

# FUTURE OF DEFINED BENEFIT SCHEMES IN INDIA

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Group 7

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# Future of DB schemes in India

## Agenda

- Introduction of DB schemes
- DB schemes in India
- Importance of DB schemes
- Challenges & Affordability of DB schemes
- Future Possibilities for DB schemes

# Future of DB schemes in India

## Introduction Of DB Schemes

- Promised Benefits for Employees
- Predetermined formula (salary, service, age)
- Benefits coupled with retirement benefit
  - Death in service
  - Spouse\Dependent benefit
  - Deferred vested benefits
- Variants
  - Flat amount accumulation with service
  - Final salary
  - Career Average & Revalued Career Average
  - Cash balance (Hybrid)

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## DB Schemes in India

Scheme	Requirement	Management
Gratuity	Statutory	Employer
Employee Pension scheme	Statutory	Central Government
Superannuation schemes	Non-Statutory	Employer
Leave encashment	Non-Statutory	Employer
Long service Awards	Non-Statutory	Employer
Exempt Provident funds	Voluntary	Employer
Employee Deposit linked insurance scheme	Statutory	Central Government

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## Advantages of DB Schemes

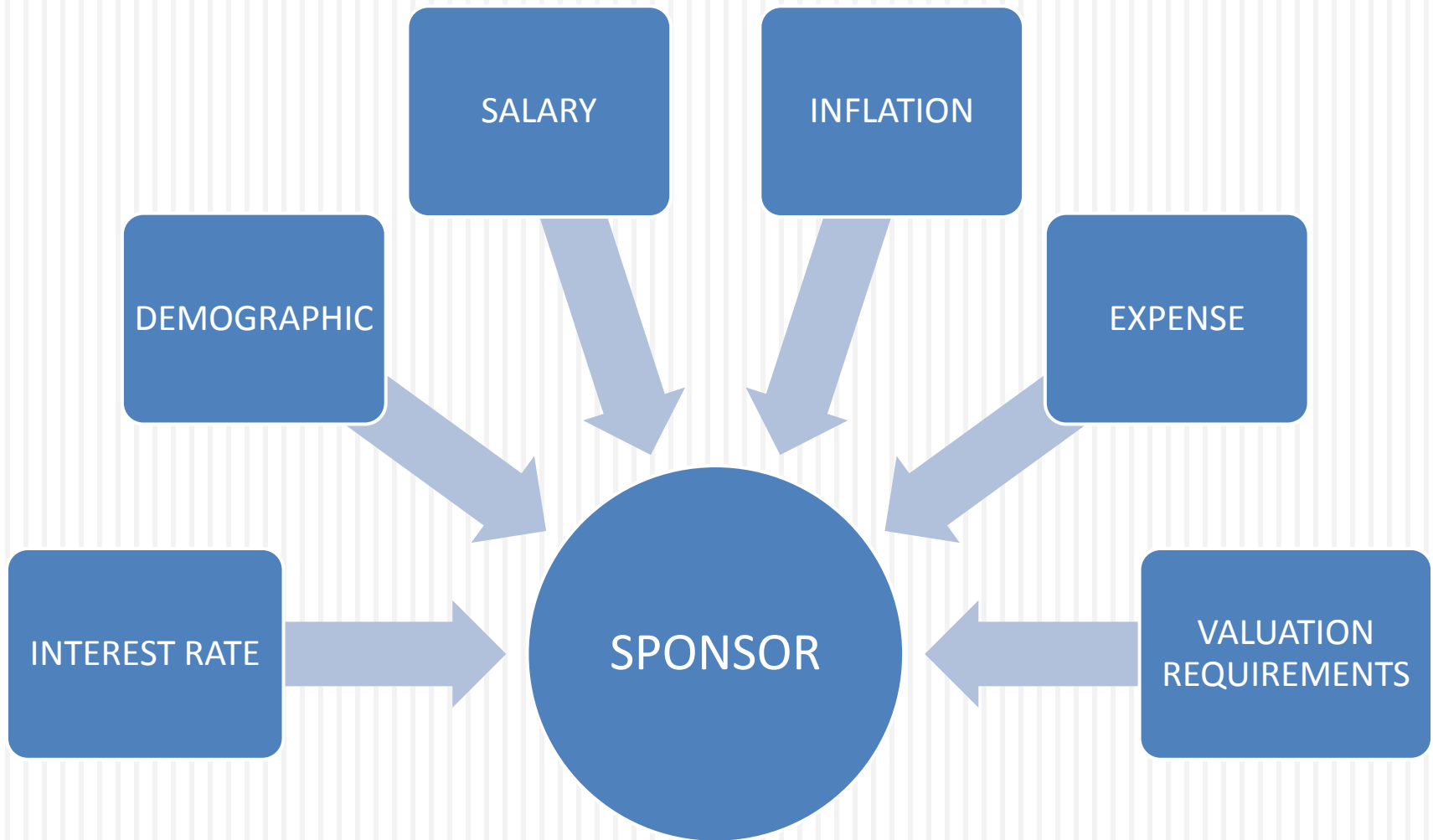
- ❑ Better staff management – layoffs, hiring, union
- ❑ Low cost mechanism (in initial years)
- ❑ Designing\altering benefits suiting needs
- ❑ Tax benefits
- ❑ Possibility of favorable experience
- ❑ Flexibility in financing
- ❑ Paternalistic approach
- ❑ Attractive benefits for high fliers, long servers



# Section: Challenges & Affordability of DB schemes

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## Risks – Liability Side



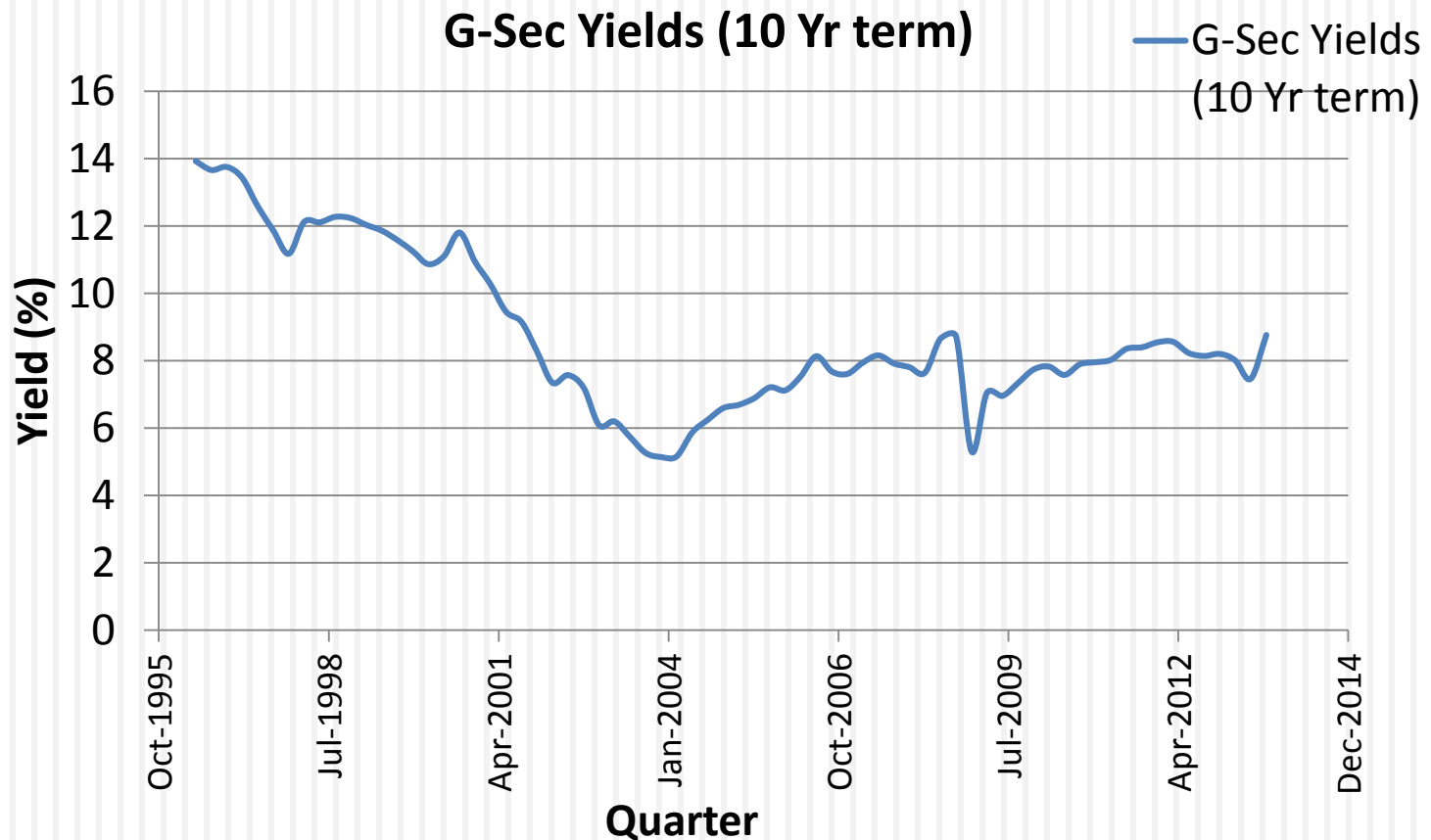
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## Risks – Interest Rate – Volatility

REDUCTION IN  
INTEREST RATE

INCREASE IN  
LIABILITY

POOR FINANCIALS





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## Risks – Demographic - Mortality Trends

MORTALITY	EXPECTED LIFETIME @ 60 (YRS)
IALM (2006-08) 3% improvement p.a.	21.13
IALM (2006-08)	20.86
LIC Assured Lives (1994-96)	17.50
LIC Annuitants (1994-96)	20.67

- ❑ Substantial improvement in expected lifetime of assured lives
- ❑ Corresponding improvements can be expected for the annuitants mortality
- ❑ Lack of study on mortality improvements
- Cost of annuities significantly different than estimated.

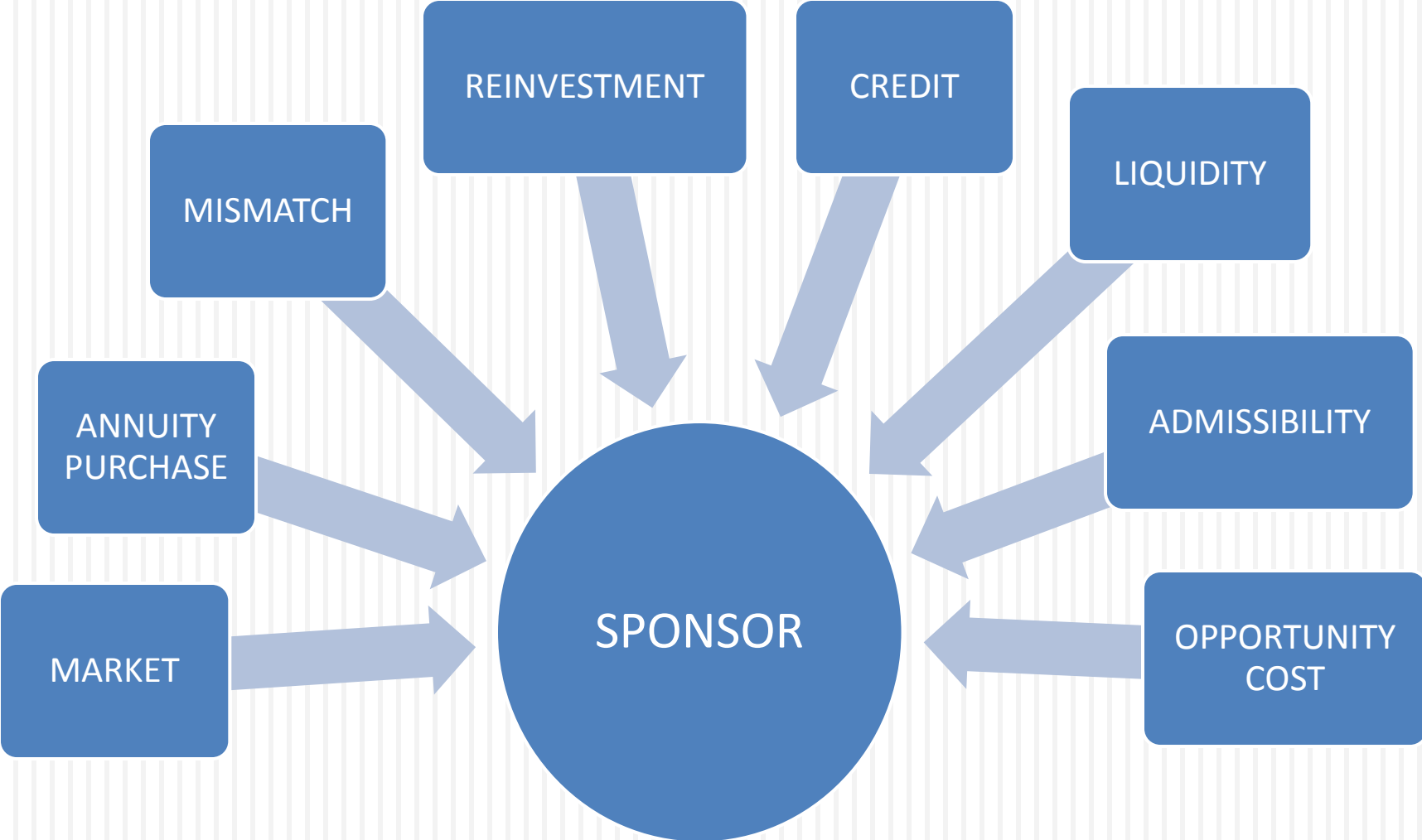
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## Risks – Salary

- ❑ Cost of providing benefits for scheme related to salary e.g. Gratuity
- ❑ For management level employees, escalation has been extremely high
- ❑ Frequent & generous Pay commissions
- ❑ High salary hikes even for the marginal employees due to high inflation
- ❑ Change in regulations e.g. increase in cap for Gratuity payments from ₹ 3.5lac to ₹ 10lac

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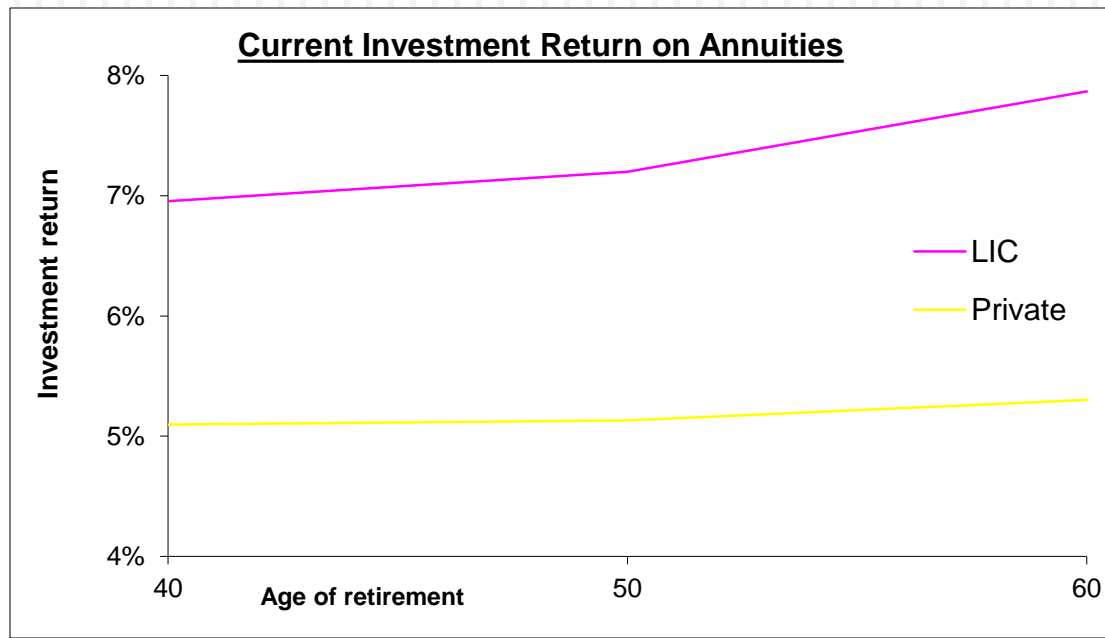
## Risks – Assets Side



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## Risks – Annuity Rates

- ❑ Decreasing interest rates and mortality improvements leads to higher annuity rates
- ❑ Low competition: only 7-8 providers
- ❑ LIC remains the biggest player in annuity market



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## Tax Benefits - Employer

- ❑ Overall cost towards scheme lowers with tax benefits
- ❑ Annual payments from employer treated as Business expense
  - ▣ Gratuity (limited to 8.33% of annual salary)
  - ▣ Superannuation Schemes (27% including PF contribution)
  - ▣ Leave encashment – no preferential treatment
- ❑ Contributions made towards past accrual liability also draw tax exemption
- ❑ Income and Capital Gains exempt from Tax

**Across Globe - Taxing is a prominent way of encouraging DB provisioning**

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## Tax Benefits - Employee

- Employer payments towards scheme is not treated as income for employee
- Extent of deduction determined by **Sec 80C** limit
  - Absence of additional tax saving for pension
  - Additional tax benefits only for NPS
- Cash commutation for members up to 1/3<sup>rd</sup> of total amount is tax free
- Tax model of Exempt-Exempt-Tax. Pensions payments are treated as income
  - Provident fund payment is also tax exempted



# Section: Future Possibilities for DB schemes

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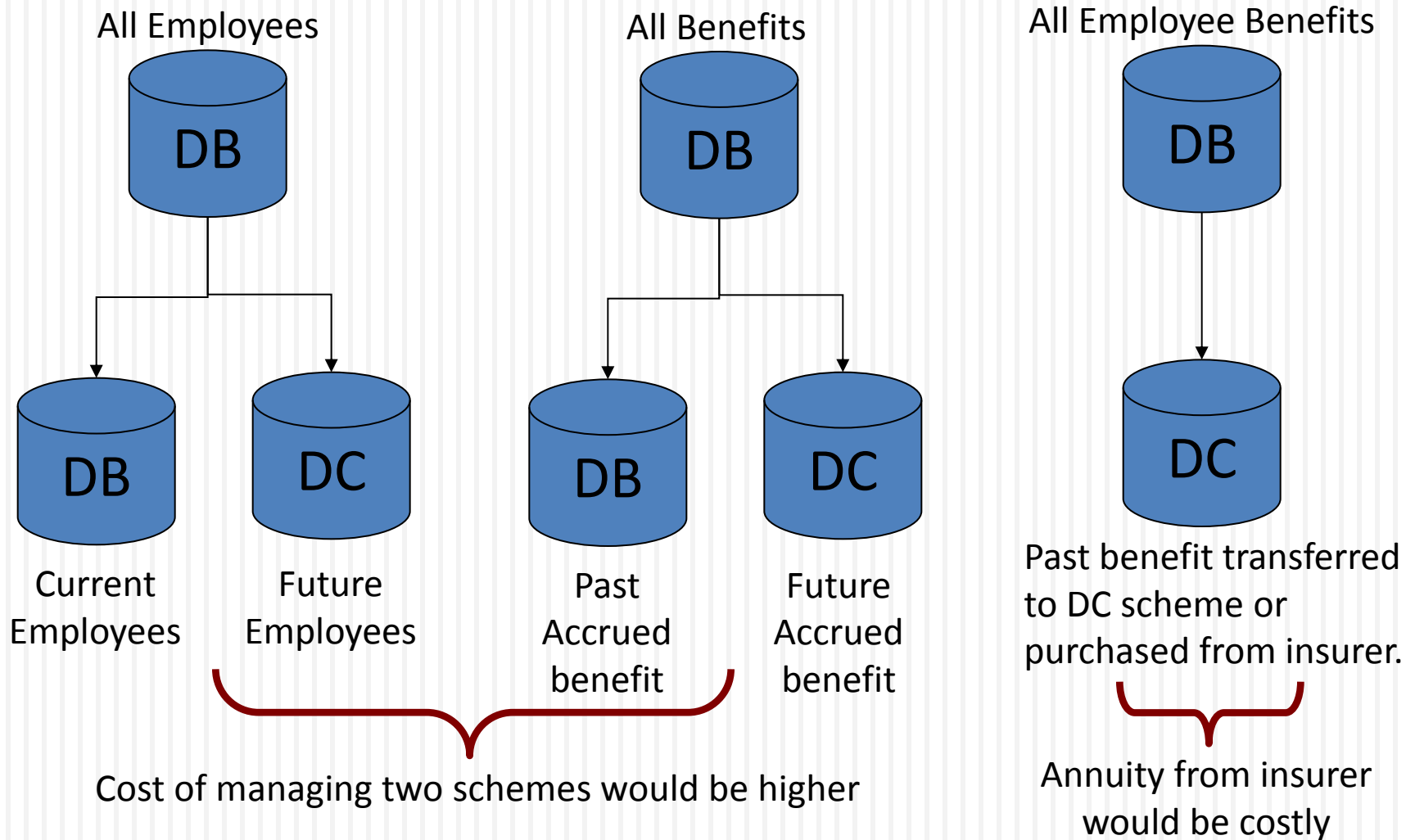
## Explore DC schemes

- ✓ Employer contributions fixed per employee
- ✓ Post retirement risks of longevity, expense, interest rate transferred to employee
- ✓ Tax benefits in India same as DB scheme
- ✓ Less reporting requirement
  
- ✗ Investments directly impact Benefits – a person with more service & salary may end up with lower benefits.
- ✗ Less flexibility in Contribution payments
- ✗ No gain from favorable experience



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## Switch to DC some options



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## Management of existing schemes

- ☑ Asset liability matching - Interest & Mortality
  - ☒ Trouble in getting very long term bonds – 25-30 yrs
  - ☒ Low investment return on long term bonds
- ☑ Adjusting pension payment based on investment performance (Hybrid schemes – e.g. cash balance)
  - ☑ Lower risks
  - ☑ Employees less exposed to risks than DC
  - ☒ Unfavorable employee reactions

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## Management of existing schemes

- ☑ Separate definitions for Salary & Pension salary
  - ☑ Better control over rate of salary increase for pension
  - ☒ Employee pressure for same increase or better accrual rate
- ☑ Favorable legislations
  - ☑ Separate section in IT Act to deal with Pension contributions (for individuals)
  - ☑ Relaxing contribution limits (for employer)
  - ☑ Relax the requirement to buy annuities from the insurer

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## Future Possibilities

- ☑ Sharing cost of schemes with employee
  - ☑ Employee\Employer would share cost together, targeting better benefits
  - ☒ Employees could claim any surplus from scheme
- ☑ Employers adopting aggressive investment strategies to earn higher return
  - ☑ Regulator may revise definition of admissible assets
- ☑ Allow profit sharing between insurer and scheme



Questions??