BASIC FEATURES OF DEFINED BENEFIT PENSION
AND EPF SCHEME

1. Features of existing EPF Scheme:

(a) Individual Account
(b) Accrued Benefit guaranteed
(c) Facility for availing refundable and non-refundable loan
(d) Facility for nomination
(e) Future accrual rate guaranteed by law
(f) Interest accumulation already accrued guaranteed
(g) A reasonable estimates of future interest accrual possible
(h) Totally tax free

2. Defined Benefit Pension

(a) It is a collective which means no individual accounting of benefit accrual possible as in EPF
(b) There is no facility for loan from the account of any kind
(c) Pension stops with the death of the pensioner and continues to the spouse at a much reduced rate since the death of the pensioner
(d) Pension is related to average Final salary at the time of exit as a fixed percentage
(e) Some pension schemes allow dearness relief based on movement of Cost of Living Index once in every six months and thus to a large extent inflation proofed
(f) A minimum qualifying service is required for pension to accrue, say 10 years. If the employee resigns without this minimum qualifying service, no pension benefit accrues. However if employee dies while in service family pension will accrue to the spouse
(g) A reasonable estimate of the possible pension accruing to the employee is possible based on the current salary structure and past and future service with the employer. The possible future final salary can be projected and estimated and the defined percentage of that salary will be the pension possible
(h) Under Defined Benefit Scheme the final salary pension is usually guaranteed and any deficit in funding support to service the pension will be financed by the employer apart from the normal contribution
(i) Pension is taxable in the hands of the recipient as per IT law and Rules

3. Financial arrangement to administer the EPF and Defined Pension Schemes

The arrangement in place for running an EPF Scheme is as follows:

(a) Contributions are taken from the salary of employees every month at rate fixed from time to time by Government under the EPF Act and remitted to the Employees Provident Fund Commissioner. Similarly at the end of every financial year matching contribution by the employer is also remitted to the EPF Commissioner. The employee has an option to make additional contribution to the Provident Fund over and the mandatory minimum contribution.
(b) The EPF has to maintain separate accounts for each and every employee for mandatory minimum employee contribution, additional contribution by employees and contribution by employer.

(c) The EPF Commissioner gathers all such contributions by all employers who join the EPF Scheme. This pool of money flowing the EPF Commissioner will then be converted into income earning assets such as Government of India Securities, State Government Securities, Bonds issued by Government approved companies etc in accordance with guidelines issued from time to time by government. These guidelines are intended to ensure the safety of capital and accrued interest on such investments from time to time.

(d) At the end of every financial year the trustees of the EPF who oversee the investment of Funds determines the total accrual of income for that year and then decide upon a rate at which the balance in the individual accounts in respect of each employee can be credited with interest. The current rate is 8.75%.

(e) At the time of the exit of the employee in service due to any reason, the accumulated balance of the individual accounts comprising the three sources of fund supply – mandatory minimum employee contribution, additional contribution by employees and the employer's contribution will be settled.

(f) Any outstanding loan taken from the EPF account of the employee will be recovered from such accumulated balance before settlement.

(g) Employers, Employees (Unions) Representative and Government Representative are there in the EPF Trust so that the investments are made in a secure way as visualized in the law and the appropriate portion of the accrued income from year to year is equitably distributed to each employee's account. There is thus control over the EPF finance by representatives of various stake holders of the Scheme.

(h) The EPF Commissioner can at his discretion allow such asset management arrangement to be operated by similar trusts created by the employer provided the employer undertakes to run the trust strictly in accordance with the EPF Act and Rules and guarantee passing on a rate of interest at least equal to the rate approved by the EPF Trustees from time to time. Such separate trusts are allowed to be operated by institutions engaging very large number of employees like Banks, Insurance companies and similar public sector and private sector companies.

(i) From out of the contributions flowing to the EPF Scheme as contributions by the employers, a part is used to service a Pension Scheme. The EPF Commissioner's discretion to allow such trusts to be run by employers themselves however does not cover this part. However, if the EPF Commissioner could be convinced that the employer is going to introduce a Pension Scheme utilizing his share of the EPF Contribution made in the past and due in the future which gives a pensionary benefit to employees which is at least equal in value to the EPF Scheme benefits, the employer may then be allowed to run such a pension scheme as a substitute to the EPF Scheme. The EPF Commissioner upon approval of such substitute pension scheme will then determine the transfer value of the fund remaining with them and transfer that value to the substitute pension scheme to be introduced by such employers. Thereafter only the employee contribution will remain operated by the EPF Commissioner. Where the employer was permitted to operate the EPF by themselves as afore mentioned, then the employee contribution will be operated by such employer sponsored trust and for the pension scheme a separate trust or fund will have to be constituted and its accounting and investments separated from the Provident Fund part. For this to happen the employer has to draft a Pension Rule and such draft Pension Rule and its viability has to be certified by an actuarial valuation. This does not mean that the EPF commissioner is not free to get this pension valued by their own actuaries before granting approval.

4. Problems and Modalities associated with a substitute Defined Pension Scheme:

(a) Defined Pension Scheme as already mentioned is a collective. Once it is instituted, no employee (member of the scheme) has the right to claim his share of the value in the fund and opt out, as is possible under EPF. This is a very important difference.

(b) Being a Collective there will be an element of cross subsidy between one segment of employees and another segment which cannot be avoided and only broad equity is possible between members. The Pension scheme implicitly assumes that every member has given is irrevocable consent to this.

(c) Future improvement in Mortality has to be estimated and allowed for.

(d) Growth of final salary of exit can pose major problems because the contribution to service the pension will be very low the salary being low in initial years of service. This will result in an insufficiency of contribution to match the growth of final salary on which the pension is reckoned.

(e) Cost of administration will be more because pension payment cheques have to be prepared every month since vesting unlike in EPF where with a single lump sum settlement the matter is settled. Furthermore, checks on survival of the beneficiary in a pension add to the cost of administration.

(f) To ensure that the pension vested for an employee the trust has to purchase a life annuity from an insurance company like LIC. The price of such annuity products do not remain constant and it can go too high causing financial problems for the trust.

(g) On the investment side, the trust has to earn a minimum guaranteed return say of 8%. The ability to earn such return depends on the economic climate and market conditions. Pension being a long term benefit, very long term guaranteed investment channels must be available. This is not always available leading to reinvestment risk and costs.

(h) There is a trend that long term investment yield is on the decline and as a result growing pension costs cannot be matched with such trends already visible.

(i) For all these reasons the defined pension scheme of the type and size prevalent in government service cannot be serviced by rate of contribution as visualized in the EPF scheme.

(j) When you start a pension Scheme, we encounter the problem of initial deficit on account of the accumulated deficit in respect of the past service of serving employees. This arises from the fact that whereas the contribution flow in the past is based on the respective yearly size of the salary, for every such year of service the pension is linked to the final salary of the employee at the time of exit which will be disproportionately high. The employer company will have to pump in funds at least equivalent to this deficit to correct the imbalance at the start of the scheme.

(k) Even after correcting the initial imbalance, new imbalances can set in, in course of time and this means that the initial corpus plus regular future fixed contribution can prove insufficient as the scheme develops further.

(l) Put briefly, to run a defined benefit pension scheme, one cannot guarantee the benefits by applying a fixed contribution rate as in EPF even after bringing in an initial corpus to bridge the initial deficit. The employer company should be prepared to guarantee the requirement of upward revision of contribution rate. This depends on matching growth rate of the company itself which cannot be expected to happen always.

(m) If the pension scheme is operated without adequate further financial support ignoring the above problems, there will be a time when the pension fund is not in a position to meet the merging pension costs. Such a situation will be most unwelcome for pensioners and serving employees as the company will not be in a position to mobilize additional finance.

5. Is there a way to overcome the above problems?

(a) If still the company and its employees still feel that a defined pension scheme suitably modified to take care of the above listed dangers, then the company and its existing and future staff has to come round for a consensus on a set of basic principles which is listed below:

(b) Required consensus of Basic Principles:

(i) Not less than 95% of the serving employees must join the pension scheme
(ii) The final salary pension must be a percentage substantially lower than 50%
(iii) There should be a cap of maximum pension including its DR component
(iv) On the investment side apart from the contribution rate as per EPF formula, the company must guarantee that the aggregate rate of return on the invested pension funds is at least 8% per annum and in the vent of any shortfall the company should regularly make good the shortfall
(v) The problem cannot be solved by investing in market related equities because just as the prospects of higher returns there is also the prospect of not only lower returns but even erosion of the capital invested in such securities. In sum, since the emerging pension liability being a guaranteed one, such guarantees cannot be matched by such speculative investments.
(vi) The pension pay outs must be met by purchasing annuities from well reputed and highly solvent insurance companies. In times when the annuity prices rise abnormally high, the must be provisions in the pension rules suitably lower the pensions in payment as well as emerging below the cap level fixed and even the cap may also have to be revised to remedy the situation.
(vii) The pension rules to be framed to take care of these contingencies must be compulsorily applicable to new recruits.
(viii) At least once in three years an independent actuarial valuation must be taken and if the valuation discloses uncomfortably high deficits, there should be provision in the pension rules streamline the pension benefits appropriately to correct these deficits. Or, alternatively the company must be in a position to bring in more funds to bridge the deficits. It is possible such deficits may arise at a time when the company itself may be in a declining phase. So the rules must necessarily be tightly drawn.
(ix) If in the event of a situation in which the deficits disclosed in the pension fund are too large to be able to be corrected by any such measures envisaged in the rules, the fund must be operated as a closed scheme and benefits suitably reduced.

6. What can be done?

If the company and its employees all agree to ensure that the above set of principles will be incorporated in the rules, then a new valuation of such benefits at an appropriate percentage of the final salary at exit as can be sustained, can be calculated and reported to the company for consideration of implementation.

Accurate data of serving staff and the date from which the scheme might be implemented should be communicated. A reasonably good estimate of the fund value that can be got transferred from the PF Commissioner is also required.