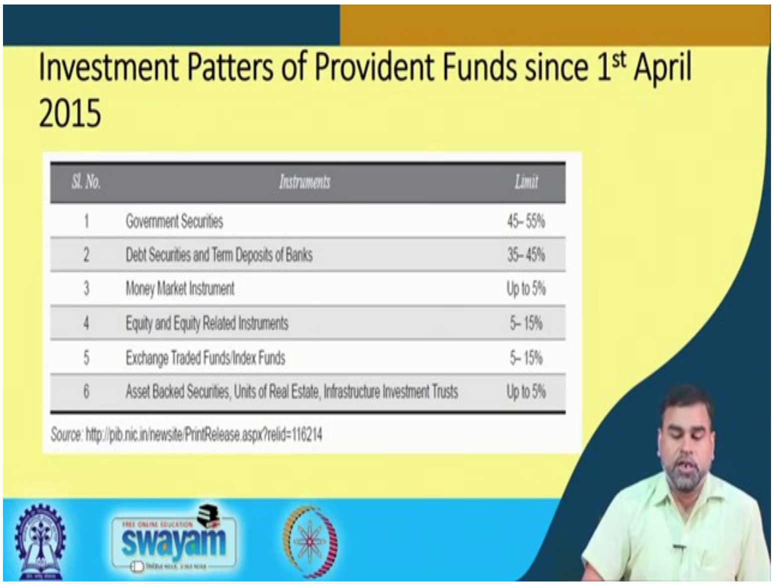

So, where this money, which is coming to the provident fund are invested; so, whenever the money comes to the GPF, the GPF funds are basically invested, because they provide the interest the whatever money is given to them. The money under this particular provident fund scheme is always invested in the market or the different kind of financial instruments. So, if you see the restrictions, there are different limits has been provided by the government. So, if it is mandatory that the 45 to 50 percent of the money has to be invested in the government securities.

Depth other depth securities and term deposits of the banks, they can invest up to 35 to 40. Money market instruments like certificate of deposits commercial papers, treasury bills, all these things can be invested up to 5 percent. Equity related investments which is relatively riskier than the other type of investments, you can go up to 5 to 15 percent. Exchange traded funds or the index funds, if they have which follows the buy and whole strategy on the passive strategy for the investment, there they invest 5 to 15 percent.

And you have of the asset backed securities or real estate, infrastructure are all investment trusts, and all these things, then you can go maximum up to 5 percent. So, these are the limits which are given by the government that where the money can be invested to attain some return from this, and finally these interest payments can be made to the particular provident fund holders. So, these are the different investment pattern, we can observe in terms of the provident fund in the market.

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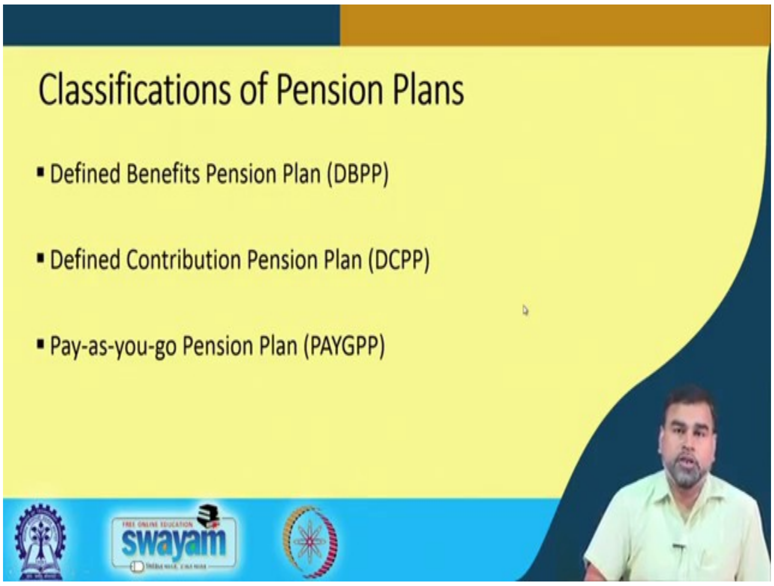

Then we can come to the pension schemes or the pension plans, you see theoretically the pensions are divided into three parts or three types of the plans, which are existing across the globe. One is your defined benefit pension plan, and you have the defined contribution pension plan, then you have pay as you go pension plan. What does it mean, if you see one by one, what do mean by the defined benefit pension plan which basically is related to GPF.

So, here what happens that the person basically after getting the job, certain amount of the money is deposited as a GPF account, and with interest the person gets back that particular money, after the retirement and as well as the person gets the pension on the basis of his last drawn salary, so that means it is a defined benefit pension plan. So, if you see that in the Indian context, how it happens that if for example the last salary of a particular person, whenever he got his retirement or he was retired from his job was let 100,000 rupees. So, then what will happen, his pension amount will be calculated in this way.

The pension amount for the basic amount will be 100,000/ 2 that means, 50% of that particular last drawn salary that is 50,000. Then after 50,000 he or she will be getting the DA, whatever DA dearness allowances available in that particular point of time. Then that 50,000 plus let in that particular point of time, the existing employees are getting

10% of the DA. Then the 10% of the 50,000 that is 5000 will be added into that then 55,000 will be his or her pension.

And once the pay revision takes place, the pension amount also changes. And accordingly, they also get the revised pension that means, it is defined and assured that that person will get the pension up to his death. And after his death his or her nominee will get the half of the pension, so that is basically we call it defined benefit pension plan, which was existing in India before up to 2003.

Then we have another plan, we have that is called the defined contribution pension plan. Then what do mean by the defined contribution pension plan. So, in this case, the particular employee basically always a certain percentage of his salary, certain percentage of the money will be deducted. And same matching amount will be provided by the government or any employer, who was given him the job. Then that particular amount will be deposited in that particular account, and or the pension fund account.

And from that pension a certain percentage of the money can be withdrawn, and certain percentage can be kept and from that certain percentage this person gets the pension. And that particular money can be invested in an annuity, and from that annuity periodical return will be realized. And from that periodical return the pension will be paid to that particular person, so that is called the defined contribution pension plan. Then we have an India, now we are following this defined contribution pension plan, after 2003, December which is popularly known as NPS. We will discuss more about NPS in the future slides.

Then other one is the pay-as-you-go pension plan means, your pension amount will be paid by the other employer. The person who is working now, they provide or they contribute certain thing certain kind of percentage of the total salary for their future generations that means, whenever you are working, you are paying something, but from that you may not get the pension, that pension amount will be paid to your future employees, who are coming to that or future generation, who will be coming to work in that particular organization.

So, most of the foreign western countries; sometimes they were following that pay-as-you-go pension plan. To provide that pension for a long time a long period that means, you are paying for the pension, but that pension amount you may not go, you may not get that pension amount basically will be given to your future generation. But, whatever pension you will be getting, that money was contributed by the previous generation, who was already worked in that particular organization, so that is basically called the pay as you go pension plan, which also works in some of the countries.

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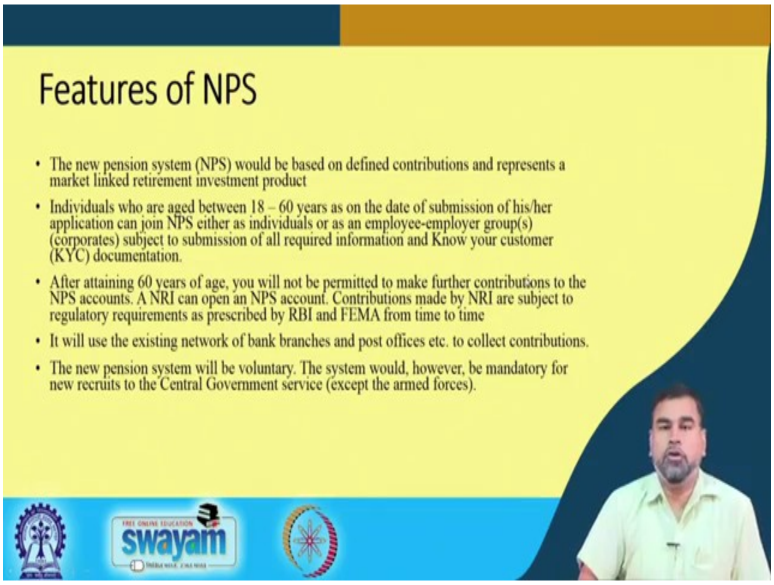

Then we have already I told you in India we are working with NPS. The NPS is very popular in the Indian context, not popular it is now mandatory for the all government employees and as well as it is also open to the private employees, and other kind of organizations, this what is called this new pension system, which was started in 2004, January.

So, any person who has started working after 2003, December he or she is basically coming under this NPS. Already I told you that NPS is based on the defined contributions, and represent a market linked retirement investment product. Just like it is a mutual fund instrument like a mutual fund instrument. And the return from that particular fund return from that particular NPS is related to the market, I will explain one by one, what are those features basically we have.

Any individual who are aged between 18 to 60 can be a part of this NPS subject to all kind of KYC norms, they have to fulfill. They have to be citizen of this particular country, and details information should be available for that particular employee, who is basic who is interested to open that NPS account.

After he or she attains age 18 and after attaining 60 years of age, which is supposed to be the retirement age for India, you will be permitted or you will not be permitted to make the further contributions to the NPS account. A NRI can open an NPS account. Contribution made by the NRI's are subject to the regulatory requirements as prescribed by the RBI and the FEMA from the time to time. All how basically you can contribute it or contribute your pension fund account, you can contribute through the existing network of the bank branches or the post offices, and anywhere basically the NPS account can be opened up.

The new pension system will be voluntary, it was voluntary for the other employees, but it is mandatory for the central government employees except this armed forces. Still this armed forces are coming under the GPF, and there is a kind of defined pension benefit they always get, after the retirement. But, whenever it comes to the other employees other kind of jobs, this NPS is mandatory for them, if he or she is the central government employee. Some of the state government also have adopted that, but it is mandatory for the central government employees.

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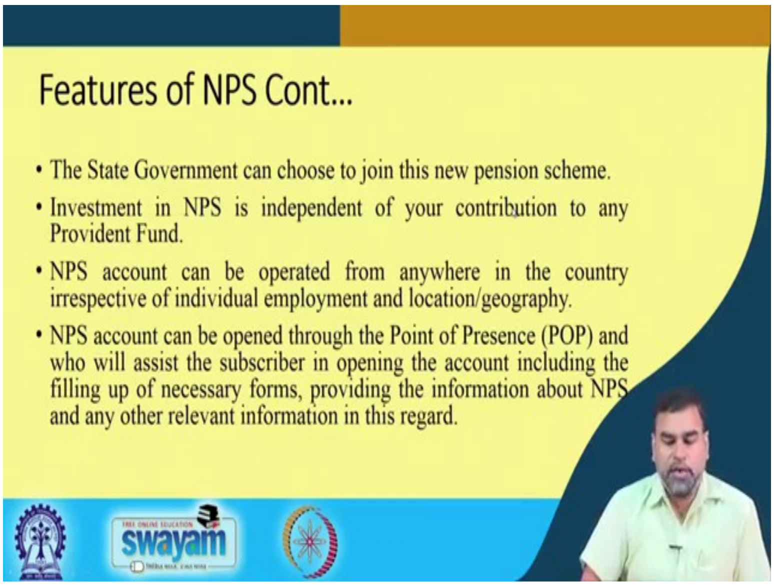

The state government can choose to join this new pension scheme that already I told you. The investment in NPS is independent of your contribution to any provident fund. So, if you are contributing any provident fund, that is nothing related to NPS. NPS account can be operated from anywhere in the country, irrespective of individual employment and location or the geography wherever you may be, but the NPS account can be operated through the post offices or the banks.

The NPS account can be opened through the point of presence, and who will assist the subscriber in opening the account including the filling of the necessary forms, providing the information about NPS, and any other relevant information in this regard. So, as it is mandatory. So, we have the point of presence it can be a bank, it can be post office, it can be any other organization, who has the license to provide this kind of services from there the NPS account can be operated or you can open that particular account with them, and finally the money can be contributed to that.

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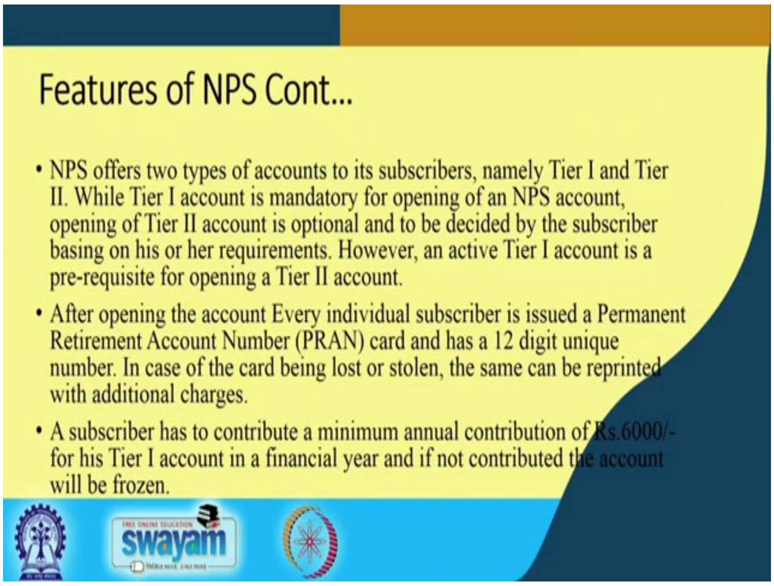

But, what exactly happens to that particular account. There are two types of account in NPS; the one is tier-1, another one is the tier-2. The tier-1 account is mandatory for opening, but tier-2 is optional. It can be decided by the subscriber, if they want to open it or there is a requirement for the tier-2 account. However, the tier-1 account is the pre-requisite for opening the tier-2 account.

Somebody can open the tier-2 account, if he or she has the tier-1 account. So, what basically here happens every customer or every individual after opening the account, he or she will be issued one permanent retirement account number or the PRAN, which has a 12 digit unique number. And wherever you are working that particular account will remain that particular number will remain, and through that particular number all kind of transactions, and all kind of information you can gather through this for this particular NP account.

A subscriber has to contribute a minimum annual contribution of 6000 that means, per month minimum five 500 rupees they have to contribute to the tier-1 account. And if you are not able to contribute, then your account will be frozen account will be closed, so that is what basically this thing, and how basically if the contributions are made.

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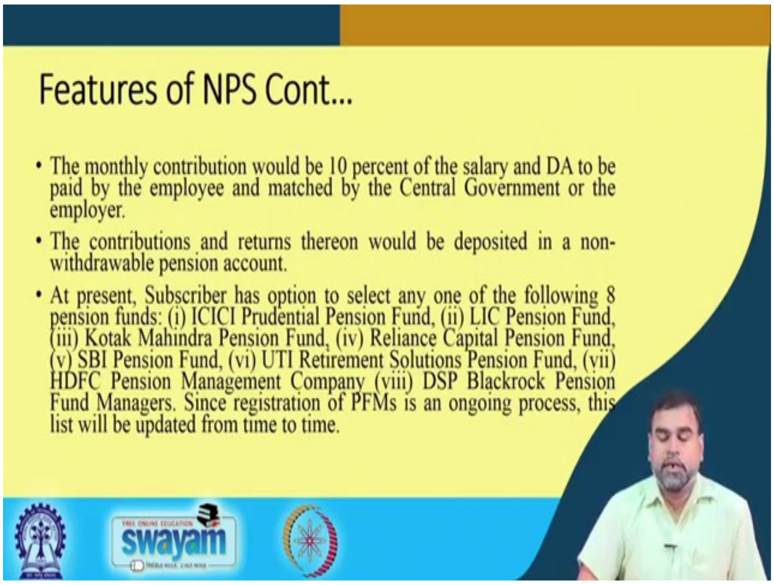

The contributions are nothing but, it is the 10% of the total salary. The basic salary and the dearness allowances that is DA to be paid by the employee and the matching amount will be given by the central government or the employer that means, the 20 percent of your total salary will be deposited in this NPS account. And another feature we have, this particular money cannot be withdrawn, before your retirement. Whatever money you have deposited, that money will be kept there up to the year of 60, because unless this person got retired at any point of time, retired before the unless he got the retirement this particular money cannot be withdrawn.

And then what will happen, the subscriber once the money has basically has been deposited in that account, what the subscriber has the option to select any of the following pension funds like ICICI Prudential, Kotak Mahindra, Reliance Capital, SBI Pension Fund, UTI Retirement Solution Pension fund, HDFC Pension Management Company, DSP Blackrock Pension Fund Managers, any of the pension funds they can choose and the money can be invested in that pension fund. And this particular pension fund managers can be changed in between if they want. They can move from one pension fund manager to another pension fund manager if they want.

And what do you mean by that pension fund, the money is deposited and every pension fund has certain assets where the money should be invested. From that asset certain money is related to debt instrument, certain money is related to equity instrument. Once the money has been deposited there; it is the responsibility of the pension fund manager to invest that money in certain kind of financial instruments to maximize the return. And out of these pension fund managers, you can choose anybody and if you need or if you want, then you can change them also in between.

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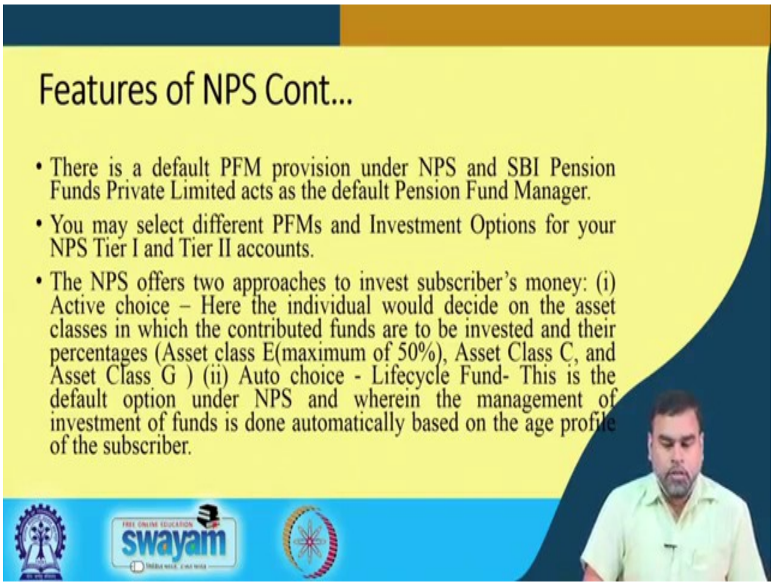

So, there is a default provision what the government has assigned, how much money can be invested where, and also you can select that how much money can be invested in what kind of instruments depending upon your age. The limits have been given. And once your age goes up, then if you are going towards the more risky investments that is not available. Maybe amount of or the percentage of the risky assets in your portfolio will go down once your age will be increasing. And the amount of government securities and other secured bonds will be increasing.

So, that is why you can go for the investment options on your own or you can go for a default option where already it is designed by the government or the pension fund managers. So, then accordingly your money whatever you are contributing that can be allotted to those funds, and the investment have been made.

So, if you see already I explained that NPS offers two approaches to invest the subscribers money, either it is active choice, here the individual would decide on the asset classes in which the contributed funds are to be invested and their percentages, E, E means equity that is maximum 50%. Asset class C and G which is basically related to the government bonds in the other corporate securities G is.

And the auto choice which is basically lifecycle fund, this is the default option under NPS and where the management of investment of funds is done automatically based on the age profile of the subscriber. And whatever age you are depending upon already I told you the E will go down and the C and G may go up, because the risky investments or risky instruments in your portfolio will be going down, and other kind of relatively less risky assets in your portfolio will be going up so that is what basically the default options, may be you can choose or you can go for your own choices for the investment in the portfolio.

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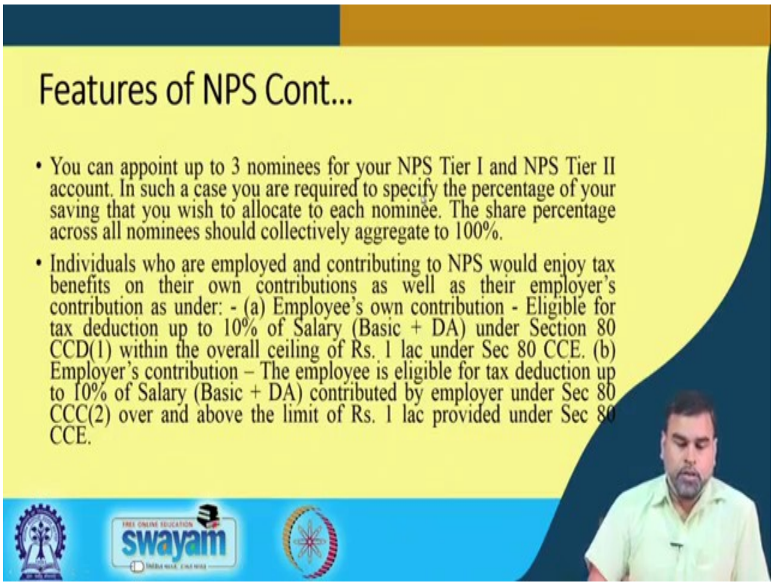

You can appoint up to 3 nominees for your NPS tier 1 and NPS tier 2 account, but tier 2 account you can withdraw whenever you want because that is apart from the 10% if any extra you want to deposit, then you can deposit, but there is no matching amount you will be getting from the employer or the government. And that amount can be invested by the pension fund manager. And whatever money you have, if you want you can withdraw that money whenever you need.

So, in such cases, if you are they have 3 nominees and the share percentage across all nominees should be collectively 100 percent, obviously, it cannot exceed that. So, you can divide that particular percentage of the total money what you are supposed to get after retirement among maximum 3 nominates.

Already I explained these individuals who are employed and contributing the NPS would I enjoy the tax benefit on their own contributions as well as the employers' contributions and under this section 80 CCE. And employer contribution the employee is eligible for a tax deduction up to 10% of salary contributed by the employer under section 80 CCC 2 2. Over and above the limit of 1 lakh provided under a section 80 CCE.

So, nowadays if you are under the NPS, then you are deductible tax whenever you are paying that is 1.5 lakh which was there for the people where they get the tax rebate out of the total income. If you are extra 50,000 tax rebate also you can get fifty thousand income tax rebate also you can get if you are a NPS subscriber, and that money has been contributed to NPS. That means, overall the person who was under NPS, they can get the tax rebate up to the 2 lakh rupees for other employees, it is 1.5 lakh rupees, but for the NPS subscriber this has basically 2 lakh rupees according to the government.

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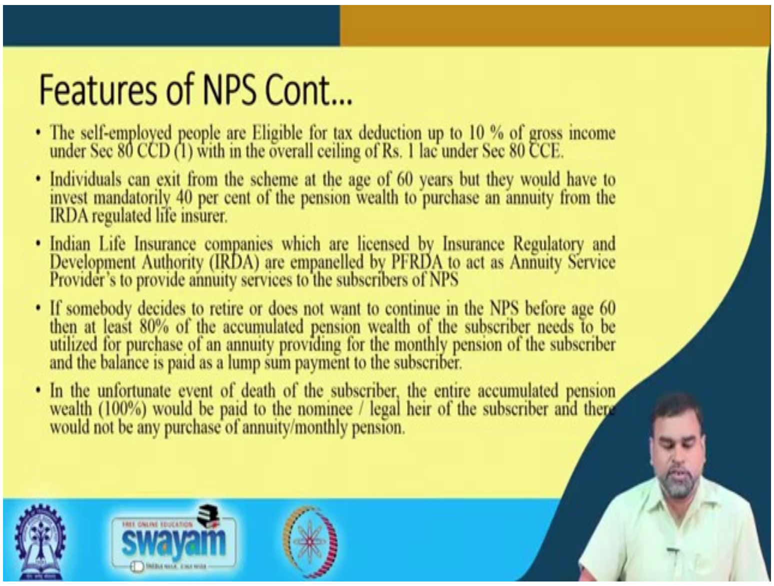

So, here individuals can exit from the scheme at the age of 60 years, but they would have to invest mandatorily 40 percent of the pension wealth to pursue an annuity from the IRDA regulated life insurer. That means, after your retirement what basically will happen, the 40 percent of your total sum which were there on the basis of the market rate, you will be getting back that money; and 60 percent will be invested in an annuity at any point of time the money cannot be withdrawn by this particular employer. And that money can be invested in an annuity, and from that annuity will be getting the pension.

Only if the person dies or the subscriber basically dies, then the entire accumulated pension wealth would be paid to the nominee or the legal heir of the subscriber, and there would not be any purchase or annuity or monthly pension after this. So, only the 100 percent money can be withdrawn by the nominee, it cannot be by the subscriber himself, only subscriber can withdraw 40 percent or can get back the 40 percent after the retirement, and 60 percent has to be invested in an annuity to get the periodical pension per month.

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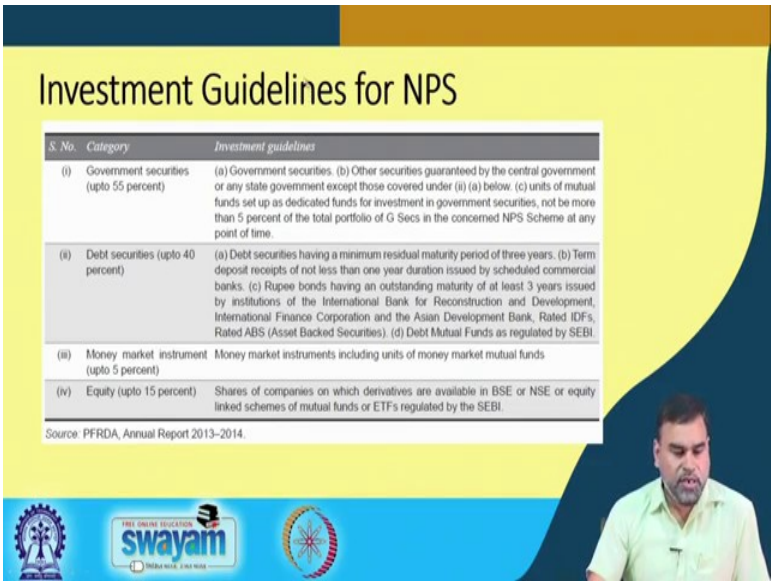

So, these are the guidelines which are given for the government employers that where the money can be invested. It is government securities up to 55%, debt securities up to 40%, money market instrument up to 5%, and equity up to 15%. These are the maximum limit which was given. And whatever money has been paid to that particular account that money can be invested either of these securities, and the limits are basically fixed accordingly.

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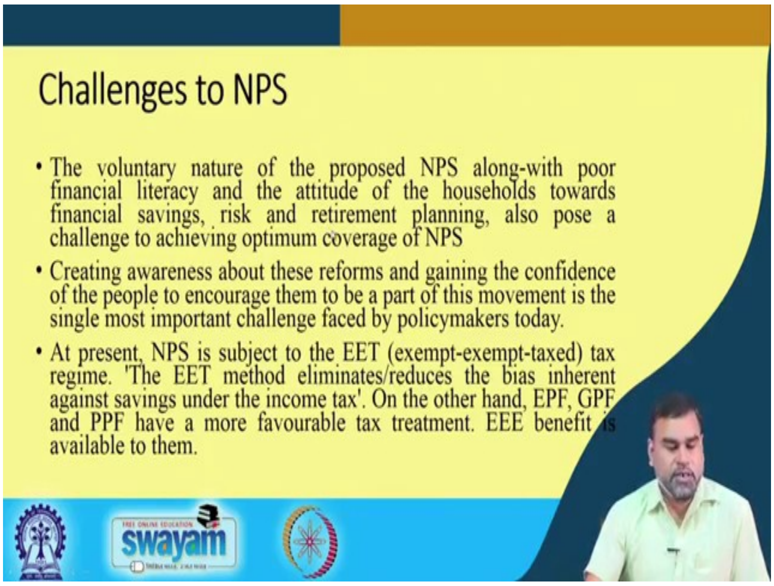

There are certain challenges, the challenges are basically that the people have less financial, there is a problem of financial literacy. The attitude of the household towards the financial savings, risk and retirement planning also pose a challenge the people may not be that much inclined to go for a long period of investment without any withdrawal. Creating awareness about these reforms and gaining the confidence of the people also the part of this movement; the single most important challenge, so what the policymakers are facing, people may not be that much convinced.

And at present the NPS is subject to EET - exempt-exempt-taxed system, where whenever the 40% amount will be paid to you, you may pay the tax against that. Although that is still on the debate that is still going on, but in the existing structure you may not get the tax rebate against that although your GPF amount and CPF amount is totally tax free. So, that is another challenge whatever always we have or the PPF amount is also totally tax free, but whenever we talk about NPS that particular tax problem is related to whenever you are getting the final amount after the retirement on the basis of the market fluctuations or the market rate of return what is available on that particular point of time.

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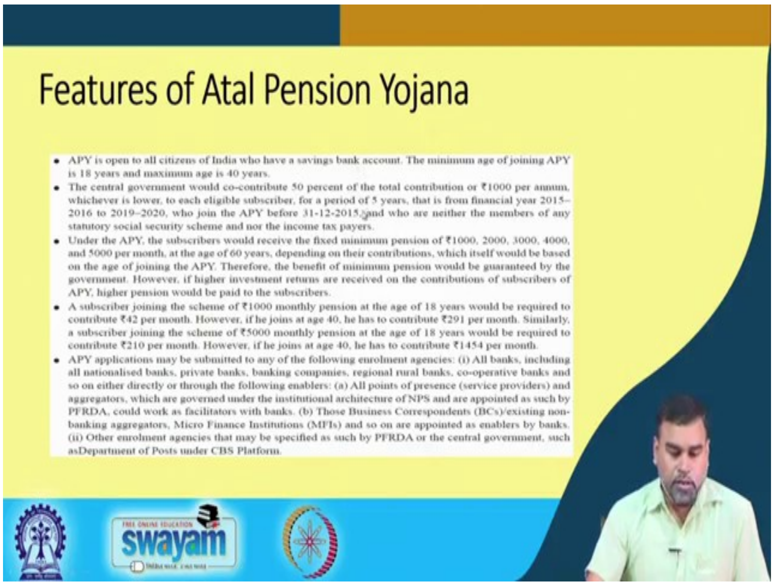

This is a new scheme which was started by this current central government which is called the Atal Pension Yojana. So, everybody who has a savings bank account, they can go for this. Minimum is 18 years, it can go to 40 years. Here government will contribute 50 percent of the total contribution or 1000 per annum whichever is lower. And to the eligible subscriber for a period of 5 years, and who join a APY before this 31st December 2015, and who are neither the members of any statutory security scheme and nor the income taxpayers.

Basically this scheme is you can see the features, this scheme is basically provided only to those people who are less income people, and they are not coming under any income tax bracket. So, this is basically a new scheme for providing the social security or the retirement benefits to the people who may not be highly organized employees, but they also need some social security or the kind of security for their family. So, this is about the overview of the pension plan or the pension system in India and as well as the provident funds which are available in the Indian context.

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Please go through these particular references for this particular session.

Thank you.