National Pension System: A primer

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Launched for the general public in May 2009, National Pension System (NPS) is a national, contributory pension system now available to all citizens on a voluntary basis. NPS is a defined contribution (DC) plan, encouraging savings for retirement. In a DC plan, individual savings accounts are created for participants, and money received at the time of a participant's retirement is based on the contributions made into the account as well as the earnings of that money during a participant's working life.

NPS was originally adopted by the government of India for new central government employees (except the armed forces), and went into effect beginning 1 January 2004. Since then, most of the state governments have also moved to NPS as the default pension system for their new employees. NPS is overseen by the Pension Fund Regulatory & Development Authority (PFRDA), which was set up as the regulator for the pension sector.

As of May 7, 2013, NPS has received the amounts of money shown in Table 1.[1]

TABLE 1: NPS HOLDINGS

Employer/Sector	Number of Subscribers	Corpus under NPS (in crore)
Central Government	11,55,307	18,693
State Government	16,84,649	11,741
Private Sector	2,27,181	1,529
NPS-Lite	19,23,851	604
Total	49,90,988	32,567

This article is the first of a three-part series on NPS and is meant to provide basic information about the retirement plan scheme. The second part will contain information about NPS for corporates, with details about how a corporate (or any nongovernmental entity) can operationalize NPS. The third part will concentrate on NPS funds, returns, and performance to date.

1 PFRDA (May 7, 2013). NPS status report. Retrieved July 18, 2013, from http://pfrda.org.in/writereaddata/linkimages/NPS%20Status%20-May2013721280868.pdf.

OVERVIEW OF NPS

Eligibility

NPS is open to any applicant who is a citizen of India, whether resident or nonresident, subject to the following conditions:

- Applicants must be between 18 and 60 years of age on the date of the submission of an application.
- Applicants must comply with the Know Your Customer (KYC) norms as detailed in the Subscriber Registration Form.

Per the rules issued by PFRDA, the following applicants cannot join:

- Preexisting account holders under NPS.
- Undischarged insolvent: Individuals who are not granted an order of discharge by a court.
- Individuals of unsound mind: An individual is said to be of unsound mind for the purposes of making a contract if, at the time the contract is made, that person is incapable of understanding it and of forming a rational judgment regarding its effect upon his or her self-interest.

Accounts

The individual accounts under NPS are categorized into two types:

- Tier I pension account: All savings for retirement are contributed into this *non-withdrawal account*.
- Tier II savings account: This is an add-on account in unitised form, which is simply a voluntary savings facility. Participants are free to withdraw savings from this account whenever they wish.

The Tier I account is mandatory for participation in NPS, whereas the Tier II account is completely optional. Minimum contribution requirements for Tier I and Tier II accounts are shown in Table 2.

TABLE 2: REQUIREMENTS FOR TIER I AND TIER II NPS ACCOUNTS

Tier Accounts	Minimum Contribution Amount	Minimum Contribution Number
Tier I Account	Rs 6,000 per annum	At least one transaction per FY
Tier II Account	Rs 250 per annum	At least one transaction per FY

Fees

Fee details for the mandatory Tier I accounts are shown in Table 3.

TABLE 3: TIER I NPS ACCOUNT, FEE DETAILS

Intermediary	Charge Head	Charges	Method of deduction
Central Recordkeeping Agency (CRA)	Permanent Retirement Account (PRAN) opening	Rs.50	Through cancellation of units
	Annual maintenance cost per account	Rs.225	
	Charge per transaction	Rs.5	
Point of Presense (POP)	Initial charges	Rs.100	Collected directly from participant
	Any subsequent transactions*	Rs.20	
Custodian	Asset servicing charges	0.01%	Through NAV deduction
Pension Fund Managers (PFM) Charges	Investment management Fee	0.25%	Through NAV deduction

*These transactions include
- Regular subscriber's contribution
- Change in subscriber details
- Change of investment scheme/fund manager
- Processing of withdrawal request
- Issuance of printed account statement
- Any other subscriber services as may be prescribed by PFRDA

Benefits of Tier II accounts

Though Tier II accounts are entirely voluntary, there are many compelling reasons for considering them, including:

- There are no additional Central Recordkeeping Agency (CRA) charges for opening and maintaining a Tier II account. A charge equal to the per-transaction cost of Tier I will also be taken separately for each Tier II transaction.
- Unlimited withdrawals, with the minimum requirement being to maintain a minimum balance of Rs 2,000 at the end of the financial year.
- Separate choice of scheme preference, pension fund manager (PFM), and nomination in Tier II.
- Participants can deposit their contributions to any Point of Presence (POP) service provider as in the case of the Tier I account.
- No separate KYC needs to be submitted for opening a Tier II account. The only requirement is a preexisting Tier I account.

NPS INVESTMENT FUND OPTIONS

NPS offers two approaches to investment:

- Active choice
  - Individual funds equity (Fund E)
  - Corporate bonds (Fund C)
  - Government securities (Fund G)
- Auto choice
  - Lifecycle fund

NPS also allows participants to choose from any one of the following seven entities to manage their pension fund: [2]

- HDFC Pension Management Company Ltd
- ICICI Prudential Pension Funds Management Company Ltd
- Kotak Mahindra Pension Fund Ltd
- LIC Pension Fund Ltd
- Reliance Capital Pension Fund Ltd
- SBI Pension Funds Private Ltd
- UTI Retirement Solutions Ltd

ACTIVE CHOICE: INDIVIDUAL FUNDS

A participant has the option to decide how his or her NPS pension wealth is to be invested among the following three options:

- Fund E, High return, high risk
  - Investments are in predominantly equity market instruments.
- Fund C, Medium return, medium risk
  - Investments are in predominantly fixed-income-bearing instruments (both corporate and government securities).
- Fund G, Low return, low risk
  - Investments are in purely fixed-income instruments (only government securities).

Participants can choose to invest their entire pension wealth in C or G asset classes and up to a maximum of 50% in equity (asset class E). They can also distribute the pension wealth across E, C, and G asset classes, subject to conditions prescribed by PFRDA.

The only restriction to active participants who want to decide how their pension wealth is to be invested is that they can only choose managers from the list of managers, as appointed by the PFRDA.[3]

2 PFRDA. Pension Fund Managers. Retrieved July 18, 2013, from http://www.pfrda.org.in/indexmain.asp?linkid=183.

3 PFRDA, Pension Fund Managers, ibid.

AUTO CHOICE: LIFECYCLE FUND

NPS offers an easy option for those participants who do not have the skills to manage their NPS investments. In the event that someone is unable or unwilling to choose, the contributions will be invested in accordance with an auto-choice option. In such cases, participants will still be required to indicate their choices of PFM. If the fund manager is not specified, the form will not be accepted by the POP service provider (POP-SP).

Under this option, the investments will be made in a lifecycle fund. The percentage of funds invested in each of the three asset classes has been predefined by reference to the participant's age. At the lowest age of entry (18 years), the auto choice will place 50% of pension wealth in the E asset class, 30% in the C asset class, and 20% in the G asset class. These percentages will remain fixed for all contributions until the participant reaches age 36. From age 36 onwards, the weights in the E and C asset classes will fall annually until they reach 10% in E and 10% in C. The weight in the G asset class will correspondingly rise annually to 80% at age 55. Table 4 shows the auto choice allocation rates at each age.

WITHDRAWAL FROM NPS

If participants wish to exit from NPS, they can only withdraw a certain portion of the Tier I corpus as a lump sum. Participants are required to buy an annuity with the remaining portion from any one of the notified 'annuity service providers' (ASPs). An ASP is a life insurance company regulated by the Insurance Regulatory and Development Authority (IRDA) but notified by the PFRDA [4] for providing annuity services to NPS.

TABLE 4: AUTO CHOICE ALLOCATION RATES BY AGE

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

- If participants would like to withdraw money before attaining age 60, they will receive only 20% of their corpus as lump sum and will have to buy an annuity with the remaining 80% of the corpus.
- On withdrawal after attaining the age of 60 years, participants will be required to buy an annuity with a minimum of 40% of their pension wealth from any of the notified ASPs.
- In the event of the death of participants before an annuity is purchased, nominated beneficiaries may elect to receive 100% of the NPS account balance in a lump sum or continue to leave the balance to accumulate in NPS under their own names.
- In the event of death after the participant has exercised the annuity option, the mode and manner of future payments (if any) will depend on the type of annuity plan selected by the participant at the time of buying the annuity.

Note: The above list restrictions apply only to Tier I accounts. There are no restrictions on Tier II accounts and participants can take Tier II money out as and when they prefer.

WHAT MAKES NPS ATTRACTIVE?

NPS has a number of advantages as a vehicle for retirement funds:

1. **Market-linked returns:** One of the main features of NPS is that the funds provide market-linked returns. The funds are invested by professional investment managers and, because the money is usually invested until age 60, young participants can invest during many years of rising and falling markets and accept investment risk in the expectation of good returns. NPS allows up to a maximum of 50% of the corpus to be invested in equities. On the one hand, this is a significant portion to put at risk and gives the participant a chance of beating inflation in the long term. On the other hand, it does commit participants to a very risky strategy of putting all their wealth in risky investments which might lose their entire value.

   In order to ensure that the fund managers invest in quality assets, the PFRDA has issued investment guidelines.[5] The funds are audited annually and the managers are required to make periodical disclosures to the PFRDA.

2. **Transparency:** NPS is based on the concept of 'unbundled architecture,' which means that there is no one single entity responsible for the entire range of services. Multiple entities are responsible for the various services.[6] Because all of these activities are driven by predefined service level agreements (SLA), participants should be able to identify problem areas and take necessary steps for rectification.

4 Please visit the following link for a list of ASPs: http://pfrda.org.in/writereaddata/linkimages/Empanelment%20of%20ASP4247914128.pdf.

5 PFRDA. Investment Guidelines for Private Sector NPS. Retrieved July 18, 2013, from http://pfrda.org.in/writereaddata/linkimages/INVESTMENT%20GUIDELINES%20FOR%20PRIVATE%20SECTOR%20NPS147808164.pdf.

6 NSDL e-Governance Infrastructure Limited (2010). Entities in NPS. Central Recordkeeping Agency. Retrieved July 18, 2013, from https://www.npscra.nsdl.co.in/entities-in-nps.php..

3. **Flexible:** NPS provides participants the option to vary contributions according to their ability to contribute, provided the contributions are in accordance with NPS rules. The annual required minimum contribution is Rs 6,000.

4. **Investment choice:** NPS allows participants to select the funds where their money will be invested. This option allows a young participant to select a fund with more equity exposure, thus allowing them the chance to generate greater returns.

5. **Portable:** A significant feature of the system is the permanent retirement account number (PRAN). Every participant of NPS is issued a PRAN. The PRAN remains constant throughout the life of the participant irrespective of the fact that the participant is putting money into NPS as an individual participant or as a part of any employer's NPS offering. In other words, there is only one number to remember throughout their working lives. In turn, this means they only have to refer to one source to arrange for retirement financial security.

6. **Cost:** NPS is one of the lowest-charging pension products in the market. Globally, retirement products are often criticized regarding the extent of fees and other charges that are a 'drag' on (reduce) investment returns. NPS was developed keeping in mind these shortcomings. The current investment management fees are limited to a maximum of 0.25% of the account value.

7. **Tax benefits:** NPS has been granted certain tax benefits. Where individuals make contributions directly to the NPS, they can claim the contribution amounts as a taxable expense up to Rs 1,00,000 under Income Tax (IT) section 80C. Where individuals contribute via 'payroll deduction' through their employers, they are eligible for exemption under IT section 80 for up to 10% of their basic salaries. This is over and above the limit under section 80C, specified in newly introduced IT section 80CCD(2).

NPS is not a product without disadvantages:

1. **Lack of flexibility to suspend payments:** In the event someone is unable to meet the minimum contributions of Rs 6,000 per annum and therefore ceases contributing, the account is suspended. Contributions may recommence but only after a suspension fee is paid, equal to Rs 100 for each year where the annual contribution was not made.

2. **Costs:** The problem of having low fees is that very few people are actively trying to sell NPS. This is hampering a competitive market.

3. **Investment risk:** Because NPS is a DC-based system, the risks and rewards of investing are borne by the participants. NPS expects the participants to understand the basic concepts of finance. In general, however, most participants are novices or have little investment experience. It is expected that participants will make decisions that will have implications long after their working lives have ended. This is daunting and places great responsibilities on those involved in regulating the system and offering services within the system.

4. **Mandatory annuitization:** NPS stipulates that for withdrawals after the age of 60, only 40% of the corpus may be paid as lump sum and an annuity must be purchased with the remaining 60% of the funds. In the case of premature withdrawal before the age of 60, the lump-sum withdrawal ratio falls to 20% with the remaining 80% used to buy an annuity. The current income tax rules specify that any income received as an annuity is taxable. However, competing products such as the Public Provident Fund (PPF) and the Employee Provident Fund (EPF) and various pension schemes offered by insurance companies provide lump-sum withdrawals and therefore do not suffer from this taxation penalty.

5. **Retirement age:** NPS does not permit withdrawal before the age of 60 other than in exceptional circumstances. An unintended side effect of this rule is that, even if participants take early retirement, they can only withdraw 20% of their corpus as lump sums. The remainder is annuitized. Those individuals anticipating early retirement, or those who are unsure when they will retire, will see this as a significant inflexibility of the system and may be reluctant to participate in the first place.

NPS is a product ready for an individual who is open to long-term investing. With more than 60% of India's population under the age of 25, NPS could form the primary retirement funding vehicle. It is a low-cost, flexible instrument with returns linked to market returns. With inflation currently approaching 10% per annum, NPS provides the opportunity to achieve real positive returns, i.e., higher than inflation.

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