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[Meuche, Arthur J.

SUCCESSFUL PENSION PLANNING.

[2d ed.]

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SUCCESSFUL PENSION PLANNING

By

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Pension Specialist

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PREFACE TO SECOND EDITION

Successful Pension Planning was written in 1949 as an introduction to basic problems of pension planning for the convenience of employers and others who faced these problems for the first time. The reader will recall that 1949 was the year of the steel strike and the Presidential Fact Finding Board which brought the issue of pensions and other "fringe benefits" to everyone's attention. It will also be recalled that there was hardly any literature on the subject available at that time, particularly of the type that could be absorbed in one reading by those who did not wish to become experts in the field but nevertheless had to be prepared to make important and far-reaching decisions on pensions. This booklet was written to fill that need.

Much of the general information in the original edition is still valid. However, many specific questions have since been answered and new trends have developed which require appropriate treatment after so many years. Inasmuch as there is still need for general pension information in readable form but in the light of conditions existing today, we thought it advisable to undertake a complete revision of the booklet, retaining, however, the basic approach of the original version. Again, we have restricted ourselves to pensions and closely related topics without trying to cover the broader field of "fringe benefits." We hope that this effort will find the same gratifying response as the first edition in 1949.

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CHAPTER (1)

DO I NEED EXPERT ADVICE?

HOW THE ADOPTION OF A RETIREMENT PLAN COMPARES WITH OTHER BUSINESS TRANSACTIONS

If you are thinking about a pension plan, the chances are that you do so for one or more of three reasons:

(1) Many of your employees are getting on in years. In every business, there is a core of executives and skilled men and women who are responsible for the success of the enterprise. They all started to work at about the same age and they have grown old together. They are entitled to financial security when younger people must take their place.

(2) Other companies in your industry or in your locality have adopted plans. You may feel that you are at a competitive disadvantage in the labor market unless you also establish a plan. Rightly or wrongly, even young men and women are far more security-minded today than they were only a generation ago.

(3) Your employees have requested a plan, or their unions demand one. Perhaps pensions have been part of the "wage package" for some time in your enterprise but the bargaining representative of your employees demands an extension of benefits to make them more attractive in comparison with programs negotiated by other unions.

Certainly you need no advice to find any of these reasons. They present themselves, gradually or suddenly, as the case may be. Who would know more about the needs of a business enterprise than its management? But can you afford a plan? It is easy enough to determine what it would cost for the first year or two to pay a given amount of retirement income to those entitled to it. But what will the probable cost be ten or twenty years hence? Let us stop to think about this question and the answer to it.

Suppose you were able to tell what the plan might cost ten or twenty years hence, and the amount seemed rather high. Could you adopt the plan anyway with the reservation that you may abandon it if it should prove too expensive? The answer is *no*. Of course, you will reserve the right to curtail benefits under the plan or to terminate it altogether. However, being free from legal obligation does not mean that you are also free from moral obligation. No matter how carefully such legal reservations are phrased, they mean nothing to your employees. Even if pensions are not funded by insurance contracts or trust funds, but instead are paid out of earnings, curtailment or termination would be a major shock to employer-employee relations. If the plan is funded and your company has received the benefit of tax deductions for premiums paid or deposits made, the Internal Revenue Service may, retroactively, cancel that benefit unless business necessity can be shown. The interpretation of the term "business necessity" is rather strict. Certainly, failure to earn dividends for a year or two would not be sufficient to establish it.

The difficulty of terminating a pension plan marks the adoption of such a program as a major business decision. Therefore, you will want to know all there is to be known about pension plans before you make that decision. But can you find all the answers by yourself? We asked a question before that sounded simple enough: What will the probable cost be ten or twenty years hence? To answer that question, one must allow for mortality, turnover and salary or wage changes. In many cases, one must be familiar with probable investment returns and other factors. To evaluate all such factors properly requires long and continuous experience in planning retirement programs. The average employer has no occasion to acquire it.

But this is only one question! There are hundreds more which occur in the course of planning a retirement program. Some have financial, some have legal and some have actuarial aspects. Each should be considered in the light of all the others to bring the entire program into proper balance.

While this booklet is addressed primarily to employers, there is no reason why it cannot serve also the needs of union leaders, particularly those who represent workers employed in many small enterprises who need pension security provided by a joint effort of the respective union and the multi-employer group.

PRECEDENT AS A SUBSTITUTE FOR PROFESSIONAL ADVICE

Of course, you are not the first employer who ever adopted a retirement program. Why should you pay fees for professional advice if there are so many other plans that have been in existence for years? Some are maintained by your competitors who operate under similar conditions.

A business enterprise is a living organism. It has its own history, its own peculiar problems. If you would blindly copy another employer's plan, you would take as much of a chance as a sick person who takes the medicine prescribed for someone else just because he feels that he has symptoms of the same disease. Should he not rather see a doctor?

This is why industry-wide bargaining may not always lead to satisfactory and permanent retirement programs. The cost of a given program may very well be within the limits of one company's budget. Adoption of the same program may force another company to reduce dividends or abandon important plans for expansion.

But financial considerations are not the only ones which make it impractical for one employer to adopt another employer's plan. Suppose for instance, that one company has a large group of old people who must be retired soon after the plan becomes effective. Many of the employees will not be able to earn adequate pensions for service after adoption of the plan, provided that length of service is to determine the size of the pension. Consequently, the company should make more than average allowance for service prior to adoption of the plan.

Suppose another company has a very simple production process. For 90% of the jobs people need little more than two weeks' training or so. Rates of compensation are relatively low for the majority of employees. Consequently, the pension must be larger in proportion to earnings than in another company where the level of earnings is higher, if the pension is to be above a subsistence minimum.

Take another company which is located in the same city with several others engaged in the same type of manufacture. Therefore, employment opportunities are plentiful and most of the younger people change their jobs frequently. Under these circumstances, it is logical for the company to insist on a long waiting period and a high minimum age for admission to its plan.

These are only a few of many possible situations that call for specific treatment. An existing plan may appeal to your way of thinking. However, you realize that your own specific requirements call for a change in some of the details. Such changes may be as dangerous as it would be to change a single gear in a complex machine. Even a minor adjustment in one place may require changes elsewhere to assure smooth functioning of the entire program. The busy executive cannot trust himself to possess the perspective which is needed to spot the flaws in a "home-made" plan.

This does not mean that you cannot gain from the study of existing plans. Such a study is indeed an excellent way of getting ideas. But you should leave it to a specialist to weave the scattered threads into a harmonious pattern. Then you may be certain that the result not only complies with existing laws and regulations but also accomplishes the most for your business and for your people.

SOURCES OF ADVICE

If you want technical advice on pension matters, you have at least four different sources to turn to:

(1) Consulting actuaries or pension consultants;
(2) Printed information in various loose-leaf services;
(3) Trust companies;
(4) Life insurance companies or agents.

Consulting actuaries are needed to service trusteed retirement plans. In that capacity they have countless opportunities to study plans in operation. Many of them received their early training in the actuarial departments of life insurance companies. With that background, they are eminently qualified to advise companies in connection with the installation of new plans. Naturally, they are not in a position to render their services free of charge. They ask fees in proportion to the amount of work involved. (These charges are small in proportion to the economies achieved by employing the trusteed method.) If you decide to fund your plan by means of a trust, they will, of course, expect to render the necessary actuarial service after the plan is established.

Some pension technicians operate as so-called independent consultants. Like actuaries, they charge a fee for their service.

Trust companies are in the business of giving trust service for so-called self-administered retirement systems. Most of them have not solicited this type of business as long as life insurance companies. However, a number of trust companies are well equipped to give reliable consulting service. They render this service free, in the hope that they will be appointed trustee of the plan. However, if the trust company has contacts with you in its commercial banking department, it will make its pension consulting service available to you without regard to a prospective trusteeship.

Life insurance companies and agents are in the business of selling, in addition to life insurance, individual and group annuity contracts. Many of them do a large volume of business and are, therefore, well versed in the technical details of retirement plans. They do not charge a fee for consulting service, in the expectation that you will select insurance contracts as the medium of funding your plan.

In practice, the division between these sources of advice is not quite as clear cut as it appears from this brief description. For instance, there are some insurance brokers operating on a large scale who maintain competent actuarial departments. Therefore, they are equipped not only to design a plan, but also to service it after installation, if an employer decides in favor of the trusteed method of funding.

Also, many individual insurance agents who have wide pension experience will make a sincere effort to present cost data and other pertinent information on various funding methods or combinations of methods.

It would be unfair to single out any of the above sources as being better equipped than another to give you constructive advice. Rather than judge them as a class, you should consider their individual qualifications as they become apparent by interview and reference to other cases they have handled.

EVALUATING ADVICE

If you are satisfied that your advisor knows what he is talking about, you will, of course, still remain on guard. Even if the advice is good, is it unbiased?

It might as well be stated right here that there is no completely unbiased advice on pensions, any more than there is in other fields. It is up to you to discount your advisor's self-interest and background. But you are no novice at that.

Bias on the part of a pension technician is not as dangerous as it seems. It should always be remembered that the plan itself is the important thing. The method of funding it, if it is to be funded, is incidental. This question should be decided upon after the plan is formulated in every detail.

Since there are primarily two classes of competitors for the business if your plan is to be funded, insurance companies and trust companies, you might consider selecting two advisors. One should be a consultant whom you suspect of bias in favor of an insured type of plan, the other should be a consultant who might be expected to lean toward the trusteed type of plan. If you compare the suggestions of both, you may find very little difference in the structure of the plan. When the time comes to decide upon the method of funding, both will put their best foot forward. They will not only present the advantages of their favorite method, but also the disadvantages of the competitor's method. As a result you will have a better picture than you would have if it were possible to obtain completely unbiased advice.

There are, however, many good reasons why nearly two-thirds of all pension reserves today are held in trusteed plans. These reasons are discussed in Chapter 7.

The information obtained from experienced pension technicians must be coordinated with the opinions of specialists inside your organization. As mentioned before, a retirement plan involves financial considerations which are the province of the treasurer or comptroller and perhaps should be discussed with the outside auditor. There are questions of personnel policy and employee relations which should be referred to the proper officials. Finally, there are legal aspects which require the attention of counsel. Sometimes an employer will even consider the appointment of special counsel if the situation warrants it.

SUMMARY

The adoption of a pension plan is a major business transaction. Once established, a plan cannot be dropped easily. It is also a highly technical matter which is well worth the attention of specialists.

You may be tempted to save the expense of expert advice and adapt some existing plan to your needs. You may want to make some changes in the model plan to allow for circumstances peculiar to your organization. However, even a minor change in one place frequently calls for adjustment in others. Only specialized experience can provide the perspective necessary to understand fully the relationship between the various parts of the entire program. Consequently copying someone else's plan is a poor substitute for expert advice.

There are several sources of advice to which you may turn. For reasons of self-interest or background, all technicians are biased and lean toward either one of the two principal funding methods, insured or trusteed. You should realize that the plan itself is the most important thing and that the funding method involves primarily financial considerations which may be decided after the program is formulated in detail. If you consult two advisors, one of each school of thought, you are likely to obtain the best possible picture.

In addition to the help of outsiders well versed in the field, the plan should receive the attention of the financial and personnel officers of your company, as well as the attention of legal counsel, before it is finally decided upon.

CHAPTER (2)

WHEN SHOULD PEOPLE RETIRE?

IDEAL RETIREMENT AGE

Have you ever listened to a mixed group of young and middle-aged people discussing the proper age for retirement? If you have, you must have been amused. Invariably young people will mention 50 or 55 as an ideal retirement age. The older people are satisfied with a much later date, if they like the idea of retiring at all.

What could be the reason for this change in attitude as a person gets older? To the young who have not as yet attained positions of responsibility, retirement means freedom from work and freedom for play. It is a vacation, and vacations are so much fun. Gradually the average individual loses the zest and the ability to play so hard. His idle hours do not seem to be half as much fun as they used to. His work begins to absorb more and more of his interest. He need not be an executive to think that his work is important. The foreman in the factory, or the experienced and competent craftsman anywhere shares the same feeling. To many of these older people, the thought of retiring is intolerable. Why should they give up their principal remaining interest in life?

Of course, both the young and the old are wrong. Retirement is neither a permanent vacation nor a period of utter uselessness. Retirement can be an opportunity to do the things a person wants to do. Many enjoy retirement and look forward to it, although employers often see fit to spend substantial sums for retirement counseling services provided by specialists. Those who do not look forward to retirement may have other than psychological reasons. Certainly, it would not be feasible to let people elect their own retirement age. But how should the ideal retirement age be determined?

Would you feel safe stepping into a commercial airplane that is piloted by a man of 70? Would you care to see a man in your plant carry heavy loads if you knew that he had a serious heart condition? Of course your answer is *no* to both questions.

Now we approach the solution to our problem. The ideal retirement age should depend on the occupation of an individual and on his physical condition. Naturally the pilot's experience would be welcome in many a ground job after his usefulness in the air is over. But it is questionable if he is fitted for a position which would pay him as much as he has been accustomed to earn. A man whose income is substantially reduced is not a happy man. The same is true of the worker in the plant. Perhaps another job could be found for him that is less strenuous, but it would probably pay less.

Not many occupations put as high a premium on youth as that of a pilot. Not every case of disability is as dramatic and sudden as serious heart disease. The infirmities of old age are slow in coming to most people. A little poorer eyesight now, some rheumatic pains later, and so on until the human machine begins wearing down noticeably. But there is "par" for every job. And most jobs are teamwork. If there is one weak member on the team, the team may lose. Obviously then, the problem is to spot the weak members in time.

This is not a practical way to solve the problem, and that is why we have been speaking of the "ideal" retirement age up to now. Many people would successfully hide their infirmities; others would be able to resist retirement with their influence. In principle, teamwork is just as important in the executive offices as it is in the plant. Therefore, we will have to find a more practical way to determine the proper retirement age, even if it involves a compromise.

NORMAL RETIREMENT AGE

Your pension plan is a substantial investment that entitles you to a tangible return. Your plan must pay dividends in the form of greater efficiency within your organization.

You are probably convinced by now that it would be impractical to retire each individual member of your working force at the precise point at which he is no longer able to keep up with the team. Therefore, a uniform age must be established as the "normal retirement age". At that point, everybody must step aside, no matter what his physical condition is.

What should be the normal retirement age? Let us see if history can help us find it.

Maintenance of efficiency has not always been the primary purpose of pensions. In the days when the pace of life and work was slower than it is today, pensions were intended to assist those who were no longer able to do any work whatsoever. The proverbial "three-score-and-ten" seemed to be the point at which it generally became difficult to tell if a person's infirmities were due to his age or if they should be considered as illness. Disability allowances were provided for those who were unable to continue working at an earlier age.

The state laws providing old age assistance fix the qualifying age at 65, and when federal old-age benefits were provided under the Social Security Act of 1935, 65 was established as the age at which benefits become payable.

Social Security benefits, as small as they may be for the higher-paid employees, represent a welcome and, in many cases, necessary supplement to the pension under a private plan. Therefore, it is not surprising that most industrial retirement systems today fix 65 as the normal retirement age.

Under some plans, women are retired at 60. It is not entirely clear how that practice developed. There is no physiological basis for it. As a matter of fact, the average life expectancy of women exceeds that of men by several years. Consequently, pensions for women, on the average, must be paid for a longer time than those for men. As a result, they are proportionately more expensive to provide even if the same retirement age is used for both sexes. If women are retired at 60, the pension is frequently supplemented by an additional payment for at least two years to compensate for the absence of Social Security benefits which do not become payable until age 62 or 65. Because of the additional cost, the practice of retiring women earlier is no longer as common as it used to be.

Some companies have special problems in choosing a normal retirement age. For instance, people who are natives of the temperate zone but spend years in the service of foreign branches or subsidiaries where they are subjected to the rigors of unfavorable climates, may have to be retired as early as age 55.

Other companies may establish a somewhat lower retirement age for certain groups within their working force. It is conceivable, for instance, that a company which markets its products by door-to-door selling may want to retire members of the sales force earlier than production workers.

Aside from common usage, cost is the most potent factor influencing the choice of the normal retirement age. It is a fairly accurate statement that the cost of a pension plan is increased by 50% if employees are retired at 60 instead of 65 (if the pension is to be the same). There are also some broad social and economic factors involved which we shall investigate later.

EARLY AND LATE RETIREMENT

No matter how carefully your pension plan is designed, it cannot provide an ideal solution for every possible situation. Unusual circumstances may arise from time to time in which some provision of the plan inflicts a real or apparent injustice. However, a number of such situations occur frequently enough so that hardships can be prevented by a small amount of flexibility in the plan.

For instance, you will find it advantageous to provide some flexibility as to retirement age. Now and then, an employee will not be able to remain in service until his normal retirement age. He need not be disabled in the proper sense of the word — he is just aging a lot faster than most people. This makes him hard to get along with. If he has been a good employee, you will be glad to retire him ahead of schedule, if it is permissible under the plan. Most modern retirement programs provide for so-called early retirement within 10 years, or at least 5 years, before normal retirement date.

In most plans, the pension is reduced when a participant retires before his normal retirement date. The reduction is made in accordance with actuarial methods. The necessary calculations take the younger age of the retiring employee into account. Since he is younger, he may be expected to live longer. Therefore the pension, most likely, will have to be paid for a longer period than if payment started at normal retirement age. Percentagewise, the actuarial reduction is rather substantial. It may be as high as 35% of the normal allowance if an employee retires at 60 instead of 65. It may be as high as 55% if he retires at 55 instead of 65. Where such a reduction would involve exceptional hardship, supplemental arrangements may be made outside the formal plan.

In some cases, an employee may retire at his own volition; more often he must get the permission of the company. If company consent is required for early retirement, care must be taken that benefits in that case do not exceed those of an employee who terminates service at his sole choice. Even if employees have the right to retire, the reduction in their pension explained above generally prevents any real abuse of the privilege. Now and then, a participant may have other resources or an opportunity to establish himself in a business of his own. If he must ask your permission to retire earlier, under the terms of the plan, you are still well advised to let him do so. You have nothing to gain by forcing an employee to remain in service if he is no longer interested in his job. Besides, it costs you nothing more — although his pension will have to be paid over a longer period, it is smaller in amount.

In other cases, it may be to your advantage to let an employee remain in service after his normal retirement age. Perhaps he has some special skill, or he is an important executive, and there has been no chance to replace him in time. If the employee is in good physical condition, and he is willing to stay, you can keep him for a limited period, if your plan so provides. Such a clause was found very helpful by many employers during the acute labor shortage of World War II.

If your plan is a formal funded and "qualified" program, generally it cannot permit the employer to continue contributions for an employee after normal retirement date. As a rule, the pension payable at actual retirement must not be larger than the actuarially equivalent pension otherwise payable at normal retirement. However, the provision for additional benefits for service after normal retirement age must not result in discrimination in favor of highly-paid employees. More often the pension is identical with the amount the employee would have received had he retired on his normal retirement date.

The discretion to retain employees in service after their normal retirement date should be used wisely. Otherwise you might as well have no pension plan at all. It would hurt the morale of the younger people if those with the most desirable positions were allowed to cling to them indefinitely. That would not only prevent or delay the promotion of younger men and women, but it would also slow down the team.

The term "qualified" used above will be explained in detail in Chapter (6). It means, briefly, that contributions to the plan are allowable tax deductions, that income derived from accumulated pension reserves is not taxed to the trust (if the plan is funded through a trust), and that covered employees do not become subject to tax until they actually receive benefits or until benefits are made available to them.

SCHEDULED DEFERMENT IN FUNDED PLANS

If a young man starting to work at 21 had the foresight, the will power and the opportunity to save $10 out of each week's earnings, he would not need a pension plan to retire at 65. If he invested his annual savings of $520 at the end of each year at 3% he would have more than $46,000 to support him for the rest of his life when he reached the age of 65, provided the earnings from his investments were not subject to tax as they accumulated. And $46,000 is sufficient to buy a life annuity of almost $300 a month beginning then.

Suppose the young man gave no thought to old-age security, when he was 21. He is now 55 and wants to make up for lost time. How much would he have to save each week to be sure of the same life income beginning 10 years later? The answer is about $75. It is very doubtful that he can save that much, and very likely he will have to postpone retirement for several years after he reaches the age of 65.

Perhaps you should have adopted a pension plan many years ago when the majority of your employees were young and when it would have taken only a small annual payment to accumulate enough money for their pensions. Perhaps a large number of your employees are now 55 or 60 years old and there is little time left to accumulate the reserves for their pensions. Hence, the annual payments which you must meet will be rather high.

Many employers who find themselves in that position resort to a staggered retirement schedule during the early years of a plan. For instance, employees who are older than 55 when the plan is adopted may be retired 10 years later instead of at age 65. That would mean that an employee who is 58 when the plan becomes effective retires at 68. Other programs provide that employees over 60 retire five years later instead of at age 65. That would, of course, mean that an employee who is 62 when the plan is adopted could not retire until he reaches age 67. Usually a maximum age, such as 70, is fixed beyond which retirement will not be postponed.

Some employers like to adopt a staggered schedule of retirements for psychological as well as financial reasons. They like to give the older employees a period of grace during which they can get their house in order and prepare themselves mentally for the days of comparative idleness ahead.

These arrangements also have a disadvantage in that a large number of employees will be retired almost simultaneously, around either the fifth or the tenth anniversary of the plan. In some cases, it will be quite a problem to compensate for this sudden depletion of the working force.

At first glance, the simplest solution of the problem presented by large numbers of old employees is to exclude them from the plan altogether. Many programs do not cover employees over 55 or 60. If you choose this solution, your plan will do only part of the job it is intended to do. There is a strong likelihood that you will incur either pension costs in addition to those under the plan (by payments made directly out of earnings), or hidden payroll costs (by keeping people on the payroll who have become useless).

Therefore, it is probably preferable to make provision under the plan for the old employees who are on the payroll when the plan is adopted. However, if employees over 56 or 60 are hired in the future, there seems to be no reason why they should be entitled to any pension. It is better for them to have employment opportunities without the promise of old-age security. Very likely they would not have such opportunities if their employment automatically saddled a company with high pension costs. Such policies, of course, should not violate non-discrimination laws in effect in various states.

FUTURE TRENDS

From time to time in recent years, statements have been published in the press which have led people to believe that the average duration of life may soon increase to biblical proportions. Such statements are based on misinterpretation of vital statistics.

What is happening primarily is this: Thanks to medical skill and improvements in living conditions, mortality has been reduced tremendously at the younger ages. Consequently, death has been postponed for many from a lower to a higher age. The total span of life, however, has been increased only to a limited extent.

In trying to forecast future trends as to retirement ages, it does not only matter how long people live after they are retired, but also, how many are likely to reach retirement age. Some authorities estimate that by 1965, 17.3 million of the population in the United States will be 65 or older. According to the figures of the Bureau of the Census, the same segment of our population comprised only about 10 million in 1945. If the estimate for 1965 turns out to be correct, this is truly an impressive increase in 20 years. It certainly gives cause for serious thinking about some popular beliefs. Many people seem to feel that, within our times, retirement at 60 or even earlier will become the accepted standard. Very likely the reduction in the work week from 48 to 40 hours in our recent past has done much to create that notion. Less hours of work in a week, less years of work in a lifetime.

We have already mentioned the attitude of the older people toward retirement. Many of them would not welcome added years of idleness. But how would a general reduction in the working life affect the nation as a whole? It is entirely possible that further technological improvements will enable us to maintain a high standard of production with a smaller number employed. But it is not so certain that we can spare the experience and mature judgment of older people.

If medical knowledge succeeds in conquering some of the degenerative diseases which still take a heavy toll of people in the older age groups, several years will be added to the average life expectancy of pensioners. As one authority puts it, the aim should not only be to add years to life, but to add life to years. That happy solution would probably lead, not to a reduction, but to an increase in the working life. In other words, it may be that, 20 or 30 years hence, people will retire at 70 instead of 65.

SUMMARY

It would be impractical to let employees choose their own retirement age. The ideal time to pension them would depend on their occupation and their physical condition. Since it is impossible to determine, in each individual case, the precise point at which an employee is no longer able to keep up with his working "team", a uniform retirement age must be fixed.

History and the Social Security Act of 1935 have established 65 as the generally accepted retirement age, although there are some notable deviations. Cost is the chief reason why younger retirement ages are the exception.

To deal effectively with special situations, it pays to provide some flexibility in a plan to permit retirement before or after normal retirement age. This does not necessarily add to the cost of the program. The discretion to retain people in service after normal retirement age should be used wisely so as not to endanger the effectiveness of the plan.

Where the average age of the covered group is high at adoption of a plan, it may be advisable to stagger the retirement of people over 55 or 60 for a 10- or 5-year period. The exclusion of the older group from the plan to hold down costs, however, may only shift the expense from the plan to the payroll.

Although many people seem to think that retirement ages in general will be lowered materially in the future, proper analysis of mortality trends seems to indicate the opposite.

CHAPTER (3)

WHAT IS AN ADEQUATE PENSION?

GENERAL APPROACH

How large should a pension be? This is an important question for you to decide. Unless you find a satisfactory answer, your plan will not work properly.

Why? A pension must be large enough to provide an adequate standard of living for a retired employee, or he will not want to retire. If he is forced to retire on an inadequate pension, he might well become a social problem in your community. Needless to say, this would have a damaging effect on your public relations.

You are, of course, aware that your retired employees are living testimony of your plan's value. If they cannot make both ends meet, the active employees will know it. They will suspect your motives. If the plan is contributory, they will hate to part with the required payroll deductions. If participation is optional, many will not apply for membership at all. Of course, membership in the plan is usually made a condition of employment as to those who are hired after the plan is established. However, it would be unwise to force employees to join who are already on the payroll when the plan is adopted. If they are not sold on the plan, they will consider their contributions as an unwarranted deduction in their take-home pay. If many employees remain outside the plan, you will face another problem: What shall be done with those who are not entitled to a pension under the plan when they reach retirement age?

In your search for an adequate pension standard you will want to find out how others have solved this problem. What pensions are provided by other companies, particularly your competitors? When you study existing plans, you will discover that most of them fall into either one of two categories:

Some provide a pension in the form of a percentage of pay or a fixed amount which, in the planner's mind, is sufficient for a decent standard of living. In the other and probably more prevalent type of plan the amount of the pension varies with years of employment. This method is preferred by those who feel that pensions are not only a matter of sound business, but also a reward for faithful service.

One would expect that employees generally think of pensions as a reward for years of service. But what of the flat monthly benefits of $100 or $150 which were so prevalent in plans some years ago and are reflected even in more recent programs? Well, history has already given the answer in many cases and the flat amount has generally become a minimum for a relatively short period of service while the pension formula appropriately recognizes higher than average pay and greater than average length of service.

By far the majority of plans established during the last 15 or 20 years are linked in some way to Social Security. Often the combined retirement income from both sources is somewhere in the neighborhood of 50% of annual earnings during employment. But under many plans a participant must have spent most of his active years in his employer's service to qualify for that percentage.

Fifty percent is an arbitrary standard. Undoubtedly it is based on the obvious reasoning that an employee should not receive as much for being idle as he did for working. So 50% seems to be the golden mean.

Of course, a 50% pension will not provide a life of ease for your retired employees. They will have to make some adjustments in their way of living, and they should have some savings of their own. But they will be protected from actual want and from becoming a burden on their families or the community they live in.

METHODS OF DETERMINING PENSIONS

Plans which make little or no allowance for length of service provide a pension which is either a flat percentage of pay, or a uniform dollar amount. Those plans which recognize length of service provide a unit of pension for each year of employment. The basic mechanics of these three types of plans will now be briefly explained.

Flat Percentage Plans

Participants receive a pension of 25% or 30% (or some other reasonable percentage) of their average or final annual earnings. Often a proportionate reduction is provided for people whose years of service total less than 15, 20 or 25.

Service over the required minimum is generally not recognized, although there are some notable exceptions. For instance, a plan established some time ago for the employees of a well-known company provides a basic pension after 20 years of service. The amounts are on a sliding scale ranging from 50% of final earnings in the lowest bracket down to 18% of final earnings for the highest-paid employees. For each year of service over 20, a participant becomes entitled to an additional 1½% of his basic benefit.

For instance, an employee who earns $50 a week and has 30 years of service to his credit when he retires, is entitled to a basic benefit of $85 a month. In recognition of the additional 10 years of service, he receives another $12.75 a month (1½% of $85 times 10).

This may seem complicated but it accomplishes two purposes. First, it tends to reduce the difference between the pensions of high- and low-paid participants. Obviously, the designers of this plan felt that the low-paid employees should receive a larger percentage of their earnings than the higher paid. Second, it gives some limited recognition for more than average length of service.

Uniform Benefit Plans

Someone has made the statement that people cannot live on percentages. Unions apparently followed the same line of reasoning in their drive for uniform benefits.

Indeed there is some justification for the principle of a uniform retirement benefit as far as hourly-paid employees are concerned. Their earnings do not vary as greatly from man to man as they do among salaried employees. Also, the annual earnings of wage-earners are normally subject to much greater fluctuations, over the years, than salaries. Therefore, a pension based on a percentage of earnings might be very small where an employee has served a company during a prolonged period of low wages.

Usually the concession is made that a participant must have served the company at least 20 years when he retires, to be entitled to the full pension. For shorter periods of service, the amount is scaled down proportionately. But frequently the unions have tried to avoid a reduction in the amount of pension by means of a flexible retirement age. They like a provision in the plan which will permit a participant who, for instance, completes only 15 years of service at retirement, to remain in service for another five years so that he may qualify for a full pension. But, as we have seen in the preceding chapter, failure to observe a mandatory retirement age is not good pension planning.

Another characteristic of these programs is that participation is usually limited to employees who are represented by unions. As a result, the employer is not identified with the plan. He receives no credit, although he is usually expected to foot the entire bill. If the program is industrywide, individual employers have a limited voice in the management of the fund.

Unit Credit Plans

For each year of membership, participants earn an annuity of 1% or 2% (or some other small percentage) of their average or final earnings. The pension then consists of the total of these annual credits. If an employer chooses a low annual credit (1% has been used quite frequently), it takes many years of service to earn an adequate pension. Therefore, some choose a high annual credit, perhaps 2%, with the provision that the maximum pension shall not exceed 50% of final earnings, or some other limit. There are probably more unit credit plans than any other type in existence today.

AVERAGE OR FINAL PAY — SUPPLEMENTAL PENSIONS

We often speak of "normal" times, just as statisticians like to refer to the "average" American. In reality, neither one of these concepts exists. If we were to chart the average earnings of a group of employees over a period of 30 or 40 years, we would see the ups and downs reflecting the booms and busts of the past. But if we step back far enough to lose sight of minor variations from year to year, we would discern an overall upward trend in the curve. Because of this trend, pensions are larger if they are based on final instead of average earnings. The difference is greatest in the case of salaried employees who rise to executive rank in middle age.

Much attention was focused on this problem by the high cost of living following World War II. People who retired on pensions based on average pre-war earnings found it difficult to get along. If they were covered by plans basing pensions on final earnings, they would fare considerably better. But if an employee had retired just before the war at a pension based on final earnings, he would be affected nearly as much by the post-war rise in price levels.

Many companies have resorted to supplementing the lowest pensions out of current earnings to assure a subsistence minimum for everybody. In other words, they distinguish between the inconvenience experienced by retirees in the upper brackets and the hardships suffered by those in the lower. They limit their attention to the latter although in some cases a "cost of living bonus" has been added to everyone's pension. None of these supplemental awards becomes part of the regular retirement allowance. They may be withdrawn or reduced at any time when and if the price level recedes.

The problem has another aspect which is not related to general economic conditions. Many employees, particularly in the salaried class, earn very little during their early years of service. Later on they advance to positions of greater responsibility and a much higher level of compensation. With that advance, they expand their standard of living to more comfortable proportions. If their final pay is far above their average pay, and the pension is based on their average compensation, they face a difficult adjustment when they retire.

This is why many plans had been basing pensions on final earnings long before any upward trend in price levels became apparent. Some plans relate pensions to average earnings during the last 5 or 10 years of employment. A few use the average of the 10-year period during which a participant received the highest earnings. The latter provision has helped many who suffered substantial wage and salary cuts during the depression of the nineteen-thirties. It also protects people whose jobs require great physical exertion that they are not quite equal to as they approach retirement age. Frequently they must be employed at lower pay in less arduous tasks during the last 5 or 10 years of service. A pension based on final pay would reflect such reduced earnings.

VARIABLE ANNUITIES

In our discussion of the "trusteed" plan in Chapter 7 we are making brief reference to the growing practice of investing part of the pension reserve in common stocks. Since pension accounting is generally based on cost values, any appreciation in the value of common stocks need not be recognized until it is converted into a realized gain on subsequent sale of the stock. At such time the gain *must* be recognized and, of course, reduces future contributions. Benefits payable to participants are not automatically affected.

Since usually at least some of the appreciation reflects inflation which reduces the purchasing power of fixed benefits, the concept of the "variable" annuity has been developed in the last decade. This is a means of passing investment experience, good or bad, directly on to participants. Contributions to a variable annuity fund are converted into units and are eventually paid out in units. The dollar equivalents of these units vary, of course, with the value of the underlying portfolio. Generally, only up to one half of the annual contribution is committed to the variable annuity fund. Studies covering the experience of a hundred years or so prove conclusively that such double-barreled pensions more accurately reflect changes in purchasing power. One of the first variable annuities was adopted in the early nineteen fifties by the retirement system of the Teachers Insurance and Annuity Association. Many important companies have since followed suit, but the concept has not been as generally accepted as it deserves because employers are fearful that many employee groups would not react favorably if common stock values went down, even though the purchasing power of the dollar might show a corresponding rise at such time.

RECOGNITION FOR PAST SERVICE

When a pension plan is adopted, many employees are already 50 or 60 years old. In most cases some are already past retirement age. If such employees are to be retired under the plan and the retirement allowance is based on years of membership (unit credit plans), they must receive some recognition for service prior to adoption of the plan (past service). Otherwise their pensions will be too low.

To what extent should past service be recognized? For instance, if an employee receives a credit of 1% of compensation for each year of service after adoption of the plan (future service), is it proper to give him a credit of 1% for each year of past service? It is justified if the retirement allowance is based on final earnings. Then the pension is computed by multiplying the total number of years of service — before or after adoption of the plan — by 1% of final earnings (or whatever the annual credit may be). However, if the pension is to be based on average earnings, allowance must be made for the fact that many employees have already reached a fairly high level of earnings when the plan is adopted. If their pension for past service were based on their present rate of pay, they would receive retirement allowances far above those which younger employees will be able to earn in the future.

Whenever complete payroll data are available, the earnings of a participant since his hiring date can be determined. At best, this is a lengthy procedure, and most employers are satisfied to achieve a fair balance between past and future service by computing past service credits in one of the following two ways:

(1) By taking the average annual earnings of a participant during the 5 or 10 years before adoption of the plan and applying the regular annual rate of benefit (or a *slightly* lower rate) to this average, multiplied by the number of years of past service.

(2) By applying a substantially lower benefit rate to the earnings at adoption of the plan, and multiplying the result by the number of years of past service.

Some plans use a graduated rate for past service benefits. If a participant is so close to retirement when the plan is adopted that he can earn only a small pension for his future service, he is credited for his past service at a higher rate than younger employees. One plan, for instance, established the following scale of pensions for each year of past service:

AGE WHEN PLAN WAS ADOPTED	ANNUAL PERCENTAGE
60—64	1.5%
55—59	1.4%
50—54	1.3%
45—49	1.2%
40—44	1.1%
30—39	1.0%

Tests in actual cases will reveal what the difference between the past and future service rate should be to produce the desired result. Where the effective earnings at adoption of the plan are used to determine past service credits (approximation (2) above) the past service rate is often half or three-quarters of the future service rate. However, slightly different ratios have been applied here and there.

EFFECT OF ELIGIBILITY PROVISIONS ON PENSIONS

It takes time before an employee becomes "seasoned". Until then he cannot be considered a permanent member of an organization. In many companies the turnover rate among new employees is so high that the employer hesitates to enroll them in a retirement plan soon after they are hired. Many will terminate their service after a short period of membership, and at least a considerable amount of administrative work will have been done in vain. If the retirement benefits that would accrue to the employee during such a brief period of participation were purchased from an insurance company, the employer would also forfeit a small portion of premiums paid, to compensate the insurance company for its wasted effort.

However, if benefits under a plan depend on length of membership (unit credit plan), restrictions on eligibility affect the size of pensions. If you prefer a long waiting period or a high qualifying age, for the reason stated, you should examine the effect of these conditions carefully. For instance, if the majority of employees enter your service at 25 years of age and you consider a pension of 30% desirable, an annual credit of ¾ of 1% will be appropriate, provided that the employees may join the plan almost immediately (¾% times 40 = 30%). If, however, a waiting period of 5 years or a minimum age of 30 is required to qualify for membership, the annual credit should be increased to ⅞ of 1% to produce approximately the same retirement allowance (⅞% times 35 = 30.625%).

Many non-contributory plans for large groups subject to a high rate of turnover do away with the ordinary concept of membership altogether. This is certainly the case in most plans negotiated for hourly wage employees since 1949. When an employee reaches retirement age, the exact amount of his pension is determined. He then receives credit for his entire service since his hiring date. Because of the difficulty of accurately determining in advance the reserve required for each participant, such plans are limited to either the trusteed method or the "deposit administration" method offered by some insurance companies (see Chapter 7). If you expect participants to contribute, a definite qualifying period or age is required.

MAXIMUM AND MINIMUM PENSIONS

It is well nigh impossible to find a formula for retirement benefits which will provide an adequate pension for every participant. Some will receive less than they need to maintain a decent living standard; others will receive far more. For this reason, many plans provide a minimum or a maximum, or both.

Such limitations are particularly important if an employer must budget his expenditures carefully and cannot afford a generous basic formula. Low-paid participants will receive such small pensions that a "floor" must be established to make the plan work. This will add to the cost of the plan. At least part of that extra cost may be covered by a low ceiling on the retirement allowances of executives. As a result, the range of pensions in many such plans is kept between certain fairly close limits.

A good way to determine a suitable minimum is to figure the probable pensions under the basic formula for all participants who will retire within the first five or ten years. If everybody who has been in service for a reasonable length of time, perhaps 15 or 20 years, may expect a pension of $50 or more, in addition to Social Security, a minimum does not seem called for.

In the interest of good employee relations, it is important to be liberal in fixing the required period of service which entitles a participant to the minimum pension. Fifteen or 20 years may be a short span in the history of an organization. However, to the employee himself, and to those associated with him, it seems like a lifetime.

Many of the older plans, even those covering large groups, put a fairly low ceiling on pensions. Either the amount of annual earnings considered in computing the pension was limited to, say, $12,000 or $15,000, or the retirement allowance itself was not permitted to exceed $6,000 or $7,200, or some such amount. The feeling prevailed that an individual in the higher earning brackets was well able to accumulate savings of his own to supplement his retirement income.

High individual income tax rates of the war and postwar years (in addition to certain restrictions of the War Labor Board) created much interest in the principle of "deferred compensation". This is how pension planners reasoned: If an executive deserved an increase of $10,000 in his annual salary, that amount would be added to his highest tax bracket. After one-half or more was absorbed by income taxes, he might invest the remainder and again pay a high tax on the income from his investment. If the same $10,000 had been invested by the company directly in deferred retirement benefits — within the rules laid down by the Internal Revenue Service — there would have been no tax on the principal nor on the income until he began receiving payments. Consequently the executive would have a much larger total amount at his disposal at retirement than he could have accumulated for himself.

In line with this new thinking many maxima in old plans were discarded or raised, and this trend still continues. Only a few of the new plans contain such restrictions, although sound actuarial reasons may still make some limitations advisable, particularly for smaller groups covered by so-called "self-administered" plans. Always remember that the actuary can determine the rate at which people covered by such a plan may be expected to die. But he cannot tell, of course, who will die first and who will live the longest. If the covered group is large and there are many employees in every age and salary bracket, it makes little difference if a highly-paid participant draws his pension for many years. Others who receive equally large pensions will die early and so equalize the cost. However, if the group is small and there are only a few in every age and salary bracket, exceptional longevity of a high paid participant could seriously upset the earlier estimates of cost. A low ceiling on pensions, in such cases, will prevent a serious drain on the fund.

CORRELATION OF PLAN BENEFITS WITH SOCIAL SECURITY

The expression "correlation" is used deliberately instead of the more common one of "integration". The latter term usually refers to the requirements of the Internal Revenue Service for a "qualified" plan (see Chapter 6). At present we are concerned primarily not with provisions of the law but with ways to produce an adequate pension.

The Social Security Act which became law in 1935 has been revised many times since. Not only rates of benefits and contributions required of employers and employees were affected by these changes but also the maximum amount of compensation covered. There is no room within the framework of this booklet to present a detailed history of Social Security. However, we should mention that the amount of compensation taken into account for purposes of benefits and taxes was originally fixed at $3,000 a year, which was later raised to $3,600, then to $4,200, and under the latest amendments (1958) to $4,800.

If a retired employee 65 years of age or older has a wife who is also 65 years of age or older, she is paid an amount equal to 50% of her husband's benefit. Under the latest version of the law, women may start drawing benefits at age 62 in reduced amounts. Social Security also provides other benefits, such as payments to widows and other dependents.

Increases in benefits adopted from time to time were reflected in higher Social Security taxes to be paid by both employers and employees. In 1958 Congress fixed the rate payable by each on the first $4,800 of annual compensation as follows: 1959, 2½%; 1960-62, 3%; 1963-65, 3½%; 1966-68, 4%; 1969 and later, 4½%.

Many employers who maintained plans installed long before the advent of Social Security felt that benefits under their own plans had been adequate right along. Therefore, they simply deducted the "primary" benefit from an employee's pension under the plan. Others deducted only one-half because the employee paid half the tax.

However, most plans now in effect reflect rules laid down by the Internal Revenue Service from time to time for "integration". These rules provide in effect that all employees must receive approximately the same retirement income, as a percent of their earnings, from both Social Security and from a private plan, for equal periods of service. In evaluating Social Security for that purpose, it has always generally been permitted to assume that all types of Social Security benefits (including payments to the wife of a retired worker, the widow and children of a deceased worker, and others) are 150% of the Social Security benefits payable to the retired worker himself. This would mean, of course, that a private plan may provide a somewhat lower benefit on the amount of compensation covered by Social Security.

Although Social Security benefits are now quite substantial and eventually may amount to as much as $127 a month for a retired worker alone (not including his dependents), companies have rarely taken full advantage of the maximum allowable differential, with the result that the lower paid employees received a somewhat higher percentage of their earnings as a pension than those in the higher brackets.

Any type of plan is adopted to such a graduated benefit. For instance, there are unit credit plans which provide benefits for each year of service of 1% on the first $4,800 plus 1½% on the excess over $4,800. It is conceivable to have a flat percentage plan which provides 25% of the first $4,800 plus 40% of the excess. Of course, these are only examples.

The Internal Revenue Code also permits a plan to exclude earnings under a certain amount. Usually the line is drawn at the limit of Social Security coverage. In all such cases certain technical requirements must be met if the Internal Revenue Service is to approve the plan.

It is doubtful if plans covering only earnings in excess of the amount covered by Social Security provide a desirable retirement benefit even for some of the higher-paid participants, because of rather severe restrictions imposed by the Internal Revenue Service. For this reason, few plans are installed today that are so restricted.

SUMMARY

You will find little guidance in your search for some standard of an adequate pension. If you study existing plans, you will find that the amount of pension is generally determined in one of three ways: The pension may be a stated percentage of pay, regardless of length of service; it may be a flat amount for every employee; or it may be the total of credits for each year of service, every credit being a small percentage of earnings.

If the pension is a percentage of earnings, you must decide if you want to base it on average or on final earnings. If the pension reflects years of service, you must decide to what extent service prior to the adoption of the plan should be recognized. This recognition poses particular problems in unit credit plans which base the pension on average earnings.

If you try to avoid extra pension costs due to labor turnover, you will want to consider either a qualifying period of service or a minimum age for membership in the plan. Such restrictions affect the size of the pension, if it is based on years of membership.

If you cannot afford a generous basic formula, you will think about a minimum pension, the cost of which may be offset, in some cases, by a ceiling on the retirement allowances of high-paid employees. Maxima which were once very popular are rarely found in modern plans. Where they still exist, they are generally at much higher levels.

Most pension plans today correlate benefits with those under Social Security. The Internal Revenue Service has set up certain standards. If these standards are applied, all employees will receive approximately the same retirement income in percent of their earnings, from both Social Security and from a private plan, for equal periods of service.

CHAPTER (4)

IS A FINANCIAL COMMITMENT NECESSARY?

PROFIT-SHARING PLANS

In the preceding chapter we have examined some of the customary methods of determining retirement benefits. No matter what method is followed, any definite pension formula involves a commitment for payments which can only be estimated in advance.

We have also found that it is difficult for an employer ever to be relieved of that commitment as long as his business remains a going concern. Therefore, you will want to be certain that you can afford to assume this commitment. Perhaps the earnings from your business are subject to sharp fluctuations from year to year. If that is the case, you may want to avoid a commitment altogether and consider a profit-sharing plan with retirement benefits, instead of a pension plan.

Annual contributions to a profit-sharing plan, as the name implies, depend on profits. If there is no profit, there is no contribution. In order to yield retirement benefits, the contributions must be accumulated in a trust fund until participants retire. Otherwise they will be dissipated by many employees to take care of real or imaginary "emergencies".

Contributions to a profit-sharing trust are deductible for tax purposes if certain conditions are met. One of these conditions used to be that the amount of the contribution must be determined in accordance with a definite formula. In other words, you could not use discretion as to the size of the contribution from year to year. However, the formula could be so worded that only the excess (or part of the excess) over a desired minimum profit was contributed. This assured stockholders of a reasonable dividend or guaranteed the addition of a minimum amount to working capital each year before contributions were made to the plan. For these reasons and in the interest of employee relations, a definite formula for contributions remains a sound principle in drawing up a profit-sharing plan, although it is no longer required for tax qualification. If contributions are made in the discretion of the company's board of directors, the liability must be established by appropriate resolution before the end of the year to assure the desired tax deduction.

After a profit-sharing plan has been in existence for many years, it may yield fairly good retirement benefits. But the benefits are not adequate for participants who retire soon after adoption of the plan. One reason is that allocations to members must follow a definite formula. For instance, funds may be allocated to participants' accounts in proportion to their basic compensation. But only limited allowance can be made for length of service.

Many plans provide for allocations under the "unit" method which operates as follows: A member is given a credit of one "unit" for each $100 of his basic annual earnings and one unit for each year of service. The total units to the credit of all participants are then added, and the contribution is allocated in the ratio that each participant's total units bear to the aggregate of all units credited to all participants. This is only one example.

Another condition that applies to a "qualified" profit-sharing trust is that the deductible portion of a company's annual contribution to it is limited to 15% of the annual compensation of all members. An example will show how large a retirement income average contributions to a profit-sharing trust can provide.

Let us assume that, allowing for good and bad years, only half of the 15% maximum is contributed to the plan each year, and that the funds are conservatively invested to yield 4%. If the contributions are allocated in the ratio of basic earnings and an employee has participated for a period of 30 years, he would have, at 65, an amount to his credit that is equivalent to 4.2 times his average annual salary. That amount would buy an annuity for him amounting to almost 32% of his average earnings.

The percentage might be somewhat higher if the interests forfeited by other employees were allocated to the remaining participants. Such forfeitures may arise under a profit-sharing plan if a member leaves the company's service before he completes a stated minimum period of service. However, if you want your contributions to be deductible for tax purposes, that minimum period cannot be too long. This is one more feature which distinguishes profit-sharing plans from pension plans.

In recent times, profit sharing has become more and more a means of serving other purposes besides providing retirement benefits. Foremost among these is to furnish incentives, particularly if a profit-sharing plan is adopted to supplement an existing pension plan. One could well write another book on that use of the profit-sharing principle, but since we are dealing here primarily with pension planning, such broader treatment would lead us too far afield.

The use of profit sharing has also become a helpful device to convert current earnings into deferred income in smaller companies where management and ownership are frequently identical. This is largely due to a provision in the tax law to the effect that lump-sum payments of profit shares on retirement, other termination of employment, or death are entitled to long-term capital gains treatment if certain conditions are met. The advantage of this provision is obvious, as the reader may prove to himself by simple arithmetic, bearing in mind also that income received on participants' shares, while in the trust fund, is not subject to income tax.

THRIFT PLANS

Perhaps you believe that your employees do not appreciate anything they receive as a gift. Then you will lean toward a contributory plan. The pros and cons of employee contributions will be considered in Chapter (8). For the moment, let it suffice that you expect your employees to contribute, and that you want to control your own commitment.

In that case your logical choice is a thrift plan, sometimes referred to as a "savings plan". Programs of this type vary in detail, but the main principle, when combined with profit sharing, is this: Participating employees are permitted to make contributions between a minimum and a maximum percentage of their earnings. The company, in turn, contributes a specified percentage of its profits which is allocated to participating employees in the ratio of their own savings. Perhaps more often, the company adds a stipulated amount (from 25 cents to a dollar) out of its current or accumulated profits to every dollar contributed by employees. Whatever the method, the more an employee saves, the more the company will add to his account. Sometimes the company contributions do not depend on the rate of contributions chosen by the employee, as long as the employee puts something into the plan.

For this reason, it is important to specify a maximum percentage of employee savings. Otherwise employees with substantial resources of their own would "save" an unreasonably large percentage of their earnings in order to receive an unduly large share of the company's contribution.

Usually the employees are permitted to change the rate of their contribution from time to time, or suspend them altogether. Withdrawals, except in the event of death, retirement or other termination of service, are often discouraged by the imposition of certain mild penalties, such as suspension of membership for six month or a year. Some plans provide for loans made to needy participants in the discretion of a committee.

Most modern thrift plans give participating employees the right to direct investment of their share in one or more of several investment media. Popular options provided in such plans are stock of the employer company, an undivided fund of common stocks and an undivided fund of fixed-income investments. Generally employees have the privilege of changing investment directions and also request the conversion of prior investments into one or more of the other available media.

Some companies which enjoy a favorable relationship between net earnings and payrolls have adopted thrift plans in addition to pension plans. This combination represents a desirable employee benefit program. It makes retirement much more attractive if an employee is assured of a sum of money in addition to his pension. No matter how well he has prepared himself, mentally and financially, for retirement, it always involves a substantial reduction in earnings. A small sum of capital, in addition to his pension, gives him an ideal opportunity to cushion the financial adjustment and to take care of emergencies that he could otherwise meet only with great difficulty. The employee may prefer to be paid in installments and in this manner add to his regular pension.

MONEY-PURCHASE PLANS

Sometimes, employers who hesitate to assume the financial commitment of a conventional pension plan but for various reasons prefer to take the spotlight off profits, consider the adoption of a "money-purchase" plan.

Under this method (which is not nearly as popular today as it was 15 or 20 years ago) a stated percentage, maybe 5 or 6% of participants' pay, is contributed each year. The amounts may be allocated to individuals in separate accounts, or they may be applied to the purchase of deferred annuities each year. Modifications of these techniques have been used in certain cases. At any rate, the pensions resulting from the contributions depend largely on the age at which an employee enters the plan. Both money-purchase pension plans and profit-sharing plans suffer from this characteristic, but in the latter there is the possibility or even the likelihood that the end result will be improved greatly by one or several "windfalls" in years of exceptionally good profits.

To lessen the adverse effect of a high entry age on the amount of pension, some money-purchase plans call for larger contributions on behalf of older employees. Sometimes the contributions are supplemented by conventional past service benefits for the original participants. All such modifications must be handled very delicately to insure proper balance of benefits for all categories of employees. It should also be remembered that these adjustments tend to add to the size of the commitment. This detracts much from the basic advantage of the money-purchase plan.

FLEXIBILITY IN MEETING PENSION COMMITMENT

The adoption of a profit-sharing plan, or a thrift plan where company contributions are based on profits, is the only way to escape a pension commitment and yet provide retirement benefits for your employees. If you choose a money-purchase plan, you do not avoid a commitment, but you are able to fix it at a definite rate. However, in either case you must accept a compromise in return for the advantage gained. Your plan, unless supplemented in some form, will not yield adequate retirement benefits and, consequently, it will not become fully effective until 20 or 30 years have passed.

This is a rather serious defect and you may well ask this question: If I am willing to pay the price of a more conventional plan in the form of a commitment for definite benefits, may I retain any control over the timing of pension costs? May I defer the annual cost whenever it is inconvenient to meet it?

In most cases you can. Take, for instance, the simplest type of retirement plan, i.e., a formal unfunded plan. Many companies have started their pension program on that basis. They adopted a benefit formula and then paid pensions according to that formula directly out of earnings. These payments are not much of a financial problem as long as only few employees are on retirement. As their number grows, many companies find it advantageous to set up a reserve for pensions on the books. The amount of this reserve is rarely determined on an actuarial basis. Therefore, it does not bear any definite relation to the size of the liability for pensions. Additions may be made from time to time as profits warrant. If, in a particular year, or during a period of years, earnings are so low that the payment of pensions would strain the company's budget, the reserve may be tapped. To serve its purpose, the reserve should be balanced by liquid assets such as marketable securities. Now and then, management has been tempted to invest these funds in fixed assets, such as buildings and other permanent improvements. That practice, of course, defeats the very purpose of the reserve.

Next, let us consider the trusteed plan. Here the actuary determines the accrued pension liability as of the effective date of the plan. This liability must never be allowed to rise above its original amount. What does that mean? Each year after a plan goes into effect, new pension credits accrue to covered employees. These credits increase the original liability. Since all pension liabilities are determined by discounting future benefits at an assumed rate of interest, the original liability is increased, not only by new pension credits, but also by interest on the unpaid balance. Contributions to the plan must, at least, be large enough to offset the total increase from year to year.

Most companies make it a point to contribute at a faster pace during the early years. Thereby they reduce the accrued liability below its original size and they enjoy a breathing spell if the need arises after a number of years.

But what of insured plans? Group annuity contracts generally permit suspension of premiums for limited periods. Payments so suspended must be made up in accordance with the terms of the particular contract.

Individual insurance policies, which serve as the principal funding medium for many smaller plans, do not provide for suspension of premiums. However, they have a cash and loan value after they are in effect for some years. Just as an individual can borrow against his equity in a policy to pay a premium due, so can a company, if the plan reserves that right. Naturally, this is a step the company will resort to only in an absolute emergency.

It is reassuring to know that, under any conceivable method of providing predetermined pension benefits, you may defer payments in an emergency. But you must also realize that the commitment remains, and a temporary suspension of payments means higher costs later on.

SUMMARY

If you want to provide pensions for your employees without assuming a financial commitment, you may consider a profit-sharing plan with retirement benefits. To be tax-exempt, such plans must comply with certain rules of the Treasury Department. As a result of these rules, retirement benefits are inadequate unless employees have participated for many years.

A variation of the profit-sharing plan is the thrift plan. Here the participants contribute savings of their own. The company adds to these either a fixed percentage of the employees' savings or it contributes a portion of its profits which are then allocated to participants in some predetermined manner. Some companies adopt a thrift plan in addition to a conventional pension program.

In case you are willing to accept a limited commitment but wish to fix it at a definite percentage of payroll, you may consider a money-purchase plan. Like a profit-sharing plan, a money-purchase plan does not provide adequate benefits unless an employee has participated for a long time. Therefore, many companies add past service benefits for the older employees.

The defects of the plans considered in this chapter may make you want to reconsider the question of assuming a commitment. May you defer the annual costs of a conventional pension plan if need be? Indeed you may in most cases, but the commitment remains, and a temporary suspension of payments means higher costs later on.

CHAPTER (5)

SHOULD A RETIREMENT PLAN PROVIDE OTHER EMPLOYEE BENEFITS?

Is your plan to be strictly a retirement program, or is it to provide other benefits too? To decide that question will require your most careful thought.

Indeed, there is considerable difference of opinion. Since the principal purpose of a pension plan is maintenance of maximum efficiency in an organization, most programs emphasize the provision of pensions at normal retirement age. Although basic attitudes towards "security" have undergone great changes since the nineteen-thirties, employee appreciation of a "pure" retirement plan is still greatest among those closest to retirement.

In order to insure more general employee appreciation, many employers take steps to provide a broader program of financial security. This may include benefits in the event of death, termination of service, and perhaps disability, in addition to retirement pensions. Even the youngest employees will appreciate these incidental benefits. They realize that the hazards they cover may be closer to them than they wish to believe.

Of course, to you as the employer there is more involved in this decision than philosophy or industrial relations. The second type of plan may easily cost twice as much as a simple retirement program.

DEATH BENEFITS

It should be pointed out that even in a pure retirement plan any contributions made by employees are usually returned in case of death (or severance) before retirement. In most cases, simple or compound interest is added to make participation more attractive to the employees. If a participant dies after retirement, the amount by which his contributions exceed the total of pension payments received by him is usually returned to his beneficiary. In most cases, his contributions are exhausted by pension payments within two to four years after retirement. Naturally, the return of employee contributions does not cost the employer anything. Its value as a death benefit is limited, since the amount is small during the early years of membership when the need for a death benefit may well be greatest.

A more substantial type of death benefit, which represents a very definite expense to the employer, consists of the payment of the pension reserve to the beneficiary. This is characteristic of plans funded by individual insurance contracts. It can be arranged with equal ease in a trusteed program.

Although the accumulated pension reserve, consisting of employer money and employee money, is, of course, greater at any time than employee contributions alone, the amount is still relatively small during the early years of membership. As a participant approaches retirement, the amount becomes unreasonably high in many cases. Therefore, most companies prefer a level amount of protection. This type of death benefit is usually provided through insurance, although it is sometimes arranged through additional deposits in a trusteed plan. Unless the covered group is large, and the benefit is relatively small, such self-insurance is not recommended. It is far better to make use of group term insurance for this purpose. As indicated below, such protection would be provided outside the pension plan itself.

If the death benefit is provided by life insurance, it is generally related to the monthly retirement benefit under the plan in the ratio of 100:1. In other words, the death benefit equals $1,000 for every $10 of monthly pension. In some cases the ratio is as high as 125:1, in others as low as 50:1. The policies may be of the "retirement-income-with-life-insurance" type or they may be "ordinary life" contracts. In the latter case, a self-administered fund must be maintained in addition, as will be explained in Chapter (7). If retirement income policies are used, they represent the sole funding medium. Consequently, these contracts provide not only the death benefit, but also the eventual pension. As the pension reserve in the policy grows, the true insurance element decreases. Shortly before retirement, it vanishes altogether, and the pension reserve exceeds the face value of the policy.

There is little doubt that large death benefits are appreciated by employees. How far you should go in providing them depends on the group you intend to cover. If you feel that death benefits as large as described above are unnecessary or too costly, you may prefer to provide more modest ones on a group insurance basis outside the framework of the retirement plan. This is the more modern solution.

SEVERANCE BENEFITS

Severance benefits in pension plans usually take the form of a "vested right" in employer contributions. This means that an employee who leaves your service before retirement retains some interest in the contributions you have made on his behalf. In some cases the employee actually receives these contributions in the form of cash or in the form of an insurance contract (if the plan is funded in that manner). More often he becomes entitled to an income beginning at normal retirement age and based on credits earned to the date of termination of his service.

Vested rights differ from "early retirement" provisions which were discussed in Chapter (3). An early retirement provision permits you to pension an employee who is unable to remain in service until his normal retirement date. The purpose of "vesting" is to create interest in your plan on the part of the younger employees. It gives them assurance that their stake in your plan is not merely a contingent one which does not materialize at all unless they remain in your service until retirement age.

Vesting is a far more controversial issue than a death benefit. This is partly due to a common misconception regarding the effect of turnover on the cost of a plan. If a plan does not confer a vested right, employees who leave before retirement naturally forfeit their pension rights. Consequently the cost of the plan is reduced. Because the turnover rate is high in many companies, the conclusion is often drawn that the cost of a pension plan will be reduced at the same rate if vesting is not provided. That conclusion is wrong since most terminations occur among the young employees. The contributions made on their behalf are small in relation to the overall cost of the plan. Consequently, very little is gained if they forfeit their interests upon leaving.

Another argument advanced against vesting is, in substance, that vesting encourages turnover. That might be so if a participant can withdraw a large sum of cash or some other immediate benefit when he leaves your service. It is not likely if all he becomes entitled to is a right to future income. But even if he could obtain a more tangible benefit, an intelligent employee will realize that he cannot lose anything by remaining with you. Instead of losing he gains, since his interest in the plan grows from year to year.

If you feel that vesting is a desirable feature in a pension plan, you may still want a compromise. This can be effected by attaching certain conditions to that right. Some plans, for instance, provide for gradual vesting. Perhaps an employee who leaves before completing five years of service receives nothing. If he leaves in the sixth year, he receives a vested right in 10% of the employer's contributions on his behalf. If he leaves in the seventh year, his vested right is increased to 20% and so on. After 15 years he is entitled to full vesting. The scale indicated can be changed in any manner, and membership in the plan may be used as a measure instead of length of service.

From an administrative viewpoint, there is considerable objection to gradual vesting if it confers only the right to an income beginning at normal retirement age, as is the case in many plans. If an employee is still young at the time he terminates his service, several decades may elapse before he becomes entitled to the income. It may be very difficult to locate him at that time. Besides, the amount is usually too small to mean much to the employee.

If vesting is limited to a deferred income, it is far more practical to confer this right only on terminating employees who have completed a stated period of service and who have reached a stated age. Very frequently, 20 years of service and age 50 are used. The day a participant satisfies both conditions he becomes entitled to a deferred income from all of the employer contributions on his behalf. The day before he has no rights whatsoever. Employers who use an age as high as 50 are not considering ease of administration alone. Very few employees as old as 50 are likely to terminate their service. Consequently the cost of vesting is reduced to a minimum.

You will want to analyze this question carefully. Naturally you do not care to include a provision in your plan that is an empty gesture. On the other hand, you do not want to divert substantial funds from the primary purpose of your plan to pay for incidental benefits. In considering the question, it should be realized that there is a definite trend toward vesting today. This fact finds some expression in a recent revenue ruling to the effect that an employee retiring early with the employer's consent must not receive a more valuable benefit than another who terminates service without the formality of early retirement.

DISABILITY BENEFITS

Total and permanent disability is a hazard against which very few people are able to protect themselves effectively. Even a man of moderate means can provide a reasonable amount of security for his family in the event of his untimely death. Since the chance of dying young is rather slight, small premiums buy large death benefits for a man in his twenties or thirties.

Insurance against disability is not so readily available. Even if it were, most people would want to save the expense in the hope that disability will not strike them. Everyone knows that he must die some day; consequently he cannot lose by buying life insurance. But not many people become disabled, so the chance of paying premiums for disability insurance in vain is very real.

Knowing that your employees are not protected against this hazard, you may consider disability benefits under your pension plan. If you adopt a provision for "early" retirement, you may make it applicable in the event of disability. This would take care of cases occurring after age 55 or 60, depending on the wording of the particular clause. Some companies go beyond that by providing for vesting of the earned pension in the event of disability at *any* age. In most cases, however, the earned pension is actuarially reduced to allow for the greater normal life expectancy at the younger age. We have seen in Chapter (2) how substantial these reductions are. At any age lower than 55, the resulting retirement allowance would be woefully inadequate. Of course, since the amount is insignificant, it does not cost the employer a great deal.

It is probably true that an adequate disability allowance can be provided only under a trusteed plan. But then you must be prepared to assume a risk which most insurance companies are unwilling to underwrite. Proper administration of a disability provision is difficult for two reasons:

(1) No matter how much care is taken to define the term exactly in the plan, it is not always easy to recognize total and permanent disability in an individual case. If the plan does not contain an adequate disability provision, employees will make greater efforts to continue in their jobs as long as they can carry on. It is often possible to help disabled employees to continue in service by giving them easier jobs in place of those they are no longer able to perform.

(2) In some cases, disability may be "total" and apparently "permanent" when it strikes. After a while, however, partial or even complete recovery takes place. Therefore, it is essential to have first-hand information on all cases at all times. Naturally this type of policing is somewhat easier for the employer himself than it would be for an insurance company.

The dangers mentioned can be substantially reduced by fixing a minimum service requirement as a condition for disability pensions. Under many plans participants do not become eligible for such benefits until they have completed 10, 15, or 20 years of service. Such a waiting period reduces the need for strict medical examinations of employees when they are hired. It also reduces the number of cases to be covered, and with that the cost.

Cost must also be considered in determining the amount of the allowance. The latter need not bear any fixed relation to the normal retirement benefit. The purpose of a disability pension is to prevent an unfortunate employee from becoming a burden to his family or the community. That will, of course, mean that in many cases the disability allowance will have to be larger than the earned normal retirement benefit. The whole allowance, of course, should not be actuarially reduced. An actuarial reduction allows for the normal life expectancy at the younger age, which has little meaning if an employee's vitality is seriously impaired.

Even such modest, though adequate, benefits may add from 20 to 30% to the cost of a pure retirement plan. Extremely generous disability pensions are out of reach of the average employer, even if they are socially desirable.

SUMMARY

When you adopt a retirement program, you must decide whether you should follow one or the other of two schools of thought. Some employers feel that the retirement of employees in the interest of efficiency is the sole purpose of a pension plan. Others prefer to provide a broader program of financial security for their employees. This may include death, severance and disability benefits.

Death benefits, on a small scale, are provided automatically under contributory pension plans by the return of employee contributions. A more substantial death benefit would include all or part of the employer contributions to the plan on behalf of a deceased employee. Because this type of benefit is naturally small if death occurs during the early years of membership, most employers prefer a level amount of protection. That can be provided by life insurance or on a self-insured basis.

Severance benefits usually take the form of a "vested" right in employer contributions. Vesting is a far more controversial issue than a death benefit, partly due to a common misconception as to the cost effect of turnover. Others object to vesting because they feel that it encourages turnover.

Some plans provide for gradual vesting, a provision which poses serious administrative problems if the vested right is limited to an income beginning at normal retirement age. Whenever the vested right is so defined, it is preferable to make it dependent on completion of a stated period of service and the attainment of a specified age. If the age selected is high enough, the vested right does not add materially to the cost of the plan.

It is difficult for an individual to protect himself against total and permanent disability. Therefore you will want to consider providing such protection under your pension plan. An early retirement clause, or a specific vesting provision in the event of disability, does not give a disabled employee sufficient income. As a general rule, adequate disability allowances are available only on a self-administered basis.

Proper administration of a disability provision requires care and the benefit naturally adds to the cost of a pension plan. The cost can be controlled by fixing a minimum period of service for participants to qualify for disability allowances. Cost should also be considered in determining the amount of the benefit. Extremely generous allowances are as much out of order as extremely meager ones.

CHAPTER (6)

WHY FUND A PLAN?

THE EMPLOYER'S VIEWPOINT

There are few pension plans in effect today which have not been amended in one way or another. Perhaps the rate of benefits was changed, or employee contributions were abandoned, or coverage was extended to groups not previously included. These are but a few of the many types of amendments. They become necessary from time to time because of circumstances which could not be foreseen when the plan was originally formulated and adopted.

Some employers are of the opinion that it is easier to make such revisions in an "unfunded" plan. An "unfunded" plan, as the name applies, is one which is not supported by an irrevocable trust nor underwritten by an insurance company. Not infrequently, balance sheet reserves are set up from which pension payments are made under the full control and discretion of the employer. The employees, however, have no vested or contingent right in the reserve and it may be used for other purposes at the employer's pleasure. The Treasury Department is not interested in that type of plan, and amounts contributed to the reserve are not deductible for tax purposes, although actual pension payments to employees are.

Since the Treasury Department is not concerned with such a plan, its consent is not required if the employer desires to amend it or even terminate it. We have already seen in Chapter (1) that an employer is not free to terminate a plan at will for reasons of employee relations. For the same reasons he cannot make amendments, unless they are in the best interest of his employees. On the other hand, if the amendment is favorable to employees and the plan is funded so that Treasury approval is required, such approval will be promptly forthcoming. In other words, this is no valid argument against funding.

Others believe that they can earn more on the funds if they remain part of working capital. If the funds are set aside in an irrevocable trust or if they are paid over to an insurance company, they must be conservatively invested, and the maximum return is likely to be less than the rate which can be earned in the operation of the average business.

It requires very little analysis to dispose of that argument. If your business is new, of course its demands for working capital are practically unlimited. But then you have no pressing retirement problem at that stage. As a business matures, a real retirement problem emerges, and its financial impact may well outweigh the need for additional working capital that can be more profitably employed. If you recognize these changed circumstances promptly, you will be able to accumulate adequate reserves in a short time to offset the accrued liability. After that the problem becomes a minor one which requires no great financial effort.

While every argument for the "unfunded" plan can be turned into an argument for the "funded" plan, there are additional obvious advantages of funding. The most important one, from the employer's viewpoint, is that only a funded plan may be "qualified". The essential rules which must be observed to qualify a plan will be described later in this chapter. The practical effect of qualification is that the employer can deduct all contributions for current service from the income of his business, as well as an amount up to 10% each year of the total past service cost. If the plan is funded by an irrevocable trust, the income earned is also tax-free to the trust. If the plan is insured, the premiums paid are tax-deductible.

The tax privilege means, of course, that the cost of the plan is reduced in proportion to the corporate tax rate. If that rate is 52%, the employer, in effect, pays only 48 cents for every dollar of pension cost. The tax exemption granted to the income from the fund is easily underestimated. All contributions to a pension plan, no matter how it is funded, are discounted for interest. Consequently, a large portion of every pension dollar is provided by income. Let us take an example. Suppose it were desired to have $10,000 on hand 30 years hence. This would require annual contributions of $210 if the accumulations earn interest at 3% compounded annually. The annual contribution would have to be increased to $266 if the interest rate were reduced to 1½%. This is approximately the rate to which a 3% return would be reduced, if it were subject to income taxes at a 50% rate. In other words, the contributions would have to be increased by almost 27%. Of course, the increase would be much more if the effective corporate tax rate is higher, as it was in the days of the excess profits tax.

THE EMPLOYEE'S VIEWPOINT

An employee who is looking forward to retirement is concerned about two things:

(1) Will his pension be large enough to cover his necessary living expenses; and

(2) Will he receive his pension as long as he lives. If he has elected

a contingent annuitant option, he will, of course, desire the same protection for his beneficiary.

How does an unfunded plan compare with a funded one from this viewpoint? It is very doubtful if your employees care particularly whether your plan is funded or not. Many of them probably would not even know. But you may rest assured that they will keep an eye on their former associates who are now retired. It was already pointed out in Chapter (3) that the active employees would think very little of your plan if the retired employees were forced to live on an inadequate allowance. The same applies if you ever had to reduce pensions under unfavorable business conditions.

In that respect, the record of unfunded plans is not good. The pensions of many who depended on such plans were cut in half during the depression of the nineteen thirties. Balance sheet reserves are of little help in such emergencies, since they may be used for other purposes. As a matter of fact, an unfunded plan should state very definitely that participants do not have any vested or contingent right in the reserve. Otherwise they might become liable for an income tax on their share in the employer's contribution to the reserve. Of course, very few could afford or would be willing to pay a tax on such funds.

If your plan is funded and qualified, your contributions, within specified limits, are not only deductible from the taxable income of your business, but in general they are also not taxed to your employees until they retire. Then, that portion of their pension which does not represent a return of their own contributions is taxed as ordinary income. By that time, however, they will be in a lower tax bracket, and most of them will be eligible for the additional exemption granted to people over 65 years of age.

If union employees are to be covered by your plan, a statement made earlier should be modified. True, individual employees will rarely care if a plan is funded or not. But union leaders have given increasing attention to this matter during the last decade, and the right of a union bargaining agent to negotiate on pensions is now firmly established in the law of the land. The attitude of unions is understandable whether pensions are regarded as "wages" or not. Unless pensions are backed up by funds set aside in an irrevocable trust or by the resources of an insurance company, a retirement plan is nothing more than a promise. Who wants to bargain for a promise?

There is still another reason why employee groups prefer a funded plan to an unfunded one. An employer can only afford to spend a certain amount on pensions. In many cases this will not be sufficient to provide adequate retirement allowances. Regardless of the general insistence of unions on noncontributory plans, many employee groups are perfectly willing to contribute toward the cost of a plan, if by doing so they can increase the amount of their pensions. But there must be a convenient receptacle for employee contributions. This is not available in an unfunded plan, unless the contributions of employees are set aside in a separate savings fund. While such a supplemental savings plan would provide welcome death and severance benefits, it is not economical as a source of pensions. The reason is that such a supplemental plan cannot be properly integrated with the employer's unfunded arrangement.

MARGINAL FUNDING

In the original edition of this booklet we devoted considerable space to a discussion of two practices which were then applied in a number of well-known plans and were certainly not conducive to orderly pension financing. These practices were:

(1) Simultaneous bargaining for definite benefits, financed by predetermined contributions (without regard to costs); and

(2) Financing of pensions through royalties on the employer's product.

Fortunately, both practices have not found widespread acceptance. Therefore, the need for their detailed discussion is no longer justified. However, if they should ever emerge again as an expedient device, we would be just as firm in condemning them as we were then.

Another method of marginal funding which still persists here and there first came to light in the famous 1949 steel dispute as a means of cutting pension costs. We refer to the failure to fund past service costs, which should be resorted to merely as a stop-gap. This is how it might be justified:

Contributions to a plan during the early years usually exceed pension payments by a considerable amount. Eventually income and outgo are more or less in balance. In other words, pensions are paid out of future service contributions and income earned on the fund. Consequently contributions originally made for past service are rarely ever used for pension payments. Only the income earned thereon is so applied. If that is so, why amortize the past service cost at all? Why not simply pay interest into the fund on the full amount of the past service liability? This was what was suggested to the steel industry.

In many cases this solution would be satisfactory as long as the plan remains in effect and contributions for future service are made each year. However, if the plan must be terminated, the fund will be short by the amount of the original past service cost. Then benefits must be curtailed. If several decades have elapsed since the plan became effective, the employees who suffer will not be the ones whose pensions were related to past service. They will be those for whom contributions for service after adoption of the plan have been made right along. They will suffer because the funds contributed on their behalf have been used to pay pensions for past service that were not properly provided for.

This is not sound financing. If such a practice were widely applied, most certainly many retirement systems would come to grief. In the long run, an employee will be better off if he looks forward to a pension of $50 that is adequately funded, instead of expecting a pension of $100 which may not be paid.

THE "QUALIFIED" PLAN

If you fund your plan, you will, of course, submit it to the Treasury Department for approval in order to gain the tax advantages described earlier in this chapter. If a plan is approved, it is generally referred to as a "qualified" plan. What are the rules you must observe to give your plan qualified status?

The basic provisions of law governing the tax status of pension plans are certain sections of the Internal Revenue Code, particularly Sections 401-404 and 501. The provisions of the Code are supplemented by Federal Income Tax Regulations, and a large number of administrative rulings. The law as well as the rulings are available in the Prentice-Hall Pension Service and in some other handy reference books and loose-leaf services. You do not need to study them in detail. Your advisors have done that for you. But you will want to be familiar with the main principles:

(1) *A plan must be for the exclusive benefit of the employees or their beneficiaries.* This principle permeates the vast body of administrative rulings. For instance, the cost of benefits for employees who are also stockholders may be subject to close scrutiny. Or, contributions made to a plan can never be recovered by the employer unless they were made as a result of an actuarial error. Or, if an employer desires to invest part of the fund in his own securities, the transaction will be subject to the close scrutiny of the Internal Revenue Service. These are but a few important applications of the principle mentioned above. Every provision of the plan and every act of administration must be considered from this viewpoint before it is put into effect.

(2) *Contributions or benefits provided under the plan must not discriminate in favor of officers, shareholders, supervisors, or highly-paid employees.* The rules for integration with Social Security, which were discussed briefly in Chapter (3), are bottomed on this principle. The principle is also

applied in "Mimeograph 5717" which restricts benefits of the 25 highest-paid employees in the event of early termination of a plan. Eligibility provisions of a plan must not indicate discrimination, to mention a third example.

In the broadest sense, all rulings of the Internal Revenue Service related to pension and profit-sharing plans are variations on one or the other of these two themes. They are obviously reasonable and fair. They will not place serious obstacles in the way of approval of your plan by the Treasury Department. However, it must be remembered that the Revenue Service concerns itself not only with the text of the plan submitted to it but also with the plan's subsequent record of operation.

SUMMARY

Some employers believe that an unfunded plan may be amended or terminated with greater ease than a funded one. Others think that they can earn more on the funds if they remain part of working capital. Both arguments can be turned into arguments for funding a plan. In addition, only a funded plan is eligible for Treasury approval and the resulting important tax advantages.

Funding gives the employees greater assurance that they will actually receive the promised benefits. This is particularly important in collective bargaining. If a plan is funded, the employees have a better chance to improve their retirement allowances by contributing toward the cost.

Certain dangerous tendencies have developed occasionally in connection with the funding of plans. Sometimes attempts were made to base fixed benefits on fixed contributions, which is, of course, impossible. Or pension costs were expected to be provided by royalties on production. Finally, it is suggested, now and then, to cut costs by failure to amortize the accrued liability.

A properly funded plan is eligible for "qualified" tax status if it meets with the approval of the Treasury Department. There are, broadly speaking, only two important principles which must be observed to secure qualification:

(1) The plan must be for the exclusive benefit of employees or their beneficiaries.

(2) The plan must not be discriminatory in favor of highly-paid, etc., employees.

There are many applications of these principles. They require care in formulating a plan as well as in administering it. But they do not place serious obstacles in the way of Treasury Department approval.

CHAPTER (7)

HOW SHALL I FUND MY PLAN?

We have already stated that, in designing a retirement program, the plan itself should have priority. The decision on funding can usually be deferred until the plan has been formulated in detail.

You have the choice of several methods which, broadly speaking, fall into one or the other of two principal classifications, insured or trusteed. A lively controversy has been going on as to the advantages and disadvantages of each method for more than two decades. While proponents of both can point to an impressive list of corporations and other organizations which have selected it, there is no question that, as a technique of funding pensions for large employee groups, insured plans have been losing considerable ground during the last ten years. The reasons for this development will be better understood if we consider the various methods in some detail.

THE GROUP ANNUITY

Group annuities, as we know them today, are about 30 years old. Their operation is comparable, in some respects, to group insurance. The insurance company issues a master contract to the employer. Participants receive certificates that contain a brief description of their rights under the contract.

As a general rule, insurance companies insist on a minimum of 25 participants. If the plan calls for contributions by employees, it is usually required that 75% of the eligible group participate.

The premium paid each year for an individual participant is applied to the purchase of a single premium deferred annuity that equals the credit earned by the employee for that year. For instance, if a participant earns $4,000 during that year and his pension is computed at the rate of 1% of earnings for each year of service, he is entitled to a credit of $40 toward his pension. The employer pays a premium which will provide an annuity of $40 for life, beginning at normal retirement age. No further payments will be required. The following year, if the participant's earnings have increased to $4,500, the employer must buy another annuity, this time for $45. The amount of the second year's premium is higher, because the benefit is larger and the employee is a year older. Consequently the annual premium, for each employee individually, rises from year to year. However, this need not be the case for the whole covered group, unless its average age or the general level of earnings rises.

Premium rates are generally guaranteed for a period of five years. After that rates are subject to annual changes. If rates are raised, the new rates are normally applied to the original participants as well as to new entrants.

The premiums are discounted for mortality and for interest at a "guaranteed rate", at present usually 2¼ or 2½%. Because of the mortality discount, the employer does not receive a refund if a participant dies before or after retirement. However, the employee's contributions are returned to his beneficiary in the event of death before retirement, with or without interest. If death occurs after retirement, the amount of annuity payments received by the employee during his lifetime is deducted from the refund.

If a participant leaves the service of his employer before he has a vested interest in his pension, and the participant is in good health, the employer becomes entitled to a surrender value, usually 96% of his contributions plus interest. If the plan is contributory, an amount of 4% of the employee's refund is generally deducted from the employer's surrender value.

Most group annuity contracts are written on a participating basis. Therefore, you may expect to receive future dividends if they are justified by the experience of your group. While the insurance company keeps a careful record of each fund's individual experience, the combined results in all plans can be expected to influence dividend policy.

Employers who select group annuities as the funding medium for their plans, do so primarily for two reasons:

(1) The insurance company provides an all-inclusive service covering investment, actuarial and certain administrative phases.

(2) The insurance company guarantees the payment of annuities actually purchased.

The insurance company adds an expense loading to the net premiums, generally 8%, as a reserve for future costs. It must also protect itself against unforeseen contingencies by basing its premiums on very conservative assumptions as to mortality and interest.

THE TRUSTEED FUND

Some of the oldest retirement plans have used this method. It increased considerably in popularity during the decade following the enactment of Social Security for several reasons:

(1) Many insurance companies did not appear to be as much interested in new annuity business as they had been. One reason was probably the difficulty of finding desirable investments that produced an attractive yield.

(2) Corporate trustees actively solicited pension business. Through directors and through their commercial banking departments, they were

already maintaining profitable relationships with many successful corporations. They realized that these relationships could be strengthened and made more permanent by their appointment as trustee of a company's pension plan.

(3) As the groups covered by retirement plans expanded in size to take in large numbers of hourly-paid employees, many employers searched for maximum economy and flexibility.

(4) Growing awareness of the devastating effect of inflation since World War II gave added impetus to trusteed plans. Most of them are today invested up to 40% or more in common stocks which serve as a hedge against further inflation and are used as a reservoir of strength that may be tapped at some future time to help reduce costs or increase benefits if necessary. Until needed, this reserve remains hidden because in pension fund accounting, securities are normally carried at cost until accumulated appreciation in market value is realized through sales which can be timed to suit the needs of the fund.

There is no guarantee under the trusteed method of funding. The employer must depend on the judgment of a consulting actuary and investment advisors for the soundness of his plan. The actuary makes initial cost estimates in much the same manner as an insurance company determines its premiums. From time to time, he tests his estimates against the actual experience of the plan. The contributions recommended by him are deposited in a trust fund which is invested in accordance with the terms of a trust agreement. Pensions are normally paid from this fund as they become due.

The flexibility of trusteed funds is illustrated by the following characteristics:

(1) A wide variety of funding procedures is available. For instance, costs may be estimated by the same method as is applied under group annuities. Or they may be computed in accordance with the annual level premium method. Finally, they may be calculated as a percentage of payroll, or in any other manner acceptable to the Treasury Department.

(2) Turnover and wage or salary increases may be allowed for. Therefore, pensions in trusteed plans may be based on final instead of average earnings of participants, if desired.

(3) No part of the fund is ever allocated to individual participants (except in some money purchase plans). Consequently, it is possible to start paying a particular pension while the required reserve is still being funded. The necessary amounts are taken from contributions made for the entire covered group.

(4) Disability benefits may be provided.

The trusteed method is bound to give you a certain cost advantage over most other funding methods. This is primarily due to the fact that the investor of pension funds is free to choose from a broader field of securities than the insurance company, which is limited in this respect by law. Furthermore, the per capita cost of administrative expenses does not rise in direct proportion to contributions made. Both trustees' and actuaries' fees are generally graduated downward as the fund or the number of covered lives increase. Other cost advantages arise from favorable experience that is reflected immediately and automatically in the trusteed plan. You do not have to wait for a dividend to be declared. In a continuing plan, these advantages are more than temporary ones.

The successful administration of a trusteed plan depends, to some extent, on the size of the covered group. The larger the group, the smaller will be the effect of fluctuations in actual experience from the assumptions. The larger the fund, the greater will be the opportunity for diversification of the investment risk and the opportunity for a favorable investment return, although the creation of commingled trusts for the collective investment of small individual funds by many banks has largely eliminated size as a criterion for successful investment in recent years.

DEPOSIT ADMINISTRATION

Although some insurance companies have issued deposit administration contracts for many years, this funding medium has not received much attention until recent times. It represents an attempt to combine the advantages of group annuities with certain advantages of the trusteed plan.

Under a deposit administration contract, the employer's contributions are held in an undivided fund at a guaranteed rate of interest. As participants retire, the full purchase price of their annuity is withdrawn from the general fund. The premium rates applied in calculating the required amount are guaranteed at the time of deposit. The cost of all annuities purchased with moneys deposited during the first five years of the contract is computed at the original guaranteed rates. After the fifth year, rates may be changed annually but the new rates are not applied in calculating the cost of annuities until the fund built up by earlier contributions is exhausted.

The analogies of deposit administration to trusteed plans and group annuities are at once apparent:

(1) Deposit administration provides much of the flexibility formerly available only in a trusteed plan. Costs may be estimated in accordance with any reasonable method. Turnover and future salary increases may be

allowed for in advance. Pensions may be based on final instead of average earnings. If many employees are close to retirement when the plan is adopted, their annuities may be purchased out of the general fund. As in a trusteed plan, the employer carries the full risk of mortality before retirement, and he enjoys the full advantage of turnover. If employees leave his service without a vested interest, there are no surrender charges. Whether they leave in good or bad health, the full amount contributed on their behalf remains in the general pool.

(2) Deposit administration also has the principal advantages of group annuities. It makes available the same all-inclusive service covering investment, actuarial and certain administrative phases. It guarantees the payment of annuities actually purchased. It guarantees the principal of contributions as well as a minimum return thereon.

Deposit administration also combines some of the disadvantages of trusteed plans and group annuitites.

(1) The basis of funding benefits under deposit administration is subject to the judgment of the actuary. The adequacy of deposits is not guaranteed. Therefore the danger of underfunding is no less than in the trusteed plan, if the actuary's judgment is poor.

(2) The insurance company must protect itself against unforeseen contingencies as under a group annuity. Therefore the premiums charged for annuitites withdrawn from the general fund are based on the same very conservative assumptions as to mortality and interest. As under a group annuity, the release of excess earnings in the form of dividends will reflect anticipated mortality and interest *trends* in addition to actual experience with respect to these two factors.

There are many variations in the details of deposit administration contracts. They are not the whole answer to the trusteed method. One proof of this statement is found in the fact that insurance companies have taken the initiative, in recent years, to propose to their customers a method of financing retirement plans generally referred to as "split funding." When using this technique, the employer contributes part of the funding requirements under a deposit administration contract and part to a supplemental trust. While the latter can then be invested primarily in common stocks, the former is, of course, subject to the investment restrictions of insurance companies. This method would appeal to the employer who feels that the insurance company can do a better job with fixed income investments. As participants retire, the required annuities are purchased from the insurance company at the going price. It will take many years until the merits of this compromise can be proved.

INDIVIDUAL INSURANCE POLICIES HELD IN TRUST

If the number of employees in your plan is relatively small, individual insurance policies are the ideal funding medium. Their principal advantages are the following:

(1) The annual premium remains unchanged during the life of the contract.

(2) The death benefit available under the policies is appreciated by employees in all age groups.

Individual policies have also been used in plans for large groups. But then their disadvantages are more likely to become apparent:

(1) Usually, cash values are not available during the first two years of the contract. Consequently, the employer suffers a penalty if the covered group is subject to a high rate of turnover.

(2) The premium cost is high in comparison with group rates. The difference is not very important where only 30 or 50 lives are involved. Where hundreds and thousands of employees are covered, the difference becomes an issue of some magnitude. This realization has led many employers to convert such plans into trust funds.

Probably the most common type of contract used in individual policy plans is the retirement-income-with-life-insurance type. These contracts generally carry a death benefit that is related to the monthly pension in the ratio of 100:1. In some cases the ratio is as high as 125:1; in others as low as 50:1. The reserve required at normal retirement age to pay the retirement benefit is considerably larger than the face value of the policy. Therefore, the cash value exceeds the face amount in the later years of the contract. When that happens, the cash value becomes the death benefit.

Employees who cannot pass a medical examination may be covered by annual premium annuity contracts. They are somewhat less expensive since they limit the death benefit to the cash value of the policy.

The most common standard form of settlement provides the payment of the retirement income for "ten years certain" and life thereafter. Some policies provide for shorter or longer "certain" periods, and all of them allow a variety of options that are equivalent in value to the standard form.

As a practical matter, a plan funded by individual policies requires the services of a trustee who holds the policies. This is advisable so that both employer and employees may enjoy the tax advantages usually associated with retirement plans.

Increases in the amount of insurance are usually not permitted for less than $500 of face value or $5 of monthly retirement benefit.

If your employee group exceeds 50 in number, and you desire substantial life insurance benefits, you may want to consider "group permanent" insurance. This method of funding a plan is of more recent origin. As in group annuity practice, a master contract is issued to the employer, and the employees receive individual certificates. The insurance company generally specifies a maximum amount of life insurance that will be written for any individual employee without medical examination. This maximum bears some reasonable relation to the size of the group and the total amount of insurance applied for.

The availability of a reasonable amount of insurance without medical examination is an important factor (although recent more liberal limits of group insurance have reduced its meaning). If higher-paid employees are entitled, under the plan formula, to an amount of insurance exceeding the non-medical maximum, the deficiency can be contracted for, subject to evidence of insurability.

The annual level premium rates are usually guaranteed with respect to new employees entering the plan at the same age for a period from one to five years. Despite this advantage, it should not be expected that the cost of group permanent insurance over the years will be much less than the cost of individual contracts. True, this method reduces administrative expenses on the part of the insurance company below those for individual contracts. However, such savings are offset by death claims paid on employees who would have been rejected if they had to pass a medical examination.

COMBINATION PLANS

A. Conversion Plans

As we have already seen, individual policies which provide retirement benefits involve a high premium cost. Consequently, an employer may suffer substantial losses if many participants leave his service before the cash values of their contracts bear some reasonable relation to premiums paid.

To reduce these potential losses and yet make substantial death benefits available, some retirement plans use ordinary life insurance contracts. The premium required to keep these contracts in force is considerably lower. But so is their cash value. Therefore, a policy at normal retirement age would not provide a monthly income as high as one one-hundredth of the face value or any amount near that.

Many insurance companies permit the conversion of ordinary life policies into annuity contracts at retirement age, provided that the difference in cash value is made up by a lump-sum payment. The amount of the required lump-sum payment is guaranteed at the time the original policy is issued. Therefore, the amount can be accumulated by periodic payments into a supplemental trust fund. (Some insurance companies agree to hold the supplemental fund at a guaranteed rate of interest.)

The advantage of this arrangement is that a substantial portion of the pension reserve is held in an undivided fund which is generally not affected by turnover. At the same time, the life insurance protection is available to participants. The death benefit may be provided by individual contracts or, if the group is large enough, group permanent insurance may be used.

B. Combinations of Funding Methods

Some employers who find group annuities attractive, nevertheless cannot see their way clear to put up the full cost of past service annuities for employees who must be retired immediately, or soon after adoption of the plan. The amount involved can be very substantial in some cases. Although the pensions must be paid for eventually, no matter how they are funded, the trusteed method is less rigid. It will generally enable the employer to budget his past service contributions more conveniently. Therefore, he might choose a trusteed plan to fund past service and insurance to fund current service.

All this solution means to a retired employee whose pension is partly based on past service is that he receives two checks, one from the insurance company for his future service pension, and one from the trustee for his past service pension. The trustee has the problem of handling a wasting fund which requires careful investment planning. The maturity dates of investments must be properly spaced to allow for pension payments as they come due. Otherwise investments might have to be sold in an unfavorable market.

Some companies have a serious turnover problem among the rank and file of employees. Therefore the trusteed plan seems to be their logical choice. But they would like to provide the advantages of individual insurance policies for the executive group and other key personnel. In some cases, this is accomplished by funding benefits arising from the first $3,000 or more of annual earnings on a trusteed basis, and benefits arising from the balance of annual earnings by individual contracts. Sometimes, the dividing line has been drawn at $5,000, or even as high as at $10,000. Of course a group annuity could take the place of the trusteed portion of this program. The potential loss from turnover would then be reduced to the 4% surrender charge which is considerably less than the loss of all premiums paid under an individual contract recently issued.

SUMMARY

Employers of large groups have a choice of several funding methods. For instance, they may enter into a group annuity contract with an insurance company. Under this method the employer, each year, buys a single premium deferred annuity for the pension amounts earned by his employees during that year. The rates are generally guaranteed for a five-year period, but subject to change annually thereafter. The insurance company guarantees the payment of annuities purchased.

For several reasons, group annuities have been receiving keen competition since World War II from trusteed plans. While these do not enjoy the dollar guarantee of a third party, like the group annuity, they offer the advantages of maximum investment freedom, resulting in a favorable cost differential. They also permit the greatest amount of flexibility in plan provisions and timing of contributions.

Deposit administration represents an attempt on the part of insurance companies to combine certain advantages of the group annuity and the trusteed plan. They have not altogether succeeded in this effort and, more recently, insurance companies themselves have suggested to employers in many instances to supplement deposit administration plans by trust funds to allow the investment of part of the pension reserves in common stocks.

Employers of small groups find individual insurance policies the ideal medium. They offer the advantage of annual level premiums and generally substantial death benefits. When used for larger groups, their higher cost becomes a factor to be reckoned with. So do losses due to turnover, since cash values are small or non-existent during the early life of a contract. More recently, "group permanent" insurance has become popular. It has all the advantages of individual contracts but provides death benefits without medical examination up to a stated maximum. However, participants must number at least 50.

If you feel that large death benefits are desirable but you are unwilling to accept the risk of substantial losses due to turnover, you may reduce that risk by adopting an ordinary life conversion plan. Here part of the pension reserve is kept in a supplemental trusteed fund which is used to convert the low-cost ordinary life policies into annuities as participants reach their retirement date.

To save costs or exercise better budget control, you may also give consideration to a combination of funding methods. For instance, you may use any group funding method with respect to benefits arising from the lower bracket of participants' earnings, and individual contracts for benefits based on the higher earnings brackets. This arrangement provides pensions for all, and substantial death benefits for key personnel.

CHAPTER (8)

WHAT WILL MY PLAN COST?

FACTORS OF COST

If you were to ask people which they would sooner have, a cash sum of $10,000 or an income of $100 a month, the answer, in nine out of ten cases, would be: Give me the cash. The value of a life income is rarely appreciated in terms of a lump sum.

Without quibbling about the appropriateness of this or that mortality table, let us assume that a man retiring at 65 years of age has an average life expectancy of 14 years. The life expectancy of a man retiring at 60 years of age is about 18 years. That means that monthly payments of $100 in one case will probably total $1200 × 14 or $16,800, in the other case $1200 × 18 or $21,600. If the two men are now 40 years of age, 25 years remain to accumulate the required total for one, but only 20 years to accumulate the larger sum for the other. The annual payments would be $672 in the first, and $1,080 in the second case. This example may be oversimplified but it proves conclusively that the cost of your plan will be affected not only by the size of the pension (which is obvious) but also by the normal retirement age.

Of course, your contributions will be kept invested until they are needed for pension payments. Consequently, the amounts set aside for a particular employee will earn income both during the period of accumulation before his retirement and during the years after retirement when his reserve is being diminished little by little by pension payments. For the sake of simplicity, let us forget about income earnings after retirement which have the effect of reducing the amount of the required reserve. Let us assume that the full $21,600 is needed to provide $100 a month for the second man who retires at 60 years of age. If he is now 40 years old, 20 annual contributions of $1,080 would be needed, if no income were earned. The annual contribution would be reduced to $845 if income at 2½% were earned, and to $698 if income at 4% were earned. So it is plain to see that income earned on pension funds is a very important factor of cost.

Although a man, once he reaches the age of 65, still has an average life expectancy of 14 years, more or less, many of your active employees will die before they reach retirement. For instance, a man 30 years of age has a 72% chance to live to age 65. Obviously, the mortality rate before retirement has a marked effect on costs. The greater the average age of the covered group is, the lesser will be that effect. It is eliminated entirely if the contributions accumulated for a deceased participant are paid to his beneficiary as a death benefit. It would not make a great deal of difference if that death benefit were made dependent on the completion of 10 or 15 years of service. Then only the younger participants would not be eligible for the death benefit, but their chance of dying is slight, and their accumulations in the fund are small.

Depending on the type of employees covered and the character of your business, a greater or lesser number will leave your service before retirement. Naturally this will reduce the cost of your plan. The cost effect of turnover is offset by vested rights granted under your plan. If vesting is totally unrestricted, the effect of turnover is entirely lost. If a minimum age or length of service, or both are made a condition for vesting, the effect of turnover is only reduced. As explained earlier (see Chapter (5)) the effect of turnover is often overestimated. Turnover is heaviest among the new and young employees for whom only small funds have as yet been set aside.

To sum up, the cost of your plan will be primarily affected by the following factors: Size of pensions, retirement age, income earned on funds, mortality and turnover. These factors operate regardless of the method of funding you select for your plan.

INITIAL COSTS VERSUS ULTIMATE COSTS

It has been stated again and again that the true cost of a retirement plan equals the amount of pensions actually paid plus the expenses of administration less income earned on the fund (adjusted for net gains or losses from investments). This cost may be referred to as the ultimate cost of your plan. Naturally the ultimate cost of a plan is unknown at the time of its adoption.

One purpose of funding a plan is to spread the amounts required for pensions as much as possible over the entire period of active service of the employees who will ultimately receive them. Since the ultimate cost is not known in advance, it must be estimated. Some yardstick must be agreed upon by which the impact of the factors influencing costs can be measured.

Most important among such aids is the mortality table. This is a record of the death rates experienced during a certain period and among certain groups of people. It may be based on census data or on the experience of insurance companies. Fundamentally, it does not predict future mortality but gives expression to past experience. However, since the long range trend of mortality is downward (primarily for ages under 65), actuaries frequently make adjustments in the tables to allow for possible future improvements in mortality. These adjustments are referred to as "rating". For instance, a table is rated up one year if a person now 40 years of age and scheduled to retire at 65 is assumed to be only 39 and is assumed to retire at 64. Frequently a further element of conservatism is introduced by using an interest factor which is smaller than the return the fund is really expected to earn. It is quite natural that an actuary, whether he represents an insurance company or supervises trusteed plans as an independent consultant, is fearful of underestimating the funds required. To an insurance company, it would be most serious to underestimate the needs, since it guarantees the payment of pensions.

This type of conservatism is a credit to the high standards of the actuarial profession. It recognizes that most retirement programs will remain in effect for many years to come; some will undoubtedly outlast the companies that initiated them. Contributions made or premiums paid in any one year are insignificant in comparison with the total requirements of the plan over the years.

If initial costs were that important, then your logical choice would be an unfunded plan where the initial costs are invariably low or non-existent, but often increase to fantastic sums after several decades. Even in comparing the cost of trusteed and insured plans, a fair degree of allowance must be made for the fact that some of the excess cost of the latter may be expected to be returned in the form of dividends. However, there is also an ultimate cost differential which is determined primarily by methods of investment mentioned in the preceding chapter. And you must realize that an insurance company, with every premium received, assumes an obligation it cannot fully discharge for 30 or 50 years. The insurance company deserves some compensation for assuming that liability.

SOME COMMON WAYS OF REDUCING COSTS

While initial costs of a plan are not entirely indicative of its ultimate cost, nevertheless they may be a matter of great importance to you. This would be particularly true if the accrued liability for past service of your employees amounts to a large sum.

In many cases the accrued liability approaches, or even exceeds, the annual payroll of eligible participants. Unless you want to follow the unorthodox recommendations made in the 1949 steel dispute by actuaries for the United Steelworkers, that cost must be amortized. If it is to be paid over a period of 20 years, for instance, and the total amounts to one year's pay of all your eligible employees, you must be prepared to pay more than 6% of that payroll for past service alone over the next 20 years. But the cost of providing for pension credits during each year after adoption of the plan, commonly referred to as future service cost, must also be paid. Very likely that cost will be somewhere between 5 and 10% of eligible payroll, depending on benefits and funding procedure. In other words, the total annual cost of your plan during the first 20 years may well run from 10 to more than 15% of eligible payroll.

There are several ways in which employers have tried to reduce costs:

(1) Sometimes retirement dates are staggered during the early years of a plan. For instance, employees who are older than 60 when the plan is adopted, may be retired after five years, those 61 at 66, those 62 at 67 etc., instead of at 65. Or people over 55 are retired after 10 years. Usually a maximum age, such as 70, is specified beyond which employees will not be retained in active service. Immediate savings resulting from staggered retirements are limited by the general practice of granting pension credits for the additional years of service. Aside from cost, this device does, of course, delay the full effectiveness of the plan for a number of years. On the other hand, it actually reduces the ultimate cost of a plan, since the employees affected will not receive their pensions for as many years as they would if they had retired at 65.

(2) In other cases, employees over 55 or 60 when the plan becomes effective are excluded from coverage altogether. This method only shifts the cost from the plan to the payroll, unless the company intends to discharge the employees when they are no longer able to work.

(3) Very frequently, the initial cost is reduced by severe restrictions on eligibility of new employees. Such restrictions hardly affect ultimate costs, since the same number of employees will reach retirement, whether they were admitted to the plan soon after they were hired, or after a long qualifying period. Of course, their pensions may be slightly smaller if they are based on years of membership and they had to wait several years to enter the plan. However, even then the effect will be negligible, because the excluded employees are young and the cost of their potential pension credits would only be small, unless the pension is based on final earnings or on the average during a final period of service.

(4) Employees may be asked to contribute to the cost of future service benefits under a plan. (Past service benefits are usually provided in their entirety at the employer's expense.) This is by far the most realistic approach toward a reduction of initial as well as ultimate costs. Since the subject of employee contributions involves some rather interesting pros and cons, it will now be considered in some greater detail.

EMPLOYEE CONTRIBUTIONS

From time to time there has been much talk about the "contributory principle" in providing pensions. It is at least doubtful if employee contributions are a matter of principle. They appear to us rather as a practical means to reduce the true cost of a retirement plan. Or, looking at them from another angle, they are a convenient means of providing higher employee benefits with the same amount of employer money.

In rare instances, employee contributions cover a stated portion of the cost of future service benefits, perhaps one third, at the most one half. Even then the contribution is generally limited to a maximum percentage of a participant's pay, such as 5 or 8%. That limitation is advisable to protect the older people, since pension costs increase with the age of participants. For instance, the cost of a 10-year endowment policy for a man age 55 which provides a 30% pension might be equivalent to 25 or 30% of his earnings. It is questionable if he could afford a contribution of half that percentage. Where contributions are required of employees, they should not be so burdensome as to make the plan acceptable only to the higher-paid employees, or else the Internal Revenue Service will consider it discriminatory.

More often employee contributions are expressed as a percentage of their earnings, such as 2, 3, 4, 5 or 6%. In plans that base pensions on annual unit credits (see Chapter (3)), the rate of contribution usually bears a definite relation to the annual credit. This relationship is referred to as the contribution ratio and may be 2:1, 3:1, more rarely 4:1, or some other combination. A 2:1 ratio, for instance, would apply in a plan where the employee contributions are fixed at 2%, and the annual pension credit is 1%. The same ratio would also be in effect, if the contribution were 2½%, and the annual credit 1¼%.

Because many plans provide higher benefits on earnings over $3,000[1] annually than on earnings under $3,000, employee contributions often vary correspondingly. For instance, if a contribution ratio of 3:1 is to apply, and the annual pension credit amounts to 1% of earnings under $3,000 and 2% of earnings over $3,000, contributions should be fixed at 3 and 6% respectively. Employees frequently have difficulty grasping the fairness of these ratios. This is because they fail to realize that the annual credit will be paid to them for life. Consequently, they usually receive their own contributions back within 2 to 4 years after retirement.

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[1] **The breaking point of $3,000 has been chosen in many plans because Social Security until 1950 covered only the first $3,000 of annual earnings. Later $3,600, $4,200, and now $4,800 have been used.**

What portion of an employee's pension is paid for by his own contributions? The answer depends on his age, the contribution ratio and the funding medium used in the plan. We must make a number of assumptions to gain an approximate impression of the value of employee contributions to the employer. Suppose $12.50 is needed to provide $1.00 of annual pension beginning at 65, and the plan grants an annual pension credit of 1% for each year of serivce, and calls for employee contributions of 2% of earnings. Therefore, an employee who is 45 years of age when he enters the plan and earns $3,000 annually until retirement at 65, will be entitled to an annual pension of $600. That pension would cost 600 times $12.50 or $7,500. If the employee contributes 2% of his earnings, his contributions, at 2½% interest compounded annually, would aggregate $1,533. This is little more than 20% of the pension cost. If all the facts were as stated in this example except that the employee entered the plan at age 25, his contributions would pay for almost 27% of his $1,200 pension for 40 years of service. It is quite obvious that employees entering a plan at young ages pay for a larger share of their pension than employees entering at higher ages.

Elsewhere in this chapter we were speaking of initial costs as opposed to ultimate costs. You may be startled when you obtain estimates for a contributory plan from various sources. The differences will be far greater than for a non-contributory plan. The reason is that the employees generally contribute a fixed amount regardless of funding method selected. Consequently the impact of apparent cost differentials is directed in its entirety against *your* share of the cost.

In addition to paying for part of the pension cost, employee contributions have other concrete advantages. It was pointed out in Chapter (5), and it should be recalled here, that employee contributions are returned in case of death or severance before retirement. Many employees have no other systematic savings. Consequently, the return of their own contributions in the two emergencies mentioned is extremely welcome. Whatever advantages employee contributions may have, it is becoming more and more obvious that the trend in pension planning is away from contributory plans. There are several reasons for this development. The most outstanding one is probably the realization that employee contributions must be made out of previously-taxed dollars while the employer receives a tax deduction for his own share of the cost.

SUMMARY

Regardless of funding medium selected, the basic factors of pension costs are the following: rate of pension, retirement age, income return on accumulated funds, mortality and turnover. However, the ultimate cost of pensions is unknown at the time of adoption of a plan. Therefore estimates are required. A mortality table must be selected and an interest factor must be assumed to produce such an estimate.

While initial costs are not necessarily a measure of ultimate costs, they may be a problem during the period of past service funding. During that time the cost of maintaining the plan may be as high as 10 to 15% of the eligible payroll. Therefore many employers attempt to reduce costs in one of the following ways:

(1) By staggering the retirement of the older employees over a 10- or 5-year period.

(2) By excluding people over 55 or 60 from the plan.

(3) By severe restrictions on eligibility.

(4) By employee contributions.

Employee contributions appear to be the most realistic approach to the employer's cost problem. Sometimes the contributions are related to the cost of benefits, more often to the earnings of participants. If the pension under a plan is based on annual credits reflecting years of service, the employee contribution usually bears a definite ratio to the annual credit.

The portion of a participant's pension covered by his own contribution depends on his age, the contribution ratio and the funding medium. Employees entering the plan at a young age pay for a greater part of their pensions than employees entering later even though their pensions are larger. On the average, the participant's share is somewhere between 20 and 50% of the total cost of future service benefits.

In addition to paying for part of the pension cost, employee contributions provide incidental death and severance benefits.

While a strong argument can be made for contributory plans, the modern trend in pension planning, for various reasons, is away from employee contributions.

CHAPTER (9)

WILL MY EMPLOYEES APPRECIATE A PENSION PLAN?

THE RIGHT AND THE WRONG KIND OF APPRECIATION

Someone once remarked rather facetiously that employees never appreciate a retirement plan when it is presented to them, but they certainly criticize and complain if the employer does not have a plan.

Indeed, it has even been observed by many who have interviewed college graduates for jobs as trainees that these young men make it a point to inquire about the company's pension plan. It is difficult to decide if that is an indication of intelligence and foresight, or if it is a deplorable state of affairs. Some observers of current trends feel that the depression of the nineteen-thirties is an event to be regretted, not so much because of the great economic losses it brought upon individuals and corporations, but rather for the psychological changes it has caused in the minds of people. As far as you as an employer are concerned, you may not be interested in this negative kind of employee appreciation. Nevertheless it is a factor that you must reckon with in the market for labor.

You may count on a somewhat more positive appreciation on the part of people whose attitude is much easier to analyze than that of the job candidates mentioned in the preceding paragraph. Some employees do not look at a pension plan as just one of many items that must be considered in picking a job. They are the kind that will trade their hopes and aspirations at any time for security at any price. If some high pressure salesmen of pension plans claim that adoption of a retirement program reduces turnover, they are unquestionably 100% correct with respect to those employees. But it might do your business good to lose them, because they have already retired mentally. Obviously, theirs is not the kind of appreciation you want your plan to receive.

The type of employees whose appreciation you are interested in are those who will appraise intelligently the value of your plan. To them your plan will be just another condition that makes working for you attractive. They are aware that some day they will enjoy the advantages of retirement. In the meantime, they will evaluate your plan properly when employment is offered elsewhere. But they do not cling to you for the sake of security alone. They will not even want to depend on the plan entirely. Instead they will make every effort to supplement its advantages with a financial program of their own. Of course, they are a minority. But that minority deserves a good plan because they are the keystone of your business.

This train of thought may sound unrealistic in this day when pension plans involving millions of dollars are "bargained" for and even struck for. However, the minority we spoke of above is not composed of executives and so-called key men alone. Even your hourly rated wage earners are not only union members—they are your employees too. Some of them belong to that minority and you owe them the obligation to establish a good plan, though you may be forced into it by their leaders. You must resist, for instance, attempts to base unrealistically high pensions on inadequate financing. No matter what chain of events brings a retirement program into being, in the end it is your plan, and it is your business to make it a good one.

APPRECIATION MUST BE DESERVED

Whether they realize it or not, all companies have a pension plan. It may not be funded, it may not even have been reduced to writing, but it will at least have the form of a retirement policy.

As a matter of fact, most retirement systems started out with an informal policy. At first only those who are in need of financial support are considered, generally according to the degree of their need. As the number of older people increases, the policy is usually formalized and all cases are treated alike, regardless of need. At that stage, the magnitude of the obligation assumed is not self-evident for two reasons: (1) The retirement age is flexible. (2) Since pensions are paid out of current earnings, no consideration is given to the emergence of future pensioners. As a result, pensions, at that stage, are rather generous.

When thought is finally given to systematic funding of the plan, the size of the problem is brought into sudden and sharp focus by actuarial calculations. This is where usually the first blow is dealt to employee appreciation. If the same pensions were provided under a funded plan, beginning at a "normal" retirement age, as have heretofore been paid out of earnings, the cost would be larger than the company could afford. Consequently, the amount of retirement income is reduced below the accustomed standard. In other cases, the employees are asked to contribute toward a benefit their former associates are enjoying without a corresponding financial sacrifice on their part. Their disappointment is generally heightened by their failure to understand that a custom has been exchanged for a definite commitment. All that matters to the average man is dollars, not legal principles.

It is impossible to suggest an all-around remedy to ease the transition from one system to another. However, if this problem applies to your own case, you can prevent much damage to employee relations by giving the problem the utmost consideration in formulating your formal funded plan. For instance, if you are unable to pay the same pension to everybody beginning at 65, that you have formerly granted to employees unable to remain in service at 70 or 75, you can make up for it by other benefits that were formerly unavailable, such as early retirement provisions and vested rights.

These incidental benefits are also important if you are interested in gaining the good will of young employees and others who are not familiar with the old method. It is difficult for a young man to appreciate pension checks he may not receive for another 30 or 40 years, and then only if he remains in your service for that length of time. It is much easier for him to visualize potential benefits he or his dependents may enjoy in the less distant future.

Of course, an intelligent employee realizes that the main purpose of a retirement program is to provide pensions. Suppose the pension under your plan amounts to about 50% of average earnings after 30 or 40 years of service. How could an employee now 30 or 40 years of age possibly realize what that percentage will mean to him in dollars and cents? He hardly remembers what he earned 10 or 15 years ago and he certainly does not know what he will earn 10 or 20 years hence. Consequently, he cannot tell what his pension will be, without specific publicity that will be discussed under a separate heading. But he will be able to judge how your former employees are getting along on their pensions under the plan. This point was stressed already in Chapter (3) but it deserves repetition here. The mere fact that everybody receives the same percentage, in proportion to earnings and length of service, will not satisfy anyone.

WAYS TO STIMULATE APPRECIATION

No matter how fine a plan you adopt, you cannot expect your employees to appreciate it unless you take the time and effort to explain its advantages to them.

Anybody who is familiar with life in an average company will agree that it is almost impossible to keep consideration of any major policy completely secret. This is particularly difficult if a matter of personnel policy is involved, such as the adoption of a retirement plan. Someone in the personnel office has to prepare payroll data. Representatives of insurance companies and banks call on officials. Lengthy meetings are held behind closed doors. All this is so interesting that office and plant will be full of rumors before long. But rumors rarely ever reflect accurate facts. They certainly make it advisable to inform all employees promptly as soon as a definite decision has been reached. *This is rule number one.*

In most cases, information about the plan is presented in the form of a booklet which is transmitted to every employee together with a letter from the president. The exact manner of presentation of the important facts about the plan should depend on the type of employees covered. It will hardly ever do to give them a copy of the actual plan or trust agreement. The careful legal phraseology arouses nothing but suspicion. If many of the employees are foreign-born or have little formal education, they would not even understand it. At the same time, do not insult their intelligence. We have seen too many such booklets adorned with standard line drawings or woodcuts reflecting a life of ease after retirement. Against that background these booklets explain the principal features of a very modest plan, hardly sufficient to satisfy the basic needs of its beneficiaries. Explain the plan in plain language, but in realistic fashion. *This is rule number two.*

If a plan calls for contributions by the employees, it is, of course, necessary to solicit their participation. Naturally, you cannot speak to every employee personally. Therefore you must delegate that job. All too often department heads and supervisors are not born salesmen. They find it irksome to "sell" the plan to their groups. Often they have too many other duties to give much time to that important task. It is so much easier to use the technique of a noncommissioned officer in the army who wants to get things done. However, it will be to your advantage to impress upon them the value of persuasion, even if the reluctant attitude of the rank and file seems shortsighted. *This is rule number three.*

In nine cases out of ten, the announcement of the plan is the last thing an employee hears about it until five years before he retires. Then he receives a call from the personnel department and he is asked to name a contingent annuitant, unless he chooses the basic option under the plan. He has never faced a similar decision in his life, because he has never owned a comparable right to property. He does not fully understand the significance of all the options he has under the plan. The chances are that the personnel clerk who interviews him, does not understand them fully himself. Of course, this is wrong. Do not overlook any opportunity to keep your employees informed of the plan's advantages! Let them know how much they may expect to receive on the basis of their present earnings! Tell them how much you pay for their benefits from year to year! And let them know how your retired employees are doing! In other words: Keep your plan sold! *This is rule number four.*

Perhaps these four basic rules apply primarily in cases where the adoption of a pension program is the result of the employer's decision only. It certainly would not seem necessary to "sell" a plan if the employees' union demanded it in collective bargaining. However, this need not be a reason why the employer should not be entitled to his proper credit, as long as he pays all or the greater share of the cost.

SUMMARY

Appreciation of pension plans on the part of employees is not always the kind an employer is entitled to expect. Often the existence of a plan is practically ignored, but the absence of one is noticed and criticized.

The type of employee whom the employer should try to please is the one who evaluates a good plan as an attractive working condition without clinging to his job for the sake of security alone. Only a good plan can evoke that kind of appreciation.

If a funded program succeeds an unfunded one, its announcement would fall flat if the benefits were reduced. If such a reduction is necessary, it can be balanced by inexpensive but important incidental benefits that were not available under the former method.

Employee reaction is influenced by the experience of those already retired more than by any other single factor.

Appreciation can be stimulated by a proper amount of tactful publicity which begins with the formal announcement of adoption of the plan and does not end until the time when employees get ready to retire.

CHAPTER (10)

WHAT MAKES PLANS FAIL?

INADEQUATE BENEFITS

If a retirement plan collapses completely, leaving its participants stranded without the benefits they had counted on, it has obviously failed. This is a relatively rare occurrence. However, it has happened and it still does. But there are other less conspicuous and less fatal degrees of failure that are quite common. Some measure of failure occurs whenever a plan does not adequately fulfill the purpose for which it was created.

In order to point out the most important dangers which can lead to failure of a plan, it will be necessary to repeat some statements made earlier in this book. This repetition can do no harm if it helps to highlight the most essential *"don'ts"* that the pension planner must observe if his plan is to be a success.

It hardly needs emphasis that adequate retirement benefits are the essence of a plan. It was argued before the steel fact-finding board in 1949 that it then cost old couples from $120 to $152 a month to "exist". You should bear such figures in mind, when you decide on the rate of pension for reasonable periods of service, say, 25 years. Standards, of course, must be reviewed from time to time in the light of changed conditions. It is perfectly proper to take old age benefits under Social Security into consideration. However, additional income resulting from private savings of employees should not be counted upon in determining the amount of the minimum pension standard. If employees have been provident enough to sacrifice immediate pleasures during their active lives in order to accumulate a nest-egg, that should entitle them to old age security beyond a mere subsistence minimum.

Many retirement programs almost seem to worship the principle of percentages. If a man is entitled to 50% of his average earnings after 30 or 40 years of service, including Social Security, his pension is definitely adequate if he has earned $20,000 on the average. But what of a man whose earnings have averaged $3,000? Your plan is not a success if you retire that man on an income of $1,500, of which most is derived from Social Security. Of course, the employee himself has paid for half of his Social Security benefits, and in many cases he has contributed toward the cost of the pension.

Many retirement plans do not achieve a fair balance between past and future service benefits. In many such cases, particularly in contributory plans, not only the lower-paid employees but also the younger executives have a justified complaint. If past service benefits are based on earnings at the time of adoption of the plan and are computed at the same rate, many of the older executives will receive pensions practically based on their final earnings without having to make any contributions. Of course, the older people in the lower income brackets enjoy the benefit of the same percentage, but their final earnings are not as far above their average earnings as those of the executives. It could be argued that the success of a business was achieved through the efforts of the senior executive class. This is basically correct, but we should not overlook general employee appreciation.

It is very doubtful that the average consultant will call your specific attention to this important danger, particularly if your consultant is primarily a salesman. Either he feels that it would be tactless to suggest the thought, or he imagines that his chance of making a sale is increased by not calling it to your attention. But you are interested in letting every pension dollar do the most good.

This exaggerated emphasis on percentages has done much to encourage union demands for flat monthly benefits including or excluding Social Security. As was to be expected, these flat benefits, since the early days of union bargaining on pensions, have become "minimum" pensions, and the merit of recognizing a "floor" in dollars is now generally accepted on both sides of the bargaining table.

INCONSISTENT RETIREMENT POLICY

The now famous dispute between Inland Steel Company and the C.I.O. originated from a difference of opinion as to the company's right to retire employees at 65 without their consent. The brief of the United Steelworkers submitted in 1949 to the President's fact-finding board contained a demand for voluntary retirement after age 65. The plan agreed upon the same year between the Ford Motor Company and the United Automobile Workers stipulated a mandatory retirement age of 68. But the company at its sole discretion could retire any employee 65 years of age or older if he was unable to perform efficiently the work assigned to him. Many instances of similar arrangements could be added.

These three examples seem to point out a conflict existing in the minds of employees. They want the right to retire as early as possible but they also want to escape the financial consequences of retirement as long as their mental and physical condition permits. If this trend of thinking continues, all retirements would become retirements for disability. Obviously, this would be a reversion to the original concept of pensions (see Chapter 2). This thinking is understandable, as long as many retirement plans provide only meager benefits for the rank and file. It may be universally accepted when, as optimists hope, not only years will be added to life but also *life to years.*

Experts seem to agree that a flexible retirement age is not harmful to a plan if it is restricted to employees who perform only mechanical or routine functions. But the decision as to who may remain in service and who may not, should be left to management, as under most plans. Certainly, an employee should not be permitted to remain in service for the sole purpose of earning additional credits toward his pension, and most plans which permit continued service after normal retirement age make it clear that such extended service shall not increase pension benefits payable on actual retirement.

The same experts agree that strict adherence to a uniform retirement age is far more important with respect to executive personnel. Management must be virile and alert if a business is to remain successful in competition. No one who is at all familiar with the pace in the executive offices of our large corporations will quarrel with that viewpoint. But it is often here where exceptions as to retirement age are made.

Death takes men in high places every day, and large corporations continue to exist and prosper. Yet some men feel they are indispensable and resist retirement. In some cases, they may be essential to the continued success of the business. In others, they not only perpetuate out-dated policies but also prevent the next generation from stepping into their places.

It should be remembered that the retirement of a single executive at the proper time can make dozens of well deserved promotions possible. His refusal to yield his place can cause an equal amount of frustration. In this manner a whole generation of potential executives may be denied the reward they have earned by years of hard work.

Of course, such inconsistency of retirement policy will not bring about a spectacular failure of a plan. It may even go unnoticed among nine-tenths of the working force. As a matter of fact, it will actually reduce the cost of a plan, if one or a few large pensions do not have to be paid for a number of years. That saving, however, may be offset by lowered morale in the potential management group. It is not worth that price. If your retirement program deserves being adopted, it deserves being applied consistently.

LACK OF EMPLOYEE INTEREST

You might as well face the fact that employee interest in your plan will not be the same among all groups. It will always be greatest among those who are soon to leave your service. There is no harm in that. But it does make a great deal of difference to the success of your plan whether employees consider retirement as only another form of discharge or an opportunity that resembles a promotion.

Some people believe that the size of pensions alone determines employee attitude in this respect. Of course, it is important that pensions, together with other available old age benefits, make a decent living standard possible. However, it is obvious that even the most generous program, of necessity, involves a reduction in income. Therefore, adequacy of benefits cannot be the only factor.

Other employers feel that people in general do not appreciate anything that is given away free. Consequently they prefer a contributory plan. Undoubtedly this observation is correct to some extent. Whether it outweighs some of the arguments against employee contributions is another matter. In considering the question, it should not be forgotten that many employees, as individuals, take pride in making some provision of their own for old age security. Taking into account all the facts, we are not convinced that employee contributions to a pension plan do much to create greater employee interest.

In the opinion of others, consistent and determined publicity will create interest where none existed before. Such methods to "sell" a plan were discussed in Chapter (9). The importance of advertising in business is demonstrated every day. No doubt some of the lessons learned from advertising can and should be applied to employee relations. Of course, it must be done carefully and with proper regard for the type of employees to whom the publicity is directed.

However, it is our firm belief that the greatest single factor to make sincere employee appreciation a reality is to give dignity to retirement. The United States is a nation of active people. We put a premium on youth because the young do more things with less effort. Their minds are restless and constantly conceive new things to do. Instinctively we give them credit even when that restlessness of spirit is not constructive. We have little regard for the wise counsel of the aged that was highly regarded in antiquity and we have no use for the constructive contemplation of the oriental. As a result retirement becomes an end, not a beginning, in our minds.

It has often been remarked that this country wastes the invaluable experience of its ex-Presidents. We know it, but we do nothing about it because we place too much emphasis on the glamor of visible success. After we climb to the top of the ladder, there seems nothing left to do but to jump off the top into oblivion.

What is true of people in high public office applies likewise to every humble corporation employee who faces retirement. There are so many things that should be done and are not being done today because they are not directly productive. Civic affairs, educational projects and charitable activities are but a few of the many fields that can absorb the interest of our aged population in a constructive way.

Unless we all change our negative attitude toward old age and retirement, the present waste of potential manpower will increase in proportion to the growth of that segment of our population. You can do much to give dignity to retirement. We do not think that you have to hire the services of a psychiatrist to prepare your employees for retirement. We do not believe that you should make particular efforts, as some authorities suggest, to awaken the interest of your aging employees in hobbies so they can "kill" time. But we hope that you will not wash your hands of them when their time comes to leave your service. Make them feel that they are welcome to reasonable help and advice when they want it. Make them realize that they are still part of your organization as long as they live. At times that may seem a nuisance. In reality it is one of the greatest contributions you can make toward the success of your program. If your efforts in this direction are sincere, they will pay dividends in true appreciation on the part of those who still have to take the final step of their career.

INADEQUATE FUNDING

Total or partial failure of pension plans has been caused in the majority of cases by inadequate funding. The fact that a plan is "insured" does not provide automatic protection against that possibility, except with respect to participants who are already retired. Since the insurance company, as a rule, insists on payment of the full pension reserve for a prospective retiree prior to retirement, participants in that class are generally taken care of.

A trusteed plan can provide the same degree of security by the inclusion of appropriate "termination" provisions in the basic document. The security of all participants, not only retired ones, can be protected further if the employer takes pains to follow the conservative advice of his actuary and makes the suggested contributions as though they were premiums payable to an insurance company.

As a pension fund grows in size, the temptation becomes great to suspect the actuary of too much conservatism. Perhaps there are only five hundred participants and the fund has grown to several million dollars in eight or ten years. When will it ever level off? This is a question asked by many employers.

The annual reconcilements of actual group experience with the actuarial assumptions give rise to further questions. Often there are wide variations of actual deaths and separations from the assumed ones in any one year. It should be remembered that actuarial assumptions are only a yardstick, not a time table. If such variations persist over many years, the actuary will adjust his assumptions to allow for the experience of a particular case.

It was pointed out in an earlier chapter how important a part income returns play in determining the cost of a retirement plan. This realization has led some into unsuitable investments. It would go beyond the scope of this book to discuss investments in detail. Let it suffice to say that a better understanding of the nature of pension funds has had a tendency in recent years of widening the field of investments. A reasonable proportion of common stocks is now considered by most authorities as appropriate for most pension funds. Careful selection of individual issues, as well as appropriate timing of purchases, is all-important. It is obviously improper to speculate with pension funds.

These are some of the pitfalls that should be avoided in funding pension costs. Just as serious are other steps that are sometimes taken deliberately. They have already been discussed in Chapter (6) under the heading of "Marginal Funding". If you are forced into a pension plan against your better judgment, the temptation is indeed great to "cut corners". But once you adopt a plan, it becomes your problem. Therefore, it will be to your advantage to give it the careful consideration that you would give to any other financial transaction of comparable magnitude.

SUMMARY

Failure of a pension plan need not take the form of its complete collapse. Some degree of failure occurs even when a plan does not fulfill completely the purpose for which it was created. Among the common causes of failure are the following:

(1) Inadequate Benefits. Pensions must allow for the needs of retired employees. Proper balance must be achieved between the retirement incomes of executives and the rank and file. The application of percentages does not accomplish that goal automatically.

(2) Inconsistent Retirement Policy. While it may do no harm to a business to retain some physically and mentally able routine employees after normal retirement age, management personnel should be retired promptly in all but exceptional cases. This will keep management virile and alert, and will facilitate promotions that are essential to the morale of key personnel.

(3) Lack of Employee Interest. Factors promoting such interest are primarily adequate pensions and a reasonable amount of publicity. However, most important are the cultivation of a new philosophy of retirement and sympathetic understanding of the problems of employees already retired or about to be retired.

(4) Inadequate Funding. There is no easy road to pension funding. Premiums must be paid and contributions must be made as planned. Investments must be carefully chosen and dangerous actuarial concepts must be avoided. A pension plan is a major financial undertaking which must be given the careful attention it deserves. No matter whose idea it was originally, it will be the employer's program, once it is adopted.