

Item No. 6: Modifications to the Accounting Policy for ETFs (equity and related instruments) for EPF Scheme.

1. Accounting policy for investment in Exchange Traded Funds (ETFs) for Employees Provident Fund Scheme falling in the category (iv) equity and related instruments of the Pattern of Investment was approved in the 219th meeting of the Central Board held on 24th November 2017.
2. As per the approved accounting policy for investment in equity (ETF), all subscribers of the EPF Scheme would individually have two separate member account heads (a) Fixed Income where fixed annual interest gets credited to members account and (b) Equity (ETF) where investment in equity (ETF) is reflected as EPFO units and the return is marked to market.
3. However, while taking the approved policy to implementation stage i.e. suggesting amendment in EPF Scheme and formulating process flow for designing the application to run the unitization process, it was found that this process of unitization is a complex process and when investment in equity (ETF) for each and every subscriber is converted to units it may not be easily comprehended by most subscribers owing to their general lack of awareness about equity as an asset class. Further timely operations of sale of equity would require market assessment, which may not be possible for many members.
4. Further as per the approved accounting policy when the entire investment in equity (ETF) of EPFO is converted to units for each subscriber on the basis of proportion of their contribution in a particular month, the subscribers would get allocation of units higher than 15% of their contribution (existing mandate for investment in equity). This is because investments in ETF are made from the fresh accretions also which include current contributions net of redemptions, maturity of existing investments and interest income from the existing debt instruments.
5. In order to make a modification in the approved accounting policy for equity (ETF), CRISIL, consultant to EPFO was asked to give their suggestion. The report of the CRISIL is enclosed as **Annexure-6A** where it has listed out advantages and disadvantages of having a pooled fund for equity investments in case option is given to the subscribers for allotment of EPFO equity units in their member account.
6. CRISIL while explaining the advantages of pooled fund has mentioned that
 - a. *One of the advantages of pooled equity account w.r.t subscribers is that the risk of short term volatility in equity markets is contained for those subscribers who withdraw their fund within a short span of time.*

b. In case of 100% unit allocation of equity investments to the subscribers, it may lead to a scenario wherein the equity allocation as a percentage of subscriber's contribution exceeds 15%. There will be a challenge for EPFO to explain to the subscribers on such higher equity exposure than mandated 15% as per the investment pattern.

7. The item was discussed in detail in the 138th FIAC held on 21st Feb 2018. Based on the discussion FIAC agreed on the following modifications:-

1. Subscribers to be allocated EPFO equity units only for 15% (presently mandated equity investment limit) of their contributions.
2. All units over and above this allocation to all the subscribers would be held by EPFO.
3. A separate policy for periodic disposal of these EPFO equity units needs to be formulated.
4. A separate reserve fund for smoothening out volatility of equity returns and to provide equitable returns to all the subscribers also needs to be created.
5. After operation of this accounting methodology for a certain period, option of enhancing equity allocation beyond the mandated equity investment limit (presently 15%) and also the option of reducing equity allocation below the mandated equity investment limit may also be given to the subscribers. This aspect may be explored at a later stage after implementation of this methodology.

FIAC further decided that in-order to study the modalities of framing policy for periodic disposal of equity held in the form of EPFO equity units by EPFO and also creation of reserve fund as mentioned above, a committee of experts may be constituted. Accordingly the committee has been constituted which will study the issue and give its findings (**Annexure-6B**).

Proposal: The recommendation of FIAC at para 7 of the agenda item is placed before the Central Board for its consideration and approval.

CRISIL's comment on proposed changes in the accounting policy for equity investment (ETF)

Background

The Employees' Provident Fund Organisation (EPFO) has sought CRISIL's comments on the following proposed changes in the accounting policy for investment in exchange traded funds (ETFs) for EPF scheme via letter no. HO/IMC/236/Amendment in Scheme/2017/19020 dated February 5, 2018.

1. Allotment of units would be as of now available only to subscribers who furnish option to create units for a certain portion of his/her monthly contribution.
2. All balance units left after allocating units to subscribers who has given option as above would be held by EPFO.
3. Subscribers would be permitted to give their option subject to some upper ceiling of monthly contribution of both employee and employer share to invest in equity (ETF).
4. For initial few years of this policy most of the investments in equity (ETF) may not be marked to individual subscribers (depending upon how many subscribers opt for allocation of ETF units) and would remain as pooled fund with EPFO.
5. A large portion of ETF investment lying as a pooled fund with EPFO will have inherent carrying risk owing to volatility of the equity market. Further EPFO would also be required to realize periodic gains from this investment as the benefit of capital appreciation would have to be passed on to the members.

CRISIL's comments on the proposed changes are as follows:

Background of earlier discussion on the accounting policy and operational guidelines for investment in ETFs: EPFO had constituted a committee to prepare the "Operational Guidelines for Accounting Policy for Investment in Equity ETFs" for the unitisation methodology suggested by IIM Bangalore. The following were the recommendations of the committee with respect to distribution of units among subscribers.

1. Unit allotment from August 2015 till the actual date of implementation of the unitisation method (past period):
 - a. For the purpose of initial allotment of units on a retrospective basis, net asset value (NAV) per unit will be considered as Re 1.
 - b. The market value of ETF investments as on the cut-off date for actual implementation of the unitisation method, i.e. go live date will be considered for this purpose.
 - c. Units will be allotted to members having balance in their EPFO accounts as on the go live date (hereinafter referred as "active members").
 - d. Units will be allotted to active members identified at the go live date in ratio of their yearly contributions during the respective periods.

2. Ongoing allotment of EPFO equity units
 - a. On an ongoing basis, NAV of units created by EPFO for its members' equity portion is proposed to be computed at the end of every month.
 - b. Amount invested in ETF during the month will be allocated to individual members' account in the ratio of their individual contribution for that month. The net amount after adjustment of members' share of ETF units will be reflected in the debt contribution (i.e. monthly contribution – ETF contribution = debt contribution).

Advantages and disadvantages of pooled fund for equity investments

Advantages	Disadvantages
<ol style="list-style-type: none"> 1. Simple to understand 2. In line with the way fixed income portion of EPFO is managed, where new subscriber reaps the benefit of past investments made by existing subscribers 3. Risk of high volatility in equity markets over short investment horizons may be reduced in case of subscribers whose holding period of investments is less 	<ol style="list-style-type: none"> 1. Unlike unitisation methodology, the distribution of benefit arising from equity investment among subscribers is not fair and appropriate 2. Warrants regular profit booking in order to aude interest rate declaration in the overall fund 3. Regular booking of profit is not in line with the long-term philosophy of equity investments 4. Allocation to equity reduces with regular profit booking and undermines the ability to maximise returns for subscribers 5. Impacts the interest rate declaration on the fund in case the equity market gives negative returns in a year

Explanation of disadvantages of pooled fund

- Units of subscribers who do not opt for allotment of units will be held in the pool account by the EPFO. In order to pass on the benefit of units held in the pool account, EPFO will have to sell units of ETFs to realise the gain for the declaration of the annual interest rate on the EPFO's portfolio. The requirement to sell ETF unis on an annual basis will defeat the philosophy of long-term investing in equity and undermine the ability to maximise returns for subscribers. Further, EPFO's annual declared interest rate will be lower in a financial year if equity delivers negative returns.
- Maintaining a pooled equity account may lead to disproportionate distribution in returns from equity investments considering the volatile nature of the equity market. Returns realised from the pooled equity account and subsequently used in the interest rate declaration in a given financial year may not be commensurate with equity returns attributable to individual subscribers during their respective period of contributions.
- The mechanism of unitisation is fair to each subscriber and appropriately distributes the mark-to-market gain/loss among subscribers.

Explanation of advantages of pooled fund

- One of the advantages of pooled equity account w.r.t subscribers is that the risk of short term volatility in equity markets is contained for those subscribers who withdraw their fund within a short span of time.

- In case of 100% unit allocation of equity investments to the subscribers, it may lead to a scenario wherein the equity allocation as a percentage of subscriber's contribution exceeds 15%. There will be a challenge for EPFO to explain subscribers on such higher equity exposure than mandated 15% as per the investment pattern.

CRISIL had discussed the above observations with EPFO on 12th February, 2018. In the meeting, EPFO has suggested to distribute equity units to subscribers, equivalent to 15% of subscriber's contribution and allocate the balance units to a pooled equity account in the name of EPFO.

Advantages and disadvantages of distributing equity units equivalent to 15% of subscribers contribution

Advantages	Disadvantages
1. Simple to understand from subscribers' perspective : subscribers can relate to the allotment of equity units which 15% of their contribution	1. Operational complexity to EPFO due to allocation of units along with managing a pooled equity account

Since, the above approach has both; allocation of equity units and pooled equity account, the advantage and disadvantages of allocating units as well as pooled equity account (as mentioned earlier in the document) will continue to be inherited in this approach.

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कर्मचारी भविष्य निधि संगठन
(श्रम एवं रोजगार मंत्रालय भारत सरकार)

Employees' Provident Fund Organisation
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File no. HO/IMC/236/Amendment in Scheme/2017

Date: 15.03.2018

15 MAR 2018

Office Order

Subject: - Constitution of a Committee to study the modalities of framing policy for periodical disposal of equity and creation of reserve funds.

Sir,

The Competent authority has constituted a Committee consisting of the following members to study the modalities of framing policy for periodical disposal of equity and creation of reserve funds:-

- (i) Shri Hemant Jain, FA & CAO, EPFO - Chairman
- (ii) Smt. Udita Chowdhary, Addl. CPFC (IMC), EPFO - Member
- (iii) Shri Prashant Jain, CIO & ED, HDFC Mutual Fund, (Expert).
- (iv) Shri Navneet Munot, CIO, SBI Mutual Fund, (Expert)
- (v) Shri Ajay Kumar, RPFC-II, IMC, EPFO (Member Secretary).

2. The Terms of references of the Committee are enclosed as Annexure 'I'


Yours faithfully,

(Sunil Yadav)

Regional P.F. Commissioner-I (IMC)

Terms of Reference of Expert Committee

- (i) Determine minimum investment period for ETF (equity) along with risk mitigation strategies.
- (ii) Develop a methodology for redemption of ETF investments including benchmarking of various market parameters and deciding the quantum to be considered before initiating the above exercise.
- (iii) Suggest modalities for formulation and operation of a reserve fund for streamlining and smoothening out volatility of ETF (equity) returns.


15/03/2018