



SOCIETY OF ACTUARIES

Article from:

The Actuary

April 1989 – Volume 23, No. 4

Editorial

Pension portability

by Barnet N. Berin and Eric P. Lofgren

Portability of pension benefits allows an employee to maintain pension benefits as he leaves one company and joins another. Advocates of portability point approvingly to the way Social Security—a portable pension plan—handles employee mobility. In their view, the private pension system would be fairer to participants and close a gap in pension coverage if it had more portability.

Of course, the voluntary private pension system and the mandatory Social Security system are quite different. Social Security has one universal benefit structure, complete with indexing. There is no funded, actuarial reserve with accompanying assets. In contrast, the private pension plans of various employers provide vastly different levels of benefits to meet their unique objectives. Indexing is ad hoc, periodic for retirees, and nonexistent for the terminated vested. The private pension system has significant assets that, under portability, would have to be allocated and transferred as the employee moves.

Definition extended

The issue of portability gets confusing because the term is used in a number of different contexts. Portability discussions in Washington, D.C., may refer to service, the transfer of specific assets, indexing of benefits, and other vaguely related matters.

Portability has also been used to refer to earlier vesting and to the merits of defined-benefit versus defined-contribution pension plans. Some of the fuzziness is not serious, but it tends to make portability even more complex than it need be and masks important considerations such as fairness and necessity.

Service

Defining portability of benefits to include related service implies that successive employers will have to count combined service in all prior companies in determining the amount of (or eligibility for) the various pension benefits. Few plans do this now, nor is there agitation for them to do so. There is an inherent unfairness if employees with the same attained age, newly hired,

are granted different benefits or service eligibility. The last employers might be required to provide a benefit calculated as if the employee's entire career had been in one place. Presumably, this total benefit would be offset by the vested accrued benefits provided by previous employers.

Indexing

Advocates of portability recognize that some of the benefits might be small (reflecting starting salaries at the beginning of a 40-year career, for example) and believe that all such benefits should be indexed with inflation. One way to partially accomplish this is by portability of service, but this does not work for those who change to an employer without a plan, or for those who leave the work force.

An alternative approach, similar in effect, is general indexing for all vested, terminated employees. This raises questions. In the extreme, should only final pay plans be permitted? Otherwise, active participants are treated less favorably than those who leave. Should exceptions be made for depressed industries or for companies that have come upon hard times? With indexing up to normal retirement for vested terminated employees, do retirees get similar treatment? Since the effect on plan costs of full scale indexing would be staggering, leading to plan terminations (if still allowed), would defined benefit coverage be mandated?

Assets

Portability of assets refers to a cash distribution of accumulated pension benefits, along with the ability to place such assets in a successor retirement arrangement without tax consequences.

A cash distribution from a defined benefit plan requires a careful statement of the assumptions used to convert deferred retirement income into a lump sum. Assumptions and methods would probably be mandated. With portability, the prior employer will lose the assets and the possibility of future actuarial gains or losses. If the plan is underfunded, a cashout at 100% value would erode the funded ratio for remaining participants. If funds are widely transferred from plan to plan, assets will have to

be kept more liquid to avoid cash flow problems, affecting investment policy and returns. But it goes beyond these considerations.

Will an IRA or a receiving plan be sufficient, or should there be a national clearinghouse receiving these assets, investing funds, keeping records, and run by Social Security, as some have proposed? Should the employee be allowed to specify how assets are invested?

Earlier vesting

A 1987 study showed that vesting in profit-sharing plans was effective immediately in 6% of plans, in up to five years in 22% of plans, and after five years in 72% of plans surveyed. Now, most pension plans will vest after five years. Is three-year or even immediate vesting necessary or desirable? For a benefit to be portable, it must first be vested. Will the administration of pension records for small benefits become burdensome?

Defined benefit vs. defined contribution

This is a contentious issue, with the arguments for and against well known to both sides. In final pay defined benefit plans, protection against preretirement inflation is provided to active participants but not to terminated employees. Defined contribution plans are portable but lack inflation protection, and nothing is guaranteed. The timing of a withdrawal is crucial to the level of retirement income that can be arranged. Advocates of mandatory indexing often offer a second choice: a mandatory defined contribution floor.

Mobility

Employee mobility is difficult or impossible to forecast. As the baby boom generation ages, with too few coming up behind them to replace them, will the population still be as mobile? If not, portability would be less of an issue in the future.

A government policy encouraging portability would also encourage mobility. The incentive to remain with one employer would be reduced. Is this a wise policy? Would portability undermine the nation's productivity, or enhance it, as is often claimed in Washington?

Continued on page 7 column 1

Portability cont'd

Legislation

The thrust of recent legislative proposals is to preserve the tax status of portable pension benefits, by transfer to an IRA, for example; by restricting cashouts prior to retirement by increasing taxes; by increasing coverage through expanded simplified employee pension plans (SEPs) and introducing salary-reduction SEPs. While current legislative proposals do not go further, portability—in the broad context described above—has become part of the Washington, D.C., scene, discussed by congressional staff and government officials as a seeming failure of the private pension system.

Barnet N. Berin, a Vice President of the Society, is Managing Director and Chief Actuary of Mercer-Meidinger-Hansen, where Eric P. Lofgren is Principal.

Upside down cont'd

on the changing pattern of investment yields.

Nonetheless, this change is likely to be viewed in Australia and New Zealand as good by governments (they get their money now), bureaucrats (life is less complex), and retirees (they get a better deal). In the face of this, the unhappiness of employers can be only sour grapes!

More important to us in the United States, this standing of the pension benefit/tax relationship on its head is likely to be popular here too. Congress in particular, and even more intensely the Congressional staff, have never believed that pension allocations are properly taxed. They look only at the present and see a tax expenditure; they can never lift their eyes unto the hills and see the tax revenues flowing in after retirement.

This could well be the outside world's revenge for ERISA—an insidious gas rather than a nuclear blockbuster, but just as devastating. Charles Barry H. Watson is an Actuary with The Wyatt Company. He is a former Vice President of the Society and a former President of the Conference of Actuaries in Public Practice.

Correction

In the March 1989 *Actuary*, there was a typographical error in the chart accompanying the article "Actuaries... be careful!" by Jerrold G. Dolins. Under total policies for the Nashville office, the figure should be 2,000, not 2,200. The figure was correct in the text.

The Fellowship Admission Course

by Michael B. McGuinness

The Fellowship Admission Course (FAC) is one of the proposals contained in the White Paper on Future Education Methods for the Actuarial Profession, circulated by the E&E Committee in early 1987. FEM proposals were developed with three primary objectives:

1. Enhance the value of the FSA designation.
2. Provide for better and broader education consistent with the future direction and needs of the actuarial profession.
3. Create a system that will attract, select, and train those people who can best fill the role of the actuary in the future.

The FAC was proposed as a 2½-day course focusing on professional ethics and the integration of syllabus material. Candidates would take this course as the final step to the FSA designation, after all exam requirements had been completed and before a FSA is awarded. All candidates who fully participated in the sessions would pass and receive their FSAs.

Currently, professional ethics appears to many candidates as one more study item. Our ability to test both the candidate's knowledge of professional standards and the ability to apply these standards is limited. Professionalism extends beyond mere

knowledge of the phrases contained in a code of conduct. It is taught better using concrete examples than through self-study. The case-study method, with the opportunity for discussion and interaction with other near-FSAs and experienced actuaries, is very appropriate.

The second focus of the course will be integration of syllabus topics. The near-FSA has been exposed to a collection of discrete topics but may not fully appreciate the important links between them. The case-study method and management-simulation exercises will help the candidate to analyze unstructured situations and solve real-world complex problems.

In late 1987, the Board directed the E&E Committee to proceed with the development of the FAC, with a view to first requiring attendance from those who completed the exam requirements during the May 1990 exam period.

Development work for the FAC is now under way by several committees under the direction of the FAC Steering Committee, which I chair.

More detailed information on the FAC, dealing with such matters as course content, timing and location, and costs to attendees, will be communicated to members and students by late summer this year.

Michael B. McGuinness is a Vice President of the Society in charge of Education and Examination. He is with Eckler Partners, Ltd.

Summary of OASDI and Medicare programs

Robert J. Myers, former Chief Actuary of the Social Security Administration, has just completed a revision of his Summary of the OASDI and Medicare programs. This 47-page document incorporates, in detail, the provisions of the Medicare Catastrophic Coverage Act of 1988 (both those immediately in effect and those to be phased in during the next few years). Copies may be obtained by writing to him at 9610 Wire Avenue, Silver Spring, MD 20901, and enclosing \$1 for postage (and, if possible, a self-addressed mailing label).

Intensive seminar business instructor chosen

Donald F. Behan, Ph.D., FSA, has been selected as the business instructor for the Applied Statistical Methods Intensive Seminar to be held in August at the University of Wisconsin—Madison. Behan, National Director of Actuarial Services for Deloitte Haskins & Sells, has had extensive experience in applying mathematical and statistical techniques to business problems.

The SOA Education and Examination Committee is pleased to have Behan join Jed Frees as the faculty for the seminar.