# Guaranty Fund for Private Pension Obligations

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## *Chapter 6*

# *Issues*

Many issues would have to be resolved if a pension guaranty fund were to be established in the United States.[1] This chapter analyses the issues and points to the various courses of action without attempting to reach final solutions.

### ADMINISTERING AGENCY

A pension guaranty fund, hereinafter referred to as the PGF or the guarantor, could be established and operated under the auspices of a federal agency, a private agency, or a combination government-private instrumentality. The choice would depend in part on political philosophies and

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1 This presupposes an earlier decision to use a guaranty fund mechanism rather than a suretyship arrangement such as that employed in Sweden and Finland. In theory the objectives of the current proposals for a pension guaranty could be achieved by requiring employers to undergird their pension promises by the purchase of a performance bond from a surety company. In the event of a default on pension obligations, the surety company would be expected to make good on the benefit promises through the purchase of annuities from life insurance companies, with recourse against the employer for its net outlays. Among other advantages, this approach would permit the charging of a premium rate commensurate with the individual risk involved. Some supervisory agency would have to determine that the mandatory performance bond was purchased and maintained in force and that employee rights were protected in the event of plan termination. There would also have to be some mechanism similar to assigned risks pools in automobile and workmen's

in part on the financial mechanism envisaged. Legislation proposed thus far has contemplated administration by a federal agency which would be feasible under any set of circumstances and would be especially appropriate if the financing scheme should embody the assessment principle, with a minimum accumulation of assets, and if the government were prepared to assume the greater part of the risk involved.

Administration by a central private agency, specially created for the purpose with representation from employers, labor unions, banks, insurance companies, and other interested parties, would appear to be equally feasible. Private control over the guaranty mechanism might make the whole idea more acceptable to employers (who would be expected to bear all or a substantial part of the cost), and it would be particularly desirable if a major investment function should be envisioned.

Another possible approach would be to utilize a central agency, either governmental or private in nature, for the collection of premiums, adjudication of plan terminations, and other ministerial functions, with the guaranteed benefits being underwritten, for a consideration, by life insurance companies on their own account or as members of a pool. The risks could be assigned to individual companies on a basis similar to that employed with Federal Employees Group Life Insurance, the Federal Employees Health Benefits Act, or Servicemen's Group Life Insurance. The pool arrangement

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compensation insurance to provide coverage to employers who could not purchase the required insurance through regular channels. Since purchase of insurance would be mandatory, the rates charged by the surety companies would have to come under public surveillance. Despite the flexibility of this approach, its feasibility would be completely dependent upon the response of a group of private insurers to a new and hazardous type of coverage. Of course, a new surety company could be established for the sole purpose of writing this coverage, but it is doubtful that such a mechanism would offer any real advantages over the type of guaranty fund described hereafter in this treatise.

could be patterned after that being considered for the flood insurance program. The primary difference between this approach and the second one mentioned above would be that in one case the central agency would retain the risks taken over from terminated plans, acting as an insurer in the process, whereas in the other case the risks would be transferred to existing insurance companies on some equitable basis.

Any approach that would place upon private agencies the basic risks inherent in plan terminations would probably have to embody some mechanism for governmental reinsurance.

## EVENT INSURED AGAINST

The most difficult problem that would have to be confronted in the establishment of a sound and equitable system for assuring the payment of accrued pension benefits would be defining or articulating the circumstances under which the protection of the system could be invoked. One would naturally assume that the guaranty would be applicable only when the pension plan has terminated under certain prescribed conditions, but all bills on this subject now pending before Congress clearly contemplate that the guaranty could be invoked by certain groups of employees even though the plan continues in existence. For example, the Javits bill defines the insured event as "substantial cessation of one or more of the operations carried on by the contributing employer in one or more facilities of such employer before funding of the . . . liabilities. . . ."

This type of thinking appears to be a throwback to the concept of a partial termination expressed in IRS regulations in language similar to the above-quoted passage. The IRS was concerned that an employer in anticipation of a complete termination of his pension plan might engage in a massive discharge of employees—through individual layoffs or closing down of specific operations—thus increasing the share of the plan assets that would be available for the officers, supervisors, and highly compensated employees. To forestall such action, the IRS introduced the concept of the partial plan termination, which has the effect of vesting all accrued benefits of the employees involved. In a real sense, the concept was introduced as a substitute for reasonable vesting provisions in the plan at a time when vesting through plan provisions was not as common as it is today.

The most baffling difficulties conjured up in connection with a pension guaranty scheme are concerned with the rights of individuals who lose their jobs while the pension plan to which they belonged continues in operation. The job loss could result from the elimination of specific positions or the closing down of an entire plant, division, or subsidiary. The problem, if there is one, is lack of adequate vesting. If the pension rights of the displaced employees were vested, they would retain a claim to benefits enforceable in due course against the assets of the plan. If the plan itself were eventually to terminate with insufficient assets, unsatisfied claims would be met by the guaranty fund. Thus, the definition of the insured event should not be complicated—perhaps to the point of utter uselessness—by an effort to meet another problem that is not an inherent part of the guaranty scheme. The vesting problem would be largely solved if some of the legislative proposals now being considered were to be adopted. The remaining discussion assumes that any pension guaranty would apply only to benefit claims arising out of a plan that has terminated in its entirety.

The definitional problem would be further simplified if it could be assumed that a plan termination was always an incident to the final dissolution of the sponsoring firm. This, of course, is not the case. Most firms (more than 80 percent according to the BLS study of terminations) continue in full operation, usually in their original form, after terminating their pension plans. In some of these cases (about one fourth according to the BLS study), the discontinuance stems from financial difficulties. In the other cases a variety of causes may be at work. Some of the more common reasons, other than financial difficulties, why a pension plan might be discontinued are (1) sale or merger of the sponsoring firm, (2) transfer of the employees to another pension plan, (3) substitution of a profit-sharing plan or other form of deferred compensation for the pension plan, (4) closing of a plant or other subdivision that had its own pension plan, (5) desire of the sponsoring firm to protect or improve its profit position, and (6) mutual agreement by the parties to a collective bargaining contract. There are undoubtedly cases where the firm ostensibly goes out of business only to reopen under another name or in another form.

There is serious doubt concerning the propriety—and feasibility—of invoking a pension guaranty when the firm that created the pension obligations continues to operate in one form or the other. It would clearly be inappropriate to have a guaranty fund assume the unfunded obligations of a plan terminated in order to transfer the employees into another pension plan or a profit-sharing plan, or pursuant to an agreement between the parties to a collective bargaining contract, presumably to protect or increase cash wages. It would also seem improper to permit a prosperous corporation to slough off unto a guaranty fund the unfunded pension claims of persons who had been employed in a plant or division (with its own pension plan) shut down for presumably sound business reasons. This would have the effect of increasing the labor costs chargeable to the remaining units of the business, an unfortunate but unavoidable consequence. A firm that purchases another should be expected to assume the pension obligations of the acquired firm, the purchase price reflecting the unfunded liabilities. It is recognized that this requirement might force complete dissolution of a firm or one of its subdivisions because of the unwillingness of the prospective purchaser to assume the unfunded accrued pension obligation of the firm to be acquired. Accrued pension benefits should also be protected when two or more firms merge, despite the fact that the merger negotiations might be complicated thereby. The guaranty would seem to be justified when the termination was motivated by financial difficulties verified by the administering agency. Yet this would create an unconscionable distinction between participants in pension plans terminated because of financial exigences and those in plans terminated for other reasons, unless the sponsoring firms undertake to honor out of corporate assets the unfunded benefits accrued to date of termination.

The whole matter would be greatly simplified—with some reduction in the attractiveness of qualifying a plan under Treasury regulations—if the guaranty scheme were established on the basis that the sponsoring firm, or its successor, would have the primary legal responsibility of meeting the cost of the benefits covered by the guaranty, the PGF having only the residual liability. Then it would be possible to define the insured event as the complete termination of a pension plan, without reference to the circumstances surrounding the event. If the sponsoring firm had gone out of business or was in process of doing so, its obligation to the plan (or the PGF) would be discharged to the extent of available resources in a lump-sum payment. If the firm continued in operation, its obligation could be discharged over a number of years in accordance with the pattern prescribed for the funding of the supplementary liability. (See the next section.) In the meantime the PGF would stand ready to assume responsibility for any benefits not ultimately funded by the employer. Unless such a feature can be made part of the guaranty arrangement, it would probably be necessary to define the insured event in terms that would limit the guaranty to plan termination arising out of the final dissolution of the sponsoring firm (or its successor), whether by bankruptcy, insolvency, or voluntary winding up.

Special rules would have to be developed for multiemployer plans, since among other distinguishing characteristics, they have an existence apart from that of any particular employer belonging to the plan. In some industries in which these plans are found, such as the building trades and the maritime industry, the employment relationship is very tenuous, frequently being limited to one construction job, voyage, or other undertaking. In other industries the employment relationship is more conventional. In either of these settings, it would be desirable to provide some measure of protection to the accrued pension benefits of the employee participants irrespective of whether the current employer or past employers continue to participate in the plan or continue in operation. The preferred arrangement would be for the plan to assume the primary responsibility for the payment of the benefits that would come under the guaranty, so long as the plan continues in operation, with the PGF providing the ultimate guaranty. There would have to be safeguards to protect the plan against abuse, and the contribution rate (or benefit levels) would have to reflect the anticipated cost of the internal guaranty.

A precedent for this type of approach is found in the

National Industrial Group Pension Plan developed by the Industrial Union Department of the AFL–CIO and jointly underwritten by a number of life insurance companies. If a participant has been drawing benefits for five years and has attained the age of 72, the plan assumes full liability for the lifetime continuation of his benefits. Furthermore, if the termination is the result of circumstances beyond the control of the employer and union involved, the plan assumes as a liability, enforceable against all assets, those accrued benefits based on a benefit level that has been in effect for at least three years for any participant already retired or eligible to retire. In addition, under those circumstances, the plan assumes responsibility for 30 percent of the accrued benefits of any participant who has had a minimum of 10 years of credited service with the employer (10 "service units"), with the percentage rising progressively for each year of employer participation in the plan and reaching 100 percent with respect to benefit levels in effect within the plan for at least 10 years.

In the absence of an internal guaranty arrangement, the PGF could assume ultimate responsibility for the payment of the covered benefits of employees whose employer withdraws from a multiemployer plan after a minimum period of participation and for reasons beyond his control. The employees would retain claims against the plan to the extent of the funds allocable to them, but the PGF would make good on any insufficiency of assets—despite the fact that the overall plan continues in operation. In other words, the employer's withdrawal from the plan would be treated as a plan termination with respect to his employees. The guaranty should not be invoked if the employees' rights are preserved through membership in another plan or in the same plan through subsequent employment with another firm belonging to the plan. This approach would not be applicable to multiemployer plans in industries characterized by temporary employment relationships. In these cases, termination of the master plan would have to be the contingency that invokes the guaranty.

## OBLIGATION OF THE GUARANTY FUND

It goes without saying that a pension guaranty mechanism should relate only to benefits accrued to date of plan termination, however that event may be defined. Thus, the PGF should not undertake obligations with respect to benefits that would have been earned had the plan remained in operation and the employee continued in the service of the employer until normal retirement age. Moreover, it does not follow that *all* accrued benefits would be entitled to the protection of the program. Various limitations, discussed later, might be necessary or desirable. Thus, the following discussion should be understood to apply only to the benefits that would be entitled to protection.

Broadly speaking, the obligation of the guaranty fund could be expressed in one of two ways: (1) assurance of ultimate payment of the benefits covered by the program or (2) completion of the employer's funding commitment.

Assurance of Ultimate Payment of Guaranteed Benefits. The most comprehensive approach would be for the PGF to assure ultimate payment of all covered benefits, irrespective of the amount, source, or cause of the asset deficiency. The deficiency could be caused by inaccurate estimates of cost, failure of the employer to undertake an adequate funding program, lack of time for the completion of a realistic funding objective, or loss of asset values through realized or unrealized capital losses. No minimum standards of funding would be imposed, and, in fact, pay-as-you-go plans would be eligible to participate. Risk classifications would be established on the basis of probability of plan termination, and the premium paid in respect of a particular plan would be derived by multiplying the probability of termination times the actuarial value of unfunded benefits. In some cases, this combination of factors might produce a premium charge as large as, or larger than, the annual contributions under a realistic funding program. Losses incurred on liquidation of assets in connection with plan termination, the subject of special provisions in the early legislative proposals, would be blanketed in under this approach in so far as they affect the payment of guaranteed benefits. Benefits not subject to the guaranty would not be protected against liquidating losses; but as will be noted later, it is possible to devise a claim settlement procedure that would eliminate or minimize the risk of such losses.

The advantages that would be associated with the approach are (1) eligibility of all types of plans, including those financed on a pay-as-you-go basis where the need for protection is greatest; (2) coverage of all sources of asset deficiency, including liquidating losses as they relate to covered benefits; (3) equitable allocation of costs through use of many risk classifications; and (4) absence of mandated standards of funding. All of these advantages would have offsetting disadvantages from other points of view. The approach would lend itself to great abuse because of its sweeping coverage; it might encourage highly speculative investment policies; it would be extremely difficult, if not impossible, to predict the probability of termination among various classifications of plans, which would be especially important in connection with unfunded plans; the need for a governmental subsidy would be greater than under any other approach, because of the foregoing factors plus absence of minimum funding standards; and finally participation by pay-as-you-go plans (which might be encouraged at the expense of funded plans) would have to be on a voluntary basis unless they are to be brought under some degree of regulatory control, as they have been in the United Kingdom and certain Canadian provinces.[2]

Most of the major disadvantages of this approach could be overcome by requiring the covered benefits to be funded in accordance with minimum standards stipulated by law or administrative agency. These standards would concern themselves with actuarial assumptions, actuarial cost methods, and the period of time allowed for the full funding of all covered benefits. If the guaranty were to apply to all accrued benefits, the employer might be expected to fund his normal cost currently and his supplemental cost, if any, over a maximum period of 25 or 30 years. If the guaranty were to apply only to a segment of the accrued benefits, such as those that have vested, the standard might speak only of the maximum period over which the covered benefits were to be funded in full, possibly on the basis of specified mortality and interest assumptions. Alternatively, the standard might require the current funding of the normal cost of the vested benefits and the amortization of the supplemental cost of the vested benefits over a specified maximum period. Another logical standard might prescribe the funding of the normal costs of all accrued benefits for the plan as a whole plus whatever additional sums are needed to assure that all vested benefits are

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[2] In the United Kingdom, the penalty for nonapproval of a plan by the Inland Revenue Department is the current taxation of employee participants in respect of employer contributions. If the plan is not funded, the contributions are imputed to the employees. In Ontario, Quebec, Alberta and Saskatchewan, the law forbids the operation of a formal pay-as-you-go plan.

fully funded by the end of 20 years. Whichever approach is used, full funding of all vested benefits should probably be required in 20 years, corresponding to the principle adopted by the AICPA for the accruing of the costs of vested benefits. A funding standard promulgated for only a segment of the total benefits would have to be reconciled with the broader minimum standard articulated by the Internal Revenue Service.

If the plan should terminate before the required level of funding has been achieved, the unfunded portion of the accrued liability would become the obligation of the PGF. The funding of supplemental costs arising after inception of the plan from such causes as retrospective benefit increases, actuarial losses (unfavorable deviation of actual from assumed experience), and revision of actuarial assumptions should also come under the "completion" guaranty, but subject to adequate safeguards against abuse. Since the obligation of the PGF would be stated in terms of *benefit payments,* the strengthening of actuarial assumptions would not add to the existing obligation of the guaranty fund and might in fact diminish it through stepping up the rate of funding. Recurring actuarial losses would be significant in that they would suggest the strong possibility that the employer's funding policy was based on an understatement of the ultimate or "true" cost of the covered benefits.

The major advantage of this modification would be the reduction of the risk assumed by the PGF through the systematic funding of covered benefits on the basis of presumably realistic cost estimates. The major disadvantage would be the exclusion of plans operating on a pay-as-you-go basis, unless such plans were forced to convert to a funded basis. There would be other disadvantages, such as the employer's authority to create additional liabilities for the PGF, without any recourse against his own corporate assets, and the risk associated with speculative investment policies.

The viability of the modified approach is clearly dependent upon the enforcement of minimum standards of funding. There should be sanctions other than suspension or cancellation of coverage since these actions would penalize only the plan participants for whose protection the program was established in the first place. One possible sanction that would be effective, assuming availability of assets, would be to make the employer financially responsible for any defaults on scheduled funding payments. The sanction might take the form of a tax penalty, possibly equal to the funding deficit, that could be diverted to the PGF to offset its increased liability. The tax payment could be refunded, at least in part, if the employer later made restitution to the plan.

A more comprehensive remedy that could also be applied without a funding requirement would be to make the employer primarily responsible for any deficiency in plan assets, with the guaranty fund being only contingently liable. Procedurally, the PGF would assume full and direct responsibility for the fulfillment of benefit expectations but would have right of action against the employer to recover any asset deficiency. The PGF would be regarded at law as a creditor of the employer and could be given an appropriate preference in an insolvency or bankruptcy proceeding. Making the employer legally responsible for the payment of accrued benefits would encourage conservatism in the granting of benefits and in the financing of the benefits. It would eliminate most of the possibilities of abuse (or selection against the fund) and make it possible for the PGF rules to be far less restrictive as to coverage, benefits, and funding. On the other hand, it could discourage the voluntary establishment of qualified plans. For constitutional reasons, it might be necessary to limit the employer's legal liability to benefits accruing after enactment of the pertinent legislation.

COMPLETION OF THE EMPLOYER'S FUNDING COMMITMENT. The second basic approach would be to limit the liability of the PGF to the completion of the employer's funding program for covered benefits, without regard to the sufficiency of the projected contributions. In other words, the guaranty would attach to the *funding* commitment rather than to the *benefit* commitment. In theory, this approach could be followed without any standards of funding other than those imposed by the IRS as a condition for continued qualification; but for all practical purposes it would have to be grounded on minimum standards comparable in nature and scope to those suggested in the preceding section. The initial accrued liability for covered benefits could be increased by benefit liberalizations, subject to necessary safeguards, but a recomputation on the basis of revised actuarial assumptions could be permitted only with the approval of the PGF. Under this procedure, the dollar amount of the PGF's potential aggregate liability could be definitely determined at any time. It would be the unfunded portion of the explicitly recorded accrued liability for all covered benefits of all plans encompassed by the program. If the covered benefits of a terminated plan could not be satisfied in full when account is taken of the PGF's obligation, benefits would have to be scaled down to manageable proportions.

As with the benefit guaranty approach, there would have to be sanctions to enforce compliance with the mandated standards of funding.

This arrangement would insulate the guaranty fund against the effects of unrealistically low cost estimates on the part of employers, an obvious advantage to the PGF and to employers who fund on the basis of adequate cost estimates. It would also protect the PGF against the undesirable consequences of unduly venturesome investment policies, unless the fund assumed responsibility for increases in unfunded liability arising out of realized and unrealized capital losses —as it might well do. The primary disadvantage of this approach is that the risk of inadequate asset accumulations would be shifted to the plan participants. It also fails to deal with the problem of the pay-as-you-go plan.

The obligation assumed by the PGF under this approach would be tantamount to assuring the fulfillment of benefit expectations if (1) the PGF prescribed the actuarial cost method and actuarial assumptions to be used and the period of time allowed for the full funding of all covered benefits, (2) the funding standards were enforced, (3) the PGF assumed responsibility for unfunded actuarial losses, and (4) the PGF or an insurer assumed the actuarial risks associated with benefits that survive a plan termination.

## PLANS COVERED

A number of questions are involved with respect to the plans that would be brought under a pension guaranty program. The most fundamental question is whether all plans eligible for coverage would be required to participate in the program. The answer is clearly in the affirmative. There would be too much selection against the PGF if employers were permitted to elect coverage. There would be an understandable tendency for financially stable firms to stay out of the system and for the less stable ones to elect coverage. Worse yet, the latter firms, where the need of a guaranty is greatest, might also elect to remain outside the program. There might be a universal reluctance to participate in any undertaking that would add to the cost of doing business; and if not properly structured, it might be grossly abused. Compulsion seems to be the only answer, despite the fact that this feature might narrow the range of plans that could be brought into the program.

If the program were to be made compulsory, it would have to be restricted to plans "qualified" under the Internal Revenue Code and implementing regulations, unless a new control mechanism is developed. At the present time the only effective club that the federal government has over pension plans is denial of the tax treatment that is accorded plans which meet certain specifications designed to prevent discrimination in favor of stockholders, officers, supervisors, and highly paid employees. Conceivably, Congress could enact a law making it unlawful to hold out the promise of pension benefits, however the promise might be hedged, unless the anticipated benefits were funded in a prescribed manner, but the prospect of such legislation in the near future seems remote. There is the possibility, of course, that a pension guaranty mechanism might prove to be so attractive that employers would convert their nonqualified plans into qualified plans in order to take advantage of the coverage.

Some have questioned whether multiemployer plans should be compelled to participate in the guaranty scheme. The probability of termination is probably lower among multiemployer plans as a group than among single-employer plans, which would lessen the need for the guaranty. On the other hand, multiemployer plans are probably funded at a lower level than single-employer plans as a class, which would suggest the need for a benefit guaranty. Many of these plans would have difficulty meeting the minimum standard of funding mentioned earlier, since a substantial percentage only pay interest on the supplemental liability rather than amortizing it. Considerable opposition to compulsory participation could be expected by multiemployer plan administrators. On balance, however, it would seem that the guaranty scheme should be applicable to all qualified plans, whether they be single-employer or multiemployer plans.

In order to protect the system, a plan should not be eligible for coverage for the first few years of its existence. Otherwise, an employer in contemplation of an event that would invoke the protection of the system could establish a plan with liberal past service benefits and let the PGF assume most of the financial burden. The need for protecting the system against this potentiality would depend on other provisions of the program, including the definition of the event insured against and the benefits that would be entitled to the guaranty. The required length of the probationary period is strictly a matter of judgment, but it should perhaps be no shorter than three nor longer than 10 years. It is of some significance in this regard that the BLS study of pension plan terminations cited earlier[3] showed that half of the plans examined, terminated within five years after establishment.

A question might be raised as to the desirability of excluding from participation in the program plans covering fewer than some specified number of employees, such as 25. There is no doubt that the probability of termination is the highest among the smaller plans. The BLS study revealed that two thirds of the terminations were accounted for by plans covering fewer than 25 employees. The issue here is whether the program should be structured in such a manner as to cover the area of greatest need or to minimize the financial burden on continuing plans. Clearly, a guaranty program could be surrounded by so many safeguards that it would

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[3] See page 20.

cover only the most unlikely occurrences, with commensurately low cost to the participating plans. In the light of the other safeguards recommended in this monograph, it would seem unnecessary—and socially undesirable—to exclude plans purely on the basis of size.

Another question of considerable moment is whether all plans falling within the eligible group would automatically be embraced in the program or whether the administering agency would have the authority to exclude those plans not measuring up to minimum underwriting standards. This is primarily a question of priorities. Is the paramount objective the protecting of benefit expectations or the integrity of the guaranty fund? If the participants in the less secure plans are to be denied the protection of the system, much of the latter's value would be sacrificed. On the other hand, employers who are meeting their pension obligations in a realistic and forthright manner can properly object to assuming a portion of the pension obligations of other employers, possibly their competitors. The issue would be blunted if a number of risk classifications could be established, with the premium being roughly commensurate with the risk of plan termination. The problem would also be diminished if the projected cost of the program turned out to be of modest or even negligible proportions.

A related question is whether a plan that falls outside the category of plans that must participate, could be brought within the scope of the program by election of the plan administrator. This should be permitted and encouraged if the aim is to maximize the coverage of the program. On the other hand, the privilege would open the door to selection against the program. Voluntary election of coverage would probably be feasible if a sound underwriting procedure could be devised and enforced.

## BENEFITS COVERED

As was stated earlier, the protection of the guaranty fund would extend only to benefits accrued as of the date of plan termination or, more precisely, the occurrence of the event insured against. However, the protection need not extend to all accrued benefits. A distinction might logically be made between benefits credited for service prior to inception of the plan and those that accrued thereafter. If only the latter benefits were to be "insured," the major costs of the program would be eliminated, but by the same token much of the *raison d'être* of the program would be destroyed. The principal problem lies with past service benefits and others granted retrospectively after the plan was established.

Another distinction that might be made is that between vested and nonvested benefits. While the Hartke bills and the current Javits Bill have envisioned the guaranteeing of all accrued benefits, the Pension Benefits Security Act would guarantee only benefits that have vested. The Act, however, would require that benefits vest after 10 years of continuous service, irrespective of the participant's attained age, subject to various transitional arrangements designed to soften the cost impact of the proposed minimum standard.

Under this concept the question arises as to whether the guaranty would attach only to the benefits that would be vested under the proposed minimum standard or to those that have vested on a more liberal standard pursuant to the terms of the pension plan. While relatively few plans, other than those funded through individual insurance or annuity contracts, vest benefits with less than 10 years of credited service, many vest past service as well as future service benefits. Moreover, all benefits of retired persons are considered to be vested and all those of employees eligible to retire may be so regarded. Any plan that has had a vesting provision for a number of years is likely to have a greater volume of vested benefits that would be generated by the proposed minimum standard.

Other distinctions among accrued benefits could be justified. In a privately circulated memorandum, an official of a major automobile company proposed that the guaranty attach to all the accrued benefits of persons in a retired status and those within 10 years of normal retirement. With respect to all other employees, the guaranty would attach in annual increments, reaching 100 percent only after the plan had participated in the guaranty program for 10 years.

There would have to be a determination as to the *types* of benefits to which the guaranty would attach. It is obvious that it would apply to retirement benefits; but would it cover death, disability, special early retirement, and other ancillary benefits? It would seem that that the guaranty ought to cover only such ancillary benefits that have matured and are in an active payment status.

It would be necessary to deal specifically with plan liberalizations that increase the unfunded liability of the plan, especially increases in the scale of benefits. The threat to the solvency of the fund is apparent. The guaranty should not attach to newly created benefits for a period of years. It would make sense to impose the same probationary period as that applicable to newly established plans.

It would probably be desirable to place a dollar limit on the benefits that would be guaranteed for any one participant, since there is an element of social insurance in the whole undertaking and some employers would inevitably subsidize the pension plans of other employers to some extent. The limit should be stated in terms of the monthly income provided at a retirement age specified in the law.

## IMPLEMENTATION OF THE GUARANTY

The implementation of the guaranty would involve two basic issues: (1) determination of the amount of the PGF's liability and (2) manner in which the guaranty would function.[4]

Determination of the Guarantor's Liability. The determination of the guarantor's liability would be divided into three steps. The first step would be to ascertain in terms of prospective monthly income the dollar amount of covered benefits accrued as of the date of plan termination. This could present difficulties if the benefits covered by the guaranty are not carefully defined. However, it is assumed for the purpose at hand that the guaranty would be limited to *vested* benefits, including those vested on a voluntary basis. It is further assumed that plans will be required by law to state precisely what benefits are vested, the conditions under which they vest, and how the amount of vested benefits is computed. There should be no distinction between the benefits vested upon termination of employment and those vested upon plan termination except as may be necessary to meet the Treasury requirement that all accrued benefits vest on plan termination to the extent that they are funded. Otherwise inequities may be created as between employees who are laid off in anticipation of the winding up of a business and those who are still employed at the point of technical termination of the plan.

The second step would be to derive the actuarial value of the guaranteed benefits. Procedurally, this would be simple

[4] It is assumed for purpose of this discussion that the PGF's obligation would be to assure payment of the guaranteed benefits. If its obligation were limited to the completion of a projected funding program, the amount of its liability would be determined on a basis different from that described herein, but its obligation could be carried out under any of the approaches outlined.

if only basic retirement benefits are vested. Their valuation would involve only mortality and interest (and possibly expense) assumptions. If any ancillary benefits are vested, additional factors might have to be considered. The basic question here would be whether to use the assumptions that had guided the employer's funding policy or the assumptions that would be applied by the agency that would have final responsibility for payment of the benefits—the residual risk bearer. The decision would be influenced or perhaps controlled by the payment mechanism adopted, to be discussed in the next section.

The final step would be to compare the actuarial liability derived in step 2 with the value of the assets considered to be available for the satisfaction of the guaranteed benefits. The law might state that all unallocated assets are to be applied on a first priority basis to the payment of guaranteed benefits. (Presumably it would not direct the recapture of assets used to purchase nonvested benefits from an insurance company or reallocate assets needed to honor benefit commitments to persons in a retired status even when the benefits do not qualify for the guaranty.) It might recognize the priorities established in the plan document for the allocation of uncommitted assets in the event of plan termination. Conceivably it might recognize no priorities and thus assume that guaranteed benefits are entitled to only their pro rata share of the assets. Whatever the concept applied, the theoretical liability of the guarantor would be measured by the difference between the actuarial value of the guaranteed benefits and the value, at book or market, of the assets applicable to those benefits. The actual liability would depend upon the manner in which the guarantor discharges its obligation.

MANNER IN WHICH THE GUARANTY WOULD FUNCTION. The guarantor could discharge its responsibility in a number of ways, the choice depending to some extent on the nature of the guarantor and to some extent on the manner in which the funded benefits are to be paid out.

It would seem logical that responsibility for the payment of benefits *purchased* from an insurer prior to termination of a covered plan would be retained by the insurer, with future dividends or experience refunds going to the PGF. Legal complications would ensue if any other course of action were to be attempted. Thus, the problem reduces to the procedure to be followed when the plan assets are held in trust or in an unallocated fund with a life insurance company.

One approach would be for the funding agency to retain the assets, paying benefits pursuant to the terms of the plan until the assets are exhausted, with the guarantor then assuming responsibility for payment of the remaining guaranteed benefits. If the guaranty program were to give guaranteed benefits first claim to available assets, distributions would have to be limited to those persons whose benefit rights were protected by the program, unless the assets appeared to be more than sufficient to meet the priority claims. In the latter event, it would be necessary to divide the assets into two accounts, one being held for guaranteed benefits and the other for nonguaranteed benefits.

This approach would have a number of virtues. The guarantor's liability would be determined on the basis of actual, emerging experience; competitive relationships between and among banks and insurance companies would not be distorted (as might happen under other approaches); it would not be necessary to transfer funds to the guarantor, thus avoiding the risk of liquidation losses and minimizing the asset accumulation of the guarantor—an especially desirable objective if the latter is a governmental agency; and (a minor point) the pensioner would receive only one check per month rather than one from the funding agency and another from the guarantor.

On the negative side, this approach would not lend itself as well as some others to an employer guaranty of an asset deficiency, however it might be formulated. The true deficiency would not be known for many years, by which time the employer might have gone out of business. It would be possible, of course, for the guarantor to levy an assessment on the employer at the time of plan termination in an amount equal to the actuarially estimated deficit. Secondly, potential complications would be involved if it became necessary to divide the accumulated assets between guaranteed and nonguaranteed benefits. The present value of the guaranteed benefits would have to be actuarially estimated, and only by sheer coincidence would the estimated and ultimately realized costs be the same. Theoretically, the guarantor should incur no liability; but if the cost estimate proves to be too low, it would have to assume the deficit. On the other hand, if the estimate were too high, individuals with nonguaranteed claims would have been unnecessarily deprived of some of their benefits. A third complication would arise if the trust agreement between the bank and the employer were to call for dissolution of the trust upon termination of the plan, with the assets to be applied to the purchase of annuities. There is no reason why such an agreement could not be enforced if the asset allocation formula were not inconsistent with the guaranty program, since this would immediately fix the amount of the guarantor's obligation. Finally, in the latter stages of liquidation of a trust, liquidity problems could arise, possibly resulting in some otherwise unnecessary capital losses.

A second approach would be for the funding agency to pay that portion of each employee's total guaranteed benefit that could be provided by the assets in its possession, with the guarantor concurrently paying the remaining portion. This would necessitate an actuarial estimate of the benefits that could be paid by the funding agency, with possible discrimination against either the guaranty fund or the individuals with nonguaranteed benefits if the estimates should prove wrong, as would be virtually certain. This method would avoid transfer of funds at time of plan termination and would leave undisturbed existing competitive relationships.

A third approach that would involve approximately the same advantages and disadvantages as the first two would be for the guarantor to transfer to the funding agency the additional sums actuarially estimated to be needed to pay the guaranteed benefits. The benefits would be charged to the pension fund as they were paid, even if the funding agency should be an insurer. In other words, the insurer would not underwrite the benefits, offering only investment and disbursement services. If the sums transferred proved to be inadequate, the guarantor would advance additional funds as the needs manifested themselves. If the sums turned out to be excessive, the funding agencies would be expected to return the unused funds to the guarantor. A delicate question that would be involved in this arrangement would be the extent to which the funding agency could invade the corpus (or fund) for its expenses and possibly a profit. Another—equally sensitive—question would be the extent to which the PGF could influence or direct the policy to be followed by the funding agency in the investment of the moneys entrusted to it.

A fourth approach would be for the funding agency to transfer to the guarantor a sum equal to the assets assumed to stand behind the guaranteed benefits. Unless the assets were transferred in kind, the funding agency should be permitted to spread the liquidation over a period of years to avoid capital losses or other forms of adverse financial consequences. If the employer were to be held responsible for the asset deficiency, the amount of his liability should be fixed at point of plan termination; but he should be permitted to spread his payments to the guarantor over a period of years, possibly equal to the remaining years in the original period over which he was to have funded the benefits. In other words, if the employer were supposed to have the guaranteed benefits completely funded within 20 years from plan inception or a later event and the plan should terminate within 10 years, he would be given 10 years in which to make up the deficiency—as under the original schedule. If he should go out of business before completing the payments, the unpaid amounts would become a claim against his business assets with whatever preference the law might assign to it.[5]

The guarantor might discharge its obligation in one of two ways. The first would be for the guarantor to act as the risk bearer and pay the guaranteed benefits directly to the claimants as they become due. Any benefit amounts not taken care of by the assets transferred to it from the funding agency would be borne out of the guarantor's general assets. This would be the logical course of action if the guarantor were to be a private agency jointly administered by the private organizations participating in the private pension movement. If the guarantor were a public agency, it might be preferable for it to discharge its obligation immediately and cleanly by the purchase of nonparticipating annuities from individual insurers or a pool of insurers formed for that purpose. Under this procedure there would be no uncertainty concerning the

[5] The concept of requiring the employer to fulfill his funding commitment would be equally applicable to the other approaches described herein, but the implementation of the requirement would differ somewhat.

guarantor's ultimate liability, and the amount of the employer's liability, if any, would be promptly and definitely determined. Furthermore, the assets securing the benefit rights would be kept in the hands of private agencies. If the decision were made to deal with individual insurers, appropriate rules would have to be promulgated with respect to the qualifications of the insurers and the process by which the insurers would be chosen. The latter would presumably be on the basis of competitive bids. A different set of procedures would be needed if a pool of insurers were to be used, with safeguards to assure that the rates are not excessive.

Under all these approaches benefits not subject to the guaranty would be paid, to the extent that assets are available, by the funding agency holding the assets at the time of plan termination, unless the trust agreement (or other legal document) specified some other arrangement.

## FINANCING THE GUARANTY

The final issue, and a most crucial one, concerns the principles that might be followed in the financing of a guaranty fund. As with the other issues, there are a number of facets to be considered.

The first matter, about which there seems to be general agreement, is the determination of the base or bases to which premium or assessment rates would be applied. If the program were to include specific protection against liquidation losses at time of plan termination, the premiums for that component should be based on the amount of assets in the plan. The premium *rate,* of course, would have to be derived from some estimate of the volume of liquidation losses to be expected and under what circumstances. The risk would appear to be limited primarily to trust fund plans and separate accounts of insurers. Since it is improbable that this particular risk would be separately dealt with in a guaranty scheme, no further attention will be given to it.

The premium base for the fundamental risk that would be involved in the program, namely, inadequate accumulation of assets, should be the unfunded liability for the accrued benefits eligible for the guaranty. This, of course, requires a valuation of both the liabilities and assets subject to the guaranty. In the interest of uniformity, the benefits would have to be valued on the basis of the accrued benefit cost method which concerns itself only with the benefits assumed to have accrued, explicitly or implicitly, as of the date of valuation. The projected benefit cost methods take both accrued and future benefits into account and produce results that can be quite different from the values derived by the accrued benefit cost method. More important, certain of the projected benefit cost methods are structured in such a manner that they never produce an *unfunded* accrued liability. Under those methods, the assets on hand plus the present value of future anticipated contributions always equal the present value of total prospective benefits. Thus, for purposes of the guaranty fund, the liabilities would have to be computed on the basis of the accrued benefit cost method, irrespective of the cost method used for funding and other purposes.

Under the accrued benefit cost method, assumptions need be made only with respect to mortality, interest, and possibly expenses. Since the values derived for a particular set of benefits are greatly influenced by the mortality and interest assumptions, especially the latter, it would undoubtedly be necesary, in the interest of equity, for the administering agency to specify the assumptions to be used. The standard might well be based on the nonparticipating annuity rates currently being charged by the leading life insurance companies. The assets would have to be valued on a realistic basis, and if liabilities are valued at "market" annuity rates it would seem appropriate to use the market value of assets. The values would be certified by independent or public accountants. The difference between the actuarial value of the accrued guaranteed benefits and the value of the assets allocated by law or plan provisions to the benefits coming under the guaranty would constitute the premium base.

Another matter with respect to which there is no clear-cut answer is whether the system should be financed on the basis of advance premiums, assessments, or a combination of the two. It is essentially a question of whether premiums would be paid before or after the fact. In general, advance premium arrangements are considered preferable to assessment schemes. In this particular case, however, the circumstances would suggest careful consideration of the assessment approach. On the basis of available data, it would be extremely difficult to predict the claims that would arise under a guaranty program. Any scale of premium rates that might be set would likely prove to be excessive or inadequate until claims experience can be accumulated. Moreover, since claims would undoubtedly be clustered in periods of economic adversity, it would be necessary to accumulate substantial reserves. In the minds of some, this would be an undesirable development if the guarantor should be a government agency.

The assessment approach would avoid the difficulties of estimating claims in advance. The assessments would be based on realized experience, and the claims and expenses would be apportioned over the participating plans in proportion to their respective unfunded liabilities—as under the advance premium method. There could be an initial assessment to provide "working capital" with annual assessments being levied thereafter. The basic objection to the assessment approach would be that it would not accumulate sufficient funds to meet the claims generated by a severe and prolonged depression. The assessment rate would have to be increased at the very time that the covered firms as a group would have the least capacity to respond to the assessment. Some firms might default on their assessment, causing a heavier burden to be placed on the other firms. The financial crisis might be so acute that in order to shift a greater proportion of the claims to the stronger firms, the administering agency might levy assessments on a basis other than unfunded liabilities for guaranteed benefits) . There would also be a question as to whether the amount of the assessments would be determined by the timing of plan terminations, the retirement of the individuals affected, or the actual payment of benefits. If either of the latter two events should serve as the basis for assessments, the wrong generation of plans would bear the burden of past plan failures. Finally, it is argued by some that the assessment approach is wrong in principle in that the plans that create the losses for the guaranty fund (and by inference were the poorest risks from the beginning) bear the smallest share of the aggregate burden. The plans that terminate the first year, for example, would pay only the initial assessment. It would appear, however, that the same objection could be made to an advance premium plan of insurance to the extent that accumulated reserves do not meet all claims.

A compromise approach would be to charge annual premiums at a minimum level, using the assessment authority to make up any deficits that might arise.

If an advance premium were to be charged, it should reflect the best estimate as to the rate at which claims will occur over a future period encompassing all phases of the business cycle. A study of past business failures should be helpful in this regard. If the analysis indicates that the guaranty fund could be sustained by premiums that would be regarded by the business community as inconsequential, a uniform premium rate should be developed. If the burden would appear to be consequential, it would be desirable to consider a rating structure that would differentiate as to (1) age of firm, (2) size of firm as measured by the most significant indices, and (3) period during which the pension plan has been in operation. The purpose would be to predict and to reflect in the premium rate classifications the probability of plan termination among the various business firms covered by the program. It would probably be necessary to place an upper limit on the premium rate for the most hazardous classifications in order not to place an intolerable burden on financially insecure firms.

Finally, it would be necessary to consider a reinsurance arrangement if the guaranty fund were to operate under private auspices. The government would be the logical reinsurer, and it would be appropriate for the fund to pay a premium for this service. The reinsurance premium might be absorbed out of the regular premium paid by the participating firms or it could be the basis of a separate levy. The program should be self-supporting in the long-run even if the fund operates under governmental auspices, but the borrowing power of the government should be used to meet a short-run excess of claims over accumulated resources.