TRANSACTIONS OF SOCIETY OF ACTUARIES
1964 VOL. 16 PT. 2

EMPLOYEE BENEFIT PLANS

Benefits for Retired Lives

A. To what extent are death benefits and medical benefits for employees and dependents kept in force after the employee retires? After his death? To what extent are conversion privileges offered? To what extent are available "65" programs being used?
B. Where there is a continuation of such benefits for a retired employee or his dependent, what special problems can result (1) from remarriage or re-employment and (2) in the event of the enactment of a federal plan?
C. What methods of paying for or funding such costs are used?
D. What are the tax implications to both the employee and employer of the various approaches?

MR. ROBERT N. POWELL: California-Western Life has, for many years, offered a group hospital-surgical-medical conversion privilege at termination of employment or at retirement. This privilege, which is currently being offered on a guaranteed renewable basis, is of real value to the retiring employee—approximately 10 per cent of our regular 1963 group conversions was issued at age 65 or over.

However, two additional forces in the market today help to serve the same need: (1) More and more employers are providing health insurance coverage for retired lives under the group plan. The state of California, for example, provides identical health insurance benefits for both active and retired employees and their dependents with the same premium rate being used for each. (2) The availability of various state 65 plans. The main advantage here is that the employer's cost is stable and predetermined. I understand that Western 65—as well as other state plans—now offers a convenient simplified group-billing approach to employers wanting to provide benefits for retired lives.

Group life insurance after retirement is generally continued with an immediate reduction in benefits at retirement and possibly a further reduction a few years later. A survey by the National Industrial Conference Board, published in February 1963, indicated that 80 per cent of firms providing group life for active employees continue life coverage after retirement.

Group life and hospital-surgical benefits after retirement, unlike pension plans, are generally funded on a pay-as-you-go basis. From an employer's standpoint, it would seem logical to prefund post-retirement benefits during an employee's working years, costs thus being charged

against the employee's active years. A prefunding approach that suggests itself here is one akin to that used in deposit-administration pension plans, whereby the present value of estimated benefits after retirement is accumulated during working years. This and other forms of "paid-up" coverage for retired employees and dependents can be developed if sufficient interest is shown by our customers.

MR. ROBERT V. YOUNG: We find an ever increasing interest among single employers and among trustees of multi-employer negotiated plans in prefunding medical care benefits for retired lives. One method of prefunding is the deposit-administration or continuous-fund approach. This basis has usually been used for large corporate, single employer clients, with moneys being placed with insurance companies. It allows you at retirement to transfer moneys from the deposit fund over to the group term contract in order to pay the term insurance premium for the medical benefits.

Prefunding in this manner is somewhat comparable to prefunding a final salary or cost-of-living pension plan, as you have an indefinite future liability because of possible future increases in medical costs.

One drawback to this approach is that the Internal Revenue Service has never ruled as to whether the employer's cost is deductible or not, but employers have been deducting the cost on the basis that the contributions are irrevocable and unallocated to any specific employee.

An additional method that involves the element of prefunding is the 501(c)(9) trust. This is sometimes used in the negotiated multi-employer field where a certain number of cents per hour are allocated to provide retired benefits. However, you do get into a funding-limitation problem on these trusts, because investment income cannot exceed 15 per cent of the total income to the trust. If you co-mingle retired funds with active funds for tax purposes, then you can prefund a greater amount for retireds because your 15 per cent limitation does not become applicable so rapidly, as reserves for active lives are accumulated quite slowly.

The newest vehicle available for prefunding medical care benefits is via pension plans under Section 401(h) of the Internal Revenue Code. Your approach would be similar to the deposit-administration approach except that the funding would be under the pension plan. You could purchase term insurance at retirement, purchase a paid-up plan for benefits for retired lives, or pay benefits directly from the pension fund. This method has the practical limitation that contributions for medical and death benefits cannot exceed 25 per cent of total contributions to the pension

plan. Also, the prefunding for medical care under 401(h) is subject to Internal Revenue Service scrutiny.

MR. JAMES F. BIGGS: A few months ago the Federal District Court in St. Louis held that a Taft-Hartley Trust may not provide medical benefits for retired persons because they were no longer employees.

MR. YOUNG: The case was Kroger v. Blassie. Many other factors were involved in the decision other than the question of coverage for retireds. The case has been appealed.

MR. EUGENE H. NEUSCHWANDER: After the affiliation of Firemen's Fund and the American Insurance Company, I was asked to recast the employees' benefits and come up with an up-to-date plan which would hopefully meet most of the competition in the industry and still keep within available company cost limits. I am talking of the retired portion only.

We have ten thousand active employees, approximately one thousand retired employees now collecting retirement benefits and approximately one hundred employees retiring each year.

We provide a medical care benefit for retired lives under an uninsured plan equal to 75 per cent of all costs that develop during a period of hospital confinement. We do not pay for any costs outside the hospital. We realize that this may force people into the hospital, but any attempt to provide routine medical maintenance costs for retireds will cause one to go broke. We charge each covered person five dollars a month—about half the cost. The company pays the other half. The contributions for the medical plan are all made by deductions out of retirement payments, so we do not have an individual collection problem.

Our group life plan provides some paid-up insurance for the employee. This has been in effect since 1956. The theoretical maximum amount of paid-up insurance that can be accumulated over a working career is five thousand dollars. At retirement, we guarantee a group life amount of five thousand dollars for men and two thousand five hundred dollars for women, including any paid-up insurance that the person has accumulated while an active employee. While the cost to the company may be high initially (the retired life insurance is noncontributory), it will taper off as time goes by and the employees accumulate paid-up insurance while active.

Underwriting

A. What has been the experience on large amounts of life insurance on individual lives under group policies of various sizes? What underwriting standards have been employed?
B. What has been the experience under group policies or individual policies issued on group underwriting principles and providing life and health insurance where the number of lives is less than ten? What underwriting standards have been employed?
C. Is there any way in which claim payments or other factors can be analyzed so as to indicate when an increase in over-all dollar limits of medical care policies should be made? What has been the experience with limits expressed in other than "dollar" terms?
D. What progress has there been in administering various forms of nonduplication of coverage provisions?

MR. PHILIP BRIGGS repeated the discussion which he had presented at the Boston and Chicago meetings.

MR. GEORGE H. DAVIS: The LIAA recently studied some experience on large amounts of group life insurance in connection with preparing a memorandum for the Internal Revenue Service on a method for determining the value of employer contributions for group life insurance under the recent amendment to the income tax law. The experience covered six of the largest group life companies during the last three or four years. The exposure was excess amounts of insurance on lives insured for amounts in excess of the company's normal group life limits. Some individual underwriting was involved.

The aggregate experience was about 85 per cent of the basic experience table underlying the 1960 standard group table. This is slightly below the 1961 United States Population Table for total white lives—the table we are recommending to the Internal Revenue Service as the basis for determining the value of employer contributions.

MR. MARCUS GUNN: It is extremely important to give attention to all factors that affect the persistency of the business written on groups of less than ten lives. We stand to lose a good deal more through high lapse rates on this business because of heavy field expenses and underwriting expenses. I question whether this business can be successful from the standpoint of persistency, which is almost as important as the mortality factor.

MR. EUGENE H. NEUSCHWANDER: The question of claim-payment analysis has three facets:

(1) Comprehensive or major medical with top limits of five thousand dollars or over and covering at least five hundred lives.
(2) Comprehensive or major medical with top limits of five thousand or over and covering less than five hundred lives.
(3) Basic coverage.

In regard to (1), the policyholder should be kept advised of new developments in the industry as well as each claim under his policy that hits the maximum. In this way coverage can be maintained on an up-to-date basis, and, if necessary, a higher limit can be negotiated, especially where a maximum claim is on an executive or a member of his family. Failure to discuss the subject of a higher limit with the policyholder can lead to strained relations after further maximum claims have developed.

Regarding (2), the frequency of maximum claims is reduced so that data taken from the company's over-all experience can be presented to good advantage. In both cases the idea of increasing the top limit while at the same time increasing the deductible should be fully discussed, especially if cost is a factor.

As to (3), the important dollar amounts are daily hospital benefit, hospital services, and surgical schedule. The dollar amounts provided should be related to local area charges. Each policyholder should be informed of industry developments, the level of local charges, and the percentage of total bills which his plan is paying. Satisfactory results for the latter can be obtained from a random sample of claims paid each year.

Experience indicates that when limits are expressed in other than dollar terms—for example, number of days in the hospital and for doctor's calls —increases are seldom made and then only at the specific request of the policyholder.

Regarding the administration of a nonduplication provision, progress has been largely one of education. The policyholder must be sold on the idea that duplication of payments is a luxury he can no longer afford. The idea must then be presented to the employees. Once it has been explained, many policyholders welcome the opportunity to reduce their costs and actively co-operate by policing claims.

Our claims form contains a section specifically asking for detailed information about other coverage. The form is completed by the insured employee and reviewed by the employer. No attempt has been made to check the truthfulness of the statements, but with proper co-operation from the policyholder reduction in claims pay-out ranges from 3 per cent to 5 per cent.

Insured or Noninsured

A. What are the advantages and disadvantages to
   1. The employer,
   2. The union or union welfare fund,
   3. The employee or union member
      a) While working,
      b) After retirement or termination of employment of insured versus noninsured plans for (1) death benefits, (2) temporary disability income, (3) long-term disability income, (4) medical expenses, (5) pensions, and (6) survivorship incomes?

B. What has been the recent trend in the development of the two approaches, by size of group and type of coverage?

C. What differences are there in the treatment of insured and noninsured plans with regard to (1) regulatory supervision, (2) legal requirements, such as those relating to conversion rights, and so forth, and (3) taxation at either the federal or state level?

MR. HENRY K. KNOWLTON: From the employer's point of view, one of the strongest reasons for self-insurance appears to be the desire to save money, that is, to reduce costs. This topic was thoroughly discussed and debated earlier this year at a meeting held by the American Management Association. I believe the only thing that can be said factually on this subject is that self-insurance may be cheaper, but it may not be. This will depend on comparisons of: (*a*) claim payments under the insured and noninsured plans; (*b*) administrative expenses, net of any investment earnings under the two plans; and (*c*) the tax, if any, paid by the employer as a result of building up claim and contingency reserves. There is no clear-cut answer, and, while optimistic assumptions may show self-insurance to be less costly, this will not make it so.

Aside from the cost question, the insured plan offers the employer both a fixed maximum cost guarantee and third-party claim settlement. The cost guarantee is most important for death, survivor, and long term disability benefits where cost fluctuations and catastrophe risk are greatest. While the fluctuations in cost are not likely to be as extreme under temporary disability and medical expense plans, substantial fluctuations do occur and the risk insured is more difficult to define and pay claims for. An employer with a noninsured plan may spend substantially more for claims through loose claim practices, may have labor problems as a result of tight claim practices, or, at worst, could have both if the same benefit plan were administered differently in two locations.

On the question of rate guarantees under insured plans, there seems to

be a tendency to undervalue these guarantees or to give them no value at all. The insurance industry has brought this on itself by its attempt to have complete experience rating, both on a retrospective and prospective basis. Rate guarantees do, however, have real value, especially under new coverages where there is no cost pattern and the risk is unknown. For example, guarantees for dental plans have frequently turned out to be far more valuable to the policyholder than had been anticipated.

Another factor influencing the value of a rate guarantee is its length. Among smaller policyholders, we have seen some movement toward two-year guarantees, and one company recently announced a three-year guarantee. If this practice spreads to larger groups, I hope we all become somewhat more conservative in our rate approach and include in our retentions sufficient margin to cover the increased risk.

Other advantages to the employer of an insured plan include the insurer's skills in drafting policy and booklet wording, in analyzing claim experience and recommending revisions, and in the uniform claims-form work and hospital-admissions program of the HIC. These advantages stem from the fact that the insurance industry is in the unique position of having the largest supply of manpower specializing in the actuarial, legal, medical, and other technical aspects of group health insurance. The availability of such technical staffs may be of tremendous value to a large employer.

From the employee's point of view, there appear to be few advantages, if in fact any, to noninsurance, unless the cost of the insured plan is so much higher than the cost of the noninsured plan as to make more benefits available under the noninsured plan. If this is so, the insurer may have fixed its retention charges twenty years ago and never changed them. Also, considering the range of premium levels frequently encountered in competitive bidding, it sometimes seems that an employer could often provide more benefits under an insured plan than under a noninsured plan.

The main advantages to the employee of an insured plan include the following:

1. The insurer's guarantee that benefits will be paid as provided in the contract. This is especially important in LTDI and survivor benefits where benefit payments will extend over a long period.
2. The conversion privilege available under insured plans. This is required under group life and commonly offered under medical expense coverage. Two years ago Occidental began offering group medical expense conversion policies which are guaranteed renewable.
3. Benefits paid by an insurer are subject to insurance department review. This review insures uniformity of claim payments.

4. Under group life policies, installment or life income options are available, and life insurance proceeds are not subject to the limited $5,000 income tax exemption applicable to noninsured death benefits.

From the point of view of the employee's risk (or his chance of not getting his benefits), LTDI seems a very poor risk for self-insurance. Premium rates are low, possibly dangerously low, so any cost advantage of noninsurance is diminished. Second, and more important, the risk may be influenced by the economic position of the employer, and it is expected that the claims will be greatest when the employer is least able to afford the poor experience. Business setbacks coupled with catastrophic LTDI experience could very well result in the termination of the LTDI plan. The employees out on disability would then be left without benefits.

With respect to the developing trend, we have seen increased interest (as evidenced by the AMA meetings and the fact that this topic is on the program) in noninsured plans. Most of this interest has been in the temporary-disability-income and medical-expense fields. A substantial number of employers (including my own) self-insured their UCD plans in California early last year when new regulations put most insured plans out of business. For medical-expense plans, the most noted recent movements have been toward minimum premium plans, whereby the employer retained an insured plan but self-insured the bulk of the claim payments to reduce premium tax to a minimum. The switch to self-insurance seems to have been at least slowed down as a result of action by the NAIC.

At present, the noninsured plans are generally unregulated and untaxed. The federal disclosure law exercises a small element of regulation over noninsured plans, but this regulation does not compare with the regulation of insured plans by the state insurance departments. If the noninsured plans remain unregulated by the states and if there is an increase in these noninsured plans, it seems likely that the federal government will fill the vacuum and regulate such plans. We have enough trouble with the federal government's trying to fill nonexistent vacuums without leaving an actual one for them to work on.

From the tax point of view, the fact that noninsured plans are not subject to state premium taxes has been a large factor in the interest in noninsurance and in minimum-premium plans. For a large employer, the premium tax under an insured plan may appear unnecessary, and the desire to escape this tax may point the employer toward noninsurance. Even under present tax laws, many attorneys question whether an employer who is self-insuring benefits is not engaging in the insurance business and may not, in some jurisdictions, be subject to state taxation and regulation. If an employer with a self-insurance plan is found to be en-

gaging in the insurance business, he may find himself liable for back premium taxes and penalties.

Even the present questionable tax advantage of noninsured plans may be short-lived. In December of 1962, the NAIC became concerned over the switch to noninsurance, and adopted a resolution urging legislation to give tax equality to insured and noninsured plans. Following this resolution, model legislation was drafted and adopted by the NAIC late in 1963. The model bills include a whole series so that noninsured plans may be regulated, or regulated and taxed, with the tax removed from or remaining on insured plans. There are a number of approaches that legislatures could take, and the model legislation is drafted only with a view toward equality between insured and noninsured plans. The NAIC model legislation, incidentally, is not intended to apply to pension plans or short-term salary-continuance programs.

The most recent move toward the regulation of noninsured plans was taken by the Insurance Commissioner of Missouri in April, 1964. The Commissioner brought suit against Schlitz Brewing Company and Monsanto Chemical Company to enjoin them from doing an insurance business. The Schlitz plan is a completely self-insured plan and the Monsanto plan is a minimum-premium plan, so these suits will test both complete and partial noninsurance. The Missouri Commissioner may or may not be successful in his suit, and the NAIC may or may not obtain legislation to give equality to insured and noninsured welfare plans. The activities of both, however, must be considered by anyone considering self-insurance. If the NAIC is successful, I believe that self-insurance will lose much of its glitter, and this topic will cease to be a timely one, at least with respect to life insurance and health and welfare benefits.

MR. LAWRENCE MITCHELL: I believe many large employers and funds have been led into noninsured approaches by the insurance companies themselves through the use of self-administration. In many cases, all the insurance company has retained is some of the consulting services.

The large employer also favors a noninsured approach because he feels he can control claim payments better than the insurance company can. He fears that the insurance company, in order to maintain a good reputation for paying claims, would be less concerned with the validity of a claim than the employer would.

MR. GILBERT E. KERNS: I am listing below the factors that might lead an employer to favor an insured plan. Some of the indicated advantages apply to all plans; others are meaningful only under special circumstances.

1. The employer is relieved of the responsibility for making investment decisions.
2. Guarantees can be made by the insurance company with respect to integrity of principal, minimum interest rate applicable to contributions, and maximum purchase rates at retirement.
3. Large well-established pooled funds held by life insurance companies permit diversification into special forms of investments.
4. A premium paid to an insurance company, particularly under a deferred group annuity contract, is easy to justify to a regulatory body, such as a public utilities commission, or as an allowable cost under a government contract.
5. Through an insured plan, an employer may more readily escape the bonding requirements under the Federal Welfare and Pension Plans Disclosure Act.
6. An insured plan permits an employer to avoid union demands for participation in plan administration and investment determinations since he can argue that he has no role in these matters.
7. An insurance company, under one central management, can perform all the functions pertaining to a plan, including the drafting of documents and the provision of actuarial services.

A number of the above arguments may apply to unions as well as to employers. Additional pertinent considerations to the union and union member are

1. The pensioner may receive a certificate at retirement containing a guarantee by the insurance company of promised benefits.
2. Expert advice may be offered regarding optional plan benefits, the taxability of payments to an individual, and so forth.

An employer may favor a noninsured pension arrangement for several reasons.

1. The employer is free to transfer funds to a successor medium without delay and with minimum penalties.
2. The noninsured fund pays neither premium taxes nor federal income taxes.
3. A noninsured fund, since it is segregated and since it is relatively free from statutory restriction, lends itself to rapid changes in investment policy.
4. The employer may exercise investment control, if he so desires.
5. Trustees have a wealth of experience in equity investments and should be able to demonstrate a high level of performance.
6. Trustees' fees for administrative expenses are on a mutually prearranged basis.
7. An employer may feel that he can more effectively hold a trustee accountable for its performance because of other relationships which may exist between the two parties.
8. A trusteed plan utilizing a terminal funding contract can obtain the full benefit of improvements in insurance company purchase rates.

The arguments that unions and union members advance in favor of a noninsured pension plan include the following two:

1. The fund may be invested in public projects which are deemed to be socially desirable. Unions are increasingly directing attention to this possibility.
2. The employee may receive stock of the company, a form of distribution which has unique tax advantages.

In the regulation of insurance companies, states have enacted elaborate codes of insurance. However, only a half dozen states or so have specific provisions applicable to group annuity business. In other states, group-insurance law has been deemed to cover group annuities as well. Some insurance commissioners regard the regulation of group pension activity as the exercise of a broad discretionary power. Possibly half of the states pass on the suitability of group annuity contracts either as a direct or an assumed right. Apparently many companies submit forms as a matter of courtesy rather than challenge the states' jurisdiction. Under an insured contract which incorporates a pension plan by reference, contractual changes and hence insurance department submissions are kept to a minimum, provided that plan changes are not filed.

Some states specify the investments which are permissible for life insurance companies. The range of authorized investments has tended to reflect (1) the fixed-dollar commitments implicit in life insurance contracts and (2) the short-term nature of obligations, at least as compared to those under annuity contracts. As a consequence, the insured development of variable annuity and cost-of-living plans has been retarded. In recent years progress has been made in the removal of restrictions pertaining to the investment of insured group annuity funds. If the investment objectives appropriate to life insurance funds are incompatible with those applying to pension funds, the provision for separate accounts may be the preferred approach. We can expect that new outlets will be sought for pension funds in the future; some of these may present legal problems to life insurance companies.

Insurance companies report operating results in a uniform convention blank and are subject to triennial examinations. Some critics complain that differences in company practices invalidate comparisons extracted from published annual statements; nevertheless, these blanks do provide a fund of information which is not available concerning the performance of trustees. An insurance company must disclose detailed information concerning activity under segregated accounts in a separate schedule. These schedules will be the source of interesting and, let us hope, meaningful comparisons.

The regulation of life insurance accounting has been responsible for

some rigidity in statement practices, which in turn has hindered group annuity product development. The departure from a portfolio rate and the adoption of the new-money concept were triumphs over inertia and fixed ideas regarding proper accounting and were a reluctant recognition that averaging investment results sets in motion a process of financial selection against the insurance industry. The requirement that bonds be carried on an amortized value basis has disguised the market effect arising from fund transfers and fostered contractual provisions inhibiting the free movement of funds outward and also unquestionably repelling new money. The linking of policy reserves to contractual guarantees has led to a dual system of accounting wherein one set of figures is developed for annual statement purposes and another set to reflect the true condition of the employer's fund.

Under certain conditions, an employee of an exempt charitable, educational, or religious organization described in Section 501(c)(3) of the Internal Revenue Code can exclude from income employer-paid premiums used to purchase a nonforfeitable annuity for the employee. The language of the law suggests that favorable tax treatment can be gained through the use of an annuity contract but not a trusteed fund. Counterbalancing this advantage, the regulations seem to require that an employer adopting an insured profit-sharing plan establish an intervening trust. Federal banks are under the supervision of the Controller of Currency; state banks are supervised by a banking commissioner or similar functionary. Periodically an audit is made of the trust department's legal investment and accounting practices.

The Securities and Exchange Commission requires registration of certain contributory thrift plans. Recently, the SEC claimed jurisdiction over common funds established as a funding medium for self-employed retirement plans. This may prelude further attempts on the part of the SEC to oversee trusteed funds held for qualified corporate retirement plans.

Unless the trust agreement specifies permitted investments, a trustee is bound to follow state law. For example, the trustee may be restricted to investing in securities on a legal list or may be required to follow the "prudent-man rule." The prudent-man rule, coupled with the threat of adverse court decisions, seems to have a greater constraining effect than the other forms of regulation. Even under an outside-directed trust arrangement, a trustee can be held responsible if he fails to dissuade the client from undesirable or imprudent courses of action.

The acceptability of actuarial assumptions has now come under the purview of the Internal Revenue Service. While attention seems to be

directed to noninsured funds, any guidelines that are established will probably be applied equally to actuarial determinations under deposit-administration plans.

The IRS requires that assets be valued consistently from year to year, although changes are permitted so long as they are not motivated solely by tax considerations. Various methods for recognizing capital appreciation are allowable. With the advent of segregated accounts, the valuation of insured assets may present some of the alternatives available to noninsured plans.

Section 503 of the Internal Revenue Code enumerates prohibited transactions between the trust and the employer who created the trust. In the event of self-dealing between the two parties, the exempt status of the trust is lost. A qualified trust fund must file form 990-P with the Internal Revenue Service in support of its tax exemption. Unrelated business income is taxable and must be reported on form 990-T. Special rules surround the investment by the trust in securities of the employer. Obviously, none of the foregoing regulations are applicable to insurance companies.

Of the other federal statutes impinging on trusteed plans, the Taft-Hartley Act and the Landrum-Griffin Act are two of the most important. The former act establishes conditions under which an employer and a union can establish a pension fund. As the administration of Taft-Hartley funds is carried out by a board of joint labor-management trustees, such funds seem to be preconditioned to the use of a corporate co-trustee rather than an insurance company. The Landrum-Griffin Act requires the bonding of individuals engaged in handling funds of a pension trust in which a labor organization is interested. Again, a trusteed plan is more apt to be affected than an insured plan.

The regulation of individual trustees varies from state to state. In California, for example, an individual trustee must comply with the State Retirement Systems Act, be licensed by the Commissioner of Corporations, and post a faithful performance bond. In Wisconsin, an individual trustee is required to register, file an annual statement, and submit to examination. In general, though, individual trustees are less closely supervised than corporate trustees.

The downward trend of state premium taxes on group annuity considerations continues without abatement, although twenty-five states and the District of Columbia still impose such taxes. While the most common rates are 1 per cent and 2 per cent, one state uses 3 per cent. The rate in California is being reduced over a seven-year period from a former 2.35 per cent to an ultimate 1 per cent in 1965. In New Hampshire, the rate will become zero in 1965, after three successive ½ per cent drops. In Missouri,

beginning in 1964, no tax is levied, as compared to a previous rate of 2 per cent.

Under deposit-administration contracts, insurance companies either pay premium taxes as contributions are received or as money is withdrawn from the active life fund to purchase annuities at retirement. The latter approach is supported by the belief that tax deferment will result in a lower liability because of a downward revision in rates. An immediate participation guarantee contract offers the possibility of longer deferment through the payment of taxes as annuity payments are made to pensioners.

Trustees continue to be free from state taxes with respect to contributions to retirement plans. However, this condition might change. For states levying a premium tax, the National Association of Insurance Commissioners has proposed model legislation which would have the effect of taxing qualified trust funds and placing them in a position comparable to insured funds.

Trusteed pension funds are exempt from federal income taxes and insured funds are virtually exempt from such taxes. While group annuity contingency reserves give rise to a small residual tax on excess investment income, apparently even this tax can be reduced or eliminated under an IPG contract which does not have pension reserves in the conventional sense.

MR. ROBERT V. YOUNG: We have noticed what seems to be a significant trend in shift of pension moneys from a self-insured basis to an insured basis. Many large corporations have taken advantage of the very low nonparticipating purchase rates offered by insurance companies to shift their liability for pensioners from a self-insured fund to an insurance company. This shift is an advantage to the employer in two respects. First, the insurance companies are usually assuming interest yields in the purchase rates that are higher than the self-insured fund is obtaining in fixed-dollar investments. Second, although the trend of improved mortality has slowed down in recent years, employers realize that there is a good chance of a major breakthrough in the treatment of heart disease and cancer which could have a very sharp effect on pensioner mortality. The employers would rather have the insurance companies bear this mortality risk than their self-insured funds.

The high level of new money rates in insurance companies is also resulting in a shift from self-insured funds to insurance companies of pre-funding moneys for active employees. The insurance companies have become very flexible in the type of contract that is offered in this area, with an

emphasis on the investment aspects of the contract as opposed to the insurance elements.

MR. DANIEL F. McGINN: I feel very optimistic about the outlook for insured pension funds. One reason for my feeling is that insurance companies have become considerably more flexible in their approach to pension funding. We no longer restrict our approach to deferred annuities or deposit administration. The investment-year or new-money method is, I believe, a definite advantage of the insurance company approach. I do not think there are many uninsured pension plans that earn what an insurance company can on new investments.

An insurance company puts a majority of its funds into mortgages which are yielding very high rates. In addition, through the private-placement route, the insurance companies obtain very attractive industrial bonds. I believe that our investment capabilities far outweigh the current disadvantage of the premium tax inequity.

Contrary to some of the statements made about an insurance company's ability to invest in stocks, our stock investments have earned over the last ten years in excess of 15 per cent per year, compounded annually, when unrealized and realized capital gains and dividends are combined. I believe the very good bank equity funds have earned between 7 and 9 per cent.

Many of the penalties on withdrawal of funds have been eliminated in contracts such as a modified IPG. For example, under our IPG contract we are willing to transfer either the full book value of our funds over an amortized period according to a fairly liberal scale or the full market value of bonds bought during the period of the fund accumulation. This is made available only to either relatively large contract holders or contract holders with a very reliable consulting actuary on whom we can depend, so that there are no misunderstandings by the contract holder. I believe this willingness to transfer funds eliminates one of the sore spots in the insurance company contract.

Valuation Standards for Pension Plans

A. Is there any practical way to develop acceptable or recognized standards as to (1) methods of valuation of pension plan assets and liabilities; (2) actuarial and other assumptions used therein; and (3) forms of presentation to employers, governmental authorities, and so forth? If so, who has the responsibility to do this?
B. Would statements along these lines be of assistance to employers generally?
C. Would these statements eliminate or reduce the possibility of additional governmental regulation?
D. How well has the recent attempt to provide a standard set of definitions for the various actuarial methods of pension funding succeeded? Is this new terminology adequate for the Society's examinations, papers, and discussions? Will the new terminology be helpful in standardizing pension-valuation reports? (See the September, 1963, *Journal of Insurance*, p. 456.)

MR. JAMES F. A. BIGGS: I will straddle question A(1) by saying both "yes" and "no." I would say "yes" in the sense that each qualified actuary has already developed a set of standards or principles which guides him in selecting the methods and assumptions for plans for which he is responsible. However, I would answer "no" if we are talking about prescribing a specific set of methods and assumptions, or even a range of assumptions, and imposing them by force of law, publicity, or professional sanction. In other words, I do not think we can have anything in the pension field comparable to the minimum valuation laws with which we are all familiar in the life insurance business.

Before considering whether standards are practical, let us look for a moment at why they might be desirable. A set of standards in any field is created both to inform and to protect. In the pension field, different groups are seeking this information and this protection, and different standards would be applicable according to their needs.

A. The employer is concerned with the level of costs of the plan on the presumption that it will continue in perpetuity. For this purpose, any of several level premium cost methods would be appropriate, using a variety of actuarial assumptions, including such assumptions as turnover and salary scale.
B. Employees and unions are directly concerned with the adequacy of the funds to meet the plan's obligations. For this purpose, a unit credit-funding method without turnover may be a more satisfactory measure.
C. The federal government, as a taxing authority, is concerned with placing appropriate limitations upon the deductible costs of such plans.
D. Both federal and state governments, as protectors of their citizens, are concerned with assuring the solvency of pension funds.

The difficulties in establishing any set of specific standards for pension valuations are tremendous. On the asset side we have these problems:

1. Plans are now using cost value, market value, and a host of intermediate values determined by various formulas. With the IRS accepting all these, there seems little likelihood of uniformity.
2. The legal limitations on the nature of pension-fund investments are very broad. These funds, therefore, contain a wide variety of highly specialized assets, such as land and buildings, industrial equipment, the stock of closely held corporations, and so forth, which create difficult valuation problems.
3. The effect of valuing assets on different bases varies widely, depending on the actuarial funding method being used. If a method which spreads gains and losses over all future working years is used, wide swings in the asset value may not cause grave problems. However, if you are not using a frozen initial liability method, or if your past service liability is already fully funded, the use of market values can cause severe distortions in the patterns of allowable employer contributions.

On the liability side, the difficulties are at least as great. First, there is a multiplicity of assumptions which must be made with respect to some or all plans: interest rate; mortality—separately for active, retired, and disabled lives; expenses—not only how much but whether they will be paid directly by the employer or by the pension fund itself; turnover—probably determined separately for each sex and possibly determined separately for different groups of employees within the plan; disablement; salary scales; future changes in the cost of living; and average number of hours to be worked in the future.

There are wide variations in experience from plan to plan in virtually all these items. Furthermore, there is tremendous disparity in the provisions of the plans themselves. It is likely, for example, that total disability will be defined as many different ways as there are lawyers writing plans in a given geographical area. I would point out just two of the obvious dangers of establishing a specific method and set of assumptions as a standard.

First, if you establish any minimum standard, whether it stand by itself or whether it is represented as the low end of an acceptable range, you have given it a certain sanctity by labeling it as official. This may well discourage the adoption of more conservative and presumably more appropriate bases. This may be a particular problem for the actuary working on negotiated cents-per-hour programs where there is already constant pressure to liberalize his calculations to increase the benefit level.

Second, if you set and enforce a standard which is too high, employers may well be discouraged from establishing plans which they would otherwise create. Alternatively, rigid valuation standards may turn an em-

ployer from a pension plan toward the profit-sharing approach, although a profit-sharing retirement plan may be an inferior solution to his problems. As a further disadvantage, most profit-sharing plans do not employ actuaries.

I do not, therefore, believe it practical to adopt a specific set of valuation standards for all plans. However, it is both possible and desirable to develop a "Statement of Guiding Principles" which would lie somewhere between a code of ethics and the minimum valuation laws. This statement would be a consensus of opinion on the approach to making a pension valuation, the factors which must be considered, and the basis for evaluating these factors. It might also prescribe the minimum information which would constitute a satisfactory actuarial report. This could include a recommended series of interrogatories:

1. Are expenses paid (1) directly by the employer or (2) by the pension fund? If paid by the fund, what provision is made in the valuation for future expenses?
2. Are benefits under the plan dependent on future salaries of employees? Has provision been made in the cost estimates for future salary increases?
3. On what bases are the assets valued? What is the current rate of return on this basis? What is the valuation interest rate?
4. What is the lump sum cost of benefits for presently retired employees? For terminated employees with vested interest? For fully vested benefits for active employees?

Such a statement of principles would be prepared by a committee under the aegis of the Society of Actuaries or the Academy of Actuaries. It would be enforced only by the internal disciplinary mechanism of the body involved. This is, I think, a logical extension of the movement toward accreditation. The real assurance that pension valuations will be performed properly lies not in standardization but in the increasing professional competence of the actuary. He is the one who must serve as the "conscience" of the plan.

As to assisting the employer, the requirement of minimum information and the interrogatories which I have suggested should help him understand the actuary's work and the status of his plan better. Since I believe that standard assumptions are themselves unsatisfactory, I cannot see how they could fail to mislead and confuse the employer, who is not an actuary and is not capable of assessing their limited worth.

Turning to the question of government regulation, the amount of money involved in private pension plans and the millions of workers dependent on them for their security would seem to make increasing government interest inevitable. Revenue Ruling 63-11 is certainly a step toward setting

up standardized assumptions. One thing is certain. If we adopt a specific set of methods and assumptions which we regard as standard, government at some level will try to enforce these standards. This makes it all the more important that we place our reliance on the professional skill of the individual actuary responsible for the valuation, operating within broad guidelines, rather than on a rigid formula and set of numbers.

MR. CHARLES G. THOMAS: At Occidental Life of California, the actuarial assumptions used in the valuation of a pension plan are determined by the characteristics of the group insured, current conditions, and future expectations. This means of determining actuarial asssumptions would not be necessary if a valuation standard were adopted. However, the financial status of the pension plan and the ability to pay the benefits promised to the participants would depend on how closely the actual experience of the plan followed the standard actuarial assumptions.

Personally, I believe that valuation statements based on standard funding methods and actuarial assumptions would be beneficial to some contract holders and detrimental to others. Certainly the flexibility that exists now in the valuation of pension plans would be reduced if valuation standards were adopted.

At Occidental Life we have developed a standard format that we use for most of our valuation reports. Our report contains four major sections: the purpose of the report, actuarial cost calculations, comments and recommendations, and an appendix. The appendix describes the funding methods, the provisions of the plan, the actuarial assumptions, and an analysis of the change in the unfunded accrued liability. If the funding method or actuarial assumptions are changed, two reports are made, along with an analysis of the differences caused by the change.

At first, many contract holders find it difficult to understand the report. However, the difficulty seems to diminish with each subsequent report. We find that even if there is a change that substantially affects the valuation results, the contract holder is able to understand the differences in cost better if we use the same format in presenting the results as was used in his previous valuation reports.

MR. DANIEL F. McGINN: I think it would be desirable to form a task force to develop suggested valuation procedures for pension plans. This task force could be established by the Society of Actuaries similar to the one established several years ago for accident and health valuation procedures.

Most of the problems in valuation of assets are noninsured pension plan

problems. I believe standards could be established for valuing these assets without too much difficulty.

The question of standard actuarial assumptions is considerably more complex. I believe, however, that there is some possibility for standardizing actuarial assumptions. In fact, we have standards of a sort now. These standards may not have been formalized, but any reasonably qualified actuary will follow certain minimum standards for valuation. For example, I doubt that any of us would use a 5 per cent interest rate in valuing a plan.

We would probably find that most interest assumptions range from $3\frac{1}{2}$ to 4 per cent. I believe a task force could help establish a range of reasonable interest assumptions based on characteristics of the fund, group, industry, and so forth.

I do not believe that there is very much difference in mortality assumptions being used. I think that most of our mortality assumptions are fairly standard and the differences do not have much effect on cost.

With respect to turnover assumptions, I believe that it is possible to come up with a reasonable range of turnover rates that would be appropriate, based on certain indices for each industry, employer type group, and so forth.

I feel that the most important problems lie not in the actuarial assumptions or the valuation of assets. I think there is more difficulty with the actuarial cost methods and understanding the operation of these methods and their effect on an employer. These methods are very often tailored to a very specific circumstance of industry or the nature of a labor group or employer as to whether there is or is not a large takeover fund, whether there will be many early retirements or relatively few retirements for many years in the future, and so on. I have no answers as to how this might be standardized, but I would like to see a task force established to consider the problems.

MR. JAMES A. CURTIS: In general the article "Actuarial Cost Methods —New Pension Terminology" has been well received by actuaries who are active in the pension field. This reaction has been obtained by the Committee on Pension and Profit Sharing Terminology in response to a direct solicitation of a small group of pension actuaries in the United States and Canada. Whether or not the new terms set forth in that article will result in a universal change will not be known for some time. I personally believe that such a evolution will be slow in coming, but eventually we, as actuaries, will commence speaking the same "pension tongue." I am certain that many persons, including actuaries, have read this paper on pension

terminology and have been disappointed that they did not find a simple panacea for curing all the problems of pension-plan terminology.

The actuary's problem of communicating ideas of a highly technical nature to laymen is an age-old problem and certainly not intrinsic to the field of pensions. How can we hope to succeed in communicating our thoughts to laymen when we speak a language that is not always clearly understood by other actuaries? As in other actuarial areas, part of the answer lies in developing uniform definitions of the terms we use. The balance of the answer still lies in our individual abilities to express ourselves clearly and simply. The success of this attempt to provide a standard set of definitions will depend upon how fast we are willing to use the terms in our everyday contact with other actuaries, our clients, and policyholders.

Because of the many different actuarial cost methods that are possible, a set of definitions of the most common methods would be required for use in actuarial literature. This would require a complete rewriting of our present syllabus on pensions, which I believe is desirable. If we do not change our terminology in examinations, papers, and discussions on pension topics to coincide with the terminology adopted by the Committee on Pension and Profit Sharing Terminology, there would appear to be little chance that they will have early success in their endeavor to come up with a workable language. Therefore, I feel that it is up to us as actuaries to take this new terminology, improve upon it wherever we can, and put it into action!

A review of most actuarial valuation reports points up the need for a minimum standard. While I would not favor a complete standardization of valuation reports, I feel that the Society of Actuaries should attempt to set certain minimum standards. To this end, there should be a standardization of pension terminology. However, I doubt very much that the new terminology by itself will have a very strong effect upon standardizing valuation reports.

MR. HARRY M. SARASON: Topic D is on nomenclature for "actuarial methods." I think the word "methods" is a clue to the advantages, the disadvantages, and the dangers of specialized nomenclature. In retirement plans a serious confusion between "methods" and numerical results is commonplace. But the recent nomenclature proposals refer to methods only. The distinction between "methods" and numerical results should be made clear in our nomenclature and in its use. In the final analysis, all that we are interested in, all that the representatives of our clients are interested in, and all that the various individuals who are really our

clients, as distinct from the representatives who deal with us, are interested in are the numbers—this year's cost and future years' cost for specified benefits.

When discussing the cost of a particular benefit structure, the term "normal cost" and, much more, the term "level cost" convey a dollar-and-cents significance, often a false significance. Unless we put some numerical teeth in nomenclature recommendations, we may be strengthening a sophistry by lending an aura of approval to a wrong use of technical words like "normal" and "level" by those who claim that they can provide a retirement plan for "less cost." Actuarial formulas and assumptions by whatever nomenclature do not directly influence costs, of course—merely the incidence of contributions from year to year: if $100,000 "less" is being contributed "this year," then $100,000 additional will have to be contributed later (*with interest*); and if $100,000 "more" is being contributed "this year," then that $100,000 extra will come back later (*with interest*). Perhaps some dollars-and-cents teeth should be affixed to the standard nomenclature recommendations. For example, for no-salary-scale in final-salary calculations, the recommended nomenclature might be "normal cost with no salary increase assumed." The standard nomenclature might be "normal increasing cost," or "normal decreasing cost," when actuarial methods plus actuarial assumptions indicate such numerical results.