Report of the Working Group on Insurance, Pensions and Small Savings

Financial Sector Legislative Reforms Commission

Contents

1. Overview

Vide Order No. 3/2/2011 - FSLRC dated 26 July, 2011, the Financial Sector Legislative Reforms Commission (FSLRC) constituted a working group on insurance, pensions, provident funds and small savings, consisting of:

1. Mr. Dhirendra Swarup - Chairperson
2. Mr. C. S. Rao - Senior Advisor
3. Mr. Tarun Bajaj
4. Ms. Anuradha Prasad
5. Mr. Rajendra Chitale

The mandate of the working group was to examine the current legislative and policy framework in the fields of insurance, pensions, provident funds and small savings, identify the major limitations in this framework and suggest necessary changes.

The working group undertook a review of existing laws, recommendations made by previous expert committee reports and international best practices and in each of the areas under its consideration. Extensive consultations were also carried out with government and private stakeholders, through written consultations as well as in-person meetings.

The working group is pleased to submit this report to the FSLRC. The report consists of three main sections:

1. Insurance
2. Retirement financing (pensions and provident funds)
3. Small savings

Each section contains a discussion on the relevant issues identified in that area followed by the recommendations of the working group. A summary of the recommendations is contained in the executive summary of the report for ease of reference.

2. Executive summary

This annexure contains a summary of the recommendations being made by the working group on insurance, retirement financing and small savings.

2.1 Insurance

2.1.1 Development goals

1. **Role of insurance regulator** - The goal of the insurance regulator should be to ensure the protection of policyholder interests and, with that objective in mind, to see that insurance companies are managed and operated in a sound manner. However, at present the regulator is also cast with the duty to promote insurance business, which could conflict with the regulator's primary goals of consumer protection and prudential regulation.

   Recommendation 1: The development of insurance markets should not be a regulatory objective. Market forces should ordinarily be able to achieve an adequate level of development in the sector. Towards his end, the law should specify that the need for pursuing competitive neutrality and fair competition should be basic principles to be followed by the regulator.

2. **Financial inclusion** - Relying entirely on economic forces may not always be sufficient to attain the required pace of growth in certain segments, such as the micro insurance segment, which caters to the needs to small consumers. This justifies the need for the legal framework to allow specific interventions in order to achieve the financial inclusion agenda. Powers in this regard may be conferred upon the insurance regulator, directly upon the government or upon a separate authority set up specifically for this purpose.

   Recommendation 2: General development of markets has to be distinguished from specific measures that need to be taken to achieve the financial inclusion agenda. The mechanisms for achieving financial inclusion in the field of insurance should be aligned with the decisions that FSLRC may take for promoting inclusion in the banking sector.

2.1.2 Prudential regulation

1. **Risk based capital requirements** - Solvency requirements stipulated under the Insurance Act, 1938 adopt a one size fits all formula which fails to relate capital requirements to the specific risks faced by insurance companies. The risk based capital approach addresses this issue by taking into account the different types of risks faced by an insurance company - underwriting risks, investment risks, operational risks - as well as the risk mitigation strategies adopted by it.

   Recommendation 3:

   (1) *The capital resources maintained by insurance companies should be commensurate with the specific risks arising from their business activities. To achieve this, the primary law should provide that the prescribed capital requirements should be determined in a risk-based manner. Subject to this principle, the regulator will frame subordinate legislations to lay down the actual capital requirements and the process for computation of capital.*

   (2) *The regulator should also be permitted to prescribe the minimum capital requirement for the setting up of an insurance company, instead of having the rupees 100 crores requirement laid down in the primary law. This will allow the entry conditions to be revised from time to time without requiring an amendment to the law.*

2. **Tiers of capital** - Insurance companies should be permitted to hold different tiers of capital for their internal capital management purposes. To the extent that the quality of capital of the insurer and its availability need to be ensured from a prudential regulation perspective, the law should empower the regulator to specify the extent to which the different tiers of capital would be taken into account for meeting regulatory capital requirements.

   Recommendation 4: The law should provide that insurance companies are permitted to hold different classes of capital. The classification of capital into different tiers will be done by the regulator through subordinated legislation. The regulator will also be empowered to restrict the extent to which insurers may rely on different tiers of capital for satisfying their capital requirements.

3. **Foreign direct investment limit** - Insurance is the only sector where the foreign direct investment (FDI) is specified in the primary legislation. As a result, any change to the investment limit is possible only through an amendment to the legislation. The working group is of the view that aspects relating to foreign investment limits should

not be a subject matter of the insurance law.

Recommendation 5: Insurance law should not specify foreign investment limits for investments in the sector. As in all other sectors, this power should be with the Central Government. In making its determination, the government may consider adopting different FDI limits for different types of insurance activities. In particular, a higher limit may be considered for the health insurance sector to promote more robust growth in the sector.

4. **Corporate governance and risk management** - One of the core objectives of insurance regulation is to ensure that insurers follow a corporate governance framework that allows for prudent management and oversight of the business. This entails ensuring that the directors and key management personnel of the insurer are fit and proper and the insurer has appropriate systems and controls in place - relating to risk management, actuarial compliance, asset liability management, internal audit, etc.

   Recommendation 6: High-level principles relating to sound governance and management of insurance firms need to be enshrined in the law. The law should also mandate self-assessment of solvency and risk profile by insurers. The regulator should then use its supervisory powers to assess the adequacy and effectiveness of the measures adopted by the insurance company.

5. **Investment norms** - The Insurance Act contains quantitative investment norms that set out the manner in which investments are to be made by insurance companies. This is prejudicial to the interests of policy holders as it restricts insurance funds from being invested in the most prudent manner. With the move towards a risk based capital regime, it is logical that the investment philosophy should also move towards the adoption of the prudent person principles. Under this approach, an insurer would be free to invest in any manner that it deems prudent provided that it holds proportionate capital to meet the specific risks emanating from its investments.

   Recommendation 7: The law should specify that investments are to be made as per the prudent person principle and quantitative investment requirements and restrictions should be removed from the primary law. To the extent necessary, the regulator should be empowered to specify appropriate investment norms through subordinate legislation. This power would be subject to certain restrictions to be specified under the law. Specifically, the regulator will not be able to prescribe the composition of the investment portfolio or the minimum levels of investment for any given category of investment.

6. **Global diversification** - The Insurance Act contains a specific prohibition on the investment of the funds of policyholders outside the country. This policy of confining insurance investments to domestic markets subjects insurers to diversifiable risks arising from asymmetric shocks to the domestic economy. It also deprives them of the flexibility to take exposure to globally well managed companies.

   Recommendation 8: The law should not prohibit insurance companies from investing overseas. Insurers may choose to globally diversify their portfolio in accordance with the prudent person principle and risk-based capital requirements. The regulator may, however, choose to set out reasonable limits on the currency mismatch risks that may be held by an insurer.

2.1.3 Consumer protection

1. **Conduct of business** - Market failures in the nature of uneven bargaining power and asymmetry of information create a need for consumer protection regulation in the field of insurance. The protections that need to be provided to insurance consumers include, protection from misleading and deceptive practices, insurer's duty to assess the suitability of the insurance product for the needs of the consumer, fair treatment of policyholders and right to appropriate redressal mechanisms.

   Recommendation 9: The law should set out the principles of consumer protection to be observed by the insurance service providers and the framework within which these principles may be implemented by the regulator.

2. **Distribution structures** - The legal framework should ensure that only persons who have the necessary qualifications and certifications would be permitted to sell insurance services to consumers.

   Recommendation 10: All individuals, who may be individual agents or employees of corporate agents, brokers, advisers, banks and insurance companies, who are involved in the sale of insurance services to consumers must be registered with the regulator. This registration process will be based on certain objective criteria, such as minimum qualifications, training and certification requirements, which will be prescribed by the regulator. The responsibility of verifying the individual's compliance with the specified requirements should be left to the insurance company, in respect of its employees and agents. In case of independent advisors and brokers, who are not aligned with any *particular insurer, the relevant service provider would be responsible for the registration of its employees.*

3. **Remuneration structures** - The limits on commissions payable to insurance agents are set out under the Insurance Act, which are very high, particularly in the initial years. This leads to problems of miselling, excessive churning and conflicts of interest. Over time, insurance markets will evolve to a state where more and more insurance consumers will prefer to opt for fee based advisory services. The legal framework should encourage this transition to take place without requiring any amendments to the primary legislation. It is therefore important that the law should not mention details of remuneration payable for sale of insurance either as commissions or fees.

   Recommendation 11: No minimum or maximum cap on commission or fee should be mentioned in the primary legislation. The law should allow the regulator to prescribe incentive structures for the sale of insurance services, keeping in view consumer interests.

4. **Lapsation of policies** - Lapsation of an insurance policy occurs when a policyholder discontinues paying premium on the policy. The high upfront commission model as well as attrition of agents contribute to high lapsation rates. The legal framework should adopt measures to minimise instances of lapsation.

   Recommendation 12: In case a policy lapses due to the non payment of premium, there should be an obligation placed on the insurer to issue a notice to the policyholder. However, these details need not be specified in the primary law. The primary law should only provide that the regulator may frame specific regulations for dealing with the lapsation on insurance policies, with a view to protecting policyholders.

5. **Grievance redressal** - The present scope of the insurance ombudsman's powers is limited - it covers disputes between the insured and insurance company on matters related to claims. The system is also designed in a manner that the award of the ombudsman is binding only on the insurer and no appeal is available against the award. There is a need to strengthen the grievance redressal system, both in terms of scope and powers.

   Recommendation 13: The scope of the present insurance ombudsman system needs to be expanded to allow complaints against insurance intermediaries, other than agents of the insurance company for whom the insurer will be directly liable. The ombudsman awards should be made enforceable against the complainant as well as the service provider, subject to the right to appeal before a specialised appellate forum.

6. **Insurance Fraud** - Insurance fraud causes detriment to the interests of policyholders as it increases their cost of insurance. To deal with this, the legal framework should clearly set out the manner for dealing with cases of fraud.

   Recommendation 14: The law should specify the duty of parties to an insurance contract to act in good faith. It should also set out the meaning and consequences of insurance fraud.

7. **Information database** - Insurance companies need access to reliable insurance data in order to be able to make accurate pricing and underwriting decisions. The availability of macro level data on insurance policies, claims and trends can also serve as a tool for public policy reform and analysis. It will also inform the viewpoint of new firms coming into the insurance business.

   Exchange of information on information frauds can also serve as a useful tool for the protection of insurers and their consumers. For these reasons, it is important to permit the sharing of data and information between insurance companies, subject to reasonable restrictions.

   Recommendation 15: The collection and sharing of insurance information can help insurers make better pricing and underwriting decisions. It can also help insurers combat instances of insurance fraud. The law should enable the sharing of insurance information while specifically providing the data protection and confidentiality requirements applicable to any person, including the regulator, that holds information belonging to others.

8. **Micro insurance** - In order to promote better access to insurance services, the regulator should have the flexibility to make variations to the general regulatory framework to take into account the specific requirements of the micro insurance sector. For instance, the regulator should be able to make specific provisions on eligibility criteria for micro insurance agents and remuneration structures for the sale of micro insurance.

   Recommendation 16: The primary legislation must empower the regulator to act in a manner that promotes better access to micro insurance. This should be done by stating that 'promoting innovation and access to insurance services' is one of the key principles to be followed by the regulator.

9. **Health insurance** - The health insurance sector faces specific moral hazard problems, which are reflected in the data that shows that hospitalisation rates and medical expenses are significantly higher for persons covered under health insurance schemes. The unregulated

environment in which the health care industry functions makes it a big challenge for health insurers to carry out proper underwriting and actuarial premium setting. This leads to higher costs for the insurer, which ultimately translates into higher premiums.

Recommendation 17: There is a need for reforms in the heath care sector to provide for the codification of ailments, procedures and protocols followed by health providers. This will help in promoting better underwriting by insurance companies by reducing the moral hazard problems in the supply of health care services to insured persons.

10. Motor insurance - The present law requires every vehicle owner to obtain mandatory third party motor insurance and the regulator prescribes the premium rates to be charged by insurers for different categories of vehicles. Fixed premium rates coupled with high claims ratios and unpredictable compensation awards have created significant problems for the viability of general insurance companies. At the same time, accident victims continue to face the problems of significant delays and inconvenience in obtaining compensation from insurance companies.

Recommendation 18:

(1) *In order to minimise inconvenience and costs, the law should provide the accident victim, insurer and insured an opportunity to arrive at a voluntary settlement of the claim without having to go through the adjudication process. If the parties fail to arrive at a settlement, the compensation should be decided on a fast track basis by a specialised tribunal.*

(2) *The law should lay down the minimum amount of insurance coverage that must be obtained by every vehicle owner. This will ensure that accident victims are assured of receiving compensation of up to the insured amount. It will also provide insurers with more certainty on their potential liabilities. In order to achieve this, the regulator will have to discontinue the practice of fixing the premium for third party motor insurance policies.*

11. Role of surveyors - The role of an insurance surveyor is to evaluate claims made by insured persons and assess whether the claim is payable. The present legal framework gives the insurance regulator the power to license and cancel the license of surveyors with very limited powers being given to the Indian Institute of Insurance Surveyors and Loss Assessors.

Recommendation 19:

(1) *The Indian Institute of Insurance Surveyors and Loss Assessors*

should be given statutory recognition as a professional body responsible for the licensing and supervision of surveyors and loss assessors.

(2) *In order to protect the interests of consumers, the legal framework should allow the consumer to appoint a surveyor in addition to the surveyor required to be appointed by the insurer. The insurer will be required to consider both reports before making a decision on the claim.*

12. **Assignment of policies** - The Insurance Laws (Amendment) Bill, 2008 proposes to grant the insurer the power to refuse an assignment of an insurance policy if it finds that the assignment is not bona fide or not in the interest of the policyholder or the public. This restricts the freedom of policyholders and subjects them to the discretion of insurers.

    Recommendation 20: The law should empower the regulator to specify the types of permitted and restricted assignments of insurance policies. The insurer will not have the discretion to refuse to record an assignment that is made in accordance with the regulations.

2.1.4 Competition issues

1. **Status of LIC** - The LIC Act conferrs certain privileges upon LIC, which continue to remain in the rulebook despite the subsequent liberalisation of the insurance sector. These provisions create an uneven playing field in the market by giving Life Insurance Corporation of India (LIC) an advantageous position over other insurance businesses.

    Recommendation 21: The legal framework governing LIC should be at par with the laws applicable to all other life insurance companies. In particular, there should be no sovereign guarantee for the policies of LIC. The status of LIC should be changed from a statutory corporation to a Government company governed under standard company law provisions.

2. **Competition in reinsurance sector** - The present legal framework contains a mandatory requirement to cede a minimum percentage of business to GIC and imposes limits on foreign reinsurance arrangements. This has the effect of hindering competition in the reinsurance business and at the same time causing excessive risk to be retained within the country.

    Recommendation 22: There is a need for encouraging competition in the reinsurance sector by adopting the following measures:

(1) do away with the mandatory requirement placed upon general insurance companies to reinsure a portion of their business with GIC;

(2) remove barriers which prevent Indian insurance companies from doing business with global reinsurers, subject only to prudential regulation requirements; and

(3) create an enabling framework for the entry of global reinsurance firms, including Lloyds, in the Indian reinsurance sector.

3. **Role of competition policy** - Government insurance schemes may sometimes discriminate against private insurance companies by requiring that only government owned companies would be entitled to participate in the schemes. This is in violation of the principles of competitive neutrality.

   While suggesting that competitive neutrality should be followed in the design of government insurance schemes it should also be noted that the government may choose to specify particular safeguards to be complied with by private parties (such as audit requirements) before dealing with them.

   Recommendation 23: Competition policy should play an effective role in ensuring that government schemes do not create an uneven playing field between state-owned and private insurance companies.

2.1.5 Resolution and systemic relevance

1. **Resolution mechanisms** - Despite having the best regulatory systems in place, it is inevitable that some insurance firms will fail. To protect the interests of policyholders of failing insurance firms, the legal framework should contemplated enhanced supervision and resolution mechanisms. The potential resolution tools to be used for insurance companies include, insurance portfolio transfer to a solvent insurer, run off, schemes of arrangements, mergers and winding up, upon the failure of all other measures.

   Recommendation 24: The law should contain appropriate resolution mechanisms to deal with failing insurance firms, including provisions for enhanced supervision and the option of transferring the business of the failing insurer to a solvent insurer. These mechanisms should be applicable to both life and non-life insurers.

2. **Policyholder protection fund** - A policyholder protection fund offers a safety net for policyholders in the event of an insurer's insolvency. The

creation of such a fund will serve the purpose of protecting individual policyholders, building public confidence in the insurance business and reducing the taxpayer's exposure to insurance firm failures.

Recommendation 25: There is a need to create a compensation scheme to protect policyholders from the inability of an insurer to meet its financial obligations and to minimise the taxpayer's exposure to the failure of insurance firms. The design of the policyholder compensation scheme should be decided under the resolution framework being designed by FSLRC.

3. **Systemic relevance** - Systemically important firms are subject to additional supervision in the form of imposition of obligations to assess resolvability and undertake recovery and resolution planning exercises. Systemic risk regulation comes at a cost to the regulator as well as the insurance company. Therefore, it is important to make an assessment of the potential systemic importance of each insurer based on its product lines and business activities before subjecting it to systemic risk regulation.

   Recommendation 26: It should be the regulator's responsibility to assess the systemic importance of individual insurance firms. Additional supervisory and resolution tools will need to be employed in respect of those insurance companies that are found to be systemically important.

2.1.6 Unregulated areas of insurance

1. **Employees' State Insurance** - The Employees State Insurance Scheme provides compulsory social security benefits to organised sector workers. Despite the comprehensive scope of the scheme benefits, it has been found the medical facilities provided by Employees' State Insurance Corporation (ESIC) are grossly under utilised due to accessibility and quality issues. This makes a case on the one hand for undertaking reforms in the management and governance of the scheme and on the other for allowing establishments the choice to opt for group health insurance offered by the insurance industry. The absence of sound risk management and investment processes in the functioning of ESIC is also a cause of concern. This points to a need for prudential regulation of the corporation.

   Recommendation 27: Establishments covered by ESIC should have the option to opt out of the medical benefit facilities provided under the scheme and obtain group health insurance coverage offered by an insurance company, if they are able to obtain similar benefits at a similar cost . In such cases, a proportionate amount of the total contribution *payable to ESIC that relates to the medical benefits provided under the scheme will be used as the premium for obtaining the insurance policy.*

Recommendation 28: Being a social security scheme administered by the government, ESIC should not be subjected to the entire gamut of insurance laws and regulations. However, the law should allow the insurance regulator to identify certain specific principles, such as those relating to corporate governance, investment management and consumer protection, that would have to be complied with by ESIC.

2. **Government-sponsored insurance schemes** - Schemes such as the Rashtriya Swasthya Bima Yojana (RSBY) and other health insurance schemes launched by various state governments in recent years have led to a significant increase in health insurance coverage. While these schemes are designed in a way that the delivery of insurance services is carried out through regulated insurance companies, it is also possible for the government to design a scheme where it directly provides insurance benefits to the public. The legal framework should identify the extent and scope of regulation that will be applicable in both these cases.

   Recommendation 29: In case of government-sponsored schemes that are administered through insurance companies, the general provisions of insurance laws would be applicable. However, the law should allow the regulator to vary the applicability of certain provisions of law, particularly in respect of the pre-sale obligations of insurers.

   Recommendation 30: In case of schemes where the insurance coverage is contemplated to be provided directly by the government and the scheme is not funded through a complete or substantial fiscal transfer, the law will identify certain specific provisions, such as those relating to corporate governance, investment management and consumer protection, that would have to be complied with by the government body implementing the scheme. In order for these provisions to be effectively implemented, the law should mandate that any insurance business carried out by the government, which is eligible for limited regulation under insurance law, should be carried out through a separate corporate entity.

3. **Postal life insurance** - Life insurance policies sold by the Department of Posts (DoP) fall outside the purview of the Insurance Act and as a result, prudential requirements relating to solvency and capital maintenance, investment norms, governance and management, etc., do not apply to them. Moreover, the policies issued by DoP are guaranteed by the government and this creates a substantial contingent liability upon the government, which is of particular concern given the absence of prudential supervision. Further, although the DoP has in place certain internal processes for dealing with consumers, its policyholders

do not have recourse to the provisions on protection of policyholders formulated by Insurance Regulatory and Development Authority of India (IRDA) and to redress by the insurance ombudsman.

Recommendation 31: Life insurance schemes operated by the DoP should be corporatised and brought within the purview of the insurance regulator to ensure effective prudential management, protect the interests of policyholders and create a level playing field.

2.2 Retirement financing

2.2.1 Introduction

1. **Scope of retirement financing regulation** - The role of regulation is to correct market failures that impede the efficient functioning of the market. This would cover all funded retirements schemes, which form part of the retirement financing market. However, unfunded, tax-financed schemes cannot be treated as a part of the same market, because they are essentially welfare schemes, which comprise of a transfer from the present generation of working people to the retired people. There is also another category which consists of schemes that are funded, but enjoy minor fiscal support. In such cases, regulation should apply as it would to any other funded scheme. Since only a small portion of the benefits in such schemes come from the tax finance, sound regulation of the schemes can ensure that consumers are protected and the funds of the scheme are safe.

   Recommendation 32: There should be common regulation and supervision for all retirement financing schemes, including various types of pension and provident fund schemes, but not including the unfunded, tax-financed schemes (such as Old Age Pension Schemes), or those that are largely tax-financed. This would mean that the mandates that are presently divided between Pension Fund Regulatory and Development Authority (PFRDA) and Employees Provident Fund Organisation (EPFO) must be brought under one regulatory agency.

2. **Role of EPFO:** At present, EPFO is conflicted in its function as the manager as well as the regulator of provident fund schemes. The performance of these different types of roles also demands different types of expertise from its senior management and board. This problem can be addressed if EPFO's regulatory function is given to an agency that is only a regulatory and supervisory agency, and EPFO is regulated like any other retirement financing entity.

Recommendation 33: EPFO should only manage and not regulate retirement financing schemes. EPFO itself should be regulated in the same manner like any other retirement financing entity, and the entire range of regulations should apply to it. Similar approach should be taken towards Public Provident Fund (PPF).

3. **Exempted funds** - Private funds that have obtained an administrative exemption from EPFO (exempted funds) are supposed to give their employees a return that is at least equal to the return that Employees' Provident Fund (EPF) is giving. Subject to certain conditions, they also enjoy tax benefits. Many of these are small funds, which on their own may never be able to establish and follow best practices, putting their consumers at risk. The law and regulation should encourage such funds to integrate with the larger retirement financing system, so that they can benefit from sound practices. This can be done if they integrate with National Pension System (NPS), which is a defined contribution (DC) scheme with no fixed returns, or with EPF, which is a DC schemes with fixed returns. The latter will be optimal only if the recommendation of applying the new regulation to EPFO is accepted.

   Recommendation 34: Smaller exempt and excluded funds should integrate with EPF or NPS. The tax treatment should continue if the fund chooses to integrate with either of the two. The law should not make reference to the possibility of exemption or exclusion, and it should mandate all existing funds that fall under these categories to opt for either NPS or EPFO.

4. **Primary objective of regulator** - Regulators should have clear objectives to which they can be held accountable. Giving them vague, contradictory objectives can make it difficult to measure their successes and failures and hold them accountable. Such objectives also make it difficult for regulators to set priorities. Objectives such as development of the market and inclusion of the financially excluded, should be pursued by the government, as part of its overall work towards welfare of the citizens and economic development of the country. Regulators should focus on regulation and supervision.

   Recommendation 35: The primary objective of retirement financing regulation should be to correct market failures in the retirement financing sector. Development of the sector or inclusion should not be mandates given to the regulator, though the regulator should have the flexibility to customise the regulation according to the profile of the consumers and the kind of the product being offered, based on cost-benefit analysis of the regulation.

2.2.2 Prudential regulation

1. **Approach towards prudential regulation** - The overall approach towards regulation should be largely proportional to the risk held by the regulated entity, with some basic rules applicable to all entities. This approach would ensure an efficient regulatory and supervisory system, in which, attention will be paid where it is most required.

   Recommendation 36: Prudential regulation and supervision of retirement financing should be largely risk-based. Regulator should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated.

2. **Licensing regime** - The objective of licensing is to ensure that only those with reasonable capability to establish and manage a retirement financing scheme are allowed to do so. Licensing also helps create a system of monitoring the schemes by giving them an identity in the regulator's purview. It is useful to think about licensing at two levels: licensing of entities that may launch retirement finance funds, and licensing of retirement finance funds. Specific plans need not be licensed separately, if the entities and funds are licensed, because prudential regulation needs to be applied at the entity and fund level. The law should only define broad principles about criteria for licensing, and leave it to the regulator to define the specific rules.

   Recommendation 37: The law must provide for licensing of retirement finance entities and retirement finance funds, but there should be no licensing of individual plans. The regulator may prescribe conditions to be fulfilled by each plan to be launched by the licensed fund. In addition to the entity's licensing, each of the trustees of the entity should be registered with the regulator.

   Recommendation 38: The law should define principles-based criteria for awarding licenses to retirement financing entities and funds. Licensing should be on the basis of demonstration by the trustees/promoters that they have the required legal, managerial and ownership structures, capability (human, technology and financial), risk management systems, investment policy, financial strength and capital to manage the entity and/or the fund. The process of awarding the licenses should be transparent, and the applicants should be given a detailed response in a reasonable amount of time. The regulator should also have the power to modify or withdraw the licenses after due process, and such decisions should be appealable in a court of law.

3. **Regulation of investment management** - Investment management is one of the key functions in retirement financing funds, because the

basic function of the fund is to manage the funds by investing them in the best possible way, given the profiles and needs of the investors. There is a debate about whether the funds should be allowed to choose their own investment strategy in entirety or should there be some regulations around the investment management choices. In our view, the approach should be largely based on the "prudent person principle", which lets the fund decide its specific investment strategy, but there may be some broad restrictions placed by the regulators to prevent excessive risk-taking by the funds.

Recommendation 39: The law should provide that the "prudent person standard" be followed for investment management by those managing retirement financing funds, such as pension funds, EPFO, etc. The regulators should also have the powers to impose some broad portfolio restrictions to prevent excessive risk-taking by the funds. These restrictions should be imposed only as exceptions, and must not take the form of the regulators prescribing investment management strategies for the funds.

For ease of supervision by the regulators, market participants, and consumers, the funds must be required to declare and pursue an investment policy, so that there is transparency in the investment management function.

Recommendation 40: All retirement financing funds must be required to set forth and actively pursue an overall "investment policy". The law should empower the regulator to define the minimum requirements for the policy.

Investment management function also faces the risk of inconsistent ways of valuing assets, which can make it difficult for the regulators and others to monitor the funds' performance, and identify problems with it. This coordination problem can be overcome if the standards for valuation are set or approved by the regulator.

Recommendation 41: The law should empower the regulator to set standards for valuation of retirement financing assets in a transparent manner, informed by prevailing standards in other parts of the domestic financial system or in other jurisdictions. The regulator may, if it so chooses, delegate the task of setting standards to a standard setting body, but the regulator would continue to be responsible for the standards.

Schemes that receive minor fiscal support should still be regulated just like any other funded retirement financing schemes. The same principle should apply to the regulation of investment management.

Recommendation 42: For DC schemes with administered interest rates, *such as EPF and PPF, the regulators should have the power to regulate and supervise them for sound investment management practices.*

4. **Regulation of risk management systems** - One of the main objectives of risk-based regulation and supervision is to ensure sound risk management at the institutional level, taking into account both the quality of risk management and the accuracy of the risk assessment. Risk-based supervision lets much of the responsibility for risk management rest with the individual funds themselves, while the supervisory authority verifies the quality of the funds risk management processes and adapts its supervisory stance in response.

   Recommendation 43: The law must empower the regulator to regulate and supervise the risk management systems of retirement finance entities and funds, to ensure the adequacy of risk management systems in place. These powers must cover all the key elements of risk management systems, and must always be used in a risk-based manner. The regulations must be principles-based, should focus on supervision rather than ex-ante rules, and the regulator should not impose any one risk management model on the entities and funds. For small funds with poor in-house capability, the regulator may mandate seeking external support in developing sound risk management practices.

5. **Capital and liquidity requirements** - For defined benefit (DB) schemes, there is a need of capital requirements to protect against various risks that may lead to a situation wherein the fund is not able to fulfil its obligations. There is debate around what standards should be followed to arrive at the capital requirements, but there seems to be consensus that the approach should be risk-based. For DC schemes, there is no concept of capital adequacy, but some paid up capital may be required to start the fund, primarily to ensure operational continuity and to signal financial capability.

   Recommendation 44: The regulators must be given the power to impose risk-based capital and liquidity requirements on retirement finance funds.

   Regulation of corporate governance - In the context of retirement finance plans and funds, governance refers to the framework by which the governing body, whether individuals or a body corporate (through its board of directors and senior management), makes decisions about the fund's business. The regulators should have the powers to notify regulations on practices to be followed for retirement fund governance, and to supervise the governance practices of these funds.

   Recommendation 45: The law should give the regulator the power to regulate and supervise all the key elements of corporate governance of *retirement finance entities and funds, in a risk-based manner.*

2.2.3 Consumer Protection

1. **Protections for consumers** - The law should provide for certain basic protections for consumers, which the retirement financing funds and regulator can be held accountable to. These protections can provide the regulator with objectives to pursue for consumer protection. The key protections are: protection against misleading and deceptive conduct; protection against unfair terms of contract; protection of accrual and payouts; right to receive decision support and reasonable quality of service; right to reasonable redress.

   Recommendation 46: The law should provide protection to consumers from being misled or deceived, subjected to unfair terms of contract, or unduly penalised by the fund. Consumers should have access to a reasonable mechanism of grievance redressal. Consumers should also be given the right to get support to take the right decisions, and receive reasonable quality of service.

2. **Approach to consumer protection regulation** - Consumer protection must be *proportional* to the risk a specific scheme or plan poses to the consumer.

   Recommendation 47: Consumer protection regulation must be proportional to the risk held by the consumer, and the extent to which the consumer is responsible for taking decisions about the plan on issues such as investment.

3. **Instruments of regulation** - To maintain the rights and protections given to the consumers, the regulators must have certain powers, which they can use to intervene in the markets and ensure consumer protection. The key powers being proposed in this report are: regulating registration of retirement finance distributors or advisors; regulating incentive alignment; ensuring inter-operability, portability and exit options; ensuring appropriate support for consumers' decisions. In this context, the recommendations are listed below.

   Recommendation 48: All individuals dealing with retirement financing must be registered with the regulator, who must stipulate significant training requirements on the individuals involved in the process of helping the consumers decide about retirement financing.

   Recommendation 49: Incentive alignment: The structure of various types of charges on retirement financing schemes should be regulated by the regulator.

Recommendation 50: The regulator must be given the powers to ensure inter-operability, portability and exit options in retirement financing plans.

Recommendation 51: The regulator must have the power to mandate suitability analysis and advice to be given by the provider to the consumer regarding the asset allocation decision. The regulator must also have the power to recommend modifications to schemes and processes to ensure that consumers are given suitable solutions.

2.2.4 Failure of retirement finance funds

1. **Approach to resolution of failing retirement finance funds:** The concept of failure is usually limited to DB plans, which promise the consumers a certain level of benefit at the time of retirement. DC plans, on the other hand, do not fail in the same category, because the retirement income they promise is entirely contingent upon the contributions and the returns earned on the contributions. For such plans, if they suffer significant investment losses or other adverse events that erode their pool of capital, the consumers may lose parts of their accumulation, but the fund will not go bankrupt, because the fund did not promise any assured return. It is possible that the entities sponsoring a DC fund may go bankrupt. In such cases, the funds can be simply transferred to another fund, and the consumers can maintain their accounts.

   Recommendation 52: The law should provide for an efficient resolution mechanism for funds offering DB retirement financing plans. This should be modelled on the resolution process for banking and insurance, but with more time for the funds to improve their financial position. There should be an agency responsible for the resolution function.

   Recommendation 53: There should be a process to smoothly move the consumers' funds from one DC fund to another if the retirement finance entity sponsoring the DC fund goes bankrupt.

2. **Resolution of failing funds**

   Recommendation 54: The agency responsible for resolution should have access to comprehensive information about retirement finance entities and funds. The agency should have access to auditors' reports and the powers to ask for information on any fund and conduct on-site investigation of a fund.

   Recommendation 55: The initiation of the resolution process should be linked to a quantitative trigger.

Recommendation 56: The resolution process should start with giving the fund a notice to improve its financial position. If the fund fails to do so, the process should focus on transfer of the assets to another fund, or under the management of another fund. Liquidation of the fund should be the last option in the resolution process. When resolution process starts, the fund should be prevented from collecting contributions

3. **Protecting consumers of a failing fund**

   Recommendation 57: Establishing a retirement finance protection fund, which would guarantee payouts from all DB schemes, may be considered. The fund could also provide some guarantees to DC schemes, to help them hedge certain investment risks.

   Recommendation 58: If the retirement finance protection fund is established, it should charge risk-based levy from the participating funds; participation should be mandatory for funds offering DB plans; and the fund could be managed by the agency that is responsible for resolution of failing funds.

2.2.5 Special topics

1. **Regulation of annuities** - Annuities provide the consumers a guaranteed income from the time of purchase till death. Longevity risk is not diversifiable for the consumer, and can therefore be managed only through a company that holds a pool of such risks. The key advantage of annuities is that they move the longevity risk of the consumer to the issuing company. There are certain issues in regulation and supervision of annuity markets, which need to be considered while drafting the laws governing annuity markets. First, annuity markets, like other insurance markets, are affected by certain markets failures. Second, there are consequences of poor decisions by retirees if they don't annuitise or under-annuitise, leading to additional liabilities for the society.

   Recommendation 59: Only insurance companies that have proven capability in offering life insurance should be allowed to do the business of issuing annuities.

   Recommendation 60: Compared to pension funds, for insurance firms issuing annuities, there should be greater flexibility given to the regulator in law to stipulate restrictions on investment choices. This should be in line with the regulations of life insurance companies.

   Recommendation 61: The regulators should work to ensure that consumers take the optimal annuitisation decision, by mandating partial *annuitisation and providing active support to consumers to take the right decision.*

Recommendation 62: Resolution of insurance firms issuing annuities should be considered along the lines of resolution of any life insurance firm. This issue has been discussed in detail in this report's chapter on insurance firms.

2. **National Pension System** - The NPS was established to overcome certain market failures in the retirement financing market. It overcomes the problems of market power and information asymmetry, by harnessing economies of scale for funds, providing low pricing through auctions, ensuring account portability, and making a DC promise. Though the individual components of NPS, such as the pension funds, points of presence, central recordkeeping agencies, need to be regulated, we need to consider how NPS should be treated in the law.

   Recommendation 63: Just as in the PFRDA Bill, NPS should be acknowledged as a unique object in the law, and its various components should be regulated at par with their respective categories.

   Recommendation 64: The law should acknowledge the unique status of NPS as a government intervention to address market failures in the retirement financing market, and the market power is commands to meet its objectives. If NPS exerts anti-competitive pressures over and above its basic objectives, it should be regulated from a competition standpoint. NPS should be separated from the retirement financing regulator, because there is conflict of interest in managing such a system and regulating the retirement financing sector. This can be achieved by making the NPS Trust an independent entity. The retirement financing regulator should regulate and supervise the NPS Trust.

3. **Regulation of retirement finance infrastructure** - In the retirement financing sector, there is a significant role for certain pieces of infrastructure that do the record-keeping and maintaining of the information about individual accounts and consumers. The PFRDA Bill provides comprehensive provisions on regulation of central recordkeeping agencies, including provisions that empower the regulator to license these agencies and regulate them.

   Recommendation 65: The law should give the regulator the powers to regulate infrastructure for retirement financing sector. Sections from PFRDA Bill on regulation of infrastructure for retirement financing can be considered for drafting these provisions in legislation. These sections provide for regulation and supervision of infrastructure services such as record keeping.

2.3 Small savings

2.3.1 Legal framework

The legal framework governing the small savings sector consists of the Government Savings Bank Act, 1873, the Government Savings Certificates Act, 1959 and the Public Provident Fund Act, 1968. All these laws provide for the rights of small savings investors (referred to as depositors, holders and subscribers under the three acts) and their nominees and empower the government to frame detailed rules to govern the specific instruments issued under the Acts. There is a case for bringing these legislations under a common legal framework. To the extent required, this common legislation may contain provisions that are specific to different types of small savings instruments.

Recommendation 66: There is a need to consolidate and modernise the laws on small savings. Accordingly, the GSB Act, GSC Act and PPF Act should be replaced with a consolidated law that should, inter alia, contain provisions relating to manner of collection and investment of funds, consumer protection, grievance redressal and, to the extent relevant, prudential regulation.

2.3.2 Structure and regulatory framework

The mobilisation of small savings and the investment and repayment of funds collected under the schemes is handled completely within the government. This results in a situation where all aspects of small savings fall outside the sphere of financial regulation. As a consequence, the National Small Savings Fund (NSSF) is not subject to the requirements relating to capital adequacy, internal controls, corporate governance, investment management, etc. that would typically be attracted in case of any other institution carrying out activities of a similar nature.

Unlike other financial sectors where the rationale for prudential regulation is grounded in the need to protect consumers from the failure of the financial service provider, the case for prudential management in the field of small savings arises from the perspective of ensuring the viability of NSSF. Since small savings schemes are guaranteed by the government, ensuring the viability of NSSF, through prudential regulation is important for limiting the government's liabilities.

Recommendation 67: All functions related to the operation and management of small savings should be performed by an independent entity that should be brought within the limited purview of the financial regulator. However, prudential regulation of the proposed small savings entity should not extend *to changing the manner in which the funds held by NSSF are invested since that constitutes a fiscal decision.*

Recommendation 68: To address concerns that corporatisation of the scheme would lead to loss of public confidence, it should be ensured that upon the transfer of the management of small savings to an independent entity, the law effecting such transfer should explicitly clarify that these schemes are guaranteed by the government.

2.3.3 Consumer protection

1. **Measures for consumer protection** - Given that the focus of small savings schemes is on providing investment avenues to small retail investors, there is an enhanced need for consumer protection in this field. The protections required by small savings consumers include, protection from misleading conduct, right to receive information about the key terms and conditions of the contract, assured quality of service and access to mechanisms for redressal of grievances.

   Recommendation 69: Requisite changes may be made in the laws governing small savings to include provisions on investor protection, compensation and grievance redressal.

2. **Distribution structure** - Small savings products are distributed through a network of post offices, bank branches and agents. The existing legal framework does not contain any substantive provisions for enabling the appointment of agents or laying down powers for setting out qualifications, classification and grievance redressal mechanisms against acts of agents.

   Recommendation 70: To minimise operational risks on account of agent defaults and to protect the interests of investors, the law should lay down the framework for the licensing, qualifications and training of agents.

3. Insurance

3.1 Introduction

The business of insurance entails the collection of premium from policyholders with a promise to protect them from uncertain future events. Pools of collected premium are then invested in a manner that would allow sufficient funds to be available for payouts as and when the need arises. This dual role of providing risk management services to individuals and businesses and financial intermediation services for the efficient allocation of resources in the economy, makes the insurance industry a vital tool for economic growth and development (Arena, 2008).

As in other elements of finance, the policy issues faced in insurance are a mix of competition policy (to drive innovation and growth), consumer protection (to ensure that the interests of policyholders are best protected), prudential regulation (to limit the failure probability of insurance companies) and resolution (to deal with failures of insurance companies when they do happen). The first milestone in the establishment of modern legal and regulatory arrangements in this field was the establishment of the IRDA in 2000, which was accompanied by the entry of private insurance companies. This led to the number of insurance players in the country increasing from 8 government owned undertakings[1] to the present number of 51, of which, 24 are in the life insurance business and 27 in non-life insurance (including 4 stand alone health insurers).

Significant improvements that have taken place in the performance of the insurance industry post liberalisation are evidenced by the increased insurance penetration (ratio of premium underwritten in a given year to the Gross Domestic Product) and insurance density (ratio of premium underwritten in a given year to the total population).[2] However, despite these positive changes, the Indian insurance industry still remains in the early stages of development. A comparison with the insurance penetration and density

[1] LIC and General Insurance Corporation of India (GIC); four state-owned general insurance companies: Oriental Insurance Company Limited, New India Assurance Company Limited, National Insurance Company Limited and United India Insurance Company Limited; and two specialised insurance companies - the Agriculture Insurance Company of India Limited, which provides agricultural insurance and the Export Credit Guarantee Corporation of India Limited, which provides credit risk insurance covers to exporters.

[2] Insurance penetration has increased from 2.32 per cent in the year 2000 to 5.10 per cent in 2010 and during the same period insurance density has improved from USD 9.9 to USD 64.4 (IRDA, 2011a).

ratios of other emerging and developed nations reveals that India still has a lot of catching up to do, particularly in the non-life segment.[3]

The present legal framework governing the field of insurance consists of the following components:

1. Insurance Act, 1938 ('Insurance Act') - This is the primary legislation governing the business of insurance in India. It deals comprehensively with the prudential supervision of insurance companies - licensing, management, operations, solvency requirements, investments, etc. It also contains provisions on specific aspects of insurance contracts, such as assignment and nomination.

2. Insurance Regulatory and Development Authority of India Act, 1999 ('IRDA Act') - This Act led to the creation of IRDA as the regulatory authority responsible for the regulation, promotion and development of insurance and re-insurance business. It deals with the composition and terms of service of members of IRDA and the powers and functions of the authority.

3. Life Insurance Corporation Act, 1956 ('LIC Act') - This Act provided for the nationalisation of the life insurance business. It created LIC into which the assets and liabilities of all life insurers existing at that time were transferred. It also lays down provisions relating to the manner in which LIC is to be managed and operated. Until 2000, LIC had the exclusive privilege to carry out life insurance business in the country, which was subsequently taken away by the IRDA Act.

4. General Insurance Business (Nationalisation) Act, 1972 ('GIBN Act') - Similar to the LIC Act, this Act provided for the nationalisation of the general insurance business. It created GIC, which, along with its four wholly owned subsidiaries, had the exclusive privilege of doing general insurance business in the country until the enactment of the IRDA Act. Subsequently, through the General Insurance Business (Nationalisation) Amendment Act 2002, the government took up direct ownership of the four subsidiaries of GIC and GIC was designated as an exclusive reinsurance company.

5. Employees State Insurance Act, 1948 ('ESIC Act') - This is a welfare legislation that confers sickness, maternity and employment injury benefits upon the employees of factories and establishments. These benefits are provided under the ambit of a comprehensive insurance scheme that is funded through contributions made by employees and their employers. The scheme is administered by the ESIC.

[3] Insurance penetration in India in the non-life is at 0.7 percent, which is well below the international average of 2.9 per cent. See SwissRe (2011).

6. Actuaries Act, 2006 ('Actuaries Act') - The actuarial profession plays a vital role in the assessment and valuation of risks in the fields of insurance and pensions. This Act creates a statutory body under the name of the Institute of Actuaries of India (IAI) to regulate and develop the profession of actuaries. It entitles IAI to grant certificates of practice to its members and undertake disciplinary measures against them.

7. Marine Insurance Act, 1963 - This legislation deals specifically with the area of marine insurance. It deals with the formation of marine insurance contracts, express and implied warranties and extent of liability for different types of losses.

8. Motor Vehicles Act, 1988 ('MV Act, 1963') - This is a consolidated legislation dealing with all aspects relating to motor insurance, including registration, licensing of drivers, special provisions relating to transport vehicles, etc. Chapter VIII of the Act is relevant in the context of insurance. It makes it mandatory for all users of vehicles to obtain third party motor insurance and casts an obligation on insurers to make payments under the policy to the third party.

With this background, this report aims to identify the changes required to the present legal and regulatory framework governing the insurance industry in order to aid further growth and development of the sector. The recommendations contained in this section are based on a review of the core principles issued by the International Association of Insurance Supervisors (IAIS), international best practices, relevant government reports, case-law and a study of the current legal framework. At relevant places, we have also taken into account the provisions of the Insurance Laws Amendment Bill, 2008 ('Insurance Amendment Bill') which is currently pending before the Parliament and the report of the Standing Committee to review the bill. The objective of the bill is to carry out improvements to the legal framework governing insurance and to remove redundant clauses. The bill notably proposes to increase the FDI limit in the insurance sector from 26 percent to 49 percent.

In addition to the overarching issues applicable to the insurance sector as a whole, there may be several specific aspects applicable to particular lines of insurance business. This report does not deal with the areas of marine insurance, agricultural insurance and export credit guarantees. As a result, the Marine Insurance Act, 1963, which also form part of the legislative framework governing insurance, has not been dealt with in our recommendations.

3.2 Role of the regulator

The need for regulation in the field of insurance arises because of the market failures that exist on account of the asymmetric information and uneven bargaining power between insurers and insured. Insurance policyholders pay an upfront premium to the insurer but they do not have the ability or the capacity to monitor the behavior and financial condition of the insurer, including the manner in which their premiums are utilised. This leads to the risk that the insurer may mismanage its affairs resulting in a situation where adequate resources are not available to make payouts to policyholders or their beneficiaries. This uneven bargaining power between the insurance provider and the consumer also gives rise to the need for specific measures to ensure that insurers treat consumers in a fair manner - by having fair disclosures and policy terms, timely settlement of claims and effective grievance redressal.

Insurance markets are also characterised by the problems of adverse selection and moral hazard. The problem of adverse selection arises because those seeking insurance are more likely to suffer losses, hence leading to a breakdown of the risk pooling mechanism, which forms the fundamental basis of insurance. Moral hazard arises because the insured would be more likely to take on additional risk after having obtained insurance protection (Acharya *et al.*, 2009). Therefore, putting in place appropriate mechanisms for the handling of these problems is of critical importance from the insurer's business viability perspective. This issue will gain significance from the point of view of policyholder protection if the unviability of the insurer's business leads to a situation where it is unable to meet its obligations.

The primary role of the regulator should therefore be to ensure the protection of policyholder interests and, with that objective in mind, to see that insurance companies are managed and operated in a sound manner.

3.3 Development role

The IRDA is presently cast with the duty to *regulate, promote and ensure orderly growth of the insurance business and re-insurance business*, hence extending its role beyond regulation and supervision to include the promotion of insurance business. The conferment of the development role upon the regulator could be attributed to the historical context of the IRDA Act, which was introduced to serve the needs of an underinsured economy by encouraging private participation in the sector. A closer examination of the different regulatory objectives however reveals that the development goal can conflict with the regulator's primary goals of consumer protection and prudential regulation. For instance, the regulator's prudential regulation function will require it to supervise the marketplace to ensure that insurers follow the prescribed prudential norms but the development goal may sometimes demand the relaxation of such norms to encourage more participation in the market, which could be at the cost of safety of consumers. The development mandate also suffers from the problem of being a poorly defined goal, which induces problems of public administration. A wide array of actions can potentially be justified as being compatible with the development objective, hence undermining the accountability of the regulator for such actions.

In a competitive insurance environment, participation and growth of insurance business can be achieved even without burdening the regulator with the 'development' mandate. The focus of the regulator should be on ensuring that the principles of competitive neutrality are taken into account while formulating its subordinate legislations and practices. Market forces should ordinarily be sufficient to ensure development of the sector without the regulator's active intervention.

However, a distinction needs to be drawn between autonomous development of markets and induced development in pursuance of a policy agenda. The need for the latter arises because relying entirely on economic forces may not always be sufficient to attain the required pace of growth in certain segments, such as the micro insurance segment, which caters to the needs to small consumers. The lives of poor people are rife with many kinds of risks, which need to be accounted for through sophisticated financial products designed to meet their specific needs. In the absence of any form of government intervention, rural areas and poorer sections of the population might be left out of the sphere of insurance despite their strong needs for insurance coverage. The Insurance Act tries to address this issue by allowing IRDA to mandate the minimum business that insurers must undertake in the rural and social sector - consisting of unorganised and informal sector and other economically vulnerable classes.[4] In exercise of the powers conferred by the Insurance Act, the IRDA (Obligations of Insurers to Rural Social Sectors) Regulations, 2002 (IRDA, 2002a) set out the compulsory minimum limits for business to be carried out in these sectors.

The reasons discussed above justify the need for the legal framework to allow specific interventions in order to achieve the financial inclusion agenda. Powers in this regard may be conferred upon the insurance regulator, directly upon the government or upon a separate authority set up specifically for this purpose. In each case, the governing principle should be that to the extent possible, the costs of inclusion should be borne by the government, rather than individual companies and their policyholders.

The working group is of the opinion that the issue of financial inclusion

[4] Sections 32B and 32C, Insurance Act.

is a broader issue that is relevant for all aspects of the financial sector, particularly in the field of banking. Therefore, the mechanisms for achieving financial inclusion in the field of insurance should be aligned with the decision that the FSLRC takes for promoting inclusion in the banking sector.

> *Recommendation 1: The development of insurance markets should not be a regulatory objective. Market forces should ordinarily be able to achieve an adequate level of development in the sector. Towards his end, the law should specify that the need for pursuing competitive neutrality and fair competition should be basic principles to be followed by the regulator.*

> *Recommendation 2: General development of markets has to be distinguished from specific measures that need to be taken to achieve the financial inclusion agenda. The mechanisms for achieving financial inclusion in the field of insurance should be aligned with the decision that FSLRC may take for promoting inclusion in the banking sector.*

3.4 Prudential regulation

3.4.1 Solvency Requirements

The Insurance Act prescribe a minimum capital requirement of rupees 100 crores for setting up an insurance company.[5] In addition, it requires every insurance company to maintain a required solvency margin - the amount by which the value of the insurance company's assets should exceed its liabilities.[6] The calculation of the solvency requirement is based on a fixed formula, which, in the case of life insurers, is based on a percentage of the reserves held to meet future claims and in case of general insurers, is based on a percentage of net premium or net claims. The IRDA has further supplemented these requirements by mandating that the actual solvency margin of an insurer should be 150 percent of the required solvency margin contemplated under the Insurance Act.

The problem with the current approach is that it adopts a one size fits all formula which fails to relate capital requirements to the specific risks faced by insurance companies. The risk based capital approach addresses this issue by identifying the buffer that the insurer needs to hold to cover potential losses, at a given risk tolerance level, over a specified time horizon. This method takes into account the different types of risks faced by insurance companies -

[5] Section 6, Insurance Act.
[6] Section 64AV, Insurance Act.

underwriting risks, investment risks, operational risks - as well as the risk mitigation strategies adopted by them, such as portfolio diversification and reinsurance.

The core principles adopted by IAIS (IAIS, 2011b), the current practice in countries such as United States, Australia, Japan and Singapore and the Solvency II framework (EC, 2009a) that is set to come into effect in the European Union by 2014, all evidence the global movement towards the risk based approach. Taking cue from international best practices, IRDA has also introduced a requirement for insurance companies to compute and report their 'economic capital', which is to be calculated based on the risks faced by them.[7]

To adopt the risk based capital approach different levels of regulatory capital requirements to be maintained by an insurance company need to be identified by the regulator. This would include the following categories of capital requirements:[8]

1. Prescribed Capital Requirement (PCR)
2. Minimum Capital Requirement (MCR)

The PCR is the capital level at which the assets of the insurer exceed technical provisions (amount required to meet insurance liabilities) and other liabilities of the insurer with a specified level of safety. The MCR is fixed at a level below the PCR and it serves as the ultimate safety net for the protection of policyholders. This could be in the range of 25 percent to 45 percent of the undertaking's PCR, subject to an absolute floor level.[9] In the Indian context, the current minimum capital requirement of rupees 100 crores forms the absolute floor level.

There needs to be a staged intervention process setting out the degree of intervention permitted to be made by the regulator at various stages of capital. The remedial actions to be taken by the insurance company would also vary depending on which capital limit is being breached by the insurer. For instance, if the insurer's capital resources fall below the PCR, the regulator would be empowered to require the insurer to either restore capital resources or reduce the level of risk undertaken. However, the regulator would be entitled to invoke much stronger actions in case the capital falls below the MCR, which is the point at which the insurer would be regarded as not being viable to operate.[10] As the financial condition of an insurance firms deteriorates, simultaneous measures will also need to be taken for the

[7] See IRDA (2010) relating to economic capital requirements for life insurance companies and IRDA (2011b) for non-life insurance companies.
[8] See para 17.4, IAIS Core Principles.
[9] Article 129, Solvency II Directive.
[10] Para 17.4, IAIS Core Principles.

enhanced supervision and resolution of the insurer in the manner discussed subsequently in the section on resolution.

In order to make the transition to risk-based capital requirements, the primary law should provide that the assets of the insurer should exceed its liabilities by such proportion as the regulations may specify. Provisions of this nature have been proposed under the Insurance Amendment Bill to specify the amount by which the assets of an insurer should exceed its liabilities at all times (equivalent to MCR) and the control level of solvency required to be maintained by insurers as may be specified by the regulator (equivalent to PCR).[11] The types of intervention that may be made by the regulator in case of a breach of these capital requirements have also been specified in the Insurance Amendment Bill. The working group agrees with these recommendations but finds that the primary law should go a step further and lay down the principle that needs to be followed by the regulator while specifying the PCR requirements - capital requirements should be determined in a risk-based manner. Subject to this principle, the regulator will be free to frame subordinate legislations to lay down the precise capital requirements and the process for computation of capital.

To provide certainty to regulated entities, the law should clearly specify a transition process for the movement from the fixed formula capital computation to risk-based requirements.

Recommendation 3:

1. *The capital resources maintained by insurance companies should be commensurate with the specific risks arising from their business activities. To achieve this, the primary law should provide that the prescribed capital requirements should be determined in a risk-based manner. Subject to this principle, the regulator will frame subordinate legislations to lay down the actual capital requirements and the process for computation of capital.*

2. *The regulator should also be permitted to prescribe the minimum capital requirement for the setting up of an insurance company, instead of having the rupees 100 crores requirement laid down in the primary law. This will allow the entry conditions to be revised from time to time without requiring an amendment to the law.*

[11] Section 87 of the Insurance Amendment Bill, 2008 proposes to amend Section 64VA of the Insurance Act.

3.4.2 Capital structure

The Insurance Act stipulates that the entire share capital of a life insurance company should consist of ordinary equity.[12] This provision has been interpreted by IRDA to mean that insurance companies are not permitted to issue preference shares or other forms of hybrid instruments (IRDA, 2005b). This position is sought to be revised through the Insurance Amendment Bill, which seeks to enable insurers to raise "such other form of capital as may be specified" apart from equity capital. There is a need for the law on this point to be made more clear.

The primary law should explicitly recognise that insurers are permitted to have different classes of capital. It should empower the regulator to identify the characteristics and features based on which the classification of capital into tiers will be carried out. The following are some parameters that may be considered by the regulator for the purposes of classification:[13]

1. Permanent availability - whether the item is available, or can be called up on demand, to fully absorb losses on a going-concern basis, as well as in the case of winding-up.
2. Subordination - whether in the case of winding-up, the total amount of the item is available to absorb losses and the repayment of the item is refused to its holder until all other obligations, including insurance and reinsurance obligations towards policy holders and beneficiaries of insurance and reinsurance contracts, have been met.
3. Duration - what is the relative duration of the item as compared to the duration of the insurance obligations of the undertaking.
4. Absence of incentives to redeem - whether the item is free from requirements or incentives to redeem the nominal sum.
5. Servicing costs - whether the item is free from mandatory fixed charges and servicing costs.
6. Encumbrances - whether the item is clear of encumbrances

The law should also empower the regulator to prescribe the extent to which the different tiers of capital would be taken into account for the purposes of satisfying the prescribed solvency capital and minimum capital requirements. However, regulations should not restrict insurers from using different tiers of capital for their internal capital management purposes.

> *Recommendation 4: The law should provide that insurance companies are permitted to hold different classes of capital. The*

[12] Section 6A, Insurance Act.
[13] Article 93, Solvency II Directive.

> *classification of capital into different tiers will be done by the regulator through subordinate legislation. The regulator will also be empowered to restrict the extent to which insurers may rely on different tiers of capital for satisfying their capital requirements.*

3.4.3 Ownership structure

Ensuring the soundness and suitability of the significant owners of insurance companies is a critical element in the prudential regulation of insurers.[14] It is equally important to ensure that the legal form of the insurer is such that would allow it to be financed, managed and operated in accordance with insurance laws. Under the Insurance Act, the only categories of persons that are permitted to carry out insurance business are companies and co-operative societies, in both cases, subject to the prescribed capital and ownership requirements.[15]

At the stage of registration of an insurance company, the IRDA carries out an assessment of the financial capabilities, experience and soundness of the promoters of the applicant company.[16] Ensuring the financial soundness of the promoters is crucial because the promoters are expected to fully fund the insurer in its initial years. After an insurer has been in business for ten years the Insurance Act requires a mandatory divestment of shares by Indian promoters to bring them to the shareholding level permitted for foreign investors.[17] While the provision on mandatory divestment is being reconsidered under the Insurance Amendment Bill, the IRDA has issued regulations specifying the eligibility criteria and procedure for listing of shares of life insurance companies (IRDA, 2011e). This move towards allowing public ownership of insurance companies will fuel the capital needs of insurance companies and, at the same time, aid effective prudential regulation by using the publicly visible share price of the insurer as an indicator of its soundness.

As noted earlier, one of the most significant features of the Insurance Amendment Bill is the proposal to increase the existing FDI limit. The Insurance Act currently provides for an investment cap of 26 percent and the Insurance

[14]At a minimum, the necessary qualities of a significant owner of an insurers are that the person should be financially sound; and must have demonstrated integrity in personal behaviour and in business conduct - Para 5.2.5, IAIS Core Principles.

[15]Similar requirements relating to the legal form of the insurer are seen in other jurisdictions. For instance, UK law states that in order to be authorised to carry on insurance business the authorised person must be a body corporate (other than a limited liability partnership), a registered friendly society or a member of Lloyds - Schedule 6, Financial Services and Markets Act, 2000.

[16]The IRDA (Registration of Indian Insurance Companies) Regulations, 2000 (IRDA, 2000c) require the applicant company to disclose details regarding its promoters and their ownership structure at the stage of requisition for registration as an insurance company.

[17]Section 6AA, Insurance Act.

Amendment Bill proposed to raise this limit to 49 percent in order to usher in more development in the sector.

Insurance is the only sector in India where the foreign investment limit is specified in the primary legislation. As a result, any change to the investment limit is possible only through an amendment to the legislation. The working group is of the view that aspects relating to foreign investment limits should not be a subject matter of the insurance law. FDI policy in insurance should be determined by the Central Government, as is the case in all other sectors.

> *Recommendation 5: Insurance law should not specify foreign investment limits for investments in the sector. As in all other sectors, this power should be with the Central Government. In making its determination, the government may consider adopting different FDI limits for different types of insurance activities. In particular, a higher limit may be considered for the health insurance sector to promote more robust growth in the sector.*

3.4.4 Corporate governance and risk management

One of the core objectives of insurance regulation is to ensure that insurers follow a corporate governance framework that allows for prudent management and oversight of the business and adequately recognise and protect the interests of policyholders.[18] This entails ensuring that the directors and key management personnel of the insurer are fit and proper and adequately qualified to discharge their functions and that the insurer has in place appropriate systems and controls - relating to risk management, actuarial compliance, asset liability management, internal audit, etc.

IRDA has already put in place a comprehensive set of guidelines that lay down corporate governance norms for insurance companies (IRDA, 2009a). However, these norms have not taken the shape of regulations, perhaps because of the absence of a specific provision in the law allowing the regulator to make regulations on this issue. High-level principles relating to sound governance and management of insurance firms need to be enshrined in the primary law itself and there should be further provisions empowering the regulator to elaborate upon these principles with specific regulations relating to the types of checks and balances that need to be put into place by insurers.

Specifically in the context of risk management, there is a need to move towards an enterprise level risk management framework. Insurers should have a complete understanding of the risks faced by them and the implementation of sound risk management practices.[19] This will require insurers to perform

[18] ICP 7, IAIS Core Principles.
[19] ICP 16, IAIS Core Principles.

their own risk and solvency assessment to assess the adequacy of their risk management systems and their solvency position. The regulator will then use its supervisory powers to assess the adequacy and effectiveness of the measures adopted by the insurance company. This is in line with the risk based capital approach.

> *Recommendation 6: High-level principles relating to sound governance and management of insurance firms need to be enshrined in the law. The law should also mandate self-assessment of solvency and risk profile by insurers. The regulator should then use its supervisory powers to assess the adequacy and effectiveness of the measures adopted by the insurance company.*

3.4.5 Investment norms

The Insurance Act contains quantitative investment norms that set out the manner in which investments are to be made by insurance companies - a minimum of 25 per cent has to be invested in government securities and a further sum of not less than 25 per cent in government securities and other securities that are fully backed by the government.[20] The remaining investment corpus has to be invested in 'approved investments', which consists of instruments that are generally considered as being secure in nature, such as, secured debentures, shares of public companies that have issued regular dividends and fixed deposits with banks. A portion of the investments is also allowed to be made in other non specified categories,[21] with the approval of the company's directors.[22] Mandating minimum investments to be made in particular categories of assets, such as government securities and infrastructure sector, is prejudicial to the interests of policy holders. Their interests would be better served if the insurance laws did not allow resource pre-emption by the regulator and insurance funds were permitted to be invested in the most efficient manner.

With the move towards a risk based capital regime, it seems logical that the investment philosophy should also move from a system of quantitative restrictions to an environment where insurers are required to invest in accordance with prudent person principles. Under this approach, an insurer would be free to invest in any manner that it deems prudent provided that it holds proportionate capital to meet the specific risks emanating from its investments. The Solvency II framework adopts the prudent person approach by allowing insurers to invest in instruments whose risks can be properly

[20] Section 27(1), Insurance Act.
[21] 15 percent for life insurers and 25 percent for general insurers.
[22] Sections 27A and 27B, Insurance Act.

monitored and controlled and requiring that investments must be made in the best interests of policyholders.[23]

When considering the prudent person principle in the Indian context it is important to recognise that the adoption of this approach presupposes the existence of requisite investment expertise within the insurance industry and the regulatory body as there are no predefined norms against which compliance can be monitored. Davis (2001) reasons that in situations where fund managers as well as regulators are highly inexperienced, which is often the case in emerging market economies, there could be a rationale for the temporary existence of quantitative restrictions. However, the regulation should become more liberal as expertise develops and financial markets become more sophisticated and mature.

In this regard, the feedback received from the insurance industry on the question of quantitative restrictions versus the prudent person was that despite the many advantages of the prudent person principle, the present scenario and level of development in the insurance industry merits the continuance of the prescribed investment approach. Their fear was that insurers in India are presently not equipped to accurately balance risks and returns. In such a situation, adopting the prudent person principle could result in excessive risk exposure, hence threatening the interests of policyholders. The working group notes that this concern can be addressed through the adoption of the risk based capital approach which will check the excessively risky behaviour of insurance firms by imposing proportionate capital requirements. However, we also recognise that it is very plausible for the balance to tilt in the opposite direction, with insurers opting for the most conservative category of investments (such as government securities) in order to keep their capital requirements at a minimum. Such a situation would also not be desirable from a portfolio diversification perspective.

Taking into account these viewpoints, the working group is of the view that there is merit in allowing for the continuation of some level of regulatory involvement in the investment decision of insurance companies, although it needs to be far less prescriptive than the present system. As a first step, the present requirement of mandatory investments in government securities and other similar government-backed instruments should be taken out of the Insurance Act. The primary legislation should instead specify that insurers are required to invest in accordance with prudent person principles to be laid down under the law - investments should be sufficiently diversified and should be held in assets that are sufficiently secure and allow sufficient liquidity to make payments to policyholders as they fall due.[24] However, the law would also provide that the investments would be subject to the investment

[23] Article 132, Solvency II Directive.

[24] Para 15.3, IAIS Core Principles.

regulations made by the regulator.

As in the current scenario, the regulator would have the right to require that investments that are required to meet the technical provisions should be largely made in asset classes that fall within the specified list of 'approved investments', which should be broad enough to cover all types of investments that a prudent insurer would typically choose to invest in. The law will however restrict the regulator from prescribing the composition of the investment portfolio or specifying minimum levels of investment for any given category of investment, except on an exceptional and temporary basis (OECD, 1998). Further, insurers would continue to have the discretion to invest a portion of their funds in 'other investments' - instruments falling outside the approved list - so as to allow innovation of new investment types.

The rationale for removing investment prescriptions from the primary law to the level of regulations is to enable investment norms to keep pace with changing economic conditions and to allow for a complete transition to the prudent person regime as and when the regulator is of the view that the industry has developed sufficient investment and risk management expertise.

> *Recommendation 7: The law should specify that investments are to be made as per the prudent person principle and quantitative investment requirements and restrictions should be removed from the primary law. To the extent necessary, the regulator should be empowered to specify appropriate investment norms through subordinate legislation. This power would be subject to certain restrictions to be specified under the law. Specifically, the regulator will not be able to prescribe the composition of the investment portfolio or the minimum levels of investment for any given category of investment.*

3.4.6 Global diversification

The Insurance Act prohibits insurers from investing the funds of policyholders outside the country.[25] This policy of confining insurance investments to domestic markets subjects insurers to diversifiable risk, including major macroeconomic risks arising from asymmetric shocks to the domestic economy, that could otherwise be avoided (Dickinson, 2001). Similar restrictions on global diversification are also seen in the context of foreign reinsurance arrangements, which will be discussed in subsequent section of the report.

Other than the diversification benefits, the flexibility to take exposure to globally well managed companies and the ability to explore developed fixed

[25] Section 27C, Insurance Act.

income markets for asset liability matching purposes, were identified during consultations with the insurance industry as the potential benefits of removing the restriction on overseas investments. However, industry participants also highlighted that any such move would need to be accompanied by prudent risk management guidelines and proper monitoring systems to safeguard the interests of policyholders.

When considering the issue of allowing overseas investments it is relevant to take into account the potential currency risks that can arise on account of having assets and liabilities denominated in different currencies. If assets and liabilities are not well matched, movements in financial variables (e.g. interest rates, market values and exchange rates) will affect the value of the assets and the liabilities of the insurer differently and hence result in an adverse economic impact for the insurer.[26] While the current approach of imposing mandatory localisation requirements is one way of tackling this risk, the working group is of the view that this causes insurers to lose out on significant diversification benefits.

To address this situation, the restrictions on investing in foreign instruments should be removed from the Insurance Act. This, coupled with the adoption of the prudent person principle and the risk based approach, will imply that insurers may choose to invest in a globally diversified portfolio to the extent that it presents lower risks and diversification benefits. Further, if the potential currency mismatch risks are found (by insurers) to be high, the risk based capital approach will ensure that insurers either opt for appropriate hedging instruments or hold additional technical provisions and capital to deal with such risks. In addition, the regulator may, using its power to frame investment regulations, set out reasonable limits on the currency mismatch risks that may be held by an insurer.

> *Recommendation 8: The law should not prohibit insurance companies from investing overseas. Insurers may choose to globally diversify their portfolio in accordance with the prudent person principle and risk-based capital requirements. The regulator may, however, choose to set out reasonable limits on the currency mismatch risks that may be held by an insurer.*

[26] Para 15.4.1, IAIS Core Principles.

3.5 Consumer protection

3.5.1 Conduct of business

The primary motivation for consumer protection regulation in the field of insurance is the idea that consumers in these markets are imperfectly informed about product characteristics and the strength of the insurer due to the complexity of contractual language and restrictions, the contingent nature of the claim payment services provided, and the fact that the services are provided in the future (Tennyson, 2010). Recognising the hardship faced by consumers in understanding and evaluating insurance products, a set of principles have been laid down to provide guidance on what are the legitimate and acceptable market practices in this field. These principles are intended to be applied to the conduct of insurers as well as intermediaries, whether they are individuals or legal entities.

Some of the key principles laid down in this regard are:[27]

1. Service providers should act honestly and in a straightforward manner. This would include the obligation to avoid indulging in misleading and deceptive acts or representations.
2. Service providers should act with due skill, care and diligence. Where appropriate an assessment of the customers individual requirements should be made to determine what insurance coverage is necessary and for this purpose, the service provider should obtain sufficient information about the customer to assess the insurance needs.
3. Service providers should pay due regard to the information needs of their customers and treat them fairly. This includes, communicating relevant and meaningful information to enable the customer to make a balanced and informed decision. The information that the consumer would be entitled to receive includes, details about the features of the product, status of the intermediary (independent or tied) and applicable charges.
4. Service providers should put in place mechanisms to deal with complaints of customers effectively and fairly.

IRDA has undertaken several measures, through regulations, guidelines and circulars, to address the consumer protection concerns identified above. The IRDA (Protection of Policyholders' Interests) Regulations, 2002 (IRDA, 2002b) contain provisions in respect of disclosures required at the point of sale, information to be contained in the insurance policy, claims processes,

[27] See (IAIS, 1999).

grievance redressal mechanisms and obligations for servicing the needs to policyholders. Other recent initiatives include the guidelines on persistency of life insurance policies that lay down minimum persistency ratios to be satisfied by life insurance agents in order for them to be eligible for renewal of their licenses (IRDA, 2011d).

An area of particular concern in the field of insurance consumer protection has been the widely noted mis-selling practices. Since insurance policies are more often sold than bought and consumers purchasing the policies may not have adequate information or expertise to assess the suitability of the policy for their needs, they often end up with products that they cannot use or do not need. The chief cause of mis-selling being the incentive structure that induces agents to look after their own interest rather than that of the customer (Swarup, 2009). To address this situation, the IRDA is in the process of framing regulations on Standard Proposal Form that will mandate insurers to have in place a process and system to assess the 'needs analysis' carried out for each and every proposal received and the soundness of a recommendation about a particular product being made (IRDA, 2012a).

While the regulator already seems to have undertaken the right initiatives in the field of consumer protection, the working group finds that there is a need for the primary law to set out the framework within which the regulator should undertake its consumer protection activities. At present the Insurance Act contains a broad provision authorising the regulator to make regulations on *matters relating to redressal of grievances of policy-holders to protect their interest and to regulate, promote and ensure orderly growth of insurance industry* without specifying the principles based on which such regulation is to be made.[28] The working group is of the view that the principles of consumer protection to be followed by the insurance service providers and the framework within which these principles may be implemented by the regulator - in the form of regulations, supervision and corrective action should be set out clearly in the primary legislation.

> *Recommendation 9: The law should set out the principles of consumer protection to be observed by the insurance service providers and the framework within which these principles may be implemented by the regulator.*

3.5.2 Distribution structures

It is widely recognised that under the current market conditions insurance services are more often sold than bought. To address this situation, there is an urgent need to enhance insurance awareness among consumers, which will

[28] Section 114A(zc), Insurance Act.

help develop a culture of insurance consumption among households. However, until we get closer to reaching a state where consumers start buying insurance at their own initiative, the use of a diverse range of distribution channels will remain the primary tool for insurers to increase insurance penetration. This necessitates a deeper understanding of the various types of insurance intermediaries and their regulation in order to ensure that the interests of consumers are adequately protected.

In addition to the traditional model of individual insurance agents, the recent years have seen the development of a variety of new distribution channels - corporate agents, bancassurance, brokers and referral providers. Insurance companies are also carrying out direct sales of policies to consumers, which constitutes a signification share of the distribution channel in the group life insurance and general insurance segments.[29] The existing insurance framework contains specific provisions on the regulation of individual agents, corporate agents and brokers and separate regulations on bancassurance, which currently falls under the corporate agency framework, are in the pipeline.[30] It is noticed that in case of distribution carried out by individual agents and corporate agents the regulations ensure that only persons who have the necessary qualifications and certifications would be permitted to sell insurance services to consumers. In the case of corporate agents, this is achieved through a requirement that only those employees of the agent who have a license to act as 'specified persons' are permitted to solicit and procure insurance business on behalf of the corporate agent. In order to ensure that all insurance consumers are assured of a minimum quality of service, irrespective of which distribution mechanism they use, is desirable that the law should mandate training, certification and registration requirements in respect of all customer facing individuals in all distribution channels. This should be equally applicable to the direct selling staff of the insurance company.

The regulator should have the authority to specify the minimum qualifications for individuals involved in different distribution channels and the task of verifying the individual's compliance with the requirements should be left to the insurance company, as seen presently in the case of insurance agents and corporate agents. In case of independent advisors and brokers, who are not aligned with any particular insurer, the task of verifying the qualifications should be carried out by the relevant service provider for its own employees.

[29]Out of a total of 10.76 crore general insurance polices that were written in 2010-11, 2.58 crore were sold through the direct sale channel, representing about 24 percent of the new business. In case of life insurance, this channel accounted for 32.36 per cent of the total new business, representing 2.42 percent of individual policies and 90 percent of group policies (IRDA, 2011a).

[30]IRDA has issued an exposure draft titled IRDA (Licensing of Bancassurance Agents) Regulations, 2011 (IRDA, 2011c) to provide for the regulation of banks that act as agents for insurance companies.

This will allow the regulator to take direct action against the concerned individuals in case of any breach of the code of conduct specified for different intermediaries.

> *Recommendation 10: All individuals, who may be individual agents or employees of corporate agents, brokers, advisers, banks and insurance companies, who are involved in the sale of insurance services to consumers must be registered with the regulator. This registration process will be based on certain objective criteria, such as minimum qualifications, training and certification requirements, which will be prescribed by the regulator. The responsibility of verifying the individual's compliance with the specified requirements should be left to the insurance company, in respect of its employees and agents. In case of independent advisors and brokers, who are not aligned with any particular insurer, the relevant service provider would be responsible for the registration of its employees.*

3.5.3 Remuneration structures

Of the various distribution channels, individual insurance agents presently represent the largest source of new insurance business. The limits of maximum commission payable to insurance agents for their services is set out under the Insurance Act. In case of life insurance products, the limits are - 35 percent of the first year's premium, 7.5 percent for second and third year's renewal premium and 5 percent after that. In the first ten years of its business an insurer is allowed to pay 40 percent of the first year's premium.[31] At the time of its introduction, the rationale of having an attractive commission structure in the law was to attract and retain talent in the business so as to achieve better insurance penetration (Malhotra, 1994). However, in the current insurance environment where a large number of insurance players are prevalent in the market, the consequence of having a commission structure with a heavy front load is that it leads to excessive churning. Each time an agent switches companies, or a new agent approaches a policyholder of some other company, they may persuade their existing customers to sell their old policy and buy a new one. This sort of cost structure, where the policyholder pays in advance the service fee for the next 10 to 50 years in the first three years of the policy, is disadvantageous from a consumer protection perspective (Swarup, 2009).

Pursuant to a comprehensive review of the Insurance Act, Law Commission (2004) proposed removing commission percentage or amount restrictions from

[31] Section 40A, Insurance Act.

the parent legislation and giving IRDA the power to impose the same on different insurance products. It had suggested that Sections 40(2) and 40A of the Insurance Act should be amended to give IRDA the power to impose the upper cap (amount or percentage) on commission or remuneration payable to the agent in respect of different types of policies in both general insurance and life insurance sector. This suggestion is reflected in the Insurance Amendment Bill, which provides that the regulator would have the power to specify, by regulation, the manner in which commission or remuneration is to be received for the sale of insurance policies. After having reviewed the provisions of the Bill and carried out consultations with stakeholders, the Standing Committee (2011) concluded that the maximum limits on commissions should be done away with from the primary law but the law should instead mention the minimum amount or percentage of premium that the agents would be entitled to receive.

The working group is of the view that the primary law should not specify either the maximum or the minimum limits for commissions. Over time, Indian insurance markets are expected to reach a stage where consumers have sufficient knowledge and awareness about the importance of insurance. This will be reflected in a transition from the present agency based distribution model to an advisory model where the intermediary selling the insurance service will be remunerated through fees paid by the consumer rather than commissions paid by the insurer. This will enhance consumer welfare by checking the conflict of interest problem faced when agents who recommend insurance services to consumers are acting on behalf of, and are paid by, the insurer. In order for this transition to take place without requiring any amendments to the primary legislation, it is important that the law should not mention details of remuneration payable for sale of insurance either as commissions or fees. There should however be a broader power under the law to allow the regulator to prescribe incentive structures for the sale of insurance products.

The suggested approach will allow the regulator to assess situations where specific types of incentives may need to be allowed or disallowed. For instance, the regulator may recommend higher incentive payments with a view to penetrate insurance markets in the rural sector or it may recommend a deferred commission payment structure to prevent lapsation of life insurance products. Over a period of time, the regulator should used its powers to make sure that the regulatory framework transitions from a predominantly commissions based environment to a fees oriented structure.

> *Recommendation 11: No minimum or maximum cap on commission or fee should be mentioned in the primary legislation. The law should allow the regulator to prescribe incentive structures for the sale of insurance services, keeping in view consumer interests.*

3.5.4 Lapsation of policies

More than 25 per cent of life insurance policies lapse within the first three years of their issue without acquiring paid up value (Malhotra, 1994). Lapsation of an insurance policy occurs when a policyholder discontinues paying premium on the policy. It adversely impacts all the involved in the process - the policyholder suffers the loss of risk cover; the insurance agent loses out on future renewal commissions and the insurance company may suffer reputational loss. Lapsation of a policy may occur for a variety of reasons. These can broadly be classified into - external factors that are beyond the control of insurers (macro-economic factors, personal circumstances of the consumer, emergence of alternate investment options) and internal factors. Internal factors may include problems with the design of the product, faulty incentive structures and attrition of sales agents (Rajagopalan, 2008). The high upfront commission model as well as attrition of agents can result in situations where the policy lapses on account of lack of continued servicing of customers.

In this regard, attention needs to be drawn to Section 50 of the Insurance Act, which imposes an obligation on the insurer to notify the policyholder in case premium has not been paid. The notice should be issued within 3 months of such non-payment and should inform the policy-holder of the available options. However, if such options have been mentioned in the policy itself, no notice needs to be given. Law Commission (2004) suggested that this section should be amended to provide that such a notice would be required even if the policy contains details about the options. Subsequently, Narasimhan (2005) opined that this suggested amendment may create practical difficulties for the insurers and therefore opposed the amendment. In accordance with the view taken by Narasimhan (2005), the Insurance Amendment Bill does not suggest any changes or amendment to this section. The working group is of the view that in order to protect the interests of policyholders, the requirement to serve notice to the policyholder in case a policy lapses for non payment of premium should be made mandatory and unconditional. The policyholder should be informed of the consequences of laspation and the options available to him.

> *Recommendation 12: In case a policy lapses due to the non payment of premium, there should be an obligation placed on the insurer to issue a notice to the policyholder. However, these details need not be specified in the primary law. The primary law should only provide that the regulator may frame specific regulations for dealing with the lapsation on insurance policies, with a view to protecting policyholders.*

3.5.5 Grievance redressal

The institution of insurance ombudsman has been put in place under the Redressal of Public Grievances Rules, 1998. The present scope of the ombudsman's powers is limited to disputes between the insured and insurance company on matters related to the payment and settlement of claims. Once the ombudsman passes an award, it is for the policyholder to accept it within the specified time period and in case the policyholder is not satisfied with the award, he has the option to approach a consumer court or a civil court. In such a case of non-acceptance of the award by the consumer, the insurance company is also not bound by it. However, if the policyholder does choose to implement the award, there is no provision for appeal by the insurance company.[32]

Law Commission (2004) observed that neither the present ombudsman system nor the consumer courts have been satisfactory in addressing the grievance of the policyholders. It found that the shortcomings in the Ombudsman system are two-fold. First, the ombudsman is not necessarily a person with judicial background and hence was not considered satisfactory from the point of view of consumers and policyholders. Second, the Law Commission found it unjust that while the consumer or policyholder can choose not to follow the award of the ombudsman, the insurer does not have a right to question the award at all. In view of the new private insurers entering the Indian market, Law Commission (2004) found that it was necessary to have an independent, transparent and accountable grievance redressal mechanism to address the concerns of the policyholders.

Based on a review of the present ombudsman system, the provisions of the Insurance Amendment Bill and the recommendations made by the Law Commission, the working group finds that the following actions need to be taken in order to provide effective grievance redressal to insurance consumers.

1. The scope of the ombudsman should be extended to include not just complaints made against the insurer but also against insurance brokers and advisors. In so far as insurance agents are concerned, due to the principal-agent relationship between the insurer and agent, the recourse of the policyholder should be only against the insurance company.

2. The ombudsman awards should be enforceable against the complainant as well as the service provider. However, there needs to be an appellate forum to hear appeals from orders made by the ombudsman.

3. The current pecuniary limit of rupees 20 lakhs on the ombudsman's

[32] This was illustrated by the Delhi High Court in *Vinod Kumar Aneja* v. *New India Assurance* (Manu/DE/4059/2010) where it was held that the insurer has to unconditionally honour such award.

awards needs to be increased.

Recommendation 13: The scope of the present insurance ombudsman system needs to be expanded to allow complaints against insurance intermediaries, other than agents of the insurance company for whom the insurer will be directly liable. The ombudsman awards should be made enforceable against the complainant as well as the service provider, subject to the right to appeal before a specialised appellate forum.

3.5.6 Insurance fraud

It is a fundamental principle in insurance law that each party to the contract of insurance has a duty of utmost good faith towards the other. This duty lies on both the insured as well as the insurer. In order to fulfill this duty, the policyholder must disclose to the insurer any matter that he knows or should reasonably have known would be relevant for the insurer in deciding whether to underwrite the risk. It is the duty of the insurer to inform the insured of such duty of disclosure while entering into the contract.

Mere failure to answer or giving an incomplete or irrelevant answer to a question asked in a proposal form by itself cannot be considered to be a violation of the duty of disclosure. Further, an untrue statement made by the insured on a *bona fide* belief that a reasonable person in his position would have held, is also not considered as a violation of his duty of good faith. This aforesaid position has evolved through case law and these principles are not enshrined in the law. The Insurance Amendment Bill seeks to clarify this position by defining the meaning of 'fraud' in the context of insurance policies and setting out the period within which a policy may be called in question on the grounds of fraud.

Recommendation 14: The law should specify the duty of parties to an insurance contract to act in good faith. It should also set out the meaning and consequences of insurance fraud.

3.5.7 Information database

Sharing of information between insurance companies promotes efficiency by allowing insurers to make better informed pricing and underwriting decisions. Availability of information in the public domain also forms a tool for public policy reform and analysis and informs the viewpoint of new firms coming into the business.

These benefits motivated IRDA to constitute the Insurance Information

Bureau (IIB) for the purpose of collecting, processing and disseminating relevant data of the insurers to various market players, researchers, policy holders as well as general public for making real time decisions (IRDA, 2009b). Although the endeavour for disseminating information is a step in the right direction, it needs to be highlighted that there is no specific provision in the primary legislation requiring such data-warehousing nor is there any provision regarding data protection or the rights and obligations of this kind of data-warehouses. It is advisable that the primary legislation should provide that the supervisor including its staff and any individual acting on its behalf must protect the confidentiality of information in the possession of the supervisor including confidential information received from other supervisors.[33]

The IIB framework allows insurers to access macro-level data relating to the insurance industry and individual insurers but not the transaction level data of other insurers. However, the might be a justification for also allowing individual level data to be shared amongst insurers in the specific context of preventing insurance frauds. Since fraudsters may target different insurers as well as other financial institutions simultaneously or consecutively, promoting the exchange of fraud information can be a useful tool for the protection of insurers and their consumers.[34] Insurers may also share information about fraud risk, trends, policy issues, prevention and detection through information databases.[35] The practice of sharing information on frauds is already seen in several countries, including United Kingdom and Australia, where insurers have set up fraud bureaus to collect and analyse information on insurance fraud and to facilitate law enforcement investigations. This should however be done with due regard for the privacy and confidentiality of collected data.

> *Recommendation 15: The collection and sharing of insurance information can help insurers make better pricing and underwriting decisions. It can also help insurers combat instances of insurance fraud. The law should enable the sharing of insurance information while specifically providing the data protection and confidentiality requirements applicable to any person, including the regulator, that holds information belonging to others.*

3.5.8 Micro insurance

The specialised needs of low-income households make a case for changing the ordinary rules of insurance while dealing with small consumers. This has

[33] See IAIS (2011b).
[34] See IAIS (2006).
[35] *Id.*

been done by the IRDA through the IRDA (Micro Insurance) Regulations, 2005 (IRDA, 2005a) that create a specialised framework for the distribution of micro insurance products. These regulations require less stringent training for insurance agents in the micro insurance space and allow for a higher percentage of commission to incentivise micro insurance agents.

India's micro insurance regulations have motivated commercial insurers to move into the low-income market and insurers have recognised the opportunities in this market segment. Other emerging and developing economies like Brazil, South Africa, Philippines, Peru, Senegal and Mali have also taken the same path.[36]

Despite these positive developments, a lot still remains to be done to further insurance penetration and cover the economically weaker sections (Standing Committee, 2011). In this regard the Standing Committee recommended that the government and IRDA have to take further measures for the development of the micro insurance sector, through better sales and servicing processes, integration with other financial intermediaries (like banks, post offices etc.) and training of financial advisers.

This discussion highlights the need for the primary legislation to empower the regulator to frame specific regulations for the micro insurance sector. To achieve this, the law should specify that 'promoting innovation and access to insurance services' is one of the key principles to be observed by the insurance regulator. This will give the regulator the authority to vary the general provisions of insurance laws when making regulations for the micro insurance sector. For instance, by making specific provisions on eligibility criteria for micro insurance agents and remuneration structures for the sale of insurance to micro insurance consumers.

> *Recommendation 16: The primary legislation must empower the regulator to act in a manner that promotes better access to micro insurance. This should be done by stating that 'promoting innovation and access to insurance services' is one of the key principles to be followed by the regulator.*

3.5.9 Health insurance

The past few years have witnessed significant expansion in the country's health insurance coverage, primarily on account of the introduction of various government insurance schemes. Regulatory aspects relating to these schemes are discussed later in the report. In so far as the private health insurance sector is concerned, it still suffers from low penetration levels - in 2010, private

[36]See IAIS (2007).

health insurers were estimated to cover 55 million beneficiaries, representing about 4 percent of the total population (Public Health Foundation, 2011). With a view towards encouraging more participation and growth in this segment, the Insurance Amendment Bill proposes to introduce health insurance as a separate class of insurance business with a lower minimum capital requirement for stand alone health insurers. Except in respect of minimum capital requirements, health insurers will be subject to the same regulatory treatment as applicable to other general insurers. The working group is in agreement with this proposal and sees it as a right step in promoting the development of this sector. To the extent that life insurance companies carry out health insurance business, they should also be bound by the same norms that are specified for other health insurers.

The existence of multiple stakeholders in the field of health insurance - insurers, consumers, agents, third party administrators and health care providers - adds complexity to the process. The risk of moral hazard is particularly evident in the conduct of hospitals and health care providers that fall squarely outside the domain of insurance regulation. As per a study conducted by the Public Health Foundation of India, the voluntary private health insurance sector reported a hospitalisation rate of about 64 per thousand, which is double the national average of 31 per thousand (Public Health Foundation, 2011). Similarly, the average hospitalisation expenses for insured persons were found to be almost double of those payable by uninsured persons.[37]

The unregulated environment and a near total absence of any form of control over health care providers makes it a challenge for health insurers to carry out proper underwriting and actuarial premium setting proper underwriting and actuarial premium setting (Rao, 2005). This leads to higher costs for the insurer, which ultimately translates into higher premiums for consumers. Further, consumers may also face inconvenience in availing cashless medical facilities on account to frequent changes in empaneled hospitals, if such hospitals are noted by the insurer to be charging disproportionate fees. In order to address these concerns there is a need to undertake a broader reform process involving the health care industry. The codification of ailments, procedures and protocols, which will need to be adhered to by all heath care providers, will help deal with the supply side moral hazard problems highlighted above. A reform of this nature will provide more certainty to all stake holders, particularly insurance companies, who will then be able to

[37]During 2004 the average hospitalisation expenses of uninsured persons were about rupees 8,851 (Rs. 11,553 in private and Rs. 3,877 in government hospitals). In contrast, the mean hospitalisation expenses of the private health insurance industry for the year 2009-10 stood at rupees 19,637 per annum. Public Health Foundation (2011) notes that even after factoring in medical inflation, the difference in the average expenses is very significant and is indicative of the extent of moral hazard.

incorporate more effective underwriting practices.

> *Recommendation 17: There is a need for reforms in the health care sector to provide for the codification of ailments, procedures and protocols followed by health providers. This will help in promoting better underwriting by insurance companies by reducing the moral hazard problems in the supply of health care services to insured persons.*

3.5.10 Motor insurance

The importance of motor insurance arises both on account of it being the largest component of business written by non-life insurance companies[38] and the social objective that is served through mandatory third party motor insurance.[39]

Accident victims often have to face significant delays and inconvenience in trying to recover accident compensation. The MV Act attempts to address this issue by setting up a specialised Motor Accidents Claims Tribunal (MACT) for adjudicating compensation claims for death, injury or damage caused due to motor accidents.[40] The present law provides that the information relating to the vehicle involved in an accident and its insurance status is to be provided by the investigating police officer to the MACT and the concerned insurer.[41] However, there may be situations where the insurer may choose to acknowledge its liability and pay appropriate compensation to the victim without having to go through the MACT proceedings. To enable this, the law should provide the parties an opportunity to arrive at a voluntary settlement of the claim without having to go through adjudication by MACT.

Due to the mandatory nature of third party motor insurance, the premium rates for this sector are prescribed by the IRDA.[42] IRDA (2011f) identifies certain peculiar characteristics of the motor insurance sector that have resulted in huge claims outgo in the motor third party business for commercial vehicles, which include, unpredictability of compensation amounts awarded by courts and lack of any limits on liability under the MV Act. To address this issue there have been proposals to impose a monetary limit on the amount of compensation that may be recovered by an accident victim under the MV Act (Saha and Bhattacharya, 2012).

[38] In 2010-11, motor insurance constituted 42.70 percent of the total business in the non-life insurance segment (IRDA, 2011a).

[39] Section 146, MV Act.

[40] Section 165, MV Act.

[41] Section 158(6), MV Act.

[42] This is done in accordance with Section 14, IRDA Act. See (IRDA, 2012b) for the latest premium rates specified by IRDA.

The working group is of the view that instead of setting a cap on the compensation that may be recovered by an accident victim, the law should lay down the minimum amounts for which insurance cover must be obtained by every vehicle owner. This practice is followed in several other jurisdictions that require mandatory third party motor insurance.[43] The minimum amount of insurance coverage should be fixed at a reasonable and adequate amount and the amount should be updated at regular intervals to take into account inflation.

A provision of this nature will ensure that the accident victim will be entitled to recover compensation up to the insured amount while at the same time providing insurers better visibility on their potential liabilities. However, in order for India to adopt the practice of setting out the minimum insurance coverage for third party insurance, the regulator will have to do away with the current practice of specifying fixed premium rates for different types of vehicles. While doing so, the regulator may however choose to specify reasonable limits on the premium amounts that may be charged by insurance companies in order to protect consumers from the levy of excessive premiums.

Recommendation 18:

1. *In order to minimise inconvenience and costs, the law should provide the accident victim, insurer and insured an opportunity to arrive at a voluntary settlement of the claim without having to go through the adjudication process. If the parties fail to arrive at a settlement, the compensation should be decided on a fast track basis by a specialised tribunal.*
2. *The law should lay down the minimum amount of insurance coverage that must be obtained by every vehicle owner. This will ensure that accident victims are assured of receiving compensation of up to the insured amount. It will also provide insurers with more certainty on their potential liabilities. In order to achieve this, the regulator will have to discontinue the practice of fixing the premium for third party motor insurance policies.*

[43] As per the motor insurance directive issued by the European Commission (EC, 2009b) the minimum level for compensation cover has been set at Euro 1,000,000 per victim in the case of personal injury or Euro 5,000,000 per claim, irrespective of the number of victims and Euro 1,000,000 per claim in the case of damage to property. Europe Economics (2009) notes that a similar practice of mandating minimum levels of insurance coverage is also followed under the laws of various states in the United States of America.

3.5.11 Role of surveyors

The role of an insurance surveyor is to evaluate claims made by insured persons and assess whether the claim is payable and the extent to which the insured ought to be indemnified. Although the surveyor report is not binding on the insurer, it is given serious consideration by the insurer as well as by courts while assessing insurance claim disputes.[44]

The Insurance Act empowers IRDA to issue licenses to surveyors and loss assessors. It also has the power to cancel such licenses. [45] In this context, Standing Committee (2011) has expressed that view that the Indian Institute of Insurance Surveyors and Loss Assessors (IISLA), which is a professional body of surveyors and loss assessors, should function as a self regulatory body for this profession (like the Institute of Chartered Accountants of India and the Institute of Actuaries of India). The working group is in agreement with this suggestion. IISLA should be the body responsible for the supervision of its members and accordingly, the power to initiate disciplinary actions against surveyors should also vest with IISLA.

Under the present law, it is the duty of the insurer to obtain the opinion of the surveyor in specified cases with a power given to IRDA to call for a report from an independent surveyor.[46] The law does not provide for the right of the consumer to appoint a surveyor. The working group is of the view that the interests of consumers will be better served if the law provides for the consumer's right to appoint his own surveyor (in addition to the insurer's surveyor). In cases where such an appointment is made, the opinion of both surveyors should be taken into account by the insurer while deciding on the claim. In case of a dispute between the insurer and the insured, both surveyors' reports would be considered by the adjudicating authority.

Recommendation 19:

1. *The Indian Institute of Insurance Surveyors and Loss Assessors should be given statutory recognition as a professional body responsible for the licensing and supervision of surveyors and loss assessors.*

2. *In order to protect the interests of consumers, the legal framework should allow the consume to appoint a surveyor in addition to the surveyor required to be appointed by the insurer. The insurer will be required to consider both reports*

[44] Consumer courts have expressed the view that "unless it is shown that the surveyor's reports are tainted with some *mala fides*, the same cannot be overlooked" - *New India Assurance Company Ltd.* v. *Sturdy Polymers Ltd.*, III (2011) CPJ 338 (NC).

[45] Sections 42D and 64UM, Insurance Act.

[46] Section 64UM(2) and (3), Insurance Act.

before making a decision on the claim.

3.5.12 Assignment of policies

The Insurance Act provides for the assignment or transfer of life insurance policies.[47] Such assignment or transfer, if not in favour of the insurer, will not be operative unless the insurer is given written notice of the same. Under the present law, once the notice has been given to the insurer, the insurer has no option but to accept and record the assignment.[48] The Insurance Amendment Bill has proposed a new provision, as per which, the insurer has been given the power to refuse the assignment if it finds that the assignment is:

1. not bona fide; or

2. not in the interest of the policyholder; or

3. not in public interest.

The rationale of giving the discretion to the insurer is to prevent assignments or transfers of insurance policies which are speculative or involve moral hazard. This method was chosen to avoid the exercise of having to prescribe specific types of assignments that were allowed and debarred (Standing Committee, 2011).

The working group finds that the proposed clause does not lay down any specific principle to guide the insurer. The terms "bonafide", "interest of the policyholder" and "public interest" are very broad in scope and allowing an assignment to be refused on these grounds would constitute excessive discretion in the hands of insurers. In order to balance the potential policy concerns of restricting certain types of assignments with the contractual freedom of policyholders, the working group is of the view that the regulator should be empowered to lay the scope of permissible assignments. To the extent that an assignment is made in accordance with these regulations, the insurance company should be bound to acknowledge the notice of assignment given by the insured.

Recommendation 20: The law should empower the regulator to specify the types of permitted and restricted assignments of insurance policies. The insurer will not have the discretion to refuse

[47] Section 38, Insurance Act.

[48] This position has been clarified in *Insure Policy Plus Services (India) Pvt. Ltd.* v. *LIC*, [2007] 79 SCL 583 (Bom). A special leave petition (civil) bearing number 8918 of 2007 impugning this decision of the Bombay High Court is pending before the Supreme Court.

to record an assignment that is made in accordance with the regulations.

3.6 Promoting fair competition

3.6.1 Status of LIC

Given its historical context, the LIC Act conferred certain privileges upon LIC, which continue to remain in the rulebook despite the subsequent liberalisation of the insurance sector. These provisions create an uneven playing field in the market by giving LIC an advantageous position over other insurance businesses. The following are some instances of the provisions in the LIC Act which are different from the insurance framework generally applicable to other insurance companies:

1. The LIC Act provides an explicit guarantee by the Central Government of all sums assured by LIC policies.[49] No other private insurance company in the country enjoys a similar benefit and this leads to an unfair competitive advantage in favor of LIC.

2. LIC may carry on reinsurance business in so far as such business pertains to life insurance business. It is also permitted to carry on any other business which it believes is capable of being conveniently carried on in connection with its business and will render it profitable.[50] This position is at variance with the law applicable to insurance companies authorised to do business under the Insurance Act, as the Insurance Act requires that the *sole purpose* of an Indian insurance company should be to carry on life insurance business or general insurance business or re-insurance business.[51]

3. Pursuant to the Life Insurance Corporation (Amendment) Act, 2011 ('LIC Amendment Act'), LIC is required to maintain a share capital of hundred crores, which is at par with the current minimum capital requirements for insurance companies.[52] By enshrining the capital requirement in the LIC Act, the provision implies that the minimum capital requirement for LIC would remain fixed at this amount irrespective any upward revision in the Insurance Act. The law should instead have provided that LIC's capital requirement would be the same as may be applicable to all other insurance companies under the prevailing insurance laws.

[49] Section 37, LIC Act.
[50] Section 6(2), LIC Act.
[51] Section2(7A), Insurance Act.
[52] Section 2, LIC Amendment Act.

The original text of the LIC Act made only certain provisions of the Insurance Act applicable to it and stated that no other provisions of the Insurance Act would apply, unless specified by the Central Government through a notification.[53] Upon the introduction of the IRDA Act, the LIC Act was amended to remove the exclusive privilege of LIC to carry out life insurance business and to provide that it would be required to carry on life insurance business in accordance with the provisions of the Insurance Act.[54] Although this amendment should mean that the Insurance Act applies to LIC in its entirety, the continuance of the provisions identified above, which list the specific provisions applicable to LIC, create confusion in this regard. Further, the Insurance Act itself confers certain special privileges upon LIC. For instance, the agency commissions payable by LIC are different from those applicable to other insurers.[55]

The working group is of the view that all the provisions in the LIC Act and the Insurance Act which confer special privileges on LIC should be done away with and it should be governed by the standard laws that apply to all insurers. To achieve this, the first step would be to amend the LIC Act to change the status of LIC from a statutory corporation to a government company governed by the Companies Act, 1956.

In particular, the existence of the sovereign guarantee for LIC policies is found to be grossly violative of the principles of competitive neutrality. The provision creates a perception of safety in the minds of consumers and hence the expectation that they will be insulated from the failure of the corporation. This would logically lead to a preference of LIC products over competing products offered by private sector participants. This provision providing a guarantee fo LIC policies should be deleted from the LIC Act.

> *Recommendation 21: The legal framework governing LIC should be at par with the laws applicable to all other life insurance companies. In particular, there should be no sovereign guarantee for the policies of LIC. The status of LIC should be changed from a statutory corporation to a government company governed under standard company law provisions.*

3.6.2 Competition in reinsurance sector

Reinsurance allows insurance companies to diversify their insurance risks. Group of Thirty (2006) notes that given that the *raison d'etre* of the reinsurance industry is risk diversification, reinsurance is almost necessarily a

[53] Section 43, LIC Act.
[54] Section 30A, LIC Act.
[55] Section 40A, Insurance Act.

global business. The reason being that the global portfolios of reinsurers, diversified both geographically and across business lines allow them to take up more risks at a lower cost and with higher security than a direct insurer (Group of Thirty, 2006). However, the present regulatory environment in India tries to ensure just the opposite by requiring that insurance companies should maximise their retention within the country.[56]

At present, GIC is India's only reinsurance company and the law mandates that every general insurer should cede a specified percentage of the sum assured on each policy (presently fixed at 10 percent) with GIC.[57] In addition to the minimum cession requirement, insurance regulations also prescribe that before general insurance companies obtain reinsurance abroad, they must offer the reinsurance business to Indian insurers and reinsurers (GIC) and no more than 10 per cent of the reinsurance business ceded abroad should be with one reinsurer.[58]

The mandatory requirement to cede business to GIC and the limit on foreign reinsurance have the effect of hindering competition in the reinsurance business and at the same time causing excessive risk to be retained within the country. Insurance companies should be free to decide and negotiate the amount of business that they would like to reinsure with GIC, without any mandatory requirement being imposed under the law.

Due to FDI restrictions, foreign reinsurers are currently allowed to set up reinsurance business in India only through joint ventures, which has not proved to be a viable option for foreign reinsurers given the nature of the business and the large amount of capital required. The Insurance Amendment Bill seeks to address this situation by allowing foreign reinsurers to operate in India through branches. It also seeks to allow the entry of the Society of Lloyds by including Lloyd's within the definition of a 'foreign insurance company' that would be permitted to set up a joint venture or branches in India. It was submitted by Lloyd's before the working group that their unique structure, which operates through syndicates, would prevent them from establishing branches in the same way as conventionally structured reinsurers can. Therefore, the regulatory framework put in place to allow participation by foreign reinsurers should specifically accommodate Lloyds unique structure in order to be consistent with the arrangements put in place for other foreign reinsurers.

> *Recommendation 22: There is a need for encouraging competition in the reinsurance sector by adopting the following measures:*

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[56]Regulation 3(1)(a), IRDA (General Insurance-Reinsurance) Regulations, 2000 (IRDA, 2000a) and Regulation 3(4), IRDA (Life Insurance-Reinsurance) Regulations, 2000 (IRDA, 2000b).

[57]Section101A, Insurance Act.

[58]Regulation 3(3) to 3(10), IRDA (General Insurance-Reinsurance) Regulations, 2000.

1. *do away with the mandatory requirement placed upon general insurance companies to reinsure a portion of their business with GIC;*
2. *remove barriers which prevent Indian insurance companies from doing business with global reinsurers, subject only to prudential regulation requirements; and*
3. *create an enabling framework for the entry of global reinsurance firms, including Lloyds, in the Indian reinsurance sector.*

3.6.3 Role of competition policy

It was brought to the attention of the working group by the General Insurance Council that there have been cases where government insurance schemes are designed in a manner that discriminates against private insurance companies by requiring that only government owned companies would be entitled to participate in the schemes. The principles of competitive neutrality require that the government should not discriminate between publicly owned and privately owed insurance companies while adopting such schemes. Since the actions of the government fall outside the regulatory purview, this concern will have to be addressed through appropriate implementation of the National Competition Policy, which is currently in the process of being finalised by the Ministry of Corporate Affairs. MCA (2011) requires the central and state governments to undertake a review of their policies, laws and regulations from a competition perspective so as to ensure that their actions do not restrict or undermine competition.

The working group however recognises that in certain situations government schemes may indicate a preference for dealing with public sector insurers merely be on account of the fact that these insurers are audited by the Comptroller and Auditor General (CAG) and are publicly accountable, which may not be the case with private insurers. Therefore, while suggesting competitive neutrality in the design of government insurance schemes it should also be noted that the government may while allowing private insurers to participate in such schemes specify the safeguard to be complied with by them (such as audit requirements).

> *Recommendation 23: Competition policy should play an effective role in ensuring that government schemes do not create an uneven playing field between state-owned and private insurance companies.*

3.7 Resolution

3.7.1 Resolution mechanisms

The objective of insurance regulation is to ensure that insurance firms are managed in a safe and sound manner so as to protect policyholders from the potential failure of such firms. However, despite having the best regulatory systems in place, it is inevitable that some insurance firms will face financial troubles and may become insolvent. The legal framework should therefore envisage appropriate mechanisms for dealing with troubled insurers. These mechanisms include, staged intervention by the regulator upon the occurrence of identified trigger events and the use of resolution tools.

Based on a review of the practices followed in various jurisdictions, the following are identified as the main approaches for the resolution of insurance entities:[59]

1. Schemes of arrangements - arrangements between an insurer and its creditors requiring majority creditor approval, confirmation by regulators, and court sanction.
2. Portfolio transfers - moving all or parts of insurance business to another insurer without the consent of each and every policyholder subject to approval by the regulatory authorities and other interested parties.
3. Merger, transfer of ownership or take-over by state-owned insurer(s) or other parties.
4. Run off - the insurer is required to discontinue the writing of new business while continuing to administer existing contractual policy obligations.
5. Winding up - the insurer's assets are liquidated and used for making payments to claimants.

Several of these mechanisms already find a place in the Insurance Act. The Act empowers the Central Government to appoint an administrator to manage the affairs of a life insurance company to protect the interests of policyholders.[60] The powers enjoyed by the administrator include the right to, cancel or vary arrangements entered into by the insurer if found to be prejudicial to the interest of policyholders, and to make recommendations to the regulator regarding the transfer of the business of the insurer to some other insurer or cause winding up of the insurer.[61] Based on a report made by

[59] See IAIS (2011c)
[60] Section 52A, Insurance Act.
[61] Sections 52B and 52C, Insurance Act.

the regulator, the government may then decide to acquire the undertaking of the insurer, either on its own or through an acquiring insurer.[62] The regulator can also request the Court for the winding up of an insurer that persistently fails to comply with the Insurance Act or is found to be insolvent.[63] Although the winding up proceedings are to take place in accordance with normal company law procedures, the Insurance Act does contain certain specifications as to the process to be followed. For instance, it has been provided that the assets and liabilities of the insurer in respect of its life insurance business should be valued separately and only the surplus of such assets (if any) would be available for the discharge of any liabilities other than those in respect of life insurance business.[64]

The working group is of the view that there is a need to clarify and strengthen resolution capabilities in the law in the following manner:

1. As seen from the discussion above, the resolution provisions laid down under the Insurance Act are applicable only to life insurance companies. While it is true that the long-term nature of life insurance business may justify a differential treatment under certain circumstances, it does not appear justified to draw this distinction in the present context. As per Oxera (2007), "evidence suggests that failures on the non-life side tend to be more frequent, and although the average loss may be smaller, there are instances where the loss exposure to individual policyholders (and, importantly, third-party claimants) can well exceed that of typical life assurance policies". Therefore, it is important that scope of intervention for the orderly resolution of insurance firms should be extended to include non life insurers also.

2. The regulator should be able to take control over the insurer's affairs in certain specified circumstances without having to make a request to the government to do so. Reference in this regard can be made to the position in Canada where the regulator is empowered to take control over the assets of the insurer or the company, unless the Minister opines that it is not in public interest to do so.[65]

3. The mechanism for securing a private sector purchaser to acquire the distressed insurance undertaking should be specified as a resolution tool.

4. In case of winding up of an insurance company, a high legal priority should be given to the claims of policyholders.

[62] Section 52H, Insurance Act.
[63] Section 53, Insurance Act.
[64] Section 56, Insurance Act.
[65] Section 679, Canada Insurance Companies Act, 1991.

Recommendation 24: The law should contain appropriate resolution mechanisms to deal with failing insurance firms, including provisions for enhanced supervision and the option of transferring the business of the failing insurer to a solvent insurer. These mechanisms should be applicable to both life and non-life insurers.

3.7.2 Policyholder protection fund

A policyholder protection fund is a safety net that seeks to compensate policyholders in the event of an insurer's insolvency. By offering protection to the policyholders and beneficiaries of a failed insurer, these funds serve the objective of building public confidence in the business. Yasui (2001) reasons that since non-professional policyholders do not have the incentive or the ability to properly evaluate the financial soundness of insurance companies, they are inclined to rely on public perceptions of financial soundness of an insurance company and the industry as a whole, which is where the safety net of the protection fund comes into play. In addition to contributing to the development of the industry, the creation of such a protection fund also reduces the taxpayer's exposure to financial firm failure.

On the flip side, the establishment of a protection fund can give rise to moral hazard problems for policyholders - they may become less likely to choose a prudent insurer, insurers - in the form of increased risk taking and supervisors - less pressure to exercise discipline (Yasui, 2001). During consultations on this proposal with industry stakeholders, a concern was also raised regarding the additional costs that will be imposed on the industry on account of the creation of a protection scheme. Given that the Indian insurance sector is still in the nascent stages of development, it is possible that the increased regulatory costs, which will be passed on by insurers to the consumers, might have the effect of reducing the overall demand for insurance products. These concerns can be tried to be addressed to some extent by choosing the appropriate scheme design for the policyholder protection fund.

The following factors are identified as the key decisions that need to be made in relation to the scope and design of a policyholder protection scheme (Oxera, 2007):

1. Identifying the segments of the insurance market that will be entitled to the protection.
2. Identifying the classes of policyholders entitled to the protection - often restricted to non-professional consumers.
3. Defining the protection amounts and limits.
4. Governance, management and staffing of the protection fund.

5. Manner of funding - this can be ex-ante, where the funds are collected from insurance companies on a regular basis or ex-post, where funds are collected after the occurrence of an insurer's failure.

6. Deciding the basis for deciding how much contributions are to be made by insurers - usually a fixed percentage of the insurer's premium, technical provisions or number of policies.

7. Deciding whether the contributions should be risk-weighted - this will reduce moral hazard of the insurers but may be more difficult and costly to implement.

8. Deciding whether there should be alternate sources of funding for the scheme - possible options include, commercial borrowing, borrowing from the state, reinsurance or other market based solutions.

   Recommendation 25: There is a need to create a compensation scheme to protect policyholders from the inability of an insurer to meet its financial obligations and to minimise the taxpayer's exposure to the failure of insurance firms. The design of the policyholder compensation scheme should be decided under the resolution framework being designed by FSLRC.

3.8 Systemic Relevance

A financial institution is considered to be systemically important if its *disorderly failure, because of its size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.*[66] Lessons from the crises have revealed the need for regulators to adopt appropriate supervisory tools to identify and deal with systemically important financial institutions ('SIFI') which include the imposition of obligations to assess resolvability of the firm and undertake recovery and resolution planning exercises.[67] In order to determine the applicability of these provisions to insurance companies it becomes critical to understand whether and to what extent can insurers be regarded as SIFIs.

In general, the traditional insurance business model, which entails the underwriting of large diversified pools of mostly idiosyncratic risks, is unlikely to lead to systemic risks. This is because, the business model involves upfront payment of premium, investment portfolios that are closely tied to underlying liabilities and low probability of a sudden cash run since payments to policyholders require the occurrence of an insured event and premature with-

[66] See FSB (2010).
[67] See FSB (2011).

drawals by them usually come at a cost.[68] An insurer may, however, become systemically important on account of its participation in non-traditional insurance businesses, for instance, where different types of guarantees are provided or policies are issued without any penalties for early surrenders. Systemic risk may also arise in cases where an insurance company expands its business to include non insurance activities. An example of this was seen recently in the case of American International Group (AIG) where the exposures from the credit default swaps written by AIG's non insurance subsidiary made it the source of global systemic risk.[69]

The above discussion reveals that the failure of an insurance company may in some situations generate systemic risks although that is not a given feature of traditional insurance business. Since systemic risk regulation comes at a cost to the regulator as well as the insurance company, it is important that the regulator should make an assessment of the potential systemic importance of each insurer based on its product lines and business activities. Systemic risk regulation should then be made applicable to only those insurers that are found to be systemically significant. The objective being to ensure that the supervisory response is commensurate with the nature and degree of the insurer's risk.[70]

> *Recommendation 26: It should be the regulator's responsibility to assess the systemic importance of individual insurance firms. Additional supervisory and resolution tools will need to be employed in respect of those insurance companies that are found to be systemically important.*

3.9 Unregulated areas of insurance

3.9.1 Employees' State Insurance

The Employees State Insurance Scheme, established under the Employees State Insurance Act, 1948 ('ESI Act'), provides compulsory social security benefits to organised workers in notified areas.[71] The scheme is administered by ESIC which collects contributions from employees of covered establishments and their employers and provides them medical care facilities administered through its network of hospitals. It also provides cash benefits in the event of sickness, maternity, death or disablement due to employment

[68] See IAIS (2011a).
[69] See Geneva Association (2010) for a case study on AIG's failure.
[70] See paras 24.6 and 24.7, IAIS Core Principles.
[71] Employees of covered factories and establishments drawing wages up to Rs.15,000 per month are covered by ESIC. Contribution is payable at a rate of 1.75 percent of wages by the employee and 4.75 percent of wages by the employer.

injuries and other benefits such as, payment of funeral expenses, supply of physical aids, preventive health care services and unemployment allowance. As on date, ESIC covers 1.55 crore insured employees and through them a total of 6.02 crore beneficiaries.[72]

ESIC's medical benefits are designed to provide coverage for outpatient care, hospitalisation and preventive care, without any cap on the coverage. Despite its comprehensive design, the medical benefits provided by ESIC remain grossly under utilised. This is evidenced by the fact that the national average rate of hospital bed occupancy in 2009-10 was only 53 percent (ESIC, 2010).[73] Asher (2010) notes that the poor acceptance of ESIC scheme has given rise to a curious phenomenon where the revenues of the scheme continue to exceed its expenditure by a large margin - by 53 percent in 2008-09. These excess funds are being utilised by ESIC to expand benefit promises, such as the unemployment allowance, and to expand its activities to include opening of medical education institutes. Such actions are likely to be found financially unsustainable in the future whenever the utilisation rates improve (Asher, 2010).

Due to accessibility and quality issues, the medical facilities provided by ESIC are not being put to adequate use by its beneficiaries despite having paid the mandatory contributions. This makes a case on the one hand for undertaking reforms in the management and governance of the scheme and on the other for allowing employees the choice to opt for group health insurance offered by the insurance industry. The scale of surplus funds held by ESIC also make a case for reassessing the amount of contributions that is being collected from employers and employees under the scheme.

At present, participation in the scheme is mandatory for all covered establishments unless they obtain a specific exemption from the Central Government for doing so, the employer will have to show that employees are being provided with benefits that are substantially similar or superior to the benefits provided under the ESI Act.[74] Similarly, participation by covered employees is mandatory unless they are granted a specific exemption under the ESI Act.[75] This position should be revised to allow establishments to opt out of only the medical benefits component of the scheme.

To the extent that an employer is able to procure group medical insurance

[72]As per the 2010-11 annual report of ESIC referred to in http://pib.nic.in/newsite/erelease.aspx?relid=78789.

[73]The CAG carried out an audit of the employees' state insurance scheme in 2006. In addition to the under-utilisation of beds, deficiencies in the management of hospitals and dispensaries were also noted in the form of idling of equipment, injudicious purchase of medicines and procurement of sub-standard drugs (CAG, 2006).

[74]Section 87, ESI Act.

[75]Section 88, ESI Act.

coverage for its employees that is similar to the medical benefits provided by ESIC at a similar cost, it should be permitted to opt out of the scheme. In such cases, the premium for the group insurance should be payable from that portion of the contributions payable to ESIC that relate to the medical benefit service that the employee would have been entitled to had the employer chosen to continue contributing to ESIC. In addition, the per capita contribution made by the state government in respect of each employee should also be contributed as part of the employees' insurance premium.[76]

> *Recommendation 27: Establishments covered by ESIC should have the option to opt out of the medical benefit facilities provided under the scheme and obtain group health insurance coverage offered by an insurance company, if they are able to obtain similar benefits at a similar cost . In such cases, a proportionate amount of the total contribution payable to ESIC that relates to the medical benefits provided under the scheme will be used as the premium for obtaining the insurance policy.*

Another area in which ESIC has come under criticism is the lack of sound risk management and investment processes - the scheme has not employed any experts to provide guidance on investment strategies and its entire surplus is invested in fixed deposits with public sector banks and special deposits with the Central Government (Public Health Foundation, 2011). As on March, 2010, ESIC had total invested funds of over rupees 21,500 crores of which approximately 65 percent were held in fixed deposits and the remaining 35 percent with the Central Government. This points to a need for prudential regulation of the corporation to ensure that it is managed in a sound and efficient manner. At the very least, the investment norms to be followed by ESIC should be at par with other similarly structured bodies, such as the EPFO.

Being a social security scheme operated by the government on a non-commercial basis, we find that ESIC need not be subjected to the entire gamut of insurance regulations. At the same time it is also crucial to ensure that it observes certain crucial aspects of prudential regulation and consumer protection that are relevant in connection with its activities. In this context, the Insurance Act already provides that certain specified provisions of the Act are applicable to the general insurance business carried out by state governments and government companies, even though these bodies may otherwise be exempt from the provisions of the Insurance Act. This specified list includes provisions relating to registration, investment norms and main-

[76] At present, ESIC and state governments share the total expenditure on medical benefits in the ratio of 7:1, subject to the per capita ceiling of Rs.1200 per annum. Any additional expenditure beyond the ceiling is required to be borne by the states.

tenance of solvency margins.[77] However, this provision does not seem to have been put into effect. The working group finds that this situation should be remedied by providing in the law that principles relating to corporate governance, investment management and consumer protection (including grievance redressal) contained in the insurance law would also be applicable to ESIC.

> *Recommendation 28: Being a social security scheme administered by the government, ESIC should not be subjected to the entire gamut of insurance laws and regulations. However, the law should allow the insurance regulator to identify certain specific principles, such as those relating to corporate governance, investment management and consumer protection, that would have to be complied with by ESIC.*

3.9.2 Government-sponsored insurance schemes

In the last few years, the introduction of government sponsored insurance schemes, such as the RSBY launched by the Central Government and health insurance schemes launched by various State governments, has led to a significant increase in health insurance coverage.[78] Unlike the ESIC which provides insurance coverage on its own, the design of these schemes provides for the administration of insurance through existing insurance companies licensed by IRDA, pursuant to a contract entered into with the government.

To the extent that registered insurance providers are involved in the administration of the schemes, their conduct would be governed by insurance laws and regulations. The regulator may however choose to vary the applicability of certain consumer protection provisions in case of insurance coverage provided under government-sponsored schemes. For instance, although the insurer would generally be under an obligation to assess the suitability of an insurance product for the consumer prior to carrying out the sale, it would not be reasonable to expect the same degree of scrutiny in case of government-sponsored schemes. These schemes are designed to provide insurance coverage to eligible persons, usually at no cost to the consumer, and it

[77] Section 110F, Insurance Act provides that Sections 3, 3A, 27B, 28B, 33, 34, Clause (a) of Section 34E, 34F, 40A, 40C, 44A, 64U to 64 UM (both inclusive), 64V, 64VA, 64VB, 64VC and 101A, 101C, 110-D, 110-G and 110-H apply to the general insurance business carried on by a state government or a government company as defined in Section 617 of the Companies Act, 1956.

[78] In 2010, 302 million individuals - constituting about 25 percent of India's population were covered under health insurance schemes. Of these people, roughly 247 million - constituting over one-fifth of India's population were covered under three giant government-sponsored schemes - RSBY, Rajiv Aarogyasri in Andhra Pradesh and Kalaignar in Tamil Nadu (Public Health Foundation, 2011).

would be assumed that the necessary suitability assessment has already been carried out by the government before bringing a particular set of individuals under the scope of the scheme.

In case of schemes where the insurance coverage is provided directly by the government, the Insurance Act already specifies that certain provisions of law will be applicable to general insurance business carried on by state governments. This provision should also be extended to life insurance schemes and to schemes launched by the Central Government. However, the following tests should be taken into account before the specified provisions are attracted:

1. The provisions would not be applicable to welfare schemes that are funded through complete or substantial fiscal transfers being made by the government.

2. The provisions would not be applicable to any insurance scheme launched by the government for the welfare of its own employees.

The law should mandate that any insurance business carried out by the government, which is eligible for limited regulation under the Insurance Act, should be carried out through a separate corporate entity so as to allow the provisions of insurance law to be made applicable to it.

> *Recommendation 29: In case of government-sponsored schemes that are administered through insurance companies, the general provisions of insurance laws would be applicable. However, the law should allow the regulator to vary the applicability of certain provisions of law, particularly in respect of the pre-sale obligations of insurers.*

> *Recommendation 30: In case of schemes where the insurance coverage is contemplated to be provided directly by the government and the scheme is not funded through a complete or substantial fiscal transfer, the law will identify certain specific provisions, such as those relating to corporate governance, investment management and consumer protection, that would have to be complied with by the government body implementing the scheme. In order for these provisions to be effectively implemented, the law should mandate that any insurance business carried out by the government, which is eligible for limited regulation under insurance law, should be carried out through a separate corporate entity.*

3.9.3 Postal life insurance

In its capacity as an agent for the Ministry of Finance, the DoP operates two life insurance schemes - Postal Life Insurance (PLI) for government and semi-government employees and Rural Postal Life Insurance (RPLI) for people living in rural areas. DoP has issued over 1.4 crore policies under these two schemes with a total sum assured of rupees 1.1 lakh crores.[79] Despite these significant figures, the postal insurance schemes remain completely out of the purview of insurance laws.[80] Even the provision referred to above regarding limited applicability of the Insurance Act is not attracted in case of postal insurance as that provision applies only to *general insurance* schemes operated by state governments and government companies - neither of those criteria are satisfied by DoP's schemes. As a result, prudential requirements relating to solvency and capital maintenance, investment norms, governance and management, etc., do not apply to DoP in respect of its insurance activities. Being an arm of the government, the policies issued by DoP are guaranteed directly by the government and this creates a substantial contingent liability upon the government, which is of particular concern given the absence of prudential supervision.

Further, although the DoP has in place certain internal processes for dealing with consumers, its policyholders do not have recourse to the provisions on protection of policyholders formulated by IRDA and to redress by the insurance ombudsman. The inadequacy of the existing processes from a consumer protection perspective is reflected in the assessment of the DoP's insurance activities undertaken by the CAG in 2008 which found that there were significant delays in the acceptance of policies and well as the settlement of claims.[81]

Since the life insurance activities being carried out by DoP are in the nature of commercial activities, there is no sound reason for keeping them out of the regulatory ambit. The working group is of the view that the insurance business of DoP should be segregated into a separate corporate entity which should be regulated by the insurance regulator at par with other insurance companies. This will, on the one hand encourage competition by creating a level playing field between DoP and the private insurance players and on the other, it will ensure that PLI and RPLI are run in accordance with

[79] As per the annual report of DoP, on 31 March, 2010, 42.8 lakh policies had been issued under PLI and 99.2 lakh under RPLI and the total sum assured was 51,209.9 crores under PLI and 59,572.5 crores under RPLI.

[80] DoP is excluded from the applicability of the Insurance Act by virtue of Section 118(c), Insurance Act.

[81] During 2002-07, 4 percent of PLI and 23 percent of RPLI proposals received were accepted with delays of more than 30 days. Further, in PLI, 25 percent of the claims received during the period 2002-07 were settled with delays of more than 30 days whereas in RPLI the figure was 17 percent (CAG, 2009).

prudential standards and remove the contingent liability of the government.

> *Recommendation 31: Life insurance schemes operated by the Department of Posts should be corporatised and brought within the purview of the insurance regulator to ensure effective prudential management, protect the interests of policyholders and create a level playing field.*

4. Retirement financing

4.1 Introduction

In this chapter, we present our recommendations on issues of special relevance for the retirement finance sector that FSLRC should take into consideration while drafting the financial sector laws. These recommendations are based on best practices from other countries, principles and guidelines put forward by International Organisation of Pension Supervisors (IOPS), Organisation for Economic Co-operation and Development (OECD) and other agencies, and academic research on retirement financing. The recommendations are organised under the framework being adapted by FSLRC, which considers the issues under the following headings: consumer protection, prudential regulation, resolution and systemic risk. We are not giving any recommendations on systemic risk, because in our view, the general work on systemic risk regulation for fund management should take care of this issue.

4.1.1 What is retirement financing?

Retirement financing can be understood as encompassing all possible sources of income available to households to finance their consumption in retirement, which is an important function in lifecycle finance. There are four pillars of retirement financing unfunded state pensions (that is, transfers from the current working population via the tax system), funded private pensions (that is, from savings accumulated in private sector pension schemes), direct private savings, and post-retirement work (Blake, 2003). There is a general public policy perspective of retirement financing, which deals with the vision for retirement financing in the country across all pillars of retirement finance. However, in this report, the working group focuses only on those schemes that need to be brought under the purview of financial sector regulation and supervision on account of being a part of the retirement financing market.

Like other countries, financial regulation in India should apply only to funded retirement financing schemes, including those offered by government-owned companies. Unfunded state pensions and government pensions, such as the old age pension scheme, are beyond the scope of FSLRC's mandate. This is because the rationale for regulation does not apply to the schemes that are designed by the government to address specific problems in the field of retirement financing and are financed directly by the government through fiscal interventions.

Accordingly, the term retirement finance is used in this chapter to refer to all funded retirement financing mechanisms focused on helping people save or invest, for the exclusive purpose of having funds available in retirement. In India's context, these mechanisms include all private pension schemes, provident funds, as well as the NPS.

Retirement financing mechanisms can be of various types, depending on the nature of promise being made (defined contribution, defined benefit, or hybrid), the nature of contribution (voluntary or mandatory), extent of contribution by beneficiary (beneficiary only or with contribution from employer/government), and so on. Under a DC plan each consumer has an account into which the consumer and, if it is a co-contributory plan, the employer or the government make regular contributions. Benefit levels depend on the total contributions and investment earnings of the accumulations in the account. Often the employee has some choice regarding the type of assets in which the accumulation is invested and can easily find out what its value is at any time. DC plans are, in effect, tax-free or tax-deferred savings accounts in trust for the consumers, and they are by definition fully funded.

In a DB plan, the pension benefit entitlement is determined by a formula which takes into account the years of service put in by the employee for the employer and, in most cases, the person's wages or salary. While the DC framework focuses on the value of the assets currently endowing a retirement account, the DB plan focuses on the flow of benefits which the individual will receive upon retirement. DB plans are usually offered by an employer or by the government.[1]

The legal framework governing retirement financing should take into account a range of possible financing mechanisms. It should enable public policy decisions and market forces to shape up in a way that allows different combinations of retirement financing solutions to emerge in the country.

Throughout the world, governments are looking to funded schemes to solve the problem of providing pensions to their ageing populations. As demographic shifts increase the proportion of population in retirement, unfunded schemes are becoming less sustainable. An efficient, well-regulated private retirement financing sector can help ensure that the reliance of the population on unfunded state pensions is reduced.

In India, where the median age is about 26 years, and only 5.3 percent of the population is over 65 years of age, it is crucial to adopt the right funded retirement financing solutions. Three decades from now, when a large number of people start going into retirement, they should be capable

[1] See Bodie *et al.* (1988) for a discussion on the distinction between the two types of schemes.

of sustaining themselves through retirement financing mechanisms adopted by them during their working lives.

4.1.2 Retirement financing in India

Over several decades, the retirement financing sector in India has gathered significant variety and complexity in terms of the plans, fund-types, regulations and laws that are in place.

Components of the sector

The current retirement financing landscape in India consists of a limited set of unfunded, tax-financed schemes (such as the old age pension scheme) coupled with a varied range of provident fund schemes and pension schemes, many of which enjoy tax advantages, interest subsidies or both.[2] The key components of this sector are:

1. EPFO, which is established under the Ministry of Labour, is the primary organisation for retirement income for private sector employees. It administers a mandatory savings DC scheme - the EPF scheme and a DB pensions scheme - the Employees' Pension Scheme (EPS), with survivor benefits. The EPFO is also empowered to decide on the companies that may be permitted to administer their own provident and pension schemes. It also supervises the exempted firms, and essentially regulates itself through its own Board of Trustees.

2. Various occupational pension schemes and gratuity schemes - schemes of public sector financial organisations such as banks, insurance companies, and the state owned enterprises. Some of these are DB, while others are DC schemes. These are currently stand-alone schemes, which need to be integrated into the retirement financing system.

3. Civil servants at the center and in the states who joined service before January 2004. The retirement benefits available to them include a non-contributory, indexed, DB pension, with survivor benefits, mandatory provident fund savings scheme of the DC type, and a gratuity component. These schemes have their own structures, and there are no regulations concerning their design, financial viability, and investment patterns. The civil servants are the beneficiaries, but for the pensions, the liability burden is on the government, which means that the taxpayers may need to pay. It is essential that the beneficiaries be not entrusted with framing the rules and also administering and

[2]See Asher (2006) and Subhedar (2004).

supervising them. Since this is a tax-financed system, there is little that financial regulation and supervision can do.

4. The NPS, which is a DC scheme, which covers all government employees who joined service after January 2004. NPS is also accessible to other formal and informal sector workers. A specific scheme, referred to as NPS Lite, has also been created to cater to the needs of the informal sector.

5. Tax advantaged voluntary schemes, most of which are administered by Post Office Savings Bank. PPF, distributed through banks and post offices, is the main scheme available under this category. As the interest rate regime in India becomes more market-based, and as pre-funding becomes more widespread for retirement, including for those in the informal sector, there will be a need to take a closer look at tax-advantaged savings schemes from a system-wide point of view.

6. Schemes offered by insurance companies and mutual funds, all of which are DC schemes, though some of them make promises to provide specified minimum returns.

Existing legal framework

The legal framework governing the retirement financing sector is comprised of the following key laws:

- *Pensions Act, 1871:* The Act consolidates and amends laws relating to pensions and grants by government of money or land revenue, and puts in place a structure that allows distribution of pension to essentially be in the hands of executive government, without intervention of civil courts. It ousts jurisdiction of civil courts except to the limited extent of acting upon receipt of a certificate from a Collector. It provides for commutation of pensions, and makes pensions exempt from attachment.
- *Employees Provident Funds and Miscellaneous Provisions Act, 1952:* The Act applies to any establishment which is a factory engaged in any industry specified and employs 20 or more persons, and any other establishment or class of establishment employing 20 or more persons, as may be notified by the Central Government. This Act covers Employees Provident Funds Scheme, 1952, Employees Pension Scheme, 1995, and Employees Deposit-Linked Insurance Scheme, 1976. The Act also lays out the regulatory architecture for these schemes, leaving it to EPFO and the Central Government to regulate these schemes, with the latter appointing the board members of EPFO. The Central Government also has the powers to give directions, to make rules, and to remove

difficulties. The Act also provides for penalties and prosecution against those avoiding payments.

- *The Payment of Gratuity Act, 1972:* The Act provides for a scheme for the payment of gratuity to employees engaged in factories, mines, oilfields, plantations, ports, railway companies, shops or other establishments. It provides for different controlling authorities to be appointed by the appropriate State government for the administration of the Act. It requires the employer to maintain a gratuity fund or obtain insurance from LIC for his/her liability for payment towards gratuity. It mandates paying gratuity to an employee on termination of his/her employment after he/she has rendered continuous service for at least five years. It also provides for penalties if any employer contravenes or makes default in complying with any of the provisions of the Act.
- *Public Provident Fund Act, 1968:* The Act provides for the functioning of the Public Provident Fund Scheme that establishes a provident fund for the general public to make contributions to the fund and obtain income tax rebate.
- *Special provident fund laws:* Coal Miners Provident Fund and Miscellaneous Provisions Act, 1948; Seamen's Provident Fund Act, 1966; Assam Tea Plantations Provident Fund and Pension Fund Scheme Act, 1955; Jammu and Kashmir Employees' Provident Funds Act, 1961 are all acts that cover special parts of the pensions sector. They have a similar structure as the EPF and are required to give returns at least equal to that being given by EPF.

Upon approval, the Pension Fund Regulatory and Development Authority Bill, 2011 ('PFRDA Bill') that is currently pending before the Parliament will also form an important part of the legislative landscape. The PFRDA Bill seeks to give statutory status to PFRDA. It also proposes the architecture of the NPS, and gives PFRDA the powers to regulate and supervise various aspects of the NPS. NPS is a DC scheme, and it comprises of three sets of entities: the Central Recordkeeping Agencies (CRA); Pension Fund Managers (PFM) and Points of Presence (POP). The bill has provisions for regulation of each of these components.

This system has developed over a period of several decades of efforts by the government and private sector to find solutions to the retirement financing challenge. With the exception of the development of NPS, most of the changes in recent decades were iterative, and as a result, a complex field has come into being, and we need to find ways to write laws that encompass all aspects of retirement financing that should be covered by financial regulation. The working group focused on identifying problems in the retirement financing sector, some of which are discussed below, but the recommendations are not meant to address only these problems, but are based on best practices internationally and a consideration of first principles. Since FSLRC has the mandate to review and rewrite all financial sector laws, this is a good opportunity to review and revise the overall retirement financing framework.

Issues with the existing system

Following is a brief discussion on some of the issues the working group identified in relation to the current legislative and regulatory framework of the retirement financing sector:

- *Fragmented and conflicted regulatory architecture:* At present, the legal and regulatory framework for retirement financing is quite fragmented, with the main regulatory responsibilities being shared between EPFO and the PFRDA. There is no need for this, and since EPFO also manages schemes, there is a clear conflict of interest in its roles. Since the regulatory ambit of EPFO is a part of a larger retirement financing industry, the regulation and supervision of the sector should be consolidated under one regulator and supervisor. The working group proposes an integrated architecture for regulation of retirement financing.
- *Inadequate prudential regulation:* Organisations such as EPFO and perhaps many of the smaller funds suffer from inadequate prudential regulation, in terms of their investment management, risk management and corporate governance practices. The EPFO board only has government appointed members, and its unwieldy size of 45 members makes it too large to function as an effective governing body. It also does not do proper valuation of its assets to understand the financial position that it is in. The promise of government support seems to have affected the incentive of the organisation to follow best practices. Large number of exempt funds are regulated by EPFO, which does not follow international best practices in regulating them. Later in this report, the working group presents a set of recommendations on what the law should provide for the prudential regulation of the retirement financing sector.
- *Poor consumer protection:* Other than the court system and the consumer courts, there is no ex-post redress mechanism in place for retirement financing schemes. Therefore, it can be argued that the redress options are limited and not adequate. More importantly, there isn't sufficient emphasis on consumer protection in the laws and regulations in the sector.
- *Other important issues:* There are many other issues that the working group noted, but since they fall outside the purview of financial

regulation, these won't be discussed. For example, there is a very large amount in terms of unfunded liabilities under EPS, which is ultimately to be paid by the taxpayer. This liability arises because government is responsible for part of the pension contribution to EPS. Even though EPS is contributory, being a DB scheme, it faces the obligation risk i.e. its funds may not suffice to meet its obligations. The government has not dealt with this issue with the clarity that is required to assure the consumers about what they can expect. It is also important to reform the scheme to make it sustainable. A recent committee appointed by the government clearly recommended making it a DC scheme (Srivastava, 2010).

Recommendation 32: There should be common regulation and supervision for all retirement financing schemes, including various types of pension and provident fund schemes, but not including the unfunded, tax-financed schemes, or those that are largely tax-financed.

Though financial regulation should apply to EPF and PPF, we are faced with a conceptual challenge in classifying them. Since these are subsidised schemes, which are funded but enjoy interest subsidy, they represent a mix of private retirement financing and welfare transfer. In the view of the working group, there is significant value in bringing best practices driven regulation to these schemes and to the organisations that manage them. If we look at these schemes as combinations of these two components, i.e. private retirement financing and welfare transfer, but treat these as separate, it should be possible to apply full financial regulation to the former. For example, if EPFO's regulatory role is taken away, and it is treated as yet another organisation managing retirement financing schemes, the full range of retirement financing regulations can be applied to it, and it is incidental that the schemes also receive a subsidy. In such funded schemes, a subsidy is not a good enough reason to not be subjected to sound financial regulation. In fact good prudential regulation, especially on investment management and risk management, can help reduce the probability of requiring a subsidy at all. For these reasons, the working group recommends bringing these schemes also under the purview of regulation.

Recommendation 33: EPFO should only manage and not regulate retirement financing schemes. EPFO itself should be regulated in the same manner like any other retirement financing entity, and the entire range of regulations should apply to it. Similar approach should be taken towards PPF.

The exempt and excluded funds are supposed to give at least the return that EPF is giving, and they also enjoy tax benefits. Many of these are small funds, which on their own may never be able to establish and follow best practices, putting the consumers at risk. The law and regulation should encourage such funds to integrate with the larger retirement financing system, so that they can benefit from sound practices. This can be done if they integrate with NPS, which is a DC scheme with no fixed returns, or with EPF, which is a DC scheme with fixed returns. The latter will be optimal only if the recommendation of applying the new regulation to EPFO is accepted.

NPS provides a framework that is built on understanding of modern design principles for retirement financing systems.[3] The working group sees value in moving more and more funds and consumers into such a framework. NPS came about as a result of significant institutional and policy reforms (Dave, 2006). It would be good if many of the independent funds take the benefit of NPS and move their funds under its framework. Even EPFO could benefit from the NPS framework, and perhaps it would be useful to think about how EPFO and other retirement finance entities can use the expertise of PFM, POP and CRA that are available to NPS.

> *Recommendation 34: Smaller exempt and excluded funds should integrate with EPF or NPS. The beneficial tax treatment available to them should continue if the fund chooses to integrate with either of the two. The law should not make reference to the possibility of exemption or exclusion, and it should mandate all existing funds that fall under these categories to opt for either NPS or EPFO.*

4.1.3 Rationale for regulation of retirement finance

Like all financial regulation, the regulation of retirement finance is supposed to ensure that consumers are protected and that the financial system is stable. The regulatory interventions should be based on the challenges posed to these two objectives that are inherent to retirement financing schemes. This section presents a detailed rationale for different types of regulation in the retirement financing sector, and the views of the working group on inclusions to be made under each type of regulation.

First, for protecting consumers, there is a need for *prudential regulation* of retirement finance funds. Though retirement finance funds are in many ways like other fund management businesses, they differ from such funds in certain important ways. Australia's Wallis Inquiry report provides guidance on how to think about the *intensity of promise* for various types of financial services, and use this as a basis for deciding whether prudential regulation is required, and to what extent it is required (Wallis, 1997). It defines the intensity of promise in terms of:

[3]Some of these principles are: a DC approach, good inter-operability, optimal charges, and a good quality front-end.

- inherent difficulty of honouring a promise
- the difficulty in assessing the creditworthiness of the promisors
- the adversity caused if the promise is breached

This framework of *intensity of promise* can be applied differently to DB and DC schemes.

The intensity of promise is very high for DB schemes, perhaps more so than any other financial service, because it is a long-term promise made for financing a basic need. So, the inherent difficulty of honouring the promise is very high; it is very difficult to assess the creditworthiness of the scheme to make good on the promise; and the adversity caused in the case of a breached promise is highly detrimental to the well-being of retirees. Though there is less of a concern in DC schemes on the first two counts, since they are market-linked, there is a big concern of adversity caused if the retirement incomes is not adequate. So, even for those schemes, some level of prudential regulation would be necessary.

Second, if a DB scheme seems to be failing, there should be a mechanism for resolving it efficiently before it goes bankrupt, to protect the consumers' interests. This would require intervention of an agency of the government, because the consumers would not be able to coordinate to enforce orderly resolution, given the *coordination failures* likely to occur among the large number of consumers.

Third, over and above prudential regulation and resolution, there is a case for *consumer protection regulation* to prevent abuse of consumers in the hand of financial service providers. The long-term nature of the contract, and the subsequent requirement to overcome individuals myopic attitude towards long-term savings make the consumer protection challenge particularly difficult in the retirement financing sector. The effect of poor decisions gets amplified, and since the decumulation starts much later, the investor may not even realise the mistakes being made till it is too late. At stakes are subsistence rather than discretionary savings, and hence the need for enhanced protections. The case for such protection is rooted in three key market failures:

1. *Information asymmetry:* There are significant information asymmetries between consumers and financial service providers, and this extends to the asymmetry of expertise about the right investment decisions. The complexity of the products, involving tax issues, assumptions over future salaries, longevity and difficulty in the valuation of assets and liabilities, gives rise to asymmetrical information between pension providers and consumers. It is quite easy for the provider to exploit the consumer by conveying partial or incorrect information.

2. *Market power:* If preventive measures are not taken, retirement financing schemes can wield high power vis-a-vis the consumers, especially because of the long-term nature of the investment. Once the investments start, unless the consumer has the choice to switch schemes, the scheme would be very powerful compared to the consumer.

3. *Externalities:* There are negative externalities if a person is not able to adequately finance his/her retirement using retirement financing schemes, and the burden of financing his/her retirement may fall on the society. So, it is in the interest of the society to ensure that consumer make the right retirement financing decisions.

These market failures essentially provide the rationale for preventive measures to be taken to ensure consumers make the right choices throughout the retirement financing cycle, have an optimal level of flexibility in choosing schemes, and are provided reasonable quality of service.

Fourth, since in most developed markets retirement financing schemes usually form a large part of the financial system (in terms of holding a large portion of securities), for *maintaining systemic stability* it is crucial to ensure that large retirement financing schemes or a large number of schemes don't fail, and that these schemes don't help fuel asset bubbles that trigger crisis in the financial system. As large pools of capital, these schemes need to be regulated from the systemic risk point of view. The market failure here is the presence of negative externalities, which mean that the costs of failures and bubbles are not fully internalised by the schemes, their managers or their investors, and must be borne partially by the larger society.

It is often argued that the regulator should also be given the development mandate, in addition to the responsibility to regulate. In our view, the regulator's mandate should be restricted to regulating the markets, and any developmental role should be fulfilled by the policy decisions made by the government directly. For example, inclusion is considered to be a desirable development goal, and it is often argued that ensuring inclusion should be the regulator's responsibility. Though well-intentioned, this argument is flawed, because if the regulator is focused on correcting market failures, adding such goals would only dilute its focus. Development may conflict with consumer protection and prudential regulation, which are the core regulatory functions. Development is also a poorly defined goal, and it may create problems of accountability for the regulator, because a wide range of actions are potentially be justified by a development mandate. Moreover, assuming that inclusion is a function of making services cheaper and accessible to more people, the regulator can contribute towards this goal by improving efficiency in the markets that it regulates. If such steps do not suffice, the government should directly subsidise access to more people. A regulator using its powers to nudge the providers to reach more people would go against its focus on market failures.

The same arguments hold for micro-pensions, where there may be calls for less stringent regulation to ensure greater inclusion. For example, a requirement to give detailed financial advice to every consumer could impose costs that may lead to exclusion for some. Such a requirement would be justified if it is known that in the absence of advice, consumers will make mistakes that may be costlier than the increase in costs due to the advice. The regulator should conduct a cost-benefit analysis to ensure that the benefits of a regulation for consumers and the financial system surely outweigh its costs. This does not imply a clear dilution of standards.

> *Recommendation 35: The primary objective of retirement financing regulation should be to correct market failures in the retirement financing sector. Development of the sector or inclusion should not be mandates given to the regulator, though the regulator should have the flexibility to customise the regulation according to the profile of the consumers and the kind of the product being offered, based on cost-benefit analysis of the regulation.*

4.2 Prudential regulation

As discussed in the introduction, the rationale for prudential regulation of retirement financing is rooted in the *high intensity of promise* made by retirement financing schemes. This rationale provides the basis for regulation to ensure safety and soundness of retirement financing schemes. Prudential regulation for DB schemes should be much more intense than that for DC schemes, because DB schemes make promises that are of a very high intensity. The approach towards prudential regulation for these two different promises should be different. While in DC schemes, regulation of basic entry barriers, corporate governance, risk management, and investment management should suffice to ensure safety and soundness of the scheme, for DB schemes much more emphasis ought to be given to capital and liquidity requirements, and only the financially strongest of entities should be allowed to offer such schemes.

The following are the key prudential regulation questions that arise in the context of retirement financing schemes:

1. *What should be the overall approach towards ensuring safety and soundness of schemes?:* This is the question of regulatory and supervisory philosophy. The working group suggests a risk-based approach to regulation and supervision, and this overall approach must inform the way prudential regulation instruments are used.

2. *Who should be allowed to establish and manage retirement financing schemes?:* This question concerns the threshold conditions to be fulfilled before one is allowed to establish and manage retirement financing schemes. This can be the first step towards ensuring safety and soundness of schemes. The working group sees merit in mandating licensing of retirement financing entity as well as the retirement financing fund, and enumerates some general criteria that may be considered while awarding licenses.

3. *How should the investment management by schemes be regulated?:* There are a number of regulatory approaches towards investment management, but the two stylised approaches are: the prudent person standard, and portfolio restrictions. It is possible to have a combination of these approaches. There are also other, additional issues to consider in this context, regarding the investment policy of the funds and valuation of assets. The working group if of the view that the prudent person standard should be enshrined in the law, while giving the regulator the powers to impose certain broad portfolio restrictions.

4. *How should the risk management systems of retirement financing funds be regulated?:* The law has to take a view on how much power must be given to the regulator to intervene with the risk management systems of retirement financing funds. The regulator should be given the powers to review all aspects of the risk management system, and advise the fund on lacunae it observes.

5. *How should the capital and liquidity requirements be regulated?:* The law has to define the principles based on which the regulators may prescribe capital and liquidity requirements for pension funds.

6. *How should the corporate governance of retirement financing be regulated?:* Safety and soundness of a retirement financing scheme is the primary responsibility of its governing body and senior management, and if the governance systems are not robust, all other instruments are not likely to work. So, the law must state if and to what extent can the regulator guide the corporate governance of retirement financing schemes.

4.2.1 Risk-based regulation and supervision

Prudential regulation and supervision must be proportional to the risk undertaken by the given scheme. This is the direction most developed countries have taken.[4] The introduction of risk-based regulation and supervision should

[4]IOPS recommends this approach in its principles of private pension supervision and calls up on regulators to develop the expertise to implement such an approach IOPS (2010).

be seen as a movement along a continuum from one extreme of complete reliance on a rules-based system to one where the emphasis of regulation is based on risk. Risk-based regulation and supervision does not mean having no rules or compliance procedures. A legal framework allowing suitable discretion in terms of interpretation and exercise of supervisory powers is required, which should also provide pension supervisory authorities with the necessary powers to adopt a risk-based approach. The regulatory and supervisory authority should communicate its risk-based approach to the industry, explaining what is expected of them particularly in relation to risk-management via guidance notes and possibly by providing training.

Risk-based approach itself can be exercised on a continuum, ranging from a light touch approach to a more intensive approach of regulation and supervision. In Europe, for instance, there is a debate going on about whether the DB retirement financing plans ought to be subjected to a full-fledged Solvency II-type prudential regulation and supervision regime[5], or should the approach remain one of light touch risk-based regulation.

> *Recommendation 36: Prudential regulation and supervision of retirement financing should be largely risk-based. Regulator should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated.*

4.2.2 Licensing regime

The objective of licensing is to ensure that only those with reasonable capability to establish and manage a retirement financing scheme are allowed to do so, and licensing also helps create a system of monitoring the schemes by giving them an identity in the regulator's purview. Delicensing serves as a strong punitive measure that may be used against those found guilty of major failures vis-a-vis laws or regulations.

The law should create a system for licensing of retirement finance entities and retirement finance funds. *Retirement finance entities* are legal entities ultimately responsible for the retirement finance fund. It can take the form of an independent legal entity acting as a trustee in the case of funds established as trusts, a fund management company, or the fund itself where the fund has legal capacity. An insurance company or other financial institution may also be considered a retirement finance entity insofar as it is legally responsible for a retirement finance fund and otherwise fits this definition.

A *Retirement finance fund* is a legally separated pool of assets that is bought with the contributions to a pension plan for the exclusive purpose of

[5] Solvency II is the proposed comprehensive risk-based prudential regulation framework for insurance sector in Europe.

financing retirement plan benefits. The plan/fund members have a legal or beneficial right or some other contractual claim against the assets of the fund. Retirement finance funds take the form of either a trust, an independent entity with legal capacity (such as a foundation or mutual association) or a legally separated fund without legal capacity managed by a dedicated provider (pension fund management company) or other financial institution on behalf of the plan/fund members.[6]

Licensing can also be considered at the level of retirement finance plans, which are specific contracts that consumers enter into to finance their retirement. The working group decided against requiring of licensing of each and every retirement plan, and agreed that licensing should be at the level of the retirement finance entity and retirement finance, but the regulator may issue regulations about the norms that each plan must fulfil. The reason for avoiding plan-level licensing is to allow innovation to develop retirement financing solutions, rather than restricting the innovation by licensing regimes. For DB plans, the regulator may impose strict pre-conditions for launching a plan, but here also licensing may not be required.

Some members of the working group raised concerns that this approach may not be the appropriate given the current stage of development of the regulatory system and the potential harm that may be caused to consumers from unchecked schemes. To address this issue, the regulator may restrict the types of plans that may be launched by a fund at the time of licensing the retirement finance entity. For example, certain funds may not be allowed to launch DB plans. The need for plan-level licensing is also reduced if licensing of retirement finance entities and funds is done well.

> *Recommendation 37: The law must provide for licensing of retirement finance entities and retirement finance funds, but there should be no licensing of individual plans. The regulator may prescribe conditions to be fulfilled by each of the plan to be launched by the licensed fund. In addition to the entity's licensing, each of the trustees of the entity should be registered with the regulator.*

The law should prescribe certain principles-based criteria that the regulators may further adapt to come up with more detailed criteria for awarding licenses. The process of awarding licenses must be transparent and objective, and the applicant must be given the opportunity to appeal the rejection of the application. Based on what is done in other countries, these criteria may span the following variables:[7]

1. Legal, managerial and ownership structures of the applicant and its wider group

[6] See "OECD-IOPS" (2008) for a discussion on entities and funds.
[7] Based on Hu and Stewart (2009) and "OECD-IOPS" (2008).

2. Fit and proper requirements: Capability of the trustees/promoters to establish and manage the retirement financing funds and plan properly

3. Risk management systems: Risk management systems already in place or proposed to be put in place before the plans are launched.

4. Financial strength and capital: Capital to be invested up front, based on the risks posed by the proposed fund, and the general financial strength of the applicant to establish and manage the schemes that it is proposing to establish.

5. Investment policy: Detailed investment policy to be presented to the regulator.

   Recommendation 38: The law should define principles-based criteria for awarding licenses to retirement financing entities and funds. Licensing should be on the basis of demonstration by the trustees/promoters that they have the required legal, managerial and ownership structures, capability (human, technology and financial), risk management systems, investment policy, financial strength and capital to manage the entity and/or the fund. The process of awarding the licenses should be transparent, and the applicants should be given a detailed response in a reasonable amount of time. The regulator should also have the power to modify or withdraw the licenses after due process, and such decisions should be appealable in a court of law.

4.2.3 Regulation of investment management

The investment function varies depending on the type of scheme. In the case of DB plans, the goal of the investment function is to generate the highest possible returns consistent with the liabilities and liquidity needs of the pension plan, and in light of the risk tolerances of affected parties. In a DC plan, the main goal of the investment function is to generate gains that accrue to individual member account balances in light of her investment goals. The regulation of investment management should vary according to the types of the scheme.[8]

There is merit in following the *prudent person standard* for regulating the investment management in retirement financing funds. The standard means that the investment of assets is undertaken with care, the skill of an expert, prudence and due diligence. Where they lack the expertise, the governing body and senior management must seek external assistance on investment management. The governing body of the pension plan or fund and other

[8] See OECD (2006).

appropriate parties is supposed to be subject to a fiduciary duty to the pension plan or fund and its members and beneficiaries.[9]

The regulator should also have the powers to impose certain broad portfolio restrictions that prevent excessive risk-taking by the funds. These restrictions may mandate maximum levels of investment by asset classes to the extent that they are consistent with and promote the prudential principles of security, profitability, and liquidity pursuant to which assets should be invested. The law should not prescribe a minimum level of investment for any given category of investment. Given the benefits of having a wide set of choices in asset classes, portfolio restrictions should be minimal, and focused only on preventing excessive risk-taking. The regulators should have the power to notify regulations on concentration risk, to limit the exposure to securities issued by the same issuer. The retirement financing funds should not be restricted from investing abroad (subject to constraints imposed by capital controls), because there are significant diversification benefits as well as hedging possibilities that emerge as a result of the opportunity to invest or share risks with parties in other countries.

> *Recommendation 39: The law should provide that the "prudent person standard" be followed for investment management by those managing retirement financing funds, such as pension fund companies, EPFO, etc. The regulators should also have the powers to impose some broad portfolio restrictions to prevent excessive risk-taking by the funds. These restrictions should be imposed only as exceptions, and must not take the form of the regulators prescribing investment management strategies for the funds.*

The regulator should have the powers to require the governing body of the retirement financing fund to set forth and observe an overall investment policy, which should establish clear investment objectives for the fund that are consistent with the retirement income objective of the fund and, therefore, with the characteristics of the liabilities of the fund and with the acceptable degree of risk for the fund, the plan sponsor and the plan members and beneficiaries. The approach for achieving the objectives should satisfy the prudent person standard, taking into account the need for proper diversification and risk management, the maturity of the obligations and the liquidity needs of the pension fund, and any specific legal limitations on portfolio allocation.[10] The regulator should be able to notify regulations setting out the issues that should be should addressed by the fund's investment policy.

For schemes in which members make investment choices, there must be an appropriate array of investment options, including a default option provided

[9] See (OECD, 2006).
[10] *Id.*

for members. In particular, the investment policy should classify the investment options according to the investment risk that members bear. The investment policy should address whether internal or external investment managers will be used, the range of their activities and authority, and the process by which they will be selected and their performance monitored. An investment management agreement should be required if external investment managers are used.

> *Recommendation 40: All retirement financing funds must be required to set forth and actively pursue an overall "investment policy". The law should empower the regulator to define the minimum requirements for the policy.*

To ensure that the reporting and disclosures by different retirement financing funds are comparable and consistent, the regulators should be empowered to establish a transparent basis for valuing retirement financing assets. The regulator may choose to delegate the responsibility of setting standards to some other body, but it would continue to be responsible for those standards. Depending on the prevailing standards, the regulator may require marking to market or doing fair value estimations. Assets must be valued for accounting, reporting, actuarial and funding purposes.

> *Recommendation 41: The law should empower the regulator to set standards for valuation of retirement financing assets and liabilities in a transparent manner, informed by prevailing standards in other parts of the domestic financial system or in other jurisdictions. The regulator may, if it so chooses, delegate the task of setting standards to a standard setting body, but the regulator would continue to be responsible for the standards.*

Certain provident fund schemes in India are DC schemes, but with interest rates administered by the government in a manner that it often involves interest subsidy. So, they are not purely market-linked DC schemes, but they need not be regulated differently, because they can still follow best practices while enjoying government subsidy. It is beyond the scope of financial regulation to advise the government on how much return should be paid on the schemes, but the regulator can play a role in ensuring the entities managing these schemes follow best practices.

> *Recommendation 42: For DC schemes with administered interest rates, such as EPF and PPF, the regulators should have the power to regulate and supervise them for sound investment management practices.*

4.2.4 Regulating risk management systems

One of the main objectives of risk-based regulation and supervision is to ensure sound risk management at the institutional level, taking into account both the quality of risk management and the accuracy of the risk assessment. Risk-based supervision lets much of the responsibility for risk management rest with the individual funds themselves, while the supervisory authority verifies the quality of the funds risk management processes and adapts its supervisory stance in response.

The following are the key elements of regulation of risk management systems:[11]

1. *Appropriate mechanisms for risk management:* The regulator must be satisfied that the fund has sound risk management systems comprising of: strategies, processes and reporting procedures necessary to identify, measure, monitor, assess, control and report, on a continuous and an ad hoc basis, all material risks, at an individual and an aggregated level, to which the pension fund or plan is or could be exposed, and their interdependencies.

2. *Management oversight and culture:* The governing board of the fund should be responsible for defining, implementing and improving the retirement financing fund or plans risk management system, and for establishing a highly ethical standard throughout the organisation. The governing board of a fund should determine and regularly review its overall risk management strategy. This process involves understanding the risks run; setting acceptable levels of risk; and outlining how these risks will be measured monitored and controlled.

3. *Funding and solvency risk control:* Funds that offer DB must be required to maintain an appropriate level of assets to meet the liabilities corresponding to the financial commitments or obligations which arise out of the pension arrangement. Such funds should be required to establish a funding and solvency policy. The regulator should have regulatory provisions on funding and benefit security.

4. *Investment/market risk control:* This element is discussed in details in the sub-section on investment management.

5. *Operational risk control:* The regulator should have the power to issue standards for sound operational risk management, based on best practices. These standards may address issues such as: IT risks, business continuity, and outsourcing.

[11] See OECD (2011).

6. *Control and monitoring mechanisms:* The regulators should have the power to review the monitoring and control mechanisms in place for retirement financing funds. Such mechanisms may comprise of physical controls and checking for compliance with exposure limits, as well as processes for verification and reconciliation etc.

7. *Information, reporting and communication systems:* Adequate and comprehensive channels for the reporting and communication of internal data, external information (e.g. from service providers and to pension supervisory authorities) and external market information (in particular to plan /fund members) should be established, with all information required to be reliable, timely, accessible and consistent. A policy should also be in place to ensure that confidential information is treated appropriately. The regulator should have the power to review these practices.

If all these elements come together, a strong risk management system can be put in place for a retirement finance entity or fund. The regulator must have the power to do risk-based regulation and supervision of all these elements.

> *Recommendation 43: The law must empower the regulator to regulate and supervise the risk management systems of retirement finance entities and funds, to ensure the adequacy of risk management systems in place. These powers must cover all the key elements of risk management systems, and must always be used in a risk-based manner. The regulations must be principles-based, should focus on supervision rather than ex-ante rules, and the regulator should not impose any one risk management model on the entities and funds. For small funds with poor in-house capability, the regulator may mandate seeking external support in developing sound risk management practices.*

4.2.5 Capital and liquidity requirements

For DB schemes, there is a need of capital requirements to protect against various risks that may lead to a situation wherein the fund is not able to fulfil its obligations. There is debate around what standards should be followed to arrive at the capital requirements, but there seems to be consensus that the approach should be risk-based. In Europe, there are debates going on about whether the prudential standards applied to insurance sector should be adapted and applied to DB schemes, both from the point of view of safety as well as competition, since both sectors seem to be managing risks. Such a standard would significantly increase the capital requirements and make the schemes safer for the consumers (Peek *et al.*, 2008).

Since the global financial crisis, the issue of choosing standards for risk-based capital and liquidity requirements is being debated and most countries are yet to arrive at a comprehensive view on this issue. The working group is of the view that the requirements imposed by regulators in India must be in congruence with best practices internationally, given the very high intensity of promise involved in DB retirement finance schemes. So, the regulator must be given the powers to develop and revise risk-based capital and liquidity requirements, to ensure a high level of safety and soundness of retirement finance funds.

> *Recommendation 44: The regulator must be given the power to impose risk-based capital and liquidity requirements on retirement finance funds.*

4.2.6 Regulation of corporate governance

Corporate governance rules exist for general purpose corporations, which also apply to the governing body of a retirement financing fund. It is also necessary to establish additional or different requirements, through legislation, that deal with matters of specific relevance to these funds. Retirement finance fund governance is conceptually more advanced than general corporate governance. Corporate governance mechanisms are necessarily focused on the interests of shareholders, whereas pension fund governance is focused on a different set of stakeholders (usually beneficiaries, but may include employers) that will, in some instances, have interests quite different to, and in some instances opposed to, the interests of shareholders. In the context of retirement finance plans and funds, governance refers to the framework by which the governing body, whether individuals or a body corporate (through its board of directors and senior management), makes decisions about the fund's business (Stewart and Antolin, 2008). Corporate governance encompasses:

- the structure of the governing body (including legal basis and segregation of functions)
- the decision making processes within the governing body (including internal controls, risk management, compliance functions and internal oversight structures)
- the requisite skills and competency of the governing body
- the means by which the governing body is accountable to stakeholders (principally beneficiaries, but also a wider stakeholder set including employers, supervisory board, supervisors, regulators and government)

Since the global financial crisis of 2007-08, corporate governance has received renewed focus as a part of the discussion on prudential regulation. It has been acknowledged that corporate governance is key to safety and soundness of a fund, and even if other elements are in place, corporate governance failure could nullify everything else. Based on research on best practices, there is a need for focus on the following aspects of pension fund governance:[12]

Governance structure

- *Identification of responsibilities:* There should be a clear identification and separation of operational and oversight responsibilities in the governance of a fund. To the extent that an entity is established that owns a fund on behalf of plan/fund members and beneficiaries, the legal form of this entity, its internal governance structure, and its main objectives should be clearly stated in the entity's statutes, by-laws, contract or trust instrument.
- *Governing body:* Every fund should have a governing body vested with the power to administer the fund and who is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interest of plan members and beneficiaries.
- *Accountability of governing body:* The governing body should be accountable to the members and beneficiaries, supervisory authority and the competent authorities.
- *Suitability of the members of governing body:* Membership in the governing body should be subject to minimum suitability (or non-suitability) standards in order to ensure a high level of integrity, competence, experience and professionalism in the governance of the fund.
- *Delegation and expert advice:* Where it lacks sufficient expertise to make fully informed decisions and fulfil its responsibilities the governing body could be required by the regulator to seek expert advice or appoint professionals to carry out certain functions. The governing body should assess the advice received, including its quality and independence, and should verify that all its professional staff and external service providers have adequate qualifications and experience.
- *The role of auditors:* An auditor, independent of the entity, the governing body, and the plan sponsor, should be appointed by the appropriate body or authority to carry out a periodic audit consistent with the needs of the arrangement.
- *The role of actuaries:* An actuary should be appointed by the appropriate body or authority for all DB plans financed via pension funds.

[12] See (OECD, 2009).

- *Custody of fund assets:* Custody of the pension fund assets may be carried out by the retirement finance entity, the financial institution that manages the retirement finance fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the fund assets and to ensure their safekeeping, the fund assets should be legally separated from those of the custodian.

Governance mechanisms

- *Risk-based internal controls:* There should be adequate internal controls in place to ensure that all persons and entities with operational and oversight responsibilities act in a manner that is consistent with the applicable rules and regulations.
- *Reporting:* Reporting channels between all the persons and entities involved in the governance of the retirement finance fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.
- *Disclosure:* The governing body should disclose relevant information to all parties involved (notably plan members and beneficiaries, plan sponsors, supervisory authorities, auditors etc.) in a clear, accurate, and timely fashion.

The law should empower the regulator to notify regulations on all these elements of corporate governance of retirement finance entities and funds. These powers should be principles-based, and it should be clearly stated that the regulations would be risk-based. The law should also empower the regulator to supervise the entities and funds on compliance across all these elements of corporate governance.

> *Recommendation 45: The law should give the regulator the power to regulate and supervise all the key elements of corporate governance of retirement finance entities and funds, in a risk-based manner*

4.3 Consumer protection

Consumer protection regulation should cover both the accumulation and the decumulation phases. During the accumulation stage, the consumers must be provided the support to take decisions about suitable asset allocation to help finance their consumption in retirement, and the charges should be levied in a manner that the consumers clearly understand what they are paying for. During the decumulation stage, they should receive a reasonable quality of service, which should not be excessively expensive for the consumers. The recommendations in this regard are presented under three broad headings: protections for consumers; approach to regulation; and instruments of regulation.

4.3.1 Protections for consumers

In the context of retirement finance, the key protections to be given to consumers in law should be:

1. *Protection against misleading and deceptive conduct:* It is important that the consumers take the decision about choosing a plan and aspects of the plan (such as, asset allocation) based on full information and/or advice they need. More importantly, they should not be misled into taking a decision that is detrimental to their financial well-being.
2. *Protection against unfair terms of contract:* Consumers should be protected against terms of contract that unfairly privilege the retirement finance entity or plan, while putting the consumer at a position of disadvantage. For example, a term that allows the fund to unilaterally terminate the account of a consumers in a manner that costs the consumer, may be deemed unfair. There are certain tests for whether a term is unfair or not: a term that permits, or has the effect of permitting, one party to avoid or limit performance of the contract; a term that permits, or has the effect of permitting, one party to vary the terms of the contract; a term that permits, or has the effect of permitting, one party unilaterally to vary financial services to be supplied under the contract.[13]
3. *Protection of accrual and payouts:* Regulations should promote the protection of benefits that an employee accrues by participating in a retirement financing plan, prevent the retroactive reduction of the value of benefits previously accrued in the plan and provide that plan members obtain timely notice regarding any reduction in the rate of future benefit accruals in the plan. Practices that substantially undermine or eviscerate benefit accrual and payout should not be permitted. In case of occupational plans, benefits of those individuals who have severed employment with an employer should be protected and not subject to forfeiture, regardless of reasons for severance, except in the limited case of dismissals resulting from acts of gross malfeasance that are clearly defined.

[13] Provisions of this nature are provided under the *Australian Securities and Investment Commission Act, 2001.*

4. *Right to receive decision support and reasonable quality of service:* The law must also ensure that the consumers get the appropriate support to take the right decisions during both the accumulation and decumulation stages, and they should also get a reasonable quality of service during both the accumulation and decumulation stages.

5. *Right to reasonable redress option:* In case of a grievance, the consumer must have a mechanism through which he can seek redress against the entity or fund.

   Recommendation 46: The law should provide protection to consumers from being misled or deceived, subjected to unfair terms of contract, or unduly penalised by the fund. Consumers should have access to a reasonable mechanism of grievance redressal. Consumers should also be given the right to get support to take the right decisions, and receive reasonable quality of service.

4.3.2 Approach to consumer protection regulation

Consumer protection must be *proportional* to the risk a specific scheme or plan poses to the consumer. For DB schemes the consumer protection regulation need only be minimal focusing on disclosure, transparency and reasonable quality of service during the decumulation stage. This is because in such schemes, the risk of poor investment decisions is with the provider. The DC plans shift some of the risks from the promoters of the fund to the consumers, and therefore require more sophistication on the part of the consumers than the DB plans.

Recommendation 47: Consumer protection regulation must be proportional to the risk held by the consumer, and the extent to which the consumer is responsible for taking decisions about the plan on issues such as investment.

4.3.3 Instruments of regulation

Regulating registration of retirement finance distributors or advisors

It is important for consumer protection to ensure that individuals dealing with consumers have domain knowledge, are well-trained, and that disciplinary measures can be taken against them if they knowingly abuse the consumers in any way. The first step to ensure this is to require registration of such individuals, including the employees of financial intermediaries as well as the agents or advisors acting independently or on behalf of a retirement financing scheme.

> *Recommendation 48: All individuals dealing with retirement financing must be registered with the regulator, who must stipulate significant training requirements on the individuals involved in the process of helping the consumers decide about retirement financing.*

Ensuring sound incentive alignment

Retirement financing has great potential for damaging impact of wrongly levied charges on consumers. A small increase in charges annually could erode a large portion of the investment pool of the consumers. There is therefore a strong case for regulation of incentive alignment in this sector, including regulation of the structure of charges, as well as the incentives for the entire range of intermediaries involved in advising/distributing retirement financing schemes, collecting contributions, and paying out during the decumulation stage.

> *Recommendation 49: Incentive alignment: The structure of various types of charges on retirement financing schemes should be regulated by the regulator.*

Ensuring inter-operability, portability and exit options

Locking in a consumer for a retirement financing scheme could have significant consequences for the market power of the scheme vis-a-vis the consumer. Those managing the scheme can then exploit this position of advantage to abuse consumers. Also, retirement financing accounts are operated for decades before the decumulation begins. During this time, the consumer may change his mind about the fund manager's capability to deliver quality service, and may therefore want to switch pension funds. Any system that locks the consumer in for the entire period, because of technological or contractual reasons, would be unfair to the consumers. One way to prevent this is to ensure a high level of inter-operability in consumers' retirement financing accounts. So, the regulator must ensure a reasonable level of inter-operability and switching among accounts.[14] For occupational plans, if an employee is leaving a job, it should be possible to move the accruals from a DC plan to another DC plan, which may be managed by the current employer or a private plan.

[14]The OASIS report, which formed the basis for NPS gave significant emphasis to inter-operability and portability of accounts, and this is reflected in the NPS design.

One of the key features of retirement financing schemes is their illiquidity, which helps them invest in long-term assets and provide higher returns to the investors. Though retirement financing plans are typically illiquid, there should be some rare occasions that allow for exit from the plan, with a cash-out for the consumer or any beneficiary entitled to them. These situations could include: emigration to another country, death of the consumer, and severe illness or disability that requires money to be spent.

This can be contrasted with the prevailing practice of EPFO, which allows the investors much greater liquidity than it ought to, thus not only creating significant challenges for asset-liability management, but also leading to sub-optimal accumulations. This also creates significant administrative burden for the staff at EPFO, and adds to the transaction costs for all the investors.

> *Recommendation 50: The regulator must be given the powers to ensure inter-operability, portability and exit options in retirement financing plans.*

Ensuring appropriate support for consumers' decisions

For DC schemes, it is crucial that consumers take right investment decisions, given their human capital profile, duration of accumulation stage, other post-retirement sources of incomes, and so on. It is not easy for an ordinary consumer to take these decisions. Conventional wisdom about asset allocation for retirement financing keeps changing as new knowledge emerges. For example, the simplistic notion of investing in more equities at a young age and gradually reducing allocation to equities, is no longer acceptable because there are factors other than age that need to be considered while allocating assets. New instruments are being developed, and innovation asset allocation approaches are being devised.[15]

An unsophisticated consumer will not have the expertise to take the right decision, and the consequences of failure may be deleterious to his welfare in retirement. Hence there is a need for the regulator to ensure that consumers are given appropriate level of support to take the right decision. This could entail a full-fledged in-person advice, or at least a system that helps them choose, through an automated process, what would be right for them. The introduction of a suite of simple regulated products, with capped charges, restrictions on investment profile and the ability to exit on reasonable terms designed for the medium and long-term savings market, with the intention that they could be sold with minimum advice, could also work in some situations.

[15] See Bodie (2003) for a review of the progress in the theory and practice of lifecycle finance.

Recommendation 51: The regulator must have the power to mandate suitability analysis and advice to be given by the provider to the consumer regarding the asset allocation decision. The regulator must also have the power to recommend modifications to schemes and processes to ensure that consumers are given suitable solutions.

4.4 Failure of retirement finance funds

The concept of failure is usually limited to DB plans, which promise the consumers a certain level of benefit at the time of retirement. DC plans, on the other hand, do not fail in the same manner, because the retirement income they promise is entirely contingent upon the contributions and the returns earned on the contributions. For such plans, if they suffer significant investment losses or other adverse events that erode their pool of capital, the consumers may lose parts of their accumulation, but the fund will not go bankrupt, because the fund did not promise any assured return.

DB plans hold investment risk and other risks that may create a situation wherein they are not able to meet their obligations. During the global financial crisis of 2007-08 several such plans failed, because many of their investments made significant losses. Failing funds offering such plans either go into bankruptcy or they must be resolved before bankruptcy sets in. Since the plans are illiquid, there is no risk of a run on the fund, but if it is clear that the fund will not be able to meet its obligations, steps need to be taken before the day comes when the fund is not able to make the payout. If the fund is supported by a government guarantee, it can't be considered bankrupt because the government can fund it using fiscal intervention, but if the fund if promoted by private entities, at some point it could go into bankruptcy.

Since there is time for a fund to ensure it finds resources, through its parent entity or from elsewhere, the resolution process need not be as quick as that for a bank. The process may involve giving the fund more time to improve its financial position. In Europe, where a large number of funds are under-funded, the regulators have focused on taking steps to slowly improve their position, rather than pushing them into resolution. But, if all other options fail, there should be an efficient resolution process in place.

It is possible that the entities sponsoring a DC fund goes bankrupt. In such cases, the funds can be simply transferred to another fund, and the consumers can maintain their accounts.

Recommendation 52: The law should provide for an efficient *resolution mechanism for funds offering DB retirement financing plans. This should be modelled on the resolution process for banking and insurance, but with more time for the funds to improve their financial position. There should be an agency responsible for the resolution function.*

Recommendation 53: There should be a process to move the consumers funds from one DC fund to another smoothly, if the retirement finance entity sponsoring the DC fund goes bankrupt.

For a failing fund, there are two sets of issues to consider:

4.4.1 Resolution of failing fund

How should a failing fund be identified?

The agency responsible for resolution should have access to complete information about the financial position of a fund on a regular basis. The agency should be required to keep track of the asset-liability mismatches on an ongoing basis. This will ensure that the agency has the information it needs to identify failing funds well before the time when they fail.

Recommendation 54: The agency responsible for resolution should have access to comprehensive information about retirement finance entities and funds. The agency should have access to auditors' reports and the powers to ask for information on any fund and conduct on-site investigation of a fund.

What should be the trigger to begin the resolution process?

The trigger for intervention by a resolution agency should be quantitative, and there should be a multi-tier approach for dealing with a fund that seems to be approaching failure. Capital adequacy would be a good quantitative measure of financial position, assuming the financial reporting standards are adequate and are being followed by the funds. Once the fund stays under-capitalised well below the minimum limit set by the regulator for more than a specified period, say 3 months, the resolution agency would have the right to intervene.

Recommendation 55: The initiation of the resolution process should be linked to a quantitative trigger.

How should the fund be resolved?

The first step for a failing fund would be that it would be asked to stop acquiring new consumers. Any new contributions coming from existing consumers could be parked in a special fund, not to be accessed till the process is complete. The intervention would start with the agency asking the fund to get fresh capital within a stipulated time period. If the fund fails to do so, the agency can, in consultation with the regulator, decide the next step. It could either start the process of transferring the assets of the fund to another well-capitalised fund; or it could transfer management of the fund to another fund, while allowing the fund to remain as it is. Liquidation should only be the last option for resolution of these funds, because the investments are likely to be in highly illiquid securities, and liquidation of these securities will make things worse for the consumer.

> *Recommendation 56: The resolution process should start with giving the fund a notice to improve its financial position. If the fund fails to do so, the process should focus on transfer of the assets to another fund, or under the management of another fund. Liquidation of fund should be the last option in the resolution process. When resolution process starts, the fund should be prevented from collecting contributions.*

4.4.2 Protecting consumers of a failing fund

Should there be a deposit insurance type system in retirement financing?

Countries such as United States and United Kingdom have guarantee funds that step in to pay the consumers if a DB fund fails to do so. In US, the Pension Benefit Guaranty Corporation,[16] and in UK, the Pension Protection Fund,[17] play this role. Both of these are government agencies, focused on protecting pension investors. One of the objectives for the regulator in UK is to minimise the possibility of a situation wherein the pension protection is invoked. OECD, in its fifteen principles for regulation of private occupational pension schemes, recommends such an insurance system, which serves as a protection when insolvency arises. We could consider a similar mechanism in India. In any case, in case of a retirement finance fund's failure, the government will be under significant pressure to bail it out using tax revenues. Establishment of such a guarantee fund could improve the

[16] The Pension Benefit Guaranty Corporation of US covers voluntary private DB pension plans.

[17] The Pension Protection Fund in UK only covers occupational pension plans.

transparency of such a process, and protect the consumers. The rationale is similar to that for deposit insurance in banking.

> *Recommendation 57: Establishing a retirement finance protection fund, which would guarantee payouts from all DB schemes, may be considered. The fund could also provide some guarantees to DC schemes, to help them hedge certain investment risks.*

How should the system be designed?

In other countries, such funds usually impose a risk-based levy on the funds, and this levy is used to make the payouts. If FSLRC decides to establish a protection fund, the working group recommends that it should be based on a similar system of levying. The fund should be managed by the agency responsible for resolution of failing funds, because the agency can then do the payouts from this fund based on how the resolution process is going. The fund would also provide an instrument to the resolution agency, to evaluate which alternative pathways for resolution would be ideal for a fund, given the level of payout expected from the protection fund.

> *Recommendation 58: If the retirement finance protection fund is established, it should charge risk-based levy from the participating funds; participation should be mandatory for funds offering DB plans; and the fund could be managed by the agency that is responsible for resolution of failing funds.*

4.5 Special topics

4.5.1 Regulation of annuities

As the decumulation stage begins, a consumer may have the choice of taking the accumulated amount as a lump sum, drawing it down (while holding longevity risk i.e. the risk of outliving the savings), or purchasing annuities (and moving longevity risk to an institution, which is usually an insurance company). Annuities provide the consumers a guaranteed income from the time of purchase till death. Longevity risk is not diversifiable for the consumer, and can therefore be managed only by a company holding a pool of such risks. The key advantage of annuities is that they move the longevity risk to the issuing company. Annuities, if fairly priced, allow maximisation of income over the pensioners lifetime compared with other ways of releasing assets, since alternatives would always require excess assets at death (Mitchell, 2001). They also can provide a smooth income consistent with what is typically assumed to be a desired pattern of consumption (Blake and Hudson, 2000).

There are certain issues in regulation and supervision of annuity markets, which need to be considered while drafting the laws governing annuity markets. First, annuity markets, like other insurance markets, are affected by certain markets failures, such as information asymmetry, coordination problems, and market power, which necessitate regulation and supervision of the markets. There needs to be prudential regulation, consumer protection regulation, as well as resolution mechanism for failing insurance firms. Second, there are consequences of poor decisions by retirees if they don't annuitise or under-annuitise, leading to additional liabilities for the society. So, there may be a role for helping the consumers take the correct decision vis-a-vis annuitisation.

Prudential regulation for the firm issuing annuities

The focus for prudential regulation of firm issuing annuities should be on entry barriers, capital and liquidity requirements, risk management, and investment management regulation.

Annuities can be classified as insurance contracts, with a strong risk management function, because they essentially cover longevity risk. Therefore, only insurance companies with proven track record of offering life insurance cover should be allowed to do the business of issuing annuities.

> *Recommendation 59: Only insurance companies that have proven capability in offering life insurance should be allowed to do the business of issuing annuities.*

Since annuities are very high intensity promises, and there is a real chance of the issuing firm not being able to meet the promise because of insolvency or illiquidity, they should be subjected to adequate capital and liquidity requirements. Adequate capital should be maintained to ensure the safety and soundness of the firm, and liquid reserves should be maintained to keep up with the cash flow demands. The capital norms can be risk-based, depending on the asset allocation decisions and the risks being under-written by the firm. The regulators should have the power to stipulate capital and liquidity requirements for firms issuing annuities. Similarly, on risk management, especially asset-liability management, the approach should be aligned with that of life insurance companies. A detailed discussion on the powers of the regulator to stipulate capital and liquidity requirements for insurance firms can be found in the insurance chapter of this report.

On investment management, compared to pension funds, the case in favour of quantitative portfolio restrictions may be quite strong for insurance companies which have nominally-fixed liabilities such as annuities (Davis, 2002). The regulator would need to analyse the latest evidence and thinking on the issue, and notify the regulations. So, compared to pension funds, for firms issuing annuities, there should be greater flexibility given to the regulator in law to stipulate restrictions on investment choices.

> *Recommendation 60: Compared to pension funds, for insurance firms issuing annuities, there should be greater flexibility given to the regulator in law to stipulate restrictions on investment choices. This should be in line with the regulations for life insurance companies.*

Consumer protection in annuities markets

The consumer protection concerns specific to annuities revolve around a few possibilities that may harm the consumer:

- the consumer may under-annuitise;
- the annuity may be poorly designed;
- the consumer may not fully understand the product, its price, or other features; and
- the quality of service by the firm may be too poor to ensure timely cash flow for the consumer.

All these issues can be addressed by the set of instruments discussed in the consumer protection section earlier. Especially the instruments that ensure that the consumers get decision support, reasonable quality of service, and incentive alignment for the issuing firm, are relevant for the annuities market. The consumers will need more than just passive decision support to take the right annuitisation decision, and there may be a role for a more active process of convincing them to adequately annuitise their retirement savings. Though some countries have mandatory annuitisation, the working group does not recommend making this mandatory for all consumers. However, the regulator should have the power to require compulsory partial annuitisation, as seen under NPS. Also, the consumers should be protected against unfair terms of contract, and misleading and deceptive conduct. In addition, consumers should have account portability that allows them to switch firms with minimal costs, if they decide to do so.

> *Recommendation 61: The regulators should work to ensure that consumers take the optimal annuitisation decision, by mandating*

partial annuitisation and providing active support to consumers to take the right decision.

Resolution of failing companies

Resolution of insurance firms issuing annuities should be considered along the lines of resolution of any life insurance firm. This issue has been discussed in detail in this chapter on insurance firms.

Recommendation 62: The resolution of failing insurance firms issuing annuities should be along the lines of resolution of any life insurance firm.

4.5.2 National pension system

NPS was established to overcome certain market failures in the retirement financing market. It overcomes the problems of market power and information asymmetry, by harnessing economies of scale for funds, providing low pricing through auctions, ensuring account portability, and making a DC promise. Though the individual components of NPS, such as the PFM, POP, CRA, need to be regulated, we need to consider how NPS should be treated in the law. The PFRDA Bill treats NPS separately as a legal object, which is essentially a system that brings together all aspects of DC retirement financing, and provides certain advantages to the consumers. The PFRDA Bill also provides for regulation of each of NPS 's components, which should be regulated at par with their categories of institutions. For example, a pension fund that happens to be a part of NPS should be regulated just like any other DC fund. This may be a good way to treat NPS in the law.

Recommendation 63: As provided in the PFRDA Bill, NPS should be acknowledged as a unique object in the law, and its various components should be regulated at par with their respective categories.

Another issue for consideration is that NPS commands much more market power than any stand-alone DC schemes, and is can therefore potentially come under the scanner of competition regulation. There is competition within NPS, because pension funds may lose business if they don't perform, but the system itself is designed in a certain manner, which could raise competition concerns. Though NPS helps overcome some market failures, it runs the risk of impeding the development of the wider DC scheme market in India. So, the treatment of NPS should be such that it is not able to unfairly impede the development of competing private providers doing DC pensions. Though this is the remit of the Competition Commission, the regulator looking after retirement financing should coordinate with the Competition Commission to ensure that the regulation of NPS is in tune with its objectives.

> *Recommendation 64: The law should acknowledge the unique status of NPS as a government intervention to address market failures in the retirement financing market, and the market power is commands to meet its objectives. If NPS exerts anti-competitive pressures over and above its basic objectives, it should be regulated from a competition standpoint. NPS should be separated from the retirement financing regulator, because there is conflict of interest in managing such a system and regulating the retirement financing sector. This can be achieved by making the NPS Trust an independent entity. The retirement financing regulator should regulate and supervise the NPS Trust.*

4.6 Regulation of retirement finance infrastructure

In the retirement financing sector, there is a significant role for certain pieces of infrastructure that do the record-keeping and maintenance of the information about individual Accounts and consumers. The draft PFRDA bill provides comprehensive provisions on regulation of CRAs, including provisions that empower the regulator to license these agencies and regulate them. The working group suggests using these provisions from the PFRDA Bill.

> *Recommendation 65: The law should give the regulator the powers to regulate infrastructure for retirement financing sector. Sections from PFRDA Bill on regulation of infrastructure for retirement financing can be considered for drafting these provisions in the legislation. These sections provide for regulation and supervision of infrastructure services such as record keeping.*

5. Small savings

5.1 Introduction

The genesis of small savings schemes in India can be traced back to the Government Savings Bank Act of 1873 that introduced postal deposits in the country. Since then numerous savings instruments have been created under this law as well as two subsequent legislations that were brought about to govern retail investments other than postal deposits. The three laws governing the issuance of small savings instruments in the country are:

1. Government Savings Bank Act, 1873 ('GSB Act')

2. Government Savings Certificates Act, 1959 ('GSC Act')

3. Public Provident Fund Act, 1968 ('PPF Act')

The savings instruments issued under these laws can be classified as - postal deposits, savings certificates, and social security schemes. While on the one hand these instruments cater to the needs of small investors by providing a secure investment product, often coupled with tax advantages, on the other they ensure a cost-effective way of raising long-term funds for the government. With a view towards ensuring widespread participation in the schemes, their distribution is done through post offices, bank branches and small savings agents.

As these schemes are owned by the government the debt raised through their issuance is credited to the NSSF that falls under the Public Accounts of India and forms a part of public debt. The funds collected by NSSF are used for paying out withdrawals and interest to the depositors as well as for making investments in securities issued by the central and state governments. Recently, the government has also made a decision to allow such investments to be made in securities issued by infrastructure companies or agencies, wholly owned by the Central Government.[1] This move will add an element of credit risk to NSSF's investment portfolio, which was otherwise seen as being risk free because the funds were being lent directly to the government.

Table 5.1 presents an overview of the existing schemes and their salient features.

[1]This decision was made pursuant to the recommendations of Gopinath (2011). See MOF (2011).

Table 5.1 Features of small savings schemes

Scheme	Period	Limits	Interest rate	Salient features & benefits under Income Tax Act, 1961
Post Office Savings Account	N.A.	Minimum Rs.50.	4.0% p.a.	Interest fully exempt under Sec 10 (11). Cheque facility available.
Recurring Deposit Account	5 years	Minimum Rs. 10 per month. No maximum limit	8.4%	One withdrawal up to 50% allowed after one year. Rebate on 6 & 12 months advance
Time Deposits	1-5 years	Minimum Rs. 200. No maximum limit	8.2% to 8.5% payable annually but calculated quarterly	Savings up to Rs. 1 Lakh in 5 year time deposits, deductible under Sec 80C.
Post Office Monthly Income Scheme	5 years	Minimum Rs. 1500. Maximum Rs. 4.5 lakh (individual) and 9 lakh (joint)	8.5% per annum	Can be prematurely encashed after one year with some conditions
Public Provident Fund	15 years	Minimum Rs.500. Maximum Rs. 100,000	8.8% p.a.	Investments deductible under Sec. 80C. Interest fully exempt under Sec. 10 (11). Withdrawal after 7th year. Loan facility after 3rd year.
Senior Citizen Savings Scheme	5 years	Minimum Rs. 1,000. Maximum Rs. 15 lakhs	9.3% p.a.	For persons over 60 years. Investment qualifies for benefit under Sec. 80C. More than one account permitted per individual.
National Savings Certificates VIII	5 years	Minimum Rs.100. No maximum limit	8.6% p.a.	Eligible for rebate under Sec. 80C. Interest deemed to be reinvested; deductible under Sec. 80C
National Savings Certificates IX	10 years	Minimum Rs. 100. No maximum limit	8.9% p.a.	Interest income liable to be taxed on the basis of annual accrual. No tax deducted at the time of payment of discharge value

5.1.1 Scope of review

In the past, several committees have looked into the issues relating to small savings. These include, Rangarajan Committee (1991), RV Gupta Committees (1998 & 1999), Rakesh Mohan Committee (2004), Thirteenth Finance Commission (2009) and Gopinath Committee (2011). These committees addressed several key issues in relation to the operational aspects of small savings schemes including interest rate structure, structure of NSSF and investment and repayment arrangements. Many of the recommendations made by these committees have already come into effect - the creation of NSSF as a separate account within the public accounts was a result of the recommendations made by the R V Gupta Committee in 1999. The government has also already accepted many of the recommendations made by Gopinath (2011) pursuant to a comprehensive review of NSSF. These changes relate to rationalisation of small saving schemes, aligning interest rates with government securities of similar maturity, revision of agency commissions and change in investment structure of NSSF.

In this report, we present our recommendations on the prudential regulation of small savings schemes and the need for consumer protection for the depositors in these schemes. With the government being the sponsor of these schemes, the issue of prudential regulation has not received much attention till now as investments in these schemes are seen to be risk free. However, we find that there is a strong case for rethinking the prudential regulation aspects of small savings scheme from a viability perspective, given the serious problems of asset-liability mismatch and maturity mismatch being faced by NSSF. Issues of consumer protection and grievance redressal have also been considered by the working group.

Based on an assessment of the organisational and operational aspects of small savings schemes, the recommendations of the working group focus on changes required to the legislative framework governing small savings to address issues of regulation and consumer protection. While the report tries to stop short of venturing into the fiscal management domain, some observations on this aspect are inevitable since NSSF is an important source for financing of fiscal deficit by the central and state governments.

5.2 Legal framework

Each small savings instrument is issued pursuant to a specific scheme framed by the government under one of the enabling legislations mentioned earlier. The rules giving effect to the scheme typically provide for the process of issuance of the instrument, interest payable, transfer rights and mode of withdrawal, including premature withdrawals. Table 5.2 contains details of the schemes that are currently in operation under each legislation. Several other schemes framed under the Acts have since been discontinued but the discontinuation did not impose mandatory withdrawal conditions on existing investors as a result of which the rules pertaining to many of those schemes continue to remain in effect.

Table 5.2 Laws governing small savings schemes

Law	Scheme
GSB Act	Post Office Savings Account Post Office Recurring Deposit Account Post Office Time Deposit Account Post Office Monthly Income Account Scheme Senior Citizen Savings Scheme
GSC Act	National Savings Certificate (VIII Issue) National Savings Certificate (IX Issue)
PPF Act	Public Provident Fund Scheme

The GSB Act enacted in 1873 was the first of the three legislations that govern small savings schemes in India. The Act allows the Central Government to design the terms and conditions of savings deposits, including specifying the maximum limits on deposits and interest conditions.[2] The other provisions contained in the Act relate to the handling of deposits belonging to a deceased person or to particular categories of depositors, namely children, lunatics and women. In a similar vein, the GSC Act that was enacted in 1959 enables the issuance and administration of savings certificates issued pursuant to rules made by the Central Government.[3] The GSB Act and the GSC Act are substantially similar in that they both lay down the enabling framework to be used by the government for the issuance of small savings instruments. The other issues dealt with in these legislations - nomination, process upon death of holder, rights of minors, etc are also similar.

The third legislation in this area is the PPF Act, which was enacted in order to constitute a provident fund for the general public. The Act empowers the Central Government to frame a PPF scheme to provide for the setting up of the PPF, the manner in which subscriptions may be made to the fund and permissible withdrawals and payments. the other key provisions of the Act relate to the rights of nominees in case of a subscriber's death and protection of the amounts contributed by a subscriber to the fund from attachment.

All these laws provide for the rights of small savings investors (referred to as depositors, holders and subscribers under the three acts) and their nominees and empower the government to frame detailed rules to govern the specific instruments issued under the Acts. The working group finds that there is a case for bringing these legislations under a common legal framework. The recommendation to amalgamate the three laws by repealing the existing legislations and replacing them with a consolidated law has also been made

[2]Section 15(2), GSB Act.
[3]Section 12, GSC Act.

previously by the Law Commission of India.[4]

The revised law should contain appropriate provisions relating to protection of the rights of investors of different types of instruments and prudential regulation of NSSF, to the extent relevant. In particular, the law should address the manner in which the collections from the issuance of various small savings instruments are to be maintained and invested and the recourse available to depositors in the event of delays in payment.

However, to the extent required, this common legislation may contain provisions that are specific to different types of small savings instruments. For instance, the section on savings certificate may require specific provisions on transferability while that on PPF may contain provisions regarding loans available against amount deposited in the fund.[5]

> *Recommendation 66: There is a need to consolidate and modernise the laws on small savings. Accordingly, the GSB Act, GSC Act and PPF Act should be replaced with a consolidated law that should, inter alia, contain provisions relating to manner of collection and investment of funds, consumer protection, grievance redressal and, to the extent relevant, prudential regulation.*

5.3 Structure and regulatory framework

Under the current framework, the Central Government, represented by the Department of Economic Affairs, Ministry of Finance, is the originator as well as the manager of small savings schemes. It acts as the originator of the schemes by virtue of the powers conferred upon it by the small savings laws. In its role as the manager of NSSF, the government is responsible for all accruals, payments and investments made out of the fund. In addition, the Ministry of Finance is also responsible for the administration of the National Savings Institute (NSI)), which undertakes the promotion and publicity of small savings schemes.

The operational issues relating to the small savings schemes are handled by the state directorates of small savings and NSI. The directorates undertake the promotion of saving schemes in the state, appoint agents and redress investor grievances. The DoP is the most significant agent for the distribution of small savings scheme. NSI also plays a role in the mobilisation of small savings. It is responsible for carrying out research and training; providing policy inputs on the development of new products; printing and supply of

[4]159th Report of the Law Commission of India on Repeal and Amendment of Laws: Part 1 dated 28th July 1998.

[5]See Section 3, GSC Act and Section 7, PPF Act.

savings instruments; detection and prevention of frauds and liaising between different stakeholders in the area of small savings.

The fact that the mobilisation of small savings and the investment and repayment of funds is handled completely within the government, results in a situation where all aspects of small savings fall outside the sphere of regulation. As a consequence, NSSF is not subject to the requirements relating to capital adequacy, internal controls, corporate governance, investment management, etc. that would typically be attracted in case of any other institution carrying out activities of a similar nature.

5.3.1 Rationale for prudential regulation

Generally, prudential regulation is applied to financial firms that make a *high intensity of promise* to consumers. The rationale being that the safety and soundness of such firms should be ensured in order to protect the consumers from the potential failure of the firm. The underlying financial activity being carried out by the government in respect of small savings schemes involves the taking of deposits and their guaranteed repayment on maturity or on demand, which involves a high intensity of promise to the investors. Typically, meeting obligations of this nature requires the institution concerned to maintain adequate provisions for capital requirements and adopt other prudential measures. In the context of small savings, having the government as the sponsor and manager of NSSF, means that the risk of default faced by consumers is negligible. Therefore, it may be reasoned that in this case consumer protection does not present a sufficient rationale for enforcing prudential regulation. However, there is a strong case for the prudential management in the field of small savings from the perspective of ensuring the viability of NSSF.

Specifically on the issue of viability of NSSF, Gopinath (2011) notes that NSSF has a negative mismatch between its income and expenditure, due to two reasons:

1. The asset base of the fund is lower than the liabilities that it has had to discharge in the past years, due to continuous loss on the income and expenditure account, a part of net collection has been used to finance the cash deficit.
2. The return on assets is lower than the cost of liabilities.

The liabilities of the government in NSSF have increased from about rupees 210,000 crores in 1999-2000 to over rupees 780,000 crores in 2011-12. Table 5.3.1 reflects that the collections under postal savings deposits have shown a downward trend in the last few years. This points towards the fact that postal deposits are becoming a less preferred source of savings, perhaps due to availability of other savings instruments. Similarly, the collections through the savings certificates have also been consistently falling. On the other hand, receipts under the PPF scheme have remained fairly stable with net positive receipts over the last few years. The net collections under the PPF scheme partly cover the deficits in the net collections under the other two schemes. This will however change over the years when the age dependency ratio becomes unfavourable for the country. Hence, rollover risk is expected to buildup in the fund over the years.

Table 5.3 Receipts and Disbursements under NSSF (In Rs. crores)

	Postal Deposits		Savings Certificates		Public Provident Fund	
	Receipts	Disbursements	Receipts	Disbursements	Receipts	Disbursements
2007-08	105285.88	115077.96	21365.94	25175.05	21057.00	8478.38
2008-09	121272.38	130489.96	22390.98	27554.89	14846.63	9916.36
2009-10	185797.43	152118.78	31685.29	23831.68	33448.59	8671.69
2010-11	211419.43	179806.50	31388.12	26858.07	31912.35	9402.11
2011-12(RE)	166300.00	187100.00	16800.00	21400.00	31400.00	12000.00
2012-13(BE)	156600.00	166600.00	19000.00	36000.00	41000.00	14000.00

Source: Based on information contained in the annual receipt budgets for years 2009-10 to 2012-13.

Reduction of rollover risk and improving the viability of NSSF requires restructuring the management and operation of NSSF. As per Gopinath (2011) *"if repayments continue to be greater than fresh collections, it could have grave consequences for the NSSF balance sheet. Were NSSF to become unsustainable, the ultimate fiscal costs would devolve on the Centre."* Given this situation, prudential regulation of NSSF assumes great importance.

5.3.2 Restructuring proposal

Based on the discussion above, we find that there is a need to transfer the management of NSSF to an independent corporate body. This issue was also examined by the R V Gupta Committee which rejected the proposal of transferring the management of the fund to an outside agency on the ground that the presence of a government guarantee is an important factor attracting investments in these schemes and transferring the management of NSSF to an outside agency may be perceived as loss of sovereign guarantee by the investors. This issue can however be addressed by including an explicit statement on sovereign guarantee in the law.

The present legal framework, consisting of the Acts discussed earlier and the specific rules framed for each scheme, does not explicitly state that small savings instruments are guaranteed by the government. This guarantee is implied by virtue of the fact that the instruments are issued by the government and the funds collected from investors are pooled into the NSSF, which is a part of the public account. As an instrument in the public account, the balances under NSSF are direct liabilities and constitute a part of the outstanding liabilities of the centre (Gopinath, 2011). Upon transfer of the management of small savings to an independent entity, the law effecting such transfer should explicitly clarify that these schemes are guaranteed by the government

To give effect to the corporatisation of NSSF, the Central Government can create a new corporate entity and transfer the existing NSSF to this entity. In addition to managing the funds of NSSF, this body should be responsible for all other functions relating to small savings, including creation and modification of small savings schemes, laying down rules with respect to the appointment of agents and responsibility for ensuring that investors in the schemes receive proper quality of service. The existing functions of NSI should also be transferred to this entity.

The proposed entity will be brought within the limited purview of the financial regulator, to the extent necessary given the nature of risks and promises in the field of small savings. The extent and type of regulation applicable will depend on the type of scheme under consideration. For instance, the PPF is in the nature of a retirement financing fund and so the regulatory framework applicable to it will be based on the recommendations made in the previous section on retirement financing. However, the working group does not intend prudential regulation in the field of small savings to extend to changing the manner in which the funds held by NSSF are invested since that constitutes a fiscal decision. The focus of prudential regulation in this field will accordingly be on improving the operations of NSSF through better internal controls and corporate governance and not on investment management.

National Savings and Investments (NS&I) in United Kingdom provides a useful example. NS&I is a government agency responsible for providing cost effective financing to the government by issuing and selling savings and investment products to the public. While NS&I is accountable to HM Treasury (and is fully backed by the Treasury), its agency status allows it greater autonomy in day-to-day management functions. As a government agency, NS&I is not regulated by the Financial Services Authority (FSA) but it chooses to voluntarily work within the spirit of the FSA guidelines, and in particular the principles on treating customers fairly. In case of any grievances against NS&I, consumers have the right to approach the dispute resolution mechanism provided by the Financial Ombudsman Service, which also covers all other financial service providers in United Kingdom.[6]

> *Recommendation 67: All functions related to the operation and management of small savings should be performed by an independent entity that should be brought within the limited purview of the financial regulator. However, prudential regulation of the proposed small savings entity should not extend to changing the manner in which the funds held by NSSF are invested since that constitutes a fiscal decision.*

> *Recommendation 68: To address concerns that corporatisation of the scheme would lead to loss of public confidence, it should be ensured that upon the transfer of the management of small savings to an independent entity, the law effecting such transfer should explicitly clarify that these schemes are guaranteed by the government.*

5.4 Consumer protection

The low level of financial literacy, diversity in investor segments, lack of access to redressal channels, need for timely redressal and potential costs of grievance redressal are some of the issues that pose a challenge to providing effective consumer protection for small investors. For these reasons, it is essential that consumer protection measures should be envisaged in the legal framework for small savings and implemented through a well publicised and easily accessible agency.

5.4.1 Existing mechanisms

At present, the NSI is charged with the task of investor protection and grievance redressal. It has set up a web-based single window mechanism for redressal of investor grievances where a complainant can file complains and track the status of the complaint. Further, coordination committees have been setup in 16 states and union territories to redress investor grievances.The institute also publishes guidelines for investors to educate them about small savings schemes, distribution channels and their rights. The Reserve Bank of India also addresses the grievances relating to the small savings mobilised through banks.

Despite the existence of these mechanisms, a significant portion of the grievances relating to small savings are redressed through consumer courts

[6] See NSI (2009) for an overview of NS&I and the activities carried out by it.

and litigation - largely related to frauds committed by agents. The role of NSI in grievance redressal, though increasing, has been minimal till now.

5.4.2 Measures for consumer protection

Given that the focus of small savings schemes is on providing investment avenues to small retail investors, there is an enhanced need for consumer protection measures in this field.

Based on a review of best practices followed in this regard and discussions with various stakeholders, we have identified the following key protections that need to be given to consumers of small savings schemes:

1. It is important that consumers should not be misled into taking a decision that is detrimental to their financial well-being. Prior to the sale of an instrument, customers must be made aware of the important terms and conditions of the contract relating to maturity, yield, current tax benefits, withdrawals and agency charges. The focus should be on providing consumers with the appropriate information or advise so that he/she may take an informed decision.

2. Information relating to brokers and agencies authorised to sell small savings products and the charges applicable in that regard should be made available in the public domain.

3. To minimise hassle-free settlement of claims, consumers should be informed of the availability of nomination facility and opening of joint accounts, with merits of both options being clearly explained.

4. The consumer should be assured of a good quality of service in terms of being able to get back his/her money in case of maturity or withdrawal, within a reasonable time frame and without any undue inconvenience.

5. There should be a maximum time limit within which payment or withdrawal requests should be processed failing which compensation should be provided to the consumer. The compensation for delay should be in-built in the process and paid suo-motu without being claimed by the customer.

6. Redress option: In case of a grievance, the consumer must have a mechanism through which he can seek redress against the small savings operator and the concerned agent. This should also include redress of grievances against employees of the postal department who deal with consumers in the process of sale or settlement of dues. The redressal mechanism should be easily accessible and provide speedy redressal at a minimum cost to the consumer.

The primary legislation should lay down the broad principles of consumer protection and empower the government or the savings scheme operator to make rules on several of the aspects listed above. It would then be the responsibility of the government or the scheme operator to frame appropriate rules in this regard.

> *Recommendation 69: Requisite changes may be made in the laws governing small savings to include provisions on investor protection, compensation and grievance redressal.*

5.4.3 Distribution structure

Small Savings products are distributed through a network of over 154,000 post offices, about 8000 bank branches and more than 500,000 agents. While post offices distribute all small savings products, bank branches distribute only Public Provident Fund and Senior Citizen Savings Scheme. The agents are paid commission from the NSSF based on gross small savings collections.

There are three agency systems for the distribution of small savings products:

1. **Standardised Agency System**: Agents falling under this category are entitled to distribute a host of small savings products, including, Postal Savings Accounts, Time Deposit Accounts, Senior Citizen Savings Scheme, Monthly Income Savings Scheme and National Savings Certificates. The appointment of agents is done by the state governments for a duration of three years from out of individuals, co-operative societies, scheduled banks, registered social service organisations, universities and institutions approved by the government.

2. **Mahila Pradhan Kshetriya Bachat Yojana**: Eligibility for appointment by state governments under this scheme is limited to women and women organisations doing social, religious, educational, recreational or charitable work. These agents are responsible for distribution and collection of deposits under the Post Office Recurring Deposit Scheme.

3. **Public Provident Fund Agency System**: For the appointment of agents for the distribution PPF.

At present, the appointment of agents (other than the DoP) is done by the state government and in most cases by the district collector in the area of operation. Any person interested in becoming an agent can approach the district collector, director of small savings or regional director of NSI for appointment. As a result, the procedure of appointing an agent varies from state to state (NSAI, 2012). The working group is of the view that while the practice of decentralisation for appointment of agents has its merits, there is a need for a standardised set of guidelines to govern the procedure for appointment.

The existing legal framework does not contain any substantive provisions for enabling the appointment of agents or laying down powers for setting out qualifications, classification, grievance redressal mechanisms against acts of agents, forms for applying for appointment as an agent. In order to address the ambiguities and subjectivity in the agent appointment procedure, the law should contain specific provisions regarding the registration of agents and their responsibilities towards investors. Further, the body responsible for the operation of small savings schemes should have the statutory authority to make rules on incentive structures for agents, requisite qualifications and other eligibility criteria.

The grievance redressal options available to investors in case of any misconduct by agents also needs to be detailed. As a step towards providing security against fraud, monetary securities may be collected from agents in proportion of the business expected from them which may be used to compensate the consumers in case of a fraud. Details of such provisions would be contained in the implementing rules made by the small savings operator.

> *Recommendation 70: To minimise operational risks on account of agent defaults and to protect the interests of investors, the law should lay down the framework for the licensing, qualifications and training of agents.*

Acronyms

AIG American International Group. 65

CAG Comptroller and Auditor General. 60, 66, 70

CRA Central Recordkeeping Agencies. 76, 79, 104, 105

DB defined benefit. 20, 22, 23, 73, 74, 78, 80, 82, 84–86, 89–92, 95, 98–101

DC defined contribution. 17, 19, 20, 22–24, 73–76, 78–80, 82, 86, 88, 95–99, 101, 104

DoP Department of Posts. 15, 16, 70, 110, 116

EPF Employees' Provident Fund. 17, 20, 74, 76, 78, 79, 88

EPFO Employees Provident Fund Organisation. 16, 17, 19, 67, 74, 75, 77–79, 87, 97

EPS Employees' Pension Scheme. 74, 78

ESIC Employees' State Insurance Corporation. 14, 15, 28, 65–68

FDI foreign direct investment. 6, 7, 29, 36, 37, 59

FSA Financial Services Authority. 113

FSLRC Financial Sector Legislative Reforms Commission. 4, 5, 14, 32, 64, 72, 77, 101

GIC General Insurance Corporation of India. 27, 28, 59, 60

IAI Institute of Actuaries of India. 29

IAIS International Association of Insurance Supervisors. 29, 33

IIB Insurance Information Bureau. 49, 50

IISLA Indian Institute of Insurance Surveyors and Loss Assessors. 55

IOPS International Organisation of Pension Supervisors. 72, 83

IRDA Insurance Regulatory and Development Authority of India. 16, 27, 28, 30–33, 35–37, 42–44, 46, 49, 51, 53, 55, 68, 70

LIC Life Insurance Corporation of India. 12, 27, 28, 57, 58, 76

MACT Motor Accidents Claims Tribunal. 53

MCR Minimum Capital Requirement. 33, 34

NPS National Pension System. 17, 24, 73, 75, 76, 79, 103–105

NSI National Savings Institute. 110, 113–116

NSSF National Small Savings Fund. 25, 26, 106, 108, 110–114, 116

OECD Organisation for Economic Co-operation and Development. 72, 100

PCR Prescribed Capital Requirement. 33, 34

PFM Pension Fund Managers. 76, 79, 104

PFRDA Pension Fund Regulatory and Development Authority. 16, 76, 77

PLI Postal Life Insurance. 70

POP Points of Presence. 76, 79, 104

PPF Public Provident Fund. 17, 20, 75, 78, 88, 109, 116

RPLI Rural Postal Life Insurance. 70

RSBY Rashtriya Swasthya Bima Yojana. 15, 68

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