HR Law Hotline

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THE FALLOUT OF THE EPF INTEREST RATE HIKE

On May 28, 2005, bowing to political pressure, the Employees' Provident Fund Organisation's ("**EPFO**") Board of Trustees ("**Board**"), confirmed the interest rate of 9.5% for fiscal 2004-2005. This rate was earlier proposed by the Ministry of Finance ("**MoF**"), Government of India. Mindful of the rate of return on the fund, currently at 8.7%. The Board had earlier recommended an interim rate of a more realistic 8.5%. The declared 1% hike translates into a yawning deficit of INR 7160 million (approximately USD 165 millon) in the EPFO account.

EPF contributions are invested in government-approved securities and bonds of companies. Previously, the EPF could offer a higher rate of return by investing around 70% of the corpus in Special Deposit Schemes ("**SDS**"), which gave a 12% return. Today, the SDS rate has sunk to 8%. The EPFO's request to increase the present interest rate on SDS has reportedly been turned down by the government. Postal schemes, which offer high returns, are of no use since institutions cannot invest in these.

The MoF has also declined to bail out the EPFO and hence it would be compelled to dip into its Special Reserve Fund ("**SRF**") [currently at INR 9,500 million (approximately USD 219 million)] for the 2004-2005 payout to its 400 million members. The SRF has been painstakingly built up over several years out of the forfeited contributions from employers, plus interest.

To enable the funds to increase its earning potential, the government notified a new investment regime from April 2005, allowing non-state provident, superannuation and gratuity funds to invest up to 5% of their assets in equities and up to 10% in corporate debts and equity-oriented funds. The EPFO, however, claims that it has neither the expertise nor the inclination to invest in equities.

The Employees' Provident Fund Scheme, 1952 ("**Scheme**") is governed by the Employees' Provident Fund and Miscellaneous Provisions Act, 1952 ("**Act**"). Under S. 17 of the Act, private companies are exempted from the Scheme provided such companies set up private trusts for the administration of their employees' provident fund. Such companies are required to offer, as per the Act, a rate of return which is "not less favorable" than that declared for the EPF. Thus the private company provident funds would also be required to pay the high 9.5% rate of interest. At this rate, the total shortfall for privately-managed funds is estimated at INR 5,000 million (approximately USD 115 million).

What are the solutions for EPF trust managers? They could:

- identify a good investment scheme to seek a return of around 9%.(In fact, many privately-managed funds have been invested in state governments' securities. However, the expected yields have not been forthcoming due to delayed payments.)
- surrender the privately-managed funds to the regional Provident Fund Commissioner, which would compel the government to meet the deficit
- invest in high-yielding junk bonds, with the attendant risk of defaults
- take a loan from the company to meet the deficit, repaying the amount over the years.

The government, well aware of the crisis that it has unleashed, has already proposed that in fiscal 2005-2006, the interest rate of the EPF should be pegged at a more sensible 8%. However, for the current fiscal the funds are plunged into deficit.

Daksha Baxi or Rina Kamath

Source: The Employees' Provident Funds & Miscellaneous Provisions Act, 1952

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