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Current Developments

A. What new developments are likely as a result of the series of studies on pension plans now being released by the Pension Research Council?

B. A number of pension plans have been established in recent years which provide for variable benefit payments. What has been the general experience of such plans? Are there particular types of employers to which these plans have more than normal appeal? To what extent are insurance companies making provision to supply such benefits?

DR. DAN M. McGILL: The Pension Research Council is an adjunct to the Wharton School of Finance and is composed of academic members, pension consultants, actuaries, attorneys and representatives of employers and labor. Five members of the Society of Actuaries, John K. Dyer, M. Albert Linton, Robert J. Myers, Ray M. Peterson and Dennis N. Warters, are members of the Council. Since 1958 most of the time has been devoted to a project called "An Inquiry into the Security of Anticipated Benefit Rights under Private Pension Plans." The subject was divided into four areas, each handled by a task force. The first one headed by Professor Patterson of Columbia University dealt with the present regulation of private pension plans. In this area a book has now been published called *Legal Protection of Private Pension Expectations.*

The second topic dealt with the actuarial aspects of private pension plans, with a task force headed by Professor Carl Fischer, University of Michigan. After the first draft of this report was finished, it was decided to broaden the scope to include more than just actuarial soundness, and to get into all areas of pension plans and administration that would have actuarial implications. It is expected that a monograph under the joint authorship of Professor Fischer and Mr. William Marples will be out by late fall, 1961.

The third subject is covered under the forthcoming publication, *Legal Status of Employee Benefit Rights under Private Pension Plans* by Professor Benjamin Aaron, Director of Institute of Industrial Relations, University of California at Los Angeles, and Professor at Harvard Law School.

A monograph on the fourth area entitled *Decision and Influence Processes in Private Pension Plans* is about to go to press. The head of this task force is Professor James McNulty of the Wharton School.

I prepared a master report entitled *Fulfilling Pension Expectations,* bringing together the principal findings and philosophies of the four reports. It is being reviewed by the members of the Pension Research Council.

We do not have all the answers to all the questions and there have been dissents within the task forces over controversial matters.

It is of interest to note that on the four task forces of 32 persons, there are nine members of the Society of Actuaries.

MR. JOHN K. DYER, JR.: The Pension Research Council is made up of three principal groups: (1) educators, primarily from the faculty of the University of Pennsylvania who sponsored the Council, (2) the "consumers," employers who are interested in providing pensions for their employees, and (3) the "pension industry," including banks, insurance companies, actuaries and lawyers. The object of the Council was to bring these three groups together, for discussion of their mutual problems and joint sponsoring of objective research.

The first project of the Council was a textbook by Dr. McGill, *Fundamentals of Private Pensions*, which has been widely used. This was followed by two brief sociological studies by Dr. Pollak of the University of Pennsylvania. Then the Council sponsored Mr. Bronson's masterpiece of actuarial writing for the layman, *Concepts of Actuarial Soundness in Pension Plans*. The most recent project was Mr. Spiegelman's exhaustive and timely study, *Ensuring Medical Care for the Aged*.

In the development of these studies many questions were encountered having to do with the real security of the benefit expectations raised by private pension plans. The Council found an important lack of understanding and cooperation, and even the lack of a common language, within the pension industry group, and between that group and the pension "consumers." They noted the financial abuses revealed in public investigations of negotiated welfare funds, and realized that pension funds were susceptible to similar abuses. They found the provisions of many pension plans obscure, sometimes unnecessarily so. They saw what seemed to be undesirable features in the competition between pension funding agencies. They found outside influences brought to bear in the making of actuarial decisions.

About three years ago the Council concluded that there was a real need for a comprehensive study covering all aspects of the security of benefit rights underlying private pension plans. The study was undertaken on a broad scale, with the object of bringing to light the basic elements of such security, pointing up the inadequacies and abuses, both actual and potential, and charting possible courses of action which would minimize the weaknesses and enhance the security of private pension provisions.

MR. DORRANCE C. BRONSON: I have read Professor Patterson's book entitled *Legal Protection of Private Pension Expectations* and found it an excellent roundup of the legal background in which pension plans operate today. He includes a recitation of where inadequacies of present legal protection could be said to exist from the employee's standpoint, suggesting, in brief, that the common-law remedies are not apt to be sought and are ex post facto anyway and that there should be *preventive* controls such as already can be found in state insurance department approval of policy forms and for which the disclosure laws are, perhaps, another step. Further comments which he makes are: employees should be given more information on the degree of actuarial soundness of their plans; inapplicability of expense limitation laws to group annuities and trust fund plans, as well as lax controls on rebating, discrimination, and standard provisions, may be criticized; more statutory force should exist to discipline the employer in keeping up current service costs and in aiming at an ultimate fully-funded status; more legal protection in uniformly designed provision of plans may be necessary; finally, the self-employed find a gap until an H.R. 10 type of legislation comes along.

Professor Patterson explores three ways to answer these inadequacies. The first is to maintain the status quo and do nothing. In favor of this is the fact that only a few bad examples in the pension area have been revealed and he suggests that those may gradually improve by themselves. The second is for a program of minimum action to correct inadequacies, such as more disclosure, government examination of pension plans, permission by the Internal Revenue Service for allowance of 10% overfunding, provision for state intervention to enforce plan provisions, establishment of standard provisions for insured and trust fund plans in all states, uniform prohibition of rebating, and enabling legislation for variable annuities and for mutual funds offering the same without the mortality guarantee.

The third approach is for even stricter regulation: enforced funding and promulgation of minimum actuarial standards; official control of plan provisions by the state, instead of merely approval by the state.

In Dr. McGill's address before the Life Insurance Association concerning the Pension Research Council's project, entitled "Keys to Security of Pension Expectations," he reviews the pension background under the headings of (1) the employer's undertaking to set aside funds (*i.e.*, money purchase or cents per hour); (2) the undertaking to provide specific benefits; and (3) the medium used in meeting costs. He is particularly concerned when benefits have attained a vested position, and suggests special guarantees or annuity purchases for vested portions of a plan, in distinction to treating nonvested or "not yet vested" benefits less rigorously. I believe this leads to a double entry type of funding which raises many actuarial, administrative, legal and investment type problems.

The proposal that an employer guarantee pensions beyond the ability of any funding medium used would create balance-sheet turmoil for the corporation, besides undermining the position of creditors and the issuance of new securities.

I would like to mention a recent report from the government of Ontario's Committee on Portable Pensions. Its findings are that vesting should be required on a briefly graduated basis by age only (and not by service) beginning at age 30 at 20% and becoming fully vested at age 34. It is even hinted that adoption of "private" plans should be mandatory. This is a drastic proposal and I understand it has been tabled by this legislature for further study.

Another recent study on vesting is that of Governor Rockefeller's special report committee in New York State, of which Professor McConnell of Cornell is chairman. Its conclusion is that continued research is desirable. Mention should be made of other recent reports such as Father Harbrecht's book (The Twentieth Century Fund) and Tilove's study for the Fund for the Republic.

I wonder at what point in the evolution of private pension plans they became so much the concern of the "public interest." If all the so-called cures proposed by these various reports were established through a crash program of state and federal legislation, private pension plans would more suitably be described as "supplementary pension plans run for the government by private employers."

None of these Pension Research Council reports is apt to result in a great body of restrictive legislation. Instead, I expect them to have a passive influence in stimulating more employer concern toward achieving certain of the objectives stated above through independent private action.

MR. SAMUEL N. AIN: I should like to limit my remarks to developments likely to ensue from the first of the Pension Research Council studies (one with which I have been connected), namely the study by Professor Patterson entitled *Legal Protection of Private Pension Expectations*. I should make clear at the outset that of the members of the Task Force chosen to "assist" in the preparation of the study, I was one of those who felt impelled to express dissent.

It should then come as no surprise if I take the position that little good will follow from this study. It disturbs me that this work may have an influence on future legislation on both federal and state levels. Many of the author's conclusions are misleading or inaccurate, stemming from a misunderstanding of some of the *basic* elements of principles and practices in the pension field. Time and again, with respect to many points of discussion, he confuses aspects unique to plans in which the employer promises a level of benefit with those in which the employer promises specific contributions only. He fails to recognize the role of the deferred profit sharing plan; and he gives insufficient weight to the force and effect of the Internal Revenue Service rules and regulations. In addition, there is a predisposition to look at pension plans from the standpoint of what provisions he thinks they *should* contain rather than from the standpoint of what they *do* contain and why. This is apparent in his discussion of court decisions on the question of the vested rights of a claimant, where he says, "In conclusion, then the limitations on vesting have been generally enforced in favor of employers." He does not say "enforced under the terms of the plan" but "in favor of employers." The implication raised by this language is that the courts were in error in basing their decisions on the terms of the plans as written.

The author's failure to recognize essential differences between multi-employer, fixed contribution plans and unilateral fixed benefit plans, is made apparent in the following discussion of employer contributions: ". . . who has the right to sue the employer for its contribution? As we have pointed out, the 'trustees' (administrators) of a union welfare or pension fund can successfully maintain an action as third-person beneficiaries of the employer-union contract. By parity of reasoning, the fund trustee, if any, to whom contributions are to be paid by the terms of the employer-employee contract contained in the (unilateral) pension plan is entitled to maintain an action to recover from the employer, as assets of the trust fund, the sums that ought to be held in trust for the employees pursuant to the terms of the trust agreement." In other words, just as the trustees can enforce the employer's obligation to contribute 5¢ per hour per employee for three years in a negotiated plan, the trustees should be able to enforce employers' contributions for benefits accrued to date in a unilateral fixed benefit plan.

The author advocates legal requirements to control the timing and the amount of employer contributions. In this he fails to recognize the force of existing tax law as it applies to level of benefit plans. Students of the subject will recognize that any legal move which reduces the employer's flexibility in timing and in determining the amount of his pension contribution will give a substantial further push forward to the growth of profit sharing plans at the expense of pension plans. It will also encourage other substitutes for the insured pension plan and the tax exempt pension trust.

It is not my purpose here to detail the inaccuracies and misconceptions of the work. I think, however, that you may be interested in hearing some of the original dissent prepared for publication as a part of the book in lieu of the one finally printed. This is a dissent to which I, along with several other Task Force members, was willing to subscribe, but which we were prevailed upon to replace.[1]

DR. McGILL: I want to address myself to one part of Mr. Ain's remarks.

There was a firm agreement that any member of the task force or the Pension Research Council could file a dissenting statement dealing with facts but not personalities. In an undertaking of this sort there have been personality clashes. Many of the criticisms were matters of interpretation and opinion rather than fact. We felt that the original dissenting statement that was prepared for publication unfairly dealt with personal matters rather than the substance of the report. We prevailed upon the members of the task force to agree to a statement that would not cast personal aspersion upon Dr. Patterson and would attempt to eliminate personal biases among the dissenting members. They agreed to that. It was with their permission that we published a shorter statement than the one you just heard.

MR. RAY M. PETERSON: A study of this kind would not be worth much unless it stimulated a lot of healthy examination in the many phases of pension operations.

The interest in vested rights does not come from some self-appointed do-gooders. The White House Conference on the Aging stressed the importance of vested pension rights in contributing to the mobility of labor. Some studies of the National Bureau of Economic Research have shown that provision for vesting has been steadily increasing. I think that we can not sit back and fail to encourage and recommend vesting on all appropriate occasions. We hear a lot today about the coming increase in so-called structural unemployment. If private pension plans prove to be a serious deterrent to the mobility of labor we might have just one grand big pension plan in the United States. But all of us would be out of jobs.

MR. D'ALTON S. RUDD: I have had some dealings with the Ontario Committee on Portable Pensions mentioned by Mr. Bronson. We have seen both in Canada and in the United States that legislatures feel quite free to spend money in Social Security and unemployment benefits

[1] Mr. Ain then read excerpts from the dissent referred to, which he said gave a more comprehensive basis for the dissent and also indicated the reasons why the Task Force was unable to function more effectively.

when they do not have to raise taxes for them. I think there is an even more dangerous trend coming into effect, that is the legislature being encouraged and given the ability by law to spend employer and employee money in supplementary Social Security benefits. The report of the Ontario Committee in effect would turn private pension plans into the arms of the Social Security system of Canada. The problem of hiring the older worker is spurring this trend in our country.

MR. CLARK T. FOSTER: In connection with section B, I have prepared the accompanying table showing the unit values for 11 variable annuity plans that have been put into force in the last five years. These units are based on experience which includes both interest and mortality, with an assumed interest rate of from 3% to 4%, depending on the plan.

Accounting Date	Unit Value on Accounting Date in					
	1955	1956	1957	1958	1959	1960
11/30	1.000	1.015	.949	1.141	1.259	1.158
11/30			1.000	1.389	1.493	1.382
11/30			1.000	1.211	1.279	1.120
11/30			1.000	1.168	1.203	1.202
5/31			1.000	1.041	1.360	1.325
10/31			1.000	1.165	1.397	1.489
6/30				1.000	1.113	1.063
8/31					1.000	1.051
8/31					1.000	1.058
11/30					1.000	.946
11/30					1.000	.945

We believe that these results are quite good, but hardly enough time has gone by to judge the permanent value of these plans. We have observed that one type of employer to which these plans have particular appeal is investment houses and similar firms.

MR. JOHN B. ST. JOHN: My comments apply to the type of plan in which all or part of the pension payments may be expressed in units calculated on market values of the investments.

The most important single element of experience is the investment return including capital appreciation. One unit value with which I am familiar has increased from a value of $10 at the end of 1952 to a value of $24 at the end of 1960, an increase of 140%. The large increase in the unit value does not mean that the pension payments from the fund have increased in this proportion. Only the units of benefit credited in 1952 have increased 140%. All units credited in the intervening years have increased in lesser proportions.

In this same period, Standard & Poor's combined index of 500 common stocks increased 120%. This index, however, does not include income received from dividends during this period. In comparing the unit value performance with the common stock index, allowance must be made for the facts that the unit value assumed an interest rate of 3½% and that the actual dividend income exceeded this assumed rate. The unit value, therefore, reflects both the actual dividend income in excess of 3½% and capital appreciation corresponding to the increase in the Standard & Poor's index.

In making these comparisons, both price and yield indexes must be combined to reflect the kind of experience that might be expected in a pension fund operation. My examination of the results of mutual funds invested wholly in common stock indicates that there is a high degree of correlation between their performance and the performance indicated by market indexes. Also, I have found from a limited review that actual investment yields of pension funds invested in common stocks seem to follow the yields indicated by market indexes.

In one large fund covering 4,000 employees, the effect on the unit value of combining mortality experience with the investment experience has been minor. However, including the mortality experience in this way is not practical for a very small group of employees. In a small group that must operate on its own experience, it is necessary to eliminate the mortality discount and provide for accumulation at interest only.

For a large company there is no particular difficulty in carrying two funds, one, either trusteed or insured, invested in fixed income securities to provide a pension in fixed dollars, and the second invested in equities to provide the variable benefit. This may not be practical in the case of a small company, however, and the same objective may be achieved by carrying investments in balanced mutual funds or in a balanced common trust fund.

The general objective is to provide a "purchasing power income," with a number of dollars of pension income which will enable the recipient to buy the same things each year despite price increases, or perhaps buy a few more things each year as the general standard of living increases. To accomplish this result without endangering the stability and safety of pension income requires only a moderate proportion of the income to come from the common stock fund. In the past eight years, ¼ to ⅓ of the income based on common stocks would have accomplished the desired results. A larger proportion of the pension coming from a common stock investment fund would result in pension payments that fluctuate to such an extent that the income produced would no longer be sufficiently stable for a satisfactory income for a pensioner.

MR. GEOFFREY N. CALVERT: We have participated in the establishment of pension plans using both the equity unit and also the cost-of-living approach to variable benefits. There is a good deal of variation of detail possible in the design of each of these basic types of plans. For example, there can be variation in equity unit plans in the method of adjusting the benefits, in special treatment for older employees, in the adjustments for mortality experience, and in the investment of the assets. Plans of the cost-of-living type can be based on either the career-average or the final-average earnings approach, with the adjustments to the benefits covered either by firm limits or with limits contingent on the investment experience. The adjustments can be applied to the whole or to only a fraction of the pension.

The plans we have established include, in one form or another, most of the variations mentioned above. In all cases they are working out to the satisfaction of employers and plan members. There are certain types of employees to whom the equity unit type of plan is of interest. These are usually more highly paid employees, such as executives, airline pilots, or professional employees. The cost-of-living approach appears to have a far wider potential field of application, and is favored by unions, although we have also found this approach to be of interest to management and similar groups. The equity unit plan makes an interesting supplement to a basic pension plan, whereas the cost-of-living approach can be introduced into the plan as a whole.

It is still true that the great majority of plans we serve are of the regular career-average or final-average or similar types. However, we have noticed a greater warming up of interest and expansion of the field of application of these variable annuity plans in the past two years.

MR. G. ASHLEY COOPER: One of the first points which must have struck all of us is the fact that variable annuities have not swept the country from coast to coast. There is a great amount of interest in the subject, including some on the part of unions, but, in practice, only a very small number of plans have provision for variable payments. Another obvious point is the diversity of plan provisions and method of varying the benefits. In some plans pension benefits vary directly with some cost-of-living statistic, such as the Consumer Price Index issued by the Bureau of Labor, although most variable plans allow the experience of the plan itself to determine the variance in the unit value. Here, too, there is diversity—some plans provide for all actuarial experience to control the unit value, while a growing number of plans determine the unit value from investment experience alone.

There is development, which I believe is relatively new, towards a more complicated formula for the determination of unit value, taking into account the combination of investment experience and changes in the cost of living. In order to iron out the fluctuations and to produce a unit value more closely related to, say, the Consumer Price Index, some plans have adopted a reserve feature to act as a cushion to the unit value. The principle is that if investment experience outperforms the cost of living, some of the excess is put in a reserve which is then used to cushion the unit value if investment experience should later produce a worse result than the change in cost-of-living index.

It is interesting to note how widely experience can vary. For the year ending September 30, 1960 the Dow-Jones (30 industry) Average went *down* about 9%. The Consumer Price Index went *up* about 1%. Another noticeable feature is the wide variation in unit value changes among different plans during the same period. Of four plans with which we work having the unit value initially determined by investment experience, the variation ranged from an increase of 1½% (in addition to a substantial increase in the reserve) to a decrease of 9%. The assets of the four plans are all invested in common stock so there is an interesting difference in the performance of the four trustees. This points up a valuable lesson I have learned, namely, that the choice of trustee bears an important relationship to the success of the plan.

One of the early criticisms of variable annuity plans was that employees would react unfavorably when and if the unit value decreased. We have now crossed that bridge and it is my feeling that the criticism was unfounded. Certainly, employees do not like their pensions reduced but we have found that a decrease was acceptable if an effort had been made to generate employee interest in, and understanding of, the workings of the plan. That brings me to the part of the question that refers to which particular types of employers this kind of plan might appeal to. My answer to this question is: the employer who is prepared to communicate the plan properly to his employees. Naturally, it helps if the employees are of the type that will more easily grasp the principles of variable benefits. On the other hand, there are so many ways in which the benefits can vary that it is wrong to be dogmatic. I feel that, for instance, benefits which vary directly with the Consumer Price Index would be understandable even to the unsophisticated employee.