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Guaranty Fund for Private Pension Obligations

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Chapter 8

Summary

Within the last few years, strong interest has developed within certain quarters in some type of cooperative arrangement that would assure the fulfillment of legitimate benefit expectations under private pension plans, irrespective of the financial status of the plans or their sponsors. The concept has found its way into various legislative proposals, some of which are currently pending before Congress.

THE SETTING

The need for a guaranty arrangement must be evaluated against the background of the limitations on the employer's undertaking in respect of a pension plan. The employer may undertake, unilaterally or pursuant to the terms of a collective bargaining agreement, to set aside funds on a specified basis, such as an amount per man-hour or man-day of work, without formal reference to the scale of benefits that can be provided by such contributions. The employer's obligation to the plan is completely fulfilled when he pays over the appropriate sums to a funding agency, even though the assets of the plan eventually prove insufficient to provide the level of benefits projected on the basis of the anticipated

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contributions. On the other hand, the employer may undertake, voluntarily or in response to union demands, to contribute whatever sums are necessary to provide a fixed scale of benefits set forth in the plan. The benefit formula of such a plan usually recognizes, and gives credit for, some or all of an employee's service performed for the employer in question prior to the inception of the plan, and subsequent benefit liberalizations are frequently given retrospective effect, both practices giving rise to an unfunded accrued liability that would be the primary source of loss to any guaranty arrangement. Except for collectively bargained plans, the employer reserves the right to alter, modify, or terminate the plan at any time and to suspend, reduce, or discontinue contributions, whether or not previous contributions have been sufficient to provide all benefits credited to date. It is also customary for the plan to state that the employer's obligation, in the event of plan termination, shall be limited to contributions already made to the plan. In other words, the participants and pensioners must look to the accumulated assets of the plan for the satisfaction of their claims.

In order to meet the benefit commitments, explicit or implicit, generated under a pension plan, the employer generally sets aside funds with a bank or insurance company in amounts and at times roughly commensurate with the rate at which the pension costs accrue, a practice known as *funding*. Under a modification of this practice called *terminal funding* only the benefits of retired employees are funded. In a relatively few cases, the employer pays the benefits directly to retired employees, a method of financing known as current disbursement or pay-as-you-go. Under existing law, an employer is under no legal obligation to fund his accruing pension costs, but if the plan is to enjoy the tax treatment accorded a "qualified" status under IRS regulations, he must

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as a minimum fund the normal cost of the plan plus interest on the initial supplemental liability. Moreover, under a rule recently adopted by the public accounting profession, the employer must charge to expense his annual pension cost accrual and to the extent that he does not hereafter fund the expense charges, he must reflect in his balance sheet the cumulative excess of charges over funding contributions.

The pattern of accounting charges and funding payments is based upon estimates of future costs prepared by actuaries who make assumptions as to mortality, investment earnings, disability, nonvested withdrawals, salary scales, and retirement ages. It is assumed that normal costs, as determined by so-called actuarial cost methods, will be funded currently and that supplemental costs, if any, will be funded —if at all—over an extended period of time, usually ranging from 12 to 40 years. As of any given time, the assets of a pension plan may be less than the actuarial value of the accrued benefits because of inaccurate estimates of cost, failure of the employer to undertake a funding program that would ultimately meet all costs, lack of time for the completion of a realistic funding objective, or loss of asset values through realized or unrealized capital losses. A pension guaranty fund would be designed to deal with an insufficiency of assets, as respects covered benefits, at time of plan termination, or under other specified circumstances.

APPLICABILITY OF INSURANCE CONCEPTS

Such an arrangement would be based upon insurance principles, and its feasibility should be tested against the criteria of an insurable hazard. These are (1) large number of homogeneous risks; (2) objective determination of the occurrence and amount of loss; (3) randomness of loss; (4)

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low probability of loss; (5) significance of loss; and (6) absence of catastrophe hazard. The first criterion would be met if all eligible plans were compelled to participate. The second would be satisfied only if the contingency insured against were clearly (and perhaps narrowly) defined and the benefits to be insured were precisely articulated. Losses would not occur in random fashion unless many safeguards were built into the system. The fourth and fifth criteria would be fulfilled to a reasonable degree, as would the sixth. Losses of catastrophic dimensions could occur during depressed economic conditions, but the problem would be minimized by the fact that most of the claims would represent deferred obligations and would not have to be fuly offset by assets in the guaranty fund at any point in time. In any event, a temporary shortage of assets could be met by a governmental subvention or loan.

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. Lessons can be learned from the Federal Deposit Insurance Corporation; the various federal mortgage insurance funds; state guaranty funds to ensure payment of automobile, workmen's compensation, and life insurance claims; and state unsatisfied judgment funds to protect against financially irresponsible motorists. In the private sector, credit insurance and performance bonds provide protection against the unwillingness or financial inability of business organizations to meet their obligations, a risk greatly influenced by the economic climate. Then there are a number of insurance programs that involve a partnership of some type between the federal government and private insurance agencies. In some of these programs, the private agencies are the

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sole risk-bearers, the government playing a strictly administrative role. In others, the private agencies furnish only fiscal and claims services, the government assuming the entire risk. In still 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. Finally, the Swedish and Finnish pension guaranty systems that have been in operation since 1960, and 1962, respectively, provide actual experience with a pension guaranty undertaking.

ISSUES

Many issues would have to be resolved if a pension guaranty fund were to be established in the United States. The first would be whether the fund, hereinafter referred to as the PGF or the guarantor, would be established and operated under the auspices of a federal agency, a private agency, or a combination government-private instrumentality. Any of these approaches would seem to be feasible, the choice depending in part on political philosophies and in part on the financial mechanism envisaged.

The most difficult problem that would have to be confronted would be defining or articulating the circumstances under which the protection of the system could be invoked. The most basic question is whether the guaranty would become operative only upon termination of the entire plan or also upon other occurrences that would adversely affect the benefit expectations of a substantial percentage of the covered employees. Another fundamental question is whether the pension guaranty should be invoked when the firm that created the pension obligations continues to operate in one form

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or the other, even though the plan has been completely terminated. A plan may be terminated under any number of circumstances that would raise doubts concerning the propriety of transferring to the PGF the responsibility for meeting benefit expectations. The whole matter would be greatly simplified 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. 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.

Another crucial issue would be the nature of the obligation that the PGF should assume in respect of the benefits covered by the guaranty. One concept would call for the PGF to assure ultimate payment of all guaranteed benefits, irrespective of the amount, source, or cause of any asset deficiency that might exist upon occurrence of the contingency insured against. In theory, this concept could be applied without any mandated standards of funding, but it would be far more practicable if it were bulwarked by an enforceable requirement that the covered benefits be funded in accordance with minimum standards concerned with actuarial assumptions, actuarial cost methods, and the period of time allowed for the attainment of a fully funded status. The approach would be even more feasible—but even less palatable to employers—if the sponsor of a terminated plan were made primarily responsible for any insufficiency of assets, with the PGF being only contingently liable. Another concept would limit the PGF's obligation to the completion of the employer's funding program for covered benefits, without regard to the adequacy of the projected contributions. In other words, the guaranty

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would attach to the *funding* commitment rather than the *benefit* commitment.

A number of questions are involved with respect to the plans that would be brought under a pension guaranty program. The first question is whether participation in the program would be compulsory or optional. If participation is to be compulsory, one must confront the problem of what categories of plans can be forced to come under the system. Other questions would relate to the advisability of excluding from coverage plans that (1) have been in operation less than a specified period of time, (2) have fewer than a stipulated number of participants, (3) can not meet reasonable underwriting standards, and (4) voluntarily seek coverage. Finally, there is the question whether multiemployer plans should be required to participate.

It would be necessary to define the classification of accrued benefits to be guaranteed. Various distinctions could be made. The program might differentiate as to (1) future service versus past service benefits, (2) vested versus nonvested benefits, (3) mandatorily vested benefits versus voluntarily vested benefits, and (4) retirement versus ancillary benefits. Special rules would be needed to protect the PGF against benefit increases and other plan changes that would enlarge the unfunded liability. Moreover, it would be desirable to place a dollar limit on the monthly benefits that would be guaranteed for any one participant.

The implementation of the guaranty would involve: (1) determination of the dollar dimensions of the PGF's obligation, and (2) a decision as to the manner in which the guaranty would be carried out. If the guarantor's obligation were to assure payment of all guaranteed benefits, its obligation would be measured by the difference between the actuarially computed value of the covered benefits less the value, at book

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or market, of the assets considered to be available for the satisfaction of such claims. It would be necessary to prescribe or recognize rules for the allocation of assets as between guaranteed and nonguaranteed benefits. If, on the other hand, the guarantor's obligation were to complete the funding program of the terminated plans, its liability would be equivalent to the present value of the remaining payments.

The guarantor's obligation as to *benefits* could be discharged in a number of ways each with its own advantages and disadvantages. The funding agency could retain the assets allocable to the covered benefits, meeting benefit claims as they come due until the assets are exhausted, with the guarantor then assuming responsibility for payment of the remaining guaranteed benefits. Secondly, the funding agency could 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. Thirdly, the guarantor might transfer to the funding agency the additional sums actuarially estimated to be needed to pay the guaranteed benefits, the funding agencies providing only investment and disbursement services. Finally, the funding agency might transfer to the guarantor a sum equal to the assets deemed to stand behind the guaranteed benefits, with the guarantor assuming responsibility for the payment in full of all covered benefits. This it could do by paying the benefits directly to the claimants as they come due or by purchasing nonparticipating annuities in the proper amount and form from individual life insurers or a pool of insurers formed for that purpose. Any of the foregoing approaches could be used, with modifications, to discharge a guaranty expressed in terms of a *funding* objective.

The basic issue in the financing realm is whether the guaranty fund would be supported by advance premiums,

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assessments, or a combination of the two. The use of the advance premium approach would necessitate estimates of future claims and the accumulation of substantial reserves. The assessment method would avoid these complications but would have offsetting disadvantages. Under both approaches, it would be necessary to establish a base against which to levy premiums or assessments and to decide whether to create a number of risk classifications. The need for reinsurance facilities would also have to be considered under either approach.

A MINIMUM PROGRAM

A pension guaranty arrangement would be technically feasible if certain conditions were satisfied and adequate safeguards were built into the system. Some of the conditions and safeguards would involve regulatory controls that employers, unions, and other elements of the pension establishment have in general opposed as being potentially detrimental to the continued sound growth of the private pension movement. They would also limit the scope of the arrangement to such narrow bounds that the social objectives underlying the proposal might be frustrated in large part.

Resolution of the fundamental question of whether a properly structured and delimited guaranty scheme should be established is beyond the purview of this monograph. If such a program should be deemed to be in the public interest, it is suggested that it be structured initially along the lines set forth hereafter, with the thought that extensions and liberalizations could be introduced as experience with the system indicates the wisdom of such action.

The program should be administered by a federal agency with the necessary enforcement powers and the au-

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thority to serve as residual risk-bearer if circumstances demand it.

The guaranty should extend only to benefit claims arising out of complete plan terminations, being further limited to those situations in which the sponsoring firm goes out of business. The lack of protection for benefit rights in terminated plans of employers who continue in business should be rectified by requiring the employer to continue funding contributions in respect of the benefits that would become the obligation of the guaranty fund in the event that the employer should go out of business.

The fund should undertake to assure payment of all guaranteed benefits, irrespective of the source of the asset deficiency. However, this obligation should be protected by a legal requirement that all covered plans be funded at a rate sufficient to meet the currently accruing cost of all benefits (whether or not guaranteed) and to have all guaranteed benefits fully funded within 20 years after the effective date of the coverage. Firms that terminate their plans before completing this funding objective would be expected to continue their funding payments until their funding commitment is fulfilled.

Participation in the program would be limited to "qualified" plans, which would be compelled to come under the program as a condition for qualification. Plans should be eligible for coverage only after they have been in operation for a minimum of five years, but there should be no other underwriting requirements. Specifically, there should be no minimum size requirement. Multiemployer plans should be expected to participate, subject to appropriate modifications in the definition of the insured event and possibly the premium rate.

The guaranty should be limited to benefits that have

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vested under the terms of the plan but the law should require both single-employer and multiemployer plans to provide a minimum degree of vesting. Vested benefits created through a retrospective liberalization of the plan should not be eligible for the guaranty until five years after the guaranty. There should be a limit on the amount of monthly income that would be guaranteed in respect of any one individual, the amount being defined in terms of payment at an age specified in the law.

Upon termination of a covered plan, the guarantor should take title to the assets in possession of the funding agency assumed to be available for the satisfaction of the guaranteed benefits. It should then discharge its obligation by the purchase of nonparticipating insurance or annuity contracts from a pool of life insurers for the full amount of guaranteed benefits. This would fix immediately and irrevocably the amount of funds needed to underwrite the guaranty and, hence, the amount of assets that would have to be transferred from the funding agency. In order to minimize liquidation losses, the funding agency should be permitted to spread the transfer of assets over a period of time.

The guaranty system should be supported by contributions from employers whose pension plans fall within the scope of the program, with the objective of making the program self-supporting as to both benefit obligations and administrative expenses. The primary source of support should be annual premiums levied on the basis of the unfunded accrued liability for guaranteed benefits. For the purpose of determining the premium base, the actuarial liability of the accrued benefits would be computed on the basis of annuity rates (reflecting mortality, interest, and expense assumptions) provided by the guaranty fund. There should be provision for assessments, within stipulated limits, to meet costs not covered

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by the regular premiums. The guaranty fund should have borrowing authority sufficient to absorb short-run deficits and should be empowered to assume an appropriate share of the total burden on a continuing basis if claims should reach a level beyond that which could be supported by reasonable contributions from the participating firms.