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FUTURE OF RETIREMENT INCOME PLANS

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The design of retirement income plans in the future will be influenced by many forces. The forces differ to some extent in the public versus private sectors and also differ in Canada versus the United States. Several aspects of the issues will be discussed.

1. Trends in plan design.
   - Canada
   - United States - Public Sector
   - United States - Private Sector

2. Changing patterns in the work force.

3. Impact of legislation and regulation.

4. Role of Social Security.

MR. WILLIAM L. SMITH: I would like to welcome you to this open forum on the Future of Retirement Income Plans. The panelists here today have three views of the future course of retirement income plans.

Mr. M. David R. Brown is with Eckler Partners Ltd. in Don Mills, Ontario. He is on the Board of Governors of the Society and has served for six years with the Pension Commission of Ontario, a regulatory body that deals with pension issues. He will give us some observations about the probable future for retirement income plans in Canada.

Our other panelist is Mr. Thomas P. Bleakney with Milliman & Robertson, Inc. in Seattle. He is well known for his work with public pension plans and he will make observations about the future of public plans. My name is Leon Smith and I am an actuary with Touche Ross & Co. in Dallas. I will give some observations with respect to what is happening in the Sun Belt, which I understand is a little bit different than what is occurring in some other parts of the United States.

We would like to begin with short presentations from our panelists and then open the meeting to comments and questions from the audience.

MR. BROWN: I think what you will see in a few minutes is that Canada is facing many of the same issues, problems and developments affecting the future of retirement plans as you have in the United States but with some twists and other kinds of developments which may or may not be indicative of the future in the United States.

I thought it might be worthwhile just to begin with a thumbnail sketch of the Canadian retirement plan environment. Without going into a lot of detail, we have a social security system which is roughly similar to yours, but it has some characteristics of its own which affect private sector retirement plans. There are two main parts to the social security system.

First, there is a universal Old Age Security system which pays a benefit to all residents at the age of 65. The benefit is a flat amount which is currently about $265 a month and is indexed quarterly to the consumer price index.

Secondly, on top of the demographic payment is an earnings related system. Actually, it is two systems but they are identical. One is called the Canada Pension Plan; the other is called the Quebec Pension Plan. Each of them functions very much like your Social Security system in that they are financed by payroll taxes from employees and employers. The benefits paid are earnings related on a segment of earnings that currently has a ceiling of $20,800 a year, which is being adjusted in line with the Average Industrial Wage. Since it only began in 1966, this part of the system is somewhat immature. The tax rate currently is 1.8% from employees and 1.8% from employers. Last year, for the first time, there was an income from tax collections which was less than sufficient to cover the benefit payments. So it's clear that we're going to have a need, starting very soon, to increase the tax rate just to support the existing system.

The private sector in Canada looks much like what you are familiar with in the United States. The largest feature of it is employer sponsored plans. We have defined benefit plans and money purchase plans. Most large employers have a defined benefit plan. One of the things that is different in Canada, however, is that many of the plans are contributory, because employee contributions are tax deductible.

We have had for some time another feature in the private sector, which we call Registered Retirement Savings Plans. These are somewhat similar to your IRAs in that the individual can save for his retirement income through a tax sheltered vehicle. Registered Retirement Savings Plans are available through banks, insurance companies, credit unions and so on.

At the present time the legislative and regulatory picture in Canada is somewhat complicated because the jurisdiction for both social security and the regulation of private plans is given under our constitution to the province rather than to the Federal Government. When Old Age Security was set up in 1952 and the Canada/Quebec Pension Plan in 1966, the Federal Government was able to get an agreement with the provinces to amend the constitution to give them dual jurisdiction. As a result, the Federal Government does operate those parts of the system, except, as I mentioned, the province of Quebec which insisted on having its own separate but identical earnings related public system. The pension legislation that we have had is legislation regulating the operation of private pension plans and is done at the provincial level, with the exception of a few industries which are Federally regulated including banks, transportation and communications. There has been, up until now, a reasonably uniform set of provincial laws, so a national employer can operate with a single plan covering employees located in different provinces.

Tax regulation is done Federally because that is where the main tax collection takes place. The Federal government has a rather complicated set of tax regulations. I don't know if it compares with your Internal Revenue Service regulations or not, but it is complicated enough in defining what types of plans will qualify for tax deduction. The defined benefit plan has a relatively favorable position in the tax system at the moment. There is really no maximum limit on employer contributions to a defined benefit plan that can be deducted for income tax. There are, however, some maximum benefit limits which apply. Essentially, the current benefit limit is $60,000 a year after 35 years of service. The maximum is pro-rated.

What has been going on in Canada over the last 7 or 8 years has been a prolonged debate about how to deal with the retirement income needs of the future. It might seem a little surprising that it has been going on for that long without having reached some resolution. I think as I describe the outcome you'll see that this could not have happened quickly and that the debate still isn't over.

In the beginning the debate was primarily over whether the route to the solution should be through an expansion of the public system or through a reform of the private system. There was fairly strong support for going as far as doubling the Canada Pension Plan, which currently provides retirement income of 25% of the covered earnings. However, as I mentioned earlier, the system is immature and we are already facing the certainty of substantial tax increases to support what we have. As that fact began to sink in, people began to have second thoughts about the advisability of going that route.

We had a whole succession of government and privately sponsored studies. The subject was really beaten to death in many ways, but in the past couple of months we seem to be arriving at some sort of consensus about a direction for the future. The Federal Government, through the Minister of Finance's budget speech in February, made public two documents dealing with pension policy.

One of them stated the Federal Government's position on what I call reform issues. It advocated vesting after two years of service and advocated access to membership in the plan of an employer for both full time and part time employees. More controversially, it advocated a requirement for indexing both pensions in pay and deferred benefits during the deferred period at not less than 60% of the consumer price index change. There are a number of other proposals as well. A joint and survivor option would be required in every case unless both parties signed off. There is an attempt to insist on the provision of a portable benefit for the terminated employee with two years vesting. Combine that with the two year vesting requirement and you have the probable picture of most people taking a defined benefit plan rather than a fixed amount of monthly pension as typically happens now. They would likely transfer some lump-sum of cash into a personal vehicle, some kind that would be non-commutable, and convert that into a monthly income when they reach retirement age.

This first document was a bit of a bombshell at first. It may sound like a bombshell, too, but in fact most of the document's proposals had been widely discussed over the previous few years.

The second document dealt with the tax system. This area has really not had very much discussion or debate. I'm not going to attempt to describe the proposals in detail here, except to say that they are a complete departure from the past. The proposals contained in this second document are trying to accomplish three things.

One is increased flexibility for the individual. The second is more equity between various forms of saving for retirement, that is, the defined benefit, defined contribution and personal plans. The third is some type of automatic structure for coping with inflation, so that, whatever limits are in place, they will be indexed each year. The way in which the document proposes to accomplish all these things involves two key features.

One is an artificial average funding factor of nine times the amount of pension from a defined benefit plan as the deemed tax benefit. In other words, if you accrue a benefit of $1,000 a year from a defined benefit plan, you will be deemed to have used up $9,000 of tax room in that year. All that really affects is your ability to contribute to defined contribution arrangements, but it will cause a lot of confusion, I think.

The second feature is that the tax limit for an individual would be comprehensive and lifetime, so if maximum deductions are not used in a given year, they can be carried forward to subsequent years.

This sounds like a pretty good idea, but it has dramatic implications for the whole system and for people's willingness to save. For younger individuals under the current system, there is an incentive to save since, if you don't use your deductibility this year, it's gone forever. With a lifetime system there's clearly going to be much less of that kind of incentive. People are going to emphasize other priorities. What it may mean, and this is putting a favorable look on it, is that people will be able to conform their pattern of lifetime savings for retirement more effectively with their economic life cycle. This is clearly what the proposals are aiming for.

These tax proposals have really taken everybody by surprise, and they have a lot of wrinkles to be ironed out. I think that we are going to have a lot more discussion before they actually are passed into law.

On the day the Federal budget papers were published, the Treasurer of Ontario, which is the largest of the provinces and which has always played a fairly leading role in the regulation of pension plans, published a "White Paper." A White Paper in Canada is not a study, nor a document for discussion, but an actual statement of the government's position. Ontario, after this long debate, finally seems to be arriving at the point of saying, "Here's where we should take our stand; this is the kind of legislation that we propose to introduce." Ontario is hoping to influence the other provinces and the Federal Government. The most interesting thing to me is that the Federal Government's budget papers and the Ontario White Paper are very close on a number of things.

First of all, they both say the solution is not to expand the Canada Pension Plan. The private plan that Ontario is advocating would require indexing at 60% of the consumer price index. Ontario is talking about five rather than two year vesting, but that's a detail for negotiation.

I have said enough about the kind of proposals that are currently in the air in Canada. I would like to make just a few comments about what we see as the thrust of these policy proposals, where they are coming from and what the implications might be for future retirement plans.

Where the proposals are coming from, in many respects, has to do with changes in people's career patterns and with the prevalence of women's participation in the labor force, frequently on a part-time basis and much less frequently on a single career basis with the same employer, which the defined benefit plans have been geared to in the past. So you have this concern to define a very short vesting standard and a means of establishing portability so that benefits can stay with the individual through all the various segments of employment of his or her career.

Another underlying factor that is behind some of these proposals are the demographics, which can include a number of things.

One of the demographic forces at work with a vengeance in Canada is the baby boom, which was relatively much larger in Canada than in the United States. There has been a corresponding precipitous decline in the birth rate, especially in the province of Quebec. If we continue to have the same retirement patterns that we do now, the ratio of retired to active population is going to increase very drastically from around 15% currently to 35% to 40% as the baby boom generation reaches retirement. This is a factor that will have to be dealt with both by public and private sector retirement arrangements.

I think the basic elements of the retirement problem are not different between the United States and Canada, but the way they are being approached may be somewhat different.

MR. SMITH: Thank you, David.

Our next speaker will be Tom Bleakney, who will speak on some of the public plan issues.

MR. BLEAKNEY: Thank you, Leon.

The topic I want to talk about this morning is retirement plans in the public sector, primarily state and local pension plans, to look at the differences between the public and private sectors and to identify some of the lessons or trends in retirement policy occurring in one sector which might be useful in the other.

I have several points I am just going to touch on.

- What is the trend going to be in defined contribution/defined benefit plans.

- Contributory vs. non-contributory plans.

- Cost of living adjustments, which are much more extensive in the public sector than in the private sector.

- Retirement ages. When retirement takes place and early retirement in particular.

- The concept of "vesting" in the public sector, how it differs from the private sector and how it impacts on benefits provided.

- Disclosure requirements of PEPPRA and the Governmental Accounting Standards Board (GASB).

Public plans have generally been around in the United States for a good deal longer than private plans. I think we can look at what's happened in the public plan area historically and note some lessons to be learned.

Back in the 20's, when a good number of the large state systems were set up, particularly teacher systems, a very common pattern was a defined contribution plan. George B. Buck set up a good number of plans in the East and these had a common thread through them. Employee contributions was translated into what were called annuities, to distinguish them from the pension, which employer money bought. Although there were some differences, it was fairly common to find that employer money matched employee money and at retirement the two accumulations were combined and bought whatever benefit could be provided. The contribution rates were often set differently for men and women, for different kinds of occupations and for different ages at hire, in order to approximate a desired benefit level at retirement. The flaws involved in the uncertainty of the escalation of the final salary and the unpredictable nature of inflation were so extreme that the defined contribution scheme simply didn't work.

Not all defined contribution type plans have been eliminated, however. TIAA/CREF benefits for university professors are very common in the public sector. Originally, some of these plans had a floor built into them so that if the resulting benefits didn't meet what other public employees in the state would get for comparable service, then there would be a minimum benefit. Well, these floor plans, that were supposed to be phased out as the defined benefit plans became mature, are still going strong.

The defined contribution trend may be something which deserves being looked at further. There has recently been additional pressure for consideration of defined contribution plans. There have been proposals for the new Civil Service plan that it become a defined contribution plan. A few states have recently considered defined contribution plans.

With respect to the issue of contributory versus non-contributory public sector systems, I think the trend is away from the contributory approach, although not necessarily in a forthright manner. One of these indirect approaches, which the IRS will now allow (IRC Section 414(h)), is to classify what are really employee contributions as employer contributions. As a result, it is treated exactly the same as if it were paid by the employer. When the employee quits and draws his money out, the total distribution is taxable. This trend has become rather common; it started out with the idea of an employer pick-up of the employee contribution and it's been refined into a simpler process in the last two or three years.

Cost of living adjustments (COLAs) are common in the public sector, particularly in fire and police plans. Police and fire plans often will base cost of living adjustments on the pay of the active group. A very common provision is that the benefit that is payable to a retired policeman or fireman is X%, often 50%, of the pay of an active policeman/fireman at the rank at which the employee retired.

What is the lesson to be learned from COLA provisions in the public sector? The COLA has created enormous financing problems, and, as a consequence, we see states thrashing about trying to work their way out of the problems COLAs have created. One of the states that's right in the midst of this at the moment is Maryland, which, I believe, is the only state that had an unlimited full scale cost of living provision for all of its employees. Ever since they instituted this provision, which was about 10 or 12 years ago, they have been back-pedaling. They back-pedaled once with a second tier, and they just passed a bill which results in a cutting back of the unlimited COLA in various ways. It is now in the courts and it will be very interesting to see how it comes out.

The point is that the unlimited COLA or even the limited COLA is very expensive. COLA proposals should be studied carefully. I'm not saying that COLAs are wrong. What it really amounts to is that it is really important to recognize the potential problems and to take the appropriate steps, which in many cases were not taken in the public sector.

With respect to retirement ages, I am sure all of you are well aware of the fact that, particularly among firemen and policemen, young retirement ages are available for many public employees. This includes general employees in many states as well as policemen and firemen.

One of the offshoots of the retirement age issue, which is rather interesting, is the situation which has happened among teachers recently. Across the country we have found that a general surplus of teachers exists. What has been done in some instances is put incentives in the retirement plan, depending upon the state and the legalities, to try to encourage people to retire.

I mentioned vesting earlier. Again my definition of "vesting" for this purpose is in the larger generic sense, the vesting of benefit rights.

In the public sector in a great number of states, the rights of employees to benefits have been established by some form of court decision. In some states these rights are established by law or actually provided for in the state's constitution. New York is an example of the latter.

The extent to which this concept of the right to vested benefits applies is subject to some discussion. There are a couple of cases floating around in California which resulted because the voters took away the right to a COLA for benefits that had yet to be earned. I mentioned the lawsuit in Maryland earlier. This lawsuit is going to test the situation in Maryland, where there were four different options granted to the employees, none of them allowing a continuation of the present situation. Any employees that want to continue with the unlimited COLA of the existing plan have to increase their contribution rate 2%. The older employees are certainly going to be attracted to doing that. The younger employees may say that's not worth it because they can opt for a 5% cap on the COLA with no additional contribution, plus either of two other options are available.

The problem of vesting of benefit rights has led to the multi-tier concept. Maryland has really gotten into a third tier. This is common in some other states as well. The whole concept is that you cannot, under various interpretations, go back and take away accrued benefits. All you can do is set up a new program and allow old employees to stay in the old program.

It is an interesting problem trying to establish the benefit rights for existing employees. I have a feeling that this issue of vested benefit rights is going to be increasingly important in the private sector. Whether it extends to benefit expectations or simply to "accrued benefits" is a very tough question.

One final thought on the question of disclosure. There has been introduced in the various Congresses in the last several years legislation similar to ERISA for public sector plans. Current legislation in this area contains no funding requirements, but is limited primarily to disclosure and fiduciary standards. I think there is increasing attention to the fact that disclosure is important. I mentioned earlier the various accounting bodies and their efforts to establish accounting standards. There is a very interesting difference between FASB and GASB reporting guidelines. The governmental approach (GASB) requires the reflecting of future salary accruals, whereas the FASB standard does not. This is an enormous difference, but the point is that in the public sector, where we have these guarantees established, you couldn't walk away from accrued benefits based on future salary increases. In the public sector there are pressures brought by the administrators and the boards of the systems to maintain the reporting standards using projected final salaries, because to do otherwise (i.e., to show a lower accrued benefit) could cause the legislatures to take away benefits.

MR. SMITH: Thank you, Tom. I would like to point out that the same people that are covered under the public plans are writing our current private sector legislation. They are well aware of what they think constitutes a good retirement plan and they also are writing legislation which they think might be good retirement rules for everyone else. Because of this, we may see some of these public sector influences reflected in private sector retirement policy.

I would like to speak briefly on some of the forces that are at work in the United States that are dictating what is occurring in the retirement income area. I would also like to dust off my crystal ball and make some observations about future trends.

Probably the largest catalyst for change in the employee benefits area is changes in the tax law, that is, change through legislation or through regulation. During the 1920's, we saw the first instances of tax law appearing. In the 1930's, Social Security came about causing radical changes in retirement policy. Finally in the 1970's, ERISA came in and changed the whole character of retirement income in the United States. What we have seen lately is an entirely new rash of legislation, including the tax bill of 1984. It is my understanding that the purpose of that bill is to raise $50 billion in revenue. The bill is some 1,000 pages thick and I guess that equates to about $5 million a page. The tax bill is extremely voluminous and complex. The issues that were faced in developing the tax bill are also very complex. Future trends will be driven basically by tax legislation and the particular rules that are enacted. Many of these new rules favor defined contribution plans. When we look at the PBGC, at TEFRA with its new top heavy requirements and its benefit cutbacks, and at the Retirement Equity Act that is currently before Congress, we see that these all tend to favor defined contribution plans.

The next major area that tends to shape trends in retirement income policy is short-term employer needs. This is primarily from a perspective of operating revenues and taxes. Over the last few years, during the oil and gas boom, employers in Texas and elsewhere in the Southwest were looking for additional ways to spend money. Additional employee benefits were created to attract and recruit employees, not only in the very technical areas but throughout the whole workforce. With a recent recession causing financial pressures, we have seen a cutting back on their benefits and putting additional controls on their expenditures.

Another force influencing retirement income trends is demographic. Employees are different today than they were in the 1940's. In the 1940's and 1950's, when a number of defined benefit plans first were started, there was an entirely different workforce. Today we see the effects of the baby boom generation: an entirely different workforce with many single young adults in their 30's who have little interest in a retirement plan, and are more interested in a defined contribution type of plan. We see any number of additional new two wage earner families. We see more single parents in the workforce.

In the past couple of years, there have been a number of retirement incentive plans implemented by companies. These programs have been effective, and depending upon the particular plan, 50 to 85% of the employees elected participation. Incentive plans are basically filling the need of a different workforce.

In addition, the workforce has become more mobile. I have heard that the average length of time that an employee will work for his current employer is four years. You view this together with a vesting scale of ten years and you will conclude that the defined benefit plan is not providing much benefit for those short service employees. However, a number of employers like the idea of long vesting scales to provide an incentive for employees to stay with the employer rather than leave and go on to another company.

Another force shaping employee benefit trends is the unions. In the past, unions have been very powerful and have been able to provide a great deal of direct influence on the provisions of retirement income plans. Indirectly, unions have also influenced the design of retirement plans for non-union employees. When companies have both non-union and union employees, and they provide additional benefits for union employees, they may feel compelled to provide the same benefit for non-union employees. Over the last couple of years, unions have not been as effective in obtaining additional retirement income benefits. In fact, they have been very diligent in holding the line with regard to retirement income, and have made concessions in other areas in order to keep the retirement income benefits. In the union environment, the concept that pensions are really deferred compensation is becoming prevalent. This is forcing a number of companies to consider faster vesting in their particular benefit plans in order to be consistent with the viewpoint that pensions are indeed deferred compensation.

The last force that influences trends in retirement policy is the interests of third parties. For example, as consultants we are responsible in a number of ways for generating some activity affecting trends in the employee benefits area.

After reviewing the major forces, I would like to comment on what I see as the evolving trends in the retirement policy area. Probably the major trend today is an additional emphasis on pre-tax accumulations for retirement. We have found that employees are well aware of the tax benefits of employee benefits, especially 401(k) type plans, and are excited about the opportunity to make decisions based on their own personal tax reasons. There are a number of pre-tax accumulation vehicles available today. These include IRAs, Section 403(b) annuities for certain tax exempt organizations, Section 457 plans in the public sector, Qualified Voluntary Employee contribution plans, and, of course, 401(k) plans.

A second major trend, one I mentioned earlier, is the increased equating of benefits and pay. In other words, employee benefits are seen as pay. No longer are employee benefits the fringes of past years, but part of the employee's compensation.

We are seeing employers think not in terms of benefit levels but in terms of contributions for those particular benefits. The distinction between employee benefits and pay is becoming much less clear, mainly due to the interest in cafeteria arrangements, which give the employees, within limits, a choice between benefits and current pay.

We've done some work recently conducting surveys of employees, asking them which they would rather have, less pay and higher benefits or vice versa. Usually the employees will elect to reduce their pay in order to obtain these additional benefits.

The next trend is additional flexibility for employees in designing their program. Employees are looking for additional flexibility in their retirement program, because a single retirement program no longer meets the needs of every employee.

Individual savings will play a much larger role in the future. We only have to look at what is happening with IRAs. In 1982, about $9 billion in tax revenue was lost in the United States due to IRAs. In 1984, there is projected to be a $14 billion loss in revenue. This represents a tremendous loss in revenue and a huge sum of money being set aside for retirement. There was a proposal before Congress to increase the maximum limits for IRAs. It is my understanding that this proposal stands little chance of majority support at this time, but the pressure is there to increase the limits or the availability of pre-tax individual savings.

Individual pre-tax savings programs are available for public and other tax exempt organizations through Section 457, Section 414(h), and Section 403(b) plans. When considered in addition to IRAs and Section 401(k) plans, we are seeing more and more interest in the availability of this type of benefit.

The last trend I would like to mention is that defined benefit plans will survive, but possibly not in their current form or level of significance. I've heard a number of people say that defined benefit plans are no longer needed, but I do not believe this to be true. There is no other vehicle that can provide target levels of income at retirement and provide income benefits when an employee retires. They are one of the best methods for coordinating private sector retirement plan benefits with Social Security. They can also be effectively structured to provide incentives to retire, a quite common practice these days.

Defined benefit plans have suffered a great deal in the press recently, mainly the effect of termination of a number of plans for the purpose of reverting plan assets to the employers. Many people feel that this is a short-term phenomenon, mainly caused by cash flow concerns of employers. There have been, however, some employers who have terminated their plans for other reasons.

As actuaries observing the underlying forces affecting trends in retirement plan design, there are clearly some things that we can do to shape our future.

First of all we can influence legislation. We can offer alternative solutions to existing problems to the legislature, but we need to be innovative in our ideas. Congress listens to many individuals and organizations regarding retirement policy legislation and not all of these people have a good understanding of the issues involved. We need to do our part to make sure that legislatures are fully aware of the implications of retirement policy proposals.

Another thing we can do is to assist employers in understanding the current situation with respect to their retirement plans, and to assist them in understanding the possible future environment within which the plans will be operating.

A third thing that we can do is to assist our clients in establishing the real needs of the workforce in the United States today and in developing a rational and systematic approach which meets these needs.

I listened with a great deal of interest to the comments that David made earlier. He mentioned that there was a trend toward providing a lower level of benefits in the defined benefit area and supplementing such plans with defined contribution plans. There have been a number of instances in the U.S. recently where actual terminations of defined benefit plans have occurred and defined contribution plans replaced them entirely.

I'd like to ask David if he is seeing this trend in Canada at all, or if it is something that is entirely a U.S. phenomenon.

MR. BROWN: There has been a certain amount of it going on in Canada, but I don't see it as necessarily reflecting a long term trend.

We do not have, except in the province of Ontario, anything like the PBGC, so that there is considerable reluctance, I believe, to leave employees in a short-fall position if a plan is terminated. Ontario introduced a plan termination arrangement in 1980. There has been to date only one claim of any size under this arrangement. I think the fact that there has only been one claim tells you something about the defined benefit plan termination situation in Canada.

I agree with some of your closing comments to the effect that the defined benefit plan does have a future. It may go through some difficult times, but it does do a better job of meeting retirement income objectives than other arrangements.

MR. DWIGHT K. BARTLETT: I wonder if anyone on the panel would comment on the trend toward adoption of lump sum retirement options in defined contribution and defined benefit plans. Is there a trend beginning and what drives those trends?

MR. BLEAKNEY: Another panel will be talking about the unisex issue. This issue has some interesting implications with respect to lump sum distributions; however, I don't sense that the issue will significantly increase the availability of lump sum options. Lump sum options are certainly very uncommon in the public sector.

MR. SMITH: I've read articles recently that point out that some plan participants are electing lump sums in the belief that they will receive favorable Federal tax treatment for those distributions. The person receiving that distribution will not always be in a favorable tax situation. As actuaries and consultants we should explain to participants or to the employers that are sponsoring these plans the impact on an after-tax basis of some of these decisions.

Another side to the lump sum issue is the continuing debate about what factors you should use to calculate these distributions. If you use, for instance, the triple A bond index and come up with a relatively low lump sum amount, the participant electing this option may discover that he would be hard pressed to invest the lump sum and receive periodic income equivalent to what he could have had from the plan.

These are two areas which I feel would need to be resolved before any trend will become apparent with respect to lump sum distributions.

MS. ANNA M. RAPPAPORT: If you forget the taxation issue surrounding lump sum distributions and think strictly about the logic behind defined benefit and defined contribution plans, this logic can influence whether the lump sum option is made available. In the defined benefit plan area, it is pretty clear that if you have career employees and your objective is to replace a certain level of income, the logical thing to do is to pass on offering a lump sum option. Different factors support the adoption of defined contribution plans.

We have a university that we're working with, where they recognize that the people that they are considering have been doing consulting on the side. Many of them have several sources of employment income. The university's retirement system for these people was constructed on the basis that they would have different assets accumulated from different places. I find it very hard in this type of situation to argue against the lump sum, because essentially the several employers are providing a small piece of the total retirement income of the individual.

MR. GREGG L. SKALINDER: With 401(k) plans, and, in somewhat of a different way, IRAs, we essentially have a system in the U.S. where employee contributions to defined contribution plans are deductible, whereas those made to defined benefit plans are not deductible. What does the panel feel is the prospect for change in this area, and, if the change does come, what impact would be expected in the balance between defined contribution and defined benefit plans? I am particularly interested in hearing more from David about whether he feels this is influencing that balance in Canada.

MR. BROWN: I was pretty brief earlier in what I said about the tax proposals in Canada. I would like to say a few more words about the present situation, because I think it may be a little difficult to understand the tax proposals without understanding what is currently happening.

As matters now stand, employees can contribute up to $3,500 a year into either a defined contribution or a defined benefit employer sponsored plan and take a deduction for it. The employer can contribute up to $3,500 a year per employee into a defined contribution plan or he can get a deduction for more than $3,500 by contributing to a defined benefit plan, provided that the benefits provided don't exceed the maximum benefit allowed by the tax rules, which is essentially a 2% benefit to a maximum of $1,715 per year of service, which works out to $60,000 after 35 years.

Outside of the employer sponsored plans, the Registered Retirement Plan, the counterpart to your IRA, permits a deduction of contributions up to the lesser of 20% of income or $5,500 if you are not a member of a registered employer plan. If you are covered under an employer sponsored plan, then the limit is the lesser of 20% or $3,500 less any employee contributions to the employer plan.

That is where we are now. The situation is heavily weighted in favor of the employee in a generous defined benefit plan. The proposals are attempting to address this imbalance and some of us think they have gone too far. The proposals up the $5,500 limit over a three year period to $15,500 for defined contribution vehicles of all kinds. This limit includes the employee and the employer contribution. There can't be much argument as far as the equitableness of this proposal between participants in employer sponsored plans. Where difficulties arise is in the attempt to incorporate a maximum benefit that the employee in the defined benefit plan gets from his employer contribution, which is much lower than it should be in relation to what can reasonably be projected to result in a defined contribution plan. As a result, individuals participating in defined contribution plans would become more heavily favored than those who participate in defined benefit plans.

MR. MARTIN STEMPLE: I wish I could share the optimism for the future of defined benefit plans. I have had a fair amount of experience with multi-employer plans and in this area it is clear to see the effect of legislation. As you know, the MEPPAA, the Multi-Employer Pension Plan Amendments Act, imposed a withdrawal liability on employers that thought that their total obligation consisted of paying the negotiated cents per hour. This contingent withdrawal liability, I believe, has caused a sharp decrease in the amount of money that employers are willing to put into multi-employer plans. I don't think it is merely the recently diminished power of the unions to negotiate those contributions.

For corporate plans, I think that future experience will tend to follow the same pattern. There are proposals to tighten the plan termination insurance provisions and there is the FASB proposal.

I do agree, though, that the defined benefit plan should have a place; however, I think that a better job of educating the sponsors and the public has to be done.

MR. SMITH: I agree with you that employers are afraid of multi-employer plans. I do not deal with multi-employer plans directly, but I do deal with some indirectly in the merger and acquisition area. The presence of a multi-employer plan is one of the questions on the check list. Buyers make sure they cover the groundwork of whether there has ever been or will ever be a multi-employer plan involved in its acquisition. If a multi-employer plan exists, buyers are being very cautious about any exposure whatsoever in this area.

I would like to come back to the previous question about IRAs and 401(k) plans and whether pre-tax contributions would find their defined benefit plans. I would say not in the foreseeable future. Everything that is occurring today in Congress is revenue driven. We hear that the biggest tax dodge today is in the private pension area. Congress is not about to provide additional incentives which would result in increased losses of revenue at this juncture. Time will tell whether the pendulum will swing more towards equity between the two types of plans.

MR. BLEAKNEY: I took the question as to what would happen if employee contributions to defined benefit plans were permitted on a pre-tax basis a little differently. As I mentioned earlier, public sector plans are generally contributory and the fact that these contributions generally have not been tax deductible has been a significant consideration. Approaches have been developed in the public sector to convert these after-tax contributions to a pre-tax basis, thus creating some equity between the public and private sector (where pre-tax defined contribution vehicles are generally available). If pre-tax contributions to defined benefit plans in the private sector can be legislated or qualified at some point in the future, that may be the way to go.

David, to change directions for a minute, do you know the basis for the 60% of the consumer price index cost of living adjustment and why this wasn't 57-1/2, 63 or some other number?

MR. BROWN: Yes, there is a bit of history to it. One of the studies that was done by the commission appointed by the government of Quebec quite early in the debate made a proposal that "excess interest" be required to be applied to provide benefit adjustments for retired employees. That idea, of course, is not a new one. In fact, it has been practiced in a number of plans over the years. When you start trying to write legislation applying the "excess interest" idea, a benchmark must be set defining what constitutes excess interest and consideration must be given to such items as the fact that you may be penalizing superior investment performance. Plans with higher investment performance will have to provide higher adjustments for their pensioners than plans that have inferior performance. These considerations went in the hopper and the excess interest idea received a lot of attention. Until the release of the Federal Green Paper at the end of 1982, there was considerable support for the "excess interest" approach. For benefits accruing in the future the benchmark would be an interest rate of 3-1/2%. There was, however, quite a bit of analysis going on about how this approach would have corresponded with inflation in the past, and it was found that it was very imperfect. In the long run and on average, however, it produced approximately 60% of the consumer price index as an average adjustment. The eventual conclusion has been for people to say that, if we want to legislate a benefit adjustment, let's pay attention to the reason we're doing it and that is inflation, and not the behavior of interest rates as such.

MR. BLEAKNEY: I mentioned earlier that I thought what has gone on in the public sector could conceivably serve as a model for the private sector. I feel that down the road as the pension plans that have been set up mature and the retiree population grows, we will have to face the pressures that will occur for post-retirement adjustments. It seems to me that the private sector in the future may find itself in a similar situation to that of the public sector, where there is some recognition of the cost of living. The question becomes one of determining what is an appropriate cost of living formula.

Dave, apparently Canada hasn't solved this problem of what constitutes an appropriate cost of living index; at least, 60% wasn't the solution.

MR. BROWN: Part of the whole process in Canada was whether the CPI does in fact represent an appropriate index for benefit adjustments. Mr. Geoffrey Calvert has been attacking the use of the general purpose consumer price index as an appropriate basis for determining the kind of adjustments that are needed. In addition, there have been at least three studies that I am aware of that looked at the CPI and at the possibility of trying to construct another index that would be better suited to the purpose. The studies have all come to the conclusion that the error involved in using the general CPI is small. It is true that the CPI may be based on a basket of goods and services that doesn't correspond to the typical pensioner's basket of goods and services, but in fact it does do a reasonable job, as reasonable a job as anything else that has been developed, in representing general price movements which affect everybody, pensioners as well as non-pensioners.

MR. CHARLES E. DEAN, JR.: We've talked a lot about defined contribution plans versus defined benefit plans and paying lump-sum payments or not paying them from defined benefit plans. The panel has remarked on how much of that is driven by tax considerations. I think there is a real danger for actuaries professionally in taking the short term view and advising clients as to how they might best take advantage of what is this year's tax wrinkle. I think we have a professional obligation to try to design an overall retirement program for our country that is helpful to the country, i.e., helps economic activity and is not a drag on it. This means using money efficiently for people. There are only so many dollars available and we want to spend them efficiently. I think we need to take a longer term view and define what the tenets of a sound retirement program should be. For example, isn't it a good thing to offer people flexibility so that they can adjust benefit packages to their own situations? Isn't it a good thing that a career employee at least be able to come close to maintaining his or her standard of living after retirement? Are there approaches that we can use that would bring us closer to these goals rather than continually adjusting retirement plans to take maximum advantage of continually changing tax code provisions?

MR. SMITH: I agree that we as a profession as well as employers need to take a long term perspective. The reality of the situation, however, is that if employees are given the choice, they like tax incentives. They will take advantage of something like a 401(k) plan. They will do something for tax incentives. Many individuals will not do what is necessary to make sure that they have an adequate retirement income when they retire if it is left solely to their discretion. So in order to provide some guarantee, or some floor of retirement protection for all employees, would imply the need for a universal system that would apply to all employees, either a universal private sector minimum system or an expanded super Social Security System.

It is an extremely difficult balance to maintain. You must make sure that you have benefits that are adequate for all of the workforce and at the same time permit them flexibility. It may be that the approach is one of permitting flexibility of choice, rather than the flexibility not to choose.

MR. BLEAKNEY: I certainly 100% agree with you, Chuck, in the sense that we should be looking at the bigger picture. However, isn't the question one of looking beyond our narrow responsibilities as actuaries and building upon our experience and professional capabilities to do what we can to influence tax policy, which in the long run is what will probably influence the direction of retirement programs. It is very difficult to go to an employer, and say that we think this is great from the standpoint of the country but it's gonna cost you some bucks.

I talked earlier about the contributory plan. In a sense, the contributory plan has some really nice philosophical advantages to it, but I don't think very many of us are going to go in and recommend that the contributions come from after-tax dollars. It seems to me that our efforts have to be directed toward doing what we can to get tax policy to encourage what is appropriate in retirement plan design.

MS. RAPPAPORT: When we say retirement income, we've all got a little model and a picture in our minds, the picture of people having certain kinds of life cycle patterns. In the traditional life cycle, we go off to school and obtain an education, we work for a long time, maybe until we are 62 to 65 and then we retire. Maybe we should be thinking about a question that relates to the future of the private non-Social Security System and the benefits that system provides to supplement the income that we get when we are working different periods of time in our lives.

The education that people get in many fields today has an increasingly short half-life; that is, when you get to the age of 40 or 45, everything you learned when you went to school might not be useful anymore. If you've got somebody that is displaced and doesn't have enough education, whether they are 42 or 45, the fact that they might be entitled to a pension at age 62 is not that significant. They are not going to be around to get it. The system that doesn't provide some way for that person to remain productive in the system is not really efficient. So if we redefine our thinking to think about income maintenance and financial security over life, we will be thinking about systems where people can receive financing and re-education and spreading this education for life.

There is another related question that bothers me a lot and I don't know the answer. That is, how are we going to provide medical care for older Americans? We have a Medicare system that is substantially out of financial balance. The kinds of changes that would be needed to get it back into balance are very radical. Balance will probably be attained, in part, by a lot more being paid by the non-government sector. This is going to put employers in the business of providing income maintenance and will put a substantial burden on them.

The third question is with respect to people that begin work at a fairly early age and are able to retire from a job and start collecting a pension at an early age, for example, the military. This doesn't mean that they are not in the workforce anymore. They may have gone out and gotten a job someplace else. It raises policy questions about the purpose of these income maintenance programs. If we get to the stage that we don't have enough money to pay for all the things we're doing, which of them should we be paying for and under what kinds of circumstances?

If we are going to have financial security systems that really meet the needs of people 20 and 30 years from now, I think today is when we need to be thinking about these kinds of issues.

MR. SMITH: Thank you Anna, that's indeed food for thought.

As the United States moves further away from an industrial to an information and service economy, there is going to be more and more opportunity for the cottage industry. For example, we see computers moving from the workplace into the home. This can provide additional opportunities to participate in the economy in the years to come, and could provide a means of support for people when they decide to change their life style.

On the question of medical care, we have seen some interest in the area of the medical IRA. In other words, you could accumulate money currently to provide for your medical benefits when you retire. We are seeing some rather high deductibles and coinsurance being applied to Medicare, so that most people when they get older have a significant band of expenses that need to be provided from some source. It is an expense that needs to be provided for. Medical IRAs are an individual means of providing for that particular need.

AUDIENCE: From those panel members and others of you who work in the higher growth areas of the country, what is the trend in the adoption of defined benefit versus defined contribution plan arrangements?

MR. SMITH: It appears that they are interested in maintaining retirement plans which take advantage of each new tax wrinkle created. They want the newest and the best. They are not afraid of the administrative difficulties. They want to take advantage of anything that's new. They use these plans in order to recruit employees in a rather sophisticated market. Many of these companies have rather short lives. Most of them have rather fast slopes going up and fast slopes going down. Defined benefit plans do not really meet the needs of that particular type of organization. I don't know if defined contribution plans really meet their needs either. We're just seeing plan design driven by tax incentives.

MR. BLEAKNEY: It seems to me also that when you start looking at different industries and particularly high tech, you find many young employees even among management. For the most part, they don't care about defined benefit plans. What it seems to me will happen is that they may have a profit-sharing plan until finally somewhere down the line, the industry starts maturing. Then I think the same kinds of pressures which over the years have led to defined benefit plans being adopted in other industries will take place. It could quite likely get to the point where they have a lot of people who are going to retire and haven't done anything about it. When these people are in their 40's and 50's, to adopt a defined contribution plan is in a sense too late, and so they will have to consider the defined benefit alternative.

MR. BROWN: In Canada, we have a different banking system than yours. We have 5 very large national banks. They are very stable, powerful organizations. I just can't imagine any of those banks not having a defined benefit pension plan.

Utilities tend to be the same way. It is just part of the way of life there and it's likely to always be that way.

These are mature organizations and it's that maturity and stability that may be causing them to hang on to the defined benefit plans.

MR. SKALINDER: Coming from good, old Chicago and dealing with stable organizations, unlike in the Sun Belt, I would have to say that I have done a great deal of work recently for venture capitalists and people who are doing leveraged buy-outs, which is, of course, a tremendous fad now. I don't know of a single case where they have adopted a defined benefit plan except when required to do so through collective bargaining. All of the people who are involved in those buy-outs, and they are not all young, are often the executives that have been running a particular division of a larger company. They are very entrepreneurial and are just flat out unwilling to take on the potential liability and the inflexibility of a defined benefit plan.

AUDIENCE: When I first entered the pension industry, one of the things that I was taught was that retirement plans were in part created to encourage long-term employee stability. All of the trends I see in retirement are sapping the ability of retirement plans to create that stability. With current arrangements such as 401(k) plans and IRAs where people are 100% vested in their benefits, what I am wondering is whether retirement plans are going to die as a tool for encouraging stability? Can they be manipulated or changed to address this need?

MR. SMITH: That would be a good topic to start out with in this afternoon's session. We thank you for your participation.