Guaranty Fund for Private Pension Obligations

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Chapter 4

Relevant Precedents in the United States

Additional insights into the feasibility of a pension guaranty fund can be gained by examining the essential elements of existing insurance arrangements that fail in one or more important respects to satisfy the conventional concepts of a sound insurance program. Some of these programs are operated under government auspices, some under private auspices, and some under joint government-private auspices.

GOVERNMENTAL PROGRAMS

The governmental program that is most frequently cited as a precedent for a pension guaranty fund is the Federal Deposit Insurance Corporation. This agency was established in 1933 to restore confidence in the commercial banking system and to prevent another debacle such as that which occurred between 1929–33 and wiped out the savings of millions of American families. Participation in the program is compulsory for banks that belong to the Federal Reserve System but is optional for all other banks. The original act provided only $2,500 of insurance per covered deposit account, but the maximum protection was later increased successively to

$5,000, $10,000, $15,000 and then $20,000, where it now stands. The program is supported by annual assessments on the member banks at the statutory rate of one twelfth of 1 percent of aggregate deposit liabilities (not just the amounts protected by insurance) but because of credits for favorable loss and expense experience, the effective assessment rate in recent years has about one thirty-first of 1 percent of average deposit liabilities. The assessment *rate* is the same for all banks, irrespective of age, size, or quality of management. This feature of the system was severely criticized in the beginning on the grounds that strong, conservatively managed banks would be required to subsidize the weaker, less conservative banks. The argument is no longer heard today, probably because the assessment rate is so low. There were also allegations that deposit insurance would encourage reckless lending and investment practices on the part of insured banks, but these fears proved to be unfounded. While the system has never been tested by a major depression, there is general agreement that deposit insurance has become a permanent feature of this country's financial structure. It is such an essential element of economic stability that the system would be maintained even if a temporary governmental subvention should become necessary.

While there are certain similarities between deposit insurance and the proposed guaranty fund for pension benefits, there are dissimilarities that largely invalidate analogies between the two schemes. From the standpoint of any one individual, the FDIC insures against loss of a known number of dollars that are currently available to the depositor. The pension guaranty fund would insure against loss of future dollars the number of which might not be presently determinable and the right to which would be contingent on survival to retirement and possibly on continuation of the current employment relationship to retirement. More important, the assets offsetting the deposit liabilities of a bank are in the possession of the bank (or else the bank would be insolvent), whereas the assets needed to liquidate the accrued benefits of a pension plan usually are not in the hands of the funding agency, at least in sufficient quantity. Thus, it may be said that the FDIC insures against loss of assets already in existence, while the guaranty fund would, in effect, provide protection against the loss of assets that never materialized (from the standpoint of the funding agency). The FDIC insures a reality, while the guaranty fund would underwrite a declaration of intention. There are types of insurance that provide protection against failure to perform (reference will be made to them later), but they are not a component of the bank deposit insurance program. To the extent that a guaranty fund would make good on benefit defaults arising out of investment losses, there would be a parallel to the FDIC program.[1]

The Federal Housing Administration administers 15 trust funds for the insuring of various types of mortgages. The oldest and largest of these is the Mutual Mortgage Insurance Fund, which insures residential mortgages. Detailed eligibility rules have been promulgated by the FHA, and each application for insurance is carefully screened to determine whether it meets the minimum standards of acceptability. Among the factors taken into account are the applicant's income, assets, character, and motivation. All approved applicants pay the same premium, one half of 1 percent of the mortgage (with the remaining balance being recomputed each year), but there is a provision for a refund of excess premiums upon final liquidation of the mortgage, the divi-

[1] The foregoing discussion is equally applicable to the Federal Savings and Loan Insurance Corporation.

dends varying with the risk classification in which the mortgage was originally placed. Defaults have been low and net claim payments well within the premium income; but as with the FDIC, the system has not been subjected to the exigencies of a severe and prolonged depression.

There is a basic similarity between mortgage insurance and a pension guaranty fund in that both involve the ability and willingness of an individual or firm to make future payments. A major difference is that with mortgage insurance the obligation to pay is secured by an asset (the home, for example), while the employer's obligation to make payments to a pension plan is neither secured nor legally enforceable (except pursuant to the terms of a collective bargaining agreement). Sensitivity to economic conditions is another common attribute, but conclusive evidence on this point lies in the future.

Many states operate guaranty funds to ensure payment of workmen's compensation benefits when the insurer or the employer, as a self-insurer, becomes insolvent. New York has a guaranty fund for claims under automobile insurance policies and another for life insurance policies. In all these cases, the state fund is protecting benefit rights to the limit of its resources against the broad economic hazard of insolvency—which would obviously be involved in a program to insure pension benefits—and even more specifically, the insolvency of insurance companies. Legislation to establish a federal guaranty fund to ensure payment of claims against insolvent automobile insurers, especially the so-called "high-risk insurers," is pending in Congress.

Somewhat farther afield but still relevant are the unsatisfied judgment funds in Maryland, Michigan, North Dakota, New Jersey, and New York (and all the Canadian provinces except Saskatchewan) established for the purpose of enabling the innocent victims of automobile accidents to collect on their adjudicated claims or judgments against financially irresponsible motorists.

PRIVATE PROGRAMS

There are two types of commercially written insurance that throw some light on the feasibility of a pension guaranty fund. The first is credit insurance, which is written by a number of nonlife insurance companies. Under this type of insurance, the insurer promises to indemnify a business firm for bad debt losses in excess of those considered (and agreed upon) to be normal for the firm. The level of losses deemed to be normal for the business, and hence not indemnifiable, is determined by the experience of the firm over a period of past years. The premium charged for the coverage reflects the Dun & Bradstreet credit ratings of the insured's customers. The risk of loss to the insurer is greatly influenced by the economic climate, a characteristic shared with the proposed pension guaranty fund. Another common characteristic is that both the ability and willingness of business firms to meet obligations are involved, although there are legal sanctions associated with credit insurance that might not be operative with a pension guaranty.

The other type of commercial insurance that should be considered is that kind of coverage that goes under the name of *suretyship*. There are various forms of suretyship coverage, including losses against infidelity of employees, but the most relevant one for the present purposes is that associated with contract or performance bonds. The basic purpose of a performance bond is to indemnify one party for economic loss sustained by failure of another party to carry out an undertaking in accordance with the terms of an agreement between the two parties. A common example of such an undertaking would be the construction of a building in accordance with certain specifications. Another would be an agreement by a parent company to guarantee payment of interest and principal of a bond issue of a subsidiary. The bond is usually purchased by the party that must perform. If the responsible party does not perform as required and the insurer (frequently called the surety) has to indemnify the aggrieved party, the insurer is then entitled to move against the defaulting party in an attempt to recover the amount of the loss payment. In other words, this is a type of insurance under which the party that procures the insurance and pays the premium is ultimately responsible for the payment of any claims that may arise. It has been suggested by some that this principle should be incorporated into any program that might be established for the guaranty of pension benefits. This would make the employer ultimately responsible (to the extent of his corporate assets) for any benefits paid in respect of his plan by the guaranty fund.

Another precedent for giving the guaranty fund a right of recovery from the employer is the doctrine of subrogation that is applicable to all forms of property and liability insurance. Under this doctrine, which is supported by common law as well as contract language, if an insured loss is caused by the tortfeasance or wrongful action of a third party, the insurance company has a right to seek recovery from the tortfeasor. The citing of this legal principle is not intended to imply that an employer who fails to fund or otherwise meet his pension obligations is a tortfeasor in the legal sense, but in granting more guaranteed benefits than he had funded an employer would cause loss to the insuring agency and under certain circumstances it might be argued that he has wilfully and irresponsibly caused loss to the guaranty fund.

PLANS JOINTLY ADMINISTERED BY GOVERNMENTAL AND PRIVATE AGENCIES

There are a number of insurance programs that involve a partnership of some type between a federal agency and private insurance agencies. In some of these programs, for example, Federal Employees Group Life Insurance and the insurance provided under the Federal Employees Health Benefits Act, the private agencies are the sole risk-bearers, the government playing a strictly administrative role. In other programs, for example, Medicare and the provision of health insurance benefits for servicemen's dependents, the private agencies furnish only fiscal and claims services, with the government assuming the entire risk. In other cases, the federal government and private insurance agencies have entered into a joint *underwriting* venture under which the government assumes that portion of the total risk considered to be uninsurable by private agencies. One case in point is export credit insurance in connection with which private insurers assume the normal business risks and the federal government, through a reinsurance arrangement, assumes the political risks. Another example is the Servicemen's Group Life Insurance program under which the participating life insurers assume the normal mortality risks and the federal government absorbs the risks associated with military service. Still another arrangement that could be used would be for the private insurers to assume the first or primary portion of the risk, with the government serving as the residual risk bearer through reinsurance or some other device. This is the approach embodied in the flood insurance program that was enacted by Congress in 1968 and became operational in June, 1969. This is an attempt to deal with a hazard that because of the threat of catastrophic losses has heretofore been considered uninsurable for all practicable purposes.

The program provides protection against flood damage for one-to-four family residential properties and structures principally occupied by small businesses. The protection is currently available to eligible properties in more than 200 flood-prone communities which have applied for the coverage and have agreed to adopt land use and control measures by December 31, 1971. The program is administered by the Federal Insurance Administration in the Department of Housing and Urban Development.

The law authorizes the Administrator of the program, after analysis of pertinent data and consultation with appropriate agencies, to promulgate two scales of premium rates. The first scale, described as "risk premiums" in the law but usually referred to as "actuarial" or "unsubsidized" premiums, is computed on the basis of actuarial estimates of the risk and administrative expenses involved. It is pitched at a level believed to be adequate to cover all valid claims plus allowances for expenses, contingencies, and profits. The second scale, referred to as "chargeable" or "subsidized" premiums, sets forth the rates that the policyholders must pay for the coverage, and these premium rates reflect consideration of many factors, including land use controls, flood proofing, and flood forecasting. The Administrator is authorized to charge lower premiums for the coverage than the actuarial rates in order to encourage the purchase of flood insurance. In low risk areas, the premiums charged the policyholders may be the same as, or only slightly less than, the actuarial premiums, but in high risk areas the chargeable premiums are always lower, the disparity growing greater with the increase in risk. Coverage at subsidized rate levels is available only to owners of structures already in existence at the time the community qualified for flood insurance. The chargeable premium for insurance on a structure that was started or substantially improved in an area of special flood hazard after flood insurance became available in the community is identical with the actuarial premium. New structures in areas not subject to a special flood hazard can obtain the coverage at subsidized rates at any time. Thus far, actuarial premium scales have been developed for only 18 communities; but as the necessary risk evaluations are carried out,[2] additional rates will be promulgated. In the meantime, coverage for new structures and their contents in areas of special flood hazard is available only in the communities for which actuarial rates have been developed.

Under present operating rules, the owner of a one-family dwelling can obtain up to $17,500 of flood insurance on the structure at the subsidized rate and another $17,500 at the actuarial rate. Coverage of $30,000 is available at subsidized rates for two-to-four family dwelling units and an additional $30,000 can be purchased at actuarial rates. Small business units can obtain up to $30,000 of protection at subsidized rates and another $30,000 at the full actuarial rates. Contents in any eligible structure can be insured for $5,000 against flood damage at subsidized rates and for another $5,000 at actuarial rates.

The protection is provided through a pool of private insurers, to which all but the smallest companies can belong. The pool charges premiums at the subsidized rates, with the federal government, through the National Flood Insurance Fund, being obligated to pay the difference, if any, between the premiums paid by the policyholders and 90 percent of

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2 The basic data for the flood risk evaluations are developed by the Army Corps of Engineers and other federal agencies. The actual rate computations are performed by the staff of the Federal Insurance Administration.

the excess of claims and administrative expenses over such subsidized premiums. The Federal Insurance Administrator has entered into an excess loss type of reinsurance agreement with the insurance pool, in accordance with which the government bears all losses in excess of a stipulated amount per year. The pool pays a reinsurance premium for the excess loss coverage that reflects the ratio of aggregate policyholder premiums to aggregate actuarial premiums in respect to both inland and coastal risks.

The aspects of this proposed program which might be considered by those studying the feasibility of a pension guaranty fund are (1) close cooperation between the government and the insurance industry in the planning stages of the program; (2) the concept of a premium rate lower than the actuarial value of the risk, with the difference being borne by the federal government in the form of premium equalization payments; (3) assumption by the government of all claims in excess of a stipulated amount per year; and (4) emphasis on loss prevention.