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PRIVATE PENSION PLANS AND THE PUBLIC INTEREST

Committee on Employee Benefits
FINANCIAL EXECUTIVES INSTITUTE

Private Pension Plans
and
the Public Interest

Prepared by the

COMMITTEE ON EMPLOYEE BENEFITS
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SECTION I

Introduction

Much discussion about the private pension system in the United States has recently been generated by Government agencies, Congressional committees, trade unions, professional associations, and representatives of the academic community. Certain legislation has been introduced in Washington which, if enacted, would alter the basic concepts underlying private pension plans. The type of legislation advocated by several spokesmen threatens the growth and existence of the private pension movement in this country.

Realizing that the future of the private pension system is a subject of vital concern to every member of Financial Executives Institute, the FEI Committee on Employee Benefits has prepared this study to:

1. Acquaint all FEI members with the serious issues which affect the future of private pension plans,
2. Aid FEI members to understand these complex issues and to determine their individual position on each,
3. Serve as an information source for further study of these issues and the communication of views and positions to government groups and others.

This study does not analyze in detail the many measures which have been suggested as "remedial" legislation but is primarily concerned with the broad principles which underlie the private pension movement. The primary purpose of the study is to help ensure the continued health and growth of the private pension system in the United States.

SECTION II

Development of Private Pension Plans

Chronologically, the private pension movement in the United States is little more than a "teenager" today, since its real growth started only in the late 1940's. The movement has had a record of continual growth, development and liberalization since then and it promises to sustain this progress if granted a favorable environment in which to grow. It is important to note that the laudable progress made by the private pension movement has been achieved with remarkably few instances of poor management or abuse.

Typically, early private pension arrangements were informal and discretionary. In time these arrangements were replaced by formal plans in which participation was broad and the level of benefits was defined by a predetermined formula. Most private plans started with simple age retirement benefits. Gradually, plans have been liberalized and other types of benefits added.

The progressive businessman realized that the prospect of retirement security was not only beneficial to his employees but was also directly advantageous to him as well. The existence of a pension plan enabled him to attract better employees, reduce turnover, facilitate orderly retirement of older workers and retain valuable employees who might otherwise seek work elsewhere.

Gradually, the private pension system became widespread as more employers found it desirable to establish pension plans and to keep pace with improvements in pension benefits in order to obtain these advantages.

Another factor of great importance in the development of the pension movement has been the increasing interest of labor unions in these plans. Today private pension contracts are in many cases the subject of bargaining between management and union representatives. From these management-union negotiations have evolved the type of pension plan, the amount of benefits and other features which best fit the divergent needs and characteristics of the company and employees involved. The nature of these pension plan benefits has been determined through the normal employer-employee relationship.

With the evolution and growth of private pension plans, it became evident that steps had to be taken to provide reasonable assurance to all concerned that money would be available for payment of pension benefits to retired employees, independent of an employer's current level of profits or cash position. This resulted in the practice now known as advance funding, under which a company sets aside each year in trust or with insurance companies an amount for the payment of pensions as they become due far in the future. In addition to providing reasonable assurance to employees that funds will be available to meet pension obligations when they become due, advance funding also permits the employer to accumulate these funds gradually over a period of time and avoid exposure to the sharply increasing demands on cash balances which result from pay-as-you-go plans.

In 1940 private plans covered about four million employees, in 1950 about ten million, and today more than twenty-five million employees are covered by these plans.

Pension plan reserves have grown from $12 billion at the end of 1950 to almost $100 billion today. Not only has the private pension system had beneficial social effects but it has also been a stabilizing influence on the entire American economy. The free flow of pension savings through normal financial channels is based mainly on investment considerations of quality and yield. As a source of capital, the private pension system is a significant factor in the proper functioning of the American free enterprise system.

The growth of private plans has been accomplished by a fine balancing of the interests of owners, managers, labor leaders and plan participants. It has been accomplished in the absence of unduly restrictive government regulations or guidelines.

In the comparatively short history of private pension plans, their use has spread widely, their provisions have been formalized, their emerging costs have been recognized and funded to a great extent, and their value in the eyes of employees and labor unions has been confirmed.

SECTION III

Current Legislative Proposals

Despite the remarkable growth of private pension plans without undue Government regulation, a number of Government officials and representatives of other interested groups have proposed legislation which would establish more extensive control over private pension plans. Many of these proposals appear to rest on one or more of the following assumptions which may or may not have merit as bases for public policy.

Assumption 1

Private plans should serve broad social objectives as well as the individual interests of employers and employees. The nation expects private pensions to be an important source of old-age income assurance. This goal will be attained only if these plans are designed with social purposes in mind and only if additional legislation is passsed.

Assumption 2

The public will be concerned whenever pension promises prove to be illusory. Public opinion will not tolerate failure to provide assurance that pension expectations are fulfilled.

Assumption 3

Preferential tax treatment is provided to private pension plans through the Internal Revenue Code. Because of this, the Government has the right to regulate provisions of these plans to see that they are consistent with the public interest.

Assumption 4

Any system that covers 25 million people and has accumulated funds of nearly $100 billion is, by its very size, so important to the country that it is a legitimate object of Congressional concern and Federal regulation.

Broadly speaking, the justification for further Government regulation appears to depend upon the conclusion that there is a conflict between the interest of parties involved in private plans, on the one hand, and the public interest, on the other. However, there is no evidence that this conflict exists in fact and such a conclusion is wholly unwarranted. Greater understanding is needed in order to evaluate and determine how the public interest in the private pension system can be applied in constructive ways.

It is recognized that Federal welfare programs must be designed to meet the basic needs of citizens through a comprehensive, uniform, tax-supported, mandatory system. Private plans, however, should be designed to enable individual employers and their employees to supplement the Government program in ways that are most suitable to their individual circumstances.

Even a casual review of a random sample of private plans shows that there is great variety in their provisions. This variety is necessary to meet the specific needs of both employees and employers in each plan and is evidence that employers and employees use these programs to meet the unique situations of particular groups. Some examples of various provisions of plans are: airlines retire pilots at age 60; steelworkers have special benefits in event of plant closings; auto workers have supplemental pension benefits between ages 55 and 65; other benefit plans covering the risks of disability and death affect pension provisions in areas such as permanent disability, widows' pensions, and lump sum death benefit payments; some plans incorporate employee contributions so that a larger benefit can be provided than can be financed by employer contributions alone; the ages at which employees are typically hired may influence the amount of benefit earned per year of service. Size and financial resources of the company and the age mix of the employees are other factors which determine the best type of plan in a particular case.

With this need for variety there cannot be standard requirements covering pension plan provisions. Uniformity is certain to have a stifling effect on the growth of private plans. Accordingly, the Committee feels that regulation which would lead to uniformity is not in the public interest.

The Committee believes that the tax treatment currently afforded to pension plans is basically sound. It is noteworthy that there are no current proposals to change the tax treatment.

The Committee suggests that the concepts listed below may serve as a sound basis for determination of public policy for private retirement plans.

Concept 1

Public policy should encourage flexibility in the design of private plans to meet the individual needs of employers and their employees. One of the fundamental justifications for private pension plans is that they meet these special needs. Allowing maximum variety among private plans recognizes the differences in circumstances in which pensions apply.

Concept 2

Public policy should encourage adequate funding of pension liabilities so that benefit expectations can be fulfilled when they become due. This encouragement should not restrict the range of deductible contributions from year to year as long as adequate cumulative funding is accomplished.

Concept 3

Public policy should encourage administrators of private plans to inform employees of all material facts which concern the fulfillment of their pension expectations. If every employee is fully aware of these facts, no illusory promises of his pension benefits exist.

Concept 4

Public policy should require high standards of fiduciary responsibility for those individuals charged with administration of private pension plans. The same concepts which underlie the ethical and legal obligations of others holding positions of fiduciary responsibility should be applied to pension plan administrators.

The Committee feels that legislative and regulatory proposals regarding the private pension system should be evaluated in terms of their compatibility with these concepts. The application of these concepts will result in the continued healthy growth of private pension plans consistent with the public interest. However, many proposals for pension regulation are in various stages of consideration in Government and in Congress. Some of these do not meet the standards of reasonableness which have been outlined above.

The following list sets forth briefly the highlights of some of the legislative and/or regulatory proposals which have been suggested for adoption.

"Public Policy and Private Pension Programs: A Report to the President on Private Employee Retirement Plans," by the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs (January 1965).

This report is generally regarded as the basic document which prompted the widespread interest and concern of the Administration, legislators and others in this area. While it deals with most aspects of the private system, it does so primarily in terms of the authors' views of the public interest, not those of individual employers and employees. The report proposes a number of changes in the private pension system, and due to the great influence it has had on the thinking of many interested parties, it should be referred to by anyone seeking insight into current developments in the legislative and regulatory scene. The comments made by the President's Advisory Committee on Labor Management Policy which are appended to the Report are also of considerable interest.

"Old Age Income Assurance: An Outline of Issues and Alternatives," by the Committee Staff for the Subcommittee on Fiscal Policy of the Joint Economic Committee, Congress of the United States (November 1966).

This sweeping and unfair indictment of the private pension system sets forth possible alternative approaches, some of which would drastically alter the private system as it is known today. For example: the plan merger suggestion, which "would require that all plans merge into one and this plan have universal coverage"; and the no funding proposal, set forth as follows: ". . . savings done by pension plans should be the least that is necessary to assure that pensions will be paid. . . . First, funding by raising current contributions costs is an impediment to extension of plan coverage. Second, the accumulation of funds poses a continuing threat to maintenance of full employment. Third, the management of pension funds presents a challenge to effective supervision of economic power. Savings could be reduced substantially through reinsurance." This publication should also be referred to by interested parties.

The governmental group which issued it plans to release a compendium of comments about the issues raised by the Report. The compendium will include analyses by companies, employer associations, labor organizations, academicians and other interested parties.

> Treasury Announcement 66-58. Proposals to amend the formula used by IRS in determining whether tax-qualified private plans "integrate" with Social Security. IRS Ruling 67-10 establishes interim integration guides.

This is a complex subject which is discussed in Section VI of this paper. If the formula amendments suggested are adopted as final changes in the Internal Revenue Code regulations, either the benefits in a significant number of private pension plans must be increased for those earning less than maximum Social Security earnings, or the level of benefits currently applicable to higher paid employees will have to be decreased. Clearly, if Social Security benefits and costs continue to increase, there must be full recognition and appreciation of the need to coordinate public and private plans realistically in order to keep total costs and benefits within reasonable limits.

> Proposals of the Inter-Agency Staff Committee (made up of representatives of the Departments of Commerce; Treasury; Labor; Health, Educa-

tion and Welfare; the Bureau of the Budget; the Securities and Exchange Commission; and the Council of Economic Advisors).

This group is studying ways to implement the President's Committee proposals (see above). The current thinking of these representatives was presented by Assistant Secretary of the Treasury Stanley S. Surrey in a speech before the American Pension Conference on May 11, 1967. The main proposals of this Staff Committee, as revealed by Mr. Surrey, were: (a) "The staff proposes the participants in private pension plans be granted vested rights after ten years of service with the employer (after the effective date of the requirement)"; (b) "The staff proposal would measure a plan's funding adequacy by comparing its assets with the liabilities to which it is committed—that is, its liabilities for vested benefits. This relationship would be reported to the Government every three years. . . . While the ultimate goal of such a funding standard would be 'assets equal to vested liabilities,' plans would be given twenty-five years in which to reach this goal"; (c) ". . . the staff proposes the establishment of a common fund (reinsurance) which would be available to meet any particular plan's unfunded liabilities in the event of its termination while moving towards full funding. Under the staff proposal, each plan would make contributions to the common fund based on the amount of its unfunded vested liabilities."

Although these suggestions are not official Government proposals, they are evidence of the type of regulation currently under serious consideration by the Administration.

Administration proposals for specific legislation amending the Disclosure Act through identical bills introduced by Senator Yarborough (S. 1024) and Representative Perkins (H.R. 5741).

These bills would give broader powers to the Secretary of Labor, establish Federal standards for fiduciaries, require yearly independent audits, limit the amounts which a pension fund may invest in securities of the employer, and require far greater detail in reporting trust fund assets and the purchase and sale of these assets.

There are currently pending approximately thirty other legislative measures which include, but are not limited to, bills by the following members of Congress: Senator Hartke (S. 1635), requiring reinsurance of pension plan liabilities; Senator McClellan (S. 1255), amending the Welfare and Pension Plans Disclosure Act; Senator Javits (S. 1103), dealing with various aspects of pension plans, including required vesting, funding, reinsurance, optional portability, and a new independent Federal agency to oversee the operation of private pension plans.

SECTION IV

Vesting

Vesting is the granting to an employee of a non-forfeitable right to receive, upon his reaching retirement age, a pension benefit for service already rendered. Ordinarily, he must have met certain age and service requirements before vesting takes place.

The current issue over vesting is whether a specified vesting provision should be required by law to be in all plans. Arguments made by proponents of mandatory vesting are (1) that an employee should retain his accrued benefits when he changes employment for any reason, and (2) that lack of vesting seriously reduces the mobility of labor.

In considering whether or not mandatory vesting is needed, it should be noted that over 70 per cent of all plans already have vesting provisions and the figure nears 85 to 90 per cent among employer-administered plans. Clearly, vesting on its own merits has become prevalent without being required by law.

Further, a Department of Labor study specifically concluded that the lack of vesting provisions may not be as important a factor with respect to labor mobility as is seniority.

The fundamental objection to such proposed regulation is that the Government should not attempt to determine this or any other pension benefit. The selection among all such benefits should be left to the parties concerned with and covered by pension programs.

Proposals for mandatory vesting are contrary to the concept that public policy should encourage flexibility, not uniformity, among private plans. Flexibility in private plans should be permitted to evolve from the normal employee-employer relationships, taking into account the employment characteristics of the individual companies and other types of benefit needs such as severance allowances, disability and other early retirement benefits.

SECTION V

Portability

Advocates of portability carry the vesting concept a step further and propose that upon the separation of an employee a transfer of assets, equal to the value of his vested pension, be made to the new employer or to a governmental agency.

For example, the Javits bill (S. 1103) proposes voluntary portability of pension credits by creating a Federal depository in which funds covering vested pensions could be placed. Other proponents of portability argue that an employee with vested benefits should be able to pick up his pension credits and applicable funds when he leaves one employer and take them with him to his next employer.

With the rapid spread of vesting and the growing emphasis on the funding of benefits, the need for a portability device, or the need to transfer pension funds from one employer to another, is questionable. In fact, when a vested employee leaves a well-funded plan, portability adds nothing to his rights. It merely changes the agency that is holding the money.

Apart from the lack of need for portability, several considerations make the transfer of pension funds impractical. First, the provisions of private pension plans and their administration differ from employer to employer. In order for portability to work, therefore, each employer's pension plan benefits would have to be translated into some kind of uniform common denominator. The employee, his subsequent employer, or an intermediary fund would then be given an appropriate amount of money to provide for these benefit rights.

Some parties have suggested that, as an alternative, the transferring employee or his new employer should be given the amounts funded with respect to the transferring employee. This amount would then be used to purchase whatever rights that sum would buy under the new employer's plan. Others have suggested that a government-operated transfer device—a kind of Social Security fund—be established. No matter what approach is used, it would still be necessary for the former employer to transfer monies from his fund.

The transfer of monies from one employer's pension fund in any form and in any amount poses problems of equity between the transferring employee and employees remaining in the original employer's fund. The transferring employee might leave the pension plan taking with him monies representing one hundred per cent funded pension credits under the plan while the pension credits for the remaining employees—a far larger number—might not be fully funded, an obvious inequity. The transfer of monies poses another problem when the two funds concerned are earning different rates of return.

A second consideration is that portability would require that a certain portion of the investment portfolio be invested in securities readily convertible to cash or easily transferable. The investment emphasis for this portion would thus have to be shifted from long-term yield, which would add to the cost of pension benefits and possibly lower the benefits which might otherwise be available.

It should be recognized that portability is not an issue but a device. It aims to provide vesting and to back up the vested benefit promises with assets. This is already a fact in well-funded plans.

Instead of portability devices, transferring employees with vested rights should be given a formal statement of the pension they will receive from their former employer upon reaching retirement age. Employers also should establish procedures to contact former employees when they become eligible to receive their pensions, so that application to receive these benefits can be made. This combination of a statement at the time of employment termination, proper follow-up communication with former employees, and an adequate funding back-up for pension benefits, eliminates the need for any portability device.

SECTION VI

Integration with Social Security

The integration tests devised by the Treasury are intended to measure whether private plans comply with the provisions of Section 401 (a) of the Internal Revenue Code. This section prohibits discrimination in contributions and benefits in favor of employees who are officers, shareholders, supervisory, or highly compensated employees.

For the past sixteen years, the Treasury has held that employer-financed Social Security benefits are equivalent to 37½ per cent of the employee Social Security taxable wages. Therefore, a private pension plan may provide, from employer funds, benefits of up to 37½ per cent of compensation in excess of the earnings taxed by Social Security.

This percentage was developed from certain assumptions with respect to the total value of the Social Security benefits (old-age plus ancillary benefits) and represents the value of Social Security benefits over and above that which the employee has paid for himself. The Treasury has maintained this 37½ per cent integration test limit despite substantial changes since 1951 in the level of Social Security benefits, the wages subject to Social Security taxes, and the tax rates applicable to employees and employers. Apparently, the Treasury Department has considered the maintenance of the 37½ per cent limit to be more important than the exact application of its mathematical assumptions.

The current integration tests do not apply to some plans because Social Security benefits are not taken into account in the design of these plans. Examples of this are plans in which benefits are computed at a uniform percentage or rate on all earnings, and plans in which benefits are based on service alone, such as those which provide a pension of so many dollars per month per year of service.

On the other hand, many employers recognize that Social Security provides a pension base for earnings up to a specified amount and that a private plan should be designed to take the Social Security benefit into account. Often this is accomplished by designing a pension plan with a dual benefit structure (an excess plan), i.e., one rate on earnings up to the maximum Social Security earnings (currently $6,600) and a higher rate of benefits on earnings in excess of this maximum. In other cases, the private plan provides that the pension benefit will be reduced by a specified amount or percentage of the employee's primary Social Security benefit (an offset plan). In all of these cases where the plan provides that the employee will receive a higher benefit on earnings in excess of the Social Security taxable wage than on earnings up to that amount, the Treasury's integration rules apply.

A great deal of attention has been focused on the integration of private pension plan benefits with Social Security benefits as the result of Treasury Announcement 66-58, issued September 19, 1966. The prompt reaction by actuaries, pension consultants, businessmen and others concerned with the private pension system was overwhelmingly against the integration tests outlined. As a result, the Treasury announced that it would study the problem further and appointed an advisory panel to assist in evaluating proposed changes in its Social Security contribution and benefit structure.

TA 66-58 theorizes that the portion of the value of Social Security benefits paid for by the employee is much greater than specified by the present assumption; therefore, using a mathematical approach, the integration limit should be 24 per cent rather than 37½ per cent. This change of thinking would force many plans either to increase the benefit payable on the first $6,600 or decrease the benefit on the excess if the plans are to continue to integrate. Obviously, it would be unfair to reduce the benefits of some employees but the only alternative would be a large increase in benefits and costs. Furthermore, TA 66-58 does not contain any "grandfather" clause which would permit plans to operate with their existing formulas.

Although the Treasury Department has deferred its final determination on integration tests until further studies have been completed with the aid of the advisory panel, the Internal Revenue Service has issued interim integration guides. As outlined in Revenue Ruling 67-10, these guides, applicable to new or amended excess plans, go more than half way toward those suggested by the Treasury in TA 66-58 and will be used until the final regulations are issued. These interim guides decrease the integration rate from 37½ per cent to 27.27 per cent (37½ per cent of $4,800/$6,600) and will in many instances require modification of benefits or added costs in such plans.

Pension plans represent long-term commitments which require long-term planning by the employer and also by employees in making long-range retirement plans. Stability in integration rules is therefore essential if this long-range planning is to be effective.

The nondiscrimination requirements of the Internal Revenue Code are very broad. Their stated purpose is to prohibit favoritism to employees who are officers, shareholders, supervisory, or highly compensated employees. Attention should be focused on developing a practical means for determining compliance with the nondiscrimination provision of the Code. One simple method would be to provide that pension plans not be considered discriminatory as long as total employer-financed normal retirement benefits from the plan and the primary Social Security benefit together do not represent a higher percentage of pay for highly paid employees. Such a provision would effectively prevent the type of discrimination which Congress intended to prohibit, and it would put an end to the controversy over the value of ancillary Social Security benefits and the percentage of Social Security benefit financed by the employee's Social Security taxes.

Similarly, an offset plan with a benefit formula uniformly related to earnings or years of service should be permitted to subtract from the plan benefit up to 100 per cent of the primary Social Security benefit actually payable to a plan participant.

Practical alternatives to the present mathematical approach would be highly desirable. If the Treasury Department persists with the formula approach, however, continuation of the 37½ per cent rule would be appropriate and reasonable. Despite the substantial changes in Social Security benefits and taxable wages which have occurred over the years, the 37½ per cent rule has been in force for sixteen years. The primary Social Security benefit has remained at approximately the same percentage of the Social Security taxable wage during that whole period and the recent changes have not affected this relationship.

These recommended approaches to continued enforcement of the nondiscrimination provisions of the Code would (1) comply with the intent of Congress, (2) give pension planners the degree of flexibility needed to design plans which are responsive to the needs of employees at all wage and salary levels, and (3) add the degree of permanence which is essential to these long-term commitments.

SECTION VII

Funding

Because questions about the financing of private pension plans are frequently raised, it is pertinent to outline here some of the basic financial principles which underlie pension plan management.

When a company establishes a pension plan, it thereby undertakes to pay pension benefits when they become due. This obligation is equally as important as other obligations to pay wages, taxes, costs of materials, and other business expenses. Thus, in order to provide reasonable assurance to employees and other beneficiaries that pension benefits will be paid when due, most companies design and establish a definite pension financing program. Prudent management chooses a program which will suitably fulfill the company's own needs and the needs of its employees and enable it to meet its pension obligations at a reasonable cost.

Before a company can provide for these pension obligations, however, it must determine the amount of the ultimate obligation or liability—the amount which will eventually be paid out as pension benefits. In calculating this ultimate liability, a number of factors must be taken into account: the length of life of participants; the ability of the company to provide employment; the disposition of employees to remain with the company; and other employee characteristics such as age, service, sex and compensation levels. In calculating the present value of the liability, the anticipated level of future investment earnings also must be estimated.

These factors will differ from company to company and from plan to plan. Because of these differences, each individual company, aided by qualified actuaries, is the best judge of which actuarial assumptions and cost methods are most appropriate for translating the provisions of its pension plan into dollar obligations.

Each company with a pension plan must also make adequate provisions to assure that sufficient cash will be available to pay benefits when they become due. A company may elect not to set aside these funds currently but it must accrue for these obligations currently in order to recognize its pension responsibility. Otherwise, an exception will be noted by its public accountant in its annual financial statement.

There are several alternative ways in which a company can fund its pension benefits. For instance, annuities may be purchased from an insurance company. In this case, the insurance company will determine the premiums needed to accumulate sufficient funds to pay the premium benefits. Or management may decide to set aside some of the company's assets in a trust fund to pay for these benefits. Here, management, assisted by qualified actuaries, must determine the amount and timing of payments to the trust, based on the variables mentioned above.

The Internal Revenue Service has long had funding standards which must be met if a pension plan is to obtain and maintain a qualified status. A plan must have a qualified status if contributions for future benefits are to be deductible currently, if a trust is to be tax exempt, and if employees are to avoid current tax liabilities for contributions made by the employer. With a qualified plan, unfunded costs may not at any time exceed the unfunded past service cost at the time the plan was established plus any supplementary past service cost resulting from subsequent plan amendments. This means that, in general, funding can be no less than the cumulative current service costs plus interest on past service costs.

It is significant that most companies fund at a faster rate than the minimum required by the Internal Revenue Service. One reason for this is the desire of employers to assure the ability to pay future pension benefits. Another is to earn flexibility for future years' contributions. The only way a company can contribute less in some future year and still retain its qualified status is to have funded its pension obligations above the minimum required amounts in previous years.

This discussion leads to three conclusions on appropriate public policy for the funding of private pensions.

Conclusion 1

Employers should be encouraged to fund pension liabilities on a basis consistent with the over-all characteristics and requirements of the business.

Conclusion 2

Flexibility should be maintained in the range of deductible contributions from year to year. Consideration should be given to broadening the range of contributions which would be deductible for tax purposes. For example, the annual maximum contribution might be determined by the amount which would fully fund all liabilities for benefits accrued to date. The minimum might be the lesser of (a) the present regulations or (b) the amount needed to assure that plan assets are equal to vested liabilities if the plan were to terminate. Rigid funding requirements will not assure the payment of future pension obligations. On the contrary, they may limit management's ability to protect the continued economic health of the business, which is the best long-range assurance of the security of pension benefits. Furthermore, rigidity could operate to discourage the adoption of new plans or the increase of benefits under existing plans.

Conclusion 3

Employers should be encouraged to make available to pension plan participants periodic statements of the status of the plan's funding.

The Committee recommends that pension plan administrators be encouraged to submit to plan participants periodic reports which should include or be based upon (a) a statement by qualified actuaries as to the reasonableness of the determination of the amount of pension obligations, and (b) certification by independent public accountants or other appropriate agency based upon examination of the accounts and records of the pension plan and fund. These reports, representing independent professional opinions, should include the extent to which pension liabilities have been funded. When coupled with other material facts and information relating to pension plan operations, they should help to assure high administrative and operating standards. Such reporting practices should, in the Committee's opinion, help sustain public confidence in the private pension system.

These conclusions are consistent with the recently enunciated Opinion No. 8 of the Accounting Principles Board of the American Institute of Certified Public Accountants. Drawing a distinction between the amount to be charged to operations in a particular year for pension costs and the amount of cash to be contributed to a pension fund or trust, the Opinion establishes a basis for reporting to stockholders on the current year's accrued costs and the accumulated extent of funding in excess of or in arrears of this accrued cost. As evidenced by this Opinion, the public accountants recognize the vital difference between long-term security of pension promises and the flexibility permitted in year-to-year contributions.

Opinion No. 8, effective for fiscal periods beginning after December 31, 1966, is an example of the way in which private industry and its professional advisors have instituted accounting standards and practices without legislative requirements by the Government. Opinion No. 8 has encouraged employers whose plans were previously thinly funded or not funded at all to make contributions at the level which is required to be recognized for accounting purposes.

SECTION VIII

Reinsurance

If a pension plan is terminated, the liability of the employer is often limited to the plan assets on hand. It is possible that the assets at the time of termination may not be sufficient to pay all of the accrued benefits. This situation would be most likely to occur in a relatively new plan or in a plan under which benefits had been recently improved. When a new plan is installed or an existing plan improved, the liabilities for benefits for service already rendered may be sizeable. A company's over-all cash needs may require that these liabilities be funded gradually over a period of time. In addition, the Internal Revenue Code places limitations, as previously noted, on the amount of pension plan contributions that are deductible for tax purposes.

Proposals have been made for the establishment of a Federal insurance program, commonly referred to as "reinsurance," to make up for any loss of benefits due to an insufficiency of assets in the event of termination of a private pension plan. A pension insurance program for qualified plans presumably would operate as follows:

1. The amount at risk would be defined as the difference between the value of benefits for service to date and the value of the assets at hand.
2. Premium rates would be set.

3. The product of (1) and (2), for any given plan, would be contributed to an insurance fund.

4. When a pension plan termination occurs and an employer is not able to continue contributions, any asset deficiency would be made up out of the insurance fund. Possibly the insuring agency would take over the assets of the plan at termination and then undertake to provide the benefits out of the insurance fund.

The idea of insuring pension obligations might at first glance appear to have considerable appeal. Failure to receive anticipated pension benefits unquestionably would be a serious financial loss to plan participants and their beneficiaries. Certainly it would be desirable to be able to assure employees that they need not be concerned about loss of pension benefits. From the employer's standpoint, the availability of insurance might seem to relieve him of the responsibility for setting aside adequate assets to meet pension obligations when they become due.

Insurance would not, however, avoid the necessity to have adequate cash to meet pension obligations. It would merely transfer this responsibility from individual employers to the insuring agency. Thus, the only advantage of an insurance program for private pension plans would be the spreading of the risks among a large number of employers.

However, there are several aspects of a pension insurance program which should also be given careful consideration. Defining the amount at risk would require exceedingly complex rules and regulations, particularly for plans which do not grant a specific benefit for each year of service or for plans with formulas under which Social Security is deducted. It would seem that actuarial assumptions and valuation procedures would have to be specified and standardized by the Government. Funding practices would probably require centralized control; otherwise, some employers would have an incentive to minimize funding and pass the risk to other employers. Plan amendments would have to be regulated and controlled in order to prevent unwarranted increases in benefit obligations, for example, prior to termination of a plan.

If uniform funding requirements were established, they would further reduce the employer's choice in the timing of his contributions and might discourage the adoption of new plans. Rigid requirements may also lead companies to put all or part of their programs on an unfunded, pay-as-you-go basis, leaving the employees both insecure and uninsured. Consideration also should be given to the penalties which would apply if an employer failed to meet the funding schedule. Can a distinction be made between insufficient contributions and unwise investment decisions? If not, will the insurance also cover the risk of investment loss? And will this lead employers to make speculative investments, the risk to be borne by the insurer or other pension plans?

Difficulties also arise in determining a proper premium structure. A conservative schedule might unduly impede the growth and liberalization of plans. In the absence of valid statistics and a clear definition of the risk insured against, however, the initial premiums would have to be set high. The alternative to high premium rates would be Federal underwriting of the insurance program out of the general revenues.

Should the premium rate be the same for all companies? If the rates vary for each class of company, what criteria should be used to measure the extent of risk in each case? Obviously the risk of termination is much smaller for some employers than others. Should strong companies be burdened to take care of the marginal companies? If so, what is to prevent a strong company from funding its own benefits, thereby avoiding any subsidy to the insurance system? Would not the progressive elimination of the strong employers from the system in time lead to increased premium charges on the weaker companies and place them at a further competitive disadvantage in the labor market?

There can be no disagreement that avoidance of unexpected loss of pension benefits is a desirable objective. However, an insurance program administered by the Federal government on a mandatory basis for all employers would drastically decrease the flexibility which is such an important feature of the private pension system. Extensive and complex Federal regulations probably would be required to assure uniformity of actuarial assumptions, investment programs, asset valuation and funding practices. In short, it is not possible for private pension plans to be tailored to meet the characteristics and needs of individual companies and groups of employees and also meet uniform insurance requirements.

The Committee believes that a Federal pension insurance program would be costly, impractical and unnecessary. The regulatory requirements of such a program would seriously impinge upon the operations of private pension plans. It would be preferable to place greater emphasis on (a) adequate funding within each private plan and (b) full disclosure to plan participants regarding the extent to which benefit obligations have been provided for through accumulation of fund assets.

SECTION IX

Fiduciary and Disclosure Responsibilities

Isolated instances have come to light where individuals, by virtue of their position as the dominant trustee of a pension fund, have diverted assets to their own account or misused assets in the fund to further their own interests. These findings have led to recommendations that Federal statutes be enacted to safeguard the rights and interests of participants and beneficiaries of employee benefit plans from abuse, impropriety and criminal activities.

Since there have been only isolated instances of abuse, legislative action should not impose unwarranted burdens on the overwhelming majority of plans which have been well run. Consistent with this philosophy, the Committee believes that the following points merit support.

> Fiduciary Responsibility. Every person who receives, disburses, or exercises any control or authority with respect to any employee pension, profit sharing or other welfare benefit fund should be deemed a fiduciary. The fiduciary's standard of conduct should require that the funds be handled with the same degree of care and skill as a man of ordinary prudence would exercise in dealing with his own property.

Defining and extending the scope of fiduciary responsibility to all persons in control of employee benefit funds are desirable steps. Proposals to accomplish these steps should be endorsed. However, these proposed rulings should be restricted to those persons who are responsible for handling and managing plan funds since the bonding requirements of the Welfare and Pension Plans Disclosure Act provide protection against fraudulent action by others who are responsible for operating the plans and determining the beneficiaries.

Care should be taken to be sure that the effort to assure a high standard of conduct of the trustees does not, through detailed prohibitions, impair their ability to meet changing investment conditions. The standard of fiduciary responsibility to which the trustees should be held is most simply achieved by reference to the "prudent man" rule and existing state law. Proposals which go beyond existing trust law by including specific prohibitions on the trustees' activities, in addition to the "prudent man" rule, do not at this time appear to be necessary. These proposals also run the risk of confusion between the Federal and state trust law and place unknown and unmeasured additional burdens on the fiduciary.

Application of the "prudent man" rule should be sufficient to preclude the necessity for specific prohibitions. The "prohibited transactions" rules of the Internal Revenue Service already limit the unwarranted use of pension funds to the advantage of the establisher of the fund.

> Disqualification of a Fiduciary. A fiduciary of an employee benefit fund should be disqualified under certain conditions.

Proposals have been made which would disqualify certain individuals from fiduciary positions in employee benefit funds. For example, a person who has been convicted of a felony or prior dishonesty in the use of other funds should be disqualified from holding any fiduciary position.

No amount of reporting and regulation will prevent losses if dishonest or irresponsible persons are permitted to handle trust funds. An individual who has been convicted of a serious criminal act, or whose dishonesty has been established, should be denied for life the privilege of acting as a fiduciary for one of these funds.

> Disclosure. Revision of the present Welfare and Pension Plans Disclosure Act gives protection against wrong-doing on the part of the fiduciary. Added protection could be gained by requiring each fund to have an annual audit made by an independent certified public accountant.

Under the 1959 Welfare and Pension Plans Disclosure Act, employers are required to submit to the Labor Department on the prescribed Form D-2 certain information concerning the pension plan operations. This form was recently revised to provide considerably more detail on plan operation. This revised form should be evaluated over a period of time before plan administrators and Government agencies are burdened with a mass of additional regular filing of detailed data.

The Committee believes that added protection could be gained by requiring employee benefit funds to be audited annually. To avoid duplication of effort and unnecessary expense, those funds which are subject to existing examinations and review, such as those required for insurance companies and banks, should not have to undergo duplicate examinations.

> Remedies. An efficient, clear and easy method of

remedying any abuse or impropriety disclosed should be developed.

Existing law presents difficult jurisdictional, procedural and substantive legal questions which have often impeded an individual's right to remedy the situation. The Committee believes that the Secretary of Labor, upon a showing of reasonable cause, should be invested with the right to investigate and, through the courts, to enjoin and to recover assets on behalf of the fund and to bring action to appoint or remove fiduciaries. Individual beneficiaries should also be given the right to seek remedial action.

The principle of making a remedy easily available can be wholeheartedly endorsed. Insofar as possible, however, the legal remedies should be enforced by local courts equipped to handle this type of case rather than by Federal courts. Provision should also be made for the absorption of the legal costs of both parties involved in litigation by the party whose position is held to be untenable by the courts.

Personal Liability of Fiduciary. In addition to the present requirement of the Disclosure Act that any fiduciary be covered by a reasonable bond, recovery of assets in the event of abuse or impropriety should be provided by subjecting a fiduciary to full personal liability for willful misconduct and gross negligence.

Making the remedy meaningful is an appropriate and logical part of improving the standards of fiduciary responsibility. Consequently, making the fiduciary personally liable for wrong-doing and requiring him to be covered by a bond can be endorsed. Any change in the law should also include a provision to allow discharge of the fiduciary's responsibility after a reasonable period of time through an appropriate statute of limitations.

SECTION X

Summary

Private pension plans in the United States have grown rapidly since 1940 and now cover more than 25 million people. Benefits have been liberalized as plans have matured and living standards have increased. Employers have adopted improved methods and techniques for assuring that adequate funds will be available to pay promised pension benefits when they become due. Adaptation of plan provisions to meet individual needs of employers and employees has been a unique and highly desirable characteristic of private plans. Labor unions have had a vital part in determining the pattern of benefits which has been established to take into account the needs and desires of their members.

Today, proposals are being made which would impose additional Federal regulatory controls over the private pension system. These proposals appear to be based on the unwarranted assumption that there is a fundamental conflict between the goals of private pension plans and the public interest. Some proposals would be far reaching in effect and would jeopardize the existence of the private pension system as a significant social and economic factor in this country.

The Committee on Employee Benefits of the Financial Executives Institute has prepared this study to assist the members of the Institute in their analysis and appraisal of legislative proposals relating to the private pension system.

The Committee stresses the rapid growth and tremendously beneficial social effects of the private pension system. It notes the stabilizing influence which private pension plan operations have had on the economy and underscores the fact that the growth of private plans has been accomplished by a fine balancing of the interests of owners, managers, labor leaders and plan participants.

The Committee suggests four concepts which should serve as a basis for determination of public policy on private pension plans.

Concept 1

Public policy should encourage flexibility in plan design to meet the needs and desires of employers and employees in light of a company's individual situation.

Concept 2

Public policy should encourage adequate funding of pension liabilities so that benefit expectations can be fulfilled when they come due. Uniform funding requirements, however, should not be established.

Concept 3

Public policy should encourage private plans to inform employees fully as to all material factors bearing on the status of their pension benefits.

Concept 4

Public policy should require high standards of fiduciary responsibility for those individuals who are charged with administration of private pension funds.

Over 70 per cent of all private pension plans today have vesting provisions. The Committee notes that this percentage indicates the importance which has already been attached to this provision in the normal evolution of private plans.

After reviewing the financial principles underlying pension plan management, the Committee concludes that portability is impractical and is not needed, that advance funding should be encouraged but that uniform standards should be avoided, and that the insuring of pension plan obligations would be impractical, inequitable and unnecessary if sound funding and disclosure practices are followed. Since the overwhelming majority of companies with private pension plans have a definite program to fund pension obligations, the Committee feels that employees have reasonable assurance that they will receive the promised benefits when they become payable.

The Committee believes that private plans will continue to develop in ways that are consistent with the public interest. Rigid requirements covering vesting, portability, funding and insurance would be detrimental. Uniformity is certain to have a stifling effect on the growth of private plans. It is doubtful that additional laws and regulations in these areas would serve the public interest.

The Committee recommends that attention be focused on developing practical alternatives to the mathematical approach which the Treasury Department has proposed in Announcement 66-58 as a Social Security integration test. Alternatives suggested by the Committee would not only comply with the intent of Congress but would also provide needed plan flexibility and the degree of permanence essential to long-term commitments.

Public policy should encourage pension administrators to inform plan participants of material factors affecting the status of their pension rights and should require high standards of fiduciary responsibility. Specific recommendations were made by the Committee on fiduciary standards, qualifications of fiduciaries, disclosure of information to pension plan participants, and remedies in the event of pension plan abuses. The Committee recommends support of proposals which would strengthen laws and regulations governing these areas.