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# PENSION LEGISLATION AND IMPLICATIONS


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- Review of recent and pending legislation affecting pensions in Canada and the United States
- Restructuring of Canadian and U.S. pension plans as a consequence of tax reform and other pension legislation

MR. DONALD S. GRUBBS, JR.: Government has been increasingly doing what some would call "meddling" in the area of pensions, while others would describe it as "taking an active role" in trying to assure that pensions meet the objectives of their nations, with respect to both employees and the tax structure. We are going to be looking both at what has happened and what may be happening in the future on the legislative front.

MR. NICHOLAS J.M. SIMMONS:

**PENSION LEGISLATION IN CANADA:**
**CURRENT STATUS AND LIKELY PRACTICAL RESULTS**

It is something of a challenge nowadays to be asked to speak on Canadian Pension Legislation. We have so many different initiatives going on right now in Canada that it is difficult, even for those working with them day to day, to keep track of:

-- what is still only a proposal,
-- what has been introduced as a bill but not yet passed,
-- what has been passed but not yet proclaimed,
-- where we have a law but still await detailed regulation,

-- whether regulations are exposure drafts or in final form, and
-- which issues are being studied by which committees and which task forces.

So when Mr. Grubbs asked me to review recent and pending legislation affecting pensions and the resultant restructuring of Canadian Pension plans, I had some difficulty deciding what to leave out.

I will spend a few minutes setting the scene in the latter part of 1987. Then I will address two specific issues: the trend to defined contribution plans and indexation.

I'm sure that both of these topics will be of interest to actuaries from both sides of the border. The defined contribution trend has been evident in both the U.S. and Canada for some time, while the subject of indexation is one we are now grappling with in Canada that I suspect has not yet surfaced in the U.S.

**CURRENT LEGISLATIVE INITIATIVES**

First, then, what is all of this regulatory activity we have in Canada?

It falls under three major headings. We have:

-- pension reform,
-- tax reform, and
-- judicial decisions based on the common law of trusts that are having unexpected ramifications for pension plans especially in the area of surplus ownership.

**PENSION REFORM**

By "pension reform," I mean changes to the various federal and provincial Pension Benefits Acts that govern areas such as vesting, funding, solvency and integration, the rights of plan members and plan sponsors, if you will. Those of you from the U.S. need to remember that pensions are a provincial responsibility in Canada. Thus, each province can have different requirements in this area. The federal government only gets involved in specific industries like banking, railways and airlines, for example, that constitutionally come under its jurisdiction. However, it's not quite as bad as it sounds. The different regulators do work quite closely together and there is a fair degree of coordination of the different laws.

Very generally then the rules we are going to see take effect in most jurisdictions will involve:

-- Making plans available to all members of the appropriate employee group after two years of employment -- This does not mean an employer has to have a pension plan and it doesn't mean he has to let hourly rated employees into his salaried staff plan. However, it does mean that if he has a plan for a particular class of employees, then everyone in that class, including a lot of the part-time employees, will have to be allowed to join after two years. The employer can decide to make membership mandatory or to leave it optional, and he can put everyone in the plan from day one, but he can't keep an employee out of the plan.

-- Full vesting after two years' plan membership.

-- Portability of benefits on termination -- This means that, on terminating employment, a vested employee can choose to take a lump sum transfer in lieu of his deferred vested entitlement. The transfer can be to a new employer's plan or to the employee's individual tax sheltered retirement saving's plan. In most cases, the transfer will be "locked in," meaning it cannot be cashed out, but has to be used to buy a life annuity at retirement.

-- The right to retire up to 10 years early.

-- A minimum death benefit that will usually be either 60% or 100% of the cash value of the accrued pension, depending on jurisdiction, and which will likely have to be paid regardless of any concurrent group life coverage. The amounts can be very significant for older, longer service employees.

-- A requirement that 50% of the accrued benefit be "employer paid" which, given the preponderance of contributory plans in Canada, is a significant extra cost item for many employers when younger employees quit.

-- Strict limits on the amount of offset allowed for government provided benefits.

-- New solvency rules with faster funding required when solvency ratios fall below a set level.

-- A new approach to investment powers.

-- Limits on employers, powers to merge or subdivide plans.

-- The one that scares employers the most, some form of mandatory indexation.

There are three obvious common trends running through all of these changes:

-- A major reallocation of the employer contribution toward the employee who quits, dies, or retires early rather than the employee who stays to retirement,

-- A significant increase in complexity and administrative cost, and

-- A significant reduction in flexibility as more provisions become mandated.

One saving grace is it is unlikely that most changes will be retroactive. Most will affect service after 1986 or 1987 only.

**TAX REFORM**

The first stage of tax reform in Canada will take effect in 1988. As in the U.S., we will see a reduction in marginal tax rates and a broadening of the tax base.

Since registered pension plans are tax sheltered, both for employee and employer contributions, the changes in marginal tax rates will have some effect on the relative attractiveness of tax deferred retirement savings arrangements as against nontax sheltered savings and stock purchase plans.

There are also major changes to the way the tax shelter for registered pension plans is to be restricted and, in particular, how it is to be integrated with the tax sheltering of individual's registered retirement savings plans.

These integration proposals have been around in various forms for some time and are now finally being integrated with the rest of tax reform. Those proposals are very complex for both employers and employees and discriminate quite heavily against defined benefit plan members. In essence, they set an overall limit for tax assistance in retirement savings of 18% of earnings (there are dollar limits too). Then they deem a contribution equivalent for any defined benefit accrual using the so-called rule of 9. That is, a 1% plan is deemed to cost 9% of pay; a 2% plan is deemed to cost 18% of pay; and so on.

Of course there are few 2% plans that actually cost 18% and employees in defined benefit plans see their other retirement savings opportunities as being reduced out of all proportion to the benefit they expect to receive. This is especially true of the younger, more mobile employees.

## JUDICIAL DECISIONS

The courts have become increasingly involved in pension plan matters in the last few years. Mostly this is in respect to limiting the powers employers have to recapture surplus funds.

To exaggerate only slightly, the general rule seems to be that unless a pension plan has now, and always has had, an explicit right for the employer to withdraw funds that are surplus to plan requirements, it will be difficult to justify a withdrawal of surplus. The problem is that in the past there was a tax rule that required contributions to be "irrevocable," so most older established plans run into trouble in this regard.

That then describes in very general terms the stage we have reached in the evolution of pension law in Canada. I'm sure U.S. actuaries can see many parallels to the changes in your own rules. I would now like to move on to consider two specific issues that are particularly topical today: defined contribution and indexation.

Both are highly emotional issues and ones on which a great many opinions are expressed -- some knowledgeable, some not, and they are curiously contradictory. For example, a large segment of the public regards defined benefit pension plans as a ripoff and thinks they could do much better under a defined contribution arrangement. Yet they want pensions to be indexed, which is really the ultimate extension of the defined benefit approach.

The social trends are toward more freedom of choice and flexibility while forcing an indexation pattern seems to reduce the freedom to receive more pension up front in the early retirement years.

Perhaps we have a generational battle here, with the young babyboomers wanting defined contributions, flexibility and the attractive investment returns of the last few years, while older people approaching or at retirement see matters in a different light and want the security of indexation. Then we get a seeming anomaly where almost all the Chrysler workers voted for a contract that was sold as including pension indexing. It seems that the younger workers thought it would encourage the older workers to retire and free up more jobs for them.

Perhaps what we have is pure self-interest! Give me money purchase benefits while I'm young and mobile, then index them at your cost when I get older. Who knows?

**THE TREND TOWARD DEFINED CONTRIBUTIONS:, WHY?**

There are plenty of reasons for the trend to money purchase plans, among them are:

-- Recent investment returns have been very high by historical standards and real returns over and above inflation have been even more so. Most people have short memories and expect good fortune to continue forever. It remains to be seen what effect the stock market movements of October 1987 will have on this psychology.

-- Current tax changes, like the "rule of 9" may well favor money purchase plans.

-- Employers perceive money purchase plans as having less financial risk for them, and depending on how these plans actually react when a long service employee comes to retirement with an obviously inadequate pension, they may be right. The whole subject of financial risk is really in the spotlight because of memories of recession in the early 1980s as well as freer trade and increased global competition. The manufacturing industry is particularly afraid of much larger and often more efficient U.S. competitors and is very wary of anything that would adversely affect their competitiveness.

-- Employers also see money purchase as the solution to their worries about pension reform and indexing in particular.

-- Employers see money purchase plans as administratively simpler too, though in practice that is often not the case.

-- There are certainly no surplus problems as the money purchase plan allocates it all to the employees, but there may be an advantage in not having pension regulators forcing the funding conservatism that often leads to the surpluses in the first place.

-- Employees too like to see their own accounts accumulating. They understand the money purchase benefit better and perceive a greater benefit.

-- With more employee mobility from job to job, the low payouts defined benefit plans made for the short service employee are seen as a major negative factor. Also, all employees seem to think they are even more mobile than they actually are. We have all heard of plan members who proclaimed that they wouldn't stay more than 5 years and then went on to stay for 30!

-- Certainly money purchase plans lend themselves to more flexibility. Members can be given choices in the amount they contribute, the type of investment their funds are in, and so on. This is a big plus as flexible benefit plans extend into the pension area -- though there needs to be a major emphasis on planning, communication, and helping improve the underprovision

-- All in all, money purchase plans are less paternalistic and paternalism seems to be a dirty word among Canadian employers in the late 1980s.

**THE TREND TOWARD DEFINED CONTRIBUTIONS: HOW?**

We are seeing all sorts of approaches in changing to defined contribution plans. Perhaps the most common will be the good old Canadian compromise where the defined benefit plan is cut back, from let's say a 1.75% or 2% level, to a 1% or 1.25% plan and a flexible money purchase arrangement is added on top. I see this as being the general pattern for the next few years, though each employer and each employee group will have different objectives that lead to different practical approaches.

We will often see flexible contribution rates and a range of investment options. Employees may control the investment of their own funds only or of the employer's too. There will have to be tax sheltered and non-tax sheltered portions to cover the higher paid on an adequate basis.

In the more distant future, there may be some very interesting changes in store as the baby boomers get closer to retirement. Will they turn back to defined benefit plans out of pure self-interest? And will they still have the economic clout to get what they want?

**INDEXATION**

Indexation is an issue that has been building gradually in Canada for some time.

Up until the mid-1970s, inflation was quite low and relatively stable and there were not very many pensioners in private plans. Indexation was not an issue.

As inflation rose in the late 1970s, many employers did begin to provide some limited ad hoc increases that helped avoid the worst of the purchasing power loss for those who had retired. Nevertheless, there was always the "shining example" of the Canada Pension Plan, which, being a very immature, pay as you go plan, was able to provide 25% of final pay, fully indexed for the total contribution of 3.6% of pay. Organized labor and a good number of politicians, who should have known (and probably did know) much better, claimed that indexation was not expensive and should be provided for everyone. If private plans wouldn't do it, then the Canada Pension Plan should be expanded, they argued.

## PENSION LEGISLATION AND IMPLICATIONS

With high inflation and high interest rates in the early 1980s, many academics argued that investment returns went up when inflation went up, so indexation would pay for itself. They seemed to miss the point of the employers' argument that paying out bigger benefits had to mean bigger contributions from somewhere. However, so many jobs were being lost in the recession that no one even tried to impose more costs on employers.

As we came out of recession, inflation fell. Indexation became less of an issue as the need for it reduced, but it had not gone away. Alarming projections continued to be made about the damage that even quite low inflation could do to the purchasing power of a fixed pension over a long enough period. Worse still, pension plans actually accumulated surpluses. The surpluses should not be withdrawn or used to pay current costs, labor argued; it should be used to provide indexing. It didn't seem to matter that the only reason for the surpluses was that inflation had fallen, leading to lower interest rates and large capital gains on both stocks and bonds. The gains and, indeed, much of the surplus would likely go away as soon as inflation rose again -- just at the time the protection of indexation began to be needed.

In 1987 we had two provinces which have enacted inflation protection provisions. The Ontario Act says:

> Pension benefits, pensions or deferred pensions shall be adjusted in accordance with the established formula or formulas and in the prescribed manner to provide inflation related increases.

A task force is currently holding hearings to consider the details of exactly what the established formula(s) and the prescribed manner should be. Many interested parties have submitted briefs or made personal appearances at the public sessions. A wide range of views has been heard. Some have argued that any system of mandatory adjustments is intrusive and unnecessary; others contend that nothing short of fully protecting the pension's purchasing power is adequate.

While none can predict the outcome of the task forces' deliberations, one of two scenarios seems likely. Either all pensions will have to be adjusted in line with some fraction of the increases in the cost of living; or retiring members will have to be given an option to choose a smaller indexed (or partially indexed) pension in lieu of the standard pension provided for under the plan. In either case, plan sponsors and their actuaries will need to address the issues of making financial provision for indexed pensions.

**SHOULD INDEXED PENSIONS BE FUNDED?**

One topic of discussion has been whether the indexing portion of a pension needs to be prefunded. General Motors has suggested that adding indexing to the pensions of auto workers would add $500 to the cost of a North American built car. There have been alarming projections of the effect this would have on employment levels. Chrysler on the other hand happily settled for a contract that everyone claims provides indexed pensions -- although in practice it is of quite limited effect, though it is a powerful precedent.

The difference of course is funding versus nonfunding and I hardly need remind actuaries that the funding decision does not change the ultimate cost of the indexed pensions. The same amounts will be paid out funded or not, so the cost has to be the same. You can add $500 to the cost of a car today or you can add $1,000 to the cost of a car at some future date. In the meantime, a growing part of the plan's financial obligations is not matched by real assets, but simply by a promise to pay the needed cost in the future. The potential for claims on a Pension Benefits Guarantee Fund is tremendous, as are the costs that are passed on to future generations.

**CAN INDEXED PENSIONS BE FUNDED?**

Another peculiar claim is that indexed pensions cannot be funded because of the open ended liability they represent; before indexed pensions can be provided, the government will have to issue indexed bonds. This ignores the ready acceptance of final earnings pensions!

Certainly there will be situations, such as funds closed to new members, where any unpredictable variation in future payments cannot be underwritten. However, in the vast majority of cases there is no structural problem in providing for indexed pensions. It would be expensive but it can be done.

I will not even try to discuss the cost of indexed pensions!

**WHAT ASSETS SHOULD BE USED?**

As for the effect on investments, there seem to be two misconceptions: indexed bonds and mortgages must be available; and since only the return on short-term paper effectively tracks inflation over the short term, short-term securities must be used to back indexed liabilities. The problem of course with both these arguments is that a great many pension plans now provide pensions based on final average earnings without embracing either strategy!

The best strategy for most pension plans of course will continue to be the one that maximizes the expected future real return, typically involving a heavy equity component. Only in special cases, where retirees represent a disproportionate share of the liabilities or where there is little or no ongoing employer financing, do more extreme strategies need to be considered to minimize risk.

**INDEXATION: SOME FINAL COMMENTS**

So that is were we now stand on indexation. There is of course a link back to defined contribution plans because a final decision on indexing may scare more employers away from defined benefit plans or even pension plans at all. If this were to happen, there would be a greater need to address indexing in the money purchase context.

I think indexation is an important issue and one that can be addressed in the private pension plan context. It may involve a large scale redesign of the whole retirement savings pattern, and this is arguably an ideal time to do just that.

During the question-and-answer period, I would really like to know the feelings of other actuaries about the subject.

MR. DAVID R. KASS:

**IMPLEMENTATION IN PRACTICE**

One of the first things I did after Mr. Grubbs asked me to serve on this panel was to consider what "recent pension legislation" means. I'm pretty sure it doesn't mean ERISA, although I believe there may be one or two Final Regulations still pending 13 years later and I'm sure it does include the Tax Reform Act of 1986 (TRA).

SECTION BREAKFAST

When I was a younger man, I would have been quite positive that "recent pension legislation" meant this year's and last year's. Thus, the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA) would warrant discussion, and indeed, I shall discuss it. An important amendment to the Age Discrimination in Employment Act (ADEA) passed by Congress was seen in 1986, which affects pension plans. I will comment on this too.

But now that I have grown older, I find that many things I consider "recent" seem to have occurred as long as five years ago. Thus, I would like to include some commentary on the Retirement Equity Act of 1984 (REA). I would also like to deal with the TRA in the context of its two immediate biennial predecessors, the 1982 and 1984 Tax Acts. For the benefit of our Canadian hosts, I will note that these last two are referred to as TEFRA and DEFRA, respectively, for reasons that at the time seemed quite compelling.

**SEPPAA**

I would like to talk first about SEPPAA. This was, of course, a 2-part program designed to make the world safe for the PBGC:

-- The first (and obvious) item was to raise the so-called insurance premium levels as high as a reluctant Congress would allow.

-- The second, and far more significant, change was a great expansion in the circumstances under which the PBGC could recover moneys from Plan Sponsors; I am tempted to refer to this as PBGC's Subrogation Clause.

This second aspect of SEPPAA clearly demonstrated that the PBGC realized it was, and was likely to continue to be, snookered by financially unstable Plan Sponsors.

Its legislative approach was *not* to mistreat the poor Plan participant whose pension benefit the PBGC guaranteed, but rather to attempt to extend the circumstances under which guaranteed benefits would in fact be paid by the Plan Sponsor itself, even after a Plan Termination took place, or to expand the situations in which the PBGC had an enforceable legal claim against the Plan Sponsor for the moneys it advanced.

Thus, the PBGC emphatically acknowledged that its role as an Insurer was to put up the money to pay the Guaranteed Benefits; and like a casualty insurer, it felt it should attempt to offset its losses by amounts recoverable from the Party -- in this case the Plan Sponsor -- whose failure to perform triggered the claim. I think the term subrogation is appropriate here. I also think that this approach by the PBGC was remarkably clear-headed.

However, the ink was not yet dry on SEPPAA when the PBGC got all its wagons in a circle and started hammering out new legislative proposals: it recognized that Congress had not come through with adequate relief for its problems. In the intervening 18 months, we have seen and heard a wide range of proposals to address, among other things, the PBGC's problems.

Where does this leave the Pension Actuary? After all, Mr. Grubbs asked me to focus on implementing these issues. Let's think about that.

The distinguishing characteristic of SEPPAA is that, from the day it was born, it was acknowledged to be stop-gap legislation. Further, it was legislation that dealt primarily with situations that do not occur annually with all plans.

Thus, I feel that the practicing Pension Actuary is not obligated to have a detailed and specific knowledge of SEPPAA in order to properly serve his clients; he should, however, be familiar with the broad structure of SEPPAA. He must be aware of the distinction it creates between "Standard" and "Distress" terminations, and the working definitions of each. He must be aware of the distinction between amending a Plan to eliminate, or curtail, further accrual of pension credits and terminating a Plan. He should be generally aware of the procedural steps needed to process a termination, and the various time intervals inherent in the termination process. A detailed and specific knowledge of the law and regulations should await a fee-paying client to subsidize the educational process.

A general knowledge of the Statute itself, together with the Pension Actuary's familiarity with prevailing interest rates, the "market" for annuities, and so on, should allow him to meet his responsibilities to any clients who feel they have overextended themselves in the Defined Benefit area, and wish to explore the possibility of terminating the Plan.

A practical point the Actuary should raise, once the countdown to a "Sufficient" Plan termination -- namely, one in which benefits has started -- is whether the Plan Sponsor should continue the existing deployment of plan assets between stocks and bonds, or whether the investment balance should shift to match up more closely with annuity-type investments, such as short- to intermediate-term high-quality bonds. Failure to have done so between, say September 1 and October 20, 1987, in a heavily stock-oriented fund could prove troublesome.

For those of a studious inclination, I bring to your attention the excellently written 25-page proposed Regulations on Distress Terminations and Standard Terminations of Single-Employer Plans which were issued September 2, 1987.

For those pessimists whose attention tends to be drawn to the half-empty part of the glass, I suggest that a reputation for expertise in terminating defined benefit plans could be a key to financial success and glory. The prospect of annual PBGC premium tax rates ranging from $20 to $100 per plan participant will dramatically accelerate the pace of Plan terminations; we can wring our hands about this, or bow to the inevitable and service the need for terminating plans. In this irrational environment, being a Funeral Director may have its rewards.

**THE ADEA AND THE 1986 BENEFIT ACCRUAL REQUIREMENTS**

Let me turn my attention briefly to the problems posed to the Plan Actuary by the ADEA. This Social Legislation, designed to relieve unfair employment practices to older workers, was originally passed in 1967. It was amended in 1978 to raise the upper limit of the age protection bracket from 65 to 70, and was further amended in 1986 to eliminate any upper age limit on its protection. The ADEA and its various amendments affected pension plans in two major respects:

-- Plan provisions which called for mandatory retirement during the protected age bracket were invalidated; and

-- Criteria were set which call for the accrual of pension benefit on a more-or-less uniform basis regardless of the employee's age. It is instructive to consider the Plan Actuary's responsibilities with respect to both of these matters.

I see two separate aspects of eliminating Plan provisions which call for mandatory retirement. They are the following:

-- The simplest of these is that the Plan itself, and of course the Summary Plan Description, must be amended to delete all references to Mandatory Retirement. The question for the Plan Actuary, simply put, is, what is my responsibility to this Client in this context? In the most limited sense, the Plan Actuary's responsibility is to Plan participants, and involves determining contribution levels under Section 412 of the Internal Revenue Code. Does this Plan Sponsor expect more than pure Valuation support from the Actuary? It can be painful if the Actuary and the Client have different ideas on this score!

-- The second aspect of this type of Social Legislation is that certain changes must be made in the way in which the Plan Sponsor maintains the working environment. Not only must Plan language be changed, but the Employer must abandon any Mandatory Retirement practices he may have followed historically.

There is, of course, greater likelihood that the Employer will look to his Attorneys to discuss the broader aspects of the ADEA, however, the Plan Actuary should be sure that he is not going beyond his intended role in these matters. Whether his role is viewed as "Plan Actuary and Pension Plan Consultant," when it is the Actuary who has drafted the language which conforms the Plan to the ADEA, do his advisory responsibilities end there?

I use this relatively non-actuarial aspect of Social Legislation which bears on employee benefits in order to highlight the troublesome issue of "jurisdiction, responsibility, or -- what you will." You must be concerned with the following questions: What are my responsibilities to the client in attaining conformity with new statutes? and equally important, Are these responsibilities different for different clients; if so, how are they determined?

But let us turn to the more obvious actuarial issues, the Benefit Accrual Rules. The lack of regulations on this score -- 9 years after the 1978 amendments -- is a singular example of our Federal government at work! The regulation-writing project was bounced between the Department of Labor (DOL) and the Equal

Employment Opportunity Commission (EEOC) for several years. It finally came to rest with EEOC, well into the Reagan Administration, which was not inclined to enforce "liberal" legislation with enthusiasm! Indeed, in 1987, the EEOC begged off yet again in producing regulations implementing the 1978 amendments on the logic that it was getting all pumped up for regulations on the 1986 amendments!

This will be most interesting to watch: The 1986 statutory language is far more specific than its predecessors in establishing the fact that defined benefit pension accruals must be provided for those who work past a Plan's Normal Retirement Age. It expressly endorses the use of an actuarial equivalent as a means of providing part of those accruals. In this complex area, regulatory guidance is essential.

The new accrual requirements are effective January 1, 1988 for calendar year plans; the statute itself acknowledges that the regulatory process involves the DOL, the Treasury Department and the EEOC. It expressly calls for the issuance of final regulations by February 1, 1988. I hope this is not a critical test of whether the United States is ready for self-government!

In the absence of Regulations, the cleanest approach for a Plan Sponsor is to base a Late Retiree's pension on his Benefit Service and Compensation through his actual retirement date. While this approach is likely to be a bit more expensive than alternative approaches, such as freezing the benefit at Normal Retirement and paying the actuarial equivalent at actual retirement, it will in many instances be the easiest to administer. The potential hassle, pending regulations, is in Plans integrated with Social Security. While the logical approach is to base any Social Security adjustment on the Social Security Law in effect on the date of actual retirement based on the individual's Social Security Wage history to that date, I have known Regulators to come up with alternatives others felt were less than logical.

Let me remind you that three separate agencies of the government will be involved here. Perhaps we might consider the efficacy of prayer.

**THE REA**

The Retirement Equity Act of 1984 was Social Legislation, and unlike ADEA, it was Social Legislation dealing exclusively with Pension Plan issues.

-- The minimum age for participation was dropped from 25 to 21;
-- Pre-retirement survivor annuity coverage of ERISA was extended to all vested participants;
-- Spousal consent was required for an election away from the Joint and Survivor Option;
-- Paternity and Maternity leave provisions were mandated; and
-- To constantly remind the Plan Actuary of the transient nature of marital bliss, Plan language concerning Qualified Domestic Relations Orders was mandated.

As a practical matter, only the second item, the pre-retirement survivor matter, involved any meaningful choices for Plan Sponsors. Thus, the consulting issues, for the most part, boiled down to figuring out the particulars of these new requirements, explaining them to the client, and taking those steps that were your responsibility to assist the client in conforming Plan (and booklet) language to the requirements.

The only truly actuarial issues in this legislation were bound up in the expanded pre-retirement survivor benefits -- namely, how to modify Valuation calculations, how to deal with the determination of actuarial equivalents, especially lump-sum settlement factors. I'm not at all sure I'm doing this right, so let's consider a simple, straightforward situation.

-- A forty-year old employee terminates with 15 years of service. His vested benefit is $100 a month, starting at 65. He is single.

-- The Plan provides the pre-retirement survivor's benefit on a "gift" basis.

Of course I value this participant's benefit as a monthly pension of $100, deferred to age 65, but what if he gets married next year? I think the Plan may be on the hook for his survivor's benefit! How many deferred vestees out there have already shed their bachelorhood for the joys of marriage and failed to invite the Plan Administrator to the wedding? Am I understating Plan liabilities?

In the same vein, what if this possibly confirmed bachelor and the Plan Sponsor agree on a lump-sum settlement when he terminates? As Plan Actuary, am I giving all parties a fair shake if I ignore the possibility of future marriage when

I make my calculations? Or does the Plan Sponsor owe our bachelor friend a wedding gift in advance? I find I still have more questions than answers, and it's already 1987.

**TAX LEGISLATION**

Two things are certain, death and the fact that in the U.S. the Ultimate Tax Bill will be passed every two years. I will talk about some patterns that appear in the last three Tax Bills to End All Tax Bills -- namely, TRA, DEFRA, and TEFRA.

**The IRS's Attempt to Minimize the Use of Qualified Plans as Tax Shelters**

The first pattern I would like to address is the IRS's ongoing attempts to defeat the use of a qualified plan where it presumes that tax sheltering is the sole purpose of the plan's existence. In fairness to the IRS, I am sure we all know that such plans do exist; indeed, I suspect that many of us at one point or another in our checkered careers have been hired guns, helping the client design a Plan that met the letter, if not the spirit, of the law. Sometimes these self-serving plans, by accident, have benefitted a non-key employee! Nevertheless, they mostly tax-shelter enormous sums of money for the Plan Sponsor.

In effect, a sort of 3-dimensional chess game has been going on for years between the IRS and pension plan designers. Tax Law changes are the IRS's moves! Unfortunately, this game is being played on the same board as the legitimate Pension Sponsors', but since we can't tell one from the other, we must respond to these moves on behalf of all clients.

In TEFRA, "Top-Heavy" became a term applicable to the pension world rather than merely to people like myself who enjoy a life of hearty eating. It called for expanded benefits to rank and filers if the "trigger" conditions are met. At the implementation end, we had to be prepared to ask our clients to identify the key employees in the data and then to produce certain plan liability measures involved in this group to see whether the "trigger" was met.

Ironically the identification of key employees is a relatively simple chore in the small case where the abuse is assumed to be involved, but the data gathering is typically troublesome under larger cases, the innocent bystanders. In some instances the trigger appears at first glance to have been met. I had a terrible time a few years ago with a medium sized bank. It was caught by the trigger until we pressed on. We ran figures for their profit-sharing plan to prove they were well out of harm's way. When we combined the plans, we came out with suitable ratios. I don't think that we should go through that agony every year, or should we?

It's a worrisome thing to deal with in the case of a larger employer who is not the target of all this top heavy, key employee nonsense. I worry further that every tax law changes the definition of key employee. I am concerned that our clients will not submit the right information simply because of these changes. I am also concerned about the practicality of maintaining records which allow for retrieval of key and non-key employees who received distributions over the past 5 years. Even in this day of computerization it involves a lot of make-work.

We have also had biennial take-backs from the maximum benefit levels established by ERISA. The automatic inflation adjustment has been stopped dead in its tracks several times. The basic dollar limitations today are a modest 20% above where they were when section 415 of the Internal Revenue Code (the Code) was established 13 years ago.

We have also been bedeviled by changes in the way in which the limits apply: where there are two or more qualified plans; retirement age is before or after age 65; on the dollar but not the percentage of pay; and so on; and so on; and so on. When are the folks at IRS going to get it right?

One of TRA's new and exciting approaches to these correctly perceived abuses is found in the greatly revised non-discrimination provisions of the Code. These provisions are designed to increase the number of employees covered by qualified plans. The long-standing "70%/80%" tests have been replaced by three new tests: a "percentage test" (still 70%), a "ratio test," and an "average benefits" test. Performing these tests is mind-boggling. For a large multi-divisional employer, the ability to identify "highly compensated employees" will take much planning. For a smaller employer, the responsibility will likely be placed on the Plan Actuary, who will have to develop methods for massaging data on all corporate employees, not merely plan participants.

I pity those who find they must resort to the "average benefits test"! This test involves determining a "benefit/compensation" ratio and then doing a 401(k)-like test which compares the ratio for the "good guys," those who are "non-highly paid," with the "bad guys," those who are "highly paid." I can hardly wait. The kickoff date is 1989.

There is also a new participation test. The Plan must cover at least 40% of all employees or, if less, 50 employees. This may cause grief to some Plan Sponsors, but at least we can all understand the test without a week's study.

Another silver bullet traveling toward the abusive plan is the requirement, effective in 1989, that Plan benefits may not be based on more than $200,000 of a participant's compensation. As the saying goes, "I think they shot the wrong man." This requirement cuts into executive pensions in many bona fide non-abusive pension situations.

New Code Section 4972, which imposes a non-deductible 10% excise tax on "excess contributions," that is, contributions in excess of the deductible limit, is another effort by IRS to curb perceived tax abuses, in this instance far more perceived, I suspect, than actual. It puts the Plan Actuary in an awkward position if a client should make such an "excess" contribution because the actuary advised him of a "too high" estimate and the client contributed before the damage could be undone. Ah well, that's what errors and omissions (E&O) insurance is for!

The new Vesting Requirements are a blend of Social Legislation and a "let's make the tax avoider suffer" mentality. My view is 5-year vesting "leaks" more of the pension fund to transient employees than I would like to see, but it's not particularly costly to the Plan overall. Indeed, a slight silver lining for the pension actuary is that 5-year vesting tilts the playing field slightly in favor of the embattled Defined Benefit Plan, since the relative leakage to short-term, younger employees is likely to be less severe here than in a Defined Contribution Plan.

**The Tax Treatment of Plan Distributions**

It's nice to know that we are moving toward a unified approach for taxing Plan distributions, whether we are looking at a plan for the self-employed, an IRA, a tax-sheltered annuity, or a qualified corporate plan.

The basis for taxing a distribution depends on whether it is classified as a lump-sum distribution or an annuity; however, for the umpteenth consecutive time, the TRA changes the options for taxing a lump-sum distribution. One must question what responsibilities a Plan Actuary has for advising a Plan participant of the tax considerations or tax options available to him with respect to a plan distribution. Are those responsibilities the same if the participant is a rank-and-filer or the President? Is the Actuary serving the role of Financial Planner? Should he? Those present will have many different answers to these questions. The key point is that you consider them consciously, not unconsciously.

**Timing of Plan Distributions**

The IRS has been concerned that tax revenue is lost if wealthy Plan participants are allowed to accumulate money tax-free in a pension fund and pass it to their heirs at their death. Thus, the IRS has consistently changed the Code to avoid this. At the same time, they don't want funds distributed too soon, presumably for the reason that if you aren't willing to lock up your benefit money, you shouldn't get a tax break on it, sort of "no pain, no gain," IRS style. TRA continued the trend of imposing new punishments to Plan participants who received their Plan distributions too early, that is, before 59.5, or too late, after 70.5.

Lest we feel comfortable with our understanding of these matters, John Wade assures me that there are exciting new twists in the road ahead.

MR. JOHN F. WADE:

**PROPOSALS FOR FUTURE ACTION**

Now that Mr. Kass has brought us up to date on the recent changes, I am going to be talking about what we will face in the near future. Mr. Kass has pointed out the problem of the complexities of each law as it comes along. It is very difficult to cope with. These new proposals aren't really going to get any simpler.

The proposals I will talking about are much more narrow in scope than tax reform. They just relate to two particular areas where there are perceived problems in defined benefit plans. I will be talking only about single employer defined benefit plans. At least some of these problems are similar to some of those occurring in Canada. So what areas will we be talking about? We will be talking about problems that exist with overfunded plans and underfunded plans, which should hit just about everyone. Of course in light of previous presentations we may need only to concentrate on the underfunded plans. Let's look at how some of these problems came about.

**OVERFUNDED PLANS**

To consider this on an historical basis I think we have to go back to the early 1980s when the economy of the U.S. was in a recession. Many employers were strapped for funds and they saw their overfunded defined benefit plans sitting there. They felt a need to tap the surplus for a source of operating funds. Section 401(a)(2) of the Code prevents an employer from reaching into that plan and withdrawing funds, so employers decided the only way to get it was to terminate the plan. Once they terminated the plan, they could get the excess money back. This caused a lot of problems and a lot of complaints, of which Congress became aware. Employees felt that their benefit security was lessened even when the employer set up a replacement plan, and in some cases there was no replacement plan, or it may have been a defined contribution plan. Some of the same concerns were expressed by some retiree groups and unions.

So, what then was done as a way to try and address these problems? In May 1984 the Joint Implementation Guidelines were issued jointly by the DOL, Treasury, IRS, and PBGC. These guidelines basically permitted an employer to recapture these surplus assets of a plan provided certain protections were given to the employees. Additional vesting had to take place, annuities had to be purchased, and a change in the funding method required to bring about a shorter amortization period was made. Despite this -- and this really didn't answer some of the fundamental questions -- some employees felt that this surplus should not all go back to the employer, but that the employee should be entitled to some of it. In a way this was a form of deferred wages and the employee should get a share of it.

What were some of the problems with the guidelines? For one, the guidelines were disruptive; they required a plan termination, and there were expensive annuities to be purchased. The effect was that the employer was able to take money out of a plan, yet an ongoing plan continued to exist. Also, there were the questions of who was really entitled to this surplus and whether too much was being taken out. Should some additional funds be left in the plan to protect future benefit accruals for the employees and also to provide future increases in benefits? So the issue of overfunded plans is whether employers should be able to take money out of the plans and whether employees should have a right to some of this surplus.

**UNDERFUNDED PLANS**

The problem there was that many plans, including very large plans, were terminating with substantial unfunded benefits which cause a very severe strain on the PBGC. This is particularly true of plans in certain industries; in the steel industries a few very large companies terminated plans and only had assets to provide a very small fraction of their termination liabilities.

What action was taken in this area? We saw the Joint Implementation Guidelines try to attack it at least to some extent, but they certainly left a lot of questions left unanswered.

Mr. Kass mentioned that when SEPPAA was enacted, it really was thought at the time a stopgap measure. The actions taken there were to make it more difficult for an employer to terminate a plan. The plan could only be terminated if the assets were sufficient to provide "benefit commitments"; if not the plan could only be terminated if the employer could demonstrate that he was in a distress situation. We have seen that it clearly did not solve the PBGC's problems. There have been some additional plans that have terminated that have really caused the PBGC's deficit to deteriorate significantly. This summarizes where we are in the area of overfunded and underfunded plans and what the problems are.

So what should be done about it? That's why these proposals were introduced. They were first introduced as administration proposals back in February 1987, and they have been under consideration in Congress since then. Congress has of course added their own twist and added some modifications to them. Let me stress that these are only proposals at this point. Nothing has been enacted, although they are working fast and furious on them, so we may see something fairly soon. There are a number of different proposals. I am just going to mention a few of them to give you an idea of the types of proposals that are being put forth. I will concentrate on the concepts involved, not so much on the details, because there is no way of knowing yet what details or provisions will be enacted. However, I will be mentioning some of the specifics of the proposals.

**OVERFUNDED PLANS: PROPOSALS**

First, what about the area of overfunded plans and withdrawal of assets? The basic proposal is that withdrawal of assets by an employer from an overfunded plan will be permitted without terminating the plan, provided certain requirements are met. The basic requirement is that an adequate surplus or an adequate cushion be left in the plan to protect the participants and their benefit security for future accruals and future benefits. This level is defined in terms of what is called a minimum benefits security level. This level is basically the greater of two things, 125% of the termination liability of the plan or the full funding limitation under the projected unit credit cost method. Residual assets due upon plan termination on account of employee contributions would also have to be added on top of that. This minimum benefits security level is modified in certain circumstances. For instance, if annuities are purchased, it can be lowered somewhat, perhaps to 110% of termination liability. On the other hand, if the plan has certain contingent benefits such as a plant shutdown benefit, this minimum benefits security level would have to be higher, perhaps up to 150% of the plan termination liability.

Another feature of this minimum benefits security level is that it is a stronger requirement than just having to be met by that plan. It has to be met by all plans sponsored by any controlled group member. There are some different ways in which this might operate. One proposal is that each plan of the controlled group has to have benefits up to this minimum benefits security level. Another proposal would require us to look at it in aggregate for the entire controlled group, and the entire controlled group would have to meet this level. What happens if the level is not met? Under one proposal, instead of withdrawing all of the surplus, transfers to the other plans may have to take place in order to bring them up to this level. That basically is the amount that can be withdrawn from an ongoing plan.

What about a plan termination? There was a desire to create a level playing field between plan terminations and withdrawals from ongoing plans. The basic idea is that in a plan termination we shouldn't be able to get any more than if you had withdrawn the money. That means that, if a plan terminates entirely, all of the surplus can't go back to the employer. Again all of the other plans of the controlled group must have assets at least equal to this minimum benefits security level. There are different ways this might occur, different proposals. One proposal would require transfers from this terminating plan to other plans. Under another proposal these other plans would have additional charges in their funding standard account to bring them up to this level. The idea is that these additional charges or this additional amount would have to be funded in a period of three years. These are the different proposals on how this can be done, but basically all the other plans of the employer would have to be adequately funded before the employer could receive money from a terminated plan.

What happens if all the plans of the controlled group terminate?

In that case, although there are some different ideas here under the Administration proposals at this time, the employer would be able to get everything back. However, he and his employees would be affected by what is called the "five-year curse." If he terminated the plan and got everything back, he would not be allowed to start a new defined benefit plan for a period of five years. There would have to be special rules for corporate sales and purchases, in which a new company or division that had an existing plan is purchased.

When there is a surplus, whose money is it? Does it belong to the employer or to the employees? The original proposals would provide that all of it could go back to the employer; none of it was required to go to the employees. However, for ongoing plans, this minimum benefits security level had to be met. One of the proposals in Congress will require a certain percentage of the surplus to go to the employees when the plan terminates. The excess assets up to 25% of the termination liability would have to be used to increase benefits of employees of a plan. That's an area where there will be some continuing discussion and some additional proposals. I don't think anything is settled yet in that area. There are some obvious advantages and disadvantages to giving some of this surplus to employees. From the employer's standpoint it may discourage him from funding a plan adequately. Why put this extra money in the plan if there is no possibility of getting it back? On the other hand, employees feel that in many cases they should be entitled to this money.

There would be special rules if there was a change in the controlled group, such as a sale of one of the companies in the controlled group which has an overfunded plan. Could that plan just go over to the new purchaser? That would be treated as a plan termination for the purposes of applying these rules. Some of the surplus that goes over to this employer may have to be restricted or limited, or else transferred back to the other members of the controlled group. There are also some tax consequences. If this surplus goes to the new employer, it would be subject to income tax and subject to excise taxes as a reversion to an employer.

If an employer is going to receive a return of plan assets either through a withdrawal or a plan termination, there would be a number of reporting and disclosure requirements. One that you would be interested in is that there would be some sort of enrolled actuary certification that the requirements of these possible changes in the law are met, that each plan has assets equal to the minimum benefit security level, that these amounts have been calculated according to certain methods and assumptions, and that the assets are sufficient to provide these amounts. There would also be some frequency limitations on these types of transactions. The basic idea is that this could only be done once every ten years. However, if the maximum amount was not taken out, some additional amounts could be taken out later, up to three times in any ten year period, to get the employer up to the maximum amount.

That is a brief summary of some of the proposals made in the area of overfunded plans. Let me emphasize that they are just proposals. The details will be worked out. The legislation does appear to be on a fast track. It is intended now to make it part of budget reconciliation, which was initially due the end of September 1987, the time that the government's fiscal year ends. Congress extended their own deadline. It should be acted on fairly soon.

**UNDERFUNDED PLANS: PROPOSALS**

What will some new minimum funding requirements be under these new proposals? The general idea is that the minimum funding requirements would be tightened for underfunded plans. These proposals deal basically just with plans that are underfunded on a termination basis.

There are a number of proposals. Let me give the initial administration proposals. The minimum funding requirements for an underfunded plan would be the greater of four amounts. First would be the current minimum funding rules. Second would be something called a "complement rule" where the amortization of the unfunded accrued liability would depend upon the extent to which the plan was underfunded. For example, let us take a plan that is 60% funded. Then approximately 40% would be amortized over as low as a three-year period. Third is an anti-deterioration rule. Under this rule, if the funding of the plan becomes worse, if there are experience losses -- let's say the funded ratio was 60% and that it drops to 50% -- that differential of 10% would have to be funded over a short time period, something like three years. If the deterioration is due to something other than experience, such as a benefit increase, it would be handled more in terms of the complement rule. The last of these four items is a cash flow rule which basically requires you to look at all the disbursements from the plan, that is, all the benefit payments and expenses. Then you have to put in an amount at least equal to these benefit payments; obviously these need some limitations in certain situations. You wouldn't want to have to put in more than is required to bring the plan up to a funded ratio of 1. The full funding limitation still applies. I think there would have to be some special rules in retiree-only plans and things of that nature.

Now that's one set of proposals. There are some others which do include some of the basic features of the complement rule, but phrased a little more simply. The amortization period is just a graded number of years depending on the extent of underfunding. I'm sure there will be a lot of further development in this area before a final decision as to what is put into the law.

Now those are some proposals to tighten minimum funding. There are some other proposals to be sure that employers actually make these payments. First, the 8.5 month period for meeting minimum funding will be cut back to 2.5. The IRS introduced some regulations several years ago to accomplish that. Those regulations are proposed and not in effect yet. They would be put into law. This is one case where there was an advantage to everyone in the delay in getting those regulations out.

Another proposal is that those minimum funding requirements would have to be met on a quarterly basis, similar to estimated tax payments, with the first payment due March 15 and every additional payment due three months after that. This would be on an estimated basis, looking at the requirements for the current year or last year, whichever is lower, with the final payment due within 2.5 months after the end of the year.

Another change is that the entire controlled group is responsible for the funding of a plan. If the funding is not met, the excise taxes that would apply to minimum funding violations would be the responsibility of the entire controlled group. So if the employer sponsoring the plan is not able to make the contribution, the other members of the group would have to make it and would be able to receive a tax deduction for it.

There are also a few changes in waivers of the minimum funding standards. This is an area in which the PBGC has had a few problems. The first change is that the number of waivers allowed would be decreased. Instead of five in any 15-year period being allowed, it would be lowered to three. This would be looked at both on an individual basis for the employer sponsoring the plan and on the controlled group basis. Both the employer and the controlled group would have to be able to demonstrate business hardship. The period for amortizing a waiver would be dropped from fifteen to as low as five years. The exact number of years would depend on the funding status of the plan, something along the lines of the complement rule that I mentioned earlier.

That is a summary of the funding proposals to give you an idea of some of the things being considered and some of the concepts behind them. Keep in mind that the details will be decided upon later.

I want to mention three other items that are also being proposed. First, under SEPPAA the idea of benefit commitments was created. A plan could not terminate unless it met all benefit commitments. That is being changed to consist of all accrued benefits or the entire termination liability of a plan. A plan could not terminate under a standard termination unless assets were sufficient for all accrued benefits and not just benefit commitments. If a plan terminated in distress and the employer had other overfunded plans, the assets of the overfunded plans would have to be transferred to the underfunded plan that is being terminated. That would relieve the financial situation of the PBGC.

There is a five-year provision here. If you did terminate in distress, you could not reinstate the plan for five years.

You have probably read recently how Ling-Temco-Vought, Inc. terminated their plan and that the PBGC took it over. Shortly after that they reinstated some of the benefits. Now the PBGC is trying to give the plan back.

Those are the basic proposals. It is possible that something will be enacted before the end of the year. We'll all have to wait to see what happens.

MR. DONALD J. SEGAL: Mr. Wade, you did not mention that in the Senate Finance Committee a bill, which I believe has been adopted by the committee, the full funding limitation is going to be changed to 150% of the plan termination liability. On the one hand Congress seems to be saying that they are worried about the financial health of the PBGC, but on the other hand, they seem to be adopting a measure which will discourage the funding of pension plans, especially final pay plans. When these plans terminate, there is a surplus which the employer gets back, and the employer already took a tax deduction for the surplus. Congress does not mention that the employer will be taxed and pay an excise tax on the reversion. Doesn't Congress understand what they are doing when they put a full funding limitation of 150% of plan termination liabilities?

MR. WADE: You ask whether Congress understands it. I would not want to comment on that. However, I think there is a schizophrenic nature to some of these proposals. On one hand Congress wants to see that plans are adequately funded and that the PBGC's problems are lessened. On the other hand, there is this big budget deficit and there is the revenue issue that they have to worry about. The particular proposal you are talking about was made because of revenue considerations. There are going to be some proposals made because of both. You may get some odd things because of the combination of the two.

MR. DANIEL M. ARNOLD: I wonder if the three panelists could comment on the responsibilities of the actuary and the hats that they wear. For instance, in the U.S. pension actuaries wear an enrolled actuary, hat acting solely for the benefit of plan participants, and then we have our hats as ASAs or FSAs helping the plan sponsor be creative in meeting their goals. Certainly in my own experience I have made a conscious decision that I will always have my own enrolled actuary's hat firmly in place. Our E&O insurer is happy with that. I always look to the plan participants' interest primarily. If a conflict comes up -- even if the attorney for the plan feels that what is being done is okay -- and if I feel that plan participants' interest may suffer, I will resign from the case and no actuary in the firm will accept the case. I wonder if you would comment on that role, and how that might be handled?

MR. KASS: On occasion the actuary may have to do some soul searching. Certainly the basic legal responsibility as to funding levels is to plan participants. However, there are many issues that pop up wherein your role is far more consultant and perhaps advisory to management. For example, there are the various plan modifications, upgrades, and alterations of the funding policy -- all within the context of the legal constraints on funding. I don't think there all that many situations where you are placed in direct conflict, where the plan sponsor calls on you for some action or activity which is at the expense of the funding of the plan. Recognizing that there is not a single wavelength that is the sole acceptable standard of plan funding, there is a range of discretion. If a client presses you to recommend putting fewer dollars in, there are some times when that can be done with a clear conscience. There are other times when it can't, and to me the decision point is clear-cut. Although your standards and mine may not coincide exactly, I suspect that 90% of the time both of our standards would overlap as to what is permissible. The client cannot force you to go outside that range.

MR. SIMMONS: I agree with everything Mr. Kass has said. The actuary in Canada does wear a number of hats, as he does in the U.S. In some cases he is really acting for the government agencies, signing a certificate that says that the plan is adequately funded, or signing the same certificate saying that the amount of contributions for adequately funding the plan and for tax deduction purposes are a specified number of dollars. So even that has a conflict. Is the amount going to be big enough to adequately fund the benefits? Is it going to be small enough to be a reasonable tax deduction? But it is more important to answer the question of whether we are acting for the plan sponsor or for the employees. I've never really felt a great conflict there, if only because there is such a range of reasonable sets of assumptions to use. I will not use a set of assumptions that I feel imperil the security of the plan members' benefits, but how high can that interest rate be before that happens? I don't think that many of the clients I work for think that I should really be testing what I think that upper range of interest rates should be. However, I will certainly advise my corporate clients as to about where in that range I think interest rates should lie, and what the implications are of being in a different area of that range. Then it should be their decision as to where they want to go, as long as I think it is within that reasonable range, but that reasonable range is quite wide. I don't know how I'd react if it really came up to it. I guess you would have to rely on your own personal integrity and your own personal standards. I don't think mine have ever been tested and I don't think they are likely to be tested.

MR. GRUBBS: I would just add that there may be occasions when resigning from the case may not be enough. I know of one instance where I thought there was evidence that the employer had absconded with plan assets. After repeated requests to the employer to provide an audited statement, I got no response and I felt that it was necessary to bring that to the attention of the DOL. The situations are not always clear-cut. It is often hard to know where the border is and what the actuary's responsibility is. Another question that some of us have struggled with is the case where we have taken over some work and the work by the prior actuary indicated such a level of incompetence that we wondered whether this was something that we should have reported to the Joint Board. I don't mean just a matter of a mistake, since all of us have made mistakes, but real incompetence.

MR. STEVEN J. KERSTEIN: Mr. Wade, you described several proposals helping to fund the underfunded pension plans. At least before yesterday we heard statistics that roughly 90% of pension plans were overfunded. In the area of post-retirement medical benefits we haven't seen many proposals from the IRS as to funding requirements. If we think of the problems the PBGC has right now, and think of what corporate America has in the way of a problem when none of the postretirement welfare benefits are funded, is the IRS going to address that?

MR. WADE: These really aren't IRS proposals. Congress would have to act, and there are Administration suggestions. The Administration proposals have a section addressing possible transfers from overfunded defined benefit plans to be used to help fund these retiree medical benefits. I don't know of any real systematic overall proposals to deal with this. There have been a few changes in the law over the last few years that have probably hurt the funding of these plans. I think that it's an area that will have to be dealt with sooner or later. I don't think that it is right at the forefront now, but I think you're right that eventually something is going to have to be done. However, I don't think that's a center of concentration right now.

MR. KERSTEIN: I would like to follow that up with a question to the rest of the panel. There are some people who are of the opinion that a lot of these proposals intended to address PBGC problems are geared toward a much smaller problem than the problem of post-retirement welfare benefits. Mr. Grubbs or Mr. Kass, what do you have to say on that?

MR. WADE: It's not just PBGC, but there are plan participants who are losing something in some of these plan terminations. The PBGC provides benefits up to the level of guaranteed benefits, but if you had read some of the articles regarding LTV, there were some early retirement supplements that people lost when the plan terminated which really affected individual's, financial situations significantly. So it's not just PBGC, although we talk about PBGC a lot. It is plan participants also.

MR. GRUBBS: I concur that we need to have tighter funding requirements in some respects, because people do lose benefits. We have made substantial progress in ERISA. Before that we had no funding requirements. There were unfunded plans. We started with a grandfather clause that allowed 40-year funding and had 30-year funding for future changes. I think that it is time to move forward, but I'm very concerned about complexity. Those in Congress and those in the Administration underestimate the problems created by complexity and the influence these problems have on causing employers to terminate plans, thus really depriving employees of their benefits. It seems to me that we could have better funding requirements but something very simple. For example, with respect to any future amendment we would just have a shorter amortization period. We might have differing judgments. Should the amortization period be 20 years instead of 30 years, or just what it should be? Any change could be something very simple.

MR. KASS: I share your concern regarding the magnitude of the post-retirement medical issue. Unfortunately, as Mr. Wade indicated quite aptly, Congress is torn between remedial social legislation and preventing any tax abatement. So the timing is obviously terrible right now. I do, however, hope that help in this regard in the meantime could come from the accounting profession, which at least can enforce the discipline of requiring corporations to expense a more suitable amount.

MR. HOWARD YOUNG: I have a couple of comments that everyone's remarks have generated. As actuaries we should be speaking even more strongly about the disadvantages and the negative impact of the shift to defined contribution plans. What we're seeing in our overall profession, not just in the pension industry but in the insurance industry also, is a movement away from the risk pooling aspects of actuarial work to some kind of recordkeeping and investment function and so forth. What is so unusual and unique about actuarial work is the idea of spreading risk over a larger group. Defined contribution plans take us in exactly the opposite direction.

The second comment relates to PBGC and SEPPAA. Like David Kass, I'm at the point where I don't see things as unqualified as I used to, even in terms of the way things happen. But having been in on some of the early discussions on SEPPAA, my view is that they were not so much generated by the PBGC as they were generated by people who were concerned with what was going on. The PBGC was part of, but not either an initiating or a forming part of, the action. The concern was that there were companies that were abusing the program. That was somewhat different from protecting the PBGC or making it sound. The real issue was to deal with companies that were dumping liabilities improperly on the PBGC program. I think that one of the big loopholes that deliberately wasn't addressed, and as actuaries unfortunately we don't know how to address, is the bankruptcy area. What really was left untouched and what LTV and others took advantage of is the bankruptcy loss, somehow being able to draw a curtain down and being able to walk away. Short of addressing that, and frankly I don't have the slightest idea of how to do it, I think we are going to continue to see serious problems with the PBGC program. I share Mr. Kass's view that the PBGC is a social program. I don't agree that $100 is going to kill the goose. I suspect the average compensation of most people in pension plans is upward of $20,000 a year, and $100 is 1/2% of that. I don't think that that is going to make or break the situation.

I've always had an optimistic view of that situation. Finally, regarding who gets the surplus, who owns the excess assets, I would like to add the idea that, whatever the employer puts into the fund presumably is taken into account. However, the argument that participants and employees have offered is that, had less money gone into the fund, presumably more money would have been available for other things at that time, and they therefore have a valid claim on at least a portion of what went into the fund.

MR. VINCENT AMOROSO: I have a comment that I would like to hear a reaction to. It was provoked in part by Mr. Simmons's presentation of what might happen in the future in regulations and legislation in Canada. One of the things we have been talking about is what has been happening in congressional reaction in the U.S. to the perception, in Mr. Simmons's words, that defined benefit plans are a ripoff. I think that there are number of pension staffers on the Hill and regulators who intend to agree with that perception, certainly as it affects short service employees. Within five and perhaps as much as ten years we're going to see something that Mr. Grubbs has wanted for quite some time and that is a mandatory defined contribution kind of a system, and that will largely address the concern of ripoffs of benefits for short service employees. My comment concerns what might happen in response to such a mandatory system. Maybe we'll have these defined contribution plans and we'll mandate providing annuities from these defined contribution plans. If we have a defined benefit plan that is essentially for long service employees and we have a defined contribution plan that is essentially for short-term employees, there may be a way of perhaps tying all this together. If we retire from the employ of a company and I have benefits coming from both of these plans, my defined benefit plan may provide a modest benefit, perhaps 20 to 30% of pay.

However, if I also have a defined contribution capital accumulation account balance, I might require that the employer money be used to provide augmented defined benefit amounts, whether in the form of early retirement subsidies or in the form of a cost of living adjustment or just increasing the basic benefit. So having scaled down the defined benefit plan and meanwhile provided a defined contribution plan, we tend to address both points of concern. We haven't required extraordinary expense, that is, big defined benefit plans for long service employees and big defined contribution for short service employees, resulting in the long service employees having quite a windfall.

MR. SIMMONS: Were you suggesting a defined contribution fall back, meaning that if you weren't in a pension plan, then there was a fairly minimal level of money purchase plan, or was it just a vehicle for transfer?

MR. AMOROSO: I'm looking for two separate vehicles. Defined benefit plans are there principally to help employers affect the age compensation of their work force. That is the premise from which I start. So there would be a defined benefit vehicle to help the employer to achieve that objective. From time to time, if the employer so choses, he could open up a window and increase the incentive to retire if that was an objective that mattered to the employer. So there would be a modest defined benefit plan that would provide a modest level of benefits for a long service employee, someone who retired from the employer with a minimum number of years, 20 years perhaps. Then we have a defined contribution plan that is either money purchase or a 401(k) match plan. If I'm covered by both plans and if I leave the employ early in my career, then I get what is in my defined contribution plan and I get very little from what is in my defined benefit plan. Having gotten my defined contribution amount, I have satisfied the perception of the ripoff, not only from my point of view as an employee but also from a regulator's point of view. If, on the other hand, I stay until retirement, I not only have this modest defined benefit amount but I also have a capital accumulation amount. I might require in my defined contribution plan that, if I retire from the employ, the employer's portion of the account balance be used to augment the defined benefit plan.

MR. SIMMONS: That's the type of arrangement in essence that I see becoming more and more common in Canada, a core defined benefit plan at a fairly low level. Now I can't restrict it to only the people who have been there 20 years because of the five-year vesting rule, but it would be a relatively small amount paid out to the short service employee. Then you have the add-ons of various defined contribution arrangements. I think that will work quite well. I think you will still see people thinking that the defined benefit portion, even though it is smaller, is still a ripoff. It may be smaller, but it will still be seen as being a ripoff. The only way out of that is probably a floor plan, which unfortunately costs more than anything else because you are paying whichever is greater.