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Valuation of Assets

A. What bases, other than cost or market, are in use for valuing pension trust assets and acceptable under the Internal Revenue Code and Rulings?
B. How can a retirement plan having assets valued on a book or cost basis utilize existing unrealized appreciation for purposes of improving benefits or reducing current funding costs without changing to a market value basis?

MR. ROBERT H. LITTLE: No plans with which we are familiar use methods other than cost or market for valuing pension trust assets. However, other methods are being given serious consideration.

The principal problem being faced is the matter of unrealized appreciation on equities held in the retirement plans. I think one of the most interesting approaches is that developed by Bankers Trust of New York whereby increments of unrealized appreciation are recognized each year. They suggest increments at the rate of three percent per year.

I think the general problem is quite different as between corporate retirement plans and public retirement systems. While many of our corporate retirement plan clients have considered the possibility of recognizing unrealized appreciation in an orderly way, most of them have felt they prefer to stay on a cost basis and perhaps build up a cushion or margin to be used later on to improve benefits.

In the case of public retirement systems, I believe we are faced with a different problem. In this area (Los Angeles, California), many of them are money purchase systems. It seems to me, just for reasons of equity, that it is desirable to recognize some of the unrealized appreciation which they may have in equity investments.

I might add that the process of recognizing unrealized appreciation should not, in my opinion, be started until you have, perhaps, a one-third or even greater appreciation in the equity portfolio.

There is another unusual problem with reference to valuation of securities. I believe the problem is pretty much limited to the West, where many of the banks have developed employee benefit common trust funds wherein the unit values vary to reflect both changes in the market values and the earnings of the securities held.

We have adopted the practice of valuing units in these common funds at a cost value equal to the amount paid to acquire the units, plus the interest and dividend earnings of those units during the period held. We feel that is as close as we can get to a cost basis on these investments.

This problem, as far as I know, is not present in the case of some of the funds handled by Eastern banks since, in those instances, the earnings

are expressed in terms of additional units in the common fund rather than in terms of increased unit values.

MR. WILLIAM F. MARPLES: A method in use by a New York bank is very interesting. Each year a charge is made against unrealized capital gains and transferred as effective income to the fund. The amount of the charge is understood to be 3% of the carrying value of the common stocks or such lesser amount as may be determined from the increase in the market value. The method is in operation for a number of plans. All of these plans had accumulated in excess of 15 percent of market value over book value before they started tapping the unrealized capital gains for any increment in growth.

I believe that if a plan were starting with no excess of market value over book value, it would have to be very careful. It would be desirable to reserve a portion of the excess of capital market values over book values before it is tapped for extra nominal income.

As I understand it, the method used by this bank arose because the Internal Revenue Service would not allow a client to offset a large unrealized capital appreciation against a large increase in liability for revised benefits. The I.R.S. required that, if the assets were written up to market values in one step, the amount must be considered a gain for the year and normal cost plus 10% of the unfunded liability charged against it until it was exhausted.

So, if a very substantial excess of market value over book value is accumulated, a distinct problem arises with the I.R.S. in trying to utilize it. The I.R.S. will, however, accept a valuation method for determining the value of investments if used year in and year out.

DR. ALAN A. GROTH: Section B raises the question as to whether the unrealized appreciation should be used for the purposes of improving benefits or reducing current funding costs. I believe that the source of unrealized appreciation, the equity portfolio, was incorporated in the investments primarily to give a hedge against inflation. For that reason, I believe that the appreciation in assets should be used, if possible, to improve benefits, rather than to reduce employer contributions. I have to admit I am not always successful in having this policy adopted by our clients.

Should a decision be reached that the unrealized appreciation is to be utilized for reducing contributions, there are alternative methods of applying it. One is to switch over to market values immediately or gradually by some system. Some authors have mentioned that there are problems one might encounter with the Internal Revenue Service in the realization of the appreciation if overfunding results.

Another method of realizing the appreciation is to change the assumed interest rate. In connection with this, I would like to suggest that whenever we are changing the interest rate, we should consider the past experience, estimate the future long-range investment yield and properly weigh these two factors.

For a number of years we have been using a third method with the approval of the Internal Revenue Service. The method, in effect, is the same as paying dividends on group annuity policies if the source of dividends were restricted to interest gains. Each year we determine the excess over the total income on assets, including realized gains, over the expected income. Such excess then is used to reduce the maximum and minimum contribution limits. This method has one defect—that the employer might be tempted to realize gains in order to reduce contribution requirements. If the realization of gains is due to other reasons than investment considerations, the result might be a lower yield or the deterioration of the portfolio or both. It can be explained, however, to the employer that, in this situation, the actuary might have to use a lower interest rate assumption, resulting in higher future contributions. Through cooperation with the trustees, we have thus far succeeded in avoiding the undesirable practice of realizing gains when not warranted by investment considerations.

MR. GEORGE V. STENNES: I think it has been observed that appreciation has caused some employers to not mind so much carrying along an unfunded liability rather than progressing toward full funding of a plan. This means that the employer is going to defer the day on which he decides whether he takes his credit for it or gives it to his employees in increased benefits.

MR. MYLES L. GROVER: I think we should keep in mind that the answers depend to a large extent on the method of funding the pension plan and the type of benefits. For example, there are a great many final salary plans where the pension is already inflation-proof as far as the participants are concerned, and, therefore, if there is some large unrealized capital growth within the fund, I see no reason why that shouldn't be used toward funding the present benefits. I see no reason why it should go toward improving the benefits.