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PORTABILITY OF PENSIONS: WORLDWIDE EXPERIENCE

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- Why portability?
  - What it is
  - How it's used
- Experience
  - International organizations
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- Actuarial considerations
  - Conversion from benefit to present value to service
  - Assumptions

MR. ROBERT M. KATZ: This session came about over the course of a couple of years and really stemmed from my own interest and the interest of a few other people who wanted to talk in portability issues. About a year ago, when I was talking with Barry Watson, who was one of the people organizing some of the sessions, I suggested that we should do a session on portability. Barry's response was affirmative as long as I was willing to organize it, so I agreed. I proceeded to find some practitioners in the field. Barry Watson is here to participate on the panel because he is replacing Roger Atkins, who, unfortunately, had some client commitments in Europe and wasn't able to join us.

Because this will be a free-flowing discussion, I thought it would be more appropriate for the panel members to introduce themselves. However, let me start by telling you that while this session is called a panel discussion, we are actually going to conduct it as a workshop. That will enable everyone in the room to participate, not just the panelists. How many people in the room are practitioners who are potentially going to be joining in the discussion, and how many are going to be principally listeners. How many practitioners do we have; that is, people who work with portability issues? Perhaps a third; and I assume everyone else is here just to find out about the topic. Our physical arrangement has three of us up front and the rest of you throughout the room, but that shouldn't affect the amount of participation. I am an actuary with the World Bank in Washington, DC, and my job is to be an internal actuary for the employees' pension plan. We are very heavily involved in portability issues, which is one of the reasons I'm interested in the topic. We have agreements with a number of other international organizations for portability arrangements. Ray and Barry are also practitioners; and I'm going to let them introduce themselves.

MR. RAYMOND E. SHARP: I'm a consulting actuary in the New York Metropolitan Office of Buck Consultants. I'm a British actuary by initial training. I have lived in the U.S. for the last 17 years, which makes me more an American actuary than a British actuary. I currently work in both domestic and international benefits, but specialize in international organization pension plans.

MR. CHARLES BARRY H. WATSON: I'm a retired practitioner. Even though I'm retired, I'm the principal actuary of something called "Watson Worldwide Enterprises" according to Mr. Katz. He sends me all my faxes that way. I'm a Canadian actuary by training, but I've been in the U.S. for over 30 years. I spent most of those years with the Wyatt Company, including 20 years doing international consulting. I've spent much time dealing with portability questions and issues like that, and have retired fairly recently.

MR. KATZ: I should tell you that I've known Barry for about 19 years and worked with him as a colleague at the Wyatt Company. Barry has also done some consulting work for the World Bank since I've been there, so our working relationship has continued. I should also tell you that Ray and I have worked together very closely since I've been at the World Bank because Ray is the principal actuary from Buck Consultants working on the World Bank accounts.

We really want to make this informal. I was almost going to start off by saying that this would be a spontaneous and unrehearsed discussion, as they do on the news talk shows, but that would not be accurate as we actually have done some preparation. We have no handouts because we thought it would be much more interesting for you, as well as for us, to be able to speak freely on topics of interest to you. For convenience I have made up a few overheads to list some talking points. If somebody has a hot button that they want to start on, we can begin there, or we can go back to the list of topics on the overheads.

To start, let's consider the big picture, under which are listed three key questions. First, what is portability? Second, why do we have portability? And we can look at that from both the employees' perspective and also the plan sponsor's perspective. Finally, how does portability work? Here we want to focus on situations where plans are similar or where plans are dissimilar, because portability can work quite differently depending on the provisions of the plans involved. So that's the big picture.

Two examples of usage are international organizations and transfer clubs. All three of us work in the international organization arena, so we can talk about that experience, which may be a bit different from the private sector or some of the other examples. Transfer clubs will certainly be meaningful for those of you with some European experience. To add a few more examples to the list, we can consider Social Security totalization agreements, multiemployer plans, and mergers and acquisitions, all of which involve some form of portability arrangement.

Because we are all actuaries, we have listed some actuarial considerations: for example, the valuation of benefits, the kinds of benefits that transfer, the conversion of benefits to present values, and conversely, the conversion of transfer values to service credits. Assumptions are also a major part of the actuarial considerations. A few are listed: discount rates, salary scale, in-service decrements, and the form of the benefit.

I'd also like to discuss some financial considerations. These are not actuarial finance issues, but rather the financial concerns of a plan sponsor or an affected individual. Are there winners and losers in portability situations? Who should be assuming the risks involved when there is a transfer of values? Finally, how should costs of transfer be recognized? In this case we want to look at it from the plan sponsor's perspective as opposed to the actuarial perspective.

These are all talking points that we have come up with. We can add to these if anyone in the audience has issues of concern. Does anybody have any issues that they would like to cover?

FROM THE FLOOR: International transfers and mergers and acquisitions.

FROM THE FLOOR: In the area of legislation in the U.K., the question of portability is mixed up with the whole issue of defined-benefit (DB) and defined-contribution (DC) plans. I think the government actually pushed defined-contribution plans at the expense of defined-benefit plans. Can we have a look at whether or not that's true?

FROM THE FLOOR: Let's also discuss Social Security.

MR. KATZ: I will start off the discussion and Ray and Barry can chime in as they see fit. But this is an open invitation to all of you, to raise your own points or ask questions. Let's start with a definition of portability, which is really a matter of how we get an individual who is participating in one benefit plan to transfer a benefit from that plan to another benefit plan. And I'm not even going to consider from where he is moving to where he is going. And I'm not going to consider the type of benefit plan. And I'm not going to consider how it works. Let's just say that we have an individual or a group of individuals moving from one benefit plan to another benefit plan. Does that sound like a good working definition?

MR. WATSON: It's important to make a distinction between vesting and portability which is sometimes overlooked. Vesting means that a person who leaves a pension plan has rights to certain benefits that will be paid to him in the future. Portability really implies that those vested benefits are or can be transferred in some fashion to the new benefit plan or new benefit situation he's moving into. They are quite distinct issues. Vesting is no longer a problem. Portability still is.

MR. SHARP: I think vesting is still a problem in many countries because of nonindexing of deferred vested benefits. Being vested in a benefit may not mean much if it is eroded by inflation. In a sense this affects portability.

MR. KATZ: The question is, are we talking about transfer of accrued benefits or vested benefits? This will depend, to a large extent, on the nature of the transfer. If you're talking about a formal arrangement, you're likely to be talking about transferring accrued benefits because the idea is to continue participation on a comparable basis. That's actually a nice lead in to the two perspectives that I have. What are the considerations when we view the transfer from the employees' perspective, and then from the plan sponsor's perspective?

MR. JOSEPH A. APPLEBAUM: One other point. It seems to me that a key issue concerns preserving the real value of pensions. That's sort of an anomalous transition, depending on whether postretirement benefits are indexed. Both indexed and nonindexed pensions are important; but it seems to me that talking about nonindexed postretirement benefits probably precedes the notion of indexed preretirement benefits.

MR. KATZ: Let's consider Ray's point on the indexation of deferred benefits, in terms of transferring now, rather than the issue of preserving vested benefits. Let's talk about the fact that in a transfer situation, you're presumably going to preserve the accrual of additional salaries and service that make the benefit, in effect, indexed. The individual who literally leaves one organization with a vested benefit and joins another without transferring, loses the ability to credit the old service in the new plan, and therefore, loses the salary increase and the accrual of service. I agree that the indexation after retirement is a separate issue.

I think the issue that we want to deal with here is the employee's perspective; that is, the employee moving from one organization to another or from one plan to another. How does the employee receive some value in the move? And we should consider the value added of a transfer as opposed to vesting. Remember that, in a transfer, future salary increases apply to old service, and I think that's the difference.

MR. SHARP: Joe, you've raised a very good point. I think that is very much a U.S. perspective. We all know that U.S. companies don't like to give cost-of-living increases too frequently. I think this is a cultural thing; in the U.S. we feel strongly about inflation and would rather fight to keep it low than accept it and adjust for it. There are other perspectives; legislation was introduced in the U.K. a few years ago which requires indexing of deferred vested benefits during the deferral period. And legislation has more recently been passed to require some sort of indexing after retirement.

FROM THE FLOOR: The deferred benefit is affected by inflation in the same way as the pensions in payment. So, if you don't agree to index pensions in payment, you don't have to index the deferred vested pension, otherwise you have to increase the deferred vested pension.

MR. SHARP: That's true, yes.

MR. WATSON: Yes, but don't forget we're talking about portability in general, not merely within a U.K. context. It's important to recognize that portability involves a number of different questions. At the most elementary level, the question is whether you can really get cash out of the pension plan you have been in, which represents some value, even if it is merely an accrued benefit without any consideration of future indexing or if it's going to be indexed in some fashion. The first question is, can you get money out? What's done with that money and where it goes are separate issues.

MR. KATZ: Let's think about the employee's perspective. Suppose I am an employee working for an organization, and I want to move to another organization or to another plan. Again, it doesn't necessarily need to be another organization—it could just be a different plan. Or I might want to go to a different country. One of the considerations that we have, particularly if we think about our typical plan participants, is that the older we get, the more important the pension becomes. The question we ask ourselves is, how much do I forfeit when I leave the plan I'm in and go to another plan. So the employee's perspective is really one of saying how can I maximize my retirement return in the course of a move? If I can have portability of benefits, it's going to be much better for me to move. Conversely, I might be going to my new employer and saying, if you can't give me credit for my prior service, and if you can't apply my new salary to my old service, then you must pay me more to make up for what I'm forfeiting in order to make this move.

Let's shift to the plan sponsor's perspective now. The questions are: does the employee do a better job if he transfers? And does the plan sponsor make a better deal for this employee if it can somehow offer him the ability to move his benefit from an old plan to a new plan? This seems to be very important when we're talking about changing employers, but even within a single employer with multiple plans, this could be important.

In the context of Social Security systems, there would be a tremendous advantage to obtain a service credit that would otherwise be lost if there weren't totalization agreements providing for the transfer of service from one scheme to another.

We'll talk about cost issues a little bit later, but there is a cost element to this discussion. It might be cheaper to provide a better benefit than it would be to provide salary upfront to make up the difference for the benefit foregone. Within a benefit plan, you've got an opportunity to fund the increase in benefit over time; whereas, the employee without that ability to transfer might very well want the money upfront, as a guaranteed increment of salary to make up for what would be forfeited in pension.

Finally, let's look at DB versus DC issues. In a defined-contribution plan, the entire risk is borne by the plan participant. There is no cost to the plan sponsor. In a transfer, the receiving plan simply credits the transfer amount with no cost impact on the plan sponsor. However, in a defined-benefit plan transfer, there is some risk involved. And remember, one of our key issues is who should bear the risk in a transfer. Presumably, the employee would be willing to take some risk in exchange for improving his benefit. And the plan sponsor, similarly, would be willing to accept some risk as part of the cost of recruitment of the employee to the new organization or plan.

MR. SHARP: On the face of it, defined-contribution plans offer full portability, because you take your cash balance with you, and, presumably, it can maintain its real value. Unfortunately, in some countries, there is a flaw because the money can be taken out during one's working career. This is particularly true in the U.S. where there's a great deal of labor mobility. You change jobs, you get laid off. Many people have to dip into their retirement funds. They are not locked into the system. So the account is portable, but at the same time, it's not really protected. So we do think of DC-plan balances as being portable, but I think in the macro sense, certainly in the U.S., there's a potential for a very serious problem looming.

MR. WATSON: This brings us to the question of similar and dissimilar types of plans. You're talking about a DC-plan benefit transferring into another DC plan. Wait until you have the pleasure of dealing with DC plan benefits going to DB plans and vice versa. There the question of reasonableness and value is appropriate, because you must take a defined-contribution accrual that, under the DB arrangement, if the transfer happens to occur at a bad time, is not going to buy you anything like your past service accrual; alternatively, if you're lucky, perhaps it will be much more than your past service accrual. So you have problems.

MR. KATZ: That's a very interesting point, Barry. At the World Bank we have a very simple solution to this problem: we do not allow a transfer from our defined-benefit plan to a defined-contribution plan.

MR. WATSON: Which means, of course, you're defeating portability.

MR. KATZ: That's quite true. If there are two DC plans, I think we can all agree that a balance from one plan becomes a balance in the other plan. We can also talk about defined-benefit plans that are basically similar. And when I say basically, there are some interesting questions. If the only difference in two plans was an accrual rate, or an averaging period for salaries, you could probably come up with a fairly simple adjustment to get from one benefit to another. But if plans become more dissimilar, then you have the issue that service in one plan really doesn't equate to service in the other plan. Or the salary structure in the new plan is so different from the salary structure in the old plan that a direct equivalence doesn't work. I suppose the ultimate dissimilarity is defined contribution to defined benefit.

FROM THE FLOOR: If you have fixed rules for determining the transfer value and for crediting the years of service, I don't really care where the money comes from.

MR. WATSON: You can do that, I agree. And that may work out very satisfactorily as far as the employer is concerned because, after all, those rules are set up and defined by the employer. The employer obviously can say, "If I'm getting so many guilders, and x guilders will "buy" one year of service under my plan, given that the salary is so much, you can define a service period." But as far as the employee is concerned, he has put in a defined number of years of service, and he may believe that he's not getting value for his money.

MR. KATZ: The employer's perspective could very well be this: we're not guaranteeing you portability, but we're going to give you an opportunity to transfer. We take some of the risk, and you take some of the risk. We offer you a deal; and if you like it, take it; if not, don't. You certainly have not forfeited your benefit in the original plan.

MR. WATSON: Undeniably so. And yet, I would merely comment that if the arrangement is that the individual does not take his money to the plan, you have zero portability and 100% vesting. And that is a perfectly acceptable solution, but it is not portability.

MR. KATZ: If the option exists, does that mean that it's not portability or merely the option denied?

MR. WATSON: If we were ranking arrangements in terms of whether or not portability is achieved, a transfer between defined-benefit and defined-contribution plans has an inherently lower likelihood of achieving satisfactory portability than a transfer from a defined-contribution plan to a defined-contribution plan or from a defined-benefit plan to a defined-benefit plan. It is just much more difficult and you may end up with a situation where you don't achieve equity. Or you may forbid such a transfer, as the World Bank does.

MR. SHARP: In fact, most portability systems would have to be voluntary because the basic rule in most pension plans, in most countries, is that you have an accrued right to remain under the plan. You can't force people to transfer monies out.

MR. KATZ: But then what would you say to multiemployer plans?

MR. SHARP: I'm not too familiar with multiemployer plans, but I expect they are truly portable.

MR. KATZ: That's not even an optional portability.

MR. SHARP: Yes, there may be, but you're still within the same plan.

MR. KATZ: Perhaps this is the ultimate in portability in that you take a plan, you apply it to many different employee groups, and you have total freedom of movement among the employee groups and no option out.

MR. SHARP: Yes, but I think it's still within the plan; there are different employers, but they are within the same plan. I was talking about different plans and different employers.

FROM THE FLOOR: Providing portability and having most people transferring their accounts is a good thing for various reasons. There's a trade-off between that and the bargaining that will go on about wages to make up losses, and this is what you pointed out before. To make a very rigid rule for the employer that he take or leave the conversion factor is not as well-thought-out. But in the absence of portability, a transferring employee will demand larger wage increases simply to make up for what he or she perceives as the loss in pension benefits for making that transfer.

MR. KATZ: I think the point is well made on that. But let's consider this. In the U.S., people change jobs fairly regularly, although that's diminishing due to the lack of portability of health benefits, as opposed to pension benefits. If we accept the fact that individuals leave jobs, then they're vested in benefits that lose value over time. When they get ready to retire, they have lots of small benefits, none of which are particularly valuable. Ultimately, that puts a drain on the Social Security system, which is being seen as the source for making up differences. Thus, the lack of portability has, I think, national consequences.

Portability of health benefits is probably more critical, because so many workers are saying that they can't afford to leave their jobs because of the potential loss of health benefits. We're not going to talk about health benefits; but I think the portability of these benefits may be an even more important issue in the future than the pension benefits issue.

FROM THE FLOOR: It also makes a difference who is requesting a transfer—the employer or the employee. Sometimes employers like to transfer employees from the U.S. to a European country or back—it makes a great difference.

MR. SHARP: Most international benefit consultants are very familiar with international transfers. It has been said that it's a subject of 5% importance but occupies 95% of the time of international benefits managers and consultants. It is a difficult problem technically, because the pension systems in most countries are closed systems, and most countries have legislation that protects the assets. In the U.S., for example, it's very difficult to transfer monies offshore from a qualified plan. It's also difficult to transfer money in. It can be done and has been done, but I would not recommend it. So, other solutions have been adopted to solve this problem. But they do end up providing, in a sense, portability. Probably the most common solution is the so-called umbrella plan. As a person moves around, he or she ends up with a series of essentially frozen accrued benefits; at retirement, there will be an umbrella benefit, usually financed offshore or on the books of the parent, which tops the benefit up to provide some sort of target. There is a movement more recently to offshore funded or even book-reserved defined-contribution arrangements, to achieve the same goal. Portability is therefore achieved in a roundabout way.

MR. WATSON: Yes. These are possible provided the laws permit them. This is where you get into regulations. The other way of doing it for such persons is to combine the years of service that the individual has with each employer in the parent group. At the end, pay him a benefit based on his total service and his final employer's pension plan (assuming that's a satisfactory formula), and offset the other arrangements. You preserve service credits, and this can be done provided it's legal.

MR. KATZ: I'll just follow up on Ray's point on the legislation front. The U.S. is fairly restrictive on asset transfers among plans in that, technically speaking, a plan that's qualified under the U.S. Internal Revenue Code (IRC) cannot conduct an asset transfer with a nonqualified plan without risking its own qualified status.

MR. SHARP: These arrangements were set up quite a few years ago as multinationals started expanding. The defined-benefit-umbrella plan is a very common device. It's very easy to set up and conceptualize. But the problem is that international employees, we found, have been very mobile. In addition, they typically couldn't care less about defined-benefit pension plans, but prefer cash. It is not improbable to find that for every hundred of these international employees, only five might survive to retirement to actually get a benefit. When they do survive, one has to calculate the benefit, which is the most horrible exercise one can imagine; there are numerous non-U.S. Social Security and other benefit offsets. In retrospect, we constructed some very elaborate solutions to the problem, and found out that the solutions turned out to be very complicated and probably unnecessary.

MR. WATSON: A current trend is for the parent to put another 5% of pay into some sort of offshore arrangement, and whatever comes out of the accrued money is your benefit.

MR. KATZ: Let's move on and talk about a few specific examples in order to consider the provisions of some actual arrangements. I will start by talking about international organizations, because that is my area of practice. Why do we enter into portability arrangements and how do they work? In essence we make these arrangements to enable valued employees to move among the organizations more readily than they would otherwise. This is in recognition of the fact that if you think about development, which is the business many of the international organizations are in, there are some experts who really should be sharing their abilities with more than one organization. If we can give them an opportunity to move among the organizations as regular staff members, without losing benefits, it's tremendously to our advantage.

In terms of how the arrangements work, we need to go back to the late 1940 or 1950s, when the plans being created were essentially all the same. So transferring was very easy. A year of service in one plan was equal to a year of service in another plan. Over the years these plans started to diverge in their provisions; and the so-called inner circle arrangement, in which service equals service, was no longer tenable. Thus, we had to move from the inner circle of similar plans to the outer circle of dissimilar plans. The outer circle arrangements consist of taking a benefit in one plan, converting it into a present value, transferring the present value to the receiving plan, and converting it to a period of service.

Originally the idea was that the transfer should be subsidized, so that the employer accepted all the risk, in order to foster the movement of employees. In other words, the cost of transfer was worthwhile in order to enable employees to move. More recently, some of the organizations have taken a much tighter control of their purse strings and have said that this kind of expenditure is not as necessary as it used to be. Employees should be given a fair option of an offer that can be accepted or rejected. Whether they accept or reject is not critical to the employer because it is the employee's choice. The arrangements are intended to be cost neutral. This is a new philosophy that we, at the World Bank, and at other international organizations, are now considering. It was expressed most eloquently by a gentleman I knew from the Organization for Economic Cooperation and Development (OECD), who said: "We have a very simple transfer arrangement with anyone. If you come to us with a sum of money from your previous employer's plan, we'll give you a service credit in our plan. If you leave our organization and join another plan, we'll give you a sum of money to transfer to that plan." And this, in effect, is the simplest sort of transfer arrangement.

FROM THE FLOOR: Do you have transfer clubs or do you have separate arrangements with these organizations?

MR. KATZ: Right now they are all separate arrangements. And this is probably due to the political nature of organizations, that might be reluctant to give up their own independence in order to create a club.

FROM THE FLOOR: It's a great deal of work to make arrangements with each club you have to deal with.

MR. WATSON: Would our friend from the Netherlands like to talk a little bit on the transfer club arrangements in the Netherlands?

MR. EDUARD OOMS: Yes, I'm from the Netherlands. I'm working for a big pension fund. We have recently set up a transfer club. It's a great deal of work. If you join the club you have to accept the rules for your pension fund. And the rules are about the amount of money you have to transfer related to the benefit amount, of course. And there are also administrative procedures, like who's going to write to the employee, who's going to sign, how exiting is arranged legally. The arrangement of the amount of money is also, of course, something that is very important. Both funds are using the same rules for calculating years of service. So if the plans are exactly the same, and the employee has the same salary, it makes no difference whether he's changed employers or not. The plan is only valid for employees changing jobs voluntarily—it doesn't apply to acquisitions, mergers or collective changes of employees.

MR. WATSON: It's important to recognize that in the Netherlands, the pension plans, at least within a particular industry, tend to be very similar. This makes the service calculations easy, and if the rules for determining the amount of money are standardized, everything is fairly easy. How do you handle a change in salary?

MR. OOMS: During the transfer it is not taken into account. The fund you are leaving says you have a certain benefit amount with a certain value. You're taking your money with you and the money amount is going to credit your years of service, based on your new salary.

MR. WATSON: So in effect they apply the amount of money transferred to purchase the service credit based on the new salary.

MR. OOMS: Yes.

MR. KATZ: I think that's a fairly common arrangement. Certainly in our case, we do the same thing. What you transfer is based on the old salary, while what you receive in credit is based on the new salary.

MR. WATSON: It's important to recognize that this means that, in calculating the amount of money that has been transferred from the old employer's plan, an assumption is made as to how salaries will increase in the future. There has to be a rate of future salary increase built in, including assumed inflation. The new employer is the person who is assuming any risk, be it plus or minus, for deviation from that assumption.

MR. OOMS: Yes, if the salary increases, the benefit amount increases also. Therefore, the costs are borne by the new employer. But the transfer amount is based on 4% investment income.

MR. WATSON: You're assuming a 4% real rate of return? But if inflation dictates that 4% isn't right in the future, that risk goes to the new employer.

MR. OOMS: Yes, or it can depend on how the plan is funded.

MR. KATZ: One thing you might consider is that if there is a major increase in salary, the service credit you get in the receiving plan is going to be significantly less than what you left your old plan with. So you might consider that when I get that big salary increase to change jobs, I'm actually giving something up in benefits. And depending on what I expected my salary increases to be in the plan I left, I might have done better by not transferring at all. So I think there's a mathematical relationship here that the employee would have to look at; and depending on his salary prospects in the two organizations, it could very much alter this idea of who's bearing the risk.

MR. OOMS: The employee has the option of transferring or not transferring within a fixed period of time. So after he or she joins the new employer, he or she has to decide within three months.

MR. KATZ: This is a very interesting topic. The employee is given a choice, but the employer is not. So, at least in the Netherlands, we have the situation where the employer has the risk but the employee does not because the employee gets free choice and the employer does not. This is also the case with the international organizations. The employers don't have any choice; the employees do.

MR. SHARP: As former international consultants we're aware that there was some proposed legislation in the Netherlands that would mandate transfer arrangements between pension plans that weren't part of clubs. It was based on the so-called "rear balcony" approach, which is similar to the one you have just described. Did that legislation die?

MR. OOMS: No, it's still pending; the procedure is still the same but the required transfer value is lower.

MR. SHARP: I think this is a good indication of how difficult it is to pass portability legislation in Holland which is a fairly homogeneous society. Even in a society like Holland with very good attitudes towards pension plans, there's trouble passing legislation on portability for the good of everybody.

FROM THE FLOOR: A large part of the problem of portability was prevented by having industry-wide pension schemes, so if the employer is in one industry, or one branch of an industry, all the employees within that branch were in the same pension plan.

Could I ask our Dutch friend a question before he sits down? One of the problems in the U.K. in relation to the portability problem is the transfer value being based on the vested benefit, which is based on salary at the date of transfer. In Holland, is that vested benefit revalued with some sort of earnings revaluation?

MR. OOMS: No, after one year, the accrued and vested benefit are the same, so the vested amount is the amount on which the transfer value is calculated. Both plans calculate on a January 1 salary.

MR. WATSON: But don't forget that there is an implicit salary increase by the use of the 4% rate of return.

MR. KATZ: Perhaps someone from the U.K. would like to speak about experience there.

MR. NORMAN D. FREETHY: The concept of the transfer club that we've just heard about in the Netherlands, to my mind, simply adds to an obligation on the new employer to take whatever transfer value is made available. He then determines what benefit he's going to give and, of course, there may be a reduction. The more the salary goes up, presumably, the more years of service that are given up. If he's going to get a higher salary at his new job, that's something he must weigh out. So, I don't think it's a be-all, end-all situation.

In the U.K. we do go a bit further in a certain area. We have what we call "local authority pension funds" and there are about 90–100 of these. They are broken down into regions, counties, London boroughs or whatever. There's a great deal of money in these funds—the largest ones have £4 billion in assets, so we're talking about quite large sums of money. Among the local authorities, the transfer club means that you get a year of service for a year of service. If an employee goes from one authority to another, the likelihood is that his salary is going to vary. Therefore, in one sector we have true portability, which I imagine is what every employee would like to see. However, very few commercial employers would like to take a transfer value in these terms.

MR. WATSON: Excuse me, Norman, you're saying that even if I'm making a salary of, say, £10,000 with one local authority, and I go to another one, and they raise my salary to £12,000, the new employer in effect says, "If you have five years of service with the old authority, we'll give you five years of service with us anyway."

MR. FREETHY: Right, that's the way it works.

MR. WATSON: So that really means the rear balcony benefit is paid for by the new employer.

MR. FREETHY: They work on the principle that presumably one authority gains and loses.

MR. KATZ: There is a principle here, however, that if one individual is transferring from one employer to another, then someone else is transferring from that one back to the first one.

MR. FREETHY: That's the point. It works on the principle that there are winners and losers and they should balance out.

MR. WATSON: It's the old English saying: "What you gain on the swings, you lose on the roundabouts." I never knew what either swings or roundabouts were, but it sounded wonderful.

MR. FREETHY: But it doesn't always work. I think local authority folks can be a little bit more relaxed about all this, because the benefits are actually guaranteed by the government. The funds held by the local authorities are shadowed funds. By that I mean that ten years ago, they weren't actually fully funded, but we're getting nearer and nearer to a fully funded situation. We've become a bit more relaxed about it due to stock market gains. No doubt, when it all goes rolling in the late 1990s, there will be a complete rethinking, and who knows what's going to happen then. We've had that situation in the U.K. for a number of years. I think it's desirable and ideal. To be applicable in any country in the world, it's going to take many exceptions.

MR. SHARP: The interesting thing about the arrangement just described is that the plans are the same. In the U.K., the Institute of Actuaries has guidance notes on transfer values. Is there much reliance on the actuary to set the assumptions?

MR. FREETHY: Oh yes indeed.

MR. SHARP: I would like to know if the lack of common assumptions leads to a lot of problems for individuals when they get their transfer values and then try to get pensions in a new plan.

MR. FREETHY: Yes, there are problems beginning to emerge. There are differences among actuarial firms. There have been numerous meetings at the Institute discussing this whole problem much more openly, in the light of the recent guidance notes and so forth.

MR. KATZ: As a non-U.K. person might I ask whether this is an attempt to establish a fixed set of assumptions or merely to establish a means for determining those assumptions?

MR. FREETHY: The latter. It's the set of principles or guidance for British actuaries to follow. I think we're a little bit wary at the moment that we may be going towards a fixed set of assumptions. Most of us would want to resist that, but the market is creating pressure to push this much closer together.

MR. SHARP: I came across an interesting problem which involved a U.S. multinational that was spinning off parts of its business in the U.K. A block of employees was transferring from the parent to a spin-off entity's plan. Transfer values were calculated by the actuary based on the common methods. However, the amounts of money being transferred weren't sufficient to buy the same amount of past service. This wasn't a group of individuals leaving of their own volition to join a competitor; this was a corporate reorganization where, for corporate convenience, employees were being moved to a different plan. I thought it was pretty unfair to the individuals. As far as they're concerned, they would continue to work for essentially the same employer, but now will find that when they retire, instead of having 35 years or 30 years of service, they might have only 25.

MR. FREETHY: Well in the case like that, I would suggest that local legislation doesn't come into it because there's no standard you have to meet. It becomes a corporate decision. So the actuary's job is to advise the corporate client that, if they want to top off the benefit to preserve full value, then it's going to cost them a certain amount of money.

MR. WATSON: But that would not be permissible in the U.S., of course.

MR. FREETHY: Really?

MR. WATSON: No. You cannot reduce accrued benefits in that fashion.

MR. FREETHY: Oh no, you wouldn't be able to do that within the U.K., but we were talking about something different. The benefits weren't accrued; they essentially received the present value of the frozen deferred benefit. The point I'm making, of course, to use accounting terminology, is that the transfer value should be more of a projected benefit obligation amount. They really have an accumulated benefit obligation amount.

MR. WATSON: But was this converted into years of service?

MR. FREETHY: Yes.

MR. WATSON: Well then, I would argue you would run into problems if you tried to make some sort of interim calculation for an individual and then reduced the number of years of service that he was given credit for. That would be a diminution of benefits.

MR. KATZ: Let's consider the situation in which we have two different sets of actuarial assumptions—one on the sending side and one on the receiving side. I might send you off with a wonderful transfer value and tell you that I'm giving you a great deal. Then you might go to a receiving plan that uses a very different set of assumptions and could gain or lose a tremendous amount, all because of the difference in actuarial assumptions used by the sending and receiving plans.

MR. SHARP: This situation also arises with mergers and acquisitions which we haven't really discussed. Here a company sells off a portion of its business and a question arises regarding the amount of assets which should be transferred to cover the pension liabilities. Depending on which side you represent, you will seek a larger or smaller transfer amount. If you are representing the seller, you would fight for the smallest amount; if you are representing the buyer, you would fight for the largest. An attorney once told me that my job in an acquisition was to be an actuarial gladiator, to fight to the death with the competing actuary for my client. Unfortunately, the participants are usually the ones that get killed, not us or the attorneys.

MR. WATSON: I think that there is a distinction when you're dealing with two totally separate plans operated by two separate employers. What I thought you were talking about was an intercompany situation, and, I must admit I'm very disturbed by what you suggested.

MR. FREETHY: Yes, if I can clarify it. It really was intercompany in the sense that they were creating a new corporation; that is, they were totally reorganizing.

MR. WATSON: But it was part of the controlled group?

MR. SHARP: Well, they'll have an ownership position in the new company, which is going to be floated. But as far as the employees are concerned, they will still tend to view their service with the former employer as being service in the same family. The problem is that the actuaries for the sending plan argue that the trustees always followed these rules in determining transfer values. Now, of course, the rules were designed to, shall we say, punish or not treat as favorably those employees who left and joined a competitor. The trustees argued that they had to follow these rules on a common basis. As Norman pointed out, the solution was to ask the company to make up any loss; unfortunately the company decided not to do so.

MR. KATZ: Ray, I'd like to pick up on your comment about the lawyer saying that your job was to be a gladiator for the company. Is it the role of the actuary to take sides and support the company or should the actuary be considering the concerns of the employees? Do we do ourselves a disservice if we are thinking of only the corporate perspective and not the employees' perspective?

MR. SHARP: That's an excellent point. In the U.S. there is an absolute minimum that can be transferred which is basically the present value of the accumulated benefits. There is also a rule that no participant can be any worse off after the exchange than before.

I have also been involved in many international mergers and acquisitions, where one multinational sold its businesses to another multinational. In this case there are plans all around the world. The same sort of problem arises. In the U.S., pension actuaries tend to look more towards the employer's interests than would be the case in the U.K., Holland or elsewhere. It is probably true to say that, in most other countries, there's more room for a gentlemen's agreement, where you have a meeting of minds with your competing actuary to do the "right thing." In the U.S. environment, that's very difficult to do. You literally have to fight to the death to achieve the best results for your client.

MR. ARNE ERIKSEN: You asked what the actuaries should do in a merger or acquisition situation. I don't think the actuary should take the employees' side versus the employer's side. I think the actuary should explain to the employers, both the acquiring company and the selling company, that all these details about pensions should be negotiated and put down on paper.

MR. ROY E. BRIMBLECOMBE: Could I just put a little gloss on what happens in the U.K. in mergers and acquisitions and bulk transfers from one scheme to another. At the moment we have had, for about four or five years, legislation in the U.K. which says that if you're transferring a group of employees (current employees or past employees) and pensioners from one scheme to another, without getting their individual consents, you have to get a certificate from the scheme actuary that says that the transfer will not make this group of people materially worse off. The trustees cannot transfer any group of people from one scheme to another without getting that certificate from the actuary. So to that extent there is protection.

MR. WATSON: Well, wouldn't that then seem to indicate that, in the situation that Ray described, the actuary who issued such a certificate must have had his tongue in his cheek.

FROM THE FLOOR: Absolutely. Yeah. I mean on the face of it.

FROM THE FLOOR: On the face of it he shouldn't have signed the certificate if he wasn't satisfied about the security of the members' benefits.

MR. WATSON: Well, of course, most of us are aware that, in the U.S., under the Employee Retirement Income Security Act (ERISA), the enrolled actuary is certainly, in theory, supposed to be acting on behalf of the interests of the plan participants. This raises all sorts of interesting problems in practice, and I don't think that they've been completely worked out.

MR. KATZ: But if we were to take the position that there is not a single and unique set of assumptions that applies to everyone, so that we now have to exercise judgment, isn't our judgment going to be influenced by knowing who is paying our fees?

MR. WATSON: It depends on what we're talking about. If we're talking about mergers and acquisitions, I think the situation is fairly clear. You are presumably working for only one side of the merger or acquisition. I've heard of a few cases where actuaries were working for both sides, but I don't quite know how that worked out. Anyway if you're working for one side, you are being asked to solve a problem for your client. You owe your client advice on the alternatives, the costs of the alternatives, and the implications of the alternatives. Then it's up to the client to make a decision.

MR. BRIMBLECOMBE: We do have this difficult position in the U.K. because many actuaries are appointed by the trustees of the plan. Others are employed by the employer of the plan, and others are employed jointly. You occasionally get to the situation described earlier, and possibly a merger and acquisition is one of them, where the actuary has this dichotomy. If he's advising the trustees, then by definition he's also taking into account the interest of the members; our professional code says he must do so. If he must act in this gladiatorial sense for the employer, he may not be considering the best interests of the members. We have situations where the actuary will have to say, "I'm sorry. I'm advising the trustees of the plan and thus the members. You need to have another actuary to advise you in this merger and acquisition situation."

MR. APPLEBAUM: I think it's very important that actuaries do recognize who their employer is in any particular situation. When there is a conflict, they should be very careful about the advice that they give. And they should be very careful about who is writing the checks, for example which is usually the employer for that purpose. They're acting for that employer.

MR. WATSON: This suggests that it is appropriate for the trust fund to pay for what you might call the ERISA calculations of the employer, but perhaps not for other actuarial services.

MR. APPLEBAUM: I'd go further. It's inappropriate.

MR. WATSON: Yes, I agree. As a matter of fact, there is a wall between the two types of services that any consulting firm I'm aware of has been building with rapidity and thickness.

MR. SHARP: On the subject of mergers and acquisitions and the resulting transfer values, the accountants have actually come to the aid here. We are seeing more and more transfer values being determined on a projected benefit obligation basis. Many modern agreements say if the amount transferred is less or more than the projected benefit obligation (PBO) on an agreed set of assumptions, then there's an adjustment to the purchase price. One thing to bear in mind, though, is that many of these transactions involve the establishment of a new plan that is identical to the old plan. Therefore, the question of different benefits doesn't come up.

MR. KATZ: Since you're raising the subject of the accountants, let's remember that the accountants are the ones telling us that we have to use our best estimates of assumptions. That seems to imply that there is such a thing as a best estimate. I think we could spend the rest of the day debating what a best estimate means.

MR. SHARP: Good point. It all boils down to the assumptions.

MR. WATSON: And the best estimate may bear absolutely no relationship to the discount rate. One other issue that can come up is the question of what is a substantial future commitment to alter benefits? This can be a highly debatable issue. The accountants say if there is a substantial future commitment, you should recognize it; if there isn't, you shouldn't. You can debate both substantial and commitment until the cows come home.

MR. KATZ: I would throw in materiality as being another issue because the accountants always tell us to ignore amounts that are not material. Let's consider a merger and acquisition. If you're looking at a purchase price, is the difference, the increment in benefit value that you create, material? I'm not talking about the value of the benefit, but rather this incremental value that you create if you change assumptions. Is that material or not?

FROM THE FLOOR: I want to draw a distinction between accounting and what actually happens in terms of employee protection, because in many cases, like in the U.K. or Germany, you don't have much leeway. In fact, employees have to be whole or practically whole. You can still fight to obtain the best terms for your client. The company can also recompense the participants separately. Accounting adds another tier on top of that which occurs after the fact. So, I think you need to distinguish among the three things.

MR. KATZ: In calculating transfer values, there is a whole set of actuarial assumptions that need to be made. Are you going to consider only a retirement benefit, or would you also consider other benefits requiring a present value? How simple or how complex do you want to get? In the international organization sector, we have considered that the need for complexity is less important than the need for understandability. We, as actuaries, have to be able to explain to our employers what it is that we're transferring. For example, we can say that we are transferring only the right to a retirement pension, not to any other benefits. So we'll ignore in-service decrements because they probably do not add or subtract too much from the values, but are very difficult to communicate. So we can take a simple approach.

MR. SHARP: I like the Dutch approach of using a 4% interest rate. When I started out as an actuarial student years ago in England, things were much simpler. The actuarial tables we used had interest rates of 2–4%. Nowadays, we tend to use a more complex approach. We use market rates of interest and inflation. The Institute of Actuaries' notes on transfer value, if my understanding is correct, require a market rate. I've seen U.K. transfer values involving a 10% discount rate with a salary scale. I think it would be very helpful if all of us could use, for these types of calculations, something a bit more simple.

MR. WATSON: In an environment in which there is automatic and guaranteed indexing of the benefits in payment, it becomes reasonable to use a lower real rate of return. It's different if you're talking about an environment like that of the U.S. or other countries where indexing of benefits in payment is neither guaranteed nor usually allowed for. There you don't have a substantial commitment. Therefore, the Internal Revenue Service (IRS) won't allow you to value the increases, and the accountants don't ask you to look at them. You really have to go to an explicit market rate, to take out the postretirement indexing.

MR. SHARP: Barry and I had a discussion on this point a few years ago. I am not entirely convinced. Inflation is viewed as a temporary problem in the U.S. If we go through a period of inflation where discount rates are at, say 10%, is it appropriate to assume that this will always hold true? Such a rate implies that inflation will be running at 5%, 6%, and higher. If inflation were to run at say, 7% consistently on a long-term basis, surely that implies that employers would, one way or the other, be forced to index benefits to some degree. In the U.S. we tend not to take inflation into account, because inflation is fought—authorities don't like to see it. Going back a few years, when discount rates were very high, I thought that many of the calculations we were doing were meaningless because it's erroneous to assume very high discount rates unless you assume there's going to be endemic inflation with them.

FROM THE FLOOR: Could I add a common trail to this long-term rate business? Some of us are rather afraid that we might have legislation on this in the U.K. You commented that when you started out, 4% was the rate one nearly always used. In fact, that was the same rate my original firm used nearly 30 years ago. But it sort of represented a mishmash between the interest you expect to earn, less some sort of salary growth rate. In the U.K., we now have bonds that are index-linked, which means that both the coupon and the maturity value are indexed to the Retail Price Index (RPI). Some of these are 30-year bonds. So they're a good long-term proxy for what the market thinks the real yield is going to be over that period.

Currently the yields are about 3% or more. They've been up to 4.5%. They've been down to about 2.75%. Now that suggests to me that 4% for a fully index-linked scheme is maybe a bit high. But if you come down to 3% or 3.5%, you probably get there. Very few schemes, it seems to me, offer fully indexed benefits. So you can obviously put that rate up a bit. So, over the longer term, we seem to gravitate back somewhere near the 4% figure. And I would say if it's between 3% for a fully indexed scheme, and 4% for sort of partial indexing, you're not far off.

MR. KATZ: Let me ask you a question. Is there a difference between a funding assumption, which might very well reflect your asset strategy, and the assumption you might use in calculating a transfer value, which presumably is not the same as your funding?

FROM THE FLOOR: Yes. I think for the funding assumption, you're going to look at what you might get on your investments, and that it is your own scheme. You're talking about people who remain with you. So, I think you can try to be reasonably conservative. But the minute people start leaving you, I think you have to think a bit differently. So from that point of view, I think there's a difference.

MR. WATSON: Don't forget though, that in your funding assumption, you say you need to be conservative, and yet, in reality, you expect to do better on your fund than "conservatism" might imply. So you could argue that you should use a higher yield to calculate the transfer value because, if you don't, you're going to give too much money away, viewed from your perspective.

FROM THE FLOOR: Yes. I think that was the point I was trying to make. With funding, U.K. actuaries like to err on the conservative side.

MR. KATZ: Look at it from a plan trustee's point of view. If we expect to earn a particular rate, let's assume something lower, we'll have a margin of error and basically make sure we look good in our investments.

FROM THE FLOOR: With the nominal pensions and the 4% interest assumption in the current transfer arrangements, there are no conditions. In the previous arrangements you had to have some type of indexing before you could even join. It was more or less a guarantee that if an employee was transferring, he would be better off after transferring than he was before transferring. In the new arrangements, we don't have that anymore. So the employee needs some advice on whether to transfer his pension money, and the employer needs to determine whether or not to join the arrangement.

MR. KATZ: Do you think that an employee has the ability to evaluate whether he is better or worse off?

FROM THE FLOOR: Not by himself.

MR. KATZ: No, I don't think so either. As soon as you say to an employee that you're giving him less service in the receiving plan than he had in the sending plan, you need a very long explanation as to why he might be better off under that circumstance.