

DIGEST OF DISCUSSION AT CONCURRENT SESSIONS

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PENSIONS

What are the current status and implications of the following?

1. Various pending legislative proposals in the United States (e.g., Welfare and Pension Plan Protection Act, Pension Benefit Security Act, etc.) for further federal regulation of private pensions, including
  - a) increased disclosure requirements,
  - b) required standards of fiduciary responsibility,
  - c) required minimum vesting standards,
  - d) mandatory minimum funding requirements, and
  - e) mandatory pension plan termination protection program.
2. United States Treasury Department regulations and rulings with respect to the integration of private pensions and other retirement plans, with specific reference to:
  - a) the philosophical and mathematical basis for such regulations and rulings and
  - b) the application of such regulations to various types of pension plans.
3. Recently enacted legislation and pending legislation in Canada concerning private pensions.

MR. THOMAS L. WILLS: My remarks today are my own; they reflect neither an official nor an unofficial position of the Aetna Life and Casualty.

It is the responsibility of government to define public policy and to establish social objectives within that policy. It is also the responsibility of government to regulate the private sector to the extent necessary to make it effective in furthering social objectives. Interested parties should examine critically public policy espoused by the government and try to influence its formulation so as to make it reflect optimum public interest.

Once the policy is defined, government will implement it by passing legislation. Interested parties should examine pending legislation and offer constructive criticism so that the legislation eventually passed best implements the established policy. To look objectively at federal legislation designed to regulate private pensions, it is necessary to try to bring private pensions into perspective within the very broad area of public policy concerned with providing economic security to the aged citizens of the United States.

I find it difficult to articulate my thoughts about public policy in this area. However, I like the following description of the objectives of such policy—to achieve four levels of equity:

First, we want everyone to live at least at a minimum level that is not poverty. Second, we desire a higher modest level for those who have contributed through work during some of their lifetime, even poorly paid work. Third, we wish to make employment opportunities available for the aged, so that those who are able and desirous of doing so can supplement their incomes beyond a minimum or modest amount. And last, we also wish to encourage savings and private pensions so that those most productive and prudent can retire without severe contraction in their personal standards of consumption.<sup>1</sup>

From this statement of policy objectives I infer that (1) private pensions, in their present form, are an important and highly specialized method of helping a large number of people, but a relatively small proportion of the total working population, achieve a level of income at retirement close to their accustomed standard of living; and (2) private pensions have obligations to covered workers and their families that are not necessarily consistent with the objectives of the employers financing private pensions.

In summary, private pensions are an instrument for implementing public policy, they have been fostered by favorable federal income tax treatment, and they have reached a size and achieved a measure of influence which make further legislation and regulation necessary if they are to continue to advance public policy effectively. Further, it is the duty of government to regulate, because industry will not regulate itself even in those areas that affect social objectives since regulation is not always to its economic advantage. So we face pending federal legislation of private pensions.

In addition to several other bills, there are three bills pending before Congress that contain provisions covering the five aspects of private pensions listed in today's program: (1) the Pension Benefit Security Act, S. 3421, introduced by Senator Yarborough; (2) the Welfare and Pension Plan Protection Act of 1968, H.R. 6498, an amendment to the Welfare and Pension Plans Disclosure Act of 1958; and (3) the Pension and Employee Benefit Act of 1967, S. 1103, introduced by Senator Javits. For this discussion, I will limit my comments to the first two bills only, in the expectation of a Democratic party majority in the Congress next year.

The Yarborough bill would establish the following:

1. *Minimum vesting standards.*—The basic standard would be full vesting upon completion of ten years of employment after age 25. There would be

<sup>1</sup> Raymond Munts, "Minimum Income as a Retirement Policy Objective," *Old Age Income Assurance: A Compendium of Papers on Problems and Policy Issues in the Public and Private Pension System, Subcommittee on Fiscal Policy of the Joint Economic Committee*, Part 2, (December 1967), p. 294.

transition rules for existing plans which would permit a plan to meet the basic standard gradually over a period of ten years. There would also be transition rules for new plans which would permit no vesting during the first five years of its existence but which would require the plan to meet the basic standard after the plan has been in effect for ten years.

2. *Minimum funding standards.*—The present IRS minimum funding standard would be retained and an additional funding standard would be introduced for plan-termination protection. It would be built around a schedule of funding ratios, where “funding ratio” would be defined as the ratio of assets to vested liabilities. Under this schedule a plan’s funding ratio would be expected to increase 4 percentage points annually, reaching 100 per cent after twenty-five years.

3. *Pension guarantee arrangement.*—The basic concept would be to provide full protection for employees’ vested benefits against involuntary plan termination through a system providing “insurance” and enforceable employer contributions to meet the termination funding standard. The amount of “insurance” would be the excess of the amount of all vested liabilities over essentially 90 per cent of actual plan assets. The premium assessed against a plan would be a uniform percentage of unfunded vested liabilities. A government corporation would be established to administer the arrangement.

The Welfare and Pension Plan Protection Act of 1968 would require additional information in the annual disclosure report relating to (a) investments in securities or properties of any party in interest, (b) investments held in common trusts maintained by banks, and (c) separate accounts maintained by insurance companies. It would require an annual audit by an independent public accountant. It would authorize the Secretary of Labor to conduct a detailed investigation when he has reasonable cause. It would give participants or beneficiaries the right to bring action for any acts by fiduciaries which violate the provisions of the proposed amendment. Under this amendment, every person who receives, disburses, or exercises any control or authority with respect to any employee benefit fund would be a fiduciary. He would be required to discharge his duties as a man of ordinary prudence would in dealing with his own property.

There are arguments both for and against further regulation of private pensions in the areas under discussion, some of which I will review with you now.

### 1. *Vesting*

Proponents expect compulsory vesting to (a) provide equitable treatment of individual workers, by entitling an employee, after a reasonable period of service, to protection of his future retirement benefit against any

termination of his employment; (b) strengthen both the nation's entire program for retirement protection and, in the process, private pensions, by making private pension benefits more widely available; (c) enhance the mobility of the work force; and (d) add flexibility to management's task of meeting manpower requirements by making plans more effective with the employees.

Opponents of compulsory vesting believe that (a) it would unduly burden the maintenance of any existing plan, because it would increase the long-range cost of a plan; (b) it may hamper the establishment of new plans, which would make private pensions less, rather than more, widely available; (c) it may interfere with decisions regarding the allocation of resources available for pension benefits, by discouraging the granting of past-service credits, for example; and (d) it is not necessary, because private pensions are making continued progress toward adequate vesting without compulsion.

So the proponents believe that compulsory vesting is necessary to implement public policy. On the other hand, the opponents, while supporting the concept of vesting, question the efficacy of compulsion. For example, there may be more equity in offering past-service credits to long-term employees near retirement than there would be in vesting pension rights of younger, short-term employees. Proponents counterargue that public policy clearly must choose the system which assures a lower level of benefits to all workers after a reasonable period of service over one which provides a higher level of benefits but only for those who remain with their employer until retirement age.

## 2. *Funding Standards*

Proponents argue that minimum funding standards are essential if pension promises are to be fulfilled. They also argue that social objectives can be achieved only if funds adequate to pay expected benefits are accumulated.

Opponents argue that minimum funding standards would (a) reduce the flexibility essential to a healthy system of private pensions by interfering with the decisions regarding the allocation of resources available for pension benefits or by discouraging the granting of past-service credits under new plans; (b) slow down improvements in pension plans; (c) discourage new plans from coming into existence; and (d) drive some old plans out of existence. Some would even argue that it is not possible to devise meaningful and equitable standards which could be applied to all plans.

### 3. *Pension Guarantee Arrangement*

The proponents favor such an arrangement because it would be an essential part of the minimum vesting and funding standards if pension obligations are to be met under plans that terminate prematurely. Or, in other words, public policy dictates that private pensions must meet their social objectives by providing for workers who would lose their pension promises through plan termination.

The opponents believe that the possibility that a business operation will come to an end is not an insurable risk. They also believe that, when pension plans include full credit for past service, employees must expect to assume the risk that their employer will remain in business long enough for past-service liabilities to be funded gradually. They further argue that if such an arrangement were set up (a) it would discourage adequate funding of past-service liabilities, since there no longer would be a compelling reason to fund such liabilities; (b) it would reduce resources otherwise available for the financing of pensions; and (c) it would invite subsequent federal regulation and possible control of pension fund investments.

### 4. *Further Disclosure and Minimum Fiduciary Standards*

The arguments advanced in favor of such standards are the following: (a) they are necessary to provide adequate protection of the rights of plan participants and beneficiaries and (b) they are necessary to prevent certain existing abuses which cannot be prevented under the existing Disclosure Act.

The following are arguments advanced against such standards: (a) disclosure is ineffective in preventing abuses; (b) they will significantly increase the administrative costs of a plan and, thus, reduce resources available to provide benefits for participants and beneficiaries; and (c) there is no need because there is no significant abuse.

In conclusion, let me list the implications of this pending federal legislation, as I see them:

1. The debate on public policy regarding private pensions, in the areas under consideration today, is over. The policy has been decided upon.
2. The government is going to pass legislation to implement this policy.
3. The government has decided, rightly I believe, that private pensions can be an important and effective instrument for implementing public policy if they are regulated in the manner outlined.
4. In drafting legislation, the government expects the private pension industry, primarily through its actuaries, lawyers, and consultants, to provide vital technical assistance. If the industry fails to provide technical assistance, legislation will be passed without it and it will be bad legislation.

5. In providing technical assistance, the industry must recognize, and be guided by, public policy. If the industry fails to make public policy the primary guide for its assistance, its advice will be ignored.

CHAIRMAN JAMES A. ATTWOOD: I would like to underline the reference to the Joint Economic Committee Compendium of Papers. It is a six-volume study containing papers on all the policy issues confronting private and public pension plans in the United States. It is well worth your perusal. Part VI contains abstracts of the papers, and a review of it gives a fair sense of the total compendium.

MR. JOHN K. DYER, JR.: I have been and continue to be unalterably opposed to the federal legislative proposals calling for minimum vesting standards, minimum funding requirements, and a mandatory pension plan termination protection arrangement for private pension plans. I believe that such legislation would be harmful to the private pension movement and that it is unnecessary in the light of available alternatives.

The principal danger in statutory minimum vesting standards is that, once the door is opened to standards relating to any provisions of private pension plans, there is no logical place to stop. If mandatory vesting makes any sense, why not mandatory widows' benefits, mandatory disability pensions (and corresponding eligibility standards), early retirement provisions, and so on?

The danger inherent in minimum funding requirements and termination protection is that these may weaken rather than strengthen the financial security of private pensions and at the same time create pressures for increased benefits. If minimum funding standards are established by law or regulation, these will inevitably come to be regarded as adequate for financial soundness. An employer who may be inclined to fund his plan on a more conservative basis will find it difficult to explain why such additional funding should not result in increased benefits. Termination protection will aggravate these problems, discouraging conservative funding and even encouraging unsound funding policies.

The main reason for my belief that such legislation is unnecessary as well as undesirable is that I see a much better way to eliminate the shortcomings in private pensions that have motivated these unsound proposals. These shortcomings, analyzed critically and objectively, all seem to focus on one fundamental difficulty—a lack of understanding on the part of employees, and sometimes even of employers and unions, of the true nature of the benefits and limitations of private pension plans. This, rather than any real flaws in plan design or financing, is the real villain.

To be more explicit, I believe that a realistic pension plan disclosure law will provide the answer to most of the problems that seem to have appeared in private pensions, without the risk of irreparable damage to the pension movement. We have a federal disclosure law, but it was designed to prevent abuses in the administration of short-term welfare-type plans and is not truly adaptable to pension plan problems.

The principal features of the pension plan disclosure law that I visualize would be the following:

- a) A requirement that every pension plan contain certain "standard provisions" analogous to those required in a life insurance policy by the state insurance laws. These would describe rights upon termination of service, retirement, death, plan termination, and so on, and the wording would be subject to review to ensure clear and unambiguous language.
- b) A requirement for periodic reports to employees, giving them specific individual information on their status in case of plan termination. This is somewhat analogous to the requirement of state insurance laws that insurance policies contain specific nonforfeiture values.
- c) A requirement that certificates be issued to employees who terminate with a vested right, setting forth the amount of the vested benefit, the conditions under which it may become payable, and the exact procedure for claiming the benefit when eligible.

These features all embody principles that have been tested and found effective at the state level, are widely accepted by the public and the insurers, and are known to be administratively feasible.

The principle underlying most American legislation designed to protect investors and consumers is one of freedom with full disclosure. The securities legislation aims not at absolute security for the investor but at full disclosure of any risk factors that may be present. The Food and Drug Administration and fair labeling laws avoid forcing standards as to content or quality but insist that the content and quality be clearly communicated to the buyer. The existing benefit plan legislation, both federal and state, stipulates no minimum benefits or eligibility requirements but does require disclosure intended to reveal the real financial security behind the benefits promised. My suggested pension plan disclosure legislation is based upon the traditional and successful principles of the American system. The proposal for mandatory vesting, funding, and pooling of plan termination risks is not!

**MR. WILLIAM A. DREHER:** The sponsors of retirement plans with social security-integrated benefit formulas are confronted with an imminent and distasteful reality—a new Internal Revenue Service ruling

about the limitations imposed on integrated plans. Their employees will be spared the nuisance of selecting among the alternative procedures for compliance with the new ruling, but their retirement incomes may suffer as a consequence. All of us who provide service to private pension plans will face new challenges to our ingenuity, heavier workloads for undermanned staffs, and a first-rate opportunity to offer sympathy and consolation to frustrated clients. One valuable derivative benefit of the new integration rules and their impact will be, in many cases, a fresh look at the design of the entire pension program and an improvement of its structure to reflect current trends and developments in the field.

Our purpose today is to illuminate this subject, without overheating the atmosphere or unduly elevating blood pressures. To encourage a sense of moderation, I would like you to know that we have among us today several Treasury Department members, including Mrs. Elizabeth Poston and Mr. Robert Feldgarden. We welcome these guests and hope that the views of actuaries on this complex and timely subject will be of assistance to them in the discharge of their duties. One would also hope that they and other government representatives will be encouraged by the results of today's meeting to consult the actuarial profession at a much earlier stage in the evolution of future developments coming within the scope of our competence.

In the charitable spirit that we hope will dominate our discussion, I believe it only fair to offer our guests and their colleagues a measure of sympathy. Each week I—and many others in this room—receive copies of several Treasury Department responses to inquiries by members of Congress who have been goaded into action directly or indirectly by actuaries and other consultants. Imagine how tedious it must be to compose those letters of defense or of promise to consider carefully the opposing viewpoint, particularly if one suspects that the issue is already closed.

One final comment before proceeding to our subject. My remarks are my own responsibility, but the opinions and analyses prepared for clients by many consulting actuaries and by insurance industry representatives, and the testimony at the September IRS hearings by many actuaries, including Jim Attwood, Pres Bassett, Jack Dyer, and Paul Jackson, were most informative, and I have used their good work liberally in preparing these opening remarks.

The proposed IRS ruling is the latest development in a chain of events originated in 1966 upon the release of Treasury Announcement 66-58. T.A. 66-58 outlined a mathematical calculation that placed a 24 per cent limit on the amount of pension related to earnings above the social security wage base. It produced an avalanche of mail that would have re-



freshed the youthful dreams of a direct-mail advertiser but gave no joy to the hopeful planners in the Treasury Department. The principal public reactions to these expressions of taxpayer outrage were three:

1. The Treasury disclaimed any purpose except a desire to promote free and open public discussion of a complex problem.
2. Secretary Fowler appointed an advisory panel to assist the Treasury in evaluating all viewpoints and arriving at an acceptable solution.
3. An interim integration rule, permitting a plan to provide an integrated benefit equal to 27.27 per cent of the earnings above \$6,600, was issued in early 1967.

The composition of the advisory panel, which included no actuaries, led some of us to believe that a narrow mathematical solution had been abandoned in favor of approaches that looked not to cost or actuarial values but to simple comparisons of the combined benefits from a private retirement plan and the social security system. Had we known more of the statutory restrictions on members of advisory panels, we might not have been so innocent.

Let me explain. I am informed by one of the panel that an advisory panel cannot meet unless the government calls the meeting and is represented at the meeting. The government sets the agenda and may adjourn the meeting at its will. In other words, the panel—as a group—is effectively prevented from any independent evaluation of the subject matter and has no realistic opportunity to develop an opinion or alternative solutions of its own. This was, in fact, the experience of the advisory panel during the two meetings called by the Treasury.

This past July the product of the Treasury's effort was revealed by Treasury Announcement 68-49, which proposes an integration limit equal to 30 per cent of the excess of (a) an employee's average annual compensation (such average to be based on at least five years' compensation) over (b) the maximum compensation which is used to determine his social security-covered wages. Because the maximum compensation for social security purposes increases each year, the Treasury interprets its general rule by introducing a thirty-nine-stage table of social security compensation amounts, varying from \$4,944 for employees reaching age 65 in 1968 to \$7,800 for employees reaching age 65 after the year 2005.

The mathematical procedure used to justify the 30 per cent limitation has four elements: two are preserved from the mathematical formulations of earlier integration rulings, one is a significant change in a familiar assumption, and the last is a new element. These elements follow, briefly stated:

1. The maximum value of the primary insurance amount is related to actual average covered wages upon which it will be based in the years 1968 and 2006. Thus, in 1968 this percentage is 37.9 per cent of \$4,944; in 2006 it is 33.5 per cent of \$7,800. The sum of 37.9 per cent and 33.5 per cent is divided by 2, and the result rounded to 36 per cent.
2. The value of total OASI benefits is assumed to be 150 per cent of the primary insurance amount.
3. Because social security benefits are financed by equal taxes on employees and employers, 50 per cent of each employee's retirement benefits is considered attributable to employer taxes.
4. In anticipation that future amendments to the social security law may increase the first two ratios, the proposed ruling increases the product of all three ratios by 10 per cent. The result, rounded to the nearest integer, produces the 30 per cent limitation.

Few actuaries, and none of my acquaintance, have agreed with the Treasury's mathematics. Some have refused to debate their logic on the grounds that the approach is fundamentally wrong; others have challenged one or more of the components. Some of the actuarial opinions most frequently heard follow:

1. With regard to the 36 per cent ratio of primary benefits to covered wages, most actuaries have agreed that this ratio has been relatively stable in recent years. (Since 1954 the ratio has hovered in the range of 31-33 per cent.)

2. Concerning the ratio of total benefits to primary benefits, many actuaries have carefully appraised this relationship since the advent of T.A. 66-58. Their conclusions vary widely, extending from endorsement of the IRS conclusion to support of a ratio in excess of 225 per cent. The consensus would appear to center around a ratio of 200 per cent.

3. The movement from a calculation of the portion of social security benefits, financed by the employee's own taxes, to a comparison of the relative taxes paid by employees and employers is a significant shift in theory and leads to an abrupt decrease (from 78 per cent down to 50 per cent) in the benefit attributed to employer taxes. Some actuaries have agreed with the shift in principle, since the original procedure leads to an unworkable result as the social security system matures and the total taxes by the employee and his employer begin to exceed the total value of the employee's benefits. However, others have argued for a smaller adjustment in the ratio, on the grounds that employees now in the work force will finance only about 40-45 per cent of their own benefits.

4. A 10 per cent allowance for the effect of future amendments in the Social Security Act has been challenged as inadequate. For example, the ratio of maximum primary benefit to covered wages has increased from 27 to 28 per cent in the early 1950's to nearly 38 per cent in 1968. An allowance of 20 per cent, rather than 10 per cent, has been suggested.

The proposed ruling changes several other numerical relationships in earlier regulations, the principal one being a change in the limit on the "excess" benefit of money-purchase pension plans and of deferred profit-sharing plans. This limitation had been  $9\frac{3}{4}$  per cent ( $37\frac{1}{2}$  per cent divided by 4); it will now be 6 per cent (30 per cent divided by 5).

The drop from  $37\frac{1}{2}$  per cent to 30 per cent is consistent with the basic change in the integration limit. The shift from a divisor of 4 to a divisor of 5 reflects an increase in the estimated amount of annual annuity which can be provided by the accumulation of a level annual premium over an employee's career. This change can be justified by assuming a thirty-five-year working career, a  $3\frac{3}{4}$  per cent interest rate, and the 1951 Group Annuity Table, adjusted by Projection Scale C to a current year. In my opinion it is a quite reasonable conclusion.

The proposed ruling offers employers a variety of options for translating the 30 per cent limit into an amount of excess benefit under different types of retirement benefit formulas. I will not attempt today to give you a complete recital of those options, although an appropriate table is included in our written report of this afternoon's session (see Table 1). To illustrate the options and the differences from past regulations, let me cite three:

1. A career-average plan using "step-rate" integration can now provide an excess benefit of 1 per cent of the earnings above the maximum taxable wage. (Formerly this limit had been  $1\frac{1}{4}$  per cent of earnings over \$4,800 or 0.9 per cent of earnings over \$6,600.)
2. A final-pay plan using "step-rate" integration can provide for each year of service an excess benefit of  $\frac{3}{4}$  per cent of the final five-year-average earnings above the amount taken from the thirty-nine-stage table of social security-covered wages. (Formerly the limitation had been  $\frac{5}{8}$  per cent of final earnings above \$4,800, or 0.6 per cent of final earnings above \$6,600.)
3. A plan using the "offset" approach to integration can take credit for 75 per cent of the employee's actual primary insurance amount. (Formerly the maximum offset was 117 per cent of the maximum PIA under the 1958 Social Security Act.)

Our topic asks about the implications of the philosophical and mathematical basis of the proposed ruling. In my opinion the four main implications are the following:

1. The 30 per cent solution is a product of competing political forces, some of which would prefer to eliminate the integration feature of retirement plans. The mathematical formulation is thus primarily an attempt to clothe this result with the respectability of a numerical defense. I say this because there are simpler and more logical ways to establish integration limits, most obviously

TABLE 1

## APPLICATION OF PROPOSED RULING TO VARIOUS TYPES OF PENSION PLANS

PLANS	MAXIMUM FOR SERVICE	
	To 1/1/68	From 1/1/68
<b>1. New plans:*</b>		
a) Unit benefit, career average earnings:		
(i) Either.....	1% over (A)	1% over (A)
(ii) Or.....	1% over \$4,800	1% over (A)
b) Unit benefit, final average earnings:		
(i) Either.....	$\frac{3}{4}$ % over \$4,800	$\frac{3}{4}$ % over (A)
(ii) Or.....	$\frac{3}{4}$ % over (T)	$\frac{3}{4}$ % over (T)
c) Flat percentage of earnings...	30% over (T)	30% over (T)
d) Offset plans (percentage of social security):		
(i) Either.....	83 $\frac{1}{2}$ % 1967 S.S.	83 $\frac{1}{2}$ % 1967 S.S.
(ii) Or.....	75% actual S.S.	75% actual S.S.
	To Amendment†	After Amendment
<b>2. Existing plans:*</b>		
a) Unit benefit, career average earnings:		
(i) Now over \$4,800.....	{ 1 $\frac{1}{4}$ % over \$4,800 1 $\frac{1}{4}$ % over \$4,800 1 $\frac{1}{4}$ % over (A)	{ 1% over \$4,800 1% over (A) 1% over (A)
(ii) Now over \$6,600.....	{ 0.9% over \$6,600 0.9% over \$6,600 1% over (A)	{ 0.9% over \$6,600 1% over (A) 1% over (A)
b) Unit benefit, final average earnings:		
(i) Now over \$4,800.....	{ 0.83% over \$4,800 0.83% over \$4,800 0.83% over (B)	{ $\frac{3}{4}$ % over \$4,800 $\frac{3}{4}$ % over (B) $\frac{3}{4}$ % over (B)
(ii) Now over \$6,600.....	{ 0.60% over \$6,600 0.60% over \$6,600 $\frac{3}{4}$ % over (B)	{ 0.6% over \$6,600 $\frac{3}{4}$ % over (B) $\frac{3}{4}$ % over (B)
c) Flat percentage of earnings:		
(i) Now over \$4,800.....	{ 37 $\frac{1}{2}$ % over \$4,800 37 $\frac{1}{2}$ % over \$4,800 37 $\frac{1}{2}$ % over (T)	{ 30% over \$4,800 30% over (T) 30% over (T)
(ii) Now over \$6,600.....	{ 27% over \$6,600 27% over \$6,600 30% over (T)	{ 27% over \$6,600 30% over (T) 30% over (T)
d) Offset plans (percentage of social security):		
Now 117% 1958 S.S.....	{ 117% 1958 S.S. 117% 1958 S.S. 117% 1958 S.S.	{ 93.6% 1958 S.S. 83.3% 1967 S.S. 75% actual S.S.

NOTE.—(A) = actual wage base under Social Security Act; (T) = actual average annual compensation on which social security benefits are based (per year of birth table); (B) = either (T) or else \$4,800 for service to 1/1/68 and (A) for service after 1/1/68.

\* Noncontributory—no death or other special benefits.

† The limits under c and d must be prorated based upon the ratio of an employee's service before (or after) the date of amendment to his total service.

the approach of comparing total benefits under social security and the private retirement plan. These other solutions, however, all lead to an integration limit of  $37\frac{1}{2}$  per cent or higher.

2. Employers are not likely to favor the thirty-nine-stage table, because it will create significant problems in administering the pension plan and communicating with employees. As a consequence we will see a greater use of final-pay plans with "offset" integration and of career-average plans with "step-rate" integration.

3. The integration limit will move even lower in future years. For example, the late Senator Robert Kennedy introduced legislation that would have increased the maximum PIA to \$383 per month and the maximum taxable wage to \$15,000 per year. These expanded benefits would have been financed to the extent of 35 per cent by general revenue financing. As soon as general revenue financing is introduced into the tax structure of the social security system—and it is clearly implied when a presidential candidate argues for a 50 per cent increase in social security benefits—the third element of the Treasury Department formula, that is, the 50-50 split between employee and employer taxes, can be modified. If, for example, one-third of the taxes come from general revenues, the logic of the proposed ruling would suggest an integration limit of 20 per cent.

4. Finally, the failure to establish any formal communications between the Treasury Department and the Society of Actuaries or one of the other actuarial organizations implies a major weakness in our profession's public relations and in our mechanisms for determining professional standards and for influencing both practitioners and the public to accept those standards.

MR. HARRY D. MORGAN: This discussion is principally concerned with the IRS proposed assumption that the ratio of total OASI benefits with respect to an employee is 150 per cent of the employee's old age (or primary) insurance benefit. Before discussing this item, however, I should like to discuss two other points first.

I would like to suggest that the IRS consider an alternative social security integration rule which would permit an employer to adopt a plan which substantially parallels social security benefits. Such an approach, in fact, avoids the controversy about whether or not the 150 per cent factor is appropriate. In other words, an employer may adopt a plan which for unmarried employees permits an integrated benefit of about 20 per cent of the final average excess earnings (assuming that the 50-50 split of employee and employer social security contributions is appropriate). For married employees the maximum integrated benefit becomes 30 per cent, while the employee and his wife survive together, and his surviving widow would receive  $82\frac{1}{2}$  per cent of his 20 per cent maximum. The other types

of social security ancillary benefits could be made available, or their actuarial values could be translated into other forms of benefits.

I would also like to question the logical or mathematical reason for disregarding contributions paid by the employer under the Social Security Act to cover the cost of Medicare benefits. Although Medicare benefits are not directly paid in the form of cash retirement income, I believe that they in fact do represent a portion of each employee's retirement benefits received under the Social Security Act. Medicare benefits are paid in the form of services rather than cash, and, if these medical services had not been made available, a retired employee would have found it necessary to pay for them (possibly under an insured program) out of his old age social security benefits. I realize that Medicare benefits become payable after age 65 whether or not the employee does in fact retire, but this reason alone does not seem to be sufficient cause for eliminating the cost of Medicare benefits.

In reference to my discussion of the 150 per cent factor, Mrs. Poston indicated that this is substantially supported by a statistical analysis of the actual benefits paid under the social security acts in prior years, that is, total benefits paid in each year were divided by the total of the old age benefits of such year. I question the actuarial validity of this type of statistical analysis for the following reasons:

1. The percentages observed have shown an increasing trend and are already over 150 per cent. If this type of analysis is projected to reflect the present Social Security Act, it is my belief that an even higher percentage factor will result.

2. I believe that these statistical tables include as part of the old age benefits that benefit earned by a wife or a widow based upon her own contributions and may include the supplemental wife's benefit as well. Therefore, her benefit is included in the denominator, thereby improperly lowering the percentage applicable to the employee.

3. It is my impression that a statistical percentage developed for employees earning more than the maximum social security wages will result in a higher percentage than that obtained for all persons covered by social security. This higher percentage should be due to (a) the greater probability that employees at higher earnings levels are married and have dependent children and (b) the lower probability that the wife is working and earning her own old age benefit.

4. An extension of the last analysis concerning employees at higher earnings levels causes me to object to the requirement that the maximum integration rates be proportionately reduced if the plan is integrated at a salary level higher than the maximum social security taxable wage. As an employee's earnings increase, the probability of having a nonworking wife and dependent

children increases materially. Our firm had previously presented evidence supported by actuarial calculations that the ratio of total OASI benefits to an employee's old age benefits equals or exceeds 200 per cent for such higher-paid employees. To illustrate this concept, let us assume that an actuarial and statistical analysis results in a factor of 175 per cent at the \$7,800 salary level and 200 per cent at the \$15,600 salary level. These factors would then result in a 35 per cent integration limit for earnings over \$7,800 and a 20 per cent limit for plans based on earnings over \$15,600. Straight-line interpolation can then be used for other salary levels.

5. Widows' pensions are in many cases deferred until they reach the necessary age for qualification or, if being paid, are based upon the lower benefits of old Social Security Acts. This would cause statistical tables of prior years and old acts to be immature and not reflect the present Social Security Act.

6. The new start compensation base, which considers earnings only from January 1, 1951, has caused a working wife's own old age benefit to be higher in past years, in relation to her husband's old age benefit, than it will be in future years.

In summation, I urge the Internal Revenue Service to develop an appropriate ratio other than the 150 per cent factor, with the use of an actuarial formula which considers various types of prospective benefits rather than relying solely upon past statistical evidence.

MR. DONALD H. REID: Before discussing recent and pending legislation in Canada, I would like to give a rundown of the two major areas where legislation having a direct or indirect effect on private pensions has been introduced over the past few years. With this background the recent and pending changes can be presented briefly and in context.

### 1. *Provincial Pension Benefits Acts*

These acts are designed to regulate private pension plans by requiring them to conform to certain standards:

1. *Vesting standards.*—All benefits accruing after the qualification date must be subject to full vesting for participants terminating after both attaining age 45 and completing ten years of service.

2. *Funding standards.*—All current-service costs (including employee contributions) and payments to amortize initial unfunded liabilities and experience deficiencies within prescribed periods must be paid into the plan each year.

3. *Investment standards.*—For the most part the standards impose quality requirements identical to those for life company assets with certain modifications in the quantity requirements, for example, no limit on percentage which may be held in equities.

4. *Disclosure requirements.*—Requirements here are designed to make sure that (a) participants have enough information to understand the benefits

provided and what *they* must do to receive the benefits and (b) provincial authorities have sufficient information to satisfy themselves that plan provisions conform, that required contributions are being made, and that investment standards are being met.

Two years ago, when Ben Holmes mentioned the initiation of the provincial efforts to regulate private pension plans in this manner, only Ontario, Quebec, and Alberta had enacted legislation of this type with qualification dates of January 1, 1965, for Ontario; January 1, 1966, for Quebec; and January 1, 1967, for Alberta.

The next legislation of this character took place at the federal level in order to apply similar standards to pension plans covering employees in employment subject to federal jurisdiction (transportation, communications, banking, and certain other specified types of employment). The qualification date for this legislation, called the Pension Benefits Standards Act, was October 1, 1967. The most recent legislation in this area was enacted by the province of Saskatchewan, with a qualification date of January 1, 1969. While most other provinces are expected to introduce similar legislation, I do not have any information on the most likely timing of their qualification dates.

Happily, there has been a high degree of co-operation between the provinces with the result that the emerging legislation has been almost identical from province to province except for the qualification dates. In addition, reciprocal agreements have been made between the provinces, and between the provinces and the federal government, to avoid multiple registration of plans.

Provincial Benefits Act requirements are now an integral part of the Canadian private pension scene, covering perhaps 80-85 per cent of registered pension plan participants. While these requirements may cause inconvenience from time to time, it would, on the basis of the past three years' experience, be hard to make the case that their existence is overburdening private pension administrators.

## 2. *Government Pensions*

Until 1966 the federal government had only one vehicle for providing pensions to Canadians—the Old Age Security Act. Under its terms flat-amount pensions had been paid to Canadians aged seventy and over without a means test since 1952.

On January 1, 1966, contributory wage-related schemes were added, with the Canada Pension Plan covering nine provinces and a separate but identical plan for Quebec. These plans provide the retirement pension, the disability pension, the flat-amount death benefits, the widow's pen-



sion, the disabled widower's pension, the orphan's pension, and the disabled contributor's child's pension.

Under the Canada/Quebec Pension Plan, ultimate retirement benefits after a ten-year phasing-in period will be roughly 25 per cent of final three-year-average pensionable earnings, and, with maximum pensionable earnings set initially at \$5,000, maximum emerging benefits will be of the order of \$1,250 annually. But such benefits are bound to increase, because benefits in the course of payment are geared to movements in the CPI with maximum increases of 2 per cent per annum. The maximum pensionable earnings figure is also geared to CPI changes for the first ten years, after which time it will be geared to movements in average wages.

This indexing has already caused the maximum pensionable earnings figure to move from \$5,000, where it was pegged for 1966 and 1967, to \$5,100 in 1968 and to \$5,200 in 1969.

The same indexing principle was also introduced in relation to old age security benefits, thus moving the \$75 monthly pension payable in 1966 and 1967 to \$76.50 in 1968 and to \$78 in 1969.

With combined ultimate benefits at the level reaching \$180 monthly and with financing shared equally between employees and employers, the implications were quite clear. Integration of both contributions and benefits was an economic necessity. For the most part, this process was completed in 1966, but our experience is that many employers are taking second looks at their integration methods today.

Here is an interesting note in contrast to what we have heard this afternoon—the *only* integration rule laid down by either level of government was the provincial requirement that accrued benefits under existing formulas must be preserved in the integration process.

To date, the only changes since 1966 in either of the government plans have been those resulting from indexing and political pressure, for change has to date been almost nonexistent. We can only hope that the politicians will maintain their hands-off attitude.

### 3. *Income Tax Act*

Apart from the two areas just discussed, in which major legislation has been effected in the last few years, the only significant area remaining is the Income Tax Act itself.

While the provisions of the Act affecting pensions have not been changed significantly of late, we were, on October 1, 1968, blessed with a new set of department rules for the registration of pension plans. We understand that these rules have been introduced to eliminate abuses of the tax-deductibility privileges afforded registered plans. Such abuses

occurred primarily in "top-hat" plans, where discrimination as to both coverage and benefits has been common but in the past acceptable to the Department of National Revenue. The rules of October 1 attempt to restrict abuses by denying "registration" to plans which are "primarily for the benefit of shareholders and members of their families." No definition of "primarily" has yet been given.

I understand that this feature of the new rules has been one of the primary concerns of the insurance industry because of the great number of "top-hat" plans that they already have registered and have in the registration process. Perhaps an insurance company spokesman here today could give us further background in this area during the discussion period, because I understand that a CLIOA delegation journeyed to Ottawa last Thursday on that subject.

Of greater concern to the consulting fraternity are the design limitations incorporated with regard to widows' pensions and disability pensions. Here benefits beyond the levels of accrued pension benefits may deny a plan-registered status. Since these new rules will apply to existing plans whenever amendments are submitted for registration, I anticipate that the design limitations will generate strong reactions from employers who now have more liberal plans.

There will also be reaction from the trust companies, which can be expected to resist the requirements that all trustees' statements be rendered on a calendar-year basis and the requirement that widows' pensions and disability benefits above accrued pension levels be funded on an insured basis.

The only remaining developments in the income tax area which might affect pensions are the following:

1. Finance Minister Benson's proposed January 1, 1969, basis for significantly increasing the income tax burden of life insurance companies from the present \$3 million level to almost \$100 million. This could affect the competitive position of insurance companies in the pension market and may also tend to create a shift in the types of contracts used to underwrite pension business.

2. The proposed general reform of the income tax laws, which is to be incorporated in a draft bill early in 1969. Hopefully, Carter Commission concepts, such as the \$12,000 annual maximum on pensions, will not find their way into this draft.

**CHAIRMAN ATTWOOD:** Laurence Coward presented an excellent paper to the NAM's Employee Benefits Committee meeting earlier this month. He discussed Canadian pension legislation and its parallels for the United States. I draw your attention particularly to the following thoughtful comment.

Most important of all, I should have thought that the business community would regard a strong private pension system as the best defense against yet further intrusions by government in the field of social planning. Improvements in vesting and solvency would greatly strengthen the pension rights and confer real benefits on millions in the labour force. These social gains are particularly attractive because they are not accompanied by the usual penalty. Unlike nearly all other measures of social betterment this would not add a penny to the taxes. It seems that the consequences of opposing this type of legislation may well be more, rather than less, government action and bureaucracy in the field of pensions. The logic of support from employers in industry and commerce is clear, at least to me. It would also benefit the public posture of modern business, at a time when it is all too often criticized for resisting social measures.