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PRACTICAL CONSIDERATIONS IN PROVIDING SERVICES UNDER INSURED PENSION PLANS

Moderator: HAROLD G. INGRAHAM, JR. Panelists: EDWARD M. LUPEAN, GLENN A. MATEJA, JAMES J. McCORMACK** .*

1. Organization of a Servicing Operation
2. Scope of Services
3. Commissions and Fees
4. Enrolled Actuary Certification
5. Outside Vendors

MR. HAROLD G. INGRAHAM, JR.: What is the best way to organize and staff a pension servicing operation, in the Home Office and in the field? Should both pension trust and group pension business be serviced within the same organization?

MR. JAMES J. McCORMACK: There is no one best way. Much depends, in organizing, on just exactly what type of company you are, on the degree of sophistication of your field force (for example, the Metropolitan field force versus the New England Life field force), and on the contrasts between the branch office and the general agency system.

There are very great differences between the small plan in the individual contract pension trust case and many of the group plans, particularly the larger ones. We are dealing basically with a small employer, a small businessman, who really is very unsophisticated in most instances; who does not understand, and does not want to understand, all of the government regulations; and who is looking to his agent to provide service. The plan was sold to him primarily for his own personal tax advantage, and it was not set up because of employee relations considerations at all. In the small plan area it is important to establish an integrated organization, where both the contract holder, or the field man, who sometimes is relatively unsophisticated, can come to get answers to questions, whether they be administrative, legal, actuarial, or, as we are now finding, a broad mixture of all of them.

Regarding separation from the group area, this involves questions such as, how do you define group? If we are talking about what I would consider true group, and what, I think,the Metropolitan would consider true group, yes, we should separate them. In the smaller case situations, we are not dealing with the same kind of employer, we are not sitting down with an employer who has perhaps on his own staff, or certainly, on a consulting basis, actuaries, lawyers, other advisers. It is a different kind of client.

MR. INGRAHAM: Should an insurance company which is committed to providing pension services establish a separate, self-sustaining consulting organization? If so, should stock in such a consulting company be sold to the agents who wish to utilize its services?

*Mr. Lupean, CLU, not a member of the Society, is General Agent of New England Mutual Life Insurance Company, Pittsburgh, Pennsylvania.
**Mr. McCormack, FLMI, not a member of the Society, is Vice President, Metropolitan Life Insurance Company, New York, N.Y.

MR. EDWARD M. LUPEAN: If you think what I say is anti-insurance company, it is not. If you think that I am pro-field, I am. If you think I talk about independence, I do. That is the way I built my organization. That is the way I feel. The insurance company is a distributor of a product. If the company is committed to servicing pensions, they have to set up a separate organization, a separate division. I am a firm believer that costs should be borne by those who use the service, and not be spread over policyholders who do not use the service. I have several reasons for this.

If you have a separate organization, separate cost accounting, and so forth, you are going to place the cost where it should be--either on the agent, or, for some expenses, on the client. I think Glenn, later, can verify some of this, because they have a separate organization at CNA. You must also remember that service is an extra. It is not something which the actuaries have built into their insurance pricing system. Servicing such as performing valuations, filling out the forms, and now maintaining the Minimum Funding Standard Accounts, was never designed or built into a policy to cover expenses. And this unit, this company, this separate division, should really operate at a profit; at least it ought to break even. If you do not, just like running any other business, you had better change your cost structure. And if you get your costs out front, where they are visible, so you can show the agents, the people who are using your service, that it is reasonable, and what it is costing, no one can come back and tell you they want you to do the work for free. No one expects you to lose money. No one expects you to charge it off to other policyholders.

You might compare this free service to one of your favorite gripes, namely, minimum deposit business. You--or perhaps the president of the company--may gripe about the fact that you are loaning money out at 5% that you could invest at 8% or 9%. You say borrowers are taking advantage of those people who do not do it. Now what is the difference between griping about a minimum deposit operation and putting controls on it, and then spending millions of dollars in servicing pension business and charging it back to those same policyholders who are also absorbing it under minimum deposit business? That is not fair.

A personal gripe of mine is that I feel that I am subsidizing the company, because I never ask them to do anything for me. All I want them to do is to distribute the product. I often have told Harold: "You know, I do all the work out in the field, and I ought to be paid extra money for the work I do. After all, if somebody else comes in, and you do the work for him, you are doing the same thing--you are spending your money, or my money, to take care of this fellow. Now, I am doing it all alone--I have my own programs and my own actuarial staff; we do all the work. All you do is issue the policy. Pay us what you would pay to do this other job." But, it is like pulling teeth; they just cannot do it. But they spend thousands to help the others, the ones that cannot do the work we do.

So a separate servicing organization has to be established. How you do it is another problem. You could sell stock to the agents, the people who are going to use it. You could sell bonds. The insurance company might even subsidize it a little bit or give it working capital, if necessary. But we ought to let these people who want to use the service, and who are going to see the real expenses, set up their own Board of Directors and their own Executive Committee, and operate. Because, after all, they should be paying for it; it should not be the company. And if this little company, subsidiary,

or division loses money, you do what any businessman does; you raise the price. And if the company needs money, you raise money. You secure additional capital. Personally, I have attacked the insurance companies, but after all, the insurance companies are known to have made poor investments in the past. Some of the more stable ones, like Penn Central, did not work out too well. But this is an organization, I think, which will. After all, these people are making money and they are trying to earn money, and I think that they will make money for the company. And also this company could share in the commissions on these cases that are sold; the same way some do in an organization like mine, where we share a part of the commissions, and part of the renewals, and we also charge fees. So I think that we have situations where we need independence. These people who are selling the product are independent, they are businessmen. At least, in theory they are businessmen, they are self-employed. And let us treat them like self-employed people, and let them stand on their own feet.

MR. GLENN A. MATEJA: CNA has set up a separate service organization in the Home Office. It is distinct from our product organization. The actuaries involved with our plan services are separate from those who are involved with our pricing and accounting. Proposal work, however, is done in the field, and it usually is not done by an actuary. I cannot say that our service organization is self-sustaining, although Ed claims insurance companies can make a lot of money on this. I think the Employee Retirement Income Security Act of 1974 (ERISA) has created many additional services that we never contemplated in our original plan. We have had to upgrade computer systems, and we have become highly involved in government forms and things like that. We have seen, also, that the job marketplace has increased demand for these qualified service people, and their value has gone up tremendously in the last two years.

We have established this separate organization at CNA to maintain a separate identity for our services. Prior to the recent past, we had been doing plan services, but without charge, as part of our product pricing. We felt that, psychologically, it was easier for the client to identify with a separate entity, since we planned on charging fees. This separation has also enabled the management to determine just what it costs to provide these plan services. To have a separate organization is the right way to go, but it is very difficult to recover the expenses, at least in the initial years.

MR. INGRAHAM: What levels of service should a company provide? For example, should they include full administration, including completion of IRS and Labor Department forms? Or should they include services supporting the agent, who may or may not provide full administration? What level of services can small pension trust plans reasonably support?

MR. LUPEAN: You actually have to determine what full administration means. Does it mean actual item by item filling in the forms, with only a signature required by the client? Or does it mean a statement which would say: "Fill in item 4, 8, 10 and 12, as follows:..." and then you put the number in? Then someone either in the client's office, or possibly even the agent's office, will fill that number in. Or does it mean some kind of a printout from the computer or from the insurance company or from someone, which merely goes to an agent, and he is supposed to complete the forms for a client? Or mail the information that you sent him? Because, if agents get something that involves work, they normally will stick it in the mail, and send it out to somebody else to do. They do not really want to do it themselves.

But full service, to me, means something a little different. It means the complete form, every slot filled in. All we need is the signature of the client. When we do this, we send a form to the accountant, we send a form to the client, along with the IRS form, and we even go to the trouble of putting in an envelope which is addressed to the particular organization that is to get that envelope, although we do not put the stamp on. We also supply a complete actuarial treatment, and the 1099-R's, the W-2P's, and early retirement information--anything the client wants, we supply. And everything we do, we bill. We have time, which we keep by tenths of an hour. We have it all programmed into the computer, so that it takes the person doing the work maybe 15 seconds to fill out the billing information. And from there it goes into the computer and out, at sometime in the future, comes the bill.

Now, from the insurance company's standpoint, and even from the consulting standpoint, you could issue some shopping list, and you could either do all of the work on a fee basis, or you could let the agent or the client choose from this list what he wants done, and also what he wants to pay for. I do not believe in flat rates, although I may eventually get to it. I believe in having someone pay for the work that we do, because we have no way of measuring what has to be done and the amount of time it is going to take. I just do not think that it is fair to a client to charge him on a flat basis for two hours of work, if we can do it in an hour.

Regarding small pension trust plans, what is small? Is it people? Is it number of people? Is it commissions? Is it premiums? And of course, naturally, it has to be a thing that eventually pays off, and that is the premium.

An agent, I think, has to have a minimum premium of $5,000 in order to break even on a case. $5,000 multiplied by 50% is $2,500. That sounds like a lot of money. But the agent probably has to make 10 proposals before he can sell one. Let us estimate that there are basically 6 hours involved at a very minimum in order to get to the final sale point, without the trust documents and filing and everything else that has to go with it. If he has to work 60 hours at $30 an hour, it is costing him $1,800 to get that far. At least it has taken him that time, and he has not earned anything else, unlike the actuary, who gets that $2,500 every few weeks, and who gets paid for it whether he works, or whether he is at a meeting, or whether he is in conferences. But the agent must obtain somebody's $5,000 on the line, and then wait until he gets the application, and then wait until the computer processes the money and gets it back to him, which may take another 6 or 8 or 10 weeks. And, if he provides full services, it is not only that first $5,000 which he must have as a minimum. He must charge something that second year and that third year, and if he does not, then it will be in vain.

MR. McCORMACK: It is quite obvious that Ed's operation is a highly sophisticated one. It is equally obvious that there are probably a lot of insurance company Home Office operations, where we are dealing with small pension plans, that are not nearly so far advanced. They do not have the expertise. They do not have the computer backup and support that Ed is able to provide. Nor do the field men who are dealing with the $2,500 (or in many cases, a lot smaller commission, because they are selling smaller cases) have the expertise to service these plans. Thus, the insurance company Home Office does have an obligation, both to its contract holders, or plan holders, and to its field force, to provide some kind of service.

It becomes increasingly expensive to try to provide this line-by-line service that Ed has talked about, particularly when you are running a national operation, and there are great difficulties in getting the data. In many instances, the Home Office does not have all the data that is necessary to fill out all the forms, particularly where you are dealing with split-funded plans. We have taken the approach of providing what, in effect, are annotated copies of the form, both to our field force, and then to our policyholders, or to the plan administrator. We go the latter route because we do not feel necessarily that we can count on the sales representative always to work with the plan administrator in completing them. But it is very important that you do provide some kind of continuing service.

As we get into this, we are going to have to charge. We are already charging for such things as actuarial certification and plan summaries. The response has been good. Ed mentioned the idea of charging for what the client uses, and again maybe in his operation, this can work. In ours, where we are dealing at great length, and with communications problems, with literally thousands of small plans and tens of thousands of Keogh plans,even though many of these requirements also apply, we have decided to use an "all-or nothing" approach. The bookkeeping and the charging and the billing operation of keeping up with the cafeteria approach could be prohibitively expensive.

MR. MATEJA: We found that a flat fee approach was more understandable to our field force and to the clients. The field force wanted some assurance as to what the service costs would be for the year. We just do not think they would be able to live with an hourly rate charge. We would rather see it amortized among all the service customers.

MR. INGRAHAM: To what extent should services be limited to prototype or master plans? Will any service (e.g., explanatory or sample forms) be provided for individually drawn plans?

MR. McCORMACK: We will have sample forms or explanatory forms for individually drawn plans. I would like to think I could get away with providing service only to master or prototype plans, but that is going to be impossible. At the same time, at least on the kind of business that we have, ERISA will have certain homogenizing effects, so that we would be moving more and more toward prototypes, which will make it much easier for us to provide service in an economical fashion. We want to use our computer as much as possible, and the ease and cost effectiveness of using the computer really come into play when you have something that is relatively standard, a prototype or a master plan. We will probably provide those plans with a far greater array of services, simply because it will be easy to crank them out. With respect to the individually drawn plans, we are going to provide the explanatory service, or charge a fee for services used on a per-hour basis. And we will probably discourage that.

MR. INGRAHAM: A question on plan terminations, which I shall ask myself, is: Where there are plan terminations, should the insurance company quote what it believes the termination liability to be, or should the company advise clients to file with the Pension Benefit Guaranty Corporation (PBGC) before doing anything?

We feel that filing with the PBGC first is probably the better idea, because they then will assign a staff member to handle the termination and will ask for specific information. The question of whether the company should become

actively involved in handling the termination as opposed to simply providing assistance on specific calculations is difficult to answer, because it involves both actuarial and legal considerations with respect to the plan, and requires determinations involving such things as identifying substantial owners, interpreting trust provisions and amendments, identifying benefits and pay status, computation of accrued benefits, handling of lump-sum payments made prior to plan termination, recapture of certain payments, asset valuation, and redistribution of assets to avoid discrimination. Companies should closely examine whether a complete involvement in plan termination is really desirable. However, companies may want to offer computational assistance when the scope of the computations has been well specified. My personal opinion is that we should offer such computational assistance, but that the plan administrator is definitely responsible for trust interpretation and other data certification.

Moving on to the subject of commissions and fees:

(1) Should the cost of administrative services be:

   (a) directly reflected in fees charged to the plans using the services,

   (b) directly reflected in fees charged to the agents using the services, or

   (c) covered indirectly by loadings in the funding vehicles?

(2) Should the agent be expected to absorb costs of administration through the commission structure? Should commissions be used to offset "fees for services"? And has the old concept of "no charge" for services if insurance is purchased now vanished?

MR. LUPEAN: Fees should be charged, and they should be charged to the agent. That agent may pass through the charge to the client if he wishes and does not want to absorb it, but that agent should not be paid first by the insurance company and second by the client. If he keeps time as we do, then at the end of the year, or whenever he bills, he has to offset his commissions against his fees. I am not suggesting that,if he has a $600 bill and gets $800 in commissions, he give back the extra $200, or that he carry it over to the next year; that is gravy, or profit. But if he does $600 of work and gets $400 in commissions, then he had better bill the client the $200. This is not a rebate. Someone has to pay for service. When the agent is doing the work, then he should be paid for that work--not twice, just once. This will have to be reported on the 5500 form as "Commissions and Fees". Hence, he is going to just charge his fee and it is going to stay reasonable.

Also, the problem of loadings is changing. I do not feel that loadings will continue, although at some companies they will have to continue. We have to bill for what we do, regardless of who is doing it, whether it is insurance companies or the agent, particularly in this type of business. I think the agent will bill for his services in the same manner that the lawyer, the accountant, or the investment broker does. If you sell a stock, down at the bottom, it says what your commission is. We cannot hide it any more. We have to admit it and to bill what we think our services are worth. Certainly within a short period of time, you will know whether your services are worth what you are charging.

The idea of no charge for service is a fine motto--and you usually get exactly what you pay for, at least from the client's end. Now if an agent or a consultant has knowledge of his product, if he provides full service, if he adds know-how and advice, someone has to pay for it, because he has worked lots of hours. Either the carrier, the purchaser, or the client will pay him. From an actuarial standpoint or a pension servicing standpoint, your motto has to be: "We charge more, we give more, we care more, and you, the client, will get more."

MR. MATEJA: At CNA we have dealt with both clients and agents as far as charging fees for services. I would hope that the agent is not double-charging. I have a moral question in my own mind as to how you can assure that the procedure of going through the agent with the charges is not abused. Ed, would you like to comment on the fact that the agent may not pass the fees unaltered to the client, but may double or triple them, and still collect commissions?

MR. LUPEAN: Don't you think this is going to be controlled now with the 5500 form? It has to be reasonable, or else the client is going to object to it. He is going to care what other people are paying, because they are going to appear. You do not have problems in group insurance; we see that. The fees and commissions are right there. Of course, once in a while the client will say: "That is a pretty good business you are in." But it really is not that much when you stop and consider the number of times he will call in.

MR. INGRAHAM: What information will insurance companies furnish when completing Schedule A of Form 5500C? I am particularly referring to questions 3 and 5 which deal with commissions and retention costs.

MR. McCORMACK: At this moment we are hampered by a total absence of regulations defining the terms commission, fee, or acquisition and retention cost. They are not defined in the statute, and they are not defined anywhere in the instructions for completing Schedule A. I get confused sometimes when I see a reference in specific instructions on Schedule A to currently nonexistent Department of Labor regulations providing alternative methods for compliance on reporting commissions and fees for plans with fewer than 100 participants. Until we have regulations, it is academic, but I shall speculate anyhow. With respect to commissions, we, and I think many other companies, are going to have a very difficult time in backtracking to furnish commissions, for example, that were paid in 1975. Our administrative systems, our commission systems, are just not geared that way, and the only way we can get them is to get an army of clerks and start backtracking through a lot of computer printouts. We have made changes in our computer system to capture all the data for our 1976 commissions, so that for any plan where 1976 is part of the contract year that ends during the plan year, we will be able to furnish at least partial, and ultimately full, commissions.

On the individual contract side, you are into questions regarding what are commissions. I am thinking about the complexity or the variety of payments which wend their way into the agent's compensation, particularly if you are in a captive agency force, such as Metropolitan's. Obviously, there is no problem in identifying a specific commission, the first year or renewal commissions that are paid on money. But we have other things, for example, quality business payments, that are geared to the ratio of an agent's lapse ratio to the company lapse ratio, and to the amount of premium that he has in force. How do you figure what portion of that applies to any particular

contract or contracts that are in a plan? Similarly we get into a question of management compensation (again, in a captive agency force). It is relatively easy to make the supposition that management overrides that are directly related to a specific percentage of commission will have to be pulled out and reported. But there are many other payments that go to management, so that at this point, we can only say that we can report on those items which are specifically identifiable back to a contract in the plan. Any of the other pool arrangements, where somebody is receiving either a quality business payment or a management payment or is dealing with promotion allowances, we probably will not report.

The acquisition and retention costs are another difficulty. Until now, we have buried everything in the policy or the contract loading. It is difficult to say what the specific charge is, and that is really what they are asking for, the specific charges incurred. The only place that we probably will be in a position to report, or, for that matter, have to report, will be on the specific charges that go with a variable annuity, when that is used in funding a plan, in whole or in part. Those charges are spelled out quite specifically in the prospectus. Problems arise in trying to figure out just exactly how much you pulled out, because you have maybe to figure average mean assets during the policy year, in order to obtain the amount of the charges. That becomes a bit difficult. We hope there will be relief, at least for this year. The American Life Insurance Association and others have filed asking that commission reporting be postponed for at least another year. Mr. Hutchinson has apparently made remarks to this effect, and hopefully, regulations will be coming out sometime in late June or July, which is about the same time that the first 5500's and Schedule A's should be going out. There is one item in the statute, Section 103(e), that provides in part that, for any company which does not maintain specific experience records covering the specific groups it serves, the report should include, in lieu of the information, just statements as to the basis of premium rates, the total amount of premiums received from the plan, a copy of the financial reports of the company, and so forth. This may provide something of an exemption from otherwise onerous reporting requirements.

MR. MATEJA: We experienced the same systems problem in trying to go back to 1975 to recover this data. Our systems capabilities limit us to doing this prospectively from 1/1/76. Another problem with our block of business is that many times a single policy was sold, for instance, on a profit-sharing plan where it may have been a key-man policy, and we are not even aware that there is a plan in existence. It just went through our Ordinary system as any other policy would, and we have no way of connecting it with a pension plan. So I can see many problems if the onus is put on the insurance company to report on this when we do not, in reality, even know that it is a pension policy.

MR. INGRAHAM: Should insurance companies provide services on uninsured plans, where their agents are responsible for plan administration?

MR. MATEJA: We have had many requests to provide services in cases that Harold has described, but in most instances the insurance company has no interest in the particular plan. The agent could have installed a tandem profit-sharing and pension plan and we may have assets on one of the two plans. Other situations occur where the agent has sold another form of business insurance to this client, for example, key-man, Section 79, or split dollar, but he does not have any of the pension plan assets. Each situation

must be reviewed on its own merits. We have provided services on tandem plans, but not in cases where the connection with the agent was because of some other business insurance purpose. Our first loyalty must be to our pension clients. We have limited resources and potentially a large number of plans to service. We do not stop our agents from performing those services, and generally, if an agent is sophisticated enough to get into the plan servicing business, he really does not need us. The only thing we could provide for him would be calculation assistance and possibly record keeping. There is an inconsistency, however, in that, from my own viewpoint, it is easier to service an uninsured plan.

MR. INGRAHAM: Are guidelines for the selection of assumptions desirable and feasible? If guidelines are used, what justifications might there be for departing from the guidelines, particularly if the departure is at the behest of the agent or plan sponsor? When should salary scales and turnover discounts be used?

MR. MATEJA: Guidelines for the selection of assumptions are not only desirable, but they are essential in the small plan area. Most small plans are sold without a proposal done by an actuary. They are usually done out in the field. The salesman and client must feel comfortable that this initial valuation done in the field will be supported by the Home Office actuary. This assurance can only be made if the actuary establishes the guidelines under which these proposals are performed. Furthermore, small plans are often installed at the time the employer incorporates. As a consequence, there is very little prior salary or turnover experience on the plan, and it makes it very difficult for the actuary to make a reasonable estimate of future experience. He must do it by means of some kind of guidelines that will cover a broad spectrum of plans. With large plans, on the other hand, this need for guidelines is not as great. The actuary tends to tailor the assumptions to the specific case, and he usually has some data upon which to base these assumptions. He generally deals with the client, instead of through an agent.

Our guidelines at CNA are intended to cover the majority of small plan situations. We have disseminated the guidelines widely to our agency force and our field representatives. The range of acceptable assumptions and cost methods is very limited. We require approval for any variance from our guidelines. Non-approval by the enrolled actuary means that no actuarial certifications will be done, unless a change in the assumptions is made. The enrolled actuary also reserves the right to change the assumptions as experience emerges. Even though they may have met the guidelines originally, we want to be able to change them if we see the experience going sour.

We limit our cost methods to the Aggregate Level method and Frozen Initial Liability method. The Frozen Liability method is only used in situations where there is no potential for an emerging liability drain. Generally, only cases with 20 or more participants are eligible for this method. For split-funded Individual Policy Pension Trust (IPPT) plans, we do not use true Entry Age Normal or Unit Credit. The interest assumptions for our valuations must fall within a defined range of 3 1/2% to 6%. We will only allow the use of 3 1/2% on an existing plan. We usually use 4% or greater on new plans. We point out that the interest assumption should be a long-term estimate of the yield on plan assets, and it should not be overly influenced by today's high new money rates. Furthermore, the liquidity of the assets must be considered in the mix between fixed and equity investments.

Our turnover assumption ranges from none to T-3 in the old Crocker-Sarason tables. We recommend using no turnover for plans with fewer than 10 lives, or of any size plans which provide for immediate vesting. T-1 is allowed for plans with at least 10 lives, where vesting is graded to 100% at the end of 10 years. We are using T-3 for plans with at least 20 lives and with a 15-year graded vesting schedule.

Salary scales should be used on large plans, where there is a credibility in prediction of salary increases. They should also be used on integrated plans, where potential participants would be excluded, because they are below the base. Small plans present their own unique problems in salary scales, however. We do not use salary scales on most of our individual policy business. Our current thought is to use them on cases over a certain size, probably in the neighborhood of 10 lives, although we do not have the computer support to do this today. Often in the small plan, 50% of the salaries are those covering the principals of the plan. In such instances it is impossible to project salaries with any degree of credibility. In fact, the salary is frequently the item which is being solved for, rather than the cost. Our funding target at retirement is an annuity rate between our contract guarantees and our non-par current rates. This figure is fixed today, but we plan on modifying our system to use an interpolation between the current rate and the guaranteed rate, based on calendar year of retirement.

Exceptions to our guidelines must be justified by the enrolled actuary. We have had requests for exceptions to our rule on use of the Frozen Liability method. It seems to be the most frequently asked for. They want to use a past service funding rather than Aggregate Level. Surprisingly, we found many requests for exceptions in going to our new funding targets. Many of these old plans were installed as savings accounts for the principals. They are not about to have their accrued benefit reduced, and they think of their accrued benefit as being a lump sum at retirement. We are trying to educate them that they really purchased a defined benefit plan, and we are not telling them anything new. This has always been true. Guidelines are essential, and an enrolled actuary, for an insurance company anyway, cannot operate without them.

MR. INGRAHAM: In the universe of small pension trust plans, we are dealing with situations where the Law of Large Numbers just simply breaks down, and any one termination, death, or early retirement can have a substantial impact on the orderly progression of funding. An overriding practical consideration in any grid of funding assumptions is that the cost of the services has to be affordable by the plan sponsor. Another consideration is: what does the term "best estimate" mean? According to Rowland Cross, at the Enrolled Actuaries meeting a few weeks ago, "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 the larger cases. Retirement of a key participant at a time of depressed market values can substantially alter the long-range return of the plan. So the actuary should be concerned not only with the type of investments but also 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.

In selecting the pre-retirement mortality assumption, it is wise to review the death benefit provisions of the plan. I have seen many plans recently where there are substantial benefits payable from the auxiliary fund. Unless you are capable of explicitly valuing these benefits, any assumption of mortality is unwise. The situation for withdrawals is similar. Typically, the benefits are concentrated in a few key people, who are unlikely to terminate on a non-vested basis. And so, unless your vested benefits are being explicitly valued and special attention is given to key participants, the assumption of withdrawal would seem inappropriate. In our case, we are using a breakpoint of 20 lives, and using no withdrawal below 20 lives, and T-1 above.

As far as salary scales are concerned, an automatic assumption of salary increases for the very small plan is not really a "best estimate". In a very small plan the key person likely has direct control over his salary, and he may keep it flat for a period of time, and then there may be a large quantum increase. However, if you have an excess-only integrated plan with a fixed Social Security offset, you had better consider explicitly recognizing salaries. Otherwise, underfunding may result to a considerable degree.

A key point in all of this is that many companies have instituted guidelines for the selection of assumptions, and they are useful only if used 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 sort of inversely proportional to the size of the plan. The selection of assumptions is really only part of the problem. Selection of the actuarial cost method is also important. In the future it may not be so easy to change cost methods for a given plan, so the initial selection is very important. In selecting a 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. Our 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.

Finally, 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. But in other situations, the actuary should take pains to get good data, and in particular, be on the alert to such things 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.

MR. MATEJA: In our service system we require that the assets be certified to us by the trustee or the plan administrator, and we will not perform a valuation unless we get this certification.

MR. LUPEAN: Do those figures balance after you get them?

MR. MATEJA: We get them to balance, through communication.

MR. INGRAHAM: How can an insurance company actuary certify a valuation prepared by a remote third party where the data is collected and controlled by that third party? This is sort of a follow-up to the last comment.

MR. LUPEAN: Very carefully. The Securities and Exchange Commission and the CPA's and now the IRS and the reporting of the enrolled actuaries and certifications seem to be like the game of kiss and tell. And it makes it very difficult for the actuary, but I think he will fit very well into the situation requiring honesty and integrity.

One of the biggest problems we seem to have in certification is the matter of assets and asset valuation. Of course, we have not required certified assets and we have not gone back to the client and asked him to certify it, so we try to balance it in the office. Four types of assets come into our office. First, there is a bank situation, where a bank is the trustee, and usually they will balance; but there is much extra work we must do to obtain them in a form we can use. Secondly, we will receive the forms from the accountants, and they are not too bad. Thirdly, we get the people who call up and say, "We cannot balance. Send somebody out." So we send somebody out, and we do what we can to help them get it straightened out. The fourth type stems from the people who bring in bankbooks and broker executions and brokerage slips and brokerage statements. They just dump them there. They have no written records and lots of missing data. Maybe Glenn has the answer. You will only do it if you get certified reports from somebody.

But, as an enrolled actuary, how will you value that half-acre lot, on the corner of Walk and Don't Walk? Or that apartment building--will you require an appraisal? What is your responsibility as an enrolled actuary, to certify this third party situation? You certainly cannot go out and do it. You do not even know where Walk and Don't Walk is. What about unlisted securities or local businesses? How can you verify that these figures are accurate? And another--what are you going to do if you have your own Real Estate Investment Trust (REIT) and it is worth 25% of what it was worth when it was sold? Or your own mutual fund gets way down? How are you going to handle these things? You know what the value is, but what are you going to tell that client, because, after all, it has been sold by representatives of the insurance company?

I really do not know how Home Offices are going to handle all this data. You are so far away from the action. We have difficulty enough when we can get on the phone and we have direct communication with these people. We have asked what happened here and what happened there, and we obtain some figures. What kind of system will you have to alert you that the filing date is here? And if the agent will forget it, or the client will forget it, who will remind him? Do you have a responsibility to do it only if it reaches you, or do you have a responsibility to do it regardless of whether they ask for the information?

What problems will you have in establishing costs, and market and actuarial values? This morning, it was stated that you should not think that you can use book value, because the law says that you have to use something that takes into account fair market values. The Internal Revenue Service has not indicated what values can be used but has indicated that you have to have something other than book value. And if you intend to send it in on a book value basis, does it mean you have an automatic problem? And either you or the accountant will have to straighten it out.

Then you have the other question that is down on the third part of the computer sections line. How does the enrolled actuary know that our computer is operating properly? What verification does he have? Will he go back and

check all this data? And if he does, can the client afford to pay for it? I think you have really got a tiger by the tail here, and the question is, when should you let go?

MR. INGRAHAM: Ed, you mentioned REIT's and mutual funds as being dubious assets in the plan. Let me ask this: Should the Home Office enrolled actuary concern himself with the funding vehicle being used by the plan sponsor in making his disclosures in the actuarial valuation? In other words, if he believes that the use of a certain funding vehicle is not in the interests of the plan participants, should he disclose it in the valuation report?

MR. LUPEAN: I do not know. If it is in my office, even though I sold the mutual fund or the REIT, I think it is our responsibility to tell the client we do not think it is a good investment. We ought to tell him what to do with it; tell him to get rid of it, sell it. We do this with mutual funds, we do it with stocks, we do it right now. We put it in our report, so that we do not get in trouble at a later date. And if you run a split-funded plan or an IPPT plan up to 50 or 75 or 100 people, that client is entitled, from someone, to receive a comment in the report that he should look at possible changes to a group program or a trusteed plan. This is a responsibility. You also have to protect yourself against competitors. These people--when I say these people, we are in the same position if we find a case that we feel should be trusteed and someone else has it-- are looking for business and will tell them about it. But if you have already told them through the salesman that had it before, you have a much better chance of maintaining his position and also maintaining that business. Now, there is another thing. If you accept the theory that IPPT is less expensive than group pension funding vehicles, as presented in the CLU Journal in January of 1976, it is possible that you do not need any disclosure, regardless of how it was handled.

I wonder if there is any actuary in an insurance company who is going to read that article and comment on it, and either say that that article is right or it is wrong, and possibly have a little rebuttal in the CLU Journal. I would like to know myself whether it is better or not. Many insurance agents have apparently been able to prove with their figures that it is much less expensive to have an Ordinary Life contract in a pension trust than it is to trustee it and buy group insurance on the side. Jack Moorhead might read that article and make some comments, but is there any other actuary who will step forward, and either say it is right, or possibly there are other angles to look at?

MR. INGRAHAM: What steps should the actuary take to ensure that the actuarial valuation is delivered to the client unaltered and on a timely basis? Should he rely on the agent to make the delivery? Or should he send the report directly? And if that is the case, should the agent be given an opportunity to review the report first?

MR. McCORMACK: Not being an actuary, I am glad that I do not really have to answer that question. As a layman, from the outside looking in, in a sense, I view the relationship on such things as the valuation as being really between the actuary and the client. The client, in this case, is the plan participant. We should not necessarily rely on the agent to make the delivery, nor should the report go directly to the agent in advance. Our actuaries feel very strongly about this, that they should go directly to the plan administrator, and that the communications should be with him. At the same time, you have to recognize the facts of life, that the agent, or servicing sales representative, is extremely important to that plan, and it is essential that any-

thing that goes out go out in duplicate, or at the same time, with appropriate explanation, to the salesman, or to the servicing representative. In the real world, the client is going to come to the servicing representative, because he is Metropolitan Life. He is the guy that he has been dealing with, he is the one to whom he is looking for service. So it is important that the agent get it, get it in a timely fashion, and get it with an explanation, so that he can go out and at least talk semi-intelligently.

MR. MATEJA: I do not think the timeliness is really a problem. The agent does have a vested interest to deliver this report, since this is usually the same report which informs him of the new insurance to be issued, and he has the commissions to look forward to.

MR. McCORMACK: When I was referring to timeliness, I did not mean it in that sense, but I am referring to the fact that sometimes the agent, or the sales representative, is, in a Home Office context, the last guy that we look at. He is viewed with suspicion, he is somebody whom we tolerate, and frequently, we will forget all about him. And, if we happen to have an empty envelope, and if we happen to have the money left in the postage meter, then he will get the copy. However, it is important to have a definite procedure set up, so that this does not happen, that he is not left out.

MR. INGRAHAM: When, let us say, 80% of the benefits are on the life of the plan sponsor, what responsibility should the enrolled actuary assume with respect to the adequacy of funding for the other plan participants?

MR. McCORMACK: Again, not being an actuary, I have personal views on this. The enrolled actuary should assume a large responsibility. I view the enrolled actuary's client, in this situation, to be one of the other plan participants, and if he is going to serve his client's interests, he had better have a very strong concern about the sufficiency of the plan assets. Harold and Glenn mentioned this, but yet it is very obvious with the 4-life, or 5-life, or 10-life plans. Typically, all the benefits are concentrated on the lives of one or two key principals, and their retirement, when it occurs, will have a substantial impact on the plan assets. Thus, several considerations that they outlined are very critical, such as: the type of investment, whether you are into equities, the possibility of retiring in a depressed market, the validity of termination assumptions since it is highly unusual for a principal to terminate with non-vested benefits, the fact that the principal controls the salary scales, and the interest assumptions. Regarding the funding, there may be a real need to use some kind of aggregate method and to avoid unfunded liabilities in the plan, to the extent possible.

The enrolled actuary should also bear in mind the possibility, and, in many cases, the strong probability, that the retirement of one or two principals can very easily trigger a plan termination, because if they go, the corporation may very well go out of existence. Therefore, one ought to be looking at, and working with, the principal, in talking about what the insured benefits on the substantial owner are, because those benefits, if there are any funding problems, are obviously subject to certain limitations, in addition to the basic 100% of salary or current dollar limit. He gets into a fraction based on his years of participation over 30, the normal time for removing that unfunded liability. He must watch out for reporting of lump sum distributions to this principal, because frequently the plan may provide that a distribution is in the form of a lump sum. He should be talking to him about the recapture provisions. These are important, especially in the small plan,

because sometimes the principal may not know all of this, and he certainly was never told it, in most instances, by the salesman, who probably did not know it either, and certainly does not find it in his interest to reveal it.

MR. INGRAHAM: I shall take the next question myself. What types of outside pension service vendors exist? What scope of services is provided by each type?

I would categorize vendors of services into four groups. Let us call them Type A, B, C, and D. Type A would be small local enterprises providing direct, independent services. Type B are small local firms providing direct actuarial services. Type C are vendors of computer services to agents and Home Offices. Type D are 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 the Types B and C, namely, that information on in-force insurance contracts is not directly available, and so they must rely on third parties to obtain it.

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 it has control over the agent. The quality of actuarial services in Types A and B is 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, a key point. The service may be viewed as a calculation and record-keeping service, with the agent remaining as the direct interface with the client. If the agent is not an enrolled actuary and Home Office actuarial services are not provided, then he has to seek certification somewhere else. This can prove to be a substantial problem to the certifying actuary, since the calculations are produced outside of his control, and the integrity of the data is outside his control. To certify such a valuation properly, 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 a third party actuary assume the system is operating correctly, just because it produced good results one month ago? Or what changes may have been made to the system, of which the actuary does not have any idea? 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. Here the software is typically integrated with the insurance company's data base. In choosing a system, the following, among others, should be considered:

(1) The ability of the system to interface effectively with the insurance company's data base.

(2) The quality of the software design. Is it efficient? Is it flexible? Is it capable of expansion?

(3) The quality of the documentation, both user and system.

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

MR. LUPEAN: In talking about error-proof situations, I feel things can be verified and they must be checked occasionally. If every computer has a test deck, you can test any aspect of anything you wish. All you need, or even all a vendor or a user needs, is a small deck, to see if he is getting the same answers as he got a month ago, or a week ago. Frankly, in our situation, and we use a mini-computer, very seldom do we have a problem, once the program is operating and it is set, unless we tinker with something that disrupts another section of the program. Usually the problem is not in the computer, but in the input data. Someone enters a bad birthdate, or a wrong date of hire, or many other little things--a decimal in the wrong place, salaries--these are all people errors, and these happen often. However, there is no way that the typical agent using the system can verify the accuracy of that system. In the first place, he has no actuarial tables and he has no facilities. Normally he does not even have a clerk working for him. And he probably cannot compute the benefit; if he could, he would do it himself. So I think that really, he is almost incapable of checking. He will just take whatever that vendor material is--whether it is from an insurance company or from this vendor itself. But, over the years, how can you be sure even the insurance company computer is correct? I have heard of situations in which the company computers could not even produce the correct PS-58 costs. So we should not knock the vendor, any more than we ought to knock what comes out of the company machine.

MR. INGRAHAM: Is it feasible to permit (or encourage) use of third-party systems by agents? Or, should servicing be centralized in the Home Office to better control quality and performance? What difficulties can be encountered under either approach?

MR. McCORMACK: It is obviously feasible, because it is being done. Much depends on the kind of organization that you have, and who is making use of it, and how knowledgeable and intelligent the user is. If he is deeply involved in the system and knows exactly what he is doing and what he is getting, then this works out fine. Many pension service organizations currently exist, and some of them do very fine things. They do a much better job than the typical Home Office. They are far more responsive, particularly in terms of prompt service, when the General Agent, or other user, has a time-sharing device in his own office.

With a less sophisticated field force, there is a high potential for chaos or havoc. In many of the very large field forces, the vast majority of the sales representatives do not know ERISA from an onion. They have certainly never read ERISA, assuming they ever heard of it. They do not know very much about valuations or actuarial assumptions, so that if you turn those people loose with an outside computer organization, where they can specify the assumptions, in many cases the assumptions will then be dictated by the client. This can create real problems in that the plan may be set up on a totally bad basis, with inadequate funding. If this is the kind of situation you are in, it is much better to have centralized control and to funnel everything into a centralized computer situation that is run out of the Home

Office, where you are providing your proposal information and your valuation information directly and on a consistent basis, and you can deal intelligently with the questions that do come in from the customers, because you organize and control what really went into the proposal in the first place.

MR. RIAN M. YAFFE: My question relates to fees and commissions and the rebating question. When one of your agents writes a pension plan that then receives administrative and actuarial services from your consulting firm, who gets charged the fee? The agent? Or the client? Or both? How does that work?

MR. LUPEAN: Our situation stands all alone. In other words, the agent gets a percentage of the fee, or a percentage of the commissions, and we take a percentage of the commissions. And we bill only if the cost of the service, our service, exceeds what we collected in commissions. This will still stand all alone. So it is the client who is going to pay for it.

MR. YAFFE: So the client whose plan comes in through one of the other agents, in a way ends up paying more than one that comes in directly.

MR. LUPEAN: I think you could say that.

MR. YAFFE: I would also like a little more information, if you have it, about the source of your belief that offsetting fees by commissions is not rebating. I do not have any facts on the matter, but I have always been told the opposite, and I am very curious about your conclusion.

MR. LUPEAN: Well, this is a personal feeling. We have never been questioned about this in 22 years of operation. And it does not show on the record, as to what has happened. We do not tell the client when we receive the commissions. We just send him a bill saying, this is what you owe us. And so far he has not objected. But I think in my particular case, if someone raised a question, we can make it very simple. We could then tell the client that the government, or the state, or whoever it happens to be, said we cannot do this. So therefore, we will take whatever commissions we get, but we will still bill you separately.

MR. YAFFE: Does the client understand the process you are going through, though?

MR. LUPEAN: Oh, yes. We have sent him letters on this. He knows about it.

MR. THOMAS C. SUTTON: I have a couple of general questions. One of them relates to the separation of the life insurance policies from the auxiliary fund. In that regard, I am curious, for example, if you use a salary scale, if you think it is incumbent upon anyone to project future insurance purchases, whatever those processes involve, as far as a level cost? Another question about the separation is, how about the dividends? Are they regarded as experience refunds or should they be treated traditionally as reducing the next year's cost? Similarly, for forfeitures, should one perhaps separate the forfeitures on allocated insurance policies from forfeitures on part of the unallocated side fund?

MR. MATEJA: As regards the separation of the insurance benefit and the rest of the plan benefits, when you are using salary scales, the approach we are using is to base the insurance on current salary. This does create actuarial gains in future years. We are using an aggregate method to project the spread.

MR. SUTTON: For a company that has a group pension operation as well as the individual pension operation, particularly if they are separate, the historical way that funding has been accomplished, and whether you use salary scales or not, questions such as that may easily give rise to the occasion that an agent would seek approval from both the group side of the house and the individual side of the house, and these essentially are noncomparable. I was wondering if any companies had addressed these problems and what they try to do to relate them or to make them comparable.

MR. INGRAHAM: At New England Life, we have a very vigorous group pension operation, and yet we are a company that administers about 16,000 IPPT plans. The structure of our organization helps greatly. We have an integrated pension operation, in that all personnel involved in the administration, marketing, and actuarial operations associated with IPPT and group pensions report to the same person--me. Pension actuaries--group pension and pension trust alike--report to one individual, who reports to me.

We also have a pension conservation unit, which has been very effective in recent years in conserving our pension business, so that when a case becomes too large to continue on a pension trust funding basis, then it does not necessarily go out the window, either trusteed or to somebody else's group pension funding vehicle. The conservation unit also makes comparability calculations at the point of initial sale.

To the extent possible, we have tried to maintain an essential equivalence between the pension trust and group pension quotes and tried not to bias comparisons in favor of IPPT just because no explicit recognition of salary scales was made in the IPPT quotes.

I guess we must be doing something right, because three years ago, a study showed that when pension trusts left the New England Life, only 10% would be conserved in the group pension shop. And now, in the last 12 months, we have found that about 40% of our pension trusts that are terminating this form of funding are being retained within the company using some form of group pension funding vehicle.