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PENSION PROBLEMS—THE ECONOMY AND ERISA

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A. Impact of economic conditions on current pension plan design.

1. What special programs are employers using to encourage early retirement? Are there ERISA problems?

MR. HARRISON GIVENS, JR.: There is understandable concern over the implications of ERISA for a variety of common pay-as-you-go benefit practices.

Take, for example, the occasional special program undertaken to induce early retirement as a means of pruning the work force. The amount or conditions of such income supplements may be tailored to individual employee circumstances; even if not, they are frequently selective and generally of temporary availability, and hence inappropriate for an on-going qualified plan. If ERISA applies to such arrangements, must there be annual reports, plan descriptions, summary plan descriptions, actuarial and accounting statements, and the rest of disclosure and reporting requirements? Funding requirements would imply mainly the nuisance of demonstrating compliance, since pay-as-you-go funding would be faster. The real Catch-22 is nonforfeitability, which produces income currently taxable to the employee equal to the present value of future benefits, unless the benefit is part of a qualified plan. This has been avoided in the past by making these nonqualified benefits terminable in form, but that may no longer be possible.

The Labor Department has indicated it might be possible to excuse from most, if not all, requirements benefits paid to present groups of retired employees. This would still effectively bar the use of nonqualified supplements for new programs.

Many other uses of nonqualified benefits come readily to mind. It would be a sorry development if a law designed to assure employees of benefits were to assure them right out of existence.

2. Are pension plans being amended to place ceilings on the amount of total pension, including all or part of Social Security benefits?

MR. WILLIAM A. DREHER: At the moment, uncertainties about ERISA regulations restrain many employers from taking formal action to modify their plans. As the air clears, I think that we will see a tendency to limit the benefits

from private pension plans, with limits expressed as a percentage of final or final average pay.

There is increasing awareness of a major change in the role of Social Security as part of our national income maintenance program and a recognition that the proper role of the private retirement plan has been diminished. Furthermore, the pattern of settlements in major industries has introduced benefit levels which were unthinkable ten or fifteen years ago. In combination with Social Security benefits, particularly if one includes the wife's benefits, it is easy to demonstrate that many employees are retiring with higher after-tax income than they received during their final years of employment. From any logical concept of benefit adequacy, these benefits are excessive.

In my opinion, it is a very weak justification to argue that a redundant pension at the time of retirement gives the pensioner some protection against future changes in the cost-of-living. Social Security benefits are responsive to Consumer Price Index changes. Many employers have introduced programs for periodic improvement for benefits based upon CPI changes. Finally, doesn't the employee have some responsibility to care for his old age by saving some part of his income during the working years? These factors will influence employers to introduce ceilings on total pensions.

The most effective way of establishing that ceiling, of course, is not to create a redundant pension in the first place. As I see it, we are at a watershed in the history of benefit planning. For the last 30 years, we have been concerned about building up benefits to reasonable levels. I believe that, for the next decade, the primary plan design issue will be to find ways of avoiding excessive benefits at the time of retirement, while, at the same time, assuring that the career employee has some degree of protection against erosion of purchasing power after his retirement.

3. The relatively recent settlements in the aluminum, can, and steel industries provided for indexing retirees' benefits during the terms of the contracts. What do you anticipate will be the long range effect of these settlements with respect to the future indexing of retirees' benefits?

MR. JOSEPH J. STAHL: Let me review the recent settlements in the aluminum and steel industries because there were differences in the way they approached them. In the aluminum industry, they changed to a flat benefit which ranged from $11.00 to $15.00 depending upon the employee's pay rate, and put in a cap at the same time to provide an overall maximum benefit. Then they put in a so-called "retirees' cost-of-living supplement" which is to be effective as of February 1, 1976. The first payment is next year, with another one the following year, which will increase all benefits for people who have retired as of that date by 65% of the increase in the cost of living during the preceding year. So, in effect, it is really more than just a post-retirement cost-of-living increase. It's really pre-retirement because if a man retires now and picks up this increase on February 1, 1976 he picks up this increase for cost of living. The same is true of a man who retires on February 1, 1976 who gets the same amount of benefits as the man retiring now would get. You are indexing not only post-retirement but pre-retirement benefits also. They kept it out of the pension plan as part of the labor agreement and agreed to pay it out of current profits, not funded as part of the plan. Another important point is that it was emphasized that the agreement was limited to the length of the contract.

In steel, they stayed away from the cost-of-living aspects. They were

afraid of that and they went to a straight 5% increase on August 1, 1976 regardless of the cost of living. Again it's limited to those retiring during the length of the term of the agreement and it's outside of the plan. It's my interpretation that this can't really exist outside of the plan and that it's going to have to be brought back into the plan. I understand that the steel companies are currently talking with the union about bringing this in the plan as a funded benefit. I don't know if this is so in the case of the aluminum or can industries. As far as the long-range impact is concerned, I suspect this will spread into many other negotiated plans with the benefit being indexed for the length of the contract. On a dollar-per-month plan, this really becomes a final average plan because the benefit is always up through negotiation based on the then current level.

MR. GIVENS: If you let someone retire in 1975 at $11.00 a month and on February 1, 1976 index it because of a one-year change in inflation, and let someone else retire in 1976 at $11.00 a month without the indexing, then you've got a strike. So you have got to index because you can't treat someone who retires in 1976 worse than the guy who retired in 1975. There is no way around that really.

Steel's approach is different from aluminum's in that it has a flat 5% increase instead of 65% of the actual change in the cost of living. It is a change of the same concept though because they also have the cap. You index and you have a cap. The cap in the steel case is more complicated, varying with the length of service, but it is the same coordinated approach. You hold down the benefit at retirement to the adequacy point and promise instead to let it go up if it needs to.

Finally, as to permanence, it is easy to say that, once you introduce the cost-of-living indexing, you're stuck with it. As a practical matter you can't walk away from it but both sides were very careful to sterilize this by keeping it away from the pension plan. First, there is a payment on February 1, 1976 and a second payment on February 1, 1977 and that is it. The person who got those payments will not get them in 1978 unless something new is created. Not only do you not have further indexing reflection for new people, you don't even have the old people getting the continuation of that payment. Second, it was kept in a separate supplemental agreement outside of the plan. My own guess is that they're equally handicapped. It's going to be a new fight all over again.

B. Impact of economic conditions on funding indexed benefits.

1. Is there a trend toward explicitly indexing benefits in private or government plans? How are costs controlled?

MR. GIVENS: What we've said about question A 3 carries over. Some kind of cap on the indexing seems to be essential. No one has the foolhardiness or courage to have the indexing without a limit. Aluminum ended up with 65% of the cost-of-living increase. Sixty-five percent of an infinite amount is still infinite, so that isn't as much the protection as is the fact that it self-destructs at the end of two years.

CHAIRMAN PRESTON C. BASSETT: If we are having indexing thrown into these negotiated plans can we expect any fallout into the salary plans of the same employers?

MR. STAHL: In steel, you generally have the same plan for hourly and salaried employees so it falls over there. Also, many of your salaried plans are final average plans so at least they're indexed pre-retirement. It remains to be seen what happens with the next go-around in negotiations on this cost-of-living index.

MR. DREHER: The minimum benefits for salaried employees would tend to move up to maintain proportionality to the union negotiations. There is considerable danger in the cost-of-living concept. We should try to avoid the automatic indexing even with the sorts of percentage limits or other controls cited. The increase in the rate of funding that would be associated with those commitments would be an enormous and unnecessary allocation of assets in anticipation of legitimate employee security needs.

MR. STAHL: There is another problem too. In the old-type plan with normal retirement at 65, cost of living was expensive but not that expensive. As we move the retirement age down and get to 30 year retirement or age 62 retirement, cost of living becomes prohibitive in many instances. I think we have to tie the two of them together.

MR. GIVENS: I'd make an analogy with the Health Insurance field. The same kind of discussion went on there between scheduled benefits which would control costs and Major Medical which did the job but had enormous cost implications. You've got the same choice here. Are you going to provide an adequate benefit at a terrible cost or are you going to control costs and provide an inadequate benefit? I don't think the decision is going to go all one way. Some people are going to do one and some people are going to do the other.

MR. DREHER: Associated with this is the idea that even though the benefit should be equitable and adequate, how far in advance of its payment should the money be accumulated? With Major Medical, of course, that wasn't as important a consideration as it is in pension funding.

C. Impact of economic conditions on investment of pension funds.

1. Has there been a noticeable switch from equity investments to other types of investments? Is there any trend away from volatile type investments in order to lessen fluctuations in market value?

MR. JOHN R. WILLIAMS: I think there has been some switch over the last year or so from equity investments. It's hard to say whether this is due to a return to fixed-income investments or just the poor state of the stock market. Recently, however, we have written a number of defined contribution plans which have been transferred from bank trustee arrangements and which were mostly in common stock. In several cases the employers made no bones about the fact that they were making the switch because of ERISA investment rules. These are medium-size companies and they may be a little more frightened than they should be. I think in this initial go-around we are getting some of that. Also there are some problems here. We don't know what the phrase "diversifying investments so as to minimize the risk of large losses" really means at this point. We're probably going to have numerous court cases on this in the future. Now I don't think that the courts will ever mandate any distribution, like percentage of assets between common stocks and securities. I don't think that's the court's job. But I

think, on the other hand, that you might see some court suits won where you might have a 100% common stock fund. My company has a subsidiary which is a large trust company and so we are on both sides of the pension business. Of course in the insurance business we have wide diversification and don't have much worry. The trust companies are very concerned about this problem of what is an adequate mix and what meets the diversification requirement of ERISA. So I think there will be some trend towards getting out of more volatile types of investments. Currently, for example, the trust company mix is about 65/35, the 65% in common stocks. They will virtually refuse to write any plan with a different mix. But we do have some clients of our own that are almost 100% common stock in our separate accounts and this is at their direction. We think that there will be second looks at this and maybe a little more diversification by investment type. There has been some trend in the last couple of years in profit sharing plans to allow participants at age 55 or 60 and over to transfer their assets into fixed securities in order to avoid sharp drops just prior to retirement. We may see a pick up of that trend. This is an area the insurance companies have pushed fairly successfully in some cases.

MR. STAHL: I would agree there has been some switch from equities into fixed-income securities but I think that is really more a reflection of the high yields that we've had and the fact that people have woken up and discovered the market can go down. I've seen another thing that really worries me much more, and that is the greater emphasis on looking at the actuarial assumptions. I'm afraid that sometimes we may have the tail wagging the dog. I know of one situation where a company shifted into fixed-income securities because they discovered what the cost reduction would be if the interest rate were increased to an 8% assumption. They felt they could sleep much more comfortably having their money in fixed income rather than in equities. I'm not sure they made the move for the right reason.

2. Some companies, concerned about the liquidity and cash flow of their pension and profit sharing funds, have defined a dual investment policy; a high liquidity strategy focussed on the part of the fund that will be used to provide near-term benefit payments; and another applicable to the remainder of the assets which is less restrictive with regard to liquidity requirements. Are many companies using this approach? How is it applied?

MR. DREHER: It will be helpful to identify three expressions of that concept. Clearly the intent is to be assured that investment decisions aren't compelled in order to meet obligations for benefits payments that aren't going to be covered by current contributions. I think most of us have observed two ways in which that concept is expressed. First, setting aside in cash equivalents or highly liquid assets an amount equal to a few years' benefit payments, somewhat on a concept of a catastrophe reserve that implies a sharp potential drop in contributions or reduction of income and fund securities. The second approach has more of an actuarial logic behind it that suggests that one set aside a fraction of the fund that is approximately equal to the present value of benefits payable to those persons already retired, and to structure the maturity of a portfolio so that the sum of income and maturities is currently matched against benefits due that year. Irwin Vanderhoof has presented a couple of papers to the Society on that concept of immunization as it relates to life insurance companies, and the principle is behind that idea. In my opinion, both of those concepts are somewhat unrealistic.

In the first case, the cash flow is on a short-term basis which is really quite accurately predictable. The combination of ERISA and Opinion 8 virtually assures a regular stream of contributions into a fund. If an investment manager is properly communicating with his client, some knowledge of an influence over the timing of cash flow is possible and, of course, income on the securities themselves are highly within the control of the investment manager. So, I think the notion of a catastrophe reserve and a short-term high-liquidity fraction of the portfolio is really not justifiable for purposes related to meeting benefit payments. One might wish to have cash equivalents for investment reasons and because of uncertainties about one or another of the securities markets. On the other hand, the actuarial concept of setting aside a fraction of assets equal to the value of retirees' benefits is going much too far into the future to guard against the possible liquidity requirements.

The third approach, which has been discussed with a few clients and has come out of conversations with investment managers, is to adopt an intermediate thought. Let's forecast, say, ten years of benefit payments. Isolate a fraction of the current fund equal to the present value of those ten years' benefit payments. Structure the portfolio so that cash yield and maturities exactly match that current years' obligation. In today's high coupon and fixed-income environment, this is really quite attractive. In testing it with a couple of funds, it would appear that roughly 25% to 40% of the fund would be needed to provide for these benefit payments in a reasonably mature fund. The test can be made both from the point of view of setting investment policy and from the point of view of guarding against liquidity requirements. In the former case, you might not, in fact, actually make those fixed-income investments, but you will be saying to yourself "How far can I go in making equity commitments or other less liquid investment decisions?" So it could be used as a rationale for 60% to 70% equity investment policies. The add-on feature to it which makes it a dynamic solution is to continue to make this analysis on a moving basis so that, out of each year's contributions, you anticipate benefits due ten years out from that date and isolate a fraction of the current contributions which, when added to accumulated income, will be sufficient to meet those benefits.

3. What effect will ERISA have on the future investment of funds?

MR. STAHL: John alluded before to the question of just what a reasonable investment mix was. There was an article yesterday in the New York Times which referred to the clause in ERISA that says that portfolio managers must diversify the investments of the plan so as to minimize the risk of large losses unless under the circumstances it is clearly proven that it is not necessary to do so. The real question comes up about investments in stocks. Are these reasonable investments, or is a money manager going to be liable if he does invest a large portion in stocks and the position is taken that he has not had proper diversification and has not kept on top of the particular situations in which he has invested? There was that recent court decision too, which, in effect, indicated that each investment is going to have to be a prudent investment. You can't look at your total fund and say that the total fund was good, and the good investments made up for the purchase of the "shifting sands" stock company. I think though that ERISA is not going to have much of an effect on investments. I think that where monies go is going to be more a function of what's happening in the market place. They will go to fixed income more because that's a better return, rather than because of ERISA, but I wouldn't want to bet on it. I think the final decisions will come through the court.

D. Actuarial responsibilities under ERISA.

1. How will asset valuation methods, particularly for common stocks, be affected by ERISA?

MR. DREHER: I am sure we all realize we're reading into a few sentences of ERISA the necessity of having market value more visibly or significantly reflected in the actuarial asset values which we assign in computing the amount of the charges and credits to the minimum funding standards account. The IRS has not yet produced a set of opinions or policy. We know that they are concerned with the issues and hopefully will be giving us some guidance in the future. So at the moment most of us are struggling to find solutions to the asset valuation problem which can both be understood by the client and have the effect of reducing the degree of instability in year-to-year patterns of pension contributions. Some of the work that we've been doing really raises a sense of alarm, particularly in the case of mature funds whose assets are a significant multiple of current contributions. If you're going to be funding at ERISA minimums and translating whatever part of the investment result gets filtered through the asset valuation method to become an experience gain or loss, and then have that gain or loss converted into adjustments to pension cost over fifteen years, you can simulate the future growth of a fund and effect of investment resolves upon contributions and see major swings over relatively short time periods that do not presume any dramatic change in the patterns of asset volatility which have been historically observed. So I think that it is important that we find methods, or be given the latitude by the IRS to use methods, that do the best possible job to achieve reasonable stability.

In that context the action taken by the Ontario Pension Commission a few months ago in defining what would be acceptable methods of valuing common stocks was quite disturbing because, as I read it, they're saying that, whatever value is assigned, by whatever technique might be used, the method cannot produce an actuarial asset value of the stocks which exceeds their market value. It may be that the test was to be applied in relation to the total portfolio including bonds but the point is still there. If you can only dampen volatility on one side, you're going to considerably exacerbate the problem. If you recognize that the securities are going to be liquidated and plans are not going to be terminated, and still force through a recognition of short-term events, it would be a material disservice to the objectives of all parties, and I can only hope that the regulators will recognize that.

2. What assumptions are being made as to future inflation? What are the prospects for consensus on a reasonable approach?

MR. GIVENS: There is sort of an easy part and a hard part to it. People are realizing more and more that that old myth that the IRS would not allow you to have any inflation recognition wasn't really so. They will let you do that if it's reasonable and you can give some kind of documentation, but on the indexing of benefits I think we're in a stage of discontinuity. The problem hasn't occurred up to now. There isn't a good body of seasoned practice to draw from. One of the current thoughts is that you can't look at inflation alone, you've got to look at it in connection with the investment return. If you have 10% a year inflation indefinitely, you really can't believe that you are going to have 4,5, or 6% coupons on your bonds. Your old bonds are going to get killed in the market-place, but the new ones

are going to have coupons that will return the investor inflation plus a 3 or 4% return in real dollars. So if you had an inflation-free universe, you'd need 3 or 4% interest; and if you have 10% inflation, you'd have to have 13 or 14% interest. It turns out that the higher set of numbers under reasonable conditions suggests you fund less than under the lower. It is hard to put a great deal of credibility on a liability working out right because there is a difference between what people perceive to be the future and what the future turns out to be.

MR. DREHER: We conducted a series of interviews in January and February with economists and investment managers in an attempt to get some non-actuarial input to the decisions that we would be making as to proper and reasonable expectations for inflation and the impact of growth of GNP on salary changes and expected investment returns. We attempted to focus the questioning on the more immediate, say three to five year picture, as well as the longer picture, say twenty years out, and there was a fairly considerable consensus. The range of opinions as to growth in real GNP extended from 2½% up to 3½% and the twenty year inflation rate was estimated in the 3% to 5% range, with 4% seeming to be the accepted view.

3. Now that actuaries are required by ERISA to use "most probable" assumptions, what long-term rate of investment income should we assume? Could conflicts arise with our clients, or the government, concerning the reasonableness of our assumptions?

MR. WILLIAMS: The interest rate remains probably the toughest item of the various assumptions that we have to make. I don't think anyone currently is looking for rates of inflation under 4% for the next ten years, so you're looking at rates of at least 6% for valuation of pension plans. You could even argue up to 9% fairly easily, but I don't think anyone can actually estimate interest rates out 30 or 40 years in the future. As an example, I can remember just after World War II the prime rate of interest was $2\frac{1}{4}$%. Our Company's investment rate on its total assets was 2.9%, and if we suggested using 6% for pension plan valuations we would have been locked up. It's that simple. The picture is not any better today as far as estimating what the rate will be, except that the long-term rate of inflation seems to have changed and sharply risen. I think at the present time under ERISA "most probable" assumptions, we can't use much less than 5½% or 6%.

Now with regard to conflicts with our clients, this is a very real prospect. Currently, as the anniversaries of our plans come up, we are completely changing the actuarial assumptions of each plan to attempt to meet ERISA requirements of "most probable". In the past we had a lot of plans that deliberately wanted to use a low rate of interest such as 3½%. In the last few years, we've had a very prosperous period. Conservative companies wanted to fund their pension plans on a very solid basis and there were tax advantages to doing this. Now we're having to raise those to, say, 5½% on a "most probable" basis. We have other clients, who were just the opposite, attempting to use the highest possible rates of interest and turnover to bring down their immediate costs. We are having problems with those clients too. This has been compounded by the fact that virtually every plan that we have that is based on final salary is having a tremendous actuarial loss because of sharp salary raises last year. We are finding this to be true almost universally, but we've had very little actual conflict with the clients when we explain that it is ERISA requirements. In some ways we are kind of glad to be able to mandate actuarial assumptions on a little better basis than we could in the past. There are conflicts about doing this.

In the past, we did not attempt to mandate actuarial assumptions but discussed them with the employer and had mutual consent as to what we were using. We used to be agreeable to using almost any actuarial assumptions as long as we had a knowledgeable employer and he knew what he was doing. In some cases the actuarial assumptions did not really meet what we thought was most probable.

I think there may be some conflict within the Government itself. The IRS has, in the past, looked at the tax impact and required use of higher rates of interest and assumptions that will produce lower costs. The Labor Department and the Pension Benefit Guarantee Corporation have almost just the opposite aim in having conservative assumptions to protect the guarantees that they are making. I don't know how that will eventually turn out, but it's obvious that their aims are not identical.

MR. STAHL: In general, we found companies more willing to talk higher interest rates than they have in the past, although they still tend to hedge. If they think they can earn 8%, they don't want to use more than 7%. They still want to keep a fudge factor in there. Regarding conflicts with our clients, one of our clients told me in jest that he realized fully that the actuary could determine the assumptions and the interest rate, but I shouldn't forget that he could determine who the actuary was.

MR. DREHER: I think we are implying that the salary assumption and the investment return assumption should be coherently linked by a shorthand expression for the differential between those assumptions. Have any of us changed our views on what that differential should be?

CHAIRMAN BASSETT: I read somewhere between 2% and 3%.

MR. GIVENS: You have to realize too that the effect of the difference varies with the level you're at. It also depends on the extent to which the plan is funded. That is going to be less so in the future, though, as you have minimum funding standards.

CHAIRMAN BASSETT: I know that ERISA states that the assumptions in aggregate have to be reasonable, so you can still use unreasonable but compensating assumptions. But I wonder if that's really practical when we're also going to have to show, for example, the present value of vested benefits. Do you feel that we are going to have to have each of the assumptions fairly reasonable?

MR. DREHER: I think it's very important that we do so because otherwise we are going to be distorting the calculation of past service liabilities for the representation of current funding status, which is more heavily affected by the investment assumption than by the salary.

MR. STAHL: I agree. Opinion 8 really started the trend in that direction. This is just going to enforce it even more and it is really essential that we do it. The real problem is that so many clients are waiting for other companies to use reasonable interest rates or reasonable salary scales. Nobody wants to lead the parade.

4. How does it appear that the relative responsibilities of the auditors and the actuaries are going to be coordinated?

CHAIRMAN BASSETT: I'm involved in several professional groups on this topic.

As many of you are probably aware, there is a committee set up that is called the Liaison Committee of Actuaries with Accountants and there is a corresponding committee in the accounting profession of the AICPA that set up a liaison committee for relations with actuaries. These two groups meet jointly three times a year and I think this is going to be, and has been to date, a very effective forum for actuaries and auditors to get together to discuss their related problems and to get an understanding of one another and how we operate. I'm very hopeful that this will provide a basis so we don't hit head on. Besides the AICPA Joint Committee there's the Financial Accounting Standard Board (FASB). They replaced the Accounting Principles Board that wrote Opinion 8. The FASB is also developing recommendations in regard to the auditing of pension plans and pension funds and the reporting on annual financial statements of corporations. In other words, a second look at APB Opinion 8. There are two actuaries on the FASB task force on auditing of pension funds as well as Labor Department and industry representatives. There will be actuarial representation on the other task force having to do with possible revision of Opinion 8. The accounting profession is looking to our profession for help. It's too early to state just what the results are going to be but at least we've got a dialogue going. Of course the results are going to depend on what comes out in the way of regulations under ERISA. There are certain responsibilities that are left to the auditors under the Disclosure Section and there are certain responsibilities left to the actuaries. There seems to be some conflict. Perhaps the regulations will specify what each area's responsibility is, and this will alleviate some problems that could arise. I think it can lead to some rather troublesome problems so I'm hoping the regulations will isolate our two responsibilities very clearly.

MR. DREHER: The AICPA Employee Benefit Committee has released two exposure drafts of an audit guide for employee benefit funds which take a somewhat hard line on several issues including the use of market values and the involvement of the accountant in the measurement of liabilities.

CHAIRMAN BASSETT: That audit guide was tossed out on the public as an exposure draft several months ago and you will recall then that an actuarial committee was set up to comment on it. They met with the group that prepared the audit guide and expressed their unhappiness with several points. The committee writing the audit guide went back and rewrote it and submitted it again saying they clarified all the objections. The actuaries looked it over and they said they hadn't changed any of them. The guide was then fortunately referred to the committee I referred to on Relationships between Actuaries and Auditors. That committee took a look at the problems and decided that they had better bury them for the time being. The entire audit guide committee has since been disbanded. The three major problems have now been sent back to other committees. The FASB is handling a couple of them, including the valuation of assets and what is to be shown on financial statements.

E. The future outlook.

1. Do you feel companies may, in the future, have to guarantee the maintenance of adequate benefits to employees after retirement? (Note there has been legislation proposed to require benefits to be increased to reflect changes in the cost of living in this country and such legislation is already in effect in some foreign countries.)

MR. WILLIAMS: Certainly this is a possibility. The legislation referred to was in California, but ever since the Townsend era we have had different proposals on pension plans in California. Usually they have been defeated and fortunately this one was too. For the forseeable future I don't see any governmental regulation in this area. I think that indexed benefits or cost-of-living increases in pension plans will arise probably from the unions to start with and then spread to employer plans. Two or three years ago, there was a lot of discussion about the indexed plans but this has died out almost entirely at the present time. I think what happened was that with modest inflation it seemed like a good idea. We did put in two plans indexed with the CPI at the 3% level. But even then, just a 3% adjustment means that every year you're going to increase 3%. It would cost between 25% and 30% extra. As inflation picked up employers became frightened of the idea of having an indexed benefit because they were having trouble maintaining adequacy of the initial retirement benefit. Until we get over that hurdle, I don't think we're going to go much further down the line towards indexed benefits. If we get a little more stablization in the rate of inflation, then it may be something that would again be talked about and become popular.

CHAIRMAN BASSETT: It seems to me from observing the past that, if the private pension industry does not in some way provide for adequate benefits after retirement, we are going to have a large and vocal group of our population asking the Government to do it. My observation would be, if private industry doesn't fill that gap with heavy or light inflation, then we will have very serious Government pressure to fill that gap.

MR. STAHL: One of the problems here is that, if we have heavy inflation, it is important but it's costly, and, if we don't, it's not really that important. I don't find any great acceptance by employers to do this. The unions may well lead the way here.

2. In view of various expected economic and demographic changes which, for example, will no doubt result in a growing retired population in relation to the future work force, will the recent trend towards a decreasing average retirement age be reversed? If so, should we be advising our clients to encourage older employees to continue working rather than to encourage them to retire early?

MR. STAHL: This is a very timely question. When I first got into the pension area, the normal retirement age was generally spread between 65 and 68. I was telling the client how much money he could save if he could keep his employees on until 67 or 68 and not retire them at 65. In effect, he came back and told me "You don't realize that, even though it's going to be a decrease in my pension cost, it is costing me money pay-wise to keep these old fellows on. I can save money overall if I look at the total picture and retire these people at 65." Then we started with this "30 and out" and the retirement age moved down. We have plans that provide for full accrued benefits at 62. I was pretty well convinced that someday, in the not-too-distant future, Social Security was going to provide unreduced benefits at 62 and we'd have a normal retirement age of 62 just like we now have 65. I'm beginning to change my mind on that and believe we may well be on the verge of a shift in what is happening. The Social Security Advisory Committee's recommendations talked about moving the retirement age back to 68. I don't think that's realistic but still it certainly gives an indication that they

are not about to move down to 62. With the inflation we've had and the substantial union contracts, many employees are staying around for the next contract. They want to see if it is better than the last one. We are not going to see the early retirements that we might have anticipated otherwise. The employee is afraid to retire in the inflationary economy that we have and it would appear that we are going to have in the future. There is also a coming shortage of certain technical skills in the middle and upper management groups. We've got the depression babies coming through and there is a shortage of trained people. Employers are going to do well to encourage at least certain of their employees to stay on until at least 65. It's in its early stages but I see companies now that are not so anxious to encourage early retirement across the board. They are looking at it much more on an individual basis.

CHAIRMAN BASSETT: Maybe this is going to solve the problem for indexed pensions. We might have a plan amended from its current retirement age of 65 with a flat benefit to give the employee the option of staying on until age 67 and we'll index it if he waits until then. Maybe that will keep your costs down some.

MR. GIVENS: We should not be advising our clients to do something along these lines, however, because they are not going to take our advice anyway. It also imputes a value judgment that may be your own, but isn't going to be universal, as to how a country and its population use their productive resources. Some people may prefer not to have a higher standard of living and instead have more leisure time. Others would rather have a higher standard of living and less leisure time. I don't think we have expertise in that field and I don't think there is a universal single solution.

CHAIRMAN BASSETT: I noted that there has been a bill introduced in Congress to provide that Social Security benefits be increased by 6 1/3% or 6 2/3% for each year of delayed retirement. A person going out at age 66 would get a little bit more of an increase in Social Security. This would be instead of the current 1% increase.

MR. RAYMOND B. KRIEGER: A lot of the discussion so far has really revolved around the larger companies and the large union situations and so forth. How do you think this might affect the smaller and medium size companies? I have the impression that attorneys and accountants are trying to scramble through this mess themselves and are recommending dropping defined benefit plans for money purchase plans.

MR. GIVENS: If a defined benefit plan changes to a defined contribution plan, you have a plan termination for Pension Benefit Guarantee Corporation (PBGC) purposes. So don't just jump through that hoop without noticing that there is something on the other side. I think ERISA is very democratic and nondiscriminatory and gives just as many headaches to the smaller company as the larger one.

MR. WILLIAMS: We are getting several terminations a week in these types of small plans. In most cases these are individual policy plans. Their lawyers are telling them to terminate and they are terminating. There is not much we can do about it except to help them straighten out the situation. We just refer it to the IRS and they take it from there if they want to terminate on that basis. It is not a big move, but we think we will lose maybe 200 or 300 clients.

MR. DREHER: There is an investment policy aspect in some of that reasoning that I think has a trap in it. You think about the fiduciary standards requirements, the prescription for reasonable investment policies, and so forth, and contrast the situation of the plan participant in a defined contribution plan with that of the defined benefit plan. To the extent that the employer is trying to protect himself and reduce his exposures, I think he is in a far better position to have the defined benefit plan. His employee has about four different layers of insulation against the consequences of an unsuccessful investment program. I am sure there will be litigation but I would say that the likelihood of successful litigation by plan participants who are concerned about results under defined benefit plans is far smaller than would be the case under profit sharing or thrift plans.

CHAIRMAN BASSETT: Disregarding ERISA, I have seen a switch the other way, in that employees and their employers are so disappointed with the results of their profit sharing plans in the investment market for the last two years that there have been switches to pension plans.

MR. DANIEL M. ARNOLD: I have a question concerning the PBGC and this unfunded vested liability. Specifically, the stockholders of the corporation may desire that the pension plan have invested in fixed investments funds sufficient to cover the unfunded vested liabilities so that there be no potential liability by PBGC coming out of the corporation's net worth. Is there some responsibility for the actuary to point out that you'd like to have for the participants, say, a 65/35 split of common stock versus fixed investments, but for the stockholders more like 50/50 in order to cover this unfunded vested liability?

MR. DREHER: I think that is the wrong handle to the question. Certainly, the concerns are legitimate, but I think it would be more appropriate to buy that second layer reinsurance and lay the risk off rather than to make investment policy decisions which might consciously forego good investment opportunities. If you felt that the more secure policy was the more productive, you ought to be there for investment reasons, not because of residual net worth claims.

MR. LAWRENCE R. SCHIFF: I was wondering whether we could look to the Society for some group arrangement for protection of a malpractice nature under ERISA fiduciary standards.

MR. GIVENS: The Labor Department is expected to issue quite soon a regulation saying that it's permissible and proper for certain degrees of indemnification. The employer can indemnify his employees with respect to the employer's plan. The vehicle, the bank, or the insurance company can indemnify its employees who are trapped under some fiduciary requirements as to assets of other plans. They probably will not allow indemnification by other parties at interest.

CHAIRMAN BASSETT: Several years ago the Conference of Actuaries in Public Practice did a survey in this area and came up with two or three companies that were doing it, but I don't know of anything recent. I'm quite confident that the Society is not considering any malpractice arrangement. I don't know whether that would be a function of our organization or not. It's a good question and I will explore it.

MR. DONALD A. LOCKWOOD: Harrison paints a pretty impossible picture with respect to the supplemental benefits on an unfunded basis. I discussed the

situation with some attorneys in New York and one of them came up with an idea. He thought he solved the problem by having employees who go out and receive supplemental benefits sign a paper which says that they understand the employer has no commitment to continue benefits. The employer can drop the benefits at any time and by having the employee sign that sort of a release he felt that they would not have to comply with ERISA.

MR. GIVENS: You can carry that to the extreme and do the same thing on the whole pension plan. I don't think that idea is worth the proverbial three-dollar bill.

MR. DONALD J. SEGAL: We were talking about the effect of inflation on the interest rate assumption and the statement was made that the interest rate assumption was the most difficult one to predict. What about the salary scale assumption? When you're talking about interest rates, you have a reasonable expectation over five or ten years. But what about salary scales? I think you could make a case that, even over the last year or two years, you may have seen salary increases in excess of your interest rates even in the fixed income market. I'd like to know what the panel's feeling is about the selection of reasonable salary scale assumptions.

MR. GIVENS: Take out inflation and you've got your classical relationship between interest and salary scales with the idea that you can offset one against the other. Add inflation and it impacts both, although the incidences are a little different. Inflation impacts wage rates as inflation actually occurs; it impacts interest rates on new funds as people perceive the future inflation most likely to occur. The effects are related but they're distinguishable. You do the best you can.