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Guaranty Fund for Private Pension Obligations

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Published for the

Pension Research Council
Wharton School of Finance and Commerce
University of Pennsylvania

by

RICHARD D. IRWIN, INC. Homewood, Illinois
Irwin-Dorsey Limited, Georgetown, Ontario

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First Printing, November, 1970

Library of Congress Catalog Card No. 75–133131

Printed in the United States of America

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Chapter 2

Hazards to Benefit Fulfillment

The primary source of security for *accrued* pension benefits is a fund of assets, including life insurance and annuity contracts, irrevocably placed beyond the control of the employer and committed to the payment of benefits and attendant expenses) in accordance with the terms of the plan. Thus, broadly speaking, any factor or circumstance that interferes with the accumulation of plan assets at approximately the same pace as the benefits accrue is a threat to the ultimate fulfillment of benefit expectations. A deficiency in plan assets as of any given time may be the result of inadequate past contributions or the shrinkage of asset accumulations through unfortunate investments, decline in market value of sound investments, or, in rare cases, misappropriation.

Past contributions may be insufficient to support the current structure of accrued benefits for a number of reasons. First of all, the projected cost of benefits and expenses may have been inaccurate. Cost projections reflect assumptions as to mortality among the participating employees and their beneficiaries; investment earnings on plan assets; employee withdrawals without vested benefits, the pattern of retirement; and the expenses of operation. If benefits are based on compensation, especially earnings during the years immedi-

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ately preceding retirement, future compensation levels must be predicted. These cost projections are normally prepared by actuaries after consultation with the employer and other interested parties. Wide areas of judgment exist with respect to most of these cost factors; and actuaries of unquestioned professional skill, judgment, and integrity can come up with sharply different answers even when working with the same basic data.

The rate at which the total estimated costs are assumed to accrue is determined by the actuarial cost method employed by the actuary. There are several basic actuarial cost methods, with numerous variations and refinements. One family of methods assumes that the cost of the plan accrues at precisely the same rate as the benefits accrue, the cost per $1 of benefit with respect to any particular individual increasing year by year as the employee nears retirement. The other family of methods projects the total cost of benefits for the covered group, individually or collectively, and assumes that the cost is spread evenly over the total employment period or the remaining years to retirement. Under each of these two basic approaches, the cost of benefits associated with years of service prior to inception of the plan (referred to hereafter as "supplemental cost") may be separately calculated and accrued at a rate different from that applicable to the normal cost. These cost methods have no influence on the ultimate true cost of the plan (other than their impact on investment earnings), but they have a significant effect on the rate at which pension costs are charged and presumably funded.

Any of the commonly accepted actuarial cost methods when employed as a guide to funding policy can under the right conditions and in time lead to the accumulation of assets equal to or in excess of the actuarial value of accrued benefits. Most employers do pattern their funding contribu-

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tions after one of the commonly recognized actuarial cost methods and undertake as a minimum to meet the normal cost of the plan plus interest on the initial supplemental cost, if any. There is no legal compulsion to fund the supplemental cost of the plan, and if the cost method in use produces a supplemental cost, the employer may decide not to fund it. In that event, the accumulated assets as of any given time would under many circumstances be less than the actuarial value of accrued benefits.[1]

Even if the employer should undertake to fund the supplemental cost (usually associated with past service benefits or retrospective benefit increases), he will usually spread the funding over an extended period of time, possibly as long as 40 years. He is unlikely to fund more than one tenth of the supplemental cost in any one year, since he would be unable to deduct currently any greater sum for income tax purposes. Retrospective benefit increases and other plan liberalizations add to the supplemental cost and usually prolong the period needed to achieve a fully funded status. In fact, many plans will never achieve a fully funded condition purely because of periodic plan liberalizations. Clearly, as long as any portion of the cost of accrued benefits under the plan remains unfunded, a termination of the plan will result in the loss of benefits by some participants.

The achievement of a fully funded status does not assure the payment of all benefits in full, even if the plan terminates while that condition exists. The cost estimates of many plans take into account anticipated withdrawals among

[1] When the participant group is immature and growing (or even stationary) and a projected benefit cost method is used, the funding of normal cost plus interest on the unfunded actuarial liability, augmented with actuarial gains, can lead to the accumulation of assets equal to or in excess of the value of all accrued benefits, including those attributable to past service and retrospective benefit increases.

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the employee group, and the funding payments are reduced by the amount of estimated nonvested withdrawals. Allowance may also be made for retirements expected to take place beyond the normal retirement age. However, when a plan terminates, these cost reducing factors become inoperative and the benefits that have been credited to that point in time may well exceed the assets that have been accumulated.

The contributions to a pension plan are invested by the funding agency and exposed to the hazards of the capital market. If the funding agency is a life insurance company, the funds must be invested in accordance with the standards set forth in applicable investment statutes. These statutes severely limit the amount of common stock that can be held in the general investment account of an insurer, but the limitations are not applicable to special (or separate) accounts set up under group deposit administration annuity contracts. Banks and individual trustees are nominally subject to fiduciary investment statutes, which can be very restrictive; but the instrument creating the trust can and generally does grant broader investment powers to the trustee than those provided by applicable state law, especially in respect to common stock holdings. At the present time the federal government imposes no standards of investment conduct, apart from the prohibition against certain types of transactions that would improperly benefit the employer. Legislation now pending before Congress would impose additional standards. Pension funds administered through the general investment accounts of life insurance companies are invested predominately in high-grade corporate securities and real estate mortgages, while the funds held in separate accounts are invested, largely, if not wholly, in common stocks. Funds held by trustees are invested mainly in high-grade corporate securities and common stocks, the proportion of com-

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mon stocks in some portfolios being well over 50 percent, especially at market value. Apart from the inherent risks associated with the common stock holdings and the unlikely possibility of forced liquidation of assets, pension plan assets, in general, appear to be relatively well protected against investment risks.

Accumulated pension assets may also be lost through the fraudulent or dishonest behavior of plan administrators. Fortunately, there has been little evidence of this type of behavior thus far, and loss of assets from this source has been infinitesimal. Moreover, a number of bills now before Congress would impose a fiduciary status on all persons exercising control over pension assets and would vest in designated federal agencies certain investigative and enforcement powers designed to protect pension funds against mismanagement.

If the employer pursues a policy of paying the pension plan benefits directly to the eligible claimants without using a funding agency, the security of the benefits rests entirely on the ability and willingness of the employer to continue his support of the program. The fulfillment of benefit expectations is subject to all the economic vicissitudes that beset the business enterprise itself. The participants can look to no fund of assets insulated from the hazards of the business. Under the action of the American Institute of CPA, to which earlier reference was made, the employer must set up a balance sheet reserve equal to the assumed value of the benefits accruing hereafter. Irrespective of whether the proper amounts are credited to the reserve, the assets offsetting the account are not earmarked for the exclusive benefit of the plan participants and their beneficiaries. If the employer should decide to discontinue the payment of retirement benefits, the pensioners and active employees would have no claim against the assets representing the reserves, unless a court were

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to hold that in the light of all the circumstances the employer had in effect guaranteed the payment of pension benefits. In that event, the pension claims would not necessarily be limited to the value of the pension reserve. On the other hand, if the employer should become insolvent or bankrupt, the accrued pension rights of employees and participants would be given no preference in the allocation of assets and might not be recognized at all.