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PRACTICAL CONSIDERATIONS IN PROVIDING SERVICES UNDER INSURED PENSION PLANS

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MR. WILLIAM R. BRITTON, JR.: The passage of ERISA has resulted in dramatic changes within the insurance industry. Companies that had previously been active in the field of pensions have been hard pressed to adapt to the new rules of the pension game and have been virtually engulfed by the ever-shifting maze of rules, regulations, procedures and forms. Companies that would like to become active in the pension area are now faced with a high-priced entry fee involving a heavy commitment of capital, development of elaborate systems, and competition for the scarce resource of qualified technical personnel. All of us have spent considerable time and energy in a reappraisal of the ways we have been conducting our business for the purpose of determining, developing and implementing the fundamental modifications necessary to remain competitive. Nowhere has this been more visible than in the area of services provided under insured pension plans. Your panelists today bring a broad range of perspectives to this discussion. John Fortin has been instrumental in the development of Southwestern Life's pension products and programs. Sam Taylor began his career as an agent, spent some time as a Group Pension representative, and has been Director of Connecticut General's Individual Pension Trust Operation since 1974. Lynd Blatchford's many credits include membership on both Society and Academy committees dealing with pensions. Lynd spent several years with New England Mutual Life before leaving recently to found Pentad, an actuarial consulting firm.

We have a good diversity of backgrounds and interests on the panel today and I hope that between them and between you we can generate a good discussion. John, would you care to start off with Home Office Considerations.

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MR. JOHN D. FORTIN: One of the real advantages that the insurance industry has over its competitors is the ability to render service. Since ERISA has greatly increased the demand for both quantity and quality of service, it is a certainty that the new law will increase the competitive advantage of those companies that can find practical solutions to the delivery of those services.

As an overview to this topic we need to consider the organization of a servicing operation and the vehicle under which services are to be provided. Should there be a separate service corporation inside a holding company? Should the servicing be a separate department inside the Life Company? Or, should the services be integrated into an existing department within the Company? The size of the company, the amount of pension business, the structure of Home Office systems, corporate philosophy, and the availability of personnel and capital will help clarify the correct decision for a given company. Similar questions arise in conjunction with the amount and nature of Field involvement; again, there is no simple, fail-safe panacea that can be universally adopted.

The vehicle for providing services is equally important in defining the service function. While companies have historically provided services extracontractually on a no-direct-charge basis (customarily and mistakenly referred to as "free"), the current trend is to some form of written enforceable contract. This separate contract covers a variety of pension services and includes provisions for fees that are completely separate from the traditional insurance premiums. Such a separation obviously affords the insurance company greater equity among its policyholders, more competitive insurance rates, and less need to revise insurance products with future expense changes, due to changes in the pension service function itself. Also it should be noted that the consumer is in a better position to the extent that he has service contracts and can demand quality service delivery. Among the practical problems in this service vehicle itself are:

1. the difficulty in defining services, since regulations are incomplete, and the nature, extent and timing of service are vague at this time.
2. the variation in service by plan, by product and by type of group.
3. the calculation, quotation and collection of fees.
4. the definition of both parties' rights and obligations.
5. the duration of the agreement: policy year, plan year, calendar year, tax year or any other period.
6. guarantees as to renewability, cancellation, and cost.
7. clarification of which reports you are providing, e.g., reports for the plan year commencing May 21, 1976 or reports with deadlines arising in the plan year commencing May 21, 1976.

If you choose the former, who will do the reporting in takeover situations on the just completed year; if you choose the latter, how do you plan to do the reporting on takeover cases?

Having decided these and many other basic questions, the Company must establish rules as to whether to force all clients to adopt its services, whether to even offer these services to every policyholder, and whether to grandfather services and fees to in-force clients. The grandfather subject arises not only from past company practices and promises but it also arises from the situation where there are policies outstanding with loads that are redundant due to post-Service Agreement direct charges.

The most significant decisions in providing services are those related to their extent and packaging. The Company must establish its philosophy as to what constitutes insurance functions -- typically this might include billing premiums, paying commissions, issuing sales proposals, providing prototypes, possibly providing specimen forms, and required minimal reporting. These functions' expenses are generally included in the product's loads and do not have to be charged explicitly as a fee, although there are some exceptions to this rule. Of the other service functions to be performed by the Company, it may be useful to categorize services as pre-ERISA or post-ERISA. This split may help the service area in its review of equity to grandfather cases and also in its planning of the extra work that will be required under the new law. Of course, it is difficult to discuss pre-ERISA functions -- valuations, allocations, etc. -- since the nature of virtually every pension function has changed considerably in the last two years.

The last category of service to be discussed is those functions that will not be performed by the Company. These functions should be identified for the purpose of anticipating where they will be performed and the implications arising as a result.

In conjunction with this analysis, the Company must look at the variations in services by product line and by market. For example, competition may not allow adequate fees on HR-10 plans. This kind of practical consideration will in turn affect the service fees and the loads for the products in this market.

Similarly, the Company must decide as to the degree of servicing and as to the packaging of services. Considerations in this category are whether your company is providing a complete turn-key operation, a full service "cafeteria" approach, or simply assistance in servicing the plan. Companies that encourage a cafeteria approach are optimizing equity among their clients. However, some very real problems arise when outside analysts amend plans without understanding completely what the insurance company can administer. Also, the Company must keep track of exactly which services each client has purchased, and the expense savings realized by not performing a given function may be very minor due to the high fixed cost per case in collecting and coding input for every group regardless of which services are to be performed.

With the above ideas in mind, decisions can be reached as to the most logical groupings into packages and the rules for their use. The result might incorporate breakdowns between first and renewal years or by amendments, reporting, actuarial and similar functions.

The fees for these services are a major practical consideration and closely follow the topic of packaging. As previously discussed, it is likely that certain functions will be classified as insurance functions and will be performed on a no-direct-charge basis. Competition and simplicity considerations generally override questions of equity on such functions as sales proposals.

For the chargeable services it becomes necessary to price out the cost of doing business on at least as detailed a basis as the refinement in the fee structure. That is, some type of functional cost study, or estimate, is needed to price out the administrative expenses in providing each service or grouping of services that are directly charged to the customer. Commissions, if any, and other direct expenses are the easiest expenses to price. On the

other hand, the cost of the insurance company's potential ERISA-related liability may be quite difficult to evaluate. The other expenses, including margins, profit, and the cost of renewal guarantees, are obviously important to the actuary's function of setting of fees.

The actual fees vary considerably from company to company and might be expressed as a function of plan benefits, funding vehicle, number of lives, whether the plan is contributory, number of entry dates, number of hours spent on service, extent of recalculations, whether you have all the plan assets, and many other criteria. Obvious practical difficulties arise at proposal in calculating exact fees when many of the provisions of the plan are unknown or subject to change prior to the actual sale.

Furthermore, it must be established who will collect the fees and also when payment is due. If payment is due in advance, how are fees to be collected if they are chargeable on a per-hour basis? As stated before, grandfather questions arise routinely when a company goes to a fee-for-service basis. Possible equitable solutions might incorporate a gradual assessment of fees against these cases, although here again it is likely that practical considerations such as record-keeping will result in a fairly simple approach that can be more easily administered.

MR. BRITTON: As John mentioned, you can establish either a separate service corporation, a separate department within the company, or provide the services within the existing facilities. Sam, I know that Connecticut General chose the first of these options. Could you give us some of the reasons why CG did so?

MR. SAMUEL A. L. TAYLOR: We did and didn't. We do have a subsidiary corporation that has the contract with the employer or plan administrator. However, this organization buys all of its services from the Life Company. We did that for a couple of reasons. One, to help us isolate costs better and more effectively. Second, to make it clear that the plan-related services were not included as part of the insurance vehicle and that there was a distinction between plan-related services and insurance product-related services. And third, we did it to prepare ourselves perhaps a little better for what might come in the not too far distant future as we begin to shake down some of the outstanding regulatory issues about who can do what for whom, when and where.

MR. BRITTON: John, how about Southwestern?

MR. FORTIN: We have the very same considerations as CG although we're on a much smaller scale. Due to the size of the Company it would not be a particularly attractive route to set up a separate service department. We opted for including the services in an existing department which currently handles all pension business. We felt that there were some economies to be gained by not having separation. The clients could look to the same person if correspondence was needed, whether it was an insurance function or a service function.

Furthermore, we set up a line of business in our accounting system similar to page 5 in the Convention Blank, only this is a separate line of business for pension services. The income that Southwestern collects on fees is put into this line of business. The investment income generated from these collected fees goes to line 4, and, from a functional cost analysis, the time that people spend on servicing functions is allocated to line 23 for expenses.

MR. AILEY BAILIN: We have also taken the approach that Connecticut General has in setting up a subsidiary. Our subsidiary is spread across the country and located in a few areas where they can be close to the people they are servicing. In my mind, I still have not straightened out what services the subsidiaries are providing and what services the Home Office is providing. I was wondering what CG is doing about that?

MR. TAYLOR: To meet the needs for local service and to take advantage of the expertise of many of our Field Offices, we established two different categories of Field Offices. We call them A and C. The A office performs most of the service functions that are not fully mechanical and receives an allowance back from the fee through the Life Company. The C office is less well equipped with expertise and thus relies more on the Home Office to produce the full package of service and receives less of the allowance. The distinction is not between what the subsidiary does and what the Head Office does, but between what the Field Office does and what the Home Office does. A key issue is what service should be done in the Field and what service is done in the Home Office. We're still not as clear on this issue as we would like to be. I think our experience over the past year has helped us a lot. And as you will see when we get to my talk, I have some very strong bias about where this work can best be performed.

MR. BRITTON: Among those of you who have established a special subsidiary corporation for these services, have you established any contractual relationship between the agent and the service corporation? Are they agents of the service corporation, or do they have any formalized relationship on a contractual basis?

MR. TAYLOR: We do have a formal contract with the agent to represent the service company as a salesman. The primary reason (and there were a lot of reasons for doing it this way) was that it made a pretty clear distinction between the responsibilities of the agent and the responsibilities of the service company. Part of our thinking was anticipation, trying to prepare ourselves for what we felt the role of the agent might have to be in the small plans for the future. We do have a very clear distinct contract between the agent and the subsidiary corporation.

MR. LYND T. BLATCHFORD: Who should pay the fees?

MR. TAYLOR: That's a tough question. We have a very hard-and-fast rule that the fees are paid by the customer and not by the agent or not by the Field Office. I'd be less than candid if I didn't say that that's created some acute problems based upon past promises made. Personally, I have difficulty in rationalizing to myself how anyone but the plan administrator can pay for actuarial valuation services. The actuary is hired by the plan administrator for the plan participants and I have some real qualms about anyone else but the plan administrator paying for this. I don't think we'll be able to clearly resolve this issue until some of the major regulatory items are cleared up.

MR. BLATCHFORD: Do you pay commissions in this case?

MR. TAYLOR: Yes, we do.

MR. FORTIN: When we first discussed fees we went to meeting after meeting, but we did not cover the tip of the iceberg in terms of the questions that have subsequently arisen on this particular subject. For example, as soon

as we announced that the plan administrator would send the check directly to Southwestern, we had agents question us on this. In passing this issue by our counsel we discussed the possibility of rebate. Is this an inducement to sell? If so, you probably cannot allow the agent to pay this fee. The second question, even apart from the legal considerations, is, "Do you want to put your agents in a bad position?" If you allow the first agent to pay a fee, aren't you expecting or forcing the other agents to pay the same fees on their cases?

MR. BLATCHFORD: I think my basic feeling goes along with what was just expressed up here at the table, particularly when it comes to the question of who is going to pay the Enrolled Actuary. Quite clearly, the law specifies the plan administrator must engage the Enrolled Actuary. Therefore, I take the stand that the plan administrator pays the fees. In addition, it puts the relationship between the servicing organization and the plan sponsor together in the long run.

MR. TAYLOR: I'm also bothered by what might be called consumer concerns. In the past the very bulk of the cost of plan administration was paid for by the agent's compensation and he did a lot of the work. Now when you say to the agent, you can't do this anymore and you can't pay the fees for this kind of work, what you have done is pass the whole cost increase on to the ultimate consumer of the product. I think that that's going to be a problem for us and, again, I don't have any good answer. I'm just worried about it and I think probably the rest of us are too.

MR. BLATCHFORD: May I ask a question on unfunded services? John, do you require that the benefits be calculated by the agent when actuarial valuations are performed?

MR. FORTIN: At Southwestern we offer virtually a complete service package. Anything to do with the installation of the plan, amending the plan, servicing of the plan, 5500's, EBS-1, allocations, and almost everything else, we handle except for services that must be performed under the direction of Enrolled Actuaries. For this purpose we have made arrangements with a local Dallas consulting firm. We have not subcontracted with them but we have informed our clients of their availability. As a result, anything to do with the actuarial certification is not directly Southwestern's concern. We do work very closely with the consultant and provide him with the plan document, with the certificate data, and sometimes even put it in his format on tape suitable for his machine. But, when there are questions to do with the actuarial valuation, with the calculation of benefits on a terminating participant, or with the calculations of vesting, we view these calculations as part of the actuary's function. Of course if it's a fully insured plan there is no need for having an Enrolled Actuary anyway, so Southwestern does all the work on those cases.

MR. BRITTON: How do you market plans in a large geographic area when you depend on one consulting firm?

MR. FORTIN: For the actuarial services, we do not have any legal right, or moral right probably, to force or to channel all of our customers to one actuary. As such, we are most happy to deal with any reputable actuary. In practice, we work most closely with one particular firm since they specialize in small plans and are familiar with our prototypes and benefit structure. However, if any consulting house wants to service our cases, it would be fine.

On the question of non-actuarial services, we have business from 35 states that is serviced out of 17 Field Offices, and we have salaried Field Representatives who are our pension experts in these offices. We instituted operation about 9 months ago to streamline the service function. Once a case reaches the Home Office we do one of two things. If all the necessary data is complete and correct, the case is sent down the production line. We do the proposal, we issue the case, or we do the renewal servicing or whatever the function happens to be. If we are missing anything that we need to service the case, it is shipped directly back to our Sales Representative in the Field. We have had very good success with this operation so far.

MR. BRITTON: Sam, have you encountered some geographical problems?

MR. TAYLOR: Yes, but ours are a little different from John's in that they're just a little bigger. Our business is very widely dispersed, with no one office out of 100 offices having more than 10% of our small corporate plan business. With respect to the data problem, that is the single biggest problem that had to be overcome in the processing of plan-related services for small plans. We haven't had quite the guts yet to do what John's done and send the case directly back to the Field when something is missing. We have taken steps of informing the Field very clearly that processing is delayed until the missing data is received. And that may be because I'm more sympathetic with the problems of the Field then maybe I should be. The geographical problem of getting good data from a customer three thousand miles away is very real.

MR. JOHN M. BRAGG: My question relates to group contracts. Much discussion has been made concerning individual contracts but there have been no comments on who's paying the outside actuary. A number of the companies under group annuity contracts are paying service fees or actuarial fees to an independent actuary engaged by the client. Have any of the companies issuing individual contracts considered this question?

MR. FORTIN: We haven't seen any change whatsoever on our large cases. Firms that engaged large consulting houses haven't changed post-ERISA, although I presume their fees have increased due to the quality and quantity of work.

MR. BRAGG: But you as an insurance company would not compensate for the actuarial fee?

MR. FORTIN: No, we did not before and we will not after ERISA.

MR. TAYLOR: We had very few where we were actually compensating the outside actuary for actuarial services. I don't see this issue being resolved until the whole question of what a provider of multiple services can do is resolved. I don't see us taking specific action right now to make a change in practice until there is some specific decision.

MR. BRITTON: Sam, maybe we can get away from the Home Office for a few minutes and turn our attention to the Field. What problems do you see with the Field in this whole picture?

MR. TAYLOR: My part in this discussion might be called "Field Considerations in the Servicing of Small Plans from an Insurance Company's Perspective." Often this topic is translated to mean problems the Home Office can expect from the Field. I think it's more instructive for us to look at some basic,

very real, business problems that the Field has, and then factor these considerations into our broader discussion.

To kick off our discussion, I want to focus on three issues, and then look briefly at some very practical considerations that bear on the location of the actual service functions.

The first issue is the nature of the existing customer.

- He is a small businessman, a very small businessman usually, with only a handful of employees.
- He established a pension plan because the personal tax consequences were favorable.
- He expects his agent to "handle the plan" because:
  - The small businessman can't, i.e., the economics of engaging an actuary, accountant and attorney to each perform their specialties either defeat the tax advantages he sought or are so time-consuming as to be impractical. Self-administration is not an option.
  - The agent promised to provide these services when the plan was sold.
  - The small businessman thinks the agent and the insurance company he "represents" is paid to provide plan-related services through the sale of the products used to fund the plan.
  - Further, the small businessman is often a customer of the agent for insurance that has nothing to do with the pension plan so the agent's stake in keeping this customer happy is high.

The second issue is the nature of the existing customer's plan:

- It's a defined benefit plan (2/3 of ours are).
- It's been explained and sold as a cash accumulation device with the actual defined benefit having little relationship to its
  - funding, or
  - benefit expectations.
- The agent and the small business owner have up until now made all actuarial decisions of consequence.

These two sets of circumstances create a third issue that smolders and often erupts affecting communication and hindering problem solving.

This third issue is resentment, resentment by customer and resentment by the agents who reinforce each other.

- There is the normal resentment against change but this is not a significant factor.
- There is resentment against the "system" - laws/regulations, etc. - that has produced a welter of confusion, that, almost two years after beginning, does not have answers to many vital day-to-day issues, like something as basic as how much cash does a participant under a fully insured plan receive if he retires at his normal retirement?
- The insurance company Home Office and the actuary become identified as a part of this system and, with some justification, the focus of customer and field resentment.

- Suddenly, the insurance company, after years of what can most charitably be called "benign neglect", is concerning itself about plan-related services delivered to this small pension plan, making noises about fees and starting to tell the agent or other Field professional what to do and not to do, and how to do it.
- Suddenly, the actuary, after years of equally benign neglect, has replaced the judgement of the agent and the small businessman with his own, and with a process that at best is usually not very well explained.

These problems of the Field, whether it be agent or branch manager or general agent or staff, are real because every day they must explain to a small businessman that:

1. He can no longer count on the lump sum he had planned to have accumulated for himself at age 65. The amount he should now expect is about 20% less.
2. And yes, his plan costs are going to increase anyway.
3. The agent or company now wants a fee in addition to insurance premiums to continue to provide services.
4. The small business owner's risk in the operation of his plan has increased and no, the insurance company can not act as plan administrator and relieve him of this risk even with the new fee.
5. He (the agent) may not be able to keep on providing any service.
6. And on and on for the plans that have been well-handled in the past. Let your imagination deal with those that may have been less than properly administered, or not at all.

And the explanations aren't very good because the reasons for either the confusion or change aren't well understood or clearly outlined, and the Field Representative doesn't really believe them because so many have changed so many times in the last six months.

When you take the situation I've just described, some very day-to-day practical considerations become all too apparent:

1. Expect whatever program of servicing small plans you embark on to be fraught with difficulty and expense. The dues for being in the pension business have gone up both in the Home Office and the Field. There are no easy answers but to stay in the business, the dues must be paid.
2. Pressures on Home Offices of insurance companies to find answers are just beginning to be felt. If you think the last 18 months have been difficult, wait until you see the next 18.
3. The re-education that must take place is staggering and to a large extent this re-education is necessary before training in new procedures and skills can be expected to "take".

But let's assume for the moment that these real problems facing the Field are solved and that the re-education takes place. Let's further assume that the multiple services and agent/fiduciary issues are resolved in a manner that permits both insurance company and agent to continue to service the small plan, no small leap of faith. If we have our druthers, what should the role of the Field be in the future in providing plan-related services?

There obviously is no one answer to this question but the following items

appear worthy of consideration.

- Who gathers the data required to process valuations or participant accounting? Can you train this small business owner to respond by mail?
- Who explains the results of a valuation and answers the questions of the business owner?
- Who gathers the data to complete the 5500's, etc?
- Who exercises quality control? Can you train the small businessman and his accountant and attorney to await the production machinery of a centralized Home Office process and then be understanding when the ultimate package is incorrect because the data was inaccurate or a clerk transposed a date of birth?
- Who schedules production knowing that this customer must have his results early because he's going to the Caribbean for six weeks but this other customer won't be back for eight weeks and his accountant has already requested an extension?

The printout from a computer is not pension service. It is only a part, and in many ways the smallest, simplest part of service.

Over the last 20 years, a system of local service has evolved. Regardless of whether the agent can, should or must be involved in the process, I question seriously whether any attempt to provide service to the small pension plan without local representation and a high degree of local control on the scene can be successful. Once we are past the hump of bringing old plans into compliance and have some long-term regulatory indication on the multiple services and agent/fiduciary questions, the location of service responsibility will become of critical importance.

MR. BRITTON: Sam, you paint a pretty gloomy picture. Before we go into further discussion, I might ask you if you see any light at the end of this tunnel?

MR. TAYLOR: Yes, I see light at the end of the tunnel but it's kind of dim. We're going to go through another couple of tough years. Once the existing plans are brought into compliance, the mechanics of introducing a whole new service system can be made to work more effectively. The economics are there and ultimately you can charge for kinds of services that you supply, but I've got some real doubts about what's happening on the regulatory scene. The issues are not easy questions to deal with and I'm afraid many people have been lulled into a false sense of security.

In looking at costs I'm beginning to believe there are very few real economies of scale in this business. The fact may be that economies of scale stop with 300 plans or some other small number of plans. This may impact dramatically the costs of services. As a matter of fact there may even be inverse economies of scale. I'm sure some actuaries will spend a lot of time looking at that issue.

MR. BLATCHFORD: Sam is quite conservative. Each plan is an individual entity and as such should be treated as such. If a company has a large number of plans, for instance, large group plans, it has more assets available to use for development purposes. In the final analysis, whatever system is developed, the development cost is only a small portion of the ongoing costs of plan services. But when we get down to the fact that they are individual entities and must be serviced individually, Sam is quite right.

MR. FORTIN: The only substantial economy of scale comes from knowing where and when to draw the line. Many insurance companies realize the complications with contributory plans, and have taken steps so that they will have no further contributory plans in the future. Some companies channel their small cases into their existing prototypes and do not allow unnecessary variations from these plans. In your fee structure it may be appropriate to charge on a hourly basis for plans wanting custom work, and to discount for those that amend to a prototype. You may find it in everyone's best interest to amend a very complicated situation to one of your prototypes without charge, even though it may take days of work. Sam is correct in that the bigness and the volume does not help the situation at all.

MR. BRITTON: Sam, one of the things you mentioned was the massive re-education of the Field. How do you see the Field responding to this. Have they undergone this effort or are they beginning to decide that maybe pension trust plans are just not worth all the effort? Have sales been affected?

MR. TAYLOR: Yes, sales have been affected in all insurance companies in the individual policy pension business. Part of it is the problem that the old way has been taken away without anything yet to replace it, particularly in the area of defined benefit plans. The defined benefit plan in many ways is still in my judgement a very attractive kind of plan for small business owners to adopt. The opportunitites to sell life insurance are greater under the defined benefit plan then they are in other kinds of plans, but the Field hasn't become comfortable in this new ballgame that we're in. I do think the re-education will take place and I think that sales will turn around, but I guess I question whether in the future, the sales of the individual policy plans will continue the significant growth that occurred in 1974 and 1975. Those were the two biggest years. If you project the growth in those two years right straight on out through 1980 everybody in the world will have a pension plan. And I don't think we will see a return to that kind of growth.

MR. BRITTON: What is the responsibility of the agent to the customer in terms of designing and recommending different kinds of plans and products? Can the agent properly service the customer by offering the products of just one insurance company?

MR. BLATCHFORD: Since I'm not a member of an insurance company, I'll take the first step here. I am uncomfortable when an insurance company offers but one plan or decides on one pension product, whether it be a defined contribution product or defined benefit product. I'm also uncomfortable if the agent is restricted to selling insured plans. There are instances where there are very valid reasons to install non-insured plans. In these instances the agent is not properly servicing his client if he is restricted. What has happened is that many agents, better agents, have gotten into both the insured and non-insured markets, and this is what is causing a number of problems at this time, now that they have to have Enrolled Actuaries. But basically I do believe the customer will best be served if the agent isn't restricted.

MR. TAYLOR: Bill, I thought you were beginning to get at the whole question of what can an agent do, what kinds of recommendations can he make to a client, where do we differentiate between selling and consulting and providing administrative services as three separate and distinct functions. Personally, I like the position that nobody tells the IBM salesman that he can't know more about his business and be smarter than the next guy, and so no one should

tell the life insurance salesman that he can't be smarter than the next guy and know more about his business then the next guy and make good sales presentations that fill the needs of his customers. But there is certainly a very fine line between that situation and the situation where the agent falls into all sorts of advisory/fiduciary roles. I don't think anybody has a good solution at this point.

MR. FORTIN: I would like to digress a little bit from the practical world for a minute to the theoretical and talk about a world where we have perfect information. Assume that we had a computer set up to locate the best DA product, the best retirement income product, and the best retirement annuity. Also assume that Sam would know which company has the best as would Lynd, Bill and myself. If I were a life insurance agent, I really don't think that I owe my client complete disclosure if I walk into his office and tell him I'm a representative of my insurance company. I'm there to sell him a product offered by my insurance company. Back in the real world, if the agent approaches the client on the correct basis, I don't think he has to comment on which company has the best products, even if he knows, so long as he doesn't misrepresent what he is saying.

MR. BLATCHFORD: The question is whether the agent is always selling a product or whether he's selling a package which consists of services, insurance products, investment vehicles, or just plain advice. If he is indeed selling this package, then the concern is not whether it is the best insurance product that the client is getting, but the best package in terms of services.

MR. BRITTON: Perhaps we can move now to the final two items on our agenda.

MR. BLATCHFORD: It should be obvious from what the previous speakers have said that life post-ERISA is not so simple and that there are no easy answers to the myriad of problems with which we are faced. As actuaries we must be sensitive to the perceptions of the Plan Sponsor and the Agent. We must recognize that, frequently, we are geographically removed from the plan and its day-to-day operation. We do not have the intimate knowledge of the characteristics of the plan which is possessed by the Plan Sponsor and Agent. Yet we have been thrust into a position where we must make assumptions as to the future experience of the plan.

Our life is complicated by the fact that most of the plans with which we are concerned are of such a size that the "law of large numbers" is not in operation. A single termination, death or early retirement can have a substantial impact on the orderly progression of funding.

An overriding consideration in all that we do is that the cost of our services must be affordable by the Plan Sponsor. This limits the actuary in his pursuit of sufficient information to make him feel comfortable in his task.

In spite of these difficulties, we must develop our "best estimate" assumptions. Although there is no unanimity concerning the meaning of "best estimate", it should be noted that last week at the Academy and Conference Meeting for Enrolled Actuaries in Washington, Rowland Cross, Chief of the Pension Actuarial Branch of IRS, expressed the personal opinion that "best estimate" means "most likely."

In selecting the investment return assumption the actuary for the typical small insured plan should recognize that these small plans are subject to

significant cash flow problems in comparison to their larger brethren. The retirement of a key participant at a time of depressed market values can substantially alter the long-range return of a plan. Thus the actuary should be concerned not only with the type of investments but also with the plan cash flow. If implicit assumptions rather than explicit assumptions are to be used, then the interest assumption should be adjusted to reflect the effect of future salary increases - but more about this later.

In selecting the preretirement mortality assumption it would be wise to review the death benefit provisions of the plan. Many plans which I have seen recently have substantial benefits payable from the side fund. Unless you are capable of explicity valuing these benefits, the assumption of mortality is unwise. In any event, no mortality is probably the best assumption for a small plan.

The situation for the withdrawal assumption is similar. Typically, the benefits are concentrated on a few key participants who are unlikely to terminate on a nonvested basis. Thus, unless vested benefits are being explicitly valued and special attention given to key participants, the assumption of withdrawals would seem inappropriate. For larger plans different considerations would hold. In these cases the Plan Sponsor and Agent may be helpful in isolating prior experience and in indicating conditions impacting upon future experience. Appropriate consideration should be given to the vesting schedule of the plan.

Fortunately, most disability benefits provided by these plans are not material. Thus disability is not normally a consideration.

At the Meeting for Enrolled Actuaries, Rowland Cross expressed the personal opinion that for final average salary plans, both large and small, the effect of future increases in compensation should be recognized if the "best estimate" requirement is to be met. On an explicit basis, this means salary scale. On an implicit basis, it means an adjustment to the interest assumption. It does not always mean that future salary increases should be anticipated. For many small plans the benefits are concentrated on one or two key participants who have complete control over their future compensation. For a variety of reasons they may intend to keep their compensation reasonably level in the future. An automatic assumption of salary increases would, in this case, not be a "best estimate." The Plan Sponsor and Agent are your most valuable resources in this area. On larger plans, and particularly on integrated plans, the effect of future salary increases on plan costs can be marked. When the plan is integrated, an explicit recognition is the most practical approach. On excess plans, plan employees below the integration base should be included in the valuation and your data acquisition forms should be designed so as to collect data on these employees who are otherwise apt to be omitted from the census data furnished by the Plan Administrator.

The selection of postretirement mortality and interest is most frequently handled in these plans by using funding targets representative of probably long-term future experience. Based on current conditions, the use of either current settlement rates or guaranteed rates is probably inappropriate. The selection of appropriate funding targets may reflect the incidence of retirements under the plan.

Many insurance companies have instituted Guidelines for the Selection of Assumptions. Such guidelines are useful <u>if used</u> as guidelines. The danger

of such guidelines is that they may be accepted on blind faith for all plans. The value of guidelines would seem to be inversely proportional to the size of the plan.

The selection of assumptions is only a part of the problem. The selection of the Actuarial Cost Method is also a consideration. In the future, it may not be easy to change methods for a specific plan so the initial selection is very important. In selecting the method consideration should be given to the interests of the plan participants and the desires of the Plan Sponsor. The first consideration requires that funding be adequate and the second may involve questions of flexibility. My own preference is for aggregate methods since they ease the burdens of the Minimum Funding Standards. Their smoothing characteristics also seem particularly well-suited for the volatile experience of small plans. In any event, the actuary is well advised to keep a weather eye out on the emerging liability of the plan.

The collection of data is another important consideration. If the assets are held by the insurance company or other financial institution, the acquisition of asset data should impose few problems. In other situations, the actuary should take pains to acquire good data. In particular, he should be on the alert for such items as securities or obligations of the Plan Sponsor. For plans where a qualified public accountant has been engaged, the actuary may rely on the accountant for such data. With respect to census data the actuary should, of course, attempt to acquire the best available data. I would like to underscore the words best available. If we bankrupt the plan by generating excessive costs for acquiring complete data, we have failed in our responsibility to the plan participants. We should ask ourselves whether or not a particular item of data is really material in the course of events. If it is not, we should swallow our professional pride and do the best we can with the material on hand.

MR. BRITTON: How much pressure has been placed on the Plan Sponsor from outside forces in the area of selecting assumptions?

MR BLATCHFORD: I haven't seen that much pressure.

MR. TAYLOR: What kind of leeway do you think the actuary has in requiring average precision in the valuation?

MR. BLATCHFORD: I don't know if I can answer your question directly. I will put forth a number of items that are quite a concern. Some insurance company actuaries go to great lengths to make sure that they have every last bit of data. We all have to recognize that for most of the plans we have discussed this morning, and indeed perhaps all plans, record-keeping has not been one of the strong points. There is a lot of information that we will not be able to obtain. For example, information on when people were hired may be very difficult to come by. This information will be needed ultimately when we're determining the benefits of the retiring participant. But do you really need it today to come up with the costs? How much is your cost going to be off if you have to make an assumption as to some of this data? If you should make a mistake, you'll have another chance next year to make amends. Whatever we do, we have to be extremely sensitive to the costs of providing services to these plans.

MR. BRITTON: Lynd, would you comment on outside vendors of pension services.

MR. BLATCHFORD: I categorize vendors of services into the following groups:

Type A: Small local enterprises providing direct independent services.
Type B: Small local firms providing direct actuarial services.
Type C: Vendors of computer services to agents and Home Offices.
Type D: Vendors of computer software.

The Type A vendors, those that provide direct independent services, work on a fee concept and sometimes pay a finder's fee to the Agent directing the client to the organization. These enterprises operate independently of the insurance company Home Office. They share a common problem with types B and C, namely, that information on in-force insurance contracts is not directly available. Thus they must rely on third parties for this information.

Under the Type B operation, where only direct actuarial services are provided by the vendor, the Agent retains control of the administrative functions. Home Office control exists to the extent that it has control over the Agent. The quality of actuarial services in types A and B are a function of the quality of the vendor.

In the Type C operation where computerized services are vended to agency organizations and Home Offices, the services are typically provided through a time-sharing terminal, an in-house mini-computer, or the vendor's remote computer. There is no direct interface with the insurance company data base. The service may be viewed as a calculation and record-keeping service with the Agent remaining as the direct interface to the client. If the Agent is not an Enrolled Actuary and Home Office actuarial services are not provided, he must seek certification elsewhere. This can prove to be a substantial problem to the certifying actuary since:

1. The calculations are produced outside of his control; and
2. The integrity of the data is outside of his control.

To properly certify such a valuation the actuary must essentially duplicate the process. In addition, he must be comfortable with the actuarial techniques used. The stability of the software is also a factor: Can the third party actuary assume the system is operating correctly merely because it produced good results a month ago? What changes may have been made to the system of which the actuary may be unaware? Has the vendor established adequate control procedures?

The Type D operation, where the software is purchased or leased, is perhaps the most satisfactory approach for Home Offices which wish to take an active role in the servicing of pension plans but which do not wish to develop their own systems for reasons of cost or timing. The software is typically integrated with the insurance company's data base. In choosing a system the following items should be considered:

1. The ability of the system to effectively interface with the insurance company's data base.
2. The quality of the documentation, both user and system.
3. The quality of the software design
   a) is it efficient?
   b) is it flexible, capable of expansion?

Finally, in the selection of any system,the actuary should not look to the system to handle 100% of his cases. The costs of a fully comprehensive system substantially outweigh the benefits to be gained therefrom. Occasional use of a desk top calculator is appropriate and desirable.