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Group Pension Plans

A. What developments can be expected from the introduction of proposed Canadian legislation which would permit life insurance companies to operate special investment accounts for pension plans?
B. What problems have been encountered in implementing legislation of this type in the United States?
C. What other recent developments can be expected to affect the relative competitive position of insured and trusteed plans and in what ways?

MR. F. EUGENE SMITH: The proposed Canadian legislation referred to in question A became law on March 30, 1961. Among other things it provided for the establishment of special investment accounts on a segregated basis. Although the legislation does not limit such accounts to the group annuity field, it is probable that they will be utilized primarily in this area. It appears that segregated investment accounts could have been established in Canada, on a nonsegregated basis, under the previous Acts. The current amendments make a segregated approach compulsory —a much more satisfactory position from the point of view of the insurance companies.

A company may now establish as many segregated accounts as it wishes. The quantitative restrictions on investments apply to each of the accounts separately, except for those accounts held for policies under which the reserves vary in accordance with the market performance of the assets in the account. The qualitative restrictions on investments apply to all accounts without exception.

A number of Canadian companies have already established separate investment accounts for use with pension plans, based variously on common stocks, N.H.A. mortgages, conventional mortgages and corporate and government bonds. North American Life Assurance Company has to date established only one segregated fund, based on common stocks. A number of controversial questions arise with this new development. One of the more important of these is the problem of how much control the policyholder should be allowed over investment policy. At one extreme it would be possible to establish a separate account for each stock or bond held by the company and allow the policyholder to make up his own portfolio from the various issues offered. At the other extreme it would be possible to offer only a single risk fund where the insurance company would retain full control over investment policy varying its buying pattern between equities and bonds from time to time in accordance with its judgment as to market trends. Most planning has assumed that each of the separate accounts would be "pooled" funds, including monies contributed by a number of different policyholders. It is quite possible, however, to establish a separate account for a single policyholder and to grant him complete control over the investment policy for his particular account. I believe that this latter approach will become quite popular with larger employers, as they become aware of the advantages of the mortality guarantees available, linked with some degree of investment freedom.

Many people argue that the reputation of the life insurance industry has been built upon guarantees and that the companies should not enter into agreements whereby the investment risk is borne by the policyholder. I believe, however, that the majority of group annuity policyholders are capable of appreciating the risks which they would be assuming by directing pension monies into special investment accounts. The type of policies now being developed in this area, including mortality and expense guarantees but no interest or capital guarantees, should fill a major gap between the fully insured and the fully self-insured approaches. To me this approach does not represent abrogation of responsibility, but rather represents a useful extension of service to the public into a field not previously covered by any funding agency.

The new legislation automatically raises the question of variable annuities. It is possible that public demand may force most insurance companies into offering variable annuities. My company at the moment is limiting the use of its segregated stock fund to preretirement accumulation. I do not believe that the public really wants variable annuities in the forms currently being offered by some companies. Rather, I believe that the public wants a variable annuity which will increase in value with an increase in the cost of living, but will not decrease with the decrease in the cost of living. Any member who can provide a formula to accomplish this result may be doing a significant public service.

MR. G. GRAEME CAMERON: One of the developments which can be expected from the recent Canadian legislation is a reassessment of over-all philosophy by life insurance companies operating in Canada. The soul-searching which has been set off has already brought forth some champions for fairly strict adherence to the insurance principle, with others expressing views ranging all the way to approval of noninsured funds preretirement, combined with variable annuities.

We have here a new competitor for the trusteed plan and mutual funds. Life insurance companies of Canada can not only compete directly with the investment services of the trusteed plan, but further can offer guaranteed purchase rates at retirement. In some cases there will be a teaming up with consulting firms, with the consultant providing the actuarial and other administrative services. In other cases there will be direct competition, with the new policies providing actuarial and administrative services in addition to investment services.

The new segregated funds will provide both a new competitor and a new partner for deposit administration. While lacking the guarantees of deposit administration plans, the new segregated funds will be more flexible with regard to transfers and cash-out privileges. They could replace the deposit administration contract with some companies or could be used on a split-funding basis in conjunction with deposit administration or group deferred annuity contracts.

We may well have requests for further modifications to the laws governing the investments of segregated funds. Each of these segregated funds now has its own basket clause covering 5% of the book value of the fund. Fluctuations in the book value could force the sale of securities from the basket whenever this exceeded the 5% limit. In order to obtain a satisfactory yield in equities in today's market it may be necessary to turn to more recent offerings with good growth potential. These are the very securities that would have to be held under the basket clause, thus making a neat problem for our investment departments.

London Life has entered the field with a series of Group Investment contracts. These range from a stripped-down contract providing investment services and guaranteed annuity purchase rates to comprehensive package plans including administrative and actuarial services.

MR. LAURENCE E. COWARD: As a consulting actuary I have a number of questions regarding the new types of contracts being offered. The Superintendent of Insurance has said that an insurance element must be present, either a mortality guarantee, an interest guarantee or an expense guarantee. If we are going to have contracts that are issued with no more than an expense guarantee, these would be scarcely different from a trusteed plan. My first question, therefore, is: "What is the minimum insurance element that should be in these plans—is it going to be real or fictional?"

I would also like to know what the insurance companies are going to do with their numerous existing group annuity contracts. If they do not go back to the old contract-holders, their position is going to be very weak indeed if the contract-holder comes back after hearing of these developments from someone else.

Most life insurance companies are offering actuarial services with these contracts at very low fees, although they say they are not anxious to be providing these services. Since they do not want to do actuarial servicing, will they refer plans to a consulting actuary?

Have the life insurance companies given any thought to the reaction of the trust companies? The trust companies are quite seriously disturbed by current developments. While they have no idea of trying to reduce the powers of life insurance companies, is it not possible that they will try to extend their powers to handle life annuities on a pooled nonprofit basis?

MR. GEORGE F. M. MAYO: The first and obvious result of the new legislation is that the companies are going to take advantage of it. I feel that this is a field which will be entered very slowly and it is right that that should be so. There is no indication yet as to whether employers or employees really want variable annuities. Employers generally will fear that they will be faced with requests to make up any difference between a true cost-of-living pension and the annuity resulting from a traditional variable annuity approach when the latter provides payments at a lower level. I do not feel that variable annuities are appropriate for pension plans except possibly for the limited portion of the employee's pension which would exceed subsistence level. In the initial development, contracts should provide for equity accumulation preretirement only.

There is a question as to how much business is available to the life insurance companies on this basis. There is very little new business available from larger employers who will be most interested in this approach. The result of this is going to be intense competition. Most competition is going to be based on the expense charges provided in the contract, an area where there is little room for movement. There will be a very heavy load of responsibility on the insurance companies not to enter into competition on recommendations as to the level of contributions under a plan. Both consulting actuaries and the actuaries of insurance companies will have to make sure that advice given to employers is given on an ethical basis.

With regard to Mr. Coward's question regarding treatment of existing policyholders, I believe that we must advise them of the current developments, presenting them as a different, but not necessarily better, method of funding. It will be up to the employer to decide which approach is preferable for him. National Life Assurance Company is one of the companies that would prefer not to provide actuarial services. It does offer a contract in which the basis of funding and of actuarial assumptions is detailed, thus allowing no room for actuarial opinion in subsequent calculations. Mr. Coward also questioned the methods which life insurance companies might use in referring clients to consulting firms. My answer is that the trust companies are in exactly the same position.

MR. SMITH: In answer to Mr. Coward's questions, I can speak only for one company. North American Life Assurance Company intends to provide a full postretirement mortality guarantee under any contracts issued under the new legislation, whether the policy provides for a fixed annuity or a variable annuity pay-out. My company has already taken the approach with our present policyholders suggested by Mr. Mayo. Rather than recommending an equity approach as something better, we have in fact declined to underwrite on such a basis for some of our smaller policyholders where the circumstances involved did not make this a proper funding vehicle. Mr. Coward has suggested that the trust companies are concerned over the fact that the insurance companies are invading their natural market. Traditionally the trusteed approach has been recommended only for larger plans. With the development of new techniques, in particular that of pooled funds, the trust companies are competing for smaller and smaller plans all the time. In fact they are invading what might be termed the natural market of the life insurance companies. I do not believe that there is a natural market for any particular funding agency. Rather, current developments are leading to tighter competition over a broader range.

MR. CONRAD M. SIEGEL: From the discussion of the representatives of the Canadian companies, it appears that the use of common stock funds would be restricted to the preretirement accumulation period and at retirement fixed dollar annuities would be purchased. It has been suggested that a real insurance element is involved, since a guarantee is provided in respect of annuity rates to be applied to the transferred funds. I believe that this transfer guarantee is more apparent than real, and, in actual practice, the extent to which funds will be transferred will be rather negligible. If common stocks are utilized to the extent usually found in uninsured pension funds, over the years it will be found that the common stock fund would serve primarily as a portion of the preretirement reserves for succeeding generations of active employees.

A numerical example can be obtained based upon the following assumptions:

(1) 1/3 of total assets (active and matured life reserves) to be invested in common stocks;
(2) Initially immature population as represented in Table III of Trowbridge's paper "Fundamentals of Pension Funding" (*TSA* IV, 17);
(3) Funding method—entry age normal with 20 year amortization of accrued liability;
(4) Actual experience equal to actuarial assumptions employed in Trowbridge's paper;
(5) No unnecessary "churning" of common stock fund, *i.e.*, stocks will not be sold at an employee's retirement only to be immediately repurchased as active life reserves for nonretired employees.

Based on the assumptions above, $\frac{1}{3}$ of the initial contribution is deposited in the common stock fund. This proportion reduces gradually so that in the 5th year the proportion is 30.7%, in the 10th year 24.9%, in the 15th year 18.7%, and in the 20th year 13.6%.

Beginning with the 21st year no further contributions are made to the common stock fund. At that time a portion of the investment income earned by the common stock fund is transferred each year to the fixed interest fund in order to maintain the $\frac{1}{3}$–$\frac{2}{3}$ relationship. When the fund is fully matured the entire investment income earned by the common stock fund is transferred to the fixed interest fund. The results above indicate that dollar cost averaging has comparatively little applicability, since the only new money coming into the common stock fund is in the form of a decreasing series of payments over the first 20 years of the pension fund's presumably perpetual existence.

MR. DONALD R. ANDERSON: As a result of the new legislation there is the likelihood that the insurance companies will be able to offer basically the same product offered by trust companies. It is, I think, highly desirable that this does not lead to a stronger trend in the direction of actuarial services being performed by insurance companies. Lawyers do not practice through corporations for good reason, and there is a danger to our profession and its ethical standards if insurance companies are going to practice the actuarial profession widely in competition with each other. Such a development cannot be forestalled unless some external force, such as pressure from the Canadian Life Insurance Officers Association, is brought to bear upon the individual insurers.

MR. NORMAN G. KIRKLAND: I want to congratulate the insurance companies on this latest legislation in Canada. The original pension plans were nearly all established to provide a pension determined by a formula related to an individual's final earnings. Now the insurance industry is in a position to offer a medium of investment best suited to this form of pension plan and I think that this is a very important step forward.

MR. LESLIE R. MARTIN, JR.: With reference to section B, in January 1959 legislation was passed in Connecticut making it possible for domestic insurance companies to operate special investment accounts for pension plans. Now, almost two and a half years later, major problems in three areas must still be resolved before contracts containing special accounts can be issued. These problems are all associated with laws or legislative bodies in the United States, so Canadian companies may not find the same problems.

1. Will special account contracts be subject to the requirements of the Securities Act of 1933 and the Investment Company Act of 1940? It would

be a real problem, especially for a stock company, to comply with these Acts. If a contract is classified as an insurance or annuity contract, it is exempt from S.E.C. regulation but is, of course, subject to regulation by state insurance departments. Aetna's special accounts contract contains, among other things, these important features:

a) The basic contract will be a deposit administration contract with an optional separate account provision,
b) the balance of the special account will at all times be less than one half of the total funds under the contract,
c) the special account will be applied to purchase guaranteed annuities in a fixed amount, and
d) all other funds under the contract will be of the normal deposit administration type.

A decision has not yet been made by the S.E.C. concerning the classification of this type of contract. One important decision has been made by the Supreme Court on a different type of contract. In the *VALIC* case, the Court held that the VALIC contract was predominantly a security with no substantial insurance element. In our contract the reverse is true—it contains features that make it predominantly an insurance contract. Efforts are being made to obtain a ruling from S.E.C. to define the nature of this type of contract.

2. Will state insurance departments approve the issuing of such contracts? Our contract has already been filed and approved in our home state of Connecticut. It has also been filed in New York, where it is currently being studied. Under the New York law no business may be conducted by a life insurance company except life insurance business or business incidental to life insurance. In essence, the issue before New York is the same as before the S.E.C.—namely, is this type of business essentially life insurance business or is it a banking operation?

3. How will the contracts be taxed? This is perhaps the most serious problem. Some of the questions that arise are:

a) Can dividends received by the insurance company on stock held in the special account be treated as interest paid in Phase 1 (Section 805(e))?
b) How will capital gains be taxed?
c) Will fluctuations in the value of the fund be considered in Phase 2 as an increase or decrease in reserves or will they be treated in the same manner as variable annuities under Section 801(g)(4)?

The tax law was never designed to fit this particular type of contract. In order to clarify the tax situation it will probably be necessary to obtain an amendment to the law.

In conclusion, the problems I mentioned are serious ones and must be resolved before special account contracts can be issued. Considerable progress has been made and we are hopeful that some time this summer the prospects of doing this type of business will be clarified.

MR. ROBERT F. LINK: We are not yet in a position to issue segregated account contracts under New York law, and my remarks are addressed to section C in the United States arena. This question should undoubtedly produce mention of the reduced federal income tax on funds held by the insurance companies under qualified plans and of the investment year method of allocating investment income. It invites the comment that these two developments will result in a stronger competitive position for insurance companies versus trusts. Before making that comment, one can well examine where we are right now from a competitive point of view. The facts as to relative growth are well known. The funds held by trusteed plans doubled from 1955 to 1960. Those held under insured plans increased by about 70%. One hears often of insured plans going trusteed; not so often do we hear the reverse.

There is a popular belief that the competitive position of the trusts is largely due to the opportunity they offer for higher investment yields. This thesis seems to be accepted even in some insurance circles. It is fostered by a number of stock arguments—the tax on insurance company investment earnings, the high rate of insurance company investment expenses, the alleged need for liquidity, reference to the interest rates involved in insurance company guarantees, state regulation of investments, and in general the stereotype of the insurance company as a conservative investor. I have never seen these arguments supported by a properly prepared comparison of actual net investment income results.

This strange situation is illustrated by an article about pension trust funds which appeared some years ago in a popular national magazine. The article spoke with favor of the imaginative and useful investment policies of trustees, citing statistics on the large amounts invested in industrial securities and the small amounts in governments, contrasting this situation with the conservative investment policies of the insurance companies. If the writer had bothered to look at the *Life Insurance Fact Book,* he would have seen that insurance companies had for some years had less in government and more in industrial securities than the trusts. This particular comparison of insured and trusteed investment policy would have been truer with the parties reversed.

According to the S.E.C., the average gross investment income rate for corporate pension trusts in the United States was 3.64% on market value basis in 1960. I have estimated 4.07% on a book value basis: The net investment income rate before federal income tax for United States insurance companies in 1960 was 4.11%. The corresponding earnings rates for 1956 were, for trusts, 3.69%, and for insurance companies, 3.63%. It must be remembered that trust funds doubled in book value from 1955 to 1960, whereas insurance company assets increased only about 33% during this period of high yields on new investments. It must also be remembered that the trust assets included a high proportion of common stocks. The earnings comparisons hardly provide a basis from which a crushing superiority for the trust fund approach can be deduced.

Of course this comparison has omitted a key point, the potential capital growth of equity investments. Opinions vary as to the merits of including stocks in a pension portfolio. There is no apparent division of opinion on the desirability of a large portion of fixed dollar investments. With respect to these fixed dollar investments, the Equitable believes that it can do better over the long pull than most trustees. This argues for split-funding as the best arrangement for the employer who wants stocks in his pension fund.

How will tax relief and the investment year method affect competition? They improve the position of insurance companies—potentially. Our investment departments will do their part. It seems to me that we must do better in telling our story to the pension-buying public. Speaking with unconcealed bias, here is a field where consultants and insurance companies should join in an effort to substitute facts for impressions.