Guaranty Fund for Private Pension Obligations

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Chapter 7

A Minimum Program

Thus far this monograph has concerned itself with the basic question of whether some type of pension guaranty arrangement would be technically feasible and the issues that would have to be resolved if such a program were to be established. It should be clear at this point that a guaranty scheme would be feasible from a technical standpoint if certain conditions were satisfied and adequate safeguards were built into the system. Some of the conditions and safeguards would involve regulatory controls that employers, unions, and other elements of the pension establishment have in general opposed as being potentially detrimental to the continued sound growth of the private pension movement. They would also limit the scope of the arrangement to such narrow bounds that the social objectives underlying the proposal might be frustrated in large part.

Resolution of the fundamental question of whether a properly structured and delimited guaranty scheme should be established is beyond the purview of this monograph. That is a political decision that will have to be made by Congress in its wisdom. The contribution of such an institution to the public weal must be balanced against whatever harmful consequences might flow from it. Without taking a position for or against the proposition, the remainder of this treatise suggests the characteristics or features that should be associated with any guaranty scheme that might be brought into existence. The proposals envision a minimum program, with the thought that extension and liberalizations could be introduced as experience with the system indicates the wisdom of such action.

ADMINISTERING AGENCY

The program should be administered by a federal agency. It would have to be brought into existence by federal legislation, and it would seem appropriate to enforce the law through a public agency. If there are to be effective remedies for noncompliance with the requirements of the law, the government should apply them directly rather than through a private intermediary. Moreover, it would be simpler to make the government the residual risk-bearer, as it probably must be, if it acts as the fiscal agent for the program. This recommendation contemplates that private insurers would underwrite the guaranteed benefits of terminated plans, which would minimize the accumulation of assets in the administering agency. In any event, the federal government is holding billions of dollars in various trust funds at the present time with no apparent harm to the economy; so the accumulation of a few billion more in a trust fund for private pension beneficiaries would cause no difficulties other than increasing the cost of the program to employers because of the relatively low yields on the government securities held by the trust fund. Moneys in the trust fund not needed for current operations should be invested in obligations of the federal government not private securities.

EVENT INSURED AGAINST

The guaranty should extend only to benefit claims arising out of complete plan terminations. Coverage of partial terminations would not only create complex problems of claim adjudication but would open the door to countless forms of abuse, possibly to the point of rendering the system inoperable. It would be almost impossible to define the insured event if various kinds of partial terminations were to be brought within the contemplated coverage. Many of the problems cited by critics of the guaranty fund proposal are centered in the concept of partial terminations. Exclusion of partial terminations would lessen to some degree the social utility of the system; but if a reasonable level of vesting is brought about, whether by mandate or voluntary action, the employees in the greatest need of, and with the strongest claim to, the benefit guaranty will enjoy the protection of the system.

Not only should the guaranty be limited to complete plan terminations, it should be invoked only when the firm goes out of business. It would be grossly unfair to other employers, some of them competitors, if a firm could terminate its pension plan, transfer to the guaranty fund the responsibility for making good on the unfunded guaranteed benefits, and then continue in business, its competitive position improved by reduction in its labor costs. This would be comparable to having the Federal Deposit Insurance Corporation assume responsibility for losses to bank depositors while permitting the bank to continue in uninterrupted operation with no loss to itself or its stockholders. If the firm were sold to, or merged with, another company, the surviving company

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should be required to assume the accrued pension obligations of the acquired firm, at least to the extent they come under the aegis of the guaranty fund. The requirement would be deemed satisfied if the surviving company were to provide benefits under its plan to the former employees of the acquired company in an amount at least equal to the unfunded benefits of the plan of the liquidated company.

The lack of protection for benefit rights in terminated plans of employers who continue in business should be rectified by requiring the employer to continue funding contributions in respect of the benefits that would become the obligation of the guaranty fund in the event that the employer should go out of busines. The funding would normally continue at the rate prescribed for going plans, but the administering agency should be given the authority to relax (or spread out) the funding contributions in the light of the financial situation of the employer. If the employer should go out of business before completing the funding schedule the unpaid amounts would *not* become a claim against his assets and the guaranty fund would assume full responsibility for the payment of the unfunded benefits entitled under the law to the guaranty. There would have to be provisions in the law designed to prevent the employer from avoiding his obligations by ostensibly going out of business and then reopening under another name or in another form. If the business were sold or merged, the continuing company would have to assume the funding commitment of the acquired firm. Likewise, if a plan is terminated in order to transfer the participants to another plan, new or existing, the continuing plan should assume the obligations of the old.

The foregoing principles would have to be modified in the case of multiemployer plans. Where more or less permanent employment relationships exist, the guaranty should become operative with respect to the employees of a particular firm upon withdrawal of that firm from the plan for reasons beyond its control and subject to a minimum period of participation. The guaranty of the PGF would be residual in character if the multiemployer plan had an internal guaranty mechanism. When the plan deals with strictly transitory employment relationships, it would appear that the guaranty could become effective only upon termination of the plan itself. In the meantime, the benefits entitled to the protection of the guaranty should find their fulfillment in the accumulated assets of the plan. While the minimum funding standards outlined in the following sections should be fully applicable to multiemployer plans, it would probably be impracticable to try to enforce the completion of projected funding schedules in the event of plan termination or the withdrawal of a participating firm from a continuing plan, especially in the face of transitory employment relationships.

OBLIGATION OF THE GUARANTY FUND

A pension guaranty fund is feasible only if superimposed on minimum standards of funding. Technically, it would be sufficient if these standards related only to the benefits subject to the guaranty. However, in order to preserve the protection now afforded nonguaranteed benefits through IRS minimum funding requirements and to harmonize the funding requirements of the guaranty system with the cost accrual position of the accounting profession, it is recommended that the law require annual contributions to a pension plan equal to the normal cost of currently accruing benefits (whether or not guaranteed) plus whatever additional sums are necessary to have all guaranteed benefits fully funded within 20 years after the effective date of the coverage. Any

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additional guaranteed benefits that might be granted *retrospectively* by plan amendment would have to be funded in full within 20 years after such amendment. Evidence that the minimum level of funding is being maintained would be furnished annually or triennially through certification from a member of the American Academy of Actuaries who would be free to choose his own actuarial assumptions and cost method in respect of the nonguaranteed benefits. The administering agency would specify the actuarial assumptions and possibly the actuarial cost methods to be used for guaranteed benefits. This is based upon the assumption that only *vested* benefits would be guaranteed, the valuation of which would require only mortality, interest, and expense assumptions. The administering agency should be given the authority to collect delinquent funding contributions, extending into insolvency or bankruptcy proceedings.

As indicated above, the guaranty fund would incur obligations only when a pension plan termination is accompanied or followed by the liquidation of the sponsoring firm, except for multiemployer plans. At that point, its obligation would be to assure the ultimate payment of the guaranteed benefits of the plan. That is, its obligation should be stated in terms of *benefit payments* rather than the completion of a *funding objective* per se. The theoretical measure of its obligation would be the difference between the assumed present value of the guaranteed benefits and the value of the assets available for payment of the benefits. Any benefits already purchased from an insurer would be subtracted from both sides of the equation.[1] The true measure of the obligation would be what it would cost the guarantor to purchase

[1] It would be reasonable to require the insurer to amend its contract to provide that future dividends or experience refunds in respect of guaranteed benefits would be payable to the guaranty fund.

the guaranteed benefits from an insurer or to pay the benefits directly to the eligible recipients.

Stating the guarantor's obligation in terms of benefit fulfillment would suggest that the system should underwrite the entire asset deficiency, whatever the cause. It would surely be appropriate to absorb any deficit arising out of actuarial losses since the guarantor would be dictating the assumptions. The underwriting of capital losses would be a little more debatable if there were no restrictions on investment policy. On balance, however, and in the interest of simplicity, it would seem desirable for the system to cover capital losses also. A deficiency arising out of a retrospective benefit increase or other type of plan liberalization would also be covered so long as the benefits involved come under the guaranty.

In accordance with an earlier recommendation, the guaranty fund would have no recourse against the assets of a liquidating firm, except for delinquent funding payments.

PLANS COVERED

Participation in the guaranty scheme should be compulsory for all eligible plans. Compulsion would be necessary to get adequate participation and to protect the guaranty fund against adverse selection. Eligibility should be limited to plans that "qualify" under IRS regulations, which unfortunately would rule out pay-as-you-go plans whose participants would have the most to gain from a benefit guaranty. There would be little danger to the system in admitting any plan that would voluntarily subject itself to the funding requirements and other features of the system.

Multiemployer plans should be required to participate with whatever modifications might be necessary to fit their particular circumstances. The basic modifications that might be appropriate have been indicated above. Many of these plans could be expected to object to the proposed minimum standards of funding, as well as minimum vesting provisions, but it is highly desirable that these plans meet the same funding and vesting standards as single employer plans.

Plans should be eligible for coverage only after they have been in operation for a minimum of five years and presumably should not be forced into membership until they have benefits subject to the guaranty which could involve a period as long as 10 years. This would greatly reduce the cost of the system and discourage the establishment of plans for the sole purpose of enjoying the benefit guaranty. Almost half of the terminations studied by BLS occurred among plans that had been in operation for five years or less. Only a fourth of the plans had been in existence for more than 10 years.

Conventional insurance theory would suggest that all eligible plans should be expected to make application for coverage and demonstrate to the satisfaction of the administering agency that their financial condition and economic prospects are such as to justify membership in the system. Extension of the guaranty to liberalized benefits would also be subject to underwriting. In practice, such screening would impose a heavy—perhaps intolerable—administrative burden and, more important, would conflict unduly with the social goals of the program. Thus, all qualified plans in operation for more than five years at the time the guaranty fund is established should be automatically covered irrespective of the financial condition of their sponsors. Other eligible plans should likewise be automatically covered as soon as they satisfy the five-year probationary period and have benefits entitled to the guaranty.

BENEFITS COVERED

The guaranty should be limited to benefits vested under the terms of the plan or by operation of law. However, it should encompass not only benefits earned after inception of the plan but also those credited for service prior to that date. It should also extend to all benefits of those employees who have retired or are eligible to retire with normal or reduced benefits. It should not be applicable to those benefits that vest only by virtue of discontinuance of the plan.

In order to assure a minimum level of protection under the program and to prevent complete avoidance of the guaranty by employers inclined in that direction, it would be necessary for the law to require a minimum degree of vesting, applicable to both single-employer and multiemployer plans. As was pointed out earlier, certain pending legislative proposals call for vesting of future service benefits after 10 years of service, with recognition being given to prior years of service in determining whether the minimum period has been satisfied. Since it would be many years before this legislative mandate would produce a level of funding equivalent to that found in many plans today, it would be desirable for the guaranty to include benefits voluntarily vested under the terms of the plan.

Vested benefits created through a retrospective liberalization of the plan should not be eligible for the guaranty until five years after the liberalization. This restriction would be necessary to protect the fund against those who would otherwise grant benefit increases just prior to winding up their business.

The monthly benefits of any particular employee should be guaranteed only to the extent that they do not exceed the lesser of 50 percent of his monthly compensation at the time of plan termination or $500. Ancillary benefits should be guaranteed only if they are in a payment status at the time of plan termination. The amount of such benefits entitled to the guaranty should be reasonably related to the amount of monthly retirement benefit guaranteed under the program.

IMPLEMENTATION OF THE GUARANTY

Upon occurrence of a plan termination coming within the scope of the guaranty, as determined by the administering agency, the guaranty fund would assume full responsibility for the payment of all guaranteed benefits. It would take title to, or assert in some other appropriate manner its jurisdiction over, the assets in possession of the funding agency assumed to be available for the satisfaction of guaranteed benefits. Its jurisdiction should extend only to unallocated funds, thus excluding insurance or annuity contracts already purchased for specific individuals. This would discriminate somewhat in favor of allocated funding instruments, which may provide for the purchase of nonvested benefits, but the difference in treatment appears unavoidable. It would not seem equitable or to be good public policy to cancel benefits already purchased. On the other hand, it would seem appropriate for the guaranty fund law to specify that vested (i.e., guaranteed) benefits, including those payable to retired employees, will have the first claim to all unallocated funds. If all of the funds are not needed to provide for the guaranteed benefits, the excess would remain with the funding agency for application to nonguaranteed benefits pursuant to terms of the plan.

The guarantor should discharge its obligation by purchase of insurance or annuity contracts from a pool of life insurance companies for the full amount of guaranteed benefits. This would fix immediately and irrevocably the amount of funds needed to underwrite the guaranty and, hence, the amount of assets that should be transferred from the funding agency. If there were delinquent funding obligations outstanding against the employer, the guarantor would be authorized and directed to seek collection of these sums from the assets of the liquidating firm, with whatever creditor's preference Congress might see fit to provide. Any sums collected in excess of the deficit originally assumed by the guarantor would be turned over to the original funding agency for application to nonguaranteed benefits.

In order to minimize liquidation losses, the funding agency should be permitted to spread the tranfer of assets over a period of time, perhaps up to five years. The assets should be transferred in a systematic manner (in instalments) with the funding agency having the option at all times of transferring the remaining assets in one sum. Investment earnings on the moneys still held by the funding agency would inure to the benefit of the guarantor.

The pool of insurers from which the guaranteed benefits would be purchased would have to be set up and administered in a manner to assure right of participation by all qualified insurers and to protect the interests of the guaranty fund. Arrangements similar to those established for Federal Employees Group Life Insurance and Servicemen's Group Life Insurance would appear to be suitable. The benefits should be purchased on a nonparticipating basis in order to determine definitely and immediately the magnitude of the guarantor's obligation, thus contributing to an equitable allocation of plan assets between guaranteed and nonguaranteed benefits.

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FINANCING THE GUARANTY

The guaranty system should be supported by contributions from employers whose pension plans fall within the scope of the program, the objective being to make the program self-supporting as to both benefit obligations and administrative expenses. The primary source of support should be annual premiums levied on the basis of the unfunded accrued liability for guaranteed benefits. For the purpose of determining the premium base, the actuarial liability of the accrued benefits would be computed on the basis of annuity rates (reflecting mortality, interest, and expense assumptions) provided by the guaranty fund. These rates should bear a reasonable relationship to the nonparticipating rates for deferred and immediate annuities being quoted on a plan close-out basis by the principal group annuity companies. The assets would be valued at market, the certification being made by a public or independent accountant. Account would be taken of only those assets allocable to guaranteed benefits.

The premium rate should be based upon the best statistical evidence as to the probable rate of termination among the plans covered by the guaranty and the magnitude of the losses that would be sustained by the guaranty mechanism. Technically, there should be rate differentials based upon the age and financial strength of the sponsoring firm, but for all practical purposes it would seem appropriate to charge a uniform rate. It might be necessary to have a different rate (or rates) for multiemployer plans if the modifications suggested earlier are made applicable to them. As a general proposition the rate, or rates, should be set at the lowest justifiable level, with the understanding that assessments would be levied to make up any deficits. There should be a limit on the amount of assessments that could be levied in any one year, such as five times the annual premium. The premium rate should be subject to upward or downward adjustment as experience with the program develops.

The guaranty fund should have borrowing authority sufficient to absorb any deficits that might arise in the short-run. Deficits of considerable magnitude could develop in the course of a severe depression. If the claims against the fund should reach catastrophic proportions—out of reach of even the assessment authority of the administering agency—the government should assume an appropriate share of the total burden in recognition of the fundamental nature of the risk.