Unitising EPFO: a step towards professional management

The decision by the Employees’ Provident Fund Organisation (EPFO) to credit exchange traded fund (ETF) units into the provident fund accounts of its members, termed unitizing, represents a long overdue progress towards modernization of investment policies and fiduciary responsibility towards its members. It is a step towards EPFO’s aim to become a professional and globally compatible social security organization.

The proposal is that the members will be able to track their EPF investments in equities, and realise the gains from them at the time of withdrawal of their EPF funds. EPFO began to make equity investments through ETFs— which unlike mutual funds are marketable securities that track an index such as the BSE Sensex—only in 2015. Its total investment in ETFs in 2017-18 is projected by market analysts to be in the range of Rs250-300 billion. The total financial assets under the EPFO’s management are estimated to be about Rs10 trillion (equivalent to about 8.5% of India’s GDP).

This step by the EPFO has several implications for members, for the EPFO as an organisation, and for the economy as a whole.

First, unitization will bring greater transparency to members for investment of a part of their EPF balances—the part that is invested through ETFs. To help members benefit from greater transparency, the EPFO should explicitly indicate the proportion of ETF investment that is allocated for the EPF, EPS (Employees’ Pension Scheme), and EDLI (Employees’ Deposit Linked Insurance) schemes. There is a case for allocating some proportion of the ETF units to each of the three schemes, with the exact proportion to be determined according to policy goals and the total contribution share to each scheme.

Second, the utilization would potentially permit realization of the monetary value of the units at the time of withdrawal by members. Since the accumulation of the EPF balances depends more on harnessing the power of compound interest over a long period, members would need to be informed about exercising restraint in withdrawals during the working years.

The EPFO, on its part, would need to tighten the withdrawal regulations before statutory age. It permits withdrawal for housing and other purposes only for the contributions made by a member, excluding accumulated interest on member contributions and employer’s share.

Greater clarity will be needed by the EPFO as to how unitization would impact the withdrawal provision during the working years. Would all the applicable ETF units be credited to the contributions and returns of members only, or to the employer’s share as well? How would the allocation between the two be made?

The third issue concerns the valuation of the ETF units. Since ETFs are traded regularly, their market value would be known at the time of withdrawal by a member.

The expert group established by the EPFO to recommend an accounting method for valuation of ETFs has suggested adopting practices followed by collective fund management schemes.

Equity investments are to be valued on a mark-to-market (MTM) basis, and unrealized gains or losses are to be stated in the MTM reserve account. It is suggested that units be allocated to members based on the net asset value (NAV) to ensure fairness to members who participate at different points in time.

The report also suggests an equalization reserve—out of MTM gains (and losses) beyond a threshold level—be created to help members cope with the timing of market entry. The EPFO is yet to decide on the recommendations of the report, but it is clear that it will need to change its accounting methods, and that these will need to be clearly communicated to members.

The first implication for the EPFO concerns how it reports its investments—both cumulative investments and those made in a given year. These should be reported in a single statement on its website (*epfindia.com*) by each asset class for each of the three schemes. The net rate of return obtained—net of investment management fees—by each asset class should be provided, at least annually.

Second, the EPFO should consider crediting returns to members on the basis of what it has earned during the period, rather than on the basis of administratively determined returns as it is doing currently.

Third, the EPFO's assets under management (AUM) are expected to increase as it improves its capabilities to enhance the proportion of members (around 80 million) that actively contribute (about 40 million).

The expected trends in EPFO's assets and changing expectations of its members and other stakeholders towards professional management, strongly suggests that there is considerable merit in the EPFO establishing an investment management unit within the organization, with the requisite augmentation of skill sets. This would not preclude mandating various fund managers to invest part of its balances. But in-house investment management expertise would enable EPFO to more efficiently manage its assets-liabilities profile. Establishment of such a unit however, should be undertaken only after careful planning, with particular focus on risk management and governance aspects.

Analytical reasoning and global experiences strongly suggest that only when mandatory savings are intermediated through capital markets and other channels into economically productive investments with potential to raise the economy's trend rate of growth, do they contribute to improving the country's total overall savings rate.

The unitization step is a recognition that EPFO's current asset allocation, heavily weighted towards public sector-debt instruments (and with no or minimum trading of even debt instruments) needs to change. The step is also a recognition that expectations of the members for better returns on their mandatory contributions need to be addressed.

As EPFO gradually shifts towards a more appropriate risk-weighted diversified portfolio, India's saving-investment process would improve, with priority sectors such as infrastructure, including for the social sector, potentially receiving long-term funds.

If this step is accompanied by the EPFO implementing suggested initiatives, the impact on the quality and rate of economic growth would be positive.

Mukul Asher is professorial fellow, Lee Kuan Yew School of Public Policy, National University of Singapore.

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