Employee Benefits: Design issues in different corporates

(18th India Fellowship Seminar)

Lead Presenter: Manoj Kumar

Second Presenter: Sunayana Mahansaria

Guided by : Saket Singhal

Overview

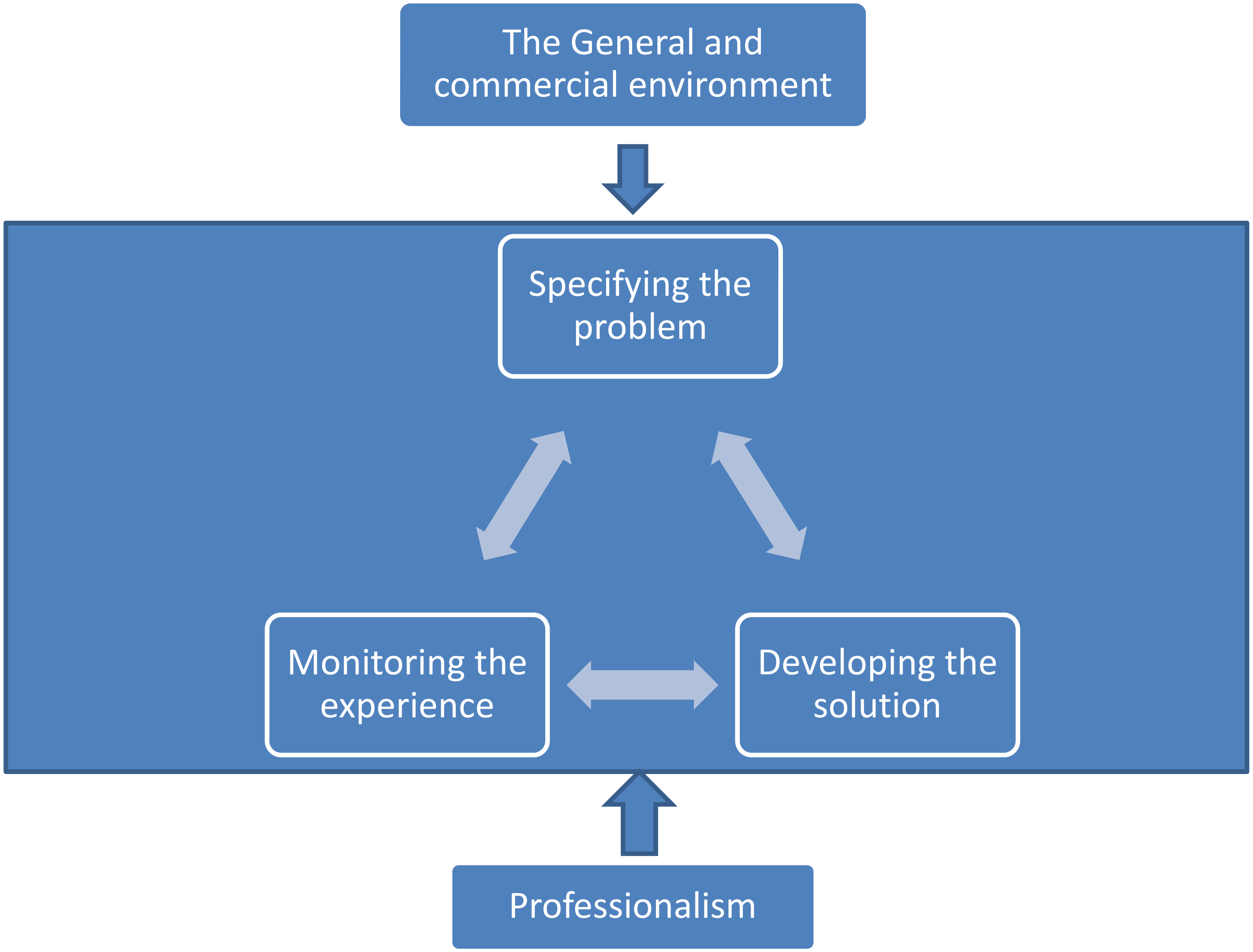
- Employee benefit design issues - Actuarial Control Cycle (framework of solution of Actuarial Problems)

- Stages of Actuarial control cycle:
    - The general commercial and economic environment
    - Specifying the problem
    - Developing the solution
    - Monitoring the experience
    - Professionalism

- India Specific
    - Main Employee Benefits in India and related issues

- Summary

Employee benefit design issues : Actuarial Control Cycle



The general commercial and economic environment

Ensure that you have the background information about:

- political issues, i.e. any proposed changes that might influence company decisions
- economic issues i.e. setting assumptions e.g. interest rate and inflation
- legislation
- tax requirements e.g. exemption from tax on benefits
- regulatory requirements e.g. IRDA , PFRDA circulars and guidelines
- accounting and reporting requirements e.g. AS 15 (Revised) , GN 26
- demographic issues e.g. Longevity risks
- social issues e.g. discrimination based on castes
- competitor schemes
- technological issues e.g. system requirements in setting complex schemes

Specifying the problem – Corporates’ objective

The key question is “**Why** are they providing a scheme?”.

What follows here is not an exhaustive list of questions but variations on the theme of “why?”.

Following on from this you can ask questions based on “**how**?” or “**what**?”, eg “how much can you afford?” or “what type of scheme – defined benefit or defined contribution or a hybrid?”.

The primary issue is to establish the employer’s objectives:

- What are the needs they are aiming to meet? eg protect the dependants in the event of the member’s death or long-term illness.
- Do they want to maintain the employee’s pre- and post-retirement standard of living? If so, what is the target level of benefits? e.g. NRR
- Is it an employment issue, e.g. do they need to recruit, motivate and/or retain employees? If so, what do their competitors provide?
- Are they seeking to reward a particular group / class of employees, eg salesmen, executives or long serving employees.
- What can they afford?
- Who should take the risks, (eg investment, longevity, expenses) (employer or employee)?

Specifying the problem – Corporates' objective

Specific-objectives

- What level of benefit should be provided?
- Should the benefits be defined in monetary or real terms?
- If in real terms should they be related to the purchasing power or earnings?
- On what events should benefits be provided, *e.g. on death, on retirement,*
- on leaving employment, whilst unable to work, during employment, on divorce?
- In what form should the benefits be provided, *eg an annuity, a cash lump* sum, goods, services?
- Should the approach differ between individuals in the group?
- If they should differ, in what way, *eg form, level, real nature, events?*
- Should the individuals be given any options about the events, forms or levels of benefits?

Specifying the problem – Corporates' objective

- Contributory or non contributory.
- Consider the administrative implications, legislative constraints and the need for specialist expertise.7
- Consider the potential impact of the proposed design on public perception and behaviour. For example, consider whether the scheme might:
  - mislead certain parties
  - cause difficulties in understanding, leading to poor appreciation of the scheme and possibly inappropriate decisions being made by members
  - create conflicts of interest.
- If a scheme currently exists, consider the transitional arrangements and whether the existing scheme will be amended or a new section or scheme set up.

Different decision leads to different scheme design and in turn different issues related to scheme design to different corporate.

Developing a solution : Suitable Benefit design

- Attention can now be directed to developing ways that cope with these problems or conflicting objectives.
- This will involve looking at alternative designs and weighing up the advantages and disadvantages relative to the objectives.
- Developing the solution will involve matching designs with the prioritised objectives and needs. Compromise will occur.
- Therefore you must be aware of potential problems and their risks. However, at this stage, a decision will be made having weighed up all the pros and cons.

Defined Benefit Schemes

The benefits are defined in advance. They can be linked to service, salary or fixed.
Costs will not be known until all benefits cease to be paid.
Often contributions are paid in advance to meet the estimated cost of benefits. The estimates are based on financial and demographic assumptions. Typically, employees pay contributions at a fixed rate and the employer pays the balance of cost.

Defined Contribution Schemes

In its basic form, the amount which the employee and employer contribute to a DC scheme is fixed and the benefit is totally dependent on the accumulated value of those contributions. The members may be able to choose the type of assets used for investment.

Developing a solution : Suitable Benefit design

Developing the solution will involve matching designs with the prioritised objectives and needs. Compromise will occur. Therefore you must be aware of potential problems and their risks. However, at this stage, a decision will be made having weighed up all the pros and cons.

Technical Issues

Defined Benefit Scheme	Defined Contribution Scheme
Risk of Inadequate fund Risk of illiquid asset Risk of benefit change Risk of failing to meet the members' need Risk of unappreciated benefits Risk of assessing the proper contribution Risk of insufficient asset Risk of excess asset	Investment risk Guarantee risk Risk of inadequate benefits Inflation risk Market value risk Risk of unaffordable contributions

Developing a solution : Suitable Benefit design

<u>Operational issues</u>

- loss of funds due to fraud or misappropriation,
- incorrect benefit payments,
- inappropriate advice to members and/or sponsors,
- administrative costs, especially as a result of compliance with changes in legislation,
- fines or removal of tax status resulting from non-compliance with legislative requirements
- decisions by parties to whom power has been delegated.

<u>Investment issues:</u>

- Poor Return on assets where benefits are funded.
- capital risk
- investment income risk
- reinvestment risk
- risk of default
- mismatching of assets relative to liabilities
- expense and taxation risk on net return
- opportunity risks.

Monitoring the experience

This stage of the control cycle enables you to build in a framework for review once the design has been implemented. There is the opportunity for fine-tuning the scheme with immediate changes to relatively minor problems.

Further, a more comprehensive review should be built in. This would take place once the scheme has bedded in and would examine how well the scheme design has met the original objectives and problems. This review could go further and see if the objectives need to be altered in the light of changing sponsor needs or legislative requirements.

Professionalism

- PCS, in totality, need to be adhere to
- **<u>Section 3.1 of PCS</u>**

  "An actuary is expected to use best judgment in formulating advice, whilst paying proper regard to any relevant professional guidance or other guidance. He must keep himself abreast with updated professional guidance and adhere to that."

- **<u>Section 3.5 of PCS</u>**

  "Advice should normally include sufficient information and discussion about each relevant factor and about the results of the actuary's investigations to enable the intended recipient of the advice to judge both the appropriateness of the recommendations and the implications of accepting them"

Main employee benefits in India and related issues

Mandatory benefits

- Gratuity
- Provident Fund
- Employee Pension Scheme 1995
- Employee Deposit Linked Insurance Sche5me (EDLI)

Non-Mandatory benefits

- Superannuation Benefits
- Bonus payments
- Leave Encashment
- Life Health and Disability Insurance Benefits
- Subsidized loans e.g. Car loan , Housing loan
- Mobile plans e.g. Blackberry services

Main Employee Benefits in India and related issues (continued….)

Gratuity

- As per Sec 10 (10) of Income Tax Act, gratuity is paid when an employee completes 5 or more years of full time service with the employer.
- Gratuity benefit is 15 days' salary for each completed year of service.

  Note:

  – Here, salary = basic + DA + commission (if it's a fixed % of sales turnover).
  – Completed year of service or part thereof' means: full time service of > 6 months is considered as 1 completed year of service; < 6 months is ignored.
  – Here, number of days in a month is considered as 26. Therefore, 15 days' salary is arrived as = salary * 15/26

Related Issues

– Some employers are more generous in paying e.g. 30 days salary
– For some the definition of salary is Basic + DA + Other allowances
– As per AS 15 (R), Para 26 (a), Gratuity benefit is a defined benefit scheme
– 5 years minimum vesting period
– Ceiling of 10 lacs may discourage high earners to get more benefits so check employers' objective is met of hiring for senior position

Main Employee Benefits in India and related issues (continued….)

Provident Fund

- Contribution of 12% of Salary (Basic + DA) was made mandatory from employer and employee; A lump sum is given on death, resignation and retirements
- This is exempted from tax on all three stages i.e. Contribution, accumulation and distribution
- The rate of interest on accumulation is declared by the Government each year based on the return
- Employers may get exemption called " Exempt Provident Fund" with certain conditions e.g. to provide at least the same rate of interest as declared by the Government under the PF Act and other administration conditions e.g. independent management by trustees, prescribed investment pattern

Related Issues

- Some employers pay 12% of (Basic + DA + Other allowances)
- Only benefit by the Government which qualifies on all three stages (E,E,E) leads to discrimination among other similar benefits
- Exempt provident fund is a defined benefit scheme as per AS 15 (R), Para 26 (b)

Main Employee Benefits in India and related issues (continued….)

Employee Pension Scheme 1995

- 8.33% of employee's wages are contributed by the employer towards this Scheme out of the total contribution of employer to EPF of 10% or 12%, as the case may be. In addition 1.16% of employee's wages are paid by the Central Government. The wages for contribution purpose are restricted to a maximum of ` 6,500/-. A member may make contribution to EPS without the ceiling of ` 6,500/- in which case this ceiling will not apply to his benefits also. However, such option to contribute above the ceiling is applicable only to those whose salary was above the ceiling of ` 6,500/- at the time of introduction of the scheme and who have been contributing to the scheme without the ceiling from that date

Related issues

  – Vesting period too short vs. too long
  – Not good for late joiners as per the definition of the pension so discourage senior employees to join at a later stage
  – Ceiling of 6500/- may be perceived unfair for high earners
  – The rates may be too low to attract the employees to go for the annuity
  – Family pension is too complex to administer
  – Children pension exacerbate the complexity

Main Employee Benefits in India and related issues (continued….)

Superannuation Benefit

- contribution made by an employer up to ` one lac is not treated as income in the hands of the employee. Any contribution over and above this sum for an employee is taxable income for that employee Under Section 17 (2) (vii) of I T Act.
- As per rule 89(ii) of Income-tax Rules, it is obligatory on the part of trustees to purchase annuities from life Insurers. However, till the pension comes into payment the trustees may accumulate contributions in which case they have to be invested as per Rule 85

Related issues

- Employees may not appreciate this as their contributions are deductible under Section 80 C and they might already have exhausted their limits purchasing Life Insurance policies, housing loan capital redemption etc.
- Also, the annuity payment is taxable
- Purchase of annuity is a compulsion on Trustees part which may or may not be available in the market
- The rates may be too low to attract the employees to go for the annuity

Main Employee Benefits in India and related issues (continued….)

Profit Sharing and bonus plans

- An enterprise should recognise the expected cost of profit-sharing and bonus payments under paragraph 10 when, and only when:
  - (a) the enterprise has a present obligation to make such payments as a result of past events; and
  - (b) a reliable estimate of the obligation can be made.As per rule 89(ii) of Income-tax Rules, it is obligatory on the part of trustees to purchase annuities from life Insurers.
- A present obligation exists when, and only when, the enterprise has no realistic alternative but to make the payments.

Related issues

  - How to allow for the attrition rates while calculating provisions i.e. based on past experience which may be distorted
  - The provision is to be made though it's not a legal obligation of the corporate to pay bonus
  - This issue further exacerbated in case of multi employer plans or a conglomerate

Main Employee Benefits in India and related issues (continued….)

Leave Encashment Plans

- Long term compensated absences
- Short term compensated absences
- As per AS 15 (R), An enterprise should recognise the expected cost of such employee benefits :

(a) the enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

Related issues

- – How to design to keep the cost at a lower level and at the same time avoid employees to take short duration leaves
- – Accumulated vs non accumulated leaves; competitors
- – How to calculate the attrition rates; may be over or under estimated e.g. redundancies
- – Reliable estimate on how many leaves an employee takes and how much he carries forward

Main Employee Benefits in India and related issues (continued….)

Subsidized Loans e.g. Car and Housing loans

Related issues

- How to value the liability
- Risk of unappreciated benefits
- Market risk

Life Health and Disability Benefits

Related issues

- Competitor scheme
- Risk of unappreciated benefits
- Underwriting risk e.g. definition misleading lead to unsatisfied employees

Summary

- The employers’ objective needs to be taken into account while designing employee benefits
- The design is always a “trade off” in meeting the employers’ objective and keeping cost within limits.
- Need to consider the General Commercial and Economic Environment while designing the product
- It’s an iterative process and may be changed on regular basis to ensure the objectives are met and employees appreciate benefits.

Thank you.