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EMPLOYEE COMPENSATION AND BENEFIT PLANNING

Moderator: JOHN A. MacDOUGALL, JR. Panelists: DENIS R. J. GEORGE, WILLIAM H. SHARKEY, JR., JOSEPH R. ZATTO

1. General considerations in planning compensation:
   a. The group vs. the individual;
   b. The executive vs. the average employee;
   c. The relative weights given to security, reward and competition.
2. The role of government in compensation and benefit planning:
   a. Social Security benefits, integration - adopt or pay a price?
   b. Tax considerations - individual and corporate;
   c. Sheltering compensation for the achieving executive;
   d. Government practices - the penalty being realized by loading compensation into deferred retirement benefits.
3. The relationship between immediate and deferred compensation:
   a. Immediate compensation and its forms;
   b. Deferred compensation, qualified or unqualified?
4. Estimating the cost of the compensation program.

MR. JOHN A. MACDOUGALL, JR: To clarify the title, I would point out that employee benefit planning means employee compensation planning. It is our contention that benefits are part of the total compensation package. Seventy-five years ago, the actuary might have viewed compensation as an immediate temporary annuity which expires upon departure from the labor force. The most complicated aspect of measuring its value was the increase from year to year. Because of tax implications and the social policy of government, which are clearly interrelated, the compensation package has become a very complicated annuity over the past 75 years. Today we are talking not about a temporary annuity, we are talking about a lifetime annuity. We are talking about an annuity which has many variables. Nevertheless, from the viewpoint of an actuary, it still has that present value. We are talking about the present value of this compensation to the employer and we are talking about the incidence or the cash flow of this compensation.

MR. DENIS R.J. GEORGE: If anyone were to ask a pension actuary to give a comprehensive summary of all the factors that have to be taken into account in designing and valuing a pension plan, I am sure that he would need more

than 15 minutes. If we now consider total compensation and all its component parts, it is obvious that in the time allotted to me I cannot do more than touch lightly on many things. Questions will be raised -- but answers will not always be given.

Pension and group insurance plans have for many years provided actuaries, whether they are employed as consultants or by insurance companies, with much work and considerable income. They will probably continue to do so for many years to come. However, there is a great danger that both the actuaries and their clients will continue to believe that the work of the profession is required only in these relatively narrow areas, and that our expertise has no application to the wider fields of total compensation and corporate financial planning.

One very simple observation -- a pension or benefit plan expressed as a percentage of employee salaries can be skillfully designed, but its objectives will probably not be reached if the underlying salary structure is inequitable or out of date. To put it very simply, therefore, can the actuary participate effectively in the designing and costing of a benefit plan if he is confined to that plan in isolation? Can a tailor make a perfectly fitted suit or dress if he never sees or touches the body which will wear it?

It is not the fault of most actuaries that they have not been called upon to look at the total picture of an employee's compensation, because it is a very recent development for employers to look at the total picture. Corporations have tended to keep personnel matters, salaries, bonuses, fringe benefits, vacations, etc. in different watertight compartments. The increase in fringe benefit costs to 30% to 40% of salaries has, however, forced employers to look at the total compensation of employees to ensure that a proper weight is given to each of the elements, and that there is no wastage of resources. It is also the responsibility of the actuary to seek out opportunities of advising in the total field, rather than awaiting a call -- which may never come.

In Canada, added emphasis has been given to the concept of total compensation by the current anti-inflation regulations, which compel an employer to add together all elements of compensation in determining allowable compensation increases. An improvement in the pension plan will mean a reduction in a wage or salary increase. Consultants and employers are being forced to look at the various elements of compensation.

Who is better qualified than the experienced actuary to advise in these fields? Who else is able to relate short and long term costs to short and long term liabilities?

In many organizations, compensation programs are a mare's nest of patches and add-ons, with the result that many of the compensation elements overlap, or there are glaring gaps and inequities. For example, it is not uncommon to find death benefits coming from five or six sources (including government plans) each introduced into the compensation program at a different time.

Where do we start in looking at total compensation? For example, we hear that "money is not a motivator; job satisfaction is more important than compensation". After many years in the compensation field, with a wide exposure to the whole spectrum of employee groups, I cannot think of any individual -- except one or two who have been independently wealthy -- who was not keenly interested in the adequacy of his salary and the way the rest of his compensation was handled. However, there is no doubt also that the organizational climate has a bearing on the way in which an employee perceives his compensation.

What is the organizational climate? What should the corporation's compensation philosophy be in relation to this climate? What specific compensation programs should be developed to fulfill the objectives? All of these questions have to be answered before any detailed work can commence on specific benefit design.

Other than a few perquisites such as a well furnished office, dining room, etc., there are relatively few rewards from our compensation package that we enjoy while at work. But there are other rewards in the work place, and it is at our peril if we do not make a conscious effort to recognize them. If we do not, we will not be able to attract, retain and motivate employees. If the organizational climate does not provide an employee with a sense or feeling that he is making a meaningful contribution, that he receives recognition (and not necessarily monetary recognition), that he has reasonable freedom to innovate and be creative, that there is opportunity for personal growth as well as promotions, the chances are that the employee, irrespective of cash compensation, will leave. Organizational climate is, therefore, an integral part of total compensation and the compensation climate. Conversely, management's approach to the design of a compensation package is probably a reflection of the organizational climate.

I should perhaps emphasize at this point that I am not saying that the actuary should become an expert in behavioral science and provide the consulting service to the corporation. I am saying that he should be an important factor in a multi-disciplined team of advisors. I have found from my own experience of working on a team which included an industrial psychologist that I could have some influence on his thinking. I could bring him down to earth occasionally by indicating some of the cost impacts of his suggestions.

Within the context of a company's organizational climate, a compensation philosophy must be developed. Some of the questions which might be asked in the development of a compensation philosophy include the following.

Should employees' opinions be sought on the design of the various compensation components? A benefit plan designed in the ivory tower of the consultant's or management's office will probably guarantee its failure.

What are the employee's views and perceptions of the present program? If you do not know what is right and what is wrong about the present program, how can you design a new one?

Should the differing needs and priorities of the various age groups be reorganized? Should we compel a young single to contribute to life insurance of three times salary?

Should the compensation programs be the same for all groups of employees, or should they be designed to recognize the needs of the hierarchical organizational arrangements? The actuary's input on the short and long term financial implications of different types of programs should be very valuable.

Should the program provide alternatives with flexibility and choice? This gives the actuary an excellent opportunity to be innovative to solve any underwriting problems arising out of a mixed bag of benefits with different anti-selection implications.

Should the organization be a leader or run with the pack? To answer this realistically, knowledge of the value of total compensation packages is essential. One organization may have much better fringe benefits than another, but its salaries may be below average. It is unrealistic to comment on the monetary value of a benefit plan in isolation from other forms of compensation. Similarly, it is foolish to compare salaries only with other organizations.

Should the design of the programs integrate or stack with government programs? Joe Zatto will be answering this later in the session.

Should the thrust of the total program be to provide rewards on the basis of performance, or position only, or should it also recognize length of service? Older ages and length of service do not always go hand in hand any more. How does this affect costs and the attitude of long service employees to the granting of "instant" benefits to new employees immediately on hiring?

Having set the parameters of the organization's compensation philosophy, it is now essential to translate these into practical, achievable and meaningful goals in the form of compensation objectives and programs.

In considering these programs, it is convenient to examine compensation under four headings. There are many other ways, but we have found this format very useful.

1. Base Salary
2. Incentive Compensation
3. Protective Compensation
4. Perquisites

I do not intend to spend any time on "Base Salary" today, other than to say that the actuary should at least be conversant with the organization's objectives, the salary administration system which is used, and where the salary levels rank in the market place. As I mentioned earlier, salary is often the base for bonus, pension, life insurance, disability benefits, etc. It is also important to know whether the organization believes that base salary should represent, say, 60% of total compensation, or whether it should be nearer 80%.

By "Incentive Compensation" I mean money granted to individual employees, or groups of employees, relative to performance. Performance could mean performance of the total organization, or of groups, or of individuals, and by money I mean cash or equivalents taken in the form of deferred compensation, stock related plans, etc. These deferred compensation plans have often been developed with or without the help of actuaries -- in isolation from the other compensation elements. Apart from the fact that our

research has shown us that the needs of recipients vary greatly, these plans are often introduced without recognition of the impact on a person's estate or the long term tax considerations. The actuary can play a large role in designing these types of plans, placing a value on them, and advising as to the tax implications for the organization and the individual. Forecasts of the long term costs of such plans are often valuable, and are very frequently overlooked.

By "Protective Compensation" I mean the programs that provide employees and their dependents with essential economic security in the event of illness, disability, death or retirement. I do not need to dwell on the actuary's role in the design and evaluation of these programs. These have been our bread and butter, but their development in a total compensation framework may change some of our predetermined concepts as to design. Chip Sharkey will be commenting on this.

By "Perquisites" I mean such elements of indirect compensation as:

1. automobiles, club memberships, etc., which can be considered job related,
2. annual medicals, recreational facilities, etc., which can be considered health related,
3. employment contracts, etc., which can be considered as security related,
4. subsidized courses and educational assistance which can be considered as job training related,
5. financial and estate planning services, subsidized meals, specialized vacation policies, company owned homes or apartments, which can be considered personal related.

Perquisites are generally related to the status needs of the employees, and are obviously more generous at the top end of an organization. Once again, the actuary can advise on the short and long term costs of these benefits, and how they dovetail into the short and long term costs of the other forms of compensation.

It is at this point that I want to emphasize dynamic cost estimation. Workshops later in the morning will be dealing with dynamic pension plan models, but this, again, is only one part of the picture. We have found that some of the more forward thinking employers are anxious to measure trends in the costs of all forms of compensation. In fact, they are even more interested in what the staff will look like ten years from now if they maintain or change their hiring and firing policies. Will the age/sex distribution be greatly changed? Will this affect the costs of any of the benefit programs? Dynamic population flow models have, in a number of cases, been the answer. We can use the "What if?" approach and measure the range of costs of all or particular aspects of compensation under varying economic and other assumptions. Heretical as it may seem, because corporate management is really more interested in the short rather than the long term (a problem which may arise 15 years from now is one that their successors can look after) dynamic short term compensation flow programs are probably of more interest than long term pension forecasts.

Having identified what we want each of these four major components of compensation to achieve, we can help select those elements under each of the headings which most closely meet the corporation's compensation philosophy and objectives including cost. Under this approach, we can examine gaps and overlaps in the total compensation program; it allows proper integration with government programs, it permits examination of the effect of taxes on the various elements, it ensures that the proper weight is given to each of the components, that is, a proper balance is achieved, and, very importantly, that costs will fall, both today and tomorrow, within the organization's budget.

This has, perforce, had to be a very cursory overview of the actuary's role in total compensation. I hope that, at least, you will be able to see that modern trends in corporate planning are leading us to a position where we cannot be known only as the "fringe benefit" specialists.

MR. JOSEPH R. ZATTO: In considering the role of the government in benefit planning and compensation, we have to keep in mind the things that the government giveth and the things that the government taketh away.

By things that the government giveth, I am referring to benefits that are provided to employees and/or their families through Federal and state programs. Of course, when the government giveth a benefit to one party, it means that some other party is paying for it.

By things that the government taketh away, I am referring to government limitations on benefits from corporate sponsored programs, or limitations on the dollars that the corporations can put into programs, or the emphasis or de-emphasis that the government can put on various benefits through changes in the tax structure, and of course, the taxes themselves.

The largest single consideration of the government's role in employee benefits is the Social Security and Medicare program, primarily with regard to retirement income but also as it affects disability benefits, survivors benefits, and medical benefits. Denis George mentioned earlier that pension and group insurance plans have provided our profession with much work and considerable income over the past years and will probably continue to do so in the future. This is particularly true in the pension area because of the magnitude of the benefits and the expenses involved and also because of the likelihood of continuing change in this field. A recent study by the U.S. Chamber of Commerce showed that a pension plan is the average employer's second most expensive benefit. The employer's most expensive benefit is the Social Security payroll tax. Indeed, the Social Security program has reached the point where it is the largest single expenditure in the national budget.

It is likely that you are all familiar with the problems in our current Social Security program, both the short range problem with regard to financing and the long range problems with regard to financing and benefits. I will not go into the details of the Social Security program, but one major item to be covered is the integration of private benefit plans with Social Security. The outline of this subject on our program today is "Social Security benefits, integration - adopt or pay a price."

If employee benefits are not integrated with Social Security, the result is that the benefits are stacked one on another. The result may be plans

that are easy to understand and to communicate, but the benefits that emerge can be excessive, costly, and lacking in some areas because of the unnecessary high cost paid in other areas. There are three major benefit areas affected by Social Security integration. These are retirement, disability and survivors' benefits. Of these three, the retirement benefits are the most troublesome, although survivors' benefits may take on increasing importance in future years. Most pension actuaries strongly believe that a pension plan should be integrated with Social Security. This is particularly true with the type of Social Security program we now have in effect. Over the past years, and most particularly since 1972 when drastic changes were made in the Social Security program, it has been providing retirement pensions that have been replacing an increasing percentage of the employee's covered earnings, particularly at the lower and middle pay ranges. For example, an employee retiring today with a final pay of $850 a month is likely to receive a primary Social Security pension of about $376 or 44% of his final pay. If we look backward to 1965, allowing pay to have increased at 4% a year, this same employee would then have had a final pay of $530 and a Social Security pension of $132 a month, or 25% of his final pay. Thus, in the twelve years from 1965 to 1977, Social Security has jumped from providing 25% of final pay for this employee to 44% of final pay. The current Social Security formula, unless it is corrected, is likely to result in a continuing increase in the replacement of final pay. The Social Security program must be corrected, but it will take time, and even after any correction, it is possible that the replacement of final pay will still continue to drift upwards, particularly at the low and moderate pay ranges. Under these conditions, if the government plan is not taken into account, the result would likely be a combination of retirement income from the private plan and Social Security that proves to be excessive for employees at many pay levels. Money that is contributed to a program that provides excessive benefits could certainly more wisely be used to provide better balanced benefits at all pay levels or, alternatively, used to provide other types of benefits.

Although the potential for excessive benefits in non-integrated private pension plans is no secret, many corporate officers and some pension consultants are surprised to find that the problem already exists today, with some employees retiring with close to or more than their final take-home pay. This is particularly true in negotiated pattern-type plans. For example, the 1975 Bankers Trust Study of Corporate Pension Plans showed that the median pension credit in a negotiated pattern pension plan was $9 per month per year of service, based on a survey of 53 such plans. It is likely that the median pension credit is higher than $9 per month today.

If we use $10 per month pension credit as a current median, calculations for a 35 year service employee with final pay of $850 per month (a modest pay, but not unusually low in many industries) would show the following:

	1977
Final Pay	$850
Final Take-Home Pay	$765 (est.)
Private Plan Pension	$350 (46%)
Primary Social Security	$375 (49%)
Total	$725 (95%)
If Married - Spouse Social Security	$187 (24%)
	$912 (119%)

The Social Security pension is tax free and fully indexed for cost of living after retirement. It is likely that standard deductions would cause no tax to be paid on the private pension either. The result for this married couple would be an increased standard of living after retirement.

By comparison the same type of employee in 1965 would not fare as well:

	1965	
Final Pay	$530	
Final Take-Home Pay	$475 (say)	
Private Pension	$ 98*	(21%)
Primary Social Security	$132**	(28%)
Total	$230	(49%)
If Married - Spouse Social Security	$ 65	(14%)
	$295	(63%)

* $2.80 Pension Credit
** 1965 Median

Thus, this comparison of a select example, but not an extreme example, shows a current retirement income of 95% to 119% of final take-home pay, while a similar comparison in 1965 would be a replacement of 49% to 63%.

As a more general example, statistics we developed for one major client recently showed that out of 1400 employees scheduled to retire in the next five years, 600 would receive pensions that, together with primary Social Security benefits, would be greater than 90% of their final take-home pay.

These facts cannot be overlooked in designing a pension plan. Because of results like this, some plans have been negotiated in the past three or four years to place a cap on the amount of benefits that will be provided in total. Under this type plan, the negotiated benefit is a typical dollar per month arrangement but there is an overriding maximum that provides that the pension from the plan plus 100% of the primary Social Security will not exceed a predetermined percentage of final average gross pay. In effect, this cap is a 100% Social Security offset plan. The steelworkers negotiated such a plan in 1974, and within the past two months the glass industry has also negotiated this type of plan, both using a 100% Social Security offset.

Despite this trend, I am experiencing an increase in the number of employers, usually on the personnel side rather than the financial side, who are frustrated with the integration feature of their pension plan and are suggesting that the integration be frozen or eliminated from the plan. Their frustration is due to the sometimes vocal employee dissatisfaction with integrated plans, particularly offset plans. There is no question but that a plan integrated with Social Security through the offset method often results in employee dissatisfaction.

From a benefit design and a cost point of view, the offset method is the best method for integrating with Social Security since it reflects not only changes in the Social Security wage base but changes in the Social Security pension due to cost of living adjustments. However, the offset plan also highlights the integration by typically describing the private pension as "50% of final average pay offset by 50% of primary Social Security."

I often compare an offset pension plan with a typical LTD plan where the benefit is described in total, such as "60% of final pay including Social Security and Workmen's Compensation benefits." There is a positive ring to the LTD plan description. Why are offset pension plans not described in the same positive terms? Mainly because the IRS regulations which limit the amount of Social Security offset to a maximum of 83-1/3% and a typical benefit design which limits the amount of Social Security offset to 50%. It is less than satisfying to describe a pension plan benefit as "50% of final pay including one-half of your primary Social Security pension."

In the final analysis, an employee is mainly concerned with how much total income he will have to live on after retirement, just as he is concerned with how much income he will have to live on if he should become disabled. He should not be overly concerned with how much of the income comes from Social Security and how much comes from the private pension. Yet the integration regulations force an employer to establish a plan that accentuates this distinction.

It would open up wide new areas of benefit design if the IRS regulations that limit the amount of integration with Social Security were redesigned to allow a 100% offset, just as LTD plans are able to do. The Social Security regulations are currently being reviewed and I wonder what the results will be. At the Enrolled Actuaries meeting two months ago, the chairman of the committee reviewing the integration regulations stated that they were considering changes that ranged from allowing 100% integration at one extreme to one that allowed no integration at all at the other extreme. If unrestricted Social Security integration were allowed, such as a 100% offset plan, it would provide benefit design challenges as well as opportunities. Consideration would have to be given to the replacement ratio of the total retirement income, and just how this should vary by pay range. A 100% offset plan based on a flat 60% of pay at all pay ranges would not be doing a very good job for the lower paid employee. Alternatively, a 100% offset plan based on a flat 80% of pay might do a good job for the lower paid employee, but it would be unnecessarily high for the executive. A percentage graded by pay level would probably be required, reflecting the fact that a greater replacement is needed at low pay levels than is needed at high pay levels. This type of plan would be attractive, easy to communicate, and well accepted by employees. Furthermore, this type of plan can have cost control features that are better than a typical pension plan.

In looking ahead, I wonder whether the area of widows and orphans benefits is not another benefit in which Social Security integration will become more important. To date, most pre-retirement death benefits are typically provided through group life insurance with or without income type payments available. Will the mandatory introduction of death benefits into retirement plans eventually lead to pressures for free and expanded death benefits in these plans? If so, will this turn the focus on income benefits rather than lump sum payments? The pre-retirement survivors' benefits under Social Security are substantial. Using an $850 per month employee again as an example, upon his death at age 40, Social Security would provide income benefits to his widow with one child of over $600 per month. This is equivalent to 70% of final pay; with two children the benefit would increase to 85% of final pay. The benefits are only paid until the child reaches age 18, but while they are paid they are very substantial. Will we some day be designing widows and orphans benefits that are built around the

Social Security benefits? If we are, will the typical lump-sum group insurance program related to a multiple of pay disappear? Perhaps we will see a cafeteria approach here that allows employees to pick and choose.

Most of the preceding comments relate to benefit design for large groups of employees and the relative role of government-provided benefits for these employees. The government also plays an important role in the type and level of benefits that can be made available to the higher-paid executive. Unfortunately, in discussing this question with our estate planning experts, I am told that the regulations are closing more and more of the incentives that were available to corporations to reward the executives.

One area of government regulation affecting the design of employee benefit plans is the maximum limitation on benefits established by ERISA. These limitations are easily overcome through the use of excess benefit plans. In some cases, the establishment of an excess benefit plan may provide the impetus for the establishment of non-qualified deferred compensation arrangements for other key employees as well. The tax treatment of deferred compensation has been improved and it is now subject to the 50% maximum tax. This appears to be opening new opportunities to reward key employees through non-qualified deferred compensation arrangements, and Chip Sharkey will be addressing this area next.

The 1976 Tax Reform also made major changes in the estate taxation of death benefits from qualified plans. Generally the death benefit payment from a qualified plan used to be excluded from the participant's estate if it was paid to someone other than his estate. Now it is not exempt from estate tax unless it is paid out as an annuity over two or more tax years. However, if it is paid out as an annuity, it then loses preferential tax treatment. One method may be best for one employee and the other best for another employee. The end result is that the change in the law should cause a careful review and perhaps a change in qualified benefit plan provisions as they relate to payments of death benefits, to allow the most favorable method to be chosen without automatic constructive receipt on the part of the beneficiary.

On further consideration is a view from the other side of the fence. Specifically, how the government handles employee benefits for its own employees. Municipal governments probably provide the clearest example of the problems that will eventually arise when the total compensation package is designed by loading compensation into deferred retirement benefits in lieu of current pay. In past years, the standard government practice was to stress the security and plush fringe benefits available to employees. These factors were intended to make up for the fact that pay levels were generally lower than those available in the private sector. However, in the past ten years the picture has changed. The pressures of inflation, of public employee unions, and other factors have caused many municipal government payrolls to increase to the point where they are not far from the pay available in the private sector. In fact, a 1976 Bureau of Labor Statistics survey of 24 major cities showed that clerical workers were making more pay in city government than similar workers in private industry. Salaries at other job levels were not as high as private industry, but they were close, much closer than was the case ten years ago. At the same time that the salaries had improved, the plush fringe benefits in many cities continued to improve. The combination of these factors together, in some cases, with weak funding policies in the past, has resulted in fringe benefit costs and particularly retirement costs that are becoming a source of alarm in many cities. It

is not necessary to belabor the point; it is obvious that some municipalities are now beginning to feel the pinch caused by plush retirement programs in the past. The actuary can play a key role in helping other cities to avoid the same problems in the future. However the pressures, obstacles and different interests found in dealing with municipalities are often much different than anything encountered in dealing with corporate or union benefit programs.

I hope that this review of the government's role in benefit planning is helpful. I have devoted much time to the question of integrating pension benefits with Social Security because, in considering the government's role, that subject as it exists today and as it may be changed in the near future is a vitally important one.

MR. WILLIAM H. SHARKEY, JR.: I am sure that many of you have been approached by an employer who wished to modify his employee benefits package to redistribute benefits in favor of one group of his employees. Generally these requests result from the client's reexamination of his compensation objectives due to employee pressure or a change in the compensation environment in his industry or locale. Obviously the employer is concerned that additional costs are minimal, so that what may originate as an objective to increase benefits for one group of employees usually means some decrease in the value of benefits for the others. The very nature of and regulatory constraints on protective compensation, as Denis has categorized it, makes response to these requests a difficult task.

To illustrate the situation, consider the employer who approaches his actuary with a request to alter his pension plan to increase benefit accruals for older and shorter service employees. Upon closer inquiry the actuary discovers that the employer's underlying objective is to attract highly skilled, experienced, and proven senior managers to his firm. As this represents a change in his hiring strategies, it has generated new objectives for his compensation program. The actuary is approached to satisfy these new objectives through one part of his compensation package -- the protective compensation element.

As actuaries, our clients' expectations of us generally center around service and design of their protective compensation. This is the area of our traditional expertise. As a result, the requests we receive are often phrased in terms of employee benefits and the objectives are those that the employer has determined can be satisfied through protective compensation. These objectives then are only a subset of his overall compensation objectives and they have been translated from their original form to the terms of employee benefits. We hope that our response always satisfies the request, but we are dependent upon the translation of the underlying objectives by the employer or his benefits consultant.

As an actuary in an insurance company we are often one further step removed from the employer's basic compensation objectives when a change or addition to his group insurance benefits is put out for bids. Our only clue to the objectives is contained in the specifications. Even if we are clever enough to decipher these objectives from the specifications, they are only marginal to the employer's overall compensation philosophy. Generally, we will develop what we believe to be improvements in the design in addition to bidding upon the specifications presented; but we are operating on less than perfect information. As a result, the client receives far less professional

service than he might if his objectives were put out for bids of both design and cost. The role of his consulting actuary would then be expanded to evaluate alternative design proposals and the final result would benefit from the creativity of a greater professional effort.

Denis has outlined for us a very useful categorization of the elements of an employer's overall compensation package. Certainly, many employers have approached their compensation program in these terms for many years, but rarely have actuaries been sought out to deal with the design of elements other than protective compensation, except perhaps in their own firms or companies. We are in a very good position to service other elements of the package. It is very likely that the service we render vis-a-vis the protective compensation elements would be improved in the process.

An employer's basic compensation philosophy is usually expressed in general terms applying to the employee group as a whole. The objectives of the compensation program reflect the expectations of his labor force, which includes his current and potential employees. However, various groups within his labor force have vastly different compensation expectations. Professionals such as attorneys, accountants, actuaries, and product managers have different preferences for current versus deferred compensation than senior executives. Clerks and administrative assistants have different expectations of perquisites than salesmen. Therefore, either explicitly or implicitly, the employer has identified one group or a combination of groups which the objectives of his compensation program are aimed to satisfy while not totally ignoring the expectations of the other groups.

The basic salary system can usually be designed with adequate flexibility to accommodate the expectations of different segments of the employer's labor force. Most of these systems have been developed to insure equity among various groups through the assignment of certain responsibility levels of which the salaries are a function. The responsibility levels to which a group is assigned usually reflect the expectations of that group in the marketplace. The overall level of compensation is a function of the need to attract talent while limiting the cost to the enterprise so that its products can be competitively priced.

To the extent that protective compensation is based upon salary, it will provide a parallel differentiation among the different groups of employees. However, it generally cannot provide for vastly different proportional splits between current and deferred compensation. To accommodate these expectations, incentive compensation and varying perquisites are often introduced.

Too often the requests we receive result from compensation objectives whose best solution is not in the area of protective compensation. Protective compensation (especially pension plans, profit sharing plans, retired life insurance plans, and the like) appears to be an attractive vehicle through which new or altered compensation objectives can be achieved because of its dollar cost efficiency. Certainly, more mileage is obtained from each dollar spent due to the more favorable tax treatment on later distributions to employees or their heirs. This efficiency is most dramatic for those whose current income is highest. As a result, employers are inclined to look to these vehicles when they seek to improve their overall compensation package for key people in the organization. However, the rules for qualification by the IRS have been designed to purposefully limit the flexibility

an employer has to satisfy the expectations of these subsets of the employees through such plans. Even with the favorable tax treatment these monies receive, the overall cost can be greater as benefits are extended to the entire employee group.

In the illustration I began earlier, the actuary has been left with a request that requires a fair amount of ingenuity. The employer's objective to improve the attractiveness of his compensation program to older, proven managers has been translated to a request for greater pension benefits for older, short service employees. The expression of his request has attempted to solve part of the problem through the decision that the protective elements of his compensation program are the appropriate vehicle. The employer has very real cost constraints and has determined for himself that the greatest benefits can be obtained through an alteration of his pension plan.

Such a narrow study of marginal objectives of a client's compensation program can result in the subversion of the objective of other elements of the total compensation scheme. The actuaries faced with our illustrative request cleverly found that they could modify the benefit formula in the pension plan without increasing total costs beyond the employer's constraints. They modified what had been a straightforward career average benefit formula through the introduction of a minimum retirement benefit. The minimum was expressed in terms of final pay less income provided by accumulations in the profit sharing plan. Unfortunately only afterwards was it realized, following a year of painfully small profits, that valuation losses of the pension plan effectively led to a guaranteed "profit sharing" distribution.

In a similar situation of another employer's desire to more adequately provide for his key managerial personnel, the actuaries found it impossible to find a solution within the context of the employer's pension plan at an acceptable cost. They found that the use of various forms of incentive compensation and protective compensation that are not qualified for special tax treatment were actually less costly. They recommended that these top managers be provided with individual life insurance in conjunction with the estate planning services of agents of a reputable insurance company and bonus compensation to cover the personal taxes incurred.

Quite often incentive compensation can be of greater benefit in situations like these where the objectives are aimed at the expectations of a few key people in the organization. Certainly, the maximum limits on individual pensions legislated in 1974 may make it the only vehicle in some cases. Beyong preserving the objectives of the pension plan and other elements of protective compensation to satisfy the expectations of the main body of employees, incentive compensation represents a more flexible and less permanent commitment on the part of the employer. As actuaries, we are rarely asked for advice on incentive compensation schemes; through our recommendations in response to requests such as those I have discussed, we have a very real opportunity to demonstrate our usefulness in this area.

Viewing the compensation package in total, as an integrated combination of its elements, better allows changed or new objectives to be properly placed within the overall scheme. Expansion of our professional service to include the design of the total package will insure that we do not complicate our clients' situation through what appears to be a very fine solution to what turned out to be only part of the problem.

MR. ALLAN C. WEAVER: When one is valuing a pension plan with a cap, is there a danger of running large losses if Social Security does not increase?

MR. ZATTO: This all depends on how you project Social Security. In our valuation procedures, we try to be conservative in our projection of Social Security and use a combination of wage base and cost of living assumptions that result in a constant replacement ratio or a declining replacement ratio as compared to the projected pay. It is anticipated that, if anything, actual experience will produce gains in this area.

If you valued a pension plan with a cap on it and projected Social Security in a manner that allowed for increasing replacement ratios, you would increase the chance that you may have experience losses in the future. However, I am unaware of anybody who does it that way and we would not recommend that a plan be valued in that manner.

MR. WEAVER: Does the panel feel that there will be a trend toward later retirement ages, especially in union plans?

MR GEORGE: In Canada, we are experiencing a reversal of a trend towards earlier retirement. This is due primarily to the high rates of increase in the cost of living which makes it more difficult for employees to retire on pension, unless the pension is indexed to cost of living increases. In Canada, very few private plans are so indexed, and these have upper limits built into the increases, so that until inflation is reduced to lower limits than at present, we will see some trend towards later retirement ages.

MR. MACDOUGALL: Management in general wants jobs available for the rising group, despite any other problems; this tends to enforce the compulsory retirement feature. This is under attack in the courts but nevertheless, compulsory retirement continues to fill a management need. Over the future years, the demographic characteristics of the population are such that the labor force will become a smaller percent of the population. Under those conditions retirement may be deferred, and then to fill a need, not just to satisfy the shortcomings of a pension plan.

MR. PAUL F. DELLA PENNA: Are there any differences in the tax treatment of deferred compensation in the U.S. and Canada?

MR. GEORGE: I am not completely familiar with the specifics of the tax treatment of deferred compensation in the United States, but I believe that the principles are similar to those in Canada.

In Canada, a deferred compensation benefit will not attract tax to the employee while he is waiting if he does not "constructively receive" any benefit until he actually retires. This means that the deferred compensation agreement must contain certain contingencies such that the employee is faced with the possibility of losing all his benefits; an obvious example is that any employee can forfeit his benefit if he is dismissed for fraud or misconduct. Another provision is that the employee must be available for consultation to the employer after retirement.

If the deferred compensation agreement is drawn up properly, the employee will pay tax only when he commences to receive the benefit; the employer gets no tax write-off during the period of deferral, but he can treat the payment to the employee after retirement as a business expense.

MR. MACDOUGALL: Could you comment on the use of profit sharing plans as incentive compensation?

MR. SHARKEY: The names "Incentive Plan" or "Profit Sharing Plan" are used by different companies to describe what are essentially the same types of qualified plans. These plans generally make distributions to employees proportional to their salaries and the total amount distributed each year varies with the earnings results of the company as a whole.

As a direct incentive toward better performance, these plans do not function very well under either name. Differentiation among organizational units or individuals whose performance has been superior during the accounting period is not possible. The earnings result of the total company is not a direct result of any one unit or individual effort, except perhaps that of the Chief Executive Officer. Individuals who have not performed well still receive the bonus. In my experience, the majority of employees feel a general sense of accomplishment when a favorable earnings result is announced and the resultant distributions are determined, but they do not see it as a direct function of their efforts.

If company objectives indicate that dollar compensation is an appropriate method to differentiate performance and thereby provide incentive for superior performance, a number of bonus and stock option plans can be used. Certainly, the 1976 Tax Reform Act has effectively eliminated the "qualified" use of these plans, but the overall cost is usually limited by restricting eligibility to key members of the organization whose performance can be effectively measured.

MR. MACDOUGALL: Denis, you had indicated you had done some research on employee attitudes in Canada. Would you care to comment on some of your findings?

MR. GEORGE: We have been conducting over the past few years certain studies to ascertain the attitude of employees towards their compensation and benefits. Many of the things which we have discovered were predictable, but others have been somewhat surprising.

We have found that the greatest criticism of compensation and benefit changes has been in the communication of them and the perceived methods of administration. Employees claim that booklets are written in too technical a language and are, therefore, difficult to understand; but more importantly, they often do not contain the information the employee requires. He is often not interested in the precise formula to determine the benefit but rather to know, generally, the level of the payments. He would like to know his and his family's liability for tax on the various benefits and what action, if any, that he or his survivors have to take to claim benefits.

We have, in one particular study regarding seamen, found that the language used in the booklet was quite inappropriate, not only because it assumed a level of education that was not there, but also in the use of words, such as "survivor", which have quite different meanings for seamen than for actuaries. This study also underlined one of the other major problems which we have discovered; dissatisfaction with the benefit plan was much more in the area of its poor administration than in its level of benefits. In this case, benefits could not be paid to family members at home until the seamen's ship had been contacted at sea. The booklet which we finally used

contained cartoons and pictograms, and included considerable reference to what happened to a claim from the date the employee submitted it to the date a cheque was issued.

Even though programs, such as salary administration, are, in fact, administered fairly, they are often perceived as being handled unfairly. It is quite common to find that an employee in one location feels he would get a better salary increase in another location because the other person's supervisor was more generous in awarding increases.

Among the more predictable things that have been confirmed is the fact that younger employees are more interested in immediate benefits and cash, whereas older employees see the need for pension and deferred compensation programs.

As employees become more aware of the value of their benefits, they are asking more questions regarding the type of investments used for their pension fund, whether or not a better yield can be obtained if the investment management were changed, and who is getting the real benefit from any increased interest earnings.

Unless employers and consultants design compensation packages which take into account some of the employees' attitudes and priorities, it is probable that the employer will not obtain full value for his compensation costs.

MR. ZATTO: I would like to add that it is not only important to communicate employee benefits to the employees in terms of the event covered rather than the plan, but also it is important to educate the client to consider his employee benefits in terms of the events covered rather than by separate plans. This has always been true but it becomes increasingly important as the amount of benefits increases; and it has gained some added impetus by the potential expansion of death benefits in a retirement plan area.

Often a corporation will call a consulting actuary in and ask for a study on the retirement plan, without any consideration or comment regarding other benefit programs. I think it is important that the consultant point out at that moment that some of the changes that might occur will have impact on other programs and steps should be taken to ensure that unnecessary duplication isn't created.