Subject Code: **03**

Subject Group : **C**

Convergence of Financial Services - Its Impact on Pensions and Pension Reforms

By S.P.Subhedar

Sr.Advisor, Prudential Corporation Asia

(Views expressed in the paper are strictly those of the author)

1. Background

1.1 Till a few years back, we were accustomed to keep our deposits at a bank, purchase insurance from an insurance company, take mortgage loan from consumer finance company and buy shares / bonds from a securities broker. However, technology, capital market innovations and globalization have irreversibly changed all this. The technology driven growth of new financial products that enabled the unbundling of risks has created new financial instruments that increasingly combine the characteristics of different financial products and services. These changes, which are occurring all over the world, have also dramatically altered the way financial services providers operate and the way they market and deliver their products.

1.2 The demand for, and the need to, offer full range of financial products to customers has resulted in various forms of associations between different financial services entities. In some cases, the proliferation of financial products offered under one legal entity, has led some financial entities to focus only on their core competencies. Financial services customers have generally been the beneficiaries of the global innovations by gaining access to greater product selection, better services, better convenience, and many times, at lower costs.

1.3 A number of financial entities act as true financial supermarkets, offering a very broad range of products. Due to deregulation, financial institutions are allowed more and more to offer complimentary or competing products, that were originally the closed privilege of neighboring financial sectors. This has led to blurring of the boundaries between the different sub-sectors of the financial system and to the formation of financial conglomerates.

1.4 “Financial convergence” can be construed to be a general term relating to all types of interfaces between financial suppliers and demand of all types of financial products and services. Where the interface is of an institutional nature, it could be termed as “financial conglomerate”. It is a group of enterprises that is formed by different types of financial institutions.

2. **Indian Scenario**

2.1 These changes have influenced the financial services sector in India as well. Since early nineties, when the financial sector reforms were initiated in India, we have witnessed considerable changes in our financial markets. While many major commercial banking and specialized institutions continue to be in the public sector, private sector institutions have been growing rapidly in commercial banking, housing finance and asset management business. The opening up of insurance sector in the year 2000 has led to the private sector having significant presence in the insurance sector.

2.2 The development finance institutions, realizing that the days of development finance were getting over, have long before entered other areas of financial services such as commercial banking, asset management, housing finance and other consumer finance, insurance, both life and general, and securities broking though separate entities.

2.3 The last about fifteen years have seen major improvements in the working of various financial market participants. The entry of foreign entities has facilitated introduction of international practices and systems. This, and technology developments, have significantly improved customer service. Overall, the cumulative effect of the developments since early nineties has been quite encouraging.

2.4 All this is leading to convergence in the financial services sector, the new buzzword. The need to meet increased consumer expectations and developments in technology is encouraging convergence. In India, many financial services groups are trying to offer various financial services to the consumers under one umbrella. Most financial services groups have banking, insurance, asset management, consumer finance and broking entities.

3. **Defining 'Pension'**

3.1 In the context of these developments in regard to convergence of financial services, this paper attempts to analyze as to how this has impacted pension sector and reforms in the pension sector.

3.2 Before this, it is necessary to outline at this stage as to what constitutes 'pension' and later in the paper outline what constitutes 'pension reforms'. Currently, any vehicle that builds up assets for old age income is termed as 'pension'. In fact, globally, the regulations of some major pension arrangements do not provide for annuitization. Even the PFRDA Bill, 2005, Chapter III, 'Extent and Application' , provisions are in keeping with this development as it has specified that, when enacted, the PFRDA Act shall apply to the New Pension System (NPS) and any other pension scheme not regulated by any other enactment and shall not, inter alia, apply to the schemes or funds under Employee Provident Fund and Misc. Provisions Act, Coal Mines PF and Misc. Provisions Act, Seamen's PF Act, Assam Tea Plantations Provident Fund and Pension Fund Scheme Act and J & K EPF Act.

4. **Changing Environment**

4.1 Reforming of the pension system would generally mean that the inadequacies in the existing system are removed and sustainable new pension system is introduced. The changed demographic and economic environment has made defined benefit pensions highly onerous from the provider perspective and globally defined benefit pensions are on decline. Low interest rate regime is only one of the number of causes of decline in defined benefit pension. Initially, defined benefit pensions were related to career average salary, a relatively less onerous proposition. Defined benefit pensions, and in particular final salary pensions, emerged between 1950s and 1970s when economic environment was relatively stable and estimates of life expectancy were much lower than today, and when uncertainties in life expectancy were not well understood. Another not very widely known feature is that, in many jurisdictions, the trustees, even in defined benefit pension, had discretion to vary benefits in line with fund performance. This was removed some time in 1980s. In some countries, exceptionally high market returns made the increase in cost and risk in defined benefit pension appear acceptable. But across the globe, shift from defined benefit to defined contribution, where possible, is sought as the providers have realized the risks involved in running defined benefit pensions. The situation in India is no different. In fact longevity in India is increasing at much higher rate than that in developed countries. Over the last ten years, the expectation of life at age 60 in India has increased by three years whereas in the UK during the corresponding period it has increased by two years. The economic environment in India is also reflecting global changes.

4.2 The changing demographic and economic environment are driving the governments around the world to initiate reforms in their pension system and move away from the pensions based on intergenerational transfers. It may be mentioned here that these reforms are structured around defined contribution fully funded individual retirement account pension, on the lines of Chilean model, with focus on self financing of pensions and fund management entrusted to private sector fund managers.

5. **Pension Providers**

5.1 Currently, pension products are offered by life insurers, asset management companies, banks, pension fund managers and maybe other financial services providers. In India, the exclusive pension fund managers are not yet in the business. These suppliers meet the demand for pension products. Pension fund trusts could also be considered as dedicated pension fund managers. It will be seen that all these entities essentially function as fund managers, managing all pension money, i.e. provident fund money and both defined benefit and defined contribution pension money. The pension fund trusts also essentially only manage pension money as the responsibility for payment of benefit is on the settlers of the trust. All these suppliers primarily offer the same basic product with some variation in its features. With ever increasing longevity, life insurers are trying to transfer / share the longevity risk during pension pay out phase to/with the pensioners and in this context the other entities like asset management companies are seeking to provide pension pay out products that do not cover longevity risk.

6. Stakeholders in Pension Arrangements

6.1 The different stakeholders in the pension arrangements are: the providers, the intermediaries, the consumers and the regulator. Convergence of financial services and its impact on pension sector and reforms in pension system are analyzed here from the perspective of these different stakeholders.

7. Provider Perspective

7.1 The way pension is currently understood, the pension products are offered by life insurers, pension fund managers, banks, asset management companies and maybe other financial services entities as well. Life insurers when they manage retail and bulk pension money, look for offering pay out products as also life insurance cover. Banks cannot look beyond managing pension money except that the relationships built up in the process do provide opportunities for other product offerings. Asset management companies, in addition to managing retail pension money, can and do offer structured pension pay out products without providing protection against longevity. Pension trusts manage the pension money and some of them also manage the pension pay out but they cannot look beyond this. The exclusive pension fund managers, because of regulatory constraints, would also not look beyond managing pension money.

7.2 While in India, the PFRDA has as yet not spelt out the structure of the pension fund manager, in other jurisdictions banks, life insurers, fund management entities can offer pension product from their existing set up, with or without the Chinese wall separating this business from their other businesses. In this context, the providers look for level playing field amongst the market participants in terms of capital requirement. When the consultation papers on the architecture of the stakeholder pension released by the UK government came up for public debate, the plea for level playing field in terms of capital requirements for different entities wanting to offer this pension product was debated. The provisions of the UK Financial Services and Markets Act, 2000, require "……authorized persons to have adequate capital for the regulated activities they wish to carry on, or are carrying on. Applicant firms will be required to maintain the minimum level of capital as determined by the category of firm into which they fall'. This level of capital is the minimum that must be maintained at all times. In determining whether the firm will be in a position to meet this requirement, the authorities will take into account any losses shown in the applicant's budgeted projections and will wish to be satisfied that the entity will have sufficient capital to offset these losses. The effect of this will be to increase the amount of initial capital required, even though the minimum financial resource requirement will remain unchanged. The authorities require the entities to meet the minimum financial resource requirement and to provide for the following three year's projected losses. The entities are also required to explain fully, how they intend to meet the minimum financial resource requirement beyond three years, if they have budgeted for projected losses after that date. The entities are therefore required to review their capital positions at quarterly intervals, to review their budget forecast for the following three year period, and to inject sufficient additional capital to meet minimum financial resource requirement, including the projected losses beyond that period. Life insurers transacting stakeholder pension were required to have minimum capital requirement for a life insurer with solvency margin of 1 percent of the assets of stakeholder pension under management; life insurance regulations requiring provision of 1 percent of assets of unit linked business if there were no guarantees and 2 percent of assets of unit linked business if there were guarantees in solvency margin requirement A fund management entity transacting the stakeholder pension was required to have minimum capital a fund management entity would need plus three years' expense overrun. These entities were required to review their budget forecast for the following three year period in the manner mentioned above to assess their capital requirement at quarterly intervals. Banks and building societies are subject to minimum solvency ratio. In addition, they are required to meet target / threshold ratios, calculated in accordance with the regulatory risks assessment of the business they are undertaking or proposed to undertake. In its response document, the Financial Services Authority (FSA) has said that "Financial groups will often have life companies and fund management companies within the group, so they will, to an extent, be able to choose which vehicle to use." to offer stakeholder pension.

7.3 Having said that, it may be mentioned here that differing capital requirement would have influence on pricing, i.e. expense structure, and while the level playing field in terms of capital requirement would give fair deal to the customers, it is difficult to achieve that in practice and is generally not available. The financial conglomerates which want to offer the pension product could choose one of their entities to offer the product that suits them best.

7.4 As per the newspaper reports, because of political compulsions the Government of India has not been able to evolve consensus on the PFRDA Bill and the Bill was reported to have been withdrawn from the agenda of the winter session of the Parliament ended on 23rd December 2006. It is expected that through an executive order the government would appoint pension fund managers set up by the Life Insurance Corporation of India, Unit Trust of India, State Bank of India and maybe some other public sector bank to offer the New Pension Scheme (NPS), a defined contribution pension, to the Central Government employees and employees of sixteen State Governments who have joined service on and after 1st January 2004. Thus a life insurer, an asset management company and a bank would be offering the same product to these government employees, thus demonstrating that there is an accelerated transformation of the financial services industry towards product-based competition (e.g. different types of entities offering similar financial products), rather than competition within traditional industry segments.

8. Intermediary Perspective

8.1 Pension is essentially an investment product and lower the distribution cost better would be the returns to the subscribers. It is in this context that most pension products on offer provide very modest intermediary incentive. The providers of the stakeholder pension in the UK which had a statutory expense ceiling of 1 percent of assets under management (AUM) , and which has now been raised to 1.5 percent of AUM, offer very meager intermediary incentive. In fact, some of the stakeholder pension providers do not offer any incentive to the Independent Financial Advisors (IFAs) who distribute their pension products and even the IFAs do not mind that in the expectation that their clients would engage them for advice. While this may not be possible in other jurisdictions, institutional intermediaries like banks find it advantageous to distribute these products at low cost, with envisaged high volumes, to increase their fee based income when they find it difficult to enter pension product manufacturing because of capital constraint. By acting as agent or broker for the pension products, banks could increase their fee based income and enlarge their service assortment with these products. This gathered strength because of the complimentary nature of banking and pension products. Further, the banks can reduce their search costs for their clients, if they wish to extend the range of financial products purchased.

8.2 Because of growth in prosperity and the expectation of higher standard of living during old age, the disposable income for pension savings increased, creating a growing emphasis on long- term, better-yield financial savings. This partly explains the success of alternative investment vehicles such as insurance and pension products funded on unit linked basis, and also investment in mutual funds. From the year 2000, with the stock market boom and increased salary levels, the situation is no different in India as well. This evolution shows the link between the financial convergence on the one hand and the converging trends with the pension market on the other hand.

8.3 If the offering of NPS remains confined to the government employees, distribution of pension may not be a problem as the Pay and Accounts offices of the government would, perhaps be directly placing this business with the public sector pension fund managers, viz. LIC, UTI, SBI and other public sector bank/s. However, when the NPS would provide universal access, distribution would pose a big challenge. Maybe, bancassurance channel could provide a solution.

9. **Consumer Perspective**

9.1 The financial convergence inevitably has a profound impact on both financial services providers and on consumers. This has led to increased competition, increased efficiency and lower costs. With blurting of boundaries and offering of similar pension products by different providers like life insurers, banks, pension fund managers and fund management entities, the consumers can look for the best deal in the market place. The product based competition amongst the different providers thus ensures better deal to the consumers in terms of efficiency and lower costs and appropriate information disclosure for decision making.

10. **Regulator Perspective**

10.1 In this environment of convergence of financial services, there is a need to establish a regulatory framework that aims at maintaining a strong and stable financial system that meets the needs of the constituents. Such framework has to focus on three areas, viz.:

- consumer protection, which sets out the rules that protect the consumers;
- competition regulation, which ensures that providers of financial services observe proper market conduct; and
- prudential regulation, which ensures that financial services providers operate in a sound manner.

10.2 In markets where the different types of entities like banks, life insurers, fund managers offer this type of defined contribution pension, there has to be great co-operation, co-ordination and exchange of information amongst the regulators of these entities. In the UK, there exists the Financial Services Authority (FSA) and the Pensions Regulator. The FSA and Pensions Regulator have a significant number of similar regulatory responsibilities under the Financial Services and Markets Act (FSMA), the Pensions Act and other legislation. These responsibilities complement each other as they mostly extend to different activities and objectives.

10.3 Both the FSA and the Pensions Regulator have responsibilities in the pensions area. The FSA's responsibilities include regulation of advice on, and the sale and marketing of, investments such as personal, including stakeholder, pensions and the prudential regulation of pension providers such as insurance companies and friendly societies. The Pension Regulator regulates work-based pension schemes, i.e. occupational pensions. It has focus mainly on employers, scheme trustees and managers and their advisers. There will be some areas of common interest with the FSA in relation to occupational pensions.

10.4 The FSA and Pensions Regulator are envisaged to co-operate in a timely way in the regulation of occupational and personal, including stakeholder, pension schemes. In particular, the FSA and the Pension Regulator are envisaged to seek to ensure that time is allowed for a proper exchange of views.

10.5 In this context, the two regulators have an MoU for co-operation, co-ordination and exchange of information in carrying out their respective responsibilities for the regulation of occupational and personal, including stakeholder, pension schemes.

10.6 As mentioned earlier, the capital requirement for different pension providers like life insurers, banks and fund management entities managing pension money are different. Pension providers will be required to maintain the minimum level of capital as determined by the category of firms into which they fall, like banks, life insurance, etc. and such additional amount as would be required as per the relevant regulations for the provider business plan.

10.7 Difference in regulation and supervision of these entities could cause competitive advantage or disadvantage to some of these entities. Different capital requirement would get reflected in charging structures and different prescribed investment patterns would get reflected in the returns to the subscribers.

11. **401 (k) Plans Offered in the USA**

11.1 Employees in the US have the option of participating in a 401(k) plan, which allows them to contribute part of their salary to a tax-sheltered plan. These plans were first permitted under federal tax law in 1980. Participation in 401(k) plans has grown steadily from 62 per cent of all US employees in 1985 to well beyond 80 per cent now. The emergence of 401(k) plans has resulted in welcome additional funds for financial services providers. However, it is the mutual fund companies that are dominating the business, rather than traditional life insurers, who might have expected to be the main beneficiaries because of their expertise with long term savings products. Mutual fund companies' share of 401 (k) assets under management has been growing steadily at the expense of life insurance companies and banks. The distribution of 401 (k) assets by provider type were: mutual funds - around 42 percent, life insurers – around 22 percent; banks – around 21 percent; and balance – other entities.

12. **Pension Reforms**

12.1 Ever increasing longevity is driving the governments around the world to move away from the pension based on intergenerational transfers to one based on self-financed pension. These reforms initiatives, drawing on Chilean model, are structured around defined contribution fully funded individual account pension and are offered by life insurers, banks, pension fund managers, mutual funds and maybe other financial institutions. Many financial services groups offer all services , viz. contribution collection, record-keeping, fund management and pay out through their group companies. Convergence of financial services and evolution of financial conglomerates are greatly helping pension reforms.

12.2 The reforms in pension system must lead to:

- reduction in unfunded pension liability
- reduction in underfunded pension liability
- increased pension coverage
- better return and better service to the subscribers

It may be mentioned here that pension reforms is a process and not an event. Following the global trend, the Government of India has already initiated the reforms process. The government employees, who have joined service on or after 1st January 2004 have been moved to the defined contribution individual account pension on the lines of the scheme recommended by the Old Age Social and Income Security (OASIS) Committee. This would arrest the growth in unfunded pension liability. The government has also advised the public sector units, who have pension schemes financed by employer's contribution provident fund, and which are unsustainable, to move their new employees to defined contribution individual retirement account pension. This would limit the underfunded pension liability.

12.3 Life insurers are currently offering pension products in a big way and a few mutual funds also offer pension products. If these entities offer simple pension products the way New Pension System is seeking to offer, with parity in tax treatment, the pension coverage would substantially increase. Unit Trust of India, (UTI) has started offering micro-pension to the section of population with modest means and this would extend pension coverage to those who need it most. UTI Retirement Benefit Pension Fund is an open ended pension plan and this has been notified by the Central Government as a Pension Fund eligible under sub-section (2), clause (xiv) of section 80C of the Income Tax Act, 1961 for tax benefits for the assessment year 2006-07 and subsequent assessment years. These entities have extensive distribution network with sufficient reach and that should facilitate increased pension coverage. The government is contemplating increasing the number of industries covered by EPF beyond 181 currently covered and also reducing the minimum number for mandatory coverage from 20 to 10. These measures would increase pension coverage.

12.4 As regards better returns and better service to the subscribers, life insurers and mutual funds do provide good returns and good service to the subscribers. The various measures have been initiated by the EPFO for improving subscriber service and this should help the subscribers. If some political consensus is reached on revising the investment pattern of EPF and other pension money it would facilitate the process of providing better returns to the subscribers.

12.5 All these processes are greatly facilitated by different financial services providers offering products required.

12.6 These initiatives would get consolidated and strengthened when the government is able to push through the PFRDA Bill and set up the PFRDA by an Act of Parliament. Current thinking, because of political compulsions, is to set up, up to three, pension fund managers and a central record-keeping agency by an executive order for covering the new Central Government employees and new employees of sixteen State Government who have decided to opt for NPS.

13. **Summing up**

13.1 It will be seen that entities from different sub-groups of financial services sector are offering similar services required by pension sector and this convergence of financial services is greatly helping pension sector. Reforms initiatives in the pension sector are structured around defined contribution individual retirement account pension and these pension products are offered by life insurers, banks, pension fund managers, mutual funds and maybe other financial institutions. Further, all the financial services groups provide all the components of services that are needed by pension sector. This amply demonstrates as to how the convergence of financial services has influenced pension sector and reforms initiatives in the pension sector.

References:

- Turner Talks - Interview with Lord Turner, Chairman of the Pensions Commission, the UK, - March 2006 issue of The ACTUARY published by the Staple Inn Actuarial Society.

- The regulation of stakeholder pension - a response document of the Financial Services Authority, the UK (Incorporating a consultation on behalf of the Personal Investment Authority, the Investment Management Regulatory Organization and the Securities and Futures Authority) – August 2000.

- Convergence in the Financial Services Industry by Prof. dr. L.A.A. Van den Berghe, Dr. K. Verweire and S.W.M. Carehon

S. P. Subhedar

Subhedar is an Actuary and after forty years with Life Insurance Corporation of India, retired as its Managing Director in October 1995.

He was the President of the Actuarial Society of India (ASI) from 1995 to 1997 and the President of the Insurance Institute of India from 1993-95.

In November 1995, he joined Prudential Corporation Asia Ltd., Hongkong, as Sr. Advisor based in Mumbai. He was associated with setting up of Prudential ICICI MF and ICICI Prudential Life Ins. Co Ltd. He was an alternate Director on the board of ICICI Prudential Life Ins. Co. and was a Director of Prudential ICICI Trust Co. Ltd. He is a Director of Prudential Process Management Services (India) Pvt. Ltd.

During the process of insurance sector liberalization, he was associated with many ASI Committees that worked with the IRDA, chaired the ASI's Insurance Law Review Committee set up in 2003 and was a member of KPN Committee constituted by the IRDA for Insurance Law review in 2005. He was a Member of the first IRDA Advisory Committee and is a member of CII Insurance and Pensions Committee and FICCI Insurance and Pensions Committee. He is a visiting Faculty at the National Insurance Academy and Indian Institute of Capital Markets.

He has presented papers on pension reforms and associated subjects at conferences in India and abroad.