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Actuarial Soundness

A. What are the problems encountered in seeking generally acceptable criteria for minimum sound funding? Can these problems be solved?
B. What emphasis should be given to the sufficiency of funds to cover vested benefits? Do any special concepts of minimum funding apply to plans where there is no vesting prior to retirement?
C. To what extent should the funding of past service cost be stressed?
D. At what point, and how, may an insurance company (or a consulting actuary) disassociate itself from a pension plan because of underfunding?

MR. DORRANCE C. BRONSON: It has been suggested by some knowledgeable people that pension actuaries, with the assistance of lawyers and accountants, prepare a statement of principles and standards to serve as a guide for actuarial soundness in pension plans. Others have suggested that such standards be set by statute. Whether the criteria for actuarial soundness are established on a voluntary basis or through legislative means, however, the essential problem is that employers, unions, and pension actuaries are not receptive to being put in strait jackets.

The establishment of such criteria would require more unanimity of opinion than I believe can be reached as to the definition of the term "actuarial soundness" itself, as well as its components of actuarial assumptions and funding methods. Even if a majority opinion were worked out, how would the criteria be applied? Would plans not currently meeting standards be discontinued or merely be labeled "unfit"? Might not any practicable minimum be set so low as to not be prudent and might it not be frequently used as a maximum rather than minimum? On the other hand, would stricter standards result in some new plans not being adopted at all?

For example, it is being suggested that, as a standard, vested benefits —for all who had reached a vested position—be viewed as guaranteed by the employer or fully funded in the trust or deposit administration fund. The standard proposed would be on the basis of a chosen life company's manual rates for deferred annuities. There are obvious difficulties with this approach, particularly for a trust fund medium; a choice must be made between the lowest and highest rate schedule on the market; changes in the life company's manual rates might affect the valuation; it is possible that manual rates will not be available for the particular retirement ages and type of plan involved; the manual rates may be on a quite different interest and mortality basis than used for the trust or D.A. fund.

If statutory full funding for vested benefits were required, it could in

my opinion work to frustrate or curtail pension plans. Vesting provisions might then be eliminated or included on very strict conditions of age and service. The trend to noncontributory plans could be stopped or reversed. The money-purchase type, with all its drawbacks, might be rejuvenated. Profit sharing plans, without such "pension" restrictions, might be greatly stimulated. In fact, it's conceivable that a nonqualified pension plan would be more attractive in many cases than a qualified plan with the statutory impedimenta.

Although statutory standards have been established in the United States for the valuation of life and annuity policies, insurance actuaries are not in complete agreement as to the need for them. Also, the standard in effect for a policy when issued is fixed for that policy thereafter. In England there are no statutory standards and the British actuaries serve in place of a statute in keeping life insurance sound. I submit that the pension actuaries should continue to take the responsibility for the use of proper standards and for persuading employers to build up to these standards. This approach would provide more flexibility in modifying the standards in the light of actual experience. It should also be remembered that private pensions are not a legal commitment in the same way that insurance companies are committed under their contracts, and trying to make a private pension plan into an insurance company is unrealistic and unworkable.

Most of the talk about standards has been concerned with liabilities. Would there not then also have to be standards for the other side of the ledger, namely for assets? Here again, I believe a statute would be required; and, in my view, it would be a bad statute. A few people have proposed that the investment restrictions on pension funds should be the same as on life insurance companies, but this would have prevented many large plans from getting the good yields and investment gains in the growth stocks of their portfolios over the last 10 to 15 years. There are others who are interested in such a law on assets in order to channel these assets into projects in which they are especially interested.

The employers, by and large, have funded the plans to a remarkable degree in the last 10 years. I don't think we need these laws, either for liabilities or for assets. I think the corporate trustees and the insurance companies on the asset side and the pension actuaries on the liability side can do and are doing a splendid job in their respective areas. A law on liabilities would need a law on assets, which might lead to a law on mandatory vesting, which in turn could result in a law requiring all employers to establish pension plans, and that would not end the spiral.

MR. GEOFFREY N. CALVERT: In my opinion, it is the responsibility of the actuarial profession to find suitable criteria for the minimum sound funding of pension plans. This involves the weighing of a number of factors:

1. The permanency of the employer.
2. The acceptability of passing costs along to future generations.
3. The nature of the assets in relationship to the type of benefit.
4. The timing of income and outgo.
5. The obligations to plan members in the event of plan discontinuance.

In discussing this whole problem with a client, we have found it most helpful at Alexander and Alexander to make a long-term projection of benefit payments, fund buildup and employer deposits under various combinations of funding rate, company growth, inflation, investment composition of the fund, retirement age and benefit structure. I believe that the pension actuary should consider the broad picture and not take refuge in the concept that he is the mere calculator of figures on the basis laid down by his client.

MR. JOHN K. DYER, JR.: Several years ago, I prepared a brief dissertation on actuarial soundness in uninsured pension plans. I prefaced my attempted definition of actuarial soundness with a quotation from that famous mathematician Lewis Carroll:

> "When *I* use a word," Humpty Dumpty said, in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."

I never did succeed in defining actuarial soundness but settled for a strictly negative definition offered around that time by an Internal Revenue Service official:

> A plan is considered *not* to be actuarially sound if either the contemplated or actual contributions are so inadequate as to portend early termination or curtailment of the plan, or to make it obvious that the fund will be unable to meet its obligations for the proposed or contemplated benefits as they come due.

And for a list of a few minimum essentials for actuarial soundness:

1. Some advance funding (not excluding terminal funding)
2. Expert actuarial supervision
3. Reasonable actuarial assumptions and methods
4. Contributions based on the actuary's recommendations
5. Sound investment of the fund.

It is my conviction that no generally acceptable criteria for minimum sound funding exist. The problem is one of identifying a condition which

is relative rather than absolute. I believe, however, that Dorrance Bronson's book *Concepts of Actuarial Soundness in Pension Plans* provides an orderly and lucid exploration of the concept of actuarial soundness. This book should be required reading for all pension actuaries, not just once but as a periodic refresher.

Turning to vested benefits, I would define a vested pension benefit as one which has been promised contingent only upon survival to the qualifying age. Under this definition, I find it difficult to see any real difference between a vested pension benefit and a deferred annuity obligation of an insurer. While I do not believe that statutory minimum reserves or state regulation is required in connection with such benefits, I believe that actuaries should pay much closer attention to the essentially contractual nature of these liabilities. Most plans have at least an early retirement provision, optional with the employee, and this is a limited vesting provision that should also be recognized. Acceptance of the concept that vested benefits are contractual liabilities should lead automatically to a recognition of the desirability for the orderly funding of not-yet-vested benefits.

MR. FRANK L. GRIFFIN, JR.: Vesting is merely one of many benefits which may be included under a pension plan. Therefore, in my opinion, terminating employees should be expected to take their chances on the sufficiency of funds just as those employees remaining in service must take their chances on continued funding of their ultimate benefits. In the past, many group annuity contracts were written to provide vesting only to the extent of that portion of an employee's benefits which had been purchased by the date of termination. I believe this practice put the emphasis in the right place.

Vesting variations under different plans are properly considered in the valuation of liabilities through appropriate choice of actuarial methods and assumptions. To require that all accrued benefits should be 100% funded at the earliest point of full vesting—whether through stringent accounting rules, unwise legislation or regulation, or what-not—would increase the cost of a plan so that it might not be adopted at all or would water down the essential pension objectives so as to be unrealistic. Alternatively, older employees with the greatest need of pensions might well have to be excluded, or vesting itself removed, until the plan had been in effect for many years.

In our zeal to protect employees in one small area, we should not lose our perspective relative to areas of more vital concern to employees—company welfare, jobs, and long-term benefits. Pension funding strait jackets could spell the ruin of marginal companies.

MR. DONALD S. GRUBBS, JR.: In negotiated plans where the level of contributions is agreed upon there is a tendency on the part of unions to press for the maximum amount of benefits. At times they demand that the level of benefits be determined on the basis of normal cost plus interest only on the past service liability. The difficulty with this is seen when we note that the United Mine Workers plan this year actually decreased benefits for members already retired because the reduced income from lower employment was insufficient to provide for interest on the large unfunded past service liability. A definite program of payments to reduce the past service liability is unnecessary only if it can be safely assumed that there will be sufficient actuarial gains to fund the past service liability.

MR. DYER: I think we actuaries have perpetrated upon our clients a serious fallacy—that a past service cost is an inherent, unavoidable, and substantial element in the funding picture. In fact, however, the actuary can within the scope of generally acceptable actuarial methods produce a substantial past service cost, avoid this element of cost entirely, or arrive at some intermediate result. Therefore, this cost should be looked upon positively as a desirable, but optional, element of funding flexibility, not as a financial burden to be overcome before the funding program can be considered achieved.

In connection with section D, I believe that a consulting actuary should exercise special caution where there is a tendency for contributions to fall substantially and consistently short of the amounts recommended. Any indication that actuarial certificates are being abused and used as a substitute for, rather than confirmation of, adequate contributions might well be the cause for resignation from the case.

MR. CALVERT: In my opinion, the disassociation of a consulting actuary from his client might be called for in the case of fraud or bad faith on the part of the client. It would, on the other hand, be a serious dereliction to disassociate himself merely because the client encountered severe financial difficulty. It is just at this time that the client needs all the help he can get in resolving the severe problem of meeting his pension obligations.

MR. BLACKBURN H. HAZLEHURST: At the Pacific Mutual we reserve the right to resign if in our opinion the deposit administration fund is not being maintained to our satisfaction. The policyholder then can withdraw the active fund without a discontinuance charge or apply it to purchase benefits, but in either case we will continue to hold the reserves for annuities already purchased. We have recently limited our

ability to resign by providing a minimum funding requirement equal to the cost to purchase vested benefits at the premium rates provided in the contract. At the inception of the contract this requirement cannot normally be met and we do not intend to impose it.

We recently determined one of our split-funded plans to be underfunded. Although total assets and contributions were adequate, the ratio of liquid assets to retired life obligations was falling rapidly. This case has been discontinued in favor of a temporary agreement, providing for reinstatement in a new form if specified deposits are made within a given interval.