Guaranty Fund for Private Pension Obligations

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Chapter 5

Pension Guaranty Programs in Sweden and Finland

Further insight into the feasibility of a pension guaranty system for the United States can be gained through an examination of the pension guaranty programs that have been functioning in Sweden and Finland for the last several years. The Swedish program was established in 1960, while the Finnish plan was set up two years later. The circumstances that led to the establishment of these two programs were very similar and the Finnish plan was patterned after the Swedish model, with some significant differences. Both are based on the credit insurance concept. While the economic, political, and legal environments in which these two plans operate are quite different from the American setting, the plans and their experience are worthy of study.

SWEDISH PENSION GUARANTY SYSTEM[1]

The Swedish pension guaranty system arose from a special, if not unique, set of circumstances. The national old-

[1] For a more detailed description of this system see G. M. Ericsson, "PRI—A Self-Insured Pension Scheme in Sweden," *Transactions of the 17th International Congress of Actuaries* (London-Edinburgh, 1964), II, 554–67;

age pension plan, established in 1913, provided only flat-rate benefits, which were deemed by salaried employees to be inadequate to their needs. Many employers agreed with this assessment and in 1917 set up a special insurance company to underwrite pension plans covering only salaried employees that, after a merger in 1929 with a similar company, has been known as the Swedish Staff Pension Society (SSP). Over the years many plans were set up for the exclusive benefit of salaried employees, the smaller ones being insured with the SSP and the larger ones tending to be self-administered. Most of the latter plans were funded only through promissory notes of the employer, for which income tax deductions could be taken, or operated on a strictly pay-as-you-go basis. By the middle 1950's a substantial portion of salaried employees were covered by supplemental plans, but relatively few hourly workers enjoyed such pension supplements. Under these circumstances, pressure built up for wage-related pensions for hourly workers. Instead of seeking such pensions through collective bargaining, the hourly workers, a highly organized and powerful group, pushed for legislation that would add a wage-related supplement to the existing flat-rate national pension, to be financed entirely by employer contributions.

Employers as a class were opposed to the proposed change in the national old-age insurance program. They were prepared to pay the costs of additional pensions for hourly employees but preferred to provide the benefits through their own private plans, which offered them the opportunity of retaining the pension contributions in their own busi-

Sven O. Hyden, "A New Approach to Financing Private Pension Schemes in Sweden," *International Review of Actuarial and Statistical Problems of Social Security,* No. 9; and Dag Helmers and Sven O. Hyden, *Modern Trends in Swedish Pension Systems* (Stockholm: Federation of Swedish Industries *et al.,* 1968), pp. 13–18.

nesses—a matter of some consequence in their capital-scarce economy. They proposed, as an alternative to an expanded national insurance program, that legislation be enacted requiring every employer to establish a pension plan for all his employees, with benefits at least equivalent to those that would be provided under the proposed new national program. As a part of their counterproposal, they developed a comprehensive plan for credit insurance that would guarantee payment of benefits of noninsured pension plans, which for the most part were completely unfunded. As a group, salaried employees favored the employers' proposal, while the hourly workers and farmers favored the liberalization of the national program. The issue went to a national referendum in 1957, and the voters approved an expansion in the national insurance program. Thereupon, the parliament enacted legislation that added a wage-related tier to the underlying flat-rate pension, with the employers bearing the entire burden of the additional costs.

The new national plan was designed to provide a combined pension that would be equal to about 60 percent of an hourly worker's average compensation over the 15 years of highest earnings, but would constitute a much smaller percentage of the compensation of salaried employees. This caused the latter to seek improvement in their private supplementary plans, not only as to benefit levels but also as to security arrangements. They had become concerned about the general absence of conventional funding in their plans and had developed an interest in the credit insurance mechanism proffered earlier by the employers. In the negotiations that followed between the Swedish Employers' Confederation and the three major unions that represent salaried employees, the latter demanded a pension guaranty arrangement as the price for their continued assent to pay-as-you-go and promissory note financing of the negotiated benefits. The Confederation agreed to this demand, as well as to the demand for more liberal supplementary benefits.

The agreements between the Swedish Employers' Confederation and the labor unions gave the employers the option of purchasing the supplementary benefits from the Swedish Staff Pension Society or of assuming legal responsibility for the direct payment of the benefits. If the employer elects the first course of action, he fully discharges his legal responsibility by the payment of the necessary premiums and he does not get involved in the pension guaranty mechanism. If, on the other hand, the employer prefers to keep the equivalent of the premium payments in his own firm, he must set up a special liability account the balance in which must at all times be equivalent to the actuarial value of all accrued benefits.[2] Furthermore, he has to register the account with and use the services of a central registration agency, called the Pension Registration Institute (PRI), which has many functions and indeed plays a very active role in the whole pension process by recording benefit accruals, informing employees of their rights, performing actuarial valuations, and paying benefits. The amount which must be transferred to the special pension account is calculated and certified annually by the PRI. Since the alternative methods of providing the bargained benefits are supposed to be endowed with equal degrees of security—and to be equal in all other respects—and since the value of the employer's obligation to pay the pension is completely dependent upon the financial well-being of the firm, it was necessary to create another agency to underwrite the credit of the employer. This organization, a mutual credit insurance company formed by

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[2] Originally, the employer was required to set up an internal fund and deposit his own unsecured promissory notes in the proper amounts.

the Swedish Employers' Confederation and known as FPG, assumes the pension obligation of an insured employer who defaults on his pension payments and then discharges its responsibilities by the purchase of annuities in the appropriate forms and amounts from SPP, the pension insurance company. It seeks recovery of its premium outlays by instituting a suit against the policyholder and competing with other creditors in the resulting bankruptcy proceedings, with no preference other than with respect to benefit rights that accrued during a short period preceding the adjudication of bankruptcy.

FPG makes credit insurance available only to joint-stock companies and economic associations (roughly equivalent to corporations) and only to such enterprises that have been in business for at least three years and employ a minimum of five salaried workers. Since there is an average of 3½ manual workers for each salaried employee, the general effect of this stipulation is to limit the coverage to firms employing a minimum of 20 persons. Applications are carefully screened since the insurance is written for a five-year term and if not renewed remains in effect for a systematically declining amount of pension liability for an additional 10 years (the time given the employer to convert his pay-as-you-go scheme to a fully insured arrangement). The financial position, economic prospects, and quality of management of the firm are considered, the risk appraisal being at least as rigorous as the standards applied by banks in making long-term loans. Firms that cannot qualify for credit insurance, either because they are too small or too unstable, must purchase the required benefits from the pension insurance company (SPP).

FPG charges a risk premium of three tenths of 1 percent of the accrued pension liability, plus a nominal loading for administrative expenses. It has the authority, not invoked as

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yet, to levy cumulative assessments of up to 3 percent of the accrued pension liability over successive five-year periods. This annual premium rate was adopted after a study of bankruptcies occurring among Swedish corporate enterprises during the period 1929 through 1958.[3] The investigation proceeded on the assumption that the present scheme of supplementary pension benefits had been inaugurated on January 1, 1929. The aim was to discover the amount of moneys that would have had to be set aside annually to cover the accrued pension obligations of the firms that went into bankruptcy, on the severe and unrealistic assumption that in no case would there have been any corporate assets available for the satisfaction of pension claims.

The study revealed that a premium slightly less than two tenths of 1 percent of the pension debt outstanding would have covered the aggregate losses occurring during the period. Only in the years 1933 and 1934 would the credit insurance company have been unable to meet all claims out of accumulated reserves, the deficit being erased by 1937. With the exception of the year 1957, the insured firms would have paid larger premiums in each of the years from 1935 to 1958, inclusive, than would have been required to pay the claims arising during those years. The premium rate was set at three tenths of 1 percent in order to permit the building up of reserves that were considered to be a substitute for a large initial guaranty capital fund.

As of the end of 1969, about 1,800 Swedish corporate

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[3] The investigation was limited to enterprises that belonged at some time during the period to the Swedish Employers' Confederation (SAF), which includes within its membership practically all firms in the manufacturing industry and the majority of those in the building and road transport industries. Bankruptcy was construed to be the equivalent of failure to pay the required contributions to SAF. In other words, any company that failed to pay its dues to the SAF was considered to be bankrupt.

employers had elected to utilize internal funding for the salaried employees' supplemental benefits, with the concomitant use of the credit insurance mechanism. Approximately 250,000 employees and 15,000 pensioners were covered by this arrangement, accounting for two thirds of the salaried employees of firms engaged in manufacturing and commerce. The obligations of these employers amounted to $820 million, with the volume expected to increase by $120 million annually over the next few years. FPG was holding open reserves of nearly $8 million, which constituted 0.81 percent of its liabilities, as measured by the balance in the employers' pension liability accounts. FPG also has so-called hidden reserves of around $1 million. The company's objective is to accumulate a reserve of 2 percent of its liabilities by the year 1980. Through December 31, 1969, the company has had to make good on its guaranty in only 20 cases involving slightly less than $700,000 in "claim" payments.[4]

This credit insurance arrangement bears a surface similarity to the proposed guaranty pension obligations in this country in that the basic risk is the insolvency of the employer. There is a fundamental difference, however, in that under the Swedish arrangement all accrued benefits are fully accounted for through charges to the pension liability account and the only risk involved is the probability that because of the employer's bankruptcy the FPG will not recover its outlays in full.[5]

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[4] These operating statistics were made available by Sven O. Hyden, managing director, Pension Guarantee Mutual Insurance Company (FPG), in a personal communication to the author. Mr. Hyden has reviewed this description of the Swedish pension guaranty system for accuracy and has been extremely helpful in other respects.

[5] In Sweden all pension benefits are funded on a level cost basis and the concept of an unfunded pension liability (i.e., a supplemental cost) is not recognized.

FINNISH PENSION GUARANTY SYSTEM[6]

The events that led to the establishment of the Finnish pension guaranty system were strikingly similar to those that gave rise to the Swedish system. In 1939 Finland had instituted a national earnings-related pension plan covering the whole population and financed by employer and employee contributions. Eighteen years later in an action that ran counter to worldwide trends, the earnings-related program was scrapped and a flat-rate benefit system was adopted, to be supplemented by an assistance program based upon a means test. In the meantime, private pension plans, some insured and others noninsured, were being established without any governmental regulation or supervision.

Dissatisfaction with the national flat-rate pension system quickly developed and led to simultaneous demands for a supplemental wage-related national program (in other words, a two-tier national pension plan) and an expansion in the coverage of private pension plans. For the next several years there occurred what might be characterized as three-way collective bargaining involving labor organizations, employer associations, and governmental representatives. Ultimately, the labor organizations offered a specific and detailed proposal for providing supplementary pensions to be financed entirely by employer contributions. The employers, wishing to use pension fund assets to finance business operations, agreed to support the labor proposal subject to three major conditions. The first was that the supplemental benefits be

[6] Information for this section was provided by Heimer Sundberg, director of the Central Pension Security Institute (Eloketurvakeskus), and his associate Antti Melkas.

provided through private pension plans rather than through the government. The second was that the individual firm be permitted the option of using the facilities of a life insurance company or its own pension fund, subject in the latter case to some mechanism for safeguarding the employer's pension promises. The third was that the employers be free to fix the terms of a supplementary pension plan so long as it satisfied certain minimum standards.

The labor organizations accepted these conditions and, as a consequence, in 1961 the Parliament enacted legislation, known as TEL, requiring employers to establish pension plans conforming to specified standards for wage earners and salaried employees, the requirements to become effective July 1, 1962. The legislation also provided for the establishment of a credit insurance company, called the Central Pension Security Institute, to assure payment of the mandatory benefits and to perform certain administrative functions similar to those of the Swedish Pension Registration Institute. The following year a similar law, known as LEL, was enacted for the protection of seasonal workers, effective July 1, 1962, with the same provisions relating to the use of credit insurance. By legislation enacted July 14, 1967, coverage was provided for self-employed persons (YEL) and farmers (MYEL), effective January 1, 1970. The benefits for self-employed persons are provided through the Central Pension Security Institute, while those for farmers are provided through their own newly established institute.

The plans established pursuant to this legislation provide old-age, invalidity, and survivors' benefits. They must provide inter alia an old-age benefit, commencing at age 65, equal to 1 percent of the participant's average compensation during the two years of highest earnings in the four-year

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period immediately preceding retirement.[7] Coverage is compulsory for all employees between the ages of 18 and 65, after 4 months of service; but benefits begin to accrue only upon attainment of age 23. The general objective is to provide a combined retirement benefit, private and governmental, equal to 60 percent of final compensation, of which about two thirds would come from the mandatory private plan. After retirement, the benefits are linked to a special wage index in order to protect the pensioner against inflation and to enable him to share in any increase in real earnings.[8] The accrued benefits are fully vested at all times and registered with the Central Pension Security Institute. The employer is free to offer on a voluntary basis more liberal benefits than those required by law and to cover individuals not automatically covered by statute; but the additional benefits must be accorded all the protection, including full and immediate vesting, prescribed for the mandatory benefits. The benefits are financed entirely by employer contributions that are currently running at the rate of about 5 percent of payroll.

The employer can undertake to provide the benefits under his pension plan through a contract with a pension insurance company (of which there are 9) by establishing a pension foundation (trust) of his own (of which there are 150), or through participation in a pooled pension fund (of which there are 10).[9] If he chooses to purchase an insurance contract, he must pay a premium equal to 5 percent of covered

[7] The benefits of seasonal workers are equal to 1 percent of cumulative earnings adjusted for changes in the general wage level.

[8] Long-term disability benefits are computed in the same manner as old-age benefits and are also linked to a wage index.

[9] The benefits of seasonal workers under the LEL legislation are provided through four union-operated pension funds set up along broad occupational lines, specifically forestry, agriculture, construction, and dock work.

payroll, the amount being set by law.[10] In order to conserve his working capital, he may then borrow back the premium in the form of an insurance premium loan, which bears interest at the rate of 5 percent (7 percent after January 1, 1971) and must be repaid at the rate of 5 percent per year. Each year's premium can be recaptured in this manner. To assure repayment of the premium loans, the employer must obtain a credit insurance policy from the Central Pension Security Institute. Not all employers take advantage of their right to borrow back their premiums.

If an employer has 50 or more employees, he may accumulate monies in a pension foundation or a pension fund for the payment of pension benefits. In that event, he is not obliged to fund the benefits at any particular rate and may, in fact, transfer less money than the value of the accruing benefits. However, the difference between the actuarial value of the accrued benefits and the value of the accumulated assets must at all times be covered by credit insurance issued by the Central Pension Security Institute. Moreover, the investments of the pension foundation or fund must be protected against loss of value through credit insurance with the Institute. Thus, the amount of credit insurance is always equal to the actuarial value of the accrued pension benefits, whether funded or not.[11]

Unlike the FPG in Sweden, the Central Pension Security Institute of Finland is not permitted to refuse credit insurance

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[10] The premium is to be increased to 5.5 percent of payroll on January 1, 1971. Eventually, the premiums of the larger employers will be subject to experience rating.

[11] If the plan is funded through an insurance company, the employer must carry credit insurance only if he exercises his right to borrow back his premiums. The insurance company, however, may take out credit insurance on *investment loans* that it makes to employers.

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to any applicant, irrespective of its financial condition.[12] Hence, the Institute has found it necessary to establish a rating system that attempts to measure the amount of financial risk involved. It uses a very simple standard of risk measurement: the ratio of a firm's capital and surplus to its outside liabilities. The minimum premium rate of 0.4 percent presupposes that the ratio of capital and surplus to outside liabilities is 0.42. As the ratio declines, the premium rate goes up. If the ratio is only 0.30, the premium rate is 0.8 percent; a ratio of 0.25 and 0.20 produces a premium rate of 1.5 percent and 3.0 percent, respectively.

The Board of Directors of the Institute is authorized to modify the standard premium scale, upward or downward, for a particular firm if its financial condition and other circumstances justify such action. The rate might be lowered, for example, if the firm's investments are unusually sound, its earnings are higher than normal, its depreciation policies are unusually conservative, or its assets are undervalued. On the other hand, the rate might be raised if the firm has had operating losses in successive years, its assets are overvalued, or the danger of bankruptcy is exceptionally high.

The premium rate is applied to the *unsecured* portion of the loan or amount insured. In other words, employers are permitted to pledge collateral with the Institute and reduce the base to which the premium will be applied. The higher the premium rate the more likely the employer is to pledge collateral, including real estate mortages, as security for the premium loan or the unfunded accrued liability. However, in order to meet the administrative costs of the Institute, every plan is required to pay the insurance premium for its

[12] However, since 1969, the Institute has had the right to demand a "guarantee" when the outside liabilities of the applicant are more than six times its capital and surplus.

risk classification on at least 1 percent of the credit insurance, irrespective of the amount of collateral pledged. The same premium rate is applied to a plan's investments as to its unfunded liabilities, even though the risk of default under the various types of obligations would be identical only by sheer coincidence.

The credit insurance is normally written for a term of one year, expiring six month after the end of the employer's fiscal year. Two months before the insurance expires the employer must submit a financial statement for the preceding fiscal year and other documents needed by the Institute to set a proper premium rate.

Almost three fourths of the employees are covered by plans that are funded through insurance companies. About a fifth are covered by plans utilizing foundations, the remaining employees being associated with plans electing to use pension funds.

Through 1968 the Central Pension Security Institute had collected 13,500,000 mk. in premiums. A total of 82 bankruptcies had occurred, producing estimated losses of 4,903,000 mk. Twenty-four of the bankruptcies took place in 1968.

The scope of this system can be put into better perspective perhaps by noting that Finland's total population in 1967 was 4.7 million, of whom 2.2 million were gainfully employed.