SOCIETY OF ACTUARIES

Article from:

International Section News

March 2006 – Issue No. 38

"Trust" in North American Qualified Retirement Plans

by Leslie John Lohmann

English law is not worldwide. An obvious statement, perhaps, but much ignored in the field of retirement plans. In fact, the importance of trust law is pretty much ignored in North America where trusts form the primary vehicles of delivering qualified retirement plan benefits. It is also ignored, to their own peril, in other countries when comparing their own retirement systems against the systems in countries that follow English legal tradition.

First, in order to avoid sophisticated arguments about the topic; a retirement plan is the systematic provision of money benefits at or after retirement. A pension plan is the systematic provision of an annuity following retirement. ERISA requires all qualified retirement plans to be pension plans; benefits must be defined in terms of annuities. Canada's laws are similar. The methods and vehicles used to provide the benefits at or after retirement are not retirement plans.

In Japan, most private plans are not pension plans. They are retirement plans: they systematically provide money (a lump sum) at or after retirement. Externally funded retirement plans must provide a roughly equivalent annuity giving them pension qualities, but the benefit form itself is defined as a lump sum.

Without additional argument, I will assert that many plans (called pension plans) sold today in North America are not even retirement plans. Single Premium Deferred Annuities have seldom been sold for the guaranteed annuity available at maturity; fewer have even been held to maturity. No defined contribution plan, regardless of qualification, is a pension plan. Prior to strict legislation limiting the owner's access to his/her own money, they were not even retirement plans. Japan also limits the rights of owners of defined contribution retirement plans to have access to their own money prior to a predefined older age, artificially changing a thrift plan to a retirement plan.

Returning to the subject, qualified North American retirement plans use the legal concept of a trust in order to make the plan sponsor's contributions to the plan complete for tax purposes and to assure the members that contributions once made cannot be taken back "until all the liabilities of the trust have been satisfied." This last requirement of a trust has caused enormous headaches due to sponsors' desire to use (or take) plan surplus.

Note the traditional use of the word contributions. Along with the words member and sponsor, these words have no employment meaning outside the legal domain of trusts.

While we call these vehicles funds, they are not—they are trusts. The trust, in order to handle the accumulation of funds in excess of immediate cash flow needs to the beneficiaries of the trust (the members), establishes a fund. Other than being the grantor, the plan sponsor has no legal relationship to the fund, not even when management provides most of the trustees, as is often the case.

Japan, until recently, achieved a similar result without the need to resort to English legal tradition—the employer contracted with a provider (usually an insurance company or a trust bank) to buy a product that required premiums and, in return, promised benefits to the participants. Unlike insured benefits, however, the insurer guaranteed nothing beyond the accumulated premiums to pay those benefits. In a sense, the insurance product is a fund. Japanese sponsors also have a small probability of getting at any plan surplus—but for different legalities.

And Japan, like North America, tends to call the money accumulated in these products pension funds.

What are the liabilities? Whose liabilities are they?

In Japan, the issue rests on whether the plan sponsor has included the benefits expected from the purchased insurance product in the Rules of Employment—the working regulations or, also, the work rules.

Work rules have an appearance of company policy as used by North American companies. Unlike the United States (and, to a lesser degree, Canada), these rules are contractual. When the company maintains a retirement plan that is a Book Reserve System plan—a plan funded on the balance sheet (North Americans culturally consider these unfunded), a portion of the future promised benefit, already earned and accrued, has priority in corporate insolvency. When the company has purchased an insurance product and the rules of employment still refer to the benefits of the retirement allowance plan, the rules in insolvency are murkier. When the rules only refer to the purchased contract, it is clearer that the benefits promised by the purchased plan are not benefits promised by the company. Most companies behave as if none of these promised future benefits would be honored in corporate insolvency if not already funded by the purchased product regardless of what the work rules say.

As mentioned, in North America, especially in the United States, company policy is not contractual. The protections attempted by ERISA were, and are being, enacted precisely to mitigate the problems arising from the failure of a plan sponsor to fully honor the apparent promises of earned and accrued funds, yet unfunded benefits not yet paid from the trust. Benefits to be earned in the future or increases in benefits in the future that have already been accrued due to the operation of the formula (final pay plans) are totally outside the scope of these protections.[1]

North American trusts, having the primary purpose of protecting the beneficiaries of the trust, also protect the grantor of the trust—the plan sponsor. To the extent permitted by law, the grantor can decide to stop funding the trust at any time without any residual liabilities. In the absence of any laws, the grantor could pay whatever (s)he wanted to the trust.[2] None of non-bargaining based benefits are contractual in a typical qualified retirement plan. Those benefits that can be met by already committed funds must be paid, since the benefits are the most important obligation of the trust.

An interesting decision recently came up in Canada that reemphasizes the legal separation of the sponsor from the trust.

The basic question explored, in my words, was, does the sponsor have an obligation to indemnify the trust from all risks, including theft? The particular facts were a situation where the trust had been robbed and the plan members sought to indemnify their position by attaching the surviving assets of the plan sponsor who was in receivership. The court found against the members; to the extent that the employer had funded the plan in accordance with law and the losses were not related to the investment performance of the assets, the sponsor did not have a duty to the members of the plan that exceeded the duty to the creditors.

The article describing the ruling in the Toronto newspaper, the *Globe and Mail*, stated, "And as all good insolvency lawyers know, pension trusts are supposed to trump even the most sacrosanct of secured creditors."[3] Once again reaffirming the advantages of little knowledge.

While such a finding is infuriating, it reflects the characteristics of trusts. The promises of a trust are not the promises of the grantor, even when those promises appear to be related to pay for performance and the grantor of the trust is the employer. In Japan as in North America, retirement benefits are not pay for performance, regardless of how employees feel about that or how much the accountants want a liability described in those terms to appear on the balance sheet.

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The promises of a trust are not the promises of the grantor, even when those promises appear to be related to pay for performance

[1] This forms the basis of my objections to the rules of IAS 19 that require balance sheet recognition of the liability due to increases in the accrued benefits based on future increases in pay.

[2] Pre-ERISA funding rules arose from the desire of companies to get a tax deduction for the obvious business expense incurred in providing retirement benefits.

[3] "Technically, pension funds don't really exist: ruling," *The Globe and Mail*, 12/14/2005.

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In Japan, I have regularly emphasized that the most important shortcoming of retirement plan security both here (Japan) and in North America is the failure to amend corporate insolvency laws to recognize the belief of the public that retirement benefits are deferred pay as summarized by the accountants:

"The Board's conclusions in this Statement derive from the basic idea that a defined benefit pension is an exchange between the employer and the employee. In exchange for services provided by the employee, the employer promises to provide, in addition to current wages and other benefits, an amount of retirement income. It follows from that basic view that pension benefits are not gratuities, but instead are part of an employee's compensation, and since payment is deferred, the pension is a type of deferred compensation. It also follows that the employer's obligation for that compensation is incurred when the services are rendered."[4]

My Japanese colleagues assured me that getting the Justice Ministry involved would take just too much political capital. Many admire the now discredited (in some camps) PBGC, not realizing that Japanese law, not permitting the formation of trusts, does not have the same kind of social obligation. If the Japanese wanted to insure unfunded benefits, products would be developed to do so.

In conclusion, it is precisely the vehicle of the trust, derived from English law, that makes the establishment of a social guarantee of the promises contained in a trust both reasonable and necessary. A social guarantee is not necessary where an employer is unable to assign the risks of future benefits to a non-related third party—a trust. Japan, in particular, does not need a social guarantor of private retirement plan benefits.

If the law in every jurisdiction where defined benefit plans are permitted would be the same as the basic idea asserted by the accountants, promised benefits would be more secure and the PBGC would not be in crisis. Japan, not having a legal tradition that permits trusts, needs only two baby steps to significantly improve the security of defined benefit "promises." They are:

1. Require the retirement plan promise to be included as a promise of deferred pay in the working regulations as part of the contractual relationship.
2. Improve the position of the deferred pay represented by these promises in corporate insolvency to the same position as all earned, but unpaid, salary.

Western jurisdictions that follow English legal tradition simply need to redefine defined-benefit retirement benefits as pay, earned and unpaid, putting the employer first in line to meet those promises, then the trust, then society. Of course, the employee would be first in line at insolvency.

Making those changes would suddenly make the opinions of employees, the accountants and the members of the plan mentioned in the *Globe and Mail* article align with the actual law. ☐

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[4] Financial Accounting Standards Board Statement of Financial Accounting Standard No. 87, Paragraph 79.