Institute of Actuaries of India

Subject SA4: Pension & Other Employee Benefits

May 2015 Examination

INDICATIVE SOLUTION

Introduction

The indicative solution has been written by the paper setters with the aim of helping markers of scripts so as to have a framework and be consistent while evaluating answers. The solutions given are only indicative. It is realized that there could be other points as valid answers and the marker may give credit for any such alternative approach or interpretation which the marker considers to be appropriate.

Solution 1:

(i)

Parties having an interest in the pension aspects and their role in an M&A transaction:

When a company that sponsors a pension scheme purchases or sells a subsidiary or a part of its business the parties to the transaction need to decide whether the Purchaser or the Vendor takes on responsibility for benefits accrued in the Vendor's pension scheme.

The below parties will play a role in advising the purchaser and the vendor with regard to the pension aspects.

Actuary:

The actuary's role will be to advise on the financial implications of the various options available during the negotiations. It will cover the wording of the Agreement (in consultation with the client's legal advisers), the actuarial methods and assumptions to be used in the calculations, the administrative arrangements and the terms to be offered to the transferring members.

The Vendor and the Purchaser may ask their respective advisers to negotiate with one another directly with a view to arriving at a mutually acceptable agreement, and the actuary needs to be aware of the commercial aspects of the deal and to frame the advice accordingly.

A bulk transfer value will be determined and paid over to the Purchaser's scheme, likely to represent the value of the transferring members' accrued rights. Usually the transfer amount is calculated by the Vendor's actuary and agreed by the Purchaser's actuary. However in a few cases where the transfer amount is material in the whole transaction or as a matter of due diligence, the purchaser's actuary could perform an individual assessment that needs to be reconciled with the vendor actuary's estimate.

Legal advisers:

Employers and trustees will employ legal advisers (also known as lawyers or solicitors) to advise on the legal aspects of the scheme. This will include advising on the pensions aspects of mergers and acquisitions and the impact on the scheme of changes in pension legislation. It is the legal adviser's responsibility to ensure the wording in the Agreement is legally correct and effective, (with the possible exception of the Actuary's letter).

The actuary should take steps to ensure that his advice has been correctly understood and interpreted by the legal adviser but should be very conscious of avoiding unnecessary risks in venturing into another professional's area.

Trustees:

The vendor's trustees have more say when it comes to what can and cannot be done with pension rights taking into account relevant requirements in the Trust Deed and Rules and legislation. Hence they play a significant role in the decision making on the treatment of the pension aspects in the transaction. Where defined benefit pensions are a significant consideration in the transaction, both sets of Trustees may be legally bound via a side agreement.

The Vendor's Trustees will also need to consider the impact of the transaction on the sponsor's covenant and the scheme's investment and funding position.

Other parties that can play a role or have an oversight on the pension aspects in the transaction are

- Members of the scheme – for consent to the offer and transfer
- Regulator – to ensure that there is no unfair treatment of pension aspects in the transaction
- Employers- The vendor may be interested that transferred employees are treated well and transferred amount is utilized for their benefit, though he will be more interested in getting maximum amount out of sale. The purchaser would also like that the transferred employees are satisfied so that they continue in the company. **[4]**

(ii) Different types of M&A transactions and relevant considerations for employee benefits:

An M&A transaction could be either a share or an asset sale.

An M&A transaction can be a share sale or an asset sale. A share sale simply relates to transfer of ownership of the shares between two parties. An asset sale involves liquidating some or all of the assets of the company and a breakup of the business.

Employees' rights to a pension differ under a share sale to those under an asset sale. Under a share sale where an employing entity is purchased, employees' contracts will usually be maintained. Where the Scheme is related to that employing entity alone, this will most commonly mean that the employees will have the right to continue to be a member of the pension scheme (in a few cases the level of benefits may also be covered).

In an asset sale situation (where an employing entity is not being sold), then the buyer would have options on the employee transfer terms (continuity of service or termination and rehire).

The decision to provide continuity of service and hence transfer the employee benefit liability and corresponding assets would then depend on

- The overall terms of the contract (for instance there could be a "no less than favourable" clause on an overall offer basis usually).
- The materiality of the liabilities
- Practical considerations around sustainability of such benefits in the current form in the future, consistency of benefits of transferring members to existing members in the transferee organization, market practice etc.
- requirements of any existing employee union agreements
- demand of unionised employees

In the case of the sale of a parent and its subsidiaries, it is usual for all of the assets and liabilities of the scheme to be transferred. In the case of the sale of a subsidiary with its own scheme, the transfer value may instead be calculated as the value of the accrued benefits of the transferring members with any remaining assets of the scheme refunded to the pension scheme of the selling parent. **[6]**

(iii)

a) Pointers for negotiation with the buyer on transition treatment:

The following points need to be borne in mind for the purpose of negotiation with the buyer on the transition treatment of the benefits

- The nature of the transaction. In this case there are two types of transactions- one of them is a share sale and another is an asset sale
- Typically in a share sale, benefit liabilities are transferred to the buyer along with the assets generally. Hence the buyer should consider transfer on current terms with continuity of benefits. Also there are unionized employees in the transaction with a bargainable agreement that has validity until 31 December 2016 at least. It would be very difficult to change the provisions of such an existing arrangement and hence the buyer must honor the contractual commitments as per the current terms at least until the end of validity period.
- Under the asset sale, while the vendor's preferred position is transfer of benefits as they are, the buyer would evaluate the sustainability and comparability of benefits of employees to be transferred with their existing employees to decide on the approach for transition. For example if the transferee legal entity does not have a post-retirement medical benefit scheme, then the likelihood of transitioning this benefit for the in-scope transferring employees would be quite low.
- It would be useful to understand the purchaser's preferred position and rationale before putting forth pointers for transition of benefits. In a few instances the buyer may be willing to transition benefits as they are or a few of the benefits as they are.
- Based on this understanding, the vendor could put forth the following aspects from a negotiation standpoint as relevant for the transition approach under the asset sale;
    - Need for protection of retirement benefits for members closer to retirement as they would have little time to make alternative plans
    - Issues with retention of critical talent if in case benefits are not continued or reduced
    - Need for an overall no less than favorable total rewards offer for transferring employees
    - Compensation for benefits that may be reduced or not provided going forward
    - Materiality in the overall deal or materiality of the benefit liabilities per se. For example, if the post-retirement medical benefit provisions have limited benefits, then the liability may not be high and can be affordable going forward as well
    - The funded position of Gratuity. If the accrued benefits are fully funded, then the buyer may be more interested to transition the benefits as they are if they are sustainable going forward.

b) Financial considerations for different benefit liabilities:

The Vendor will consider the financial implications of the pensions' aspects of the deal as below:

- The effect on its Profit & Loss Account and Balance Sheet. For instance, if additional funding needs to be done for the Gratuity scheme for the purpose of the transfer, then such cash out flow would create an impact in the vendor's Balance Sheet and P&L Account.
- Any requirements contained within the Trust Deed and Rules and the Trustees powers. For example, a requirement to protect the remaining members benefits' and hence any post transaction funding requirements and investment decisions for the Vendor's pension scheme and in particular, any agreements made with the Trustees in that regard.
- Any surplus due to release of the liabilities if the sale leads to a significant improvement in scheme funding levels or net liability position. For instance, if the leave benefit is encashed on transfer, then the difference between the accounting provision and the accrued value would be either a gain or loss depending on the assumptions used for estimating the provision.
- Hidden liabilities, historic administration costs, redundancy or early retirement costs triggered in conjunction with the transaction. For example, if the post-retirement medical benefit would not be transitioned, then as per rules, there may be a requirement to provide some early retirement benefits.
- In principle, if a bulk transfer is to be provided, the Vendor will want to ensure that no more money is paid across than is strictly necessary to secure the transferring employees' entitlements and that after the transaction the Vendor's finances (including its obligations to finance its pension scheme for remaining employees) are in no worse a position overall than before.
- Hence the main factors that need to be agreed by the two sides are:
    - The calculation method to be used to determine the transfer amount - Would it be on accounting basis, accrual basis or any other pragmatic approach for instance
    - The actuarial assumptions to be used when applying that method – would it be on accounting basis or any other basis that is relevant for the transferring in-scope employees with allowance for market practice, macro-economic situation etc.
    - The benefits to be valued e.g. will there be any allowance for discretionary practices, options, guarantees etc… - for example, was there any past practice of pension increase for instance.

c) Aspects to be considered for incorporating in the sale and purchase agreement:

The sale and purchase of a company or business is usually achieved by the execution of a legal document, the Sale and Purchase Agreement ("Agreement"), by the company selling the business (the "Vendor" or "Seller") and the company buying (the "Purchaser" or "Buyer") it.

The nature of the deal will also dictate what further legal requirements should be considered. For example, if it is a share sale as in this case and the benefits liabilities and assets would transfer as they are, then the sale and purchase agreement could typically have an "Actuary's letter" setting out the agreed basis for transfer of pension & other employee benefits, if any. This letter from the Vendor's actuary to the Purchaser's actuary sets out the details of the actuarial methods and assumptions agreed upon for the calculation of the liabilities, and is sometimes countersigned by the Purchaser's actuary.

The pension schedule of the Agreement will set out, often in some detail the terms agreed between the Vendor and the Purchaser. Typical sections would include:

- Definitions of terms used. For example:
  - ✓ Completion date is the date at which the sale and purchase is completed, and employees move from the Vendor to the Purchaser.
  - ✓ Transfer date is the date at which transferring members leave the Vendor's Scheme and join the Purchaser's Scheme. In this case there are two different transfer dates for the two business units being divested during the year
  - ✓ Participation period is the period between completion and transfer dates (sometimes called the interim period) where the employees transfer their employment to the Purchaser but still remain in the Vendor's Scheme for a short period for administrative or other reasons
  - ✓ Payment date is the date at which the transfer value is paid (or the outstanding balance, if earlier part payment has been made)
  - ✓ In-service employees are the employees of the entity or business sold at completion date
  - ✓ Transferring members are those members of the Vendor's Scheme who transfer on the transfer date to the Purchaser's Scheme.
  - ✓ The actuarial liabilities (and the corresponding assets in the case of a funded scheme), how these are calculated (with particular attention to the calculation of reserves for benefits that do not accrue with service, such as benefits related to potential service
  - ✓ The calculation date
  - ✓ The timing of any payment and how the liability figure is adjusted to reflect the period between calculation and payment dates. This clause will cover a number of areas: how any experience items will be dealt with (deaths, salary increases, etc.), at what rate liabilities will be rolled up (in line with an index, in line with asset performance, etc.), potentially how assets backing the liabilities will be invested during the period between calculation and payment (to minimise the asset/liability mismatch) dates, who does the calculations, who agrees them and how close those calculations need to be to one another to signify that agreement has been reached,

what happens in the event of a dispute, whether cash or assets are to be transferred etc..

Also usually, to protect the Purchaser from under payment by the Trustees, the Agreement usually includes a “shortfall clause” at the expense of the Vendor. This will say that if the Trustees pay less than the agreed transfer value, to the Trustees of the Purchaser’s Scheme, the Vendor will pay the shortfall amount.

d) Practical aspects that need to be considered for actual transfer:

The actuary needs to be aware of the commercial aspects of the deal as for the Vendor and the Purchaser; pensions are one of many issues under consideration. Both are interested in achieving a satisfactory overall deal and will balance positive and negative outcomes on the detailed issues against their overall negotiation position for the transaction. They may well be prepared to forgo an advantage in one particular aspect of the deal in return for a benefit elsewhere. This understanding would enable the actuary to frame the advice in a pragmatic manner.

The Purchaser will be keen (subject to other deal considerations) for the transfer value to be as large as possible to support the benefits to be granted in its scheme and to reduce the risk of having to part fund prior service for the employees transferring into its scheme. For instance if the better than Act provisions for Gratuity transfer as it is, the purchaser would be keen to use a prudent salary escalation assumption for the purpose of estimating the transfer value while the vendor may insist using the current accounting basis for this purpose.

Where some benefits are not continued, then there may be a negotiation on the manner in which such benefits are compensated (form, manner, periodicity etc...) to ensure “overall no less favorable” terms.

Negotiation capability and balance of power in the transaction would determine the outcome in such cases.

The negotiations are often conducted over a very short timescale in some secrecy with the result that it may not be possible to carry out detailed investigations into all the pension aspects which might otherwise be desirable. Hence a pragmatic approach is critical to the success of the negotiation. For example, if the defined benefit pension scheme was to transfer, then clauses that indemnify and provide a fall back option against unexpected liability implications for the purchaser on transfer may be incorporated in the sale and purchase agreement.

During the negotiation, the purchaser would be keen to ensure that the deal terms are both sustainable for the business being acquired. Further, if the employee benefits of transferring employees are significantly different to the employee benefits the Purchaser’s existing employees receive then the purchaser would like the reasons for the difference are explainable and will not give rise to claims for similar treatment or risk of poor employee relations or other disruption. For example, if the purchaser’s scheme allows for a lower accumulation ceiling for leave, then it may be difficult to substantiate a 180 day cap for the transferring employees.

Likewise, the Purchaser will be conscious of administrative aspects such as any additional complexities introduced into its scheme due to the admission of the new members and the practical aspects of explaining the terms to the employees and finalising the transfer. For instance, if a suitable insurance arrangement is not feasible to provide post-retirement medical benefit cover after transfer, then the purchaser would be exposed to the administrative hassle of setting up a process and governance for such pay-outs in the future.

In few cases, the Vendor's Trustees will need to consider the impact of the transaction on the sponsor's covenant and the scheme's investment and funding position. The Vendor's Trustees will also consider whether the transaction triggers special terms in the Trust Deed and Rules which may give them additional powers. **[30]**

[40 Marks]

<u>Solution 2:</u>

(i) Possible sources of deficit

<u>Actual Experience vs assumptions used in funding plan,</u>

1. The actual investment performance (of 9.8%) over the 10 years is lower than that assumed (10.5%) in the funding plan.
2. Actual salary escalation of members higher than that assumed but there will be an offset in the deficit as contribution expressed as a % of salary will also increase. The salary increased at the rate of 7% as against the assumption of 5% (50000 x (1.07)^10 =98358 as against 50000x(1.05)^10= 81445)
3. The Scheme offers no benefits to the members who withdraw from the scheme due to resignation & other reasons. There will be release of funds when members withdrew from the scheme. Deficit arises when the actual withdrawal experience is less than that assumed in the funding plan.-But we have no information on the withdrawal experience of the scheme.
4. The profile of the officers entering into the" pension club "significantly different from that assumed. For example, the officers enter into the eligible zone at a higher age than that assumed; salary profile of these eligible officers is higher than that assumed;
5. contribution paid into the scheme is lower than that recommended – No contribution paid into the Scheme for the last two years

<u>Strengthening of funding Basis</u>

1. Lower discount rate & higher salary escalation used in the valuation will cause deficit. More importantly, the gap between (d-s) has narrowed down to 3% -this will add to deficit.
2. The cost of purchasing pension of Re.1/- per month has increased from Rs.100 to Rs.110/- There is thus strengthening of post retirement assumptions used in the valuation.
3. The deficit is further exacerbated as the size of membership increases from 15 to 120

<u>Other sources</u>

1. The interest on existing deficit;
2. Change of funding or valuation method, assumptions will also cause deficit.
3. Small deficits may arise due to random fluctuations.

[9]

(ii) Conflict of Interest

Finance director is responsible for controlling the escalating cost and finding out ways of reducing the deficit. He may also be in possession of certain (confidential) information about the financial health of the company.

Professional Standards require that the Company is entitled to assume that the advice given by the FD is unaffected by the interest of the FD as a beneficiary of the scheme.

But the advice given by the FD in reducing the deficit is likely to be impacted by his role as a beneficiary of the scheme, as his advice may result in reduction of his own benefits. **[4]**

(iii) Issues to be considered in the valuation of a closed scheme:

Changes in Profile of the group

Following the decision to close the scheme to the new entrants, the scheme will become increasingly matured as the age of the members increases as they approach retirement.

Benefits prior to vesting which are real will increase rapidly as the pensionable salary of the members increases as they move further in the senior level;

Higher proportion of members will be approaching retirement age; the outstanding term of the liabilities will decrease. There will be a change in the distribution of members and the group will be increasingly dominated by Pensioners.

The cost of funding the salary related pension benefit will increase sharply on short term basis as more and more active members approach retirement.

But over the period, as the number of pensioners increase, there will be a change in the nature of benefits, as pension which are in monetary terms will be the main benefit outgo.

Ultimately the pension in payment will decrease over the period depending on the mortality experience of the pensioners; and the pension fund will be approaching towards a definite end.

Funding Strategy

The valuation should take into account the need for change in funding strategy to be adopted by the Company following the change in profile of the group. Further funding strategy needs to be reviewed more frequently.

As the cost of funding increases due to the ageing of the membership, the contribution requirements of the company increase. If the size of the pension cost is significant, then the decision to close will have an impact on the profits of the company and its financial results.

This risk may be exacerbated if the company needs to address the issue of managing the deficit immediately as it will be having less time to manage the deficit..

The Actuarial Valuation should suggest a suitable funding strategy to achieve stability in Contributions rates, eg moving to Attained Age method. This depends upon the financial ability of the Company and the balance between the objective of Stability of the Contribution & security of the member’s benefits.

Investment Strategy

Currently 60% of the assets are in equities; they provide a good match for real liabilities of the active members. As the Scheme matures, and the benefits transform to pension payments, the Company may need to consider moving the Equities to Bonds over a period of time. The changes in the profile of members following the closure will help the Actuary to assess the suitability of the investment strategy.

The Company is unlikely to have high risk tolerance to remain invested in equities as the chances of deficit following closure of the scheme will increase.

The Company may look for investments that may provide a stable returns similar to the one achieved by the present portfolio without diluting the security.

The Company has 39% of the investments in Bonds that will be sufficient to match initial pensions in payment. The bonds are also likely to match the pension corpus with the market cost of the pension as reflected in the annuity rates quoted by the insurance companies.

The company may wish to avoid the risk of selling Equities at an inopportune time when markets are low.

The Company should check the quality of Assets especially the rating of corporate Bonds; any default in the coupon payment on the Bonds issued by the Company will be viewed unfavourably by the members.

A cash flow approach to match the asset proceeds with the benefit outgo is likely to provide a guidance on the strategy to be adopted.

The Valuation should take into account these changes in the investment strategy

Taking insurance

The Company may use the insurance products available to manage the funding of pension benefits. This option will remove the risk and the expenses associated with the management of funds internally.

The Company may also need to reconsider its plan to pay pensions directly to the future retiring members and may wish to purchase annuities to secure pension benefits.

The decision to purchase annuities will accelerate the winding of the Scheme but this option will be more expensive as the annuity rates will have loading for the expenses & profits of the insurer.

Valuation:

General : Should take into account closing of scheme; needs to consider any change in valuation method; valuation basis needs to be prudent; due to small size , cash flow approach for each individual will be more suitable;

Discount rate: should take into account the changes in the investment strategy and the likely lower investment return; allowance to be given for reinvestment risk & default in assets. The Actuary should look into the credit ratings of the investments held while giving allowance for credit spread. He should review the margins in the discount rate for the possible adverse deviations, for its adequacy.

Salary escalation: The views of the Company on the possible increases in the basic pay component needs to be obtained while deciding the basis. The Actuary may look into the reports on recent trends in the salary escalation in the Private Sector.

Longevity of pensioners: should reflect the general improvement in longevity and the expected good health of the retiring executives, particularly if company decides to pay pension itself.

Decrement prior to retirement: may be ignored

Should consider charging expenses for administration of the scheme from the fund.

The approach should be prudent overall; but not very cautious. **[10]**

(iv)

a) Disadvantages of offering DC scheme to members:

1. No flexibility in timing the contributions; rigid contribution schedule
2. On short term basis, contributions may increase depending on the contribution rate fixed
3. Company has to contribute for DC members as well as to fund DB scheme
4. Resources are not targeted towards those approaching retirement
5. In DC Schemes employers will usually have less control over the funding arrangement & investment
6. Vulnerable to complaints from members if they are not getting targeted pension
7. DC & DB scheme simultaneous add to complexity in Administration, Accounting of Pension cost
8. Increase in Administrative Expenses; needs to maintain individual accounts, payment of Professional fee
9. Need to educate members- additional disclosures

[4]

b) How to arrive at a suitable contribution rate?

The proposed Contribution Rates Should take into account the primary objective of the employer – viz to control the cost. It should also attract and retain the best talents for the company. The rates should reflect the cost of funding the targeted pension.

<u>Can choose the contribution rate of 32% of pensionable pay:</u>

Original rate under DB scheme – members can easily understand it- but basis used might have gone out of date – economic conditions might have changed significantly – demographic assumptions also require a review – unlikely to represent the underlying cost.

<u>May choose the latest recommended rate of the Scheme Actuary 46%:</u>

It is likely to reflect the ongoing cost as it is derived taking into account the recent experience. It also considers the most recent performance of the underlying assets & the cost of providing pensions on retirement. It is therefore likely to reflect the market conditions.

But the recommended rate takes into account underlying deficit of the Scheme. Further an element of prudence would have been built into the basis. Therefore this rate is likely to overstate the cost of providing pension.

Derive the expected cost of providing pension independently:

Target pension will be 10% of the pensionable pay payable from NRA 60 –needs to decide on the expected service over which it is to be accrued – can choose assumed entry age 40 – consistent with the existing scheme – alternatively they can choose to fund from assumed younger age – rate of contribution will be less – but members unlikely to reach the target pension if they join the scheme at a higher age than that assumed.

Basis:

Basis should be the best estimate to reflect the expected experience; no margins should be added.

Investment return should reflect the expected return available from investments. It depends on the investment strategy & the expected performance of assets chosen. In case the Company decides to use the investment vehicles (e g NPS, funded Schemes of Insurance Companies etc.) to fund the DC, the recent performance of the funds can serve as guide to determine the investment return.

Salary increase –The industrial data may give an indication of the trends in the Salary increase which could be used to derive the Pensionable Pay increases. This could be modified after discussion with the employer on the pensionable pay, to reflect the expected experience.

Pre-retirement withdrawal decrement – allowance may be given based company scheme experience or industry data – but it is difficult to estimate future trends. It is important not to overstate the decrement as it may result in contribution rates not sufficient to reach the target benefits.

Death benefits are insured and there will be no strain on the funding arrangement – hence pre- retirement mortality can be ignored.

Post retirement assumptions:

Should be based on the expected annuity rates. Yield on Long Term Government Bonds provide a guide for developing the base. Allowance for possible lower reinvestment return to be given.

We need to make assumption on the longevity of the pensioners and the likely loading of the expenses of insurer.

The rate of contribution will be the

- Expected value of pension benefits payable from NRA spread over expected working span of the model member joining at an assumed entry age.
- Contribution rate can be expressed as a flat rate or age related or service related.
- Can be expressed as a % of pensionable pay or total salary depending on Company objectives.

Needs to demonstrate on the

- Variability of the cost for different scenarios, e g Equity crash, Economic slowdown
- Assess the probability of reaching the target pension under normal circumstances

Needs to compare the contribution rates derived with the rates offered in the Industry to check its attractiveness.

Need to assess the impact on the CTC

Generous death Benefits could be added to the scheme design to make it more attractive. The premium rates for the death cover are likely to be small and it can be met by the employer independent of the scheme. **[10]**

(v)

a) Why option offered to existing members:

Reduction of cost under DB scheme – Cost of accrual increases under the closed scheme with the increasing age of the members – The cost may be reduced when a member moves out of DB scheme and joins the DC Scheme.

The Scheme has a deficit of Rs. 9 Crores and the Company may want to control and remove the deficit.

It may wish to take release of the Prudence built in funding – Offering a transfer value determined on Best Estimate basis will result in release of margin.

May want to accelerate wind up of the DB Scheme which would protect the Company from future uncertainties and may reduce the pension strain in the company's financial results.

There may be a demand from the members for this type of offer, particularly the younger ones. **[3]**

b) Why some DB members prefer DC scheme?

Security of the Pension benefit – There will be a separate trust fund in case of DC scheme whereas the company has not established a separate Trust for DB scheme. The Dc scheme, therefore provides more security.

Volatility of Equities, Default Risks in corporate Bonds–Self investment in company's own bonds offers poor security of the pension benefits in case of DB scheme. In case of DC scheme the investment choice lies generally with the members.

Payment of Pension in case of DB scheme is dependent on the size of earmarked fund and the continued profitability of the employer and there is a risk that pension can be stopped by employer.

Changes in funding strategy, investment decisions in case of DB scheme may also impact the pension in payment.

Purchase of annuity from insurance companies provides more security from the point of view of members. In case of DC scheme pension is purchased necessarily from insurers whereas in

case of DB scheme company may pay pension from its end (though in India annuities have to be purchased from insurers unless specific approval has been sought).

Contribution rates offered under DC Scheme may be more attractive.

In DC Scheme the employer has to make annual contribution into the credit of members' account. This is more attractive as compared to the DB arrangement where the employer has not paid any contributions over the last two years.

Some Members are not likely to continue with the employer –for them transfer value credit into the DC scheme may be more easily portable unless there is a condition for serving till NRA for vesting of benefits. Whereas in case of DB scheme no benefit will be available if a member does not continue till NRD.

Some may be Risk loving –and for some members there may be no need for pension. **[5]**

c) Benefit illustration:

The Benefit Illustration (BI)

- Should be objective – should take into account the needs of the members
- Should help the members to take informed decisions – on the option of moving from Defined Benefit to Defined Contribution arrangement
- Should indicate the likely Pension Corpus accumulations and the Pension benefits targeted in the benefit illustrations & the likely variability of these targeted benefits
- Should indicate the assumptions used such as investment return, salary escalation & the pension cost and the variability of the assumptions over the future period
- Should Illustrate the variability of the accumulations and pension for different assumptions (For example with one high interest rate, say 9% p.a. Scenario & another with low interest rate, 6% p. a.)
- Should illustrate the variability of monthly pensions due to the changes in the annuity rates offered by the insurers

The lump sum contribution due to the transfer value should be projected separately in the illustration.

The Projected Pension should be expressed as a percentage of Final Pensionable Pay and should be compared with the Pension of Defined Benefit Final Salary Scheme.

The BI should also provide appropriate Risk Warnings, such as:

1. Inform that the benefits illustrated for an average member using average assumptions and the experience for any individual member is bound to differ
2. Alternatively member specific BIs may need to be provided
3. Specify that the risks related to investments and other experience are to be borne by the members under DC arrangements
4. Specify clearly that the benefits are not guaranteed and in real circumstances these benefits are bound to differ from the projected benefits.
5. Indicate the need for monitoring from time to time

There may be Regulatory and/or professional guidelines on the way the Benefit illustrations are to be prepared. Though currently there are no such guidelines. **[8]**

d) Why pension lower?:

1) In DB scheme pension is fixed as 10%_of pensionable Pay; expressed as a % of salary; funding is done over the period of payment of benefits to secure the benefits –funding strategy varied to reflect the changing characteristics to secure the pension-The contribution is varied to reflect the investment & other scheme experience risk which is met by the employer.

In DC scheme, contributions are fixed to reflect the expected cost of providing the pension based on assumptions which are generally set on realistic basis. The Contribution rate once determined will remain largely unchanged. The investment & other risks during the funding period are borne individually by the members. The accumulations at NRA and the annuity rates available at that time will determine the pension at retirement. There will be no link between member's final salary & the pension purchased under DC scheme.

2) When the member has moved from Defined benefit to DC scheme, the transfer value will be given in monetary terms, and the Salary link is broken. Though the transfer value might have considered future salary increases, the actual salary rises might be different from the salary growth assumed in calculating the transfer value.

3) The basis used in deriving and fixing Contribution Rate and/or to determine the Transfer Value might be optimistic – might be biased towards the objective of undermining the pension cost. E. g. high investment Return during the deferment period and low annuity cost.

4) Contribution rates might be derived for an average member based on certain assumptions. The Individual experience is bound to differ as DC's are individually funded and there is no cross subsidy.

5) The cost of providing annuities over the period is gradually increasing as the guaranteed benefits are to be given over an increasingly longer period of time due to improving mortality. Deep market is not available in India to mitigate the investment related risk.

6) Introduction of Tax on the pension Corpus (for example Service Tax) could reduce the pension benefits.

7) The member will be having several options while receiving annuities. For example, if he chooses the option "Life Pension with Return of Capital on death" the annuity instalment is likely to be low as compared to "life" pension targeted.

[9]
[60 Marks]

****