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PORTABILITY OF DEFINED-BENEFIT PENSIONS

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- Definition
  - Reciprocity -- use of credits for eligibility
  - Transfer of credits and funds
  - Indexing
  - Whose cost?
- What is now portable and how
- The European approach
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  - A trend for U.S. or Canada?
- Current legislative proposals
- Implications for retiree medical coverage

MR. WILLIAM DAVID SMITH: This session is on portability. My name is Bill Smith. I am a Consulting Actuary with Milliman & Robertson in San Francisco and I have spent most of my career dealing with pensions. I will define the problem of portability and then Mr. Peter Hardcastle will describe what Europe is doing about this problem. Finally, Mr. Joe Brownlee, an expert on portability as a result of writing an article for the first issue of *Contingencies*, will wrap it up.

Neither the U.S. nor the Canadian federal government has a clear, mandated policy on retirement plans. Instead, there exists only a hodgepodge of laws, regulations, and restraints that are not well coordinated between varying kinds of employment. We need a more rational, better coordinated retirement policy that will lead to effective use of our taxation system and government controls to motivate our citizens to be self-sufficient in retirement without bankrupting our working population.

Financial independence in retirement traditionally results from three sources. First, a Social Security program at subsistence level only, with a goal of universal coverage. Second, personal savings and a mortgage-free home. Third, employer-provided retirement plans. Support of older adults by their children, which was a feature of earlier societies, is mostly absent in today's society. Social Security is one of the things the government mandates. It also promotes both personal savings and employer plans through its tax laws. However, there is no government mandate for employer-provided pension plans, even though there are numerous rules covering benefits and funding for employer plans. Currently there is talk in the legislative halls of mandating portability for pension plans.

In the U.S., we have two basic kinds of pension plans: defined-contribution plans and defined-benefit plans. There are also various plans that are a mixture of these two types.

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In defined-contribution plans, portability should not be a problem. Most of these plans have early vesting and when an employee leaves a company he can (1) leave his money in the plan, (2) take his money with him, or (3) roll his money into other forms of investment. The problem that typically arises is that employees can invalidate the retirement use of that money by unwisely using the lump-sum distribution that they receive on termination. This problem is hard to control without a government mandate on plans that would prevent employees from taking their money out and using it unwisely.

In defined-benefit plans, a problem arises because we have had an inflationary economy throughout this century. Final salary plans were designed to cope with inflation. However, transfer of employment during a career can result in long service at a prior employer with outdated final compensation and short service at a current employer with appropriate final compensation. Thus the problem. The portability problem does not exist everywhere. In union-negotiated plans, reasonable portability or reciprocity is available. It is not perfect but it is not bad. Government employees within states are often protected against the problem of portability. Private employment and transfers between government and private employment is where the problem primarily exists.

What are the solutions? One solution would be to have portability be strictly voluntary on the part of employers. However, it is difficult to make portability voluntary because employers establish pension plans to attract employees and to keep them. Employers do not want to motivate their employees to leave, and the better deal they make for portability, the more they are motivating their employees to leave.

Another possible solution is to legislate portability. However, for legislation to work, the government must first mandate that there is a plan provided for every employee. Even if we get legislation for portability, it will be awkward and will add to the already complex regulation problems. Undoubtedly this legislation would also be ineffective in many situations.

If we choose a legislative solution, who is going to pay for it? That is a question our other two panel members will discuss. Finally, other fringe benefits, especially retiree medical coverage, are inextricably wound in with this problem. There again, I merely point out the problem. I am not sure I even know a good solution.

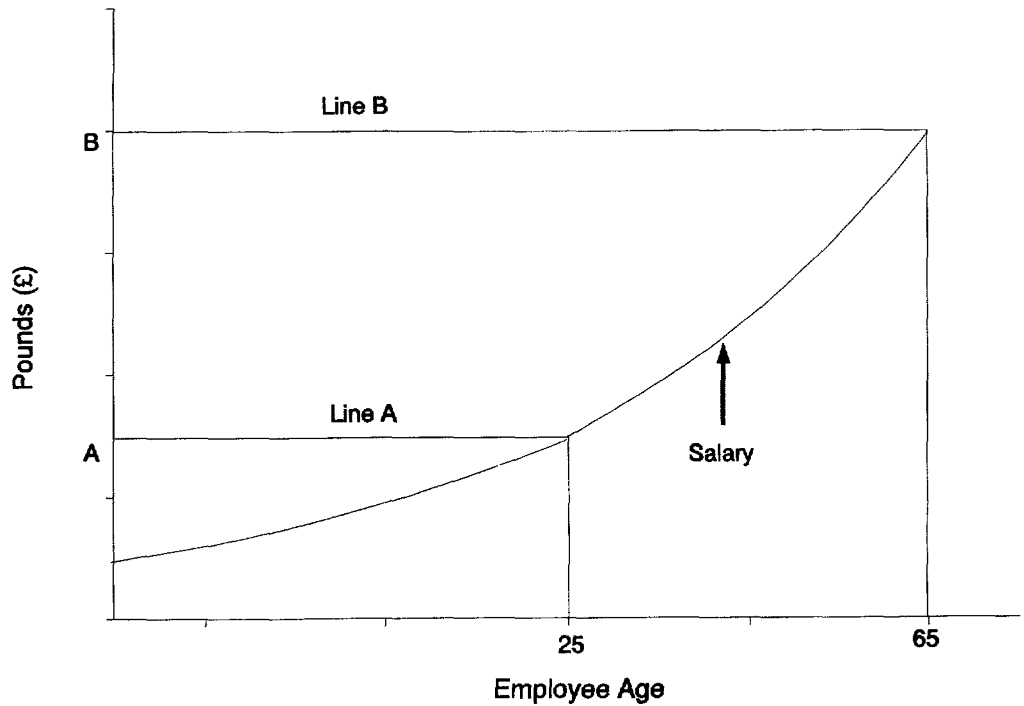
The regulatory environment is already demotivating defined-benefit plans. Any portability legislation in this area is likely to make it worse.

Our next panel member, Mr. Peter Hardcastle, is a graduate of Oxford. He joined Bacon & Woodrow in London in 1980 where he specializes in pensions. Peter became a Fellow of the Institute of Actuaries in 1988. Currently he is in the U.S. as an exchange employee between Bacon & Woodrow of London and Milliman & Robertson in Washington, D.C.

MR. PETER HARDCASTLE: In the U.K. we have what are referred to as transfer values. However, having transfer values has not actually stopped the U.K. from having a debate on the problem that you call portability. In the U.K., the phenomenon is referred to as the early leaver problem and is illustrated in Chart 1.

CHART 1

UK Early Leaver Problem



Essentially, the line going up in Chart 1 represents an employee's salary, or to look at it another way, the accrual of pension for each year of service. If the employee leaves early at age 25, he gets a pension based on his salary, which is at level A. If he works all the way to retirement, his benefit is based on his retirement salary which is at level B. The difference between line A and line B is simply the loss of pension due to the employee's leaving the plan that he was in.

Apart from the fact that the U.K. has transfer values, they still have the early leaver problem. Originally, the U.K. actuary calculated the value of the deferred pension for the chap who left early and told him, "You can take this to your new employer's pension plan and he will give you a credit for that amount of money." In reality what was happening was that typically an employee with 10 years of service in plan A would transfer to plan B and would find he had only enough money to purchase two years of service in plan B. This was because the actuary in plan B said, "This chap is going to get future salary increases from employer B. Therefore, we need to have a reserve which will allow for that future salary growth." So you can see that portability does not completely solve the early leaver problem.

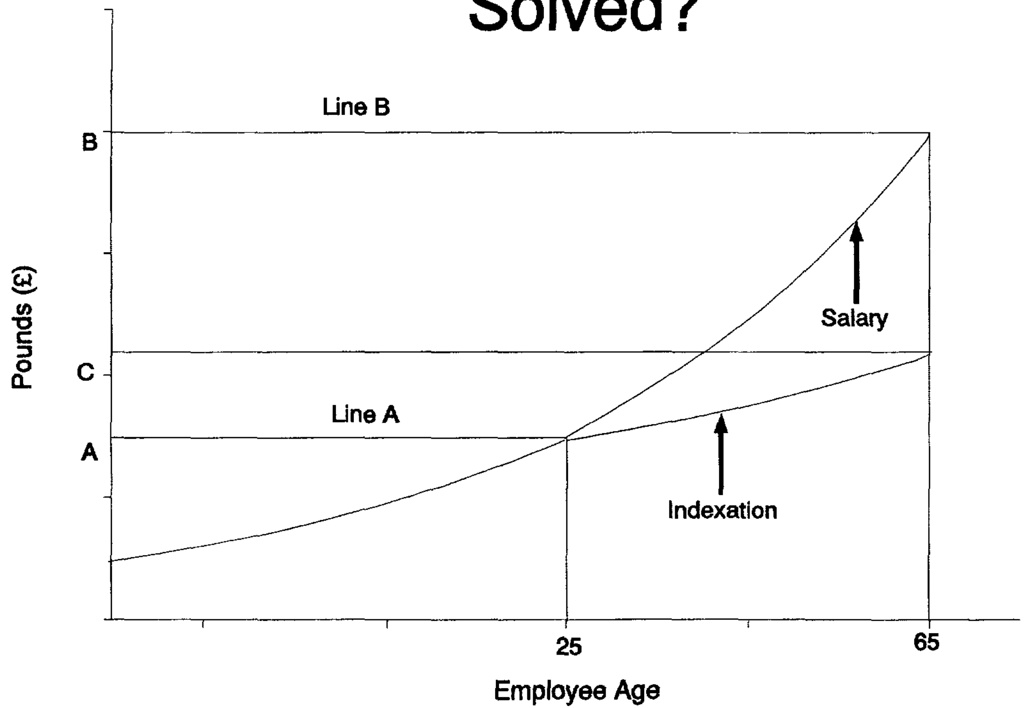
The steps that the U.K. has taken to try to solve the early leaver problem have been numerous. The U.K. now has laws that require the following things aimed at solving the early leaver problem: (1) two-year cliff vesting, (2) revaluation of pension, and (3) the right to transfer cash equivalents. The two-year cliff vesting is so that people will usually get something out of the plans even when they leave early. Revaluing the pension during its deferment partially alleviates the problem of loss of salary increases after leaving early. The pension is revalued with a price index of up to 5% per annum. In this respect it is a capped revaluation. Each employee who is vested also has a right to a cash equivalent. A cash equivalent is nearly the same as a transfer value but not quite because the cash equivalent is the strict actuarial equivalent of the employee's entitlement in the plan that he has just left.

The cash equivalent is a calculation that is done under guidance from actuarial bodies. The actuarial bodies are the Institute and Faculty of Actuaries. The Institute and Faculty guidance say the cash equivalent value "should be assessed, having regard to market rates of interest." One of the ways in which a market value assessment may be made is on the basis of market redemption yields on British Government Stocks of appropriate duration and type at the time of transfer, with allowance for investment of future interest receipts at such rates as the actuary considers reasonable. In valuing amounts which are subject to revaluation in accordance with the general index of retail prices, yields on index linked stocks will be an appropriate criteria. This is all it says on one of the most important parts of the calculation, the rate of interest. The cash equivalent is the minimum amount of the transfer. Some employers in the U.K. actively encourage transfer by paying out more than the cash equivalent because they do not want to have deferred pensions with their plan due to the administrative expense associated with deferred pensions. This is especially true if the employee has been there only for two years and accrues only a small deferred pension.

All of these legislative requirements have made the lot of the early leaver slightly better, but the U.K. still has not totally eradicated the early leaver problem. Looking at Chart 2, you will notice that there is an additional line (line C) that was not on Chart 1.

CHART 2

UK Early Leaver Problem Solved?



Line C represents the capped inflation increases. Looking at where line C intersects the salary increases line, you can see there is still a loss of pension benefits for early leavers.

Currently, the U.K. is experiencing some difficulties with deferred pensions being indexed. This is because there is legislation on the statute books that has not yet been put into force that will require plans to index pensions in pay status as well as those in deferment.

The laws in the U.K. allow a member to transfer his pension and they provide for some indexation of the deferred pension. There are then a plethora of choices for the early leaver in the U.K. Basically there are three options. The first one is to do nothing and to stay with plan A, the old employer's plan, and receive the deferred pension at retirement date with the indexation. It is not a very exciting option. Second, the early leaver has the option to transfer. He has the statutory right to take his cash equivalent that he can transfer to his new employer's plan if the new employer will accept it. There is no statutory requirement that the new employer's plan must take the transfer value. The employee could also transfer his cash equivalent to an individual pension arrangement that is commonly a personal pension policy. This money purchase vehicle was dreamed up by the right wing of the Conservative Party on the ideological grounds that members of pension plans ought to have some say over what their investments are doing. The idea was that if you introduced a portable pension (an insurance policy to which both the employer and the employee can contribute with tax advantages, the policy itself has tax advantages), then more people would opt out of their employer-provided pension plans and would persuade their employer to pay into these personal pension arrangements. The employee would be able to manage his own pot of money and would generally take an interest in the economy and become a more involved part of the capitalist system. Unfortunately, many employers felt that contributing to several hundred personal pension arrangements would be too much of a hassle. Therefore, these personal pension policies have not taken off as much as was first intended. Ironically, one of the uses of these policies is as a group vehicle that a small employer might use as its pension arrangement. They tell their employees, "If you contribute to this personal pension provider's pension arrangement, we will match your contribution," which has made it an easy way of providing a defined-contribution plan. Within the personal pension policy, the early leaver has lots of options. He can divert his transfer value to any one of many types of funds: stock funds, bond funds, property funds, participating insurance contracts, cash vehicles, and overseas funds. The list goes on and on and on. It must be bewildering for the layman to try to find out enough about these investment vehicles to actually make a sensible choice. This is another reason they have not gained widespread popularity.

The transfer to the new employer's plan, if the new plan is a defined-benefit plan, usually results in added years for the benefit. The added years calculation is done on the receiving plan's actuary's basis so there is no guarantee that the two calculations, the exporting calculation and the importing calculation, will be done on like bases. Not only that, but often the benefit provisions of the plans are different. Also salaries on entering plan B might be a lot higher than those on exiting plan A. Commonly we find that a man with 10 years of service from plan A still ends up with fewer years of service in plan B. It is not quite as bad as 10 years to two years these days, but it is still only about 10 years to four years. Some employers' plans will give an early leaver a fixed pension instead of added years of service, which is slightly easier for the employee to understand because he can compare his fixed pension with 5% increases in plan A with the fixed pension in plan B and then take the larger of the two. Of course, in many cases, plan A will have cost of living increases in payment guaranteed up to 5% and plan B is guaranteed only up to 3% which complicates the calculation.

Another way the new employer's plan can deal with transfers is by investing them in a separate arrangement. This is done by a number of plans in the U.K., so essentially the employee is just getting a cash roll-up, only he does not have any of the wonderful investment choices that he has in the personal pension system.

So far I have talked only about individual arrangements between private companies' plans in the U.K. Often if a group of employees is involved in the sale of part of a business from company A to company B, special arrangements are made so that essentially the full value, including future salary increases, will be taken into account in the transfer. But these are usually special terms and they are negotiated as part of the sale and purchase agreement between the two companies.

Another thing in the U.K. is that many public sector plans operate a club whereby transfer from one plan in the club to another plan in the club is done on a basis that allows for future salary increases. Most public sector plans have the same benefit design so that the only possible loss to a member on transferring from one public sector plan to another public sector plan will be due to his salary increasing. Essentially what is done is that they calculate a deferred pension from plan A and determine what number of years of service is required to give the same deferred pension in plan B. If the employee's salary has increased due to the transfer, then he will get fewer years of service in plan B than he had in plan A.

That is all I am going to say about the U.K. I am now going to move on to the Netherlands. The Netherlands' early leaver problem is slightly different from the problem in the U.K. In the Netherlands, when an employee left a plan, they typically calculated the amount of pension that had been bought by the contributions made to the plan on behalf of that employee. This meant the employee effectively got what had been paid in, which made it a bit like doing a defined-contribution calculation. The only problem with the calculation was that it was done using the premium basis of the insurer (most Netherlands plans have some insurance basis) and the method of funding in the Netherlands is often the individual level premium method, so that the reserve in the plan is usually less than the employee's time proportional accrued benefit. The benefit is funded on a level premium basis from the time of joining or from the time of benefit increase until the employee's retirement date. Therefore, if there is a benefit increase due to salary increasing, there is going to be a funding deficit. This situation led to legislation whereby deferred pensions in the Netherlands are now calculated on the time proportional method, i.e., the deferred pension is the expected pension at normal retirement age for the employee assuming he remains in service less the expected pension at normal retirement age for a new entrant of the same age with the same salary as the exiting employee. This, of course, only if it gives a larger deferred pension.

This looks very much like the sort of formula that will be used in the U.S. to calculate the right of a terminated vested employee, though it's a solution for a very different problem. The solution really is to put the calculation of the deferred pension where you would think it ought to have been to start with. The Netherlands has a funding basis in which the maximum rate of interest that can be used is 4%. This means that the reserves held are often greater than necessary to provide for the deferred pension or the accrued pension. In a way, this has led to a solution to the early leaver problem. The way Netherlands plans are funded is that the premiums are typically paid based on a 4% interest rate. A surplus builds up because investment returns outstrip 4%. Therefore, the next year's premium can be decreased because of the surplus built up and so on and so forth. Obviously it does not always work so nicely and the 4% does not always close the gap between salary increases and investment returns. However, it is almost as if they are doing the valuation on a real rate of interest rather than a nominal rate of interest.

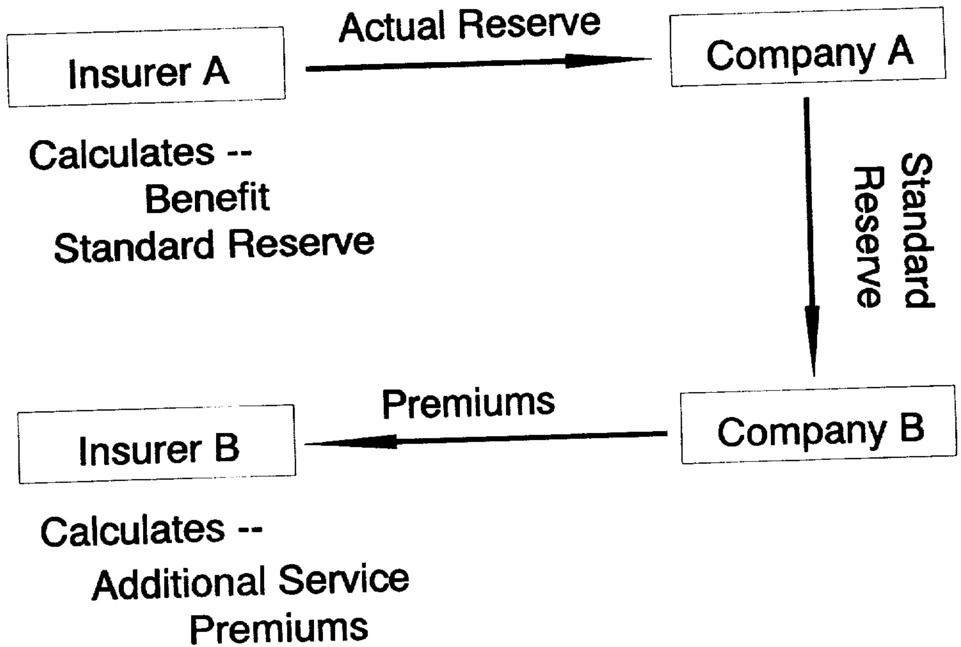
The Netherlands has also arranged several transfer clubs whereby transfers are made between plan A and plan B of an amount that is sufficient to maintain the salary linking on transfer. What happens is that a transfer is made effectively as illustrated in Chart 3.

The first line is from insurer A to company A. The second line is from company A to company B. The final line is from company B to insurer B. The transfer takes place on a standardized reserve. What happens is that insurer A calculates the deferred pension. Insurer A will also calculate the reserve that it holds in respect to that deferred pension which will be the old method, the accumulating contribution method. Insurer A will then tell company A what the standard reserve is and what money it holds. Company A will pay across the standard reserve to company B. Company B will tell its insurer that it has received this amount of money from company A. Insurer B will reverse the calculation using the standard basis to arrive at additional service credit in company B's plan. But insurer B will charge company B whatever its premium basis says the sum of money should be. Because of the funding method in the Netherlands, the true cost of the increases in the amount transferred due to pay increases while with company B is slightly hidden. First of all, the amount that is transferred across the standard reserve is calculated on a 4% basis with some adjustment for market rates of interest but not fully adjusted. Second, because both plan A and plan B tend to be funded on real rates of return and because the transfer is based on real rates of return, that hides the fact that there is a salary increase problem. Effectively, the member who does not transfer is losing out because the reserve that is held for him in insurer A is more than enough to cover the benefits that he is going to get ultimately out of plan A. And any surpluses that arise from the investment of the reserve go to the benefit of company A. Company A is paying partially for the protection against salary inflation with company B by losing this surplus that would arise from the reserve held for the transferring employee. Company B is paying for the balance of the increase in benefit due to salary as it would for all its own employees on the funding plan that company B has adopted.

Although Chart 3 shows an insurer A and an insurer B, not all Netherlands plans have an insurer backing them. You also do not need an insurer to belong to these clubs. Interestingly enough, in the Netherlands within these clubs, it is the employee who has the option to transfer from plan A to plan B. If plan B belongs to the club, it

CHART 3

Netherlands Transfer



cannot refuse the transfer. There are two requirements for belonging to the club. First, the plan must base benefits on final pay. And second, it must provide full index linking of pensions in pay status. It is also fairly common for plans in the Netherlands to provide index linking on pensions in deferment, so that even if the employee did not transfer from A to B, in most cases he would still be protected to some extent. That just about covers all I intend to say on the approaches to portability that are used in the U.K. and the Netherlands.

MR. SMITH: You have discussed the situation involving the typical private plan for both the U.K. and the Netherlands. Do they have plans in either country like our Taft-Hartley plans?

MR. HARDCASTLE: Your what?

MR. SMITH: Typically it would be a union-negotiated plan.

MR. HARDCASTLE: Not in the U.K., but yes in the Netherlands. Quite a lot of the Netherlands employees are actually covered not by private company arrangements but by industry-wide arrangements.

MR. SMITH: Are they final salary plans?

MR. HARDCASTLE: Yes, they are final salary plans.

MR. SMITH: I see. Our typical union plans are not final salary.

MR. HARDCASTLE: Are they brick by brick, sort of a fixed amount for years of service?

MR. SMITH: Not exactly. They define a benefit equal to so many dollars per month per year of service. And that is changed by the trustees from time to time so that those benefits do tend to keep up with inflation. Sometimes they do and sometimes they do not protect the employees who have already retired. However, inflation gets into it as a result of trustee action even though it is not final salary by design. Apparently that kind of plan does not exist?

MR. HARDCASTLE: They used to exist in the U.K. I do not know whether they still do. I know of a plan that was for milk delivery men that provided a very tiny benefit until their dairy was taken over by a larger dairy. When the plan was investigated it was found to have so much surplus that the pensions were quadrupled. Therefore, my only experience with such a plan has been that inflation has not been well compensated for.

MR. HAROLD J. BROWNLEE: If I might add a point. Mr. Smith mentioned that in some of the plans the retired members are protected if there is improvement in the benefits, and in other plans they are not. The tendency is that if the individual remains a member of the union after retirement and has a vote, then he gets the protection. But if he is required to leave the union at the time of retirement, then he is not protected. It is one of those unusual things.

MR. SMITH: Our next panelist is Mr. H. Joe Brownlee. Mr. Brownlee is a graduate of Haverford College and he became an FSA in 1956. He spent his whole career with the Prudential in Newark, New Jersey. He was most recently President of the American Academy of Actuaries.

MR. BROWNLEE: I used to think that portability was simply a matter of vesting. If you had vesting you had portability. That is, you did not lose your credits when you left your job. We have seen, from what Mr. Hardcastle has said, that in the U.K. and the Netherlands, it gets much more complicated than that, largely because of the problem of the loss of benefits due to inflation. To define the portability problem, I will use an example so that you get the feeling of the problem for people who move around from job to job as opposed to those who stay with one employer. Here is the example. Employee A and employee B are the same age and have identical employment histories and incomes throughout their careers except for one thing. Employee A spends his entire career with one employer, while employee B changes employers one or more times during his career. When they retire, A gets a much larger monthly pension check than B. It turns out that since all of B's employers had pension plans identical to that of A's employer, the difference is due solely to B's having changed jobs repeatedly. Had B stayed with his first employer, he would have had a pension equal to A's.

You will notice that this example shows two portability problems. First, do you keep the benefit credits you have accrued? Second, is there some way to make up this loss that you experience when you finally get to an age when you start to draw the benefits? Mr. Hardcastle's discussion shows that in the U.K. and the Netherlands, they look at the loss due to inflation, either full inflation or a capped rate, and they are trying to pass this cost on to the employers in one form or another. Many people would say they have solved this problem. In my article on portability two years ago, I pointed out that if you make these changes, then employers, in order to keep their total cost from going up, take defensive actions. For example, if you take employee A and employee B and do a fairly simple numerical example with a standard plan, you find out that for B the sum of his pension if he changes jobs every 10 years is maybe half of what A will get.

Therefore, it is the employee who moves around who accepts and pays for the inflation risk. Some people feel that this is somewhat unfair. So the problem is to try to palm this cost on to someone else. The government does not want to pick it up. The government does not have any money. That means that employers should somehow pick up this cost. I might mention that each of the last three individuals who have become Secretary of Labor in this country had an item on their personal agenda that they were going to do something about the portability problem. The last time I checked, which was a few days ago, none of the three ever got a proposal in shape to put before Congress. There do not appear to be any current plans to do anything about the portability problem in this country. This is largely because it will end up costing someone money to do it. For example, if you say the employers must pay more into pension funds to provide for portability, there will be a revenue loss to the government from the higher deductions that will be going to pension plans. Legislation that involves revenue loss is not very popular in Congress or anywhere else in Washington. If employers then take defensive action so that they will not have to pay increased pension contributions for portability, many of them will switch to defined-contribution plans.

There has been considerable criticism of Washington ever since ERISA was enacted 17 years ago. Many of the pension laws they have passed have made it less attractive for employers to have defined-benefit plans and more attractive for them to have defined-contribution plans. The termination rate of defined-benefit plans has been substantial, with the effect that employees are being asked to take on more and more of the risk. Under a defined-contribution plan, the employee has all of the inflation risk, has all of the investment risk, and generally as a class, will end up with smaller pensions than under defined-benefit plans. In Washington, people like to talk about this problem a great deal, but no one seems to do anything about it. This is probably a result of the fact that on first glance this appears to be a fairly simple problem that can be solved in a simple way. Then, after further investigation, they learn that the problem is much more complicated than they first thought so they quietly drop it.

Mr. Smith referred to multiemployer plans and the fact that many of them have some kind of reciprocal arrangement. It is interesting that the portability in these plans is quite limited. There are two types of reciprocal arrangements in multiemployer plans. One that is fairly common in the construction trades is sort of the money follows the man. Say you have a carpenter who is a member of a local in Binghamton, New York. The carpenter then quits and gets a job in Elmira that is covered by a different local. He works in Elmira for three months or six months or a year on a project during which time the employer pays the Elmira local so many cents per hour for the pension fund that has been agreed to under their collective bargaining agreement. The Elmira local then transfers these contributions back to the Binghamton local, which will then provide credits for the carpenter under the Binghamton local's plan for his period of employment in Elmira. However, if the same carpenter in Binghamton goes and finds work as a plumber or in city or county government somewhere, this reciprocal arrangement does not happen. So as you can see, multiemployer plans provide for very limited portability within a group of employees who have a common arrangement or agreement.

The other kind of arrangement that I have run into in teamster plans is what is called the pro-rata arrangement. This is the case if there is an agreement between two separate teamster plans, so that a teamster who moves from the jurisdiction of one plan to the jurisdiction of the other will have his retirement benefit calculated by each plan as though his combined service had been in their own plan. Then each plan simply prorates the dollars of the total pension according to the ratio of service in their plan to the employee's total service. Therefore, the employee gets two pensions, and to the extent that there have been plan improvements in either plan to take account of inflation or increased contributions, he gets the benefit of these improvements from each plan. However, he is not allowed to get more than he would have gotten if he had stayed with one plan throughout his whole career. In other words, you cannot increase your pension by this arrangement.

In both the U.S. and Canada, there are some reciprocal and portability arrangements between various government plans. However, this again is quite limited in that it applies only if you move from one participating government plan to another participating government plan, in which case you carry your service credits with you. If you get outside of that orbit of participating government plans and take a job in private industry, you will encounter the same portability problem that we have mentioned before with regard to employees in private industry.

Additionally, in Canada there is an arrangement among a large number of the insurance companies that all have similar pension plans. If you move from one of these insurance companies to another, you have some degree of portability. Once again, however, this is limited to the employees in that rather small circle and does not solve the general portability problem.

It is not difficult for pension actuaries to understand the difficulties involved in calculating benefits for an employee who moves from a multiemployer plan to a government plan to an insurance company plan to some other kind of a plan. To calculate the benefit, would you move credits or would you move money, or would you use some other approach?

One of the things that I said in my article of two years ago was that one of the problems in portability would be calculating the transfer amount if you did move. I would not say that because it is fairly easy to set a standard for calculating a transfer amount. As Mr. Hardcastle pointed out, there are already standards in the U.K. for this. In Canada, the Canadian Institute has also issued a standard on minimum transfer values. Up there they have two different standards that are now being consolidated. One is the standard for a transfer value from a pension plan to a Registered Retirement Savings Plan (RRSP), which is a little bit like an Individual Retirement Account (IRA) in the U.S. The other standard is for a cash value for pension benefits in case of what the Canadians call marriage breakdown. In general, what they use to calculate the cash value is the interest rate obtainable on government bonds for the first 15 years after which time the interest rate is dropped down to 6%.

While talking to someone from Canada recently, it was pointed out that in Canada, when an individual transfers cash from a pension plan into an RRSP, it goes into what's called a locked-in RRSP, which means that you simply cannot have access to the funds before you reach retirement. However, the flaw in the system is that if you move that RRSP around from one bank to another bank to an insurance company to a bank, at some point it is highly likely that the fact that it is supposed to be locked in will get lost in the shuffle. Then you can take the money out and spend it in riotous living. This leads to another point; in this country I had always thought of portability as being a problem only for defined-benefit plans. However, it is also a problem for defined-contribution plans.

In Washington there is a great deal of concern because there is such a huge rollover of funds in defined-contribution plans. My personal view is that this may not be as alarming as it first seems since there are two kinds of defined-contribution plans. There are those plans that used to be called thrift plans that companies set up under IRS rules, strictly for employees to save money for the short to medium term. The Prudential had one and I was able to dip into that to put kids through college. These plans were meant as a supplement to the company's defined-benefit pension plan. However, there are also defined-contribution plans that are set up specifically for retirement purposes. Theoretically, in these plans, you are unable to take the money out until you are age 59.5.

A lot of people are concerned mostly about portability for defined-contribution plans. I found an article on pension portability in the U.K. in this weekend's *Financial Times*. This article was strictly about the defined-contribution arrangement, or the arrangement after a person has taken his cash out of some kind of money purchase or defined-benefit plan. Typically in this situation, a person will move the funds around from one insurance company to another, or one investment vehicle to another. With each move there is a commission to the salesman who persuaded you to move your money. Typically in the U.K. this commission would be 4% which would be similar for arrangements here in the U.S. Assume the insurance company chooses to amortize that commission over 25 years. Unfortunately, if you move your money again after three years, you will find out that there is what we call a back-end load. Therefore, if you move your money around fast enough, you could have substantial negative growth, and what was designed to provide you with a comfortable retirement may leave you in utter poverty by the time you get to retirement age.

Another question related to portability is retiree medical coverage. When employers in this country started providing coverage to their retired employees they did not think much about the cost of that coverage. That was partly because it usually was provided only to people who retired after the day that the company made up their mind to offer such benefits, not to existing retireds. Also, medical care 20 and 30 years ago was not as complex or as expensive as it is today. Companies never really thought about the cost of these benefits very much until the Financial Accounting Standards Board (FASB) started looking at the expenses associated with the other postemployment benefits. At this point, employers realized that if you provided full coverage for postemployment medical benefits to someone who had been with the company only for five or 10 years, it was very uneconomical because the benefit had a very high cost related to the employee's total salary for that short period. For a good guy like me who stayed with the company for 37 years, it's less of a burden. However, when you start talking about whether you are going to have portability of pensions, should the same question be raised about portability of credits for post-retirement medical benefits? I have not yet heard any discussion on this question, but it is bound to come up with the general question of portability.

Another real problem I see is that to have portability, you have to decide where you want to spend your money. If you were an employer that had extra money to spend on employee benefits, you would just as soon spend it on people who are actively working on the job. They are the people who are producing for you and they are the people you depend on from day to day to get the return on equity that you need to keep your stockholders happy. The second group that you would consider, if you had money to spend, would be the people who used to work for you who are now retired. When you talk about indexing pensions, these are the people that you would go to first. The last people you would think of are people who used to work for you, who left after only two or five or 10 years of service and have not been around for years. You would probably feel that you do not owe those people anything. My feeling is that the protection of what Mr. Hardcastle calls early leavers against inflation is bound to take second place to a move to general indexing of pensions in the private pension system. However, since that kind of a change could easily increase pension costs by 50% or 100%, it is not likely to happen very soon due to employer resistance. If you did implement this, employers would very quickly begin changing to defined-contribution plans and shift the inflation risk to their employees.

MR. SMITH: First, I think I can summarize the portability problem by saying that the problem differs considerably between different types of employment, different types of employees, and between different countries. Although governments and employers have toyed around with the problem, it has not been solved very well anywhere. The Netherlands seem to be closest to recognizing it accurately.

MR. HARDCASTLE: I think the Netherlands has an advantage in that they have this almost real rate of interest that was used for funding. And one of the things that I have toyed with is asking clients what happens if there is no inflation. Then there would be no problem. Everybody would have indexed pensions because cash would not lose value. Would you still maintain your defined-benefit plan? The answer is probably yes. Then you say the cost of that plan is going to be higher than it is now because the real rates of return are unlikely to grow because there's no inflation. The real rates of return are likely to be still at the same sort of level, which means that the rates of return in nominal terms are going to fall. It would be interesting to hear what people here think of that argument.

MR. SMITH: It still seems as if the only way this problem could be solved would be to go back and force everyone to have a defined-benefit final salary plan, and institute a system something like that of the Netherlands which would force someone to pay for the inflation loss on an employee transferring between plans. Without going back too far, I do not see an easy way to do anything but nibble at the edges of this portability problem. Does anyone else?

MR. BROWNLEE: The way I look at it is if you decide that you have a fixed amount of your gross national product or some measure of that going into pension plans, then it's simply a question of how you divide it up among all the claimants. The question is whether the government is going to decide who gets what share of it, or whether it is the employers who decide. I do not know how it is in the U.K. or the Netherlands, but in this country for example, if you leave your employer with a vested pension and even if it was indexed, in many plans it would still not be subject to the same liberal early retirement provisions that apply to people who retire directly from service. If you decided that you wanted to start drawing your pension at age 55, you might find that there is an early retirement factor that cuts your $100 a month back to $30 a month. Whereas if you retired directly from service, you might get $70 a month retirement at age 55. This is just one more level of complication.

It is not an actuarial problem. You are talking about a social problem, and it's a political problem. You have pots of money. Everybody wants the big piece of that pie. Who is going to decide who gets how big a piece? Clearly there is a benefit to our economy to having a mobile work force, and I am certainly grateful to the people like Mr. Smith that you see who are willing to move around and meet the needs of our economy by going to San Francisco or some place like that, while I get to stay in beautiful New Jersey. But dividing up the pie is really what it is all about. The question is how much central control will you have over letting employers or entrepreneurs make these decisions.

Another question that comes up is suppose you do have these transfer values that allow for inflation, and you go to calculate one for somebody and you find out his transfer value is larger than the amount of money that is then in the fund. This could happen if a business has been starting to go downhill and the company has been letting people go or people have been quitting and taking their money with them. At some point you get down to where there are some employees left, and when the next guy leaves there is not enough money for him. A very real problem.

MR. HARDCASTLE: The transfer value is cut back in the U.K.

MR. BROWNLEE: Eventually to zero?

MR. HARDCASTLE: Yes. There are provisions if the fund is not sufficiently funded, which reduces the cash equivalent to allow effectively for the security angle. An employee must be told that he is not getting the full cash equivalent but a reduced amount because of the funding position of the fund, and probably would not move his money unless he thought the employer was definitely on his last legs and the situation was unlikely to be rectified.

MR. BROWNLEE: In which case everybody takes it and they all get less?

MR. HARDCASTLE: And the plan is terminated.

MR. SMITH: On a different level of thinking, it appears that the major problem that causes us to discuss portability is inflation. If a social planner ever stood back and looked at the whole flow of goods and services in society, and studied inflation and the effect of inflation on the transfer of value between different groups of people, portability and pensions would be a side issue, a very small problem compared with the big problems that are caused by inflation. That again says to me that we're just nibbling at the edges of something when we talk about this subject. I mean, if the problem really is inflation, that should be addressed far more directly. Then if we could solve it in the big areas, maybe this area would be more readily solved.

MS. NEELA RANADE: Two items I would like to invite comment on. One is portability legislation for defined-benefit plans. Although that would meet the needs of the average employee who might have three to five jobs in a lifetime, it seems like increased legislation may lead to termination of defined-benefit plans. I am speaking from some experience because we dealt with AT&T's U.K. plan. About four years ago, we decided to terminate the plan because of all the legislation in the U.K. and we replaced it with a defined-contribution plan. I'd like the panel to comment on whether there are any trends you've observed in the U.K. with respect to legislation, and what proportions of the plans are defined-benefit plans now versus before all the increased legislation?

MR. HARDCASTLE: I am afraid it is too early to give you any statistics. There is definitely a trend for new plans to be defined-contribution plans, especially for the smaller employers. Indeed, for the very small employers, a group personal pension arrangement is often the pension vehicle because if you give people personal pensions, then they have their own plan. It is like a lot of individual pension plans. There are no portability problems whatsoever. When the employee leaves service, he carries his plan with him.

MS. RANADE: It just seemed that from what we heard in the U.K. there were more defined-contribution plans being formed. It seems like there should be some connection.

MR. HARDCASTLE: I certainly agree with that. I think it's partly because of the indexing of pensions, both in deferment and now on the books. For a defined-contribution arrangement, there's no requirement to provide pensions that are indexed. You just provide the money and at the end of the day it's converted into a pension, probably bought out with an insurance company in the smaller cases. I agree with your comment that the trend is for new plans to be defined-contribution plans. However, most of the large defined-benefit plans are coping with the legislation.

MS. RANADE: Are there any statistics available from Canada, because they have had similar legislation in the last few years?

MR. BROWNLEE: If there are, I don't know. In Ontario there is currently a proposal about requiring some kind of indexing to inflation. If you want some information about that, I would suggest you call the Canadian Institute's office and they can put you on to somebody or you could ask a Canadian here in the audience.

MR. SMITH: Certainly there is no question that any new law or regulation that affects defined-benefit plans in the portability area adds to the problem, either financially or administratively. It is just one more demotivator for defined-benefit plans. No question of that.

MR. HARDCASTLE: One of the things that has been a hot issue among pension practitioners in the U.K. is the proposal to mandate pension increases for pensions in payment for defined-benefit plans, whereas there is no corresponding mandate or provision proposed for defined-contribution plans. Therefore, a defined-contribution plan or a personal pension plan can be misleadingly marketed by a broker, but after retirement, the pension from the defined-contribution plan that's been quoted is going to be a flat rate, and the pension that's come out of the defined-benefit plan is going to be an increasing pension.

It seems in the U.K. that defined-contribution plans are understood by the regulators in that they are like saving with a bank. Defined-benefit plans are very queer animals indeed, and I do not think that a lot of the policy makers really understand the defined-benefit plan at all well.

MS. RANADE: There's one more item to mention that might be a model for some type of portability for certain segments. When the Bell System broke up in 1984, there were a million employees and the union got legislation written that said that if the union employees went from one telephone company to another, say from Minex to a Pactel, they would have portability of pensions. The new company would pay the pension benefit under expansion formula, but the old company would transfer assets related to the person transferring. It happened to be that all the plans were fairly well funded, so you did not have the problem of not having sufficient assets. Also the benefit formulas were similar. As a byproduct, it created a lot of work for us as actuaries in valuing this every year. But it seems like in some industries where you have similar plan formulas, maybe in multiemployer trusts, that could be a model.

MR. HARDCASTLE: It certainly sounds very much like the club that's operating between the public sector plans in the U.K., where most of the plans all look very similar. Essentially the only adjustment is because of salary differences. It seems to go even further than that with what you are discussing. If somebody's salary increased by 20%, the pension would increase by 20% in respective services before?

MS. RANADE: Yes, because the new company will calculate it based on the final salary.

MR. SMITH: You pointed out the inconsistency in our current society of how people are treated. In the telephone company, there were huge numbers of employees, the unions perceived the problem, and there were enough people to do something about it. In other industries, nothing like that happens and those employees lose out. That is an unfortunate aspect. However, that would be a good model, but it probably would not be well enough known by the unions so that if some other small company broke up, it just wouldn't happen. Unfortunate, but a fact.

MS. JUDITH MARKLAND*: I've spent a fair amount of time in Washington lately and have discovered that the regulatory attack on defined-benefit plans really is not an accident. Most of the congressional staff people that I have talked to, Education & Labor Committee people, etc., really believe that defined-benefit plans are unconscionable for a society that's as mobile as ours is. They really feel they are an inappropriate pension policy as things are currently. They are also worried, as I am, about the retirement protection that is really given in defined-contribution plans. Even if it is a pure retirement plan, in order to get people to contribute, you have to allow withdrawal of funds for hardship and that includes home purchase or college education, etc. The people with the lowest income levels are undoubtedly the people who in the long run are going to have the least retirement benefit because obviously they are the most likely to incur hardship. I was wondering whether anyone in the Academy or anyone in the actuarial profession is doing anything proactively to try and see whether there is a way to make defined-benefit plans, even if only prospective defined-benefit plans, socially more acceptable and working some degree of portability in? If not, what could be done?

MR. SMITH: You used the word unconscionable. Do you think the feeling is that it is the lack of portability protection that makes them think that the defined-benefit plans are unconscionable?

MS. MARKLAND: Yes. It is also partly tied with the curve in funding pattern. But mostly the early leaver cost is the problem.

* Ms. Markland, not a member of the sponsoring organizations, is Vice President for Group Pension and Guaranteed Product of John Hancock Mutual Life Insurance in Boston, Massachusetts.

MR. BROWNLEE: It is interesting because these people that you are talking to are covered under a defined-benefit plan in the federal government. However, to answer your other question, I would suggest you talk to Gary Hendricks who is employed in the Academy office. He is our Director of Government Information. We hired him away from the Department of Labor (DOL) about two years ago, and he coordinates the efforts of our pension committees and the pension area as well as the health area in dealing with everybody on the Hill. He can give you an excellent run-down. Maybe we could even get you to work on one of the committees.

MS. LINDA M. LANKOWSKI: We seem to have been talking a lot about problems with inflation messing up portability and losing out if you move from one company to the next company. We were given an example of a person in company A who stayed and a person who went to company B and then company C and lost money. Wouldn't that have been solved if it had been a career pay plan? Wouldn't this person have received the same benefit? Couldn't we discuss having a career pay system rather than final salary? I certainly am not going to say that I want my pension based on a career pay at the same percentage as my final salary, but this would certainly solve that problem of the system.

MR. SMITH: It's an excellent question because I think one of the things that employers would do, if you required some kind of portability, would be to shift to career average plans instead of final average plans. As I mentioned in my remarks, when I started with the Prudential we had a career average plan. The final average salary plans sort of came in the 1950s with the inflation that resulted from the Korean War. And it turned out that people who were retiring in the 1950s with a full career, had started say back in the 1920s or around World War I. They worked through all those depression years when we were hiring brand new actuarial students right out of college for $60 a month. When you put all those years of low earnings in, the pension was just terrible. It was totally unrelated to needs after retirement.

Technically of course, you're correct. Now what you are doing is you're transferring an inflation risk from the employer to the employee for the period while he is employed. And you are right, it works.

MR. HARDCASTLE: Let me go one stage further. You can also move the investment risk to the employee and you get a money purchase plan. You've got a halfway house. One of the components of the state pension system in the U.K. is a revalued career average plan.

Essentially, the earnings between an upper and lower limit are increased in line with national average earnings, which gets rid of the inflation problem. But of course, that passes the inflation problem away from the employee back to the employer. Although it is a revalued career average plan and all that might be cheaper than providing a pension based on final salary, it's not quite as good as getting all those lovely profits from the early leavers.

MR. SMITH: One of the reasons that major corporations have final salary plans is that the people who are making the decisions look at the difference for them between a final salary plan and a career average salary plan and of course, these are people who may have had fairly level pay which then shoots way up. They just love final salary defined-benefit plans.

MS. LANKOWSKI: I can agree. I look at what my salary has done as an actuarial student; it has increased wildly in the last few years. I've certainly gone up double in the last five years because of the exam increases and all that. I can agree that I would rather have a final average pay plan, if it's 2% of final average pay rather than 2% of my career pay. Or even 3%, right.

MR. BROWNLEE: Or even 3%.

MS. LANKOWSKI: But couldn't we say we recognize that the average person gets a 5% increase if there's inflation, and so at the end we're pushing to get 40% or something. So we get a 5% career average rather than a 2%.

MR. SMITH: We could probably work something out if you could depend on inflation being the same rate constantly. The problem is that in the 1970s inflation was rampant, and then it slowed down in the 1980s. It was low in the 1950s. And the only type of plan that is going to provide genuine retirement protection is one that looks at a short span of the career near the final earnings period. Actually, one that provides a cost of living adjustment after retirement that is somewhat related to inflation. Most private plans do not do this but most public plans do. This gets back the original problem. The problem is inflation and the uncertainty of that inflation and the change in the inflation rate from time to time. A good part of that has to be laid at the feet of the government and they should solve that rather than expect us to solve all the world's problems in the pension plan area.