Chapter 14

RETIREMENT BENEFITS

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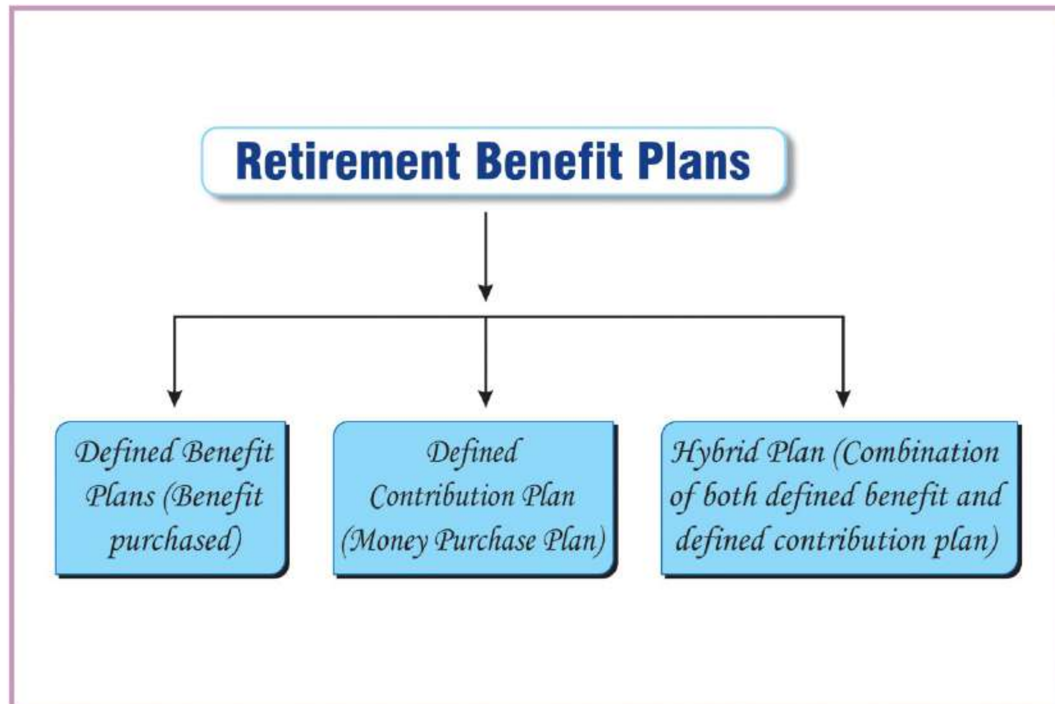
14 RETIREMENT BENEFITS

Retirement benefits available to an employee can be classified into three types based on how the quantum of money required is accumulated during the working life according to contributions and to the nature of benefits available in the post-retirement period.



DEFINED BENEFIT PLANS (BENEFIT PURCHASED)

Defined Benefit Plan reflects a traditional pension or fixed pension. A pension plan under which an employee receives a set monthly amount upon retirement, guaranteed for their life or the joint lives of the member and their spouse. This benefit may also include a cost-of-living increase each year during retirement.

In most of Defined Benefit Plans, the benefit is stated as a percentage of the pre-retirement salary, which is payable for the remaining life in case of regular payment, or a lump sum on the date of retirement. Some plans will also provide benefits before the stated Retirement Date if the plan participant dies or is disabled.

In Defined Benefit schemes, since the benefits payable on retirement are fixed, contributions (mostly by an employer or occasionally by both employer and employee) are varied to ensure that the defined level is achieved on the retirement of the employee. This works on a pooled fund basis- all contributions are paid into a common fund, which is invested to provide all retirement benefits. In the normal course of events, the investment performance of the scheme assets has no or minimal impact on the benefit any employee receives. Better the investment performance lowers the contributions needed & vice versa.

The monthly regular income that the employee will get after retirement is generally calculated as

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1/60th of his last drawn basic salary per month for each completed year of service, as per his term of employment. Some plans also compensate for inflation in the form of dearness allowance on the basic retirement income as calculated above.

Examples of Defined Benefit Plans are:

Gratuity, Leave Salary, Retrenchment Compensation, Voluntary Retirement Schemes, Employee's Pension Scheme, 1995 (EPS is a Hybrid Plan), etc.

The main points of this scheme:

1. The better the investment performance the lower the contributions needed.
2. The benefit payable in futures is determined or defined in the beginning.
3. There is no relation to accumulated value.
4. The benefit may be:
   a. Of fixed amount
   b. Percentage or multiple of salary etc.
5. A defined benefit plan is sometimes referred to as a fully funded pension plan.

Cost of Defined Benefit Plan

- The calculation of cost depends on many probabilities.
- A contribution could vary from time to time because of inflation and some other factors.
- Regular review required.
- The actuary would determine the liability and the investment required for the plan to generate sufficient funds.

The defined benefit plan generally involves 'cross subsidies'. Hence it works on a pooled fund basis. Young may subsidize the old. All can share the cost of a loss as in an Insurance plan.

Advantages of Defined Benefit Plans

- Assurance of a fixed retirement income
- No investment risk to the recipient
- Provide for an increase in the cost of living
- Not dependent on the participant's ability to save
- Tax liability is deferred over the retirement age

Disadvantages of Defined Benefit Plans

- Difficult to understand by the participant
- Not beneficial to employees who leave before retirement

CASE STUDY

Mohit is a software engineer working with a limited company. His date of birth is 24/08/1971. He had joined the company on 15 March 2001 and his present salary is Rs. 15,000/- p.m. The age of normal retirement in his company is 60 years, which implies that he would retire on 24/08/2031. His company has a system of paying a retirement benefit in the form of a lump sum payment as well as a regular assured monthly income for the balance of his life.

If at the time of retirement he was placed in Engineer- scale 6, for which the maximum retirement benefit is fixed at Rs. 15 lakhs, and was drawing a basic salary of Rs. 55,000/- p.m., then his lump-sum retirement benefit would be calculated as follows:

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The total No. of completed years of service from 15/03/2001 to 24/08/2031 is 30 years. The retirement benefit would be 30 ´ Rs. 55,000/- = Rs. 16,50,000/-

Since the maximum benefit payable is Rs. 15 lakhs, he would be paid Rs. 15 lakhs as the retirement benefit. The monthly income would be calculated as 1/60 ´ 30 = 50% of the last pay drawn, i.e. Rs. 27,500/- p.m.

In this case, you will find that the amount payable on his retirement does not depend upon the amount set aside to fund the benefit by either the employer or the employee. The lump-sum amount payable depends on the cadre and the basic pay he draws at the time of retirement and the regular monthly income only on the last pay drawn.

Mohit would be paid the fixed amount calculated according to the formula on his retirement and hence he need not worry about funding his retirement benefit.

It is his advantage that the investment risk and funding of the benefit are with the employer. But at the same time, he faces the risk of not reaching the cadre that he would like to at the time of retirement or his basic salary not being the amount that he would have liked it to be. In both these cases, he would be left with a retirement benefit lower than his expectation.

DEFINED CONTRIBUTION PLAN (MONEY PURCHASE PLAN)

A retirement savings program, under which an employer promises certain contributions to a participant's account during employment, but with no guaranteed retirement benefit.

The ultimate benefit available at the time of retirement is based on the corpus accumulated in the fund. The actual benefit payable on retirement would be the accumulated value of the contributions throughout service depending upon the yield on the investments earned by the funds.

The benefit ceases when the account balance is depleted, regardless of the retiree's age or circumstances.

Here you will find that the investment performance of scheme assets would make a great impact on the benefit that the employee receives on retirement. The better the performance the higher is his payout.

The contributions are usually expressed as a percentage of salary or total earnings. The rate of the contribution could be a flat rate or could be tiered by some other consideration like the length of service or seniority etc. But the final benefit payout is never fixed and would be based on the accumulation of the contributions made.

The main points:

- The better the performance of investments the higher is his payout.
- A pre-determined quantum of money called contribution is set aside periodically.
- The contribution could be a fixed rate or fixed amount
- The fixed benefit is based on the accumulated value of all such contribution

Advantages of Defined Contribution Plans

- Tax liability is deferred over the retirement age.
- The amount of contribution is known.
- Can be funded through payroll deductions.
- Lump-sum distributions may be eligible for a special 10-year average.
- Participants can benefit from good investment results.
- Easily understood by participants.

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Disadvantages of Defined Contribution Plans

- Difficult to build a fund for those who enter late in a career.
- Participants bear the investment risk.

CASE STUDY

Let us consider the same case of Mohit. If the retirement benefit plan was such that he would be paid the accumulated value of contributions made by the employer every month at the rate of 15% of the basic pay of Mohit for the lump sum benefit and 10% for the monthly income, then we know that the current month's contribution would have been Rs. 3750 (2250 lump sum at 15% of 15000 and 1500 hundred for monthly payment @10% of 15000).

If we assume that he would be getting regular salary increases @ 5% p.a., his contributions during the last year before retirement would be 15% and 10% of Rs. 59,000/- approx), which would be Rs. 8,850/- and Rs. 5,900/- p.m. respectively. If the assets of the retirement fund to which the contributions are credited earn a regular return @ 9% p.a., then the values would be as follows:

By using Growing annuity the contribution for a lump sum of Rs. 45,000/- (3,750 pm ´ 12) increasing at 5% with the rate of interest being 9% in 28 years would be Rs. 81,52,875/-(lump sum benefit).

Similarly the accumulated value of the contribution for a monthly income of Rs. 18,000/- (1,500 ´ 12) increasing as 5% with the rate of interest being 9% in 28 years would be Rs. 32,61,150/-.

Here the accumulated value is not dependent on the cadre in which he would be placed at the time of retirement. It is the contribution that goes into the retirement fund and the yield on its assets, which determine the benefit payout.

If the interest rates had gone down and the longevity of persons had increased by the time of his retirement, the annuity rates the providers would offer would have gone down and Mohit would end up getting a reduced monthly income not related to the final salary of average salary, etc.

HYBRID PLAN (DEFINED BENEFIT + DEFINED CONTRIBUTION)

It is the combination of the defined benefit plan and defined contribution plan. In such plans, the ends, the rate of Contribution, and also the future benefits to be made available to the beneficiary are fixed. Such plans are rare but do exist on account of social, political, economic, or other compulsions. So a hybrid plan is very rare and also difficult to manage unless:

- Some financial guarantees are there, or
- The financial assumptions come true

Defined Benefit v/s Defined Contribution

Difference between Defined Benefit Plan and Defined Contribution Plan

S.No.	Defined Benefit Plan	Defined Contribution Plan
1.	The quantum of the benefit on the retirement of an employee is fixed either as an absolute sum or as based on the length of service and salary drawn by the employee.	The quantum of the benefit on the retirement of an employee depends on the accumulated value of the contribution made by the employer or employee or both and hence is not fixed.
2.	The amount of contribution to be made by the employer will depend upon the benefit payable, which is fixed and hence can vary tremendously.	The contribution to be made by the employer is fixed either as an absolute sum or as a proportion of salary or wages payable to the employee.

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S.No.	Defined Benefit Plan	Defined Contribution Plan
3.	An Actuary has to be appointed to calculate the contribution and the quantum of funding required.	Actuary not required.
4.	The employee would prefer to have a defined benefit scheme promising a regular payment of a proportion of the last drawn salary so that he can maintain the same standard of living.	The employee would not prefer this type of scheme as the benefit payable would depend on various factors that are not in control and hence can fluctuate over a wide range.
5.	The employer would not like as his liability can vary due to a lot of factors like returns on investment etc. and can put a heavy strain on the employer's finances.	The employer would find these schemes rather easy to finance as he is quite aware of his liability and even at the time of pay revision or promotion of some employees the exact impact on the liability can be calculated accurately.

Defined Benefit and Defined Contribution Plans from the Perspective of the Employer and the Employees

If an employer wishes to establish a new retirement benefits scheme for the employees, first and foremost he would like to know what would be the cost of having his benefit in place. This can be measured in terms of the contribution to be made towards building up the funds required for meeting the liabilities as and when they arise. As per accounting standards and regulations, most of the retirement benefits schemes are regulated in such a way that the contributions to be made to the schemes be valued as accurately as possible, and the funds set aside. Actuaries are authorized to value such long-term liabilities and certify the adequacy of the funds allocated.

If the employer has to choose a defined contribution plan for the retirement benefit, his liability is clearly defined on a month-to-month or year-to-year basis and he knows what the scheme would cost him at the beginning itself. No need for professional valuation and certification. Particularly he is not affected by the increase in longevity or the decrease in interest rates that would adversely affect the annuity rates.

In the case of a defined benefit plan, the employer will have to estimate the liability that the scheme brings in based on many assumptions, which would include the future pay increases and the promotions that the employee would get. Consider the benefits scheme described in the case study of Mohit. The liability will depend upon the last drawn salary and an increase in salary would not only increase the benefit accruing to the employee for the service he is going to put in but also the benefit for the past service would also go up. This means that the funding for the scheme would require an immediate increase in past service liability.

From the employer's point of view, a defined contribution retirement benefit plan would be advantageous for the following reasons

1. The employer's liability towards the retirement benefit is well defined and hence the employer can take clear decisions regarding his recruitment and remuneration arrangements in advance whereas, under the defined benefit plans, he has to estimate the liability or cost of recruitment/ remuneration package.
2. The employer is not affected by the changes in the economy like interest rate fluctuations or improvements in the longevity of the population, which would drastically affect the retirement income of the employees. Under the defined benefit plan, with every change in interest rate, he has to evaluate the liability, which will go up considerably in case of all interest rates.

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3. There is no need for actuarial valuation and certification to either get the approval of the schemes by tax authorities or other regulatory bodies, whereas these will be required in case of defined benefit plans.
4. The assets belonging to each employee can be clearly identified and in case of an employee leaving the scheme early, he can be paid his share of the assets immediately without any complicated calculations. In the case of defined benefit plans, the assets are always held on a pooling basis and the share of each employee cannot be accurately calculated. Actuarial methods are employed to arrive at the amounts payable to each employee, which is more cumbersome and expensive.
5. Employers can make informed decisions regarding promotions and pay revisions as the cost of these can be correctly assessed. Defined benefit plans make the decisions difficult to make as a salary increase can have a higher impact on the liability of the employer and hence the employer may not be willing to take on the additional costs.

Employees Perspective

An employee would always aim at maximizing his benefit be it lump-sum payment or regular monthly income. But since every employee is used to a certain standard of life, which is dependent on the amount of salary drawn every month, he would like to have the same standard of living even after retirement considering the effect of inflation and other health-related new expenses.

Also, the botheration of increased funding due to interest rate fall, wage increase, promotions, etc. are for the employer and the employee would only stand to gain in case of wage increase closer to retirement or promotion. Hence, he would always like to have a defined benefit plan. Even in some scenarios where the interest rates keep increasing with time and inflation remains high, normally the wages are expected to rise in tandem with the trends and hence a defined benefit plan would be better off.

Defined benefit retirement plans have almost always included a vesting condition that the employees have to put in a minimum period of service for getting the benefit. Also, the employer can resort to salary cuts or placing in a lower cadre just before retirement, which can drastically reduce the retirement benefit. These fears will not be there in case of a defined contribution plan. With employee mobility on the increase, employees look forward to the portability of the retirement benefit plan more than the assured returns.

Portability of Plans

One of the effects of economic reforms is an increase in private sector employment and change of the outlook of the employers and the employees. Earlier, loyalty to the employer and sticking to the same employment was considered to be paramount by both the employer and employees. Now, with more professionalization of education and employment, neither the employees nor the employers expect employee loyalty as a prime requirement.

Now, employees switch jobs and are always on the lookout for greener pastures. Hence, any plan that has the flexibility or portability is generally liked by the employees. The employee would like the benefits to be carried forward from one employer to another.

- The Defined Benefit plan does not enjoy much portability.
- Only a Defined Contribution plan offers easy portability

Hence, the preference for the DC plans is on the increase

Trends and Reasons for Transition

Most expert observers agree that corporate defined - benefit (DB) plans are on their way out. The trend in that direction was emphasized in particular when the Government of India has scrapped its Defined Benefit pension plan for the new employees from 1-1-2004. IBM announced in early 2006

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that it intended to close its defined - benefit plan to both existing and new employees. IBM is an employee-centric, financially strong company with an overfunded DB plan, and yet the DB plan is being shut down.

Some observers say that defined benefit plans have become too expensive for the corporations to maintain; others say they are too risky. A simple explanation for what happened to defined - benefit plans is that they were mispriced, not three or five years ago but from the outset.

For example, assume that the liabilities in a defined - benefit pension plan have the equivalent duration of 10 years and a risk - free rate of 5 percent. Assume, too, that the plan used a blended expected return on the asset portfolio of 9 percent, not risk-adjusted (with assets including risky securities). If liabilities that should have been discounted at 5 percent with a 10 - year life span are instead discounted at 9 percent, the result is two - thirds of the present value. Thus, for every Re.1/- of cost, a corporation is expecting from a plan, the cost is Rs.1.50.

If a corporation is negotiating with its employees and it offers what it mistakenly believes is Re. 1/- of benefits that are worth Rs. 1.50, then employees are likely to choose the benefits offered over cash, even if they do not know the actual value of the benefits. As an analogy, consider a corporate automobile perk that allows employees to choose either a Toyota Camry or a Bentley. Which will they choose? Will the outcome be random?

Even if they have no idea of the actual cost of each, most people are likely to pick the Rs. 300,000 Bentley over an Rs. 30,000 Camry, and just so with generous benefits versus cash compensation.

The use of defined - contribution plans has become the default strategy following the decline in defined - benefits plans. Although defined - contribution plans solve the problem for the plan sponsor by (1) making costs predictable and (2) taking risks off the balance sheet, they place a tremendous burden of complex decision making on the user.

For example, assume that employees hope to maintain the same standard of living in their retirement that they enjoyed in the latter part of their work lives. If that is the goal, then a defined- benefit type of payout is quite attractive. In a defined- contribution scenario, however, a 45 - year - old will have contributions coming in for 20 years or more and a 35 - year - old for 30 years before retirement, and each will need to decide the size of these contributions, as well as the types of investments to make with these funds, to provide the required standard of living at the age of 65.

A recent trend is that more and more retirement benefit plans are either converted or being attempted to be converted from defined benefit to defined contribution plans. This phenomenon is being observed worldwide. You will find that the share of defined contribution plans has been increasing steadily and has almost reached a stage when they at least completely replace the defined benefit plans.

Why is this shift towards defined contribution plans? Are they against the interest of the employees concerned? There is a big difficulty is financing a defined benefit plan in a falling interest rate scenario. The liability in terms of the service already put in by an employee increases manifold with ever-falling interest rates. This poses the twin problems of assessment of the increase in the present value of the liability and setting aside the sum required to meet the liability.

The demand for portability of retirement benefit plans by the employees who switch jobs has made defined benefit plans all the more unattractive from the employer’s point of view. A defined benefit plan is likely to be a cross-subsidization of the benefits by one group of employees for another and hence it is not straightway feasible to identify the share of the assets about any one member. Hence when a member withdraws from the benefit plan, the exit value, or the surrender value that is allowed to him may not be equal to the contributions made towards his benefits.

When the liability of the employer increases beyond a level, some employers also default on the funds’ allocation thereby affecting the benefits payable to the employees. The accumulated value of the funds already set aside may not be sufficient to provide the assured benefit and hence employers

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may have to bridge the gap. On the other hand defined contribution plans are by definition fully funded and hence the danger of the employees losing the benefits is minimal.

Simplicity and being easy to understand are the other features of defined contribution plans. Hence, employees prefer to have defined contributions plans.

Defined contributions plans also have the benefit of allowing additional contributions to be made by the employees to supplement their retirement benefits. Also, accumulation through a retirement benefit pan is tax-efficient because of the liberal tax benefits that Governments allow for the funding of retirement benefit plans. This also allows employees to pay better incentives to high performing employees with lesser tax liabilities by way of increasing contributions to the retirement plans.

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