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Pensions & Gratuity

Gratuity: To fund? or not?

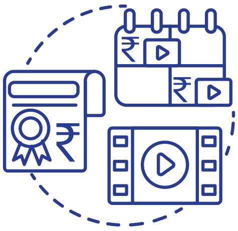
Section 57 of the upcoming Code on Social Security 2020 mandates compulsory insurance for Gratuity schemes. Since it is yet to be notified, the choice remains with the employers. In this article, **Arpaan** guides us on how to answer the question to fund or not to fund.

Gratuity is payable on leaving service provided the employee satisfies the vesting condition requirements. The vast majority of employers in India, particularly small and medium enterprises, do not finance the liability provision in advance. However, there are several ways an employer can finance its post-employment benefit scheme, such as the gratuity benefit.

The two most prominent approaches are:

Pay As You Go (PAYG)

The PAYG method has the advantage of deferring the contribution until the time of payment. Secondly, it also reduces trust-related administration and management expenses for small and medium-sized companies.



Regular contribution

Under this method, the contribution payment is spread over the member's working life and is determined based on actuarial valuation. The accuracy of the contribution payment depends upon the assumptions adopted in carrying out the actuarial valuation and the scheme experiences. However, the true cost of the liability will be known only at the time of making payment.

Is the PAYG method the most suitable financing approach that employers should adopt? Should the employer consider regular contributions instead of PAYG? What are the possible advantages of regularly financing the provision? Should regular contributions be a mandatory requirement? The article discusses the merits and demerits of introducing a regular financing requirement. It also discusses the key factors to consider while making a financing decision.

Why regular contributions instead of PAYG ?

The merits of advance funding:

From the employer's point of view

- **Provides additional benefit security to employees:** The approach will provide a greater sense of security to employees. Demonstrating greater benefit security is also important from the point of view of employee retention.

- **Reduces liquidity risk for the employer:** In the case of PAYG, the employer is also subject to liquidity risk if an unexpected benefit payment of a significant size arises.

Regular contribution minimises liquidity risk and can be useful for employers to plan future payments systematically.

- **Stability of the future contribution payment:** Regular contributions introduce greater stability of contribution payment for the employer and eliminate the randomness in the payments.

- **Tax benefits:** Regular contributions also provide a regular advantage of tax benefits to employers. In the case of gratuity benefits with an approved trust, the employer can avail of a deduction of the contribution made up to 8.33% of the salary each year.

Investment income earned on contributions is also eligible for tax benefits.

- **Funding position stability:** If the gratuity liability is fully funded and the investment profile (in terms of timing of payment, size of payment and currency of payment) closely matches the liability profile, then the funding position will also remain stable irrespective of the interest rate movements.

Regular contribution, though, has its perils and challenges:

- **Opportunity Cost:** There can be a significant opportunity cost associated with regular contributions. The employer may be able to generate higher returns by investing the same funds elsewhere or by re-investing funds in its business.

A new gratuity plan will have minimal cash outflow requirements from the employer during the initial years, and the opportunity cost will be lower. However, for a mature - unfunded scheme with a mounting initial deficit, the one-off contribution requirement can be huge. It may probably lead to an employer's cash flow insolvency. Thus, maintaining a balance between the contribution requirement and the sponsor covenant is essential.

From the economy's point of view

Boost investment in the capital market: Regular contribution will formally inject significant capital into the economy, resulting in the development and growth of the capital market, in particular, the debt and government bond markets.

For example, Canadian Pension Plan Investment Board recently invested about INR 3,000 crores in the NHAI's infrastructure investment trust. The investment trust could meet its long-term capital requirement and, in return, offered a pension plan with high-quality security along with adequate returns.

Regular contributions, if subsequently invested across diverse securities (only securities meeting the minimum rating and quality requirement) or suitable insurance arrangements, can provide access to much-needed capital required to boost several economic activities in the country. As observed above, the advance financing of pension provided benefit security to the pension plan and simultaneously fulfilled NHAI's capital requirements to foster its infrastructure development plans.

Thus, the economic benefit of regular contribution alongside improved gratuity benefit security should not be underestimated.

What does the law mention about gratuity funding?

The requirement for compulsory insurance is mentioned in Section 57 of the Code on Social Security, 2020. The same corresponds with Section 4A of the Payment of Gratuity Act, 1972. However, the requirement is not notified and is yet to be implemented.

Section 57, sub-section (1) reads as follows:

"With effect from such date as may be notified by the appropriate Government on this behalf, every employer, other than an employer or an establishment belonging to, or under the control of, the Central Government or a State Government, shall, subject to the provisions of sub-section (2), obtain insurance in the manner prescribed by the Central Government, for his liability for payment towards the gratuity under this Chapter, from any insurance company regulated by the Authority as defined under clause (b) of sub-section (1) of section 2 of the Insurance Regulatory and Development Authority Act, 1999:

Provided that different dates may be appointed for different establishments or classes of establishments or for different areas."

Introducing a requirement for compulsory funding can be a landmark reform. However, the same will need to be addressed through careful funding and investment rules.

NSE 50 - Analysis

An analysis based on the 31 March 21 results of NSE 50 companies was performed. The purpose was to assess the gratuity funding position and determine the size of funds invested. The results were available for 49 companies and are summarized as follows:

- 47 companies operate on a funded basis
- The cumulative funding position of NSE 50 companies is 95%
- Not all companies that operate on funded basis secure assets with an insurance company. Few companies have also established a separate trust to self-manage their gratuity provision

Further, the funding position of the remaining companies (in particular – unlisted companies) is expected to be much lower. The key reasons why the funding position may be lower are as below:

- Lack of access to capital
- Lack of resources, both financial and skill
- Relatively lower liability size
- Lack of available insurance products or investment opportunities matching the liability profile
- Also, because it is not a regulatory requirement, companies may want to defer contribution payment

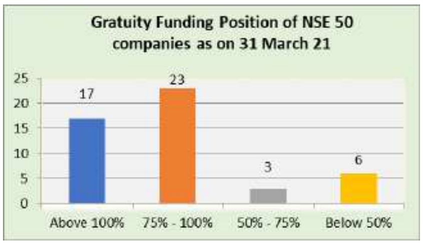


Figure 1: Funding position of NSE 50 companies as on 31 March 21

It is also important to note that the funding position of NSE 50 companies may not be a true representation of the remainder companies but can provide useful best practice cases.

Actuary's role in funding

Should actuaries encourage employers to make a regular contribution or push towards a mandatory requirement for regular contribution? The answer can be random and may be subjective, but actuaries should certainly demonstrate the importance and benefits to the employers of doing so. The move can help to create awareness amongst the employers, provide greater opportunities and enable us to go beyond the traditional practice areas in Employee Benefits.

Irrespective of the methods chosen, the total contribution cost or the pay-out remains the same under both approaches. Only the pace/timing of contribution payment varies, which impacts the cost of providing the benefit.

PAYG and regular contribution, both financing methods, have variable arguments in favour and against. PAYG offers employers an opportunity to invest funds in higher return opportunities; but also increases the liquidity risk and reduces the flexibility relating to the timing of contribution.

Regular contribution reduces the liquidity risk for the employer. It can also reduce the employer's financial stress in the long run when the number of payments may rise steeply. Inevitably, the move can also generate a significant flow of capital into the capital market, leading to several positive macroeconomic effects.

Lastly, in order to avoid the transition risk relating to initial deficit contribution, employers should consider reviewing Rule 104 of the Income Tax.

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Arpaan is a nearly qualified actuary with vast experience in the employee benefits domain. He is an avid reader and likes taking adventurous trails to satiate its personal desires.