Little tension on pensions

The reasons why the new pension system is good news for our financial markets are many

By being demanding customers, pension funds can act as a catalyst for financial sector reforms

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The new pension system, currently in the works, augurs well for Indian financial markets, especially for the capital market. At one level, it will fulfil a long-felt need for providing long-term funding to companies, especially those in infrastructure sectors. At another, it will enable large domestic institutions to facilitate the growth of the stock market, as well as reduce the dominance of FIIs there.

Modern pension systems consist of two distinct stages. Stage one is 'accumulation', where members make regular contributions to their pension accounts. These contributions are invested in the financial markets (equity or debt), where they grow for the period of the members' working life. Stage two is 'payout', where members draw upon the accumulation in their account. Typically, these assets are used to purchase annuities that provide members with an income stream for as long as they live.

Debt deficiencies

The effectiveness of pension funds to deliver on these two objectives is contingent on their ability to access financial markets. Several experts have said that pension reform isn't possible without financial market reform, and that countries without the latter have had to simultaneously develop the two. As the government clears the road for the new pension system, it is pertinent to take stock of the readiness of India's financial markets to take on pension reforms.

Since a majority of Indian households don't invest in equities, it's likely that, in the initial years at least, the bulk of the pension assets will be invested in debt instruments. If we assume that 80 per cent of this amount flows into the bond market and 20 per cent into the stock market, we could see an accumulation of Rs 15,555 crore in the bond market and Rs 4,525 crore in the equity market in 10 years. Can these two markets handle such volumes?

The stock market, easily. The market capitalisation of all listed companies in India is currently about Rs 20,00,000 crore. In 2004-05, the National Stock Exchange (NSE) recorded trading volumes of Rs 10,00,000 crore. If we assume our market cap doubles every 10 years, we are looking at a figure of Rs Rs 40,00,000 crore in 2015. In other words, pension savings will take a long time to become the biggest chunk on the stock market.

However, absorption of pension savings might not be as easy in the bond markets. A profligate Centre's borrowing programme -- Rs 90,000 crore during April-October 2004, for instance -- ensures a huge inflow of new paper into the market every year. The problem is that secondary market volumes in the debt segment are dismal. The bond market records a daily turnover of only Rs 2,000 crore -- one-fourth of that in the equity market. A screen-based trading system, where the order book is anonymous, does not exist -- dealers still buy and sell over the phone. It's an opaque market, which is detrimental to pension investment -- and consequently pension reform.

Bringing about reforms

There is an urgent need for reforms in the bond market. As the pension system matures, annuity providers will require longer-dated securities to be able to provide income streams to their customers. There is also a need for inflation-indexed bonds to provide for real annuities. By being demanding customers, pension funds can act as a catalyst for much-needed reforms in India's debt markets, and elsewhere.

Pension funds are, typically, conservative and careful about where they invest their money. Large funds like CalPERS (California Public Employees' Retirement System) demand the companies they invest in be profitable and practice high standards of governance. Pension funds have raised standards of corporate governance in the US. They could do so in India too. Already, our financial markets have passed one important test: CalPERS deciding to invest in Indian companies. But this should be looked at only as the beginning.

If the evidence of other countries is anything to go by, pension reforms do lead to gains for financial markets -- not just in terms of better processes, but also better performance on account of greater inflows. It will take time for the full effect to be felt, given that, in the initial years, pension assets will make up only a small percentage of the overall financial assets. But as they scale up, the change will happen.