TRANSACTIONS OF SOCIETY OF ACTUARIES
1959 VOL. 11 NO. 31

Pension Plans

A. Rates for Group Annuities

What rate revisions have been made or may be expected in connection with various types of group annuity contracts as a result of the treatment given to qualified pension plans under the new Federal income tax law?

B. New Developments

1. What have been the recent developments in the pension field with respect to (*a*) the equity annuity and (*b*) the cost-of-living annuity?
2. What effect can be expected from the passage of legislation (such as was recently enacted in Connecticut) to permit life insurance companies to operate special investment accounts for pension plans?

MR. LESLIE R. MARTIN, JR., said that the Aetna's group annuity rates effective September 1, 1959, are on the average about 7% lower than their previous rates. This reduction was made possible by the combination of the new Federal income tax law and the continued improvement in the interest yield on investments. These favorable circumstances permitted more liberal interest factors which were partially offset by the adoption of a more conservative mortality table.

The new rates are based on the *Ga*–1951 Table with Projection Scale C and ages in 1960. The interest factor is $3\frac{1}{4}\%$ for deferred annuity and regular deposit administration contracts, $3\frac{1}{2}\%$ for terminal funding contracts, and $4\frac{1}{4}\%$ for contracts issued in Canada. The loading is 3% of the gross for terminal funding contracts and 5% of the gross for all others. The new contract charge is a function of the number of employees covered under the plan and the average total premium per employee. In general, the new contract charge is lower than formerly and there is no contract charge when the annual premiums exceed about $40,000.

Rates for deferred annuities are guaranteed for five years. All regular deposit administration funds deposited during the first five contract years carry annuity rate guarantees and a guarantee of $3\frac{1}{4}\%$ interest until applied. A special deposit administration plan is also available using rates for a terminal funding plan, but the interest and annuity rate guarantees expire at the end of five years.

Interest on employer withdrawal credits was increased to 3%. This rate is guaranteed for the first five contract years on premiums paid during that time and may be reduced to not less than 2% thereafter on such premiums. Interest used in computing employee withdrawal credits will normally be 2% but may be $2\frac{1}{2}\%$ or 3% upon request of the employer.

MR. BLACKBURN H. HAZLEHURST said that the Pacific Mutual had increased its long-term interest guarantees to $3\frac{1}{4}\%$ and that, in his opinion, this change was due in part at least to the tax relief afforded under Phase 1 of the new Federal income tax law. Another change which has some tax implications is their plan to credit full earned interest on deposit administration and immediate participation guarantee funds.

He suggested that the failure of the new Federal income tax law to relieve qualified pension plans from tax on capital gains would appear to reduce to a considerable extent any advantage which might be derived from the broader investment latitude for pension plans sought in some of the recent state legislative activity.

MR. WILLIAM H. SCHMIDT outlined the new group annuity rates of the Mutual of New York.

On deposit administration funds paid in during the first contract year, interest is guaranteed at $4\frac{1}{2}\%$ for the first five contract years and at 3% for the fifth to tenth contract years, inclusive. For money deposited in the second to fifth contract years, inclusive, interest is guaranteed at $3\frac{1}{2}\%$ to the end of the fifth contract year and thereafter at 3% for the second five year period.

The new annuity rates for deposit administration contracts are based on $3\frac{1}{2}\%$ with *Ga*-1951 mortality projected to 1960 by Scale C and rated down five years for females. The loading is 4% of the gross plus any state tax. These rates are applicable for money applied for immediate annuities during the first five contract years; for money deposited during the first five contract years and applied thereafter, the annuity rate basis is the same except that the interest assumption is reduced to $3\frac{1}{4}\%$. In addition to the loading, there is an annual case administration charge that starts off at about $700 and grades down to zero when the annual purchase payments total about $60,000.

The new rates for deferred group annuities are based on $3\frac{1}{4}\%$ and the same mortality as deposit administration. The loading has been decreased from $6\frac{1}{2}\%$ to 5%. These rates are guaranteed for the first five contract years.

MR. HENRY E. BLAGDEN said that the Prudential first adopted what might be loosely called "generation mortality" in their dividend formula. However, instead of using a different table for each age, they used a different table for each decade. Thus, the mortality table used for people born from 1890 to 1899 was the Prudential 1950 Group Annuity Valuation Table with the age rated down one-half year; for people born from 1900 to 1909 this table was rated down an additional year; etc.

In their new rate basis, essentially the same mortality tables have been used for the middle points of the decades and the rates for intervening years have been interpolated. The new rates for deferred annuity contracts involve $3\frac{3}{8}\%$ interest and 5% loading. In addition, there is an annual contract administration charge which is \$500 plus 5% of the first \$10,000 of considerations less 1% of the considerations in excess of \$25,000. Thus, the annual administration charge disappears when the annual considerations total \$125,000. It applies to all forms of contract.

On their standard deposit administration funds, they will now guarantee $3\frac{3}{4}\%$ for the first five contract years, $3\frac{1}{2}\%$ for the next five contract years and $3\frac{1}{4}\%$ thereafter on money paid in during the first five contract years. Interest will be credited at 3% on employee money if it is recognized as such and records are kept accordingly.

They have adopted a somewhat unusual approach for recognizing mortality improvement in their immediate annuity rates. The rates for age 65 are calculated on the appropriate table at $3\frac{1}{2}\%$; the same rate is calculated taking into account assumed mortality improvement for 30 years with 3% interest; then intermediate rates are interpolated geometrically.

They have also developed a special guaranteed basis for deposit administration type contracts. On this special basis, on money paid during the first five contract years, interest is allowed at 4% during the first five contract years and at $3\frac{3}{4}\%$ during the second five contract years with no interest guarantee thereafter. With these special interest guarantees, the immediate annuity rates start off on a 4% basis and are graded into a 3% basis 30 years later. The rates, however, are only guaranteed for annuities purchased during the first 10 contract years.

He said the Prudential had made comparable changes in its immediate participation guarantee contracts and that he expected reasonably comparable changes would eventually be made in their group retirement income contracts which are similar to the group permanent contracts offered by some companies.

MR. RAY M. PETERSON said one question posed by the new Federal income tax law is whether deposit administration funds are pension plan reserves. He suggested that such funds may be so regarded where there are interest and rate guarantees applicable until the money is applied, but that there may be more doubt under contracts with limited guarantees or contracts on the immediate participation guarantee form. He said he was aware of the view held by some persons that for all types of deposit administration contracts, including those with limited guarantees, the Federal income tax may be calculated on the "interest paid" basis. He pointed out, however, that this procedure does not rely on the provisions of the law which were intended to benefit qualified plans, and therefore would not be in accordance with the spirit of the law. Furthermore, on this basis the interest which is deducted must actually be paid or credited.

He suggested that the new Federal income tax law should be regarded as involving a tax abatement, an approach to tax equality, rather than relief or a windfall. He said that the change in the income tax afforded a welcome opportunity to strengthen mortality assumptions and that he believed many consulting actuaries as well as insurance company actuaries agreed with him. He offered a word of caution that in the pension business we can only make guesses and estimates for the future, and he hoped therefore that the current favorable circumstances would not lead to unrealistic liberalizations.

MR. D'ALTON S. RUDD said he was interested in the fact that several United States companies had adopted what were called "select" interest rates, *i.e.*, interest rates which do not remain constant but may be reduced, say, at the end of five years, etc. He said that this approach has been in use for some years now in Canada, and as an example the London Life used a yearly discount on the rates of their nonparticipating conventional Group Annuity contracts to give high temporary interest assumptions—$5\frac{1}{4}\%$ for 15 years currently—and maintain rates in all contracts on the same basis.

MR. FREDERICK P. SLOAT, speaking on section B, described the retirement plan of a large petroleum company which is being amended effective January 1, 1960, to include variable benefits.

The present plan is contributory and provides for pensions equal to $1\frac{1}{2}\%$ of each year's earnings up to the Social Security wage base and $2\frac{1}{2}\%$ of earnings in excess thereof. Under the amended plan each employee is assured that he will not receive less than he would have if the variable benefit feature had not been introduced.

The variable benefit fund will normally be invested primarily in equities. Any variation in the amounts of retirement income payments will be determined solely by the relationship between the earnings and changes in market values of the variable benefit fund and the applicable assumed interest rate. Since the $2\frac{1}{2}\%$ level of benefits instead of the usual 2% is intended to protect against moderate inflation prior to retirement, the assumed interest rate used for the variable benefit prior to an employee's retirement will be higher than the rate used after his retirement. For example, the assumed interest rate may be 4% prior to retirement and, say, 3% after retirement. Then if the actual investment experience for the year is 5%, variable benefits prior to retirement will be increased in the ratio of 1.05 to 1.04, while variable benefits after retirement will be increased in the ratio of 1.05 to 1.03.

Normally one-half of the basic future service retirement income credited in any year will accrue as a fixed-dollar benefit and one-half as a variable benefit. For employees who have annuities accrued under the previous group annuity plan, the entire future service will accrue as a variable benefit until the basic variable benefit equals 50% of the total benefits then credited including those under the group annuity contract. Thereafter the normal 50-50 split will be followed. An important feature of the plan is that the variable benefit for an employee will be built up by annual increments over a period of years so as to avoid the possibility of concentrating their accrual at unfavorable times in the investment market.

The variable benefit fund will be handled so that all of the effects of mortality and turnover with respect to variable benefits will be reflected in the employer's payments under the plan, while all of the investment results will be reflected in the size of the variable benefits payable to employees. There is no occasion to determine capital sums for individual employees at any time. The entire procedure will depend only upon amounts of benefits and investment results.

If an employee retires at an early retirement date, or elects an optional form of annuity, the amount of variable benefits will be adjusted at the time of retirement in the same manner as for the fixed-dollar benefits. The variable benefits for a retired employee will be annually increased or decreased in the same way as for an active employee. If, in any year, the total variable benefit to a retired employee is not equal to the total basic retirement income credit originally accrued to him as a variable benefit, any additional payments required will be made from the general funds and not from the variable benefit fund.

MR. PETERSON thought it should be emphasized that the plan described by Mr. Sloat involves a variable benefit with a floor or minimum guaranteed by the employer. He suggested that this plan reflects the employer's belief that he cannot expect his employees to accept the negative side of variable annuities and he questioned whether there is any practical way for an insurance company to handle such a plan.

MR. EDWARD D. BROWN, JR., described three large state retirement funds in Wisconsin which permit variable annuities on an optional basis under legislation enacted by the state in 1957.

Under the Wisconsin Retirement Fund, which includes state employees and employees of most of the municipalities in the state, a member may elect to have 50% of the contributions made by him and by the state for him deposited in the variable annuity account. Once the election has been made, it cannot thereafter be changed. The member also has the option of transferring either 5% or 10% of the amount to his credit in the fund on January 1, 1958. Such transfers can be made once each year for a total of not more than five such transfers.

Approximately 12% to 15% of the eligible employees have elected to come under the variable annuity plan. The total amount contributed to the variable annuity fund from January 1, 1958, to December 31, 1958, was in excess of $1,600,000. The variable annuity fund, which consisted entirely of common stocks in 1958, had a net gain for the year of 36.8%. Five persons who retired during 1958 had exercised the variable annuity option. As of December 31, 1958, the variable annuities paid to these persons were increased by 32% to reflect investment gain.

In the twelve months ending June 30, 1959, 5,068 members of the Wisconsin State Teachers Retirement System (including approximately 51% of the faculties of the state colleges, 46% of the faculty of the University of Wisconsin, and 13% of the public school teachers) had elected to participate in their variable annuity plan. Of these, 3,773 elected to transfer a part of the accumulation in their accounts to the variable annuity division.

At June 30, 1959, the portfolio of the variable annuity division consisting entirely of common stocks had a market value in excess of $3,100,000. Results of the first year of operation of the variable annuity plan show a net gain of 15.1%. Fourteen variable annuities were granted during the first year. All variable annuities were increased by 7.25% beginning with payments for July 1959.

As of September 1959, 635 members of the Milwaukee Public School Teachers Annuity and Retirement Fund had elected variable annuity coverage. This is slightly more than 26% of the total of 2,430 eligible members. The total amount paid into their variable annuity fund from September 1, 1958, through August 1959 was approximately $76,000. Investment results of the first year of operation are not yet available.

The investments of all three funds are made by the State Investment Board which is charged with the duty of investing all public funds in the state. This Board is appointed by the Governor, and has an outstanding record of investment results. However, it is probably not safe to use the phenomenal results of the first year of operation of these funds as an indication of what future results might be, since the funds have been in operation only a short time and the stock market trend during the period of operation was probably more favorable than could be expected over a period of considerable years.

MR. KENNETH H. ROSS said that the new plan of the Teachers Retirement System of the City of Chicago provides that a teacher's pension at retirement will be increased progressively each year following retirement by $1\frac{1}{2}\%$ of the original amount.

MR. MEYER MELNIKOFF referred to an employer who had established a cost-of-living pension plan for a major portion of his employees and then tried to extend it to a group of his employees with whom he had to deal in collective bargaining. This group of employees preferred a variable annuity plan under which the benefits would vary with investment experience. After protracted collective bargaining sessions, the question was turned over to arbitration. The arbitrator held extensive hearings and then resolved the question essentially in this way: benefits provided by the employer would be on a cost-of-living basis while benefits provided by employee contributions would be on a variable annuity basis.

MR. C. MANTON EDDY said that the purpose of the legislation recently enacted in Connecticut was to permit greater investment in equities. He observed that the most desirable type of distribution of investments for life insurance funds generally may not be equally desirable for the investment of pension funds. Many employers wish to have a portion of the funds supporting their pension plans placed in equities, and it is hoped that the new legislation will create a greater opportunity for insurance companies to undertake new plans and to conserve existing business with such employers.

He said that to the best of his knowledge no plan has yet been written under the new legislation, and he pointed out in this connection that there are several matters which require further consideration. One has to do with capital gains under the new Federal income tax law; under this law such gains are taxable, while one of the chief purposes of equity investments is to get capital gains. Also, the tax exemption under the new Federal income tax law applies to interest on qualified pension reserves, and there may be a question as to whether dividends on stocks in a special investment account will qualify for such tax exemption. In addition, it appears to be the accepted legal opinion that an insurance company offering pension plans under the new Connecticut legislation may be required to submit to SEC jurisdiction.

Mr. Eddy offered a word of caution to those who might wish to sponsor similar legislation in their own states. He said that he found bankers very strongly opposed to any legislation which would give insurance companies trust powers. Consequently, before initiating such legislation it would be well to have frank and friendly discussions with local bankers so that they will not misunderstand the motives.