INSTITUTE OF ACTUARIES OF INDIA

SA4 - Pensions and Other Benefits

November 2025 Examination

Indicative Solution

Introduction

The indicative solution has been written by the Examiners with the aim of helping candidates. The solutions given are only indicative. It is realized that there could be other points as valid answers and examiner have given credit for any alternative approach or interpretation which they consider to be reasonable.

Solution 1:

i) Key characteristics of pension vehicles in India

National Pension Scheme (NPS):

This is a DC type model established by the NPS trust to accumulate pension corpus. Individual members/employers can contribute to the scheme.

Choice is available in choosing the investment category. The investment risk is generally met by the subscriber.

On attaining the superannuation age, annuity is to be purchased from the "annuity providers. The risk of annuity not matching the target benefits is met by the subscriber.

Several products (NPS, APY, NPS corporate, Vatsalya) are available to meet the specific needs of the target group.

There are some minimum guarantees of pension provided in several schemes. (eg: APY provides a guaranteed pension of Rs 1000-Rs.5000 depending upon age related contributions) to moderate the risk.

Unified Pension Scheme (UPS):

This is a DC type-hybrid model recently introduced by the NPS that provides guarantee of pension linked to the final pay. There is provision for DA increases to pension as notified by Government to its employees. They meet the target benefit on the normal retirement age.

Option to join UPS is available to central government employees as on 01.04.2025 who are covered under NPS.

The scheme is financed by the contributions of Central Government & the employees.

The risk of deficit in the funds to provide the assured benefits is expected to be met by the NPS Trust from the additional contributions of the Government.

Employee Pension Scheme (EPS'95):

It is applicable to all employees covered under EPFO Act 1952 and whose monthly pay is less than Rs.15000. This scheme provides assured pension linked to the final salary. But there is a ceiling on the final salary (Rs 15000 per month) for calculating pension. The present minimum pension is Rs.1000/per month.

The scheme is financed by the contribution of employers towards PF (8.33%) & by the contributions from the Government (1.16%).

The risk of deficit in providing the assured benefits is met by the EPF Trust.

Privately Administered Superannuation Funds:

There are also pension funds established by employers to take advantage of tax benefits under the provisions (part B) of Income tax Act 1961 to provide pension to its employees.

They provide both DC/DB type benefits depending upon the scheme rules of the Trust.

The scheme is financed largely by the employer. The risk sharing depends upon DB/DC model chosen.

Generally, they use insurance products to accumulate the pension products & to provide pension.

Insurance/Mutual fund products:

Most of the insurance companies/mutual funds customize their products to accumulate pension corpus to various segment of customers.

Choice is available to the investors in choosing the investment model & the type of annuity.

However, the risk of not meeting the target pension is met by the individual policy/fund holder.

Systematic withdrawal plans (SWP) of mutual fund aim to provide regular income from a specified age but faces the risk of funds running out during life time of the subscriber. (10 marks)

ii) Comparison of risk profile of NPS (corporate) & EPS'95

Risk Profile of NPS (corporate) (maximum 8 marks)	Risk profile of EPS'95 (maximum 8 marks)
NPSC is a DC scheme. The primary risk is that the accumulated pension corpus is not sufficient to buy the targeted pension payout from the planned retirement age. The risk is met by the subscriber in general. NPSC faces investment risk-i.e. the risk of lower return during the funding period. Government bonds, Corporate Bonds, Equities are the asset classes backing the NPSC funding. These assets inherently have interest rate risk, default risk & volatility risk respectively. The composition of investment risk depends upon the Investment choice the individual/corporate are making. For e.g. for a subscriber choosing 100% corporate bond option, the investment risk will be risk of default but for a subscriber choosing the investment option LC75, the primary investment risk will be equity related volatility. The investment risk also depends upon the investment style of the fund manager opted by the subscriber. NPS is having transaction-based fee to meet its expenses. Frequent changes in the investment options, changing the fund manager will also diminish the investment returns. The funding plan under NPSC will be impacted by the failure to make regular contributions to the subscriber account. Poor business/financial performance of the corporate, loss of job of the subscriber, changes in the profile of the subscriber (e.g. new employment or moving to "entrepreneur") may also hamper the funding plan. Movement of annuity prices in the insurance market will be a risk as the subscriber approaches the planned vesting age.	EPS'95 is essentially a DB plan. Contributions of the employer & the Government goes to a pooled fund from which pension payouts have been made. The primary risk is that the fund is not sufficient to make the guaranteed payout at any point of time. The risk of deficit is met by the EPF Trust. The objective of EPS'95 is to provide a minimum level of assured benefit. This is achieved by the limited pensionable salary. The pension targeted may not be sufficient to meet the standard of living of the pensioner at retirement. EPS'95 funds are invested as per the investment rules of EPF1952. Most of the investments are made in Debt securities of the Government & a small portion in ETF funds that mirror BSE or NSE-Nifty movements. The risk of lower return will be the main investment risk of Eps'95. Changes in the stocks comprising the BSE or NSE & its performance will be having a smaller effect on the investment performance. Longevity of the pensioners is witnessing increasing trend in India. EPS'95 extends pension benefits to family also. It therefore faces the risks of longer pension payout periods than expected. The scheme provides guaranteed benefits but fixed in monetary terms. There is a risk of the pension eroded in real terms due to inflation. Pensioners may not appreciate the benefits being provided in EPS'95 Trustees are offering "occasional" pension increases (e.g.4%) to pensioners. This creates PRE in the minds of pensioners. While they expect the increases to be regular, it has cost complications. There are several significant operational risks faced by the EPS'95. The scheme is having a huge membership; variety of pension benefits are being provided.

The subscriber may find that the pension corpus is not sufficient to buy the target pension at the vesting age if the annuity rates are expensive. He may also find that the available annuity products are not meeting the post-retirement needs (e.g. inflation linked pension payments). Insurance companies are well regulated by IRDAI. The security risk of pension payouts will be therefore minimal. NPS is having a robust support system for maintaining records & making payments. Operational risk relating to the NPSC will be less. Legislative changes, changes in the tax incentives will have second order effect in the retirement plans under NPSC	There is a need for developing robust supporting system to cater the needs of different stake holders viz Trustees, employers, members, pensioners, investment managers etc. Partially mechanized records pose a serious operational risks to the EPS'95. It hampers the regular/periodical actuarial investigations on the funding status of the scheme. Court orders (e.g redefining the salary limit for pensions) on legal disputes may have significant financial implications. Frauds, errors in making pension payout are other operational risks relating to the funds.

(16 marks)

<u>Points about convergence of the two plans: (maximum 4 marks)</u>

- Both the schemes are initiatives of GOI to ensure that the "working population" have pension benefits after retirement.
- Security of the pension benefits is the primary objectives in both the schemes.
- Asset categories to fund the benefits are similar for both the schemes.
- Convergence of the two schemes under a single supervisory mechanism may bring better governance, improve operational efficiency of the schemes.
- But it requires changes in the legislations such as labour law, EPF Act, PFRDA act etc.
- Convergence helps both the schemes when the synergy starts flowing between the schemes. E.g. NPS(Corporate) may evolve a pension payout system (instead of relying on Annuity service providers) based on the vast experience of EPS'95 pension payouts.
- Similarly, EPS'95 will have access to the robust record keeping system, investment expertise of the fund managers of NPS for its services.
- However complete merger of the scheme is not possible as the benefits provided under the schemes are different; profile of the members of the schemes are different; risk profile of the two schemes are different.
- Merger of the schemes will be difficult to explain & educate;
- it will involve trade-off between two groups of members one gaining at the expense of another, bringing legal disputes, administrative challenges (20 marks)

iii) <u>Proposed guidelines for DC/NPS (corporate)</u>

Guidelines of PFRDA should prescribe an "eligibility test" for all DC schemes seeking exemptions.

The test should be applied to all the individual members/subscribers of the scheme.

The test should verify the adequacy of pension corpus at a given date to purchase accrued pension payable from the prescribed retirement age (58) equivalent at least to the accrued pensions under EPS'95.

EPS'95 is mainly financed by the employer's contribution. Hence corpus relating to the members contributions are to be excluded from the calculations.

The test should project pension corpus in respect of each member up to the age 58 allowing for salary growth using the investment returns. The capacity of the projected pension corpus to purchase the annuity that resemble EPS'95 pensions (eg: Life pension +50% spouse) should be verified.

Guidelines may prescribe the basis for salary growth. It may be a single rate or industry based or cadre based.

Investment return basis should consider the investment strategy /investment choice adopted by the scheme & suitable volatility parameters should also be prescribed for higher volatile returns.

Guidelines may prescribe proxy (annuity)factors for post-retirement experience.

It is also possible for the regulations to allow freedom to actuarial professional to develop basis while performing the test.

Regulations should prescribe the qualification of Actuarial professional for this exercise. E.g Fellow members of IAI with COP in pensions & establish best professional practice standards consistent with Actuaries Act 2016.

Periodicity of the exercise (each financial year), format for the certification is also to be decided in the guidelines.

Members/Schemes that satisfy the eligibility will be given exemptions from the provisions of EPS'95.

Guidelines should be set for companies who do not pass the eligibility test to help them getting exemptions (eg time line for making the short fall contributions into the members account).

Penalty for non-compliance, grievance redressal mechanism, process for settling disputes are also to be set in the guidelines.

Other information about the scheme such as management, profile of members, benefits payout details are to be collected. (6 marks)

iv) Guidelines for DB schemes:

In DB schemes, benefits are defined. It is possible to verify the level of benefits offered under the scheme using Scheme documents & compare with EPS'95 benefits.

Schemes that offer higher benefits than EPS'95 become eligible for the exemption.

In DB schemes, however, the security of the vested benefits should be the primary issue for getting exemption.

Guidelines should exclude unfunded schemes for the exemptions as they offer no security to the vested benefits.

Similarly, schemes in which financing is done mostly by members will also be not eligible for the exemptions as employers financing to the scheme is low as compared to EPS'95 financing.

Actuarial investigation should independently verify the funding status of the scheme using the method & basis prescribed by the guidelines.

Investigation should look into the composition of assets & its quality. (e.g. extent of "self-investment" in the assets should be disclosed).

Method of valuation of liabilities & each asset class should be prescribed (either on prudent basis or market related basis).

Changes in the scheme benefits, rules will require prior approval of PFRDA

The test criteria could be set as:

All schemes that offer higher benefits than EPS'95 having funding level greater than or equal to a fixed percentage (eg 80%) will be eligible for exemptions

OR

the capacity of the value of available assets to purchase the accrued pension in respect of members equivalent to the EPS'95 benefits may be assessed for granting exemptions. (similar to DC schemes)

Other operational guidelines & actuarial guidelines will be similar to that DC schemes. (5 marks)

v) Use of surplus for improving death benefits & pension increases- aspects to be considered

Before using surplus, we need to analyse the surplus. Analysis to be done year wise & source wise.

The analysis will help to identify the source of surplus & identify the trend in the surplus emerging & help in taking informed decision about its use.

Source of surplus may cover one or more of the following areas:

- Investment return in PF funds higher than the interest credited into the subscriber's account
- Surplus emerging in EPS'95 as revealed in actuarial valuation due to favourable experience
- Favourable claims experience in EDLI 1976
- Unclaimed money of the subscribers who left the scheme for several reasons
- One-off surplus due to revaluation of assets or release of reserves due to favourable court orders in legal disputes
- (spurious) surplus may arise due to errors in data/missing data

It is preferable to use the surplus over a period of time; it is also prudent to keep a reserve for the unclaimed money of the subscriber considering the long tail nature of the claims and for the error/missing data.

Increasing the death benefits under EDLI scheme will benefit the existing subscribers. Young members appreciate the benefits especially when the PF accumulations are low.

Needs to consider how death benefits are to be increased? Increasing the multiplication factor from 35 OR increasing the eligible salary from Rs.15000 OR increase in death benefit ceiling of Rs. 7,00,000

Cashflow model using the membership profile of EDLI scheme will help to identify surplus distribution for the above proposals. The model projects flow of improved benefits for these options & the use of surplus

Pension increases will benefit the pensioner group. Pension increases are appropriate especially surplus emerges from EPS'95 scheme.

Need to consider several ways of allowing pension increases. These include

- Revising the minimum pension
- Offering discretionary pension increases either flat rate or age related
- May consider offering separate rates for regular & family pensioners.

Cashflow model (similar to the one described earlier) should allow for the expected improvement in longevity of the pensioners, while projecting increases in pension.

Pension increases need careful consideration as they increase the expectations of pensioners & the long-term liabilities of the fund.

May also consider the alternative use of surplus e.g. uses portion of surplus as a capital to increase the investment in ETF funds to generate higher return

It is also possible to use the surplus to offer a combination of benefit improvements (e.g. death benefit + pension increases)

Use of surplus requires the approval Board of Trustees; systems must be in place to implement the decision taken. (9 marks)

[50 Marks]

Solution 2:

i) Possible reasons for keeping the gratuity liabilities unfunded: (3)

- **No Mandatory Funding Requirement in India**: Under Indian law, specifically the Payment of Gratuity Act, 1972 there is no statutory requirement for employers to maintain a funded gratuity scheme. This allows companies the flexibility to manage gratuity payments on pay-as-you-go basis.

- **Opportunity Cost -** Allocating funds to a gratuity trust or insurance scheme or any other investment vehicles means diverting capital away from potentially higher-yielding business investments.

- **Low Initial Liability**: In the initial years, accrued gratuity or benefit payouts may have been minimal due to limited employee size, service tenure or high attrition rate, making funding seem unnecessary.

- **Cost saving**: Setting up and maintaining a gratuity trust involves administrative costs, actuarial valuations, and compliance overheads, which the company may have wanted to avoid in its early years.

- **prioritizing business needs over funding retirement benefits**: The company may not have prioritized long-term employee benefit planning due to its focus on meeting its immediate business needs.

<u>Factors, the company X, should evaluate while initiating a funded gratuity arrangement: (5)</u>

When a company decides to move from an unfunded to a funded gratuity model, several financial dimensions must be carefully evaluated to ensure sustainability, efficiency, and compliance. These include:

<u>Opportunity Cost</u>

Allocating funds to a gratuity trust or insurance scheme or other investment vehicles means diverting capital away from potentially higher-yielding business investments.

The company must weigh the long-term security of employee benefits against short-term strategic returns from alternative uses of cash.

<u>Tax Advantages</u>

Contributions to an *approved gratuity fund* are deductible under **Section 36(1)(v)** of the Income Tax Act, 1961 subject to prescribed maximum initial and annual contributions.

Investment income of an approved gratuity fund is exempt from tax under Section 10(25)(iv).

These tax benefits can partially offset the cost of funding and improve net financial efficiency.

<u>Pace of Funding</u>

Companies may choose between: **Full funding upfront** (covering all PVO), or **Gradual funding** over time

The pace should align with cash flow capacity, workforce growth, and liability projections.

The pace should align with the tax advantages available to the contribution paid

<u>Liquidity Impact</u>

The company must plan for predictable outflows and avoid liquidity stress, especially during economic downturns or seasonal revenue cycles.

<u>Investment management internal or using external services such as insurance products</u>

Managing funds internally provides freedom to the Trustees while choosing assets (subject to statutory rules). They also have control over assets. Trust may save investment related expenses.

The returns from approved investments such as bank deposits, Post office deposits face the inflation risk as they may offer lower returns compared to equity.

Choosing the services of insurer for managing the investment provides diversification of investments risk, expertise in managing the investment funds. Funds get exposed to wider category of assets which may result in higher expected returns.

But selecting the right Insurer, the right Insurance Products (Unit Linked or non-Linked Product) in case of Insured Scheme, understanding the charging structure of these products will be a challenge to the Trustees.

Industry practices on funding, Company's risk appetite, are other factors influencing the funding decision of the company. (8 Marks)

ii) Reply to the Finance Director addressing his concerns and the suitability of his suggestions related to the assumptions in the context of Ind AS 19.

Assumptions Vs Cost of providing Benefits:

The actual and final cost of providing the gratuity benefits will be known only when all the benefits relating to the scheme have been paid out & the scheme cease to exist. It will take many years to reach that position.

However, an estimate of the cost has to be arrived periodically for several reasons, e.g. for accounting, financing, compliance etc.

An appropriate set of assumptions is an important step in estimating the cost and it significantly depends upon the purpose of the estimation.

These assumptions which are used to project future cashflows, needs to be consistent on year-to-year basis & should also reflect the long term expected experience of the scheme.

Assumptions used in actuarial investigations for determining the liability & the expenses of Gratuity schemes are often prescribed by the accounting standards (e.g. Ind As 19)

The main objectives of accounting standards are to promote transparency, consistency, and comparability in financial reporting, thereby increasing reliability and facilitating informed decision-making for users like investors and creditors.

The purpose of using market-consistent assumptions is to ensure that the financial statements reflect a fair and transparent estimate of the company’s obligations.

Therefore, while the assumptions influence the reported liability and expense in the financial statements, they do not alter the cost of providing the benefits.

Suitability of the proposed Assumptions:

As the purpose of the valuation (in our case) is for accounting, the basis should reflect the fair value of the benefits of the scheme. Assumptions should be chosen based on the credible market data (e.g. investment return), industrial data (e.g. mortality, withdrawal) & past data of the scheme (salary growth). They should be modified suitably to reflect the future experience.

Professional guidelines such as APS-27 issued by IAI are also to be considered while developing the basis.

Discount Rate:

Para 83 of Ind AS 19 requires that the discount rate be determined by reference to market yields on government bonds at the balance sheet date, with a term consistent with the expected duration of the benefit obligations.

The yield government bond which reflects the risk-free yield is prescribed by the accounting standards brings consistency across all valuation of retirement funds & also removes the volatility in the parameter due to the different management style of the fund managers

The 9% return from the Group Gratuity Unit-Linked Insurance Policy quoted by the Finance Director reflects investment performance, not market yield on government bonds. The discount rate reflects the time value of money but not the actuarial or investment risk and therefore it has to be modified to reflect risk free rate of return of government bonds of appropriate duration.

As of 31 March 2025, the yield on the appropriate long-term government bonds is 7%, which aligns with the assumption used in the valuation. The additional investment return of 2% reflect "the higher return-higher risk" strategy of the insurance company and will be volatile in nature & hence reflected as actuarial gains and reflected as other comprehensive income (OCI) in financial statements.

Salary Escalation Rate

As per Para 90, the estimates of future salary increase take account of inflation, seniority, promotion and other relevant factors such as supply and demand in the employment market. The salary escalation rate should reflect long-term expectations of salary growth specific to the company, not just based on one year experience of the industry.

Reducing it to 3% per annum based solely on the one-year industry experience may not capture future salary dynamics and may result in a significant actuarial loss in the subsequent year when the actual salary increases are more than 3% (The 2% difference in salary escalation may result in 20% to 25% actuarial losses when compared to the opening liability when the actual increase of the company is closed to 5% per annum).

The consistent occurrence of actuarial loss on year-to-year basis will require change in assumptions of the parameters more frequently. This may create volatility in the financial statement which will be spurious & likely to be erased as and when the scheme approaches maturity.

As per the Ind AS-19, any actuarial gains or losses will be a part of remeasurement of net defined benefit liability/asset and will pass through OCI-Other Comprehensive Income and not through P&L Account.

Withdrawal Rate

While actual turnover data is valuable, the withdrawal rate should be based on multi-year experience and actuarial judgment to ensure stability and avoid volatility in liability estimates.

As per the valuation exercise, the expected duration of liabilities is 21 years which is consistent with our withdrawal assumption of 5% pa and the discount rate of 7% pa. Any arbitrary change in the withdrawal assumption will reduce the expected duration of liabilities and hence reduce the discount rate.

Also, as the average past service is 12 years and therefore any increase in withdrawal rate will increase the liabilities and may result in actuarial gains if the actual experience is lower than 15% (as proposed by the FD).

Again, the gains will pass through OCI and leads to volatility in equity components which need to be clarified to shareholders. (12 marks)

iii(a) Relevance of Accounting figures considered for acquisition purpose:

Accounting valuation is the most widely accepted method for acquisitions due to its compliance with financial reporting standards ensuring consistency, transparency, and comparability across entities.

The accounting valuation figures are audited, publicly available and considered by all stakeholders to decide the core value of the company.

It reflects the present value of defined benefit obligations and plan assets, aligning with the fair value principles required under Ind AS 103 for business combinations.

The use of accounting liabilities for acquisition purpose makes the post-acquisition accounting simpler and thus enhance the confidence of stakeholders.

Limitation of Accounting figures:

While accounting liabilities represent best estimates that offer a true and fair view for financial reporting, acquisition-related valuations must also capture the inherent, uncontrolled risks embedded in the benefit scheme.

It does not reflect explicitly the value of the uncontrolled risk relating to the company & the scheme (in particular).

While these risks are reported in the financial statements as part of disclosure, placing a value on these risks is left to the judgement of the users of the financial statements.

For example, while the accounting statements report the funding status of the scheme on fair value basis, it does not explicitly reflect factors, its relevance & their variability on the accounting figures.

A prudent assessment of these risks will have to be made independently by the (potential)buying company X.

Financial statements provide a true and fair representation of an entity's financial position by presenting a comprehensive view—including assets, liabilities, and relevant disclosures. It is the collective insight from this full spectrum of information, rather than isolated figures, that enables accurate interpretation and informed decision-making.

Aspects of the Company Y gratuity Scheme arrangement to be examined:

As all the actuarial risks of the company Y's gratuity scheme is borne by the acquirer, the company has to be prudent in assessing the liabilities as well as assets. The main objective in the due diligence exercise is to ensure that the surplus reported in the financial statements are not overstated. (1)

It is also necessary to verify the quality of assets backing the surplus & its realisable value (as compared against its market value). The actuarial assumptions used in this exercise should reflect the objective of the buyer company X.

Validity of assumptions:

Check whether the discount rate used (7.5%) in the valuation reflect the risk-free Government bond yield consistent with duration.

Compare the discount rate with the actual investment return on the assets to ascertain the volatility of the return.

Compare the 3 to 5 years' salary data of company Y employees to verify the appropriateness of using 3% salary growth.

Attrition, mortality & other exits related assumptions are to be set in an appropriate way so that the liabilities will not be under stated.

Method of Valuation:

The method of valuation may be Projected Unit Credit Method considering service up to the date of merger or an agreed date.

Liability calculations are to be done again using a revised set of assumptions reflecting the purpose(acquisitions).

Several calculations are to be done to understand its variability.

Margins for unhedged risk:

Needs to verify from the company Y disclosures to understand the significance of unhedged risk. Value can be placed on the risk using cost of capital approach.

Assets related Information:

We needs to assess the quality of assets and other details including Split of assets by class (equity, corporate debt and government bonds), details of self-investment, Level of NPA for last three years and unrealised capital gains/losses.

Other information:

We need to verify the presence of any legal cases related to gratuity benefits, unsettled gratuity liabilities of the company Y, Employment Contracts to be checked for the nature of guarantee provided related to gratuity benefits (Whether uncapped benefits are exclusively mentioned) and the previous Actuary's adverse opinion on issues related to data, setting assumptions, valuation of assets etc.

Events happened between the last accounting valuation and the Current date have to be analysed specifically their impact on assumptions, assets data, employee profile and Benefits paid.

Ultimately, the assumptions used for the valuation and the liabilities determined may depend upon the Company X's business need, overall price to be paid for the company X and the related negotiating powers of stakeholders. (10 marks)

iii(b) benefits and challenges of keeping a single fund to meet all the benefits payouts post-acquisition:

Benefits:

Simplified Fund Management: Keeping all the funds in one unit linked policy helps the company in managing their investment and risks in a better way. One consolidated fund streamlines administration, reporting, and actuarial valuation.

Cost Efficiency: Higher funds in a Unit linked policy will attract lower fund management charges and hence improve the returns from the policy. The expenses related to keeping unapproved trust, valuation of assets and other compliance related expenses could be avoided.

Tax efficiency: Moving assets from unapproved fund to Unit Linked policy may improve tax efficiency as the investment income are tax-free under Section 10(25)(iii) of the Income Tax Act 1961 and future contributions of company X to the policy will get tax exempted.

Improve Confidence of employees: One consolidated fund under an approved trust wherein the assets are invested outside the company and with an insurer will improve the confidence of employees. (especially of company Y)

Administrative Simplicity: Company Y was established ten years ago, and as a result, most employees have not yet accrued substantial gratuity benefits—particularly under the uncapped scheme. Only a small group of high-earning individuals may have gratuity entitlements exceeding ₹20 lakhs.

Therefore, managing both capped and uncapped benefits within a single consolidated fund is unlikely to pose significant complexity.

Maintaining one unified gratuity fund will streamline payout

Challenges of single Fund:

Funding disparity: The gratuity fund of company X is in deficit and company Y is in surplus on accounting basis. Merging both funds together may create accounting complexities, dissatisfaction among employees and handle claims related to uncapped legacy liabilities of company Y.

Legal Implications: Transferring fund from the trust requires Trust approval and Board resolution. Employees consent may be required to reduce the future benefits or the employment contracts have to be re-negotiated.

Tax implications; Transferring fund from an unapproved trust to an approved trust may require approval of IT Department.

Investment related issues: Company Y currently operates an unapproved gratuity trust, and its investment portfolio may not adhere to the prescribed regulatory patterns. Quality of assets becomes an issue while merging. It may potentially include self-investments and illiquid assets, which complicate fund management.

Liquidating these assets poses a significant challenge, especially since insurance providers typically require premium payments in cash.

Even if an insurer is willing to accept securities in lieu of cash, there are likely to be stringent conditions—such as minimum credit ratings, bond quality standards, and exposure limits of asset class—that further hinder the trust’s ability to transfer its assets into a unit-linked insurance policy

Preservation of past accruals: The trust of Company X is responsible for maintaining detailed records of past gratuity accruals for employees of Company Y and ensuring that future benefit payments are made in accordance with those entitlements.

Since the trust's sole asset is the unit-linked insurance policy, it is essential that the insurer’s payout mechanism accommodates such legacy-based disbursements.

Market Risk Exposure: Unit-linked gratuity policies are inherently exposed to market fluctuations. In periods of poor fund performance, the ability to meet future gratuity obligations may be compromised, especially if the funding ratio deteriorates.

Although the investment risk is met by company X, the poor performance of the fund will have a negatively influence employee perception, as they may begin to question the reliability and security of the arrangement. (10 marks)

iv) What could be the possible reasons for the company x to make this request and What are the concerns of the Trust related to the company’s request and how the company can address the concerns of the Trust.

Reasons for the contributions three years contribution holiday:

Company X has just started funding its gratuity liability and paid nearly Rs.3030 lakhs towards (considering the balance of 270 lakhs as investment income @9% pa) which could have been a major cash outgo from the company and affected its capital available for business.

The company X funded for the acquisition of company Y which would have affected its free cash or capital available for funding.

The company X may require a contribution holiday due to opportunity cost of investing the money in their core business which might be giving a better return to the company.

The company may believe that the Trust will not experience a huge payout of gratuity benefits in the near future as the expected future duration of liabilities are more than 20 years and average past service is 12 years only.

It is confident, a fund with 76% funded ratio with an expected investment return of 9% pa will be sufficient to meet the accrued benefit payouts given a salary escalation rate of 5% pa and an equal rate of attrition.

Concerns of the Trust of company X:

Trustees always concerned about the security of the benefits payouts and with 76% of funded ratio, Trustees may not be agreeing to the suggestion of the company X.

The funds are invested in a Unit Linked Policy whose return may vary as per market fluctuations and hence the Trust may require additional funds to cover those market related risks.

Post-acquisition, the Trust may anticipate higher employee turnover, especially related to those employees of company Y who have accrued gratuity benefits of more than 20 lacs and therefore may require additional funds to meet the payouts.

The value of assets transferred to the insurance policy from company Y might have lesser than their value reported at the accounting date due to market fluctuations and the quality of assets. So, the deficit reductions might not be on the expected line and therefore the trust is declining the request of the company.

How to address the concerns of the Trust:

Company A's initiative to fund the gratuity liability (not mandated) indicates his strong convenance.

It's initiative to buy another company reflects its confidence on the success of its business expansion plan.

Seeking contribution holiday on temporary basis will serve its business needs & all the stakeholders of the company will be benefited.

Company can initiate the following steps:

Project the next three to five years' payouts based on actuarial projections and convince the trustees that the fund is more than sufficient to meet the immediate payouts.

Provide results of sensitivity analysis of major assumptions like Investment Return, etc. that a funding level will not fall below a threshold limit say 50% under stressed conditions.

May agree with the Trustees to a minimum funding level (e.g. threshold limit of say 50% or 60%) to allow contributions holidays or may agree to make contributions if the market conditions vary significantly (e.g. yield reduces by 200 bps)

May propose to the trustees that annual contributions be made equivalent to the current service cost. This approach ensures that the incremental liability arising from ongoing employee service is funded regularly, while the liability related to past service is addressed gradually through a phased funding plan.

Additionally, the company can earmark specific assets from its balance sheet to provide assurance to the trustees. By identifying and allocating tangible, high-quality assets, the trustees may gain confidence in the company's ability to meet future gratuity obligations, thereby supporting the case for a temporary contribution holiday. (10 marks)

[50 Marks]

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