Steep decline in bond yields may force a cut in EPF and PPF rates

By *Babar Zaidi*, ET Bureau |Updated: Sep 05, 2016, 11.06 AM IST

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NEW DELHI: While the capital markets await a cut in policy rates, small investors and salaried workers should brace for a reduction in interest rates on retirement savings.

Given the steep decline in bond yields in the past six months, it seems unlikely that Employees' Provident Fund will be able to maintain last year's interest rate of 8.8 per cent. Also, the finance ministry may have to reduce rates on small savings schemes, including Public Provident Fund and Senior Citizens' Saving Scheme.

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A basis point is 0.01 percentage point. ET reached out to 25 finance professionals, including mutual fund managers, investment analysts and independent financial advisers, for their views.

An overwhelming 84 per cent expect EPF rate to be lower this year. Most (64 per cent) also believe that a cut in interest rates of small saving schemes is imminent, though 32 per cent believe the political implications could prevent the Centre from following the quarterly reset rule it introduced in February.

Can NAV-based approach resolve the problem?
To boost EPF returns, the Employees' Provident Fund Organisation (EPFO) has been investing 5 per cent of the fresh inflows in equity exchange-traded funds (ETFs) since August 2015.

But this also means 95 per cent of fresh inflows get invested in bonds at the prevailing low interest rates. "Therefore, one should expect a fall in the PF interest rate this year," says Amit Gopal, senior vice-president of India Life Capital, an investment and legal advisory firm for pension funds.

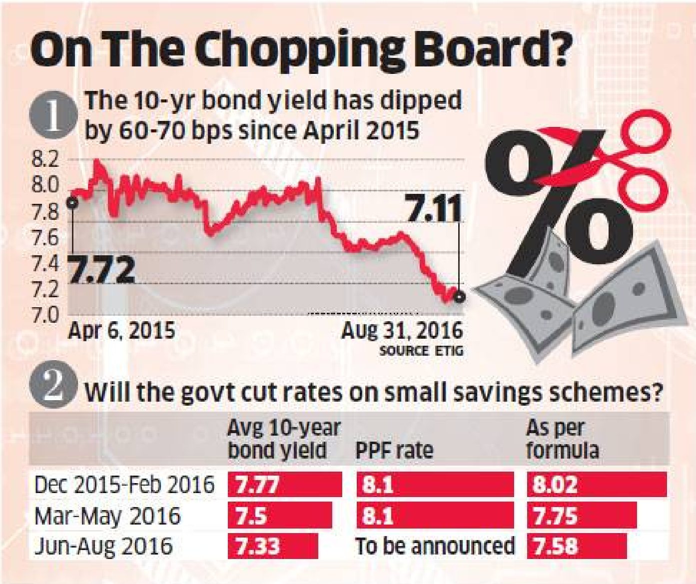
Experts say the current equity allocation in EPF is too small to make a meaningful difference. "Equity assets account for barely 1 per cent of the total EPF corpus so it will take some years before they show results," said Manoj Nagpal, CEO of Outlook Asia Capital.

A study by Crisil shows that if only 5 per cent of incremental inflows are invested, it will take about 15 years for the equity exposure to reach 5 per cent of the overall corpus. This assumes 12 per cent returns on equity and 8 per cent returns on debt investment.

Not willing to wait so long, the government wants to raise the EPF's exposure to ETFs from current 5 per cent of incremental inflows to 10 per cent. In a few

ETFs from current 5 per cent of incremental inflows to 10 per cent. In a few days from now, Union Labour Minister Bandaru Dattatreya is expected to call an emergency meeting of Central Board of Trustees (CBT) of EPFO to discuss this.

He contends that the Rs 7,500 crore put into equity ETFs since August has grown to about Rs 8,500 crore, a return of almost 12 per cent in absolute terms. Trade union representatives in CBT say these are notional gains that could quickly vanish if markets slip.



"Equities are speculative. The value of the investments had turned negative last year when markets were down. We can't invest workers' savings in risky instruments," said Arjun Dev Nagpal, secretary of Hind Mazdoor Sabha.

Even the right-leaning Bharatiya Mazdoor Sangh (BMS) is opposed to the move. "If interest rates have fallen, we will give a lower return of say 8.25 per cent this year. But at least it will not fall to 5 per cent or 3 per cent. Low-income earners cannot afford to risk their retirement savings in equities," said Virjesh Upadhyay, national general secretary of BMS and a CBT member.

Need to give enough time
Government officials rubbish such views.

"This opposition to equity investments stems from a lack of understanding of the equity market," said Labour Secretary Shankar Aggarwal, vice-chairman of CBT.

Aggarwal agrees that the value of equity investments had fallen last year but points out that such investment should be given enough time to deliver results. Most financial experts agree with the government's viewpoint.

"Globally, about 30 per cent of retirement savings are allocated to equities. In India, EPFO has started investing in equity ETFs only recently," said Jiju Vidyadharan, director, funds and fixed income research, Crisil.

Experts say a flaw in the way EPFO is valuing the equity assets of EPF. Till it used to invest only in bonds and deposits, the instruments were accounted for at face value and the interest earned on them was credited to PF accounts of individual members.

But the value of equity ETFs moves with the market. "Giving out a fixed return based on notional gains of these investments is not prudent accounting," said based on notional gains of these investments is not prudent accounting," said Gopal of India Life Capital. Turning EPF into an NAV-based instrument could resolve this problem. However, this requires a total overhaul of the scheme and a complete change in the mindset of the people who run it.

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