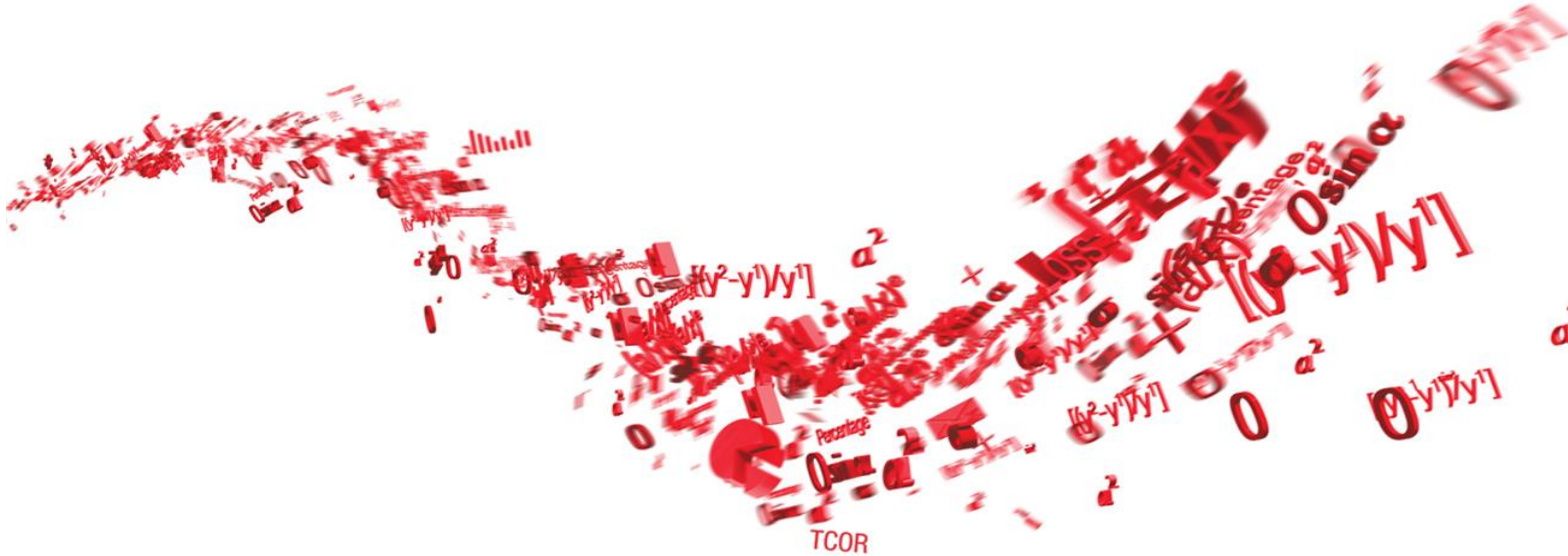

Impact of Labour Codes on Compensation and Benefits Costs
Aon’s Point of View

December 2020

Empower Results®

Your Speakers

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Agenda

Understand Key Provisions of the Labour Codes

Impact of New Definition of Wages

Illustrations

Employer Actions

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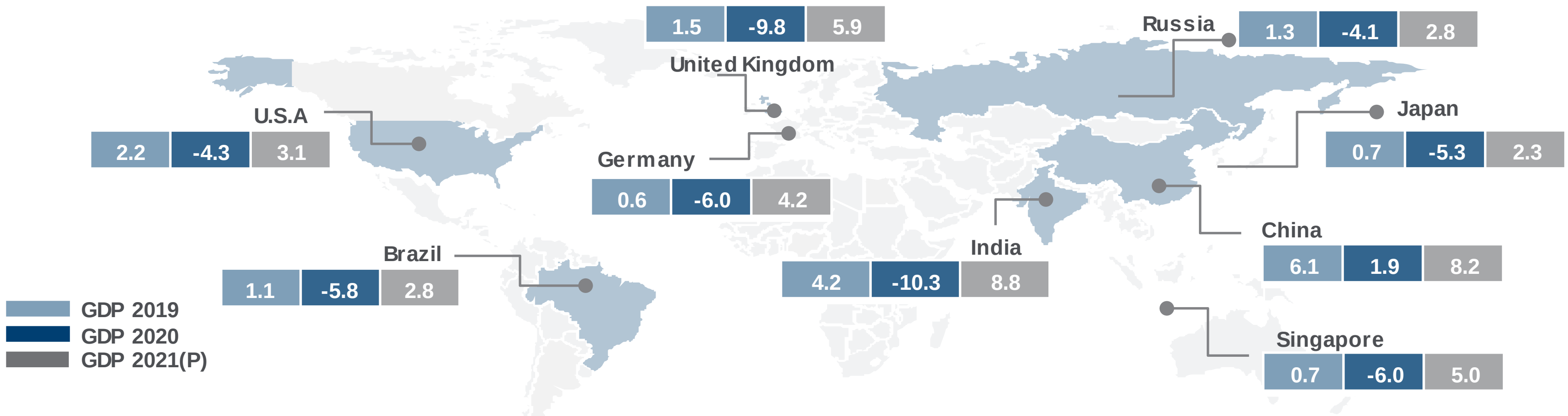
Global Economic Outlook

The Great Lockdown

Global economy limping back to life, with partial recovery expected in 2021



But the strength of the rebound still remains questionable, with the world struggling to cope with the second wave of COVID-19…

Pre & Post COVID Economic Impact

World economy predicted to shrink by **3% in FY'21**

+

Investor Sentiments

Oil prices and impact on commodity markets, **adversely affecting investor sentiments**

+

Changing Consumer Preferences

Steep shift in consumer preferences & consumption indicators, characterized by weak demand & reduced productivity

+

Technology Disruption

The workforce of the future needs **new skills**

+

Geo Political Dynamics

Trade wars, Brexit, US Presidential elections **creating whirlwinds**

+

COVID related Public Safety Hazards

Questions around ethics and cost of doing **business vs loss of life**

Source: Moody's Global Macro Outlook 2020 – 2021, IMF

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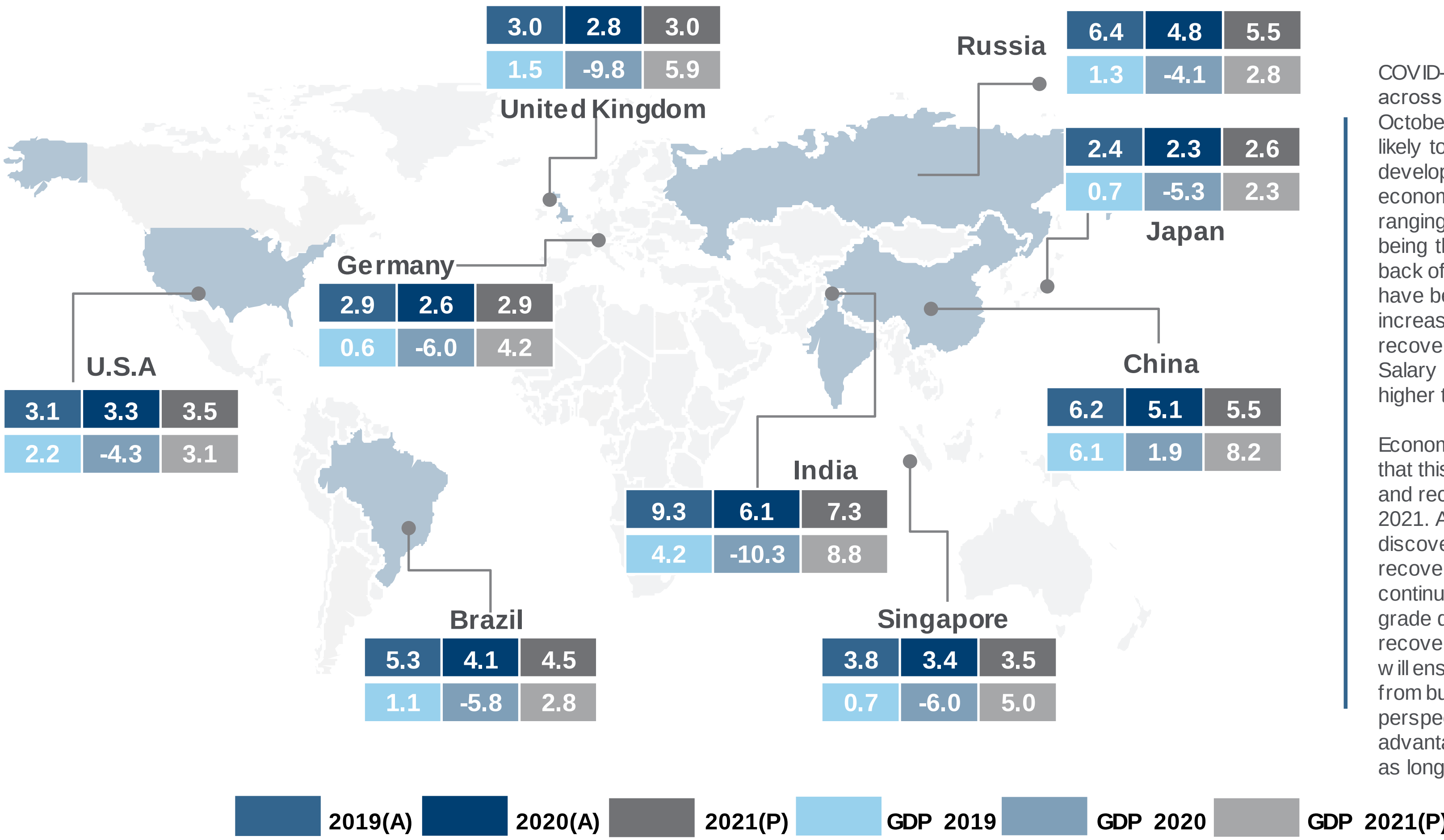
Glimpse of Salary Increments Globally

Salary Increase Numbers and their correlation with GDP



COVID-19 has impacted GDP across the globe. As per IMF's October forecast, world output is likely to drop by 3% with most major developing and developed economies showing de-growth ranging from 4% to 10% (China being the only exception). At the back of this, 2020 salary increases have been lower than 2019 increases however with expected recovery and growth in 2021, the Salary Increase projections are higher than the 2020 actuals.

Economists across the globe believe that this will be a short recession and recovery will start in Q1/ Q2 of 2021. As the vaccine gets discovered and distributed, the recovery rate will increase. India continues to remain investment grade destination globally. As recovery globally picks up, MNCs will ensure they invest in India both from business and talent perspective to gain competitive advantage both in the short as well as long term.

Source: IMF: World Economic Outlook, October 2020

Figures in %

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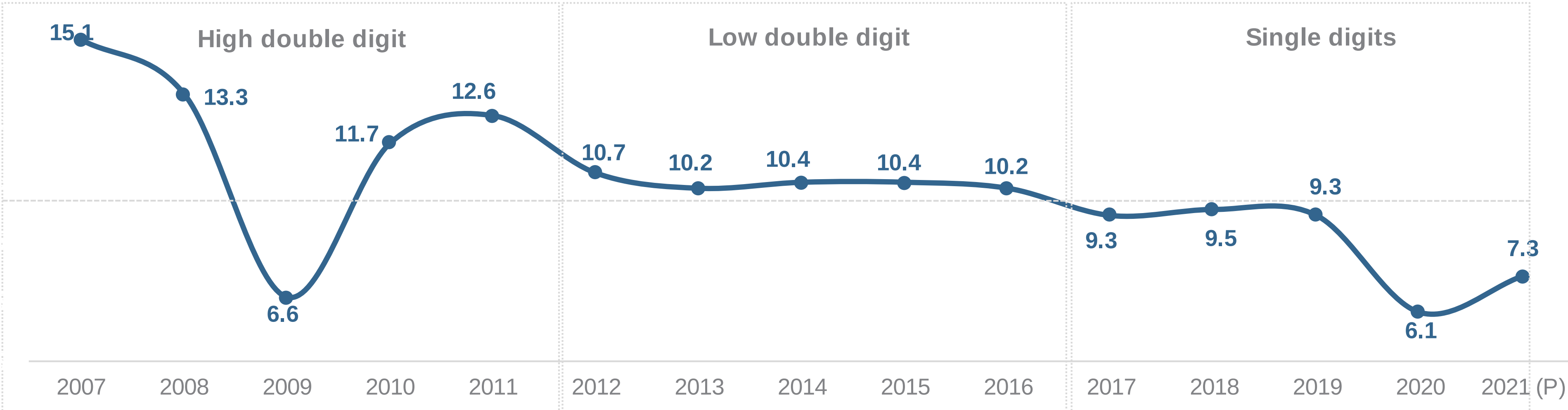
Salary Increase Trend for India Inc.

Absolute increment numbers over the two crisis



Comparing salary increases across two crises, salary increments for both 2009 and 2020 are in the 6% range but that's where the similarities end. Pre-2009 crisis, India was witnessing high economic growth and activity and the salary increases were in the range of 13-15%. With Global Financial Crises and impact of the same of the Indian economy, the plunge led to a significant dip in salary increases, the same dipping by 50%. In contrast, with the COVID-19 crises, the numbers in 2020 dropped less dramatically by 33%. This reflects the more mature outlook and actions taken by India Inc. as compared to the much more drastic and short-term actions taken in 2009. Clearly this shows far greater resilience by India Inc as compared to 2009. The fact that this is humanitarian crisis and not caused by defaults on big financial institutions as a results of mismanagement and lack of control, hasn't disrupted the markets as much and there is a clear plan of recovery for most sectors, which has already started. As can be seen in the past decade, the confidence in India's economic fundamentals remains strong, and economists are betting strong on the long-term resilience and resurgence of the Indian economy.

Immediately after the GFC, there was a strong jump in increment numbers in 2010, which reflected the short-term actions of companies in 2009, and also the bouncing back of salary levels which were still lower as compared to other economies. 2021 shows a different scenario – A decade of close to 10% annual increments has pushed Indian salaries to higher levels, reduced the gap, reduced the competitiveness of labor, and also prompted companies to take a hard look at their P&L, growth, affordability and balance sheets. Hence the projections for 2021 are more muted to 7.3% as companies will tread with caution before we see the numbers return to the 9-9.5% range.

Source: Aon Salary Increase Survey

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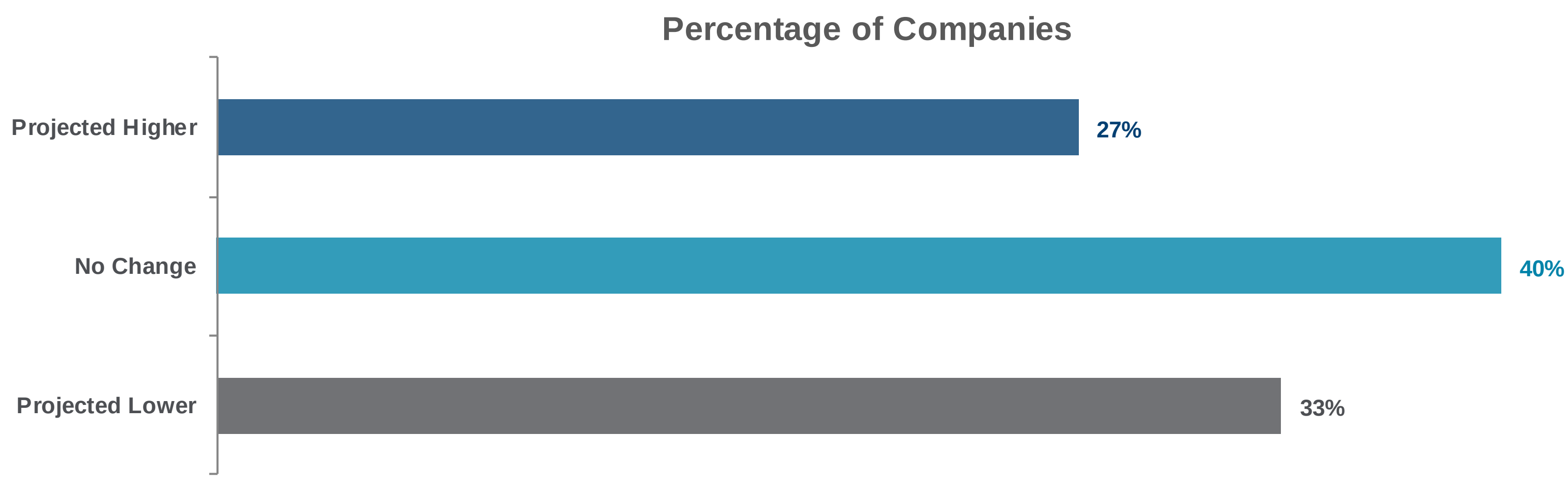
2020 vs 2021 Comparison

Actual Increments vs. Projected Increments



Further substantiating the previous point, while 26.7% of the organizations are projecting a higher increase, 33.5% are projecting a lower increase and 40% are looking at same budget as of 2020. In other words, 2/3rd of the organizations are looking at same or higher increase.

The trend looks like this, with higher number of organizations projecting a lower increase given the whole timing issue with (~25%) of the organizations having done their increase before COVID-19 impacted India, ending up doing higher increases. Some of these organizations are planning a lower increase in 2021.

Source: Aon Salary Increase Survey

Industry Wise Increment Numbers

Represented as 2020 (Actuals) | 2021 (Projections) – Including 0s

Automotive/Vehicle Manufacturing
4.1% | 6.8%

Cement
4.1% | 7.3%

Chemicals
7.4% | 8.3%

E-commerce/Early Stage
7.1% | 8.4%

Energy (Oil/Gas/Coal/Power)
4.9% | 5.5%

Engineering Services
4.6% | 4.9%

Engineering/ Manufacturing
4.4% | 7.5%

Financial Institutions
4.8% | 5.3%

FMCG/FMCD
7.3% | 7.6%

Hi Tech/Information Technology
7.8% | 8.7%

Hospitality/ Restaurants
1.1% | 2.9%

ITeS
7.2% | 8.6%

Life Sciences
8.3% | 8.7%

Entertainment & Media
6.0% | 5.5%

Metals
3.7% | 7.5%

Other Manufacturing
3.5% | 5.4%

Other Services
5.2% | 5.9%

Professional Services
6.7% | 8.0%

RE/Infrastructure
1.5% | 4.2%

Retail (incl. Wholesale & Distribution)
1.6% | 6.3%

Telecommunication Services
5.2% | 5.5%

Transportation Services/Logistics
3.7% | 7.5%

Taking a look at Salary Increases by industry segments, the variance is extremely high; both intra and inter industry sectors in 2020 and 2021 as compared to previous years. Early- stage organizations, Hi-Tech, Pharma organizations are leading the way on salary increase while hospitality, RE/Infra are at the bottom of the pyramid. Over the last few survey cycles, we have observed a narrow range of about 2.2% to 2.5% in terms of salary increases across different sectors; however, with the impact of COVID being varied on different sectors; this year, the difference is much higher at 7%. Not only has the impact of COVID has been varied for different sectors with sectors, the recovery cycle is likely to be much slower, longer for some sectors. This in context, sectors and organizations that did less than average increase, are likely to give less than average increase even in the next year. This trend of high variance in increases both inter and intra sectors is likely to continue for the next 2-3 years. The implication of this is likely increase in parity/disparity in pay across industry segments and across organizations within each sector.

Almost all sectors are projecting a higher increase in 2021 as compared with the actuals of 2020. This is at the back of signs of gradual recovery and better business outlook for 2021.

Source: Aon Salary Increase Survey

**Salary increment numbers are including 0's*

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Reward Challenges

Top challenges in managing rewards between 2019 and 2020

Challenge	2019	2020
Strategic differentiation for key talent	2	1
Effective communication of rewards	3	2
Maintaining market competitiveness	1	3
Pay for performance & productivity	5	4

In terms of top rewards challenges for organizations, in a market like India with high growth and demand & supply mismatch of talent, maintaining external / market competitiveness has been the key challenge for organizations over the years. However, interestingly the same has moved down from Rank 1 to Rank 3 in 2020. This indicates that organizations have taken an inward view (based on business outlook and cash flow situation) to compensation increase this year as opposed to following external benchmarks to remain competitive.

Also, given limited salary increase budgets, strategic differentiation for key talent has become even more critical, yet difficult for organizations

Source: Aon Salary Increase Survey

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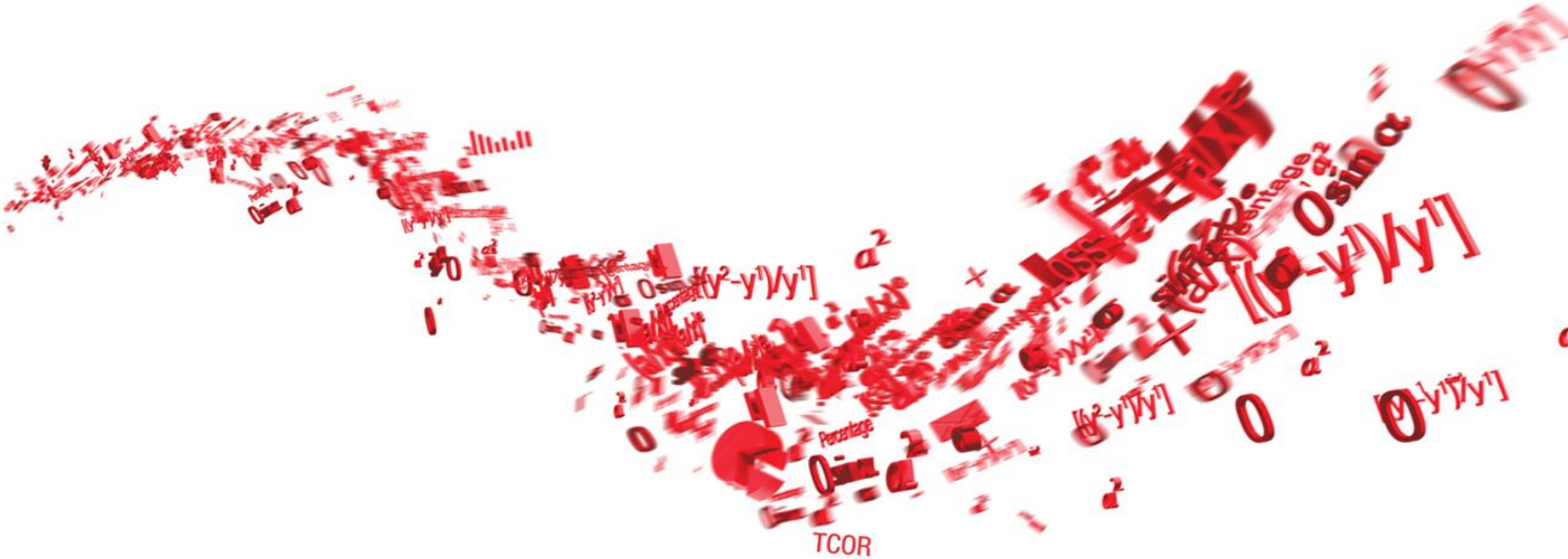

Impact of Labour Codes on Rewards

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The Four Labour Codes

Code on Wages

- The Payment of Wages Act, 1936
- The Minimum Wages Act, 1948
- The Payment of Bonus Act, 1965
- The Equal Remuneration Act, 1976

Code on Social Security

- The Employees' Compensation Act, 1923
- The Employees' State Insurance Act, 1948
- The Employees' Provident Funds and Miscellaneous Provisions Act, 1952
- The Employment Exchanges (Compulsory Notification of Vacancies) Act, 1959
- The Maternity Benefit Act, 1961
- The Payment of Gratuity Act, 1972
- The Cine-Workers Welfare Fund Act, 1981
- The Building and Other Construction Workers' Welfare Cess Act, 1996
- The Unorganised Workers Social Security Act, 2008.

Code on Occupational Safety, Health and Working Conditions

- The Factories Act, 1948
- The Mines Act, 1952
- The Dock Workers (Safety, Health and Welfare) Act, 1986
- The Building and Other Construction Workers (Regulation of Employment and Conditions of Service) Act, 1996
- The Plantations Labour Act, 1951
- The Contract Labour (Regulation and Abolition) Act, 1970
- The Inter-State Migrant workmen (Regulation of Employment and Conditions of Service) Act, 1979
- The Working Journalist and other News Paper Employees (Conditions of Service and Miscellaneous Provision) Act, 1955
- The Working Journalist (Fixation of rates of wages) Act, 1958
- The Motor Transport Workers Act, 1961
- The Sales Promotion Employees (Conditions of Service) Act, 1976
- The Beedi and Cigar Workers (Conditions of Employment) Act, 1966
- The Cine Workers and Cinema Theatre Workers Act, 1981.

Code on Industrial Relations

- The Trade Unions Act, 1926
- The Industrial Employment (Standing Orders) Act, 1946
- The Industrial Disputes Act, 1947

The Labour Codes : Vision

Enhances social security and safety for employees

Cut-down red-tape and labour related litigation

Ease labour law compliance for employers

Improve India's ranking in doing business and attracting foreign investments.

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Labour Codes : Key Areas of Focus

- Uniform definition of “wages”
- Universal Provisions for all categories of employees
- Inspector cum Facilitator
- Reduction in number of Returns and Registers
- Increased Penalties for non-compliance
- Social Security for Gig and Platform Workers
- Focus on Unorganized Workers
- Maternity Benefits and Creches
- Encourage Fixed Term Employment
- Compulsory Funding of Gratuity
- Potential Flexibility in Provident Fund
- Easier Retrenchment
- Flash Strike Prohibited
- Focus on Gender Equality
- Focus on Inter-state Migrant workers

Key Proposals of the Labour Codes

Subject	Proposals	Impact
Definition of Wages	New Definition of Wages which targets Basic to be at least 50% of Total Gross Remuneration	Overhaul of all Benefits and Compensation items linked to Wages (to be covered in detail in the presentation)
Provident Fund	Provision of both 10% and 12% of wages contribution rates (Clause 16 SS Code)	Limited impact under a Cost to Company (CTC) model where reduction in ER contribution rates to 10% would be offset by higher special/flexible allowance
Funding of Gratuity	Compulsory insurance or Funding via Trust (Clause 40 SS Code)	Organisations need to set up insurance or Trust Fund against Gratuity liabilities
Leave Encashment	Annual Leaves for Workers : One Leave for every 20 days worked Accumulation upto 30 days (encashment beyond 30 days also allowed)	Broadly in line with Factories Act but need alignment with State Shops Act.
Maternity and Creches	26 weeks paid maternity leave + Provision of Creches for firms with 50+ employees	Reinforce provision of Creches to be set- up by employers
Overtime	Applies above 8 hours a day or 48 hours a week	Similar provisions existed earlier but could now apply to workers earning less than INR 18000 per month wages

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Key Proposals of the Labour Codes

Subject	Proposals	Impact
Focus on Fixed Term Unorganized Sector, Gig and Platform Workers	Multiple provisions across the Codes. Fixed Term employment allowed freely with similar compensation & benefits as permanent hires CG, SG, employer (aggregators) to contribute towards social security for gig and platform workers	Ensuring protection of rights for these categories of workers Encourage Fixed Term employment
Gender Equality	Night Shifts for women allowed (before 6am or after 7pm). Responsibility on the employers to ensure safety	Women empowerment .
Industrial Disputes	Standing order and prior permission for retrenchment only for firms with 300+ employees Flash strike prohibited. 14-day notice for strikes	Ease of doing business for smaller manufacturing firms
Compliances and Documentation	Less number of returns and registers Move to electronic documentation Single India license to hire contract labour Web-based inspection + Inspector-cum-Facilitator Increased Penalties for non-compliance	To be monitored for real changes on the ground which make a difference to the compliance obligations

The New Definition of Wages

Inclusions	Basic Pay, Dearness Allowance and Retaining Allowance
Specified Exclusions	**Statutory bonus,** **Value of house accommodation and utilities (light, water, medical etc.),** **Employer contribution to provident fund/ pension,** **Conveyance allowance/ travelling concession,** **Sum paid to defray special work expenses,** **House rent allowance (HRA),** **Remuneration payable under settlement,** **Overtime Allowance,** **Commission**, Gratuity, Retrenchment Compensation
Conditions for exclusion	If payments made by the employer to the employee under the bold sections above **exceeds one-half** of the all remuneration the amount which exceeds such one-half, shall be added in wages

Future State : Basic Pay = 50% of Gross (Fixed) Pay?

Wages in Kind	Where an employee is given any **remuneration in kind,** the value of such remuneration in kind which does not **exceed fifteen per cent**. of the total wages payable to him, shall be deemed to form part of the wages

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New Definition of Wages : Indicative Illustrations

Scenario	Scenario 1	Scenario 2	Scenario 3
Basic Pay	50	25	60
Excluded Allowances	50	75	40
Total Gross (Fixed) Pay	**100**	**100**	**100**
“Wages” as per Codes	**50**	**50**	**60**

All statutory Benefits and allowances/components need to be linked to the new definition of Wages

Recent legislations and judgements

- ***Supreme Court 2019 judgement on Provident Fund** "The wage structure and the components of salary have been examined on facts, both by the authority and the appellate authority under the Act, who have arrived at a factual conclusion that the allowances in question (special allowance) were essentially a part of the basic wage, camouflaged as part of an allowance, so as to avoid deduction and contribution accordingly to the provident fund account of the employees"*

- ***Finance Minister as part of Budget 2020 speech "**It was surprising to know that currently more than one hundred exemptions and deductions of different nature are provided in the Income-tax Act. I have removed around 70 of them in the new simplified regime. We will review and rationalize the remaining exemptions and deductions in the coming years with a view to further simplifying the tax system and lowering the tax rate."*

Are we heading towards simple Compensation Structures in the long term?

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New Definition of Wages : Impact on Compensation and Benefits

Definition of Wages

- Proposal to move “Wages” towards 50% of Gross Pay/Remuneration
- Proposal to make the definition consistent across all statutory Benefits and labour laws
- Any statutory and non-statutory Benefits linked to “Wages” to get impacted

Provident Fund (Statutory DC)

- Higher Wages (Basic) to Increase PF contributions leading to higher retirement savings but lower cash in hand for employees if PF is included within CTC
- Potential reduction of PF contribution rate at 10%

Gratuity (Statutory Defined Benefit Lump Sum)

- Higher Wages (Basic) to sharply increase past service actuarial liabilities in the Balance Sheet
- Compulsory Funding/Insurance for Gratuity plan

Leave Encashment (of accumulated unused leaves)

- Higher Wages (Basic) to sharply increase actuarial liabilities in the Balance Sheet and increase in short-term encashment costs

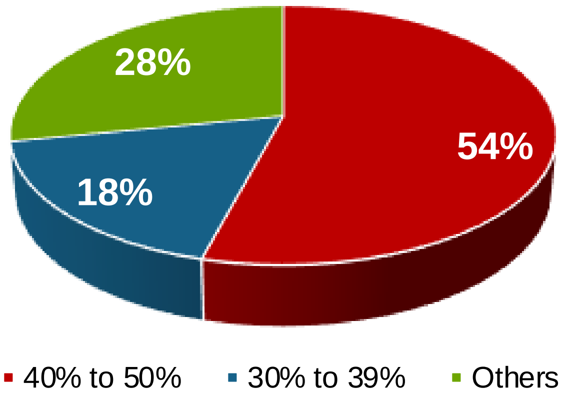
Flexible Compensation

- Higher Basic (and PF + HRA) to reduce flexible compensation basket leading to lower tax saving opportunities for employees
- Potential move towards a simplified structure

Impact of Labour Code on Compensation Structures

Basic Pay to Gross Pay Ratio

Aon's IT/ITES database Extract



- *Historically most companies would have Basic to Gross Pay ratio of somewhere between 25%-50%*
- *This ratio evolved as a market benchmark mostly to take advantages of tax-efficient allowances*
- *All this could potentially change with new Labour Code guidelines as shared in the previous slide.*

Current State

Components	Percentage of Fixed Pay
Basic Salary	**25 to 50%**
Provident Fund	**50% to 75%**
Special Allowance	
House Rent Allowance	
Company Accommodation	
Car Lease Rentals + Fuel	
Superannuation Allowance	
National Pension Scheme	
Professional Development	
Children Education	
Supplementary Allowance	
Leave Travel Allowance	
Total Fixed Pay	**100%**

Potential Future State?

Components	Percentage of Fixed Pay
Basic Salary	**50%**
Provident Fund	**50%**
Special Allowance	
House Rent Allowance	
Company Accommodation	
Car Lease Rentals + Fuel	
Superannuation Allowance	
National Pension Scheme	
Professional Development	
Children Education	
Supplementary Allowance	
Leave Travel Allowance	
Total Fixed Pay	**100%**

Is there any enough space for tax-efficient allowances

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Provident Fund : Impact of moving Basic Pay to 50% under a CTC model

Scenario	Basic to Gross Ratio = 25%	Basic to Gross Ratio = 50%
Basic Pay	**25**	**50**
Flexible Allowance	72	44
Provident Fund (ER) – 12% of Basic Pay	3	6
Total Gross (Fixed) Pay	**100**	**100**
Less : Provident Fund (EE)	3	6
Less : Provident Fund (ER)	3	6
Cash in hand salary (pre-tax)	94	88
Income Tax (30%)	28.2	26.4
Cash in hand salary (post-tax)	**65.8**	**61.6**

Percentage reduction in cash-in-hand salary 6%

- Under a CTC model, most employers would aim to offset the higher Basic Pay and PF contributions by reducing the Special Allowance or the Flexible Allowance Basket
- Depending on the ratio between Basic Pay and Gross (Fixed) Pay, the reduction in the salary in hand would range from 3% to 8% if PF contributions are increased.
- At the same time, employees would have a much-reduced flexible allowance basket and employees would get further impacted if they had earlier opted for flexible benefits such as NPS and Car Leasing.
- Depending on the salary budgeting for 2021, there is a possibility that employees do not see any significant increase in cash-in-hand in 2021 even after a salary increase

Provident Fund outside Fixed Pay

Scenario	Basic to Gross Ratio = 25%	Basic to Gross Ratio = 50%
Basic Pay	25	50
Flexible Allowance	75	50
Total Gross (Fixed) Pay	100	100
Provident Fund (ER) – 12% of Basic	3	6
Total Fixed Pay + PF	103	106
Increase in Wage Bill		**3%**

- Where Provident Fund is outside Fixed Pay, the increase in Basic would lead to immediate increase in PF contributions and higher wage bill by approximately 3%
- It may not possible to pass on such additional cost of employer PF contributions as per below. Clause 17 of the SS Code says "*Notwithstanding any contract to the contrary, no contractor shall be entitled to deduct the employer's contribution or the charges referred to in sub-section (1) from the wages payable to an employee employed by or through him or otherwise to recover such contribution or charges from such employee.*"

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Gratuity + Leave Encashment : Impact of moving Basic Pay to 50%

Gratuity	Basic to Gross Ratio = 25%	Basic to Gross Ratio = 50%
Basic Salary	25	50
Past Service as on date (Years)	10	10
Accrued Gratuity**	144.23	288.46
Percentage increase in accrued Gratuity		**100%**

15 days Basic Pay for each year of service

Leave Encashment	Basic to Gross Ratio = 25%	Basic to Gross Ratio = 50%
Basic Salary	25	50
Leave Balance (days)	45	45
Accrued Leave Encashment Value**	37.5	75
Percentage increase in Leave Encashment		**100%**

Leave Balance x Basic salary/30

- The actuarial liabilities against Gratuity and Leave encashment plans would increase sharply if the definition of Wages is applied retrospectively.
- Depending on the ratio between Basic Pay and Gross (Fixed) Pay, the increase in liabilities could be even upto 100% or higher (particularly in a scenario where the Gratuity Benefit does not have a cap of INR 2mn)
- Some organisations include Gratuity within the CTC but unlike PF this will not help as the past service liabilities would increase at one-go.
- Leave encashment plans where the encashment is paid on Gross pay will not get impacted.
- Organisations should proactively assess these increase in actuarial liabilities and allow for these in the 2021 budgets

Impact on Other Components of Pay if Wages (Basic Pay) moves up

House Rent Allowance	Upto 50% of Basic is tax-exempt, therefore HRA allowance will go up.
Group Life and Accidental Insurances	If linked to Basic Pay, the supplementary insurance covers would move up leading to higher premiums
National Pension Scheme & Superannuation	Employer contribution of 10% and 15% towards NPS and Superannuation to increase significantly
Leave Travel Allowance	Where Leave Travel Allowance is linked to Basic (for e.g. 1 months Basic Pay), the allocation towards LTA would move up
Employees State Insurances	Could impact eligibility as current ESI wages includes HRA but the Labour Code definition of Wages excludes HRA potentially resulting in more employees falling within the threshold of ESI
Statutory Bonus	Potential exclusion of some employees if eligibility salary is higher than the current Basic Pay used for eligibility threshold?

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Budgeting and Cost Control : Options

Gratuity

- Do we cap the Gratuity scheme to INR 2mn?

Leave Encashment

- Do we bring down the Leave accumulation limits?
- Do we encash leaves before Labour Codes kick in?
- If Leave encashment is on Gross Pay, do we bring it down to 50% of Gross to save some costs.

Provident Fund

- Do we bring down PF contributions to statutory minimum wage leaves (INR 15,000 per month).

Compensation Structure

- Do we review our existing compensation structure and remove components heavy on administration?

Overtime

- Do we start monitoring working hours

Outstanding Issues

Wages in Kind	• Need clarity on components included within wages in kind (Car Leasing, Company Lease Accommodation, Meal vouchers etc.)
Exclusions from Wages	• The list of exclusions from the definition of Wages is not comprehensive. (No mention of Flexible allowance, special allowance, supplementary allowance, variable bonus, LTIPs, income tax, mobile, shift, NPS etc. in the list of exclusions)
Gratuity Funding	• Does the Code mandate 100% funding of Gratuity Liability
Overtime	• Whether overtime needs to be paid to white-collared employees and professionals?
Maternity	• Whether maternity wages also need to be capped at 50% of Gross wages?
Leave Encashment	• Does Leave encashment need to be on the new definition of Wages
Employees State Insurance and Payment of Bonus Act	• Need clarity on new eligibility and benefit thresholds under new definition of Wages
Alignment with other legislations and Acts *(Income Tax Acts, Shops Act)*	• Clarity needed on change in definition of salary under I.T. Laws (HRA, CLA, NPS, Superannuation, Leave encashment, Gratuity) • Need to clarify overlaps with Shops Act (Leave encashment, Wages Overtime,

Key Actions for Employers

- Set-up an internal Task-Force (HR, Legal, Finance, Payroll, Compliance) to review various aspects of the Labour Codes
- Financial impact assessments on various scenarios
- Incorporate Labour Code impacts within 2021 salary budgets
- Assess Technology (payroll tools) readiness

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Labour Codes : Impact on Rewards

Aon's Offering and Approach Note

Compensation Structure Review

- Review Compensation Structure in view of the guidelines issued by the Labour Codes
- Generate potential Compensation Structure options based on new Definition of Wages with financial impact assessment for each option
- Recommend new Compensation Structure to ensure alignment with the provisions of the Codes
- Provide market data on compensation structure changes post implementation of the Code

Retirement Liability Actuarial Reviews

- Actuarial Valuations to determine Impact on Defined Benefit Plans Liabilities like Gratuity and Leave Encashment.
- Recommend potential redesign options to mitigate cost impact

Market Surveys

- Market surveys to capture decisions taken by organizations on the Codes
- Agree on Survey Questionnaires, roll-out surveys and data analytics

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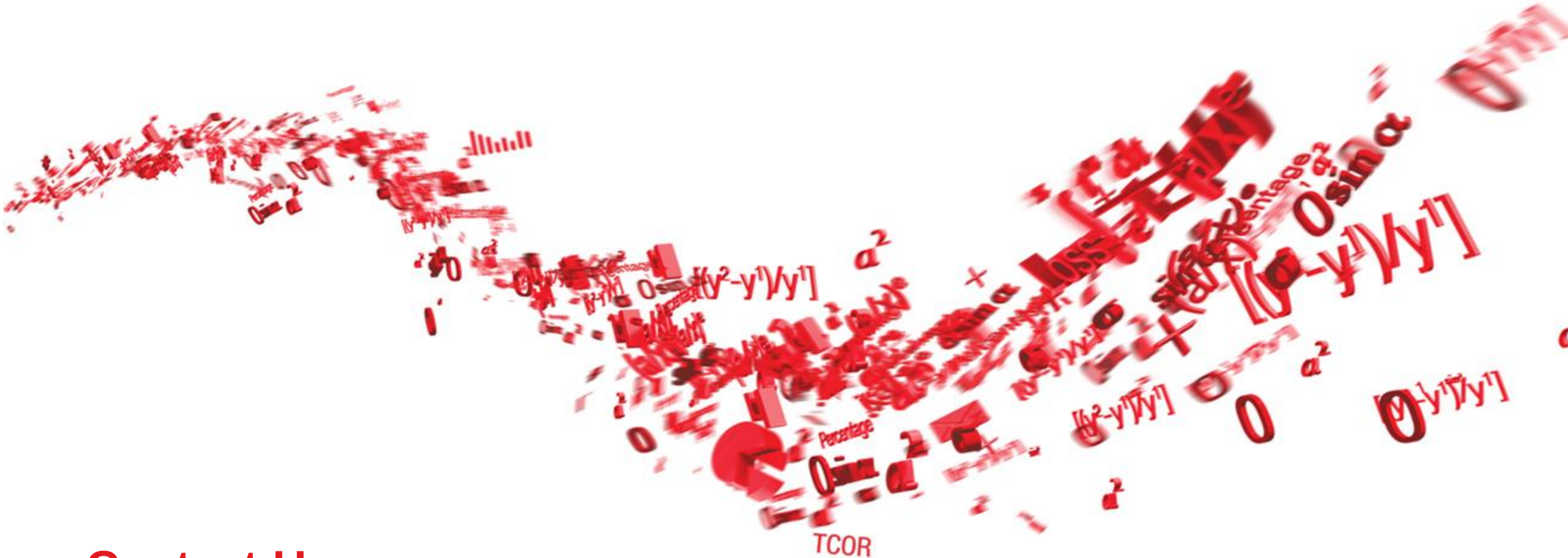

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