

**Report of the Committee
on
Investment Pattern
for Insurance and Pension Sector**

Government of India
Ministry of Finance
Department of Financial Services
3rd Floor, Jeevan Deep Building
Parliament Street, New Delhi

2013

F.No.11/19/2012-PR
Government of India
Ministry of Finance
Department of Financial Services

3rd Floor, Jeevan Deep Building,
Parliament Street, New Delhi,
Dated, the 29th May, 2012

OFFICE ORDER

Subject: Committee on Investment Pattern for Insurance and Pension Sector

A committee has been constituted in the Department of Financial Services with a view to review the Investment pattern of Insurance and Pension sectors. The Committee will examine the existing investment pattern being followed in Banking, Capital Market, Pensions and Insurance Sector and will suggest an investment pattern, keeping, inter-alia, in view the existing investment patterns and claims time cycle in Insurance Sector.

The constitution of the Committee is as under:

1.	Sh. G.N. Bajpai, Ex-Chairman, LIC	Chairman
2.	Sh. K.N. Bhandari, Ex. CMD, NIACL	Member
3.	Sh. M.S. Sahoo, Ex-Member, SEBI	Member
4.	Sh. Vinay Bajjal, Ex-CGM, RBI	Member
5.	Sh. Biswajit Mohanty, MD & CEO, SBI Pension Fund Ltd.	Member
6.	Prof. Jayant Verma, IIM, Ahmedabad	Member
7.	Dr. Shashank Saksena, Director (PR & BO-II)	Member
8.	Sh. Lalit Kumar, Director (Insurance)	Member
9.	Ms. Mamta Rohit, CGM, PFRDA	Member
10.	Sh. S.N. Jayasimhan, JD, IRDA	Member
11.	Sh. Gautam Bhardwaj, MD, IIEF	Member
12.	Sh. P.C. James, Chair Professor (Non-Life), NIA	Member

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Director (BO-II & PR)
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1. Sh. G.N. Bajpai, Ex-Chairman, Life Insurance Corporation
2. Sh. K.N. Bhandari, Ex. CMD, NIACL, to represent non-life sector
3. Sh. M.S. Sahoo, Ex-Member, SEBI
4. Sh. Vinay Bajjal, Ex-CGM, Reserve Bank of India
5. Sh. Biswajit Mohanty, MD & CEO, SBI Pension Fund Ltd.
6. Prof. Jayant Verma, IIM, Ahmedabad
7. Dr. Shashank Saksena, Director (PR & BO-II), Deptt. Of Financial Services
8. Sh. Lalit Kumar, Director (Insurance), Deptt. Of Financial Services
9. Ms. Mamta Rohit, CGM, PFRDA
10. Sh. S. N. Jayasimhan, JD, IRDA
11. Sh. Gautam Bhardwaj, MD, IIEF, will be the coordinator and will provide necessary arrangements for compilation of report.
12. Sh. P.C. James, Chair Professor (Non-Life), NIA

F.No.11/19/2012-PR
Government of India
Ministry of Finance
Department of Financial Services

3rd Floor, Jeevan Deep Building
Parliament Street, New Delhi
Dated, the 10 May, 2013

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| 5. Sh. Biswajit Mohanty, MD & CEO, SBI Pension Funds Ltd. | Member |
| 6. Prof. Jayant Verma, IIM, Ahmedabad | Member |
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| 13. Shri Rajrishi Singhal | Member |

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New Delhi, , 2013

The Secretary,
Department of Financial Services
Ministry of Finance
3rd Floor, Jeevan Deep Building
Parliament Street
New Delhi

Dear Sir,

We submit herewith a Report of The Committee to Review the Investment Pattern of Insurance and Pension Sectors.

Yours sincerely,

.....
Shri G. N. Bajpai
Former Chairman, LIC
(Chairman)

.....
Shri K.N. Bhandari
Ex. CMD, NIACL
(Member)

.....
Shri M.S. Sahoo
Ex-Member, SEBI
(Member)

.....
Shri Vinay Baijal
Ex-CGM, RBI
(Member)

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Shri Biswajit Mohanty
MD&CEO, SBI Pension Fund Ltd.
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Prof. Jayant Verma
IIM, Ahmedabad
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Shri S.N. Jayasimhan
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Shri Gautam Bhardwaj
MD, IIEF
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Shri P.C. James
Chair Professor (Non-Life) NIA
(Member)

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Shri Rajrishi Singhal
(Member)

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List of Abbreviations

AUM	Assets Under Management
BSE	Bombay Stock Exchange
CAGR	Compounded Annual Growth Rate
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
CG	Central Government
CIRC	Chinese Insurance Regulatory Corporation
DB	Defined Benefit
DC	Defined Contribution
DEA	Department of Economic Affairs
DFS	Department of Financial Services
EEE	Exempt-Exempt-Exempt Tax Status
EPF&MP ACT	Employees Provident Fund & Miscellaneous Provisions Act, 1952
EPFO	Employees Provident Fund Organisation
ETF	Exchange Traded Fund
FDI	Foreign Direct Investment
FII	Foreign Institutional Investor
GDP	Gross Domestic Product
GOI	Government of India
G-SEC	Government Security
GST	Goods and Services Tax
IDR	Indian Depository Receipt
IIFCL	Indian Infrastructure Finance Corporation Ltd
IPF	Insurance and Pension Fund
IPFM	Insurance and Pension Fund Manager
IRDA	Insurance Regulatory and Development Authority
IIT	Infrastructure Investment Trust
KYC	Know Your Customer
KYP	Know Your Product (or Provider)
LIC	Life Insurance Corporation of India Ltd

MF	Mutual Fund
NAV	Net Asset Value
NPS	National Pension System
NSAP	National Social Assistance Programme
NSE	National Stock Exchange
OECD	Organisation for Economic Cooperation & Development
P&GA	Pension and Group Annuity
PE	Private Equity
PFM	Pension Fund Manager
PFRDA	Pension Funds Regulatory and Development Authority
PIR	Prudent Investor Regime
PSU	Public Sector Unit
RBI	Reserve Bank of India
REIT	Real Estate Investment Trust
SBI	State Bank of India
SDS	Special Deposit Scheme
SEBI	Securities and Exchange Board of India
SG	State Government
SLR	Statutory Liquidity Ratio
SPV	Special Purpose Vehicle
UK	United Kingdom
ULIP	Unit Linked Insurance Plan
USA	United States of America
UTI	Unit Trust of India
VCF	Venture Capital Fund
YTM	Yield To Maturity

FOREWORD

I, on behalf of my colleagues in the Committee, take great pleasure in presenting the Report of this Committee. The Committee was constituted by the Government of India, Ministry of Finance on May 15, 2012 to review the Investment Pattern of Insurance and Pension Sectors. The Committee was expected to examine the existing investment patterns being followed in Banking, Capital Markets, Pensions and Insurance Sectors and to suggest an investment pattern, keeping, *inter alia*, in mind the existing investment patterns and claims time cycle in Insurance Sector. The Government of India, which has been redesigning and restrengthening the sector for reinforcing retirement benefits of the investing public and stepping up the economic development of the country, felt that the time had come to revisit the current investment guidelines so that the industry is able to serve better the twin purposes of its existence.

It is our belief that the analysis of the Committee and recommendations made in the Report would help the policy-makers initiate steps to address some mission-critical issues, dismantle the obstacles that hinder the growth of Insurance and Pension Sectors and improve the economic efficiency of savings pooled by the sector for the economic growth of India.

I take this opportunity to thank The Secretary, Department of Financial Services for having reposed his faith in the Committee and also for having been patient. I take this opportunity to thank the cross-section of individuals and organizations that met with the Committee to share their views and suggestions in order to make Insurance and Pension products a more viable proposition. I thank Dr. Achintan Bhattacharya, JS (Banking) and then Interim Director of NIA, Pune for his valuable suggestions and assistance in hosting the meetings for the Committee, taking care of all travel and other arrangements. Our special thanks are due to Mr. Arvind Kumar, Joint Secretary (Pension & Insurance) who rendered invaluable assistance and support to the Committee. I also take this opportunity to thank Mr. Rajrishi Singhal, Dr. Shashank Saksena, and Dr. M .S. Sahoo for the extensive help in researching and assimilating the material to be put in the cogent form of the report. Last but not the least, thanks are also due to Ms. Surinder Kaur, Under Secretary (Pension Reforms), and Ms. Connie Franco, Executive Assistant of Intuit Consulting for providing valuable assistance and support during several meetings of the Committee.

CHAPTER I

EXECUTIVE SUMMARY

India is firmly on the path of reforms since 1991. The reforms broadly have three components, namely, liberalisation, regulation and development. Economic agents are being liberalised to take decisions in a developed and regulated environment and take responsibility for their decisions. However, it was a gradual process and liberalisation, regulation and development fed on one another in a virtuous circle. The time has come when we need to provide similar freedom to insurance and pension fund managers to invest their funds in asset classes they consider appropriate, keeping in view the interests of their clients and the opportunities available in the environment. However, the environment needs to be well developed and regulated so that a professional fund manager enjoys investing. Otherwise, the Insurance and Pension Sector would soon find their investment options limited and the available options would not provide them an opportunity to build a safe and balanced portfolio. Incidentally, such freedom would help the economy by promoting savings of households by providing them risk-adjusted adequate returns and channelising investments to socially productive and useful projects. However, this freedom needs to be carefully calibrated to avoid any untoward occurrences and make the reforms sustainable.

2. A committee was constituted in the Department of Financial Services, Ministry of Finance under the Chairmanship of Shri G. N. Bajpai, Ex-Chairman of Life Insurance Corporation of India and Ex-Chairman of Securities and Exchange Board of India with a view to examine the existing investment pattern being followed in the Capital Market, Pensions and Insurance Sector and to suggest an investment pattern, keeping, inter-alia, in view the existing investment patterns and claims time cycle in Insurance Sector.
3. The composition of the Committee is annexed at Annex 1. The terms of reference for the Committee on investment pattern are as under:
 - 1) To analyse the:
 - investment of funds under Insurance Sector and Pension Sector and review the existing Investment patterns and exposure limits laid down by the Regulator and the Government.
 - market mechanisms and review the potential of Insurance and Pension funds in contributing to the development and deepening of markets as well as re-energise investment management.
 - 2) To review the scope for modification of investment patterns and exposure limits in order to provide recommendations as guidance to the Government and the Regulators.

- 3) To study international best practices and experiences on Insurance and Pension fund management as well as investment patterns to learn from the best practices of OECD and emerging economies.
 - 4) To examine and provide recommendations to help:
 - understand and capture the potential of Insurance and Pension sectors in contributing to meeting the long term financing needs of the nation while maintaining the safety of the policyholder as the topmost priority.
 - bridge the regulatory gaps in investment pattern of Insurance and Pension funds across funds of similar nature and risk profile.
 - 5) To suggest a road map for the gradual easing of investment exposure patterns with the aim of eventual alignment of Indian Insurance and Pension Fund management to a global investment framework.
4. The Committee examined and reviewed all the factors responsible for the growth slowdown experienced in the Indian economy in the past few quarters, including the ripple effects of the global financial meltdown and the attendant Euro-crisis, a few domestic reasons also contributed to slowing investment demand. Insurance and pension companies need to focus on twin objectives of improving real rate of returns and making more financing available for infrastructure and other long term projects, since they need assets that match the maturity profile of their liabilities, which requires introduction of some new products and expansion of some existing ones, such as credit enhancement and credit derivatives.

On the basis of discussion with various stakeholders of the industry, the recommendations of the committee are summarised as under:

- i. The investment philosophy pertaining to both the insurance and the pension sectors has to leapfrog to the “prudent investor” regime.
- ii. The move to a “prudent investor” regime cannot, and must not, take place abruptly without giving the extant systems an opportunity to upgrade, re-learn and re-tool. Since there is not enough supply of fixed income paper in categories other than government securities, the move needs to be phased out. The Committee recommends a five-year phase-out plan to move to the “prudent investor” regime. During the first two years, the current boundaries of directed investment should be shrunk and more play allowed to individual fund managers. In the next three years, the Committee recommends that strings of directed investment norms must be substantially loosened, including as a preparatory to paradigm shift to ‘Prudent Investor’ regime. While doing so the regulator must allow for the introduction of some new ideas and new products, such as Real Estate Investment Trusts, commodity futures, Infrastructure Investment Trusts - units, etc. It is only after

five years that the Insurance and Pension sectors should move to 'Prudent Investor' regime completely.

- iii. As a measure of abundant precaution, the regulator should lay down guidelines and rules regarding "fit and proper" persons that can be appointed to the Investment Committee and provide detailed guidelines on Board-led governance processes, including risk management and risk mitigation.
- iv. Budget 2013-14 has announced the launch of inflation-indexed bonds or inflation-indexed national security certificates. For an understanding of how these bonds work, the Reserve Bank published a technical paper titled "Inflation Indexed Bonds."
(<http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=598>).
- v. Allow pension fund managers and insurance companies to pool their investments together in a company, like it is done in the case of bank consortia. This will allow sharing of risk.
- vi. Implement financialisation of products, which are popularly perceived to be risky and volatile, such as bullion or real estate. Financialisation allows for exchange-traded instruments and provides liquidity. Exchange trading also provides guarantees against counter-party risk.
- vii. The commodity market, especially the futures market, also needs to be developed. This will be only possible when the commodity exchanges are brought under an autonomous and statutory regulator.
- viii. Most insurance companies and pension funds are barred from investing below a certain credit rating which needs to be relaxed a bit more. Credit enhancement can be of immense help here.
- ix. Re-focus on Indian Depository Receipts. The product already exists but suffers from poor marketing. In fact, there is also enormous scope for extending the rupee bonds market to wider range of overseas issuers. Such rupee bonds and IDRs not only provide a unique opportunity for insurance and pension companies it also gives them an opportunity to invest in select foreign companies without having to go cross the borders and also insulates them from currency risks.
- x. It might also be apposite for the government to revisit the report submitted by the High Powered Expert Committee on Making Mumbai an International Financial Centre, and re-examine the various proposals.
- xi. Existing rules and guidelines prohibit insurance companies and pension funds from investing in private limited companies, which needs to be scrapped or modified.
- xii. Wide-ranging capacity building has to take place across the categories (insurance and pension) and sectors (public versus private) to enable fund managers,

compliance officers, dealers, marketing experts, sales agents, board members, risk officers to improve their skills and help deliver improved returns to investors.

- xiii. The Government should look at launching some more infrastructure finance companies, in addition to the ones existing today – such as, Rural Electrification Corporation, Power Finance Corporation. This will automatically increase the supply of paper to the market.
 - xiv. The Government could examine the possibility of exempting income - arising out of investments in infrastructure made by insurance companies or pension funds -- from tax.
 - xv. Government should examine the possibility of infrastructure bonds carrying some sort of an explicit guarantee. This will immediately improve the rating of the projects and allow investment by insurance companies and pension funds.
 - xvi. The regulators should examine the possibility of allowing insurance companies and pension funds to access the credit default swap markets to hedge their exposure to paper floated by the infrastructure projects.
 - xvii. Greater regulatory clarity on whether investments made by insurance companies and pension funds in infrastructure funds should be classified as an investment in a mutual fund as this will allow greater flexibility in portfolio construction.
 - xviii. Insurance companies and pension funds should be allowed to invest in derivatives, in both equities and bonds. This is essential for hedging their exposure in the cash market. Each of the regulators should evolve a roadmap with a definite time-frame and clearly enunciated milestones – that include capacity building, improved governance and regulatory structures, higher disclosure norms -- to move the industry towards a greater level of sophistication, one that reduces risk but increases the returns. In addition, it goes without saying that use of derivatives should be restricted to only hedging the investment position in the cash markets.
 - xix. Insurance companies can currently invest only up to 3% in a single bank's fixed deposits. The regulator concerned should reconsider raising this upper limit. While it will improve the liquidity position in banks, it will also provide a cash buffer for fund managers to meet unforeseen redemption calls or withdrawals.
 - xx. It is recommended that the minimum rating standard for infrastructure projects be relaxed substantially. Project investors should get a wider choice of credit enhancement facilities.
 - xxi. It is recommended that exposure of insurance companies should be linked to 15-20% total project cost.
5. The Committee had five Meetings from 18th April, 2012 to 28th January, 2013. The Committee also assigned the responsibility of drafting Chapters to its Members and the following 3 Sub-Groups were constituted with dedicated jobs:

1. **Financial Markets Sub-Group** to analyse the market mechanisms and consider the nation's requirements in terms of development and deepening of financial markets. The Group was also requested to explore the market mechanisms and the potential of Insurance and Pension funds in contributing to the development of markets.
2. **Insurance Investment Sub-Group** to analyse the funds under management of Life and Nonlife Insurers.
3. **Pension Investment Sub-Group** to analyse the funds under management of the National Pension System (NPS) as well as other retirement savings funds.

The subgroups on Insurance and Pension also examined the International experience on Investment patterns to learn from the best practices of the US, UK, Japan and other nations that have gone through turbulent changes in Investment of Insurance and Pension funds.

6. The Committee would like to thank the National Insurance Academy, Pune, for providing the logistic and administrative support for organising meetings of the Committee. The Committee would also like to thank the Pension Division and Insurance Division, Department of Financial Services, Ministry of Finance, Government of India for providing administrative and technical support to the Committee.
7. It is expected that the recommendations of the Committee would be taken into consideration to revise the investment patterns for the Non-Government provident funds, Superannuation Funds and Gratuity Funds and for insurance companies. It is also hoped that, at a later date, the practice of prescribing and investment pattern would be abandoned provided the enabling environment is created and the institutional mechanism is put in place.

CHAPTER II

THE ECONOMIC BACKDROP: TWO MORAL DILEMMAS

The Indian economy has been experiencing a growth slowdown over the past few quarters. This has caused concern all around, coming as it does on the back of strong growth registered over the past few years. The growth rate of the Indian economy has faltered during 2012-13 after many years of strong and impressive growth. According to quick estimates of India's GDP, the Indian economy's gross domestic product (GDP) managed to post a growth rate of 5% during FY13, which is the lowest in past 10 years, against 6.2% in the previous year.

The overall growth rate was also pulled down by the low 4.8% Y-o-Y growth posted for the January-March 2013 quarter. Unfortunately, the low growth rate now seems to have sunk its roots. GDP growth rate for the first quarter of 2013-14 (April-June) at 4.4% has also not been very encouraging.

The year 2012-13 also saw the investment rate of the economy dipping due to supply bottlenecks and weak demand, leading to a knock-on effect on consumption as well, and thereby depressing the twin drivers of the growth engine -- investment demand and consumption demand. The slowing investment demand also was reflected in the decelerating industrial production data being released every month.

While there are multiple factors behind the slowdown, including the ripple effects of the global financial meltdown and the attendant Euro-crisis, a few domestic reasons also contributed to slowing investment demand. In the aftermath of the Lehman Brothers collapse and the global financial crisis, the Indian government and the central bank – Reserve Bank of India (RBI) – focused their attention on stimulating consumption demand (through a combination of fiscal measures and entitlement schemes) and pursuing an easy money policy, respectively, to ensure continuing economic growth. While this did help the economy stave off an egregious slowdown, this strategy was not without its inherent drawbacks.

While the consumption driven growth was able to shield overall economic growth from the global economic freeze on a temporary basis, it soon gave birth to inflationary impulses in the economy in the absence of adequate capacity to meet this increasing demand for goods and services. Inflation and inflationary expectations forced RBI to reverse its easy money policy and pursue a path of increasing interest rates and tight monetary policy to squeeze out inflationary expectations. While monetary policy does have a role to play in combating inflation, its efficacy is limited if the fiscal side is out of alignment.

In addition, the inflation construct in India has certain structural infirmities which are outside the pale of monetary policy. For example, the wage increase in the rural areas – as a consequence of the enhanced entitlement programmes -- has a direct correlation with the increase in demand for essential, including high protein, food items. Given the lack of investment in building either capacity to meet enhanced consumption levels, or lack of

investment in building infrastructure that is capable of delivering goods and services from producers to consumers efficiently, friction builds up in the system and creates inflationary pressures.

Therefore, while lack of investment demand and slowing investment activity directly impact economic growth, it also results in a heightened inflationary state. What's worse, a combination of slow growth and inflation has a crushing effect on the poor more than anybody else. This is particularly relevant to India, since past periods of high growth were directly a fall-out of increasing levels of investment activity. With GDP growth now close to the lower band of the tolerance limit, there is an urgent need to rekindle the economy's "animal spirits" and focus on reviving investment demand.

Specifically, investment activity in infrastructure needs to be stepped up urgently since lack of infrastructure acts as a dampener on overall investment demand for manufacturing. Investment activity in both infrastructure and manufacturing also needs to be increased for another urgent reason: to absorb the large armies of youth that will be added to the labour force every year. According to various studies and reports, it is estimated that over 10 million employable people are expected to join the workforce every year. Therefore, the manufacturing sector (including infrastructure) has to create job opportunities that will absorb at least substantial number of these millions of people every year. India has been the beneficiary of a propitious economic event known as the "demographic dividend". However, this gain may turn out to be not only illusory but can also become a severe drag on the economy if investment demand is not catalysed in time; some initial signs of the impending crisis are already visible in some parts of the country.

The Approach Paper for the Twelfth Five Year Plan, drafted by the Planning Commission, has this to say: "India has a younger population not only in comparison to advanced economies but also in relation to the large developing countries. As a result, the labour force in India is expected to increase by 32 per cent over the next 20 years, while it will decline by 4 per cent in industrialised countries and by nearly 5 per cent in China. This 'demographic dividend' can add to growth potential, provided two conditions are fulfilled. First, higher levels of health, education and skill development must be achieved. Second, an environment must be created in which the economy not only grows rapidly, but also enhances good quality employment/livelihood opportunities to meet the needs and aspirations of the youth."

The Economic Survey for 2012-13 has a chapter devoted to the issue and is titled '*Seizing The Demographic Dividend*'. The introduction to the chapter states: "The central long-run question facing India is where will good jobs come from? Productive jobs are vital for growth. And a good job is the best form of inclusion. More than half our population depends on agriculture, but the experience of other countries suggests that the number of people dependent on agriculture will have to shrink if per capita incomes in agriculture are to go up substantially. While industry is creating jobs, too many such jobs are low productivity non-contractual jobs in the unorganized sector, offering low incomes, little protection, and no benefits. Service jobs are relatively high productivity, but employment growth in services has been slow in recent years. India's challenge is to create the conditions for faster growth of productive jobs outside of agriculture, especially in organized manufacturing and in services,

even while improving productivity in agriculture. The benefit of rising to the challenge is decades of strong inclusive growth.”

The repercussions of not building adequate capacity for absorbing/employing 10 million employable persons every year can be devastating on society and the social fabric. It is a chilling thought and that makes the task of improving investment demand that much more pressing.

So, What Is To Be Done?

So, in a nutshell, improving investment demand seems to constitute the central pillar of the suite of solutions needed by the economy. However, improving investment demand is a multi-pronged task involving changes that need to be introduced in the political matrix, the skill development capacities, policies for use of natural resources, the entire approval chain stretching from central to state to local authorities, consolidation of the regulatory structure in each sector, the move from multi-point, multi-levy taxation regime to GST, availability of proper infrastructure and, finally, an efficient financial system.

However, since this committee’s remit is limited, this report will focus on improving the delivery mechanism in the financial system and examine specific areas within the financial system that need policy, regulatory and legislative changes to facilitate efficient capital allocation to both infrastructure as well as manufacturing projects. The two sectors (infrastructure and manufacturing) have been mentioned separately because both have varied needs – in terms of the capital blend, the maturity profile, the investor class, the mix of assets, the markets approach strategy, the regulatory and legislative structure.

Within the two needs mentioned above, this paper will focus largely on infrastructure financing since the financial infrastructure for meeting the needs of manufacturing sector are already well developed, barring a few noticeable gaps (such as the lack of a decent corporate bond market). However, financing of infrastructure projects requires special attention since there are many mission-critical gaps that need to be resolved urgently.

So, the central question then boils down to this: what level of investment in manufacturing and infrastructure is required over the next five years to not only help deliver 9% annual growth on an average, but also create capacity to bring down the average annual rate of inflation to 4-5% and employ large armies of people every year?

During the 11th Five year plan, which just got over, the Planning Commission had envisaged a total investment of \$500 billion in infrastructure. Going by the preliminary reports available, total investment has fallen short of the target, though the performance varies across sectors. This is also evident from the slowing down of the economy and the concomitant shocks from the growing infrastructure deficit. However, when seen from a GDP point of view, investment in infrastructure increased from 5% of GDP during the Tenth Plan (2002-07) to 8.9% of GDP now. While the growth looks impressive, it should be seen in perspective of other countries. For example, China’s annual spend on infrastructure is close to 20% of GDP.

To achieve an average annual growth of 9%, the Working Group constituted by the Planning Commission¹ to ascertain the financing needs of infrastructure during the Twelfth Five Year Plan (2012-17), has envisaged an investment of Rs 41,00,000 crore at 2006-07 prices if resource mobilisation in the sector is to reach 10% of GDP. Assuming an average annual inflation of 5%, the working group has estimated that infrastructure will require an investment of Rs 65,80,000 crore at current prices.

The Department for Industrial Policy and Promotion, under the Ministry of Commerce and Industry, has also released a discussion paper on financing requirements of infrastructure and industry². In that paper, it is estimated that the manufacturing sector will require Rs 51,80,000 crore during the same period, on the basis of investment in manufacturing during 2004-10 and the government's avowed target of raising the share of manufacturing in GDP from the current 16% to 25%.

Assuming an average annual inflation rate of 5%, manufacturing will require an investment of Rs 83,20,000 crore at current prices. However, even if we stick with the estimates based on the 2006-07 prices, the total requirement for both infrastructure and industry works out to 24.2% of GDP in the terminal year (2016-17) of the Twelfth Plan, compared with 19.4% of GDP in 2010-11. Therefore, on an average, the total investment in infrastructure and manufacturing works out to about 22.5% of GDP every year.

Investments in Infrastructure and Manufacturing sector at 2006-07 prices (Rs crore)

Years	GDP	Investment In Infrastructure (Rs in Crore)	Investment in Manufacturing (Rs in Crore)	Total Investment to GDP (In %)	Net Requirement from Market	Net Requirement to GDP (In %)
2011-12	6,314,265	528,316	694,569	19.4	541,986	8.6
2012-13	6,882,549	619,429	791,493	20.5	626,312	9.1
2013-14	7,501,978	712,688	900,237	21.5	716,439	9.6
2014-15	8,177,156	809,538	1,022,145	22.4	813,627	9.9
2015-16	8,913,100	918,049	1,158,703	23.3	922,506	10.3
2016-17	9,715,279	1,039,535	1,311,563	24.2	1,044,393	10.8
2012-17	41,190,063	4,099,239	5,184,141	22.5	4,123,276	10.0

Base Year = 2011-12; Total Investment = Investment in Infrastructure + Investment in Manufacturing; * Note: GDP numbers are as per the Report of the Working Group on Investment in Infrastructure

While the Planning Commission's Working Group assumes that almost half the estimated investment amounts for infrastructure will be met by the government through budgetary support, the DIPP discussion paper assumes 60% of the estimated outlay in manufacturing will emanate from internal accruals (based on the track record for 2004-09). If we accept this

¹ Draft Report of the Sub group on Infrastructure funding requirements and sources for the 12th Plan

² http://dipp.nic.in/English/Discuss_paper/Feedback.aspx

assumption (though the intervening years have not been too kind for manufacturing and internal accruals would have reduced somewhat during 2009-12), then the balance Rs 41,23,276 crore will have to be accessed from the market. Assuming further a debt-equity ratio of 70:30, the debt markets will have to provide Rs 28,86,293 crore and the balance Rs 12,36,983 crore will have to come from the equity markets.

Seen from a historic perspective, the volumes alone suggest that all the existing and known sources of financing for infrastructure – the Indian banking system, the Indian capital markets, foreign direct investment, external commercial borrowing, alternative investment platforms (private equity and venture capital) – combined will not be able to provide the staggering amount of Rs 41,23,276 crore. For instance, the banking system, has been providing a large proportion of financing for infrastructure – during the first three years of the Eleventh Five Year Plan, banks provided 56% of the total funding to infrastructure projects. Infrastructure projects accounted for 11.7% of total bank credit during FY10 compared with 1.7% during FY00. Banks now face two key challenges in expanding their exposure to the sector – an asset-liability mismatch (banks typically access short term liabilities while infrastructure assets are usually long term in nature) and hitting the existing regulatory sectoral caps.

These two problems could be surmounted partially by introducing certain products (such as, take-out financing) but it would still not address the problem of finding the required amount of financing. There are other visible gaps in the existing financial systems that need to be sorted out too – such as, increasing depth and liquidity of the Indian capital markets, providing increased financing options (such as mezzanine equity), lack of a deep forward market inhibiting long term currency loans, an underdeveloped debt market, and so on. These are issues that will definitely improve the efficiency of the capital markets and are likely to result in improving the flow of finance to projects. However, sorting out these issues alone might not be capable of bringing about the huge spike in funding requirements that is needed.

This would then require tapping newer sources of financing. This will require a policy strategy envisaging a higher level of intermediation of household savings in the economy. The two sectors that corner a large proportion of the household sector's savings and are yet to contribute meaningfully to the available pool of investible funds in the capital markets are insurance and pension. These two have the potential to substantially increase the flow of funds into both infrastructure and manufacturing.

Insurance and pension combined account for close to 32% of household savings in financial assets, second to bank deposits (which corners close to 49% of gross financial assets). However, because of certain mandated investment norms followed by insurance companies and various pension funds, very little of this money finds its way to the capital market to fund growth of either infrastructure projects or manufacturing assets. At a time when the economy, and the nation, need long term funds to lay the foundation for future growth, insurance and pension sector provide the right balance – in terms of volume as well in terms of tenor.

This then presents Moral Dilemma I: at a time when the country needs long term capital, can the Insurance and Pension sectors be governed by policies that are inimical to this national objective?

Are Institutions Serving The Customer?

One of the over-riding concerns of the insurance and pension sector custodians have been to shield the savings of beneficiaries from volatility and risk, and protect it from capital erosion. These anxieties are justified and are essential for the healthy growth of long term savings culture in the economy. However, it might be worthwhile examining whether the walls built around the insurance and pension sectors have outlived their utility and whether the custodians of these funds need to rethink their defence strategy in the light of changed times and developments.

There is another larger moral dilemma that now confronts the insurance and pension sectors. As the overall savings pattern in the economy has been showing for a while now, savers are preferring to move their investments out of financial assets into physical assets, such as gold and property. This trend has accelerated over the past few years when the perceived rate of inflation and expectations of future inflation rates have exceeded the returns provided by most classes of financial assets, especially fixed income assets. Household savings committed to equities and mutual funds have also decelerated after the 2008 global financial meltdown.

According to data from the RBI's Annual Report for 2012-13, the household sector's savings show a marked preference for physical assets over financial assets. Data from the report (which is available only up to 2011-12) shows that the gap between financial investments and physical investments has been growing almost every year – from 1.2% of GDP in 2009-10, the wedge widened to 6.3% during 2011-12.

Therefore, while the proposition in both insurance and pension is substantially different from the other categories of fixed income assets (in that the saver does not have easy access to his funds for a prolonged period), it is quite likely that the overall propensity towards physical assets is hurting the insurance and pension sectors. In fact, data clearly shows that accruals to the head "Pension and Provident Funds" have been progressively declining with each passing year. Growth of life insurance sector is also declining. It is a common practice to measure insurance penetration through the ratio of insurance premium to GDP. In India, not only is it abysmally low but it has even dropped from these low rates. Sure, there are other legislative and regulatory issues that are retarding the growth rate of funds accruals to pension and life insurance sectors, but negative real returns might over time also result in large-scale flight to physical savings. For example: inflation, as measured by the consumer price index, averaged around 9.3% during the 12-month period January-December 2012 (as per Economic Survey 2012-13, <http://indiabudget.nic.in/es2012-13/echap-04.pdf>). The RBI's Annual Report for 2012-13 lists the weighted average yield of government securities for 2011-12 at 8.52% and at 8.36% for 2012-13 (http://rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/P2_07PDM220813.pdf). Therefore, clearly, government securities (as well as a host of other fixed income investment opportunities) were yielding negative returns.

This then brings up Moral Dilemma II – can the insurance and pension sectors seek safe harbour under policies that are denying investors positive rates of return, in the name of safety and risk mitigation? Today, a large percentage of investible funds from the insurance and pension sectors gets invested in government bonds, which are perceived as the safest, risk-free investment in the economy. While that might be substantially true, there have been periods in the recent past when the rate of inflation in the economy exceeded the yield on government bonds, thereby yielding a negative real return on investment.

In the classic trade-off between risk and return, the design of the mandated investment norms in vogue today –whether it’s insurance or pension – has no tolerance for risk, but a high tolerance level for low returns. This is, in the opinion of this Committee, unfair for the investors who need a combination of both low risk as well as moderate returns. There might even be some investors who do not mind taking slightly higher risks with a proportion of their long term savings in the pursuit of higher returns, especially those in the early stages of their saving curve.

It is not the contention of this Committee that risk mitigation measures, regulatory overview or compliance standards be compromised or that the investment norms be redesigned to give free rein to cavalier, injudicious or imprudent investment styles. But, there can be no denying that in the pursuit of risk-free investment, investors are getting the short shrift and therefore revealing a preference for physical assets. Finally, as recent events in Europe have shown, there are today no assets which are completely risk-free.

Summing Up

It is by now quite evident that both the insurance and pension sectors are somewhat remiss in their duty as financial intermediaries. On the one hand, they are unable to provide funds to industry and infrastructure, which provide the ideal investment opportunity for the nature of funds parked with the institutions. On the other, as financial agents, they are unable to provide investors with the right returns. And, the root cause for these slippages seems to be the mandated investment regulations that are preventing funds from finding the right investment opportunities as well as hobbling returns.

Apart from the moral dilemma, the continuation of these investment norms are likely to erect potential future roadblocks for the economy and are probably carrying the seeds of future fiscal disequilibrium as well. And, these issues are related to the demographic dividend that have so propitiously positioned India in an economic sweet spot. As mentioned earlier in this chapter, the demographic problems start with finding suitably employment for the large number of young people who are expected to join the working force every year. But, the problems do not end with only finding suitable employment. There are other consequences for the Indian economy, which will start kicking in 10-15 years from now but need remedial measures to be implemented here and now. Here are the reasons.

The Indian economy is currently enjoying the collateral benefits from the demographic dividend – a crucial ratio called the “dependency ratio”, or the number of people in the country not working/earning to the working/earning population. In India, till about 2005, the

dependency ratio was 0.6. In other words, the measure calculates exactly what it says: the number of non-earning people in the economy who are dependent on the people who are earning. This is expected to decline over the next 20-30 years as the demographic dividend takes effect. With fertility rates dropping over the years, especially in the past 20 years, from 3.8 in 1990 to 2.9 in 2007 and expected to fall further, the number of new-borns will decrease. This will further bring down the number of people not working/earning to a situation where the bulk of the population will be working/earning.

A lower dependency ratio has many economic benefits: with a larger percentage of the population working, savings and consumption levels in the economy go up, providing vector forces for higher economic growth. But, unfortunately, this dividend is not permanent. Over time, this huge bulge in the working force – which is being considered as an economic windfall currently -- is expected to retire. At the same time, the lower dependency ratio will see fewer younger people joining the workforce, resulting in a greying of the economy or the number of older people not working increasing. Consequently, if the economy fails to implement a proper pension system today, the economy will have fewer people in the working age group to support the old. And, if the retired do not have access to regular income streams by then, for which they need to save today, the burden on the economy is likely to be crippling in nature.

A larger number of older and retired people, in the absence of a dependable pension system, will pose a danger to the old age income security in the country and put enormous pressure on the government of the day to re-route expenditure earmarked for public goods and services towards providing for health and pension spending. This will inevitably cause a drain on the state of the fiscal and, subsequently, on the economy.

It is therefore imperative that the pension programme be strengthened and all inherent weaknesses tackled forthwith. It is absolutely necessary that a larger proportion of the current working force – whether in the formal or the informal sector – be moved over to a robust and dependable pension system predicated on the defined contribution philosophy. The challenge lies in making the pension sector attractive enough to draw in the large percentage of the working force that is currently outside its pale. And, there is a necessary and sufficient conditions required to make this happen --- ensure that the pension sector is in a position to provide returns that are stable and competitive in nature.

CHAPTER III

INVESTMENT NORMS & THEIR RATIONALE

It is imperative that an urgent resolution be found for the two moral dilemmas described in detail in the previous chapter. This will be needed for removing a key irritant that bedevils financing of long-term projects, especially infrastructure ventures. But, more importantly, it is also required to provide a positive net real return to the millions of investors and savers. We owe it to the people of this country.

However, before we recommend any changes in the way pension and insurance sectors invest their funds, it might be necessary to examine the rules governing current investment activity and to chart their evolution to get a better understanding of the thought process behind the existing framework.

The history of investment norms is quite old in India. But, first, what is investment? It is the commitment of money or capital to purchase financial instruments or other assets in order to gain profitable returns in the form of interest, income, or appreciation of the value of the instrument. An investment involves the choice by an individual or an organization such as a pension fund, after some analysis or thought, to place or lend money in a vehicle, instrument or asset -- such as, property, commodity, stock, bond, financial derivatives (e.g. futures or options), or a foreign asset denominated in foreign currency -- that has certain level of risk and provides the possibility of generating returns over a period of time.

Long-term investment can be bifurcated into two basic categories: pension and insurance. Ideally, any directed investment advisory should be available in two versions – one for insurance and one for pension. However, as with all things Indian, there are four sets of guidelines which govern how insurance companies or pension funds should invest their accretions – one issued by the department of economic affairs in the finance ministry, one issued by the Insurance Regulatory and Development Authority (IRDA), one from the labour ministry for guiding the investment activities of employees provident funds, and finally, another one authored by the Pension Fund Regulatory and Development Authority (PFRDA) to guide the National Pension System (NPS). Actually, there are two sets of guidelines within NPS – one for government employees (who constitute the majority of subscribers) and the non-government employees. Similarly, there are four sets of guidelines issued by IRDA for its constituents – one for life insurance, one for ULIPs, one for general insurance and one for pension and general annuity funds.

Given the diversity of opinions and directives, it is only natural that methodologies will get mangled and objectives will get obfuscated in the ensuing melee. This committee actively wishes for some realignment of objectives and harmonisation of processes, which will eventually allow for efficient allocation of capital and maximisation of returns.

The following section looks at the history of mandated investment norms in the pension sector.

PENSION SECTOR

A report published by the City of London Corporation (*Insurance Companies & Pension Funds As Institutional Investors: Global Investment Patterns*) has broadly classified Indian pension system into four segments:

- **The National Social Assistance Programme (NSAP).** A limited “first pillar”, the central government has launched poverty alleviation programmes aimed at the aged under this umbrella scheme. It’s a pay-as-you-go plan (an unfunded scheme, with current revenue receipts used for paying out retirement benefits). Under the scheme, the government pays out Rs 200-1,000 every month to 15.7 million poor citizens aged 65 and above. Some state governments make a matching contribution. Obviously, this falls short of the optimal universal, old-age, income security plan.
- **The Employees’ Provident Fund Organisation (EPFO).** The Employees Provident Fund, India’s largest defined contribution and publicly managed plan, is an example of the typical Pillar-II arrangement. Employees in the organised sector are required to participate in provident funds and pension plans administered by EPFO. According to the City report: “These include a defined-contribution provident fund and a defined-benefit pension plan that cover only 14% of the workforce (59 million workers as of March 2010). Included in this ambit are about 2,750 private trusts approved by the EPFO that offer similar programmes in private companies with 4.9 million members and assets of Rs 100,500 crore (\$20.4 billion).”
- **Private pensions and annuities.** Regulated by the insurance regulator (IRDA), these are various schemes administered by life insurance companies. In 2010, IRDA directed all insurance companies, which had launched unit-linked pension plans, to provide a guaranteed return indexed to interest rates. The order was reversed in 2011 but sales in this segment have remained sluggish.
- **The National Pension System (NPS).** All government employees have to enrol under this new, mandatory, defined contribution plan. However, it is optional for private sector workers. The product has not found much popularity among non-government individual investors. The scheme has a unique architecture – it allows investors portability and the ability to select the fund manager as well as the investment strategy.

In terms of assets under management, EPFO funds hold two-thirds of the market and private pensions and annuities one-third. NPS is still very small but is expected to gain in importance as product awareness grows. As of now, though, NPS seems to be providing a higher return than all the other options available. Pension funds are expected to grow vigorously as the population grows richer and seeks to secure sufficient old-age provisions.

Investment Norms for Provident, Superannuation & Gratuity Funds: A History

Till 1969-70, the history of investment norms was quite simple. The entire investment by provident funds was required to be made in central and state government securities only. This represented the classic text-book definition of financial repression, providing captive financing of government debt. It also resulted in hindering the development and emergence of a deep and liquid financial market in the country.

A provision in the Income Tax Act, 1961, was made for investment of provident funds and pension funds according to the investment pattern prescribed by the government from time to time. In the beginning, a major part of investible funds was required to be invested in securities issued by state/central governments or in the securities where payment of principle and interest was guaranteed by the central/state governments.

In 1974, post office time deposits were added to the list of eligible investments for provident funds, superannuation funds and gratuity funds. With the passage of time and changes in the economic environment, the list started adding a larger number of eligible investments.

In 1975, investment in Special Deposit Scheme (SDS) – up to a maximum of 20% -- was introduced. SDS was introduced in the mandated investment pattern mainly to provide a secure financial instrument and better returns for provident funds. There was a sweetener attached to the investment -- interest income accruing from deposits under the scheme was exempt from income tax. Initially, the scheme was supposed to run only for 10 years. However, it was extended for another 10 years in 1985, three years in 1995 and for a further five years in 1998. The scheme was finally wound up in May 2003.

The rate of interest in SDS was administratively determined and it varied from year to year. At launch, the rate of interest offered was 10% per annum. Subsequently, on April 1, 1983 this was raised by one percentage point to 11%, and by another percentage point to 12% on April 1, 1986. It remained unchanged for almost 15 years after that.

As a consequence of the balance of payments crisis and the precarious fiscal health during 1990-91, the government undertook a fiscal consolidation programme. SDS came under the scanner for its high administered interest rate and the consequent repayment burden. As a result, the government decided to gradually reduce the interest rate offered by the scheme. It was also in keeping with the government's policy to reduce administered interest rates on other instruments. The first reduction – to 11% -- came about in April 2000. Subsequently, the rate was reduced to 9.5% on April 2001 and to 9% on April 2002. In 2003, the rate was further lowered to 8%.

Given the high interest rates and tax allure of the scheme, the minimum investment prescription under the scheme also changed. From an initial limit of a maximum of 20% of net accretions, the limit was increased to 70% in January 1993. Thereafter, the limit was reduced to 55% in May 1994, 30% in May 1995 and 20% in September 1996. And from March 1997, no fresh deposits were allowed under the scheme. However, the interest received on the deposits could be reinvested.

The design of the scheme and the interest rate scenario point to an inherent risk in investing long term liabilities in assets with mismatched tenors: reinvestment risk. As the administered rate on SDS kept declining, the fund administrators faced declining yields from reinvestment options.

The investments in National Savings Certificates or Post Office Time Deposits continued till 1985 only. The investment pattern has been progressively liberalised over the years. During the period 1993-94, the pattern allowed investment in bonds issued by the public sector undertakings (PSUs) up to a limit of 15% initially, which was subsequently increased to 40%. At the same time, investment in public sector financial institutions and public sector banks were also prescribed, which like PSU bonds, generally carried higher rates of return. Keeping in mind the requirements of the private sector, investment in corporate bonds (bonds issued by private sector) were allowed in 1998 for the first time, with an option to invest up to 10%.

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the behest of the government and Reserve Bank of India. But the mutual fund units could be included as an eligible asset in the investment pattern for pension funds only in 1999 with an option of investing 40% at the initial stage. In fact, by then, the mutual fund industry had been substantially liberalised and a number of financial institutions – both in the public and private sectors – had set up their mutual funds.

With the introduction of pension reforms in India, it was found desirable to leave the choice of investment decision to various pension funds, irrespective of their provenance -- whether they were in the government or private sector. Going by the type of problems coming to the notice of the government -- such as, theft of government securities, default in repayment by public financial institutions -- it was felt that the government should stop prescribing any investment pattern to avoid any explicit or implicit guarantee or liability. Consequently, the onus of due diligence rested with the trustees of the fund. This allowed the government to maintain a distance from the investment decisions of a provident fund, while at the same time provide guidance for safe and reasonable returns.

The investment pattern of 2008 saw the introduction of three new instruments -- money market instruments, term deposits of private scheduled commercial banks and rupee bonds. Money market instruments are debt instruments with residual maturity of up to one year – such as, commercial paper, certificates of deposits, treasury bills, etc. These instruments are safe, less volatile and provide safe avenues for temporary parking of incremental accretions. Thus, a part of accretion to the funds was earmarked for investment in money market instruments including mutual fund schemes.

The permission for rupee bonds stems from the interest displayed by multilateral funding agencies – such as, World Bank or Asian Development Bank -- in borrowing and lending in the Indian currency by leveraging their international credit rating, which translates into fine pricing of rupee bonds. The logic was: since these institutions were using resources raised overseas to lend to Indian projects in rupees, their exposure suffered from a currency risk. The rupee bonds were made eligible instruments as funds raised through these bonds would

also be used for infrastructure projects, thereby providing an opportunity to lock in long-term liabilities into secure, long-term assets.

To encourage long term investments and promote the equity culture, equity shares as a class of investments were introduced in 2005 as an option with a limit of 5%. In August 2008, the limit on investment in equity was increased to 15%. However, again this was an option given to the provident funds etc. Government, in 2008, also permitted slightly active portfolio management, by including the option of trading in securities.

Central government securities and state government securities were also merged into a single category in the 2008 revision. It permits direct investment up to 15% of the investible funds in shares of companies on which derivatives are available in Bombay Stock Exchange or National Stock Exchange or indirect investment in stock market through equity linked schemes of mutual funds. Pension funds were given the freedom to trade in securities subject to the turnover ratio (defined as the total value of shares traded divided by the average market capitalisation for that period) not exceeding two. The investment pattern of 2008 also permitted flexibility in choosing investment instruments by introducing the concept of flexible ceiling against the fixed investment ceiling in the past investment patterns. The changes in the investment pattern for provident funds are summarised below.

Table: Changes in the Provident Fund Investment pattern (1975 – 2008)

Investment Categories	S.D.S (A) (%)	G.O.I./ Gilt MF @ (B) (%)	State Guaranteed / Gilt MF @ (C) (%)	PSU bonds / Term Deposits/ Money Market MFs (D) (%)	Any of A,B,C & D (%)	Pvt Sector (%)	Equity Shares (%)	Total (%)
Before 1975	-	100	-	-	-	-	-	100
1975-85	30	70	-	-	-	-	-	100
1986-92	Not more than 85	Not less than 15	-	-	-	-	-	100
1993-94	70	15	15	-	-	-	-	100
1994-95	55	15	30	-	-	-	-	100
1995-96	30	25	15	30	-	-	-	100
1996-97	20	25	15	40	-	-	-	100
1997-98	-	25	15	40	20	-	-	100
1998	-	25	15	40	20	10	-	100
1999-2002	-	25	15	40	20	10	-	100
2003-04	-	25	15	30	30	10	-	100
2005-08	-	25	15	25	30	10	5	100

Legal and Regulatory Framework Governing Investment Norms

The prescription of an investment pattern by the Department of Economic Affairs (DEA), in the Ministry of Finance, is done under the Government of India (Allocation of Business) Rules, 1961. The rules have been framed by the cabinet secretariat in exercise of the powers conferred by clause (3) of Article 77 of the Constitution. The Second Schedule to these rules lists the distribution of subjects among the departments of the government, which includes “investment pattern for Employees’ Provident Fund and other like provident funds” as part of the DEA’s oversight. The Central Board of Direct Taxes, Department of Revenue also notifies the same investment pattern for the recognised provident funds etc. under the Income Tax Rules, 1962.

After the work relating to pension reforms was transferred to the Department of Financial Services (DFS), the work related to investment norms was also transferred to DFS. The pattern notified by DEA is suitably adopted by the Ministry of Labour and notified in terms of the powers given under the Employees’ Provident Fund and Miscellaneous Provisions Act, 1952. The pattern was last modified by DEA in August 2008 and was made effective from April 1, 2009. This investment norm is being used for the central government and state government employees covered under the National Pension System (NPS). The investment pattern of 2008 was adopted by Department of Revenue and notified under the Income Tax Rules, 1962, but it has not been adopted for the employees covered under the Employees’ Provident Fund and Miscellaneous Provisions Act, 1952 by the Ministry of Labour.

Therefore, while the investment pattern for Employees’ Provident Fund notified in July 2003 continues even today, there is now a divergence between the investment philosophies followed by different parts of the pension industry. This is another aberration in the strategy for the deployment of long term investments in the country. This is over and above the difference mandated in NPS between funds managing accretions from central government employees and those from the state governments.

Game-Changer: The National Pension System (NPS)

Particulars	Corpus (Rs in crores)	No. of Subscribers (in lakhs)
Central Government Employees	17,672	11.42
State Government Employees	10,760	16.29
Private	1,385	2.16
NPS Lite	457	18.75
Total	30,274	48.62

Source: PFRDA

As of April 7, 2013, the total NPS corpus was Rs 30,274 crore, contributed by 48.62 lakh NPS subscribers. The break-up of the corpus and the subscribers is as under:

For managing the contributions of government employees, PFRDA appointed three pension fund managers (PFMs) in April 2012 – namely, LIC Pension Fund Ltd, SBI Pension Funds Private Ltd, and, UTI Retirement Solutions Ltd. The applicable annual investment management fee is only 0.0102%.

In a recent move, the Ministry of Finance has given PFRDA the dispensation to allow government employees to make investment choices in the same manner as that applicable to voluntary NPS for private citizens. The modalities are still being worked out.

For managing the contributions of the non-government private sector, PFRDA issued guidelines for registration of PFMs in July 2012, which has done away with the earlier bidding process. Under the old process, PFMs bid for a pre-determined number of slots, and the fees charged by them for managing the pension funds had to be uniform for all players. The earlier process has now been replaced by a system which lays down the eligibility criteria for registration as PFMs, and all interested players desiring to enter the pension industry, can register as PFMs subject to their fulfilling the eligibility criteria. There is no restriction on the number of PFMs.

Further, the PFMs were allowed to prescribe their own fee charges, subject to an overall annual ceiling of 0.25%, laid down by PFRDA. The changes are as per the recommendations of the **Committee to Review Implementation of Informal Sector Pension**, set up by PFRDA to go into the reasons for the slow progress of NPS in the private sector. Currently, five PFMs manage the contributions of the non-government private sector subscribers -- SBI Pension Funds, UTI Retirement Solutions, Reliance Capital Pension Fund, ICICI Prudential Pension Fund, and, Kotak Mahindra Pension Fund.

The revised guidelines, available on PFRDA's website (www.pfrda.org.in), have done away with the earlier bidding process, which was constrained by a pre-determined number of slots and fixed fees. The earlier process has now been replaced by a system which lays down an eligibility criteria and all those interested in acting as PFMs can register with PFRDA, subject to their fulfilling the eligibility criteria. There is no limit on the number of PFMs. Further, PFMs are now allowed to prescribe their own fee charges, subject to an overall ceiling to be laid down by PFRDA. It is expected that this would provide for an economically viable business model for the PFMs attracting a fresh set of entrants into the pension industry, and the resultant competition would ensure a market-driven fee structure, which would work to the advantage of the pension subscribers.

The non-government private sector subscribers have the option of three schemes -- "E" or equity market instruments, "C" or credit risk bearing fixed income instruments and "G" or government securities. Subscribers are free to switch across schemes as well as PFMs once in a year free of charges, in case they so desire.

There is a separate scheme for the underprivileged – NPS Lite -- which is also supported by the government through "Swavalamban" scheme under which the government contributes Rs 1,000 annually per account, subject to fulfillment of conditions of eligibility by the subscribers.

The investment guidelines for the non-government private sector were revised to facilitate active fund management by PFMs and utilisation of their investment skills for generating optimum returns to subscribers. Broadly, the instruments approved for investments by PFMs

are as under:

- i. Central Government Bonds and State Government Bonds
- ii. Equity shares listed in BSE or NSE on which derivatives are available or are part of BSE Sensex or Nifty Fifty Index
- iii. Fixed Deposits of scheduled commercial banks
- iv. Debt securities issued by Bodies Corporate including scheduled commercial banks and public financial institutions
- v. Credit Rated Public Financial Institutions/PSU Bonds
- vi. Credit Rated Municipal Bonds/Infrastructure Bonds / Infrastructure Debt Funds
- vii. Money Market instruments including liquid schemes of mutual funds.

The above investments contribute to economic growth by directing investments to infrastructure (through bonds and equity) and participating in Government borrowings. The above schemes have enabled indirect participation of subscribers from all sectors, in the financial markets, who would have otherwise remained unexposed and also bereft of its benefits. Incentives in the form of tax benefits are given to subscribers. The exit is allowed from the age of 60 years and has been kept flexible keeping the interests of the subscribers in mind, albeit with 40% compulsory annuitisation of the accumulated corpus.

PFMs are active participants in the markets as they have to constantly monitor and conserve the scheme portfolio. PFMs have to be proactive as the scheme portfolio is marked to market and subscribers are allotted units based on the NAV of the portfolio. Generation of reasonable returns by PFMs on the scheme portfolio is a reflection of their market competence and has a direct bearing on subscriber acquisition.

As contributions to NPS are considered long term investments, the selection of instruments in each scheme is based on the PFM's risk-return perception, subject to the objectives of the scheme. While building the scheme portfolio, PFMs are broadly guided by credit quality of investments, tenor/ maturity of instruments, yields and returns. Risks related to investments are mitigated through stringent internal procedures and controls by PFMs and through regular monitoring by PFRDA/NPS Trust.

Investment pattern under NPS for Private Citizens

One of the criticisms often levelled against NPS has been its failure in propagating its product. There is also an apprehension that, given the poor standard of financial literacy in India, whether the ordinary investor will have the required financial knowledge to understand the nature of NPS. However, the design of NPS includes a provision for such a contingency.

The investment guidelines for NPS for private citizens allow investment in government securities (asset class G), corporate bonds (asset class C) and equities (asset class E) in various proportions (subject to condition that investment in equity cannot exceed 50% of the

investible funds). For subscribers not exercising any choice, their funds are invested under the “auto choice”, which is based on life-cycle investment choice.

Allocation of funds across asset class for “Auto choice”

Age (In Years)	Asset Class E (%)	Asset Class C (%)	Asset Class G (%)
Up to 35	50	30	20
36	48	29	23
37	46	28	26
38	44	27	29
39	42	26	32
40	40	25	35
41	38	24	38
42	36	23	41
43	34	22	44
44	32	21	47
45	30	20	50
46	28	19	53
47	26	18	56
48	24	17	59
49	22	16	62
50	20	15	65
51	18	14	68
52	16	13	71
53	14	12	74
54	12	11	77
55	10	10	80

The following table shows the existing exposure of government schemes under NPS.

Exposure to various financial instruments under NPS (as on February 28, 2013)

Investment Category	Minimum Limit	Maximum Limit (%)	Existing Exposure (%)	Existing Exposure (%)
			NPS CG	NPS SG
Government Securities : G	Not Specified	55	49.63	49.83
Fixed Income : C-Debt Corporate Debt	Not Specified	40	38.87	35.92
Fixed Income : C-MM Money Market	Not Specified	5	4.26	7.29
Fixed Income Total : C	Not Specified	45	43.13	43.21
Equity : E	Not Specified	15	7.24	6.96

Source: PFRDA

The table throws up two important findings. One, the total exposure to fixed income category of investments is reaching the maximum limit of 45%, with corporate debt close to the upper limit of 40%. Two, investment in government securities and equities are well within the prescribed upper limits. It can be inferred from the above that while pension funds seem to

have an appetite for fixed income securities yielding higher returns than government bonds, they are yet to fully embrace the equities culture. However, it also must be remembered that this data pertains to the post-crisis period when funds across the world trimmed down their equity exposure.

This becomes all the more evident when we compare the performance of the NPS private sector schemes which, unlike the government schemes, are invested separately in each investment category. The table below shows that Scheme C (fixed income) has outperformed scheme G (government securities) as shown in data from pension fund managers (PFM).

Pension Fund Mangers' Performance for Scheme C and Scheme G since inception (as on March 31, 2013)

PFM	Return since Inception CAGR (%) Scheme C (Tier I)	Return since Inception CAGR (%) Scheme G (Tier I)	Yield Spread (C over G) (%)
SBI Pension Funds Pvt Ltd	12.52	10.49	1.76
UTI Retirement Solutions Ltd	9.36	7.97	1.39
Kotak Mahindra Pension Fund Ltd	11.76	8.21	3.54
Reliance Capital Pension Fund Ltd	8.74	7.51	1.23
ICICI Prudential Pension Funds Management Co Ltd	11.51	8.15	3.36

Source: PFRDA

It is clear that corporate fixed income securities are more attractive investment options when compared with government securities, which yield a very low real rate of return due to high inflation in India. While equities have performed poorly during 2010-12, this is on account of underperforming equity markets in the aftermath of the global financial crisis. It is common knowledge that corporate debt yields are necessarily higher than that offered by government securities, given the risk differential. Therefore, given the persistence of inflationary pressures in the economy and the near-negative real yields available on gilts, there is an urgent need to shift asset allocation from government securities to corporate bonds.

It may be mentioned that the corporate debt (fixed income) category of investments includes (i) corporate debt securities of not less than 3 years tenure, (ii) term deposits of not less than 1 year duration, and, (iii) rupee bonds having outstanding maturity of at least 3 years. Corporate debt (category i) requires at least 75% of investments to be made in securities with an investment grade rating (BBB and above). The remaining 25% can be invested in securities below investment grade. It is to be noted that corporate long-term infrastructure debt would qualify under category (i) due to the 3-year tenure requirement.

Considering that (a) infrastructure represents the most urgent, long-term financing need of the nation, and, (b) pension funds are a long term source of financing, which are typically invested by the fund managers over a longer horizon, there is an alignment of supply and demand financing. With appropriate credit enhancement mechanisms for infrastructure debt,

a substantial part of the annual flow of pension funds could potentially be invested in infrastructure debt, subject to the normal risk provisions.

The long term nature of pension funds, the robustness of equity markets and the existence of equity risk premium in stock markets over the longer horizon present a strong case for greater investment in equities. Studies have shown that “equity risk premium” -- the excess return of stock markets over the risk-free rate -- exists in many developed countries as is evident from historical stock returns data. The “equity risk premium” in India from 1981 to 2006 has been estimated on a geometric mean basis at 8.74%. Similar experience of existence of “equity risk premium” has been documented for many OECD countries for which the data of more than 100 years is now available.

EPFO vs NPS

The rate of return provided by the Employees’ Provident Fund are declared rates and not net market returns on investments, which are arrived at after incorporating penalties and damages and the use of some reserves. Even if we look at the nominal returns on the Employees’ Provident Fund against the rate of inflation, it would appear that the real rate of returns has been negative. This could be directly related to the pattern of investment adopted, which has not been revised since July 2003.

There has been high tolerance to the negative real returns but a low level of acceptance to taking risk in equity investment as the investment pattern of the finance ministry, which allows a small proportion of investible funds in equity, has not been adopted by the labour ministry. On the other hand, the higher returns (compared to the returns on the Employees’ Provident Fund) delivered by NPS – even though it’s been around for only a short period -- are essentially due to a relaxed and flexible investment pattern. The objectives of long-term savings cannot be met if there are shortfalls in the return performance. As mentioned elsewhere, a 1% shortfall in investment return would reduce the terminal pension wealth over a 40-year period by 20-30%. Therefore, the interests of the subscribers to a pension fund are not being served by an investment pattern which has high tolerance for low or negative real returns.

Deficiency in Laws/Regulations

Although there is no legal restriction in revision of the investment patterns and the review of investment pattern is mostly policy based, which can be done through a notification under the Employees’ Provident Funds and Miscellaneous Provisions Act, 1952 or the Income-tax Rules, 1962, a piquant situation has emerged creating regulatory anomaly and compliance nightmare for the provident funds.

After the enactment of Finance Act, 2006, even establishments which were uncovered under the Employees’ Provident Fund and Miscellaneous Provident Fund Act, 1952 (EPF & MP Act) have been asked to get registration under sub-section (4) of section 1 and exemption under section 17 of the EPF & MP Act before they approach the income tax authorities for grant of status of “Recognised Provident Fund” under Schedule IV of the Income Tax Act, 1961 (rule 4 (ea) of Part A of the Fourth Schedule of the Income-tax Act, 1961). The status

of a “Recognised Provident Fund” is required to get income tax benefits for provident funds. This has resulted in a situation where even the establishments which are not covered under EPF and MP Act are forced to go to the Ministry of Labour for seeking exemption under Section 17 of the EPF and MP Act.

Further, there is a provision in paragraphs 27 and 27A of the EPF Scheme to exempt from all or any of the provisions of the Scheme any class of employees to whom the scheme applies, subject to such condition as may be specified in the order of exemption.

It is, therefore, clear that the uncovered provident funds are required to be specifically exempted under the provisions of the EPF and MP Act before these funds acquire the status of a “Recognised Provident Fund” which gets EEE tax status, meaning thereby that the contributions to the provident fund, its returns and even payments from the fund are tax exempt.

However, this has created an anomalous situation for these funds as one of the conditions of the exemption from EPF and MP Act is that these provident funds are required to follow the investment pattern specified by Ministry of Labour. But, on the other hand, the condition to qualify as a “Recognised Provident Fund” under Income Tax Act, 1961 is that these funds should follow the investment pattern set down by the Ministry of Finance. Earlier, the labour ministry adopted the investment pattern laid down by Ministry of Finance. This trend was broken in 2005 after which the Ministry of Labour has not adopted the new investment notifications announced by the Ministry of Finance, first in January, 2005 and the subsequent notification of August 2008. Therefore, the Ministry of Labour’s investment pattern has not been revised since July 2003. As a result, under the current conditions, a private “Recognised Provident Fund” is forced to violate one of the investment patterns.

Lack of Opportunities and Lack of Competency

The investment pattern for provident funds assigns the trustees of provident fund trusts with the responsibility of maintaining a balance between the risk-return trade-off. This is a fairly onerous burden considering that we are still far away from creating a robust framework for selecting “fit and proper” provident fund trustees. The investment guidelines for NPS for all citizens – which lets them chose the blend of their portfolio – has also created space for inclusion of financially illiterate subscribers through the use of index fund investment in equities and also through an auto choice which is based on life-cycle investment strategy. This has two implications – one, relating to cost minimisation of asset management thorough the passive fund management and, two, it has created an intelligent option for default investment behaviour for financially illiterate subscribers.

Needs/Concerns of Clients

A defined contribution (DC) scheme, such as the NPS which maintains individual retirement accounts of pensioners who bear the investment risk, must not only maximise pension wealth, but also ensure that the return of pensioners reported, as net asset value of units, are relatively smoothed. This means special care should be taken to ensure that the volatility of returns, which is also an important parameter, is monitored regularly. It is, therefore, essential that

while increasing the awareness and literacy of the individual subscribers under NPS is important, it is equally vital to appoint “fit and proper” trustees on provident funds which work on pooled investment principle. It is, therefore, clear that no liberalisation of investment pattern is complete without simultaneously increasing the administrative and governance capacity of the trustees of the provident funds. This in-house capacity creation is required for monitoring external fund managers -- so that not only investment objectives are satisfied but also volatility of investment returns is minimised.

Needs/Concerns of Fund Managers

The concept of auction of pension fund managers has been gradually accepted for all the major provident and pension systems (including Employees’ Provident Funds, Seamen’s Provident Fund and National Pension System). The pension fund managers (PFMs) had bid aggressively to manage NPS assets and eventually ended up with a low fee of 0.0009 basis points in the open auction process. This gave rise to the concern about whether PFMs would be able to provide quality asset management services at such a low fee. However, there has been a change in the strategy and PFRDA has now decided to appoint PFMs on “fit and proper” criteria and the fee of the PFMs has also been increased with the expectation that this would also spur the PFMs to promote NPS as a long-term savings product.

Needs/Concerns of Economy/Market

There is a symbiotic relationship between the pension market and the financial markets. While the long-term saving instruments require long-term financial assets for investment, the economy needs these investors to provide resilience and depth to the financial markets. In many developed markets, pension assets add up to a large percentage of the country’s GDP and influence financial market development. In turn, these funds benefit from efficient execution of investment strategies in deep and liquid financial markets. In many small economies, their small domestic financial markets are unable to provide scale, volume and depth to pension funds. India, however, does not face that challenge as our financial markets can provide safe and sound avenues for pension assets.

Need for review of investment pattern based on NPS performance

To summarise, there is a case to reduce exposure to government securities and allow greater investment in corporate debt (fixed income) and equities, because:

- Government securities yield a low real rate of return in persistently high inflationary environment.
- Corporate debt yields are considerably higher than government yields as observed from the performance data of the PFMs under NPS.
- Corporate debt includes investment in infrastructure debt which is an urgent financing need that is in alignment with the long-term nature of pension fund liabilities.
- Equities provide a “risk premium” that can be captured over a longer time horizon by pension funds.

The relatively large mandated portfolio allocation in government bonds creates an undesirable concentration in the sovereign, yielding a low real rate of return. Allowing an opportunity for greater investment in corporate debt would not only provide better real returns but also help deepen the debt markets and contribute to infrastructure financing. Due to the presence of equity premium, greater investment in equities over the longer horizon would help maximise pensioners' terminal pension wealth.

Let us now look at the history of investment norms in the insurance sector.

INSURANCE SECTOR

The Indian Life Assurance Companies Act, 1912 was the first statutory measure to regulate life business. In 1928, the Indian Insurance Companies Act was enacted to enable the Government to collect statistical information about both life and non-life business transacted in India by Indian and foreign insurers including provident insurance societies. In 1938, with a view to protecting the interest of the insuring public, the earlier legislation was consolidated and amended by the Insurance Act, 1938 with comprehensive provisions for effective control over the activities of insurers. The Insurance Amendment Act of 1950 abolished Principal Agencies. However, there were a large number of insurance companies and the level of competition was high. There were also allegations of unfair trade practices. The Government of India, therefore, decided to nationalise insurance business. An Ordinance was issued on January 19, 1956, nationalising the life insurance sector and Life Insurance Corporation came into existence in the same year. The LIC absorbed 154 Indian, 16 non-Indian insurers as well as 75 provident societies — 245 Indian and foreign insurers in all. The LIC had monopoly till the late 90s when the insurance sector was reopened to the private sector.

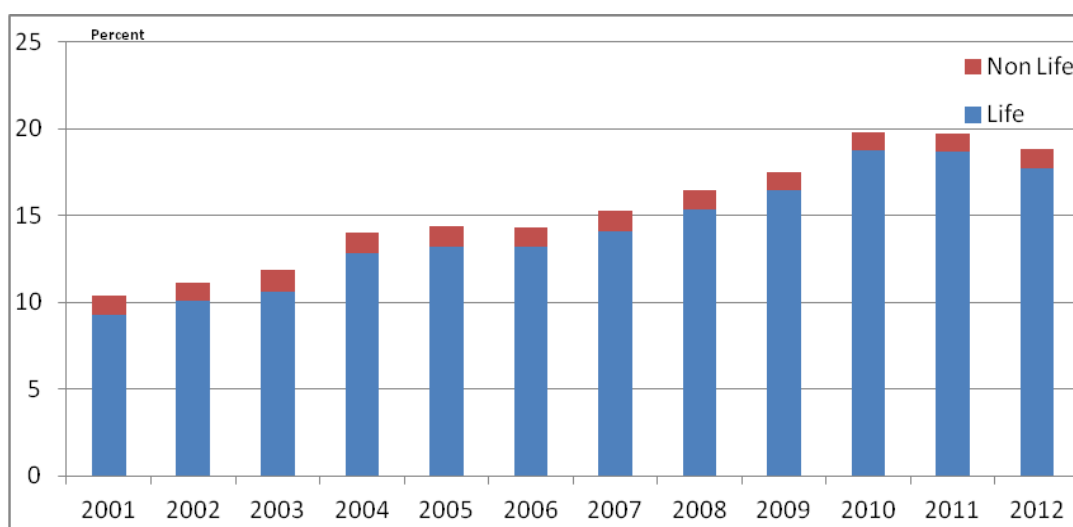
The history of general insurance dates back to the Industrial Revolution in the west and the consequent growth of sea-faring trade and commerce in the 17th century. It came to India as a legacy of British occupation. In 1907, the Indian Mercantile Insurance Ltd was set up. This was the first company to transact all classes of general insurance business. The General Insurance Council, a wing of the Insurance Association of India, was formed in 1957. The General Insurance Council framed a code of conduct for ensuring fair conduct and sound business practices. In 1968, the Insurance Act was amended to regulate investments and set minimum solvency margins. The Tariff Advisory Committee was also set up around that time. In 1972, with the passing of the General Insurance Business (Nationalisation) Act, general insurance business was nationalised with effect from January 1, 1973. A total of 107 insurers were amalgamated and grouped into four companies – namely, National Insurance Company Ltd, the New India Assurance Company Ltd, the Oriental Insurance Company Ltd and the United India Insurance Company Ltd. The General Insurance Corporation of India was incorporated as a company in 1971 and it commenced business on January 1, 1973.

This millennium has seen insurance come a full circle in a journey extending to nearly 200 years. The process of re-opening of the sector had begun in the early 1990s and the last decade and more has seen it been opened up substantially. In 1993, the Government set up a committee under the chairmanship of R.N.Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector. The objective was to complement the reforms initiated in the financial sector. The committee submitted its report in 1994 wherein, among other things, it recommended that the private sector be permitted to enter the insurance industry. The committee suggested that foreign companies be allowed to enter by floating Indian companies, preferably a joint venture with Indian partners.

Following the recommendations of the Malhotra Committee report, the Insurance Regulatory and Development Authority (IRDA) was constituted in 1999 as an autonomous body to regulate and develop the insurance industry. The IRDA was incorporated as a statutory body in April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premiums, while ensuring the financial security of the insurance market. The IRDA opened up the market in August 2000 with by inviting applications for registrations. Foreign companies were allowed ownership of up to 26%. The Authority has the power to frame regulations under Section 114A of the Insurance Act, 1938 and has from 2000 onwards framed various regulations, ranging from registration of companies for carrying on insurance business to protection of policyholders' interests. In December, 2000, the subsidiaries of the General Insurance Corporation of India were restructured as independent companies and at the same time GIC was converted into a national re-insurer. Parliament passed a bill de-linking the four subsidiaries from GIC in July, 2002.

Today there are 27 general insurance companies (including the Export Credit Guarantee Corporation and Agriculture Insurance Corporation of India) and 24 life insurance companies operating in the country. The insurance sector is a colossal one and is growing at a healthy rate of 15-20%. Together with banking services, insurance services add about 7% to the country's GDP. Since the passage in 1999 of the Insurance Regulatory and Development Authority Act, which permitted the entry of private and foreign firms into the insurance sector, the market share of the state-run firms has decreased to 71% (2012-13) for life insurance and to 56% (2012-13) for non-life insurance. A well-developed and evolved insurance sector is a boon for economic development as it provides long-term funds for infrastructure development while simultaneously strengthening the country's risk-taking ability.

Chart 1: Insurance company assets as share of GDP*, 2001-10



Source: IRDA, Ministry of Statistics

The nature of the industry requires insurers to generate reserves for claims that might arise any time in the future; as a result, over time, a large corpus of funds is built up. Thus, it is important that insurance companies invest these funds judiciously with the combined objectives of liquidity, maximisation of yield and safety. The returns on investments of life funds influence the premium rates and bonuses of life insurance business and, eventually, the buying behaviour of customers. Thus, the rate of return offered by insurance companies has a direct bearing on the growth rate of insurance industry, especially in a country like India where persistently high inflationary trends have skewed expectations of yields. Hence, this endeavour in reforming the investment norms is directly related to the growth and development of the insurance sector in our country.

Prevailing Investments Norms

The Insurance Industry in India is subject to a complicated set of rules and regulations. Companies are required to invest minimum amounts in government securities; and restrictions are put on the amount to be invested in “approved investments” and “other investments”, as per a detailed list that includes specific equities and corporate bonds as well as bank deposits. Approved investments are in companies that have a strong, multi-year dividend payment record. Investments that do not fit these criteria are called “Other Investments”.

The Insurance Act of 1938 required that the life insurers should hold 55% of their assets in government securities or other approved securities (Section 27A). In the 1940s, many insurers were part of financial conglomerates. With a 45% balance to play with, some insurers used these funds for financing their other enterprises or even for speculation. Based on the reading of Section 27A of the Insurance Act, 1938, together with the exposure norms issued by IRDA from time to time, the following can be the summary of the currently prevailing rules and regulations pertaining to investment norms for insurance companies.

- **Life insurance.** A minimum 25% is to be invested in Central Government securities. A minimum 50% is to be invested in Central Government and state government securities (and in securities guaranteed by those entities), and equity investments cannot exceed 35%. Housing and infrastructure require a minimum 15% investment.
- **Pension and annuity plans** offered by life insurance firms. A minimum of 20% is to be invested in Central Government securities and a minimum of 40% in Central and State Government securities (and in securities guaranteed by those entities). Equities have a cap of 60%.
- **General insurance.** A minimum of 20% is to be invested in Central Government securities. A minimum of 30% is to be invested in Central Government and State government securities (and in securities guaranteed by those governments), and equity investments cannot exceed 55%. Housing and loans to State Governments for housing and fire-fighting equipment require a minimum of 5% investment and infrastructure requires a minimum of 10% investment.
- **ULIPs** face fewer restrictions. At least 75% should go to “approved investments”, which tend to be liquid stocks with a strong dividend payment record, and not more

than 25% to “other investments”. Unit-linked policies may be offered only where the units are linked to categories of asset that are both marketable and easily realisable.

In 1958, the central government issued a notification under Section 43 of the LIC Act, vide which Section 27A of the Insurance Act, 1938 was made applicable to LIC in terms of: at least 25% in central govt securities; at least 50% in Central govt. and State govt. securities; further 25% in social sector (including housing and infrastructure). Further, LIC is allowed to invest 15% of the life fund in “other than approved” investments. For the P&GA fund, it is: at least 20% in central government securities; at least 40% in central government and state government securities; Balance in approved investments. No investment is permitted in “other than approved” investments.

Insurance companies can invest in corporate bonds, including infrastructure bonds, within the overall cap specified by the regulator. At least 75% of the debt held by life insurance and general insurance plans must have a sovereign rating or be rated AAA (for long-term securities) or P1 (for short-term securities). They also cannot own more than 10% of the equity or debt of a single firm, group of firms or sector. Insurance companies are increasing their investments in equities, albeit at a glacial pace. Insurance companies have shifted their equity allocation from 22% of assets in FY06 to 34% in FY11. The rest of their assets are invested almost entirely in debt instruments, mostly in government bonds. In case of LIC, which accounts for 71% of the market, there has been a shift into corporate bonds, which accounted for nearly 20% of assets in FY10 – up from 10% in FY06.

Total Investments of the Insurance sector

As on March 31, 2013, the accumulated total investments of the insurance sector stood at Rs 18,60,500 crore, showing a 10.70% increase over the Rs. 16,80,527 crore AUM recorded during 2011-12. Life insurers continue to contribute a major share of total investments held by the industry with a share of 93.58% (previous year 94%). Similarly, public sector companies continue to contribute a major share (79.74%) in total investments, although the share of AUM held by private sector insurers has also been growing fairly in recent years, particularly in the backdrop of increase in sales of Unit Linked Insurance Products (ULIPs).

INVESTMENT OF INSURERS			
Sector	2000-01	2011-12	2012-13
Life	1,94,009	15,81,259 (11%)	17,41,175 (10.11%)
General	24,462	99,268 (20%)	1,19,325 (20.20%)
Total	2,18,471	16,80,527 (11%)	18,60,500 (10.70%)

Source: IRDA

Investments of Life Insurers

The various sources of funds available for investment by life insurers are classified as (i) funds from traditional products, and, (ii) funds from ULIP products. The total funds invested

by life insurers as on March 31, 2013, amounted to Rs 17,41,175 crore, compared with Rs15,81,259 crore in the previous year. Of this, Rs 3,42,507 crore or 19.67% of the total funds (Rs. 3,69,972 crore or 23.4% in the previous year) were contributed by ULIP funds. The remaining Rs 13,98,668 crore or 80.33% (Rs. 12,11,287 crore, or 76.60% in previous year) was contributed by traditional products. The share of ULIP funds in total investments has decreased in the last year. Thus, during the year the increase in total investments was contributed entirely by traditional funds as there was a reduction in funds contributed by ULIP funds.

The pattern of investments made by life insurers as on March 31, 2012, followed the trend of the previous year. According to IRDA's 2011-12 annual report: "Central government securities and approved investments continued to be the two major avenues of investments by life insurers." Segregated on the basis of funds, life funds contributed Rs 974,620 crore or 61.64% of the total funds (Rs.8,41,075 crore, 58.81%, in the previous year), pension and general annuity & group funds Rs 2,36,667 crore at 14.97% (Rs.1,89,927 crore, 13.28%) and ULIP funds Rs 3,69,972 crore at 23.4% (Rs.3,99,116 crore, 27.91%). Two interesting trends emerge – one, during 2011-12, share of pension/annuity funds increased to 14.97% from 13.28% in the previous year, and two, share of ULIP funds decreased from 27.91% to 23.4%.

TOTAL INVESTMENTS BY LIFE INSURERS: INSTRUMENT WISE						
(As on 31st March) (Rs in Crore)						
Pattern Of Investments	2010		2011		2012	
	Amount	Percentage	Amount	Percentage	Amount	Percentage
Traditional Products						
1. Central Govt Securities	360447	41.20	420952	40.83	468082	38.64
2. State govt and other approved securities	137236	15.69	173733	16.85	214515	17.71
3. Housing & Infrastructure	85675	9.79	89181	8.65	97320	8.03
4. Approved Investments	257084	29.38	304977	29.58	385107	31.79
5. Other Investments	34477	3.94	42159	4.09	46262	3.82
A. Total (1+2+3+4+5)	874918	100.00	1031002	100.00	1211287	100.00
ULIP Funds						
6. Approved Investments	311669	92.34	371899	93.18	346340	93.61
7. Other Investments	25871	7.66	27217	6.82	23632	6.39
B. Total (6+7)	337540	100.00	399116	100.00	369972	100.00
Grand Total (A+B)	1212458		1430118		1581259	

Source: IRDA

GROWTH OF INVESTMENTS : FUND WISE
(As on 31st March) (Rs in Crore)

Fund	2010		2011		2012	
	Total	Growth in %	Total	Growth in %	Total	Growth in %
Life	731291	16.14	841075	15.01	974620	15.88
Pension & General Annuity & Group Fund	143627	26.04	189927	32.24	236667	24.61
Traditional (A)	874918	17.66	1031002	17.84	1211287	17.49
Unit Linked Funds (B)	337540	95.38	399116	18.24	369972	-7.30
Total (A+B)	1212458	32.31	1430118	17.95	1581259	10.57

Source: IRDA

Investments of Non Life Insurers

Non-life insurers contributed to the extent of only 6.41% (6% in the previous year) of total investments held by the insurance industry. The total investments of the non-life sector, as on March 31, 2013, stood at Rs 1,19,325 crore, compared with Rs.99,268 crore in the previous year, showing a growth of 20.20% growth. The pattern of investments remained the same as in the previous year. As on March 31, 2012, non-life insurers held Rs 24,241 crore in central government securities, representing 24.42% of total investments (Rs 19,865 crore, 24.07%, in the previous year) and Rs 38,563 crore, representing 38.84% of total investments (Rs.31,769 crore, 38.50%) in approved investments.

TOTAL INVESTMENTS OF NON-LIFE INSURERS : INSTRUMENT WISE						
(As on 31st March)						
(Rs in Crore)						
Pattern of Investments	2010		2011		2012	
	Total	%	Total	%	Total	%
Central Govt Securities	16038	24.16	19865	24.07	24241	24.42
State Govt and other approved securities	6971	10.50	8191	9.93	9339	9.41
Housing and Loans to State Govt for Housing & FFE	4790	7.22	6973	8.45	8179	8.24
Infrastructure Investments	10373	15.63	12216	14.80	15198	15.31
Approved Investments	24256	36.55	31769	38.50	38563	38.85
Other Investments	3944	5.94	3506	4.25	3749	3.78
Total	66372	100.00	82520	100.00	99268	100.00

Source: IRDA

Based on the above mentioned prevailing state of affairs in terms of the complicated set of regulations and the consequent impact they have on the overall growth of the industry we can now look at the specific key constraints being faced by the life and the general insurance sector relating to the investment pattern.

What are the issues:

The **Life Insurance Sector** is very close to the cap of 35% for approved plus other investment and feels restricted by rules on corporate bonds. A trend analysis of NCDs/bond issuances during FY12 shows that many large investors – such as state-owned LIC -- may have already touched/breached the IRDA specified cap of 10% of the capital employed in the case of some issuers. But, more important is the lack of supply (a chicken-and-egg problem). The corporate bond market is less than 6% of GDP, compared to 140% of GDP in the US. There is a shortage of long-tenor securities, as most insurance companies would like to invest in securities with a tenor of 10 years or more but corporate debt currently available are of a maturity of 2-5 years. Moreover, issue sizes in “AA”, “AA-“ and “A+” categories are fairly small compared to the overall size of the Indian bond market (together 7.67%) whereas a large insurer like LIC requires much larger headroom for investment than what is available in “A+” to “AA” categories. Hence, the space available for investments in Indian bond market in the context of IRDA’s current regulatory framework may not be enough for the larger players like the Life Insurance Corporation of India. SEBI, RBI and the government need to resolve the outstanding issues to develop the market and also lower the cost of issuance and to add liquidity to the market. The imminent entry of foreign pension funds into rupee-denominated corporate bonds and focus on innovations (such as takeout financing, securitisation and infrastructure debt funds) is expected to stimulate its development.

In the **General Insurance Sector**, PSUs as well as private sector non-life companies do not have a large corpus of funds such as LIC and their business is typically short term, which at the moment depends a great deal on “investment income” to overcome underwriting losses. Such a short term focus -- that too with a predominance of bank fixed deposits -- indicates risk aversion on their part together with the paucity of adequate human capital to effectively gauge market sentiments and accordingly invest in riskier but higher return bearing equity capital. To resolve this predicament, there is a need to ensure that, on one hand, the infrastructure debt market takes off (due to the credit enhancement schemes of IIFCL, tax incentives from the Government and encouragement to FII as well as greater clarity in investment classification by the regulator) so that the limits can be eased or modified as and when required while, on the other, necessary human capital is developed in terms of equipping the sector with the necessary technical skills of financial management in order to survive and thrive in the riskier environment.

What is required:

Given this state of affairs, there is an urgent need to have reforms on the lines of:

- i. Making available sufficient head-room for making investments into “AAA” and “AA+” sector on a regular basis.
- ii. Promoting diversification by having enough fresh institutional borrowers with good, long-term financial standing. Also, permission to use derivatives (including futures, options and credit default swaps) to hedge investment risk needs to be provided.
- iii. Making available greater avenues for investing in infrastructure projects (which are

long term in nature). For instance, equity investments in infrastructure to be eligible for the “approved investments” category, the investee companies need to have a strong, multi-year dividend payment record. Since infrastructure projects in their early years tend to have poor credit ratings and are unlikely to have a strong dividend payment record, these strict conditions eliminate a number of potential investments opportunities from consideration. There is thus an imminent need for their relaxation.

- iv. Regulatory uncertainty has also slowed down sales of pensions and annuities products, especially after IRDA prescribed a guaranteed return for pension plans, which was subsequently withdrawn in August 2011. Given the fact that the potential for growth for such products in India is huge, especially because India’s household savings rate is high and social security net is almost non-existent, there is an urgent need to ensure regulatory consistency and cohesiveness.

Thus we can state that, investment by insurance companies and approved pension funds in India is currently subject to a prescriptive model with a substantial chunk of funds being channelled into government related investments. This invariably raises questions about the underlying risk aversion and the consequential ability of funds to earn adequate returns given their over-dependence on low-yielding government securities.

If we look at India’s high-growth, high-inflation environment, ideally it would be equities which make more sense than fixed income securities given the higher yield that they traditionally generate. The optimal investment strategy should therefore be one more similar to that of the UK – where equity has been favoured by institutional investors because inflation has historically been high – than that of, for example, Germany, where inflation has been low. However for this to happen, there is a need for two opposing forces to balance each other out – a tendency by insurance companies to misinform investors about the cost structure and a regulatory propensity to micro-manage.

In conclusion it can thus be said that, the time has probably come to re-examine the prescriptions, as well as the model itself, and see whether greater investment latitude can be created for new and existing insurers. Such a step would result in an improved rate of return and the consequential improvement in the low penetration levels and greater flow of funding to large scale infrastructure projects, many of which are now being undertaken by private sector. However, simultaneously, funds and fund managers should be required to hone their skills in portfolio management and stock selection techniques before participating in corporate debt and equity markets in order to develop the necessary human capital for having a sustainable growth of the sector.

CHAPTER IV

INTERNATIONAL EXPERIENCE WITH INVESTMENT NORMS

INSURANCE

Whereas the activities of the insurance industry are undoubtedly of great benefit to people and the economy at large, the consequences of insurance companies failing to meet their contractual obligations are extremely serious and far-reaching. In the 19th century, fraud and mismanagement led to frequent failures of insurance companies with serious consequences for policyholders and adverse effects on the reputation of the industry. Even so, it was not until the middle of the 20th century that the need for regulations to protect policyholders was recognised across geographies. The Insurance Companies Act (1982) of UK (which consolidated the earlier 1974 Act) brought in minimum solvency margins and defined eligibility for an insurer to be licensed to transact business in the UK. The guiding principle of the legislations was to ensure that only ‘fit and proper persons’ be allowed to undertake insurance business so that eventually a strong insurance market can be developed and built.

S. No	Parameter	U.K		U.S		Comments
		Insurance Company	Pension Fund	Insurance Company	Pension Fund	
1	Regulations	Relaxation with respect to investment abroad and derivatives		Relaxation led to shift in equities		Risk control via Hedging -- Riskier assets become attractive
2	Asset-Liability matching	Bonds -- inappropriate match for liabilities due to exposure to inflation risk Equities -- move in line with nominal wages thus better				Equities help counter inflation risk
3	Assets Supply	Development of Corporate Bond Market requires-greater demand and supply				Role for institutional investors & Companies
4	Macro Economic conditions	[High inflation: Equity preferred over fixed income product] + [Large Govt. deficit: Govt. bonds give higher returns]				State of economy also determines attractiveness of investment choice
5	Competition	Greater Competition - need to have greater returns by investing in riskier assets				

The history of economic development indicates that there is a direct co-relation between the national prosperity and the degree of development in the insurance and pension sectors. The City of London Corporation report outlines that, insurance assets in the UK grew exponentially from 20 per cent of GDP in 1980 up to 100 per cent of GDP and have since stabilised at that level in the past one decade. The trend of growing insurance and pension sectors seems universal, but there are numerous factors that influence its size. In the US, the insurance sector seems to have stabilised at around 40 per cent of GDP and in Germany at 60 per cent. Even though insurance penetration is relatively low in southern European countries, it is expected to grow as greater fissures appear on the versatile social safety net.

In line with the trend, Indian insurance sector has also grown rapidly during the past decade post liberalisation. Assets of life insurance companies, as a share of GDP, increased from 9.6 per cent in 2001 to 16.1 per cent in 2010. However, the Indian insurance sector is still

small in comparison to that of most developed economies, notwithstanding absence of a meaningful social safety net. The potential for growth in India is therefore huge, especially because of declining dependency ratio and growth potential of household savings.

Further, according to the report prepared by the City of London, investment patterns are driven by certain country-specific factors, of which five are most relevant – namely, regulations, asset-liability matching, supply of assets, macro economic conditions and competition. According to this report, the relatively liberal position of the countries (that of U.K and U.S is summarised below) on these 5 factors determines the extent to which the insurance and pension Sector succeed in their role as institutional investors.

The report concludes that, driven by the liberal position on the above mentioned 5 key elements, much of the financial wealth of UK and US households was in insurance companies and pension funds and these institutions have invested actively in equities and corporate bonds, which in turn helped to develop and establish liquid and sophisticated financial markets with reduced volatility. It can thus be surmised that investment norms cannot be visualised in a vacuum, rather a holistic view of the prevailing macroeconomic scenario in the country as well as the world has to be taken into account; in addition, a freer approach to investing helps develop the financial markets.

A similar analysis on China shows that insurance companies there have diversified their investment mandates over time to include bonds, mutual funds, equities and infrastructure. Bank deposits have gradually declined from 53 per cent of total invested assets in 2001 to 30 per cent in 2010. Bonds have become a much more important asset class, and comprised half of total investment in 2010. But conservative investment norms are still predominant. Equity investment has stabilised at around 11 per cent of total investment after shooting up to 18 per cent in the bull market of 2007 and subsequently collapsing in 2008 owing to the global financial crisis. Investment in securities investment funds has remained flat at around 6-7 per cent. The various limits as existing currently in China are as follows:

S. No	Investment Head	Insurance
1	Guaranteed Corp. Bonds (A or above rating)	No limit
2	Non guaranteed Corp. bonds (AA or above)	Not more than 20%
3	Stocks and Securities Investment Funds (SIFs)	Not more than 25%
4	Overseas stock markets	Not more than 15%
5	Private equity	Not more than 5%
6	Real estate, excluding residential properties	Not more than 10%
7	Infrastructure	Not More than 10%

The Chinese market also highlights a risk averse investment style by way of a conservative investment pattern and the consequent lower returns. This risk aversion is not purely cultural, but also related to the short history of liberal regulation, the lack of investment management skills, as well as the indelible shadow of past investment failures. Many life insurance companies lobbied the China Insurance Regulatory Commission (CIRC) in 2007

to relax its controls over stock market investment and aggressively bought shares during the bull market, but they took a massive hit in the 2008 collapse. This experience helps to explain why no insurance company dramatically increased its equity position when regulations were loosened in 2010.

How does this compare with India?

India's current position on the above mentioned five key parameters shows that insurance companies have increased their involvement in both equities and corporate bonds in recent times. They currently hold the equivalent of 11 per cent of free-float market capitalization, but compared with the US and the UK, their participation is still low. The reason is India's regulations are still quite restrictive, in comparison with most developed countries where either no limits exist or investment limits for equity and corporate bonds are quite high. The following table provides a snapshot of the Indian limits:

S. No	Investment Head	Life Insurance	General Insurance
1	C.G. Security	Min 25%	Min 20%
2	C.G + S.G Security	Min 50%	Min 30%
3	Equity	Max 35%	Max 55%
4	Housing & Infrastructure	Min 15%	Min 5% + Min 10%
5	Derivatives/foreign assets	Not Permitted to Invest	
6	Corporate Bonds(infra bonds also)	Only AA or higher(Min 75% Debt be AAA/Sovereign rated)	
7	Equity/Debt of single firm/group/sector	Not More than 10%	

The move to ULIPs however, creates a more liberal investment climate and is a step in the right direction. For ULIPs at least 75 per cent should go to "approved investments", which tend to be very liquid stocks with a strong dividend payment record, and not more than 25 per cent to "other investments".

The holdings of government securities by life insurance funds have been consistently higher than the minimum 50 per cent threshold set by the regulator. This demonstrates two obvious trends: one, life insurance companies are risk averse and, two, low availability of good-quality corporate bonds. The life insurance sector is very close to the cap of 35 per cent for approved plus other investment and feels restricted by rules on corporate bonds, but more important is the lack of supply (a chicken-and-egg problem). Permission to use derivatives (including futures, options and credit default swaps) to hedge investment risk is also required. Further, for equity investments in infrastructure to be eligible for the "approved investments" category, investee companies need to have a strong, multi-year dividend payment record. Since infrastructure projects in their early years tend to have poor credit ratings and are unlikely to have a strong dividend payment record, these strict conditions eliminate a number of potential investments from consideration.

Inadequate supply of non-governmental debt instruments is the principal constraint on the bond investment strategies of insurance companies. The corporate bond market is less than 6 per cent of GDP, compared to 140 per cent of GDP in the US. There is also a shortage of long-tenor securities, as most insurance companies would like to invest in securities with a tenor of 10 years or more but corporate debt currently available are of a maturity of 2-5 years. SEBI, RBI and the government need to resolve the outstanding issues to develop the market and also lower the cost of issuance and to add liquidity to the market. The imminent entry of foreign pension funds into rupee-denominated corporate bonds and focus on innovations (such as takeout financing, securitisation and infrastructure debt funds) is expected stimulate its development.

India's high-growth, high-inflation environment makes equities more attractive than fixed income securities. The optimal investment strategy would therefore be one more similar to that of the UK – where equity has been favoured by institutional investors because inflation has historically been high – than that of, for example, Germany, where inflation has been low. In fact, regulatory intent in the mature economies to liberate insurance and pension fund managers from a directed investment regime has helped them deliver positive real rate returns, something that has eluded Indian investors.

This explains the enormous popularity of ULIPs and points to continued growth of demand for such instruments, provided two opposing forces can manage to balance each other out – a tendency by insurance companies to misinform investors about the cost structure and a regulatory propensity to micro-manage. The yield on 10-year government bonds is currently 8.3 per cent, lower than the current inflation rate of 9.2 per cent. If insurance companies and pension funds want to offer a decent real return to savers, they will have to venture into higher-yielding securities. For instance, the below mentioned analysis depicts that as we move from AAA rated corporate securities to the consequent lower rated securities the average yield to maturity (YTM) goes on increasing at an exponential rate and is also higher than the YTM on G-Sec for similar maturity profiles.

Rating	Invest. During 2011-12 (Rs. in cr.)	Average tenor (years)	Average YTM (%)	Avg. Annual G-sec YTM for similar tenor (%)	Avg. Spread received (bps)
AAA	16817.13	10.52	9.53	8.55	98
AA+	4080.00	10.42	10.10	8.50	160
AA	2700.00	8.33	11.47	8.44	303
AA-	0.00	0.00	0.00	0.00	0
A+	1000.00	6.65	12.38	8.74	364
Total	24597.13	10.11	9.95	8.54	141

Presence of Equity Risk Premium in India

In the “equity risk premium study” by Varma and Barua³, the equity risk premium, defined as the excess return of the stock markets over the risk free rate, has been estimated for the Indian capital markets. BSE Sensex was used to derive the stock market index by narrowing the stock universe to highly traded stocks, adjustment for self-selection bias, removal of the outliers, incorporation of dividend and a weighted adjustment for revision of the Sensex in 1996. During the pre-reform period, the risk-free rate was determined based on estimates of financial repression using the call market rate, real interest rates pre and post-deregulation and a comparison of the US and Indian interest rates. From 1995 onwards, the risk-free rate was estimated as the yield on the 1 year T-Bill. Linear interpolation was used to determine the risk free rate from 1992 to 1995.

The risk premium in India from 1981 to 2006 has been estimated on a geometric mean basis at 8.74% (Varma and Barua). The study has found that there has not been a significant difference in the equity risk premium between the pre-reform (8.96% from 1981-1991) and post-reform period (8.58% from 1991-2006). However, the volatility in returns has been found to increase from 20% to 25% between the pre-reform and post-reform periods.

In a different study⁴, the equity risk premium has been estimated for various countries for long historical periods. In the US, the risk premium (excess of the real market return over the risk free rate) has been estimated at 7% for the period of 1947 to 2000. Similarly in other countries, the equity risk premium has been estimated using the similar methodology -- stock market return over the risk free rate (treasury bill rate).

Country	Time Period	Equity Risk Premium
United States	(1947-2000)	7.00%
United Kingdom	(1947-1999)	4.60%
Japan	(1970-1999)	3.30%
Germany	(1978-1997)	6.60%
France	(1973-1998)	6.30%
Sweden	(1919-2003)	5.50%
Australia	(1900-2000)	8.70%

It is noteworthy that taken together, the United States, the United Kingdom, Japan, Germany, and France accounted for more than 85% of capitalised global equity value at the time of the study in 2006. In the same study, the question of why there exists such a large equity risk premium has been examined. While modern portfolio theory and the standard model for estimating the value of marginal utility to the investor of the excess stock returns during good and bad states of the economy do not seem to fully explain why such a large equity premium

³ A First Cut Estimate of the Equity Risk Premium in India: Jayanth R Varma & Samir K Barua; IIM Working Paper Number 2006-06-04, June 2006, <http://www.iimahd.ernet.in/~jrvarma/papers/WP2006-06-04.pdf>

⁴ The Equity Premium: A Puzzle; Rajnish Mehra & Edward C Prescott; http://www.artsci.wustl.edu/~cedec/azariadis/teaching/e589Sp08/papers/MehraPrescott_jme85.pdf

exists, it is widely held by most economists that the equity premium that has been discovered in the historical data across countries is statistically significant.

Similarly the following two tables highlight the favourable impact that any reduction in the mandated investment in government securities and the consequent increase in equity/corporate bonds can have on the return from a portfolio of, say, Rs 1000 crore.

Return on Investment of Rs.1000 crore as per present IRDA Regulation				
	Present Ceiling	Amt Invt. In Cr	Return	Absolute Return in Cr
Govt Securities	50%	500	8.50%	42.50
Infrastructure	15%	150	9%	13.50
Corporate Bonds	20%	200	9.50%	19.00
Equity	10%	100	20%	20.00
Other Investment	5%	50	8%	4.00
TOTAL	100%	1000	9.90%	99.00

If the exposure limits are relaxed the returns may show significant improvement. This is illustrated in the following table.

Return on Investment of Rs.1000 crore as per suggested modification in Regulation

	Modified Ceiling	Amt Invt. In Cr	Return	Absolute Return in Cr
Govt Securities	40%	400	8.50%	34.00
Infrastructure	15%	150	9%	13.50
Corporate Bonds	20%	200	9.50%	19.00
Equity	20%	200	20%	40.00
Other Investment	5%	50	8%	4.00
TOTAL	100%	1000	11.05%	110.50

PENSIONS

Performance of the National Pension System

For NPS, computing the weighted average of returns of each scheme under different fund managers would be necessary in order to keep track of the overall performance of the funds under management. The NPS corpus is broken up based on source of funds of pensioners – Central Government (CG), State Government (SG), Private Sector (Tier I and II) and NPS Lite (unorganised sector via aggregators).

NPS CG, SG and NPS Lite corpus funds are invested under Ministry of Finance guidelines. Overall, the NPS CG corpus has witnessed a healthy return (CAGR since inception in April 2008) of 9.95% (average return of the three PFMs) in spite of global economic downturns which adversely affected capital markets. The reasons commonly adduced for the comparatively improved returns so far have been: (i) Ministry of Finance guidelines which permit low exposure to equity and higher exposure to G-secs and domestic fixed income securities, and, (ii) steady cash flows received from Central Government employees.

The NPS SG corpus has a return (CAGR since inception in June 2009) of 9.62% (average return of the three PFMs) which is relatively low compared to the NPS CG corpus in spite of its management by the same PFMs and coming under the same guidelines of the Ministry of Finance. This could possibly be due to (i) investments in different instruments within each category due to size of corpus (ii) lack of a steady source of fund inflow from state government employees. It might, therefore, be necessary to investigate the reason behind unsteady cash flows and how to streamline them. Also, by pooling funds with similar cash flow streams, NPS fund managers can extract greater bargaining power and cooperative bidding for instruments, or achieving economies of scale in investments where possible.

Despite relatively unsteady cash flows of the unorganised sector, NPS Lite has performed well with a healthy return of 11.61% (CAGR since inception in October 2010, average return of the same three PFMs) due to the Ministry of Finance guidelines. A closer look and attempt to stabilise the cash flows received from aggregators, especially those serving the unorganised sector with more predictable sources of income, could possibly help contribute to improving investment returns for the vulnerable sector of the society participating in the co-contributory Swavalamban Scheme.

NPS Private has a segregated fund allocation strategy for private sector – C (Fixed Income and Money Market), G (Government Securities) and E (Equity). While an individual's return depends on his asset allocation preference, the performance of the entire corpus under the Private Sector can be computed based on a weighted average. A computation of weighted average return of funds under NPS Private (Tier I and Tier II) vis-à-vis the return on NPS funds of the Central and State Government employees as well as NPS Lite would help measure and compare the performance of funds with and without investment limits.

The movement towards greater efficiency and sophistication in markets calls for a greater adoption of the modern portfolio theory which is based on the efficient market hypothesis. While some of the assumptions of the efficient market hypothesis -- such as normally distributed asset returns, fixed correlation between assets, rational and risk-averse investors, symmetry of information, lack of transaction costs and taxes -- do not exactly hold true even in sophisticated and well-developed financial markets, the degree to which the modern

portfolio theory is applicable is dependent on the degree to which these assumptions can be approximated as true.

As per the **European Journal of Economic and Finance**, several factors may be contributing to inefficiency in Indian markets (Mishra et al). Inflationary pressures in India are bound to lead to periods of high interest rate regimes. During such periods, while the coupon rates on debt securities – both corporate and government – are expected to be higher, the high inflationary environment would imply a low real rate of return on the debt securities. However, three facts remain that are applicable and should be considered for investment of pension funds:

- (i) The contributions to the NPS pension funds (except in the case of NPS Tier II) are all long- term.
- (ii) The equity markets in India are robust and well-developed.
- (i) There exists an equity risk premium in the Indian stock markets over the longer horizon.

Basis and rationale for regulation of pension portfolios

Financial sector customers in countries which have introduced mandatory, funded, defined contribution based pension systems often had little experience of investing in the financial market. Besides this, financial services industries were rarely well developed. There is an apprehension in the minds of the pension sector regulators and governments that the lack of experience of investment and risk management might lead to poor portfolio choices. The risks of investing in emerging economies can take many forms -- capital markets can be weak, lacking both liquidity and transparency.

Countries with more developed financial markets, where the population has more investment experience, may require only a light regulatory regime. The preponderance of individual and voluntary retirement savings also put a less onerous responsibility on the government and pension regulators than mandatory pensions, again suggesting less need for strict regulation of pension fund investments.

International Experience of Portfolio Limits

“Prudent person rules” are more common for pension fund members in most OECD countries (2011 Survey of Investment Regulations of Pension Funds, Organisation for Economic Cooperation and Development) except in some countries. Governments and pension regulators in OECD impose few rules on pension funds’ asset allocation (beyond some basic prudential restrictions, such as concentration of holdings or prohibition of related party transactions).

The second type of restriction imposed on pension fund managers is the embargo on investing in foreign assets. The economic logic is that the pension fund liabilities are domestic and so, by investing at home, assets and liabilities are denominated in the same currency. Investing overseas, in contrast, involves exchange rate risk. Although hedging

against currency movements is possible and the products to achieve this are available in the market, there is a cost element involved; further, the complex financial instruments that hedging involves have been known to adversely affect even sophisticated investors.

Relationship between asset allocation and pension fund returns

The main concern about allowing portfolios with small equity holdings is that while equity has historically generated a higher rate of return than bonds, these returns are more volatile than bond yields. But pension and insurance funds are long-term investors and there is a possibility that much of volatility is smoothed out over a long investment period. Further, any shortfall in funds' returns is very important for the value of the terminal wealth.

The impact of investment restrictions on returns is that pension funds in countries with relatively liberal investment regimes earn more compared to the countries that restrict asset allocations. Or, in other words, returns in countries where pension funds have sizeable investments in equity have been higher than countries where bonds dominate portfolios. Portfolio limits could, therefore, have a high cost in terms of reduced benefits for subscribers of pension and insurance funds.

One objective of transition towards a funded pension system is to increase an individual's responsibility for his or her own retirement income planning, based on self-effort. The ability to choose a pension fund manager is an important factor for increasing competition between funds in both service and performance. Stipulation of portfolio limits, along with regulation of industry structure and fund returns, significantly reduces individual choice. These rules interacted to produce almost identical pension fund portfolios and performance in Latin America (the so-called 'herding' behaviour). The trends are evident in the investment patterns of insurance companies and pension funds.

Portfolio Limits – Are these important in India?

A pension scheme may be funded – that is, there exists a savings corpus from which pension is paid. Alternatively, it may be a pay-as-you-go scheme, where taxes of current generation of workers pay for the pension of current pensioners and there is no stock of savings to invest. The goal of any funded pension scheme should be to maximise return on investment of pension funds under management in order to provide “adequate” pension to the pensioners. A 1% increase in annual returns increases the terminal pension wealth for a full 40-year lifetime of contributions by 20-30%.

For a funded defined benefit (DB) pension scheme, the pension outgo is a defined formula, dependent on factors such as average wage and number of years of service. There does exist a corpus of savings which must be invested with the goal of maximising return. The specific investment objectives would have to be defined based on the existing size of the corpus fund as well as the pension obligations of the fund. Reducing the volatility of returns may not be the priority. Also, any shortfall in the returns of the fund would have to be borne by the employer providing the pension benefit.

On the other hand, a defined contribution (DC) scheme (such as, the NPS), which maintains individual retirement accounts of pensioners who bear the investment risk, must not only maximise pension wealth, but also ensure that returns are relatively smoothened, or the volatility of returns is minimised. It is, therefore, not surprising to notice that several countries, developed and emerging, which run both DB and DC schemes as separate pillars of social security, have different investment pattern requirements for their schemes.

The above international experiences indicate the following:

- A defined contribution scheme in which a pensioner bears the investment risk requires more prudent investment regulations as the goal is to maximise pension wealth as well as smoothen returns by reducing volatility to assuage any concerns about the NAV reported.
- A voluntary defined contribution scheme would have to provide greater freedom to the pensioner to decide his investment exposure based on risk appetite. A mandatory DC scheme could, on the other hand, be more prescriptive in terms of investment norms.

The above observations also hold true for the investment limits of the NPS. The NPS for central government employees and state government employees, both mandatory schemes, prescribe investment limits for the pension funds under management. Since they are co-contributory schemes, there is an alignment of interest between the pensioner and the government to maximise terminal pension wealth. NPS for the private sector, a voluntary scheme, provides flexibility to the investor to decide his investment portfolio based on risk appetite. However, for those employed in the unorganised sector, without sufficient awareness of financial investments, there is a default investment portfolio balancing mechanism which incorporates the goal of maximising terminal pension wealth while mitigating the risk of dispersion in returns.

An important reason for the existence of investment limits for mandatory pension schemes is the information asymmetry between the various stakeholders—this is most obvious, for example, in the case between fund managers and subscribers to NPS Lite scheme for the unorganised sector. It could also be the case that there exists a knowledge gap between the pension fund managers and the board of trustees of other pension and provident fund schemes. The above are examples of the “principal-agent problem”, which serves as a deterrent to applying the “prudent person” rule in the current Indian framework.

Rationale for Stipulating Investment Limits:

Pensions

Investment rules in mandatory funded schemes are globally structured such that most countries, which follow mandatorily provided defined contribution pension schemes usually impose explicit investment limits. Such limits can take several forms including asset class limits, issuer limits and concentration limits. While in many OECD countries pension funds are required to follow the “prudent man” rule -- that is, assets should be invested in a manner

that would be approved by a prudent investor -- there are some quantitative restrictions based on minimum diversification requirement (in terms of investment instruments), self investment/conflict of interests, other quantitative rules and ownership concentration limits (which seeks to minimise exposure risk by restricting a fund's investment to each company beyond a certain limit). On the other hand, while no emerging market economy follows the "prudent person" rule, but instead follows directed investment approach, some countries do allow a high proportion of their portfolio in stocks.

The asset limits are usually justified from three public policy objectives:

- (i) There is an unstated desire to limit the dispersion of outcomes (in terms of terminal pension wealth) for equivalent workers. In some jurisdictions, this is reflected into a policy response of a relative return guarantee;
- (ii) There is a desire to limit the downside risk even if it compromises average return;
- (iii) There may be a "moral hazard" when a minimum pension guarantee exists and the absence of investment limits would encourage an investor to choose a riskier portfolio.

The "prudent person" approach does not address these issues and in any case its effective application requires a robust legal system and well-developed institutional capacity at the level of trustees of the pension funds. In most emerging market countries, that seems to be absent. On the other hand, placing limits on the overall risk level of the portfolio would address the three concerns.

The risk-return trade off that underlies the entire financial management is at work here as well. For, as we move from predominantly risk-free government securities to risk-prone securities like equity, the return is seen to be increasing but commensurate with the risk. However, shift to prudent person approach warrants ability of the capital markets to facilitate investing. Let us look at the state of the Indian capital market. According to the Financial Development Report 2011 of the World Economic Forum, the characteristics of capital markets in India in 2011 were still at a nascent stage in certain categories, such as corporate bonds.

Market	State	Global Rank (on 60)	Metric	Vis-à-vis
Foreign Exchange Markets	Robust	14 (spot)	% share of global foreign exchange spot turnover*: India: 0.74 (spot)	UK: 38.5 (spot) US: 26.1 (spot)
Foreign Exchange Derivatives	Robust	14 (outward forward) 13 (options)	% share of global foreign exchange derivatives turnover*: 0.89 (outward forward) 0.54 (options)	UK: 41.3 (outward forward) US: 21 (outward forward) UK: 55.3(options) US: 16.14 (options)

Government Securities (G-Sec) Market	Robust, large share of the debt market	19	G-Secs as % of GDP: Domestic: 37.3% International: ~0% (No external holders of Government Debt)	Domestic US: 70% of GDP UK: 56% of GDP International: US: 0.08% of GDP UK: 3.3% of GDP
Private (Corporate Debt) Market	Underdeveloped	32	Financial Institution (FI) /Corporate Debt as % of GDP: Domestic: 5.6% International: 3.15%	Domestic US: 101% of GDP UK: 15% of GDP International US: 47% of GDP UK: 137% of GDP
Interest Rate Derivatives	Robust	13 (Options) 21(Swaps)	% share of OTC turnover 0.51 (Options) 0.14 (Swaps)	UK: 45.3 (swaps) US: 18.9 (swaps) UK: 50.4(options) US: 28.4 (options)
Equities Market	Well Developed	4 (Market cap) 16 (Trading value/GDP)	Value of listed shares (market cap) as % of GDP: 278% Value traded as % of GDP: 170%	US Stock market cap: 152% of GDP Value traded: 350% of GDP

* turnover = trading volume as % of market cap

Source: Financial Development Report, 2011

Thus, although at an overall level the Indian financial markets are robust and well-developed. The development is non-uniform and skewed across various segments, with a very well developed equity market (market cap at 278% of GDP), a robust G-sec market (market cap at 37.3% of GDP) and an underdeveloped corporate debt market (market cap at 5.6% of GDP). This skewed development of capital markets, combined with weaknesses in institutional and business environment and low financial access, implies the need for prudent regulation of investment assets under management in general.

Thus a movement towards liberalisation, beneficial from returns point of view, has to be embedded in the overall framework of the prevailing state of economy (for instance the fiscal deficit and its impact on driving out private investment); availability of expertise to effectively manage funds; corporate governance and also things like creativity and innovation of the MSME sector to use funds for generating disproportionate gains for the nation. Thus the word 'Prudent' has to be the guiding mantra for an 'investor' in India and such a movement should also be in phases accompanied by capacity building.

The asset constraints do have important effects on the funds' asset allocations and hence on the development of local securities market. A comparison of the mature and emerging markets indicates that because of these asset restrictions the mature markets hold a predominant proportion of pension assets in equities, whereas emerging market pension funds

hold smaller shares of their portfolio in stocks. In short, emerging markets pension funds have relatively larger holding of domestic bonds and smaller allocation in equities and foreign securities than most mature market pension funds. Thus, an important policy issue is whether the emerging market economy should gradually liberalise some of the investment restrictions and how much weight should be given to the development of local securities market in formulating pension fund regulations.

The portfolio regulations on equity holdings in most countries undertaking pension reforms appear not to be too restrictive and the relatively large portfolio allocation in government bonds could be construed to be a natural outcome of the early stages of such a reform process. However, it creates an undesirable concentration of assets in one category of financial instruments. There is a case for not only increasing investment limits for corporate bonds in the investment guidelines for pension funds, but also relaxing the credit rating eligibility norms for such bonds in the mandated guidelines. However, stringent requirements on minimum acceptable ratings for corporate bonds could also be relaxed gradually and prudently, if only to allow for investment in infrastructure projects. This relaxation should happen concurrently with the creation of adequate support systems providing credit guarantees and credit enhancement.

Pension fund assets under management (AUM) have been growing at a rapid pace in the mature markets as well as in the emerging markets that have implemented pension reforms. There could be an imbalance between the demand (from pension funds) and supply in the local securities market which may cause significant distortions in asset pricing, concentration of exposures and price bubbles. This calls for constant and coordinated efforts to improve the regulatory frameworks for both pension funds and securities market. Considering the diversification argument, the limits on equity holdings and corporate bonds could be gradually relaxed as the local asset managers become used to risk management techniques. The gradual relaxation of portfolio limits to investment in bonds and shares (both domestic and offshore), perhaps through diversified mutual funds, is likely to improve pension fund diversification opportunities and financial market stability. In case of offshore investments, since it amounts to relaxation of control over capital outflows, the macro-economic consequences of such measures have to be carefully considered. However, for the time being, in view of the prohibition on offshore investments by pension funds in the Pension Fund Regulatory and Development Authority Bill, 2011, the offshore investments are not being considered. In view of this, the gradual liberalisation of investment instruments attempted in January 2005 by the Ministry of Finance (which permitted equity investment for the first time) needs to be continued.

Finally, it has already been discussed that the skewed development of financial markets in India would put some inherent restrictions for liberalised investment framework. To sum up, the pension funds in India, especially the defined contribution scheme of the NPS, would require prudent investment limits with the intention of maximising shareholder wealth while reducing the volatility of returns. Also, the presence of individual retirement accounts requires consistency of investment performance without large dispersion between returns of individual pensioners.

Why exposure limits are necessary for Insurance and Pension Funds in India

The efficient market hypothesis, which states that markets carry information of prices, can be expected to hold to a certain extent in uniform, transparent and well-developed financial markets. In India, however, empirical studies have provided evidence of growing market size and liquidity but also greater volatility and inefficient capital markets. As discussed above, the non-uniform development of capital markets, weaknesses in institutional and business environment and low financial access leaves room for inefficiencies across markets. The disaggregated structure of supervision of financial services and markets also leaves room for regulatory arbitrage.

The combined effect of the abovementioned factors could have two implications – (i) the risk-return trade-off may not always hold true, and (ii) there could be existence of “alpha” or excess returns due to mispricing of financial instruments. Stock markets in emerging economies, such as, India are therefore characterised by higher returns coupled with higher volatility, but their Sharpe ratios (excess return over the risk free rate/volatility) need not be higher compared to developed economies.

Correlation between funds tenor/nature of cash flows and existence of investment limits

Insurance and pension funds are characterised by longer term funds with more stable and predictable cash flows. They represent large pools of long-term household savings and therefore require a more predictable rate of return for policyholders and pension savers. In Indian markets, with risk-return mispricing and existence of “alpha” or excess returns, insurance and pension funds would require prudent investment limits to ensure there is a predictable rate of return on investments. The exposure limits for long term investors can be tweaked and eventually relaxed as the markets evolve with short term investors acting as drivers of market efficiency. The beneficial impact of declining interest rates – as anticipated in the future -- on fixed income securities is likely to increase the gap in the rate of returns between equity and bonds.

G-Secs are stable and low risk but provide a low real rate of return

While Government securities are low risk and safe instruments, there could be a case for lowering the minimum requirement limits of G-Sec investments for the following reasons:

- Persistent inflationary pressures in India translate into a low real rate of return on G-sec investments.
- High minimum exposure investment limits in G-secs may be contributing to the chicken-and-egg problem of the underdeveloped domestic debt market.
- Lowering investment limit requirements on G-secs may also serve as an indication of the government’s intention to rein in fiscal deficit by reducing borrowing.

Chicken-and-Egg Problem of the Corporate Debt Market

The second point above can also be observed by a comparison of the debt funds raised on the primary market and turnover on the secondary market.

	Amt raised (Rs mn) (%)		Turnover (Volume traded) (%)	
	Primary Market		Secondary Market	
	2009-10	2010-11	2009-10	2010-11
Government	6,236,190 (76%)	5,835,210 (75%)	84,337,567 (98%)	70,682,541 (97.8%)
Corporate/Non-Government	1,919,902 (24%)	2,016,763 (25%)	1,442,484 (2%)	1,591,623 (2.2%)
Total	8,156,092	7,851,973	85,780,050	72,274,164

Source: NSE Indian Securities Market Review 2011

Funds raised in the primary bond market during 2012 were split in the ratio of 3:1 for G-secs and corporate bonds, respectively. The turnover (volume traded) in the secondary market is almost entirely from G-secs. This implies that there is lack of sufficient depth and liquidity for corporate bonds when compared with G-secs. Depth in the corporate bond market could be achieved by means of more product innovation and securitisation under an appropriate risk mitigation framework. Liquidity in the corporate debt market can be improved by an increase in trading across the yield curve. However, trading may not pick up under low liquidity conditions leading to a typical chicken-and-egg problem. Tweaking limits to improve the liquidity can be done by either (i) reducing the minimum investment limits of G-secs and increasing the minimum limits of corporate debt securities or (ii) increasing maximum limits of corporate debt securities where applicable keeping the limits on G-secs unchanged.

Equity Markets

Emerging economies such as India are characterised by equity markets with high returns and high volatility. Since insurance and pension fund managers seek to maximise long-term returns and are less concerned about short-term volatility, the Indian equity markets are good avenues for investment. Having said that, there is a strong case for risk mitigation via equity derivatives even for long term funds to smoothen out returns and avoid excess loss of NAV during economic downturns.

Case for more Dynamic Asset Allocation strategies for Insurance and Pension Funds

Typically, long term investors use fundamental analysis of securities for more tactical and passive asset allocation strategies. This may be expected to work in efficient markets. However, greater inefficiencies imply that long term investors who do not dynamically balance their portfolios may be (i) foregoing opportunities of “alpha” and leaving excess returns on the table, or, (ii) booking excess losses due to economic downturns, market sentiments or inefficiencies. Therefore, while broad investment limits are necessary for long term funds, there is no reason why certain investment categories with high volatility, such as equity, should not adopt a more dynamic portfolio allocation strategy by utilising derivatives

to hedge risk. More dynamic strategies for interest-rate hedging can be used in the fixed income markets as well. Active hedging combined with tactical asset allocation based on fundamental analysis would allow long-term fund managers to mitigate risk during market downturns and maximise the wealth of pensioners within each investment category while adhering to the overall investment exposure limits.

Role of Pension Fund and Insurance Companies in the Development of Financial Markets:

Empirical research suggests that pension funds and insurance companies have over time helped the development of the financial markets in mature economies. Their large size investments in debt of various maturities along with hedging of interest rate risk with fixed income derivatives have helped in building robust debt markets. Huge allocations of investible resources to equities coupled with their initiatives of minimising the risks of the investment and its return via equity derivatives have helped in improving the micro-structure of also the equity markets. Arguably, it's their sheer size and their capacity to hold securities over a long period, along with their active portfolio management, that provided size, depth and liquidity to the financial markets. The directed investment regime in India has provided very little space for the insurance companies and provident funds to help develop the financial market, especially the debt market.

Meeting nation's financing requirements provided there is an alignment of interests

Developing countries may have certain financing requirements in sectors such as infrastructure that can be met by long term institutional investors, such as insurance and pension funds due to the matching of supply and demand for long term funds. The Twelfth Five Year Plan has identified infrastructure as a crucial driver of sustainable economic growth. India has huge financing needs as \$1 trillion of infrastructure projects are planned during the period 2012-17.

As has happened in developed markets, a more mature insurance and pension system could help in meeting these needs by channelling more savings into productive investments through the stock and corporate bond markets. The greater involvement of insurance companies and pension funds will also contribute to reducing the volatility of the stock market, as they bring stable pools of capital interested in long-term positions instead of speculative trades. They provide the much needed heterogeneity to the markets which have otherwise usually been characterised by players with the similar time horizons.

Thus, regulations should be liberalised to encourage greater participation of pension funds and insurance companies in capital markets. Further, restrictions on corporate bond issuance should be removed in order to boost supply and promote the growth of the market.

The Government has taken several initiatives to encourage investment in the sector by increasing the limit on purchase of tax-free infrastructure bonds, setting up infrastructure

debt funds to tap overseas insurance and pension markets, raising the FII limit on long term infrastructure bonds, extending the scope of the viability gap funding scheme to include agricultural infrastructure, oil and gas storage and fixed network telecommunication sectors as well as establishing a harmonised master list of infrastructure sectors.

However, the lack of adequate opportunities for infrastructure investment, other than directly acquiring equity stake, poses a problem. One of the reasons for the lack of development of infrastructure financing debt markets has been the credit rating of the debt raised for infrastructure projects. Typically, the infrastructure project developer creates a special purpose vehicle (SPV) which serves as a mechanism to raise debt. Since infrastructure projects are capital intensive and have a long gestation period requiring several years for cash inflows to stabilise, credit rating agencies assign BBB rating to the infrastructure debt raised via the SPV. However, debt rated below AA is generally not picked up by insurance and pension funds in India or foreign investors.

To summarise, while there is a need to further relax the investment pattern. However, abrupt abandonment of prescriptive investment pattern may not be desirable. Hence a sequenced approach may be pursued.

CHAPTER V

WHY CHANGE NOW?

This chapter reviews the ground conditions and the reasons that are forcing the need to think about changing the investment norms now.

The investment norms currently in force seem to have stood the system in good stead. They have, unarguably, managed to meet their primary objective – of shielding long term savings from the menacing shadow of risk, especially in the realm of insurance and pension. So, what has changed that requires us to even contemplate overhauling the extant system? This chapter will examine some of the reasons why there seems to be a compelling need now to re-examine the entire framework and identify where the tectonic plates have shifted.

As mentioned in Chapter-I, one of the pressing needs for reviewing the investment norms are the diminishing real returns earned by investors in these sectors. Given the excessive risk-

protection measures adopted by the sector regulators, the flexibility to diversify investments and earn higher real returns – a fundamental concept enshrined in modern portfolio management theory – seems to have been repeatedly overlooked.

This spells trouble for both the insurance and pension sectors because this might force investors to turn their backs on these savings channels. The trend is already discernable, though it's still in its nascent stages. Both pension and insurance sectors do not seem to be the preferred choices for incremental flows into financial instruments.

The current investment philosophy in both the sectors presumes that, fundamentally, over the long term investors might be willing to sacrifice higher returns for capital protection. Although this might seem to be intuitively true, there is no academic study to back this hypothesis. Also empirical data seems to be suggesting otherwise with the incremental inflows into both insurance and pension narrowing down. This committee would like to reiterate that while it is not in favour of throwing caution to the wind -- nor does it believe in advocating investment norms that are bereft of any safeguards – it nevertheless feels strongly that the investment norms definitely need a launch-pad that will not only allow beneficiaries gain positive real rates of returns but also shelter them from capital erosion. In fact, the reality is extreme – the mandated investment norms do not allow even for a balanced portfolio, one that hedges its risk between equities and bonds. This is an extremely outdated concept, as the next Chapter shows.

The economy is facing a crisis today: the savings rate, especially the household savings rate, seems to be stalling. According to the report submitted by the Sub-Group on Household Sector Savings During Twelfth Five Year Plan, commissioned by the Planning Commission's Working Group on Savings, the household savings rate has levelled off at around 23% after 2003-04.

Therefore, this sounds a bit contra-indicative: post-2004, while the economy experienced an annual average growth rate of over 9%, the household savings rate remained more or less stagnant. Numerous empirical studies have shown a direct, causal relationship between economic growth and savings rate growth.^{5 6} While the jury is still out on the exact nature of relationship between economic growth and household savings, especially in the context of a developing economy like India's, there is little doubt that three consecutive years of 9%-plus growth should have had some impact on the rate of household savings.

This is an ominous trend and would require further research, especially if the trend is at odds with the pattern seen globally and with the average Indian template observed so far.

Let us look at some numbers here.

YEAR	GDP Growth (%)	Household Sector Savings*
2000-01	4.3	21.4

⁵ Mohan, Ramesh: *Causal Relationship Between Savings and Economic Growth in Countries with Different Income Levels* (2006), *Economics Bulletin*. <http://www.economicsbulletin.com/2006/volume5/EB-05E20002A.pdf>

⁶ Salz, I S: *An Examination of the Causal Relationship between Savings and Growth in the Third World* (1999), *Journal of Economics and Finance*

2001-02	5.5	23.2
2002-03	4	22.3
2003-04	8.1	23.2
2004-05	7	23.6
2005-06	9.5	23.5
2006-07	9.6	23.2
2007-08	9.3	22.4
2008-09	6.7	23.6
2009-10	8.4	25.4
2010-11	8.4	22.8

* As percentage of GDP at current market prices

According to both the Sub-Group and the Working Group, “During the second half of the decade, even though the gross financial savings (assets) and gross financial liabilities of the households increased sharply, the increase in net financial savings rate remained modest. At the same time, the rate of physical savings declined partly in response to the tightening in credit norms, offsetting the increase in the financial savings rate. Consequently, the households’ overall savings rate remained largely unchanged (at around 23 per cent) since mid-2000s.”

According to the Reserve Bank of India’s Annual Report for 2011-12: “Preliminary estimates show that the net financial saving of the household sector declined further to 7.8% of GDP at current market prices in 2011-12 from 9.3% in the previous year and 12.2% in 2009-10...The moderation in the net financial saving rate of the household sector during the year mainly reflected an absolute decline in small savings and slower growth in households’ holdings of bank deposits, currency as well as life funds. At the same time, the persistence of inflation at a high average rate of about 9% during 2011-12 further atrophied financial saving, as households attempted to stave off the downward pressure on their real consumption/lifestyle.”

However, it is widely believed that the recent and prolonged episode of high inflation (ignited by the failure of monsoons in 2009) and inflationary expectations might have rekindled the propensity for physical savings, especially constructed property and bullion. Therefore, the decline in financial savings might have been compensated to an extent by an increase in physical savings and/or a spike in consumption levels. The Reserve Bank’s Macroeconomic and Monetary Development Report for 2011-12, in fact, shows the physical savings rate increasing to 12.8% during 2010-11, after briefly dipping 12.4% in 2009-10, even though it’s still lower than the 13.5% recorded in 2008-09.

Gross Domestic Savings: A Break-Up

(Percentage of GDP at current market prices)

	2008-09	2009-10	2010-11*
Gross Domestic Savings	32	33.8	32.3
1. Household savings	23.6	25.4	22.8
Of which,			
a. Financial Savings (Gross)	10.1	12.9	10

b. Savings in Physical Assets	13.5	12.4	12.8
2. Private Corporate Sector	7.4	8.2	7.9
3. Public Sector	1	0.2	1.7

Source: Reserve Bank of India

*Quick Estimate

But, to return to the broader question: why has the household savings rate stagnated? Among the many reasons, one stands out -- contributions under the heading “Provident and Pension Fund” have declined steeply from 15.1% of gross financial assets during the period 2000-05 to 9.7% during 2005-10. Contrast this with the 19.6% provided by the same head during the 1970s.

One of the reasons for the dwindling interest is the archaic policy design. The sub-group’s report mentions: “The EPF and MP Act, 1952 covers only those employees of organised sector whose salary is below Rs 6500 per month. This statutory limit is stagnant since 2002 while there has been a phenomenal growth in wage structure in industry over the years. Resultantly, in new coverage of the establishments, very few categories of employees are eligible for coverage under the Act...While the new enrolment of members has become difficult as mentioned above, the exit of members by way of retirement, retrenchment and death are keeping normal pace.”

However, it is this committee’s observation that one of the reasons, as yet unstated in the working group report on savings, could probably be the declining yield from such savings. Given the low inflation-adjusted yield on savings from existing provident and pension funds, especially those in the public sector, the income that could have been saved is flowing into other avenues – particularly physical assets – in search of higher yields.

An exception needs to be made here. Funds invested under the National Pension Scheme, which was launched in 2004 and allows investors to chose their fund managers as well as their investment plans, have been consistently providing higher inflation-adjusted returns than other similar investment channels.^{7 8} However, the NPS has a long way to go before it attains the level of popularity enjoyed by some of the other alternative instruments (such as Public Provident Fund or EPF) despite delivering higher returns. According to PFRDA trustees, as on May 7, 2013, NPS had 49,90,988 subscribers with Rs 32,567 crore of assets under management. Therefore, the daunting task before the pension regulator – Pension Fund Regulatory and Development Authority – is to fulfil its “development” role by increasing awareness and literacy about pension products.

The story of declining yields could well be repeated in the case of insurance because the return from insurance products has also been somewhat tardy, In addition, it has been

⁷ NPS scores on charges, returns over PPF, Business Standard (August 16, 2012), <http://www.business-standard.com/india/news/nps-scorescharges-returns-over-ppf/483367/>

⁸ Why new NPS could be the best way to save for retirement, The Economic Times (August6, 2012), http://articles.economictimes.indiatimes.com/2012-08-06/news/33065696_1_nps-schemes-fund-managers-pension-fund

believed so far that life insurance sales in India is driven primarily by tax considerations. An initial examination of the data seems to prove otherwise. Life insurance funds accounted for 20.1% of gross financial assets during 2005-10, compared with 14.7% during 2000-05. The working group had this to say: “The share of **life insurance funds** continued to increase during 2000s, in line with higher insurance penetration and robust economic growth.”

However, this committee feels that the life insurance numbers could probably have been inflated somewhat by the phenomenon of single-premium products, which witnessed a tremendous spike primarily due to the lopsided agency commission structure. It is only in 2010 that the insurance regulator – Insurance Regulatory and Development Authority – tightened the rules surrounding the commission structure and, it is believed, this seems to have impacted the sales of single premium life insurance policies severely. It will be interesting to see the extent of life insurance contribution to gross financial assets post 2010.

Data from the website of the insurance regulator (Insurance Regulation and Development Authority, IRDA) is illustrative. For instance, individual single premium collected by all life insurance companies in India during the 12-month period ending March 2012 amounted to Rs 18,401.75 crore, against Rs 35,873.52 crore in the previous comparable period. Further, the life insurance penetration – ratio of premium to GDP-fell for second consecutive year and has declined from a peak of 4.6% in 2009-10 to 3.4% in 2011-12. It must be noted here that life insurance penetration in India is lowest even compared to some of the emerging economies including China.

According to preliminary data published by the Reserve Bank of India, life insurance funds as a percentage of gross financial savings of the household sector, have dropped from 26.2% in 2009-10, to 22.3% during 2010-11, to a provisional estimate of 23.1% during 2011-12.

There is another inescapable fact: despite the lopsided commission structure of single premium products, and the associated mis-selling that resulted in the sharp spike in sales, investors found the product remunerative because it managed to side-step the asphyxiating investment norms prescribed for all the other insurance premium and deliver comparatively higher returns than other competing financial instruments. This is indeed, in some ways, an eloquent commentary on investors’ disappointment with the returns provided by the pension and insurance sectors.

The story of insurance and pension sectors, as well as the overall level of household savings in the country, is definitely a cause for concern. Any plans to boost investment in the economy will need to be matched with a domestic savings rate, especially in financial instruments, that can supply the required funds. Only a small balance can be met from external sources (such as, external commercial borrowings). Therefore, given the economy’s ambitious investment plans, the savings rate today is far from what would be necessary. One of the tasks before the government today is to ensure that household savings flow back into financial instruments and for that to happen the inflation-adjusted returns from these instruments have to be more attractive than physical savings, without forfeiting any of the risk-containment measures. This will be necessary not only for the continuing relevance of the pension and insurance sectors but also in the national interest.

The insurance and pension sectors help the growth and development of financial markets. Unfortunately, the directed investment norms have left very little room for the sector to contribute to this important aspect of the development of Indian economy. Further, if investing by these sectors is liberalised it can contribute very significantly to financialisation of savings described in a separate chapter devoted to this.

As we outlined in Chapter-II, India needs large sums of money, especially funds of a long-term nature, for building infrastructure in the country. This includes both physical as well as social infrastructure. In addition, funds of medium-to-long-term nature will also be required for enhancing the capacity in the manufacturing sector. As the current inflationary episode has so eloquently highlighted, capacity shortage in various industries has provided the necessary ignition to runaway inflation and inflationary expectations. Needless to say, the sums required are large and, seemingly, beyond the capacity of the current sources combined.

Therefore, newer fund sources have to be tapped. Especially sources which have at their command funds with a maturity profile matching the long-gestation nature of the projects. At this point, the only such source seems to be the insurance and pension fund industry.

It's worthwhile to pause for a moment and survey the supply sources of long maturity funds in the economy. Till the mid-90s, the Indian economy had three large institutions tasked with the supply of long-term funds. These institutions were called development finance institutions – namely, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India and Industrial Finance Corporation of India.

Given their development status, the state allowed these institutions to raise cheap, long-term finances by issuing bonds that were accorded the status of SLR bonds – therefore, these bonds found ready subscribers in the commercial banks. Apart from being an inexpensive source, SLR-eligible bonds also gave these institutions access to 10-15 year funds, which is an ideal maturity profile for project financing.

However, by virtue of being SLR bonds, the bonds carried an explicit government guarantee against defaults. Therefore, as part of the government's fiscal adjustment programme, which began in 1992, these institutions had to cede the privilege of issuing SLR-eligible bonds. As a result, they had to resort to market borrowings to finance their lending operations. Market financing led to escalating interest costs and thinning margins; in addition, some other project-related issues made them unviable. Consequently, two of these institutions were forced to convert themselves into commercial banks – IDBI Bank and ICICI Bank.

As a result of this conversion, two things have happened. One, while commercial banking operations gave them access to household savings, these typically had a shorter maturity profile. At the same time, the regular flow of long-term funds required for project finance, either dwindled or dried up. Second, and more importantly, the competence built up by these two institutions over years for evaluating long term projects also evaporated. Inadequacy of these skills will be felt much more as the wheels of economy move to greater growth and size in years ahead.

However, one institution which had also provided long-term funds in the past and continues to do so is Life Insurance Corporation of India. It has both access to long-term funds as well as the inherent appraisal skills intact within the organisation, but that is not enough. But, unfortunately, LIC's hands are somewhat tied by the investment norms in vogue. There are numerous other insurance companies that have emerged in the economy over the past few years – both in the private and the public space (with shareholding from a state-owned bank) – which have garnered long maturity funds from investors. But, unfortunately, a bulk of these investment funds cannot find assets that are matching in terms of either maturity or the returns. It has, therefore, become necessary to take a fresh look at the availability of long-term funds in the system.

Therefore, given the urgent nature of the twin problems confronting the economy at this stage along with the attendant benefit of development of financial market eventually aiding and assisting financialisation of physical savings, it has become imperative to revisit the existing investment norms governing the pension and insurance sectors, examine the possibility of updating them without sacrificing any safety and risk mitigation measures. Further delay will cause serious damage to the long term prospects of the growth of Indian economy.

CHAPTER VI

MOVING TO “PRUDENT INVESTOR RULE”

It has become increasingly evident that the existing rules governing investment of funds in the insurance and pension industries has clearly lost their *raison d’etre* – they have failed to serve the investors by not providing adequate inflation-adjusted real returns, and, failed to match the nature of funds with appropriate investment destinations as well. Therefore, there is a need to migrate to another regime, without sacrificing any of the risk mitigation principles. One of the legal templates that seems to be adequate for our endeavour is the “prudent-investor rule”.

Before we begin this chapter on introducing prudent investor rule in the country, it might be necessary to dwell upon the changes in this global set of rules. The government’s involvement in investment decisions was prompted by the bursting of the South Sea bubble in Britain in 1720. As a consequence of the wide-spread financial ruin that followed the crisis, the English Court of Chancery drew up a list of permissible investments – primarily government securities – for trustees. This list, by default, became the gold standard and was adopted even in the United States, which was a fledgling union at that point. This list prohibited investments in equity.

A paper⁹ authored by John H. Langbein (Yale Law School) provides a brief historical background: “English law got off to a bad start on trust investing. In 1719 Parliament authorized trustees to invest in shares of the South Sea Company. A number of them did, and when the South Sea "Bubble" burst the next year, share prices declined by 90%. The Chancellors took fright and developed a restricted list of presumptively proper trust investments, initially government bonds, later well-secured first mortgages. Lord St. Leonard's Act in 1859 added East India stock, and across the decades, some dribbles of legislation approved various other issues. Only in 1961 was the English statute amended to allow trustees to invest in equities more generally, and even then the investment was subject to a ceiling of half the trust funds.”

This rule came in for a massive shake-up in 1830 as a consequence of a landmark US trusts law case – *Harvard College v Amory* – under which the Supreme Judicial Court of Massachusetts rejected the earlier prescription and formulated the now-famous “prudent-man rule” or the “prudent person rule”. The events leading up to the historic judgement will help understand the import of the “prudent person rule.”

According to the facts listed in Wikipedia, in 1823 a certain John McLean died after drawing up a detailed will. In it, he left his wife \$35,000 a house and some personal property. He also left \$50,000 to Jonathan and Francis Amory to manage the funds “in trust” to lend or invest,

⁹ Langbein, John H: *The Uniform Prudent Investor Act and the Future of Trust Investing* (1996). *Faculty Scholarship Series. Yale Law School*. Paper 486. http://digitalcommons.law.yale.edu/fss_papers/486

as quoted in Wikipedia, “in safe and productive stock, either in the public funds, bank shares, or other stock, according to their best judgment and discretion”. The proceeds of the investment were to go to his wife. On her death, half the value of the fund was to go to Harvard College for funding a professor of ancient and modern history, and the other half to Massachusetts General Hospital. However, Harvard College went to court after it learnt that the investments had made losses.

This prompted the judge to remark, and this formed the bedrock on which the principle of “prudent persons rule” was based, before exonerating Francis Amory: “All that can be required of a trustee is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested...Do what you will, the capital is at hazard.”

What this meant was that trustees had to exercise discretion and prudence while managing somebody else’s money, similar to what they would have applied had they been managing their own funds. This also tantamount to creating a legal precedent restricting a trustee’s discretion to investments that a prudent person would ideally commit for his or her own portfolio. At the same time, the ruling also relaxed the strait-jacket imposed in the aftermath of the South Sea Bubble. While this did loosen the earlier restrictions somewhat, it created a new template for fiduciary investments, which imposed new constraints. The *Harvard v Amory* judgement exhorted trustees to eschew speculation and to treat “the probable safety of the capital” as central. This led to various – including some ludicrous – interpretations on what constituted “speculation” and how safety of capital could be ensured. The default investment portfolio then largely constituted government bonds, with mortgages and selective equity investments being minor contributors. In addition, regulators (or law courts, as the case might have been) assessed the prudence of each individual investment rather than the composition of the portfolio or the risk-return profile of the portfolio.

Then came WWII and with it an intense inflationary episode. The war-induced, and shortage fuelled, price rise of the war years showed how bonds were no less riskier than equities. This led fiduciaries over the second half the Twentieth Century to focus on improving the mix of investments in their portfolios and reducing the risk emanating from being overweight on government or corporate bonds.

In their well known paper¹⁰ on the subject, authors Max M. Schanzenbach and Robert H. Sitkoff have written: “How do you make a small fortune? Give a bank a large one to manage in trust (*Dukeminier and Krier* 2003, p. 1335). So goes an old saw about the banking industry that reflects long experience with risk-averse, conservative trust investing by institutional trustees operating under the prudent-man rule of trust investment law. The prudent-man rule favored safe investments such as government bonds and disfavored speculation in stock, and under the rule the courts assessed the prudence of each investment in isolation rather than in the context of the portfolio as a whole. In the last 20 years, however, all states have replaced

¹⁰ Schanzenbach, Max M & Sitkoff, Robert H: *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation* (2008), Discussion Paper No 580, John M Olin Center for Law, Economics, and Business, Harvard Law School

the old prudent-man rule with the new prudent-investor rule. Drawing on the teachings of modern portfolio theory, the new prudent-investor rule directs the trustee to invest on the basis of risk and return objectives reasonably suited to the trust and instructs courts to review the prudence of individual investments not in isolation but in the context of the trust portfolio as a whole. The new prudent investor rule thus abolishes all categorical restrictions on permissible types of investments and clearly rejects the old law's hostility to investment in stock."

In effect, over the past fifty years or so, the "prudent-man" rule morphed or evolved into the "prudent-investor" rule. Among all the changes that were forged, three important ones stand out. The first is the trustees' duty to diversify investments to minimise risk. Second, while the old order emphasised the need to avoid speculation, the new set of rules requires trustees to assess the risk-tolerance of a particular trust and to invest for "risk and return objectives reasonably suited to the trust". Finally, the new rules reverse the earlier accent on non-delegation and encourage trustees to delegate the investment responsibility to professionals.

However, the "prudent-investor" rule is by no means the end-point or the final destination in the journey of investing philosophies. The rule has been subject to refinements and fine-tuning, especially in the aftermath of the 2008 financial crisis and the resultant global economic slowdown. Some of the assumptions are under scrutiny while some others are being reinforced.

At the centre of this flux is the philosophical debate over the differences between "reasonable" behaviour and "rational" behaviour.¹¹ In fact, there is even a debate whether the "prudent-investor" rule should stay solely focused on the modern portfolio theory and whether there is a need to also include the efficient capital markets hypothesis.¹²

For our purpose, it is abundantly clear that we are still stuck in the era of "legal lists" -- when the government or courts of law dictated how much should be invested, and into what -- and it is high time we moved on. In fact, it is suggested that we move to the "prudent-investor" rule straight away, albeit with some modifications and special features suited to the Indian environment.

There will be some course corrections necessary before sweeping changes can be made in the environment. Before adopting the "prudent-investor" rule, there is a need to make a systematic assessment of the human resource capabilities within the institutional framework, map their competence and skill levels and match them with the competence needs of a "prudent-investor" framework. Wherever gaps exist, as surely they do across the industry, the regulator should provide a time-frame to allow insurance companies and pension funds to bring their managers up to the mark, through adequate training and capacity building.

¹¹ Lydenberg, Steve: Reason, Rationality and Fiduciary Duty, Investor Responsibility Research Centre Institute, <http://www.irrcinstitute.org/pdf/FINAL-Lydenberg-Reason-Rationality-2012-Winner.pdf>

¹² Schanzenbach, Max M & Sitkoff, Robert H: The Prudent Investor Rule: A Theoretical and Empirical Reassessment, <https://www.utexas.edu/law/academics/centers/clbe/wp/wp-content/uploads/centers/clbe/schanzenback-the-prudent-investor-rule.pdf>

The market also needs to improve, modernise and open up before the investment norms can be revamped. The next chapter deals with that issue.

There will indeed be some critics who will rush to point to the 2008 financial crisis and use that to justify their opposition to the changes being proposed by this committee. But, as all references and the empirical data so far suggest, nothing is bereft of risk. Recent global experience has shown us how even government securities can teeter on the brink of default. Therefore, given the low-growth-high-inflationary phase that the Indian economy is currently passing through, there is a dire necessity to overhaul the current legal and regulatory framework – in the interest of the funds, the investors and the economy.

CHAPTER VII

MOVING TO ‘PRUDENT INVESTORS’ REGIME’: THE ROAD-MAP

India is now unarguably settled that India is committed to economic reforms which, among other things, entails allowing economic agents the liberty to take decisions in a developed and regulated environment and to take responsibility for their decisions.

While entities wishing to raise resources have the freedom to do so in any manner they like, subject to complying with existing regulations, all entities wishing to invest their resources do not enjoy a similar freedom. For example, the insurance and pension funds/fund managers (IPFs / IPFMs) do not have full freedom, as detailed in earlier chapters, to invest their funds in asset classes they consider appropriate keeping in view the interests of their clients and the opportunities afforded by the environment. This approach prevents IPFs from exercising skills in the most prudent and efficient manner and dilutes their accountability. It also contradicts with the principle of consumer protection as it prevents generation of optimum returns for the clients. For these reasons, legal frameworks governing institutional investors globally have moved towards the ‘prudent investors’ approach, which allows such investors the freedom to invest their funds in the manner that appears most prudent taking into account the needs and interests of their consumers.

Such freedom is absolutely necessary for the growth and survival of insurance and pension industry as argued in the previous chapters, as IPFs would soon find their investment options limited and the available options would not provide them an opportunity to build a safe, balanced portfolio and thereby deliver appropriate returns to their clients. Incidentally, such freedom would help the economy – higher returns would promote higher household savings, allowing insurance companies and pensions funds to channel such savings to most productive investments, including infrastructure projects. However, all markets need to be well developed and regulated to ensure that a professional fund manager enjoys the freedom of investing within the rigours of a proper governance framework. The freedom of professional fund managers will have to be calibrated, probably in step with the development of markets, to avoid any untoward occurrences and to make the reforms sustainable. This essentially entails moving gradually to ‘prudent investors’ regime (PIR) along with appropriate safeguards.

The success of PIR hinges on three pillars, namely,

I. Freedom To Invest In A Broader Range Of Asset Classes, Domestic & Overseas:

- i. Government Securities,
- ii. Corporate Securities (Equities, Debentures and any other),
- iii. Units issued by Investment Funds (CISs, MFs, VCFs, PEs, etc.)
- iv. Paper/Demat Commodities, including Metals,
- v. Derivatives of Securities/Commodities, including interest rate futures
- vi. Real Estate Projects, and,
- vii. Infrastructure Projects.

This has a direct and proportionate relationship with expansion of financial market.

II. Institutionalisation of Capacity Building:

The move to the new investment regime and philosophy will warrant institutionalisation of capacity building in the areas of:

- i. Regulatory oversight
- ii. Corporate governance structure and processes
- iii. Policy formulation
- iv. Risk management
- v. Pool of Investment Managers and Trustees, with a deep reservoir of skill sets, including project appraisal skills

III. Regulatory Oversight:

The IPFMs can have such freedom only if the markets for the wider range of asset classes are appropriate in terms of:

- i. Regulated Market: (a) Empowered, capable and motivated regulator, and, (b) Robust Regulation
- ii. Developed Market: (a) Range of Products, (b) Depth, Liquidity, Costs, Safety, Efficiency, and (c) Transparency, Research, Databases.
- iii. Protected Market: (a) Market Stability, (b) Market Surveillance, (c) Investor Protection, (d) Indemnity against Loss, (e) Governance of Investee, and, (f) Bankruptcy Laws.

While it might be difficult to deal with this subject comprehensively in this report, it might be desirable to broadly outline the approach to regulatory oversight and very briefly touch upon other areas listed above.

Accountability of IPFMs: The new regime envisages that IPFMs have a fiduciary responsibility towards their clients and beneficiaries. They must discharge their duties with the care, skill and diligence that a 'prudent investor' of similar character and objectives would do in a similar environment. Thus, the prudent investor regime focuses on the approach rather than outcomes. It concentrates on how diligently a fiduciary discharges its obligations, including how investment decisions are made. It believes that every investment option and every investment strategy is benign. Accordingly, the most aggressive and unconventional investment would be good, if preceded by a sound process; at the same time, the most conservative and traditional investment strategy may fail the test if a due process is not followed.

As the moniker itself suggests, prudence will be required in developing, executing, and monitoring the investment strategies, subject to the options available in the market and the objectives of the fund. What is material, therefore, is the manner of taking investment decisions, which necessarily have to be 'principle based' rather than 'rule based'. It assesses the fiduciaries, not on the basis whether its investment decisions were successful, but whether it applied reasonable principles and processes in arriving at its decisions. The accountability

must, therefore, focus on how the fund managers acted in the selection of the investment, and not whether the investments succeeded or failed.

The Prudent Investor Act, which was adopted in 1990 by the American Law Institute's Third Restatement of the Law of Trusts, reflects a "modern portfolio theory" and "total return" approach to the exercise of fiduciary investment discretion. This approach allows fiduciaries to utilise modern portfolio theory to guide investment decisions and requires risk versus return analysis. Therefore, a fiduciary's performance is measured on the performance of the entire portfolio, rather than individual investments. In a complete departure from historical practices, the prudent investor rule now measures a trustee's liability by comparing the portfolio's total return, whether positive or negative, with what the portfolio reasonably could expect to earn under an "appropriate" investment programme. This makes the governance as one of the most significant elements in the approach to 'prudent investor' principle.

Governance of Funds: A fund manager must invest only in assets whose risks it can properly identify, measure, monitor, manage, control and report. Investments must balance the security, quality, liquidity and profitability of the portfolio as a whole, commensurate with the disclosed policy objectives, as well as in line with the nature and duration of the funds and in the best interest of all clients and beneficiaries. The adoption of the regime, therefore, requires that the fund managers must have sufficient resources and systems of governance in place. Existence, implementation and constant upgradation of such systems would be the initial steps towards the adoption of a prudent investor regime.

A fund manager must at all times fulfil the fit and proper requirements – that is, his professional qualifications, knowledge and experience should be adequate to enable sound and prudent investment management. Also, he should have impeccable integrity and a rock-solid reputation. The fund must have in place effective governance systems that include an adequate and transparent organisational structure with a clear allocation and appropriate segregation of responsibilities, and an effective system for ensuring transmission of information. It should have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report -- on a continuous basis -- risks, at an individual and at an aggregated level, to which it is or could be exposed. The risk-management system must be effective and well integrated into the organisational structure and in the decision-making processes of the fund.

In particular, the following must be ensured:

- a. Every fund must have an Investment Committee empowered to administer the fund and take ultimate responsibility for ensuring that fund managers adhere scrupulously to the terms of the arrangement and are protecting the best interests of clients and beneficiaries. The governing body should retain ultimate responsibility for the fund, even when delegating certain functions to downstream decision makers and those executing these decisions and /or external service providers. It should be accountable to the clients and beneficiaries, and the competent authorities. Membership in the governing body should be subject to minimum suitability standards in order to ensure

a high level of integrity, competence, experience and professionalism in the governance of the fund.

- b. The governing body must draft an overall investment policy that is actively observed. This investment policy should establish clear investment goals for the fund that are consistent with the objectives of the fund. The approach for achieving those objectives should satisfy the prudent investor regime, taking into account the need for proper diversification and risk management, the maturity of the obligations and the liquidity needs of the fund, and any specific legal limitations on portfolio allocation. The investment policy has to be dynamic and should identify the strategic asset allocation strategy for the fund (the long-term asset mix over the main investment categories), the overall performance objectives for the fund, and the means of monitoring and, when necessary, modifying allocations and performance objectives in the light of changing liabilities and market conditions. It should also include any broad decisions regarding tactical asset allocation, security selection and trade execution. There should be procedures and criteria by which the governing body periodically reviews the effectiveness of the investment policy and determines whether there is a need to change the policy, its implementation procedures, the decision-making structure, as well as the responsibilities linked to its design, implementation, and review.
- c. The governing body must establish adequate internal controls in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives of the fund. There should also be appropriate controls to promote the independence and impartiality of the decisions taken by the governing body, to ensure the confidentiality of sensitive information pertaining to the fund and to prevent the improper use of privileged or confidential information. Reporting channels between all the persons and entities involved in the governance of the fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.
- d. The governing body should engage persons of repute who have appropriate professional qualifications and experience. Persons responsible for the overall implementation of the investment policy should be identified together with any other significant persons who will be part of the investment management process.
- e. There should be clear a outline on how any conflict of interests in the investment function, as and when it arises, will be managed.
- f. The governing body must establish a sound risk management process to measure and appropriately control portfolio risks and to manage the assets and liabilities in a coherent and integrated manner.
- g. The governing body must appoint an auditor, independent of itself, the fund, the fund manager, and the sponsor to carry out a periodic audit consistent with the needs of the arrangement.

- h. The IPFM must draw up annual accounts and annual reports which reflect a true and fair view of the assets, liabilities and financial position of each fund. Such reports must also reflect the governance processes followed.
- i. The IPFM must disseminate proper information to clients and beneficiaries, including information regarding rights and obligations of the parties involved, the financial and other risks involved, and the nature and distribution of those risks, in a clear, accurate, and timely fashion. It must provide any other relevant information as may be sought by the clients and beneficiaries and/or may be relevant to understanding/appreciating the decision making processes.
- j. The IPFM must provide relevant, material and updated information to competent authorities, on a regular basis.

In short, the quality of meeting room practices of the governing body become very significant and have necessary to be ensured at a very high pedestal in terms of objectivity, engagement and support systems.

Markets for Asset Classes

Governance of Markets: The fund manager is like an investor. An investor needs a developed and regulated market where he is protected in case he loses money for no fault of his. This means that the system must ensure that (i) the investor learns investing, obtains and uses information required for investing, and takes adequate precautions; (ii) the market participants reveal relevant details about themselves, the products, the market and the regulations so that the investor has full knowledge about the market; (iii) the market has systems and practices which make transactions safe, only the fit and proper persons are allowed to operate in the market, every participant has incentive to comply with the prescribed standards, and there is assurance that the miscreant will be meted out exemplary punishment; and, (iv) the investor is fully compensated, if he happens to lose money due to failure of any system or participant, malafide or otherwise.

In short, the investor needs an empowered and accountable regulator to regulate and develop the market for the assets and protect the investors in those assets before the investor ventures to invest in those assets. A fund manager may invest in securities because there is an empowered and accountable regulator called SEBI, which is responsible for protecting the interests of investors in securities and for promoting the development of and regulating the securities market. If a fund manager is to consider investing in real estate projects, for example, we need to establish a regulator to promote the development of and regulate the market for real estates and protect the interests of investors in real estates. We should allow a fund manager to invest in the assets in those markets, which operate under the oversight of an empowered and accountable regulator.

Conducive Legal Framework: Dynamic and inter-connected markets are now witness to rapid changes – something that would earlier take centuries to transform now happens in some years, and sometimes even in months. The governance response to this has been establishment of regulators empowered by ‘almost incomplete’ form of law. This form

believes that it is not possible to visualise all the possible future circumstances and provide for all of them the legislation. Here, the legislations tend to be skeletal, but have the potential to deal with all the possible circumstances. The separation of powers is blurred -- the same entity is vested with the quasi-legislative, executive and quasi-judicial functions so that it can enforce the laws proactively and preferably before any harm has been done either to the efficacy of the market or the interests of the participants.

An example is the Securities and Exchange Board of India Act, 1992. It empowers SEBI to register and regulate not only the intermediaries listed in the Act, but also such other intermediaries who may be associated with the securities market in any manner. This allows SEBI to regulate the intermediaries who are not listed in the Act, should the need arise in future and also the new intermediaries that may emerge in future, without an amendment to the law. At the time of enactment, the legislature could not possibly visualise all intermediaries who would need to be regulated in future. Similarly, the Act mandates SEBI to take such measures as it considers fit to protect the interests of investors with an illustrative list, as at the time of enactment, it could not visualise all possible measures that might prospectively become necessary. This enables SEBI to undertake innovative measures to respond appropriately to the circumstances at hand. For example, SEBI recently sought disgorgement of illegal gains from fraudsters and disbursed the proceeds among the victims, though disgorgement is not explicitly mentioned in the illustrative list.

The Act also confers on SEBI substantial powers of delegated legislation (quasi-legislative) to make subordinate legislation (regulations) to fill the gaps in laws and to deal with the matters of detail, which rapidly change with time. While the SEBI Act is about ten pages, SEBI has framed regulations running into thousands of pages and changes from time to time. This enables it to strike the moving targets at the right time and at the same time, keep the laws relevant. The Act further confers on SEBI the enforcement, including quasi-judicial, powers, to enforce the laws made by the legislature and also by itself. In particular, it can by regulations cast obligations on participants and dispense civil penalties for failure to discharge the said obligations.

Consequently, if SEBI considers a particular conduct undesirable, it can immediately outlaw it through regulations and enforce such regulations. It does not have to wait for the legislature to outlaw any conduct or create an offence through legislations. Nor does it need to seek judicial concurrence for levying a variety of penalties (except prosecution) on the accused. This form of law is eminently suitable for markets, which evolve very fast and the authority needs to respond faster with preventive and remedial measures.

The regulator has to keep pace with moving targets. This is possible only if the law evolves continuously, in tandem with the environment to meet the emerging deficiencies, accommodate new products and market designs, deal with innovative transactions by the market participants and improve the safety and efficiency of operations in the market by overcoming the legislative lags. The law should enable the regulator to expeditiously issue a variety of innovative (administrative and quasi-judicial) preventive, remedial and penal measures matching the conduct of the participants. This requires an incomplete legal regime where the regulator, which has a better understanding of the environment, has adequate

powers of promulgating subordinate legislation within the basic frame of the statute and also the powers to enforce the laws proactively and promptly.

Protection of Investors: What worries an investor are regulatory overlaps, gaps and overlapping jurisdictions of various regulatory agencies. A plethora of laws and agencies seemingly created to protect the interests of investors has created this confusion. There must be a single window, where an investor can seek redressal of his grievances. While the banking and insurance regulators have created separate Ombudsmen offices, there is a need to institute a common Ombudsman for the markets of all asset classes in the country to reduce duplication of efforts and costs and dispense justice from one source. A specialised ombudsman must be created who can award compensation by following a summary procedure to investors (across markets/products) who have lost money for whatever reason, except for market loss or their own negligence. The compensation must be paid by the negligent or defrauding party.

Depositors in banks are protected to the extent of Rs 1lakh against liquidation or bankruptcy of the bank. This protects innocent depositors and thereby contributes to the stability of the financial system. A similar mechanism may be instituted to compensate an investor. A group insurance policy may be considered under which investors can be insured. An investor, losing any money for whatever reason except for market loss or his own negligence and not compensated by the negligent or defrauding party, will be compensated up to a specified amount. A national non-profit organization is needed which will espouse the cause of investors and take up their case before the authorities such as regulators, arbitrators, courts, ombudsmen etc. An enabling environment needs to be created for emergence of such an organization.

Investment Advice: A fund manager may be competent to take appropriate investment decisions on its own. How does a client choose a fund manager? The authorities find great solace in KYC, or know your client, norms. The clients, however, find solace in KYP, know your product and know your participant.

There is an elaborate arrangement to enforce KYC while there is not even talk of KYP. The retail client struggles to undertake KYP, while products and participants get increasingly complex. The modern markets attempt to address the issue, inter alia, by making available a cadre of competent, responsible professionals who help clients undertake effective KYP. Given the role of such professionals, who are generally referred to as investment advisers, in the financial well-being of retail clients, the SEBI Act, 1992 mandates SEBI to register and regulate them. It has recently notified regulations to regulate the investment advisers in securities.

A fund manager invests in markets some of which are regulated. However, clients entrust their resources to a fund manager. While the regulators of markets are bound by the limits of their respective jurisdictions, the business is not. The economies of scale and scope together with deregulations have blurred the legal boundaries. Consequently, a person simultaneously engages in activities that come under the purview of multiple regulators. An investment adviser, for example, renders advice on assets across jurisdictions and even outside regulatory

jurisdictions. He holistically assesses the needs of a client and the suitability of all assets classes for him before recommending an asset or a combination of assets. If he limits his assessment to the assets in the jurisdiction of A, the client may miss out a better asset which is in the jurisdiction of B. It is, therefore, not possible to render and regulate jurisdiction-wise investment advice. It is difficult for a regulator to lay down standards for investment advice across jurisdictions. It is not practical for all regulators to simultaneously register and regulate the same person as investment adviser. The resolution lies in unified regulation of investment advisers by a statutory authority.

Distribution and advice are generally offered together as a composite service. There is hardly a person who only distributes assets/financial products and does not advise clients on those products and vice versa. Multiple conflicts of interest are inherent in this model. First, as distributor, he is an agent of the product provider, and as adviser, he is an agent of the client. Thus, he serves simultaneously two principals who generally have conflicting objectives. The interests of one principal may take precedence over that of another depending on the importance of the principal to his business and/or reward. Second, while advice is totally unregulated, distribution is not. There are rules from respective regulators in respect of origination, including distribution, of products and product distributors. As a result, while an adviser is theoretically capable of advising on all products, he can distribute only those products which he is authorised to. This obviously prompts the adviser to recommend those products which are available with him even if those are not most suitable for the client. Third, it is not uncommon for a person to deal simultaneously in many competing products. In such a case, he would naturally recommend those products which maximise his incentives. He may even exploit regulatory arbitrage and push those products where regulatory compliance is minimal. This calls for segregation of distribution from investment advice. While regulation of distribution is left to the respective product regulators, investment advice needs unified regulation.

All kinds of persons, irrespective of their competence, advise retail clients on various assets. This adds to confusion and insecurity among clients. There are generally two requirements to ensure that an investment adviser works in the best interest of clients. First is the requirement of registration and oversight. The investment advisers need to be registered and regulated by an appropriate regulator. They should be held accountable for their investment advice and obliged to redress grievances of their clients. There should be a code of conduct for them and enforcement actions should follow in appropriate circumstances. Second is the capability. There should be arrangement to equip investment advisers to render competent investment advice. The appropriate regulator should develop a comprehensive specialized course covering all kinds of assets and prescribe the same as one of the eligibility requirements for registration as investment adviser. There should also be continuing professional education to ensure that the investment adviser remains abreast with the developments (products and participants) in the market. This would ensure effective investment advice from qualified and responsible people.

Given the twin responsibilities of developing and regulating financial advisers, it is necessary to establish a statutory body which will have two broad activities, namely, (a) development of

appropriate courses which a person must complete to be eligible for registration as investment adviser, and, (b) registration and regulation of investment advisers. The institute can be called 'Institute of Investment Advisers of India (IIAI)'. The institute shall also provide continuing professional education to update knowledge of investment advisers and exercise oversight over them to ensure orderly growth of a responsible profession. After a particular cut-off date, no person shall act as a investment adviser unless he has a certificate of registration from the IIAI.

Governance of Investee: A fund manager would have comfort if the investee, such as company, collective investment scheme, venture capital fund, infrastructure project, etc. abides by certain best practices and governance norms. For example, an IPF should invest in securities issued by a listed company which is subject to corporate governance norms prescribed under the Companies Act, 1956 and Listing agreement. In fact, the operations of a company are governed under the Companies Act. The operations of a mutual fund are governed by the SEBI (Mutual Funds) Regulations. The operations of Government are governed by the Constitution. An IPF may invest in the assets issued by the investee who is subject to certain regulations and governance norms. The gaps, which do exist must be filled up fast.

IV. CORPORATE GOVERNANCE STRUCTURE & PROCESSES

The dynamism of the market – rapidity and profundity of changes have to be matched by the concurrently evolving corporate governance structure and processes. This will involve institutional capacity into knowledge management, research and recommendations for reengineering of the structure and processes. Acceptance and quick adjustment will warrant opinion building. This cannot be left to one off exercise to be undertaken periodically and hence, will necessitate creation of institutions/wings to engage in this exclusively with stakeholders, which may incidentally help the policy formulation too.

V. POLICY FORMULATION:

Public policy has to keep pace with dynamism of the market and environment. Hence, it will have to be reoriented to the emerging demands so that the legislature and judiciary collaborate in the process of tectonic shift and are on board to changing philosophies. It is the inadequacy of changing face of public policy, which is withholding investment of EPF moneys in capital market instruments directly.

VI. RISK MANAGEMENT:

Risk management is going to be the key to the success PIR. Hence, significant investment both in academics and operations in designing, operationalising and refurbishing will be called for eventually enabling optimal risk management and risk mitigation.

VII. CADRE OF INVESTMENT MANAGERS & TRUSTEES:

Switch over to new regime will demand different skills sets for investment management. And, as the market expands and undergoes transformation, the needs will grow both quantitatively and qualitatively.

This will require academic institutional capacities and cadre building capabilities within the organisation.

Conclusion: The above are some of the building blocks before the PIR is adopted and IPFM is granted freedom to invest in various asset classes. However, a comprehensive governance framework will have to worked out, while the nation prepares to move to 'prudent investor' rule.

CHAPTER VIII

FINANCIALISATION OF PHYSICAL ASSETS

The disposable surplus – income minus expenses -- of individuals culminates into physical and financial savings. As the economy of a country matures and the financial markets acquire depth and width, the proportion of financial savings grows and that of physical savings contracts. This process is, among other things, also enabled by the ability of the markets to financialise physical assets.

The mature economies of US, Europe are marked by a higher proportion of financial savings over physical savings; the contrary holds true for emerging economies, especially India.

The preference for physical savings accelerates if the financial instruments deliver negative/marginal real returns, as by and large physical assets act as a natural hedge against inflation. In India, as mentioned in one of earlier chapters, in the past 3 years, the proportion of financial savings has declined by nearly four per cent. Investment in physical assets, if not financialised, becomes a locked asset and does not benefit the economy.

Developed financial markets facilitate financialisation of physical assets and help the economy to grow even with these investments. Hence, financialisation of physical assets have found increasing favour across many economies as a means of capturing value that might be otherwise get lost. Wikipedia has a simple definition for the process: “Financialisation is a term that describes an economic system or process that attempts to reduce all value that is exchanged (whether tangible, intangible, future or present promises, etc.) either into a financial instrument or a derivative of a financial instrument. The original intent of financialisation is to be able to reduce any work-product or service to an exchangeable financial instrument, like currency, and thus make it easier for people to trade these financial instruments.”

The concept, in its most basic form, involves taking ownership of the physical assets out of the equation and providing financiers with financial paper that not only promises fractional ownership of a physical asset but also allows for liquidity through an exchange-traded mechanism. In India, the endeavour should be to increasingly seek financialisation of investment in bullion and real estate. There are pitfalls associated with financialisation, as the recent global financial crisis has shown. Numerous academic papers have highlighted how increasing financialisation of commodity markets in the developed markets led to inflationary tendencies in some commodity categories.

However, that should not detract from our task at hand. There is already enough academic work that will help Indian markets going down the same path. This will require necessary legal and regulatory changes. An UNCTAD policy brief, which is titled “*Don’t Blame the Physical Markets: Financialization Is The Root Cause Of Oil And Commodity Price*

Volatility”, has provided a checklist of regulations that might be a necessary accompaniment to financialisation of physical assets.¹³

This economic re-engineering can be facilitated by addition of some of missing links in the creation and marketing of financial products, like:

1. Real Estate Investment Trusts (REITS):

Globally, REITS are used to channelise and formalise investment in property, using capital market platform and all the risk-mitigation systems that comes with exchange traded mechanism (such as novation). Unfortunately, SEBI is yet to notify regulations governing the activities of REITS. It is a pity that this opportunity has been exported and investors in overseas markets (such as Singapore) are benefitting from the opportunity of investing in the Indian property market. However, in addition to action by SEBI, this would also require setting up of an empowered and active housing regulator and formulation of a House Pricing Index.

2. Infrastructure Investment Trusts (IITs):

On similar lines, ISITs can be floated for financing roads, ports, airports, railways, power projects. With adequate credit enhancements, it should be possible to attract private – individual and institutional -- investments into the sector and fill up the gaps of equity that constrains financial closures.

3. Gold and Commodity ETF:

Even though gold ETF have since been introduced in the market, commodity ETF are yet to find their place.

However, products like gold ETF will remain a non-starter or under-penetrated if the size and liquidity do not shape up. This can be achieved only if the insurance and pension funds are allowed to invest in these products. Expansion of investment basket into these products for insurance and pension industries would have the following benefits:

- 1) Primary Benefits: Insurance and pension funds will find an avenue to notch up a real rate of return, which today is largely missing in fixed income securities, particularly government bonds.
- 2) Secondary Benefits: (a) This will help develop and broaden the financial markets, (b) It will provide liquidity and depth to the market of these instruments and discourage individuals from investing into locked assets of the underlying products, (c) This will help financialise the existing investments in property and gold in particular thus help mitigating at least partly concern of the nation.

¹³ http://unctad.org/en/PublicationsLibrary/presspb2012d1_en.pdf

CHAPTER IX

RECOMMENDATIONS

It is this committee's firm view that the era of directed investments is now an antiquity which must be discarded and replaced. However, as we have repeatedly stressed elsewhere in this report, it is not the intention of this committee to suggest that precautions should be thrown to winds, or to completely dispense with regulation, or even slacken the governance norms. As economies, markets and systems evolve, so must regulation. What worked in the 1960s or the 1980s may not necessarily be relevant for the current environment.

For example, the regulatory structure has to take into account the changing nature of risk, especially risk that emanates elsewhere and sweeps across porous global financial boundaries. Comprehensive work has been done in risk-predictive and risk-mitigation models. Regulation has to evolve in such a manner that it takes into account extensive changes being fashioned in corporate governance theory and practice and other related areas. Dynamic markets, like moving targets, cannot be regulated through static policies. It has to evolve concurrently with the development of markets.

It is also time that regulators moved away from micro-management of companies and their business practices. In fact, the regulators should leave micro-management of investment to the investment committees of individual companies. The regulator currently requires every company to draw up an investment policy, which needs to be ratified by the Board every six months. If that be the case, why still insist on a set of directed investments all over again?

This indicates two things. One, probably the regulators do not have adequate trust in the companies, the board members and their governance structures or practices. Two, by indulging in such micro-management, the regulators run the risk of losing sight of the big picture and the way risks seem to be morphing across the world. It also forces regulators to become reactive to changes rather than anticipating them well in advance and putting adequate and alternate macro-prudential and micro-prudential measures in place.

Unfortunately, regulation in India is, by and large, a *post factum* occurrence. Rules and guidelines are typically fashioned after an isolated incidence of misdemeanour by one or two players. A situation, thus, arises when everybody else in the industry has to suffer on account of mis-steps by one or two members of the industry. The entire regulatory structure needs to evolve, build credible monitoring processes, design transparent communication processes, involve stakeholders in structuring the regulatory direction, create just and swift arbitration mechanisms, among other things.

It may be instructive to point out here that many developed countries have not abolished their existing "prudent investor" regime despite the debilitating blow dealt by the 2008 global financial crisis. At best the regulatory structures have been reviewed and restructured/reoriented.

This chapter – consolidating the committee’s recommendations strewn across the report -- rests primarily on the twin pillars of introducing the “prudent investor” concept and on suggesting for an accelerated pace of financialisation of various physical assets.

One of the primary reasons behind the falling savings rate in the Indian economy is the high inflation rate and the absence of financial instruments that can offer a positive real rate of return. As a result, investments in physical assets – such as gold or real estate – have emerged as popular alternatives for individual investors. While investments in physical assets do manage to shield capital from the corrosive effects of sticky inflation, it also takes away investible resources from the economy.

The paragraphs below provide the committee’s recommendations on what needs to be done to resolve the two moral dilemmas that this report outlines in its initial chapters.

RECOMMENDATIONS:

1. It is evident that the era of directed investments is over and it is time to search for new paradigms. This committee feels that the investment philosophy pertaining to both the insurance and the pension sectors has to leapfrog to the “prudent investor” regime. However, it must be kept in mind that such a tectonic shift cannot happen without its attendant risks and due care has to be taken while moving to this new investment regime.

The reason for this shift is simple. This committee, after speaking to various stakeholders, feels that the concern for preserving the investor’s capital should remain paramount but, perhaps, not at the cost of eroding her corpus and/or real returns. Indians parting with their savings for extended periods, as is the case with insurance and pension, should get back an enhanced corpus, thereby yielding a positive real rate of return. The principle is simple: people save during their working years so that a corpus is available to finance consumption during their “golden years,” or years spent in retirement. Receiving a marginal or incremental addition to the original corpus, where the delta is lower than the rate of inflation, is doing injustice to the investor.

This committee also felt that moving to an interim regime of “prudent man” doesn’t make much sense in the current economic and financial environment. Indian financial systems, finance professionals and regulators have acquired enough sophistication to enable to leap frog to the “prudent investor” regime.

2. This committee believes that multiplicity of investment mandates across pension and insurance domains is self-defeating in nature and dissipates the original objectives of pension and insurance industries. The Employees Provident Fund Organisation, for example, steadfastly refuses to follow the investment philosophy laid down by the Ministry of Finance and is sticking to an outdated mandate. This committee, therefore, recommends that the existing investment norms across all verticals be harmonised, at least till such time as the move to a “prudent investor regime” is complete. This creation of a uniform regime will usher in transparency and allow investors to compare their returns across product platforms.

3. Flowing from the above recommendation, it is quite clear that customers should have adequate, reliable information available in the public domain which they can then use to compare and take an educated decision before choosing any pension scheme or insurance fund. Therefore, a framework for benchmarking performance of pension and insurance funds is necessary for generating healthy competition and for meeting the standards of transparency. Therefore, the Committee feels that intra-fund comparison, as well as internal assessment of the performance of each fund, is a desirable practice. It will, therefore, become necessary for the regulator to develop and define a benchmark that can be used by every pension scheme and insurance fund to assess its performance. Currently, no such benchmark exists.

In addition, every fund house must conduct an internal benchmarking exercise to assess the performance of each fund. There are many ways to achieve this. The committee recommends that each fund may allocate a small portion of the funds under its management to an external fund manager with clearly defined investment benchmark. For a fair comparison, it would be desirable that the benchmark followed for internal fund investment should be the benchmark for the external fund manager also.

This committee is consciously not recommending any specific percentage of the funds that may be allocated to the external fund managers. The Boards of the respective pension or insurance companies may be left free to decide the portion that they would like to allocate to the external fund manager, but the amount should not exceed 15% of the total funds under management. The management can benchmark its performance on fund management to the external manager and take corrective measures, if required. This practice of allocating a part of the funds to external fund manager would also provide a fair opportunity to the pension and insurance companies to update their investment skills.

4. This committee would also like to address an issue of natural justice that eludes all investors investing in pension and insurance products. All citizens must get an opportunity to maximise their retirement income, regardless of where they work. In the interest of equity and natural justice, all citizens must be allowed freedom of individual choice to invest in whichever long-term retirement fund they want. Today, citizens covered by the mandatory Employees Provident Fund Organisation are locked in by the existing rules and are denied mobility. As a consequence, they are deprived of the higher returns available to other retirement products, such as the National Pension System (NPS) administered by the Pension Fund Regulatory and Development Authority. This is patently unfair.

The NPS architecture already allows investors portability within the system – any investor is free to move his retirement corpus from one fund manager to another. The architecture is also not restricted by geography or by place of work. This is to allow all investors freedom of choice and an opportunity to maximise their retirement

incomes. This committee recommends that all pension and insurance investors be granted their right of portability; they should be able to take their investments to whichever fund manager is providing their higher returns. This is a fundamental right and should be granted forthwith.

Importantly, if all long-term savings are managed by funds which are regulated by either PFRDA or SEBI, it will be possible to get a better handle on setting suitable and uniform investment regulations and on obtaining investment compliance.

5. It goes without saying that the move to a “prudent investor” regime cannot, and must not, take place abruptly and overnight without giving the extant systems an opportunity to upgrade, re-learn and re-tool. In other words, the move needs to be phased out. The committee recommends the following phase-out:

- a. First Two Years: The current boundaries of directed investment should be diminished to allow for more play to individual fund managers. As a beginning, the regulator can start tweaking the ratios in the overall menu of directed investments. This committee feels that, following up on its recommendation of a uniform investment mandate, the immediate requirement is to allow for a higher investment limit into equities. Room should also be made for investment in exchange traded funds, debt mutual funds and asset-backed securities, as highlighted by Finance Minister Shri P Chidambaram in his budget announcement for 2013-14. The new investment mandate should look like this:

	Nature of Investment	%age to be Invested
1.	Government Securities	30%
	a. Including a maximum of 10% in other securities where principal and interest payment are guaranteed by the Central or State governments	
2.	Equities and Equity-related Mutual Funds	15%
3.	Corporate Bonds	40%
	a. Including a maximum of 15% in bonds which are floated by infrastructure companies as defined by the Reserve Bank of India	
4.	ETFs, Debt Mutual Funds, Asset-Backed Securities, Derivatives	15%

As is evident from the table above, the time is indeed ripe for allowing greater limits in equity, corporate bonds (especially with a slightly higher risk profile), paper from infrastructure sector, derivatives (within reasonable limits). Apart from allowing higher investment limits in equity, the regulators might even examine the possibility of allowing insurance and pension companies to trade in derivatives so that they can hedge their cash positions. The move should be marginal and must suggest a change in approach.

Insurance and pension companies need to focus on twin objectives of improving real rate of returns and making more financing available for infrastructure and other long term projects, since they need assets that match the maturity profile of their liabilities. This would require introduction of some new products and expansion of some existing ones, such as credit enhancement and credit derivatives.

- b. Next Three Years: During this period, strings of directed investment norms must be substantially loosened to prepare for a complete shift to ‘product investor’ regime. The committee feels that the regulators must jettison the mandated investment edict at this stage and move to a structure of prudential guidelines, which seek to achieve substantive and qualitative risk diminution within the framework of modern portfolio theory. For instance, the regulator must at this stage specify which assets should be out of bounds or how much of its AUM a fund can invest in the equity of any one company or sector. For fixed income securities, the regulator can prescribe a dynamic and comprehensive asset-liability management module which could include, among others, duration gap limits, prudential limits for interest rate sensitivity and a structural liquidity framework. While doing so the regulator must allow for the introduction of some new ideas and new products, such as Real Estate Investment Trusts, commodity futures, Infrastructure Investment Trusts units, etc. It must be kept in mind that only such financial products be allowed which are exchange-traded, so that counter-party risk is eliminated, liquidity is enhanced and exchange-level regulation keeps a check on excess volatility. Progress can be reviewed after three years. This should be the phase when financial markets get ready to offer full basket of products for IPFM to choose from.
 - c. After Five Years: Move to Prudent Investor regime completely.
6. As a measure of abundant precaution, the regulator should lay down guidelines and rules regarding “fit and proper” persons that can be appointed to the Investment Committee and provide detailed guidelines on the broad principles of the governance processes, including risk management and risk mitigation. This will take into account the knowledge, skills and experience of the professionals being appointed to the Committee.
 - a. Their term being limited to 3-5 years with a second term only possible after a gap of another three years. All members should have a maximum of only two terms.
 - b. It is also not necessary that only Board members be seconded to the Investment Committee. The Board should also be given the freedom to invite experts in the fields of finance and investment analysis.
7. In addition to the above recommendations, some of the measures briefly outlined in one of the earlier chapters must be implemented -- during the interim 5-year transition to prudent investor regime -- to allow for capacity building within the related

institutional architecture, primarily to smoothen the journey to ‘prudent investor’ regime. This will include the following:

- i. Regulatory oversight
 - ii. Corporate governance structure and processes
 - iii. Policy formulation
 - iv. Risk management
 - v. Building up a pool of Trustees and Investment Managers
8. In this committee’s various meetings with stakeholders, one misgiving kept cropping up: while it might be desirable to move to a “prudent investor” regime, this might not be possible immediately since there is not enough supply of fixed income paper in categories other than government securities. As our research has shown, and as has been covered in this report in the earlier chapters, there is indeed a shortage of paper supply.

There is, therefore, a dire need to increase the supply of paper across the maturity curve and across risk profiles. This will only be possible when there is fully functioning corporate bond market, which has an equally diverse mix of issuers and investors. Today, the debt market is characterised by the presence of homogenous players with analogous horizons.

Numerous reports – such as the R.H. Patil Committee Report -- have outlined what needs to be done to get a proper, deep and liquid corporate bond market. It is time that such a market was put in place, not only for increasing the pipeline of paper for insurance companies and pension funds, but to also provide an alternative and necessary platform for projects seeking a proper blend of funds. Today, for most companies which are not rated AAA, bank funds are the only source of non-equity financing. This not only leads to inefficient allocation of capital but also ends up putting an enormous strain on bank balance sheets.

Substantial groundwork has already been undertaken by all the agencies concerned. However, progress still eludes us. The development of a proper corporate bond market will require the removal of the remaining tax and regulatory constraints. The government might want to also examine if some introductory incentives can be built into the overall structure – say, exempting bond trading from securities trading tax as a run-up to incentivising the growth and development of the markets. It is our belief that the pay-off arising from a vibrant debt market will be in multiples and will more than compensate for the temporary loss in revenue.

9. It might, also, not be such a bad idea to entrust the Securities and Exchange Board of India with all forms of exchange trading, including for corporate bonds and other fixed income products, as has been suggested on numerous occasions. Alternatively, a system like the Negotiated Dealing System – an electronic trading system operated by RBI for G-sec trade confirmation and settlement under novation from the Clearing Corporation – could be made available for corporate bonds as well.

10. Separately, regulators should allow insurance companies and pension funds to invest a higher limit of their investible funds in securities rated below AAA. Insurance companies have the ability to stay invested in long dated bonds, even if they are below the desired AAA-rating. The credit enhancement through CDO (Collateralised Debt Obligations) and CDS (Credit Default Swaps) etc. can help risk mitigation.

There is another related issue. Today insurance companies cannot invest more than 10% in any single issuer. The regulators should re-examine the validity of this limit in the current circumstances, particularly when the current shallow market does not provide adequate space to invest elsewhere profitably for large investors like LIC.

11. There is no denying the fact that government bonds will continue to play a vital role in the investment portfolios of both insurance companies and pension funds. Government bonds play a stabilising role in any portfolio, especially for smoothening out volatility. However, recent experience shows that yield on government bonds has been lagging the rate of inflation, thereby providing investors with a negative real rate of return.

Given that a large portion of investment portfolios in insurance companies and pension funds will continue to comprise government securities, it might become necessary for them to seek a hedge against their real returns turning negative. A partial solution has already been offered. After Budget 2013-14 announced the launch of inflation-indexed bonds or inflation-indexed national security certificates, the central bank launched its first tranche of inflation-indexed bonds (Rs 1,000 crore) on June 4, 2013. These bonds were indexed to the wholesale price index of January, as per RBI's policy of using the final inflation with a lag of four months. The RBI is also now promising to issue inflation-indexed securities indexed to the consumer price inflation.

Pension funds and insurance companies need a special dispensation. Given that they absorb subscriptions and premium inflows on a continuous basis, the central bank will have to provide them with inflation-indexed bonds on tap, at pre-determined intervals. The other regulators concerned should take this up with RBI immediately to develop a protocol and issuance calendar.

For an understanding of how these bonds work, the Reserve Bank published a technical paper titled "Inflation Indexed Bonds" (<http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=598>).

12. Allow pension fund managers and insurance companies to pool their investments together in a company, like it is done in the case of bank consortia. This will allow sharing of risk.

Alternatively, given the limited scope for banks to keep participating in infrastructure, allow insurance and pension funds to participate in the consortia. This allows insurance and pension access to the appraisal skills present in banks till these institutions build their own.

13. Implement financialisation of physical assets, which are popularly perceived to be risky and volatile, such as bullion or real estate. Financialisation allows for exchange-traded instruments and provides liquidity. Exchange trading also provides guarantees against counter-party risk. This committee would also request regulators to examine how infrastructure projects can be made appealing to retail investors, without weakening any of the safety issues. Introduction of Infrastructure Investment Trust units, traded on the exchange platform could be one of the methods to do.

This has another collateral benefit. Many gold buyers in India – with the exception of those purchasing it for traditional reasons, such as weddings – invest in the yellow metal as a hedge against inflation. Once they realise that buying a gold unit, which can also be traded on the exchanges, is almost similar to buying the real thing, and in a crunch can actually be exchanged for the real thing, it might bring down the widespread propensity to hoard bullion. However, this market will develop -- with depth and liquidity -- only if the insurance and pension funds are allowed to invest in such instruments.

14. As a logical corollary to the recommendations of financialising physical assets, this committee also sees some opportunity in reviving the reverse mortgage market. Given the rapidly transforming demographic, sociological and economic dynamics of Indian society, particularly in relation to those in 60-80-years age group, it makes sense to revive the reverse mortgage market for those willing to leverage their investment in property to finance their old age consumption. This committee is aware that reverse mortgages will, at best, enjoy marginal acceptance – as is evident from its low popularity after its introduction – but it does provide an opportunity to add another product to deepen and diversify the market.
15. The commodity market – especially the futures market -- also needs to be developed. This will be only possible when the commodity exchanges are brought under a single regulator responsible for all futures trading. Today, equity futures trading is regulated by Sebi, while all commodity futures trading exchanges come under the regulatory jurisdiction of the Forward Markets Commission, which is an arm of the Agriculture Ministry. It might be pointed out here that SEBI has already gained expertise on regulating futures market for over a decade now, including building a robust framework around it. Therefore, this committee suggests that all futures trading be brought under SEBI which already has the necessary capability.
16. One of the main hurdles hindering the financing of infrastructure projects is the absence of a vibrant credit enhancement culture. Most insurance companies and pension funds are barred from investing below a certain credit rating. While that floor

needs to be relaxed a bit more, it may still not be sufficient to include paper issued by infrastructure companies. Credit enhancement can be of immense help here.

Today the system has only one proper credit enhancement agency – India Infrastructure Finance Corporation Ltd. However, given the volume and scope of financing needed during the Twelfth Five year Plan, multiple platforms are required for credit enhancement. Many more institutions offering credit enhancement products have to be developed. The need is urgent and will demand for the instrument will grow with growth and expansion of the economy.

17. Re-focus on Indian Depository Receipts. The product already exists but suffers from poor marketing. In fact, there is also enormous scope for extending the rupee bonds market to wider range of overseas issuers. Currently, barring Standard Chartered Bank, only multilateral lending agencies have used that window, and that too sparingly. Such rupee bonds and IDRs provide a unique investment opportunity for insurance and pension companies. It not only gives them an opportunity to invest in select foreign companies without having to cross the national borders (currently they are prohibited from investing in overseas assets), it also insulates them from currency risks. There is another bonus: it provides them with the opportunity to upgrade their appraisal skills and benefit from an ability to invest in profitable overseas opportunities. Insurance and pension funds should be allowed to invest in such instruments.
18. It might also be apposite for the government to revisit the report submitted by the High Powered Expert Committee on Making Mumbai an International Financial Centre, and re-examine its various proposals. An International Financial Centre will be useful in product development, increasing the depth and liquidity of markets, and improving financialisation of physical assets. In fact, this will greatly help in reaping greater benefits of ‘prudent investor’ regime. The attendant benefits accruing from such a development would be accelerated innovation in the product lines of the financial markets.
19. Existing rules and guidelines prohibit insurance companies and pension funds from investing in private limited companies. However, while this rule might have had some logic in the past, in the current scenario it seems to be having unintended consequences. For instance, most infrastructure projects are housed in private limited companies, termed as Special Purpose Vehicles, or SPVs. As a result, these remain out of the investment purview of insurance companies and pension funds. This rule, therefore, needs to be scrapped or modified.
20. Focus on skill development. Wide-ranging capacity building has to take place across the categories (insurance and pension) and sectors (public versus private) to enable fund managers, compliance officers, dealers, marketing experts, sales agents, board members, risk officers to improve their skills and help deliver improved returns to investors.

- a. As part of this exercise, companies and funds might need to tie up with various management institutions and law schools. The regulator's help might be necessary for drafting the course structure and the pedagogy for the new regime.
21. The government should look at launching some more infrastructure finance companies, in addition to the ones existing today – such as, Rural Electrification Corporation, Power Finance Corporation. This will automatically increase the supply of paper to the market.
22. The government should examine the possibility of exempting income -- arising out of investments in infrastructure made by insurance companies or pension funds -- from tax. This income can be in the form of dividends, interest income or capital gains. The benefit of tax exemptions can create a virtuous circle — apart from improving the returns, it will also help infrastructure companies bring down their cost of capital raising. A sunset clause can be built into the proposal to accelerate funds flows into infrastructure projects in the initial stages of market development.
23. Government should examine the possibility of infrastructure bonds carrying some sort of an explicit guarantee. We are not suggesting that the government provide the guarantee on its own account since that would directly impact the fiscal balance. Instead, the government could examine the possibility of allowing some of the infrastructure finance companies – such as IIFCL or Infrastructure Development Finance Corporation -- to provide capital guarantee for a fee. In addition, the overall design of the projects should include a partial recourse to the sponsors. This will immediately improve the rating of the projects and allow investment by insurance companies and pension funds.
24. The regulators should examine the possibility of allowing insurance companies and pension funds to access the credit default swap markets to hedge their exposure to paper floated by the infrastructure projects. However, the regulator will not only have to ensure that the exposure to CDS is backed by an investment in fixed income paper but also draw up a regulatory structure to minimise exposure risk in this market. It is quite likely that the example of AIG (or other related incidents) would be used to beat down the proposition. The only difference is this: while the CDS related blow-outs in the western financial markets were a case of unfettered speculation and regulatory failure, this committee is recommending facilitation of risk management. And this is a great financial innovation, which is being used across geographies and sectors, notwithstanding incidents of market failures and mishaps. When operated within a proper regulatory framework, CDS can be used as an effective hedging tool.
25. Greater regulatory clarity is required on whether investments made by insurance companies and pension funds in infrastructure funds should be classified as an investment in a mutual fund – which are currently allowed only as short-term

investments – or in infrastructure. This will allow greater flexibility in portfolio construction.

26. Insurance companies and pension funds should be allowed to invest in derivatives, in both equities and bonds. This is essential for hedging their exposure in the cash market.
 - a. Regulators may have valid concerns about the risks emanating from excessive speculation in derivatives, especially since the eco-system prevailing in the insurance and pension sectors has limited domain knowledge in the field. This committee, however, is not suggesting or recommending that the floodgates to be opened immediately. But, the regulators must evolve a roadmap with a definite time-frame and clearly enunciated milestones – that include capacity building, improved governance and regulatory structures, higher disclosure norms -- to move the industry towards a greater level of sophistication, one that reduces risk but increases the returns. In addition, it goes without saying that use of derivatives should be restricted to only hedging the investment position in the cash markets.
27. Regulators should examine the possibility of allowing long-term fixed income derivatives or interest rate swaps. Today, the insurance companies are allowed to cover only one year's cash flows. The time horizon should be elongated suitably, given the liability profile of the insurance companies and pension funds. This will also benefit the interest rate futures market.
28. We have already spoken about equity derivatives. Volatility is a given in any market, the only difference being the degree of turbulence. Institutions investing the long term savings of a large number of policy-holders should be provided the opportunity to shield these investments from volatility through the instrumentality of derivatives. For instance, a high beta portfolio can easily be brought down to a lower beta through selling index futures.
29. Insurance companies can currently invest only up to 3% in a single bank's fixed deposits. The regulator concerned should reconsider raising this upper limit. While it will improve the liquidity position in banks, it will also provide a cash buffer for fund managers to meet unforeseen redemption calls or withdrawals.
30. Current IRDA investment guidelines allow investments in infrastructure only if such assets/instruments have a minimum credit rating of AA, or A+ in exceptional cases with the approval of the investment committee. Given the nature of structuring and financing of infrastructure projects in the country, there is neither any revenue stream in the initial years nor any recourse to the sponsor. This results in a low rating in the initial years. It is recommended that the minimum rating standard for infrastructure projects be relaxed substantially. Alternatively, as suggested earlier, project investors should get a wider choice of credit enhancement facilities. Today, the number of

projects that can avail of credit enhancement is limited, directly proportional to the limited number of players offering the service.

31. These guidelines further stipulate that not less than 75% of debt instruments, excluding government and other approved securities, shall have a AAA or equivalent rating. Given this condition, most of the insurance sector's infrastructure exposure gets restricted to only AAA paper, most of which are issued by public sector companies. Therefore, there is a crowding out of such investments for infrastructure projects promoted by the private sector or even in the public-private participation space. This 75% limit should, hence, be relaxed.
 32. Under the IRDA Investment Regulations and Clarifications, insurance companies can invest in debt of infrastructure companies up to a maximum of 25% of the project equity or capital employed. In real terms, this works out to only 5-8.75% of the total project cost, depending on the equity brought in by the promoters. It should also be remembered that not all equity is brought in at the same time. It is recommended that exposure of insurance companies should be linked to 15-20% total project cost.
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CHAPTER X

RECOMMENDATIONS: APPROACH & SUMMARY

The recommendations of the Committee attempt to achieve twin objectives of:

- a) Facilitating the journey of insurance companies and pension funds to delivering positive real rate returns
- b) Facilitating financing of infrastructure and other financing needs of the economy in greater measure.

In the process, the attendant benefits will hopefully be the following:

- a) Broadening and deepening of the financial markets
- b) Building capacities for credit enhancement
- c) Growth and development of insurance and pension sectors with the delivery of positive real rate returns
- d) Growth of financial savings (which are low even from emerging market standards and are declining) and thus helping higher GDP growth

These are sought to be achieved by moving to:

- a) 'Prudent Investor' regime from the current directed investment
- b) Financialisation of investment in physical assets
- c) Capacity building across the institutional framework to handle the challenges of the new 'prudent investor' regime sagaciously.
- d) Clearing the bottlenecks on the path of new 'prudent investor' regime
- e) Transitional arrangements for a smooth roll-over from the current regime to new regime.

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