TRANSACTIONS OF SOCIETY OF ACTUARIES
1950 VOL. 2 NO. 4

PENSIONS

A. Have trends in union agreements stimulated a demand for Deposit Administration?
B. What methods are being used under Deposit Administration for handling disability retirements?
C. To what extent have companies granted the right to "cash out" the Deposit Fund? With what conditions and restrictions? With what expense and investment liquidation charge?
D. What is the attitude of the United States Bureau of Internal Revenue toward "terminal funding" plans?

MR. D. C. BRONSON said it appeared that insurance companies are becoming more competitive both among themselves and with the trust fund people in the field of group annuities. He indicated that under D.A. (Deposit Administration), cost range and benefit indefiniteness were fertile fields for offering or implying more than the other fellow.

Generally in the past the classic distinction between the trust fund and insurance company methods has been that the insurance company received premiums to provide guaranteed protection whereas the trust fund received contributions to protect and nurture by means of which it gave the best retirement benefits possible consistent with the safety of the pension plan. Recently there has been the development of the practice on the part of insurance companies of receiving premiums not attached for specific purposes. The D.A. plan has been a suitable vehicle for this development.

Up to now the insured plan has offered a measure of *specified* protection to the employees both active and retired. If the plan terminated, benefits accrued were vested or the money which was available was used to purchase vested benefits even in the case of D.A. plans. Fundamentally, under the trust company approach, this has not been true. Usually employees already retired were taken care of first and then the active employees to the extent of the balance in the fund. Maybe this is not unfair in the noncontributory negotiated plan in that wages and conditions of employment, now including pensions, are not immutable and indeed are subject to collective bargaining.

Despite the fact that the insurance companies have always emphasized the employee's interest, the labor unions have appeared to favor the trust fund approach. However, the insurance companies are now offering to take money on deposit where the employer or union retains control. Control by the union is infrequent as yet but it may develop. Of course,

now, unions are represented frequently with the employer on administration boards. If the employer or the union wants to change insurance companies or wants to alter the arrangements, the deposit fund is transferable not to the employer but to another fiduciary. The offering of transferability of funds is akin to the banking business. Moreover, someone had asked him recently why the trust companies cannot utilize their capital and surplus to put a firmer guarantee on pensions for life instead of only to the exhaustion of the funds. He stated that his comments were not by way of criticism of the new D.A. trend but only to point out the fundamental shift in emphasis.

MR. S. L. EISNER stated that the demand for D.A. plans still left a good deal of sales effort necessary. It is true, however, that an increasing proportion of the new group annuity contracts written by the Prudential has been on a D.A. basis, the proportion this year being 50%.

Under the more traditional deferred annuity type, the employee has a definite guarantee as he continues to work that a definite amount of annuity has been purchased for him to commence at a fixed future date. This very guarantee tends to limit the flexibility of the contract and in many cases arising out of collective bargaining makes it quite unsuitable. On the other hand, the D.A. contract is ideally suited for this purpose. Normally no annuity is purchased until the employee retires. This tends to minimize the problems that would normally come up because of the absence of a definite retirement age or because of a complicated benefit formula or because of frequent plan changes resulting from collective bargaining. The D.A. contract also permits the introduction of assumptions as to turnover rates, retirement rates, disability rates and salary schedules in the computation of the estimated employer cost. Furthermore, it is not necessary under a D.A. contract to use the mortality, interest, and expense assumptions which the insurance company has used in computing its guaranteed rates. Therefore, the D.A. contract gives the employer and the union the opportunity to arrive at the estimated employer cost of the pension plan for bargaining purposes with a high degree of refinement.

In referring to disability retirements Mr. Eisner said that frequently the employer is willing and anxious to pay the disability pension before age 65 on a pay-as-you-go basis. Age 65 is normally the earliest age at which employees can retire under these collective bargaining pension plans without reduction in the accrued pension credits. At age 65 the D.A. fund is applied to buy the disability pension to which the employee is entitled thereafter. Moreover the employer has the privilege of buying temporary disability or deferred disability annuities at any time before 65. As all of these disability annuities are purchased at standard group

annuity rates, it is never necessary to get evidence of the commencement or continuance of the employee's disability. If annuities are purchased before age 65 and the employer notifies the company that the employee has recovered from disability, the annuity is canceled and the employer is allowed a credit to his D.A. fund.

If the employer pays the disability pension himself until age 65, generally it is necessary to insist that the annuity be purchased at age 65 if the employee is still alive; otherwise, the remaining employees for whom annuities would be bought would be a superselect group and the standard group annuity rates might prove to be quite inadequate.

The Prudential has been rather hesitant under group annuity contracts to insure the risk of disablement or to sell temporary disability annuities at rates that are less than standard group annuity rates with or without a discount for recoveries. Disability is at best difficult to define and may later be interpreted differently by the courts. Moreover, under the group annuity contract, unlike the individual disability income coverage, the employer and the union are interested parties who are likely to interpret disability as inability of the employee to perform his regular job and not just any job for remuneration. Under a group annuity contract, too, it is difficult to differentiate retirement on account of disability from retirement on account of inability and inefficiency. Moreover, any reduction in the annuity purchase rates which results from the assumption of heavier mortality for disabled people or the introduction of a turnover discount is likely to be largely offset by the resulting increase in expenses for underwriting, processing disability claims and other administration.

Mr. Eisner discussed cashing out the D.A. fund. Under a D.A. contract, it is almost universally the custom not only to guarantee every dollar of the employer's contribution but also to guarantee the minimum accumulation rate and the schedule of annuity purchase rates at the time each dollar of contribution comes into the D.A. fund. If there is the right to cash out this fund at any time, the employer with adequate investment counsel is going to be most anxious to do it when we would be least willing to let him, namely in a depressed asset market.

The Prudential has been willing to provide a "cash out" privilege only where it is absolutely necessary to carry out the terms of the pension plan and then only if there are adequate safeguards available to limit the possible extent of selection against the insurance company. Under plans where the pension benefits are reduced by Social Security, it is possible that a future general increase in the level of Social Security will result in a deposit fund much larger than the amount required to provide all future pensions for present employees. Under those circumstances, the Prudential is willing to let the employer cash out the excess portion provided he

does it within a specified period following the change in the Social Security Act. If the annuity purchase rates do not have a projection feature built into them, it would be wise for the insurance company to reserve a similar "cash out" provision for the excess portion or at least to reserve the right to change the rate basis applicable thereto. Otherwise, it might be found that the rate guarantee extended over a much longer period than was originally contemplated. The Prudential is providing a similar "cash out" provision in connection with government sponsored corporations where for one reason or another there may sometime be a great percentage reduction in personnel with resultant overfunding.

Under the maturity funding form of the D.A. contract designed to handle some of the newer pension plan schedules, the employer has no obligation to maintain a D.A. fund. Normally, this contract would be issued only where the pension plan clearly provides that the employer's sole obligation is to provide pensions as employees retire or become eligible to retire and where the plan provides that there is no benefit for employees who have been accruing credit up to that point if the plan is terminated. The deposit fund on this type of contract as written by the Prudential is normally kept small. Its function is mainly to guarantee the purchase of annuities for employees who have become eligible to retire and have not done so or to average out the employer's contribution over a short period of years, generally the period of the bargaining agreement on pensions. Under those circumstances, the employer is allowed to cash out any portion of the deposit funds which are left after meeting the residual pension obligations on our contract if the plan is terminated.

Under the noncontributory D.A. contract written by the Prudential, it is provided that at any time the employer can stop making contributions under the contract and commence making contributions under another group annuity contract or to a trust company, in which case the pension credits continue to accrue under the plan and the deposit funds are applied for these continuing pension credits until the funds in the company's hands are used up. This provision has removed most of the pressure for a "cash out" provision in group annuity contracts. Moreover, their contracts also provide that at any time the employer can terminate the contract, apply the deposit funds to buy paid-up vested deferred annuities generally trying to equal the accrued pension credits, prorating if the funds are insufficient. If the funds are more than sufficient, the employer is allowed to cash out the excess funds.

In permitting cashing out of deposit funds, a 5% expense and liquidation charge is made. The right is also reserved to pay any return over as long as a 10 year period in which event each installment includes interest. Under present contracts, the rate of interest is 2%.

Provision is also made in the company's contracts for a "cash in" as well as a "cash out." If an employee's pension is reduced in accordance with the pension plan as a result of an increase in the deductible benefits under an offset type plan, the company will reduce his annuity accordingly and allow the employer a credit to his deposit fund.

MR. R. M. PETERSON stated that the pension pattern developed in the course of union bargaining during the last year or so had stimulated the development of a type of D.A. contract possessing unusual flexibility. The usual type of deferred annuity or Deposit Administration contract is poorly adapted to meet the needs of the new situation, and the insurance company found it difficult if not impossible to offer its services to cover plans with this new pattern. This new pattern necessitated a contract under which one or more of the following features were available.

1. The widest flexibility in funding ranging from the purchase of annuities at retirement by five annual payments to full orthodox funding on the basis of conservative assumptions.
2. An automatic reduction of any pension which had been purchased upon a future increase in primary benefits under the Social Security Act.
3. The privilege of transferring unallocated funds from the insurance company to another carrier or trustee to allow for possible future development of industry-wide plans.
4. Some arrangement for handling disability pensions.

Although he felt that some of these developments were retrogressive, he also believed that it was important that insurance companies find some way of making their services available to industry if a reasonably satisfactory method of doing it could be discovered. Accordingly, the Equitable developed a special form of D.A. contract with certain features not characteristic of its regular D.A. form, namely: (1) complete freedom of funding with a minimum requirement of purchasing annuities at retirement date and even, in one or two unusual cases, involving the purchase of annuities at retirement by five annual payments beginning at retirement; (2) a provision for a transfer value with respect to the unallocated D.A. funds; (3) a provision for the cancellation or reduction of annuities after retirement where such modification is made pursuant to the terms of the employer's plan; and (4) a provision permitting payments to disabled employees to be payable from the D.A. fund. This contract is offered only with respect to plans which have their origin in union bargaining and is not available for contributory plans nor does it contain any optional annuity forms. It therefore has limited usefulness and interest in it will probably diminish. It is encouraging to note that there is increasing interest in adequate funding on the part of both employers and unions. There are also plans developing where the benefit is independent of the Social

Security benefits thus eliminating the necessity of canceling annuities after they are purchased. Moreover, as the situation becomes more stabilized, he believed that there would be a lessening interest in the transfer privilege.

With respect to disability retirements, the Equitable has recommended that prior to normal retirement date the employer either make payments directly or make contributions under the D.A. contract. In the latter event the D.A. contract provides for making payments to disabled lives up to the normal retirement date. At normal retirement date, the employer may purchase an annuity in the same manner as for other employees. Although this purchase is not compulsory, the contract provides for no payments beyond normal retirement date except by purchase of the annuity. Contracts involving this feature have been filed in a number of states. All but two of these states have been heard from, with approval except in Massachusetts where it was claimed that the statute required a definition of disability. It is expected that the contract will be offered in that jurisdiction without the disability feature.

The special form of D.A. contract referred to above gives the employer the right to have an amount not exceeding 95% of the D.A. fund paid to a trustee under the plan. The company has the contractual right to effect such a transfer if the plan is changed at any time and the company then determines that it is not practical to provide for the benefits thereunder. The right is reserved to make payment of a transfer value in equal annual installments over a period not exceeding ten years. It is expected that the company will follow a more conservative policy in distributing surplus under contracts having this privilege.

The expense and liquidation charge frequently needs clarification. The expenses covered by the charge must be all expenses, including commissions and premium taxes, which have been incurred on amounts paid into the D.A. fund. Accordingly, the expenses involved are much more than merely the expenses incident to the liquidation and disbursement of money from the D.A. fund.

With respect to the need for an investment liquidation charge, there is an investment loss if the withdrawal comes at a time when market values of the portfolio are in the aggregate less than the book value, *i.e.*, when the average return on the portfolio on a book value basis is less than the return which can be obtained on new investment. This loss is nonetheless real if premium income is used to cover the cash withdrawal, for the effect is the same whether the company sells securities for the cash withdrawal and invests all premium income, or pays the withdrawal out of premium income and invests only the remainder of the premium income to improve the aggregate return. In the first mentioned action of selling securities, the

investment loss is the excess of book value over market value on the amount of the withdrawal. An aggregate ratio of market value to book value for the whole portfolio would be the logical ratio for evaluating the loss.

With respect to the Bureau's attitude on "terminal funding" plans, obviously no one can answer this question authoritatively except the Bureau itself. As a test of the permanence of the plan, the Bureau has a rule requiring that the funding must be at such a rate that at no time is the unfunded liability greater than it was at the inception of the plan. It is understood that there have been plans approved where the initial rate of funding was not adequate to meet this requirement. Whether or not these plans will be in difficulty when the real test comes a year or two later is unknown. The test apparently is based upon the particular assumptions adopted to determine the amount of deductions under Section 23(p) of the Internal Revenue Code. Suppose one of two companies, alike in all respects, decides to adopt fairly conservative assumptions producing an initial unfunded liability of $1,000,000 and a current cost of $50,000 a year; and the other company, using more liberal assumptions, has an unfunded liability of $800,000 and $40,000 a year current cost. Each company pays $60,000 a year, which for the second company represents current cost plus 2½% interest on the unfunded liability. If it is assumed that 2¼% interest was used by the conservative company, its total contribution should be $72,500 to avoid an increase in unfunded liability at the end of the first year. Applying the test of the Bureau, the second company, merely by the choice of funding assumptions, would meet the requirements, but the first company, because it chose to be conservative, would be in trouble at the end of the year. This obviously is an unfair result and would suggest that the test of the Bureau should be based upon the most liberal assumptions that it would find acceptable without regard to the basis actually adopted by a given company. It is hoped that the Bureau will operate its rules and regulations in a realistic manner so that there is no penalty for conservatism.

MR. E. A. GREEN stated that in considering the desirability of providing for "cash out" and the restrictions which might be imposed, a leaf might be taken from our divorce laws, even though the analogy is not complete. When a man and woman are married, it presumably is for life. Frequently, divorces arise from incompatibility or outside attractions, either amateur or professional. Divorce laws usually provide for a cooling-off period to determine that true incompatibility is present, not just a temporary annoyance at the man's new necktie or the woman's new hairdo, or to determine that the outside attraction is a permanent affair and not just a temporary infatuation with a pretty face. Likewise, the "cash

out" provision of a D.A. contract might provide for a cooling-off period to determine that true incompatibility is present, not just temporary annoyance at minor operational difficulties, or to determine that the outside attraction is a permanent affair and not just a temporary lure of a rising interest rate or a smooth-talking individual.

He felt that a one-year notice requirement in the contract would serve the purpose of protecting the fund against financial selection and precipitant action. The John Hancock was prepared to offer about the same type of "cash out" provisions as have been described by previous speakers, but with a one-year notice provision. He felt the length of time over which the installments are to be paid out need not be as long if there is a one-year waiting period.

MR. R. H. MAGLATHLIN said that Mr. Eisner and Mr. Peterson had covered his points almost verbatim. Like the Equitable, The Travelers gives an unlimited right to cash out at any time with the same conditions and restrictions as have been mentioned. In addition, The Travelers attempts to offer such a contract only to an employer who is vitally interested in having a true pension plan and not just putting into the pension fund the minimum amount of money necessary to satisfy the union's desires.

He indicated that the method used by The Travelers at the present time for handling disability retirements under D.A. plans is to have the monthly disability benefits deducted directly from the deposit fund on a pay-as-you-go basis up to age 65. At age 65 a normal retirement annuity is purchased at regular premium rates.

MR. W. K. WHITE said that one of the more common features of recently negotiated pension plans had been the element of indefiniteness as to the amount of retirement income to be provided by the employer. This results from a final salary type of benefit formula or one having a direct tie-in with Social Security. It might seem at first glance that the D.A. plan would be the most satisfactory and perhaps the only way of insuring benefits of this type. However, the Aetna Life has found that most of these plans can be handled on what is basically the deferred annuity method for the major portion of the benefits with the balance being provided by the deposit fund type of financing. Except for a small portion of employees' total pensions or sometimes for past service which is usually purchased over a limited period, it does not write or quote on a D.A. basis.

Aside from the greater security afforded the employees and the employer under the deferred annuity method, the insurance company is saved from the potential problems and embarrassment inherent in the D.A. plan.

In the D.A. plan, the insurance company is offering the same type of investment services, with respect to the active employees at least, as the trust department of a bank. In doing this, the insurance company makes guarantees which no bank offers. The question therefore arises as to whether the insurance company is taking too much of a risk.

With an uninsured retirement plan, it is usually clear to the employees that the employer is assuming the responsibility for the adequacy of the funding. With the D.A. plan, the insurance company joins with the employer in assuming this responsibility. It is doubtful that the members of the plan will fully understand the limitations of the insurance company guarantees and responsibility.

The insurance company frequently gives actuarial service to the extent of indicating the minimum and maximum annual deposits that are practicable. Presumably these deposits would generally tend toward the minimum level since low initial cost is usually the most important reason for adopting a D.A. plan. While these estimates may be adjusted periodically to conform with actual experience, there will be instances where the insurance company will eventually be faced with a real dilemma, having either to explain to the employees why their benefits must be reduced or else to explain to the employer's Board of Directors why the cost picture is so much darker than when the plan was initiated. While the consequences may be unpleasant where the employer had stayed within the insurance company's limits and the plan is still underfunded, there may be even more serious problems where the employer does not meet the minimum funding requirements.

Aside from the question of flexibility and low initial cost, the supposed saving in administrative expense appeals to many companies. This saving is relatively insignificant, however, compared to the total cost of a retirement plan, as can be seen from the fact that, according to the published statements of seven leading insurance companies, group annuity expenses for 1949, other than investment expenses, commissions and taxes, averaged just under $1\frac{1}{2}\%$ of premiums and, of course, this figure includes such items as sales expense which is not materially affected by the method of financing.

As a general matter almost any method of funding a pension plan works out satisfactorily when the benefits are being paid according to schedule and the employer meets the cost. The real test of the method of financing a plan will rarely come during a period of prosperity such as we have experienced in recent years when the majority of the D.A. plans were adopted, but it will come during a period of economic stress when suspensions and discontinuances are common.