

Examining the Nitty-Gritty of NPS

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ABSTRACT

The main intention of National Pension System (NPS) is to provide social security to the people of the country during old age. Pension Fund Regulatory and Development Authority (PFRDA) acts as the regulatory body for NPS. The NPS offers two kinds of account: Tier I Account and Tier II Account. The tax benefit is linked only to Tier I Account. The driving forces behind the NPS are the increase in the cost of living, a rise of the nuclear family, increased longevity and ensuring monthly income in old age when one is not as productive as in youth. In this backdrop, the study has made an endeavour to highlight the critical issues of NPS in terms of taxation, return potential, cost, flexibility etc. It is observed that all the Pension Fund Managers (PFMs) succeeded in delivering a return in excess of 11% during 2-year, 3-year and the 5-year period for the Central Government and State Government Schemes. Average annualised returns of aggressive investors are the best in 1-year and 5-year time period, whereas average annualised returns of ultra-safe investors are the best in the 3-year time period. All stakeholders: the government, employers and employees have a role to play in fostering a conducive pension environment in India. The government needs to consider higher tax incentives, consistent tax treatment of various pension plans and transparency in regulations to augment pension coverage in India.

1. Introduction and Background

National Pension System (NPS) is a government-promoted financial instrument designed to provide social security to citizens of the nation in their twilight years. The Union Government introduced NPS for all employees joining services of Central Government (except Armed Forces) on or after 01.01.2004. Pension Fund Regulatory and Development Authority (PFRDA) acts as the regulatory body for NPS. NSDL is a Central Recordkeeping Agency (CRA) for NPS. Many State Governments have also made NPS mandatory for their employees through Gazette Notifications. The old pension scheme of the Government of India (GOI), known as Defined Benefit Pension System (DBPS), was based on the last pay drawn by the employee. But NPS is a Defined Contribution Pension System (DCPS).

As per the DBPS, an assured monthly pension is paid, based on the last drawn pay, by applying a pension factor as defined in the scheme rules. This is in addition to a General Provident Fund. Private sector employees, on the other hand, had access only to provident fund for financial needs during retirement in the form of Employee Provident Fund (EPF). Several factors compelled the Government to move from DBPS to DCPS. Notable amongst these factors are falling interest rate and rising inflation. Under DCPS, the pension payable is based on annuities purchased on the corpus amount on retirement (Srinivasan, 2015).

NPS has the twin broad objectives: extending old age security coverage and providing reasonable market-linked returns over the long term. The GOI rolled out the NPS for all citizens of India from May 1, 2009, and for the corporate sector from December 2011. The NPS-Lite is essentially designed with the intention to protect the future of the individuals who are

economically underprivileged and who are not financially well-off.

Under NPS, two types of account are available to subscribers: Tier I (non-withdrawable account) and Tier II (a withdrawable voluntary savings account). An active Tier I account will be mandatory for the opening of Tier II Account.

Over and above the deduction of Rs. 1,50,000 available under section 80C of Income Tax Act, an additional deduction up to Rs. 50,000 in NPS (Tier I account) has been exclusively available under subsection 80CCD (1B). Under NPS, subscribers' funds are managed by professional, qualified, and experienced fund managers. NPS inculcates disciplined savings habit for retirement. The entry age in NPs has been increased gradually. The maximum age of joining under NPS-Private Sector (All Citizen Model and Corporate Model) has been increased from 60 years to 65 years. Now, any Indian Citizen, resident or non-resident, between the age of 60 years and 65 years can also join NPS and continue up to the age of 70 years in NPS.

The driving forces behind the NPS are the increase in the cost of living, a rise of the nuclear family, increased longevity and ensuring monthly income in old age when one is not as productive as in youth.

The goal of the NPS was to provide for a system that: (a) Increases coverage on the large area, population and diversity of India; (b) Has long-run sustainability; (c) Is low cost; (d) Is accessible to unsophisticated participants; (e) Provides choice of investment; and (f) Is backed by sound regulation (Sane & Thomas, 2014).

The oft-quoted benefits of NPS include: (a) Greater flexibility in terms of choice of fund managers and asset classes; (b) low-cost structure (NPS is considered to be the world’s lowest cost pension scheme. Administrative charges and fund management fee are also lowest).; (c) Portability feature with a unique NPS account number given to every employee for straightforward transferability during a change in employment; (d) An Exclusive tax benefit of up to Rs. 50000 under section 80CCD (1B); (e) Greater transparency; (f) Simplicity in opening accounts in both online and offline mode; and (g) Proper regulation.

The NPS offers the subscriber two approaches to invest:

(a) Active choice - Individual Funds; (b) Auto choice - Lifecycle Fund.

In case of active choice individual funds, one has the following three investment options:

Asset Class E: investments in predominantly equity market instruments.

Asset Class C: investments in fixed income instruments other than Government securities.

Asset Class G: investments in Government securities.

2. Objective of the Study

The broad objectives of the present study are: (a) To have an understanding of the concept of NPS; (b) To analyse the performance of NPS; and (c) To highlight the critical issues of NPS in terms of taxation, liquidity, convenience, return potential, cost, and flexibility.

3. Data Source and Methodology

The study is exploratory in nature where secondary data have been used. The sources from where these secondary data have been gathered include articles in journals and dailies, reports, web materials, reports etc. On the basis of these data, performance has been analysed with reference to risk and return. Critical issues have also been explored on the basis of these data.

4. Performance Analysis of NPS

The average annualised returns of different types of investors during different time periods are presented in Table 1.

Table 1: Average Annualised Returns of Different Types of Investors

S.N.	Type of Investor	Asset Allocation (%)			Average Returns (%)		
		E	C	G	1-YR	3-YR	5YR
1	AGGRESSIVE	50	30	20	16.48	9.49	12.61
2	BALANCED	33.33	33.33	33.33	11.49	9.74	11.75
3	CONSERVATIVE	20	30	50	7.17	9.93	11.04
4	ULTRA SAFE	0	40	60	1.49	10.24	10.04

Source: Compiled and arranged by the Researcher from the Article titled "How much have your NPS funds earned?", ET Bureau (December 04, 2017)

Note: E: Equity Fund, C: Corporate Bond Fund, G: Gilt Fund

It is evident from Table 1 that average annualised returns of aggressive investors are the best in 1-year and 5-year time period, whereas average annualised returns of ultra-safe

investors are the best in the 3-year time period. But 1-year average annualised returns of ultra-safe investors is extremely low (1.49%) which is really a matter of concern. Risk-averse

There are 29 states under NPS. Tamil Nadu was the first state to adopt the pension scheme under NPS. However, West Bengal and Tripura have not adopted the NPS so far, and PFRDA is in discussion with both the states to take them on board. As on 26th August 2017, Uttar Pradesh has the highest number of subscribers enrolled under NPS with 4.3 lakh subscribers, followed by Madhya Pradesh, Rajasthan and Chhattisgarh with 3.9 lakh, 2.9 lakh and 2.8 lakh respectively. In terms of contributions, Rajasthan makes the highest contribution at Rs 8836 crores. Rajasthan also has the highest AUM of Rs 11482 crores. There are 500036 total numbers of active accounts of All Citizen subscribers under Tier I as in August 2017. This is a 14.40% increase since the start of this FY 2017-18. In comparison, the number of Tier II Account subscribers is 98501 in August 2017, which is 20.70 % increase for this FY 2017-18 (PFRDA, 2017).

Assets under Management (AUM) of National Pension System (NPS) crossed Rs. 1 lac crore and stood at Rs. 118,810 crores as on March 2016 from Rs. 80,855 crore as on March 2015. At the same time, the number of subscribers increased to 122.35 lakhs in March 2016 from 87.49 lakhs in March 2015. Further, NPS contribution stood at Rs. 95849 crores in March 2016 from Rs. 63838 crore in March 2015 (PFRDA Annual Report 2015-16). The AUM of NPS stood at Rs 201984 crores as on 26th August 2017. The figure was Rs 174558 crores at the end of FY 2016-17. Thus, the AUM of NPS has grown by 15.71% this financial year, up to August 2017. The contribution under NPS has cumulated to Rs 153045 crores as on 26th August 2017. The share of the Government (Central Government & State Government taken together) to the total contributions (Rs 153045 crores) is the largest at 85.41 % (PFRDA, 2017).

Till 2015, equity funds of NPS were mirroring the returns of the index because pension funds were supposed to invest in index stocks (Large Cap Stocks) only. But from September 2015, fund managers (SBI/ICICI/UTI/LIC/HDFC/Kotak/Reliance) have been allowed to invest in a larger universe of stocks and follow an active investment strategy that does not mirror the index (Reddy, 2017).

investors who put their entire corpus in gilt and corporate bond funds have not done well in the 1-year period. The average G class gilt fund of the NPS has managed to generate less than 2% returns in the last one year. Unless bond yields go down, the returns for such investors will remain muted in the coming months. Balanced investors rank second in terms of average annualised returns during 1-year and 5-year time period. So it can be said that in the long term, a balanced approach can

deliver decent returns without taking too much risk. It is also interesting to note that average annualised returns of conservative investors record a continuous rise over the period. Another important observation is that in 3-year period average annualised returns decrease with increase in exposure to equity. The situation has just reversed in the 5-year period when average annualised returns increase with an increase in exposure to equity.

The performance of different funds with respect to different categories of investors is exhibited in Table 2.

Table 2: Performance of Different Funds with respect to Different Investors

S.N.	Type of Investor	Rank 1			Worst Performer		
		1-Y	3-Y	5-Y	1-Y	3-Y	5-Y
1	AGGRESSIVE	H	K	U	L	L	R
2	BALANCED	H	K	I	S	L	R,S
3	CONSERVATIVE	H,L,R	K	I	I	U	S,U
4	ULTRA SAFE	L	L	I	K	U	U

Source: Compiled and arranged by the Researcher from the Article titled "How much have your NPS funds earned?", ET Bureau (December 04, 2017)

Note: H: HDFC Pension Fund, I: ICICI Prudential Pension Fund, K: Kotak Pension Fund, L: LIC Pension Fund, R: Reliance Pension Fund, S: SBI Pension Fund, U: UTI Pension Fund

It is noticed that for aggressive investors, HDFC Pension Fund provided the best returns in the 1-year period, Kotak Pension Fund delivered the best return in the 3-year period and UTI Pension Fund generated the best return in the 5-year period. In case of balanced investors, HDFC Pension Fund provided the best returns in the 1-year period, Kotak Pension Fund delivered the best return in the 3-year period and ICICI Pension Fund generated the best return in the 5-year period. The similar is the situation for conservative investors where Kotak Pension Fund delivered the best return in the 3-year period and ICICI Pension Fund generated the best return in the 5-year period. But in the 1-year period, three Pension Funds (HDFC, LIC and Reliance) delivered the best return. In case of risk-averse or ultra safe investors, LIC Pension Fund provided

the best returns in the 1-year and 3-year period, while ICICI Pension Fund generated the best return in the 5-year period. The worst performing Pension Funds in the 1-year period were LIC Pension Fund, SBI Pension Fund, ICICI Pension Fund and Kotak Pension Fund for aggressive, balanced, conservative and ultra safe investors respectively. The worst performing Pension Funds in the 3-year period were LIC Pension Fund for aggressive and balanced investors and UTI Pension Fund for conservative and ultra safe investors. The worst performing Pension Funds in 5-year time frame were Reliance Pension Fund, SBI Pension Fund (jointly with Reliance Pension Fund), UTI Pension Fund (jointly with SBI Pension Fund) and UTI Pension Fund for aggressive, balanced, conservative and ultra safe investors respectively.

Performance of Central Government Scheme of NPS as on 31st August 2017 is presented below in Table 3:

Table 3: Performance of Central Government Scheme of NPS as on 31st August 2017

PFM (Pension Fund Manager)	Return (%)			
	1-YR	2-YR	3-YR	5-YR
LIC	9.35	11.64	11.81	11.20
SBI	9.32	11.63	12.29	11.10
UTI	9.74	11.90	12.08	11.20

Source: PFRDA Bulletin, Vol VI, Issue VIII

It is observed from Table 3 that the performance of UTI was the best in 1-year, 2-year, and 5-year (jointly with LIC) time period. All the PFMs succeeded in delivering a return in excess

of 11% during 2-year, 3-year and the 5-year period which is indeed a decent return.

Performance of State Government Scheme of NPS as on 31st August 2017 is presented below in Table 4:

Table 4: Performance of State Government Scheme of NPS as on 31st August 2017

PFM (Pension Fund Manager)	Return (%)			
	1-YR	2-YR	3-YR	5-YR
LIC	9.38	11.61	12.01	11.38
SBI	9.30	11.72	12.48	11.21
UTI	9.47	11.81	12.15	11.24

Source: PFRDA Bulletin, Vol VI, Issue VIII

It is observed from Table 4 that the performance of UTI was the best in 1-year and 2-year period whereas SBI was the best performer in 3-year and LIC remained the best performer in the 5-year period. Here also, all the PFMs succeeded in delivering a return in excess of 11% during 2-year, 3-year and the 5-year period which is indeed a decent return.

5. Critical Issues

Retirement planning is a long-term goal. As such, financial instrument offering retirement benefits or solutions should be simple, flexible, easy to comprehend, tax efficient and liquid.

Critical Issue I: Taxation on Maturity

Why the NPS corpus should be taxed when other financial instruments like PPF, ELSS and Life Insurance etc. are tax-free, asked the critics. It is the tax treatment of the corpus of the NPS which prevents many investors from joining the NPS. Merely 40% of the corpus is tax-free, compared to 100% in other retirement products like EPF, GPF and PPF. According to NPS rules, 40% corpus is to be put into an annuity. This finally gets taxed because the pension is entirely taxable. Pension from the annuity comprises of two things: the principal and the gain. Accordingly, the investor, in effect, pays tax not only on the gains but also on the invested capital. Many people find this unacceptable. Investors in equity instruments like stocks and equity mutual funds are in a favourable position because they don't have to pay any tax on long-term capital gains (LTCG) if they hold the stocks or units of equity mutual funds for a period of more than 1 year from the date of purchase. Investors in debt mutual fund schemes are taxed at a lower rate after three years and also benefit from indexation. But investments in the equity funds of the NPS get taxed. At the same time, debt funds of NPS investments are not eligible for inflation indexation. In its current form, the NPS is a perplexing combine of EET and EEE. A part of the corpus is tax-free on retirement. Another part is put into an annuity which ultimately gets taxed. A smaller part is taxable if withdrawn on maturity. This part can escape tax only if it is managed properly. For an average investor, this is fairly difficult. The rules have to be simplified in order to make the scheme more acceptable and attractive to the investors.

The NPS corpus is taxed, but a well-structured withdrawal strategy can reduce tax liability to zero, opined the experts. At present, 40% of the maturity corpus of NPS is tax-free. Another 40% of the corpus can be out of the ambit of tax when put in an annuity to get a monthly pension. Nevertheless, the remaining 20% of the corpus is still subject to tax at maturity. But there exist tax-saving options as well. If that 20% is also put in the annuity (in addition to the mandatory 40%), it will not be taxed. Moreover, the investor can also withdraw in instalments spread over 10 years since NPS permits the investor to remain invested even after retirement and stagger the withdrawals till he turns 70. So it is seen that a well-structured withdrawal strategy, together with practical tax planning, can well reduce the tax to zero. Further, premature withdrawals are tax-free. Those apart, premature withdrawals do not affect the taxability of the corpus. Another tax-friendly characteristic of the NPS is that GST is waived on annuities purchased with the NPS corpus. In general, 1.8% GST is payable on the value of the

annuity. But NPS investors are excepted. Another tax-friendly characteristic of the NPS is that GST is waived on annuities purchased with the NPS corpus. In general, 1.8% GST is payable on the value of the annuity. But NPS investors are excepted.

Critical Issue II: Premature Withdrawal

Investors may desire to utilise the money to meet other financial goals as well. Investors may have other requirements. The stiff rules for withdrawals trim down the attractiveness of the NPS. During the productive years of an individual, there are several circumstances where he might require money. At this juncture, inaccessibility to one's own funds curbs one's financial autonomy. Partial withdrawals are permitted up to 25% of the contributed amount. However, there are certain restrictions. Partial withdrawals can be made only thrice and only for specific reasons. Moreover, there should be a gap of at least five years between two partial withdrawals. This is very restricted. It implies that an individual cannot withdraw money for his daughter's marriage if he had withdrawn less than five years ago for her education. Premature withdrawal rules should be associated with real-life conditions to make them more consequential.

The counter opinion is that early exit hurts retirement. As such, it is necessary to discourage early exits. Keeping investments in long-term products enables the investor to enjoy the benefit of compounding. For example, if an investor keeps his money untouched in a long-term financial instrument which offers interest rate @ 10% p.a., his money will be more than doubled within a time span of 10 years. Premature withdrawal shatters the impact of compounding. When the rationale of the product is to facilitate subscribers to accumulate funds for twilight years, then restrictions on early withdrawals are absolutely essential. The NPS, nevertheless, has some flexibility in certain cases for withdrawals. Patience and discipline are of utmost importance in case of long-term investment product like NPS.

Critical Issue III: Returns not Assured

Some investors look for assurance and are suspicious of market-linked returns. According to critics, it should not be called a pension scheme since pension is not defined. They are of the opinion that during equity market downturns the returns of NPS investors are going to be affected severely. They further advocate that if the bear market prevails long (10 or more years) the investors will be badly impacted and the return from equity component may even be in the negative territory.

The counter view is that markets deliver in the long run and debt-based financial instruments will not sustain. Interest rates have fallen considerably in current years. Hence, the rates offered on the EPF, GPF and PPF have become more and more untenable. But NPS funds have generated very decent returns to investors in the last 3-5 years. In case of an inflationary condition, returns from the government securities and other fixed-return debt instruments can dwindle. However, investing in equity can avoid inflation in the long run because equity is the only asset class capable of generating inflation-

beating returns. Further, as viewed by many, NPS is not an all-equity investment option. It also has under its kitty debt instruments and allows the investor to select his asset allocation. An investor can switch over to debt if the equity markets look edgy. The high returns from NPS will also reduce the tax burden at the time of retirement.

Critical Issue IV: Flexibility

It is stated that compulsory annuity takes away flexibility. An investor is forced to keep 40% of the corpus at a low-yield and tax inefficient option.

The annuity rates offered by the life insurance companies are pretty low and the pension amount is dependent on the annuity rates. The yields on annuity products offered in the market today are in the range of 5 to 7% only. This is low when compared to other conservative products like Debt mutual funds, Senior citizens Savings Schemes, Post office MIS, or MF MIP Schemes etc. (Reddy, 2017).

Low annuity rates cannot beat inflation. If it is not possible to avoid annuity, PFRDA must offer NPS subscribers a special rate, observed some experts. Compelling the subscriber to buy an annuity with 40% of the corpus can limit his ability to battle inflation after retirement. Subscribers annuitising 60% of their corpus for avoiding tax will suffer more. The annuity purchase can be delayed only for three years. It implies that one cannot take the advantage of better annuity rates at higher ages. Further, if a subscriber dies during the period of deferment, the spouse will be compelled to buy the annuity.

Critical Issue V: Limited Equity Exposure

It is argued that 50% cap on equity restricts return potential. Younger and aggressive investors may desire to invest further in equities. By removing the 50% cap and allowing 100% allocation to equities, NPS could turn into an ideal means to save for retirement. If investors make out what they were doing, they should be free to choose their asset allocation. A lifecycle fund is there for those who don't know where to invest.

Several studies have shown that equities have delivered a high inflation-adjusted return as compared to other assets such as debt, gold, and real estate, over long-term. NPS currently offers a choice to invest 50 percent of investment into equity under the scheme E fund option. About 50 percent of one's investment in NPS even in the scheme E fund option is into debt (Dhawan, 2017).

The counter-argument is that cap on equities protects the downside. The 50% cap on equity exposure balances the risk-reward equation for the investor. Since NPS is meant for retirement, it is desirable that it should be handled with caution and care. Removing or even increasing the 50% cap on equities will make the NPS exposed to negative returns, especially in the short to medium term. If the bearish phase prolongs, it can gravely dent the savings of those about to retire.

6. Challenges

The main challenges before the NPS are:

- ✓ lack of awareness among the common people
- ✓ poor incentives to intermediaries
- ✓ inadequate return
- ✓ deficient marketing and promotion of the product
- ✓ compulsory annuity
- ✓ stiff competition from Employees' Provident Fund (EPF)
- ✓ difficulty in popularising the scheme in the unorganised sector due to poor financial literacy

7. Conclusion

It is a very long-term investment product, so make sure you understand the implications and the working of NPS before opening an account. Estimate the amount of monthly savings required to meet your post-retirement expenses, keeping the inflation and your life expectancy in mind. Diversify across various investments, including mutual funds and NPS, but do not bank entirely on the latter (Dhawan, 2017).

The PFRDA has made some vital proposals to the Finance Ministry. These are: (i) Equity investments should get an exemption from long-term capital gains (LTCG) tax; (ii) Debt investments should get indexation benefit; and (iii) NPS Tier II savings should get the same tax benefit as mutual funds. If these proposals are accepted, the entire landscape of NPS will change and NPS will become a more tax-friendly financial instrument which will certainly attract more investors.

A look at Melbourne Mercer Global Pension Index 2017 reveals that India's overall index value has increased from 43.4 in 2016 to 44.9 in 2017 and it occupies the 28th position among 30 countries reviewed. It is observed in the index that Government of India and PFRDA have provided much-required impetus and thrust in encouraging participation in the National Pension System both in the organised and unorganised sector by its sustained campaigns and tax incentives.

All stakeholders: the government, employers and employees have a role to play in fostering a conducive pension environment in India. The government needs to consider higher tax incentives, consistent tax treatment of various pension plans and transparency in regulations to augment pension coverage in India. Employers not only need to give a pension platform to their employees but also need to educate them on the various pension plans and their respective benefits. Employees need to outline their retirement objectives and choose pension plans that will help them build a terminal corpus, which will realise these goals (KPMG-FICCI Report, 2015). It is still early period for the NPS, and it remains to be seen if it can attain the mass appeal and scale.

6.1 Recommendations

Some of the recommendations are listed below:

- i. Buying an annuity product should be made optional.
- ii. The NPS should be brought under the category of EEE to avoid tax on maturity.

- iii. NPS should have a liquid fund option where risk-averse investors can store their gains without fear of loss.
- iv. NPS should discourage early withdrawals unless the situation is extremely grave because an average Indian investor does not have the discipline to remain invested for the long term.
- v. Introduction of some tax benefits for the pension from annuities may be considered to make the NPS more popular.
- vi. There should be uniformity in tax treatments for all retirement products.
- vii. The choice of investments and fund managers should be made available to central government employees.

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