Pensions - Financing

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PENSION PLAN FINANCING

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P E N S I O N   P L A N   F I N A N C I N G

by

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An address before the conference on Pension Plans in Collective Bargaining sponsored by the Practicing Law Institute of New York and held at the Hotel Commodore in New York City on April 1, 1950.

In line with its objective of improving understanding of labor relations, the Labor-Management Institute will from time to time make available in mimeograph form articles which will serve to shed some light in this field.

The busy, successful practicing lawyer who is suddenly plunged into a collective bargaining session devoted to pensions is an unenviable position. He directs his research-conditioned mind to the problem and is confronted by a sky-high pension haystack in which he must find, for his client, the appropriate pension needle. He is met with an endless mutation of plans. There are a baker's dozen insured plans, countless varieties of trusteed plans, and an infinite selection of union welfare plans. He can have a full reserve plan, a partial reserve plan, or perhaps a formal or informal pay-as-you-go plan. Digging a little deeper he comes upon contributory or non-contributory schemes; unit benefit, level percentage benefit, flat dollar benefit and money purchase plans. But we can't stop here, and further on we find particularization of the basic plans and he has his choice of group annuities, pure and group annuities compromised, i.e. deposit administration plans; pension trusts with individual policies; group permanent either as a whole hog or partial hog; even group life insurance on the yearly renewable term basis is not immune as a pension setup which can be spiked with a later rate guarantee for pension purchases. The trust fund is a magician which can pull out of its hat any pension rabbit that your delicate intellectual taste might require. Insured and trusteed methods in combination are limited only by the inventive genius of the consultant. Brooding over this melange is the ubiquitous Bureau of Internal Revenue with its approved and unapproved plans; formulae integrated with Social Security; aggregate funding, entry age funding, over-funding, under-funding, etc.

From this entanglement can we string out some golden guide thread which can give you some direction in the pension hunt? This task has been assigned to me by my friend and mentor, Denny Maduro. Fortunately, I have been able to tap the resources of Denny and other scholars in this field. This paper is the result. My only role is that of the factotum who will serve up the heady intellectual wine of pension financing.

ECONOMIC GROUPS CONCERNED

To whom must we answer, in the development of our pension funding thinking? I visualize six legal, economic and sociological units whose reactions will be important to us. I give them to you not necessarily in the order of their significance in any individual situation.

There is management seeking to hold the lid on costs; trying to avoid abnormal variations in its income exhibits; dedicated to a strong invulnerable cash position. It is an alert management which wants to pass on to future managements a smooth working plan, financially in a position to discharge its promises, and which has assumed its share of past service costs.

Second, there are the dividend-conscious stockholders to whom the plan must be sold and who must approve it.

Third, there are the employees individually and in union dress who want a plan that will pay off on retirement day and furnish a reasonable gross pension supplemented by Social Security.

Fourth, there are the firm creditors who want assurance that the balance sheet of the company clearly and accurately expresses its pension liability.

The Bureau of Internal Revenue is an interested party and will pass on Uncle Sam's participation in the pension cost through tax deduction.

Finally, there is the public of which we hear so much today. American Management and American Organized Labor are on trial in the court of public opinion to prove their ability to solve our economic problems through voluntary, free enterprise techniques. We cannot ignore community attitude in our pension decisions.

FACTORS TO BE CONSIDERED

Within the corporate family, there are a number of philosophical guide posts which should be carefully scanned as you approach your choice of plan. Perhaps the most important caveat is to avoid what might be called lump-concept thinking about the financing vehicle. Style and keeping up with the Joneses are unimportant. Your pension suit must be tailored to fit the needs of your particular situation. It may be a traditional form but it might also be a combination of a little bit from each of five different forms. Don't let the ready-to-wear pension suit destroy your desire to work out a genuine form-fitting suit for your client. There is plenty of flexibility available to you.

Second, gear your thinking to an open-end philosophy. There can be no finality in pension decisions. Even if you prefer the peace of finality, your union may not be willing to acquiesce in such a point of view. Social and economic changes may compel pension plan changes. You need both a microscope and a periscope in pension finance planning.

Then there is a series of facts which will shape your thinking and try your good nature. Briefly noted, some of these are: the size of the company; the present financeial status of the company and your educated guess as to its financial future; the age and sex distribution of the company's personnel; the ratio of labor cost to total cost of operations; the rate of labor turnover; the death and disability rate in this business and industry; the attitude of the union; the pension status of the company's competitors; your wishes as to integration with social security; and finally your gambling spirit as to the risk you are willing to assume on the future of mortality and interest rates.

FINANCING TECHNIQUES

With some of the broad and immediate landmarks sighted, what can your client have in the way of financing techniques? For convenience' sake, I have divided his choice into three major groupings with the aside that there is no iron wall between the groups. In fact, cross-fertilization is often the most virile approach. The three groups are the insurance plan, the trust plan, the self-assumption plan.

Because of the temporal limitations on this brief paper, and the richness and variety of the flora and fauna of pension plans, I must give you an aerial survey rather than a microscopic one.

The first thing to understand is the difference between the financing and the funding of a pension plan.

Financing means the investment vehicle which is to be used to either purchase or provide the benefits of the plan for each employee. By analogy, it is like trying to decide whether the development of a new product should be financed by a bond issue or a preferred stock issue or a common stock issue.

On the other hand, funding represents a method of amortizing the liabilities created by the plan. By analogy, it is like trying to decide the sinking fund provisions to meet the liabilities under a mortgage trust indenture.

Unfortunately, there are certain occasions when there is a merger of financing and funding. This is because the very nature of certain financing vehicles are best adapted to certain types of funding, and in these cases the pension field uses the terms financing and funding as if they were the same thing.

THE INSURED PLAN

Delving into the treasure land of the insured technique, there is first the traditional group annuity. It is still probably the "best seller" among employers of fifty or more employees. It is issued in the form of a master contract between the insurance company and the employer. The contributions made by or on behalf of each employee are utilized to buy each year a single premium deferred annuity to begin at the stipulated retirement age. Premium rates are usually guaranteed for a period of five years. After that the rates are subject to annual changes.

The premiums are discounted for mortality and for interest at a guaranteed rate, at present usually 2% or 2¼%. Because of the mortality discount, the employer doesn't receive a refund if a participant dies before or after retirement. However, the employees' contributions are usually returned to his beneficiary in the event of death before retirement, sometimes with or sometimes without interest.

If the employee leaves the service of his employer before the pension vests, and he is in good health, the employer receives a return of his contribution, improved by interest but reduced by an expense charge of about 4% of the total premium paid with respect to the employee.

A variation of the group annuity plan is the Deposit Administration form. It is sometimes referred to as the "modernized group annuity", but it actually came into being ih the early group annuity days—about 1929.

Originally the Deposit Administration plan was available only to the larger employer. I believe 1500 employees was the usual minimum. But today this minimum has dropped to 500 and perhaps in some companies it may be lower. Its current popularity is attested to by this statistic. There were seven times as many Deposit Premium plans written during 1947 and 1948 as were written during the five-year period preceding 1947.

Under this plan, generally speaking, the employer's contributions are held in an undivided fund at a guaranteed rate of interest. As an employee retires, the company withdraws the price of the annuity from this fund. The premium rates used to calculate this price are guaranteed at the time of deposit. The cost of all annuities purchased with money 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 figuring the cost of annuities until the fund built by the earlier contributions of the first five years are exhausted.

In contrast to the group annuity is the individual policy approach. The policies are usually purchased under a pension trust, by the trustee, on each individual participant in the plan. The trust is the depository of the policies. It acts as a brake on participant control of their policies prior to the date set forth in the plan. It is the conventional technique for obtaining the tax benefit. In addition to retirement income, such plans usually provide large initial life insurance benefits, death benefits after retirement, disability, vesting of cash values and some severance vesting in the form of either paid-up annuity credits or lump-sum or installment cash payments. Three types of policies are in general use: (a) the retirement income form which provides $1,000 of initial life insurance for each $10 of anticipated monthly pension; (b) the retirement annuity policy which contains no life insurance element; (c) ordinary life converted to retirement income retroactively at original issue date rates with guaranteed settlement options. Since the cash value on the comparable retirement income (per $1,000 basis) is greater than the ordinary life, a supplementary trusteed fund is created to provide the amount needed for the conversion. This supplementary trusteed fund is discounted for death and perhaps for disability and turnover.

The pension trust is **especially appropriate for the small employer with** few employees. Since the benefit under many pension trusts is a percentage of current pay, the costs in relation to payroll may be quite high if the few employees involved are old or if pay raises are substantial at the higher ages.

The pension trust also has an appeal for the larger organization. It can be utilized as a medium for the funding of premium credits arising from earnings above a certain level—e.g. $3,000 a year.

Several years ago, an interesting specie of the pension fauna came into being. It was called group permanent. It was developed, among other reasons, to reduce the cost and volume of administration of the individual policy technique and also to eliminate the medical examination feature of the individual policy plans. It involves the group technique of the master contract issued to the employer and certificates given to the employees. It is generally confined to groups of fifty or more. Group permanent contracts are available on both the retirement income and convertible ordinary life basis so that they can be adapted to the fully insured or the combination of the insured and uninsured fund. It has been predicted that there would not be any significant savings in cost as between the pension trust and the group permanent plan. What may be saved in administration costs may be offset in higher mortality costs due to the elimination of the medical examination.

THE TRUST PLAN

The trust plan calls for the creating of a formal trust. Funds are placed in the trust under the arrangements found in the trust agreement. The funds are invested by the trustee. Annuity benefits are disbursed from the trust on certification by the administrative group. The trustee's obligation is to pay annuities to the extent of available funds. There are many variations and combinations in this device. I will mention four. There is the "straight" trust fund under which all contributions, benefits and other transactions are handled exclusively by the employer, perhaps the employee and the trustee.

Then we might have a trust fund with the option to buy deferred or immediate insurance annuities. In this plan the trustee is given the privilege, as part of its investment policy, to provide all or part of the benefits from annuities.

There is the trust fund with mandatory annuity purchase. No discretion is involved. The trustee must buy for all retiring employees as they come up, an immediate annuity. The trust company administers the funds before retirement, the insurance company after retirement. This is an infrequent use of the trust device.

The combination trust fund plan I touched on previously. Under this technique part of the benefits will come from the trust fund and part from an insurance policy (e.g. ordinary life individual policies or group permanent). The cash value of the policy at retirement age augmented by the trust fund accumulation is used to convert the policy as of original age or of attained age into a retirement income contract with immediate maturity.

Among trust funds, there are also many variations in investment and administrative powers.

THE SELF-ASSUMPTION PLAN

The final form I want to mention briefly is the self-assumption of the pension obligation by the employer. This is accomplished sometimes by the mere payment of the pensions from month to month without advance financing, sometimes by the creation of a reserve account on the books of the company. Generally the provisions of the plan are reduced to writing and communicated to employees. Other self-assumption plans are very informal. The terms are less completely formulated and possibly none of the terms are communicated to the employees. There may or may not be a reserve account. The employer controls the account and there is no guarantee of a benefit at retirement age. No immediate tax allowance is granted by the Bureau for this plan.

There is an endless variety of combinations that can be created from these basic forms. In fact there is a current fashion to take the pension in a cocktail rather than straight.

ADVANTAGES AND DISADVANTAGES OF THESE METHODS OF FINANCING

In summary and brief fashion, what are some of the claimed advantages and disadvantages of these financing media?

A number of arguments are advanced for the insured plan:

1. It furnishes a definiteness in the accruing benefits. Each contribution buys a guaranteed annuity.

2. The insurance company gives you an over-all service for the handling of your pension fund. It furnishes you with such assistance as investment, actuarial, and even in some cases administration, help at the employer's end.

3. The pension trust form of insurance plan is virtually the only attractive alternative for the small employer.

4. The insurance company, through its guarantees gives the employee a precise expectation of his pension right if the plan terminates.

5. The comparatively strict requirements of a steady premium payment has a psychological pull similar to the premium payments on your personal life insurance. The employer is less likely to postpone a payment.

6. The comparative rigidity of the insurance plan may have labor relations value. It prevents potential bargaining and grievance possibilities inherent in the highly flexible, discretionary plan.

7. If your plan provides for vesting, the insurance company is well equipped to locate former employees and beneficiaries who may have vested rights in the plan.

8. The insurance companies use a conservative mortality and interest assumption which from a long-range point of view may have considerable advantage to the employee collecting benefits thirty or forty years from now, not to mention the probable advantage of conservative assumptions in the matter of the employer's financial condition thirty to forty years hence.

9. The insurance company may have an investment advantage which may offset its lower guaranteed interest rate. With its large funds, the insurance company can obtain a greater diversification of investment than could the trust funds of most single employers. Insurance companies can be expected to pay dividends based partly upon their actual rate of interest earnings. By this means the employer may get the benefit of a considerably higher interest rate than the guaranteed rate at which the premiums are computed.

10. The Deposit Administration plan promises more flexibility than the group annuity. It can give effect to labor turnover, salary changes. Contributions can be made in amounts and at times suitable to the employer. Surrender charges can be minimized. It holds tremendous promise for the

larger employer who has been concerned over the rigidity of the insurance plan. But remember the flexibility lasts only until the point of retirement. The flexibility also implies the risk of unwise decisions. This risk is the employer's gamble and not that of the insurance company.

The objections to the insured plan generally divide into three categories:

1. They do not offer enough flexibility--e.g., as the trust device does.

2. The charge made for administrative expenses is higher than that of the trust plan.

3. The margins of safety in the interest and mortality assumptions are too high and are unnecessary for the particular employer.

This matter of disadvantages has been debated at great length and appears to some extent in the advantages of the trust fund. The limitations of this paper preclude extensive analysis of these alleged disadvantages.

The supporters of the trust technique offer substantially these arguments on behalf of their vehicle:

1. The pension liability is basically an investment problem and the corporate trustee is well-qualified to handle this.

2. It is a highly flexible device--e.g. (a) it can offer membership in the plan to all employees regardless of age, service record, and rate of turnover without any administrative difficulty; (b) employees can be retained in service beyond normal retirement age without complications; (c) the trust fund can handle disability benefits and severance pay; (d) it may give more flexibility in its integration with Social Security. Where the employer and the union make provision for crediting against the company pension social security benefits, the trust fund is well adapted to adjust to this agreement.

(e) The amount and timing of contributions can be fixed and altered by the employer and the union without the consent of the trustee. The rate of interest assumed and the mortality assumptions can likewise be altered freely as can the turnover discount, but the change is the risk of the employer and not that of the trustee or the consulting actuary. (f) Plan amendments can be made easily. No insurance company consent is necessary.

3. Argument three is that the trust fund offers lower costs. It is estimated by one authority that the contribution from the employer for a non-contributory plan can be fixed at from 15% to 20% less than would be required for group annuities. The difference flows from two sources: (1) lower administration costs and (2) claimed more realistic attitude toward future mortality and interest earnings.

Under source (1) the trust supporters claim a lower cost of administration than the 5-8% loading in group annuities. Further, there is no surrender charge for termination of the trust prior to retirement. This is in contrast to the 4% surrender charge of the insurance company which may be reduced by dividends or through an experience retiring formula. There is a claimed advantage in record keeping. No duplication of records is necessary under the trust fund--just the simple personnel records of the employer are all that are needed.

Some of the claimed disadvantages of the trust inhere in its claimed advantages. For example, the mere promise of flexibility may encourage management and labor to adopt predictions on interest, mortality, turnover, and disability, which are not conservative enough. It is easy enough to be mistaken when you try to peer into the future--thirty, forty, fifty years away. If the insurance companies need to be conservative, the individual employer needs to be even more so.

Then it is argued that the trustee may not have the investment diversification or the investment sources that a large life insurance company would possess.

The trust does not set a ceiling on costs. A plan may be pronounced by the actuary as fully funded through a trust, but in the last analysis, if the money isn't there, the unlucky left-over employees do not get paid, or the employer may have to strain his financial position to make up the deficit. There is no way under the trust to completely discharge an employer's liability as can be done under the insurance plan.

The self-assumption plan has these alleged advantages:

1. The employer does not commit himself to the irrevocable relinquishment of an annual contribution.

2. He does not need the permission of the Bureau to revise or terminate his plan.

3. It has flexibility. Pensions can be paid according to the conditions in existence at and after retirement.

4. Turnover rate may be so high that perhaps only a small percentage of the employees will actually receive the pension. Therefore why fund past service costs?

5. Some employers believe that they can earn more on their funds if they remain part of working capital. Therefore, why fund past service or other costs before actual retirement?

The basic disadvantage is obvious. The reserve is as good as the financial condition of the company at the time the employee retires, and thereafter—a big contingency for the employee seeking security.

This is a brief summary of the funding pictures through the pin-pointing approach. I hope that I have given you some little light as you walk the path of security with your client--be it union or management.