Pensions
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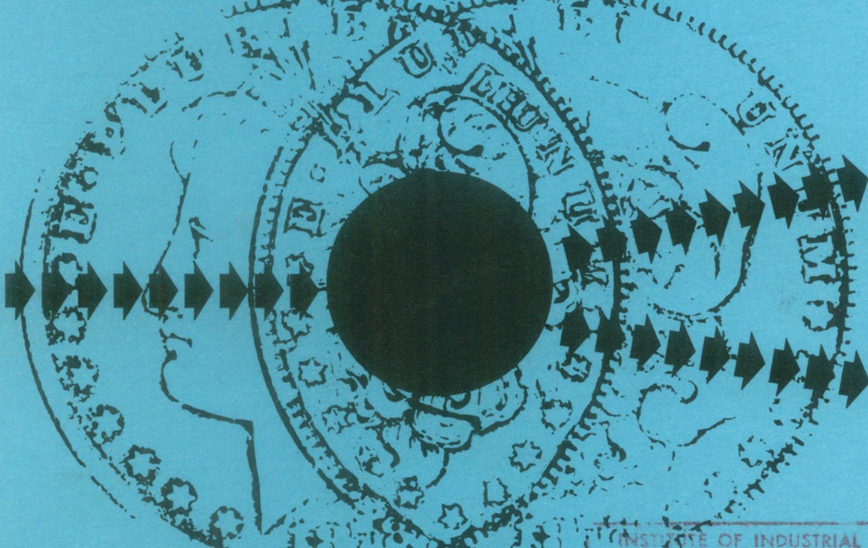
Handbook on Negotiated Multi-Employer Pension Plans

[Institute of Life Insurance]



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Handbook on Negotiated Multi-Employer Pension Plans

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FOREWORD

This Handbook on negotiated multi-employer pension plans is written to provide basic information for the representatives of both unions and employers who will share the great trust of planning and administering retirement income plans for millions of American working men and women.

It is intended as a contribution of the life insurance business to the understanding of this highly complex subject. Trustees' involvement in the pension plan is but one of the many demands upon their time and talents. This Handbook has been prepared to include the general facts needed for a knowledge of the pension arrangement and to indicate the nature of the responsibilities assumed by trustees.

The Handbook is also intended as an informational source for plan administrators and consultants, for the press, and for life insurance people who have not previously worked on this type of pension plan.

Historically, the life insurance business has made major contributions to the development of pension plans. Actuaries of the life insurance companies have constructed the mortality tables that are the basis for funding most of the benefits paid from pension plans.

For a long period, insured pension plans were at a disadvantage because of such factors as discriminatory Federal tax laws, methods of crediting interest, and inability to offer equity funding. Today, a more favorable climate prevails. Discriminatory Federal tax burdens have been for the most part removed. Interest rates credited to insured plans have increased markedly as a result of the adoption of new crediting methods, and, in most states, insurance companies can offer equity funding facilities based on common stock investments.

Coupled with these factors is the long experience and continuity of management enabling the life insurance business to provide a major contribution to sound pension planning.

In the preparation of this Handbook, the Institute of Life Insurance received advice and technical assistance from many sources having an interest in this project:

1. Labor and management representatives outlined what information was needed;

2. Government sources provided an interpretation of the important Federal and state roles in this type of pension planning;

3. Trustees and typical employees were interviewed as to their attitudes, understanding and communication needs relating to their particular pension plans;

4. Specialists in the life insurance business who have concentrated in the area of multi-employer pension plans, have contributed technical assistance. This Handbook represents the combined thoughts of actuaries, lawyers, researchers, and the men in the field who plan and service these plans.

The Institute of Life Insurance serves as the informational source for the life insurance business. We shall be glad to try to answer any general question that readers might pose. For specific information, a list of the pension-writing life insurance companies in the United States and Canada is available from the Institute.

Joseph M. McCarthy
Institute of Life Insurance

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CHAPTER I

JOINTLY ADMINISTERED LABOR MANAGEMENT PENSION PLANS

HISTORY

Pension plans have existed as part of our economic life for a long time. However, they did not begin to affect the general public until 1935, when generally depressed business conditions and reduced employment opportunities intensified the rising need for pensions in older age. Although private pension plans were beginning to be established by business, the widespread need for income for the aged unable to find employment led Congress in 1937 to pass the Federal Social Security Act, to provide retirement benefits when a worker retires at or after age 65 (now 62).

World War II gave impetus to the private pension movement in the United States. To fight inflation, the Federal government clamped a ceiling on wages. As this did not apply to employee benefits, liberal employee benefit plans, including pensions, became the order of the day. This development was also encouraged by the high corporate income and excess profits tax which allowed deductions for employer pension contributions. In 1949, further stimulus was given to pensions when the U. S. Seventh Circuit Court of Appeals affirmed a National Labor Relations Board ruling that pension and welfare benefits are properly subject to collective bargaining, and the U. S. Supreme Court declined to review the decision.

In some industries, it is readily apparent that private pension plans can be established only on a multi-employer basis, since the union is the primary cohesive factor in the economic life of employees. One example is the construction industry with its great number of small contractors, some of whom exist as a corporation only until a particular job is completed. A man can work for quite a few of them during the course of a year.

The objective in such cases is to set up a sound pension plan which would allow workers to accumulate pension credits as they change employers to follow the work. Many unions have negotiated with the employers in a given trade and geographic area to pay into a common pension fund a fixed number of cents for each hour of work performed for the employer by a member of the collective bargaining unit. Such a plan is called a negotiated multi-employer pension plan.

PURPOSE

The purpose of this Handbook is to provide general background on pension planning, especially on negotiated multi-employer plans, for all who may be interested — particularly the trustees of such plans.

DEVELOPMENT OF THE PLAN

In general, the first step is that the employer contribution — the number of cents per hour worked — is agreed upon in collective bargaining negotiations between one or more local unions and an association of employers.

The next step is to appoint a board of trustees, to adopt a trust instrument and establish a trust fund. The trustees then formulate the terms of the pension plan and arrange for the administration of the plan. Since contributions are fixed in advance, the benefit level is usually determined by estimating an amount which can be actuarially supported by the incoming contributions plus the investment income expected to be earned.

This amount is usually expressed in terms of a number of dollars a month for each year of service credited in accordance with the plan.

LABOR LAW ASPECTS

If a multi-employer pension plan provides for union participation in the administration of the pension fund — that is, joint management — it must conform to the Labor Management Relations Act of 1947 (Taft-Hartley Act). A section of the Act makes it unlawful for an employer to pay or deliver any moneys to a representative of his employees and conversely prohibits the representative from accepting moneys from the employer.

However, trust funds established for the sole and exclusive benefit of employees and their families and dependents are exempt from this provision if the following conditions are met:

1. Payments are held in trust for the benefit of eligible employees.
2. The basis for making such payments is specified in a written agreement with the employer.
3. The employees and employer have equal representation in administering the trust fund and the agreement contains a provision which, in the event of a deadlock, permits the appointment of an impartial umpire at the request of either party.
4. The agreement provides for an annual audit of the trust fund.
5. Payments to provide pensions or annuities are made to a separate trust fund which cannot be used for any other purpose.

If a negotiated plan does not meet the requirements and a prohibited transaction takes place, each person who willfully violates any of the above provisions is liable for a fine of $10,000 or one year imprisonment or both.

TRUST-TRUSTEES

Under law, a trust is defined as a fiduciary relationship whereby one person has legal title to property or money which he holds for the benefit of someone else. Therefore, a jointly administered pension trust is one under which the trustees hold title to the property and money contributed by the employers for the exclusive benefit of the employees covered under the pension plan.

The trustees are a small group of persons appointed or elected to represent the employees and employers in the operation of the pension plan. The employer (or employers) appoint the same number of trustees as the union.

The law requires very high standards of conduct on the part of anyone who acts in a fiduciary capacity. No one need accept the responsibilities of a trustee but, once he has accepted he must serve until he is relieved by the terms of the trust agreement, unless the trust agreement gives him the right to resign.

A trustee is under duty to act for the benefit of the beneficiaries under the trust. He cannot delegate his own duties as fiduciary, and he may not profit at the expense of the individuals who are to receive benefits under the plan.

Even if the terms of the trust agreement prove to be unwise, shortsighted or ill-advised, the trustee is obliged to carry out the terms of the agreement unless it becomes illegal or impossible to do so. This emphasizes the importance of a well drawn trust agreement.

RESPONSIBILITIES OF TRUSTEES

Although the specific responsibilities of a trustee are governed by the terms of the trust agreement under which he is appointed, a trustee is generally responsible for seeing that:

1. His actions are legal, reasonable and prudent.

2. The pension plan is organized to provide permanency.

3. The pension plan is qualified in accordance with the Internal Revenue Code.
4. The employees and employers are receiving good value from the program.
5. The plan is being administered efficiently.
6. The plan is actuarially sound.

The trustee need not be a technical expert to meet these obligations. Actually, he can carry out his duties by appointing competent technicians and advisors to provide actuarial, legal and administrative help.

The actuary performs the mathematical computations to determine financial soundness of the plan. The lawyer provides the legal counsel and the documents needed to insure the smooth operation of the plan. The administrator is responsible for record keeping, accounting, collection and transmittal of contributions, and other similar functions. These advisors make periodic reports to the trustees concerning the operations of the plan.

One area where expert recommendation is important, for instance, is in funding the pensions provided under the plan. There are numerous ways by which this can be accomplished and it should be noted that there is no one best way to fund and administer all pension programs. Different circumstances will dictate different approaches; what works well for one group may be unsuitable for another. It is up to the trustees themselves, working with a team of technical experts, to determine which funding method best suits the needs of their particular group.

CHAPTER II

LEGAL CONSIDERATIONS

Among the most serious problems of jointly administered negotiated pension plans are their legal aspects. These should be examined carefully by the attorney retained by the trustees before the plan begins to operate. In addition to the Labor Management Relations Act, consideration must be given to the following Federal and State Laws which have a bearing on the operation of a pension program:

FEDERAL INTERNAL REVENUE CODE

The pension plan qualifies under the terms of the Internal Revenue Code if contributions by the employer:

1. Are to be deductible as a business expense for income tax purposes; and
2. Are not to be considered as taxable income to the employees until benefits are made available or distributed to them.

Briefly, the requirements for qualification are:

(1) The trust must be created in the United States and must be maintained as a domestic trust in the United States at all times.

(2) The trust must be established for the exclusive benefit of the employees and their beneficiaries. While the Code generally refers to a single employer, it is clear that a trust forming part of a plan of several employers will also qualify if all other conditions are satisfied.

(3) The plan must be a definite written program and must be communicated to the employees.

(4) The plan must be permanent as distinguished from a temporary one. For this purpose the U. S. Treasury Department has indicated that a plan with no fixed termination date established under an agreement negotiated between an employer or group of employers may be considered as permanent even though the agreement with the union may itself run for only a fixed number of years.

(5) It must be impossible under the trust agreement for any part of the corpus or income of the fund to be used for purposes other than for the exclusive benefit of employees and their beneficiaries.

(6) The plan may not discriminate in favor of highly paid employees in determining eligibility for or amount of pension benefits.

Several Treasury rulings apply specifically to negotiated plans. As mentioned, one of the requirements for qualification is that the plan be a permanent one. Treasury ruling P.S. 64 recognizes that negotiated plans usually call for a fixed rate of contributions in accordance with a collective bargaining agreement which may be terminated after a certain number of years.

Such a plan will nevertheless be considered permanent if an employer or the representatives of an association of employers, or the trustees (if the plan is jointly administered), certify that actuarial calculations indicate the contributions expected during the term of the collective bargaining agreement will at least equal the greater of:

1. The full costs of the prospective pensions for employees expected to retire under the plan during such term;
2. The normal costs for currently accruing benefits, plus interest on the unfunded liability.

The trustees must also certify that the methods, assumptions and results of the actuarial calculations are considered reasonable by them.

FEDERAL WELFARE AND PENSION PLANS DISCLOSURE ACT

Under this Act, the "administrator" is required to file an annual report within 90 days after the end of the fiscal year with: The Director, Office of Labor-Management and Welfare-Pension Reports, U. S. Department of Labor, Washington, D.C. 20210.

A description of the plan and an annual financial statement must also be published for the benefit of each participant. The "administrator" is the person or persons actually responsible for the ultimate control, disposition or management of the money received or contributed. The trustees would, therefore, be the "administrator" under the usual jointly administered plan.

Description of Plan: The description of the plan must be signed and sworn to and should include:

1. Names and addresses of administrators.
2. Their relationship to the employer or to the union, and any other offices, positions or employment held by them.
3. Name, address and description of the plan and the type of administration.
4. Names, titles and addresses of a trustee or trustees different from those defined as "administrator."
5. A statement as to whether or not the plan is mentioned in a collective bargaining agreement.

6. Copies of the plan contract or other instruments under which the plan was established and is operating.

7. The source of financing and identity of any organization through which benefits are provided.

8. Specification of the fiscal year for accounting purposes.

9. The procedure for presenting claims and the remedies available where claims are denied in whole or in part.

Amendments to the plan affecting any of the points listed must be included and formally filed within 60 days after they become effective.

Financial Statement: As far as the annual financial statement is concerned, the following information must be published and sworn to by each of the trustees:

1. Employer or employee contributions.

2. Benefits paid or otherwise funded.

3. Number of employees covered.

4. Summary statement of assets, liabilities, receipts and disbursements.

5. Detailed statement of the salaries, fees and commissions charged against the plan, to whom paid, in what amount, and for what purpose.

The above information is to be sworn to by the administrator or certified to by an independent certified or licensed public accountant, based on an audit conducted according to accepted standards.

Bonding: Everyone who handles funds or other property of a trust must be bonded. This includes persons with supervisory or decision making responsibility for physical contact with funds or property, the transfer of funds or property, disbursement of funds, or the signing or endorsement of checks.

The bond must be at least 10% of the amount of funds handled and must be in a form or of a type approved by the Labor Department. Such bond must be issued by a corporate surety approved by the Secretary of the Treasury. The bonds cannot be procured from any surety or through any agent or broker in whose business the plan, or any party in interest in the plan, has any direct or indirect significant control or financial interest.

It is a violation of the law for any person who is required to be bonded to exercise any control over funds or other property of the plan without being bonded.

The provisions of the Labor-Management Reporting and Disclosure Act of 1959 (Landrum-Griffin Act) also provide for bonding. However, any person required to be bonded under the Federal Welfare and Pension Plans Disclosure Act is relieved from the bonding provisions of any Federal or state law which overlap, since the bonding requirements of this Act supersede all others.

Miscellaneous Information: Other information which must be indicated includes the type and basis of funding, assumptions used, amount of liabilities, various breakdowns of assets, and a detailed list showing all loans to the employer or to any interested employee organization. In addition, if the plan is insured, other information concerning premium rates, claims and commissions must also be included.

Publication: Publication of the information required is to be made as follows:

> Copies should be available for examination by any employee or beneficiary at the principal office of the plan. The administrator should deliver a copy of the description and report to each person or beneficiary who requests one in writing; and two copies of the description and report should be filed with the U. S. Secretary of Labor.

Necessary forms can be obtained from the U. S. Department of Labor.

STATE LAWS

In addition to the Federal laws mentioned, several states have legislation that should be considered in the creation and operation of a jointly administered pension trust. Among these are:

(1) State Welfare and Disclosure Laws: States with such laws include: Connecticut, Massachusetts, New York, Washington and Wisconsin.

(2) State Tax Laws: Govern taxation of trust income and disposition of benefits.

(3) State Trust Laws: May govern creation and operation of employee trusts, investment responsibilities of the trustees and law of agency as pertaining to the hiring of consultants and advisors.

(4) Rules against perpetuities and the accumulation of income: Although many states have enacted legislation exempting pension trusts from these rules, the situation in a particular state should be investigated.

(5) Delinquency laws: Several states have enacted legislation which provides for fine and imprisonment if contributions due the pension fund are not made in a stipulated period.

Some legal problems may arise beyond what is set down in the various laws regarding pension funds. For instance, it would be prudent to find out in advance whether the establishing organization has the power or authority to create a pension plan. Care should be taken to find out what rights and liabilities are created between the employee and the trust once a pension program is established. Also, consideration should be given to problems that may arise if the plan is amended or terminated.

SUMMARY

The problems listed here are not the only ones which may be encountered and the role of the attorney is very important. It is generally advisable to retain expert counsel who have specialized in this subject.

CHAPTER III

ELEMENTS OF PLAN DESIGN WHICH AFFECT COST

Before going into some of the financial problems which have to be considered when planning a specific multi-employer pension plan, it might be helpful to review the pattern of benefits which has developed since such plans became popular. In most of these plans the entire cost is borne by employers, who contribute a fixed number of cents for each hour worked by a covered employee. The actual amount is usually fixed by collective bargaining.

The difference between this type of plan and that of most plans established by single employers, is that all the benefits must be supported by the "cents per hour" income (plus any investment income credited to it), without reliance upon other income such as extra contributions.

Thus, the trustees have the task of establishing a schedule of benefits which they believe can be supported by the fixed contributions. For this purpose they will need the guidance of an actuary.

FACTORS TO BE CONSIDERED

Between the fixing of contributions and the determination of benefits, however, lie such factors as:

1. The type of pension benefit formula.

2. Age at which retirement takes place.

3. Vesting rights.

4. Death, disability, and other types of benefits in the plan.

5. Hours of employment.

After analyzing the facts, the actuary makes his recommendations to the trustees as to the benefit level that can be supported by the incoming contributions. Before we examine the relative importance of each of these factors, one point should be made clear: a pension program is a long range project. It must remain sound long after the original trustees have passed out of the picture; the trustees need to remember this fact when they formulate the plan.

The proposed benefits should not place the plan in financial jeopardy at any time. In the early years, a certain element of conservatism is highly desirable in order to build a safety margin. It would be very undesirable to have the margins so thin that sometime in the future it might be necessary to reduce the pensions then being paid. Employees would be critical and no doubt feel that their plan was letting them down and the result would no doubt be resented.

On the other hand, a future increase in benefits would have the opposite effect. Because contributions may be used only for the benefit of the covered employees, the employees as a group are sure of benefiting in some way from each dollar contributed on their behalf, even though individual employees may not have such assurance. They may have to stay in covered employment to retirement in order to qualify for benefits.

Thus, the most prudent course to follow is to have a safety margin built into the plan to provide for its continuance should experience prove worse than expected or provide for increased benefits should the opposite be true. The immediate future should not, of course, be forgotten. However, the long range nature of the plan itself is one of the most important facts to keep in mind.

Here is a description of factors which affect cost:

1. Benefit Formula

The fixing of the benefit level is probably the last step taken by the actuary after he sifts through all of the details of the plan. However, for the purpose of this Handbook, it might be easier to start from this point, since the actual monetary effect of changing the benefit level is the easiest concept to illustrate.

While there is a mathematical relationship between the employers' contributions and the benefits which can be supported, the relationship is often highly complex. In some cases it may be so simple that doubling the contribution rate enables the benefit to be doubled. In such a case, if it were determined that a contribution of ten cents per hour made for each employee would provide a retirement income unit of $2.00 per month for each year of service credited, an increase in the contribution to twenty cents per hour would increase the unit payable to $4.00. However, in other cases the relationship may be less simple.

Under a fixed cents-per-hour type plan, the only sound basis for increasing the pensions payable without increasing the employer's per hour contribution would be if the experience has proven more favorable than that assumed in the cost factors of the plan.

Importance of Records: If, as is usually the case, the plan is to provide pensions based on the number of years an employee works in the industry or in the area, a major determinant of the benefit level will be the length of service each employee will have accrued when he retires. One difficulty arises from the fact that complete employment records are seldom available for service prior to the effective date of the plan.

In a few cases a solution has been reached for past service pension purposes by counting only the work years for the last employer or for the employer with whom the employee had seniority. If this is not practical, a questionnaire could be sent to each employee asking him to report all of the employers in the industry for whom he worked and the time worked. If all else fails, it may be possible to obtain past employment records from Social Security offices. These could be examined to determine how much credit for prior employment could be given.

Crediting of Prior Service: If a satisfactory record of prior employment has been accepted, the next step is to determine how much of the reported service can be used in determining the benefit. Suppose the aim of the trustees is to provide a monthly pension of $3.00 times the number of years of service credited.

In such an example, an employee who has 30 years of service when he retires at age 65, would have a monthly pension of $90.00. Suppose, however, that most of the employee's service, say 25 years, were completed before the plan became effective. If the majority of the employees of the group to which this employee belongs will have completed most of their service to retirement age before the plan became effective, a serious cost problem may exist.

Actually, it may be virtually impossible to recognize all the service credited before the plan begins to operate and still maintain financial soundness. The trustees might have to make a decision at this point, based on the advice of their actuary, to limit the prior pension credits in some way.

The decision might be to limit the number of years of prior service which are to be counted for credit purposes or to decrease the dollar unit of pensions based on prior service.

Keep in mind that the purpose of a pension plan is to provide pensions for employees who retire and are no longer drawing a paycheck. Thus, if prior service is in some way restricted, the dollar unit can be increased. If it were eliminated entirely, the benefit for service after the plan becomes effective could be increased substantially. However, this would weaken the initial effectiveness and acceptance of the plan. Employees close to retirement might only be able to accrue one or two years of service and find the income too small to be of much assistance in retirement.

Crediting of Future Service: The crediting of future service is not nearly as difficult as past service. But there are still a number of questions which must be resolved. For instance, it is a normal practice to record the number of hours worked by each employee during a year, and to establish a base or minimum number of hours that the employee must work in order to receive a full year of credit.

This base varies with the type of employment and from area to area. In Alaska, for instance, employees involved in outside work might only be able to complete 1000 hours of work per year. In a factory in the east, 2000 hours is representative of a normal work year.

Consider what this means. If the normal contribution is ten cents per hour in both places, the northwest plan gets an average of $100 per member per year while in the east the contribution is twice as much. All other things being equal, it is reasonable to expect that the benefit in the second plan can be twice as much as that in the first.

What happens if a member works less than the number of hours required for a full year of credit? Usually he is credited with a fraction of a year of credit based on the actual number of hours he worked. If the base were 1000 hours, this means that an employee who worked 250 hours, but less than 500, might receive ¼ of a year of service; 500 or more but less than 750, ½ year; 750 or more but less than 1000, ¾ of a year.

Hours in excess of the quarterly base are usually excluded, as are hours in excess of 1000. Excess hours worked for which contributions are received, add to the financial strength of the plan during the year, and possibly may increase the benefit that can be paid out.

The number of years which must be completed before an employee becomes eligible for a pension is related to the overall problem of crediting service. If the eligibility rules are too stringent, few employees may become eligible for a pension and the purpose of the plan would be defeated.

On the other hand, eliminating all eligibility requirements may qualify so many employees that the dollar amount of benefit may have to be cut to a bare minimum. To achieve a happy medium, the rules regarding eligibility and crediting of service must recognize the characteristics of the covered group.

Some Practical Examples: Can prior service be credited in full? If not, by how much should it be cut back? Should it be cut back by limiting the number of years to be considered or by lowering the dollar unit? What about future service? Do the same questions arise? Should some minimum number of years be established before benefits become payable in full?

While these questions can be answered by the actuary, consider the practical side of the problem. Suppose service is limited to a total of 30 years and at the same time no more than 20 years is to be credited for service before the plan begins operation. If a member is 56 years old when the plan is established and he has worked for 25 years before that, he will have a total of 29 years of service (20 prior years credit plus 9 working years) when he retires at 65.

For simplicity let us also assume that the dollar benefit is $3.00 per month per year of service credited. This will provide the member with a pension of $87.00 per month, plus benefits payable from Social Security. If the plan did not allow any credit for prior service, his pension would be only $27.00 per month.

Take a second example of an employee entering the plan at age 55 with 20 years of service. By the time he is 65 he will have accrued 30 years of service in all and would be eligible for a pension of $90.00 a month. But what happens to a man who enters the plan at age 45 with 20 years of service. By the time he is 55 he has accrued the maximum number of years that can be credited. From age 55 to 65 he accrues no additional benefit.

It is important to note that the contributions from age 55 to 65 are needed to support the $3.00 a month benefit for the group, even though the individual employee is receiving no credit for this service.

If there were no limit on the number of years of service that could be accumulated, the employee described in the last example above who entered at age 45 could accumulate 10 extra years of service. But chances are that if the plan operated in this way, the dollar unit of benefit would have to be reduced. This change would not affect the employee with a long work record, but could hurt the employee with a short period of service what would happen if instead of entering at 45, he was not covered until he were 55 or 60?

For the short service employee, his total pension would be less than if service credits had been limited. In other words, the service limitation restricts service credits of the long service employees, but at the same time increases the dollar benefit that can be established for all employees.

Another practice which has an effect on the crediting of service, particularly in multi-employer plans, is the establishment of what is sometimes called a "cut-off date." This is the date after which no prior service is credited. Usually it is the date on which the plan becomes effective but it is sometimes delayed to benefit members of the bargaining unit in companies which enter after the plan is established.

There are two reasons for the "cut-off date":

(1) To encourage local unions to negotiate for contributions to the plan or be penalized for delay.

(2) To restrict the amount of the liability which can be incurred by the fund for late entrants.

The practical effect of a cut-off date is to restrict possible claims for prior service by automatically eliminating any period of time between this date and the later commencement of contributions under the plan.

There are two ways in which this is accomplished. The first is to establish a maximum period of prior service as of the "cut-off date," and to reduce this maximum by one year for each year which has elapsed at the time contributions into the fund begin.

The other method is somewhat less severe. It permits all service before the "cut-off date" to be considered regardless of when contributions to the plan begin. This has the effect of eliminating from consideration only the service completed between the "cut-off date" and the date contributions actually commence.

2. Retirement Age

Under most plans the normal retirement age is 65 – the first point in time at which an employee can retire and receive a full, unreduced benefit. It does not necessarily mean that retirement at age 65 is automatic or compulsory. Whether there should be a compulsory retirement age in a given plan is a question which trustees must consider carefully.

Although most multi-employer negotiated plans provide for completely voluntary action on the part of the employee, policy in a given plan should be decided on the basis of the applicable circumstances.

The fact that in most instances employees are not forced to retire at age 65 is very important to the actuary in his calculations. An increase in one year in the average retirement age increases the dollar benefit which can be supported by approximately 7%.

To illustrate: if an employee enters the plan at age 30 and the normal retirement age is 65, contributions are made on his behalf for 35 years. His pension, on the other hand, might be payable for about 15 years or until age 80, assuming this is his expected remaining lifetime. If the plan specifies a normal retirement age of 70, two factors would be at work. Contributions would be made for an additional 5 years or for a total of 40 years; and in all probability, the employee would live only to receive 12 years or so of pension payments.

Naturally, a higher pension can be paid under plans where normal retirement occurs at age 70. If circumstances indicate the average age of retiring employees will be higher than 65, the use of such higher age by the actuary in his assumptions will raise the pensions which can be provided.

Early Retirement-Options: Considerations of retirement age should include the possibility of both early and late retirement. Upon early retirement, an employee generally receives a reduced pension, or *actuarial equivalent*. Actuarial equivalents have no direct effect on the cost of the plan; they merely exchange one benefit for a different benefit of the same value.

For example, assume that an employee would normally retire at age 65 with accumulated pension credits of $1,200 a year. Assume also that he will survive until age 80, or for 15 years. He will then live long enough to collect $18,000 from the plan. If, instead of waiting until age 65, this employee retired at age 55, his benefit would be reduced to recognize the early commencement of payments, which would be expected to be payable for almost 25 years and also the shorter period of his covered service.

If we assume the employee had the maximum service credits at age 55, then to approximately determine the annual income at early retirement, divide the expected return had he retired normally ($18,000) by 25 and, return the result ($720 per year) over the longer period. The cost to the plan is the same. That is, the amount of money required at age 55 to provide the monthly payment for life of $720 per year, is an *actuarial equivalent* of the amount of money required to pay the $1,200 a year for life commencing at age 65. This is a simple illustration and does not take into account interest earned on the pension fund, mortality between age 55 and 65, and the loss of contributions to the fund after age 55.

Other actuarial equivalents which may be included in a plan are called "optional forms of settlement." One such option allows an employee who retires early to elect a higher pension before attaining age 65 (or 62) and a lower pension when Social Security payments begin; this provides him a level income for life.

Another option allows an employee to elect a reduced pension during his lifetime with the provision that upon his death the same amount, or a portion of it, be paid to his wife as long as she lives. This second option is seldom used since the amounts that can be provided under most multi-employer negotiated plans are relatively small.

Employment After Normal Retirement Age: What happens to an employee's credits if he continues to work beyond the normal retirement age? What happens to an employee's pension if he returns to work after retirement?

The answers to these questions depend on industry practices. If there is an abundance of labor in a particular industry, the view is sometimes expressed that older employees should make way for younger ones and should be encouraged to retire completely. In this case, pension credits may not be granted for service after normal retirement age. On the other hand, if labor is scarce, pension credits may continue to accrue since the retired employee is not "taking a job away" from a younger man.

Several methods have been used to encourage employees to retire at the normal retirement age. One method is to stop the accrual of benefits after a specific point in time. This allows the employee to work but his pension remains fixed after a predetermined age.

At the other end of the scale is a provision that for every year an employee remains at work after a specified age, he loses a year or a fraction of a year of his retirement credit. This has the effect of decreasing the employee's pension as long as he works. For an employee who goes back to work after having retired, the provisions range from the liberal – continuing his pension – to strict forfeiture of all pension rights. The more common provision is to merely stop pension payments while a man is in covered employment.

Naturally, between the extremes are probably as many provisions as there are plans. The need for a restrictive work clause depends on the situation in a particular industry, and calls for review from time to time.

3. Vesting and Turnover

Vesting is the right of an employee to a future pension if he leaves his employment covered by the plan before retirement age.

In a negotiated multi-employer type pension plan the problem of termination is different than under a single-employer plan. If termination with one employer should occur, there is a chance the employee will continue to work in the area for a different employer also covered by the plan. Here the worker retains his accrued pension credits and for the purposes of the plan is not considered to have terminated his coverage.

There has been much discussion of reciprocal agreements among multi-employer pension plans to provide vesting for an employee who transfers from one pension fund to another, even if normal vesting requirements are not met. So far reciprocal agreements of this type are relatively rare.

In pension planning, the trend toward vesting has been along more liberal lines, and there is no indication that it will reverse.

Reasons for Vesting: A young worker who leaves a given employer has ample opportunity to accrue pension credits elsewhere; but this is not quite as true of the older employee. In recognition, more and more plans now allow retention of credits if, for example, the employee works at least to age 45 or 50 and completes 10 or 15 years of service. The retained benefit usually begins at normal retirement age and is calculated on the basis of the credits earned up to termination.

Effect on Costs: Studies show that termination or turnover is much greater at younger ages – before an employee completes much service in a particular industry or job. Naturally, contributions previously made on behalf of non-vested employees are not needed for their benefit, since they lose their right to a benefit at termination. However, contributions which have previously been made on their behalf allow pensions for the remaining employees to be increased. The actuary can estimate the effect of such contributions in advance and adjust the benefit level accordingly.

4. Disability Benefits

While the primary purpose of a pension plan is to help provide adequate retirement income to employees and their families, it cannot be overlooked that total disability can create the same need at an earlier age.

In fact, the disability problem is probably more acute: not only does income stop but, more than likely, expenses increase at the same time. Recognizing this, a large majority of all single-employer negotiated pension plans and more than half of all multi-employer negotiated plans provide for some form of disability benefits to be paid to an employee who becomes disabled before his normal retirement age.

Disability benefits are certainly desirable but their effect on cost cannot be overlooked. In some cents-per-hour plans, a liberal disability provision can reduce the average retirement benefit considerably. The cost of disability is, of course, dependent on many factors, including the amount of the benefit and the eligibility requirements.

Some of the factors to be considered in providing for disability in a pension plan are: eligibility – minimum age and length of service; what determines disability; who determines disability – a physician – or eligibility for Social Security disability benefits; relationship of benefits, if any, to payments under Social Security and Workmen's Compensation Laws; length of payment, and provisions relating to recovery from disability and termination of disability payments.

While trustees seek the opinion of their consultant or actuary, it should be realized that disability benefits under a pension plan can rarely provide an employee with all the income he may need if he becomes disabled. They can, however, give the employee a platform upon which he can build additional disability protection through personal savings or insurance.

5. Death Benefits

A payment made after an employee's death, either before or after retirement, can materially affect the cost of a pension plan. Such a benefit may be a lump sum flat payment, or a series of annuity payments to a beneficiary. The inclusion of a death benefit, of course, reduces the retirement benefits that can be supported by the fixed contributions.

Pension planners have recently shown a great deal of interest in benefits to widows upon the death of the breadwinner. In the few negotiated plans with this provision, it is usually an optional form of settlement. Here, the employee who lives to retirement elects a Joint and Survivor Option which provides that payments continue after his death to his wife as long as she lives. The amount of his pension is reduced actuarially to "pay" for his wife's benefits.

Some plans provide that should the employee die before retirement and after a specific age such as 55, it is assumed that he elected the option immediately prior to his death. His accrued benefit is reduced actuarially for early retirement and then reduced again to provide for the continuation of pension payments to his wife. Because of this double reduction the pension amounts payable are usually small.

A somewhat more liberal approach is followed by a few plans which provide that the widow's pension will be 50% of the employee's accrued pension with no other reduction.

In general, married women are younger than their husbands and live to an older age. Providing a benefit to them, therefore, is much more costly than providing the same benefit to their husbands. Reducing the employee's benefit actuarially is not the answer since it does not accurately reflect the needs of the wife upon her husband's death. Provision for a widow's benefit can be made directly from the trust fund, or by insurance premiums from the trust fund under a "risk premium" method offered by several insurance companies, or through a group life insurance program.

If a program of widow's benefits is adopted, the trustees must set policy on payments after a widow remarries. It is often argued that the widow should not be receiving financial support from her late husband's pension plan if she is being supported by another husband, and therefore the plan should provide for the cessation of payments upon remarriage. This may cause administrative problems.

6 Employee Contributions

Another major factor affecting benefits is whether or not employee contributions are required. Employee contributions could, of course, increase pension benefits. However, very few negotiated multi-employer plans call for employee contributions and there is no indication of change in sight.

CHAPTER IV

FINANCING THE PLAN

The previous section discussed how individual provisions affect the cost of a pension plan. This section covers the basic concepts of financing.

ACCUMULATED FUND

Contributions by employers go into an undivided fund; they are not set aside for any individual. When an employee retires his monthly pension is withdrawn from the fund. If the plan is insured, an amount is withdrawn from the fund at his retirement to provide an annuity which is guaranteed for his lifetime.

Probably the greatest misunderstandings about pension financing arise from the fact that accumulated funds seem to grow to immense proportions. Many people look at these "huge" funds and, not understanding their purpose, ask why the pensions cannot be increased or why death and disability benefits cannot be added to the plan.

Actually, the purpose of the pension fund, however large it may seem, is to assure employees of payment of their pensions whether or not their employers are still doing business.

ACTUARIAL VIEWPOINT ON FUNDING

The aim of the actuary is to fix contributions – or in the case of a cents-per-hour type plan, the benefit level – so that there will aways be sufficient funds on hand to pay the benefits which fall due. In making his calculations, he divides the total contributions into four parts: expenses, normal cost, interest on the accrued liability, and the accrued liability itself. Following is an explanation of these terms:

Expenses: Before anything can be paid out in pensions, certain expenses will be incurred, including the actuary's fee and that of the lawyer, administrator and investment counsellor. Another recurrent expense is the cost of checks and postage. Under an insured plan, all of these separate expenses are handled as a single collective expense. Still another expense in some pension plans is the trustees' fees paid for attending meetings. However, in many plans the trustees serve on a voluntary basis.

Expenses are small in relation to the total contributions made by the employers – usually less than 5%. In a well-managed plan there is actually very little the trustee can do to reduce expenses appreciably below this figure.

Normal Cost: This is the cost of funding benefits expected to accrue in the future; that is, how much must be set aside now, which together with interest earned will pay these benefits to employees after they retire. The "normal cost" represents a substantial portion of the total funds.

When a plan is established without credit for prior employment service, expenses and normal cost are the only items that concern the actuary, and contributions can be based to cover only the two.

Interest on Accrued Liability: When benefits based on prior service are included, however, the situation changes. Here, even before one penny of contribution is received, the plan incurs an obligation often substantial; namely the amount required to pay benefits which accrued before the plan became effective. This is the "unfunded accrued liability" – unfunded because no contributions have yet been received to pay off this obligation or debt.

As with any debt, the longer it takes to pay off, the more it costs in interest charges. If the obligation could be paid off in one sum, of course, there would be no interest charges, but the amounts involved are usually so large that it is impractical, if not impossible, to make a single payment into the plan. Tax considerations also favor the gradual amortization of the accrued liability. Therefore, as the debt is reduced, the interest on the unfunded accrued liability must also be paid. Whatever is left after expenses, normal cost, and interest on accrued liability can be used to reduce the accrued liability itself.

ACTUARY'S FUNCTIONS

The trustees of a pension plan should establish the amount of benefits with the advice of an actuary. Using age and service records, the actuary reviews turnover and average hours worked and arrives at a benefit level which can be supported by the anticipated contributions.

The actuary estimates expenses, normal costs, interest and re-payment on the accrued liability for various benefit levels, and then selects the particular level which will fit two requirements: anticipated contributions to a large extent based on future levels of employment, and payment of accrued liability in a reasonable time.

Fixing the benefit level is probably the most important problem that the trustees must resolve. Initial estimates upon which the early decisions are based are most critical. Actuarial assumptions involving the probabilities of death, termination, disability, the rate of pension fund earnings, and the age and rate of retirement, must be determined at the outset. Some conservatism in assumptions is desirable at the inception of the plan and before experience emerges. The resulting cost estimates should then be realistic and the benefit level supported by the fixed contributions provided in the bargaining contract.

In the final analysis, however, the true cost of the plan can only be determined in retrospect after the last plan member dies. Stated simply, the cost of any pension plan equals total benefits plus expenses, less investment income earned on the assets of the plan. Once the benefit level is fixed, the cost cannot be altered by juggling actuarial assumptions. It is the professional responsibility of the actuary to place before the trustees a benefit level which he believes will assure a sound and continuing pension program.

CHAPTER V

ADMINISTRATION OF THE PLAN

Administration of a pension plan can be carried out by a life insurance company, a salaried administrator or a contract administrator. The salaried administrator manages the plan from an office provided for by the pension fund. The fund pays rent, equipment, and staff salaries. The administrator may also be responsible for administering other welfare plans for the same union-employer combination.

A contract administrator's services are usually provided by an outside specialist who administers a number of welfare and pension plans. Such an administrator operates under a contract with the trustees, with the cost of his service normally negotiated in advance. He may, for instance, have an office solely for the administration of a particular plan with reimbursement for costs and perhaps a management fee. Or he may work out of his own office, using his own employees, charging a flat fee or percentage of the trust income.

Administrative arrangements can vary widely from these basic approaches. The determining factors are size, type of plan, availability of personnel, and the type of services to be rendered.

FUNCTIONS OF THE SALARIED OR CONTRACT ADMINISTRATOR

The administrator has many additional responsibilities keyed to the operation of the pension fund. Among these are:

Employer Reports: The administrator must organize a system to maintain a flow of reports from employers on the employees covered under the plan, number of hours worked, and contributions made by the employer. If employee contributions are required under the plan, separate records must be kept for each employee. If any employer is delinquent in his payments, the administrator must deal with him according to procedures set up by the trustees.

Employee Records: If trustees decide to provide for annual statements to the employees in the plan, the administrator keeps the records and transmits the statements to the employees. Accurate record-keeping is, of course, absolutely necessary.

Should any change be contemplated in the plan, these records are invaluable in determining the extent and the nature of the change. The records are the property of the trust, and the administrator is responsible to the trustees for their safekeeping and availability.

Accounting: Annual financial reports and forms are prepared from accounting records that are kept by the administrator as part of his responsibility.

Reports: The administrator provides the actuary with the statistical data he needs in his calculations. The actuary needs other reports from time to time and the administrator assists in this respect.

Pension Records: The administrator is responsible for payment of pensions to the individual. Application forms must be processed and pension payments authorized; individual records of pensions must be kept. If the plan is not insured, checks may be issued by the administrator or the bank handling the fund. Under an insured plan, an additional option is to have pension checks mailed by the insurance company directly. Addresses of pensioners must be kept up to date; questions by individuals must be answered. This aspect of the administrator's function, while most important, is time consuming.

Trustees Meetings: The administrator attends meetings of the trustees to report on his operations, to suggest ways to improve services, advises on problems which arise, and assists the trustees in reaching decisions.

COMMUNICATING THE PENSION PLAN

This is another area to which adequate attention should be paid. The employees covered under a plan should be given sufficient information about the benefits and the work of the trustees and the staff. Here is where a good deal of the trustees' work must be done.

Basically, the reception given the plan by employees will depend on the adequacy of the benefits, the degree to which they are understood and whether or not they seem equitable to employees as a group as well as to individuals.

The reactions of employees who retire in the early years of the plan are especially important. Their feelings quickly become known to the active employees and any dissatisfaction may create a hostile attitude toward the plan in its early stages.

Thus, it is practically mandatory for trustees to use careful judgment and skills in communicating the plan to the employees. For their part, the union business agent, secretary and the president have to get their ideas across to win the endorsement and support of the union membership.

Communication skills are most important. Generally, communications about an employee benefit plan follow a pattern. The first or preliminary step is to announce that the plan is being discussed or developed, and to ask for data such as age and length of service of employees. At this time, the actuary and the administrator answer questions that may be asked by employees.

The second step occurs when the pension plan becomes final. It involves the distribution of material describing the plan, usually a booklet, to each covered employee and to employees who will eventually become eligible for participation. In this second step, the lawyer with the help of the actuary decides what to say, but the form in which the facts are circulated is chosen by the trustees. This is an area where a personal touch can be used effectively. For example, the literature that is distributed can be warm and friendly, and give the employee the facts he wants to know in a simple, understandable way.

Too often pamphlets or booklets are written in a cold, formal tone and are so detailed and involved that employees never get far beyond the cover before discarding them. On the other hand, there are many examples of effective material which can be used as a model or guide.

Another approach is to prepare informative articles for regular publication in the union newspaper and in company publications. This can do much toward generating interest in the pension plan and making it more generally understood.

CHAPTER VI

FACILITIES OF A LIFE INSURANCE COMPANY FOR NEGOTIATED MULTI-EMPLOYER PENSION PLANS

The successful operation of any pension plan involves many functions, as this Handbook has shown. Summarized they include:

- ✓ Actuarial services;
- ✓ Investment management or arrangements for investment management;
- ✓ Accurate record keeping and maintenance of economical accounting systems;
- ✓ Effective communication to employees;
- ✓ Prompt payment of pensions and other benefits; and
- ✓ Research facilities for keeping abreast of Federal and state laws and other developments affecting pension plans.

Actually these are functions in which the life insurance business has specialized for years. Combining the experience of an insurance company with that of the trustees' own advisors is an approach that is being used by many plans today. The trustees gain from an exchange of ideas and the possibility of a choice of different types of plans to meet the group's specific needs.

Only a life insurance company offers a guaranteed rate of interest, as well as guaranteed annuity purchase rates. The life company backs its guarantee with a successful and mature investment program, a wealth of actual annuity experience, and comprehensive service facilities.

FUNDING FACILITIES

To outline the various types of contracts offered by life insurance companies, it would be helpful to review briefly the contract forms which can be used.

Deposit Administration: This contract form is first in popularity and suitability for the funding of pensions under a negotiated pension plan. Under the deposit administration contract employer contributions are accumulated in an undivided fund. When an employee retires, the money needed is set aside to provide an annuity equaling the employee's pension credits.

The life insurance company guarantees the interest rate at which these funds accumulate, and also the rates at which annuities are purchased. These guarantees are customarily made initially for the money paid during the first five years of the contract. (A further explanation of the contract guarantees will be found at the end of this section under the heading "Experience Participation.")

While deposit administration contracts were issued as early as 1931 they have become much better known and more widely used in recent years. This form of contract can be applied to any benefit formula, and to all methods of actuarial funding. Such contracts are particularly well suited to the multiple employer type of plan, under which contributions of many employers, fixed by collective bargaining in terms of cents per hour, are paid into a jointly managed pension fund. Under a deposit administration contract, once a life annuity has been purchased for a retiring employee, there is complete assurance in the form of an absolute guarantee that payments will be continued even if the employee lives to be 100, or beyond.

Immediate Participation Guarantee: This contract, sometimes called Direct-Rating Deposit Administration, is similar in operation to a deposit administration contract and is rapidly increasing in usage. The principal difference is in the nature of the guarantees provided by the insurance company. It is appropriate primarily for larger groups.

Under a deposit administration contract, the insurance company guarantees the interest rate applicable to the undivided fund and the annuity purchase rates. Favorable experience is reflected in dividends to the pension plan.

Under an immediate participation guarantee contract, the contract holder participates immediately in the experience of the plan as it develops. For instance, interest is credited at the rate actually earned by the insurance company. Also, mortality gains or losses are reflected immediately and expenses are charged as they are incurred.

It is particularly attractive to large groups who believe their funds can experience average mortality and investment results, but want to use the administrative and investment facilities of the life insurance companies.

Under some contracts of this type, annuities are purchased as employees retire – and experience rated. Under other forms of this contract, annuities are not purchased – retirement benefits are paid from an individual fund. However, in either case, pension payments to retired workers are guaranteed by the life insurance companies. For this purpose, in the contract which does not normally purchase annuities, if the IPG fund falls below a pre-established level, annuities are purchased for the retired employees at predetermined rates.

Equity Funding: Only recently have insurance companies moved from their traditional position of holding relatively small proportions of common stocks. To permit greater utilization of common stocks for contracts especially designed for that purpose, many states have enacted legislation to permit the establishment of separate accounts, and almost all states now permit companies to issue contracts based on such accounts.

Contracts with reserves based on such separate accounts include equity funding contracts, to be used to accumulate employer contributions in equities until the retirement of employees, at which time a fixed dollar annuity is to be provided in the amount called for by the pension plan.

Although insurers are securing a favorable return on fixed income investments, the recent separate account contracts will enable them, as far as pension funds are concerned, to invest pension funds, in the amount deemed appropriate, in common stocks.

Where segregated funds are allowed, insurance companies can now offer a comprehensive program which could previously be accomplished only under a split funding arrangement.

Split Funding: Under this arrangement, only a portion of the pension contributions are paid to the insurance company. The remainder is invested through a corporate trustee primarily in equities. When an employee retires, his entire pension is purchased from the insurance company with the funds coming from either the amounts with the insurance company or from the trustee or both. In this way, it is possible to provide guaranteed pensions for employees once they have retired, and still permit the investment desired in common stocks.

Group Deferred Annuity: This is one of the oldest forms of group contracts issued by life insurance companies for the funding of pensions, and offers the most in the way of guarantees but it is seldom used for multi-employer plans. It calls for the purchase each year of a single premium deferred annuity which commences at retirement and is guaranteed payable for the lifetime of the person for whom it is purchased.

Most insurance companies guarantee the *initial rate basis* for annuity purchases during the first five years of the contract and, since the cost of each year's pension accrual is met in full as it arises, there is complete assurance that the amount purchased will be paid, regardless of future contingencies.

Individual Policies: These policies are more or less standard and are basically the type an individual can purchase for himself. Each employee is covered by a separate contract for the amount of his expected pension; as that amount changes, additional policies are obtained. The policies often include a substantial death benefit. The premium for each policy is guaranteed at issue for the life of the policy. Generally, a trustee is appointed to hold the contract and to receive any refunds which may become available. Such contracts are rarely used for multi-employer plans.

Group Permanent (or Group Retirement Income Policy): This type of contract resembles the individual policy except that it is issued on a group basis. One master contract is issued instead of a number of separate policies, eliminating the expense of having a corporate trustee administer the policies.

Blended Trust: This rather recent development is primarily an individual policy plan with an auxiliary fund set up under a trust or deposit administration contract to provide some degree of advance funding.

SUMMARY

This very brief outline points out that while insurance contracts differ widely in many respects, they have one thing in common; that is, a guaranteed basis of performance by the life insurance company especially as to the benefit payments to be made under purchased annuities. These guarantees are backed up by the entire assets of the insurance company.

In specific situations they can prove extremely valuable to the contract holder and they always offer an added and very worthwhile measure of assurance to the employees covered. For the medium-sized or small pension fund, these guarantees are of particular importance. Such guarantees are made possible by the spreading of risk; and, along with the security inherent in them, can be offered on a contractual basis only by life insurance companies.

Another aspect which the various pension contracts of insurance companies have in common is the facility for continuing the operation of the plan and the payment of benefits previously purchased after contributions are discontinued. Whatever the problems in administering a pension plan and investing its assets while the plan is in active operation, they are compounded many times if it should terminate. In the termination of a group contract, the life insurance company stands ready to handle whatever the future may bring.

For example, the trustees of the fund are not forced to cope with the investment problems of a shrinking fund, since money in the plan is commingled with all of the funds of the insurance company. Therefore, it does not become necessary to liquidate assets – possibly in a depressed market.

For that matter, all that the trustees need to do is continue to use the facilities of the insurance company. The expenses incurred by the insurance company in making pension payments are paid for at the time annuities are purchased. No extra expenses are incurred as a result of the discontinuance of the pension plan. Any employee for whom a life annuity is purchased can be sure of getting his full pension as long as he lives.

SUPERIOR INVESTMENTS

Fixed Income: Probably the single most important factor in the financial management of pension plans is the funding arrangement adopted by the administrator. Due to the desire for stability, a large proportion of pension fund assets are placed in fixed income investments such as bonds and mortgages. The excellent performance of life insurance companies with respect to such investments, however, has only recently been recognized by some pension specialists.

Following are three reasons for this current recognition:

1. Almost all insurance companies entered the Fifties with established portfolios invested largely in low yield

securities marketed during World War II and early post-war years. The interest credited each year on pension funds was based on the average rate earned by the insurance company on all its funds, regardless of when they were deposited.

This so called "portfolio interest rate" cannot be compared with the yield obtainable by newly invested pension funds during a period of rising interest rates. As an example, the prevailing interest rate for funds invested in 1960 might have been around 5.5%, whereas the rate insurance companies were crediting based on the average return of all investments, regardless of the year the monies were received, was less than 4.5%.

To recognize this, most life insurance companies have recently adopted a method of crediting interest on pension funds which takes into account the fact that the amount of investment income depends on the prevailing interest rates for new investments at the time the funds are invested and the rates prevailing at the time of any subsequent reinvestment. This has resulted in a higher yield on the new pension funds which have been deposited with the life companies in recent years.

Pension plans placing new pension funds in such companies realize that their funds will be credited with interest at the prevailing rate. Thus they will receive interest on the basis of their current earning potential, and not on the average portfolio rate the insurance company earns on all its pension reserves. This new method is called "investment year interest."

2. During the Fifties, Federal income tax on investment income had an appreciable effect on insured pension plans as interest rates improved. Remedial legislation was enacted in 1959. Today, the Federal income tax on qualified insured pension plans has been largely eliminated. The effect has been to increase the net investment yield of life insurance companies as applied to their pension business.

3. The National Association of Insurance Commissioners requires life insurance companies to establish a "security valuation reserve" as further provision against possible security losses in the future. The reserve does not represent money spent or lost to contract holders but, depending on the bookkeeping methods of the particular insurance company, it has tended to reduce the apparent interest yield. Nevertheless, such a reserve helps smooth out the effect of capital gains and losses. As a matter of fact, some trust fund managers have suggested the desirability of changing the tax laws to permit a similar reserve for non-insured plans.

   It may be noted that the published interest returns of most insurance companies are net rates after deduction of all investment expenses.

The excellent earnings realized by insurance companies on their fixed income investments result primarily from the operational function – their capacity to make direct placement of new security investments. Security issues placed through direct negotiations have distinct advantages for the lender and borrower which tend to increase the yield obtainable on the investment.

For instance, there is a considerable saving in the expense of floating a public issue. Also, the terms of the loan may be tailored to fit the specific needs of both the borrower and the lender. Since only two parties are involved, these terms may be modified during periods of general business decline in order to stave off defaults or to reduce losses.

In recent years, some life insurance companies have begun to employ direct placements to their mortgage investments. This is an important development, since close to 80% of all life insurance company assets are invested in mortgages and in the securities of business and industry.

EXPERIENCE PARTICIPATION

Most life insurance company pension contracts provide for participation in the earnings of the company in the form of dividends or experience rating. Practically all group contracts issued, whether by mutual or stock companies, are participating. Participation under a group contract is affected by both the experience of the contract itself and the over-all experience of the insurance company's business on all such contracts. The larger the contract, the more weight is given to its individual experience. A very large contract almost always stands substantially on its own.

While the aim of all life insurance companies is to enable their contract holders to participate fully in their dividend or experience rating calculations, there are differences in the practices followed by individual companies. Nevertheless, the following description of a typical procedure for a group annuity contract will help the trustee to understand the insured pension plan approach:

In managing its group pension business, the "XYZ Life Insurance Company" maintains a calendar year record of financial experience for each contract. The exceptions are plans of small size (perhaps $20,000 annual contributions) for which a record is maintained on a combined basis. This record is called an "experience accumulation."

The amount of the "experience accumulation" for any contract at the end of a calendar year represents:

1. All cash payments received by the XYZ Life Insurance Company, plus

2. Interest added at the group annuity experience interest rate which, with most insurance companies, now reflects the rates earned by the company on funds invested in the years in which the funds are made available for investment, minus

3. All benefit payments made by the XYZ Life Insurance Company, together with the expenses and taxes allocable to the contract.

As far as the experience accumulation is concerned, individual annuity payments are charged only as they are made.

In this way, actual mortality is recognized. Carefully devised expense allocation methods are used to make sure that as far as practical, each contract is charged with the expenses attributable to its operation.

The group annuity experience interest rate used in calculating the experience accumulation is based upon the interest rate earned by the XYZ Life Insurance Company, on the contributions received under the contract, after adjustment for certain items such as capital gains and losses. This is in accordance with the method of allocating investment results followed by the Company.

After the close of each calendar year, the experience accumulation of each contract in force for more than one year is analyzed and the dividends payable are determined. In this way, over a period of time each contract receives the benefit of its actual experience which is usually more favorable than the guarantees.

SERVICE

A life insurance company with experience in the pension field can offer a complete range of all the specialized and administrative services needed for efficient pension planning and administration, including such specific facilities and services as:

1. A trained staff of representatives to assist in designing and installing a pension program and available for service once the program is installed.

2. A comprehensive means of keeping in touch with retired employees, and recording address changes in order to keep up regular pension payments. This is perhaps the most troublesome aspect of the administration of a pension plan. However, through the use of the same modern high speed computers which are used for calculating individual costs, personal records are kept accurately and up-to-date.

   Life insurance companies also have the use of regional and nationwide networks of local offices for locating employees with whom contact might be lost. Care is taken to mail each pension check timed to arrive on or before the date it is due, regardless of where the employee happens to live.

These functions have been fulfilled by the life insurance business for many years. As a result, life insurance companies are able to carry out these operations with maximum efficiency.

3. A highly trained home office administrative staff skilled in record keeping, design of forms and experience in coordinating all facets of pension planning. These skills have been acquired through the administration of many pension programs.
4. A qualified actuarial staff with facilities for specific case work and calculations, and for broad research into all areas of the actuarial aspects of pension plans. Some life insurance company actuaries devote their entire time to the specific area of pension research and planning.
5. A legal staff to furnish regulatory references without delay. The services of this staff are available to the counsel for the pension plan in drafting the necessary documents. The company's legal staff can also assist him through discussions of the Federal and state laws which apply to pension plans.

The ultimate success of a pension plan depends to a considerable degree upon the quality of advice received by the trustees, and upon which they can rely for the all important decisions they must make.

Objective measurements of funding methods are difficult but it is well to bear in mind that over the years, as all things change, two factors do not change:

1) The expectation of the worker to have a dependable and continuous monthly pension check available to him in his retirement years;

2) The contractual guarantee of the life insurance company that the expectation will be fulfilled.

COMMON PENSION TERMINOLOGY

Accrued Liability (or Past Service Liability) — The actuarial value (single sum) of the past service benefits as of the effective date of establishment under the plan. The maximum annual past service tax deduction allowable is 10% of the original single sum liability. Minimum funding sufficient to prevent this liability from exceeding its initial size is required by the Internal Revenue Service.

Actuarial Cost Methods — Systems for determining either the contributions to be made under a retirement plan or level of benefits when the contributions are fixed. In addition to forecasts of mortality, interest, and expenses, some of the methods involve estimates as to future labor turnover, salary scales and retirement rates. The methods of prime importance are those, such as the Entry Age Normal Method, Attained Age Normal Method and Unit Credit Method, which have been recognized by the Internal Revenue Service:

Actuarial Equivalent — If the present value of two series of payments are equal, taking into account a given interest rate and mortality according to a given table, the two series are said to be actuarially equivalent on this basis. For example, a lifetime monthly benefit of $67.60 beginning at age 60 (on a given set of actuarial assumptions) can be said to be the actuarial equivalent of $100 a month beginning at age 65. The actual benefit amounts are different but the present value of the two benefits, considering mortality and interest, is the same.

Actuary — A person professionally trained in the technical and mathematical aspects of insurance, pensions and related fields.

Administrator — For purposes of the Federal Disclosure Act, the "Administrator" is the trustee of a jointly administered labor management pension plan. In its usual meaning, "Administrator" designates the person or organization that performs the routine clerical operations of the plan.

Allocation – The setting aside of funds to purchase annuities or pay a benefit due.

Amortization – Paying off an interest bearing liability by gradual reduction through a series of installments, as opposed to paying it off by one lump-sum payment.

Annuity Benefit – A series of payments which is payable at fixed intervals of time. The person receiving the payment is called an annuitant. Annuity payments may be made monthly, quarterly, semi-annually or annually.

Beneficiary – The person named by the employee to receive any death payment due under the Group Annuity Contract.

Contingent Annuity Option (or Joint and Survivor Option) – An option under which an employee may elect to receive, under certain conditions, a reduced amount of annuity with all, or a specified fraction thereof, to be continued after his death to another person designated as his contingent annuitant.

Contract-Holder – The group, entity or person to whom a Group Annuity Contract is issued – in jointly administered plans, the trustees.

Cut-Off Date – Date after which no prior service is credited. Discussed on page 24 of this Handbook.

Death Benefit – A payment made to the designated beneficiary upon the death of the employee annuitant.

Deduction under Section 404 – Refers to the Section of the 1954 Internal Revenue Code under which the contributions by an employer to a qualified plan are claimed as a deduction for Federal income tax purposes.

Deferred Annuity – An annuity under which payment will begin at some definite future date, such as in a specified number of years or at a specified age. (See Immediate Annuity)

Disability Benefit – Under some retirement plans, if an employee becomes totally and permanently disabled before retirement, he becomes eligible to receive a monthly disability benefit.

Discounting for Mortality — The assumption, in accordance with a mortality table, that some employees will die before retirement and the others after receiving only a limited number of annuity payments. Contribution rates or benefit costs so calculated have been discounted for mortality.

Early Retirement Date — Under some retirement plans an employee may retire before his normal retirement date, usually with a reduced amount of annuity. Early retirement is generally allowed at any time during a period of 5 or 10 years preceding Normal Retirement Date.

Eligibility Requirements — (1) Sometimes these refer to the conditions which an employee must satisfy to participate in a retirement plan. One such condition may be the completion of from 1 to 5 years of service with the employer, another the attainment of a specified age such as 25. (2) Sometimes these refer to conditions which an employee must satisfy to obtain a retirement benefit. For example, the completion of 15 years of service and the attainment of age 65. Item (2) is more common to negotiated plans.

Equities — This refers to ownership of property, usually in the form of common stocks, as distinguished from fixed income bearing securities, such as bonds or mortgages.

Fixed Dollar Annuities — An annuity under which the amount of each annuity payment is a fixed number of dollars.

Funded Retirement Plan — A plan under which funds are set aside in advance to provide expected benefits. The plan is not necessarily insured.

Future Service Benefits — Benefits for service after the effective date of coverage under the plan.

Future Service Cost — The cost of future service benefits.

Group Annuity Contract — A contract issued by a life insurance company that may be used as the funding instrument for benefits to be made in accordance with a pension plan. A single master contract provides that the group of persons participating in the plan will receive annuities during retirement. Individual certificates stating coverage may be issued to members of the group. Forms of group annuity contracts include: Deposit Administration, Immediate Participation Guarantee, Deferred Annuity, and Group Permanent. These forms are discussed on pages 39 through 42 of this Handbook.

Immediate Annuitant – An individual who, on the effective date of the contract, is eligible to receive an immediate annuity.

Immediate Annuity – An annuity providing for payment to begin immediately.

Insured Plan – A plan funded with a life insurance company. The life insurance company guarantees the payment of annuities purchased. Depending upon the form of contract used, other guarantees are given with respect to purchase rates and interest rates.

Labor-Management Relations Act of 1947 (Taft-Hartley Act) – Controls conditions under which an employer may pay any moneys to a representative of his employees. Discussed in pages 9 through 11 of this Handbook.

Life Annuity – A series of payments under which payments, once begun, continue throughout the remaining lifetime of the annuitant. Under this form of annuity, there is no further benefit payment of any kind after the death of the annuitant.

Life Expectancy At An Age – The average number of years as estimated from a mortality table that individuals will live, after attaining the specific age.

Maximum Benefits – In order to limit costs or to prevent discrimination prohibited by the Internal Revenue Service, some plans provide that an employee may not receive more than a prescribed benefit under the plan, regardless of the regular benefit formula.

Minimum Benefits – Some plans provide that a minimum amount of annuity will be paid if the regular benefit formula produces less. This minimum is usually payable only if certain service requirements are met at retirement.

Mortality Table – A table showing how many members of a group, starting at a certain age, will be alive at each succeeding age. It is used to calculate the probability of dying in, or surviving through, any period, and the value of an annuity benefit. To be appropriate for a specific group, it should be based on the experience of individuals having common characteristics such as sex, occupational group, etc.

Non-Qualified Plan – A plan which has not been approved by the Internal Revenue Service and which, as a result, suffers distinct disadvantages from a tax viewpoint.

Normal Retirement Age – The age, as established by a plan, when retirement normally occurs. Since unreduced Social Security benefits are available at 65, that is the most common normal retirement age.

Past Service Benefits – Benefits for service before the effective date of coverage under the plan.

Pension Benefits – A series of payments to be provided in accordance with the plan of benefits.

Portability – Any provision for retaining pension rights when changing from one employer to another.

Postponed Retirement – Under some plans, it is possible for an employee to continue in employment beyond his normal retirement date, sometimes only with the consent of his employer. Most plans provide that pension payments will not begin until retirement actually occurs.

Qualified Plan – A plan which the Internal Revenue Service approves as meeting the requirements of Section 401 of the 1954 Internal Revenue Code. Such a plan receives distinct tax advantages.

Reserve – The reserve, for an annuity, is the amount of money required to guarantee the payment of annuity benefits coming due.

Self Administered (Trusteed or Directly Invested) Plan – A plan funded through a fiduciary, which is generally a bank but may sometimes be a group of individuals which directly invests the fund accumulated. Retirement annuity payments are made from the fund as they fall due.

Social Security Option – An option under which the employee may elect that monthly payments of annuity before a specified age (62 or 65), be increased, and that payments thereafter are decreased to produce as nearly as practicable, a level *total* annual annuity to the employee, including Social Security.

Split-Funding – An arrangement whereby a portion of the contributions to the pension plan are paid to an insurance company and the remainder of the contributions invested through a corporate trustee, primarily in equities. Discussed on page 41 of this Handbook.

Temporary Life Annuity – An annuity payable while the annuitant lives but not beyond a specified period, such as five years. No payments are made after the end of the stipulated temporary period or the death of the annuitant.

Ten Per Cent Funding – The 1954 Internal Revenue Code will permit deduction of the entire future service cost plus 10% of the original past service liability, subject to experience adjustments because of turnover, dividends, etc. Such annual 10% contributions will completely fund the Past Service Liability in about 13 years, using an assumed interest rate of 3¾% and if actual experience follows the assumptions.

Ten Years Certain and Life Annuity – An annuity which pays an income to the annuitant for as long as he lives, but if he dies within 10 years after his retirement, continues payments to his beneficiary for the remainder of the 10 years.

Termination of the Contract – The contract may terminate or cease if no further annuity payments are payable, if the employer loses his corporate identity, or if he no longer wishes to perform the duties of the contract-holder.

Turnover Rate – The rate at which employees terminate covered service other than by death or retirement. Expected future turnover can be taken into account, in translating contributions into benefits.

Vesting – A plan may provide that an employee will, after meeting certain requirements, retain a right to the benefits he has accrued, or some portion of them, even though his coverage under the plan terminates before retirement. An employee who has met such requirements is said to have a vested right. Note that vesting is in the form of future annuity benefits, not the cash paid to purchase the benefits.

Widow's Benefit – Payments to a widow of a deceased employee, usually in the form of a series of payments, upon meeting certain requirements and usually terminating with the widow's remarriage or death.

Year-End – The end of the contract year.

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