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Small Pensions

A. How successful are the traditional individual policy products in meeting the pension needs of small employers? What new products are in use, or are being developed, to fund pension plans for such employers?
B. What arguments can be given for and against shifting individual policy plans to some other basis when the number of participants becomes relatively large?
C. What products and methods are being developed in contemplation of enactment of a Keogh-type bill to provide retirement benefits for the self-employed?

MR. EDWARD H. OWEN: For an employer with less than 10 employees, individual retirement income or retirement annuity contracts are satisfactory. They give an employer which, in most states, cannot obtain group life insurance a combination of death benefits and pension funding not otherwise available on a satisfactory basis. Individual ordinary life policies with the insurance company investing additional deposits for converting at retirement to retirement income may be satisfactory, but with administrative complications and little likelihood of any saving in cost.

Other funding media available include a trusteed plan with a trust company having a common pension trust fund for qualified plans, which provides the small employer with essentially the same investment opportunity as that available to larger employers—including prompt investment of deposits, diversification of portfolio, etc. Also, deposit administration contracts are available from some insurance companies but probably require an annual deposit of at least $5,000. It is unlikely that either of these media will result in savings in cost, because of minimum trustee fees ($400 to $500 annually) and fees for actuarial and legal services.

For employers with 10 to 24 employees, other available funding media include deferred group annuity contracts and possibly also group permanent contracts, as well as guaranteed issue of individual contracts.

For employers with at least 50 employees and annual contributions of at least $10,000, all known funding media are available, including "IPG" deposit administration contracts.

It has been the experience of Ostheimer & Co., Inc., that, except for the employer with less than 10 covered employees, individual contracts are not the best funding medium. We have concluded that we should not spend any great time or effort on even a streamlined approach. We have decided to concentrate on a streamlined basis for handling trusteed plans in cooperation with local banks and attorneys. This makes available to small employers (without fancy ideas) a "package" plan with modest fees and involving a minimum of time and effort for all. It has been operating with modest success in a metropolitan area, and is expected to be utilized to a greater extent if and when the Keogh Bill is passed.

MR. STUART J. KINGSTON: Traditional individual policy products are very successful in meeting the pension needs of small employers principally because of:

1. Guaranteed gross premium.
2. Guaranteed cash values.
3. Availability of life insurance, with estate and income tax advantages.
4. Availability of optional settlements (including lump sum, qualifying currently for capital gains tax treatment) without notice or health evidence.
5. Absence of necessity for actuarial or investment decisions, and little administrative detail, by employer.
6. Continuity of plan management.
7. Attractiveness to stockholders of closed corporations.

However, traditional products have certain disadvantages, principally:

1. Requirement of a new policy for each increase in pension, creating administrative detail for the employer.
2. Inflexibility of the incidence of contributions.
3. High initial cost.
4. Commissions which are too high for agents' services.

National Life has been selling since 1956 a pair of individual policies which overcome all four objections. Gross premium guarantees are restricted to past premiums on retirement annuities (overcoming the first three objections)—low, flexible gross premiums with increases handled by adjusting premiums. The companion yearly renewable term policy has a guaranteed premium on a conservative basis, but since life insurance is incidental the total premium is not unduly increased. Both policies have reduced loading reflecting savings from mechanization and lower commissions—due to agents having less work.

We feel it important to develop satisfactory individual policies because other methods are often unsatisfactory and misleading.

MR. KENNETH H. ROSS: From observation after the fact, usually when an employer decides to change to another funding method, individual policies appear unsuccessful for the long run. Frequently they appear to have been adopted to help owner-managers solve their tax problems, but with a high, inflexible cost which he frequently comes to regret. Ordinary life policies with a deposit fund, either insured or trusteed, are an improvement because of less liberal vesting and greater cost flexibility.

New products include commingled pension trust funds, including the two-fund approach with a bond fund and a common stock fund, mortgage–real estate funds, and some special situation funds utilizing other than "blue-chip" stocks. One or two insurance companies offer special group annuity contracts with a split-funding arrangement whereby part of the deposits is placed with a trust company.

MR. GEORGE N. WATSON: The use of individual contracts is most unsuitable for a small pension program. They are inflexible, difficult to modify, and get out of line with current investment return.

In 1956 Crown Life developed a group annuity contract for issue to small groups. They resolved two important and apparently contradictory actuarial problems—being able to charge enough money to make issue economic and at the same time have a satisfactory surrender charge at termination, 5% or thereabouts. Most companies in Canada will issue this type of contract. No minimum number of lives is required.

MR. JOHN M. BURLEIGH: Traditional individual policy products continue to successfully fulfill the pension needs of the small employer. Advantages include the accumulation of individual equities for the principals involved, with Internal Revenue approval, thus providing a simple method of funding deferred compensation, freedom from estate tax, guarantees, and simplicity of operation—for example, cash values fulfill vesting and early retirement provisions.

About 8 months ago Connecticut General brought out a new series of individual policy pension products, designed to reflect the favorable treatment afforded qualified pension fund reserves under the new life insurance company income tax law. Under nonparticipating business, the higher interest assumption is used for premiums and nonforfeiture value; for participating business it is reflected in dividends; for existing nonparticipating business, rate reduction riders are used, with right to charge original premium reserved only in event the tax law is changed. Credit on retired life reserves is passed along to pensioners through increased excess payments of income.

Rates, values, dividends and commissions are the same for both fully underwritten and simplified underwriting business. On the latter, expense savings offset extra mortality expected.

Under the auxiliary fund plan, the fund may be valued on the entry age normal method with frozen initial liability, thus providing greater flexibility in annual contributions.

MR. OWEN: Referring to section B, from the financial side of the picture the plan should be changed. It appears that currently an employer can realize at least a 1% greater return on pension funds under either a group annuity or trusteed funding method. Under the latter he can also invest in equities.

Other considerations which may operate against changing are: It is difficult to produce exactly the same benefits. Employees may like the security of individual contracts so much they will resent change.

One possibility is to keep some or all existing contracts in force, and change with respect to the future only.

MR. KINGSTON: Our modernized individual policies have provided a vehicle for conserving by change many older plans issued under the traditional individual policies.

Arguments for shifting from traditional individual policies to some other basis include:

1. Lower gross premiums and net cost.
2. Flexibility in the incidence of contributions.
3. Availability of sophisticated funding methods.
4. Opportunity to make uninsured investments.
5. Opportunity to earn interest on the investment year method.
6. Opportunity to use group term insurance outside the pension plan for death benefits, thereby avoiding current income tax on cost of insurance (but losing estate tax exemption).
7. Lower loadings due to mass coverage.
8. Less administrative detail for the employer.
9. Service by trained home office employer or consultant.

Arguments against shifting include the following:

1. Excellent annuity guarantees, especially in older policies, will be lost.
2. If policies are not surrendered, there are no surrender charges.
3. Surrender of policies will forfeit the opportunity to receive larger future dividends.
4. It may not be possible to replace very large amounts of insurance, even with group term; estate tax advantage will be lost.
5. Vested rights may be affected.
6. There is a temptation to indulge in minimum funding under sophisticated methods, leading to less flexibility in the future.
7. Employer must assume more administrative work, which insurance companies can do more economically.
8. Employees may feel insecure.

A type of analysis which may be misleading is to accrue gross premiums, dividends, cash values paid, maturity values, and death benefits with interest and compare with current cash values. If the latter are lower, the conclusion is that the individual policy method is uneconomical. Fallacies include the following:

1. Interest rate may be too high.
2. No credit is given for value of services received which are covered by premium loadings.
3. No allowance is made for value of future services in excess of future loadings.
4. No allowance is made for past contributions to surplus, which strengthen the future of the plan.
5. No allowance is made for past favorable mortality experience which may be counterbalanced by unfavorable experience exceeding reserve provisions.
6. No allowance is made for the restoration of surrender charges if policies are not surrendered.

Other improper presentations have come to my attention, as follows:

1. Use of unit credit method without projecting future cost progress.
2. Use of the aggregate method without explaining its difference from the individual funding method.
3. Presenting entry age normal cost as being level, when future entrants will have a higher cost.

MR. FRANK L. GRIFFIN, JR.: Mr. Kingston used, as one of the arguments against changing from individual policies, the fact that there is a surrender charge. The reason for a surrender charge is not the surrender of the policy, but rather the issuance in the first place of a form of insurance with high initial commissions and other expenses which must be recovered from the reserve upon surrender. There is no way for the owner of the policy to recoup by continuing the policies in force.

MR. ROSS: Arguments for shifting* are as follows:

1. Individual policies are designed for sale to individuals and do not normally meet all the requirements of a pension plan.
2. The expense saving on a group basis will usually offset the temporary additional cost of shifting.
3. The mechanics of handling many policies for each plan member, with different provisions, are time-consuming, laborious and confusing.
4. Service by individual agent may be unsatisfactory; it can be improved under a group arrangement.
5. Money invested in individual policies becomes more and more inflexible because of surrender charges which are quite substantial in early years.

* Mr. Ross also gave arguments against shifting, similar to Mr. Kingston's arguments, as to loss on surrender, loss of guarantees, damage to employee morale, different vesting, loss of individual security.

6. Higher yields, availability of equity investments, and greater flexibility will result.
7. Surrender of all policies simplifies future operation.
8. Individual policies lead to restrictive provisions as to entry, anniversary, and normal retirement dates and treatment of deferred retirement.

MR. BURLEIGH: The objectives of a large corporation with respect to executives and other salaried employees may be better realized under individual rather than group methods. Guaranteed individual cash values are important. Cost savings under a different funding method may be more apparent than real.

MR. OWEN: Regarding section C, we expect substantially greater use of the uninsured pension package referred to under section A in connection with a Keogh-type law. We also expect substantial use of individual policies for the self-employed.

The bill as passed by the House of Representatives makes provision for two new funding media:

a) A plan may invest in a custodial account with a bank, if the contributions and earnings are invested solely in shares of regulated investment companies.
b) An employer (whether or not self-employed) may purchase and distribute to his employees a special form of nontransferable U.S. Government Bond, redeemable after age $59\frac{1}{2}$ or upon earlier disability, with interest payable only on redemption.

MR. ROSS: In addition to the two types of funding media mentioned by Mr. Owen, H.R. 10 as reported to the Senate on September 13, 1961, would permit investing in:

1. Trusteed and employee annuity plans, similar to qualified retirement plans, including variable annuity plans.
2. Face amount certificates, *i.e.*, nontransferable certificates treated like annuities. The bill would also require annuity contracts in retirement plans to be nontransferable.

As the bill has progressed, new funding media have been added with the main intent of making the adoption of plans less costly by reducing or eliminating trustee, custodial and legal fees. Insurance companies are able to offer association plans on an individual or group basis as well as straight individual policies. Trust companies can offer regular trusteed arrangements or custodial accounts.