

# ECONOMIC COMMENTARY

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## Can We Count on Private Pensions?

by James F. Siekmeier

As a nation, Americans save a smaller portion of income than residents of most developed, free-market economies.

For example, between 1960 and 1983, the savings rate in the United States averaged about 7.5 percent of disposable personal income. This is significantly less than the rates in West Germany (14.5 percent), in France (12.9 percent), and in Japan (18.9 percent).

Since American retirees are living longer, the low savings rate suggests that many of them may have difficulty maintaining their standard of living throughout their retirement years.

The condition of the Social Security System doesn't do much to change this assessment. The system's retirement fund became technically insolvent in 1982. Since the future health of the entire Social Security System depends on uncertain factors, such as demographics (population growth, etc.), future tax rates, and future benefit programs, it may not be prudent to count on Social Security to be as generous a source of retirement income in the future as it has been in the past.<sup>1</sup>

In recent years, the welfare of older Americans has become increasingly dependent on income earned from private pensions. Between 1962 and 1982, the percentage of total financial assets in private pensions increased from about 3 percent to about 9 percent of seniors' incomes.

In spite of reforms undertaken over a decade ago, however, there are still questions about the safety of private pension funds. Will the money actually be there when it's time to retire? In this *Economic Commentary*, we examine private pension funds, and discuss their safety and the federal government's efforts to ensure that the funds will continue to provide retirement support in the next century.

### The Basics of Private Pensions

In general, there are two major types of private pensions. Funds in which contributions are determined by the benefits they will eventually yield are called defined benefit pensions. Funds in which contributions are predetermined, and in which benefits are determined by the accumulation and return on total fund assets, are called defined contribution pensions.

Defined contribution plans are easier for companies to manage, and account for about two-thirds of all private pensions. This type of plan, however, is usually preferred by companies with relatively few employees. Consequently, defined-contribution pension plans cover only about 25 percent of all pensions.

Defined-benefit pensions, while more cumbersome, offer some distinct advantages. They can serve as a lucrative tax shelter and can be used to stabilize a company's work force because pension benefits are tied either to the highest level of salary attained or to salary at the time of retirement, thus giving workers an incentive to stay with the company.<sup>2</sup>

Pension fund savings are typically generated through employer contributions, although this has not always been the case. In 1940, about 42 percent of the contributions to private pensions were made by employees and 58 percent by employers. But the post-WWII growth in private pensions has occurred primarily as a result of employer contributions. In 1980, employers were responsible for about 94 percent of the total contributions to private pension funds in that year, and only 6 percent came from direct contributions by employees.

Overall growth in private pensions as a percent of wages has been consistent with the growth of most non-wage employee benefits. This is most likely due to the special tax treatments that make fringe benefits a financially attractive alternative to wages. Between 1955 and 1983, employer contributions for private pensions and profit sharing plans as a percentage of wages rose from 1.9 percent to 3.9 percent.

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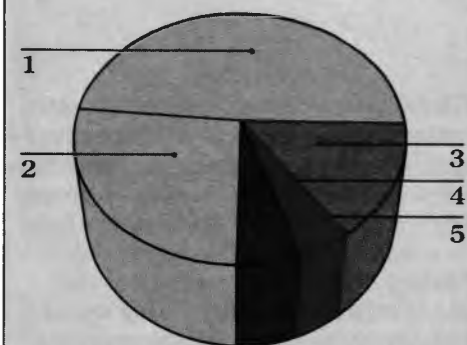
The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

1. Reforms in the Social Security System were enacted in early 1983. See Kerka (1983).

2. Since pension benefits are tied to final labor income, increases in salary can increase total compensation (income plus pension benefits) by a proportionately larger amount. For a more thorough discussion of the financial advantages of the defined-benefit plan, see Bulow and Scholes (1983).

Preferential tax treatment notwithstanding, only about half of the civilian-nonagricultural workforce is currently covered by private pensions (48.1 percent in 1980) and private pension coverage seems to be heavily concentrated among relatively high-income earners.

**Chart 1 Distribution of Pension Assets-1984**  
(percent)



1. Equities (47.2)
2. U.S. Government Securities (27.4)
3. Corporate and Foreign Bonds (15.2)
4. Demand and Time Deposits (4.6)
5. Mortgages and Open-Market Paper (5.6)

SOURCE: Board of Governors of the Federal Reserve System.

### The Investment Performance of Private Pensions

Private pensions provide an important source of funds in U.S. financial markets. How important? In 1984, private pension assets were valued at over \$916 billion, which is roughly the same magnitude as the combined value of assets for finance companies, mutual savings banks, and credit unions.

Fiduciaries (financial managers of pension funds) typically invest pension funds in capital market securities, although private pension holdings can also include a broad range of financial assets. The types of assets owned by private pensions are largely determined by the type of institution that acts as the fund fiduciary. For example, in 1980, about 37 percent of private pension assets were managed by life insurance companies (called insured plans) and, for the most part, were subject to the rather conservative laws that govern that particular industry.<sup>3</sup>

Nearly all of the remaining private pension assets, however, are operated as trusts (called trustee plans) and are managed primarily by commercial banks. These trustee pensions are typically allowed more flexible investment options as compared to insured plans, which is an important factor influencing the investments of private pension funds.

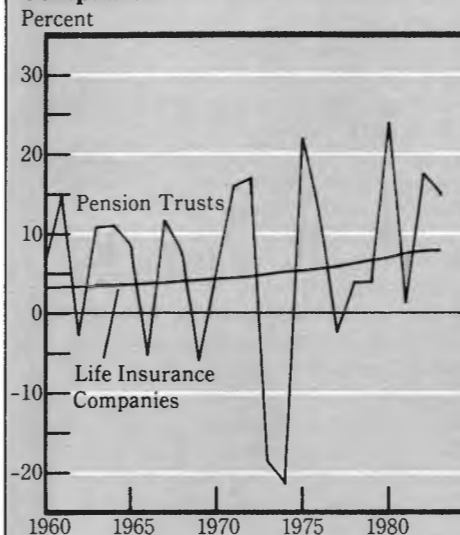
The distribution of outstanding private pension assets in 1984 is illustrated in chart 1. Unlike life insurance companies (and insured plans), trustee plans have placed a large portion of their assets in relatively unpredictable investments. Because of heavy participation in the often-volatile corporate equity market, which in 1972 included a record high of about 75 percent of trustee-fund portfolios, earnings by trustee funds have been irregular over several decades (chart 2).

Between 1960 and 1980, earnings by private pension trusts were about 5.2 percent per year, somewhat less than the 5.6 percent annual rate of return earned by life insurance companies. Despite a modest earnings rate over the 21-year period, the variation in private pension trust returns was enormous, particularly when compared against the investment performance of life insurance companies. The rate of return on pension funds over the 1970-1983 period was 6.1 percent, as opposed to the rate of return on life insurance company assets of 7.5 percent, which was larger than the spread during the 1960-1980 period. The rate of return on pension fund assets remained irregular in the early 1980s.

Why have pension fund administrators invested in volatile instruments? Some observers have noted that the choice of assets made by fiduciaries of trustee plans are often made on institutional rather than economic grounds. Potentially serious conflicts of interest exist between some private pension plan fiduciaries and beneficiaries (pensioners or pension plan participants).

About 65 percent of trustee fund assets are managed by outside banks and trusts. Often, these same fiduciaries sit on the boards of directors of companies in which the pension fund has invested. Linkages between fiduciaries and private corporations may cause the fiduciary to be reluctant to sell these equity interests.

**Chart 2 Rates of Return for Pension Trusts and Life Insurance Companies**  
Percent



SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis; and American Life Insurance Corporation.

Other conflicts of interest could arise when the assets of trustee plans are invested in the parent company of the pensioners. The conflict may occur if a company needs to alter the price of its stock for balance sheet considerations. For example, a firm may use pension fund assets to purchase its own stock in order to increase its value in anticipation of a stock-related trade.<sup>4</sup>

The rate of return on pension funds is important because if pension funds cannot meet their obligations to participants, these participants lose part or all of their contracted benefits. As a result of the 1974 Pension Reform Act, the federal government has a lien on part of the company's worth and will use this lien to augment pension funds should workers stand to lose the pension share of their compensation. Although this lien may not fully replace workers' pension benefits, it could have a significant effect on the firm's balance sheet.

### Pensions and the Corporate Balance Sheet

The value of pension assets will vary with changes in market returns. When pension funds assets exceed the amount owed to present and future pensioners, pension agreements typically allow such surpluses to be claimed by firm shareholders—not by firm pensioners.

For defined contribution pensions, the issue of asset ownership is not particularly interesting. Changes in the asset value of the fund are equally offset by changes in the liabilities of the fund; pension surpluses rarely exist. The value of defined-benefit pensions, however, has important implications for corporate balance sheets.

For defined-benefit pensions, the commitment to pay out benefits (the liability) need not change with asset market fluctuations. Consequently, market advances can improve the value of the corporation when it claims the overfunded portion of the pension.

Since 1980, rates of return on pension fund investments have been high due to stock market rallies and high interest rates. As a result, the asset value of pension funds has increased sharply compared to the amount of expected future commitments. Indeed, the vast majority of pension funds hold assets far in excess of the accrued benefits of the plan beneficiaries. This has made some firms so-called "cash cows," a term derived from the large amount of financial wealth associated with some overfunded plans. These firms are sometimes the target of so-called corporate "raiders." As a result, the fear of takeover has increasingly encouraged firms to eliminate overfunded defined-benefit plans, to absorb the surpluses, and to adopt defined-contribution plans.<sup>5</sup>

Of greater concern, particularly to senior Americans, has been the downside risk of pension funds: that is, who assumes the risks if the pension plan is underfunded? Historically, the limited liability of firms to underfunded private pensions implied that private pensioners were only as secure as the firms that provided them. In the event of firm bankruptcy, pensioners had no claim on firm assets beyond those in the pension fund, thus exposing them to a great deal of retirement income risk.

For example, as a result of sagging operations, the Studebaker-Packard Corporation declared the Packard pension fund unable to meet its liabilities to plan participants in 1958. Packard and the union representing employees agreed that the firm would provide benefits that amounted to only 85 percent of the vested amount for current retirees, and a cash settlement of 19 months full benefits for plan participants over the age of 60 (amounting to \$13,452). However, 3,300 plan participants under the age of 60, about one-third of Studebaker-Packard's employees, were denied their pension benefits.

3. In the 1960s, the insurance industry was allowed to manage assets of pension funds (and some other assets) in separate accounts. These separate accounts are not governed by the same rules that restrict the investment options of life insurance companies. See Munnell (1982, pp. 93-108). In 1983, about 24 percent of private pension assets managed by life insurance companies were

held in separate accounts. About 30 percent of these pension fund assets (insured funds) are held in private stock. See American Council of Life Insurance, *Pension Facts* (1984).

4. Legislation has restricted an employer's ability to buy its own stock: The Employee Retirement Income Security Act of 1974, P.L. 93-406, sec. 407(2) limits the holdings of a parent firm's stock by a pension fund to 10 percent of the fund's assets.

5. For example Union Carbide has recently asked for approval to terminate its existing overfunded pension plan for fear of takeover. Indeed, the GAF corporation has already purchased a huge portion of Carbide stock. See Williams (1985).

## ERISA and PBGC: The Road to Reform?

U.S. legislators responded to many of the problems associated with the management of private pensions by enacting the Employee Retirement Income Security Act of 1974 (P.L. 93-406), also known as ERISA or the Pension Reform Act.

Among ERISA's major contributions were the regulation of funding, investment management, benefit coverage, and the creation of the Pension Benefit Guaranty Corporation (PBGC). The quasi-public PBGC acts as an insurance corporation to private pensions, much like the FDIC insures depositors in most commercial banks; PBGC guarantees a portion of the employee's pension if the pension plan fails.

The PBGC is funded from four major sources: 1) premium monies—every worker who participates in a plan must pay annual premiums, currently \$2.60 per worker each year, 2) assets inherited from terminated plans (plans the PBGC has determined are inadequately funded, or that have been voluntarily submitted to the PBGC by the parent firm), 3) income from investments, and 4) amounts received from employers upon termination of a pension under the employer liability provisions of ERISA.

Although creation of the PBGC is an important step toward private pension management reform, the PBGC guarantee is not unqualified. For plans that have been in existence for five or more years, the guarantee covers vested pension benefits up to a maximum either of 100 percent of average gross monthly income during the highest-paid five consecutive years of plan participation or of \$1789.77 per month (indexed in accordance with the Social Security wage base increase), whichever is smaller.<sup>6</sup>

Administration of ERISA is jointly performed by the U.S. Department of Labor and the Internal Revenue Service. The Labor Department is charged with the responsibility of protecting the rights of individuals and with policing fiduciary performance, while the IRS is responsible for overseeing whether or not funding, vesting, and other plan-related requirements are being fulfilled.

Private pension funds are subjected to examination by a series of required disclosures. Under the provisions of ERISA, pension fund administrators must submit annual reports of pension fund activities to the Labor Department. In addition, reports of termination and vested pension obligations are now required before pensions can be terminated.

If the PBGC deems a plan insufficient to pay out the benefits it guarantees, it has the authority to force the termination of a plan (table one). In such cases, the PBGC (or a PBGC appointee) becomes the plan fiduciary. In addition, the PBGC has a high-priority claim on up to 30 percent of the employer's net worth, which may be invoked to ensure that workers receive what the pension agreement prescribes. The priority of the PBGC claim is approximately equal to the priority of the federal government's claim for unpaid taxes. This represents an important change from the pre-ERISA environment when pensioners had virtually no claim on corporate assets. If the employer's liability still does not raise the benefit level up to the PBGC's guaranteed amount, the PBGC will contribute to the terminated fund up to the limits set forth by ERISA.

ERISA reformed many other questionable practices of the private pension system by requiring stricter accountability of fiduciary investments, and by mandating that fiduciaries invest pension monies "prudently," and that workers have access to vital pension investment information. Although there are no laws that require employers to offer a pension, ERISA loosened the requirements that had previously disqualified some employees from joining existing plans or from obtaining vesting. For example, existing pension plans must permit all employees who

**Table 1 Terminations by the PBGC**

	Termination Notices Received-Plans with Sufficient Assets	Total Plans with Insufficient Funds Under PBGC Trusteeship
FY80	3,933	514
FY81	4,949	659
FY82	6,003	771
FY83	6,730	891
FY84	7,621	999
FY85	8,600 <sup>a</sup>	N.A.

a. Estimate.

SOURCE: Pension Benefit Guaranty Corporation.

6. For plans that have not existed for five years, the PBGC-guaranteed pension is the larger of either 20 percent of the benefits contributed or of \$20 times the number of years the plan has existed.



### Vesting

Before 1974, private pensions were not legally bound to vest employer-contributed benefits prior to employee retirement. Vesting in a pension means that employees have retained a right to at least part of their accrued pension benefits. Without vesting, a plan participant has no guarantee of eventually collecting his private pension benefits. Some pension plans had such strict vesting provisions that in the event of layoff, leave of absence, or change of job some participants would see their benefits reduced or forfeited entirely. In short, termination of employment, even temporarily, often resulted in a significant loss of a covered employees' total compensation.

are at least 25 years old, and who have at least one year of work experience, to participate in a company-sponsored plan. And ERISA requires all employers to vest one-half of employee benefits for employees after 10 years service (or when years of plan participation and age equal 45).<sup>7</sup>

### Prospects for Further Reform

How is the post-ERISA pension system faring? Uncertainties over the management of private pensions still exist. Specifically, issues remain concerning the ownership of pension surpluses and the ability of the PBGC to enforce claims against corporate assets.<sup>8</sup> The long-term health of the pension insurance system itself is even more uncertain.

In some instances, the underfunding problems that plague some private pension funds have simply been shifted to the government insurance agency. As a result, the PBGC is currently underfunded itself. Its assets (in the form of premiums and assets of terminated plans) are falling behind its liabilities (the reserve to pay out benefits to plan participants).

The value of claims (benefits PBGC must pay out) incurred during the last five years greatly exceed those incurred during the first five years of the PBGC's existence. For example, net claims on PBGC for fiscal years 1975 through 1979 averaged only \$37.3 million per year, and for fiscal years 1980 through 1984, net claims averaged \$129.8 million per annum. This increase in claims was undoubtedly due to the generally poor performance of the national economy over that period.<sup>9</sup>

On September 30, 1984 the PBGC had assets totaling \$1.063 billion and liabilities of \$1.525 billion, for a negative net worth of about \$500 million.

Consequently, the PBGC's ability to deal with a major increase of claims is in doubt. Indeed, a single claim from a major private pension fund could seriously jeopardize the financial underpinnings of the PBGC. For example, after the Wheeling-Pittsburg Steel Company terminated its pension fund last November, claims against PBGC assets rose by \$450-\$475 million, which reduced PBGC reserves by almost one-third, and which reduced PBGC net worth to a level of about minus \$1 billion.

Two challenges face the PBGC. First, it faces a risk because by law it must insure all pensions, including the poorly managed. Second, like other insurance systems created by the government, it insures a potentially nondiversifiable risk. Unlike claims accruing on life or health insurance plans, claims against several pension insurance funds need not be independent of one another. A prolonged decline in economic activity can produce a large number of retirees and pension plan terminations. Moreover, since pension assets are strongly influenced by the performance of the stock market, the value of private pension assets could be simultaneously reduced.

Consequently, adverse national economic conditions can threaten pension insurance and, in turn, threaten the safety of private pension savings. Although the FSLIC and FDIC insurance systems for deposits may face a similar problem, these organizations have the full faith and credit of the federal government, *something that the PBGC does not have.*

To survive, the PBGC must seek additional funding. Even though it was created by the federal government, it has only a \$100 million line of credit from the U.S. Treasury. Two more potential sources of additional funding that are currently being considered in Congress are: 1) increasing employee premiums from \$2.60 per year to \$8.10, and 2) increasing an employer's liability upon termination of its pension fund.<sup>10</sup> Alternatively, the federal government could cut back PBGC responsibilities. The Reagan Administration recently proposed the privatization of the pension insurance business

by drastically limiting the government's ability to insure private pensions and by allowing private insurers to insure the bulk of the funds.

The PBGC has managed to meet its present responsibilities to plan participants of terminated pension plans, but its future ability to make payouts will be significantly hampered if it terminates more substantially underfunded large plans.

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10. For companies planning to go bankrupt, The PBGC's lien would continue to be 30 percent of net worth. For companies that plan to terminate a pension fund and remain operative, the lien would be 30 percent of net worth and 10 percent

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of 10 (or less) years' profits, until the underfunded portion is made up. This change would increase the deterrent against companies dumping underfunded pensions on the PBGC.

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7. Minimum vesting regulations require that privately managed pensions meet one of three vesting standards: (1) 100 percent vesting after 10 years of covered service; (2) gradual vesting with 25 percent of pension rights after five years of covered service, rising by 5 percent annually over the next five years and 10 percent annually for five more years; (3) gradually vesting with 50 percent attained when the employee's age and

years of service total 45, rising by 10 percent annually over the next five years.

8. Alloyteck, a firm with negative book value and stock that was not trading, terminated its underfunded defined-benefit pension plan and started a new plan. The firm argued that its net value was zero, and the settlement reached was very favorable to Alloyteck, which may set an ominous precedent for the PBGC.

9. In 1984, the second year of national recovery, the value of claims against the PBGC (benefits it must pay out) dropped dramatically.

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