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Regulation and supervision of occupational
pension funds and gratuity funds

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1 INTRODUCTION

Much of the debate on pension reform in India has focused on the central and state governments and the informal sector. The government announced a contributory scheme for new entrants to central government starting January 1, 2004. The government also has set up a Pension Fund Regulatory & Development Authority (PFRDA) to regulate the new pension scheme. The debate and developments on pensions however have largely ignored the occupational pensions segment in India. Occupational pensions in India can be broadly divided into mandatory provisions (those that fall under an Act), and voluntary provisions (those that are provided by the employer or more specifically do not fall under an Act). Figure 1 gives an overview of occupational schemes in India. A large part of the mandatory occupational schemes come under the umbrella of the Employees Provident Fund Organisation (EPFO) run by the Ministry of Labour. However, regulation and supervision of the gratuity (mandatory provision) and superannuation trusts (voluntary provision) is currently left to self-regulation through auditors and actuaries. While self-regulation is useful, it needs to be within some legislative framework.

For the salaried class, retirement benefits form a very important part of their savings for old age income security. In 2001-02, provident and pension funds accounted for 19% of the gross financial savings of the household sector in India.¹ Though there has not been much scandal in the public domain in India over the mismanagement of these funds, there are questions about the sustainability of many of these funds. Further the members of occupational retirement benefit schemes like pension and gratuity have expectations that the benefits would accrue with service and those would be protected and paid when due. Effective supervision and regulation alone will ensure public confidence in the system as well as safety of the employees' savings.

This paper provides an overview of the occupational retirement benefit plans in India. It deals with the issue of regulation of funds outside the purview of the EPFO and preempts a role for the PFRDA to regulate these funds. Section 2 talks about pension plans under the EPF&MP Act. Section 3 deals with the gratuity provisions in India. Section 4 talks about superannuation schemes in India. Section 5 describes the regulations currently affecting the plans outside of the EPFO. Section 6 deals with the problems in the existing regulatory structure. Section 7 outlines a framework for regulation of occupational pensions in India. Section 8 concludes.

¹IRDA Annual report

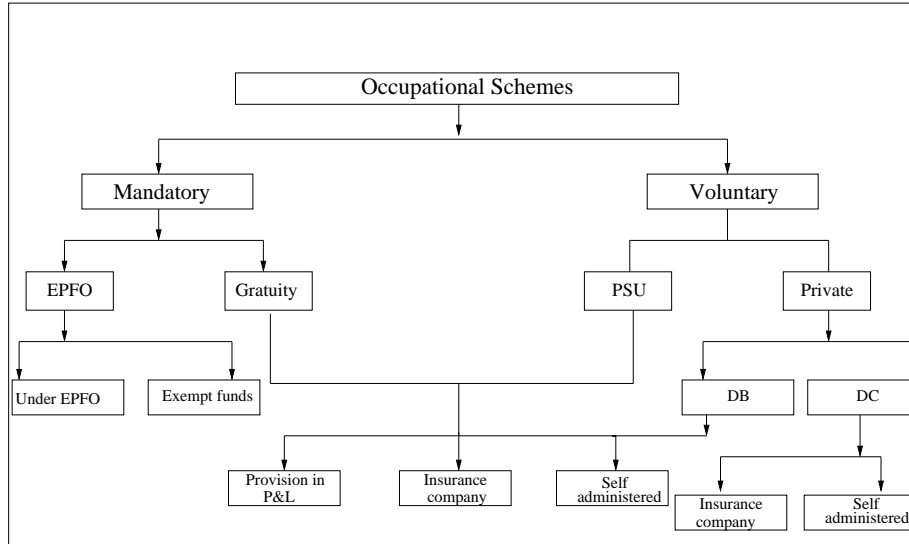


Figure 1: Overview of occupational pensions in India

2 MANDATORY OCCUPATIONAL SCHEMES UNDER THE EPF&MP ACT

A large fraction of the occupational retirement benefit schemes in India are governed by the *Employees Provident Funds and Miscellaneous Provisions Act, 1952* (EPF&MP). The Act extends to the whole of India except the state of Jammu and Kashmir. The EPF&MP Act, 1952 is applicable to

- every establishment which is engaged in one or more of the specified 177 industries;
- employing 20 or more persons; and
- employees drawing salary up to Rs.6500/- p.m.

Once an establishment/employee is covered under the EPF and MP Act, 1952, it continues to be covered under this Act even if any of the conditions mentioned above do not apply to the establishment/employee at a later date.

2.1 Schemes under the EPF&MP Act

The EPF & MP Act, 1952 requires the provision of three benefits

1. Provident fund, called the Employee Provident Fund (EPF)
2. Defined benefit pension, called the Employees Pension Scheme (EPS)
3. Insurance scheme, called the Employees Deposit Linked Insurance Scheme (EDLI)

2.1.1 Employees Provident Fund (EPF)

The EPF is an individual account defined contribution system. Individuals contribute to their account through their working life and take the benefit as a lump-sum at the time of retirement. Employees in establishments in 172 of the 177 specified industries have to contribute at the rate of 12% of salary² and establishments in five industries viz. Jute, Beedi, Coir, Brick and Guar Gum and certain sick/financially weak companies as specified, have to contribute at the rate of 10% of a maximum salary of Rs.6500 per month; A matching contribution of 12% or 10% as applicable is made by the employer. The EPF has several provisions for premature withdrawal of balances which are exercised by most of the members, leading to small balances at the time of retirement and consequently limited old age income security.

Even though the EPF&MP Act, 1952 requires contributions only in respect of covered employees and up to salary of Rs.6500, it is a common practice amongst employers to extend the provident fund benefits to all employees and contribute the provident fund contributions on employees' full salary without capping the same at the maximum salary ceiling of Rs.6500 p.m.

2.1.2 Employees Pension Scheme (EPS)

The EPS is a defined benefit scheme. It came into effect from November 16, 1995 replacing the Family Pension Scheme 1971. All the assets and liabilities of the erstwhile Family Pension Fund were transferred and merged with the EPS 95 Fund. The EPS 95 is financed by diverting 8.33% of salary upto a maximum of Rs.6500³ from the employers contribution of 12% to the EPF;

²The Act defines salary as the basic plus the dearness allowance

³In case of covered employee earning say Rs.10000 per month, the employers share of provident fund contributions would be Rs.1200 (12% of Rs.10000). Of this only Rs.541.67 (8.33% of Rs.6500) will be diverted to the EPS. The balance along with the employees contribution is credited to the individual account of the employee under the EPF

the balance contribution being credited to EPF. The central government contribution of 1.16% of to the erstwhile Family Pension Scheme is diverted to EPS 95.

EPS 95 is mandatory to all those who were members of erstwhile Family Pension Fund 1971 on 16 November 1995 as well as those employees who are subsequently covered under the EPF & Miscellaneous Act, 1952.

The EPS 95 provides the benefits only after the member has completed a minimum of 20 years of service and attained 58 years of age.⁴ The benefits are as follows

1. To the member
 - (a) pension for life on superannuation/retirement and invalidation;
 - (b) facility for capital return if opted for;
 - (c) commutation of pension upto one-third of pension amount. The commutation is done on the basis of a table prepared by the EPFO
2. To the members family upon death of the member
 - (a) pension to spouse for life or till remarriage;
 - (b) pension to two children at a time upto age 25 with spouse pension

Member's pension is calculated at the rate of 1/70th of pensionable salary for each year of service subject to maximum of 50%. Pensionable salary is the salary drawn during the contributory period of service in the span of 12 months preceding the date of exit from the membership of EPF. The pensionable salary is capped at Rs.6500.

2.1.3 Employees Deposit Linked Insurance Scheme (EDLI)

The EDLI offers a lump sum benefit on the death of the employee based on the provident fund balance to the credit of the deceased employee at the time of his death. The EDLI came into force from August, 1, 1976. While the subscribers to PF are not required to contribute to the Insurance Fund, the employers are required to pay contributions to the Insurance Fund at the rate of 0.5% of pay i.e. basic wages, dearness allowance including cash value of food concession and retaining allowance, if any. On the death of the

⁴In case an employee leaves without putting in 10 years of eligible service he will be entitled to a withdrawal benefit which is essentially a return of contribution with some interest at the date of exit. In case he completes more than 10 years of service but less than not 20 years then he is entitled to a short service pension. On completion of 20 years or more he is entitled to a full pension.

subscriber, the persons entitled to receive the provident fund accumulations will be paid an additional amount equal to the average balance in the provident fund account of the deceased during the preceding 12 months wherever the average provident fund balance is less than Rs.35000. In case the average balance in provident fund exceeds Rs.35000, the amount payable is Rs.35000 plus 25% of the average balance in excess of Rs.35000 subject to ceiling of Rs.60000.

2.2 Administration of the schemes

An establishment which is covered under the EPF & MP Act, 1952 can either join the Trustee administered Employee Provident Fund Organisation (EPFO) controlled Central Provident Fund or alternatively seek an exemption from the Regional Provident Fund Commissioner by setting up its own self administered fund.

An employer needs to separately seek exemption from EPFO for not participating in EPF as well as EPS. Those who do not seek exemption from EPF also do not seek exemption from EPS. Those who seek exemption from EPF may or may not seek exemption from EPS. A company can contract out of the EPS if it sets up a pension scheme which provides benefits equal to or higher than that offered by the EPS. However, the EPFO has been very stringent about granting exemption from EPS and so far only three employers have been granted such exemptions.

In the case of EDLI, an exemption can be granted by the Central Provident Fund Commissioner from the operation of all or any of the provision of the insurance scheme. However, the exemption is granted only if the employees of such establishments are getting the benefit of life insurance, without making any separate contribution or payment of premium. This benefit has to be more favourable to such employees than the benefits admissible under the insurance scheme. Under EDLI Scheme, 8694 establishments were granted exemption from the scheme up to 31st March 2000. Such life insurance benefits outside the EDLI Scheme are granted through the group life insurance schemes offered by life insurers approved by the Central PF Commissioner.

The data on the number of covered establishments as well as the break up between exempted and non-exempted establishments as of March 31, 2003 is listed in Table 1, Table 2 and Table 3.

	Exempt	Un-exempt	Total
No of covered establishments	2564	341944	344508

Table 1: Covered establishments in the EPFO

	Exempt	Un-exempt	Total
Employees provident fund	37.51	357.47	394.98
Net increase during the year	-1.45	122.25	120.80
Pension fund			274.87

Table 2: Members in the EPFO (in lakhs)

	Exempt	Un-exempt	Total
EPF			
During the year	3859.37	7528.77	11388.14
Progressive	49882.54	58627.60	108510.14
	Members share	Government share	Total
EPS			
During the year	4387.84	400.00	4787.84
Progressive	28070.15	5143.02	33213.17
	Employer's share	Government share	Total
EDLI			
During the year	158.62	0.00	158.62
Progressive	1478.43	0.00	1478.43

Table 3: Contributions received in the EPFO (in Rs.crore)

2.3 Investment policy

The EPFO has laid down guidelines for investment of provident fund money. Along with the investment guidelines, the EPFO also prescribes the minimum interest rate that is to be credited to the members account. As of 2002-03 this rate of interest was 9.50% on monthly running balances. The prescribed investment pattern is shown in Table 4

The investment pattern of the exempted funds is as per the pattern of investments prescribed under the Income Tax Act, 1961 and is the same as that prescribed for the EPF.

2.4 Taxation policy

The employers contribution at the rates specified under the EPF & MP Act, 1952 to the EPFO managed Central Provident Fund or an exempt income tax approved fund are tax deductible in employers tax assessment. The contributions made by the employer for the benefit of an employee to the EPFO managed Central Provident Fund or an exempt income tax approved fund is not treated as a perquisite in the tax assessment of employees and hence not taxed. The contributions made by the employees to their Provident Fund account are eligible for tax rebate as per Section 88 of the Income Tax Act, 1961. The investment income and capital gains that accrue from investments made by the trust fund are free of tax.

In case an employee leaves the company before putting at least five years of service any lumpsum amount withdrawn by him is taxable. The Section 88 benefit in respect of his own contributions is withdrawn in this case. The employers contribution is treated as income in his hands and taxed accordingly and the investment income credited is also be taxed. In case the employee has put in more than five years of service the full lumpsum is tax free.

2.5 Accounting policy

The actual contributions made to the EPFO managed Central Provident Fund or exempt income tax approved funds are expensed as the charge for the year in the profit & loss account of the company accounts.

Table 4: Investment pattern of the EPFO

Investment pattern	% to be invested
i) Central government securities as defined in Section 2 of the Public Debt Act, 1944 and/or units of mutual funds which have been set up as dedicated funds for investment in g-secs and which have been approved by SEBI	25%
ii) a) government securities as defined under section 2 of the Public Debt Act 1944 created and issued by the State government and/or units of such mutual funds which have been set up as dedicated funds for investment in govt. securities and which have been approved by the SEBI and or b) any other negotiable securities the principal whereof and interest whereon is fully and unconditionally guaranteed by the central government or any state government except those covered under iii)(a) below	15%
iii) a) Bonds/Securities of Public Financial Institutions as specified under Section 4(1) of the Companies Act, "Public Sector Companies" as defined in Section 2(36-A) of the Income Tax act, 1961, including public sector banks and/or Short duration (less than a year) Term Deposit Receipt (TDR) issued by public sector banks	30%
iv) To be invested in any of the above three categories as decided by the Board of Trustees	30%
v) The Trusts, subject to their assessment of the risk return prospects, may invest up to 1/3rd out of (iv) above, in private sector bonds/securities which have an investment grade rating from at least two credit rating agencies	

Source: Ministry of Labour, 2003

3 MANDATORY GRATUITY SCHEME

Gratuity is primarily a final salary related lumpsum benefit given to employees at the time of retirement or exit as an acknowledgement of their services. In India, gratuity is institutionalised under the Payment of Gratuity Act, 1972.

The Payment of Gratuity Act, 1972 applies to

- every factory, mine, oilfield, plantation, port and railway company;
- every shop or establishment⁵ within the meaning of a law for the time being in force in relation to shops and establishments in a State, in which ten or more persons are employed, or were employed on any day of the preceding twelve months; and
- such other establishments or class of establishments, in which ten or more employees are employed, or were employed, on any day of the preceding twelve months, as the Central Government may, by notification, specify in this behalf.

Like the EPF Act, this Act does not apply to the state of Jammu and Kashmir.

The mandatory minimum scale of gratuity payable to employees on leaving the services of the employer is calculated on the basis of 15 days salary⁶ for each year of service or part thereof (where a months salary is determined on the basis of 26 days in a month) subject to a maximum gratuity of Rs.3,50,000. To be eligible for this gratuity, an employee has to put in at least five years of service.

Very often, employers offer a gratuity at a rate higher than that mandated by the Act. This is used more as a retention tool and to reward the long standing staff in the company. In this case, at the time of employee leaving the services of the employer, two gratuity calculations have to be carried out. One as per the Payment of Gratuity Act, 1972 and the other as per the scales prescribed under the employers gratuity scheme. The employee has to be paid gratuity which is greater of the two.

Gratuity can be withheld under certain conditions, such as disciplinary proceedings against the employee or the abolition of the specific post.

⁵An establishment is defined in Section 2(8) of the Bombay Shop & Establishments Act and includes a 'commercial establishment as defined in Section 2(4) of the said Act.

⁶Salary for the purposes of the Act is taken as basic salary plus dearness allowance

	Type of investment	% invested
i)	Government securities being	Not less than 25%
ii)	Government Securities or other approved Securities (in i) above)	Not less than 50%
iii)	Approved Investments	
a)	Infrastructure & Social Sector	Not less than 15%
b)	Others Governed by Exposure/Prudential norms	Not less than 20%
iv)	Other than in Approved Investments to be governed by Exposure / Prudential norms	Not exceeding 15%

Table 5: Investment pattern of non-linked products of life insurance firms

3.1 Administration of gratuity

Gratuity is an employer driven benefit and the full cost of it is borne by the employer. The employers have essentially two choices

1. Leave the gratuity liability unfunded. In this case a provision is held in the books of accounts of the company.
2. Fund the gratuity liability. This can be done using one of the two following options
 - i. Trustee managed self administered trust fund.
 - ii. Trustees entering into an arrangement with Life Insurer for management of trust fund assets.

3.2 Investment policy

In the event that the trustees set up a trust fund, they have to follow the investment pattern of the EPF. If the trustees choose a scheme offered by life insurers, they can choose between non-linked and linked funding options offered by life insurers. The investment pattern for the non-linked products offered by life insurers is as per the pattern of investments prescribed for life insurance funds specified under the IRDA (Investment) Regulations, 2000 and the same is set-out in Table 5.

For linked products offered by life insurers, the investment pattern would be as per the investment objectives of the fund, the only restriction being that

not more than 25% of the assets can be invested in 'other than approved investment' category as specified in the IRDA regulations.

The rate of interest credited by the LIC on its gratuity scheme has been between 8.25% and 9.50% for 2002-03.⁷

3.3 Taxation policy

The taxation policy with respect to gratuity extends to employees at the time they avail of the benefits as well as employers, at the time of contributions as well as investment returns.

3.3.1 Tax policy for the employees

If an employee is paid gratuity under the Act, then the lumpsum is free of tax. However, if an employee is paid a gratuity under a scheme established by the employer (i.e. a scale of gratuity more liberal than under the Act), then the tax free amount of gratuity is as defined by a formula in the Income Tax Act and not the gratuity amount as per the Act. The contribution made by the employer to an income tax approved fund is not treated as a perquisite in the tax assessment of employees and hence not taxed.

3.3.2 Tax policy for the employers

The employers contribution, up to 8.33% of salary, to an income tax approved fund is tax deductible in employers tax assessment. In case of unfunded schemes, amount expensed through the profit & loss account for the purpose of creating the provision is not tax allowed at the time of creating the provision. However, at the time of making payment to the employee, such amount when debited to the provision account will be tax deductible. The investment income and capital gain that accrue from investments made from the trust fund are free of tax.

3.4 Accounting policy

Every employer is required to account the cost of accrual of benefits of gratuity as per the Accounting Standard No.15 (AS15) issued by the Institute

⁷Source:LIC

of Chartered Accountants of India. AS15 requires liability to be computed on an actuarial basis and this can be done by an independent actuary in case of a trustee managed scheme or as worked out and certified by the insurer in case of life insurer managed schemes. The common practice amongst employers in accounting of gratuity cost as per AS15 is to get an actuarial valuation of the gratuity liability carried out at the end of each financial year. The liability so ascertained is compared with the assets (in case of funded arrangement) and provisions (in case of unfunded arrangement). The difference between the liability and asset/provision is taken as the charge for the year which is expensed off in the profit and loss account of the employer. In carrying out the actuarial valuation of gratuity schemes, for the purpose of reporting under AS15, the valuing actuary has to take into account the professional guidance notes (GNs) issued by the Actuarial Society of India. The professional guidance notes deal with the minimum basis on which an actuary can certify the gratuity liabilities as well as the minimum disclosure requirements in his actuarial certificate / report.

4 SUPERANNUATION SCHEME

Superannuation schemes in India are primarily voluntary schemes constituted by the employer. There are three main kinds of schemes

1. those for government employees.
2. those for public sector.
3. those for private sector.

The pension for government employees is a part of the *Directive Principles of State Policy* and not part of any *Act or statute* and therefore come as a part of the voluntary superannuation scheme. Central government employees who joined service prior to January 1, 2004 are entitled to a defined benefit, final salary index linked pension. The pension benefit computation is done with respect to the mean wage over the last 10 months of employment. The benefit rate is computed as $1/66$ for each year of service, subject to a cap of a 50%. Employees entering service post January 1, 2004 are entitled to a defined contribution system, wherein the employees and employer contribute at a rate of 10%.

All state government employees get a final salary indexed linked pension under a defined benefit scheme similar to the one available to the central government employees who have joined service prior to January 1, 2004.

Employees of public sector banks and public sector insurance company employees get a final salary index linked pension under a defined benefit scheme (similar to the one offered to the central government employees prior to January 1, 2004) in lieu of the employer's contribution to provident fund.

As far as private sector is concerned, both defined benefits as well as defined contribution schemes are prevalent. However, in line with the international trend as well as increasing cost of annuities in India due to falling interest rates and rising longevity, more and more defined benefit schemes are getting converted into defined contribution schemes. Furthermore, new schemes set-up by employers are invariably defined contribution schemes.

4.1 Administration of the schemes

In India, it is very common for the employers to bear the full cost of providing superannuation benefits to their employees. There are very few schemes in existence which are contributory for the employees. The liability of the central government on its DB pension scheme, is totally unfunded and the pension when due is paid from the current revenues. The superannuation schemes of public sector companies, which offer a defined benefit pension are usually funded on an actuarial basis. The superannuation liability in case of defined benefit schemes amongst private sector companies is either unfunded in which case an accounting provision is held in the books of accounts of the company or the liability is funded. In case of funded schemes, the options available are the same as those available for funding of gratuity namely

- i. Trustee managed self administered trust fund.
- ii. Trustees entering into an arrangement with Life Insurer for management of trust fund assets.

The superannuation liability in case of defined contribution schemes is always fully funded unless the contributions are in arrears.

All funds are required to buy an annuity from a life insurance company at the time of retirement of the employee. There are however some superannuation funds, maybe four or five in number now, which are approved under section 58-N of the Income Tax, 1922 and which were exempted from the purview of Life Insurance (Emergency Provisions) Act, 1956, when life insurance business in India was nationalised in 1956. These funds are not required to buy life annuities from a life insurer and can pay the pension from the fund. When the public sector bank employee pension fund was set up in mid-nineties, this fund was granted exemption from the provisions of Rule 89 of

	Type of investment	% invested
i)	Government securities being	Not less than 25%
ii)	Government Securities or other approved Securities (in i) above)	Not less than 50%
iii)	Approved Investments	
a)	Infrastructure & Social Sector	Not less than 15%
b)	Others Governed by Exposure/Prudential norms	Not less than 20%
iv)	Other than in Approved Investments to be governed by Exposure / Prudential norms	Not exceeding 15%

Table 6: Investment pattern of non-linked products of life insurance firms

the Income Tax Rules that requires the trustees to buy annuities from life insurers. This pension fund manages the pension pay out also. These trusts therefore, not only bear the investment risk at the time of accumulation, but also bear significant re-investment and mortality risk at the time of payout, especially because the terms of pension are set up ex-ante. However, many funds are moving away from self provision of annuities. For example, the Mumbai Port Trust which used to manage retirement funds on its own transferred Rs.210 crore to the LIC.⁸

4.2 Investment policy

The investment pattern of the self administered funds is the same as that set-out for gratuity funds. The investment pattern for non-linked pension products offered by life insurers is shown in Table 6.

For linked products offered by life insurers, the investment pattern would be as per the investment objectives of the fund but in any case cannot be 100% in equities for superannuation products. Here again, investments in 'other than approved investment' category shall not exceed 25% of the investments as specified in the IRDA regulations.

⁸Source: Economic Times, April 22, 2004

The rate of interest credited by the LIC on its superannuation scheme has been between 8.25% and 9.50% for 2002-03.⁹

4.3 Tax policy

The employer's annual contribution to an income tax approved fund up to a limit of 27% of salaries less employer's contribution to the Provident Fund is tax deductible in employer's tax assessment. The contribution made by the employer to an income tax approved fund is not treated as a perquisite in the tax assessment of employees and hence not taxed. The investment income and capital gain that accrue from investments made from the trust fund are free of tax.

Employees contributions in case of a contributory scheme qualifies for tax rebate under Section 88 of the Income Tax Act, 1961. Irrespective of the financing mechanism, tax advantages available to all superannuation schemes are: Tax free commutation up to 1/3 rd of the pension (50% in case no gratuity paid) Commuted value of full pension to a widow on death of the employee is tax free Pension paid is treated as salary in the hands of the employee and taxed accordingly with benefit of standard deduction.

In case of unfunded schemes, amount expensed through the profit & loss account for the purpose of creating the provision is not tax allowed at the time of creating the provision. However, at the time of buying annuities on retirement of the employees or making pension payments to the retired employee, such amount when debited to the provision account will be tax deductible.

4.4 Accounting policy

In case of defined contribution superannuation scheme, the amount contributed by the employer to the fund is the amount that has to be expensed in the profit & loss account of the company. In case of defined benefit superannuation scheme, the issues are identical to those discussed for gratuity in Section 3.4 of this report.

⁹Source:LIC

5 TRUST FUND STRUCTURE

The defining characteristic of occupational retirement benefit funds in India is the trust structure of these funds. The legal framework of funded occupational retirement benefit schemes is largely through trust laws as provided in the Indian Trust Act, 1882. This has been done to ensure that the retirement benefits are funded independent of the employer, and employees' accrued benefits are not affected by the financial position of the employer. Employers, therefore, are encouraged to take this route by the government providing them tax incentives. It is in this context that the employer can avail of tax concessions under the IT Act 1961, if the liabilities of retirement benefits such as provident fund, gratuity and superannuation benefit are pre-funded through an external trust fund, wherein the assets of the fund are completely separate from the assets of the employers. Any future changes to the trust deed and rules have to be by way of deed of variation and the same have to be approved by the income tax authorities. The trust funds are to be set up as irrevocable trusts. A trust document is to be drawn up which governs the scheme of benefits. A set of trustees are to be appointed who will have a fiduciary role to play. These trustees are to hold, and administer the assets of the funds on behalf of the beneficiaries. The responsibilities of trustees of such a trust include:

1. Collecting contributions from employer & employees in case of contributory scheme
2. Investing the contributions of the fund as per the prescribed pattern of investment or going in for scheme offered by life insurers
3. Payment of the benefit to employees as and when they separate from the company
4. Delegating the functions such as investment management and administration to external providers if the expertise for the same is not available in house
5. Using their discretionary powers on settlement of benefits in unusual circumstances
6. Maintain proper accounts of the fund and get the same audited annually
7. Appointment of legal advisors, actuaries and auditors
8. Meet all regulatory requirements as prescribed under the Income Tax Act

Once the trust fund has been set up the trustees are expected to meet regularly to discharge their responsibilities pertaining to the trusts. An agenda for such meetings has to be prepared and circulated amongst the trustees before hand and similarly minutes of the meetings also have to be prepared and circulated.

6 PROBLEMS WITH CURRENT REGULATIONS

While the trust laws do define the obligations of the trustees, there is no regulatory and supervisory structure to oversee these funds, except that the tax authorities are envisaged to supervise that the funds adhere to the prescribed investment pattern. Further, there is no legislative framework that would ensure proper standards in administration of retirement benefit schemes.

6.1 Trust laws in India

Although, the trust structure is an effective mechanism to protect the interests of employees, in India, what is clearly lacking is the administration and the implementation aspects of trust laws. The law allows wide powers to the employer, as against the board of trustees that the interests of the employees are not always sufficiently protected. It is not uncommon to find that except for exempt provident fund where there is a statutory requirement of having 50% trustees as employee representation, there is barely any employee representation. The Trust Laws which provide for the foundation for interests, rights and duties arising in connection with the occupational retirement benefit schemes, should be reinforced by an *Occupational Retirement Benefits Regulations* framed and administered by a pension regulatory authority.

6.2 Funding and solvency

The funding of retirement benefits is the single most important factor in contributing to safeguard the retirement benefits for the employees. In case of provident fund and defined contribution pension schemes, the schemes are always fully funded, except in case of misappropriation, and where the contributions are in arrears and hence the employees benefits are fully protected. The same however, is not the case with gratuity benefits and defined benefit pension schemes in India. There are currently no regulations for the latter type of benefits to be funded, despite the tax advantages of funding benefits, nor are there any regulations on the minimum funding requirements to which the defined benefit retirement funds need to adhere to. Funding requirements are entirely self regulated and supervised by the auditors and actuaries.

6.3 Investment management and protection of assets

The funding of liabilities in case of gratuity and pension can take place either through a self administered fund or through a scheme offered by life insurer. Whilst the necessary exposure and prudential investment norms are put in place by the IRDA in case of funding through insurance company schemes, no such investment regulations exist in case of self administered funds except that the pattern of investments is prescribed by the income tax authorities for such funds. In India, tax exempted approved self administered retirement schemes have to abide by the prescribed pattern of investment laid down in the Income Tax Act, 1961. The pattern of investments for self administered schemes has in the past been fairly prescriptive in terms of asset classes and mainly comprised of government securities, public sector bonds and special deposits with the Reserve Bank of India. The revenue authorities also did not, till recently, allow active trading in securities within the prescribed pattern. As a result, there had not been any need for active fund management between different asset classes nor within the pattern laid out. The fund managers are known to stress more on implicit government guarantees on the bonds they purchase than the credit rating of the bonds. It is necessary that prudential norms of investment, similar to the norms prescribed for insurance company funds are required to be put in place for these funds also. Far more than what is required now, the trustees would be expected to apply an extra degree of care and diligence in taking investment decisions. The trust deed of the schemes should clearly envisage delegation of fund management to professional fund managers.

6.4 Taxation

Employers contribution up to 8 1/3% of salary to an approved gratuity fund is allowed for tax deductibility purposes. In case of an approved pension scheme, employers contribution up to 27% of salary less employers share of contribution to provident fund is tax allowed for tax deductibility purpose. In theory, if based on an actuarial valuation, the contribution required to fund the benefits is less than that prescribed by the limits, the employer is only entitled to tax deductibility on the amount required to fund the benefit. However, it is a common practice in India that an employer claiming tax deductibility up to the income-tax limits is allowed to do so by the income-tax authorities without verifying the amount of funding certified by the actuary. Furthermore, since the basis used for the purposes of actuarial valuation is not prescribed, and is subjective, it is possible to arrive at a funding requirement

which is close to the income tax allowable limits by choosing valuation basis to achieve this. Consequently, the income-tax authorities are losing out on tax revenue on many schemes as employers are using these limits to reduce their tax incidence. On the other hand, some employers offer a higher level of benefits which cannot be funded within the prescribed limits set-out by income tax authorities. In such cases, even though the employer would like to fully fund the benefits, due to taxation limits, he is unable to do so resulting in lower security for the employees.

7 FRAMEWORK FOR REGULATION OF OCCUPATIONAL PENSIONS IN INDIA

The primary purpose of the occupational retirement benefit regulations would be to create a frame-work for regulation and supervision of these schemes by laying down principles and general rules governing these benefits. The legislation for this purpose generally gets divided into two parts, viz the principal legislation or frame-work Act, i.e. Act passed by the parliament which lays down the basic principles, and subordinate legislation, i.e. the rules framed by the Central Government regarding policy matters and regulations framed by the regulatory authority in terms of the provisions of the principal legislation covering various details of regulation and supervision. It is presumed here that the Pension Fund Regulatory and Development Authority (PFRDA) would regulate and supervise the occupational retirement benefit schemes. In this context, it may not be considered necessary to have any principal legislation for regulation and supervision of occupational retirement benefits and the Act setting up the PFRDA could have provisions to empower the Central Government to frame Rules and the PFRDA to frame regulations consistent with the provisions of the Act and Rules framed by the Central Government for regulation and supervision of occupational retirement benefits. These regulations would apply to all occupational retirement benefit schemes, funded or unfunded, self administered or arranged with life insurer. The legislative provisions would be of two kinds, mandatory and non-mandatory. Mandatory provisions would include rules relating to the basic obligations of the employer and trustees, the protection of accrued rights, the essential rights of early leavers and the employers liability for scheme deficit. Non-mandatory provisions would lay down a default rule to be applied to situations not dealt with by the scheme documents, for example priority of claims on winding up of a scheme and the rules, governing investment of retirement benefit fund other than investment pattern.

The regulations, among other things, must cover:

- the primary duties of employers, trustees and others under occupational retirement benefit schemes;
- the protection of accrued rights;
- the appointment and removal of trustees, the composition of the trust board and the discretionary powers of the trustees so far as not varied or excluded by the trust deed;
- minimum funding requirement;
- general criteria for appropriate investment;
- the establishment of the office and powers of the retirement benefit regulator;
- powers of the retirement benefit ombudsman;
- the application of unallocated surplus on winding up and the priority of payment of schemes in deficit;
- the appointment of a scheme actuary and a scheme auditor, and the powers and duties of the actuary and auditor;
- the employers liability for scheme deficits;
- the rights of early leavers and matters relating to transfers;
- the compensation scheme for loss suffered through fraud, theft or misappropriation of scheme assets;
- dispute resolution;
- grievance redressal machinery;

7.1 Pension promise

Members of the occupational retirement benefit scheme have certain reasonable expectations that the law should protect. These include the expectations that rights will accrue with service and, once accrued, will be protected and that benefits will be provided in accordance with the scheme rules. These reasonable expectations (which are not strictly legal rights, as the trust deeds usually provide wide powers of amendments to employers and trustees) form the core of what may be called the pension promise. It is this promise that the that the law should protect, particularly in respect of accrued rights.

7.2 Minimum funding requirement

The funding of occupational retirement benefit schemes accrued liabilities is fundamental to the pension promise as it provides means whereby accrued rights are protected even if the sponsoring employer becomes insolvent. To achieve this, funding needs to be set up at a level which ensures that the scheme is in a position to meet its liabilities when those fall due. Generally, there is a solvency band between the minimum funding requirement of 100% and a base level of 90%. Any scheme which falls below this base level would require an immediate injection of funds, as may be stipulated by the regulatory authority, to bring it up to the base level. All schemes should be required to establish and keep in place a funding plan adhering to not less than 100 per cent level, i.e. having assets at least equal to liabilities. In the event of drop below this level but at or above the base level, the trustees should be made to submit a plan to the regulatory authority providing for restoration of the fund upto a specified time limit.

In the case where employers set up such schemes by making a provision in the books of accounts, the authorities could draw up a road-map to transit such schemes to funded schemes over a period of time though it is very unlikely that it would be possible to achieve this. Further, there are jurisdictions where such book reserve provisioning is prevalent. The authorities must therefore draw up a two way approach:

- to regulate and supervise the provision for the accrued benefits in the same way it is envisaged to regulate and supervise funding and solvency in a funded arrangement; and
- since the security of accrued benefits would essentially depend on the solvency of the employer, a scheme be drawn up to restore the accrued benefits in the event of employer going insolvent.

International experience shows that there are mechanisms to protect accrued benefits to employees.¹⁰ It is necessary that in India also the authorities

¹⁰For example social security benefits are set at a level which encourages employers to establish occupational pension arrangements, which are typically designed to integrate with the social security benefits to provide an adequate income in total. The occupational pension arrangements, however, are mostly pension promises which employers support through tax-allowable book reserves on their balance sheets. These could be seen as funded occupational pension schemes with full investment in the employer's business itself. There is obviously risk to the security of member's accrued benefits if the employer gets into financial difficulties. To mitigate this risk, the German employers operating book reserve pension arrangements pay annual premiums to an insolvency scheme that would underwrite vested pension rights if an employer's insolvency leaves the accrued benefits uncovered. In the USA also, there is an employee benefit protection fund to which the

evolve such mechanisms to ensure security of accrued retirement benefits of the employees.

7.3 Pension fund trustees

As the trust law is the basis of the vast majority of occupational retirement benefit schemes, the role of the trustees is of crucial importance in the administration of schemes. The regulations need to address issues like qualification and disqualification of trustees, the degree of employer control over their appointment and removal, the composition of the trust board, the distribution of the power between the employer and the trustees, trustees conflict of interests. The employers should not have the sole power to appoint trustees, and should not be able to veto a trustee selected by the scheme members.

Certain rights need to be reserved for the trustees, irrespective of what the trust deed provides. Decisions on the following matters should be reserved to the trustees by legislation:

- to appoint the scheme auditor, actuary, fund manager and other professional advisors;
- to decide, in consultation with the employer, on the investment strategy of the fund;
- to decide on unallocated surplus on winding up of the scheme

7.4 Ammendment and winding up

Schemes can be amended in accordance with the rules contained in the trust deed. The interests of members are to be protected primarily through the trustees whose role is to balance, as fairly as possible, the differing interests of the various groups involved. The regulatory authority should have the power to wind up schemes if

- the employer is insolvent;
- the trustees have asked the regulator to wind up the scheme because clear under-funding or inadequate plans for future funding mean that scheme members are at risk;
- the regulatory authority's investigations reveal situations in which, in its opinion, this is the most appropriate course of action

employers contribute and in the event of any employer getting insolvent the fund restores the accrued benefits.

7.5 Early leavers and transfers

There are number of reasons why members might leave their occupational retirement benefit scheme before normal retirement age: as a result of individual choice; bulk transfer from one employers scheme to another on sale or merger of companies. The most significant issue in this is the preservation of the value of the accrued benefits by the early leavers. The actuarial certificate should provide adequate protection for scheme members affected by bulk transfers. If a scheme is fully funded, transfer values should be calculated on a basis which is no less favourable to the departing member than that used in assessing the minimum solvency of the scheme. Where the schemes funding level is less than 100 per cent, the transfer value may be reduced proportionately.

7.6 Scheme administration

In the occupational retirement benefit schemes the roles of the administrator and the professional advisors, i.e. actuaries, auditors, lawyers, are of vital importance. Every scheme should have an appointed scheme actuary appointed by the trustees. The scheme actuary should be required to certify adequacy of funding on the minimum funding requirement basis and the adequacy of funding certificate should be furnished to the regulatory authority. Scheme actuaries should have a duty to report or persistent irregularities to the regulatory authority and if they do so in good faith any legal liability they might otherwise incur.

The scheme auditor should be appointed by the trustees. Auditors of occupational retirement benefit schemes should, like auditors of regulated entities, be statutorily required to report serious or persistent irregularities to the regulatory authority and if they do so in good faith should be exempt from any legal liability they might otherwise incur.

The fund managers' should be appointed by the trustees and should act on the instructions of the trustees. As a matter of good practice, trustees should always ensure that the fund manager is provided with a well-defined brief setting out the fund managers duties and the investment strategy to be followed.

The trustees should be required to make an annual return to the regulatory authority consisting of

- a copy of the audited scheme account

- an audited copy of the scheme administrators statement of payment of contributions
- a copy of the actuarial certificate of scheme solvency (in relation to the minimum funding requirement)

7.7 Fund management

The investment of retirement benefit fund is of importance to the security occupational retirement benefit rights, together with contributions to the fund from both employee and employer whereby the assets of the scheme are able to match the liabilities. Flexible and widely defined guidelines for investments should be provided for in the regulations. The annual report should contain a statement by the trustees that they have carefully considered the investments and are satisfied that those conform to the statutory criteria. The regulations need to provide for socially responsible investments.

7.8 Dispute resolution

All schemes, other than small schemes, should be required to establish a formal grievance redressal machinery of a nature approved by the regulatory authority and to make the details of this known to the scheme members. An office of occupational retirement benefit ombudsman should be set up on the lines of the office of insurance ombudsman. The jurisdiction of the ombudsman should include disputes between the employer and the trustees or amongst the trustees themselves.

7.9 The roadmap ahead

Once it is decided that the occupational retirement benefit schemes need to be regulated and supervised by the PFRDA, an enabling provision may be made in the PFRDA Act. This provision would enable the Central Government to frame rules on policy matters and the PFRDA to frame regulations consistent with the provisions of the PFRDA Act and the rules framed by the Central Government. The Actuarial Society of India which regulates the actuarial profession in India and the Institute of Chartered Accountants would have to be associated with the process of framing regulations to address the issues relating to:

- the role of an actuary and the role of an auditor in the defined benefit schemes
- introduction of the system of Scheme Actuary for the defined benefit schemes

- setting out the Minimum Funding Requirement for the defined benefit schemes
- information to the scheme members in the form of annual disclosure by way of illustration in the defined contribution schemes
- require the occupational retirement benefit funds to seek registration with PFRDA which should be mandatory for tax relief
- setting up of the office of Pension Ombudsman

The further steps would be relating to the operational matters.

8 CONCLUSION

It is essential to have in place a legal framework which is conceptually coherent and at the same time applicable to the industry. A fair and sound regulatory environment would ensure that scheme members feel secure about their accrued benefits and at the same time the employers feel secure about their future commitments. Thus, it would be the responsibility of the PFRDA to exercise general supervision over occupational retirement benefit schemes. The regulatory authority would

- register schemes, wherein such registration would be a pre-requisite for tax approval
- monitor schemes and compliance with legal requirements, including rules relating to trustees, minimum funding requirements and disclosure
- intervene in scheme administration where the scheme assets appear to the regulatory authority in jeopardy
- receive and investigate complaints and impropriety in the management of pension schemes or the composition or conduct of the trustees
- ensure that persons in the management of retirement benefit schemes are 'fit and proper'
- issue or approve standards and code of practice