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PENSION PROBLEMS—THE ECONOMY AND ERISA

1. What is the impact of economic conditions on:
   a. Current Pension Plan Design?
   b. Investment of Pension Funds?
   c. Funding Indexed Benefits?
2. What are the Actuary's responsibilities under ERISA?
3. What are the Pension Problems presented by the economy and ERISA?

MR. PAUL HART: To provide briefly some background for this session let me review the series of major economic events of the past couple of years:

1. Extraordinary fiscal and monetary stimulus early in 1973,
2. Rapidly increasing inflation,
3. Reduced savings available for mortgage money,
4. New home construction reduced significantly,
5. Oil embargo,
6. Reduced auto sales and energy-related demand,
7. Federal Reserve eased monetary policy,
8. Explosive increase in prices,
9. Real wages fall behind prices,
10. Inventories became more valuable, orders high anticipating higher prices,
11. Businesses borrowed more anticipating further inflation,
12. Interest rates moved sharply up,
13. Businesses undertook massive expansion programs,
14. The serious immediate problems as inventories were too high, production fell, plants closed, unemployment increased and profits slumped,
15. Savings deposits increased,
16. Mortgage money became more available, and
17. Liquidity improved as businesses and individuals repaid past debts.

But after all these events and in spite of the relatively high level of unemployment, most people have still kept their jobs and most of them will get salary increases in 1975. The changes in the cost of living are still historically high and the prospect of the largest Federal budget deficits in the history of this country lie on the horizon.

The impact of these factors on current pension plan design has been substantial. I would like to reach into some of my recent experiences to discuss the impact on existing pension plans and on new plans.

Current Pension Plan Design

The economic factors affecting current pension plan design are many and their impact has not always been in the same direction at the same time. Those factors which I see as having the most impact are:

1. High salary increases over the past two to three years which in many cases have increased wages by 25-35% over that short period. These increases have been substantially greater than the rates assumed by many actuaries in the past and have had a real impact on plan costs. The prospect of future increases at this magnitude has emphasized the value of benefits tied to final earnings and at the same time has emphasized the high cost of such a benefit structure.
2. Higher than normal layoffs in many industries and the prospect of more future reductions has created turnover higher than anticipated in many plans but has also brought about increased demands for more rapid vesting and improved early and disability retirement benefits.
3. Reduced current earnings of many corporations have meant less money available for pension contributions. Some smaller employers and others in industries most heavily hit have had to look at other plan alternatives to keep plan costs at manageable levels. Many plans are moving to higher integration levels or have changed from a unit benefit structure to one which provides for a direct offset of Social Security benefits.
4. Some regional employers who have only had profit sharing plans in the past are moving to defined benefit plans in place of or as a supplement to the profit sharing plans as their recent investment experience has eroded the value of accounts for individuals close to retirement and lower profits have reduced employer contributions.
5. Some smaller employers have been moving in the other direction by terminating defined benefit plans and establishing profit sharing plans in order to continue some retirement program but to avoid the recurring cost of the pension plan.
6. Plan terminations have increased as plants or divisions are closed.
7. Reduced contributions to negotiated cents-per-hour plans as a result of reduced work levels have extended amortization periods and in some cases forced plan trustees to consider modification of plan benefit structures.
8. Pressure for cost-of-living increases to retired employees has increased and many plans have made such adjustments.
9. Existing automatic cost-of-living increases become more expensive for plans which have not anticipated such high levels of changes in the cost of living. Some control over the extent of the increase has become even more important.
10. Thrift and savings plans have continued to become more prevalent and in some cases have been adopted in lieu of increasing benefit levels under existing pension plans.

New pension plans have been influenced more by ERISA than by the current economy. The combined effect of both has been to make the decision between a pension or profit sharing plan even more difficult than it has been in the past. The economy's greatest impact on new plans, however, has been the effect

of the liquidity crisis in many corporations on the adoption of any new employee benefit program.

Investment of Pension Funds

The current state of the retirement fund investment market reminds me of some of Franz Kafka's allegories. If I can take some literary liberties, I would like to suggest an allegory of my own:

Looking at the state of the pension investment market, I feel like a theater critic sitting in a crowded theater that is only one part of a multiple-theater structure.

There are several plays going on in these theaters. The bankers are performing in one, the insurance companies in another, and the investment advisers in a third. Around the corner are a number of experimental theaters which are playing to smaller crowds.

The audiences have been moving restlessly from one theater to another, trying to find a play which is to their liking.

As a critic I, too, have been moving from theater to theater trying to judge the skills of the players and the quality of the scripts.

Each of the actors is working from a script which is being written by several committees off-stage. Some of the committees are writing in foreign languages. The scripts are given to the actors periodically throughout the play and, as the plays have progressed, the actors have been allowed to see less and less of the script in advance.

Some of the actors are still using their lines from the scripts for Act I or Act II even though we are now well into Act III.

While all of this is taking place, more and more of the actors are spending increasingly longer times off the stage and out in front of the theaters selling tickets, coaxing their audiences to stay, or entering the other theaters to entice their audiences away.

As I look at the activity around me, I congratulate myself on my critic's role and my freedom to get up and walk out, only to find that, while I was so involved, ERISA has chained me to my chair!

Let's leave the allegories and look at the factors in the current economy which are having the greatest impact on the investment of pension funds.

Most economists currently anticipate a bottoming economy, with easing monetary policy and perhaps some real growth. In the most recent months we have seen declining interest rates and a reduction in the level of inflation with substantial increases in stock prices. But interest rates appear certain to head back up again and I see some real dangers for pension fund investors in the current climate.

Plans that moved to 80-100% equities several years ago may be looking at the current maket situation as a time to get out and move to bonds just at a time when long-term bond rates start up again with the increasing demand for financing. The prudent man rule doesn't mean that we can forget about common sense.

Some of the immediate problems that I see in the area of investment of funds are:

1. Asset valuation problems with substantial differences between cost and market values.
2. Recognition of realized and unrealized losses.
3. Possible permanent write-down of some equities and mortgage values for investments made at peak prices.
4. Switching of money managers.

I also see several important areas in the investment of funds which will affect the relative position of the insurance companies in the pension field:

1. At least one attorney I work with has challenged the traditional debtor/creditor relationship between the insurance company and its group pension policyholders as a result of ERISA.
2. Current new money rates and guarantees look good in relation to other investment alternatives.
3. Special guarantees on lump-sum transfers have been responsible for attracting substantial amounts of new group pension investment funds.

Funding Indexed Benefits

I would like to close with a few comments on methods for funding indexed benefits. The January 1975 edition of Pension and Welfare News included two current articles on this subject which you may want to read.

Howard Heaton of the Rockefeller Foundation presents a provocative approach which ties indexing and funding for indexed benefits to the average prime rate during a year.

Variable annuities have not worked successfully during the past few years and some companies have been abandoning them altogether. Others have been placing a floor under the variable annuities.

My own opinion is that, regardless of how the benefits are indexed, it is imperative that the cost be recognized and be funded in advance. The cost must be faced at some time and our experience in the past few years has shown that we just can't assume that equity investments will continually increase in value to meet our actuarial investment yield assumption plus the cost of indexed benefits.

Mr. WILLIAM K. STEINER: The actuary has many responsibilities under ERISA. He must file reports to:

(a) IRS - Annual Report
(b) Labor Department - Annual Report
(c) PBGC (if required by regulations)
(d) IRS in event of mergers or transfers of assets.

The actuary will also be responsible for advising his clients regarding many of the cost provisions of ERISA, e.g. the vesting alternative to be selected and the joint and survivor election to be made by an employee who is eligible for early retirement. By far the most important responsibility, however, will be in complying with the funding requirements of the new law. All of my remaining remarks will relate to this aspect of the actuary's duties under ERISA.

Prior to ERISA, it has been common practice for the client to take an active role in the choice of actuarial assumptions. In many cases it has been difficult for the actuary to determine whether his client contact is speaking for the Company, for the participants, or for himself, e.g. it is not unusual for a financial executive to have stock options or a contractual bonus. Under either of these arrangements, and other similar plans, increased profits (due in part to low or decreased pension costs) could result in substantial rewards for the executive.

In most cases it has been difficult, if not impossible, for the actuary to communicate with the stockholders, whose interest might be substantially different. In many cases the interests of participants were given little consideration.

We have not been comfortable with the current "ground rules". Most actuaries have been asked to compromise somewhat to suit the desires of the Company (as expressed by an executive or department head). It has not been easy for an individual actuary to resist such pressure if other actuaries are more willing to be flexible.

It is not clear that efforts to hold Company deposits at a low level are in the interest of management or of the stockholders. The price of the common stock of a listed Company often depends more on the rate of growth of the earnings of the Company, rather than the absolute amount of the earnings for a particular year. Efforts to reduce pension expense for a year (and consequently increase that year's earnings) lead inevitably to larger pension costs in later years and reduced rates of growth.

Under ERISA the actuary must act on behalf of the participants and must use past experience of the plan and its reasonable expectations to form his best estimate of future experience in setting actuarial assumptions.

This is a great opportunity for actuaries to establish themselves as professionals. Now is the time for weak-kneed actuaries to insist on their independence and to resist attempts to weaken the actuarial assumptions that should be used in determining pension costs.

I would like to close with some forecasts:

1. The need to use the best estimate of future experience will lead to smaller variations between assumptions used by actuaries, an increase in conservatism, and generally to improvement in the quality of actuarial work.
2. Most actuaries will continue to consult with employers in setting these assumptions, but will not be willing to make changes which would significantly reduce or increase the deposits.
3. An individual actuary will reduce the variation in the assumptions he uses for the plans that he handles, except in those cases where experience shows that the variation is warranted. This change will be tempered, in part, by a greater emphasis on the tailoring of assumptions to the experience of the individual company.
4. There will be a greater emphasis on the use of assumptions which are all reasonable, rather than balancing conservative and optimistic assumptions. This balancing approach has led to some odd results, e.g. some actuaries have felt that it

is all right to ignore salary raises in a final salary plan if terminations are not anticipated. If the client wants to know what an improved vesting schedule will cost, he is often told - "Nothing." This is not satisfactory. Hopefully, each of the assumptions can include a modest safety margin - with somewhat larger margin percentages allowed for smaller plans.

5. There will be suits. Some will be groundless but, if the actuary's neck is out, there could be severe consequences.
6. There will be a decline in the use of separate actuaries for the employer and the union in negotiated plans. The actuary who performs a valuation under ERISA must represent the participants and should, therefore, be acceptable to the union. If, as is often the case, he was originally selected by the employer, he should also be acceptable to the union.
   The actuary can assist each side individually in negotiations or he can provide information to both sides at the same time. Either course will work if both parties know and approve in advance. If you detect some wishful thinking on this forecast, you are right.
7. Actuaries will be required, under certain circumstances, to reveal breaches by fiduciaries (whether or not actuaries are finally determined to be fiduciaries). Not a pleasant thought, but consider the alternative under ERISA.
8. Data needed for valuations will improve. If the actuary is given insufficient information, he should (a) qualify his report which will produce difficulties for the administrator or (b) refuse to perform the valuation. The Plan administrator will be forced to obtain better data.
9. There will be an increased tendency toward annual valuations rather than at less frequent intervals.
10. The quality of actuarial work performed for individual policy plus side fund plans will improve but will continue to lag behind, due to the low budget alloted and the complexity of the computations needed if an adequate valuation is to be made. Any of you who haven't tried to allow for salary raises in a "final salary" split-funded plan, don't know what you are missing.
11. Valuation of assets will become more scientific and time-consuming.
12. The pressure of ERISA on actuaries and the effect of the funding requirements will lead to a higher level of funding for those plans most in need, and improve the chances of the PBGC to provide the benefits of Title 4 at a reasonable cost.

MR. GERALD E. McCONNEY: Prior to September 2, 1974, private pension plans in the United States involved two principal parties. They were:

1. The employer, and
2. The employees, or their bargaining agents.

Additionally, secondary or minor parties involved in the private plan promise included insurance companies, trustees, investment managers, consulting actuaries, and the U.S. Treasury.

With the passage of the Employee Retirement Income Security Act of 1974, the administrative branches of our Federal Government have become a major party to this private pension plan promise. Moreover, as I will outline shortly, the legislative branch of our Federal Government may play an important role in the future in the private pension plan contracts.

Before predicting how these new major parties to the pension contract will affect us in the future, let us review very briefly the history of Social Security in the United States.

Brief Review of Social Security

The Social Security Act was passed by Congress in 1935. It was amended in 1939 and again in 1946. However, by comparison to the changes made by Congress in subsequent years, these first two amendments were really technical or minor in nature. Hence, it enjoyed a 15-year honeymoon period before Congress made significant amendments to it.

Then in 1950, the old-age benefit formula was liberalized to provide for a "fresh start", and the maximum annual taxable wage base increased from $3,000 to $3,600. State and local government employees were also permitted to join. In 1954, 1958, 1965, 1967, and 1972, benefits and maximum annual taxable wage base were increased. Coverage was also expanded to farm workers, domestics, ministers, etc. Finally, in 1973, the Social Security Act was amended twice in one year.

During this 38-year period from 1937 to 1975, the maximum annual Social Security tax payable by both the employee and the employer rose from $30 in 1937 to $698 in 1975. Additionally, if we add to this the 9/10ths of 1% tax for Medicare, the 1975 Social Security tax payable by many of us is $824.

During this period, the maximum primary old age benefit increased from approximately $25 a month in 1939 to something in excess of $450 per month today.

In the course of all these changes, it is quite remarkable that we have been able to preserve, at least to this date, the concepts of:

- Separate trust fund accounting for contributions and benefit payments, and
- 50/50 sharing of the tax between employees and employers.

In 1973, however, an event occurred which shook up a number of our Congressmen. During that year, more workers in the United States paid a larger Social Security tax than they paid in Federal Income Tax.

The history of our Social Security system tells us two things. They are:

1. Pension increases are very popular among the voters.
2. As long as we continue the 50/50 cost sharing concept in our Social Security system, future improvements in benefits will have to be slower than during the past 25 years. Otherwise, there will be a revolt against increases in Social Security tax rates.

Now let us apply this experience under Social Security to Private Pensions. Before ERISA was passed, Congress was concerned that legislation might discourage the growth of private pensions. Hence, I look forward to a "honeymoon" period during

which the only changes in law will be technical in nature. During this period, Congress will sit back and observe the number of plans terminated, curtailed, or converted from defined benefit plans to defined contribution plans.

Our Experience to Date

Based on our discussions with clients, few pension plans covering more than 25 employees will be terminated. Among plans covering fewer than 25 employees, we anticipate some terminations. However, we expect that some of the smaller terminated plans will be replaced by Company-sponsored IRA's. Also, as a result of the earlier eligibility requirements under ERISA, we expect the number of workers covered by pension plans will be greater in 1977 than it is today.

As a result of the unfavorable investment experience during 1973 and 1974, we do not foresee very many defined benefit plans being converted to defined contribution plans.

Another observation, labor unions generally are not asking for earlier vesting, portability, or shorter funding periods for past service. The union representatives are satisfied to let their Congressmen bargain for these benefits. The unions are asking instead for higher benefit levels.

How Long Will this "Honeymoon" Last?

In my view, I expect the honeymoon period to last only until 1977 or 1978. This is because the pace of legislation is far faster today than it was prior to 1950. Also, World War II required the country's full attention for several years, and thereby lengthened the honeymoon.

After the "Honeymoon" Is Over

Since there are a number of problems created by inflation and asset depreciation among the State, County and Municipal pension plans, we believe that similar legislation regulating the public employee plans will be forthcoming.

We should point out that the plan improvements arising from ERISA are generally paid for 100% by the employer, whereas under Social Security, the cost of benefit improvements heretofore have been shared 50/50 between employer and employee. Hence, we foresee new legislation every two years, just before an election, which will:

- Reduce the maximum allowable waiting period (after all, age 25 and 1 year of service is a long time for a young voter to wait before participating in a pension plan),
- Shorten the vesting period (most employed voters have less than 10 years of service),
- Require the employer to pay for the cost of the surviving spouse's pension under a Joint and Survivor settlement,
- Add dependent children's or orphans' benefits,
- Freeze the allowable level of integration with Social Security old age benefits (Congress came very close to doing this last summer), and

- Possibly require a modified cost-of-living adjustment after retirement.

As evidence of this continuing interest of Congress in the subject of private pension and welfare plans, I call to your attention Section 513 of the Act. The Secretary of Labor is:

- Directed to undertake research and surveys on plans covered and not covered by the Act. These studies include, but are not limited to:
  - The role of private pensions in meeting the economic security needs of the Nation,
  - Operation of plans,
  - Portability,
  - Financial and actuarial practices, and
  - Methods of encouraging growth of the private pension system.
- Also, the Secretary of Labor is directed to submit annually to Congress the results of his studies and his recommendations for further legislation.

You will note that I failed to mention changes in the disclosure requirements. Once written into law, it is very difficult to remove or modify disclosure requirements even though they are very burdensome.

The fiduciary standard contained in the law presents a problem. If interpreted strictly, they will modify many of the traditional methods of providing services to plan sponsors and administrators. However, I understand that many groups representing investment bankers, insurance companies, insurance agents, etc. are attempting to obtain special concessions from Congress. The legislators' reaction may be to do nothing. This is because whatever changes are made will favor a relatively small group of voters at the expense of another small group of voters. Hence, if I have to guess, I would say there will be no changes in this area of the law, but administrative rulings thereunder will attempt to maintain the status quo.

15 Year Pension Forecast

By 1990, I suspect that we will have a three-tier pension system firmly entrenched in the United States. The first, or bottom tier, will be a universal old age Social Security system payable for all workers. The next tier will be a minimum standard pension plan which is regulated by the Federal Government. It will probably be mandatory for the larger and well established companies, say those with 25 or more employees who have been in business for 5 years. The employers will probably have a choice of funding this standard pension with a licensed insurance company, fund manager, or insuring with the Federal Government.

The third layer will be the "excess" plans for executives. They will probably continue to be funded on a pay-as-you-go basis and enjoy fewer of the tax benefits available to qualified plans.

This 1990 pension system is similar to the programs presently in existence in some of the socialistic countries.

Economic Impact

The added cost of:

- Compliance with ERISA,
- Funding for the investment losses experienced in 1973 and 1974, and
- Funding for the salary scale losses experienced by many final pay plans,

will increase pension contributions significantly in the future. This, in turn, must be added to the cost of the products produced and sold by companies. Hence, it will contribute to future inflation.

Higher labor costs will encourage more automation, and more contracting out for services. It will not contribute to the solution of our national unemployment problem.

In summary, I believe the worker in 1990 will receive more of his compensation in the form of deferred payments and less in the form of cash payments than his 1975 counterpart. Also, I believe that those of you in this room who earn your living servicing pension plans can look forward to a period of full employment.