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EPFO's move to lower interest rates is welcome. A high rate is unsustainable

ON THURSDAY, THE Employees' Provident Fund Organisation (EPFO) decided to lower the interest rate on provident fund savings to a seven year low of 8.5 per cent for 2019-20, down 15 basis points from 8.65 per cent in the previous year. The decision was ostensibly shaped by two factors: First, lower return on government securities, and second, the desire to withhold a higher surplus because of economic uncertainties. Being one of the largest social security organisations in the world — it has over 60 million active users — any reduction in interest rates is unlikely to be popular with its contributors. However, this is a welcome move. With interest rates falling across the economy — yields on both central and state government debt have been falling over the past year with the monetary policy committee cutting the benchmark repo rate by 135 basis points over the past year — paying a rate that is out of line with that in the broader economy will end up being unsustainable.

According to reports, the calculations shared at the EPFO meeting showed that retaining the interest rate at 8.65 per cent would have left a deficit of around Rs 350 crore. On the other hand, an interest rate of 8.45 per cent would have led to a surplus of Rs 1,000 crore. Considering the uncertain economic environment — EPFO's investments have in the past come under stress, as in the IL&FS case — there is a legitimate argument for not taking excessive risk. By reducing the rate by 15 basis points, the organisation will end up with a surplus of Rs 700 crore. EPFO should be mindful that higher returns, over and above those from government securities, come from investments in corporate debt, and equities (through exchange-traded funds), which are risky in nature. In the current economic environment, there is a risk of such investments turning bad. Being principally a social security provider, it must thus seek to minimise risk. Further, as the formalisation of the economy gathers steam, and its subscriber base ramps up, it must seek to manage its risks more efficiently. This requires greater flexibility in setting the interest rate.

Alongside the lowering of the EPFO rate, the government should also move to bring about greater and speedier alignment of interest rates on voluntary small savings with market rates. While interest on small savings schemes is based on a fixed formula, and is revised quarterly, the actual rate is higher than that based on the formula. Bringing it in line with rates prevailing in the economy will aid in faster transmission of monetary policy.