Optional Pension Schemes in lieu of Contributory Provident Fund vis-à-vis dilemma of the Optee employee

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Paper submitted by Sanjay Khambete

Dear Brothers & Sisters,

I am a banker by profession. During my earlier service with a Public sector bank in 1994 the employees of Public sector Bank were offered an Optional Pension Scheme in lieu of their Employers' Provident fund contribution.

Then, my learned colleagues roughly 10 lakh Public sector Bank employees, working in banking and aware of gimmicks of Interest rate calculations, were in dilemma as to what option can be chosen. This was mainly on account of uncertainty of interest and inflation rates. This was more so because the inflation and interest rate trends were reversed due to process of globalization started in last decade.

The option for pension was opened up for a limited period of three months later it was extended for a period of further three months.

Afterwards the Employees Pension Scheme (EPS), 1995 was implemented in November 1995. This scheme was encompassing all the members of then Family Pension scheme (roughly 130 lakh). In the scheme there is an inbuilt provision of exemption if a better scheme is formulated.

As such in case of devising of any Pension scheme the benchmark parameters of EPS 1995 should be the minimum.

So even today if an optional scheme is prepared then the employee concerned may be undergoing the same dilemma as was faced by Public sector Bank employees in 1994.

The audience in this august gathering would be responsible for drafting and implementing such scheme.

1. The Employees Pension Scheme (EPS), 1995 needs to be studied minutely. For ready reference I have put together the salient features (Annexure A) and an illustrative chart of the benefits under the scheme (Annexure B) for your reference.
2. The Highest rate of interest paid by Public Sector Banks would be very much useful in understanding the trend. In this trend upto September 1993 Reserve Bank of India (RBI) was declaring all the rates hence uniform for all the banks. Hence after September 1993 the rates of my previous employer Bank of Maharashtra are used. In the competitive environment all the banks rate would be hovering around each other with a margin of 0.25% to 0.50%. Hence the rates given here could be an indicator to the trend. (Annexure C)
3. The same table also gives the Bank Rates declared by RBI from time to time. These rates are the rate of interest charged by the RBI to commercial banks. (Annexure C)

4. Under the Provident fund Act the minimum rate of interest payable by Provident fund Trusts is declared the same is tabulated for ready reference. (Annexure C)
5. The best indicator for inflation for a salary earner is All India Consumer Price Index (Industrial workers) with base year of 1960. The entire series from Jan 1961 to November 2004 is provided (Annexure D) with the analysis of rise every year and also five yearly average(Annexure E).
6. For calculating recovery factor an Equated Monthly Installment table with monthly compounding of interest is provided for interest rates from 5% to 10% (at 0.25% intervals) for the periods from 5 to 20 years. Besides the Discounted value of Rs. 1 lakh for 20 years is also provided (Annexure F).
7. The graphical presentation of Bank Fixed Deposit rates, Bank Rate (RBI) and rise in Inflation (CPI) for the period between 1977 to 2004 is provided (Annexure G).

For their reference the following points need to be carefully considered.

a) If the movement in interest rate is observed then it is evident that nearly two decades between 1981 to 2001 the interest payable on Fixed deposit was above 10% mark. In some periods it has even touched 13% level. After 2001 a consistent decline is observed and present level is around 6%. This inclines the option towards favour of Pension.
b) The average rise is inflation was consistently above 8% during 1971 to 2000 for three decades. However, it has stabilized at around 4% in last 5 years. This trend inclines the decision more towards PF option since the erosion in money would be less.
c) Again the factor whether the pension is with or without dearness allowance would also determine the impact of both the above factors. Since the pension scheme applicable to Central as well as state Government employees and also Bank Employees are DA linked pensions. While the pension under EPS is without DA linkage.

Now let us consider a case of person joining EPS 1995 at the age of 20 years with a salary of 1000 pm and increment of 5% every year. At his retirement at 58 he would receive following benefits as per CPS 1995 (refer Annexure B)

(i) Pension of Rs 3466 pm (of which Rs 1155 can be commuted to take Rs 115547 as commuted value)
(ii) Thus after commutation he would receive Rs 2311 pm against his contribution to the fund Rs 2,74,322 (Rs 3,89,868 as contribution in pension fund at 7% interest minus Rs 1,15,547 received as commutation value).
(iii) Thus if he gets pension for 17 years then the value of his sacrifice (contribution) is recovered at the age of 75 (58+17).
(iv) He has got option of receiving 87.5% pension for 20 years and receives 100 times of pension at the end of 20 years. The captioned person can receive Rs 2022 pm for 20 years and Rs 2,31,100 at the end of 20 years.

(v) This option is equivalent of getting Rs 57,220 (24760 *231100/ 100000) or the sacrifice would be Rs 2,17,102 (2,74,322 – 57,220) for an assured pension of Rs 2022 pm for 20 years. This works out to Rs 931 per lakh of sacrifice or a return at 9.5% pa.

(vi) All these factors will have to be considered before devising any better scheme (better than EPS 1995).

(vii) Now let us discuss the points of dilemma for the individual employee in taking a decision for the option between PF and Pension.

DILEMMA FOR OPTION BETWEEN PENSION AND PF

Employee has to take a vital decision to opt for PENSION OR PROVIDENT FUND in a very short time. Various parameters need to be considered. Some parameters are listed below:

1. RATE OF INTEREST ON INVESTMENT:

The rate has got a double effect. Firstly it will decide the quantum i.e. increase/ decrease in your future accumulation of Provident Fund during your balance service and secondly it will decide the returns on your investment in-case you opt for Provident Fund after retirement.

1.1. Maximum rate of interest on bank deposits have varied from 7.25 % to 13 % since 1970 to 1992. The rates saw an upward revision upto 1992 and later they have started declining presently the rates are around 6% level.

1.2. Globalization of Indian Economy and announcement of full convertibility of rupee might have an adverse impact on rate of return on the investments in general and bank deposit rates in particular. It may be noted here that present global rates on advances are around 3 % to 7 %. Thus after giving allowance for spread the rates on deposits are further lower. Besides the rates are fluctuating as per global demand and supply for the money.

1.3. Since the investments of Provident Fund by Trustees (employer) are in long term Government securities the globalization impact on these rates i.e. fluctuations in returns on accumulated balance will be in a phased manner and increase / decrease may be spread over five to six years.

1.4. A critical analysis and comparison between return on investment on lump sum Provident Fund and monthly pension is needed for deciding the option of PF or Pension. Earning interest is one of the major avenues for such return on investment.

1.5. The present UPA Government under pressure from left lobby could not mark to market the rates of interest payable on Provident fund and was compelled to keep the rates high despite of diminishing returns on PF investment. This subsidization would also have the impact on the decision making.

1.6. A special scheme floated for Senior citizens with 9.0% interest rate by Govt. of India will also have the bearing on the decision.

2. CONSUMER PRICE INDEX (CPI) / INFLATION

The index is an indicator of the cost of living. Since pension is generally with CPI linked Dearness Allowance (exception EPS 1995) this index would determine the monthly pension receivable. More the inflation, more the rise in CPI and accordingly more the pension. Hence the employee is faced with the daunting task of predicting the CPI for nearly 20 years beyond 2000. If anticipated rise in CP| is beyond the rate of return on investment pension could be the option over Provident Fund.

2.1. The dearness allowance of all government employees / bankers / insurance is based on All India Working Class Consumer Price Index (CPI) with base year 1960 = 100. The Index shows an average increase of 8.0 % pa in Pre reforms period for 30 years since 1960 to 1991, while during the last post reform decade the average increase is 7.1 % for 13 years since 1992 to 2004. It appears to be stabilized at a rise of around 4% since 2001.

2.2. The budget deficit and control measures for reducing inflation are the main ingredients controlling the movement of the CPI. Hence the policies of the governments would have a great impact on the change.

2.3. The growth of economy will also play a major role in deciding the CPI

2.4. India's position in international market, the impact of globalization on our economy in general and on production, income and generation o employment in particular would' also be the major factors influencing the CPI.

2.5. Predicting the movement based on past trends in India or globally may not be a useful exercise. Since globally the variation of annual growth rates is between -30% to +800% while in India it is between -8% to 29%.

2.6. Some feel that there is a definite correlation between interest rates and CPI or inflation. The assumption is not correct because inflation is related to the deficit financing and growth rate of the economy while interest rate is dependent on supply and demand for the credit. In closed economy this belief would be true to some extent since they would have some interrelation but with opening up of economy relation would also be diluted to a great extent.

3. LIFE EXPECTANCY:

This factor is going to decide the pension able life after the retirement. The following factors need to be considered.

3.1. Expectancy of life is one of the major areas which are going to have a major bearing on decision. Of course, one can't predict this parameter since the choice is left with the Almighty. As per national average the life expectancy is at 61 years. For salary earner considering the standard of living, education and medical awareness it could be around 70 years.

3.2. The hereditary medical history would play a major role in determining the life expectancy.

3.3. The present health status of the person would also be a crucial determining factor.

4. PERSONAL TRAITS:

Present level of investment, nature of accepting risk while taking investment decisions, other income support opportunities like spouse earning etc., Besides, person's age and qualifications in case of voluntary retirement and alternate job opportunities, need also to be considered before arriving at a conclusion.

4.1. INVESTMENTS : Present level of other investments is going to decide the level of investments by the expected date of retirement. As such the sound backing of planned investment may eliminate the need for a fixed monthly income. Besides expertise earned through the years in managing the portfolio would lead to prudent decision making in planning for investment of superannuation benefits.

4.2. ACCEPTANCE OF RISK : The nature of a person to accept risks, i.e. calculated risks may pave a way for bettering the returns on the investment. Of course, one need not and should not venture into risk areas at the time of superannuation. One may opt for the risk if he had already ventured and knows the rules and pitfalls of the game well, then one may take a conscious decision to opt for the lump sum i.e. CPF option.

4.3. OTHER OPPORTUNITIES : Some might have support of family business or agriculture activity which is flourishing and in fact waiting eagerly for entry of this person. In that case a lump sum option based on expected rate of return in the business or replacement cost for the presently arranged funds could be considered for the decision making.

4.4. OTHER INCOME : Income of spouse, income from family business or agriculture etc. would also have a bearing on the decision.

4.5. CHILDREN LEVEL OF EDUCATION / POTENTIAL OF EARNING : The educational and earning status of children would also decide the level of their expectations from parents for settling in life and also future expectations / support to parents.

4.6. MARRIAGE OF DAUGHTER : In Indian culture the major financial outgo is treated on this account. Thus number of female children and their age would also have a bearing on capital sum requirement of the parents.

4.7. SPOUSE PENSION ABLE : If both the husband and wife are eligible for pension, one of them can opt for lump sum option thereby avoiding putting all the eggs in one basket.

5. FUTURE AGREEMENTS / CHANGES IN SERVICE CONDITIONS :

What is in store in future agreements is also supposed to be taken into account by the employee while arriving at the decision.

5.1. Since the economics of either PF or Pension option depends on the proportion of merger of Dearness allowance into Basic. In case of Government employees the rise of Dearness allowance beyond 50% automatically converts it into Basic Pay. In case of employees where PF act is applicable the Basic + DA is considered for deduction of PF and hence this question does not arise. Besides one important

factor of the opening up of the options in future either way would also largely influence the decision.

5.2. It can be observed that in the past this type of introduction and implementation of optional Pension schemes, in future agreements the "PF to Pension options" were opened repeatedly. For Government employees till Fourth Pay Commission the option for "PF to Pension" was opened for the fourth time since introduction.

6. STABILITY OF INDUSTRY / COMPANY

Some employees feel insecure and worry whether their employer would continue to have the same financial stature and afford the Pension commitments in future. The following points may be considered:

6.1. Firstly the present crisis situation is not related to any inefficiency or internal decontrol, but because of sudden imposition of international norms resulting into Global competition, without proper backup infrastructure and mindset for change at all levels.

6.2. Secondly in either of the options, Pension or PF, an equal element of risk in the event of failure of company. However, like in PF act a legal framework for investment of Pension Fund would suffice the purpose of security to some extent.

7. MANAGEMENT PERSPECTIVE:

It is equally important to consider the management's thought process before arriving at a conclusion.

7.1. It is clearly evident that the employees already retired or retiring shortly can take a better decision since for them the projections would be based on more realistic data. For example an employee retiring in 2 to 3 years may have to decide on Interest / Inflation rates for the balance period of 2 to 3 years as against this an employee retiring after 15 or 20 years may find it difficult to arrive at self satisfying projections on the most uncertain data of future Interest / Inflation rates for the balance period of 15 to 20 years.

7.2. In the past schemes the option was for existing employees and for all future recruits the pension option was mandatory. This gives an impression that Pension option benefits the exchequer. However, of late the reluctance of managements to open up the PF to Pension in fresh agreements gives the impression that PF option benefits the exchequer.

7.3. A golden hand shake or VRS schemes also changes the original calculations done by the employee assuming normal superannuation. Such schemes are thought of to pave the way for mechanization by reducing the staff strength of the unit and make the unit more competitive for global competition.

7.4. The future good conduct contract built in the pension scheme also needs a careful consideration.

8. TAX AND INVESTMENT PLANNING

First of aft let us discuss the TAX LIABILITY on the various superannuation benefits that are going to be accrued at the time of retirement. The provisions are given as applicable to Assessment Year 2005 - 06 or Accounting Year ending 31 03.2005.

8.1. LEAVE ENCASHMENT: Leave encashment receivable only in case of retirement is exempt from Income Tax under Section 10 (10AA) subject to following conditions.

8.1.1. For Government Employees fully exempt.

8.1.2. For Public Sector or Local Self Government employees least of the below.

8.1.2.1. a. maximum of thirty days encashment per completed year of service, b. eight months of average salary, (i.e. average of last ten months), c. Rs 3,00,000

8.1.2.2. actual amount received as encashment of leave.

8.2. GRATUITY: Gratuity receivable is exempt from Income Tax under Section 10 (10) subject to following conditions.

8.2.1. For Government Employees fully exempt,

8.2.2. For other employees least of the below.

8.2.2.1. maximum of fifteen days salary per completed year of service.

8.2.2.2. Rs. 3,50,000.

8.2.2.3. actual amount received as gratuity.

8.3. COMMUTATION OF PENSION: Commutation receivable is exempt from Income Tax under Section 10 (10A) subject to following conditions.

8.3.1. For Government Employees fully exempt,

8.3.2. For other employees either of the below.

8.3.2.1. commuted value of one third of normal pension if the employee is in receipt of gratuity.

8.3.2.2. commuted value of one half of normal pension if the employee is not in receipt of gratuity.

8.4. PENSION: The monthly pension received with notional addition of commuted portion would be treated as Salary Income and taxed accordingly.

8.5. TAX RELIEF FOR SENIOR CITIZENS: For citizens with age above sixty five years a tax rebate of least of following will be allowed under Section 88B.

8.5.1. The amount of income tax before giving any rebate under 88, 88B, 88c and 89(1) or

8.5.2. Rs 20,000

8.6. LONG TERM CAPITAL GAINS: In case of shares and units if held for more than one year and in case of other assets if held more than three years. The

income arrived after applying index (declared by Income Tax Department for the purpose) on fair market value of 01st April 1981.

8.7. INTEREST AND DIVIDEND INCOME: Exempt upto Rs. 12,000 (plus Rs 3000 for Government Securities) under Sn 80L.

PLANNING PROCESS

Now your planning would be much easier. Your post retiral investments and income should be planned in such a way that it will attract minimum tax liability. So far you were not aware of this technique because you were in receipt of fixed salary income and were receiving it after deduction of tax. As such there was no flexibility. Now following guidelines would be of much help.

10. If your Pension income is taxable and your age is below 65 then it is better to plan to avoid paying tax by depositing sums in the PPF account to be continued after retirement or opened afresh. Please remember that after attaining age of 65 more taxes can be saved by provisions under Sn 88B.

11. Your interest and dividend income is exempt upto Rs. 12,000 and as such your fortune invested may earn you income by way of interest but part of it would be taken away by way of taxes. The planning could be done by investing in low yield and high capital appreciation securities such as blue chip shares or debentures. Of course if Pension is not taxable then the interest plus taxable pension (after standard deduction) should be considered.

12. Gifting away the fortune may also be a viable way, specially, to your spouse. Since such gifting would yield the income to your spouse by way of interest and thus your tax burden can be reduced. Of course it is assumed that your spouse is free from tax liability. Annual gift upto Rs. 30,000 may not attract any tax and this limit is extended to Rs. 1,00,000 in case of marriage of the dependent.

13. Continuance of PPF account is always advisable with two distinct advantages. Firstly, the advantage of rebate of tax under section 88 can be taken by depositing sums in the account. The allowable withdrawals can be continued without any tax liability. Secondly, the interest received in PPF account is not at all taxable.

14. Plan your withdrawals from NSS account besides encashment of Tax Savings Units (e.g. MEP etc.) carefully so as to minimize the tax liability. Such as, withdrawal after sixty five years of age, withdrawing the amounts and claiming exemption by using PPF route, taking a prudent decision not to withdraw since your heirs need not be liable to pay any taxes etc.

COMMON QUERIES

1. Employee opts for Pension and has to resign from services before completion of minimum service, what will happen to his case?

   He will be losing the Pension but would get some amount as return of contribution on exit from employment (see para 14 of EPS 1995).

2. How half pay sick leave would be computed for purpose of Qualifying Service?

   It will be computed fully.

3. Whether commutation of family pension is allowed?

   No.

4. Whether re-commutation, of 1/3rd basic pension restored after 15 years, is allowed?

   No.

5. Whether pension is payable after re-employment of pensioner?

   Yes, only DA would be stopped till he is in other employment attracting DA as part of his salary.

6. Whether Family Pension is dependent on income of spouse?

   No, only if spouse is employed in that case he/she will have to forgo DA on the pension. However in case of FP to children they would be disentitled for payment of FP if they get employment.

7. In case of death in service, whether employment to spouse or child of the employee would be given in addition to Family Pension ?

   Yes.

8. When the commuted pension would be restored 15 years from date of retirement or date of commutation?

   From the date of commutation.

9. If both husband and wife are employed both get pensions after retirement, one dies, whether surviving spouse would be eligible for both the Pension (own) and Family Pension (of deceased spouse)?

   Yes.

10. Which is the most important factor that needs to be considered for option?

    Date of exit from services (either normal or voluntary retirement).

I am hopeful that the dilemma of an employee spelt out above would be of use for the actuaries present in devising a better scheme which could be optional to employee for his better retired life.

Thank you for your patient hearing.

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Annexure A

The Employees" Pension Scheme, 1995 Salient features

The Employees" Pension Scheme, 1995 is a Government of India (Ministry of Labour) scheme applicable to all the workers for whom provisions of PF act, 1952 are applicable. The salient features of the scheme are as under.

1. From 16.11.95 it is applicable to all without option. (p1)
2. Every employer will contribute 8.33% of the pay of the employee towards the Pension Fund instead of towards CPF. (p3.1)
3. The Central Government will contribute 1.16% towards the fund. (p3.2)
4. Pay for the purpose of this scheme will be pay as defined by PF act with a celling of Rs 6500 per month. (p3.2)
5. Pension payable is 1/70th of pay for each completed year. Thus half of the pay can be drawn as pension for a service of 35 years. The pension is eligible after minimum 10 years of service (p12.2)
6. A commutation of 1/3 of pension is allowed and a 100 times amount will be paid as commutation. (p12A)
7. Three attractive schemes of Return of Capital are available under the scheme. (p13)
8. Receive 90% pension and 100 times of pension on death (no family pension).
9. Receive 90% pension and 80% family pension and 90 times of pension on death of family pensioner.
10. Receive 87.5% pension and family pension for 20 years (assured) and 100 times of pension on completion of 20 years.
11. Family pension to spouse for life or upto remarriage at 50% of the amount of pension of member. (p16.2)
12. Children Pension for the children after the death of the member for maximum two children upto their attaining age of 25 or marriage of the daughter whichever is earlier. (p16.3)
13. The Central Government had offered the exemption from the scheme if better scheme is formulated by an establishment. (p39)