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

First Printing, November, 1970

Library of Congress Catalog Card No. 75–133131
Printed in the United States of America

Chapter 3

Applicability of Insurance Concepts to a Pension Guaranty Fund

A mechanism to assure the payment of accrued benefits under private pension plans is, in essence, an insurance arrangement; and its feasibility must be tested against the criteria of an insurable hazard.

LARGE NUMBER OF HOMOGENEOUS RISKS

A sound insurance program must encompass a large number of risks in order that losses may be predicted in accordance with the laws of probability, with reasonable assurance that actual results will conform closely to predicted experience. The risks should be homogeneous in order that an equitable rating structure can be developed. In other words, the losses should be spread among the participating risks in an equitable manner. If the total body of risks is not sufficiently homogeneous to permit the charging of a uniform premium rate, it should be possible to classify the risks into subgroups sufficiently large and homogeneous to permit the development of sound rating procedures. A corollary to this concept is that the insurance program must attract a representative cross-section of the risks exposed to the hazard, since otherwise the premium rate will be so high as to discourage voluntary participation by all except the worst risks.

There is obviously a sufficiently large number of pension plans subject to the hazard of termination to satisfy this first criterion. The risks are not homogeneous, however, in the sense that they are subject to approximately the same probability of termination. Unless the premium rate is adjusted to the probability of termination—or is so small as to be inconsequential—the better-than-average risks could be expected to shun the arrangement. Even with an equitable and realistic rating structure, pension plan administrators might find the scheme unattractive, since is would involve an added element of cost. It would appear that participation would have to be compulsory to obtain a random selection of risks.

OBJECTIVE DETERMINATION OF OCCURRENCE AND AMOUNT OF LOSS

For an insurance arrangement to be feasible, it must be possible to determine beyond reasonable doubt that the event insured against has occurred, and the amount of loss sustained should be susceptible to fairly precise determination.

This aspect of an insurable risk could prove to be very troublesome for a pension guaranty fund. The basic difficulty would be to define the event insured against. It is an open question as to whether all plan terminations should be covered or only those originating in certain causes. Some would argue, for example, that the guaranty should be restricted to those plan terminations that occurred because the employer went out of business, while others would regard it as immaterial that the employer continues to operate in one form or the other. Varying attitudes are taken toward mergers, cessation of operation in one plant or locality, and so forth. Special problems exist with respect to multiemployer plans. Questions would arise as to whether a discontinuance of employer contributions is merely a suspension, discontinuance, or termination, as those terms are defined in IRS regulations. Presumably, a pension guaranty program could adopt its own definition (or definitions) of the risk insured against, as contrasted with the views of the Internal Revenue Service; but unless the insured event were carefully delineated, complex problems of interpretation would be involved in determining whether a particular event or transaction fell within the prescribed limits.

The determination of the amount of loss would involve potential difficulties. Plans that provide for a specific unit of benefit for each year of credited service would present no difficulties if the annual accrual were a flat amount or based on current earnings. There would be complications with respect to plans that base the benefit on the employee's compensation during the years immediately preceding retirement or provide a basic benefit geared to career average earnings, subject to a minimum benefit related to final average salary. The minimum benefit—which may be financed through an auxiliary (or side) fund, a terminal funding arrangement, or on a current disbursement basis—may vest at a different rate from the basic benefit and may in fact be subject to its own set of eligibility requirements. Money purchase plans, especially those involving split funding arrangements, would require special consideration; as would plans that provide a composite benefit, subject only to a minimum period of service. Ancillary benefits, such as those payable for the employee's death or disability prior to retirement, would complicate matters, along with special (nonactuarial) early retirement allowances, annuity options of unequal actuarial value, and social security offsets. These problems, formidable as they may appear, could be overcome by a precise definition of the benefits covered, excluding those that would unduly complicate the administration of the program.

Once the aggregate value of covered benefits was determined at point of plan termination, there would still be a question as to what portion of the liability should be transferred to the guaranty fund and when. This question will be considered in detail at a later point.

RANDOMNESS OF LOSS

The occurrence of loss among the risks exposed to it should be random and beyond the control of the person receiving reimbursement for (or benefiting in any other way from) the loss and any person or firm who would otherwise be liable for the payment. Since this condition is seldom met in practice, the objective is sometimes restated as follows: where the occurrence of the loss may be influenced by the actions of the individuals purchasing the insurance or receiving the claim payment, the benefits payable should be such that the occurrence of the loss is always less advantageous financially than the nonoccurrence of the loss.

In the absence of proper safeguards, this prerequisite would not be satisfied by a pension guaranty fund. There are so many ways that the fund could be abused that many persons believe the whole guaranty idea is unrealistic. If not prohibited, an employer could increase benefits retrospectively just before terminating his plan and let the guaranty fund make up the deficiency in plan assets. Or he might discontinue contributions to the plan in anticipation of formal termination. If an employer could terminate his plan at any time and for any reason, with no one having any recourse against him for the unfunded accrued liability, his willingness to continue his plan through periods of adverse economic conditions could be seriously undermined. Most of the opportunities for abuse could be eliminated or minimized by appropriate limitations in the undertaking, but some of the restrictions might produce an arrangement quite different from that envisioned by sponsors of the idea.

LOW PROBABILITY OF LOSS

The probability that any particular exposure unit will incur a loss during any given year should be relatively low. If losses occur with high frequency, it will generally be more economical for the person or firm exposed to the risk to budget for the losses outside of an insurance mechanism which, of necessity, involves some administrative expense.

Available data would suggest that the probability of plan termination is fairly small, at least in periods of economic prosperity and among plans that have been in operation for several years. Since most plans that terminate are small, the potential losses to benefit claimants is an insignificant percentage of the total exposure.

The latest and most comprehensive study of plan terminations was carried out by the Bureau of Labor Statistics in cooperation with the Internal Revenue Service.[1] The study encompassed the years 1955–65. During that period, there were 4,259 pension plan terminations, 30 percent of which were due to mergers. Almost half of the terminations involved plans in effect for five years or less, and two thirds of the terminating plans covered fewer than 25 employees. An average of 20,000 employees per year were affected by terminations, about one tenth of 1 percent of the number exposed to loss.[2] In many cases no accrued benefits were lost, and in other cases the losses were less than total.

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1 Emerson H. Beier, "Termination of Pension Plans: 11 Years' Experience," *Monthly Labor Review*, June, 1967, pp. 26–30.

2 *Ibid.*, p. 26.

The rate of plan termination and resulting benefit forfeitures would undoubtedly increase sharply during a period of depressed business activity. Also, the very existence of a guaranty scheme might increase the risk of plan termination. On balance, however, it would appear that a pension guaranty fund would stand up fairly well against this criterion.

SIGNIFICANCE OF LOSS

The loss suffered by the insured from the occurrence of the event against which insurance is arranged should be large enough to constitute an economic burden. Otherwise, the expense of maintaining the insurance mechanism and settling claims might exceed the value of the loss payment. This principle is given effect in private insurance operations through the use of so-called "deductibles," which cause the insured to bear the first portion or layer of any loss.

The aggregate loss of accrued benefits occasioned by the termination of a pension plan is likely to be sizable enough to satisfy this criterion. The loss to some of the participants, however, may not be. This suggests that the protection of a pension guaranty fund might properly be limited to individuals having some minimum amount of benefit accruals or having participated in the plan for a specified period of years.

ABSENCE OF CATASTROPHE HAZARD

Under an ideal insurance arrangement, the hazard insured against should not be capable of producing a catastrophic loss to the insuring agency out of one event or occurrence. In reality, many hazards that are regarded as readily insurable can under certain circumstances produce losses in the catastrophic area. The problem has been overcome through the use of exclusion clauses and reinsurance facilities.

It is conceivable that in a period of extended economic distress, pension plan terminations could confront a guaranty fund with claims of such magnitude that the solvency of the program would be threatened. At such a time, the financial condition of many firms might be so precarious that they could not absorb the additional burden of support that would be required. The problem would be alleviated to some extent by the fact that most of the claims against the guaranty fund would represent deferred obligations, which would not have to be fully offset by assets at any point in time. In an extreme emergency, funds could be made available by the federal government either in the form of a loan, a direct subsidy, or indemnity payments under a formal reinsurance scheme.