# Important developments impacting the statutory Provident Fund – India

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- *Exempt Provident Funds get severely impacted by investments made in Infrastructure Leasing & Financial Services (IL&FS) group*
- *Supreme Court judgement sets aside amendments made by Employees Provident Fund Organization in 2014 with respect to Employees Pension Scheme (EPS) potentially increasing the scope and size of pensions access for employees*
- *Supreme Court rules special allowances to be included in basic wages in determining Provident Fund contributions*

## Exempt Provident Funds get severely impacted by investments made in Infrastructure Leasing & Financial Services (IL&FS) group

### Overview

The Provident Fund (PF) is a statutory Defined Contribution plan where both the employer and employee contribute 12% of the employee's applicable wage to the Provident Fund and its sub-plans. The plans are managed and administered by the central PF governing body – the Employees Provident Fund Organization which declares an annual interest rate for the Provident Fund for all employees.
However, Section 17 of the Employees' Provident Funds and Miscellaneous Provisions Act (EPFMP) Act, 1952 empowers the Government to ***exempt*** any establishment (employer) from the provisions of the Employees Provident Fund Scheme 1952 provided the rules of the provident fund set up by the establishment (employer) are not less favorable for employees than those specified in section 6 of the EPFMP Act.

The above indicates that the returns provided by Exempt Provident Funds (Exempt PFs) cannot be lower than those declared by the government managed PF and that any interest rate or capital shortfall must be made good in the year the shortfall occurs. Therefore, such Exempt PFs carry an embedded interest rate guarantee and are a type of hybrid arrangement where the PF account balances are Defined Contribution (DC) in nature and the guaranteed interest rate credited to contributions is Defined Benefit (DB) in nature. Such interest rate guarantees therefore need to be recognized in the employer's Balance Sheet provisions through actuarial valuations.

Exempt PFs manage their own PF investments on behalf of their employees and invest in securities and asset classes as per the pattern prescribed by law.

Currently less than 5% of organizations in India would have such arrangements (in absolute numbers, this equates to around 1,500 organizations). Organizations with such arrangements are typically large multinational companies or traditional Indian business houses who have the required infrastructure to manage these plans in-house.

### Recent Developments

In the last quarter of 2018, one of the most popular investment avenues for Exempt PFs (Infrastructure Leasing & Financial Services institution or IL&FS) defaulted on its interest/coupon payments to several of its bond holders including PFs.

IL&FS is a large non-banking financial institution (NBFC). It finances several infrastructure projects in the country and includes other large institutions (i.e. the state-insurer Life Insurance Corporation of India and Orix Corporation of Japan) as its top shareholders. IL&FS was a popular high yielding investment avenue for PFs for several years until their default on several bonds and the credit ratings changed from "AAA" to "Default" in a matter of weeks. The reason for these defaults provided by management was a liquidity mismatch and delay in clearance of government invoices. However, preliminary investigations have revealed gross mismanagement of assets and other governance issues as the likely cause.

With several institutions subscribed to the corporate bonds issued by IL&FS and the fear of a contagion, the Government has now taken control of IL&FS to ensure its assets are divested smoothly and paid back to lenders. IL&FS is reported to have a debt in excess of USD 10 billion.

## Impact on Employers

Exempt PFs heavily invested in IL&FS corporate bonds would mostly likely report interest rate shortfalls compared to the government managed PF scheme this financial year (FY 2018-19). This may also create **larger actuarial liabilities** in respect of potential future interest rate shortfalls as the actuarial liabilities are based on expected return assumptions drawn from historic returns which have been impacted adversely this year because of the IL&FS default.

In addition, if Exempt PFs are not able to recover the principal bond value, the employer would also have to make good the same , leading to **higher short-term provisions/contributions** (any interest rate or capital shortfall must be made good in the year the shortfall occurs).This is highly likely as the PFs do not have these investments secured and therefore classify as unsecured creditors. These may not be able to get priority on sale of assets as compared to secured creditors like Banks. At this stage there has been no guidance from the Government or the Employees Provident Fund Organization on the extent of provisions to be made by employers towards this impact.

Some organizations have been able to reduce the financial impact by tapping into accumulated Reserves and Surpluses within the Exempt PFs. These Surpluses were accumulated over the past years when the Exempt PFs were able to outperform the statutory return and retained the excess earnings as Reserves.

Going forward, employers with Exempt PFs may have to **review the investment governance framework of all their retirement funds** to avoid such risks in the future. The selection of investment funds must be made using stronger risk monitoring frameworks, with a stronger focus on aspects such as liquidity and governance rather than solely focusing on the credit ratings issued by external credit rating agencies.

Organization should consider if they would want to **move out of the current Exempt arrangement** to the government managed arrangement freeing the employer from interest shortfall obligations in the future, including performing actuarial valuations.

## Supreme Court judgement sets aside amendments made by Employees Provident Fund Organization in 2014 with respect to Employees Pension Scheme (EPS)

In a judgement which could potentially have a significant impact on pension provision in India, the Supreme Court of India upheld the decision of The Kerala High Court in the case of P. Sasikumar & Others vs Union of India whereby the amendments by the Employees Provident Fund Organization (EPFO) to the Employees' Pension Scheme (EPS) scheme in 2014 were set aside.

The EPS scheme is a sub-plan of the statutory Provident Fund plan whereby 8.33% of the Employer's contribution to the PF is redirected to the EPS scheme. The EPS scheme in turn promises a Defined Benefit pension to employees at retirement and the liability for this benefit sits with the Provident Fund authority (EPFO).

The EPFO had introduced several amendments effective September 2014. The key amendments impacting the EPS were:

- First time employees whose basic pay was more than INR 15,000 per month would not be allowed to join the EPS scheme. The full employer's contribution (12% of applicable pay) for these employees would go the Provident Fund scheme.

- Employees who elected to contribute towards the EPS based on uncapped salary were required to re-elect (within a stipulated timeframe along with employer) to continue paying contributions based on uncapped salary. These employees would also have to bear government contribution at a rate of 1.16% of pay going forward.

- The pensionable salary for calculating the EPS pension benefit at retirement would be calculated at 60 months of last drawn average salary (instead of 12 months).

## Triggers for the 2014 EPS amendments

- To receive an uncapped pension at retirement, an employee must redirect the employer's contribution of 8.33% of uncapped pay towards the EPS throughout his active service for life. However, if contributions to the EPS are based on a capped salary of INR 15,000 per month (as per the existing rules) the maximum pension benefit receivable is limited to INR 7,500 per month at retirement.

- High level calculations suggest that there is potential for an employee to gain handsomely if he/she receives a pension based on their last drawn uncapped pay compared to a pension where contributions were based on a capped salary of INR 15,000 per month. For example, if an employee contributes at an uncapped salary towards the EPS for 35 years, the pension he/she could potentially receive would be much higher than if the employee continued to contribute to the Provident Fund and bought a pension from the accumulated PF at retirement from the retail market. The magnitude of such differential gains depends on the salary growth rate of the employee throughout his/her active service life and the annuity market at the time of retirement. The reverse is true if the pension receivable is based on a capped salary of INR 15,000 per month where the maximum pension would be limited to INR 7,500 per month, since if the contributions were invested in the PF instead and accumulated to buy a pension from the market at retirement, the pension would certainly be much higher than INR 7,500 per month.

- For this reason, the PF authorities closed the EPS scheme to new entrants and removed the ability to elect contributions based on an uncapped salary, since it could have resulted in a significant financial strain on their future liabilities and possibly made the scheme unsustainable.

## Recent developments and the impact of the judgement on employees

The Kerala High Court in the case of P. Sasikumar & Others vs Union of India set aside the above amendments made by the EPFO. Subsequently the Supreme Court also dismissed the special leave petition on the 1st April 2019 filed by EPFO.

- As a result of the judgement, it is now expected that all the amendments made by the EPFO with respect to the EPS scheme in September 2014 would not be valid.

- Employees should now be able to contribute towards the EPS at contributions based on their full basic salary (i.e. uncapped) and the final pension therefore would also be based on an uncapped basic salary (based on an average of 12 months' pay).

- In all likelihood, the scheme would open once again to all employees whose salaries are above INR 15,000 per month.

- As the judgement may apply retrospectively, employees who opt for uncapped EPS plan may have to refund the employer's PF contributions with interest to the EPFO to obtain the higher EPS pension based on an uncapped salary.

- Retired employees could also potentially opt for a higher pension based on their last drawn uncapped salary by refunding their PF contributions with interest. There are potential arbitrage opportunities for retired employees who opt for uncapped EPS pension.

- Operationally it becomes an immense task to implement these changes, transferring employees' funds from the PF to the EPS and redoing calculations for all active and retired employees in the country. Employees may have to deal with a significant amount of paperwork and face significant delays in getting the higher EPS pension benefits which could be emotionally stressful

## Impact on the employer

There is no financial impact on the employer as the EPS liability sits with the government. However, employees would look to their employers for guidance and education to help them make decisions based on these changes i.e. whether to contribute to the EPS on full basic salary or contribute on to the EPS at a capped basic salary of INR 15,000 per month and keep contributing towards the Provident Fund.

## Impact on the EPFO

In future, the EPS could potentially become unsustainable which may prompt the EPFO to raise the EPS contribution rate. They may also have to ask the government to fund any deficits.

## Recommendations

- We recommend employers to approach their respective Regional PF Commissioner (RPFC) to get clarity on the judgement and the steps needed to implement the uncapped EPS pension scheme for their employees.
- We also recommended that employers should not state preference to any particular scheme (i.e. PF or EPS) to its employees and instead focus on providing the correct, unbiased education for employees to make their own informed decisions.
- On face value, it appears that contributing towards the EPS pension scheme based on an uncapped salary is advantageous compared to contributions based on a capped salary. However, a younger employee should keep in mind the factors below which may make the EPS scheme a riskier alternative in the future:
  - ✓ Ability for EPFO to service the EPS pension benefits for life
  - ✓ Government default risk impacting benefit provision
  - ✓ Unpredictable future changes in the EPS benefits or contributions required by legislation
  - ✓ Interest rate movements impacting the annuity market (and cost of buying pension benefits) at retirement
  - ✓ Employee's own aspirations and needs at retirement (e.g. a lump sum from the PF or pension benefit from the EPS)

# Supreme Court rules special allowances to be included in basic wages in determining Provident Fund contributions

In another landmark judgement, the Supreme Court has ruled that special allowances which are *universally, ordinarily and necessarily* paid to employees would be considered as basic wages in of calculating Provident Fund (PF) contributions. The judgement clears the air on several decades of litigation between employers and the statutory PF authority – the EPFO around the same topic.

## Background

The Provident Fund Act provides that statutory PF contributions (12% of applicable pay) are based on Basic wages, dearness allowance (D.A.) and retaining allowance. (PF contributions are mandatory for employees earning below INR 15,000 per month).

Historically most organizations split the gross salary of employees into Basic wages and other allowances at the time of making the employment offer to the employee. The Basic wage would typically be fixed at 30% to 50% of the gross salary and the balance of pay was split into various allowances such as a Housing Rent Allowance, Conveyance Allowance, Special Allowance, Supplementary Allowance, Flexible allowances or any other allowance differently named.

These allowances achieved significant tax efficiencies as per Income Tax laws.

The Provident Fund contributions were being calculated based on Basic wages only in these organizations and other allowances were not being included in the definition of Basic wage. This was contested by the EPFO who insisted on the inclusion of all allowances within the definition of Basic wages.

## Judgement

The Court held that allowances *universally, necessarily and ordinarily paid* across the board are part of the Basic wage and hence eligible for PF contributions.

The Court highlighted that employers that were part of the appeal could not present any material which demonstrated that such allowances were variable in nature, linked to production or being paid to those who availed the opportunity. In other words, if an employer intended to remove such allowances from the definition of PF wages, it must be proved that such allowances were variable, linked to production, not paid to all employees or category of employees, and are paid to those who avail the opportunity. *(an example of this would be a special hardship allowance being given to employees who are working in remote areas)*

## Impact on employers

- The judgement is expected to have significant financial implications for employers who have large number of employees with Basic wages less than statutory PF wage limit of INR 15,000 per month and where the gross pay is above INR 15,000 per month. The financial impact due to contributions on higher PF wages could be up to 6% of gross pay assuming Basic wages is defined as 50% of gross salary.

- An alternate way to achieve compliance is to increase the Basic wage to at least INR 15,000 per month which would lead to higher PF contributions (but less than the prior approach). However, this would adversely impact liabilities towards other benefit plans related to Basic wages (i.e. Gratuity benefits, Leave encashment and National Pension scheme benefits as these benefits are also based on Basic wages), hence would likely not be preferred by employers.

- Based on the tests of universality, the employer would have to include applicable allowances as part of Basic wages for calculating PF contributions going forward. For example, a special allowance given only to employees who work for a short period of time in a remote location would be excluded from the calculation, but a special allowance given to all employees as part of compensation structure would need to be included.

- It should also be noted that attempts made by employers to deduct the additional employer PF contributions from the employee's pay would be met with stiff resistance by impacted employees and may lead to litigation.

- Reduced take home for employees and higher contributions by the employer are expected to impact other elements such as internal pay ranges, salary increment budgets, hiring strategy and the overall compensation strategy of the organization.

## Impact on employees with Basic wage below INR 15,000 per month

Employees' retirement savings would get a boost if an employer provides additional PF contributions towards an employee's PF account. However, by law, employees would have to match such additional contributions leading to a reduction in take-home salary. The reduction could be in the range of 6% of gross salary assuming the Basic wage is defined as is 50% of gross salary.

## Impact on employees with Basic wage greater than INR 15,000 per month

It is widely expected that the judgement would not impact employees whose Basic wages are higher than the statutory PF wage limit of INR 15,000 per month. It is common market practice for employers in India to pay PF contributions on full basic salary and not limit the contributions to the statutory PF wage limit of INR 15,000 per month.

Although the Supreme Court judgement has not expressly stated the exclusion of these employees, decisions in past legal cases suggests that PF authorities cannot force employers to contribute towards the PF on wages beyond the statutory limit of INR 15,000 per month.

## Retrospective applicability

Another question which has remained unanswered in this judgement is the retrospective applicability of the judgement, that is, whether impacted employers would have to make good all prior deficit contributions along with any applicable penalty and interest. Such retrospective applicability could have a serious financial impact on the employer as the employer would have to make good deficits towards both employer and employee contributions and pay these for employees who have since left employment as well.

Employers should closely monitor the EPFO decision on retrospective application.

## Contact Information

We're here to empower results, if you would like further information or to discuss these or other retirement matters, please reach out to Indiamarketing@aon.com

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