# Pension schemes need strong sense of purpose

India needs to define and review the purpose of the different so-called retirement plans that salaried employees are eligible for[1] and possibly scrap the pension under the Employees Provident Fund (Employees' Pension Scheme 1995) "EPS95". However, we recently saw the EPFO being embroiled in a matter where salaried employees' EPS95 pension has the potential of increasing significantly. There are several factors and ramifications that need to be considered.

**Employers**

As on 31 March 2016, there were over 900,000 unique PF codes from establishments registered with the EPFO[2]. Out of which about 4,365 unique codes from approx. 1,500 establishments with exempt private Provident Fund trusts.

While, in the context of the current discussion around EPS95 there are no significant additional costs or liabilities that the employer will bear. However, a lot of communication to employees to explain a complex issue and additional administrative work around recalculating contributions will be required. Exempt trusts too could be burdened with more record keeping, administrative challenges and investment issues.

**Employees**

Employees who joined the EPFO before September 2014 are potentially the biggest gainers as they could get a guaranteed pension from the EPS based on uncapped PF wages (currently limited to INR 15,000 monthly).

- For example, an employee who joined the EPF at the age of 25 in 1996 with a monthly basic salary of INR 10,000 (and gets reasonable salary increases), his projected eligibility for the maximum monthly pension is INR 7,500 at age of 58 under the capped arrangement of the EPS95.
- However, the pension amount would increase sharply if the cap on salary is removed. Assuming a salary increase of 6% pa, the uncapped monthly EPS95 pension for the same employee increases to approx. INR 29,000 per month and at 8% p.a. salary increase, it would be over INR 50,000 per month (if the employee remains in EPF until age 58).

In exchange for the higher amount, the EPFO would need to calculate retroactive EPS95 contributions on the uncapped salary. For employees who have already taken their PF benefits will need to find a considerable amount of cash to contribute back to the EPFO for these retroactive contributions.

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[1] http://www.livemint.com/Money/d1s4LMiz9XcjmYa5lTZicL/Retire-the-obsolete-retirement-conventions.html

[2] as per the EPFO annual report 2015-2016

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Employees still working and in the EPF may not need to pay anything additional. Their retroactive higher contributions will come from a notional "transfer" from their existing main EPF account.

**EPFO**

With employees gaining so much and employers not impacted, who picks up the cost of the much higher EPS95 pension? The main point is whether 8.33% contribution to EPS is enough to fund the EPS95 benefit obligation. Based on some simple assumptions and actuarial models the answer is a definite "no". I have estimated the "cost" of our sample employee electing the EPS95 option, to the EPFO.

- I have estimated a 'present value' of pension payments that the EPFO will need to pay, less the value of the notional accumulated EPS95 corpus of the member. If the value of the projected pension payments is more than the projected notional EPS95 corpus, then EPFO pays (and the employee gains). To calculate the pension stream value, I have taken an assumed cost to purchase an annuity.
- Making suitable assumptions, the net present value (assuming 8.5% pa) of the shortfalls roughly work out to INR 3,90,000; INR 12,50,000 and INR 28,50,000 under salary increase assumptions of 6% pa; 8% pa and 10% pa respectively.

Such costs to be borne by the system are just for one person. The vast range of salaries makes it is very difficult to extrapolate this to the broader membership of EPFO. However, it would be very large due to high earners.

If these huge costs emerge over time, they will either need to be covered by increasing the 8.33% contribution rate or reducing the benefits or even asking employers and employees to pay more than the 12% total EPF contribution or funds from the Government. Notably, the existing EPFO contribution of 1.16% of wages contribution for EPS95 will cover that part of the cost too.

**Opinion**

Whilst the EPS95 development is no doubt good for employees, it does beg the question at what cost? We may be going back to a defined benefit regime that goes against the longer term direction that India has implemented towards defined contribution pensions.

For NPS, I fear take up rates in corporates may substantially fall from the organised sector. Willis Towers Watson's India 2017 Retirement Governance survey revealed that 90% of corporates still face take up rates of less than 25% in NPS. To employees, this latest on EPS95 will make NPS unfavourable (through no fault of its own).

**Is that really the purpose?**

We need to assess the impact and determine if long terms costs are well spent on a long term defined benefit scheme or on incentivising a defined contribution environment and social security for those who really need it. This should be considered further whilst the Labour Code on Social Security is also being developed.

*The article by Kulin Patel was first published by Mint dated 04 June, 2018.*

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