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PANEL DISCUSSION

CURRENT PENSION FUND ISSUES

Panel Members:
JOHN H. MILLER, *Moderator*
JAMES A. ATTWOOD
LAURENCE E. COWARD
HOWARD YOUNG

JOHN H. MILLER

We will start our discussion of several pension fund issues with Mr. Coward, who is to discuss certain Canadian developments and problems, after which Mr. Attwood and Mr. Young will present discussions primarily of interest to those in the States.

Our panel members include Mr. Laurence E. Coward, vice president and director of William Mercer, Limited, who recently served as chairman of the Pension Commission of Ontario; Mr. James A. Attwood, second vice president of the Equitable Life Assurance Society, New York; and Mr. Howard Young, actuary of the United Automobile Workers.

Among other things, Mr. Attwood will speak about a recent publication, "Accounting for the Cost of Pension Plans," an accounting research study published by the director of accounting research of the American Institute of Certified Public Accountants.

We are happy to have in our audience the author of this book, a certified public accountant and a partner of Arthur Young & Company, Mr. Ernest L. Hicks. [Mr. Hicks rose to be recognized by the audience.]

LAURENCE E. COWARD:

A new "unpredictable" has arisen in Canada to trouble those responsible for the design and valuation of pension plans. It is the impact of government legislation, regulatory or social. The actuary should, of course, be conscious of the very long-term nature of the commitments of a pension plan. He should try to insure that the pension plan is designed and funded for stability into the fairly distant future. However, he cannot be expected to outguess the politicians and must be prepared at short notice to see the pension plan drastically amended in the light of new legislation.

Canada is in the middle of a major upheaval in pension planning. The great majority of pension plans has recently been or will soon be amended as a result of portable pension legislation or the Canada Pension Plan, or both.

Portable pension legislation is a provincial responsibility and Ontario's Act has been in force from January 1, 1965. A similar law in Quebec will come into operation on January 1, 1966. There are strong indications that some other provinces will introduce similar legislation next year, as well as the federal government in respect to employees under its jurisdiction. An interprovincial organization has been set up, and the goal of uniform ground rules for pension plans across Canada is in sight.

The Pension Benefits Act requires two main things. Every pension plan must provide, for a member who terminates over age 45 with more than ten years of service, a vested deferred pension in respect to service after the effective date of the Act. The second main requirement is that pension plans must meet standards of solvency. Unfunded and terminally funded pension plans must change to advance funding on conventional lines if they continue in force. Many funded pension plans did not meet the solvency standards, which require payment of all current service costs and liquidation of unfunded liabilities over not more than twenty-five years.

The original purpose of the portable pension act, as the name implies, was to provide deferred pensions for terminating employees. Solvency rules were not even mentioned in the Report of the Committee on Portable Pensions. We now realize that changing vesting in a pension plan is in the nature of a one-shot job (another shot may be needed later if the qualification is reduced to, say, five years) but that the regulation of solvency requires continuing supervision of the actuarial valuations and financial reports. The supervision of solvency and regulation of investments are likely to be the more important and more difficult tasks for the Pension Commission. This is based on the simple thought that the employer should not promise pensions unless he is prepared to back his promises with money. As far as possible the Commission will avoid prescribing actuarial tables and methods and will instead rely on the certificates of qualified actuaries. Nevertheless, it is obvious that the Commission's influence on these matters will grow.

The Canada Pension Plan will be in effect from January 1, 1966, from which date employees and employers will each be required to pay contributions of 1.8 per cent on earnings in excess of $50 a month up to $416.17 a month. The pension benefit will rise during a ten-year transition period, at the end of which time it will be 25 per cent of average earnings to a maximum of $104.17 a month. Provision is made for increasing the salary limits and pensions according to indices of wages and price.

The amount of old age security was increased to $75 a month and the retirement age under both O.A.S. and C.P.P. will come down to age 65 by the year 1970. With so large a government pension, it is natural that most employers intend to "integrate" or "co-ordinate" their pension plans with the C.P.P.

Consider, for example, an employee earning $5,000 a year, retiring ten years hence, who belongs to a pension plan of the "civil service" type. He will be entitled to a 25 per cent pension from the C.P.P., plus a further 18 per cent pension from old age security, making a total of 43 per cent from these universal plans. His private plan pension, even if it is integrated as proposed by the federal government, will be 63 per cent of earnings. This makes 106 per cent of previous pay, ignoring the possibility that he may have a wife over age 65 who will receive old age security, ignoring the effect of escalation of the government benefits, and ignoring the political promises being made in this election campaign of another $25 a month pension increase. This 106 per cent pension compares with his previous net pay of 94 per cent, if we allow for his contributions to the private plan and to the C.P.P.

If the plan is integrated, the total pension income is 106 per cent, compared with previous net pay of 94 per cent. If the plan is "stacked," the pension income is 113 per cent compared with previous net pay of 92½ per cent.

Let us not forget that the financial needs of the retired man are rarely as great as those of the young or middle-aged man. He may want to take a world cruise, and I do not grudge it to him. But as a rule his needs are considerably less. As a rule he is through with the expense of bringing up his children. He has usually paid off the mortgage on his house. He no longer pays pension contributions, union dues, and the like. He has an additional income tax allowance of $500. He rarely has the energy and the desire to spend money as freely as a younger man, since his capacity for wine, women, and song is less than he formerly enjoyed.

It is necessary to say this, because, surprisingly enough, the demand for "stacking" is heard even from teachers, civil servants, and other government employees.

I agree emphatically that the retired man is entitled to be as well off as he was when he was working. I maintain that he does not need as much money to keep up the same standard and that there is no sense in providing more pension than previous pay.

While there seems to be an overwhelming case for integration in the case of pension plans of the public service type, much more modest pension plans are also integrating. Here the benefits of the private plan and public plans in total may be far from excessive, but the cost aspect is paramount. Few employers are willing to pay the extra contribution of up to $79.20 for each employee without adjusting other fringe benefits.

Even if the employer is not out to reduce his over-all costs, "stacking" results in inequities between employees of different salaries. The first $5,000 of earnings will produce a government pension of $2,150 a year, and hence the private plan does not need to provide as much on the first $5,000 of earnings as on earnings in excess of $5,000. Thus there is a strong trend toward the two-level pension plan, which is well established in the United States.

A surprisingly high percentage of employers have expressed their intention of integrating their plans, especially if they are contributory. In some cases, where benefits are low or a noncontributory union plan is in effect, the decision is to stack. A very few plans are being wound up.

The various methods of integrating have been discussed at length elsewhere. A natural approach is to establish the total benefit and contribution levels that are thought appropriate and to offset the benefits and contributions of all government plans. I will only say that the full offset approach is not as satisfactory and easy to carry out as it might at first sight appear to be. The offset tends to run afoul of provincial law, which is based on the general idea that pensions are deferred pay, that existing pension rights must be preserved intact, and that a definite portable pension must be available for each employee.

The most favored integration method in a contributory plan is to reduce contributions of employees by the amounts that they will contribute to the Canada Pension Plan and then to reduce the future service pension benefits proportionately. In this way the cost of the pension plan is shared between employer and employee in the same proportion as before, and the employee will receive the same pension for each $1 of his contributions as before the change. The method is fairly easy to explain to employees and has the appearance of equity.

Much of our pension thinking must be revised. We must allow for state pensions on a vastly larger scale and for ascendency of the deferred pay concept of pensions. We must define carefully how each individual's pension accrues over the years and what he is entitled to if he leaves employment or if the plan is wound up.

JAMES A. ATTWOOD:

Introduction

At our Annual Meeting last year we had a panel discussion on topics of current joint concern to the accounting and actuarial professions. One of the topics discussed was the problem of accounting for the cost of pension plans. Russ Thomas, one of the panel members, mentioned the study in progress on this subject by the Accounting Research Division of the American Institute of Certified Public Accountants. In May of this year, *Accounting Research Study No. 8* appeared. The author of the study is Ernest L. Hicks, C.P.A. and partner of a major United States accounting firm, Arthur Young & Company. As John Miller mentioned, Mr. Hicks is in the audience today, and I too hope he will feel free to participate in our discussion of this subject—both to raise and respond to questions.

Publication of this study brought to a head several years of consideration of this topic by the research staff of the AICPA. Last year Russ Thomas covered in considerable detail the background and history of the study. I will not go over that again. All I will repeat is the fact that several members of the Society have been in the thick of this development over the past five years or so. A Society of Actuaries' Committee To Study Pension Accounting, headed by Frank Griffin, worked closely with the research staff of the AICPA and with Mr. Hicks in this connection.

Later Mr. Hicks may want to comment specifically on the current status of the accounting profession's deliberations on this subject and to indicate what the future may bring in the form of public pronouncements on accounting principles on this subject. This would be done by the Accounting Principles Board—the agency of the AICPA which has authority to do this. But, let us look at the study itself—its recommendations, the reasons behind the recommendations, and some of the concerns and criticisms which have been raised about the recommendations.

In general, it is sufficient here to say that these recommendations will be highly significant to the Accounting Principles Board in forming its final pronouncements on this subject. On the other hand, the AICPA is extremely interested in obtaining the views on this subject of all interested individuals and groups. They are more interested in the reasoning behind views rather than just positive or negative reactions. Any members of the Society who have thoughts on this subject are urged to send them to the Director of Accounting Research of AICPA. All views will be studied, analyzed, and presented to the Accounting Principles Board for its further deliberations on this subject.

Recommendations of the Study

Now for the report itself. Obviously, I can only hit the highlights of this 159-page study. I know that many of you have already read the report and are well versed in its contents. I want also to mention that Frank Griffin has written an excellent book review of the Hicks report. I believe that this will appear in this year's Annual Meeting number of the *Transactions.*

The basic, fundamental recommendation of the study is that pension costs should be accounted for on the books of the employer on an accrual basis rather than on a cash basis, which has generally been the practice to date. What does this mean? It means that for accounting purposes (i.e., the accounts and financial statements of the employer) there will be a periodic, consistent accrual charge against operations for pension costs. If the employer contributes to the plan more than such charge, an asset item is set up on the books and is reflected in the balance sheet. If less than the accrual charge is contributed, a liability is set up on the books and balance sheet.

Most of the other recommendations of the study refine and implement this basic recommendation for accrual accounting. Although many of these implementing recommendations are in themselves controversial, they all seem to fall in place once the basic recommendation is understood and accepted. Here are a few of the other recommendations.

1. Supplemental liabilities (or so-called past-service costs) of a pension plan "should be taken into expense systematically over a reasonable period" following the inception of a plan or following the amendment of a plan. Hicks feels that a reasonable range for amortization would be from 10 to 40 years.
2. Actuarial gains and losses "should in most instances be spread over the current year and future years."
3. Unrealized appreciation or depreciation on common stocks (and, in some instances, bonds and investments of other types) in a pension fund "should be recognized systematically in estimating the employer's pension cost for accounting purposes."

Other recommendations cover (*a*) acceptable actuarial cost methods for determining accrual costs, (*b*) unacceptability of pay-as-you-go and terminal funding, (*c*) handling of normal costs, (*d*) inclusion of all potential participants in accrual cost calculations, and (*e*) disclosure of information in the corporate financial statements—both what information should be disclosed and where the information should be disclosed. The recommendations as to expensing past-service costs and recognizing appreciation or depreciation on common stocks have probably been the most controversial ones of the report.

Arguments Favoring Adoption of Recommendations

These are far-reaching recommendations. If they are adopted, the recommendations are bound significantly to affect most, if not all, private pension plans. Why do accountants and others, including some actuaries, feel that changes in current practices are necessary?

The basic reason for change is simple—many accountants are dissatisfied with present practices. Part of this dissatisfaction stems from a desire to obtain greater consistency, continuity, uniformity, and comparability of accounting figures. But, mainly, this dissatisfaction was brought to a head in the late 50's when a number of employers substantially reduced—or even eliminated entirely for a period—contributions under their pension plans. This had the effect of substantially increasing per share corporate earnings.

In recent years, more employers have realized the flexibility available in making pension plan contributions and the consequent ability substantially to affect (or manipulate, as some would say) the corporate earnings from one year to another. Unless this practice is abated, many accountants (including Mr. Hicks) feel that the income statement—and the important per share earnings figure from such statement—will possibly become meaningless and misleading. Further, there is always the possible threat of governmental or regulatory action if the accounting profession voluntarily does not do something to curb practices which can result in misleading information being given to owners and purchasers of publicly traded securities.

Observations and Criticisms of Study

Mr. Hicks may want to comment later on the formal reactions he and the AICPA have received on the recommendations. There is no doubt that the study itself—the quality of its arguments and presentation—is receiving the highest praise, especially from pension experts. The study is very well done. Further, there is general sympathy for the accountant's understandable concern to maintain meaningful and consistent financial statements. However, there have been criticisms of the recommendations of the study. Let us look at some of these. If any of you have observations or criticisms, I hope that you will bring them up in the discussion period.

A major criticism concerns the recommendation that past-service costs be expensed against operations until the total cost is fully amortized. Many persons take issue with this. Some argue that there should be no required amortization of past-service costs, that normal cost plus interest should be the maximum required accrual charge against operations. Others argue that a company should not be required to accumulate assets (or charge against operations) more than is necessary to meet the accrued benefit obligations. Full funding on certain actuarial cost methods (notably the entry age level cost method) involves funding in excess of the amount necessary to satisfy accrued benefit obligations at any given point of time.

Another technical criticism concerns the inconsistency in accounting treatment between valuation of common stocks held in a pension fund and such securities held by the company directly as an investment. In his review for the *Transactions*, Mr. Griffin also raises questions about treatment of certain special situations—such as the special benefits of the 1964 auto settlements—and the application to pension costs incurred outside the United States.

There is another set of criticisms which go to the heart of the recommendation for accrual accounting. These are not actuarial or technical in nature. They are broader concerns which raise fundamental questions as to the impact of the recommendations on the growth of private pension plans in general. Dorrance Bronson touched on some of these last year in his review of Pres Bassett's paper. Others, including Howard Hennington, Frank Griffin, and myself, have raised similar questions. Time does not permit me in these introductory remarks to go into the rationale behind these concerns, but let me raise some questions that I hope might be provocative of comments from you.

1. *Effect on funding outlay.*—Accrual accounting requires the establishment of a standardized basis for accruing annual expense charges for a pension plan. Could the standardized basis for accruing expense become the standardized basis for making contributions to a plan? That is, will contributions mirror expenses? If so, what are possible adverse consequences? Would financial soundness of a plan be impaired and solvency threatened? Would collective bargaining be affected? How could a company explain to its employees and its unions that it made a contribution higher or lower than the amount expensed against operations? Could rigid funding patterns have serious effects on the financial success of some companies?

2. *Inherent dangers of standardization.*—Could standardized accounting lead to *regulated* standardized funding? Could accrual accounting lead to changes in the permissible levels of funding under the IRS code and regulations?

3. *Effects on growth of private pension plans.*—Could accrual accounting, and the standardization and lack of flexibility it involves, lead to developments which possibly are inimical to the future growth of private pensions? Could this lead to greater use of profit sharing plans? Could this lead to more unfunded plans? Could this lead to greater emphasis on fixed contribution plans, say, of the multiemployer type?

4. *Other concerns.*—Could the asset and liability items set up lead to more misunderstanding and problems than accountants are trying to solve? Would there be too much reliance on uniformity between companies? Could this create liabilities which do not exist? How can consistency be maintained with a company with no pension plan?

Alternatives of Increased Disclosure and Footnotes

There is no doubt that accountants have a legitimate concern over the problem of expensing pension costs against operations. The flexibility currently available raises concerns which go to the core of fundamental accounting. It seriously challenges the conscience of accountants when they are called upon to certify that the accounts and statements of an employer appropriately reflect—in accordance with generally accepted accounting principles—the operations of the employer for the period covered.

A logical question, however, is whether there is another approach which might solve or lessen their problems but avoid the concern that the accrual method of accounting may create more problems and misunderstanding than it solves. One suggestion follows the advice "to walk before one runs." It suggests that increased disclosure requirements be tried first. This could, for example, take the form of a specific disclosure in a company's financial statements of a comparison of amount contributed and charged to operations with an accrual cost determined on the basis espoused in the study. If this does not do the trick after a period of experimentation, more rigid methods could be tried.

Conclusion

As you can see, consideration of the topic of accounting for pension costs goes far beyond strict accounting, actuarial and other technical considerations. It enters the arena of public discussion where we now find discussion of (*a*) the President's Cabinet Committee Report and its chief recommendations as to vesting and funding standards; (*b*) Professor Bernstein's book, *The Future of Private Pensions;* (*c*) social security legislation and the debate as to respective roles of government and private pensions; (*d*) clearinghouse proposal; and (*e*) reinsurance proposal to be discussed by Howard Young.

In considering these problems, actuaries must appreciate their dual functions in the private pension area. First, they have interests as professional actuaries in sound pension practices. Second, they have interests as private pension experts. Let us keep our minds, eyes, and mouths open for thoughtful consideration, observation, and discussion on all these topics of current interest.

HOWARD YOUNG:

The basic actuarial concern with respect to a pension plan is its financial soundness, that is, the ability to pay benefits as they fall due. In general the establishment of a separate fund through a regular system of contributions is the best way to attain such soundness. Funding is also useful as a means to currently recognize the long-range financial impact of a plan. As Jim Attwood has discussed, we now see accounting considerations leading some people to advocate recognition of this financial impact—and reflection of it in annual statements—even if funding is not actually taking place.

There are situations, however, in which funding will not result in the desired security. Under the Ontario legislation, discussed by Laurence Coward, a maximum of twenty-five years is permitted for the funding of liabilities which existed at the end of 1964 and fifteen years for liabilities created subsequent to that time. In the United States, the minimum practical amortization period is about twelve years, but periods of thirty years or longer are the general rule. During this period there is a risk that the plan will be inadequately financed due to premature termination. The situation is further compounded by the periodic improvement of plans with the establishment of new unfunded liabilities.

Furthermore, exclusive reliance on the fund of the individual pension plan in question ignores the basic actuarial concept of pooling resources to meet contingent financial needs. As actuaries, we should be concerned with the possibility of developing such pooling arrangements to enhance the soundness of private pension plans. One such arrangement is the proposed guarantee fund.

Briefly stated, the proposal calls for federal legislation requiring each qualified pension plan to contribute to a guarantee fund which would provide accrued benefits that have not yet been funded if the employment unit with which the plan is associated is terminated. The required contribution would be proportional to the value of those unfunded benefits.

The primary actuarial consideration in evaluating such a proposal is, I believe, the possibility of antiselection. This could most likely occur through (*a*) deferral of joining the guarantee fund until shortly before a termination, (*b*) establishment of very large liabilities in anticipation of a termination, or (*c*) termination of a plan primarily to shift liabilities to the guarantee fund. Some safeguards which might minimize such antiselection are (*a*) the imposition of a maximum on the benefits guaranteed, for example, the smaller of a specified dollar amount or a percentage of earnings; (*b*) compulsory participation; (*c*) a "suicide clause" which limits the guarantee to terminations that occur after a specified period has elapsed since the plan joined the fund; and (*d*) limitation of the guarantee to terminations which are not due primarily to pension plan considerations. Even more sophisticated concepts could be used; for example, the amount guaranteed might be the lesser of the value of unfunded benefits or the assets already funded. It will be recognized that some of these safeguards have been incorporated in the bills now pending in Congress.

Probably the most controversial aspect of the proposal is the requirement for compulsory participation, and this should be examined further.

First, as noted above, this is a safeguard against antiselection. If participation is voluntary, we must assume that only plans associated with employment units in which a termination is likely during the relatively near future would join. This would result in extremely high contribution requirements. On the other hand, a universal program should not require very high contributions. Unfortunately, very few data are available upon which to base a reliable estimate of the required contribution. As one indicator, however, we have the following data concerning business terminations due to financial difficulty:

TERMINATING MANUFACTURING OPERATIONS AS A PER CENT OF ALL MANUFACTURING OPERATIONS

	1961	1962	1963
By number of companies	0.64%	0.61%	0.56%
By current liabilities	0.57	0.59	0.85

SOURCE: Dun's Review and "Quarterly Financial Report for U.S. Manufacturing Corporations," by FTC-SEC.

Second, if participation were not compulsory, the desired goal of security might be defeated for many plans through nonparticipation. This could come about because those responsible for the decision feel the risk of termination to be remote, or because they do not feel the protection worth the cost. In connection with the latter possibility, it must be recognized that the plan beneficiaries frequently would not have very much part in making the decision.

Third, the interdependence of our economy makes it very difficult to identify the proper source of financing such a guarantee fund. While one's first inclination might be to attempt to establish a contribution structure which allocates the cost against those plans with greatest probability of termination, it should be recognized that the cause of termination is frequently only remotely connected with the particular employment unit with which the plan is associated. To illustrate from the area I am most familiar with, consider two recent developments:

1. The new auto tariff agreement between our countries may cause a shift in the purchasing patterns of major auto manufacturers. While this should result in greater efficiency and thus benefit each country's economy, individual firms may find themselves out of business due to loss of their primary customers.
2. If the turbine engine changes the fuel requirements for automobiles, many employment units in the fuel industry may be affected.

In cases such as these—and I believe you can think of some closer to your own activities—where should the cost of the guarantee fund fall?

In short then, compulsory participation would avoid antiselection, assure protection to all plans, and assess the cost against all plans. Incidentally, the major reason for proposing that the program be established by federal legislation is the belief that it should be on a compulsory universal basis.

What are the alternatives to a compulsory universal program? One might be to permit a pledge of other assets to provide benefits; for example, a corporation establishing a plan might subject its assets to claims for benefit payments. Another might be the requirement of very rapid funding, thus minimizing the period during which there is a risk. Another might be a legal requirement that, once established, the liability for accrued benefits must be honored by the establisher of the plan and any successors; as you know, most plans now provide that they can be terminated at any time without obligation to complete the funding of accrued benefits. In any event, there is in almost every case the possibility that the promise to provide benefits cannot be fulfilled. Therefore the alternatives seem to be a possible basis for narrowing the types of termination, which would require recourse to a guarantee fund but not a substitute for such a fund.

There are other aspects of the proposal of special interest to actuaries. The rate structure is one; aside from the lack of data needed to determine a rate of termination, it would also be necessary to establish the amount guaranteed. Since the proposal is to guarantee benefits—not a dollar estimate of unfunded liabilities—the unfunded value of such benefits would have to be determined. It would be necessary to do this on a uniform basis for all plans, even if a particular plan did not use that basis for its own valuation purposes. The question of mandatory funding also is important here. If it is believed that the probability of termination increases with the age of a plan, funding would be desirable to avoid an assessment spiral. If, on the other hand, there is no such relationship, there would be no direct connection between the desirability of funding and the establishment of a guarantee fund; in fact, participation in the guarantee fund might in that case be a valid alternative to funding.

The entire mechanism of such a guarantee fund should, of course, be evaluated by actuaries. It would, however, be premature and of little value to discuss that now.

It should nevertheless be recognized that the pooling of funds to meet benefits of various employment units, including some which may have terminated, is not new in practice or concept. Most multiemployer plans provide, either implicitly or explicitly, for some pooling against the risk of terminations by individual employers. Some industrial plans have been established on a plant-by-plant basis; others are pooled over the entire corporation. When the question of enhancing soundness through mandatory funding comes up, one frequently hears the assertion that such assets could be more useful if invested in the enterprise with which the plan is associated; in this connection a vice president of a large Canadian manufacturer suggested in 1962:

> I sometimes wonder, if we went to pensions supported in Canada by a faith in free enterprise, whether political requirements could be met by some arrangement for insuring private pension plans up to an acceptable minimal level at premium rates less than the cost of borrowed money.

While there are several bills pending in Congress which would establish a government guarantee fund, it was not the purpose of this discussion to specifically analyze those bills. Instead, I have attempted to delineate the problems which should be examined by actuaries in the hope that you will review them to determine whether solutions are possible and not get bogged down in an argument of whether any specific proposal should be enacted.

As pointed out earlier, actuaries should be concerned with a new area in which the basic concept of pooling resources to meet contingent financial needs may be applicable. Even more important, we must recognize that, if the need to assure soundness is not met, the private pension structure is constantly in danger of being rejected by those whose valid expectations have been defeated. If the private system is to provide a real alternative to—and a middle ground between—individual annuities and social security, it must include a mechanism to assure those currently providing money to pay benefits that their benefits will in turn be paid when they reach retirement age.

At the conclusion of the presentations by the panel members, the moderator opened the meeting for questions and informal discussion from the floor. A report of this portion of the program follows, in digest form.

DORRANCE C. BRONSON: Are we actuaries endorsing "social purpose objectives" in pension plan provisions as required ingredients for IRS approval? On what points, if any, are we *en rapport* with current pension reformists, for example, newcomer authors of academe and government theoreticians? How many of us have turned from belief in freely contracted, but contingent, pensions under private plans to envision the happy scene of riskless pensions, dealt out through government rules from plans euphemistically labeled "Private"? (*Mais regardez le mirage!*)

Answers are not imputed to any of the above questions by alluding briefly to two of today's earlier remarks, as below:

Mr. Attwood spoke for more Disclosure Act requirements on funding details, and several bills to amend other areas of said Act have already been introduced. The whole initial pitch and purpose of the Act—information intended to be of help to participants—would be altered by these measures, and this law would become a basket of miscellany for whatever you wanted to throw into it.

Mr. Young, for the "Hartke idea," would, imperatively, lean on the government for the complex record-keeping required for this "reinsurance dilemma" and again, imperatively, would turn to Washington for policing the funding of the applicable plans.

But, in my opinion, neither of these two actuaries nor any others that I know have really "struck camp" on the "private" side of the river. Perhaps a few hand-lines have been cast across the stream for experimental purposes, but I hope that I am correct in my prophecy that only a merest few of our "private pension area" membership would actually lend aid and encouragement, active or passive, for adding successive increments to existing government controls, the inevitable result of which would deprivatize the private pension plans which have been built up over the years *without* need of any controls, to the splendid accomplishments in coverages, benefit provisions, and high funded ratios attained by the year 1965.

MR. ATTWOOD: When I referred to the possibility of increased disclosure, I was not referring to increased disclosure under the Federal Welfare and Pension Plans Disclosure Act. I was referring to the possibility of increased disclosure in the annual financial statements of employers. However, much could be said about the possibility of increasing disclosure requirements to individual employees as to benefit rights and extent of funding. If this were required under the Federal Disclosure Act, it would not be inconsistent with the Act's original purpose of providing disclosure to covered participants.

MR. HENRY E. BLAGDEN: There are all kinds of problems that can be created by trying to provide guarantees. In considering this problem, we have not come up with much in the way of solutions.

MR. ERNEST L. HICKS: I think that I can speak for both C.P.A.'s and Chartered Accountants in saying that we appreciate the time and attention actuaries have given to the problems of accounting for the cost of pension plans.

I agree with Jim Attwood that we should consider the social questions. One is the possible effect of accounting principles on the development of pension plans. Another, equally important, is how to maintain and improve the usefulness of financial statements to investors, creditors, and others who rely on them.

Jim Attwood has suggested that we may be able to deal with the pension matter by disclosure in footnotes, not concerning ourselves very much with the body of the balance sheet or of the statement of income. This runs counter to one important school of accounting thought, which holds that notes may properly be used only to amplify financial statements which are otherwise fairly presented.

The Canadian Institute of Chartered Accountants has issued a research study on accounting for pension cost and, quite recently, a more definitive statement of opinion. In the United States we are between the two. We hope that you will make your views known to the Accounting Principles Board of the American Institute of Certified Public Accountants, which is planning to issue a statement of opinion.

MR. JOHN HANSON: My discussion deals with the appropriate level of a pension fund. Actuaries have failed to delineate fundamental criteria in this area. This is evidenced by wide differences in actuarial practices, by the widely different degrees of benefit security among employers with identical funding commitments and identical plans in the same industry, and by the report of the Committee To Study Pension Problems. The Committee is undertaking certain studies to develop the "principles and practices" necessary to ensure sound pension funding. The purpose is to "illustrate by mathematical models or by other means the consequences of changes in actual experience or plans specifications, the interrelation of the various contingencies, and the incidence of recognized costs under different funding methods." I fail to see how these studies can add to the existing body of knowledge, and I am not aware of any lack of understanding of the incidence of cost under the different funding methods. A cursory review of "Fundamentals of Pension Funding" will reveal the incidence of each very clearly.

The problem is, What is the appropriate fund level? Is it truly a fundamental of pension funding that the pension fund should rise until it equals the largest available actuarial figure? Of course not. I submit as a fundamental of pension funding that the pension fund level should be determined, first, by benefit security considerations and, second, by other considerations. The former are generally the more important, but, if corporate assets provide benefit security, the latter may be the more important.

Let us analyze the pension fund needed for benefit security, assuming the benefits are secured only by the pension fund and remembering that a plan will either continue or terminate and that a fund not appropriate in either case cannot be appropriate merely because the lifetime of the plan is uncertain.

If a plan terminates, a fund equal to the value of accrued benefits is sufficient by definition. If the plan continues, there is generally a presumption that there will be future contributions which will fund future benefit accruals; therefore, a fund equal to the value of accrued benefits is again appropriate. This raises the question, Is pay-as-you-go adequate? The answer to that is "No." An employer cannot expect the full advantages to flow from a pension plan without a reasonable program of advance funding.

A logical funding objective is a fund with assets equal to the value of the benefits accrued by all vested employees. This objective is certainly consistent with the desire to protect the legitimate benefit expectations of the employees.

With respect to other than benefit security considerations, can they justify a fund in excess of the value of accrued benefits? Sometimes the answer is "Yes" to avoid fluctuating contributions, to prepare for a plan change, or to improve the future profitability of a business by maximizing tax-free pension fund investments. But it is up to the employer to decide whether he wants to overfund to avoid inconsistent contributions, to change the plan, or to get into the investment business.

Most employers place great trust in pension actuaries to guide them in developing benefit security for their employees. This trust is abused if the actuary does not provide adequate information regarding these other considerations, with the result that the employer does not in fact choose the ultimate fund level deliberately.

As a minimum, a unit credit measure of the value of accrued benefits is a necessary adjunct to any calculations under the projected benefit methods.

Reviewing, I submit as a fundamental of pension funding that the fund level should be based, first, on benefit security considerations and, second, on other considerations which are of a corporate financial nature. I further submit that an actuary who does not distinguish between benefit security considerations and these other considerations, in a manner understood by the employer, cannot be practicing competently. I submit as a general rule that benefit security considerations do not require the fund to exceed the value of accrued benefits.

I am not saying that many employers might not contribute more than the value of accrued benefits in order to provide benefit security with respect to benefits accruing in the future. I am saying that, if they do, they should do it intentionally, with a complete understanding of what they are doing. This, of course, is just my own opinion. The "Guides to Professional Conduct" give us each a right to his own opinion. I urge on the membership the thought that the professional right to one's own opinion should not be misused as an excuse to evade our scientific obligation either to refute the logic of new ideas or to change our practices. The right is no license to perpetuate errors of the past.

Pension actuaries have indulged in a number of unscientific oversimplifications, and I will enumerate four:

1. They have used the same term for two actuarial values, one always greater than the other. I refer, of course, to the unit credit and the entry age normal past-service costs.
2. Actuaries have used the term "past-service cost" as though it were related only to the years prior to the effective date of the plan, in spite of its intimate actuarial relationship with the normal cost.
3. Actuaries have shown a willingness to have the term "pension cost" defined as something else, such as "employment cost" or "compensation cost," instead of developing the unique characteristics of pension costs.
4. Even when our assumptions have no application except to groups, actuaries nevertheless think in terms of individual employees. Our assumptions reflect the ever-changing and never-ending fixed and contingent obligations of continuing pension plans, but our words do not.

Accountants instinctively feel that pensions are compensation, earned individually each year by each employee. Through our experience with employers, we know that many young employees have virtually no interest in pensions and that, for some employees approaching retirement, pensions are a matter of life and death.

Adopting our oversimplifications as their basic premises, accountants have, with considerable logic, arrived at conclusions with which many of us disagree.

MR. COWARD: The aggregate cost method does lead to certain difficulties under the Ontario funding regulations. It is contemplated in the Ontario regulations that a pension plan, whether funded by the aggregate cost method or otherwise, may fall into deficit and, if so, the deficiency must be paid up over five years. Under frozen initial liability or aggregate cost methods, one normally does not reveal such a thing as a deficit. Hence, a problem arises in trying to decide how the solvency rules for this method can be reconciled with the treatment of other types of plans.

MR. JAMES L. CLARE: The implication that I see in the proposal of Mr. Howard Young is that the government would be in the curious position of doing "more for the richer and less for the poorer." By this I mean that the government would be imposing reinsurance premiums only on behalf of an employee with a pension plan, who is thereby richer in this respect than an employee without a pension plan.

Mr. Young's proposal would also presumably have a larger reinsurance premium for a plan with bigger benefits than for a plan with smaller benefits. I find it curious that he is suggesting more governmental activity for the richer and less for the poorer. But, of course, our own Canada Pension Plan does just exactly that.

You can get around some of the difficulties of enforced funding from the employer's point of view by having a plan which is "future service" only. You could set up a plan without past service, make additional contributions over and above future service contributions as suited to the over-all finances of the employer, and then amend the plan to add past-service benefits bit by bit. This would comply with the Ontario Pension Benefits Act. The plan would be funded and solvent, and you would have past service, as you can "afford" it. This is, however, a detail, and I would prefer to concentrate on fundamentals.

The starting point of a pension plan is the money going in, and this is resolved by the employer. Under the Ontario Pension Benefits Act, he has to communicate the terms of the plan to the employees. The objective is to have the plan appear reasonable to the employees; the employer is guided thereby in determining how much he will put in.

Under the Act, the quality of the investments for the monies of the fund is a matter of government concern and government regulation.

When dollars are to be paid out, there is a basic question which overrides all technicalities; that is the "adequacy" of the pensions. But how can a "reasonable" cost be reconciled with adequate pensions?

Seven years ago, I suggested at the Annual Meeting of the Society of Actuaries that the "balancing item" could be an actuarial determination of the retirement age that can be "afforded."

This, of course, raises more questions. What is a reasonable cost? What is an adequate pension? What are the retirement ages that can be afforded? What are the retirement ages that will be most "profitable"?

I have yet to see an actuarial calculation suggesting what is an appropriate age to retire people. I think that this is an area that should be looked into.

Time is getting short, and we as actuaries ought to stand back and look at the *basics* of the situation and make constructive suggestions.

This is what the Ontario Committee on Portable Pensions attempted when making recommendations leading up to the Ontario Pension Benefits Act. The Ontario government did not dictate answers. It invited people to submit briefs and made an honest effort to find out what needed to be done.

MR. YOUNG: I indicated in my proposal that there is a feeling that there ought to be a maximum on the benefit which is reinsured in dollars terms as well as in a per cent of payroll terms. I think also that it is not unheard of for governments to do more for the richer than the poorer. I think there is no question that there should be an expression of ideas by actuaries on the question of reinsurance. Those who have reached the stage that I have did not start with the assumption that government action is desirable but ended up with the conclusion that there is practically no other way to work a program. Certainly, if someone can come up with a proposal for any kind of program which would provide equal security without government action, no one would reject it on those grounds.

MR. COWARD: Mr. Clare proposed a method which seems to be acceptable under the Ontario Pension Benefits Act, by which the current-service costs would be paid regularly and the past-service costs from time to time as desired. This method is satisfactory as long as the employer does not promise past-service benefits to his employees and then fail to fund them on a reasonable basis.

The solvency principle of the Ontario Act is simple. If the employer makes promises to his employees, he must back them with cash, and he is allowed twenty-five years to pay off past-service liabilities. Apart from that, he can promise what pensions he likes. He can make new promises in the future and, if a past-service liability is then created, it must be paid over fifteen years.

Ontario insists not merely that amounts of accruing liability be shown in accounts of the fund but that the current-service costs be actually paid. It requires that the past-service costs be liquidated on a systematic basis. It also refuses to recognize terminal funding and pay-as-you-go. These steps to try to improve the standards of solvency in pension plans are all in the direction of Mr. Hicks's proposals. They also make less necessary a guarantee fund of the type suggested by Mr. Young.

MR. CHARLES B. H. WATSON: It has been implied that you can use the retirement age as a balancing factor in terms of determining whether a plan is being properly funded. I fail to see if the balancing age is unrealistic how this can have much relevance to the soundness of the plan.

We are being presented in the pension industry with a number of ideas which many of us in the past rarely thought of. For example, the subject of reinsuring pension plans represents a new idea coming out of a changing social milieu. I suspect that the question of reinsuring plans might not be as troublesome to an employer as the question of portability of pensions. I do not see, for example, why one might not think of Lloyd's of London's reinsuring pension plans. I am not convinced that it has to be done through the medium of a government agency.

MR. CONRAD M. SIEGEL: How many different actuarial valuations can a small employer pay for? We have the first valuation for tax purposes, a second for accounting purposes, and now possibly a third for determining his reinsurance premiums, all perhaps involving different actuarial assumptions, different funding methods, and even different groups of employees. We have Forms 2950, 990-P, D-1, D-2, D-3, Bonding, etc., etc. Mr. Hicks's study indicates that special accounting treatment will be required if pensions costs are "material." Unless "materiality" is defined for small employers, in absolute terms, the burdensome administrative requirements of pension plans are going to drive the small employer to profit-sharing plans.