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THE FUTURE FOR PENSIONS

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What can be expected in the future with regard to the following:

1. Plan terminations.
2. Trend toward defined contribution or profit-sharing plans.
3. Trend toward career pay benefit formulas.
4. Slowdown in plan liberalizations.
5. Slowdown in establishment of new plans.
6. Integration with Social Security--increase or decrease.
7. Cost-of-living increases--automatic or ad hoc.
8. Inclusion of pre- and postretirement spouse's benefit at employer's cost.
9. Retirement age.
10. Mandatory pensions.

MR. PAUL H. JACKSON: We hear from the Pension Benefit Guaranty Corporation (PBGC) that more plans are terminating than expected. What is the outlook for the future? Are we going to have more plans terminating and fewer plans in existence in the future or is this merely a temporary reflection of business conditions?

MR. CLAUDE POULIN: It does not augur well to start off with plan terminations when the topic is the future of private pension plans. It is true that since June 30, 1974 a fairly large number of plans have terminated. The PBGC recently reported that about 3,800 pension plans have terminated since the plan termination insurance features came into effect for single employer plans. By comparison, a joint study of the Departments of Labor and Treasury showed that in 1972 only 1,200 pension plans terminated. There are indications that this latter figure is representative of what we might call a normal year. A number of factors explain the abnormally high rate of plan terminations reported to the PBGC so far:

1. Some plans that would otherwise have been terminated in 1973 or early 1974 were terminated after the enactment of ERISA, in order for the participants to receive the guarantees afforded by the law.

2. Some plans that, in fact, terminated prior to June 30, 1974 filed a termination notice after the passage of the legislation.

3. Many inferior plans (containing, for instance, very poor participation, vesting, or benefit accrual provisions) were terminated by their sponsors who preferred to terminate them rather than be forced, in 1976, to make them comply with the requirements of ERISA.

4. Finally, in the last two years we have witnessed the worst economic recession since the thirties. In these depressed times, pension plan terminations are another unfortunate result of business failures. On this point, a recent article in the New York Times stated that bankruptcies in the U.S. increased from June, 1974 to June, 1975 by 45%; and obviously, bankruptcies bring with them pension plan terminations.

Since these factors are not typical, we may reasonably expect, after the initial overreaction to ERISA has passed, that the present high rate of plan terminations will fall drastically next year and stabilize at a level for 1976 and later of between 1,000 and 1,500 terminations a year.

MR. HARRISON GIVENS: The single most important point in creating this large number of terminations is the economic climate. Although bankruptcies have gone up, they are not the prime cause because those bankruptcies are with very small companies that typically have not yet established a defined benefit pension plan. The ones that are terminating voluntarily need not be inferior. We have seen in our clientele, which tends to be the larger plan, a high degree of panic; and we have talked a number of these clients out of termination.

There is another reason that I have heard about indirectly, and it relates to situations where there are several interconnected corporations, yet only the employees of Company "A" may be covered by a pension plan. Now that the law has been changed, "salaried only" plans are permitted; but, on the other hand, in applying tests of discrimination, the law picks up all the employees of the family of corporations. This latter point is allegedly causing a lot of terminations.

MR. JACKSON: Canada has had regulation for some time. Based on Canadian experience, is the existence of regulation likely to lead to the discontinuation of pension plans?

MR. D'ALTON S. RUDD: Before answering directly, let me place Canada in context. I do not have any statistics on a Canada-wide basis; but I do have statistics on pension plans under the jurisdiction of the Province of Ontario, which probably involve about half the pension plans in Canada. There are about 8,700 plans with a million and a half members in Ontario. About 74% of these plans have less than 50 members in Ontario; in fact, that 74% of plans covers only about 4.2% of the members. Seven of the large public plans (federal government plans, Province of Ontario, teachers and civil servants, etc.) provide coverage for 34% of the membership. So, in Canada, we are generally talking about small plans.

The introduction of pension legislation in Ontario, which was followed in three other provinces and by the federal government for the territories, has not caused any significant termination of pension plans. It was hard to judge, because at about the same time the equivalent of your U.S. Social Security system was coming into force in Canada with the Canada and Quebec Pension Plans in 1966. Some plans were terminated because the government moved into the field with a contributory, wage-related plan. There is, however, another factor; Canadian pension plans generally had higher funding standards than American plans. We have not tolerated the "pay-as-you-go" type of plan that has been permitted in the States. We do see some tendency among smaller plans in Canada on the executive group to move to a combination of a deferred profit-sharing plan and what we call group registered retirement savings (the individual tax relief pension system that is available under Canadian tax law) in order to escape a lot of income tax rules and restrictions under the pension legislation. The great majority of plan terminations, however, still arise from business failures, mergers of companies, etc.

MR. JACKSON: Most of the pension plans that I work on have been adopted because of the benefits that people want to provide to the older worker--not for the tax advantage. That basic reason is pretty strong and it will take a high degree of overregulation before these people decide not to have plans.

The plan termination insurance under the Pension Reform Act applies only to defined benefit plans. If you have a defined contribution plan (money purchase, target benefit, profit-sharing, or thrift), you avoid both the dollar-a-head tax that goes to the PBGC and the threat of having the PBGC step in and terminate your plan, collecting 30% of your net worth in the process. With that in mind, do any of you see a trend toward defined contribution plans and away from defined benefit plans?

MR. POULIN: ERISA will not result in an increase in the proportion of defined contribution or profit-sharing plans compared to defined benefit plans. Let us examine the situation of an employer now sponsoring a defined benefit plan who wants to replace it by a profit-sharing plan. His desire is motivated by his apprehension over the new employer's liability created by Title IV of ERISA. The problem that this employer faces is that, by terminating his present plan, he would precipitate the very event he wants to avoid. The termination of his defined benefit plan would automatically create this new liability.

There may well be pressures in newly established plans to avoid defined benefits. However, the purpose of pension plans is, together with Social Security, to provide employees with a sense of security throughout their retirement years. Defined contribution plans cannot provide this security, particularly to those employees who are closer to retirement age when such plans are first established. The experience of profit-sharing plans which are heavily invested in common stocks has been disastrous over the last several years. There are indications that many profit-sharing plans recently have been abandoned in favor of defined benefit plans. This is not to say that profit-sharing plans or the more recent Employee Stock Ownership Plans do not have a role; but it should be one of supplementing, not replacing, pension plans.

MR. JACKSON: Are you saying that the United Auto Workers, in its negotiations with various employers in the future, will continue to emphasize defined benefit plans?

MR. POULIN: Yes.

MR. GIVENS: Starting from the same facts, or lack of them, I come to a different conclusion. I am thinking now of salaried, unilateral plans.

The proportion of defined benefit plans over the years ahead will decrease. This is because ERISA will have an influence, and because there will be more widespread adoption of thrift plans, which are very popular. The point is very well taken that the employer who might, in a state of panic, decide to close down his defined benefit plan, simply would not do it when he realizes that he will not get out of the PBGC area and the exposure of 30% of his net worth. But it sure can stop him from liberalizing his benefits in the future. He can wait until the day comes when he is funded for all accrued benefits, and then there is nothing to stop him from termination. We have seen some large, sulky employers who have said, "All right, we are going to bide our time; but the day will come when we can get rid of this albatross."

MR. RUDD: We do not have this complication of plan termination insurance in Canada. The bulk of our plans are contributory (because of tax relief on employee contributions), and the bulk of employees are in contributory plans. The money purchase plan has always been very popular, particularly in the smaller groups, i.e., about 43% of the plans but only 5% of the members. We do not find any trend towards more money purchase plans. Profit-sharing

plans have never been popular; the smaller employer does not want to get into discussions with his employees as to what his profits are. They account for only about 1-1/2% of the plans.

MR. JACKSON: When a U.S. employer freezes his pension plan and institutes a new defined contribution plan for future service benefits, he may or may not bring the PBGC down upon his head. Even so, there may well be some situations in which the employer would prefer to bring them down at a time when the market value of his plan assets is high and when the liability is a known amount rather than continuing with an open-ended obligation.

MR. POULIN: It is true that there is now a period of uncertainty regarding this new employer liability; but ERISA states that within 36 months of enactment, i.e., within the next two years, there will be some form of insurance for the employer liability, made available either through a consortium of insurance companies or by the PBGC itself. The fears of employers should calm down when this machinery is in place.

MR. JACKSON: We will skip Item 3 momentarily and address Items 4 and 5. Do we anticipate any slowdown in plan liberalizations or any slowdown in the establishment of new plans in the future?

MR. POULIN: The immediate future will be characterized as a period of consolidation for the private pension system. In 1976 some existing pension plans will be liberalized to conform with ERISA's requirements in the areas of participation, vesting, funding, and benefit accruals. In addition, a surviving spouse benefit will have to be offered to retirees and active employees eligible for retirement. In contributory plans the treatment of employee contributions may have to be modified. It should be noted that the majority of pension plans are already either in compliance or very close to full compliance in several of these areas, and the cost of these liberalizations will be minimal. For the relatively few plans, however, which did not provide for any form of vesting before early retirement or did not permit employees to become participants before, say, age 35 or 40, it goes without saying that their costs will increase substantially next year. But this was precisely the intent of Congress when it passed ERISA: To force such plans to eliminate those artifices that worked to keep employees from receiving their pensions.

The process of plan liberalization will continue after the current period of digestion is over. Hopefully, the present economic recession will also be over soon. If the trend in plan improvements over the last 10 years is any indication of what will happen in the near future, we may conclude that pension plans will be amended in the following areas:

1. Reduction of the normal retirement age and reduction of the age at which full benefits are payable, based either on a combination of age and service or on service alone. For example, full benefits might be payable after 30 years of service, irrespective of age.

2. A more widespread provision of early retirement supplements prior to the age at which Social Security benefits become payable.

3. A more frequent inclusion of disability benefits in pension plans. The guarantee of these benefits by the PBGC will be another advantage of providing disability benefits through pension plans.

4. Earlier vesting; for example, vesting after five years of service, irrespective of age.

5. The trend toward noncontributory pension plans will accelerate. From the employee's point of view, contributory plans have never appeared in a very favorable light (in the U.S.) because they are partly funded from their after-tax income. One of the advantages for an employer was that a terminating employee withdrawing his own contributions was also forfeiting the employer-paid portion of his pension. This will no longer be the case under ERISA. The law prohibits such forfeitures of pension benefits when a terminated employee is at least 50% vested. The Act also stipulates that contributory plans must contain "buy back" provisions; that is, the employee's forfeited benefits will be restored if he repays the plan his withdrawn contributions with interest limited to 5% a year. These provisions will necessitate elaborate actuarial calculations and would further increase the record keeping burdens of the administrators of contributory plans.

With respect to new plans, the many comments that were made in the discussion of liberalization of existing plans are equally applicable to new plans. When the present era of uncertainty has ended, we will witness a continuation of the growth of the private pension system by the addition of new plans; and the trend toward defined benefit plans will continue because they are the only ones capable of achieving the basic goal of the pension plans, which is to provide, with Social Security, a predetermined amount of income upon retirement.

MR. GIVENS: I agree completely with Mr. Poulin that the near term is going to be a period of consolidating and settling down to see whether it is possible to live with the new rules--not to mention reading them to begin with! But it may be too strong to speak of age 35 eligibility as an artifice to keep people from getting benefits. There are only two plans that I can remember that had an entry age of 30 or 35; both of them had 10 year vesting. The purpose of the high entry age was to produce a good benefit at age 65 without a lot of paper work with respect to a high turnover group.

I question very much that the trend in plan improvements over the last 10 years will continue. The market for pension benefits is reaching that asymptotic pie-in-the-sky; it is in a flat trajectory now. Half of the people are covered, and the half of the people who are not in qualified plans are mostly employees of small companies. The standard solution for the large company, where you start off with a profit-sharing plan and because you can afford it switch to a defined benefit pension plan, would not apply for the small case. For a firm of 10 employees, the concepts and characterizations of defined benefit pension plans are too subtle and too complicated. What is wanted, if there is to be private coverage at all, is the simplest, defined contribution, thrift plan approach available; and there is a new vehicle for that--the Individual Retirement Account (IRA). The real challenge to the expansion of private pensions, and even the maintenance of what we have today, is going to be the extent to which the other half of the labor force becomes covered by qualified plans; and I do not see them coming in the way that was traditional for the larger companies.

MR. RUDD: I agree with what was just said. As for the future, there will be liberalizations with increasing interest in some form of protection against the erosion of the value of pensions after retirement or termination of employment. Human rights legislation, as we call it in Canada, with respect to age, sex, and marital status discrimination will cause some liberalizations.

As for the establishment of new plans, wearing my life insurance company hat for a moment, we certainly do not see any slowdown in the small case market. There is a great uncovered area, maybe 40% of the labor force in Canada, in what we call registered group pension plans; and there is a major marketing job for everybody in the pension field to get the smaller employers to adopt a plan. It will be the money purchase plan because it is so easily understood; there are fewer complications, and everybody seems to be happier.

MR. JACKSON: I agree that the regulations now add so much fuss and bother to the contributory type of plan as to make them even more unattractive. As to the suggestion that we ought to concentrate on the other half of the work force that does not have private pensions, I see no problem in expanding private pensions beyond the 50% point to, say, the 70% point. But there is a natural limit to the private process (perhaps 85% or 90%) beyond which you cannot reach people with private pension plans and probably should not try. The purpose of our Social Security system is to provide a reasonable level of benefit for everyone. To aim at a goal of 100% private coverage is to imply that Social Security should be inadequate and everybody should therefore need something on top of it. If Social Security is at a reasonable level, there should be a goodly portion of people who will elect not to have private pensions but to spend their money currently on something else.

MR. GIVENS: Thinking back 10 years to the development of Medicare, Henry Smith of the Equitable evolved a rule that the degree of agitation for Medicare was going to be in inverse proportion to the need. The first whimperings came while less than 50% of the employed population had health insurance. There were very serious discussions when there was 75% coverage; and it became an impassioned, politically feasible crusade when there was more than 90% coverage. Those that do not trouble to look at the lessons of history are doomed to repeat them. I see the same thing for the private pension business. With ERISA, we paid for the opportunity to preserve this kind of diversified system. We have two very important blessings: We have not had any expansion of Social Security to blot out the need for private pensions, and we have the opportunity to develop further a large pool of private capital. They are well worth the disciplines of the vesting, participation, funding, and other requirements, however, maniacally interpreted by the government. But it is not a gift of immortality; the public interest is on the side of the development of private pensions and they cannot afford to stay at the 50% or 60% level of coverage.

MR. RUDD: One question of my American colleagues. Now that you have these Individual Retirement Accounts, how can your tax laws continue without tax deductibility for employee contributions to pension plans? Is not the logical extension that there will be tax deductibility or that the employee contribution will be deemed to be an IRA?

MR. GIVENS: Will you vouch for the fact that I did not put you up to that question?

MR. RUDD: Absolutely.

MR. GIVENS: Fifteen years ago, Ray Peterson was a voice crying in the wilderness for the deductibility of employee contributions to private pension plans and, equally logically, for the deduction by employees of the Social Security tax, making the whole thing taxable at the end of the line. If you think about what that means in terms of Social Security benefits, you have quite an impact.

MR. RUDD: In Canada we went the other route, starting with the employee deductibility. Then, in 1957, we got the equivalent of what you call the IRA for the professional man, or as a supplement for someone in a pension plan.

MR. JACKSON: As legislation moves to make ever more certain the delivery of a benefit to a worker, do we not reach the point where there is that much more reason to tax the worker immediately on the benefit that is granted? In the past, the very forfeitability that Congress complained about was a sufficient reason why the individual worker should not pay a current income tax on the value of the benefits being accrued by him; they were forfeitable. Does not the deferral of an income tax on something that is certain to be delivered to somebody in the employee's family, through a death benefit or otherwise, simply become a tax loophole?

MR. GIVENS: You are absolutely right; that is the inevitable conclusion. If you have immediate vesting, you no longer have the whole logical problem that the taxation of private pension plans was intended to solve. Going further, why should the investment earnings of pension funds be tax free?

MR. POULIN: Congress, over the 10 years that ERISA was developed, had considered deductibility of employee contributions for tax purposes. But they concluded that it was not socially desirable, because a pension plan is not a savings plan. There is now a bill before Congress that would allow this deductibility and also increase the IRA limits from $1,500 to, perhaps, the same limits as for the HR-10 plans for the self-employed. It probably will not pass both houses because it will be perceived as being less socially desirable.

MR. JACKSON: At this point let us skip over Item 6 and take up Items 7 and 3 simultaneously. Item 7 is the question of whether cost-of-living increases are going to be included on an automatic basis in the future or whether there will be ad hoc changes on a periodic basis. Related to that is the problem before retirement as to whether there will be a continuing trend toward the final pay plan or whether there will be a shifting back to a career pay plan with the provision for ad hoc adjustments from time to time by updating past service benefits. Two major companies in the U.S. (G.E. and I.B.M.) follow that approach. In passing the Pension Reform Act, Congress was telling the country to promise less in the way of a pension but to make the delivery of whatever benefit is promised more certain.

MR. POULIN: In the discussion of career average versus final pay plans, it should be mentioned that, in most cases, these concepts apply to nonnegotiated, salaried employee plans. Traditionally, collectively bargained plans have provided a dollar benefit for each year of service to all participants. These benefits are not expressed as a percentage of wages, but to the extent that their benefit levels are the same for all years of service, they are more analogous to final pay than to career average arrangements.

With respect to nonnegotiated or unilateral plans, the recent trend has definitely been toward final pay plans and away from career average plans. The Bankers Trust Company of New York has recently conducted a study of current practices under pension plans of 190 of the largest corporate employers in the U.S. The employees covered by these plans total 8.4 million or about 25% of the covered population. The study shows that, over the last decade, the proportion of final pay arrangements among nonnegotiated plans has increased from 55% to 78%. Another recent study of major pension plans made by Mr. Evan L. Hodgens of the U.S. Department of Labor also shows an increase in the proportion of final pay arrangements and a shift away from career average plans.

This trend will not reverse itself. The rates of inflation we have experienced in the recent past have made pension plan participants more conscious of the deficiencies inherent in career average plans. This new awareness results in pressures for pension benefits more closely related to the level of compensation immediately preceding retirement. The Bankers Trust study shows that a number of final pay plans have recently been amended to shorten the period over which compensation is averaged and that the proportion of final pay plans using a period of five years or less has increased from 78% to 95% since 1970.

With respect to cost-of-living increases, during the five-year period ended in August of this year, the Consumer Price Index increased by nearly 40% in the U.S., an increase averaging 7% a year. There are indications that, if an index were established that would closely reflect the price increases in those commodities that make up the retired population's "goods basket," the recent rate of increase of that index would have been even greater. Therefore, measures must be taken to prevent, or at least diminish, such an erosion of the purchasing power of pensioners. Social Security has recently been amended to provide cost-of-living adjustments; but, so far, the private pension system has not taken similar measures. The absence of cost-of-living escalators in pension plans is explained in large measure by their substantial cost: To assume that retirees' benefits will increase indefinitely at an annual rate of 5% is, in fact, saying that these benefits will double in 14 years, a period close to the average life expectancy of retiring employees. Pension plans providing such retiree benefit escalators would have to be funded accordingly. Incidentally, a very interesting development took place in this area last month in Canada. The Ontario Government amended its regulations under Ontario's Pension Benefits Act to provide that anticipated future costs arising from cost-of-living escalators may be excluded from the funding requirements of the Act. The cost-of-living increases to retirees may simply be added to the normal cost of the plan in the year in which payments are made. Such an action by the government removes a major obstacle to the establishment of cost-of-living escalators in pension plans and, it may also be said, is a dangerous precedent.

In any event, in most jurisdictions future increases stemming from cost-of-living formulas must still be prefunded. That is why other approaches have been followed by a number of plans. Under plans negotiated by the UAW, for instance, ad hoc increases in retirees' benefits are provided as a result of periodic collective bargaining sessions. The scheduled increases over the term of the present six-year agreement apply not only to new retirees, but also to those employees who retired prior to the present agreement. We will see more of these ad hoc increases in the future.

MR. RUDD: With respect to the trend of benefit formulas, Mr. Poulin's figures were based on some large plans. Looking at the Province of Ontario as a whole, 12% of the plans have benefits based on average final earnings but they cover half the membership in Ontario. Once again the government plans have a major effect along with the large corporations. Approximately 32% of the plans covering about 24% of the members are of the career average type. I do not see any slowdown in moving towards final earnings. Inflation is going to push it even harder. The employees want and need the protection. Our contributory scene in Canada means that the defined benefit, career average plan is losing steadily in popularity, since, with high interest rates, the employee contributions alone are, in effect, providing more than the career average benefit at ever higher ages, even into the 40's and 50's. Employees, or their union representatives, are getting more sophisticated and the career average plan is

in some difficulty. Our own company plan has a minimum withdrawal benefit of 150% of employee contributions, even though it is a final earnings plan because, as an insurance company, we have a fairly sophisticated work force that understood what is going on in a defined benefit plan.

Union plans generally follow the U.S. pattern of a flat dollar benefit, and they are our biggest problem as far as degree of funding is concerned. They are really a final earnings form of pension plan but can be funded without a salary scale. I sometimes wonder if the union plans should not be defined as a percentage of a current rate per hour so that funding would be on a heavier basis rather than have periodic upgrading with amortization and the attendant problem of underfunding. In our regulations, we override the plan orders of priority to make sure that some unfortunate soul does not lose his benefit because of a plan being liberalized or terminated in the last few years. Plan termination insurance in the States is going to help solve that problem.

On cost-of-living increases, we had a problem in Canada in that the federal government denied tax breaks for funding in advance for the effects of inflation. However, the provincial rules and the corresponding federal rules, on the funding of pension benefits, require advance funding during the working lifetime for escalated pensions after retirement. As Mr. Poulin pointed out, we changed our Ontario regulation, when our federal government put in fully-indexed pensions for their civil servants on a pay-as-you-go basis, to permit pay-as-you-go funding for cost-of-living escalated pensions. But Mr. Poulin did not mention that our regulations were also changed to prohibit terminated pension plans from allocating all the assets to these unfunded escalations. The escalations are the last priority. Actually, most employers use an ad hoc arrangement outside the pension plan to look after their retired employees and this will continue to be a popular approach. At the present time there are less than 25 plans covering Ontario employees which even partially escalate after retirement.

MR. GIVENS: Over the last 20 years, final pay has won for large cases and those small cases that are funded through individual policy pension trusts. The only reason to consider career average as a possible new trend would be the newly important need to control the development of accrued liability because of PBGC rules and because a couple of respected consultants are promoting the idea of reverting to career average plans. But final pay is the only way to have any kind of adequate benefit at retirement.

Of course, if you are going to send the fellow off into retirement with an adequate benefit that soon evaporates because of inflation, you really have not done the full job. In our own company's plans, we went from career average to final pay some years ago and explicitly indexed the benefits to cost of living.

But we associate that with one other topic on the agenda, integration. Integration is a natural subject to consider at the time you are trying to design an adequate benefit; because, without integration, you end up with too fat a benefit. This is one of the arguments for having too fat a benefit in negotiated plans, since it is going to be inadequate a few years down the road anyway. But if you can package the idea of an adequate benefit at the point of retirement, and not a redundant one, it can be kept adequate by cost-of-living indexing for a reasonable price. You can introduce the idea of substantial integration and that has been done in the aluminum, steel, and can workers' plans. I wonder what Mr. Poulin would have to say about the idea of exchanging strong integration for cost-of-living indexing?

MR. POULIN: We are keeping benefits adequate by providing ad hoc increases.

MR. GIVENS: Suppose the employer has a certain amount of money to spend. Should he provide redundant or excess benefits at retirement, so that the retiree has a higher standard of living immediately but finds it an illusion five or 10 years down the road? Or, would it be better to start him off at a level consistent with his standard of living before retirement and keep it that way?

MR. JACKSON: Let me add a different point of view. One of the stumbling blocks to retirement has been the sharp reduction in income that the person has to take. For the first few years after retirement the pensioner is more inclined to travel and more able to make use of extra funds, so that there may well be some personal reasons why an individual, if he were to have a choice, would prefer a larger pension in the first few years tapering down ultimately to some lower but still adequate level. So, instead of having to shift his financial affairs from 100% of earned income in one month to 50% the next, even with a fairly generous pension, perhaps it is not unreasonable to grade it down to permit the individual to travel and enjoy himself.

MR. POULIN: Our goal in negotiating pension benefits is to provide for employees who have a certain number of years of service (e.g. 30 years) a substantial stability of income throughout retirement by providing larger earlier retirement benefits before Social Security becomes payable. These benefits are, in fact, integrated with Social Security. We would like full inflation protection after age 65; but since the cost is prohibitive, we must settle for ad hoc increases.

MR. JACKSON: I find myself in disagreement with all the panel members on the possibility of a trend toward career pay benefit formulas. Unlike the other panelists who deal with universes much larger, I only look to the two dozen plans that I work with; and two of them have shifted from a final pay basis to a career average basis within the last two years. One of the reasons is the one Mr. Givens mentioned; when an employer is financially responsible up to 30% of his net worth for the pension liability, sound or conservative management suggests that you try to get that under control and not leave it open to inflation. The final pay approach with cost-of-living increases after retirement is one which an employer might have taken in the past in an effort to avoid going back to his pension plan and changing it every year. In theory, if he adopts a final pay plan with cost-of-living increases, he could forget the annual pension plan design problem and concentrate on his main business of building cars or selling insurance. However, continual review of pension benefits is necessary anyway; you cannot start a pension plan off and assume it will operate properly without annual review. So there is less of a reason now for final pay plans.

In one of the cases that converted to a career average basis, a further reason was to be able to provide annual benefit statements to the employee to show him in dollars and cents, rather than percentages of some future pay, just what he had accumulated up to the present time and what he could probably count on at retirement. On a final pay basis, because they did not want to promise future pay increases, they were projecting benefits forward to retirement at 65 on the basis of current pay anyway; thus, they were hiding a good deal of the attractiveness of the final pay formula. So, they converted to a career average basis with a higher benefit formula. Of course, their intent is that if the career pay feature becomes inadequate, they can update the pay base for past service benefits. They can improve benefits after retirement if

they are eroded by inflation. But they can do that at a point in time when their finances can stand it, and in an amount that is known rather than unknown.

MR. RUDD: There is one implication in this escalation after retirement. In Canada, we have had some well-publicized early retirements of senior civil servants. After a certain number of years of service, one can retire early without actuarial reduction. With pensions based on the average of the last five years' earnings, it pays people to retire early because they get escalation of 100% of the cost of living, while if they stay and work they only get 20% of it a year in the five year averaging. Also, rather than stopping inflation, governments are taking other steps to ease the position of the retired portion of the population through additional tax exemptions, free Medicare premiums, etc. So if you have the situation where retirees are getting full escalation for cost of living, the retired population is ending up better off than they really should be; a very expensive approach.

MR. JACKSON: In the U.S. Government Civil Service program, the cost-of-living feature operates in such a way as to encourage retirements to bunch up at a particular date in time just before an increase is going to come through; because if they retire after that date they do not get the increase, they just receive the basic formula benefit. In effect, we have a benefit formula that rises in the aggregate by perhaps 5% and then drops if you did not retire the month before the cost-of-living increase went into effect.

MR. GIVENS: We also have the great feature that gives you an increase of 4% if the cost of living goes up by 3%. If the cost of living goes up by 3% twice in the same year, you get an increase of 8% to compensate for the 6%.

MR. RUDD: I thought we were wild.

MR. JACKSON: Back to Item 6, integration with Social Security. At the time the Pension Reform Act was passed by the House, it contained a provision (Section 1021(g) of the Act) that would have frozen integration with Social Security at the level in effect in June of 1974, while Congress studied the matter. In a very unusual move, this was stricken from the Conference Committee bill by concurrent resolution. However, the matter was referred to a task force for study. Basically, the Congressional view is a very simple, straightforward one. Many Congressmen look at Social Security as a vote-getting device. If they improve the benefits, certain people are going to vote for them. However, if they improve the benefits, they have to increase the tax to pay for it and certain other people will not vote for them. This is a balancing that they can test out. However, if, when they improve the benefits, the people who would ordinarily vote for them merely get less in the way of private pensions because of the offsetting of the Social Security benefit improvement, there is a total distortion of political equity. Thus, consideration is probably being given by Congress to the possibility of outlawing integration with Social Security entirely and requiring that all benefits be of an add-on variety. Of course, plans such as the UAW pattern plan really are integrated with Social Security prior to the onset of Social Security in two respects: The early retirement supplement and the disability benefit where Social Security approval is not received, since the plan pays a makeup.

MR. POULIN: I do not expect great changes in the area of pension plan integration with Social Security. Negotiated plans covering hourly employees will continue without integration, except for the integration just mentioned, whereas conventional plans for salaried employees will probably retain their integrated features. The Social Security income bases used by the plans which do

integrate, as well as the differentials in benefits below and above these Social Security bases, might be frozen at their present levels, or even reduced by virtue of the additions of disability and survivor benefits and more liberal retirement features.

MR. JACKSON: It might also be noted that the IRS integration rules permit a greater limit if you have a life annuity without any supplementary benefits. They allow you to convert the Social Security equivalent, which contains disability and death benefits, into a life annuity of larger amount; and then, in exchange for that larger limit, if your pension plan provides preretirement or postretirement death benefits, or disability features, the limit is cut back accordingly.

MR. GIVENS: You certainly can expect to find some kind of development in the area of integration. There is the task force effort, Ways and Means interest, and the IRS with its eternal vigilance thinking up new ways to clarify the situation, especially since they have not updated their integration ruling for the last several years to recognize the higher Social Security wage base. This is where the fog ahead is perhaps the most dense.

As far as the rules are concerned, we urge our clients to keep the disability benefits out of the pension plan. There are ways to provide early retirement sweeteners without hurting your integration allowance. The political factor is very important; maybe the publicity that is being given to the pension benefits of New York City, which are not integrated, will make excessive benefits less viable. The New York Times has cited cases of transit workers whose final salaries were $13,000 - $15,000, who retired on pensions allegedly of 50% of final pay. The pensions were $17,000 - $18,000. The factor there is that overtime is included, and at astronomical amounts in the last year.

MR. JACKSON: In some of those departments they appear to have an arrangement where, in the year before retirement, the prospective pensioner is designated as the man to handle all overtime. I am reminded of a story that appeared in the Washington papers where a member of the police force retired and somehow did not get the word that everybody who retires is disabled. It went without saying that you would apply for a disability pension because you would get a bigger benefit, and your application was always approved. But this gentleman merely retired, innocent in his assumption that the city would look after him. Later, when he found how he had been "cheated," he tried to submit a disability application. There was a total miscarriage of justice in this case, according to the front page article in the Washington Post which suggested that the city had treated this man unfairly because they had not properly informed him of all of his "rights" under the city retirement plan.

MR. RUDD: On integration, there are conflicting forces at work. As regulators looking at contributory plans, we have been concerned that on the offset types some serious injustices could arise. The Ontario Government recently amended the Pension Benefits Act of Ontario to provide that an employee could not receive at retirement, or upon termination, a pension that was less than the value of his own contributions, which probably does not go far enough. There is pressure for higher benefits in final earnings plans and there will be a greater tendency there towards even more integration with Social Security benefits. However, the smaller money purchase and career average plans have been showing an increasing tendency to add-on, at least, in appearance. Mr. Poulin claims that the UAW benefits are not integrated; but I am sure that when he sits down to bargain with one of the large auto companies, even though there is no formula bringing Social Security into the picture, everybody has a good

idea of what the current Social Security benefit is so that there is implicit integration going on in some fashion in these add-on plans. At the present time, about 5,100 of the 8,700 plans in Ontario are integrated in some way. About half of the contributory plans are integrated but close to 90% of the contributors are in the integrated half; it is the smaller money purchase and career average plans that are add-on. Keep in mind that our payroll tax on the employee and employer is still only 1.8%; we are not yet a mature system.

MR. JACKSON: The next item on the agenda is the inclusion of pre- and postretirement spouses' benefits at employer cost. This item reflects the fact that the Pension Reform Act requires an automatic option at retirement, which the employee must elect out of if he wants a life annuity; the automatic option is to be joint and at least 50% to the surviving spouse. Regulations were just published and they contain two surprises. The first is that the employee must be permitted to elect or diselect the preretirement, or "dead horse," option at any time from 55 to 65. (It is called a "dead horse" option because the only people who pay for the cost of the option are the people for whom it was of no value at all because they survived to the end of the period; yet they get to pay the cost out of their pension for the rest of their lives. It is not good plan design because it permits an individual to divert part of his pension to provide preretirement insurance protection.) If the individual is permitted to elect or to diselect at any time, he could elect the option when he goes into the hospital and one month later when all is well he could decide to diselect, knowing full well that after such diselection the plan has to pay anyway, if he should die by accident within two years, and he will have time to reelect if he comes down with a lingering illness.

The other problem deals with the automatic option at retirement. The law apparently said that you had to offer it to retirees after age 55. However, the regulations say that if an individual retires after 30 years of service but prior to age 55, you must offer him an option which, if he were to die, would provide his surviving spouse a benefit commencing on the date he would have been 55 if he had survived. So instead of a deferred right to elect a survivor option, the regulations require an immediate election of a deferred survivor option. This can be a real cost problem for disability retirements, all of whom ought to antiselect.

MR. POULIN: The same regulation surprised me for a different reason. I thought that the 10-year period applied only to active employees eligible for early retirement and not to those retiring early. In other words, I thought that ERISA required plans to provide for the automatic survivor election for retirements before age 55, and that the age 55 restriction only applied to active employees.

There will be more employer subsidization of the pre- and postretirement surviving spouse benefit because of the inequity just mentioned and also because, in many plans, when you do not have any subsidy the proportion of takers is very low. If someone could have received $X a month but now would receive only 75% or 80% of $X with the survivor benefit, the nonelection or the rejection of the survivor benefit will result in his widow receiving nothing upon his death. There is also the fact of the complexity of calculating the myriads of possibilities (male, female, employee age, and spouse age). Furthermore, the Equal Employment Opportunity Commission (EEOC) may file sex discrimination charges if we refine the actuarial calculations. All this will encourage employers to subsidize the survivor benefit option.

MR. GIVENS: Many of the employers with nonunion plans already have generous preretirement and postretirement coverage, typically through group life

insurance or in the form of survivor benefits. Universally, we find that they do not want to provide the coverage free in the pension plan. They already have everything in place, and what they are looking for is some way to leave it where it is and to discourage the election for very sound tax planning reasons. The drift then for the company that has benefits already in place is for the pension plan to make the employee pay for it.

For the company that does not have it in place, I would expect that the postretirement coverage certainly will not be paid for by the employer because it is such an easy mechanism to install as an employee cost item. Preretirement is more confusing; there are questions of how to charge for it and what variations are needed to recognize age and sex differences. Since the cost for preretirement coverage is perhaps a third of what it is for the postretirement coverage, plan sponsors may throw up their hands and just pay for it and not insist on beating that old "dead horse."

MR. RUDD: In Ontario, 289 of 8,600 plans provide widows' pensions after retirement. I do not see much encouragement to increase this coverage now that the new human rights legislation exists for the spouses of the females as well as for the spouses of the males.

MR. JACKSON: On the retirement age issue, the trend toward early retirement will continue; but I also foresee some shifting upward in the mandatory 65 retirement age, perhaps as a result of EEOC regulation.

MR. POULIN: I agree that the reduction in the earlier retirement ages and the provisions of normal retirement benefits at an earlier age will continue, both formally and informally--formally by actually designating the normal retirement age as 62 or 60 and informally by providing full benefits at an earlier age. With respect to mandatory pensions, there is already a comprehensive, quasi-universal, and fully portable pension system, which is Social Security (and in Canada, the Canada and Quebec Pension Plans); and there should be improvement in these areas rather than trying to force employers to adopt pension plans.

MR. GIVENS: The first order of procedure ought to be adequate benefit at some point; and so instead of spending money on providing an inadequate benefit earlier, the drift should be toward providing an adequate benefit at the normal retirement age. Cost-of-living indexing would be more important than letting people retire at 50 with an unreduced benefit. You are going to have more interest certainly in retiring at a broader range of ages, the emphasis being on individual choice. In the U.S., there is a statutory exemption on the age discrimination laws for qualified pension plans; but that is being contested. I do not see it being overturned in the immediate future, but there will be a lot of examination of the desirability of not having compulsory retirement at so early an age. There is even the whisper that one way for the Social Security program itself to buy its way out of its problems is to postpone the normal retirement age.

MR. RUDD: People are staying with the Social Security age; and the concept of lowering that from 65 has been rejected as being too expensive, despite the Canadian Labor Congress' request for 75% pension from age 60. Our Minister of National Health and Welfare has even commented that the loss in private investment by expanding the Social Security system to such a degree would be detrimental to the country.

I have been receiving written notice of strong concern from the Pension Commission of Ontario about vested benefits under ERISA. Once a plan has 10-year vesting and early retirement with an unreduced pension at age 62, when should the vested benefit be payable for somebody who terminates employment at age 48? Is the normal retirement age really 65 or is it really 62 with the employee election to defer retirement to 65?

MR. JACKSON: It is really 65.

MR. RUDD: This is a problem which is exercising us at the present time. I do not know what ERISA does about it.

MR. JACKSON: To summarize, each of the panelists, while emphasizing problems, has suggested that there is at least some future for private pensions and some hope for future employment of actuaries in this area, either in the private sector or with the Pension Benefit Guaranty Corporation. It is always nice to have a future.