



**EIILM UNIVERSITY**  
S I K K I M

## **GROUP INSURANCE AND PENSION SCHEMES**

**SYLLABUS**

**Introduction:** Retirement Benefit Schemes – Object of Employee Benefit Schemes Service Benefits through insurance contracts – Segments of Group Schemes Market – Development of Employee-benefit schemes – Schemes of Group Insurance – Insurable interest in group insurance scheme policies.

**Superannuation Schemes –I:** Object of the scheme – Development of superannuation schemes – Pension as a retirement benefit – Different ways of arranging pension schemes – Trustee Administered schemes vis-à-vis Insured schemes – Non-contributory schemes Contributory schemes.

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**Superannuation Schemes –III:** Methods of costing Pensions – Single premium costing – Annual premium costing – Cash accumulation system – Definite funding method – Indefinite funding method – Controlled funding.

**Group Life Insurance Schemes I:** Object of scheme – Development of scheme – Development of scheme – Group insurance vis-à-vis individual insurance – Conditions for eligibility of group insurance – Eligible groups – Individual employer groups – Multiple employer groups – Labour union groups – Creditor-debtor groups – Miscellaneous groups – Financial aspects of group insurance – Group selection.

**Group Life Insurance Schemes II:** Rate making in group insurance – Experience rating – Benefits of group insurance – Group insurance scheme in-lieu of E.D.L.I.Scheme 1976 – Group creditor insurance – Level premium temporary Assurance plan – Group insurance from non-employee groups – Unit Linked insurance scheme – Group Savings – linked Insurance scheme.

**Gratuity Schemes:** Object of the gratuity scheme – Evolution of gratuity as a Service benefit – Nature of liability – Need for funding gratuity liability – Different ways of funding gratuity liability – Payment by employer – Creation of internal reserve – Funding through Trust – Group Gratuity scheme – Combination of plans – Group gratuity scheme – a tripartite arrangement – Trustee administered scheme Vs Insured Scheme – Life Insurance Benefit – Experience rating adjustment – Nomination – Disclosure of gratuity liability in Balance Sheet – Methods of costing – Cash accumulation system.

**Provident Fund & Employees' Family Pension and Deposit-linked insurance Schemes:** Recognised Provident fund – Employees Provident Fund Scheme – Administration – Employees Family pension scheme – Employees deposit – linked scheme.

**Taxation Treatment of provisions for Retirement Benefits-I:** Why tax relief – Recognised Provident funds – Income Tax Relief – Approved super annuation schemes – Conditions for approval – Rationale of conditions.

**Taxation Treatment of provisions for Retirement Benefits-II:** Superannuation schemes (contnd) – Rationale of conditions – Exemption from tax on gratuity – Group Insurance Schemes – Taxation under group insurance schemes.

**Group schemes and Data Processing:** The Computer – Computer equipment – Computer systems for Administration of group schemes – Group insurance schemes – Group gratuity schemes – Group superannuation schemes – Appendix containing samples of formats of trust deeds etc.

### **Suggested Readings**

1. Kaplan Publishing Staff, Group Insurance, Kaplan Publishing
2. William Theodore Bluhm, Group Insurance, ACTEX Publications
3. Dearborn Financial Publishing, Introduction to Group Insurance, Kaplan Publishing

A pension scheme is quite simply an arrangement that provides for payments to be made to a worker on retirement from paid work, or to his/her dependants in the event of death.

The most common kind of pension scheme in Ireland is that provided for by the Social Welfare Acts, which cover the provision of retirement and old age pensions to the employed and the self-employed and spouses' pensions to their surviving marriage partners. *Occupational pension schemes* are the name given to employer-sponsored schemes for employees which are approved by the Revenue Commissioners under various Finance and Income Tax Acts.

The term also includes scheme for employees in the various arms of the Public Sector, which in many cases may not require Revenue approval and which are set up under statutory provisions.

Under the Family Law Acts, the definition is widened to include pensions for the self employed, annuities and buyout policies and any sort of pension promise, whether or not it is funded.

This Topic concerned with occupational pension schemes and those which apply to the self-employed. The Pensions Act, 1990 recognises two distinct types of scheme: A Defined Benefit Scheme, in which the pensions and other benefits are clearly stated in the rules of the scheme and promised to members and their dependants;

A Defined Contribution Scheme (also known as a Money Purchase Scheme), where the benefits payable are determined solely by reference to the contributions paid into the scheme and the investment return earned on those contributions – there is no specific promise or guarantee of particular benefit levels, except perhaps on death.

Many of the questions contained in Sections 2 and 3 of this book have answers that are common to both types of scheme. Because of the differences between the two types of scheme and how they work, the questions dealing with the two types have been dealt with separately. Before approaching Sections 2 and 3, therefore, it is important for readers to be clear what kind of scheme they participate in. It is worth noting that, even where the main pension scheme is a defined benefit scheme, a scheme or section of a scheme

designed to accept additional voluntary contributions (AVCs) will often be set up on a defined contribution basis. The pensions of the self employed and those in non-pensionable employment are always defined contribution arrangements, although the Pensions Act does not apply to them. PRSAs are also defined contribution arrangements.

## **HOW DOES A DEFINED BENEFIT SCHEME WORK?**

An employer setting up a defined benefits scheme intends to promise the scheme members a specific amount of benefit to be paid on their retirement. In the old days, this benefit might have been a fixed amount of annual or weekly pension, or perhaps a set amount of pension for every year spent in the service of the employer.

Later, the promised pension began to be defined as something based on pay and service combined, so the common pattern of defined benefits that we see today emerged. Modern defined benefit promises are usually expressed as a fraction or percentage of pay taken at or near retirement age, and multiplied by the completed service of the member.

A common formula nowadays would promise  $\frac{1}{60}$ th of final pensionable pay for each year of pensionable service. This is usually intended to fix the maximum pension promised at  $\frac{40}{60}$ , or two-thirds, of salary.

Because the benefit to be paid is fixed in this way, and because it is not possible to predict what the amount of final salary is going to be, it follows that we cannot know in advance what the promised benefit is going to cost.

### ***Pay As You Go***

For some employers this is not a problem. They simply pay their pensioners out of their current income and make no attempt to make any provision for them in advance of employees' retirement. Typically, this approach (called "pay as you go") is taken by Government, by local authorities and by some other public sector employers. Since the thinking behind this is that the Government cannot go bankrupt, it is possible for them to take this approach.

### ***Advance Funding***

For most employers and their staff, however, this approach is not attractive. Employees are not happy with the idea that their security in retirement is going to depend on the employer being (a) still in existence and (b) making enough profit to pay their pensions. These employers put away money during their employees' working lives, to provide a fund from which the promised benefits can be paid in the future. Some of the money may be contributed by the members themselves. In that case, the rate at which they will contribute is usually also defined. The employer then pays the balance of the cost.

The recommended rate of payment is decided by an actuary, who makes various assumptions as to what will happen in the future to the members (how long they will live, how long, on average, their dependants will survive them, and so on), their future rates of pay and the investment returns that the fund will be able to earn.

These assumptions are reviewed from time to time in the light of actual experience and a new rate of contribution recommended, if appropriate.

### ***Tax Treatment***

Funding in advance for pensions is encouraged by the government, which gives favourable tax treatment to pension funds. This applies, not just to defined benefit schemes, but to defined contribution schemes as well. Both employers and scheme members receive tax relief on their contributions as they pay them. In addition, what the employer pays is not treated as employee earnings for tax purposes.

Most important of all, the pension fund pays no tax on the investment income that it makes in the shape of dividend income and capital gains. In return, except for some limited benefits paid in cash on retirement or death, most of what is paid out as benefits from pension schemes is taxed under the PAYE system.

To qualify for this tax treatment, a scheme must be approved by the Revenue

Commissioners, who police the maximum benefits that can be provided. It must be set up under a trust, which has the effect of legally separating the assets of the pension scheme from those of the employer.

Employee contributions are allowed, at the same rates as those mentioned below in the context of defined contribution schemes. It is usual for employees' compulsory contributions to be fixed as a percentage of their pensionable pay. The employer then pays the "balance of cost" – the difference between the employees' total contributions and the contribution required to maintain the benefit promise.

The employer must make a "meaningful" contribution to the scheme. See Defined Contribution schemes, below. The test is applied to employer contributions on a lifetime basis in defined benefit schemes, whereas it must be met year by year in defined contribution schemes.

### ***Other Features***

Apart from retirement pensions, defined benefit schemes usually include the option for the retiring employee to exchange some of his/her pension for a lump sum. Lump sum benefits for dependants on death are common features. Many schemes also provide pensions payable to spouses and/or other dependants.

## **HOW DOES A DEFINED CONTRIBUTION SCHEME WORK?**

Unlike the defined benefit scheme, the defined contribution scheme promises only that a certain level of contribution will be paid and the pensions to come from the scheme are not defined or promised.

### ***How Is The Contribution Fixed?***

Generally, the employer's contribution is decided in advance by the employer. Employee contributions will be in addition to the employer's fixed rate of contribution.

There are many variations on the way an employer's contribution may be established and the following are all examples taken from schemes actually in operation:

- a fixed pension contribution, with the cost of death benefits and possibly also disability benefits paid in addition;
- a fixed overall contribution rate, with death and disability costs charged as a first charge against that contribution, the balance going to pension provision.
- different rates of contribution at different starting ages – the older the employee when the scheme starts, the higher the contribution made by the employer. There are variations on this also – contributions that increase in line with the member's age, or with service completed.

Contributions can be at any suitable level but there are some **conditions** attaching to them:

1. The employer must make a “meaningful” contribution to the cost of benefits in any particular year. This was originally set by the Revenue Commissioners at one third of the total cost for each member. Later, they reduced this to one sixth, largely in response to demands by members of schemes where the level of employer contributions was low – the limit made it difficult for these people to pay the maximum allowable personal contribution. After the increase in allowable employee contributions to an age-related scale, the rules were further relaxed. The Revenue requirement for an employer to make a “meaningful” contribution can be satisfied if the employer pays the establishment and ongoing running costs of the scheme and the cost of death benefits, OR not less than 10% of the total ordinary contributions to the scheme.

2. The benefits likely to be generated by both employer and employee contributions combined will not exceed the maximum limits which the Revenue impose on an employee by reference to salary and completed service at retirement.

3. Employee contributions themselves are limited to an overall maximum percentage of gross pay, including any contributions required by the rules of the scheme. The maximum



allowable employee contribution, originally 15% for all, is now age related: 15% for those under age 30; 20% between 30 and 39; 25% for those aged 40-49; and 30% for those aged 50 or over. Employer contributions are made in addition, as long as the overall benefit limits are not breached. An earnings “cap” of €254,000 applies to contributions by employees,

### ***What happens when the contributions are paid in?***

Once contributions are received by the pension scheme trustees, they are invested through an insurance company or other investment manager. They are usually invested separately for each individual member, so that the member’s share of the fund can be easily tracked.

Exactly how they are invested depends on a number of things, including how close the member may be to retirement age. For example, if the member was quite close to retirement, appropriate investment would be in assets whose value was not likely to reduce. A younger member might invest in more volatile assets, in the hope of making substantial capital gains before he/she needs to “consolidate” in the run-up to retirement.

The assets of pension funds build up without any tax being paid on investment income or capital gains. Under normal circumstances, therefore, they should accumulate faster than an investment fund that has to pay tax.

### ***What Happens When I Retire?***

When you retire, the total fund accumulated in your name becomes available to the trustees to provide benefits. The maximum benefits that can be provided are dictated by the Revenue Commissioners' rules (see Section 5). For those retiring at normal pension date, having completed at least 20 years' service, the maximum lump sum is 12 times salary (or "final remuneration" calculated on the most favorable definition the scheme rules and Revenue regulations will permit).

The balance of the fund available for the individual has to be applied to purchase pensions (for the scheme member and also perhaps for his/her dependants). The amount of pension available after the lump sum has been taken will be dictated by

- (a) the value of the accumulated fund and

- (b) the cost of purchasing an annuity/pension at the time of retirement.

Neither of these can be predicted in advance. The best that can be done in the case of someone who is years away from retirement age is to make a reasonable estimate of what might be available. Such an estimate would be based on assumptions regarding future fund performance and annuity rates. It is important to review these regularly, to measure actual performance against the assumptions. That way, changes can be made to the rate of contribution if needed.

### ***What Happens If I Die In Service?***

If you die in service, the fund that has accumulated for your pension will form part of the overall death benefit provided by the scheme – how that is calculated will be determined by the rules of the scheme itself. Death benefits may be paid as tax-free lump sums within certain limits, with any balance going to purchase pensions.

### ***What Happens If I Die After Retirement?***

That will depend on the choices you made at the point of retirement to provide for

your dependants. Some people set up a pension only on their own lives. Others ensure that part of the capital available at retirement age is used to buy an extra pension which will be paid to a spouse or other dependant on the death of the member after retirement. The available capital can be used to tailor the benefits to fit your individual circumstances.

### ***Advantages and Disadvantages***

From the foregoing, it will be obvious that a defined contribution scheme places a great many things firmly under the control of the member. Benefits do not have to be taken in any prescribed pattern, even though the maximum levels of benefit are laid down by the Revenue Commissioners. Thus, the scheme member can decide on the distribution of benefits, between personal pension, lump sum, dependants' pensions and cost-of-living increases.

As well as this flexibility, defined contribution schemes have the great benefit of allowing an individual to trace the buildup of his/her fund, so that he/she knows its exact capital value as it accumulates over the years. However, he/she will not be able to estimate with any accuracy how that fund will translate into a pension until he/she is quite close to retirement age.

If a person leaves service early, particularly at a young age, defined contribution schemes can generate leaving service benefits that are quite generous by reference to the relatively short period of service that the person has completed.

As against all this, there are risks involved. The member is taking the investment risk – i.e., the possibility that the returns on money invested could be poor. Returns cannot be guaranteed in advance in most circumstances. If poor investment returns are experienced, it follows that the capital available at retirement age would be less than a person might expect or wish for.

Secondly, there is the risk involved in annuity rates. The scheme member and the trustees are not stuck with the insurance company or investment manager with which the fund of money was built up – the money can be taken to the “open annuity market” to get the best value available in annuity rates. However, if long-term interest rates are low at the time of retirement, they will feed into *all* life offices' annuity rates and so the annual pension

available for any given amount of capital is likely to be poor. That said, it does pay to “shop around” for the best quotations.

## **HOW ARE PENSION SCHEME MONEYS INVESTED?**

### **1. Retirement Annuity Contracts (Self-Employed and Non-Pensionable Employment)**

Retirement Annuity Contracts or Personal Pension Plans are primarily for the self-employed, but are also designed for people who are not members of pension schemes in their places of employment. They are described in more detail. The investment position under these contracts is fairly straightforward. The person who is paying the pension premiums can choose the insurance company that is to manage or invest them.

In the first place, the individual must decide what kind of investment he/she needs – for example, a traditional with profits endowment /deferred annuity policy, or an alternative unit-linked fund. If he/she chooses the traditional with-profit policy, this narrows that range of providers available to a small number of insurance companies.

If he/she selects the option of a unit-linked fund, this will certainly open up much wider variety of choices. Some insurance companies offer a very wide range of funds in which the money may be invested – and the choice rests with the individual who pays the premiums. Other insurance companies offer, not only a range of funds within their own management, but also the services of other investment managers, including investment banks. Once the manager is selected, the individual can then choose whether to go for a “mixed” fund, in which the manager is investing in different kinds of assets, including ordinary shares, government and other fixed interest stocks and possibly property. There can be further choice available when it comes to ordinary shares (equity) investment, as the manager may offer a range of funds that invest in different markets, such as the UK, the United States, Japan, and so on.

There is often considerable freedom to switch between these funds as time goes on, so that control of the investment remains with the premium payer. Funds can now be moved

freely from one investment manager to another, though there may be some costs incurred when this is done.

## **2. Occupational Pension Schemes**

In occupational pension schemes, the trustee is always responsible for the investment of the pension scheme moneys. Although it was always accepted that this was the case, the Pensions Act 1990 specifically mentions this as a responsibility of the trustees. How this actually works in practice depends on the nature and size of the scheme concerned.

### ***Who Does the Investing?***

Although the trustee is responsible for the investment of pension scheme moneys, they rarely perform this duty themselves. In practice, most trust deeds give the trustees some discretion to delegate the conduct of the investment to an investment manager and the choice of manager will, again, depend on the nature and size of the scheme concerned.

### ***Why is Investment so Important?***

There are two basic types of pension scheme – defined benefit and defined contribution. In a defined benefit scheme, the employer has promised a given level of benefit. If the investments do not perform well, the money to meet these benefits has to be made up somewhere, and this usually takes the form in an increased contribution from the employer. Therefore, the employer is particularly interested in the success of the pension scheme's investment policy.

The second kind of scheme is a defined contribution scheme. The benefits to be provided under a scheme of this type depend solely on the amount of money available when a person comes to retire, leaves service, or dies. If the investment policy followed by the trustees is not successful, this will mean that the member gets less by way of benefits than he/she might have hoped or expected. In this kind of scheme, therefore, the member is vitally interested in the performance of the investments.

### ***What Kind of Investment Vehicles Are Used?***

This depends on the type of scheme and its size in terms of numbers of members and total contributions. Most smaller schemes nowadays are defined contribution schemes. So are most of the arrangements designed to accept additional voluntary contributions (AVCs). The pattern of investment is very similar to that adopted for Retirement Annuity Contracts, except that trustees are legally responsible for the investments.

Therefore, the individual scheme member may have little or no say in how his/her money is invested. Sometimes the trustees will allow members a choice between a limited number of investment options – at times including a choice of different investment managers. The contributions made for and by individual members must be “tracked” so that each receives a fair return on his/her investment.

Defined benefit schemes include most of the biggest schemes in terms of membership. Trustees will decide how they wish to invest the money in conjunction with their appointed investment manager. Insurance contracts are not as widely used now as they once were. Most schemes use shared or pooled investment vehicles, and the largest are “directly invested” – often called “segregated”.

### ***Pooled Funds***

Shared investment vehicles include the wide variety of managed funds offered by insurance companies and unit trusts offered by the investment banks and specialist fund managers. They are similar to the funds used for individual investment. The main advantage of pooled investment vehicles is that they offer even smaller pension schemes an opportunity to spread their investments over a wide range of assets. A scheme that could never consider buying a property, for example, can still benefit from property investment by buying units in a managed property fund.

### ***Direct Investment***

When the value of a scheme’s assets reaches a certain size, trustees often feel that they can add value by moving away from shared investment arrangements and asking their

investment manager to invest in stocks, shares and other assets that are owned directly by the trustees.

Even these schemes, however, may not hold direct property investments, but purchase property fund units instead. Because a scheme is investing directly, it may follow an investment strategy that is closely designed for its particular needs. Without going into too much detail, it should be clear that a scheme that has a lot of pensioners, for example, and therefore needs cash to pay benefits, may invest differently from one whose members are far from retirement age – and there are many variations in between those extremes.

### ***Information on Scheme Investments***

The annual report of the trustees of each pension scheme will contain information on how the assets are invested, the name of the investment manager and how he/she is paid. It will also include information on the investment policies followed by the trustees during the scheme year and on any changes made to those policies. The report should give details of any significant financial developments (such as large movements of money in or out of the scheme) and comment on the performance of the investments during the year.

Other information that must be given, if it applies, is whether there is what is called a concentration of investment – that is, whether more than 5% of the assets – are invested in a particular asset or asset type. If there is significant “self investment” (this means investment in employer-related assets or property) it must also be reported.

### ***ABOUT YOUR BENEFITS***

The main purpose is to address the questions most often asked by members about their pension benefits. Obviously, answers will be of a general nature and cannot possibly cover every scheme as the rules of all schemes are different. It is essential that you get specific information before you decide on any course of action or on any option which you may be entitled to exercise. In particular, you should not take any action, defer any action, agree to exercise any option, or fail to exercise it, *solely on the basis of information contained.*

You should always ask your scheme trustees or administrators for any information or explanation you need in order to come to a decision. In general trust law and under the Regulations governing disclosure of information to scheme members under the Pensions Act, you are entitled to that information.

Even when you have the information to which you are entitled, it may be advisable for you to seek individual financial advice before coming to certain decisions – such as making or increasing voluntary contributions or exercising the various options that may be available to you at the time of retirement or leaving service.

## **DEFINED BENEFIT SCHEMES**

### ***At what age is normal retirement pension payable?***

Normal retirement age under the rules of each scheme is the age at which the benefits specified by the rules will be paid in full. If retirement takes place before that age (which may be subject to consent), a smaller benefit would usually be payable.

Conversely, if late retirement is allowed, most schemes would provide a larger benefit. “Normal Retirement Age” in most Irish pension schemes is 65, because this is the age at which the social welfare system pays pensions to qualified employees and it is common for occupational pension scheme benefits to be designed in a way that takes account of social welfare expectations.

### ***How is my pension calculated?***

In defined benefit schemes, pension is calculated usually by reference to a member’s *final pensionable pay* and *pensionable service*. In most schemes, these two factors would be multiplied by a “pension fraction” to arrive at the member’s entitlement. An example of this would be as follows:

Pensionable Pay: €21,000 per year

Pensionable Service: 40 years

Pension Fraction: 1/60th

Pension Entitlement:  $€21,000 \times 40/60 = €14,000$

The following should be noted:



### ***Pensionable service***

This will be defined in the rules of the scheme. It may be service as an employee, or service as a member of the scheme. It may be expressed in complete years, years and months or even years and days. It may be continuous, or could include periods of broken service. Service with other companies in a group may also be included.

### ***Pensionable Salary***

This is the part of your salary which is taken into account for pension purposes. It could be your gross annual pay but is usually something lower than that. The usual starting point for calculating this is basic salary. If the scheme is “integrated” with social welfare benefits (see below), it may be subject to a deduction. Anything included in pensionable pay must be taxable under Schedule E of the tax code and the Revenue Commissioners require that anything which is not a fixed part of pay (such as bonuses, commissions, etc.) must be averaged over 3 or more years, or any shorter period for which it has actually been paid. What is included in pensionable salary in your case will depend upon the rules of your own scheme.

### ***Final Pensionable Salary***

This will be based on your pensionable salary (see above). It may be that salary taken at the date of your retirement or at some date close to that, or it could be an average over several years.

### ***How the Social Welfare Pension can influence your Occupational Pension***

It is common in Irish pension schemes that the benefits provided under the occupational pension scheme are “integrated” with the benefits paid under the Social Welfare system. In the public sector, this is known as “co-ordination”. This can be done in a number of different ways. Sometimes it is done simply by subtracting all or part of the amount of the individual’s Social Welfare retirement pension from the pension calculated on the scale or the formula contained in the rules of the scheme. Most commonly, however, it is done by means of a salary “offset”. This works by reducing the salary for pension purposes by an amount which is related to the Social Welfare pension currently payable. Members’ benefits and contributions would then be based on this lower **pensionable** salary. The thinking behind this is that the Social Welfare pension is regarded as catering

for a person's pension needs in relation to that part of salary, and only the balance of the intended overall pension needs to be provided under the occupational pension scheme.

In most pension schemes, the answer is “yes”. The term commutation is used to indicate the right, which members usually have under pension scheme rules, to exchange part of their pension for a lump sum. This lump sum is payable tax free (unlike the part of your pension that you exchange for it). The lump sum paid by any pension scheme will usually be based on the final pensionable salary and pensionable service of a member and the maximum allowed by the Revenue Commissioners is 12 times final pay. Exactly what is payable as a tax free lump sum depends upon the rules of your own scheme. One way or the other, the maximum benefit cannot be paid to anyone who has less than 20 years' service at normal retirement age.

The Revenue Commissioners require smaller amounts to apply to shorter service, and to early retirement. The rate at which the lump sum is then converted into equivalent pension will also vary from scheme to scheme. The most common formula in Ireland is probably €900 cash = €100 annual pension, but it will vary from scheme to scheme. In many cases, the exchange rate for women may be higher than that for men, reflecting their longer life expectancy.

In public sector schemes, lump sums are not given by commutation, but are provided as a separate addition to each member's pension entitlement. In a very few pension schemes, the option to receive a lump sum is not given under the scheme rules.

### ***How are pension scheme benefits taxed?***

In Ireland, schemes that have “exempt” approval from the Revenue Commissioners don't pay tax on their investment income. Most schemes are treated in this way. When benefits come to be paid, however, they may be taxable.

### ***Retirement Benefits***

Benefits payable in lump sum form on retirement (up to certain limits) are not subject to income tax. Benefits payable in pension form are taxed under the PAYE system, just like salary. However, they don't attract full PRSI contributions, but only the Health Contribution. This is PRSI Class K1, currently 2% of the pension.

### ***Death Benefits***

Similarly, benefits which are allowed to be paid in lump sum form on the death of a member are not subject to income tax, but those paid in pension form are taxable under PAYE. Death benefits are subject to Inheritance Tax. For the purpose of this tax, they are treated as if they were an inheritance from the member who has died, so the question of tax is governed by the relationship to the member of any beneficiary. Thus, a payment to a husband or wife will be free from this tax. Payments to children and others will fall under the various "classes" set out in the Capital Acquisitions Tax Act.

### ***Foreign Benefits***

If you have pension benefits payable from a foreign country, the tax treatment of these benefits when you receive them will vary. In some cases, they will already have been subject to foreign tax and you may be able to get credit for this against your own tax liability here. Benefits payable from the United Kingdom can be exempted from UK tax but you must make proper application for this to be done. Ireland has double taxation agreements with many countries, designed to ensure that you are not taxed twice on the same benefits. In all cases where foreign pensions are payable, you should check with your local tax office.

### ***Do pensions increase after retirement?***

Where payment of increases in pensions after they start to be paid is provided for in the scheme rules, this is often called "escalation". Some schemes do not provide any such increases. Where increases are provided, the amount of the increase is often a defined percentage figure, or may be related to a suitable index, such as the Consumer Price Index. In some schemes, increases are provided purely at the trustees' discretion. This

usually happens where no specific funding is being provided in advance for pension increases.

Sometimes, increases in pensions are paid, not from the pension fund, but purely from the income of the employer. In this case, these increases would be likely to cease if the employer closed down. The Pensions Act Disclosure Regulations require that retiring members are informed if their increases are not guaranteed.

In many Public Sector schemes, it is customary for pensions to be increased in line with any changes which take place in the salary appropriate to the post formerly held by a retired member, although many non-standard increases, such as productivity related pay increases, may be excluded. This method of treating pensions post retirement is called “pay parity”.

### ***How soon may I retire?***

Retirement before normal retirement age is usually subject to the consent of the employer and/or the trustees. The Revenue Commissioners will permit a pension to be paid at any age if it is due to ill-health. Otherwise, the minimum age at which a person can receive a pension is normally age 50. A member who retires in advance of normal pension age could expect a reduction in pension benefits and these reductions can be quite large if the period from the date of retirement to normal pension age is long. The reduction takes place because

- fewer contributions have been paid and those which have been paid have been invested for a shorter time;
- the payment of the pension starts earlier; the average expectation of life is longer, leading to a longer period of payment of benefits.

If early retirement takes place due to ill-health, sometimes a scheme will give better benefits than would be paid on early retirement in normal health.

**Please note, however, that the rules of each scheme will specify the earliest date at which retirement will be allowed under that scheme.**

***What happens if I retire late?***

If your retirement is to be postponed beyond normal retirement age, this usually requires the consent of your employer and/or the trustees of the scheme. What happens then depends very much on the rules of the individual scheme. Revenue rules and the provisions of most pension schemes give the option to take all of your benefits at normal retirement age. Alternatively, you may have an option to take the cash element (see “commutation” above) and defer receiving your pension until you actually do retire. The third option is to defer your benefits altogether until you eventually retire. If that option is taken, death in service cover may continue to be provided until you actually retire, although it would be unusual for this provision to continue after age 70.

If you defer your benefits beyond normal retirement age, it is usual for these benefits to increase, to reflect the fact that their value continues to be invested in the fund, and that average life expectancy will be shorter from a later age, so fewer installments of pension will be payable overall.

***I have contributed for 40 years but I have not yet reached normal retirement age. Can I stop my contributions, or even retire now on full benefits?***

The answer to the first part of the question depends on the rules of your scheme. Some schemes will permit members to stop contributing after 40 years of contributions but most schemes require people to continue to contribute up to normal pension age, even if this means that they would have contributed for longer than the maximum period of service credited for pension purposes. If you want to take your benefits before the normal retirement age specified in the scheme rules, this is a case of early retirement and your benefits in those circumstances would be subject to whatever reduction the scheme would usually require for benefits paid before normal retirement age.

### ***What happens if I die before retirement age?***

Almost all pension schemes provide some sort of death in service benefit designed to provide for the dependants of members who die before reaching pension age. These death-in-service benefits take the following forms:

#### ***(i) Lump Sum Benefits***

Lump sums are payable income tax free and are often expressed as a multiple of salary. The maximum lump sum benefit which the Revenue Commissioners will allow is four times your final pay. However, your own contributions **can** be refunded in lump sum form in addition, with or without interest, if the rules allow that. This refund of contributions would also be tax free. If the benefit provided in the form of a capital sum exceeds the Revenue limits on cash payments, anything over the limits must be used to provide a pension for a dependant or other beneficiary. Check the rules of your own scheme.

#### ***(ii) Pensions for Dependants***

Many schemes provide pensions for dependants in addition to lump sum benefits. These pensions can take the form of spouses' benefits, spouses' and children's benefits, or benefits payable to dependants generally. The total amount of these pensions is regulated by the Revenue Commissioners and the total cannot exceed the maximum pension which you could have had, based on your final pay and the service you would have completed if you had lived to normal retirement age.

#### ***(iii) Preserved Benefits***

If you have left employment since the 1st January 1993 **and** are entitled to preserved benefits under the Pensions Act, the value of these benefits must be paid to your estate in the event of your death. Alternatively, the trustees of your Pension Scheme may have chosen the option to pay a dependant's pension instead. The notification of your benefits on leaving service must specify what is payable in the event of your death, and in what manner. Beneficiaries may be liable to Inheritance Tax on these benefits.

### ***Who gets my death-in-service benefits?***

The rules of the majority of pension schemes specify that the lump sum death in service benefits are payable to a broad category of “dependants”. These will normally include a member’s wife or husband and children under 18. Often, in addition, the category of dependants will include those over 18 who are still receiving education or who are mentally or physically handicapped, and any person who was ordinarily dependent on the member for the necessities of life. Remember, the definition of dependants can vary considerably from scheme to scheme and you should check your scheme booklet or other explanatory documents.

### ***Discretionary Powers of Trustees***

In most schemes, the trustees will have a fairly wide discretion to decide who gets these benefits. In some schemes, apart from “dependants” as outlined above, there might also be a broader category of eligible beneficiaries whom the trustees can choose to pay. You cannot direct the trustees in the way they exercise these discretionary powers (but see next paragraph).

### ***Nomination of Dependants***

The trustees may give you the option of completing a form of nomination of dependants, often known as a “wishes letter” or “expression of wishes”. The purpose of this is to specify your own wishes in the disposal of your death benefit. Such a letter or expression of wishes cannot bind the trustees but they will normally try to give effect to your wishes. They will not do so, however, where your wishes are in conflict with the obligations imposed by law on trustees.

### ***Spouses’ Pensions***

If the dependants’ pensions are expressed as “spouses’ pensions” in the scheme rules, they can be paid only to the lawful spouse of the member.

### ***Payment to the estate***

The majority of pension schemes do not provide for payment of your death benefit to your estate except, perhaps, where there are no dependants.

However, the Pensions Act does require the value of any compulsory Preserved Benefits under that Act to be paid to your estate. Any moneys due under a Pensions Adjustment Order made at the time of divorce or separation would also be paid to your estate. Any amount paid to your estate will be disposed of in accordance with your will, or in accordance with the rules on intestacy if you don't make a will. Every pension scheme member is strongly advised to make a will.

### ***Leaving Death Benefits by will:***

You can leave your death benefits to someone else by means of your will ***only*** if the death benefit is paid into your estate. In most pension schemes, this does not happen immediately, because the death benefits are usually expressed as something payable to dependants. Generally, payment to your estate will take place only if you have no dependants (except in the case of certain benefits mentioned in the previous paragraph). Therefore, in most cases, your will can have absolutely no effect on who becomes entitled to the benefits payable under the rules of the pension scheme on your death. You should also note that benefits payable to dependants or other beneficiaries under the rules of the scheme can be paid fairly quickly after the death of the scheme member.

Benefits that have to be paid to your estate could not be paid until your will has been submitted to probate (or until letters of administration have been granted, if there is no will).

There are a few circumstances in which death benefits will be paid automatically to your estate: lump sum death benefits under public sector schemes are always payable to the member's Legal Personal Representatives; the actuarial value of preserved benefits under the Pensions Act must also be paid in this way (unless the Trustees choose to pay dependants' pensions instead); and the value of pension benefits that may be due to you as a result of a Pensions Adjustment Order will go to your estate as well.



### ***What happens if I die after retirement?***

Benefits payable after the death of a pensioner in retirement vary considerably from scheme to scheme. It is quite unusual for any benefit to be paid *in lump sum form* when death occurs more than 5 years after retirement. Death in retirement benefits can be any one or more of the following:

#### ***Guarantee***

Many pension schemes provide a guaranteed minimum period for payment of your benefits, whether you live or die. This period can be up to 10 years. However, if it is 5 years or less, then the remaining installments payable under this guarantee can be translated into a lump sum payable to your dependants or estate instead. Pensions payable to dependants may commence within the 5-year guarantee period. If the guarantee is more than 5 years, the outstanding installments *must* be taken in pension form, and no benefit payable to dependants may commence until after the period the guarantee has expired.

#### ***Dependants' benefits provided by surrender***

Many pension schemes give a retiring employee the option to give up some of his/her own personal pension to provide for a continuing pension to be paid to a dependant on death after retirement. This is an option that has to be exercised before you actually retire. The cost to you in terms of a reduction in your own benefits will depend on the age and sex of your dependant, relative to your own age and sex. The older the dependant, the less of your own pension you will have to give up to make this sort of provision. As women generally have a longer life expectancy than men, it would cost more to provide for a female dependant than for a male.

#### ***Dependants' Pensions***

Sometimes the scheme rules will provide for specific dependants' pensions to be paid on your death after retirement, without any need for you to give up any part of your own pension. These benefits may be payable immediately on the death of a pensioner, even

though a 5 year guarantee might still be in force, or they may begin payment after the guarantee expires.

### ***Marriage after Retirement***

Generally speaking, pension schemes which provide spouses' pensions on death after retirement cater only for the spouse to whom the pensioner was married at the time retirement took place. The same usually applies in the case of other nominated dependants – payment will be confined to the dependant/s nominated at the point of retirement. However, you should check the rules of your own scheme for precise information in this area.

### ***How are my death benefits treated for tax purposes?***

As has already been stated benefits are taken into account for tax only when they come into payment. Any benefits which the Revenue Commissioners allow to be paid as lump sums in normal circumstances are not taxed. Benefits payable in pension form are subject to tax under the PAYE system, so the tax payable on them will be determined by the individual tax position of whoever is receiving the payment.

There is another tax to which death benefits can be exposed. Benefits paid on death are regarded as part of your estate for the purposes of Inheritance Tax, even though you cannot normally control who gets these benefits by means of your will.

For the purposes of inheritance tax, death benefits are treated like every other inheritance. The amount of tax payable (if any) depends on who is receiving the benefit and the relationship to you. For example, if the only beneficiary is your husband or wife, no inheritance tax would be payable. If a child or children receive the benefit, anything they get from the pension scheme will be added to whatever else they have inherited for the purpose of calculating whether they are liable to tax or not. The thresholds for relatives other than children are low and, for non-relatives, even lower still. In summary, therefore, if your death benefit is inherited by anyone except your lawful spouse, there is at least a possibility that inheritance tax will be payable.

Non-relatives, such as a defendant who is not legally married to you, are the most likely people to pay substantial amounts of inheritance tax. **The trustees will want to satisfy themselves that the liability for inheritance tax has been taken care of before they pay out the full death benefit, as they could be held liable for payment of the tax otherwise.**

***What are my options on leaving service?***

Under the Pensions Act, your pension scheme trustees have an obligation to let you have a detailed note of the full options available to you on leaving service. The following may help you to understand what these options mean:

***What are vested rights?***

This is a term used to describe a right which a pension scheme member acquires to a benefit on leaving service, which is provided for in the rules of the scheme. Many scheme rules giving vested rights are now overridden by the provisions of the Pensions Act, which confers rights to preserved benefits. The Pensions Act does not permit schemes to give leaving-service rights which are less than those provided for under the Act. However, it is possible for schemes to exceed these statutory **preserved benefits**. A “vested rights” rule may apply automatically on leaving service, usually after a certain minimum period, regardless of the circumstances in which you leave. Sometimes, vested rights apply only if you leave through no fault of your own, such as through redundancy. In practice, most vested rights rules have been superseded, because preservation under the Act is compulsory after two years in the scheme.

***What are preserved benefits?***

Preserved benefits are benefits “earned” during service as a member of a pension scheme. The Pensions Act 1990 originally provided only for preservation of benefits earned after the 1st January 1991, the date on which the Act came into operation. They were available to those who left service after the 1st January 1993, and who had been at least five years in the pension scheme, in any other scheme of the same employer or in any pension scheme from which rights have been transferred to your present scheme. The Pensions (Amendment) Act, 2002 extended preservation to all benefits, regardless of when they

were earned, provided only that you have been a scheme member for two years or more. In defined benefit schemes, these benefits will be subject to “revaluation” between 1996 (or later date of leaving service) and the time you collect your benefits.

***Can I take a refund of contributions made to the scheme by***

***(i) myself and***

***(ii) my employer?***

If you are entitled to a preserved benefit under the Pensions Act, you will have no right to take a refund of your own contributions. This also applies to voluntary contributions. If, however, you have not completed enough service (two years as a member of the scheme, or any scheme of the employer, or any scheme from which rights have been transferred) to acquire rights to preserved pension, you can take a refund of all your own contributions, subject to whatever the rules of your scheme provide. Interest may or may not be payable, depending on the detailed rules of your own scheme. The tax currently payable on a refund of contributions is 20%.

You can **never** take a refund of the contributions made by your employer to the scheme on leaving service. Also, certain industry-wide schemes that provide for transferability between participating employers do not allow contribution refunds at all.”

***Will a transfer value buy an equivalent period of service in a new scheme?***

In general terms, the answer to this is “no”. It is usually up to the trustees of the receiving scheme to decide what credit you are given in the new scheme in return for any transfer value paid in.

This decision will generally be made on the advice of the scheme actuary. No two schemes are the same in every detail but, even if they were, the benefits which you take from the first scheme are likely to be calculated on your pay at the time you leave service, not on the pay you will be receiving when you retire from the service of the second employer.

If you are considering asking for a transfer payment, you should obtain detailed information on what it is likely to buy for you in the new scheme before you ask for the money to be transferred. If the transfer value will not replace all of your service, you may be able to make up some or all of the difference by making Additional Voluntary Contributions (AVCs).

### **How are my personal contributions calculated?**

The rules of your scheme will contain a formula, normally expressing your contributions as a percentage of pensionable salary. If your scheme is “integrated” with social welfare, you may have a pensionable salary that is lower than your actual salary. If your pensionable salary is calculated by subtracting from your basic salary in order to calculate your pay for pension purposes, the contribution you pay would be based on the adjusted figure. Sometimes earnings other than basic pay may be counted for pension purposes. Only the detailed rules of your own scheme will provide an accurate answer to this question.

### **Is there tax relief on contributions?**

Yes. Contributions which you make, including additional voluntary contributions, up to maximum limits that vary with age, from 15% to 30% of your gross earnings, will receive income tax relief. Earnings “cap” of €254,000 applies to contributions by employees. The relief will be given at your marginal rate of tax. Since contributions are normally deducted from your pay before tax is calculated, you will also receive relief from PRSI on these contributions.

However, the maximum allowable contribution by you is subject to the condition that the employer must have paid a substantial contribution to the total cost of your benefits. In other words, tax relief would not be available on a defined benefits scheme which was funded solely by contributions from members. Since the Finance Act of 2003, contributions to all forms of pension provision – occupational pensions, PRSAs and Retirement Annuities or “personal pensions” are added together in computing the contribution limits and the earnings cap.

### ***Have I got scope for Additional Voluntary Contributions?***

Whether or not you have scope for additional voluntary contributions will depend on the extent to which there is a gap between the maximum benefits permitted by the Revenue Commissioners and the benefits actually being provided in the scheme. The scope for additional voluntary contributions generally arises where:

- (i) not all pay is pensioned: For example, if your scheme is “integrated” with social welfare or if you have non-pensioned pay, such as overtime, bonuses or benefits in kind.
- (ii) the scheme does not provide for the absolute maximum benefit that the Revenue would approve. Very few schemes can afford to give maximum approvable benefits.
- (iii) your service with your present employer is short, so that your service-related pension falls short of what you would receive for a full career with the same employer.

The scope to make voluntary contributions may be limited by the amount of your into account.

***You should be aware that you cannot make voluntary contributions at all unless the rules of the pension scheme permit this, or there is a separate scheme in existence designed to cater for them. The Pensions Act requires that, if the scheme does not offer an AVC facility (or if a separate AVC scheme is not available), the employer must grant access to a Standard PRSA that can be used for this purpose. Incidentally, the Revenue Commissioners are no longer allowed to approve a single-member AVC scheme.***

The Revenue Commissioners treat a separate AVC scheme as if it were part of the main pension scheme, because an AVC arrangement cannot exist on its own. Therefore, the benefits of an AVC scheme must be dealt with in the same way as the benefits emerging from the main scheme – for example, if one is transferred to a new employer’s scheme, they will require both to be transferred. The only time AVCs can be treated differently is at retirement, when they can be used to invest in Approved Retirement Funds .

## **THE DEVELOPMENT OF PUBLIC SUPERANNUATION SCHEMES**

A STUDY of the history of public superannuation schemes reveals that, in general, steady progress has been, and is being, made ; there is, however, little consistency as between various branches of the public service. There have already been many post-war developments, in which there is some evidence of a common pattern, yet in which there are many startling divergences.

In view of the ever-increasing scope of the public services, it is surely time to give serious consideration to the question of standardization of such schemes; and the object of this paper is to suggest possible future developments along these lines.

2. In order to appreciate the problem, it is necessary to consider past trends in public superannuation and to have some general knowledge of the major schemes at present in force.

Accordingly outlines the main features of the principal schemes applicable to general classes of public servants, i.e. where there are no abnormal occupational hazards or other special features, and where the maximum pension can be secured on completion of 40 years' service.

Deals similarly with schemes applicable to particular classes, such as police and firemen, where the maximum pension can be secured on completion of only 30 years' service. It must be emphasized that the Appendices are throughout expressed in general terms only; for the specific provisions of the various schemes reference must be made to the actual instruments governing them. These are so numerous that, for reasons of space, it is impossible to include in this paper a full list of the proper titles,

3. Prior consideration must be given to the Civil Service scheme, which may be regarded as the foundation of the present system. Its development has been generally logical and progressive, and little comment is necessary except to point out that it is virtually the one remaining non-contributory scheme within the public services.

4. Turning to the local government service, the position is less satisfactory. A standard contributory scheme has been in operation, with relatively small changes, for over a quarter of a century, yet local-Act schemes (i.e. schemes established under private Acts obtained by individual local authorities before the introduction of the general scheme) still persist. Their continued survival is due in the main to their distinguished history as pioneers in the field of public superannuation, and to the fact that they are, without any doubt, in general considerably in advance of the standard scheme. The Civil Service abandoned the 'pension only' scheme in favor of the 'pension plus lump sum' to a large degree in 1909 and completely in 1935; yet we find the standard.

4 The Development of Public Superannuation Schemes local government scheme written in 1922 and confirmed in 1937 on a 'pension only' basis. Local-Act authorities, however, in the main adopted 'pension plus lump sum' schemes at varying dates after about 1920; and it is thought to have been the common experience that the bulk of contributors on the old basis opted to change over to the new—the main exceptions were, as might be expected, spinsters with no dependent relatives. Whilst it does not necessarily follow that what the average man wants is good for him, nevertheless in this case his sense of what he considered desirable was in close accord with what was considered desirable for him.

5. In 1948 a very large volume of staff was transferred from local authorities to the National Health Service. The scheme for the latter has been framed in many respects on the current Civil Service pattern, i.e. including a pension and a lump sum benefit. It also includes the revolutionary innovation of a compulsory widow's benefit (as opposed to the normal provision that, subject to proof of health, a contributor may at the time of retirement surrender a part of his pension to secure a reversionary annuity for his spouse) and an adequate death benefit where no widow is left. The combined benefits are probably the most satisfactory yet provided under any public superannuation scheme, and local authorities have not been slow to realize this. In 1948 two local Acts were passed modifying, in its application to the authorities concerned, the Local Government Superannuation Act, 1937 (hereafter referred to as 'the 1937 Act') by the substitution of benefits as under the National Health Service scheme; and it is understood that some ten similar Bills are included in the 1949-1950 Session of Parliament. Naturally the



piecemeal introduction into local government of benefits of this nature is viewed with a certain amount of disquiet, and proposals for appropriate amendments to the 1937 Act are Already being considered.

6. Such a revision, it may be expected, will have repercussions on existing local-Act authorities; an effort will undoubtedly be made to bring them into line with other authorities. It is equally certain that such a move will be seriously opposed, for authorities already complain bitterly against the gradual alienation of many of their powers and are not likely to view with complacency the loss of local autonomy over their superannuation schemes. There is, moreover, the consideration that the statutory imposition of a standard scheme would place a very serious financial strain upon local-Act authorities, since service now excluded by them would presumably become reckonable in the same way as under the 1937 Act. (At present, if a former local-Act contributor enters the service of another local authority, any service previously excluded becomes reckonable by virtue of the provisions of the 1937 Act, and the financial strain thereby falls upon the new employer—a deterrent to fluidity of staffs.)

7. There can be no doubt that looked at impartially; the existence of local- Act schemes is an anomaly. As stated earlier, they are still, in general, considerably in advance of the present standard scheme; but this merit will disappear if and when the 1937 Act is amended to incorporate the National Health Service benefits, and the differences will then appear as demerits.

Probably the most adverse feature is the discriminatory treatment of past service, as compared with the 1937 Act, which provides that all service under any local authority shall count for superannuation purposes either as contributing or as non-contributing service. It is obviously undesirable that a relatively small The Development of Public Superannuation Schemes 5 proportion of local government employees should be treated less favorably than the majority, and a strong case thus exists for the introduction of a Standardized scheme for all authorities.

Unless, however, the new scheme were to provide benefits better, on the whole, than those under any superseded scheme (which is financially impracticable) it would be necessary to give existing contributors an option to retain their former superannuation conditions. Such an option could, following police and fire service precedents, be

restricted to schemes certified to be, on the whole, not less favorable than the unified scheme; but, even so, the full advantage of unification would not be felt for a further 40 years. Nevertheless, a large step towards uniformity would have been taken, and there would be an immediate gain in simplicity and economy of administration.

8. Under the 1937 Act, each authority (including a local-Act authority) is responsible for the solvency of its own superannuation fund. A unified scheme could lead to simplified financial arrangements, e.g. an unfunded scheme—which most actuaries would probably deprecate—or a single fund for all authorities.

9. The question of a single fund was considered by the Norman Committee in their report *On the Superannuation of Persons employed by Local Authorities in England and Wales* (Cmd, 329 of 1919). Paragraph 73 of that report said that 'this plan has much to commend it inasmuch as it unites the advantage of the freest opportunities of interchange between the various staffs, the averaging of all risks, and the smallest aggregate amount of administrative work'. The proposal was rejected because (paragraph 74) 'the solvency of the fund would be at the mercy of the separate action' of the independent authorities, as regards conditions of service and scales of pay, "without their having individually more than an indirect and remote responsibility for it'. Since 1919, however, conditions of service and scales of pay in local government employment have, to a large degree, been standardized, and the above objections have now lost some of their former force.

10. The advantages of a unified fund may be summarized as follows.

(1) Uniformity of benefits, both by reason of the standardized scheme and also since there would be fewer variations of practice. (Certain discretionary powers, such as the addition of years for purposes of calculation of benefits, might well continue, but any excess cost thereby is a charge to the general rate account and not to the superannuation fund.)

(2) Simplicity and economy of administration, including the disappearance of transfer values.

(3) Possibility of unified valuation, with simplified allocation to authorities (e.g. on basis of salary rolls or rateable values—although both are objectionable in certain respects).

(4) Spreading of actuarial risks, with possible advantage to smaller authorities.

(5) Disappearance of any financial strain to employing authority on admission of employee with previous service, and consequent increase in fluidity of staff. (This strain now results from admission in such circumstances that no transfer value is receivable, i.e. after a 'disqualifying break', or where the transfer value is calculated by reference to a part only of previous service, i.e. in the case of certain former local-Act contributors.)

## 6 The Development of Public Superannuation Schemes

(6) Facility of suspension of superannuation allowances during periods of subsequent employment with any local authorities—a common provision in many present schemes, but difficult to apply in practice.

(7) Disappearance of certain tax inconsistencies due to differing degrees of approval of funds under Section 32 of the Finance Act, 1921, etc. 11. Against these can be adduced the following disadvantages.

(1) Mortality rates differ significantly in different parts of the country. With a unified fund and a single valuation, some authorities would gain at the expense of others. It may be noted that this objection did not prevent the introduction of a centrally financed scheme for teachers.

(2) Local conditions and practices have a significant effect upon the cost of superannuation, e.g. salary scales (where the national scales are not in force), staff structure (i.e. the proportion of highly salaried officers), policy as to recruitment and promotions (e.g. whether permitted at late ages), classes of staff admitted to the scheme, stringency of medical examination before appointment and before retirement on account of ill-health, etc. Authorities might tend to become less vigilant as to cost where they are not directly concerned in the resultant liability,

(3) Any attempt to control factors as in (2) would lead to further interference with existing powers of local authorities.

(4) If account were taken of variations in mortality, etc., sectionalized valuations would be necessary, i.e. gain in administrative simplicity and economy would be reduced.

(5) Superannuation funds can at present be used for internal investment by authorities (e.g. for financing capital expenditure). Any compensating power of borrowing from a central fund would involve some measure of control by an external body.

(6) Local-Act authorities would strongly resist any proposals involving the abolition of their special privileges.

(7) Abolition of local-Act schemes would lead to options to retain former rights and consequential increase in complexity.

(8) Administrative saving might be relatively small—there would still be extensive local work in collecting and recording contributions, and possibly in decentralized payment of pensions. With the passing of hospital services from local government, inter-authority transfers will in any event be relatively few.

(9) Centralization might lead to administrative delays in paying benefits.

(10) Gain in fluidity of staff (by easing of financial strain) may prove to be overestimated. Where there is a twelvemonth's break in service the contributor can hardly, except in special circumstances claim to make his career in local government.

12. Considered purely from a theoretical viewpoint, argument (2) against a single fund, viz. the effect of local conditions and practices, may well be held to constitute an insuperable objection against unification, or, indeed, against any regrouping, of funds.

There is, however, a practical point at the present time. There are now some 480 separate local authority funds, each with a minimum membership, under the 1937 Act, of 100 contributors. The recent large-scale transfers to the National Health Service and to Gas and Electricity Boards will reduce a number of funds below the minimum membership, and some regrouping is essential. Thus the present time would be opportune for the inception of a single fund.

The Development of Public Superannuation Schemes 7 (As a preliminary all existing funds would require to be valued, and the aggregate emerging liability paid into the central fund.)

A compromise solution might be the regrouping into regional funds, but this suffers from the demerits common to all compromises.

13. The former considerations are related to the local government service, but the arguments for a unified scheme (irrespective of unified finance) are capable of far wider application. Broadly speaking, all the schemes outlined in Appendix I, based on a 40-year service life, offer benefits which are approximately equivalent in value, and there are roughly similar risks in the corresponding branches of public service, i.e. Civil Service,

local government, National Health Service, teachers, public boards, etc. (with the exception of certain classes of 'operatives', such as miners and rail way men, who are subject to special risks). There would appear to be no reason why a single unified scheme (presumably unfunded, for obvious practical reasons) should not extend to all such classes of public employment. This would ensure uniformity of treatment without the need for, and the restrictions imposed by, the elaborate interchange arrangements at present in force or contemplated under numerous sets of interchange rules, etc.

14. Such a unification would remove the many present inconsistencies, of which the conditions governing payment of transfer values and reckon ability of service may be cited as examples.

Under all existing regulations, the payment of a transfer value is dependent on there not having been a disqualifying break of 12 months or more. As between local authorities, the payment of a transfer value is governed only by the above condition, and is independent of the return or otherwise of past contributions. The right to reckon past service, in some form or other, following transfer does not depend on the passage of a transfer value. As between a local authority and the National Health Service, the payment of a transfer value is dependent also upon the repayment of any contributions which may have been returned. Unless a transfer value passes, previous service with the other branch of public service is completely excluded from reckoning.

As between a local authority and a public board, the position is generally similar to the preceding interchange; but a still further proviso is proposed, viz. that a transfer value shall be payable only with the consent of the former employer.

15. The non-contributory nature of the present Civil Service scheme presents a difficulty as regards its inclusion in a unified system. It is interesting in this connection to note that the Chorley Committee (set up to advise the government on the general level of remuneration in higher posts in the Civil Service and kindred matters) included, in their report issued in February 1949, a recommendation for the urgent and thorough examination of the question of introducing a contributory system of superannuation, which, the Committee felt, would have many advantages in facilitating exchange between the Civil Service and other public employments. A step in this direction has been taken in the Superannuation Bill, 1949, which provides for a contributory • The Superannuation

(Local Government and Public Boards) Interchange Rules 1949, which have been issued since the paper was written, do not in fact contain this proviso.

8 The Development of Public Superannuation Schemes widows' and children's scheme, but this is in addition to the ordinary noncontributory superannuation scheme, and not in any way in substitution therefore.

16. In the event of unification of schemes, it would probably be essential for each branch of the public service to be treated initially as a separate financial entity, since the ultimate responsibility for solvency may rest variously with the Exchequer or local rates or revenues. If, however, comparable wage structures are evolved with the passage of time, experience may reveal some permissible financial simplification.

17. One incidental advantage of unification of schemes would be the resulting uniformity of treatment for tax purposes. In the case of funded schemes, tax relief is allowed under Section 32 of the Finance Act, 1921, The relief in respect of members' contributions varies according to the degree of approval of the fund (dependent on the proportion of the contribution which secures the main pension benefit). Contributions returned to the member are assessed to tax, at one-quarter of the standard rate current at the date of return, to a similar extent ; under public funded schemes this tax liability is not passed on to the member.

In the case of schemes which derive from ' public general Acts of Parliament ',tax relief may be allowed, under Section 31 of the Finance Act, 1922, on the whole of the members' contributions. Any return of contributions is subject to deduction of the tax which would have been paid had no such relief been given, i.e. having regard to the incidence of payment of the contributions. This gives rise to anomalies in certain cases. For example, for persons subject to the National Health Service modification to a local government scheme, the tax position as regards members' contributions is as follows.

(a) In respect of the 'approved' portion (the degree of approval being reassessed from 5 July 1948, when the modification became fully effective) full relief is given under the 1921 Act. Tax on returned contributions is borne by the fund.

(b) In respect of the ' non-approved ' portion, full relief is given under the 1922 Act, for a ' 1937 Act' fund (tax being deducted from any return of contributions) ; but no relief is

given for a 'local Act' fund, since the contributions, not being made 'in pursuance of any public general Act of Parliament', are outside the scope of the 1922 Act.

18. The foregoing paragraphs relate to public superannuation schemes based on a 40-year service life.

There is a similar case for a unified system for all public schemes based on a 30-year service life, i.e. police, firemen, mental health officers in the National Health Service, and prison officers.

Interchange between the two unified systems could take place subject to an appropriate adjustment on transfer in respect of reckon ability of past service.

19. All the preceding considerations have referred to existing branches of the public service. The Labour Party has indicated a considerable sphere in which future nationalization is proposed. If this programme materializes, the appropriate existing 'private' superannuation schemes will presumably be assimilated and the scope of the interchange rules still further extended. The exact degree of future nationalization is of course unpredictable. For this reason, and also on general grounds, it would seem not unreasonable that any unified superannuation scheme for the public service should contain provision for its adoption, on a voluntary basis, by approved 'private'.

The Development of Public Superannuation Schemes 9 employers, such as the financial houses and the larger commercial and industrial concerns; separate financial arrangements might or might not be essential. The practical difficulty would, of course, lie in determining how far this process should be allowed to continue.

20. It is hoped that the above remarks may serve to produce a useful discussion on what is, I feel, a matter of great practical importance at this time. Continued haphazard development in this sphere will introduce yet further complexities into an already over-complicated subject, and will render ultimate clarification more and more difficult and remote.

In the limited sphere of the local government service, the possibility of simplification, with particular reference to unification of funds, has already attracted attention. Since this paper was first prepared, a paper entitled Superannuation—Present Tendencies and their Implications by R. S. McDougall, F.I.M.T.A., A.C.A., has been presented to the Institute of Municipal Treasurers and Accountants. As I have endeavored to show, however, all

branches of the public service require to be considered simultaneously. I have outlined only what appear to me to be the main issues affecting the problem. There are numerous minor questions that suggest themselves; e.g. it might be considered that the right to reckon previous service should in all cases be subject to the repayment of any contributions returned; or, again, some simplification in the taxation position might be sought.

I should add that all opinions expressed in this paper are personal to myself, and must not be taken as representing in any way the views of the London County Council.

## 10 The Development of Public Superannuation Schemes

### APPENDIX I

Outline of the main features of principal schemes applicable to general classes of public servants, where maximum pension can be secured after 40 years' service Introductory.

The schemes will be considered in the following order:

- (a) Civil Service
- (b) Local government (except as (c), (d) and (e) below)
- (c) Poor Law
- (d) Mental hospitals, etc.
- (e) Teachers
- (f) National Health Service
- (g) Public boards
- (h) Modifications by reason of State Insurance benefits
- (j) Pensions (Increase) Acts

There are several threads to trace, sometimes parallel, but frequently intermingled.

Generally speaking, the Civil Service schemes have set the pattern. Where a scheme has been materially altered, existing contributors at the time have almost invariably been allowed an option to retain former conditions or to transfer to the new scheme. In general, where the new scheme introduces a lump sum on retirement and a benefit (other than return of contributions) on death in the service, the lump sum is increased by 1/2% for each year of service completed at the date of alteration.

- (a) Civil Service schemes have throughout been non-contributory and unfunded.



(i) The Superannuation Act, 1834, provided pensions on retirement on grounds of full age (65) or earlier incapacity; benefits were based on the 'annual salary' at retirement, i.e. the then-operative rate, or the average over the last three years of service if there had been a promotion within this period. For entrants before 1829, the scale provided a pension at the full 'annual salary' after 50 years' service.

For entrants after 1829, the scale was reduced—10 years' service secured a pension of  $\frac{3}{12}$  of the 'annual salary', rising by  $\frac{1}{12}$  for each further 7 years to a maximum of two-thirds after 45 years' service.

(ii) The Superannuation Act, 1859, revised the scale to that which became standard for all schemes providing a 'pension only' benefit, viz., at the rate of  $\frac{1}{60}$  of 'annual salary' per completed year of established service, subject to a maximum of two-thirds, and with a qualifying period of 10 years. The optional retiring age was reduced to 60, at which it has since remained. Provision was made for a permissive short-service gratuity in the event of enforced retirement before qualifying for pension.

(iii) The Superannuation Act, 1909, introduced, for male officers only, the scale which became standard for schemes providing a 'pension plus lump sum' benefit, viz., subject to a qualifying period of 10 years, a pension at the rate of  $\frac{1}{80}$  per completed year, maximum  $\frac{40}{80}$ , and a lump sum on retirement at the rate of  $\frac{1}{30}$  per completed year, maximum  $\frac{45}{30}$ ; all related to 'annual salary'. Each completed year of service after age 65 entailed a 5 % reduction in the lump sum.

The Development of Public Superannuation Schemes 11 This Act also introduced a death benefit, subject to five years' qualifying service, of one year's 'annual salary', with provision to secure that a pensioner's estate was not worse off by his retirement than it would have been had he died on his last day of service.

(Under the Superannuation Act, 1914, the death benefit was increased to the lump sum benefit which would have been payable in the event of ill-health retirement as at the date of death, where this was greater than one year's salary.)

(iv) The Superannuation Act, 1935, discarded the 'annual salary\*' basis and substituted the 'average salary' over the last three years of service. At the same time the scale of the lump sum benefit was varied to  $\frac{3}{80}$  per completed year of service, and the 'pension plus lump sum' basis was extended to female civil servants.

The 1935 Act also contained provisions whereby prospective pensioners were empowered, within three months preceding retirement, to surrender a part, not exceeding one-third, of their pension in favor of an approved dependant. The option became effective only on proof that the pensioner was in good health at the time of retirement. The amount of pension secured by the beneficiary depended on the relative ages of the pensioner and the beneficiary, and the tables published by the Government Actuary for this purpose are used as the standard for practically every similar scheme for apportionment. A point of interest is that the beneficiary's benefit under virtually all other schemes is a reversionary annuity (since tax difficulties arise otherwise in connection with '1921 Act' funds) but the benefit to a spouse under the 1935 Act may be an immediate or a reversionary annuity. It may be noted that where a beneficiary receives an immediate annuity the amount is doubled on the death of the officer pensioner.

(v) Miscellaneous developments which may be mentioned in passing govern the reckonability of service. Originally, only established civil service was pensionable; gradually the scope was widened to include unestablished service (at half length), with discretionary aggregation of discontinuous service, other public service not subject to the Superannuation Acts, etc. The 1935 Act recognized approved local government and teaching service for qualifying purposes only (since such service attracts normal benefits under the appropriate schemes); and Regulations under the Superannuation (Miscellaneous Provisions) Act, 1948, which are in course of issue will give complete recognition to such service for all purposes, subject to payment of the appropriate transfer values.

For civil servants who, by reason of their being required to possess 'professional or other peculiar qualifications not ordinarily to be acquired in the public service', enter at late ages, there was, at one stage, a power to add years, not exceeding 20, for calculation of benefits. This has now been superseded

by a power to approve increased reckonability, at the rate of eight-fifths of a year for each year of actual service, for entrants after age 40, with a provision extending this benefit in a modified form to entrants aged between 35 and 40.

(vi) The Superannuation Bill, 1949, includes two entirely new developments. The first relates to the maximum benefit. Hitherto service after 40 years has attracted no pension

benefit other than that due to an increase in the 'average salary' at retirement. The Bill provides that such service performed after the optional retiring age (60) shall secure also an increased proportion of such

12 The Development of Public Superannuation Schemes 'average salary'. There will be a resulting tendency to defer retirement, and this will probably tend to reduce the ultimate cost. The second innovation is the establishment of a separate widows' and children's scheme, on a contributory basis, half the cost being borne by the Exchequer. The member's share may be either by way of contribution (1¼% of salary), or by abatement by one-third of the normal lump sum at retirement or of the death benefit. The scheme will be compulsory for all future male civil servants; but entry may be deferred until marriage, when arrears will become due as from the commencement of pensionable service. Where the risk subsequently disappears by widowerhood, contributions will continue until retirement, when there will be a refund of contributions in respect of the period of widowerhood or, if the abatement of lump sum method is chosen, there will be a corresponding adjustment.

(b) Local government (general)

Except for certain very early local Acts, the schemes have throughout been contributory and funded, subject to quinquennial actuarial valuations. Each local authority can (subject to a minimum membership) establish its own fund, or authorities can combine.

(i) The Local Government and other Officers' Superannuation Act, 1922, was the first general Act. This was permissive in its application, but was very widely adopted by authorities. Once adopted, it applied only to employees 'designated', individually or by classes, by special resolution of the authority. Contributions were at the rate of 5 % by the member and 5 % by the authority. The compulsory retiring age was 65. The standard 'pension only' benefits applied, i.e. at 1/60 per completed year of contributing service, maximum two-thirds, based on the average remuneration over the last five years of service, subject to 10 years' qualifying service. On enforced retirement before qualifying for pension, or on death, contributions were returnable with compound interest; on voluntary resignation they were returnable without interest. There was also provision for

a permissive gratuity, payable out of the rate account, in the event of enforced retirement before qualifying for pension.

'Designated' employees were entitled to reckon all service between ages 18 and 65, under all local authorities, as either contributing or non-contributing. Benefits in respect of non-contributing service were at half the normal rate, chargeable to the superannuation fund; but authorities could increase this to the full rate, subject to reimbursement from the rate account to the fund in respect of the additional expenditure. On transfer between 1922 Act authorities, a transfer value was payable provided that there was no disqualifying break of 6 months or more and that the former authority consented to the transfer.

Some local authorities which did not adopt the 1922 Act established schemes under privately promoted local Acts. Such schemes did not, in general, recognize service with any other authority, and the 1922 Act system of transfer values did not apply.

(ii) The Local Government Superannuation Act, 1937, which repealed the 1922 Act as from 1939, now applies compulsorily to all local authorities other than those with local-Act schemes. The provisions are generally similar to those of the 1922 Act, but apply compulsorily to all whole-time ' officers ' (i.e. administrative, professional, technical, etc.) and at the discretion of the authority to all other employees. Contributions are at the rate of 6% by Officers' and 5% by ' servants ' (i.e. other than ' officers ') with equal contributions by the employer.

The Development of Public Superannuation Schemes 13 except that a former ' designated ' officer continues to pay 5 %. Benefits are as in the 1922 Act, except that, for female nurses and kindred grades who enter local government service after 1939, the compulsory retiring age is 60, and there is a compensating power for the authority to add years, up to a maximum of five, for calculation of benefits (the additional cost being chargeable to the rate account and not to the fund). Provision is made, on the lines of the Superannuation Act, 1935, for the surrender of part pension in favor of an approved dependant. The provisions for reckon ability of service are similar to those of the 1922 Act; but contributors are now empowered to purchase full rights in noncontributing service by making ' additional contributory payments ' calculated on a prescribed actuarial basis with reference to age and salary at the date of option.

Local-Act authorities are empowered to continue their former schemes, but were required to prepare amending schemes (approved by the Minister of Health) to confer rights, substantially similar to those under the 1937 Act, upon new entrants who had previously contributed under another authority.

The transfer value system is extended to include local-Act authorities. A disqualifying break only occurs after 12 months (as against 6 months previously), and the consent of the former employer is now no longer required. Return of contributions to the employee does not remove liability for the payment of a transfer value.

(iii) Local-Act authorities are relatively few in number—London County Council, Edinburgh, Glasgow and Manchester Corporations, and certain Metropolitan Borough Councils—and these represent the pioneers in local government superannuation. The non-contributory Superannuation (Metropolis) Act, 1866, in respect of officers of Metropolitan parochial bodies and of the Metropolitan Board of Works, paralleled closely the Superannuation Act, 1859.

Contributory funded schemes for the London County Council and the Metropolitan Borough Councils came into being from 1895 onwards. Their development followed generally the Civil Service pattern of benefits, although there were, and still are, many minor variations, e.g. as regards the death benefit. There is little uniformity in members' rates of contribution (at present these vary from 2% upwards and may exceed 6 %) or in the circumstances governing return of contributions with or without interest. The payments required to purchase full rights in earlier service also vary widely: some authorities are content with an amount equal to the normal contributions based on actual remuneration for the period in question ; others charge an additional percentage contribution payable throughout the remainder of service; yet others use a basis similar to the additional contributory payments of the 1937 Act; and at least one requires, in effect, payment of the member's and employer's contributions.

Local-Act authorities are required, under the 1937 Act, to reckon previous service only where contributors have, at some time since 1939, paid contributions under some other authority; apart from this statutory requirement, they lay down their own conditions as to reckon ability.

(c) Poor Law, i.e. employees of the late boards of guardians, etc. (i) The Poor Law Officers' Superannuation Act, 1864, was non-contributory and unfunded. The award of a pension, not exceeding two-thirds of the final 14 The Development of Public Superannuation Schemes salary, on grounds of full age (60) or ill-health, and subject to 20 years' whole time poor law service, was solely at the discretion of the guardians, subject to the consent of the Poor Law Board.

(ii) The Poor Law Officers' Superannuation Act, 1896, which superseded the preceding, was also unfunded, but required a contribution, normally at the rate of 2%, from every employee, whole-time or part-time, permanent or temporary. Even this contribution was soon considered excessive in some cases, for an Amendment Act of 1897 empowered ' female nurses ', for so long as they continued to serve in that capacity, to contract out of any rights and liabilities under the 1896 Act.

The pensions, which were a direct charge on the rate fund of the final employer, were on the standard 1/60 basis. All poor-law service, other than as a contracted-out nurse, aggregated subject to repayment of any contributions which had been returned. Such a return, without interest, was made only on the determination of an appointment, and not on voluntary resignation.

The 1896 Act was repealed by the Local Government Act, 1929, when the poor-law functions were transferred to local authorities ; and the general local government schemes now apply, subject to certain modifications in respect of the transferred poor-law officers.

(d) Mental Hospitals, etc.

(i) The Lunatic Asylums Act, 1853, and subsequently the Lunacy Act, 1890, provided for discretionary non-contributory pensions on the lines of the Poor Law Officers' Superannuation Act, 1864.

(ii) The Asylums Officers' Superannuation Act, 1909, was generally similar to the Poor Law Officers' Superannuation Act, 1896, except that only established employees participated, at a normal contribution of 3 %, and there was no power for female nurses to contract out. Established employees were divided into two classes, the first class (having care or charge of patients in the usual course of their duties) qualified for the maximum pension after 34 years' service only (see Appendix II, item (c)); the second class qualified for pension on the standard 1/60 basis. For both classes, all established asylums service

normally aggregated for calculation of pension. There was no system of transfer values ; but, as and when the pension became payable out of the rate account of the last employer, all previous employers became liable to pay 'pension contributions ' to reimburse that part of the pension which was attributable to the appropriate previous service. An ill-health pension could be withdrawn in the event of subsequent recovery, and the pensioner required to resume duty until the normal pension age.

(iii) The Asylums and Certified Institutions (Officers' Pensions) Act, 1919, extended the 1909 Act to include service (treated as of the second class) in certified institutions provided under the Mental Deficiency Act, 1913.

(iv) The Local Government Superannuation Act, 1937, provided for interchange between the general and the mental hospitals, etc., service, requiring, inter alia, payment of 1937 Act transfer values to the Mental Hospital authority and ' pension contributions ' in the reverse direction, subject, in all cases, to the repayment of any contributions returned by the former employer.

The 1909 and 1919 Acts were repealed by the National Health Service (Superannuation) Regulations, 1947. The Development of Public Superannuation Schemes 15

(e) Teachers (this scheme has throughout been financed centrally but administered, prior to pension age, by local authorities)

(i) The Elementary School Teachers (Superannuation) Acts, 1898 to 1912, provided a deferred-annuity money-purchase scheme coupled with a noncontributory unfunded superannuation scheme. Under the former, the annual contribution, at rates varying from £3 in 1899 to £3 12s. in 1919 for men, and at two-thirds of those rates for women teachers, was normally payable until age 65 when the deferred annuity vested. The non-contributory superannuation allowance, payable by the Exchequer, was at the rate of 10s. per year of recorded service in the case of retirements before 1912, and at £1 per year in the case of later retirements. Provision was also made for ill-health pensions, on a much more generous scale, but subject to withdrawal in the event of recovery.

(ii) The current Teachers (Superannuation) Acts, 1918-46, superseded the above. Members' contributions, at 5 % of salary, and equal employers' contributions by the local authorities, are carried to a national Teachers Superannuation Account, which, although on an unfunded basis, is statutorily subject to actuarial investigation at seven-year

intervals. Owing to the intervention of the war, the last investigation to be made was that of 1932. Pension and lump sum benefits are on the scales set out under the (Civil Service) Superannuation Act, 1909, but are related to the average salary over the last five years of service. There is provision for the suspension or withdrawal of an ill-health award in the event of recovery.

Successive Acts have broadened the scope of service which may be recognized for various purposes. Broadly speaking, all service of an educational nature (other than purely administrative) reckons for calculation of benefits, and previous administrative service (educational or otherwise) may reckon for qualifying purposes. It is probable that Regulations to be issued under the Superannuation (Miscellaneous Provisions) Act, 1948, will still further increase the interchangeability with other branches of public service.

It may be mentioned in passing that the Teachers (Superannuation) Act, 1945, provides that a person formerly subject to an 'independent superannuation scheme ' such as the Local Government Superannuation Act, 1937, who transfers, without a disqualifying break, to the teaching service, remains subject to the former scheme unless he elects otherwise.

#### **(f) National Health Service**

Under the National Health Service Act, 1946, the central authority has become responsible for hospital services (taken over from local authorities and boards of governors) and local authorities remain responsible for services such as maternity centres, day nurseries, etc. The National Health Service (Superannuation) Regulations 1947-48, set out the superannuation scheme for staff of the new central service and prescribe similar modifications to local government schemes in respect of medical and nursing, etc., staff employed in local health services.

The central scheme is contributory, but unfunded; as under the Teachers' scheme, provision is made for an actuarial investigation every seven years. All whole-time employees, permanent and temporary, are subject to the scheme, except that manual grades are excluded for their first two years of service; part time employees may be admitted at the discretion of the Minister of Health.



Independent medical and dental practitioners are also brought within the 16 The Development of Public Superannuation Schemes scope of the scheme. Members' contributions are at the rate of 6% for non-manual and 5 % for manual employees (corresponding with the previous 'officer' and 'servant' classifications respectively); employers' contributions are 8% and 6% respectively, as against 6% and 5% under the 1937 Act.

Pension and lump sum benefits, based on average remuneration over the last three years of service, are again related to contributing and non-contributing service, the latter attracting benefits at half the rate of the former. Pension per completed year of contributing service is at the rate of 1/80 (maximum 40/80); lump sum, subject to the following, 3/80 (maximum 120/80).

(Further Regulations, now in draft form, will provide for increases in these maximum limits, on the lines of the Superannuation Bill, 1949-) Compulsory retirement is at age 60 for female nurses, midwives, health visitors and physiotherapists, and age 65 for all others, with optional retirement 5 years earlier subject only to 10 years' service (including hospital service prior to 1948).

The important new feature is the automatic provision of a widow's pension, payable to the widow of every male contributor who has (normally) at least 10 years' service. This pension, subject to adjustment on account of relative ages, is at the rate of one-third of the pension drawn by the former contributor, or which would have been drawn had he retired on the day preceding the date of his death in the service. It is secured by the compulsory abatement, in the case of men married at the date of retirement, of two-thirds of the lump sum which would otherwise have been payable ; in the case of married men dying in the service, a similar abatement is made in the death benefit (equal to the accrued lump sum) which would otherwise have been payable. Where a widower retires, the lump sum is reduced having regard to the period for which he was at risk. Under all schemes previously considered (except the Superannuation Bill, 1949), a widow's pension can be secured only when a contributor elects, at the time of his retirement, to surrender a part of his pension, and subject to proof of his health. The new scheme provides for a benefit in cases previously excluded, i.e. to widows of ill-health pensioners and of contributors dying in the service, and these are the two classes for whom, generally speaking, the

provision of a widow's pension is most necessary. Turning now to regressive aspects of the scheme, the first point concerns reckon ability of service for superannuation purposes.

All continuous service under the National Health Scheme counts; but similar discontinuous service is only aggregated if (a) there has been no disqualifying break of 12 months or more, and contributions previously returned are repaid, or (b) there has been a disqualifying break and additional contributory payments are made to secure reckon ability as 'contributing' service (provided always that no outgoing transfer value was paid in respect of such earlier service). On transfer from a local authority, previous local government service reckons only if a transfer value passes, and this is dependent on the absence of a disqualifying break and on the repayment of any contributions returned by the former employer, with a converse regulation governing reckons ability on removal from the National Health Service to a local authority. This is a regrettable departure from local government precedents, particularly so since transfers of this nature will probably continue to be fairly numerous.

A further retrograde step is that, on the appointed day under the 1946 Act, very large sums became payable, by way of transfer values, from the superannuation funds of local authorities. Since the central scheme is unfunded, these sums will, presumably, be applied by the Exchequer towards current The Development of Public Superannuation Schemes 17 expenditure, i.e. there will be an actual disposal of funds, which cannot be regarded as financially sound. The only other point worthy of note is in connexion with former voluntary hospitals. The staff of these was pensionable by way of policy schemes, such as the Federated Superannuation Scheme for Nurses and Hospital Officers, and provision has been made in the 1947 Regulations for the continuance of existing policies following the transfer of the staff to the National Health Service. It may be added that parallel Superannuation (Local Government and Policy Schemes) Interchange Rules have been made under the Superannuation (Miscellaneous Provisions) Act, 1948.

### **(g) Public boards**

Arising from the recent nationalization programme, sundry public boards have been established. In general, existing schemes (very diverse in scope and character) of the transferred bodies and organizations are being continued as 'closed' schemes, by reason of the impracticability of a satisfactory unification ; and the position is further complicated since each nationalization Act provides that there shall be no worsening in the pension position of any person transferred under the Act. Schemes approved for new entrants to the public boards adhere to the general pension and lump sum pattern.

Regulations which are in course of issue under the Superannuation (Miscellaneous Provisions) Act, 1948, will preserve pension rights on transfer between public boards and other branches of the public service ; but, as with the National Health Service, such preservation is dependent on the passage of a transfer value, which is conditional upon there being no disqualifying break, upon the repayment of any contributions returned by the former employer, and also upon the consent of such former employer.

Bodies such as the Port of London Authority and the Metropolitan Water Board have, of course, had their own private schemes for a considerable number of years, but as yet have not been brought within the scope of interchange rules.

### **(A) Modifications by reason of State Insurance benefits**

(i) Prior to 1946, insured persons qualified for an old age pension at the rate of 10s. a week, under the Widows', Orphans' and Old Age Contributory Pensions Act, 1936. The Local Government Superannuation Act, 1937, contained power (now repealed) for an authority to make a scheme, of voluntary application, whereby, to avoid overlap of benefits from public moneys, an initial amount of remuneration could be disregarded for purposes of contribution and of benefit. This power was not widely used.

(ii) Under the National Insurance Act, 1946, a retirement pension of 26s. A week becomes payable under prescribed conditions. Various regulations have been issued to avoid overlap of benefits. These provide for the reduction, from the appropriate age, of the normal annual superannuation allowance by an amount at the rate of £1. 14s. 0d. for each year of pensionable service, with a corresponding reduction in the contribution

throughout service. The modification is compulsory for new entrants after 1948. Persons previously contributing could elect to have the regulations applied to them as regards the reduction in future contributions, but with the reduction in benefit, restricted to future service, assessed with regard to their age at the time of election, AJ 2

18 The Development of Public Superannuation Schemes instead of the normal £1. 14s.0d.; in practice a negligible proportion of those eligible opted for the modified scheme.

Under all modified schemes there is provision for a consequential modification of transfer values.

### **(j) Pensions (Increase) Acts**

For contributors on the active list, the general wartime and post-war increases in salaries and wages are reflected in increased averages on which benefits are calculated, although the full effect will not be felt until stable conditions have obtained throughout the period over which the average is assessed. For persons already retired, there is normally no means whereby the pension could be increased to offset the rise in the cost of living. To overcome this position, there has been a series of Pensions (Increase) Acts, those of 1944 and 1947 being now current. These authorize increases of pension, commencing at 40 % and decreasing to nil when the total income exceeds £450 a year. For this purpose, stability is assumed to have been reached in 1947, and where the pensionable average is assessed over a period ending after that date, the increase is restricted to the pre-1947 remuneration.

## **APPENDIX II**

Outline of the main features of principal schemes applicable to special classes of public servants, where maximum pension can be secured after 30 years' service Introductory.

The following classes will be considered:

- (a) Police.
- (b) Firemen.
- (c) Mental health officers.
- (d) Prison officers.

{Note: As under Appendix I, National Insurance modifications and the

Pensions (Increase) Acts apply generally.)

(a) Police (i) Pride of place must go to the Metropolitan Police, since in 1829 'an Act for improving the police in and near the Metropolis ' provided for discretionary allowances to such policemen ' as shall be disabled by bodily injury received, or shall be worn out by length of service'. This and other local-Act schemes persisted until superseded by the Police Act, 1890.

During this period, the position was governed generally by a series of Police Acts from 1839 to 1865, which provided for pensions and gratuities on grounds of age or incapacity. Benefits, at the discretion of the Justices but subject to prescribed maximum limitations, were paid out of a police pensions fund ; to this were carried contributions (not exceeding 2½ % of remuneration), stoppages on account of sickness, fines on policemen for misconduct and on the public for drunkenness and assaults on the police, and the proceeds of sales of old police clothing. If this did not produce solvency, the fund was secured on the local rates.

## **INTRODUCTION:**

The Development of Public Superannuation Schemes (ii) The Police Act, 1890, superseded all previous schemes (other than that of the City of London). This Act, and subsequent amending Acts to 1919, provided for a contributory (2½ %) funded scheme with prescribed upper and lower limits for benefits ; within these limits the precise scale was decided by each police authority. The scheme was generally on the lines of the 1921 and 1926 Acts next described.

(iii) The Police Pensions Acts, 1921 and 1926, provided an ordinary pension, based normally on the final rate of pay, calculated on a ' sixtieths ' scale at the rate of one per year of service up to 20 years, and two thereafter up to the maximum of two-thirds on completion of 30 years' service. Voluntary retirement on pension was permissible after 25 years' service. Owing to the abnormal injury risks, scales of special pensions were prescribed, according to length of service.

Separate scales were laid down for accidental injury and for non-accidental (i.e. intentionally inflicted or incurred in the performance of duty involving special risks) and discretion were given to the police authority to make an intermediate award where appropriate. Each scale was in turn subdivided to show the rate for total disablement and the minimum rate for partial disablement (determined by reference to loss of earning capacity). There was no lump sum benefit. Scales of ordinary and special pensions and allowances were also prescribed for widows and children of deceased policemen and police pensioners.

Contributions were payable by policemen at the rate of 2½% of pay from 1921 to 1926 and at 5% thereafter. The scheme was not funded. The reckon ability of service was unaltered by an approved transfer between police forces, with a discretion in respect of other changes. The pension was a charge on the general rate account of the last employer, who was, however, entitled to call upon previous employers for an appropriate 'pension contribution' towards the pension as paid. There was no provision for interchange with any other scheme except with the established Civil Service, four years of which reckoned as three of police service and vice versa.

(iv) The Police Pensions Act, 1948, and Police Pensions Regulations, 1948, superseded the 1921 and 1926 Acts. The scale of ordinary pensions was unaffected; but the former special pensions disappeared, being replaced by a scale of 'standard amounts' applicable in the event of retirement on account of permanent disablement resulting from an injury received by a policeman in the execution of his duty without his own default. These 'standard amounts', by reference to length of service, are subdivided as between total and partial disablement as under the 1921 Act. From the 'standard amount' must be deducted any benefits under the National Insurance (Industrial Injuries) Act, 1946, and any sickness benefit, so long as this is paid continuously from the date of retirement, under the National Insurance Act, 1946. Widows' and children's ordinary and special benefits are again prescribed.

Contributions are payable at the rate of 5 % of pensionable pay less 1s.2d. a week under a National Insurance modification (the abatement being optional in the case of serving policemen in 1948). Reckon ability of service and financial arrangements are generally as under the 1921-26 Acts.

(v) The Police Pensions Regulations, 1949 (issued following the adoption of the Oaksey report), are generally similar to the preceding, except that benefits are calculated on a three-year average basis instead of by reference to final pay as hitherto. These Regulations supersede those of 1948 except in the case of existing policemen who elect otherwise; such election excludes the operation of the increased (Oaksey) rates of pay.

## **The Development of Public Superannuation Schemes**

### **Firemen**

(i) The Fire Brigade Pensions Acts, 1925 and 1929, were generally similar to the Police scheme of 1921, except that the maximum ordinary pension was secured only after 35 years' service; the scale, again based on 'sixtieths', was at the rate of one per year of service up to 30 years, and two thereafter up to the maximum of two-thirds. The special pensions in the main followed the police scheme, i.e. reached their maximum after 30 years.

The financial basis, however, differed completely from that of the police scheme. An authority employing ten or more whole-time permanent firemen was required to establish

a pension fund, to which were carried the firemen's 5 % contributions, an equivalent sum by the authority, and such further sums, if any, as the authority saw fit to provide. There was no system of transfer values, but, as with the police scheme, ' pension contributions ' were recoverable from former employers. The 1925 Act applied to all whole-time permanent operational firemen, except that local-Act schemes previously in force continued to operate where these were certified by the Government Actuary to be on the whole not less favorable than the 1925 Act.

(ii) The Firemen's Pension Scheme, 1948 and 1949, made under the Fire Services Act, 1947, superseded the 1925 and 1929 Acts. This scheme is very similar to the 1948 Police scheme, and, like it, is based on a 30-year service life.

The financial arrangements are, however, different. In view of the wartime nationalization of the fire service, a centrally administered scheme was considered, but was rejected. Fire authorities are now required to maintain a Firemen's Pensions Account, but the present indications are that this will be unfunded. This will entail, inter alia, the disposal of existing 1925 Act funds, but these are, in any case, probably all actuarially insolvent. The former ' pension contributions ' are replaced by the more administratively convenient system of transfer values in the case of approved changes of brigade. Consideration is being given to the preparation of interchange rules with other branches of the public service.

(iii) All local-Act schemes are also superseded, except where these are certified by the Government Actuary as being on the whole not less favorable than the 1948 Scheme; and thereafter they continue as 'closed' schemes, limited to existing contributors in 1948 for so long as they continue in operational employment with the parent brigade, subject to the right of individuals to opt into the general 1948 scheme. The major local-Act schemes approved by the Government Actuary are those of London and West Ham, and certain police-firemen are allowed to continue under the police scheme. As an example, the pre-1948 London firemen derive their pension rights under the Metropolitan Fire Brigade Act, 1865; pension is based on a ' fiftieths ' scale, and the maximum (two-thirds of final pay) is earned after only 28 years' service. The member's contribution is at the rate of 2½ % of pay. The scheme is unfunded.



(c) Mental Health Officers (former established employees of the first class) (i) Under the Asylums Officers' Superannuation Act, 1909, these officers (having care or charge of patients in the usual course of their duties) qualified for pension, based on 'fiftieths', on a scale which secured the maximum (two-thirds) pension after 34 years of established service of the first class. Retirement was optional at age 55, as against the normal 60. Otherwise the scheme was as described in Appendix I, item (d). (ii) Under the National Health Service (Superannuation) Regulations, 1947-48, which superseded the above, the general conditions are preserved, but the substituted scale is based, at the rate of one per year of appropriate service up to 20 years and at two per year thereafter, on 'eightieths' for pension and on 'three-eightieths' for lump sum, reaching the maximum ( $\frac{1}{2}$ ) pension, etc., after 30 years' service as a mental health officer. (d) Prison Officers Under the Superannuation (Prison Officers) Act, 1919, and the Superannuation Act, 1935, the standard type of civil service benefits apply, but service after 20 years attracts benefit at twice the normal rate, until the maximum is reached after 30 years as a prison officer. Retirement is optional at age 55.

### **The development of Public Superannuation Schemes**

Mr A. C. Robb, in introducing the paper, said that, since it had gone to print, the Superannuation Bill, 1949, had become law, and sundry Statutory Instruments had been issued on the lines of the draft regulations referred to in the paper. The Superannuation (Prison Officers) Act, 1919, which was referred to in Appendix II, item (d), had been repealed, but similar rights were conferred by the Superannuation Act, 1949, with the modification that extended service could earn an increased benefit, subject to a new maximum.

Illustrating the desirability of standardization from a practical viewpoint he said that local-Act schemes for the local government service were originally designed purely to suit the authority concerned. The Local Government Act, 1929, required amending schemes in connexion with the assimilation of transferred staff. The Local Government Superannuation Act, 1937, required amending schemes governing mainly the pensionability of earlier service. Regulations under the National Insurance Act, 1946,

imposed modifications to avoid duplication of benefits from public moneys. Regulations under the National Health Service Act, 1946, imposed modifications in respect of local Health Service staff; moreover, contributors transferred under that Act were empowered to retain their former superannuation conditions.

The cumulative effect on the 'local-Act' fund with which he was concerned was startling. In 1947 there were six sub varieties of pension scales and conditions, but the number of possible sub varieties in that one fund had grown to no less than 136, and its administration entailed reference to ten public general Acts and forty-two local ones, not forgetting a wide range of Statutory Instruments and amending schemes. That increase in complexity resulted entirely from statutory requirements. It might, of course, be claimed that these arose from advances in superannuation methods and conditions; but they did not assist practical administration, nor did they show any evidence of a reason approach to the general question. As he saw it, the need was for a review of the whole field of public superannuation, his own conclusion being that the introduction of a generally standardized scheme was long overdue.

The question of finance was a secondary consideration, since unified finance was by no means essential, though obviously desirable in practice if it could be justified. Mr F. J. Lloyd, in opening the discussion, said that the paper set out and discussed the various superannuation schemes which covered members of the public services and employees of the nationalized boards. While those schemes were of interest to all as tax payers, and to some as actual or potential members, they were of particular interest to those actuaries who had to advise on the many problems which arose in day-to-day administration. Members and management, although partners in a superannuation fund, did not always take the same view—the members wished to secure the maximum benefits at the minimum cost to themselves; the management wished to provide reasonable benefits at a reasonable cost. In those public funds, the members either paid contributions at a fixed rate, or paid none at all, and the balance of the cost fell on the management.

In public funds the management meant ultimately the general population, who were the taxpayers or the users of the products of the nationalized industries. He approached the matter as a taxpayer, and it was in that sense that he wished to speak for the management. The main public superannuation schemes—Civil Service, local authorities, teachers, National Health Service—had approximately 1,500,000 members. The recently formed public boards for coal, electricity, transport and gas had about 2,000,000 employees.

Whether all those employees would be covered eventually by superannuation schemes was not known. The large number of members and potential members involved vast sums of money. In a funded scheme with interest at 3 %, a pension of two-thirds of final average salary after forty years' service required a joint contribution in the region of 15 % of salary for a young entrant. In the event of inflation, such as had been experienced over the last ten years, the additional resources required—conventionally described by the unhappy word 'deficiencies'—were often staggering in their amount. If, however, instead of being funded, the scheme was to be financed on an emerging cost basis, The Development of Public Superannuation Schemes<sup>23</sup> Heywood and Maples had shown that, provided the size of the working population remained the same, the cost of the benefits would rise ultimately to about 30% of the pay-roll. That figure, of course, was independent of the rate of interest.

Those liabilities, apart from the members' fixed percentage contributions, normally fell on the management—the taxpayer—because the schemes were guaranteed. An annual outgo of 30 % of the pay-roll for a million employees was an immense future commitment.

Modern accounting practice aimed at isolating individual sources of cost or expenditure, and allocating to each item or service the true cost of making the item or providing the service. Prudent finance dictated that all liabilities, as soon as they accrued, should be covered by assets. Expenditure on superannuation was an important factor in the analysis of the total cost of a service, and the appropriate provision, either as a percentage of the pay-roll or an equalized annual charge, should be made currently as the superannuation liabilities accrued. The best estimate of the necessary provision could be made by an actuary. Of the 1,500,000 members of public superannuation schemes, about 500,000 were members of local government schemes which were funded ; the other 1,000,000

members were covered by schemes which had either no funds or merely notional funds, and were, in effect, financed on an emerging cost basis. Although he would like to see the schemes for all those members funded, he could understand the historical development of the Civil Service scheme on a non-funded basis. When the size of the Civil Service was small, relative to the general population, the future commitment of a scheme on an emerging cost basis was bearable, but with the increase in the size and scope of the Civil Service, the problem required reconsideration. He would regard the trading and general service departments—Post Office, Supply, Health Service, teaching, National Insurance, etc.—as sections where it was essential that the superannuation liabilities, as they accrued, should be covered by interest-earning assets. The true cost of such services would then be disclosed, and might be better understood by politicians and the general public.

Incidentally the National Health Service was an example, on a grand scale, of a non funded scheme taking over the accumulated assets of funded schemes. When local health service staffs were taken over, the superannuation funds of the local authorities paid to the Central Government sums in cash of about forty million pounds. He understood that the Central Government had used that large capital sum as a credit to revenue in the national accounts. The nationalized industries were required by statute to balance their revenue and expenditure, taking one year with another. Since the cost of superannuation was such an important factor, he would consider it essential that those industries should make provision each year to cover all superannuation liabilities incurred during the year. Only thus could the true cost of the products of the nationalized industries be measured. Members of superannuation funds frequently asked for additional or revised benefits. He thought that it was important to assess the additional cost before an executive decision was taken.

He had heard the argument of some economists that, whether a superannuation scheme was funded or not, the chance of receiving a pension years ahead depended on the share of the national income available for pensions and the proportion of the population pensioned at that time. He submitted that if a superannuation scheme were funded, the productive investment of the fund would tend to produce, by the time of retirement, a

larger real national income to be shared, without it causing unnecessary inflation. Funding avoided subsidizing the present at the expense of the future, and it did not hide the true cost of superannuation. A benefit was fully appreciated only when its true value was understood by all parties. Was any economist prepared to argue that funding was, at that time, harmful to the national economy?. The author had advocated that there should be a standardized scheme for all public and local authority services. If that meant a single unified scheme which would be unfunded, then he would object strongly, for the reasons already given. Even if the scheme were to be funded, he could not agree that a single fund would be desirable. He believed that the best way to keep superannuation costs at a reasonable level was to disclose clearly the true cost of superannuation to each separate financial authority. Even if there 24 The Development of Public Superannuation Schemes were a single fund, he would advocate the keeping of separate accounts for each authority, so that the liabilities of each authority could be accurately assessed at each valuation.

The local conditions and practices detailed by the author in paragraph 11 (2) of the paper had a powerful effect on the finances of a fund. A single large fund would be more vulnerable, because each separate authority would try to secure maximum benefits for its own members, knowing that the cost would be shared by all the other authorities.

In addition, there were technical difficulties in forming a single fund. Those had been demonstrated in the formation of the public boards, which in effect collected together members of a number of diverse superannuation schemes. The supporting legislation usually protected the superannuation rights or expectations, whether formal or derived by customary practice, of existing members, and therefore, unless the unified scheme was at least as good as the old schemes in each and every particular, some members of the old schemes would object. This 'best of all worlds' method of unification was expensive, and the cost fell almost entirely on the management. The Ministry of National Insurance, when absorbing the staffs of the Approved Societies, granted, at the management's expense, past service pension benefits which in many cases were more generous than those previously enjoyed in the Approved Societies. It would be instructive to know the cost to the management of those concessions.

The most practical solution, in his opinion, was to close all existing funds to new members. The public board should then set up a new fund, or funds, which would become the standard of superannuation which the board was prepared, or was able, to provide. Some of the closed funds would be superior, some inferior, to those standards. If members of the superior funds wished to secure additional benefits, they should meet the entire cost themselves. Members of the inferior funds should be given an option to transfer to the new standard scheme as new entrants, paying the contribution for their attained ages. Any transfer value, or withdrawal benefit, taken over from the old scheme should be used to purchase past service benefits, on the understanding that no additional cost for past service benefits would fall on the board. If the board were prepared to be more generous than the realistic policy which he had outlined, the cost of the more generous treatment should be calculated by an actuary before the executive decision was taken, so that the true cost of the benefits might be understood.

His closing words were concerned with interchange arrangements. Under existing conditions, members of local authority funds could move from local authority to local authority taking their past service rights with them as transfer values ; civil servants had freedom to move within the Civil Service, because they remained in the same scheme; teachers had the same facility in their own sphere ; but in general a member of one public board or service, on transfer to another public board or service, lost a large part of his past service rights, because he could not stay in the same scheme nor take a transfer value. The Superannuation (Miscellaneous Provisions) Act, 1948, enabled various Ministers to make regulations permitting transfer values, but few regulations had so far been issued. In his opinion, there should be no deterrent which impeded the movement of individuals from one public service or board to any other. That interchanges of staff could be beneficial to all concerned. He saw no reason why a member on moving should not take a transfer value as certified by the fund's actuary. The technical difficulties to be overcome were not insurmountable. Transfers were not directly reciprocal. Many schemes had large deficiencies, or, in the case of the unfunded schemes, no assets, and it was for consideration how far the management should have to meet deficiency charges after the employee had left. Should transfer values be calculated on a common rate of

interest and experience or on the rates used at the last valuation of the fund? Should the new employer grant past service benefits which were equivalent in value to the amount of the transfer values, or should they be based on the number of years of past service? Mr A. Farncombe found it difficult to see why lump sums should be paid on retirement rather than at any other milestone in a man's life; lump sums on marriage, for example, would be socially more desirable. The cost of providing adequate pensions was proving an almost intolerable burden on private employers, and to attempt to compete with public superannuation funds, equipped with lump sum payments and widows'.

## **The Development of Public Superannuation Schemes 25**

Pensions, was virtually impossible. It was very surprising that public bodies, which were not usually over-generous to their active staff, should treat their pensioners so well, and it was also odd that, with public pension funds leading the way in the matter of lump sums, the Government should discriminate against lump sums in private pension funds by its taxation policy.

He was not sure that he agreed with the author that local authorities were so fond of their pension funds as to oppose bitterly their absorption in a national fund. Their experience had been somewhat unfortunate since the appointed day in 1939, and valuation reports had not made happy reading for the local finance committees. Many of them would define a pension fund as something into which large contributions were paid every year, and which produced a deficiency regularly every five years. In many cases the assets had not been invested very remuneratively, and overworked borough treasurers must find the administrative work very onerous. That state of affairs tended to react on private self-administered funds, and there was a well-authenticated story of a broker who, on reading in the newspapers of a deficiency in a local government fund, cut out the reference and used it to frighten his clients into life assurance schemes. Local authorities might well, therefore, feel a sense of relief if faced with the early loss of their pension funds, but, given a reasonable period of stable salaries and hardening interest rates, coupled with a realization that there were other outlets for the investment of funds besides a very narrow range of gilt-edged securities and loans to the authority itself, it might well be that pension funds would become a source of pride to the authority. Any scheme for the

nationalization of local government funds might then be opposed as vocally as was the case with industrial assurance.

The appendices to the paper, though very full in the case of Civil Service, local government and Health Service schemes, were less comprehensive when dealing with the superannuation schemes of public boards. The consulting practice with which he himself was connected had recently had close contact with the actuaries of the National Coal Board, and it might be that a brief examination of some of the problems arising from the absorption of a large number of small funds into the unified scheme of the National Coal Board would be of interest. Those funds were not being continued as closed funds, but members were being granted benefits in the new scheme of equivalent value to those given up. The National Coal Board had inherited a remarkable collection of pension funds, and great ingenuity had been exercised by the Board's actuaries in devising suitable terms for ex-members of those funds.

The member on transferring was granted benefits equivalent to those which he had been promised according to the rules of his former fund, and no regard was had to his prospects of actually receiving those benefits, although many of the schemes had never seen the light of actuarial investigation and were hopelessly insolvent. In some cases the pensions were paid only at the discretion of the management, there being no fund in existence. In those cases, the members could claim what were known as customary rights, which, if established, could be exchanged for equivalent benefits in the new fund.

Members of the schemes taken over had, however, the right to take what was known as assimilated benefits, whereby their existing rights to benefit were preserved so far as past service was concerned, but they must come into the new fund for future service. If they could, on retiring, prove that they would have been better off in their former schemes, they could claim the benefits to which they would have been entitled under those schemes.

Needless to say, the new National Coal Board scheme was far superior to most of the schemes taken over, and cases where members elected to take assimilated benefit were likely to be rare. On the other hand, the new scheme applied only to those in the industry of the rank of deputy and upwards, and he did not know what steps were being taken to preserve the pension rights of those below that rank.



Mr W. F. Marples said that there was so much food for thought and there were so many opportunities for argument in the paper that he wished the author had devoted a little more time and space to the leisurely development of his arguments, instead of following the modern practice and putting more in the appendices than in the paper itself. 26 The Development of Public Superannuation Schemes In the first place, there was the curious reflection on the designers of the 1922 Act to be found in paragraph 4 of the paper. It was possible that those gentlemen had had a clearer idea of the purpose of the adjustment of the Civil Service scheme than many people had at that present time. The Civil Service scheme was non-contributory and therefore did not provide the usual returns on death and withdrawal which were of help and value to a widow. The alteration was designed to make some provision for the widow, and also for the member on retirement to provide himself with a house and furnishings not hitherto acquired owing to the exigencies of the service. Those objects had since been met by other means. There were the extended provisions for allocations for widow's benefits, and more recently the contributory scheme for widows' pensions.

The means of providing houses and furnishings through income had multiplied vary greatly since 1909. The original reason for introducing the lump sum payment had therefore disappeared, but the lump sum had been perpetuated, human nature being what it is.

His own view was that the reason for the existence of a pension fund was to pay pensions. That view was supported by the published writings of various actuaries. Reference might be made, for instance, to George King's famous paper (J.I.A. Vol. xxxix, p. 129), and to the address of Mr R. C. Simmons to the Association of Superannuation Funds in 1946. It was a corollary that the subsidiary benefits should be reduced to the minimum in order to produce the maximum pension. Unfortunately, those views did not appear to command the agreement of the non-actuarial designers of schemes, who tended to overload a pension fund with lump sums, injury allowances, and provisions for death benefit in the most exaggerated form. He would affirm, however, that a pension fund was designed to provide a continuation of income to members who were no longer able to work, or to their dependents after their death. Thus, pensions and widows' annuities were legitimate products of a pension scheme. An exaggerated lump sum payment on death or

retirement should be provided by other means, if considered necessary. From that point of view, he regarded the design of the National Health Service superannuation scheme as a retrograde step in pension funds, in so far as it contained lump sum benefits. In any case, the extraordinary gymnastics by which the lump sums were given with one hand and taken away with the other were ludicrous. He would suggest to the authors of the scheme that the lump sum should be abolished. They would then find themselves in a position to increase the pension for widows and the pension for bachelors.

Much could be said about nearly every one of the advantages and disadvantages listed in paragraphs 10 and 11 of the paper, but he would like to pick out one point in particular for comment in the light of such experience as he possessed. In his opinion, control of remuneration scales, dealt with in paragraph 11 (2), required the maximum emphasis; the author's comment was, he felt, half-hearted. It was 40 years since the Departmental Committee inquired into the affairs of the Railway Clearing House pension fund and disclosed a position not merely of 'less vigilance' but of open disregard of individual responsibility in the operation of what would now be referred to as a joint contributory scheme. Anyone who knew how scrupulously the scales had to be held between joint authorities, or between an admitted and an administering authority, in a local government superannuation fund could have foreseen the situation disclosed by that inquiry, the conclusions of which were still worth studying. He would push the point further. He had a vivid recollection of an interview between an actuary and a treasurer; the former of whom maintained that the average level of remuneration had risen and the latter that he had stuck to his salary scales and had not altered them. Close investigation produced the solution : they were both right. In point of fact the treasurer had appointed many more deputy heads of his department and many more high-salaried officers, with the result the actuary had shown. The inference the speaker drew was that both salary scales and establishment numbers would have to be controlled in order to avoid acts by constituent authorities which would throw the central scheme into jeopardy.

He submitted that it would be an intolerable affront to a local authority to be told how many employees of each category it should employ, and to have to seek permission from some central authority to employ larger numbers. The Development of Public

Superannuation Schemes 27 He found himself in entire agreement with the opener's remarks on unfunded schemes.

Essentially, pensioners did not want money; they wanted clothing, a house, food and so on. The drawback to the ordinary pension scheme was that the pension was simply a ticket, under the signature of K. O. Peppiatt, for a relative share in the current production of the community, and not for an absolute share. It followed that the assets of pension funds should be employed in increasing the relative production per head of the community, so as to allow pensioners their share without reducing the standard of the active workers. He was not entirely happy that that was being done in current investment policy, and if it was not being done it was time that attention was paid to that aspect of the matter. In the meantime, he would point out once more that a funded scheme was surely saving, to which so much attention was being directed by the Government at the present time. It was an unhappy commentary that on the one hand the Government should advocate saving while on the other hand appropriating sums such as were mentioned by the opener out of capital and treating them as revenue.

He would point out also that the decision whether to fund or not had an important bearing on the scale of benefits adopted. Anyone who had taken part in discussions on the setting up of a new fund knew the vital part played by past service cost. He was always in favor of funding a scheme, whether by a private employer or a public authority, so that full appreciation of the genuine costs of the scheme could not be avoided ; that full appreciation could be achieved only when payment had to be made not only for current benefits but also for past service pensions.

If he might attempt to find the keynote of the paper, he would suggest that it was a subtle dissertation on the theme 'Let me not to the marriage of true minds admit impediment'. He would draw attention to the fact that there were so many parties to the marriage as to resemble a harem. They had been at pains as a nation to break the bonds of slavery, and he hoped that they would be reluctant to impose them, however disguised, on their institutions. Let them have standardization, but not centralization or unification, for that way lay frustration.

Mr R. S. McDougall (a visitor) said that he was the author of a paper on superannuation presented a short time before to another body, and he felt then and still felt that the three

most important things were the increase in longevity, the fall in the rate of interest (which, however, seemed to have been checked), and the increase in scales of salary. Those three things were the major causes of the large deficiencies which caused the local government officer and the finance committee so much concern. He felt sure that actuaries, when they made their quinquennial reports, would bring home to the members of the authorities the causes of those big deficiencies, which were not understood in local government. It would take a long time to make them properly understood.

He spoke, of course, as one who advised a local authority and not as one who hoped to get some benefits from the pension scheme, but to his mind the defect in the local government schemes was that the deficiencies were inevitably met by the employer, and not shared by the employer and employee. There were no provisions for varying the rate of contribution for existing members, however much the circumstances might have changed, and hence the position arose that an officer might get a substantial increase in his remuneration towards the end of his career which would ultimately cause a very severe deficiency in the fund, and that substantial deficiency was, of course, met entirely by the employer and not by the employee. The people who negotiated the 1932 Act, and subsequently the 1937 Act, may have intended that the cost of pensions should be borne equally between employer and employee, but that position had been lost, and the employer was now bearing, and would in future bear, a much larger proportion of the cost of the pension. He thought that that sort of thing ought to be brought home to the employer.

The other important matter, which had already been touched on both by the author and by other speakers, was the growing complexity of superannuation in local government, and indeed in the public service generally. The regulations issued under the National Health Service scheme covered 88 pages, and he believed that ten pages of amendments had already been issued since the regulations were published in July, 1948. 28 The Development of Public Superannuation Schemes Much more could be said about the complexities of superannuation schemes in the public service. The reason was, he thought, the insistence in every conceivable case on absolute fairness to the individual. So long as this was insisted upon, it would be necessary to go on making superannuation legislation more and more complicated. Only if there was a readiness to be content with

doing rough justice would it be possible to succeed in bringing about any form of simplification at all. He then touched on the question whether pension schemes in the public service should be contributory or non-contributory. Leaving out of account for the moment the question of funding or not funding, or of having only one fund, he wished to direct attention to the administrative benefits of a non-contributory scheme. He was well aware that the Chorley Committee on Civil Service pay recently recommended that the Civil Service scheme should be made contributory, but the only argument advanced in favour of that was that it would bring it into line with the local government scheme; in other words, transfer from the Civil Service to local government would be more simply and easily effected if both schemes were on the same basis. Personally, he felt that the proper thing was to go the other way and have non-contributory schemes for local government. He did not mean that there should be no funding; he believed that it was perfectly possible to have a non-contributory scheme with a fund, and he believed that it was even possible to refund contributions which had never been made. He thought that there were merits in doing even that. The greatest disadvantage of a non-contributory scheme was that a man leaving local government or the Civil Service and going into industry could not take his contributions away with him, but it should be quite possible to devise a scheme under which contributions he had made not directly, but by a diminution in his rate of pay, could be recognized, and a refund made.

Mr A. J. D. Winnifrith (a visitor) was definitely against standardization, his first reason being a practical one. To unify the numerous systems which prevailed, it would be necessary to negotiate with all the interests concerned and that process of negotiation would be lengthy and expensive. It would be expensive because, as a previous speaker had suggested, the process would be one of levelling up and not of leveling down. It would be protracted, because all the different bodies would have to be brought into the talks, and they would all have individual points of view. It was all very well to say that the Government should use a strong arm and mete out rough justice, but a Bill would be necessary to bring the new unified scheme into force and there was no constituent more persistent in his attentions to Members of Parliament than the disgruntled pensioner.

All the staff associations would write to all their members and all the members would write to their Members of Parliament. Could any Government be blamed for being somewhat chary of undertaking such a process?

His second point was less important. One of the reasons which had been suggested for unification was to promote interchange, and in that connexion he was going to utter the grossest heresy. He thought that far too much lip service was paid to the new doctrine, which everybody was supposed to advocate, of promoting interchangeability. Of course there should be interchangeability, but it would be over a very small area of the different services. Some people were eminently fitted for transfer, and would benefit their new service by transferring to it, but the great majority would end where they began, for the excellent reason that they had spent a large part of their service in acquiring the technique of that service, and it would be a waste of their talents to send them out to other fields. Without pressing the point too far, he said that, in the small area where interchangeability was desirable, interchange would not be stopped by the existence of different superannuation provisions; that difficulty could always be overcome if there was a sufficient reason for getting the right man into the new job.

Thirdly, as an individualist, he disliked the idea of being straight-jacketed into a uniform scheme. He was not speaking for the management, whose interests would be served by having a uniform scheme at the lowest common denominator. He thought, however, that the interests of the members of the different schemes were best served by various individuals in the different services hammering away at their different points of view and getting improvements in their respective schemes. In the Civil Service they The Development of Public Superannuation Schemes 29 had scored a point recently by securing something for their widows. The other public services had not yet got there but no doubt they would do so ; they would be stimulated by the efforts made by the civil servants and secure similar benefits under their own schemes. They should obtain those benefits, however, by improving their own schemes, the framework of which was suited to the requirements of their own services, and not by being brought within a uniform scheme.

Mr R. W. Abbott confessed to finding it ironical that, during the five years of office of a Government devoted to planning, there should have been so much unplanned

development of public superannuation schemes. He felt that the valuable paper which the author had presented should have been discussed, not by the Institute of Actuaries, but by an institute of administrators of pension funds, which would doubtless come into being if that unplanned development continued.

He would take as an example one of the most recent major developments, the extension of widows' pensions to members of the Civil Service, the National Health Service and various public boards. He wondered whether the author had emphasized strongly enough the differences between the various schemes, and particularly between the widows' benefits described in the appendices to the paper. For instance, in the National Health Service scheme there was automatic provision for a pension of one-third of the former contributor's actual or accrued pension at date of death, a benefit secured by the reduction in the lump sum payable on death or retirement from  $\frac{3}{80}$ ths to  $\frac{1}{80}$ th of the average remuneration over the last three years' service for each year of contributory service. The benefit was compulsory for all married men, and there were no children's benefits payable. On the other hand, the scheme brought into force by the Superannuation Act, 1949, for civil servants granted a widows' pension of one-third of the former contributor's actual or accrued pension, with a minimum of £26 a year, but there were in addition certain children's benefits dependent on the number of children, which might increase the total pension payable by another one-third, or £26 a year. Unlike the National Health Service scheme, existing civil servants might contract out of it, and the cost was shared between the Exchequer and the member, the latter paying  $1\frac{1}{4}$  % of salary or suffering a reduction in the lump sum payable on death or retirement of  $\frac{1}{80}$ th of the average salary over the last 3 years of service for each year of pensionable service. He felt that a particularly regrettable feature of that Act—although it was easy to see why it had been incorporated—was that there was one clause debarring the contributor from obtaining relief of income tax in respect of his contributions, despite the provisions of the Income Tax Act, 1918, and the Finance Act, 1921, thus adding one further complication to income tax law.

He referred also to the National Coal Board scheme and to the scheme for the British Electricity Authority staff, under which were included certain family benefits. A member who wished to have those family benefits paid a contribution of 1 % of his salary, and his

widow became entitled to a pension on his death of one-quarter of the accrued or actual pension of which he was formerly in receipt. Children's benefits were included amounting to £50 a year for the youngest child and £45 a year for each other child up to a certain maximum, and the Boarder Authority contributed twice as much as the member. The scheme was optional for existing and new employees. It would be seen, therefore, that there were many variations in the few schemes set up to provide widows' and orphans' benefits for public servants. There appeared to be no intrinsic reason for those variations, and it would have been a big step forward if one standard set of provisions had been adopted. Such a reform was possible in respect of widows' and orphans' pensions, because they were a recent innovation. The arguments for a unified scheme for all classes of public servants—apart from unified finance, which he deplored—were strong, but the forces against such a reform were stronger, and it would be wiser to limit any efforts which were made to an attempt to secure immediately possible reforms. Unified widows' and orphans' benefits were practicable and would, to a limited degree, ease the problem of transfers such as were in fact taking place between local authorities, the Civil Service and public boards. The standard widows' scheme he would recommend would be the National Health Service scheme, where the whole cost 30 The Development of Public Superannuation Schemes was thrown on the employee by scaling down the lump sum payable on death or retirement.

Lump sum benefits were, he agreed, a luxury, which the Inland Revenue authorities rightly discouraged by taxation regulations, with the result that private employers were rarely able to include such benefits in their pension schemes. A standard scheme on the National Health Service lines for all classes of public servants would encourage private employers to embark on widows' and orphans' benefits as opposed to lump sums on death or retirement. He would not encourage them to enter a State unfunded scheme, as the author suggested in paragraph 19, but would strongly deprecate such a proposal.

Mr M. D. W. Elphinstone thought that there was nothing so objectionable in anything that actuaries came across as the unfunded pension scheme. It was a form of promise which the members of that generation were giving to their colleagues in the Civil Service and in the public service generally, and which might be met, and probably would be met, by their successors, who would, it was to be hoped, be honest men. If met, it would be at



the expense of somebody else, because in the unfunded scheme there was no fund to be invested in capital investment, and there was no means of ensuring that goods and services were available to meet those pensions when they became due.

The same considerations applied to a funded scheme, unless the amount of capital investment was equivalent to the amount of the fund. There was a correlation between the size of the scheme and the likelihood of its being based upon final salary. The small schemes, underwritten by Life Offices, the bulk of whose investments were producing capital goods (apart, unfortunately, from some 40 % in government debt), were rarely based on final salary. Then there were the large schemes, possibly underwritten, possibly private schemes properly funded (except for the apparently inevitable deficiency), into that class came many local government schemes.

The large private funded scheme was sometimes based on final salary and sometimes not; it was occasionally based prudently on the money-purchase plan. The very large schemes, the Civil Service scheme and so on, nobody dreamed of funding and these were invariably based on final salary.

An example of the tendency to which he objected was the F.S.S.N. scheme (with which he had never had anything to do but which he believed to be an excellent scheme) ; that had been abolished and a large amorphous unfunded scheme substituted, which would be a burden to the present generation in their old age and to their successors. Of the total amount of money available to pay pensions to non-producing old people he was afraid that too large a share would go to the ex-civil service pensioners and others belonging to unfunded schemes and he believed that was a serious matter. Private industry, with its carefully fostered funded or insured schemes would not be able to afford extra payments, and it was the pensioners of the unfunded schemes who would have cost of living allowances added.

Mr A. E. Hickinbotham (a visitor) did not claim to be an expert in any way but said he was merely a lay administrator; he had, however, had a little to do with the Health Service scheme and he had to perform mental gymnastics to produce the regulations which Mr McDougall had mentioned. He would very much like to see some uniformity in schemes, because without it extremely complex regulations were unavoidable. Quite apart from the fact that they were very difficult to understand, the ordinary man was

liable to fall between them and lose rights which he ought to have. A certain amount of uniformity would be quite easy to achieve, with a little guidance. The three main schemes were already running on fairly similar lines—the scheme for teachers, the Health Service scheme and the Civil Service scheme. Discussions were proceeding for getting widows' pensions written into the scheme for teachers, and he thought that they could easily be introduced in the same way as they were in the Health Service or the Civil Service. It was unfortunate that there were different terms for widows in those two cases, but there was something close to uniformity there, and the sort of arrangement was much the same. One of the difficulties in obtaining uniformity was partly historical. All the schemes had just grown up, like Topsy, and everybody had his own opinion about their provisions.

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Personally, he thought that the lump sum had some advantages, in spite of what Mr Marples had said. There was evidence that people liked to have a small lump sum when they retired, which enabled them to change their mode of living, and it was useful when a man died for his widow to have not only a pension but also a lump sum. If some uniformity were to be achieved, he thought that the technicians would have to throw overboard some of their finer principles; it would not be possible to follow the tendency, in interchange rules, etc., to tie everything up to the last detail. He was not an expert on the question whether pension schemes should be funded. As an individual, he inclined to the view that there ought to be a fund as a way of trying to provide in the present for the liabilities of the future ; but nobody had referred to the biggest scheme of all, the National Insurance Scheme, and nobody had suggested that an enormous fund should be run for that. He thought the answer might be that a public service scheme had to be set against the credit of the employer, and if that credit was very good, as was the case where the employer was the nation or a local authority, there was no point in incurring all the expense and trouble of keeping a large fund going and of valuing it. But, even if there were no fund, he thought that contributions from the individual represented a principle which should be maintained; because it preserved the individual's feeling that he participated in the scheme and that it meant something to him.

As an example of the tendency in the non-funding direction, he mentioned that discussions were going on with a view to the dismantling of the Fire Service funds and substituting an unfunded scheme. As an individual, he felt that it was pleasant to have a fund to look at, and for contributors to be able to say 'That is our money', but in practice there were objections to it, and, even with a fund, in a scheme relating pensions to pay it was never possible to provide for the unexpected liability due to an increase in pay. It was necessary for employers when negotiating pay changes to have in mind that they had that deferred liability overhanging them.

Mr J. K. Scholey, referring to the advantages of unification of funds set out in paragraph 10 of the paper, said that some was shown as leading to corresponding disadvantages in paragraph 11 and all were minor in character. The two main factors to take into account were both disadvantages and were given under headings (1) and (2) of paragraph 11. Under heading (3) of paragraph 10 the author spoke of the ' Possibility of unified valuation, with simplified allocation to authorities (e.g. on basis of salary rolls or rateable values—although both are objectionable in certain respects).' Personally, he felt that they were objectionable in many respects. Where an actuary was called upon to allocate liabilities between two financial entities (unless those financial entities were small and closely related, when perhaps some ad hoc division might be reasonably justified) it was necessary in fairness to both authorities to have a complete valuation of each set of liabilities. That meant that it was not proper to have a unified scheme of the type dealt with in the paper, which would involve rolling everybody in together and sorting out the liabilities on some general basis.

He thought that there was a misapprehension about the nationalized boards, which, in paragraph 13, were classed with the public services. In his view, the nationalized boards were not ' public services ' in the sense that the other classes in that paragraph were. They were independent companies of which the community held the capital; they were trading companies, as the opener had so accurately put it. They were to pay their way, but they could not properly be said to do so unless they knew what their superannuation costs were, and that meant that they must have their own separate schemes.

Equity apart, even, it was the easier course for them. In addition to maintaining their own superannuation schemes, they must ' fund ' those schemes. The word ' funding ' had been

used that evening in several senses. But the minimum meaning to be inferred from the term was that they must periodically have their superannuation liabilities valued, and on the capital liability left after taking credit for any assets they must at least pay annual interest. Whether they should pay more than that and accumulate capital over the years, had been touched on by one or two speakers, but he did not think that the final answer had been given, and there was not time to deal with so big a subject 32 The Development of Public Superannuation Schemes that evening. There seemed to be scope for investigation to decide what advice actuaries should give on that problem, although it was not only an actuarial but also an economic problem.

The author had referred to the practical importance of 'administrative convenience' but he felt that administration was the second consideration to bear in mind. They must first of all make up their minds as actuaries whether unification was proper or improper on financial and actuarial grounds. If it was improper, then no amount of administrative convenience ought to tilt the scales towards unification.

There were obvious differences between the various schemes they were discussing. The author had mentioned the many Acts of Parliament to which he had had to refer. Furthermore there were no doubt anomalies, particularly in regard to the transfer of funds.

Surely, however, those differences, though not the anomalies, were part of our national culture? He did not know how many members had heard Mr Birley's Reith Lecture the previous day, in which he had pointed out the multiplicity of political forms that there were in the country, and how in that multiplicity lay our genius and strength. The issue under discussion was a much smaller one, but it should be borne in mind that the differences which were found between pension funds were not there because of the incompetence of those who framed the schemes, that the framers were not willfully obstinate in departing from the pattern set by other schemes nor blind because they failed to see that a unified scheme was necessary or desirable ; the differences were there because human problems were being dealt with, and because those who framed and ran the schemes were human beings. So far as transfer arrangements were concerned, it was obviously a good thing to eliminate anomalies, and he felt sure that there were many

ways in which, by altering and simplifying the rules governing transfer values, a good deal of help could be given to those who were saddled with the administration of funds.

Mr K. G. Smith wished to make it clear, in view of the doubt there seemed to be on the point, that the public boards which had been set up recently as a result of nationalization had separate funds and had made provision for valuation of their liabilities and for making deficiency payments to make their funds self-sufficient. It had already been pointed out that the information given in the appendices to the paper was incomplete in one particular, and that was that in the public board with which he himself was associated the independent schemes existing at the date when the board took over were not being continued. It was a similar problem to the one which was to be found in the paper as a whole, but on a smaller scale. There were 200 schemes at the vesting date, and the problem was whether they should be continued or wound up. The board decided to wind them up. The actual machinery was interesting, because it might be an example for a larger amalgamation. Each scheme was considered, and an offer was made to each member, not necessarily an offer of a year for a year. There were two simple devices which made it much easier to equate benefits. One was to offer a proportion of a year in the board's scheme for each year in the old scheme, and the other, in those schemes which were money-purchase schemes or insurance schemes and which did not relate their benefits to salary at retirement, to grant a year with a fixed pensionable ceiling instead of one related to the pension at retirement. It was possible by those two methods to allow satisfactory terms to the vast majority of people who were transferred.

There would always be exceptions, and special steps had to be taken to safeguard their rights, including the guarantee of benefits on the scale of their old scheme but limited by certain notional increases of salary, and taking into account any future difference in contributions. It was then possible for the Minister fairly and equitably to issue an order winding up the scheme, and the scheme then ceased to exist, the assets being transferred.

He was surprised that one point had not been mentioned in the paper. Most people were agreed that freedom of transfer between the various public boards was a good thing. He was equally convinced that free transfer between public boards and private enterprise was an even better thing, and it seemed to him that an immediate practical approach would be

to amend the legislation relating to approval of funds to ensure that no fund should be approved unless it was prepared to grant a transfer value in respect of.

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A member who was transferring to another approved fund. That, it seemed to him, would do away with a great deal of the standstill imposed by different pension schemes, but would not restrict future legislation on the lines proposed by the author. Mr C. H. L. Brown said that Mr Hickinbotham had referred to the National Insurance Scheme in terms which suggested that there could be no possible alternative to its being an unfunded scheme. He wished to make the point, therefore, that some people felt that the approved societies system had worked very well, and it should not be inferred that actuaries as a body acquiesced in the suggestion that the National Insurance Scheme must be unfunded. Mr G. Heywood proposed to confine his remarks to local government schemes and to the suggestion of one uniform central fund. He wished to consider particularly the effect of centralizing local government funds so far as administration was concerned. In paragraph 10 (2) it was stated that one of the advantages of a unified fund was 'Simplicity and economy of administration, including the disappearance of transfer values,' but in paragraph 11 (8) it was stated as a disadvantage of a unified scheme that the administrative saving might be relatively small. The author seemed to be satisfied that there would be some saving, but was doubtful of its extent. Presumably he reached that conclusion because it would mean the disappearance of transfer values in the form in which they were now known, and it would relieve the local authority of the necessity of making investments.

There would remain, however—and it seemed that the author agreed with that—other duties at present undertaken by the administrators of local government funds. They would still have to collect the contributions, pay the benefits, and keep some basic records; otherwise there would be an enormous correspondence between each local authority and the central body. He submitted that those duties formed the greater part of the administration of local government funds as it was, and that any saving would be very small indeed. As a set-off against any saving, moreover, there might be an increase in the work which the administrators of local government funds had to do. They would have to

make returns to the central office, if not to regional offices as well, returns which might be quarterly, monthly, weekly or even daily. Paragraph 11 (9) referred to the possibility of delay in the payment of benefits, and that seemed to indicate the existence of an even closer liaison, so that it might well be necessary to obtain authority from the central body to make any and every payment or to arrive at the simplest decision. In fact, the greater part of the initiative which was a feature of the present system of local government funds would largely disappear, and in his view would be replaced by increased routine and administrative work. Quite apart from that, the central staff would be set up on a scale at which he hesitated even to guess. He considered therefore that, taking everything into consideration, it was unlikely that centralization of local government funds would relieve the local staffs of any administration at all, and the reverse might well be the case. Taking into account the new staff of the central office, the overall result would undoubtedly be more administrative work, increased cost of administration, and a loss of man-power which could be ill-afforded in our present national difficulties.

The ultimate cost of pension schemes, excluding administration, was quite independent of centralization and depended entirely on salaries, service, and the duration of life after retirement. On the other hand, the cost of administration might be kept to a minimum or might be lavishly extended beyond any reasonable limit. He thought that the control of that cost by every local authority running its own fund was the best way to keep it at a minimum.

He would digress for a moment to refer to the subject of transfer values, as they were often referred to as a major difficulty in the administration of present local government schemes. In an effort to discover their extent, he had selected five local government funds at random, and for the five years prior to the past valuation had obtained the figure for the number of transfer values per annum expressed as a percentage of total members. That was a period when there was great fluidity in local government staffs, and many changes due to the abnormal conditions of the war and post-war years.

**34 The Development of Public Superannuation Schemes** might be expected to be a maximum. For all classes, excluding female nurses, the average figure was 1.1 % ; taking the figures for each individual fund the maximum figure was 2.2% and the minimum 0.4%. It hardly seemed to him that such small proportions could be a major problem. He

would suppose for a moment, however, that it was a problem. The simplest task was the calculation of the transfer value itself; the difficult task was agreeing the salary, the contributory service, the non-contributory service and the contributions paid with the other authority. If each local authority was to keep any records at all after unification, this task would remain, except that the amount of correspondence would be doubled by passing through a central office. Much had already been said on the subject of funding, but he felt that at a meeting of the Institute it could not be said too often. The system of unfunding completely obscured the true cost of a pension scheme, a cost which should be provided, as the opener so rightly said, when the members were in active service and were still a producing asset.

It would be unsound, in his view, to advise any company, however large and prosperous, to establish an unfunded scheme, and he saw no reason why an exception should be made in the case of a nationalized industry or the centralized fund of a service. He would welcome the continuation of the traditional actuarial method of funding.

Mr J. H. Gunlake, in closing the discussion, said that there had been a very long and full debate, and he did not think that there remained much for him to do except to underline one or two of the more important points.

While agreeing with almost everything that Mr Marples had said, he disagreed with him slightly on one point, namely, his comment on the arrangement of the paper. The paper fell naturally into two parts—first, an historical survey, very brief but extremely useful, which the author properly relegated to the appendices, and secondly, an equally brief and very tersely argued survey of certain possible future developments. The appendices were arranged in a particular way, and it was of some interest to re-arrange the information in chronological order and pick out a few of the milestones in this progress through history, because it revealed some of the salient problems as they had become apparent—problems which, of course, still existed and were still encountered in dealing with pension schemes. How, then, did it all begin? He knew of at least one very early case of the problem of a pension in the public service, and that was the problem that faced Samuel Pepys in 1660, when he took over the job of Clerk of the Acts of the Navy Board and had to deal with his predecessor. Having successfully fought him off (because he showed some signs of trying to take on the job again) Pepys allowed him a pension out of his own salary, and it



was an amusing footnote to something which the opener had said that the proportion which he allowed him was almost exactly 30%. It might be added that Pepys dealt with his own pension problem out of his own savings.

The first of the historical cases mentioned in the paper was the 1829 Metropolitan Police Act, and it was worth while reading again the words in Appendix II of the paper; the Act provided ' for discretionary allowances to such policemen " as shall be disabled by bodily injury received, or shall be worn out by length of service " '. There was the enunciation of the principle that a pension should only be granted in case of need. Some of the difficulties that had arisen in the last hundred odd years might be the result of straying a little too far from the fundamental conception.

The main event in the history of the matter, however, was the first Civil Service Act, the Superannuation Act of 1834. That scheme had a number of special features. In the first place, following up the thought that arose in the case of the police, it seemed to have been assumed that, so far as civil servants were concerned, they could be regarded as being worn out by length of service on reaching the age of 65. That might have been a reasonable assumption at the time. It was fair to add that, physiologically, the age of 65 in 1834 might have been equivalent to 70 or even 75 to-days. The next great feature of that Civil Service scheme was that it was non-contributory and not funded. He did not know anything of the circumstances in which the matter was argued at the time, but he thought that it was quite probable that those points were not very much discussed. The Civil Service, as had already been said, was then very small. It was not recruited by The Development of Public Superannuation Schemes 35 examination, but by what might be called ' appointment ', and pensions were probably granted for obvious reasons. Incidentally, the pensions for the pre-1829 entrants were at the rate of 100 % of final pay. The next Civil Service Act, the Act of 1859, took the pension-age question a little further, the idea being, apparently, that if the Government might fairly assume that a civil servant was worn out at 65, the civil servant himself might consider that he was worn out at 60, and so he was given an optional right to retire at that age. That process had been reversed recently by the belated but necessary recognition of the fact that people now lived so much longer, and remained fit so much longer, that everything possible should be done to encourage them not to retire until the last possible moment. The next piece of legislation

was the 1890 Police Act, where at last full respectability was achieved by a scheme which was both contributory and funded.

The Act of 1898 relating to teachers had an interesting feature, about which the author might be able to give a little further information in his reply to the discussion. The author said that the scheme had throughout been centrally financed but administered locally until pension age. Much might lie behind those words, and it would be interesting to have more information on how that worked out in practice.

In 1909 a new difficulty came to light, which was recognized in the scheme for asylums officers in that year. The difficulty was how to arrange that people who changed their jobs should have their pension liabilities properly allocated to their previous employers. That was a scheme financed on an emerging cost basis, and the arrangement was that the previous employers had to pay an appropriate part of the emerging cost; but it emphasized the point made in the discussion, that pension liabilities should be placed fairly and squarely on the shoulders that ought to carry them, and should be met, so far as possible, at the time when they accrued. In passing, he mentioned that he agreed thoroughly with Mr Marples's castigation of lump sum benefits. The teachers in 1918 had a new idea; they introduced a scheme which was contributory, not funded, but valued. If there was one thing worse than an unfunded scheme, it was a contributory unfunded scheme, where contributions were collected from the employees, in return for which they were given a promissory note that could at any time become the plaything of politicians and (what might sometimes be worse) of economists. The next outstanding event was the Local Government Officers' Act of 1922. That Act was very important; it recognized what he regarded as a vital principle. The arrangement was that contributions should be paid which would provide the future service pensions, and, further, the generation of that time was prepared to shoulder the liability for which its fathers and grandfathers had forgotten to provide, namely, the cost of back service. There was nothing more deplorable than to go back on that brave decision.

The main point in the paper itself arose, he thought, in paragraph 10, and he ventured to repeat what had already been said, namely, that the points set out in paragraph 10 were all answered, and to his mind most effectively answered, in paragraph 11 and in other places

in the paper. On the question of uniformity, variations were always disliked by planners and administrators and legislators, because they made work.

Perhaps no department of Government might have been better excused for objecting to variations than the Treasury, yet Mr Winnifrith had said that he was an individualist, and opposed to uniformity. There was no doubt that Mr Winnifrith was right. Human beings were untidy, and human development was untidy; that was what made life interesting. He thought it also made it efficient. Those variations were not haphazard, or the product of obstinate minds ; they had arisen for definite reasons, and before they were swept away it was necessary to be very careful indeed to see that the reasons which gave rise to them were no longer valid. The next point was economy of administration, and on that subject he had been delighted to hear, though somewhat late in the discussion, some very trenchant remarks. Centralization and uniformity, to his mind, would inevitably lead to duplication of records and duplication of function, because head office would never allow the branches to administer without checks, and the branches would never be satisfied to leave it to head office without checks. Then came the question of unified valuation. That was the second stage in the rake's progress; the first stage was uniformity of benefits, then all the liabilities were amalgamated, and the third step was 3-2.

**36 The Development of Public Superannuation Schemes** to dissipate all the assets. He did not know how it would be possible to amalgamate the liabilities while continuing to place the pension liability on the proper shoulders. Local authorities should meet the liabilities arising out of the service of their employees with them, and there was no way of seeing that they did that except by valuing the separate liabilities, as Mr Scholey had pointed out. Reference had been made to fluidity of staff, and that was a matter that might be left to the local government authorities. Clearly there was something to be said, in the national interest, for promoting the movement of staff from over-manned to under-manned industries, but whether it was equally right to promote what some unkind people might call a movement of staff from one overmanned public authority to another over-manned public authority was another matter.

The dissipation of assets was a question about which it was impossible to speak too seriously, and he was glad that so many speakers had taken that line.

He had begun his remarks by asking how pension business all originated, and perhaps he might conclude them by asking how it would all end. If all the benefits were unified, all the liabilities amalgamated and all the assets of the local government authorities dissipated, what next? That was dealt with in paragraph 13 of the paper and in the following paragraphs. Apparently a whole lot of other groups—the Civil Service, and so on—were to be put into the common pool. Would it stop there? If the Government had taken £40,000,000 and put it in the till, what might happen to the £2,000,000,000 (or thereabouts) of funds which had been so carefully accumulated by the life assurance companies? In case there might be anybody present—though he did not think that there was—who might be tempted to say that the fate of those local government funds was no particular concern of his, he would quote the terrible words of John Donne: ' Any man's death diminishes me, because I am involved in Mankinde ; and therefore never send to know for whom the bell tolls; it tolls for Thee.'

The Chairman (Mr W. F. Gardner), before asking the author to reply, said that he would like to make one human, and therefore actuarial, point. As actuaries, they might well be thought to be close to their actuarial and financial problems, but remote from the individual. They necessarily dealt with aggregations of numbers, and therefore in the minds of those who might later read the paper, and to a lesser degree of those who might read their discussions, they might seem remote ; yet implicit in Mr Robb's paper, and sometimes implicit and sometimes explicit in the discussion that evening, had been that concern for the individual, and he felt it right that he should emphasize that. He had been particularly glad to hear Mr Marples say that the object of a pension fund was to pay pensions, and that the pensioner needed his pension to buy food and clothes. There was danger in remoteness. He was sure that the members would wish to express to Mr Robb their appreciation of the paper which he had submitted and of the vigorous discussion which it had produced.

Mr A. C. Robb, in reply, expressed his thanks for the way in which the paper had been received. He had tried to write a paper which he hoped might be provocative, and in view of the discussion he thought he could claim to have been successful in that. As Mr Gunlake had pointed out, it had been necessary to set out the history in some detail, and he had had to relegate that to the appendices. Having done that he had had space in the

paper only to indicate ideas, and not necessarily to follow them to conclusions ; he had left that for the speakers in the discussion. He did not propose to deal at great length with all the points which had arisen, many of which were important but somewhat incidental to the main question of standardizing or combining schemes. He fully agreed that unification of finance was not desirable. There were arguments for it, but in his opinion, as in the opinion of most of those present, they were weak arguments.

There were far stronger and more cogent reasons for separate finance, but he did not regard those reasons as in any way detracting from the idea of standard benefits.

One or two speakers had said that they did not think that transfers were very frequent. Again he could only speak for his own authority. He hesitated to quote a figure, but he would put the number of transfer values, incoming and outgoing, with which they had dealt annually, at between 5 and 10 per cent, of the membership of their fund.

Although The Development of Public Superannuation Schemes 37 that figure included transfers of nurses, who would, to a large extent, cease, the total was certainly not inconsiderable. Probably also they saw more of the special cases of transfer values than did most other authorities, and knew the difficulties of the person who said that he had lost something by his transfer from another scheme.

That kind of thing should not be allowed. He knew that in many cases people transferred voluntarily, but they should not have artificial penalties put on them for what was presumably an increase in the efficiency of the public service—because otherwise they would not be taken into the employment of their new employer.

That kind of discrepancy could be avoided by uniform benefits. Reference had been made to the way in which those pension schemes had developed, and to the reasons behind their provisions. The reasons for creating a particular benefit at a certain time might have been very good ones even if the need for some of the provisions had since largely disappeared. For instance, the reasons for the lump sum benefit were very good when it was first introduced, for at that time no special provision was made for widows. He

agreed with Mr Hickinbotham, however, that there still remained some case for a small lump sum.

The other main point made in the discussion concerned unfunding. He agreed with everything said by the actuarial profession as to the merits of funded schemes and with regard to the National Health Service scheme, he regarded the annexation of that £40,000,000 as a completely inexcusable squandering of capital assets designed for the future.

The Exchequer might hold that as they were financing it they could run it their own way, but what about the Fire Service? That was primarily the financial responsibility of local authorities. In the negotiations which had gone on he had not heard a single local authority spokesman declare in favor of an unfunded scheme, and he had heard several very strong expressions in favor of a funded scheme; yet it was understood that the Treasury had ruled that it should be unfunded.

Mr Elphinstone later wrote: The ideas which I was trying to express at the meeting spring from the fact that when the present generation retires, the next generation will determine the total amount of goods and services which its pensions will buy. If the present generation does not make capital investment as the actuarial liabilities for its pensions grow, then it will be hard up in its old age. It will not be the servants of private industry, members of insured and funded schemes, who will then be granted cost of living bonuses to relieve their distress, but the members of the unfunded schemes, for there such relief involves no immediate deficiency. In an unfunded scheme, such extravagance is encouraged because there is no machinery to count the cost.

Members of these schemes drawing pensions based on final salaries will already hold a disproportionate claim to the goods and services available for the old people. But though their claims will be out of proportion and further increased by the reliefs, it will be these same people who will have caused distress among their fellows by claiming pensions against which there is no capital investment.

Some attempt at least is made to create real assets to back the liabilities of properly funded or insured schemes. In schemes with deficient funds—i.e. in nearly all final salary schemes—only a half-hearted attempt is made. An unfunded scheme for pensions based on final salaries is but a way of raiding the savings of other people. For this reason I consider such schemes to be wholly objectionable.

The argument is simplified—an outline only—but it should prevail, being derived from economic principles, not from administrative convenience. Our forefathers, the early actuaries, were at pains to abolish the assessment Life Offices; we have so far lost touch with the principles of our craft that we condone, and now even encourage, assessment pension schemes.

## INTRODUCTION:

IN THE past two or three years there has been considerable activity on the part of the accounting profession to establish greater uniformity in the charges made on corporate financial statements for the cost of pension plans. Many actuaries, accountants, and others interested in the problem have attempted to develop a procedure that will satisfy all parties concerned. The purpose of this paper is to set forth the nature of this problem, to give a résumé of what is currently being done, and to suggest possible solutions.

One of the principal problems existing in this area is that different technical terms mean different things to different people. Thus it is essential to have a clear definition of the terms as they are used in this paper. These follow:

**a) True cost.**--This is a theoretical figure which is defined as the amount which should be contributed for the plan in a given year on the basis that, if this same cost (expressed in dollars or percentage of payroll) were contributed for every year in perpetuity, all the commitments of the pension plan would be fully met, and at no time in the future would either more or less than this amount ever have to be contributed. Actually, this true cost can never be computed for a plan in effect but can only be estimated.

**b) Past-service cost:** This is the amount that would have been in the fund as of the effective date of the pension plan for the employees then included if the plan had always been in effect, if the company had always contributed the normal cost for the plan, and if the actuarial assumptions had been exactly realized.

**c) Prior-service cost.**--This is the amount that would have been in the fund as of the date of the valuation of the pension plan for the employees then included if the plan had always been in effect, if the company had always contributed the normal cost for the plan, and if the actuarial assumptions had been exactly realized. This is the net



accumulation of the past-service cost and the normal costs less the benefit payments and expenses, if any, since the effective date of the plan.

**d) Normal cost.--**This is the amount of the contribution to be made to the fund with respect to the service of the employees during the current year on the assumption that the prior-service costs as of the beginning of the year were fully provided for by the assets of the fund.

**e) Standard cost.--**This is the amount of the normal cost plus an additional level cost to be charged each year until the pension plan becomes fully funded.

**f) Fully funded pension plan.--**A pension plan will be considered fully funded when the assets in the fund are sufficient to provide for all the benefits credited to the participants at that point of time. The terms "contributed" or "contribution" as used above are meant to be taken in the broad sense and thus include credits to book reserves as well as contributions to insurance companies or trust funds. Also, "fund" as used in this paper is meant to include book reserves, insurance company reserves, trust funds, and the like.

For convenience, this paper is divided into the following sections: present practices, problems with present practices, accrual accounting, estimating the true cost, determination of the standard cost, practical considerations, disclosure in the annual statement, and conclusion.

## **PRESENT PRACTICES**

The concern over accounting for pension charges centers on the determination of the amount to be charged to operations each year. Also under discussion is the way the amount should be shown on the financial statement of the corporation, where it should be shown, and what supplemental information should also be provided in the annual report.

The present method of accounting for charges to pension plans on corporate financial statements has evolved because it is simple and logical in many respects. This method is to charge whatever is paid out in cash or accrued for the year. Companies which do not

have formal pension plans but which discriminately give pensions to former employees charge on the books the amount of these pensions paid. Similarly, the companies which have adopted formal plans but do not choose to fund them also charge on their books the amounts actually paid to the pensioners.

Today, most major companies have funded pension plans for which contributions are made in advance of the retirement of the individual employees. The amount of these contributions is charged as an expense as they are paid.

With the unfunded plan, or pay-as-you-go plan, the amount charged as an expense for the year will be the actual payments to the pensioners and, generally, is not subject to change by the corporation except in unusual circumstances. On the other hand, for plans which are being funded in advance, the corporation is generally allowed considerable latitude in the amount to be contributed during the year. This is particularly true for many large corporations where substantial funds have been built up in the past to meet pension liabilities. The corporation may use prior contributions to cover current costs. In this way, it is possible to eliminate contributions entirely for a year or more.

At the other extreme, the Internal Revenue Service allows corporations to contribute on tax-deductible basis contributions up to the amount of the normal cost plus 10 per cent of the past-service cost in most instances. Thus the level of the contributions in any specific year and the corresponding charge on the company's books are to a considerable extent within the control of the company. In addition, the actuary's choice of the assumptions and methods used to value the plan affect the range of the amount that can be contributed on a tax-deductible basis.

The amount charged to pensions during the year, on a condensed income and outgo statement furnished the stockholders, generally will be included with other payroll items.

Thus the amount charged to pension plans is not shown separately on the outgo statement. Many companies, however, do show the amount separately in the footnotes along with any remaining unfunded past-service costs. The term "unfunded past-service

cost," when so used, usually means the prior-service cost less the current assets, valued at cost.

The information shown in the footnotes to the annual statement varies substantially. Some companies say nothing, while others go into considerable detail. Generally speaking, there are no balance-sheet items with respect to pension-plan liabilities. For plans which are qualified with the Internal Revenue Service, contributions are made to an irrevocable fund for the employees and their beneficiaries, and the assets are not assets of the corporation. Similarly, most corporations consider the liability for pension benefits to be contingent on future events and thus not appropriate for entry on the balance-sheet account.

Occasionally, if conditions warrant, there may be accrual items with respect to contributions due and unpaid. A few companies have chosen to establish a book reserve on the balance sheet to provide the benefits of the plan. However, this procedure is seldom used today because of the tax tax advantage of having a qualified pension plan requiring a separate fund.

Usually, whenever there is a change in the benefit provisions of a pension plan, and less frequently when there is a change in the actuarial assumptions or methods, comments will be made in the footnotes to the annual statement reflecting the change in the prior-service costs due to these changes. Information will sometimes be volunteered as to how this increased or decreased prior-service cost will be met in future years.

Whether or not the increase or decrease in prior-service cost is reflected in the footnotes depends on the circumstances of the case. Consideration is given to the size of the item, prior commitments made to stockholders regarding future changes in the plan, and the attitude of the corporation, their lawyers, and the auditors regarding the importance of such disclosure. There is no uniformity of practice in this area.

The Securities and Exchange Commission sets forth in its "Regulations" that certain information must be disclosed in the proxy statements. Rule 3-19 of Regulation S-X has the following statement:

**(e) Pension and retirement plans—**

(1) A brief description of the essential provisions of any employee pension or retirement plan shall be given.

(2) The estimated annual cost of the plan shall be stated.

(3) If a plan has not been funded or otherwise provided for, the estimated amount that would be necessary to fund or otherwise provide for the past-service cost of the plan shall be disclosed.

Since the SEC requires the disclosure of any unfunded prior-service cost in certain situations, the corporations at the request of their auditors often show this same information in the footnotes to the annual statement. However, there is no requirement for such disclosure.

**PROBLEM'S WITH PRESENT PRACTICES**

Whether or not there is a problem with the present practice of accounting for charges made for pension plans depends on one's point of view. Many corporations take the position that the charge for pension expense is a minor item on the income and outgo statement, and thus simplicity should be overriding. Other corporations feel that management should have some flexibility to meet changing conditions by varying contributions- pension-plan charges--from one year to the next. This gives management the opportunity to level out minor fluctuations in earned income. Others, particularly the accountants, feel that present practices distort corporate financial statements in that companies have a choice in the amount to be charged to operations during the year. Thus a company wanting to show increased earnings may be able to do so by eliminating its charge to the pension plan entirely for a given year. Alternatively, the companies that have a particularly good year, but want to carry forward some of its earnings to a later year, can make a high contribution to the pension fund and thereby increase its current charges.

This, the accountants feel, distorts the true picture of the corporation's cost of the operation during this year, which should be disclosed to the stockholders and other interested parties.

Disagreement also exists on what should be disclosed in the annual statement and how it should be done. No one denies that pertinent information should be made available, provided further that it is not misleading or likely to be misinterpreted.

### **ACCRUAL ACCOUNTING**

Accrual accounting for the charge to operations for a pension plan means that the estimated true cost for the pension plan is charged to operations during the year regardless of the actual contribution made to the pension fund. The proposition is that the company has this cost during the year and that this cost should be entered on the books.

The accounting profession generally takes this position.

The accountants as independent auditors have the responsibility of satisfying themselves that the financial statement of a company is a true reflection of its operations and conditions for the year.

As independent auditors, they have responsibility to the stockholders, to management, and to the public in general where stock is offered to the public. Thus, to the best of their ability, they wish to insure that all items in the balance sheet and income and outgo statements reflect the actual status of the company and its operations during the period reviewed.

With respect to the financial statement, most accountants feel that the income and outgo statement and the resulting net earnings for the year are the most important financial figures. Thus particular emphasis is placed on obtaining the proper entries for this statement. Under the present cash system of accounting for pension charges, management has the opportunity of increasing or decreasing earnings by contributing a small or large amount during the year to the pension fund. It may be within the power of management to show a favorable earnings history from one year to the next for several years merely by adjusting the contributions to the pension fund. Also, it may be possible to adjust the

Results of a poor year by reducing or eliminating the contributions to the pension fund. This was brought to the public's attention not long ago in the case of a large company. In a particular year this corporation substantially reduced its contributions to the pension plan and thereby increased the after-tax earnings by approximately \$46.6 million.

### **Controlled Funding Methods:**

THE costing technique known variously as Controlled Funding, Stabilized Costing and Aggregate Costing, is a comparatively recent development in the field of Life Office group pension schemes.

Before explaining and discussing the methods used, it may be helpful to outline the principal types of Life Office group pension scheme, and to examine the more traditional methods of costing employed. It should be made clear at the outset that the term 'group pension scheme' relates to schemes insured by means of group deferred annuity contracts and approved under section 388(1) or section 379(3) of the Income Tax Act, 1952—endowment assurance schemes and group life assurance schemes are not within the scope of this paper.

### **Types of scheme**

Group pension schemes fall into the following principal categories:

#### **(1) Graded schemes**

Employees are graded according to pensionable salary and/or status (e.g. monthly paid staff, hourly paid works, etc.), and accrue a fixed amount of pension for each year of service in the grade. Contributions by employees, where payable, are usually related to the rate of pension accrual—e.g. are. per week for each £1 per annum of annual pension accrual—and the employer pays the balance of the cost. Past service at the inception of the scheme is usually recognized, on a non-contributory basis, at a proportion of the employee's grade units at entry for each year of pensionable past service.

**Special cases of the graded type of scheme are:**

(i) Pension accrues as a percentage of each year's pensionable salary; i.e. final pension is related to average pensionable salary and years of pensionable service.

(ii) Pension accrues at the same fixed rate for all members of the scheme—i.e. there is only one grade. This type of scheme is common for works employees, whose earnings generally vary little with age after the age of 21 (except to the extent that general wage increases are granted.)

**(2) Final salary schemes**

Pensions are expressed as a percentage (or fraction) of final pensionable salary for each year of pensionable service. 'Final pensionable salary' may be defined in a variety of ways; not infrequently increases in salary during the 5 years preceding normal pension date are excluded. Contributions by employees are usually expressed as a percentage of current pensionable salary; the employer pays the balance of the cost. Past service at the inception of the scheme is usually recognized, either at the same rate as for future service or at a proportion of this rate; sometimes the past service provision is based on salary at entry into the scheme, not on final salary, but this is by no means general.

**(3) Fixed benefit schemes**

A fixed amount of pension is payable on retirement at normal pension date irrespective of length of service or salary. If any contributions are payable by employees, they are generally at a fixed rate; the employer pays the balance of the cost. This type of scheme is occasionally adopted for works employees.

**(4) Money purchase schemes**

Employees contribute a fixed percentage of current pensionable salary, the employer also contributing a percentage (not necessarily the same percentage). The amount of pension is that which can be secured by the contributions.

The most popular type of Life Office scheme is still, after many years, the graded scheme. This tends to prove inadequate in times of inflation, and for this reason the final salary scheme is gradually gaining ground; sometimes final salary benefits are superimposed on a graded scheme for employees within, say, 15 years of normal pension date. Fixed benefit and money purchase schemes are in the minority: the former suffer from the disadvantage of not rewarding employees according to salary and service, and the latter are made inadequate by salary increases at the older ages.

Some schemes provide, in addition to the employee's own pension, a widow's pension for married men, generally of an amount not exceeding half the employee's pension, and payable in the event of the employee's death while in service, or after retirement on pension.

Traditional costing methods—future service There are two traditional methods of costing:

### **(1) Annual Premium method**

When an employee joins the scheme, his pension entitlement is calculated on the assumption that his salary will remain unchanged in the future. The amount of pension which will be secured by the employee's own contributions is determined, and the employer buys the balance by level premiums payable up to normal pension date. Whenever an increase in pension takes place, a similar calculation is made in respect of the increase, and the premium is adjusted accordingly. The method can be used for all types of scheme.

### **(2) Single Premium method**

This method can only be used for graded schemes. The employee's contribution for a given year is applied as a single premium to buy a pension which may fall short of or exceed the pension accrual for the year as determined by the employee's grade, depending on the age of the employee and the relationship between the unit of pension and the unit of contribution. If the pension bought by the employee's contribution falls short of the accruing pension, the balance is bought by the employer by payment of a single premium.



If it exceeds the accruing pension, the excess is carried forward as a credit against the pension accruing in the following year, and so on until in due course a year is reached in which the pension bought by the employee's contribution, when added to the excess pension brought forward from the previous year, falls short of the pension accruing in the year; a payment is then required from the employer, who will continue to make payments in all subsequent years. In both cases employees' contributions are normally returnable in full on death or withdrawal, generally without interest. The employer's premiums are usually not returnable on death.

### **Traditional costing methods—past service**

There are three methods applicable to past service pensions:

#### **Annual Premium method**

As in the case of future service, the pension entitlement is calculated and bought by level premiums up to normal pension date. The employer, pays the whole cost, and premiums are usually not returnable on an employee's death.

#### **Single Premium Indefinite Funding**

The cost of purchasing all past service pensions outright by a single premium is determined, and spread over a period by the use of an annuity-certain function. The period is referred to as the estimated duration of the spread. Each premium is applied, as it is paid, to purchase so far as is possible the pension (or the balance of pension) of the employee nearest to normal pension date whose pension is not already fully purchased; and so on. If more than one employee has the same normal pension date the premium can be applied either to buy a proportion of the pensions of all such employees (assuming that it is insufficient to buy the whole), or alternatively to buy pensions for individual employees in order of seniority of age. Employees who leave service or die before their pensions have been purchased are deleted from the rote; if the pensions have been purchased, a surrender value is payable on withdrawal, and a return of premium is made on death if premiums are being applied on that basis.

It is necessary to forecast the way in which the allocation of premiums will work out, and to test that the premium installment is sufficient to ensure that no employee can reach normal pension date before the purchase of his pension has been completed, even if there are no deaths or withdrawals. If all employees do remain in service, the purchase of pensions may take a year to two longer than the estimated period.

### **Single Premium Definite Funding**

The single premium cost is calculated and spread over a period in the same way as for Indefinite Funding. The premiums are regarded as true installments, payable for a fixed period, and each employee's pension is thus purchased by installments. If an employee dies there is no reduction in the installment unless the costing basis provides for a return of premiums on death; on withdrawal the installment is reduced for the future and a surrender value is paid in respect of the pension already bought. Care must be taken by the Life Office to ensure that it is adequately protected in the event of premium payments being discontinued.

The third method is the least used in practice, presumably because of the discontinuance position. Indefinite Funding is generally used if the number of employees is substantial, because it ensures a uniform cost for a more or less known period. Analysis of the future service methods in analyzing the costing basis for a group pension scheme, a number of factors need to be considered, among the most important of which are initial cost, future cost, turnover and discontinuance. These will now be considered in turn in relation to the Single Premium and Annual Premium methods, as applied to graded schemes; the conclusions will then be interpreted in relation to final salary schemes.

#### **(1) Initial cost**

Initial cost is an important factor in competition which must not, however, be considered out of context. A low initial cost may be achieved at the expense of a high future cost: conversely, a high initial cost may lead to a reduction in the future. The former state can arise with Single Premium costing when applied to a relatively young staff; in the extreme case of a male staff all aged under 35, with employees contributing at the rate of

is. 3d. per week for an annual pension of £1 per year of service, the employer's cost would be negligible but would rise steadily as his staff grew older.

## **(2) Future cost**

The future cost, expressed in terms of the average premium payable by the employer for each £1 per annum of pension accrual, is affected by many variable factors, more or less predictable in their effect as the case may be. The table in Appendix I indicate the general trend resulting from the operation of each of the most important factors, both on a scheme for salaried staff for whom an age-grade salary scale applies, and on a flat-rate scheme for works employees. It will be seen that the dominant upward trend of Single Premium costing as the membership ages is counteracted by three of the other five factors listed, and is not normally aggravated by the other two.

The net effect depends on their relative magnitude and on the age distribution of the present membership, weighted according to rate of pension accrual. In making estimates of future costs it is usual to ignore the last four factors and to assume an average age for replacements which may or may not take account of staff promotions. These estimates are likely to be pessimistic in the case of works schemes where the turnover is high, but may be nearer the mark for schemes for salaried staff where the turnover is usually lower (except for females). In general, it usually happens that any predicted upward trend in the cost of a Single.

Premium scheme does not fully materialize unless there is a contraction in membership. With Annual Premium costing a downward trend will be predicted, but this trend may not be fully realized in practice in a scheme for salaried staff, due to age-grade or inflationary salary increases. If the future costs were predicted allowing only for the ageing of the membership and the retirement of present members without replacement, the difference between the Annual Premium and Single Premium costs would diminish, until after some years the two costs would be equal; thereafter the Single Premium cost would be shown to become progressively more expensive. In practice the action of the other factors which

are at work in a continuing scheme causes the Single Premium cost to rise more gradually, and the Annual Premium cost to diminish more slowly, than would otherwise be the case: in fact, it frequently happens that the point is never reached—or has not yet been reached—at which the Annual Premium cost falls below the corresponding Single Premium cost.

### **(3) Turnover**

Employees leaving service generally have the option of taking either a refund of their own contributions (sometimes with, but more usually without interest) or the paid-up pension purchased by their own contributions. In the latter case the pension secured by the employer's premiums may be granted in addition. In most cases the employee elects to take a refund, and the employer's paid-up pension is surrendered.

The paid-up pension secured by the employer's premiums is always greater with Annual Premium costing than with Single Premium costing, and in the former case, when added to the pension purchased by the employee's own contributions, always exceeds the scale pension which has accrued. Unless the rules of the scheme require the excess paid-up pension to be surrendered, the employer has paid for an unnecessarily high withdrawal benefit in cases where the employee is entitled to the full paid-up pension. With Single Premium costing, this situation does not occur.

Any surrender value to the employer is necessarily less than the full actuarial value of the paid-up pension being surrendered.

For this reason, the Annual Premium method is more wasteful from the employer's point of view than the Single Premium method. There is often no surrender value at all with Single Premium costing in respect of an employee who withdraws below the age of, say, 30 because no pension has been bought by the employer, the employee's own contributions having been more than sufficient to secure his full scale accrued pension. In such circumstances, however, the only profit to the Life Office is the difference between the full actuarial value of the paid-up pension purchased by the employee's own

contributions and the return of contributions made; this is insufficient to cover expenses in respect of withdrawals at short durations.

#### **(4) Discontinuance**

On the discontinuance of a scheme for which Single Premium costing has been used, the pension secured for each member is the scale pension which has accrued (or the pension purchased by his own contributions, if greater). If Annual Premium costing has been used, the pension secured exceeds the scale pension accrued in every case.

Summing up, Single Premium costing is economical, and the level of funding matches the accrual of pensions. It does, however, lack stability, and the smaller the scheme, the greater the instability. Annual Premium costing is expensive, and the level of funding is correspondingly higher, but for small schemes it provides greater stability. Each method has its weakness, and each is inflexible in that it is not possible to make allowances for predictable future trends and hence ensure greater stability.

Whereas a graded scheme can be coasted satisfactorily without any allowance for normal future salary increases (the rate of accrual of pensions, and hence the cost, increasing more or less proportionately to pensionable salaries when such increases occur), this is by no means the case for a final salary scheme. If the costing basis makes no allowance for future salary increases in such a scheme, the effect of such increases is likely to be a sharp rise in the cost of the scheme in terms of the percentage of pensionable pay- roll. The following example, in which the build-up of a final salary pension is translated into graded form, illustrates this point: An employee joins a scheme at the age of 25.

His pension at 65 is 1 % of his salary at 60 for each year of membership. His salary at entry is £500, and his progression through the scheme is as follows:

Age	Salary GO	Pension GO	Rate of future annual accrual	Rate of future annual accrual (% of salary)
25	5 0 0	2 0 0	5.0	1.0
3 0	6 0 0	2 4 0	6.1	1.1
35	750	3 0 0	8.1	1.2
4 0	9 0 0	360	1 0 . 5	1.3
45	1100	440	14.5	
50	1400	560	22.5	
55	1700	680	34.5	
60	2000	8 0 0	58.5	

The pattern emerging, when superimposed on the pattern of future cost of an Annual Premium graded scheme, will inevitably produce an eventual rise in cost in terms of pensionable salaries.

How soon this will become apparent to an embarrassing degree will depend on the age distribution of the members (the effect is most marked in respect of the older employees with long service) and the extent to which the trend is masked by an initial past service liability, the cost of which will steadily diminish if calculated on the Annual Premium basis. Except for small groups, for which projections are particularly unreliable, Annual Premium costing is not a satisfactory method of costing final salary schemes. The inflation of recent years has served to underline this conclusion.

### **The Basic Principle**

The inflexibility of the two future service costing methods so far considered is due to each member's present position being considered and his benefits purchased individually. For this reason they are unable to take account of future trends which will affect the membership as a whole. What is required to overcome this difficulty is a costing method in which the calculation of the premium to be paid by the employer in respect of the

group as a whole is entirely separated from the application of that premium towards the purchase of pensions for individual members within the group. In such circumstances various future trends can be taken into consideration in calculating the premium for the scheme.

It will be recalled that, in the purchase of past service pensions by the Indefinite Funding method, the lump sum cost of purchasing the pensions outright is calculated and spread over a period.

Premiums are used as they are paid, to buy pensions outright for individual members in order of proximity to normal pension date. The actual amount of the installment of premium depends on the period over which it is desired to spread the purchase of the pensions; it must, however, be sufficient to ensure that pensions are fully purchased by normal pension date in every case.

The important feature of this method of purchase is that the calculation of the premium installment is entirely divorced from the allocation of the premiums paid, subject only to the solvency test.

The method forms the basis of one of the Controlled Funding techniques.

Instead of using the premiums to buy pensions outright, it is possible to apply them as level premiums to purchase the pensions of as many of the members, taken in order of proximity to normal pension date, as the installment permits. Another form of Controlled Funding uses this method, which has the merit of allocating the employer's premiums to a wider group of members.

These two methods may be described as Single and Annual Premium Controlled Funding respectively. The method of allocating premiums is, however, incidental to the main purpose, which is to separate the calculation of the premium from its allocation to individual members.

### **The level of funding**

Before the premium payable can be calculated, it is necessary to determine the level at which the scheme is to be funded. It is possible, for example, to determine a funding level just sufficient to purchase, on certain assumptions, the pensions of members reaching

normal pension date during the next  $n$  years. Such a level is clearly inadequate, since no allowance is made for the accruing pensions of other members, including new entrants; on discontinuance the pensions secured for members who had not reached normal pension date would not, if reallocated among all members in service, be sufficient to secure the accrued benefits. The value of  $n$  could be extended indefinitely, but the level of funding would then become indeterminate and could only be explained to the employer in the vaguest terms.

With a Life Office scheme it is important that the employer is told exactly what benefits his premiums may be expected to buy over a period, and on what assumptions. If the Life Office states no more than that, in its opinion, a premium of a certain amount will be sufficient to secure the benefits of the scheme, the employer has no means of judging whether the assumptions made by the Office are reasonable in the circumstances, nor any means of comparing an estimate from one Office with another from a different source. The Life Office is an insurer, and the limits of its cover should be made clear to the employer.

Considering the two main types of scheme in turn:

### **(i) Graded schemes**

In the case of a graded scheme a level of funding can be chosen which is sufficient to secure, on defined assumptions regarding replacements, the pensions of all members reaching normal pension date during the next  $n$  years, and also the pensions which will have accrued by the end of the period in respect of all other members, including new entrants, after allowing for the proportion to be secured by the member's own contributions.

The cost emerging will be approximately equal to the projected cost during the period, calculated by the Single Premium costing method and discounted and respired: in other words, the anticipated fluctuations of Single Premium costing are ironed out.

It is usual to express the premium for future service pensions as a rate per £1 per annum of pension accrual. By so doing, it is possible to allow automatically for fluctuations in membership and payroll, and to maintain the cost at a more or less constant proportion of payroll. The scheme is reposted at quinquennial or other suitable intervals, the new projection being made for  $n$  years from the recasting date and allowance being made for



pensions already purchased. The cost of past service pensions at the inception of a scheme is generally quoted separately as a level installment, being coasted on normal Indefinite Funding principles.

If the scheme is discontinued after it has been in operation for some years, the pensions purchased for members in service will, if reallocated among all members, approximately match the accrued pensions. The match will not be perfect: only Single Premium costing will produce an exact match. In order to minimize the risk of the discontinuance benefits falling below the accrued level, it may be thought desirable to quote a rate of premium at the inception of the scheme which is not less than the initial cost on the Single Premium basis: this precaution will in general only prove necessary in cases where the projected Single Premium cost is below the initial Single Premium cost over much of the control period.

## **(2) Final salary schemes**

The general principle of funding over  $n$  years the benefits which will have accrued by the end of  $n$  years is also appropriate in the case of final salary schemes. In estimating these benefits, assumptions must be made about future salary increases, and these assumptions should be agreed with the employer.

Service up to the end of the control period is taken into account, and accrued pensions may be related either to projected final salaries or to projected salaries at the end of the control period: the latter assumption results in funding at what may be described as the discontinuance level, comparable to that used for graded schemes, whereas the former results in a higher level of funding. If the assumptions are borne out in practice, future recasting (projecting over a new  $n$ -year period) will tend to show a gradual reduction in cost if projected final salaries are used, and a more stable cost if salaries are only projected to the end of the control period.

The cost of a final salary scheme is normally expressed as a percentage of total pensionable payrolls, and the function used in spreading the cost takes account of the trend of future payroll assumed in the calculation of the single premium liability.

There may be some advantage in quoting a separate level Installment in respect of past service at the inception of a scheme as this will result in a more stable normal rate of

premium, particularly if the past service installment is designed to meet only the past service liability on the basis of salaries at inception (the past service liability in respect of future increases in salary being included in the normal rate of premium). Practice varies considerably between Life Offices in the assumptions made in costing final salary schemes, and it must be recognized that these are largely a matter of individual judgment. Nevertheless it is important not to underestimate the probable effect of future salary increases; if the standard of living is to be doubled in the next 25 years, it is unlikely that present levels of salary will remain stable.

The value chosen for  $n$  should not be so short that the stability of the cost is jeopardized nor so long that undue weight is given to benefits and contributions in respect of replacements, or that the discontinuance level of funding takes too long to achieve. If the Value of  $n$  is varied from scheme to scheme there are practical difficulties of explanation and administration, and it is not uncommon to choose a fixed period such as 20 years. The effect of withdrawals and deaths on the level of funding It is usual to take no specific account of withdrawals in determining the level of cost to be paid by the employer. Withdrawals will certainly occur, and their individual effect on the funding of the scheme may vary considerably in different circumstances.

In the case of a graded scheme, there may be a release of employer's liability in respect of accrued benefits if the employee is only granted the benefit of his own contributions, and this will speed up the rate of funding. Any such release will probably be small, since it is usually the younger employees who withdraw, and there will be no release if the employee's contributions have over secured the accrued benefits. In respect of future service, there will be a release of employer's liability for older withdrawals, the value of whose future benefits forfeited is greater than the value of the future premiums and contributions (i.e. at the average rate for the scheme) which will not be paid. For younger withdrawals the reverse will apply, and there will be a strain on the funding. If, however, as is normally the case, withdrawing employees are replaced by younger new entrants, this strain will usually be fully counterbalanced, even allowing for the lower salaries of the replacements, by the excess of the value of their future premiums and contributions over the value of their future benefits.

The net effect of withdrawals and their replacement by new entrants on the rate of funding of a graded scheme is not likely to be large, particularly if full vested rights are granted, but in general the rate of funding will tend to be accelerated. If the withdrawals are not replaced the cost of the scheme will tend to rise in relation to pensionable salaries. For a final salary scheme a similar result can be deduced. Because a replacement will only accrue benefits in respect of his service subsequent to joining the scheme, whereas the withdrawing employee would have accrued additional benefits in respect of his previous service whenever a salary increase occurred in the future, the effect of withdrawals and their replacement by new entrants will be rather more pronounced than under a graded scheme.

An allowance for mortality is normally made in calculating the value of future benefits and of future contributions, and the rates of premium on which allocations are made will themselves allow for mortality. If mortality is heavier than expected at ages where no employer's premiums have been allocated, the effect will be similar to that created by withdrawals at the same ages. In addition, at ages where employer's premiums have been allocated there will be a mortality loss in respect of premiums already paid which, in the case of Single Premium Controlled Funding in particular, could exceed the release of employer's liability if employer's premiums were applied on the basis of no return on death, if benefits had been purchased which had not yet accrued. For this reason, it is usual to allocate such premiums on rates which provide for a return without interest on death; this reduces the mortality loss to the difference between the reserve value on the premium basis of the benefits secured and the amount of premium refunded.

## **Other features**

Apart from its stabilizing effect on the cost of a scheme, Controlled Funding introduces a degree of flexibility which cannot be achieved with Annual Premium or Single Premium costing. Features generally associated with Controlled Funding, in which this added flexibility is apparent, include the following:

## **1. Pensions on withdrawal and early retirement**

The benefits available on withdrawal and early retirement are fixed by rule in relation to pension's accrued to date: they are not dependent on the amounts of pension which may have been secured by the employer's premiums. In order to meet the point that the pension actually secured for him may fall short of a member's entitlement under the rules, provision is made for past allocations of premium to other members to be set aside, if necessary, and for the premiums so released to be reallocated to the withdrawing member. In the long run the level of funding should be adequate to enable such benefits to be provided out of normal premiums, unless the pensions granted exceed the accrued pensions, or their early retirement equivalent; the solvency of the scheme may, however, be temporarily affected in the immediate future, and in such circumstances it may be necessary to require an extra payment from the employer instead of permitting the reallocation of past premiums.

### **(1) Discontinuance**

A general reallocation of premiums allocated to members in service who have not reached normal pension date takes place on discontinuance. Pensions available will not exactly match the accrued pensions, but should be roughly equivalent if the costing assumptions have been borne out reasonably well in practice—except of course, during the period when the past service liability is still being met.

### **(2) Turnover**

Most withdrawal take place at the younger ages, at which no pension will have been secured by the employer's premiums. There is thus little wastage to the employer on account of surrender values. Such surrender values as do arise are generally added to the next premium and re-used. The loss to the Life Office of potential surrender profit is a point which should be considered when framing the terms for the scheme, particularly if 100% refunds of employee's contributions are to be made on withdrawal.

### **(3) 'With-profits' schemes**

If a scheme is arranged on a 'with-profits' basis, part of the bonus can be anticipated in the costing. This is an advantage both from the point of view of stability of cost and of competition with a 'non-profit' scheme. If bonuses are declared in cash, they are normally retained and treated as additional premium; if they are declared as an addition to pension, the amount of pension to be purchased is reduced. This aspect of Controlled Funding has proved to be one of the strongest motives for its increased adoption in recent years as a standard method of costing. It should, however, be stressed that Controlled Funding is not a sine qua non of 'with-profits' schemes in general.

A detailed discussion of this subject is contained in a paper by M. D. W. Elphinstone and M. W. Melton, 'With-Profits Group Pension Schemes' (T.F.A. 23, 85). Controlled Funding as a costing method for group pension schemes possesses greater flexibility and assures greater stability of cost than Single Premium and Annual Premium costing, particularly for graded schemes for salaried staff, and for final salary schemes. It is particularly valuable for 'with-profits' schemes. Its principal disadvantage is that it is not easy to explain to employers, nor indeed to the selling organizations. It may therefore prove difficult to sell—particularly when applied to final salary schemes, for which its use is especially desirable. It is not really suitable for the smallest schemes.

Life Offices differ considerably in the ways in which they apply the method; it is therefore unlikely that the views expressed in this paper will go unchallenged. If, taken with the discussion which will follow, it leads to a wider understanding of the method and its applications, it will have served its purpose.

***Group insurance'*** is an insurance that covers a group of people, usually who are the members of societies, employees of a common employer, or professionals in a common group.

Group coverage can help reduce the problem of adverse selection by creating a pool of people eligible to purchase insurance that belong to the group for reasons *other than* for the purposes of obtaining insurance. In other words, people belong to the group not because they possess some high-risk factor which makes them more apt to purchase insurance (thus increasing adverse selection); instead they are in the group for reasons unrelated to insurance, such as all working for a particular employer.

Group Life Insurance is defined as "Life insurance offered by an employer or large-scale entity (i.e. association or labor organization) to its workers or members. Group life insurance is typically offered as a piece of a larger employer or membership benefit package. By purchasing coverage through a provider on a "wholesale" basis for its members, the coverage costs each individual worker/member much less than if they had to purchase an individual policy. . People who elect coverage through the group policy receive a "certificate of credible coverage," which will be necessary to provide to a subsequent insurance company in the event that the individual leaves the company or organization and terminates their coverage

We can infer the following are the characteristics of Group Life Insurance

- a. there must be a group of people to be insured which should have something in common other than the purpose of obtaining insurance.
- b. there must be a Master Policy Holder who will retain the contract on the behalf of the member and the carriers
- c. Such covers are typically available at a discount to the respective individual rates.

Insurable Groups can broadly be classified as mainly two types - " employer - employee " groups where all members work for the employer proposing to cover them or "affinity" groups, whose members have a commonality other than employment - say deposit holders of a bank.

The Master Policy Holder of a Group Life Insurance Plan in the case of an "Employer Employee Group" is basically the Employer and for other groups would be the entity that has an insurable interest in the lives of its members. So in the case of a bank it could be said to have an insurable interest in the lives of its members who hold a deposit or have taken a loan. The Master Policy Holder also ensures each member gets their certificate of coverage stating the details of the premium paid, cover available, term of the cover and the claims process

A feature which is sometimes common in group insurance is that the premium cost on an individual basis is not individually risk-based. Instead it is the same amount for all the insured persons in the group. So, for example, in the United States, often all employees of an employer receiving health or life insurance coverage pay the same premium amount for the same coverage regardless of their age or other factors. In contrast, under private individual health or life insurance coverage in the U.S., different insured persons will pay different premium amounts for the same coverage based on their age, location, pre-existing conditions, etc. Group policies are also attractive to consumers because the average price per policy is often lower. Carriers are interested in gaining customers and will cut prices a bit to accommodate members of group. Data shows that, for example, drivers save 29% on average by attaching themselves to a group policy.<sup>1</sup>

All members for whom the premium is paid for the period and the risks in respect of such members accepted by the underwriters of the insurance company are generally eligible to purchase or renew coverage all whilst he or she is a member of the group subject to certain conditions. Again, using U.S. health coverage as an example, under group insurance a person will normally remain covered as long as he or she continues to work for a certain employer and pays the required insurance premiums, whereas under individual coverage, the insurance company often has the right to non-renew a person's

individual health insurance policy when the policy is up for renewal, which it may do if the person's risk profile changes (though some states limit the insurance company's ability to non-renew after the person has been under individual coverage with a given company for a certain number of years).

In Canada group insurance is usually purchased through larger brokerage firms because brokers receive better rates than individual companies or unions. There may be slight differences in terms of administration and market related practices world wide, even though the concept may be the same. For example, In India, broker procured group term insurance, unlike Canada, does not intrinsically have any price advantage to the buyer i.e. the Master Policy Holder.

Group Life Insurance covers may be either compulsory - in which case every member has no say in opting for the cover or voluntary where all eligible members may decide within an enrolment window to opt for the available Group Insurance. This is irrespective of who pays the premium.

Since compulsory covers offer no scope for adverse selection they come with far relaxed underwriting requirements than voluntary covers, Underwriting requirements even for Voluntary Group Life Covers are far lower than the respective requirements for individual lives.

Group Health Insurance is also provided in India. It provides healthcare coverage to a group of people belonging to a common community (typically as employees of a company). These plans are generally uniform in nature, offering the same benefits to all employees or members of the group.

Most professionally run companies today provide Group Health Insurance as a part of their Employee Welfare program. Each company however gets the plan customized based on the employee demographics.



## **Know your COBRA**

It's a safety net for those who might lose their health insurance. Here are the rules regarding your eligibility, how long your rights last and how much it'll cost you.

If you've lost your job, don't panic yet about losing your health coverage, too. You could be eligible for the continuation of your benefits.

A federal law known as COBRA (short for the Consolidated Omnibus Budget Reconciliation Act of 1985) provides a vital bridge between health plans for qualified workers, their spouses and their dependent children when their health insurance otherwise might be cut off. Because of that security, COBRA has been hailed as a much-needed safety net for families in the midst of crisis, such as unemployment, divorce or death.

Under COBRA, if you voluntarily resign from a job or are terminated for any reason other than "gross misconduct" you are guaranteed the right to continue your former employer's group plan as individual or family health care coverage for up to 18 months, at your own expense. In many cases, your spouse and dependent children also are eligible for COBRA coverage, sometimes for as long as three years. However, individual plans -- that is, plans you buy on your own, rather than through work or an association -- are not subject to COBRA law, and once you lose that coverage, you won't be able to get an extension under COBRA.

## **Are you eligible for COBRA?**

In general, three groups of people, known as beneficiaries, are eligible for COBRA coverage: employees or former employees in private business, their spouses and their dependent children. One of several types of "qualifying events" must occur in order to trigger COBRA, as outlined in the chart below. You then are eligible to buy COBRA for the maximum coverage period as determined by your beneficiary status and the qualifying event. Remember: You don't have to stay on COBRA the whole time -- nor will you always be able to -- if different coverage comes along.

## COBRA coverage periods

Qualifying event	Beneficiary eligible for COBRA	Maximum coverage time (months)
Termination of job		
Reduced hours		
Employee Spouse Dependent child	18	
Employee entitled to Medicare		
Divorce or legal separation		
Death of employee		
Spouse Dependent child	36	
Loss of dependent-child status		
Dependent child	36	

COBRA eligibility also extends to workers in state and local government, as well as to workers classified as independent contractors. However, the law grants an exemption to the District of Columbia, federal employees, certain church-related organizations and firms employing fewer than 20 people. The IRS has said that employers must figure part-time workers into their employee total to determine if they can claim exemption.

Even if you work at a small company that is exempt from federal law, you might not be completely out of luck. Many states have adopted their own laws, sometimes known as "mini-COBRA," that often grant broader rights in determining eligibility for coverage. Check with your state insurance department to find out if you are entitled to continued health-care coverage under a state COBRA plan.

Employers with self-funded health plans (generally large corporations) are exempt from state regulation of their plans, but employers who buy coverage through outside insurers (generally smaller businesses) are subject to such laws.

Keep in mind, too, that you must actually be covered under an employer health plan to be eligible for COBRA. If your employer has more than 20 workers but doesn't offer health

coverage, or offers coverage to only certain groups of employees and you're not one of them, you won't be eligible for COBRA even if one of the qualifying events occurs -- nor will your spouse or children be eligible.

### **Your COBRA coverage ends when:**

- You reach the last day of maximum coverage.
- Premiums are not paid on a timely basis.
- The employer ceases to maintain any group health plan.

You obtain coverage through another employer group health plan that does not contain any exclusion or limitation with respect to any pre-existing condition of a beneficiary. A beneficiary is entitled to Medicare benefits.

### **Paying for COBRA**

Eligibility isn't the only issue you should consider when it comes to COBRA. Cost is another major factor.

Sticker shock: For some, COBRA still proves elusive

The cost of the monthly premiums for COBRA can come as quite a surprise if you're accustomed to your employer picking up most of your health insurance tab via pretax paycheck deductions. When you opt to buy COBRA, you must pay the full premium amount -- which can be a hefty monthly sum, even for group health coverage. And don't forget to add as much as 2% on top of that for the administrative fees.

"For a family, you figure COBRA coverage is going to be \$400 or \$500 a month instead of \$40 or \$50 a month. And in most cases, they're not even getting a tax COBRA. Insurance anymore," explains Paul Fronstin, a senior research associate with the Employee Benefits Research Institute (EBRI), a Washington-based nonprofit, nonpartisan organization that conducts research about employee benefits.

For single people, you can expect to pay upwards of \$200 a month. For disabled beneficiaries who receive an additional 11 months of coverage after the initial 18 months, the premium for those extra months may be increased to 150% of the plan's total cost of coverage.

It's not surprising, then, that a 1996 survey conducted by Charles D. Spencer & Associates, covering 1.42 million workers at about 200 firms, concluded that just 28% of eligible people opted for COBRA.

Still, for someone who's only other option is getting an individual health policy or who could wind up in a state's "high-risk pool" -- generally considered insurance of the last resort for people who can't get coverage in the open market -- COBRA is generally less expensive.

And keep in mind that you can't COBRA Insurance a tax deduction on your medical and dental expenses that exceed 7.5% of your adjusted gross income.

When you're on COBRA, no longer will your employer be picking up a big chunk of the monthly premiums. You'll be responsible for paying the full amount, plus an administrative fee of up to 2%. You'll have to weigh your ability -- and desire -- to pay the extra expenses against you and your family's need for health coverage and the financial dangers of going without it.

The fact is, though, that if you have children, you should have health insurance to help pay for all those routine check-ups and immunizations they need, plus the unexpected emergencies. One broken wrist could set you back thousands of dollars.

And how are you feeling? If you have ongoing medical problems or need prescriptions frequently, you probably should opt for COBRA not only because the insurance coverage will help defray your out-of-pocket costs, but also because it will ensure that you don't inadvertently lock yourself out of the health-insurance market.

People who have "pre-existing conditions" -- meaning medical problems that exist before you buy a policy -- find it much more difficult to buy individual health coverage because

their policies can often be "medically underwritten." That is, insurers can consider the health of the applicants when deciding whether to insure someone. They could reject you for coverage completely or exclude coverage of your existing condition -- which goes against the very reason you need health insurance (some states, though, like Washington, ban that practice, and federal law forbids all group health plans from medically underwriting you).

However, the federal Health Insurance Portability and Accountability Act (HIPAA) guarantees that people who have continuous health coverage -- and meet certain other qualifications -- can't be denied insurance even if they have pre-existing conditions. So if you forgo COBRA and thus create a gap in your coverage, you would lose your HIPAA protection when you later decide to buy insurance.

Two other factors to review when considering COBRA: the extent of your health-plan benefits and your network of doctors and other health-care providers. If your plan has extensive benefits, you might want to stay on COBRA even if you're eligible for coverage under your spouse's health-care plan. The IRS says you have that right. And you might not want to risk losing a favorite doctor if you have to switch plans.

If you decide against COBRA, you still can consider buying individual insurance or even a short-term policy to tide you over until you land a new job with health benefits.

Your coverage offered under COBRA must be identical to the coverage you had before. "An employer can't allow employees to choose a less-expensive plan," notes Paul Fronstin, a senior research associate with the Employee Benefits Research Institute, a Washington-based nonprofit, nonpartisan organization that conducts research about employee benefits. However, employers can -- but are not required to -- give you the option of dropping such "noncore" benefits as dental and vision care. On the other hand, if you were covered by, say, three different health plans at the same time (for hospitalization, prescriptions, medical, etc.), you have the right to elect to continue coverage in any or all of them.

## **The rules for beginning COBRA**

Both you and your employer must follow proper procedure to initiate COBRA, or else you could forfeit your rights to coverage.

The employer must notify the health plan administrator within 30 days after an employee's death, job termination, reduced hours of employment or eligibility for Medicare.

In cases of divorce, legal marital separation, or a child's loss of dependent status, it is your or your family's responsibility to notify the health plan administrator within 60 days of the event.

Once notified, the plan administrator then has 14 days to alert you and your family members -- in person or by first-class mail -- about your right to elect COBRA. The IRS gets tough here: If the plan administrator fails to act, he or she can be held personally liable for breaching their duties.

There are two exceptions to the notification rule, if the plan allows them: First, the time limit for both notification periods can be extended; and second, employers may be relieved of the obligation to notify plan administrators that the employees quit or reduced their work hours. It is then up to the plan administrator to determine if a qualifying event has occurred. You should find out in advance what your health plan allows.

You, your spouse and your children have 60 days to decide whether to buy COBRA. This election period is counted from the date your eligibility notification is sent to you or the date that you lost your health coverage, whichever is later. Your COBRA coverage will be retroactive to the date that you lost your benefits (as long as you pay the premium).

During the election period when you have to choose whether to buy COBRA, you might initially decide not to, which means you waive your right to coverage. However, as long as the election period hasn't expired, you can change your mind and revoke your waiver, and COBRA coverage would then start on the day the waiver was revoked. Bear in mind that if you visit a doctor during the period you initially waived COBRA, you will not be reimbursed for that claim even if you later decide to buy COBRA. In this case, COBRA is not retroactive to the date you lost your employer-sponsored plan.

## **Other COBRA tidbits**

Here are a few other things you should keep in mind:

**Premium payments:** After you elect COBRA, you have to pay the first premium within 45 days. And that first premium is likely to be high because it covers the period retroactive to the date coverage ended through your employer. Successive payments are due according to health-plan requirements, but COBRA rules allow for a 30-day grace period after each due date for payment.

**Extensions:** Although COBRA sets specific time limits on coverage, there is nothing stopping the health plan from extending your benefits beyond the coverage period.

**Notification rights:** The U.S. Department of Labor has jurisdiction over issues involving notification of private-sector employees about COBRA coverage. Employers who fail to comply with the notification rules face fines of up to \$110 for every day that no notice is sent after the deadline. In addition, the IRS can assess an excise tax against any company that does not comply with COBRA regulations.

## **Life insurance-COBRA insurances no provisions for life insurance:**

**New workers:** Newly hired employees must be given an initial general notice about their COBRA rights.

**Plan description:** COBRA information must be contained in the summary of the health-plan description employees must receive when they are new to the plan.

**Switching plans:** If your employer offers an open enrollment period to active employees and you're on COBRA, you must also be given the option to switch plans during that time.

**Conversion plans:** If the health plan offers the option of converting from a group plan to an individual policy under COBRA, you must be given that option and allowed to

convert within 180 days before COBRA ends. But you'll pay individual, not group, rates, and switching to individual coverage could us COBRA Insurances any HIPAA protections you have.

**Moving:** If you relocate out of your COBRA health plan's coverage area, you will lose your COBRA benefits; the employer is not required to offer you a plan in your new area.

**Premium costs:** Your premiums can be increased if the costs of the health plan increase for everyone at the workplace, but generally they must be fixed in advance of each 12-month cycle. The plan must also allow you to pay premiums on a monthly basis if you want.

**Premium notices:** Neither the health plan nor the employer is required to send you monthly premium notices, so COBRA Insurance sure you pay attention to due dates.

**Disability:** People eligible for Social Security disability benefits may receive COBRA coverage for 29 months.

Before we discuss the specific details of group disability income insurance, let's briefly review the basic principles of group insurance coverage's. In general, group insurance refers to various insurance products available to those who collectively belong to a definable group, as opposed to individually purchased insurance policies. The most common type of group associated with group insurance is employment related. Employers frequently offer insurance to their employees as a way to attract and retain high quality people.

Although group insurance includes life and health coverage's, this chapter addresses only group disability income insurance, which is a member of the health insurance family. While many benefits are the same as those found in individual DI policies, group DI insurance is defined by several distinctive features discussed in this chapter.



## **Eligible Groups**

Exactly what constitutes an eligible group for group insurance purposes is regulated by law since certain tax benefits accrue to group participants. Following is a short summary of the common types of groups the law deems eligible for group insurance plans.

### **Single Employer Groups**

A single employer group is probably the most familiar type. Under this arrangement, a single employer makes group benefits available to its employees. Employers can be sole proprietors, partnerships or corporations. Medium and larger sized companies provide the primary market for single employer groups, which account for most existing group insurance plans. They are also a lucrative source of new business for agents selling group insurance plans.

### **Multiple Employer Trust**

Groups composed of two or more small employers who join together to receive the same group insurance consideration as larger employers are called multiple employer trusts or METs. Without METs, many small employee groups would be ineligible for group benefits since a group must have a minimum number of people-usually 10-to qualify. A separate trust is formed to handle the group business, from collecting and paying premiums to filing claims. Insurance companies and non-insurance organizations sponsor and administer METs.

### **Organized Unions**

Organized unions are groups comprised of workers in related fields, such as the Communications Workers of America, the United Auto Workers and any other organized labor or workers' union. Federal law requires a trust to be established to collect funds and otherwise administer employee benefits for unions.

## **Associations and Miscellaneous Groups**

Associations and other miscellaneous groups encompass nearly any other type of group for whom insurance benefits are made available on a group basis. Types of eligible groups in this classification vary according to state law. Typical examples are professional associations such as the American Bar Association and the American Medical Association, associations made up of people who are members of automobile clubs, fraternities, sororities, and just about any other group with a common relationship that is recognized by state law.

## **Creditor-Debtor Groups**

Creditor-debtor group insurance is offered by a lender to people who borrow money. The purpose of credit DI insurance is to protect the creditor to whom the policy's benefits are paid if the debtor becomes disabled (or dies, in the case of credit life insurance) before the debt is paid. Some credit coverage's are provided as individual policies, rather than group policies.

What qualifies each of these entities for group insurance is the factor the members have in common-their employer, their union or association, or their group status as debtors to a particular financial institution. Some insurers also make group insurance available to those whose common relationship is even more tenuous, such as people who hold a major credit card through the same organization. Some of these less well defined groups are solicited for group insurance through the mail or other direct advertising. Because people so solicited essentially select themselves for coverage, rather than being qualified by an insurance agent and underwriter, these groups tend to have a greater tendency toward adverse selection-a preponderance of high-risk insured's who are most likely to have claims.

## **Group Underwriting**

Naturally, insurers want to avoid adverse selection by balancing the number of high-risk insured's with low risk insured's. This is the essence of group underwriting. Most types of group insurance have this balance built in since there is a large pool of people of varying ages and health conditions who come and go and are being replaced in the group

with some regularity. Group plans require the participation of a high percentage of eligible people to ensure that the plan is not composed primarily of those who are likely to have claims. Additionally, group members must sign up for insurance coverage very soon after they become eligible-usually within 30 or 31 days. This prevents those who do not purchase the coverage initially from changing their minds when they are injured or ill and want to use the plan's benefits-another feature of group underwriting that helps avoid adverse selection.

Of the eligible groups, METs are scrutinized more carefully than others because each "sub-group" is small, whereas group insurance underwriting principles depend on larger numbers. The MET sponsor decides what requirements the smaller groups must meet in order to be accepted into the group. When enough sub-groups are included in the MET to form a large group, underwriting and resulting rates are essentially identical to those of larger groups.

### **Advantages of Group Coverage**

The characteristics of group insurance we've described help insurers avoid adverse selection, but the same characteristics are also the foundation for the advantages group coverage offers the group members. One advantage is that people who sign up within the specified time are not normally subject to medical examinations that could uncover an uninsurable condition. Therefore, essentially everyone in the group may have coverage regardless of their current physical conditions. That's the general rule: there are exceptions.

Some insurers routinely require individual medical exams and underwriting for the very smallest groups only, while members of larger groups need not meet this requirement. This is typical, but there are exceptions, so it is important to know exactly how a particular insurer writes group coverage. Some insurers require new group members to complete an application and answer medical questions, but not to have physical examinations.

However, a more recent trend among insurers is to require more medical exams and financial information about individual group members. These stricter requirements have arisen from the more liberal benefits appearing in many group DI plans—benefits similar to those provided in high quality individual DI policies that offer greater monthly benefits and fewer restrictions.

As long as individuals remain with the group, they have some measure of security that the coverage will remain in place. Group plans may be canceled only if the insurer cancels the entire group: no person's group coverage may be canceled individually because of poor claims experience. While it's possible for a particular group's experience to be so adverse an insurer might choose to cancel the entire group, this is a fairly rare event. And finally, members of the group benefit from insurance rates that are lower than individual rates. The lower cost is possible because the insurer's risk is spread among so many people, most of whom will never have a claim. As a result, premiums from the entire group help offset the disability claims that do occur.

## **Group DI Compared to Individual DI**

How does group DI coverage compare to individual policies? Some of the primary differences and similarities are presented in this section, and then expanded later under the descriptions of short-term and long-term DI coverage. While direct comparisons are difficult because of wide variations in benefits and other provisions among both types of coverage, this section highlights typical differences.

## **Employee Benefit Regulations**

Like all employer-sponsored group benefits, group DI is subject to both state and federal regulation. Laws governing employee benefits address issues such as nondiscrimination, employees' rights and privileges, dependents' rights and privileges, to name just a few. The details of employee benefit plan regulation are beyond the scope of this course. If you plan to work this market and you are unfamiliar with the area, we encourage further study outside this course.

## **Eligibility**

Employees must meet eligibility requirements for group DI coverage just as they do for other group benefits and the details may vary somewhat among employers and among particular group plans. A basic requirement for group DI is full-time employment, which is usually defined as 30 or more hours per week.

Workers must be continuously employed for a probationary or waiting period before becoming eligible for the plan. A 90-day period is most common. When that period expires, employees who are still actively employed full time may sign up for the coverage during the enrollment period, which typically extends for 30 or 31 days.

You'll recall that little or no medical or financial underwriting is usually required when eligible employees enroll promptly, unlike individual DI coverages that always require medical and financial information. Employees who fail to enroll during this period may still be eligible for the coverage at a later date, but generally would be required to undergo a medical exam at that time and take the chance of being rejected for coverage based on the results of the exam.

## **Policies and Premiums**

Like all group insurance plans, group DI is written with the employer or other sponsor as the master policy owner. The employer holds a master policy and each enrolled individual receives a certificate of insurance detailing his or her particular coverage. While these plans must be nondiscriminatory, the certificates differ somewhat because of salary levels.

For example, a maximum monthly dollar benefit must be specified in the certificate and that maximum will often be quite different for clerical workers than for highly-paid executives.

Because of group underwriting principles, premiums for group DI are typically less than for a comparable individual policy. However, because of the wide variations in benefits, direct comparisons are not easy to make. Employers may pay all or part of the premiums

for employees, but tax rules make it more advantageous for employees to pay their own premiums. Remember that DI benefit payments are not taxable income to disabled employees who paid the premiums themselves. Conversely, any part of the benefit attributable to employer premium contributions is taxed as current income.

Many employers today pay the premiums for short-term disability (STD) benefits (often through salary continuation plans funded by DI insurance) and require employee contributions for long-term disability (LTD). STD benefits are generally defined as those extending up to 52 weeks (although 13 and 26 weeks are more common) and LTD benefits are those payable for longer than one year. It is also becoming more common to require employees who want to participate to pay 100% of the premiums for LTD plans. When employee contributions are mandatory, the employer must provide a way to collect the premiums and pay the insurance company, usually by payroll deduction.

### **Provisions for STD and LTD**

When a group plan provides both short-term and long-term disability benefits, different provisions may apply to each. For example, the elimination period for STD benefits might be as short as seven or 14 days, compared to the typical 90-day elimination period for LTD. If the employee becomes eligible for STD benefits and later for LTD benefits, these must be carefully coordinated to avoid over insuring.

A dual definition of total disability is common in-group DI policies. For both STD and LTD benefits, the "own occupation" definition is typically used initially. Then, if disability continues beyond a stipulated period, the disabled person must qualify under the "any occupation" definition.

### **Other Group Provisions**

Group DI policies usually cover only non occupational injury or sickness, specifically stating that benefits provided by workers compensation or similar disability plans will not be duplicated or replaced by the group policy.

The pre-existing conditions provision in-group DI policies is sometimes more restrictive than its counterpart in individual policies, largely due to the absence of medical underwriting. However, sometimes the pre-existing conditions provision must be eliminated from a group DI plan when the plan replaces an existing one under which an employee had already satisfied the pre-existing condition requirements.

For example, suppose the existing plan did not pay for a pre-existing condition until after the employee had been in the plan for 12 months. Employee Baxter has met that 12-month requirement under the existing plan for herniated disk. Now Baxter's employer drops the plan and installs a new plan with another insurer. The new insurer is prohibited from imposing another pre-existing condition restriction on Baxter for the disk problem. Whether or not this restriction applies may depend on state regulations and/or the insurers involved.

We have discussed a number of desirable benefits and optional riders that are often available with individual DI policies. Many such benefits and rider options are not available for group DI policies.

One of the most significant differences between group and individual policies is that most group DI coverage may be canceled for the entire group at the insurer's option. The insurance company also may raise premiums for the entire group. You've learned that individual policies, on the other hand, are often non cancelable and for the best classes of risks, premiums remain level throughout the policy term. Now we will look in more depth at group STD and LTD plans.

### **Short-Term Disability (STD) Plans**

In the previous chapter, we discussed salary continuation or sick pay plans that provide short-term disability (STD) benefits for employees. You learned that one way to fund such plans is with disability income policies. Another market for STD policies exists in some of the five states that require employers to provide short-term temporary benefits

for non-occupational disability. If you plan to do business in any of these States-California, Hawaii, New Jersey, New York and Rhode Island-you must determine whether a commercial DI plan may be used. Some states require a state-operated plan to provide these benefits while others allow employers to use commercial policies.

Another name for STD benefits that you will encounter in some jurisdictions is weekly indemnity insurance. In some locales, the term used for STD benefits is accident and sickness insurance. This can be misleading since the accident and sickness terminology more often refers to medical expense insurance.

### **Probationary Period**

For group STD policies, the probationary period following employment and during which the employee establishes eligibility extends for three months or less. A few STD plans eliminate the probationary period completely, but these are rare. On the eligibility date, the employee must be actively at work in order to enroll in the plan.

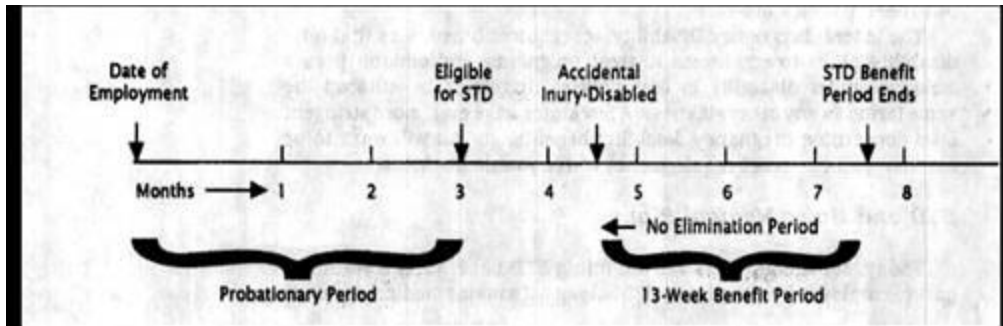
### **Elimination and Benefit Periods**

STD policies have a very short elimination period for sickness-either seven or 14 days. There is usually no elimination period for accidents, so benefits begin on the first day of disability.

By definition, STD benefit periods are short, generally six months or less. Some STD policies pay for as long as 52 weeks, but overall, periods of 13 and 26 weeks are the most common. Some insurers identify their short-term disability plans by numbers that describe the elimination periods for accidents and for sickness as well as the benefit period. For example, an STD plan referred to as a "1-8-13" plan is one that pays accident benefits beginning on the first day of disability, sickness benefits beginning on the eighth day of disability and, in both cases, for a 13-week benefit period.

Figure 6-1 illustrates how the probationary, elimination and benefit periods might apply. In this example, the probationary period is three months, there is no elimination period for disability from accidental injury and the benefit period is 13 weeks.





## STD Benefits

The actual amount of the STD benefit is based on weekly income, rather than monthly income and there is wide variation in the percentage of income paid for the short term. While 66 2/3% is common, the range is from 50% to 70% and even 100% in some cases. Following are several ways STD benefits are handled.

Some employers provide a STD policy that pays a certain percentage of the employee's gross weekly earnings and the employer bears the balance, so the employee actually receives 100% of earnings in the form of salary continuation or sick pay benefits. For example, let's say the STD policy pays 60% and the employer pays the 40% balance. A certain employee earns \$700 per week. Here's how the plan works:

STD Policy:  $\$700 \times .60 = \$420$  per week

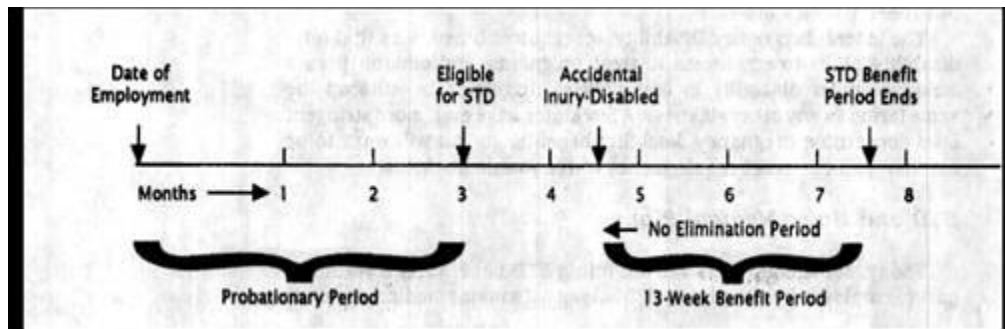
Employer:  $\$700 \times .40 = \$280$  per week

Employee receives:  $\$700$  per week

You'll recall that disability income policies typically pay less than 100% of earnings. However, when salary continuation or sick pay benefits are funded by a short-term disability income policy, full income may be paid either through the STD policy itself or through a combination of the employer's direct contribution plus a percentage of income provided by the disability policy as illustrated above.

Some STD plans provide two different percentages of earnings, depending on the income level. For example, a higher percentage, perhaps 70%, might apply to weekly earnings up to \$999 and a lower

Figure 6-1



STD Application percentage, 50% perhaps, to weekly earnings of \$1,000 and over. Then, a maximum weekly benefit is likely to apply to all levels, such as \$1,000 per week regardless of actual income. Here's an example:

Weekly Earning	STD	Weekly Benefit
\$3,000	50%	\$1,000
\$1,200	50%	\$ 600
\$ 500	70%	\$ 350

In the first example, notice that although a 50% benefit would equal \$1,500, the \$1,000 weekly maximum applies. Usually, the policy also stipulates a minimum weekly benefit of perhaps \$100.

Still another method for paying STD benefits is to pay 100% of weekly earnings for a certain period-four to six weeks are common-followed by 70% or some other percentage for the duration of the STD benefit period. Here's a comparison of the total STD benefits paid under this arrangement versus two other, lower percentages paid uniformly for the

same period. We're assuming weekly earnings of \$500, 12 weeks of benefits with 100% of wages paid for six weeks in the first example.

$$\begin{aligned} \$500 @ 100\% &= \$500 \times 6 \text{ weeks} = \$3,000 \\ \$500 @ 70\% &= \$350 \times 6 \text{ weeks} = \$2,100 \\ \text{Total Benefits} &= \$5,100 \end{aligned}$$

$$\begin{aligned} \$500 @ 70\% &= \$350 \times 12 \text{ weeks} = \$4,200 \\ \$500 @ 66\% &= \$333.50 \times 12 \text{ weeks} = \$4,002 \end{aligned}$$

These are some of the more common ways percentages of earnings and duration of benefits may be applied. You will want to determine the details of the STD plans you sell.

### **Definition of Disability**

Most STD policies use the liberal "own occupation" definition of total disability to trigger benefit payments. This means the insured is unable to perform the substantial and material duties of his or her own occupation. A few STD policies still include the more restrictive definition, requiring the inability to work in any gainful occupation, but these policies are rare.

The federal Pregnancy Disability Act requires businesses that offer disability plans to employees to treat pregnancy and childbirth as a sickness under disability income policies, triggering benefits on the same terms as any other sickness. A few states have even more stringent laws concerning pregnancy disability benefits, so you will want to be familiar with the exact requirements where you do business.

## **STD and Major Medical Plans**

Today, some employers are including STD benefits as a standard part of employee health plans, right along with major medical expense coverage's. Other employers offer STD coverage separately as an option the employee may choose or not. In whatever form, many employers offer STD benefits at every income and occupational level within their companies. As you will see in the next section, long-term disability benefits may be offered differently.

## **Long-Term Disability (LTD) Plans**

After the short-term disability benefit period ends, many group plans provide long-term disability benefits when the employee is still disabled. However, LTD benefits, unlike STD, are sometimes made available only to higher-income, usually salaried, personnel rather than to both salaried and hourly employees. For example, the LTD plan might be available only for employees earning \$30,000 or more annually. There are two reasons for this. First, lower-income earners are often covered adequately by social insurance programs. Second, because insurance company experience shows that lower-income and hourly employees as a group incur greater claim costs, the risk is less desirable from the insurer's point of view.

## **Probationary Period**

Different LTD and STD plans might have probationary periods as short as three months before the employee is eligible to enroll. On the other hand, some LTD group policies require an employee to be continuously employed for as long as one year before becoming eligible.

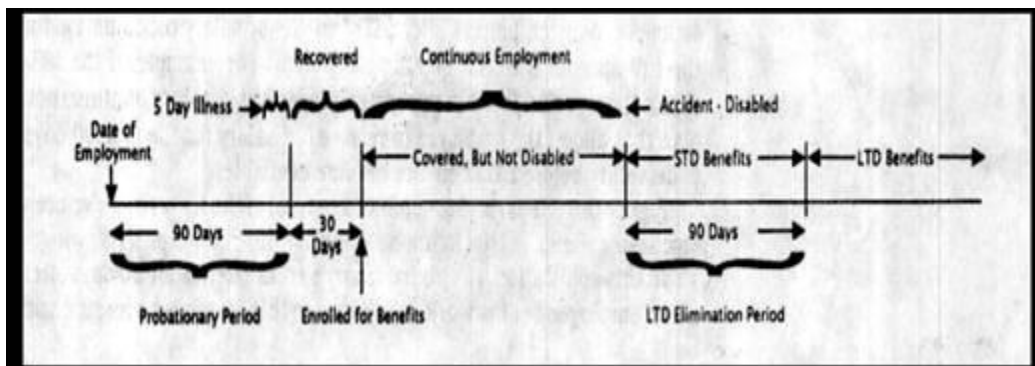
Some LTD plans also require the employee to be actively at work for a specified period-30 days, typically-without illness or injury in order to enroll. For example, suppose the three-month required probationary period has passed for a certain employee, but the employee has been ill for the final four days of the last month of the probationary period.

This person would be ineligible to enroll until 30 more days have passed during which the individual was at work full time, with no intervening illness.

## Elimination Period

Insurance companies offer a wide range of elimination periods for group LTD plans, from as few as seven days to as long as one year. In between, 30, 90 and 180-day periods are generally available, with the 180-day, or six-month, period most common. Unlike STD plans, LTD plans do not usually specify different elimination periods for injury and sickness. Many employers offer STD benefits or salary continuation for the full span of the LTD elimination period. For example, if the LTD elimination period is 90 days, the employer has a salary continuation plan that allows the employee to receive full salary for the first 90 days of disability before LTD benefits become available.

Figure 6-2 combines several of the features we've been discussing. Refer to this figure as you read the paragraphs following.



In this application, the probationary period extends for 90 days after a new employee begins work, but because this employee was sick and off work during the last several days of the probationary period, he is not eligible to enroll until 30 more days of continuous employment. When this requirement is fulfilled, he enrolls and is eligible for LTD benefits.

The employee works for some indefinite time, then suffers an accidental injury that leaves him disabled. His group LTD plan has a 90-day elimination period, but the

employer provides salary continuation through a STD policy that has no elimination period for disability from accidents. At the end of the 90-day elimination period, the STD benefits stop and, since the individual is still disabled, LTD benefits begin.

This is just one way STD or salary continuation benefits and long-term disability benefits might be combined to provide significant income replacement under a group disability plan. As usual, you must be fully aware of the types and duration of benefits available from the insurers you represent in order to offer options that will meet the needs and desires of different group sponsors.

## **Benefit Period**

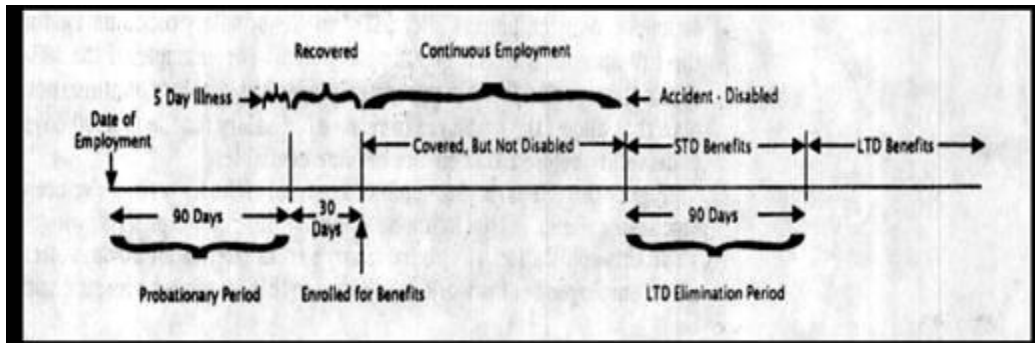
By definition, the benefit periods for LTD are longer as compared to short-term disability plans, but some LTD plans pay benefits for no more than two or five years. Of the longer periods available, two of the most popular are benefits paid to age 65 and lifetime benefits.

## **Lifetime Restrictions**

When a long-term disability plan pays benefits for a lifetime, insurers usually impose additional restrictions. Some policies stipulate an upper age before which the coverage must be purchased. As an example, if an individual is covered by the LTD plan before age 45, the lifetime benefit period applies. For those age 45 and older when the plan becomes effective, the benefit period is restricted to age 65.

Other LTD plans specify an age before which disability must begin in order for lifetime benefits to be paid. For example, a person age 50 or younger when disability begins receives lifetime benefits, while a disability that begins at a person 5 age 51 or older pays benefits only to age 65.

Figure 6-2



### Application of Salary Continuation and LTD Benefits

## Age Discrimination in Employment Act

While insurers and employers may place some restrictions on lifetime benefits, they also must consider the requirements of the Age Discrimination in Employment Act. Under this law, the upper age limits must be adjusted in some cases. The general requirements include:

- \*Extending benefits to age 70 when disability occurs before that age.

- \*Paying benefits for disability that occurs after age 70, tempered by a shorter benefit period than if disability had occurred earlier.

As an example of how the shorter benefit period might apply, the plan could be written in such a way that any disability occurring at age 70 or earlier calls for a benefit period of 18 months. However, if the individual is age 71 or greater, the benefit period is shortened to 12 months.

## Benefit Amount

The monthly benefits paid under group LTD policies are determined in various ways, with

a percentage of gross earnings being the most typical method. While options range from 50% to 70%, 60% or 66⅔% are common. An upper limit generally applies to the amount of monthly benefits available-such as \$6,000 or \$8,000 per month. In other words, the benefit paid is the lesser of the dollar maximum or the specified percentage of earnings. Different maximums apply at different income levels in order to retain the incentive to return to work and avoid over insuring. As is true for STD policies, different percentages may be used at different income levels: higher percentages for lower incomes, lower percentages for higher incomes. Similarly, LTD plans specify monthly minimum benefit amounts as well.

Some plans use different percentages for the same individual's income, paying a higher percentage for income up to a certain dollar amount and a lower percentage for all income that exceeds that amount. Suppose Rosanne O'Malley earns \$7,000 per month. The LTD plan her employer provides pays 66⅔% of earnings up to \$5,000 and 40% of amounts from \$5,001 up. O'Malley's monthly benefit is determined like this:

$$\$5,000 \times .667 = \$3,335$$

$$\$2,000 \times .40 = \$ 800$$

$$\$4,135 \quad \text{Total Monthly Benefit}$$

The actual percentages that apply when this split percentage arrangement is used vary from insurer to insurer.

## **Rehabilitation Benefit**

Because of the good experience insurers have had in providing payments for rehabilitative services for disabled insured's, more and more group LTD plans today pay some form of rehabilitation benefits.

While the specific details vary from plan to plan, it is typical to as encourage a disabled employee to return to work by paying a reduced benefit during a "trial" work period.



Instead of discontinuing benefits as soon as the employee returns to work, the insurer pays the smaller benefit for a short period during which the employee determines whether he or she will be able to be gainfully employed.

During the trial period, the employee receives both the reduced DI benefit and current income. The amount of the rehabilitation benefit is generally determined by reducing the total disability monthly benefit by a certain percentage of current earnings-usually from 50% to 80%. Let's say employee Trevor Brandt has been receiving a \$2,000 per month disability benefit. He returns to work part time for a trial period during which he earns \$1,400 per month. This particular insurer pays a rehabilitation benefit that is the disability benefit reduced by 70% of current income.

Current earnings of \$1,400 x .70 = \$ 980

Monthly total DI benefit = \$2,000

Minus earnings reduction = -980

Rehabilitation benefit = \$1,020

Plus current earnings = \$1,400

Income during trial period = \$2,420

Thus, the rehabilitation benefit allows the disabled employee to return to work gradually, possibly improving the changes the individual will be able to return to full time gainful employment. The reduced DI benefit supplements the income so the individual is not discouraged from returning to work at a lower income than before the disability occurred since current income and the rehabilitation benefit combined provide more income than the total DI benefits alone.

After the trial period, the individual would normally either return to work full time and DI benefits would stop, or, if the trial employment indicates that the individual is unable to continue working, the full DI benefits would be reinstated without requiring a new elimination period.

Remember, too, that many insurers pay rehabilitation benefits in the form of payments for vocational rehabilitation or medical rehabilitative services, whether or not such benefits are specifically mentioned in the policy. Insurers recognize that helping disabled insured's in this way can reduce the insurance company's outlay in the long run by making it possible for the individual to become employable again, rather than continuing to receive DI benefits.

### **Residual Disability Benefit**

Another partial benefit that goes hand in hand with rehabilitation is the residual disability benefit discussed at length in Chapter Two. When residual disability is covered in a group LTD plan, the insurer may agree that, if the individual's post-disability earnings are at least 20% less than pre-disability earnings, a proportionate residual benefit will be paid.

For example, suppose a disabled employee was receiving \$2,000 in DI benefits each month. He returns to work, but earns 30% less than his pre-disability earnings. The insurer pays a residual benefit equal to 30% of \$2,000 or \$600 per month to this insured. A time limit is placed on the period for which the residual benefit will be paid, often up to two years as long as the post-disability earnings are reduced. Like the rehabilitation benefit, a residual benefit encourages the insured to attempt to return to gainful employment.

Some LTD policies call this a partial benefit rather than residual benefit, although it does not operate like a true partial disability benefit. These partial or residual benefits are often found in group LTD plans for the best classes of risks—professionals and a few other high-income earners.

## **Definition of Disability**

Group LTD policies often use a dual definition of total disability. The "own occupation" definition probably applies for a period ranging from one to five years, with 24 or 36 months the most commonly used time. If the insured is still disabled after the stipulated period, the "own occupation" definition is then replaced with the "any occupation" definition. This requires the insured to be unable to engage in any gainful employment for which he or she is reasonably suited by training, education or experience.

Some group LTD policies include a presumptive disability benefit that is paid when the insured suffers loss of limb or eyesight. The elimination period is typically waived for presumptive disability and monthly benefits begin at once.

## **Benefit Coordination**

Avery few group LTD policies provide coverage for both occupational and non-occupational injury and sickness, rather than just non-occupational disability. Even so, the benefits must be coordinated with any other DI benefits from programs such as workers compensation.

Additionally, group LTD benefits will always be coordinated with any other potential or existing DI benefits such as Social Security, state cash sickness temporary benefits or other government-sponsored benefits. Other possibilities include any STD or sick pay plan the employer provides, pension benefits that might be available earlier than retirement age because of the disability, and any individual disability income policies the individual owns.

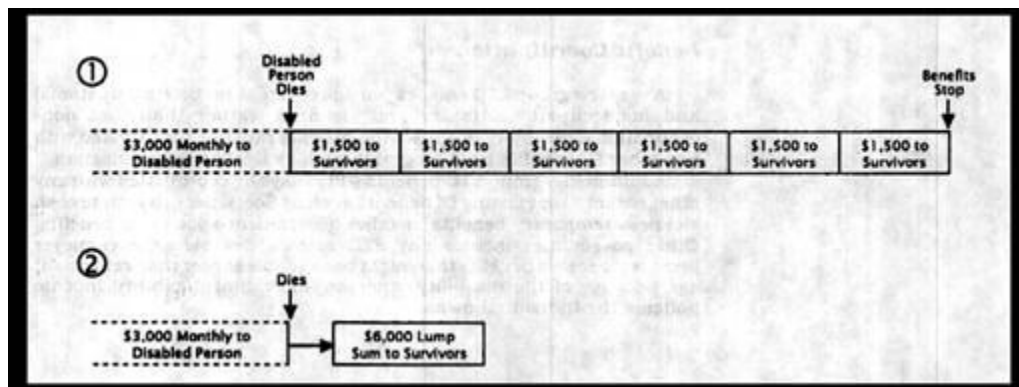
## **Survivor Benefits**

Some group LTD policies pay survivor benefits when a disabled insured dies after having received DI benefits from the policy. Typically, the survivor benefit is paid only if the deceased received benefits for a certain length of time, such as six months. The LTD policy specifies who are "survivors" for purposes of receiving the benefit. Survivors

generally include a spouse or children younger than age 25 or 21, depending on the policy. If the deceased has no such survivors, the benefits are paid to the estate.

There are at least two different ways survivor benefits might be paid. Under some policies, the survivors receive a reduced monthly benefit for a short period or up to as long as two years. Other policies pay survivors a single lump sum equal to two or three times the monthly benefit the disabled person was receiving before death. Both of these methods are illustrated in Figure 6-3.

Figure 6-3



## Exclusions in Group DI Plans

Exclusions most frequently written into group disability income plans include these:

- \*Disability resulting from acts of war.
- \*Disability resulting from participating in criminal activities.
- \*Disability resulting from self-inflicted injury and/or attempted suicide.
- \*Disability resulting from certain mental conditions and substance abuse, although these may be covered for limited periods.
- \*Periods during which the individual is not under a physician's care.
- \*Disability that began before the individual was covered under the group plan.
- \*Employment of the insured in any gainful occupation.
- \*Disability from pre-existing conditions as defined in the policy.

Remember, however, that pre-existing conditions for certain individuals must be covered when a group plan replaces another group plan under which the requirements for pre-existing conditions had already been met.

## **Opportunities in the Group Market**

The group disability income insurance market is a large, potentially lucrative source of new business for you. Although many businesses already have group health and life insurance plans, fewer plans include group DI insurance. The less stringent underwriting and lower individual cost that characterize group disability plans are just two features that make this coverage attractive to both employers and employees. The trade-offs in benefit restrictions as compared to individual policies are often worth the difference in price and availability to more people.

Because only a small percentage of people have individual disability income policies, group DI coverage fulfills a genuine societal need. Group DI is the only income protection that some people have, barring catastrophic disabilities that qualify them for government DI benefits. And, people whose incomes fall in the lower range and who are therefore not good candidates for individual policies are usually eligible for group DI.

Finally, group DI can be incorporated into an employer's benefit package at very little cost to the employer since there are tax advantages to having premiums paid by the employees themselves rather than by the employer. These are some of the advantages you are in a position to promote with employers and other groups as you work in this market.

If you are a small business owner or operator and want to get an explanation of the way premiums are priced for the company, then please read on. There are basically two ways these premiums can be calculated.

## **Group Insurance Pricing**

The pricing (rate making) process in group insurance is essentially the same as pricing in other industries. The insurance company must generate enough revenue to cover the cost of its claims and expenses and contribute to the surplus of the company. It differs in that the price of a group insurance product is initially determined on the basis of expected future events and may also be subject to experience rating so that the final price to the contract holder can be determined only after the coverage period has ended. Group insurance pricing consist of two steps.

(1) The determination of a unit price, referred to as a rate or premium rate for each unit of benefit (e.g., \$1,000.00 of life insurance, \$1 of daily hospital benefit, or \$1 of monthly income disability benefit)

(2) The determination of the total price or premium that will be paid by the contract holder for all of the coverage purchased.

The approach to group insurance rate making differs depending on whether manual rating or experience rating is used. In the case of manual rating, the premium rate is determined independently of a particular groups claim experience. When experience rating is used, the past claims experience of a group is considered in determining future premiums for the group and/or adjusting past premiums after a coverage period has ended. As in all rate making, the primary objective for all types of group insurance is to develop premium rates that are adequate, reasonable, and equitable.

## **Manual Rating**

In the manual rating process, premium rates are established for broad classes of group insurance business. Manual rating is used with small groups for which no credible individual loss experience is available. This lack of credibility exist because the size of the group is such that it is impossible to determine whether the experience is due to random chance or is truly reflective of the risk exposure. Manual rating is also used to establish the initial premiums for larger groups that are subject to experience rating, particularly when a group is being written for the first time. In all but the largest groups, experience rating is used to combine manual rates and the actual experience of a given group to determine the final premium. The relative weights depend on the credibility of the groups own experience. Manual premium rates (also called tabular rates) are quoted in a company's rate manual. As pointed out earlier, these manual rates are applied to a specific group insurance case in order to determine the average premium rate for the case that will then be multiplied by the number of benefit units to obtain a premium for the group. The rating process involves the determination of the net premium rate, which is the amount necessary to meet the cost of expected claims. For any given classification, this is calculated by multiplying the probability (frequency) of a claim occurring by the expected amount (severity) of the claim.

The second step in the development of manual premium rates is the adjustment of the net premium rates for expenses, a risk charge, and a contribution to profit or surplus. The term retention, frequently used in connection with group insurance, usually is defined as the excess of premiums over claim payments and dividends. It consists of charges for (1) the stop-loss coverage, (2) expenses, (3) a risk charge, and (4) a contribution to the insurer's surplus. The sum of these changes usually is reduced by the interest credited to certain reserves (e.g., the claim reserve and any contingency reserves) the insurer holds to pay future claims under the group contract. For large groups, a formula is usually applied that is based on the insurers average claim experience. The formula varies by the size of a group and the type of coverage involved. Insurance companies that write a large volume of any given type of group insurance rely on their own experience in determining the frequency and severity of future claims. Where the benefit is a fixed sum, as in life

insurance, the expected claim is the amount of insurance. For most group health benefits, the expected claim is a variable that depends on such factors as the expected length of disability, the expected duration of a hospital confinement, or the expected amount of reimbursable expenses. Companies that do not have enough past data for reliable future projections can use industry wide sources. The major source for such U.S. industry wide data is the Society of Actuaries. Insurers must also consider whether to establish a single manual rate level or develop select or substandard rate classifications on objective standards related to risk characteristics of the group such as occupation and type of industry. These standards are largely independent of the groups past experience.

The adjustment of the net premium rate to provide reasonable equity is complex. Some factors such as premium taxes and commissions vary with the premium charge. At the same time, the premium tax rate is not affected by the size of the group, whereas commission rates decrease as the size of a group increases. Claim expenses tend to vary with the number, not the size of claims. Allocating indirect expenses is always a difficult process as is the determination of the risk charge. Community-rating systems, developed originally by Blue Cross Blue Shield, are often defined to limit the demographic and other risk factors being recognized. They typically ignore most or all of the factors necessary for rate equity and may be as simple as one rate applicable to those with families. There is little actuarial rationale for charging all groups the same rate regardless of the expected morbidity. Community rating has been mandated in some jurisdictions. This makes it a matter of public policy rather than an actuarial pricing question.

## **Experience Rating**

Experience rating is the process whereby a contract holder is given the financial benefit or held financially accountable for its past claims experience in insurance-rating calculations. Probably the major reason for using experience rating is competition. Charging identical rates for all groups regardless of their experience would lead to adverse selection with employers with good experience seeking out insurance companies that offered lower rates, or they would turn to self funding as a way to reduce cost. The insurance company that did not consider claims experience would, therefore, be left with



only the poor risk. This is why Blue Cross Blue Shield had to abandon community rating for group insurance cases above a certain size. The starting point for prospective experience rating is the past claim experience for a group. The incurred claims for a given period include those claims that have been paid and those in process of being paid. In evaluating the amount of incurred claims, provision is usually made for catastrophic claim pooling. Both individual and aggregate stop loss limits are established in which exceptionally large claims (above these limits) are not charged to the group's experience. The "excess" portions of claims are pooled for all groups and an average charge is accounted for in the pricing process. The approach is to give weight to the individual groups own experience to the extent that it is credible. In determining the claims charge, a credibility factor, usually based on the size of the group (determined by the number of insured lives insured) and the type of coverage involved, is used. This factor can vary from zero to one depending on the actuarial estimates of experience credibility and other considerations such as the adequacy of the contingency reserve developed by the group.

In effect, the claims charge is a weighted average of (1) the incurred claims subject to experience rating and (2) the expected claims, with the incurred claims being assigned a weight equal to the credibility factor and the expected claims being assigned to a weight equal to one minus the credibility factor. The incurred claims subject to experience rating are after consideration of any stop loss provisions. Where the credibility factor is one, the incurred claims subject to experience rating will be the same as the claims charge. In such cases, the expected claims underlying the prospective rates will not be considered. Thus, when companies insure a group of substantial size, experience rating reflects the claim levels resulting from that group's own unique risk characteristics. It has become common practice to give to the group the financial benefit of good experience and hold them financially responsible for bad experience at the end of each policy period. When experience turns out to be better than was expected in prospective rating assumptions, the excess can either be accumulated in an account called a premium stabilization reserve, claim fluctuation reserve, or contingency reserve or the excess can simply be refunded. The refund is either called a dividend (mutual company) or an experience rating refund (stock company).

The net result of the experience rating process is usually called the contract holder account balance, representing the final balance attributed to the individual contract holder. As pointed out earlier this balance or a portion of the balance can be refunded to the contract holder. The adequacy of the group's premium stabilization reserve influences dividend or rate adjustment decisions.

Liability insurance is designed to protect an individual against the possibility that he will be held responsible in a court of law for injury to another's person, property, or other interests. The property owner is held responsible for accidents happening on his property if negligence can be established or legal liability exists by statute. Similarly, the contractor is held responsible for accidents that result from his operations, and the manufacturer for accidents arising from the use of his product, while the professional may even be held liable for the advice he gives. The insurance for these diverse forms of liability is provided by several lines of insurance which are generally grouped together under the title "Liability Other Than Automobile," or "General Liability Insurance." Manuals of rules and rates for general liability insurance are published by the National Bureau of Casualty Underwriters, by the Mutual Insurance Rating Bureau, and by several independent insurance companies. These rules and rates are also the basis of the liability rates appearing in the multi-peril manuals published by the Multi-Line Insurance Rating Bureau and the various state fire rating bureaus.

The rating techniques used by the general liability underwriter are in some ways similar to those used by fire underwriters despite their superficial antitheses. Both liability and fire insurance premiums are determined by a complex process in which the rates are influenced by the business of the insured occupying the premises and by risk characteristics that modify the hazard (e.g., the existence of elevators); however, the actuarial procedures used to establish the rates charged by the general liability underwriter are closely related to the other casualty lines rather than property insurance. The determination of the overall rate level change closely resembles the procedure used for automobile liability insurance, while the determination of class rates mixes techniques borrowed from both automobile and workmen's compensation ratemaking with some unique procedures. Unlike many other lines of insurance, there is no single general

liability insurance rate filing in a given state. Individual rate filings are made for each subline of general liability insurance and for each coverage. The filings for individual sublines differ considerably from each other because the form of liability insured under each of them is quite different:

Therefore, some knowledge of the coverage provided by the various sub lines is essential in understanding the ratemaking procedures.' It should be noted that the ratemaking techniques discussed in this paper are those developed and used by the National Bureau of Casualty Underwriters. Similar procedures are used by the Mutual Insurance Rating Bureau in their filings.

### **Lines of Insurance**

Although each liability line corresponds to a particular type of liability hazard, there is some overlap between lines for a particular hazard. The basic liability hazard is generally considered to be the liability which arises out of the existence of the premises occupied by the insured and his operations, There are four ways of providing this coverage:

1. Owners', Landlords' and Tenants' (OL&T) covers the liability which arises out of the existence of the premises and necessary and incidental operations.
2. Manufacturers' and Contractors' (M&C) covers the liability which arises out of the existence of the premises and all operations.
3. Farmers' Comprehensive Personal Liability (FCPL) covers premises, farm operations, and personal liability of the insured.
4. Comprehensive Personal Liability (CPL) covers premises and personal liability but not business operations of the insured.

Each of the four is a basic coverage component, or part, which is separately rated and which may be purchased by the insured as a separate policy or as an integral part of a broader liability package. The typical commercial risk would need either the OL&T or the M&C coverage; in addition, CPL coverage might be added to the basic policy by endorsement to cover the personal liability of the owner of the business.

OL&T and M&C coverage's do not include liability hazards which may be separately identified and rated; for example, an OL&T policy would not cover liability imposed by a workmen's compensation statute. Such hazards may be covered by separate policies and/or by other coverage components in the basic general liability policy. In the

following list those hazards which may be covered in a general liability insurance policy are listed first (items 1-7) and are followed by hazards which are covered in other liability policies. (There are other liability hazards which are generally not covered by insurance, e.g., liability resulting from war, revolution, etc.) In a few cases, a part of the hazards mentioned below is covered in the basic policy (e.g., some automobile liability coverage is given in an OL&T policy).

Liability arising out of the existence and use of elevators located on the premises of the insured (Elevator Liability Insurance). Liability arising from the use of products sold or distributed by the insured or from operations of the insured after the insured has relinquished control over the operations (Product Liability Insurance).

Liability arising out of the operations of independent contractors employed by the insured (Owners' or Contractors' Protective Insurance).

Liability assumed by the insured under written agreement (Contractual Liability Insurance).

Liability resulting from the sale of alcoholic beverages (Liquor Law Liability).

Liability resulting from sprinkler leakage, etc. (Water Damage Liability).

Liability resulting from the rendering of (or failure to render) medical care or professional service (Professional Malpractice Liability).

Liability imposed by workmen's compensation statute (Workmen's Compensation Insurance).

Liability arising out of the ownership of an automobile (Automobile Liability Insurance).

Liability arising out of the ownership of aircraft (Aircraft Liability Insurance),

Liability resulting from the operation of an atomic reactor, the production of nuclear energy, etc. (Nuclear Energy Liability).

## **Class Rating**

The variation in hazard presented by the diverse risks seeking to purchase general liability insurance necessitates a wide range of rates. Schedule rating of the type used in life insurance rating is unknown in the general liability field. Individual risk rating techniques similar to those which apply for workmen's compensation are used for general liability insurant. In addition, the experience rating plan applicable in most states

provides credits and debits for certain general management characteristics such as cooperation with the insurance company. A majority of the liability risks do not develop premium and loss experience of sufficient volume to have any significant degree of credibility, and therefore fail to qualify for the application of rating plans. As a result, in most cases neither experience nor schedule rating techniques can be used to tailor the manual rate to the individual risk; therefore, general liability underwriters have relied upon the use of a large number of manual classifications in order to arrive at a premium for an individual risk which as closely as possible represents the hazard of that risk, and which needs little further modification for most risks. The rates for these numerous classes may be varied by state, or even by city, depending upon the nature of the coverage provided. For example, the class rates for Owners', Landlords' and Tenants' sub-line vary by rate territory, resulting in a total of over 30,000 individual manual rates. The multiplicity of classifications coupled with the large number of sub-lines, each covering a specific type of liability insurance, results in a rating technique which, in end result, parallels fire schedule rating even though the techniques employed seem quite different. A typical fire rating schedule provides an extensive list of credits and debits which are used to modify the basic class rate for the risk; these credits and debits reflect various risk characteristics which have some bearing on the hazard.

In rating an individual risk for general liability insurance, there is no one basic manual rate and no lengthy list of credits or debits. Instead there are a number of manual rates which apply to the risk; these rates reflect various liability hazards (line of insurance) as well as risk type and characteristics (class rates). For example, in rating the liability insurance of the owner of an individual building, the underwriter might first have to apply several different OL&T rates to provide the basic premises coverage. The section of the building used as a store by the owner would take a higher rate than that used for offices. A section of the building occupied by a tenant would be rated a still lower rate. Having applied the appropriate OL&T rates reflecting type of occupancy and location, the underwriter would then rate any other public liability hazard. For example, the owner would be charged separately for any elevators on the premises, and for the hazard resulting from products he sells. In each case, it might be necessary to use more than one class rate. The overall general liability premium reflects those risk characteristics which

he hazard, just as the overall fire premium does; however, for liability. Insurance this has been accomplished by a schedule of coverage's and by the use of a number of class rates for each coverage rather than a schedule of credits and debits modifying a single class rate.

There is one more significant difference between the fire and liability approaches. Whereas the credits and debits used for fire insurance must of necessity be established on a judgment basis, the various class rates used in rating liability risks may be established statistically. To assess statistically the credits and debits of a tire rate schedule, it would be necessary to apportion each individual fire loss among those risk characteristics which contributed to the loss. Since many factors influence the loss, and as the loss is destructive. Liability losses, on the other hand, usually result from a specific accident at a single location. Such a loss can generally be assigned to a particular sub-line and class.

Setting rates for the individual classes within each of the sub-lines is in many respects comparable to attempting to determine statistically the appropriate credits and debits in a fire rating schedule. Since the latter is considered impossible, it should not be surprising that the former is somewhat abstruse.

## **RATEMAKING**

Each of the various general liability insurance sublines is considered independently for ratemaking purposes. The sub-lines are further sub-divided by coverage: bodily injury, property damage, medical payments, and personal injury coverage are each rated independently. In addition, the basic limits experience is reviewed separately from excess limits. Manual rates are generally published for limits of \$5,000 per person and \$10,000 per accident for bodily injury coverage and \$5,000 per accident for property damage coverage. These rates are generally termed basic limits rates, and the charges for limits of liability above basic limits are referred to as excess or increased limits, rates. The rate filings discussed in the following sections are filings of basic limits manual rates; therefore, premiums exclude any charges for excess limits coverage's and losses are limited to basic limits (e.g., if a claimant were paid \$15,000, only the first \$5,000 would be included in the basic limits losses and the remaining \$10,000 would be considered excess losses).

The rate maker is presented with the problem of setting basic limits manual rates for a particular coverage and a particular sub-line. With a limited volume of statistical data, he must revise several thousand individual rates. In most cases, there are so many classes that a number of years of experience would be necessary to obtain credible experience for individual classes even on a countrywide basis. As liability loss levels are sensitive not only to inflationary trends but also to changes in the legal climate, the rate maker should rely only on the latest data in setting rates.

Finally, in many cases he must develop rates that vary by state and even by city. The result is a two-fold dilemma: to assure credibility many years of statistics should be used, but to assure responsiveness only the latest data should be used; to assure credibility the statistics for broad geographic regions should be used, but to assure responsiveness to the local situation statistics should be analyzed by state and city.

This dilemma has been solved by a rather involved procedure. The latest experience of all classes on a combined basis is used to establish the overall rate change needed in a particular state (or countrywide), this rate change is distributed by rate territory (if any) using a longer experience period. The resulting overall rate changes are then used to develop class rates by means of a procedure which gives recognition to class experience both in the state and countrywide. The complex procedures used to establish class rates for the various sub-lines represent an attempt to give recognition to the experience of individual classes whose data has very low credibility. This is accomplished by grouping similar classes and analyzing the experience of each group of classes in the state and the experience of the individual classes countrywide. For a typical sub-line the individual class rate results from an analysis of the class experience on a countrywide basis, the experience of similar classes in the state during the past five years, the experience of all classes in the rating territory during the last five years, and the experience of all classes in the state during the last year or two. The exact method of accomplishing this varies by sub-line of insurance.

## **Determination of Overall Rate Level**

The first step in the development of manual rates for a sub-line of insurance is to determine the overall rate change. For the major sub-lines this is usually done on a statewide basis while for the minor sub-lines it is done on a regional or countrywide basis. While the ratemaking procedures are not identical for the various sub-lines, it is possible to make certain general statements which hold true for most sub-lines.

For most of its rate filings the National Bureau uses the experience of members, subscribers, and some other companies; however, some filings include the experience of the Mutual Insurance Rating Bureau. Experience is tabulated on a policy year basis and the loss ratio method is used in ratemaking. A comparison is made between basic limits incurred losses and the premiums at present manual rates, which are computed by multiplying the earned exposures for each class in each territory by the appropriate basic limits manual rate.

The reported losses include all allocated loss adjustment expense; for ratemaking purposes they are multiplied by 1.16 to reflect unallocated loss adjustment expense. This countrywide factor is obtained from the Insurance Expense Exhibit by taking the three year average of the ratios of unallocated loss adjustment expenses to the sum of losses and allocated loss adjustment expense.” The losses must be adjusted to the present cost level since they will be compared to premiums at present rates. This is accomplished in two steps: first, these losses must be adjusted for subsequent changes in the level of reserves and for incurred but not reported losses, i.e., for loss development; second, the losses must be adjusted to reflect changes in the level at which claims are being paid, i.e., for the trend in average paid claim costs.

## **What is EDLI?**

All employees to whom the Employee's Provident Fund and Miscellaneous Provision Act, 1952 applies, have a Statutory liability to subscribe to Employee's Deposit Linked Insurance Scheme, 1976 to provide for the benefit of Life insurance to all their employees. Under the scheme as amended with effect from 24th June, 2000 the insurance benefit is equal to the average balance to the credit of the deceased employee in the Provident Fund during the last 12 months, provided that where such balance exceeds



Rs.35,000, insurance cover would be equal to Rs.35,000 plus 25% of the amount in excess of Rs.35,000 subject to a maximum of Rs.60,000. Thus if the length of service is not adequate and/ or the salary is low the average balance may be substantially less and such the benefit to the employee's family is either inadequate or non-existent.

The contribution @ 0.50% of each employee's salary is payable by the Employer to the Provident Fund Authorities.

### **THE BETTER ALTERNATIVE:**

However, under Sec. 17(2A) of the act, the employer may be exempted from contributing to this scheme, if he/she has provided for better insurance benefits through alternative scheme. LIC's Group Insurance Scheme in lieu of EDLI has been accepted as one such better alternative.

### **ADVANTAGES TO THE EMPLOYER:**

The premium payable by the employer is usually less than the total contribution being paid by the employer to R.P.F.C; particularly when the salary level is high and average age of the group is low.

Settlement of claim is quicker, LIC requires only the death certificate and the Claim Form from the employer.

Premium paid by the employer is treated as normal business expenses for Income-Tax purpose.

### **ADVANTAGES TO THE EMPLOYEE:**

Each employee is covered for a sum assured ranging between 5,000 to 2, 00,000 depending upon the current salary and service put in from day one irrespective of the actual balance in the Provident Fund. Alternatively every employee/ worker can be covered for a uniform sum assured which will be decided depending upon the group size.

**ACCIDENT BENEFIT:**

Double accident benefit can be allowed to the extent of the Sum Assured for an extra Premium.

**STEPS TO INTRODUCE THE SCHEME:**

Put up notice for the knowledge of the employees that you are going in for LIC's Scheme in lieu of EDLI.

Apply to the Regional Provident Fund Commissioner under Sec.17 (2A) of the E.P.F. and M.P. Act 1952 to exempt you from EDLI Scheme. The application should be accompanied by the prescribed requirements including the Rules of the Proposed Group Insurance scheme.

All employers who are having 20 or more employees are covered under the Provident Fund and Miscellaneous Provisions Act of 1952.

They have to compulsorily deduct 12% of the salary (Basic+DA) of the employees working under them and also to contribute 12% of the salary (Basic+DA) as employer's contribution and remit both the amounts to the Provident Fund Authorities every month.

The 12% is to be deducted subject to ceiling on salary of 6500. Out of this amount, an amount of 8.33% out of the employer's contribution of 12% is transferred to a pension fund account. From this Pension Fund the employees are assured of a pension depending on the accumulation in their account. The remaining amount of the employer's contribution along with the employee's contribution is invested as per the norms prescribed by the Government, and interest is credited to the employee's PF account. This balance amount to his credit will be paid to him in case of his resignation or retirement. However in case of death while in service, the payment of contribution will cease and only the accumulated balance standing to his credit at the time of death will become payable to his family. If this happens in the early part of his employment, the amount would be meager.

In order to supplement the benefits available, the Employees Deposit Linked Insurance Scheme (EDLI) was introduced in 1976.

In 1976, when the scheme was introduced the benefits were as follows:

1. In case of death of an employee while in service, in addition to the accumulated amount of Provident Fund to his credit an additional amount equal to the balance at the time of death subject to a maximum of Rs. 10000 will be paid to his family.
2. For this benefit, all the employers covered under the PF Act, shall contribute 50 paise for every hundred Rupees Salary towards the insurance and one paise for every Rs.100 salary towards administrative expenses.

The scheme also provides an exemption clause Section 17(2A), as per which if the employer provides better benefits than that of the EDLI Scheme, then he can discontinue payment of the above contribution of 51 paise per every Rs. 100 salary to the PF authorities, but after getting exemption from the Central Provident Fund Commissioner (CPFC), New Delhi.

Life Insurance Corporation of India came out with an alternative and better scheme in 1976 and offered a Group Insurance Scheme in lieu of EDLI. The sum assured was 10500 flat and the premium was based on the ages of the employees. Generally it was found that the premiums payable to the insurer were much less than the contribution payable to the PF, and hence many companies switched over to the LIC Scheme after getting exemption from the CPFC, New Delhi.

The benefits under the scheme were changed periodically in 1990, 1994 and 2000 and 2010 as follows:

In 1990, the death benefit was made equal to the PF balance upto 15000, and in case the PF balance is above 15000, the death benefit was equal to 15000 + one fourth of the amount in excess of 15000, subject to a maximum of 25000. So LIC modified its scheme and offered a graded benefit of 11000 to 27000. It also assured that in case of death of a

member, the benefit his family will get will at least be 2000 above what they would have got under the PF Scheme.

In 1994, the death benefit was made equal to the PF balance upto 25000, and in case the PF balance is above 25000, the death benefit was equal to 25000 + one fourth of the amount in excess of 25000, subject to a maximum of 35000. So LIC modified its scheme and offered a graded benefit of 11000 to 37000. It also assured that in case of death of a member, the benefit his family will get will at least be 2000 above what they would have got under the PF Scheme.

In 2000, the death benefit was made equal to the PF balance upto 35000, and in case the PF balance is above 35000, the death benefit was equal to 35000 + one fourth of the amount in excess of 35000, subject to a maximum of 60000. So LIC modified its scheme and offered a graded benefit of 5000 to 62000. It also assured that in case of death of a member, the benefit his family will get will at least be 2000 above what they would have got under the PF Scheme.

From July, 2010, the death benefit was made equal to the PF balance upto 50000, and 40% of the PF balance in excess of 50000, subject to a maximum benefit of Rs. 100000. Again it was modified so that the death benefit will be as above or last drawn salary (with a maximum of 6500) x service with a maximum of 1,30,000, whichever is higher.

The LIC also offered a flat cover of the maximum of 27000 or 37000 or 62000 or 102000 or 132000 if the employers are willing to pay a little higher premium.

From 2001, with the entry of private players in the life insurance industry, the competition became more intense, and the private insurers started offering more benefits. For example they offered a higher cover for each company depending on the age group of the employees in return for the payment of 51 paise per every hundred Rupees salary to the insurer. Now many of the insurers including LIC offer this option also, which gets an

assured sum of money, which is, much more than the amount the employees would have got under the PF Scheme. With all these developments a large number of PF EDLI Schemes are shifted from PF to the Insurance Companies.

Now let us see what is the procedure for shifting from PF Scheme to an insured scheme.

1. First the company will have to put up a notice in their notice board, informing the employees of their decision to shift from PF Scheme to insured scheme and inviting objections if any from the employee. Normally there will not be any objection as the benefits are more for the employees.
2. Then the employer will have to make an application to the CPFC requesting for exemption from the PF EDLI scheme and approval for the switchover.
3. The insurer from whom the employer desires to get the scheme should have an alternative scheme, which is already approved by the CPFC.
4. Normally the approval is automatic and the insurer can commence the scheme from the first of the month in which the application to CPFC is made.

Then the employer can stop payment of the EDLI contribution to the PF authorities and start paying the premium to the insurer. However in spite of paying the premium, the employer has to pay half a paise per every Rs.100 salary to the PF authorities as inspection charges.

Thus it is a compulsory and statutory scheme and all the employers covered under the PF Act will have to contribute either to the PF EDLI Scheme or to an alternative insurance scheme. Now suppose an employer switches over to the insured scheme and then stops payment of the premium to the insurer. Then the employees will be deprived of their benefits. The PF authorities have the authority to inspect the company and see that the premiums are regularly paid to the insurer, so that the employees will not be deprived of their benefit. Also the insurer can inform the PF authorities about the non payment of premium so that they can initiate action against the employer. In case the employer is found to be at fault then he will be liable for imprisonment and/or monetary penalties.

Thus Group Insurance in lieu of EDLI is a very good opportunity for all the insurers to offer alternative and better schemes and get a large amount of business.

All employees to whom the Employee's Provident Fund and Miscellaneous Provision Act, 1952 applies, have a statutory liability to subscribe to Employee's Deposit Linked Insurance Scheme, 1976 to provide for the benefit of Life insurance to all their employees. Under the scheme as amended with effect from 24th June, 2000 the insurance benefit is equal to the average balance to the credit of the deceased employee in the Provident Fund during the last 12 months, provided that where such balance exceeds Rs.35, 000, insurance cover would be equal to Rs.35,000 plus 25% of the amount in excess of Rs.35,000 subject to a maximum of Rs.60,000. Thus if the length of service is not adequate and/ or the salary is low the average balance may be substantially less and such the benefit to the employee's family is either inadequate or non-existent. The contribution @ 0.50% of each employee's salary is payable by the Employer to the Provident Fund Authorities. The EPF&MP Act, 1952 provided for a provident fund and a family pension scheme for employees from 1971 onwards. However it was felt that problems arising out of early death of the employee were left unaddressed. In view of this, the Act was amended to incorporate an insurance scheme, called the Employees' Deposit Linked Insurance Scheme (EDLIS) in 1976. The objective of the scheme was to put in place a mechanism to provide employees' families with income security after the death of the member. It was funded through contributions by the employer and the Central Government with no contribution by the employee himself. The scheme has undergone several changes since its introduction. The Government no longer contributes to the scheme and the rates of benefits have also been changed many times. The contributions thus come only from the employers. A comprehensive administrative framework was set-up to ensure smooth functioning of the scheme.

## **Overview**

S-6-C of the Act empowers the Central Government, to frame a scheme to be called the Employees' Deposit-linked Insurance Scheme for the purpose of providing life insurance

benefits to the employees of any establishment or class of establishments to which this Act applies. After the framing of the Insurance Scheme, a Deposit linked insurance Fund, shall be established, into which contribution shall be paid by the employer from time to time in respect of every such employee in relation to whom he is the employer, such amount, not being more than 1 % of the aggregate of the basic wages ,dearness allowance and retaining amount for the time being payable in relation to such employee as the Central Government notified. The employer shall pay into the Insurance Fund such further sums of money, not exceeding 1/4th of the contribution, which he is required to make towards Deposit linked Insurance Fund.

The Insurance fund shall vest in the Central Board and be administered by it in such manner as may be specified in the Insurance Scheme. The Insurance Scheme may provide for all or any of the matters specified in Schedule IV .The Insurance Scheme may provide that any of its provisions shall take effect either prospectively or retrospectively on such date as may be specified in this behalf in that Scheme.

### **Applicability**

Employees' Deposit linked insurance Fund Scheme is applicable to all the factories and establishments to which the EPF&MA Act, 1952 applies. This includes both the exempt and unexempt establishments covered by the Act. All employees who join the Employees' Provident Fund are covered by the EDLIS.

### ***Operational Framework of the Employees' Deposit linked insurance Fund Scheme*** **Contributions**

At the time of inception of EDLIS, contributions were made by both employer and the Central Government. The Act specified that the employer shall contribute not more than 1% of the aggregate of basic wages, dearness allowance including cash value of food concession and retaining allowance. In 1977 it was decided that the employer would contribute 0.5% of the above mentioned aggregate pay, subject to a ceiling of Rs.6500. The Central Government contributed 0.25% of the pay in respect of the covered employees. In 1996, an amendment was passed which ended the Government's contributions with respect to covered employees. The Government stopped contributing in 1998. The employers continued to contribute at the rate of 0.5% of pay. The time limit

for the employer to remit his contributions to the Deposit-Linked Insurance Fund is within fifteen days of the close of every month. The Central Government must credit its contributions to the Fund as soon as possible after the close of every financial year. As of 2004-05, the total contributions received under the EDLI were Rs.191.62 crores.

### **Benefits**

On the death of an employee who is a member of the Provident Fund, the selected nominee will get the existent accumulations in the PF account of the employee as well as an additional amount. This additional amount is equal to the average balance in the account of the deceased during the preceding twelve months or during the period of membership, whichever is less. Where the average balance exceeds Rs.35, 000, the amount payable is Rs.35,000 plus 25% of the amount in excess of this figure. This total amount is subject to a ceiling of Rs.60, 000. The lump sum is tax free.

### **Investments**

Before 1997, the corpus of the Deposit-Linked Insurance Fund was deposited with the Central government in the public account. It earned an interest of 7.5% before 1989. In 1989 the interest rate was increased to 8.5%. After 1997, the corpus already in the Fund was left in the public account, and new contributions were invested according to a specified pattern described below.

	<b>Percentage invested</b>
<b>Investment category</b>	
Central Government Securities	Not less than 25%
State government securities and guaranteed securities	Not less than 25%
7-Year National Savings Certificates or Post Office Time Deposits	Not exceeding 30%
Special Deposits	Not exceeding 20%



The EDLIS portfolio stands at Rs.4375 crores as of 2004-05. The exposure of the EDLIS portfolio to various State Governments has been quite substantial.

### **Administration**

The contributions towards administration and inspection charges have changed over the years through reforms. At the time of inception, the employer paid 0.1% while the Government contributed 0.05% of pay. In 1980 a proposal was passed which put in place inspection charges for employers of exempt establishments. This charge was 0.02% of pay. In 1988, administration charges were reduced from 0.1% to 0.01% for employers and from 0.05% to 0.005% for the Government. These charges were then subject to a minimum of Rs.2 per month for the employer and Rs.1 per month for the Government. The scheme is currently following this pattern of charges but the Government stopped contributing towards administration charges after 1998. As of the year 2000 employers of exempt establishments must pay inspection charges of 0.005% instead of the earlier 0.02%. These payments are deposited in the Insurance Fund Central Administration Account and are used to fund the expenditures involved in the running of the scheme. The EPFO collected Rs.8.66 crores on account of charges in 2004-05.

### **Exemption**

Provisions for exemption from the EDLIS are listed under Section 17 of the EPF&MP Act 1952 along with Section 28(1) of EDLIS. An exemption from EDLIS is granted where the employees receive an insurance benefit without making any separate contribution or paying premium. It is necessary that this insurance benefit be greater than the insurance benefit provided under the EDLIS. An establishment exempted from the operation of the EDLIS is required to submit a monthly return to the RPFC. The establishment is also liable to pay inspection charges at the rate of 0.005% of the basic wages and dearness allowance, subject to a minimum of Re.1 per month. It does not have to pay any administration charges.

### **Default**

Where an employer makes a default in the payment of any contribution or charges, the

Central Provident Fund Commissioner may recover penalty from the employer at varying rates depending on the period of default. The penalty rates are as follows

Less than 2 months default period      17%

Between 2 to 4 months default period   22%

Between 4 to 6 months default period   27%

6 months and above default period      37%

These damages may be waived or reduced in certain cases. If the management changes, or there is a merger or amalgamation, the damages may be waived completely. If the Board for Industrial and Financial Reconstruction recommends a waiver, a waiver up to 100% may be granted. In other cases, depending on the merit of the claims for waiver, up to 50% of damages may be reduced. If an employer deducts or attempts to deduct contributions from the employees' remuneration, fails to submit a return, obstructs an official in the discharge of duty or fails to produce records for inspection, he is punishable with imprisonment up to one year, or a fine of up to Rs.4000, or both. In 2005, of a total of 14,748 prosecution cases, only 774 cases were disposed while the remaining 13,974 cases were still pending. The top five states as of 2004-05 in terms of prosecution cases lunched were Madhya Pradesh, Bihar, Maharashtra, Karnataka and Gujarat.

### **Advantages of Employees' Deposit linked insurance Fund Scheme**

#### **Advantages to the Employer:**

The premium payable by the employer is usually less than the total contribution being paid by the employer to R.P.F.C; particularly when the salary level is high and average age of the group is low.

Settlement of claim is quicker; LIC requires only the death certificate and the Claim Form from the employer. Premium paid by the employer is treated as normal business expenses for Income-Tax purpose.

**Advantage to the Employee:**

Each employee is covered for a sum assured ranging between 5,000 to 2,00,000 depending upon the current salary and service put in from day one irrespective of the actual balance in the Provident Fund. Alternatively every employee/ worker can be covered for a uniform sum assured which will be decided depending upon the group size.

**Accident Benefit:**

Double accident benefit can be allowed to the extent of the Sum Assured for an extra Premium.

**Steps to introduce the scheme:**

Put up notice for the knowledge of the employees that you are going in for LIC's Scheme in lieu of EDLI.

Apply to the Regional Provident Fund Commissioner under Sec.17 (2A) of the E.P.F. and M.P. Act 1952 to exempt you from EDLI Scheme. The application should be accompanied by the prescribed requirements including the Rules of the Proposed Group Insurance scheme. Central PF Commissioner has authorized the R.P.F.C. to grant exemption from the 1st of the month in which the application for relaxation is submitted. LIC also offers necessary guidance to the employers for seeking relaxation.

**Exemption from the Employees Deposit Linked Insurance Scheme, 1976**

Section 17 (2A) of the Act provides for grant of exemption from the operation of Employees Deposit Linked Insurance Scheme, 1976. It is granted to an establishment, where the employees are, without making any separate contribution or payment of premium, in enjoyment of benefits in the nature of Life Insurance whether linked to their deposits in Provident Fund or not and such benefits are more favorable than the benefits admissible under the Insurance Scheme. It is granted by the Central Provident Fund Commissioner by notification in the official gazette and is subject to conditions that may be specified in the notification. It is granted either prospectively or retrospectively.

Pending grant of exemption to an establishment relaxation order may be issued under

Para – 28 (7) of the Employees Deposit Linked Insurance Scheme, 1976.

An establishment exempted from the operation of Employees' Deposit Linked Insurance Scheme, 1976 is required to submit a monthly return to the Regional Provident Fund Commissioner by the 25th of the month in Form 7(IF).

Para 28 (4) of the Scheme provides for grant of exemption by the Central Provident Fund Commissioner to any Class of employees.

Under Section 17 (2B) read with Para – 28 (1) of the Employees' Deposit Linked Insurance Scheme, 1976, the Regional Provident Fund Commissioner may grant exemption from the operation of all or any of the provisions of the Employees' Deposit Linked Insurance Scheme to an employee.

The establishment shall pay inspection charges at the rate of 0.005 % of the basic wages and Dearness Allowance subject to a minimum of Rs.1/- per month.

### **Conclusion**

The Central Government while exercising the powers U/S 6C of the EPF and MP Act ,1952, enacted the Employees Deposit Linked Insurance Scheme in 1976 by GSR/488 ,dated 28th July 1976.This Scheme came into force i.e. 1st August ,1976.The purpose of the scheme is to provide life insurance benefits to employees ,who are already covered under Provident Fund /Pension Funds. The employer has to pay contribution equal to 0.5 % of the total wages of the employees. The employee does not contribute any amount to the scheme. The salary limit for average of employees is same as the Provident Fund.

Benefit to nominee of employee- If an employee dies during employment, his nominee or family member gets an amount equal to average balance in the Provident Fund Account of the deceased employee during last 12 months. If such balance is more than Rs.35000,the insurance amount payable is Rs.35000 plus 25% of the amount in excess of Rs. 35000 ,subject to overall limit of Rs. 60000( w.e.f. 13th June 2000). If the employees are covered under another life insurance scheme whose benefits are better than this scheme, an exemption from this scheme can be obtained.

## **Gratuity Schemes**

*Gratuity is one of the least understood components of salary. Investment Yogi explains everything about Gratuity and the tax implications for you.*

Gratuity is a part of salary that is received by an employee from his/her employer in gratitude for the services offered by the employee in the company. Gratuity is a defined benefit plan and is one of the many retirement benefits offered by the employer to the employee upon leaving his job. An employee may leave his job for various reasons, such as - retirement/superannuation, for a better job elsewhere, on being retrenched or by way of voluntary retirement.

### ***Eligibility***

As per Sec 10 (10) of Income Tax Act, gratuity is paid when an employee completes 5 or more years of full time service with the employer (minimum 240 days a year).

### ***How does it work?***

An employer may offer gratuity out of his own funds or may approach a life insurer in order to purchase a group gratuity plan. In case the employer chooses a life insurer, he has to pay annual contributions as decided by the insurer. The employee is also free to make contributions to his gratuity fund. The gratuity will be paid by the insurer based upon the terms of the group gratuity scheme.

### ***Tax treatment of gratuity***

The gratuity so received by the employee is taxable under the head 'Income from salary'. In case gratuity is received by the nominee/legal heirs of the employee, the same is taxable in their hands under the head 'Income from other sources'. This tax treatment varies for different categories of individual assesses. We shall discuss the tax treatment of gratuity for each assessed in detail.

For the purpose of calculation of exempt gratuity, employees may be divided into 3 categories –

- (a) Government employees and
- (b) Non-government employees *covered* under the Payment of Gratuity Act, 1972
- (c) Non-government employees *not covered* under the Payment of Gratuity Act, 1972

*In case of government employees* – they are **fully exempt** from receipt of gratuity.

*In case of non-government employees covered under the Payment of Gratuity Act, 1972* –

Maximum exemption from tax is **least of the 3 below**:

- (i) Actual gratuity received;
- (ii) Rs 10,00,000;
- (iii) *15 days' salary for each completed year of service or part thereof*

**Note:**

- Here, salary = basic + DA + commission (if it's a fixed % of sales turnover).
- 'Completed year of service or part thereof' means: full time service of > 6 months is considered as 1 completed year of service; ≤ 6 months is ignored.
- Here, number of days in a month is considered as 26. Therefore, 15 days' salary is arrived as = salary \* 15/26

*In case of non-government employees not covered under the Payment of Gratuity Act, 1972* – Maximum exemption from tax is **least of the 3 below**:

- (i) Actual gratuity received;
- (ii) Rs 10,00,000;
- (iii) Half-month's average salary for each completed year of service (no part thereof)

Note:

- Here, salary = basic + DA + commission (if it's a fixed % of sales turnover).
- Completed year of service (no part thereof) means: full time service of ≥ 1 year is considered as 1 completed year of service. < 1 year is ignored.
- *Average salary = 10 months' salary (immediately preceding the month of leaving the job)/10*

## Illustration

Let's understand the above math clearly with an example:

Varun had been working with an IT company since past 10 years, 7 months. He is retiring on 15<sup>th</sup> April, 2010. His current Basic = Rs 40,000 pm, DA = Rs 5,000 pm. He is going to receive a gratuity amount of Rs 3 lakhs on retirement. Note: Varun's basic and DA have been the same since past 1 year.

Let's consider 2 situations here – (a) Varun's employer is *covered* under Payment of Gratuity Act, 1972; and (b) Varun's employer is *not covered* under Payment of Gratuity Act, 1972.

- Salary = Basic + DA = Rs 40,000 pm + Rs 5,000 pm = Rs 45,000 pm
- Average salary = 10 months' salary (immediately preceding the month of leaving the job)/10 = (Rs 45,000 pm \* 10)/10 = Rs 45,000 pm. Therefore, half-month's average salary is = Rs 45,000/2

## Important points to remember

- Generally, only government employers give DA to their employees. Above example is only for illustrative purpose.
- The salary of the employee may differ over a period of time on account of change in basic, DA and/or other factors.
- In case gratuity is received from more than one employer during the previous year, maximum exemption allowed is up to Rs 10,00,000.
- Where employee has already claimed gratuity exemption in any previous year (s), the maximum exemption amount allowed for the current previous year i.e. Rs 10,00,000 will be reduced by the amount of deduction already claimed in the previous years.
- In case of an employee who is employed in a seasonal establishment ( not employed throughout the year), the gratuity exemption shall be for seven days wages for each season.

The gratuity arrangement with LIC provides the following services to the company

Fund management under interest accumulation system

Claim settlement on exit as per company rules/gratuity act

Built in Insurance arrangement for the employees for future service

MIS related to Income Tax and trusts accounts and Actuarial valuation

Fund management: Critical issues

### **Safety:**

Liability on account of gratuity experiences sharp increase every year due to its nature of its computation. Apart from increase in service, increase in salary also contributes to increase in liability substantially as the benefits are payable on last drawn salary. Hence funds have to be invested in a conservative way with a consistent growth and insulated from market risks

The unique advantage with LIC is the contributions made by the company and interests credited by LIC are irreversible. This ensures highest level of safety for the total corpus and consistency in future contributions. As the gratuity payments are statutory and LIC gratuity scheme being the only investment tool which enjoys sovereign guarantee, gives a greater comfort to employer.

Liquidity: Funds available with LIC is a single account for investment and claim settlement. Hence 100% liquidity is ensured for the purpose of claim settlement

Yield: LIC has been offering very competitive and consistent interest rates over the years. For the year 2009-10, LIC has offered 9.00% - 9.65% depending on fund size. The interest declared is net of administrative expenses incurred, hence no separate charges are charged after crediting the interest.



Interest rate offered by LIC is on daily balancing method. Hence, there is no idle time for earning interest, hence effective rate of interest is much higher. Another significant aspect is interest gets compounded annually, hence no reinvestment issues and no time lags.

No responsibility on trustees on Investment decisions: Trustees are free from all investment risks and hassles in cash accumulation system. Advantage of 'real outsourcing' can be derived by associating with LIC

No hidden charges: The scheme is focused on a long term association in compliance with investment regulations and statutory payment obligations and no charges are levied on the transactions for which the fund is meant for.

Funding can also be in a staggered pattern during the year, but no charges at entry level for any number of payments. No charges on withdrawals for resignation or retirement or death. Total corpus comprising of money contributed by the company and interest credited by LIC is available for claim settlement up to 100% subject to availability of funds.

Actuarial recommendations: On annual basis, LIC provides this information to the trustees and recommends the level of contributions.

Claim settlement: On the exit of an employee due to retirement / death/ resignation, trust may prefer a claim from LIC by sending a claim form. Claim amount will be made available to trustees. Trustees can have the following options

Preferring a claim from LIC and paying to employee

Paying the money to employees and seek reimbursement

Paying claims to employees at their end and seeking annual reimbursement

MIS: LIC provides statement of receipts and payments and actuarial valuation certificate and certificate of balance for the trust account.

Besides the above said advantages, the scheme also provides for employee welfare measures with built in insurance cover.

### **Insurance cover for future service gratuity**

Another salient feature of the Gratuity Scheme with LIC is that it provides for insurance coverage to the employees to the tune of future service gratuity subject to certain limits. The insurance cover can be flexible depending on the requirements of the Trust. The Group Insurance premium will be commensurate to the cover provided.

### **Income Tax Benefit on Insurance Premium**

The insurance premium paid towards the above said benefits is treated as deductible business expenses to the company.

The premium is not treated as perks in the hands of the employees

The main provisions of the Act in 1972 were as follows:

1. All the establishments in which 10 or more employees are employed are covered under the Act.
2. Employees drawing a salary(Basic+DA) of less than Rs. 1000 per month only were covered under the Act.
3. 15 days salary(Basic+DA) for each year of service was to be paid as gratuity at the time of exit by resignation, death or retirement.
4. In case of resignation a completed service of 5 years was required for the eligibility.
5. A maximum of 20 months salary and a monetary limit of 30000 were fixed as the ceiling.

Gradually the ceiling on salary for eligibility was raised periodically to Rs. 1600, 2500, 3500 and then removed. The ceiling on gratuity was raised periodically to Rs. 36000, 50000, 100000, 250000, 350000 and now stands at Rs.1000000 (with effect from 24.05.2010). The 20 months salary ceiling on gratuity was removed.

15 days salary was construed as salary for half a month and on that basis gratuity was being paid. But some of the unions went to Court claiming that monthly salary pertains to 26 working days, leaving four Sundays. This contention was accepted by the Courts, and on that basis the gratuity was calculated at the rate of 15 days salary and each day's salary was taken as 1/26th of the monthly salary. This was also incorporated in the Gratuity Act by an amendment.

Thus it is a statutory liability and all the employers (with 10 or more employees) covered under the Act have to make the payments compulsorily.

For a long time most of the employers were paying gratuity on a "Pay as you go method". That is whenever an employee resigns, retires or dies his gratuity was paid in that year and shown as expenses for that year. No provision or funding was made. But as the liability arises every year, it was felt that each year's balance sheet should reflect that year's liability in respect of that year's gratuity. At the same time, the gratuity actually payable at the time of exit will depend on the time of exit and the salary at the time of exit, which are variables and cannot be determined with precision. Therefore an actuarial valuation, taking into account the probabilities of salary increase, death, resignation and retirement, was made mandatory as per the Accounting Standard-15 (AS-15) issued by the Institute of Chartered Accountants of India.

#### **Different ways of meeting Gratuity Liability:**

- (i) An employer may set up an internal reserve or provision in the books of accounts based on actuarial valuation of the liability.
- (ii) An employer may set up an irrevocable gratuity trust fund which is approved under part 'C' of the Fourth Schedule of the Income Tax Act 1961.
- (iii) An employer may set up a fund as in (ii) and the trustees may enter into a group gratuity scheme with an insurer.

**Creation of Internal Reserve:**

After the introduction of Section 40A(7) of the Income Tax Act, it is not possible to obtain income tax relief on the internal reserve created by the mere accounting provision in the books. But companies, which in their initial years of existence and which do not have too much of profits can, adopt this method. Their liability in respect of gratuity will relate to only death gratuity, which will be very small and as employees resigning before completing 5 years of service are not eligible for gratuity.

**Funding through Trust:**

The employer is required to part with the proprietary control over the funds. The gratuity rights of the employees become independent of the business fortunes. The reserves are setup on the basis of the concept of going concern where most of the employees would retire from service on attaining specific age, but for early death or resignation.

**Trustee Administered Fund**

If the trustees decide to manage the gratuity funds themselves, then it will be their responsibility to arrange for investment of the contributions according to the pattern prescribed by the rule 101 of the IT Act. The rate of contribution will have to be determined scientifically by an actuarial valuation of the liability and the same has to be reviewed periodically.

**Insured Group Gratuity Scheme:**

While extending the advantages of immediate income tax relief to the employer and security to the employees, the trustees can enter into a Group Gratuity Scheme with the insurer. It has two fold advantages, relieving the trustees of the responsibilities of investment of contribution and administration of the fund and provision of higher amount of gratuity payable in the event of death of employee while in service.

## **Comparison of Trustee Administered scheme and Insured Scheme:**

The main advantages of an insured fund over a self-managed fund are as follows:

1. Possibility of earning a higher yield. Now that more private life insurers have entered the market, different options are available for the companies to invest their gratuity funds. Many funds are unit linked, and offer a higher return (however not guaranteed) with options like secure fund, growth fund, balanced fund etc. There are also options for switching from one fund to another.
2. Liquidity: Liquidity is better under the insured schemes, as whenever employees retire or resign or die, the gratuity payable can be obtained from the insurer without any loss of interest. But for self managed funds, either they have to keep liquid funds for paying gratuity, which will result in loss of interest or sell securities at a loss to make the payments.
3. Management: The problems of managing and investing the funds are removed from the company. The insurance companies with huge funds have better expertise in investing and hence may be able to get a better yield on the funds.
4. Additional death benefit: An additional death benefit equal to the future service gratuity of an employee who dies in service is provided by a term assurance, for which an extra risk premium has to be paid.

Accounting provision is only an entry in the books of accounts and gratuity when paid is allowed as an “expense” before arriving at Profit or Loss for the year.

Accounting provision is not allowed as deductible expenditure in computation of tax liability.

However if you set up an Approved Gratuity Fund recognized under Part of the Fourth Schedule to the Income Tax Act, 1961, the contribution to the Trust Fund is allowed as deductible expenditure in terms of Section 36 (I) (v) of the Income Tax Act, 1961.

Tax Treatment follows EET pattern

Contribution exempt E

Interest Income tax-free E

(build-up of the Fund)

Gratuity Benefit in excess of  $\frac{1}{2}$  month's

salary for each year of service or

15 months' salary (which is lower) subject

to maximum of Rs. 3,50,000/- is taxable. T

Funding is not compulsory

Partial Funding is allowed.

You can fund part of the liability and for the balance portion you may make only accounting provision.

You may not Fund the liability and keep the Entire liability is unfunded

Many employers are under the impression that if gratuity is funded with LIC or any other insurers, there is no need for actuarial valuation.

The Accounting Standards Board of Institute of Chartered Accountants of India has clarified as under:

In case of defined benefit schemes covered under a Group Gratuity or other defined benefit scheme with an insurance company, where the actuarial risk and investment risk have not been transferred from the enterprise, where an enterprise can rely upon actuarial valuation certificate provided by the insurance company or a separate certificate from a qualified actuary is required to be obtained for determination of actuarial liability

In the case of defined benefit schemes covered under Group Gratuity or other defined benefit scheme with an insurance company where the actuarial risk and investment risk have not been transferred from the enterprise, the actuarial valuation certificate provided by the insurance company can be relied upon by the enterprise. However, the enterprise should ensure that such actuarial valuation has been carried out by a qualified actuary in

accordance with AS 15 (revised 2005), the underlying data is accurate, the assumptions are appropriate and the information required for compliance with the disclosure requirements of the Standard have been provided by the insurance company. A separate certificate from another qualified actuary is not necessary.

Let us look at alternative scenarios when the company has to adopt Revised Accounting Standard AS (15).

Scenario I: Company was not making any provision towards Gratuity Liability

Scenario II: Company was making provision according to old standard AS (15) of 1995

Scenario III: company was having a Group Gratuity Policy of LIC but the Fund accumulated with LIC was not adequate compared to amount of actuarial provision required by Revised Accounting Standard AS (15).

The liability arising on implementation of Revised AS (15) is clearly prior period item which should be debited to Profit & Loss Account

#### Scenario II

Under old Accounting Standard Actuarial Method was prescribed and as such incremental liability arising on account of switch-over from old standard to new standard will be adjusted against Revenue Reserves / Surplus as provided in the Accounting Standard.

However many employers do not include employees for computation of liability if they have not completed five years of service. This interpretation was always wrong 7777since gratuity liability is incurred for every year of service and not merely on vesting of liability after five years. Any incremental liability arising on account of inclusion of such employees will be treated as prior year charge and debited to Profit & Loss Account.

LIC calculates contribution payable on actuarial basis but does not follow Projected Unit Credit Method as laid down by Revised AS (15); in fact it follows Aggregate Method which results in lower contribution and lower level of funding. On adoption of Revised AS (15) incremental liability will have to be adjusted against Revenue Reserves / Surplus since old AS (15) did not lay down Projected Unit Credit Method.



## **Provident Fund & Employees' Family Pension and Deposit-linked insurance Schemes**

### **Types of Exemption**

An establishment covered under the Employees' Provident Fund & Miscellaneous Provisions Act 1952 is required to comply with the statutory provisions of the Act and also the provisions of the Schemes framed under the Act namely Employees' Provident Fund Scheme, 1952, Employees' Pension Scheme, 1995 and Employees' Deposit Linked Insurance Schemes, 1976.

However, the Act provides for grant of exemption from the operation of the Act and also exemption from the operation of the Schemes framed under the Act. Thus, the types of exemptions provided under the Act may be broadly classified as under:

- a.** Exemption from the Act (Including the Schemes), under Section -16 (2) of the Act.
- b.** Exemption from the operation of the Scheme(s) viz. Employees' Provident Fund Scheme / Employees' Pension Scheme /Employees' Deposit Linked Insurance Schemes.

#### **(a) Exemption from the Act (Including the Schemes) :**

This type of Exemption is allowed under Section 16(2) of the Act by the Central Government. Exemption from the Act is allowed only to a class of establishments. It is granted considering the financial or other circumstances of the class of establishments. This exemption can be given prospectively or retrospectively. It is allowed for a specified period only. The classes of establishments for which this type of exemption currently in force are:

- a .**Establishments registered under the Societies Registration Act, 1860, run mainly on grants-in-aid received from the Central Government or the State Government. Establishments which are employing only ex-servicemen who are in receipt of pension benefits as admissible under the trust rules for a period of 5 years w.e.f. 18-02-2000. (Notification dated on 5.4.2000)
  - b.** Voluntary organizations engaged in leprosy eradication programmers.
- (b) Exemption from the operation of the Scheme(s) viz. Employees' Provident Fund Scheme / Employees' Pension Scheme /Employees' Deposit Linked Insurance Schemes:

In this type of exemption, it is only an exemption from the operation of a specified scheme and not from the Act. Apart from granting exemption to an establishment from the operation of a particular scheme, the Act also provides for grant of exemption to an individual employee and also to a class of employees. Thus, exemption from the operation of the Scheme is granted:

- a. To an establishment as a whole.
- b. To an individual employee ( under the Employees' Provident Fund & Employees' Deposit Linked Insurance Scheme only )
- c. To a class of employees.

**Issue of Relaxation order under the Employees' Provident Fund & Employees' Deposit Linked Insurance Schemes:**

Before granting exemption to an establishment the application of the establishment and also the rules of the Fund are required to be scrutinized for considering the grant of exemption. As it may take some time to process the application, the Regional Provident Fund Commissioner / Central Provident Fund Commissioner as the case may be, may issue a relaxation order to the establishment specifying that the establishment may not, pending grant of exemption:

- a. Submit the returns required to be submitted under the Scheme.
- b. Remit the dues to the Fund
- c. Transfer the accumulations from the existing Fund to the C.B.T., Employees' Provident Fund.

The Regional Provident Fund Commissioner / Central Provident Fund Commissioner may also impose certain other conditions on maintenance of accounts, enrolment of members, Investment of monies, payment of inspection charges and submission of returns etc., in the Relaxation Order. For all practical purposes the establishment under Relaxation Order shall be treated on par with the establishment granted exemption. The Relaxation Order is issued under para 28(7) of the Employees' Deposit Linked Insurance Scheme.

**Exemption from the operation of Employees' Provident Fund Scheme , 1952:**

Exemption from the operation of Employees' Provident Funds to an establishment as a whole, is granted either under Section 17(1)(a) or under Section 17 (1)(b) of the Act.

**Exemption under Section 17 (1)(a):**

The grant of exemption to an establishment under Section 17 (1)(a) is considered where the rates of contribution are not less favorable than the statutory rates provided in Section 6 of the Act and the employees are also in enjoyment of other PF benefits which are also on the whole not less favorable than the benefits provided under the Act / Scheme. The authority to grant this exemption is the 'Appropriate Government', as defined in Section 2(a) of the Act (Central / State Government, as the case may be) and notified in Gazette.

**Exemption under Section 17(1) (b):**

Exemption under Section 17 (1) (b) is granted where the employees in establishment are in enjoyment of benefits in the nature of Provident Fund, Pension or gratuity which are separately or jointly on the whole not less favorable than the benefits provided under the Act / Scheme. It is granted by the 'Appropriate Government ', through a notification in the gazette.

**Payment of Inspection charges:**

The establishment to which Relaxation Order is issued / exemption is granted is required to pay Inspection charges @ 0.18% of total wages on which Provident Fund is recovered, to the Regional Provident Fund Commissioner concerned by deposit in cash / local cheque in S.B.I. to the credit in A/C No. 2 of the Employees' Provident Fund, through prescribed challan.

**Exemption of an Employee : (Employees' Provident Fund Scheme ,52 )**

Section 17 (2) read with para-27 of the Employees' Provident Fund Scheme provides for exemption from the operation of all or any of the provisions of the scheme to an individual employee. It is granted by the Regional Provident Fund Commissioner on the receipt of application in Form-1 from the employee. The exemption is granted where an employee is entitled to benefits in the nature of Provident Fund, gratuity or old age pension and such benefits separately or jointly is on the whole not less favorable than the benefits provided under the Act and Scheme.

The re-election is permitted only once on each account.

**Exemption of a Class of Employees: ( Employees' Provident Fund Scheme ,52 )**

Section 17 (2) read with para-27A of the Employees' Provident Fund Scheme provides for grant of exemption from the operation of all or any of the provisions of the scheme to

a class of employees. It is granted by the appropriate Government on the receipt of application from the employer. The exemption is granted where employees are entitled to benefits in the nature of Provident Fund, gratuity or old age pension and such benefits separately or jointly are on the whole not less favorable than the benefits provided under the Act and Scheme.

Wherever the exemption to a class of employees is granted, the employer is required to submit a monthly return to the Regional Provident Fund Commissioner in the prescribed Performa. The due date for submission of this return is 25th of the month following that to which it relates. The employer is required to pay Inspection Charges @ 0.18% on wages of employees exempted and invest the Provident Fund monies in accordance with the pattern of investment prescribed by the Central Government.

## **Chapter 9: Taxation Treatment of provisions for Retirement Benefits-I:**

Guidance Note on Benefits from Retirement Schemes

Guidelines on the Malta tax treatment of Retirement Benefits arising from Retirement Funds or Schemes

This guidance note applies to any benefit derived from a retirement fund or scheme that is licensed under the provisions of the Special Funds (Regulation) Act or any Act replacing the said Act. It applies from 1 January 2012 onwards and constitutes a guideline for the purposes of Article 96(2) of the Income Tax Act. It is intended to provide guidance to practitioners, retirement fund administrators licensed/recognised by the Malta Financial Services Authority and beneficiaries of such funds or schemes that are administered in or from Malta.

### **A. Taxation of the Retirement Fund or Scheme**

In accordance with the provisions of Article 12(1)(d) of the Income Tax Act, the income of any retirement fund or retirement scheme that is licensed, registered or otherwise authorised under the Special Funds (Regulation) Act or any Act replacing the said Act is exempt from income tax provided that this income is not derived from immovable property situated in Malta.

### **B. Taxation of the Benefits derived from a Retirement Fund or Scheme**

Given that under the provisions of the Special Funds (Regulation) Act, the principal purpose of any such funds or schemes is to provide retirement benefits, these retirement benefits are to be characterised as a pension for the purposes of Article 4(1)(d) of the Income Tax Act. Any capital sum received by way of commutation of a pension remains exempt in accordance with the provisions of Article 12(1)(h) of the Income Tax Act. These benefits are considered to be arising in Malta and taxable accordingly. In determining the tax treatment of such benefits, due consideration needs to be given to any relevant provisions found in any applicable double tax treaty.

### **C. Registration of Beneficiaries**

Pursuant to the above, beneficiaries receiving retirement benefits considered to be a pension arising in Malta are required to register for Maltese income tax purposes and to submit an annual tax return in terms of Article 10 of the Income Tax Management Act. These returns will also need to include details of any tax withheld at source on the distribution under the provisions of Article 73 of the Income Tax Act or, if distributed free of withholding tax due to the provisions of a double tax treaty, then details of the treaty benefits being claimed would need to be provided, together with evidence of the tax residence of the recipient. Such evidence should ideally be in the form of a tax residence certificate issued by the tax authority of the jurisdiction in which the beneficiary is resident. Where it is not possible to procure such a certificate, the evidence may take the form of a declaration by the beneficiary to the trustee supported by relevant documentation (e.g. utility bills excluding mobile telephones).

## **Chapter 10: Taxation Treatment of provisions for Retirement Benefits-II:**

A **retirement plan** is a financial arrangement designed to replace employment income upon retirement. These plans may be set up by employers, insurance companies, trade unions, the government, or other institutions. Congress has expressed a desire to encourage responsible retirement planning by granting favorable tax treatment to a wide variety of plans. Retirement plans in the U.S. are defined in tax terms by the IRS code and are regulated by the Department of Labor's provisions under the Employee Retirement Income Security Act.

Retirement plans are classified as *defined benefit* or *defined contribution* according to how benefits are determined. A defined benefit (or pension) plan calculates benefits using a fixed formula that typically factors in final pay and service with an employer, and payments are made from a trust fund specifically dedicated to the plan. In a defined contribution plan, the payout is dependent upon both the amount of money contributed into an individual account and the performance of the investment vehicles utilized.

Some types of retirement plans, such as *cash balance* plans, combine features of both defined benefit and defined contribution schemes.

### **Defined contribution plan**

According to the Internal Revenue Code Section 414, a defined contribution plan is an employer-sponsored plan with an individual account for each participant. The accrued benefit from such a plan is solely attributable to contributions made into an individual account and investment gains on those funds, less any losses and expense charges. The contributions are invested (*e.g.*, in the stock market), and the returns on the investment are credited to or deducted from the individual's account. Upon retirement, the participant's account is used to provide retirement benefits, often through the purchase of an annuity. Defined contribution plans have become more widespread over recent years and are now the dominant form of plan in the private sector. The number of defined benefit plans in the US has been steadily declining, as more employers see pension

funding as a financial risk they can avoid by freezing the plan and instead offering a defined contribution plan.

Examples of Defined contribution plan include Individual Retirement Account (IRA), 401(k), and profit sharing plans. In such plans, the participant is responsible for selecting the types of investments toward which the funds in the retirement plan are allocated. This may range from choosing one of a small number of pre-determined mutual funds to selecting individual stocks or other securities. Most self-directed retirement plans are characterized by certain tax advantages. The funds in such plans may not be withdrawn without penalty until the investor reaches retirement age, which is typically 59.5 years of age.

Money contributed can be from employee salary deferrals, employer contributions, or employer matching contributions. Defined contribution plan are subject to IRS section 415 limits on how much can be contributed. As of 2012, the total deferral amount including the employee and employer contribution is the lesser of \$50,000 or 100% of compensation. The employee-only amount is \$17,000 for 2012, but a plan can permit participants who are age 50 or older to make "catch-up" contributions of up to an additional \$5,500.

### **Defined benefit plans**

Commonly referred to as a pension in the US, a defined benefit plan pays benefits from a trust fund using a specific formula set forth by the plan sponsor. In other words, the plan *defines a benefit* that will be paid upon retirement. The statutory definition of *defined benefit* encompasses all pension plans that are not defined contribution and therefore do not have individual accounts.

While this catch-all definition has been interpreted by the courts to capture some hybrid pension plans like cash balance (CB) plans and pension equity plans (PEP), most pension plans offered by large businesses or government agencies are *final average pay* (FAP) plans, under which the monthly benefit is equal to the number of years worked multiplied by the member's salary at retirement multiplied by a factor known as the *accrual rate*. At a minimum, benefits are payable in *normal form* as a Single Life Annuity (SLA) for single participants or as a Qualified Joint and Survivor Annuity (QJSA) for married



participants. Both normal forms are paid at Normal Retirement Age (usually 65) and may be actuarially adjusted for early or late commencement. Other optional forms of payment, such as lump sum distributions, may be available but are not required.

The cash balance plan typically offers a lump sum at and often before normal retirement age. However, as is the case with all defined benefit plans, a cash balance plan must also provide the option of receiving the benefit as a life annuity. The amount of the annuity benefit must be *definitely determinable* as per IRS regulation 1.412-1.

Defined benefit plans may be either *funded* or *unfunded*. In a funded plan, contributions from the employer and participants are invested into a trust fund dedicated solely to paying benefits to retirees under a given plan. The future returns on the investments and the future benefits to be paid are not known in advance, so there is no guarantee that a given level of contributions will meet future obligations. Therefore, fund assets and liabilities are regularly reviewed by an actuary in a process known as valuation. A defined benefit plan is required to maintain adequate funding if it is to remain qualified.

In an unfunded plan, no funds are set aside for the specific purpose of paying benefits. The benefits to be paid are met immediately by contributions to the plan or by general assets. Most government-run retirement plans, including Social Security, are unfunded, with benefits being paid directly out of current taxes and Social Security contributions. Most non-qualified plans are also unfunded.

### **Hybrid and Cash Balance Plans**

Hybrid plan designs combine the features of defined benefit and defined contribution plan designs. In general, they are treated as defined benefit plans for tax, accounting, and regulatory purposes. As with defined benefit plans, investment risk is largely borne by the plan sponsor. As with defined contribution designs, plan benefits are expressed in the terms of a notional *account balance*, and are usually paid as cash balances upon termination of employment. These features make them more portable than traditional defined benefit plans and perhaps more attractive to a highly mobile workforce. A typical hybrid design is the Cash Balance Plan, where the employee's notional account balance grows by some defined rate of interest and annual employer contribution.

In the US, conversions from traditional to hybrid plan designs have been controversial. Upon conversion, plan sponsors are required to retrospectively calculate employee account balances, and if the employee's actual vested benefit under the old design is more than the account balance, the employee enters a period of *wear away*. During this period, the employee would be eligible to receive the already accrued benefit under the old formula, but all future benefits are accrued under the new plan design. Eventually, the accrued benefit under the new design exceeds the grandfathered amount under the old design. To the participant, however, it appears as if there is a period where no new benefits are accrued. Hybrid designs also typically eliminate the more generous early retirement provisions of traditional pensions.

Since younger workers have more years in which to accrue interest and pay credits than those approaching retirement age, critics of cash balance plans have called the new designs discriminatory. On the other hand, the new designs may better meet the needs of a modern workforce and actually encourage older workers to remain at work, since benefit accruals continue at a constant pace as long as an employee remains on the job. As of 2008, the courts have generally rejected the notion that cash balance plans discriminate based on age, while the Pension Protection Act of 2006 offers relief for most hybrid plans on a prospective basis.

While a cash balance plan is technically a defined benefit plan designed to allow workers to evaluate the economic worth their pension benefit in the manner of a defined contribution plan (*i.e.*, as an account balance), the *target benefit* plan is a defined contribution plan designed to express its projected impact in terms of lifetime income as a percent of final salary at retirement (*i.e.*, as an annuity amount). For example, a target benefit plan may mimic a typical defined benefit plan offering 1.5% of salary per year of service times the final 3-year average salary. Actuarial assumptions like 5% interest, 3% salary increases and the UP84 Life Table for mortality are used to calculate a level contribution rate that would create the needed lump sum at retirement age. The problem with such plans is that the flat rate could be low for young entrants and high for old entrants. While this may appear unfair, the skewing of benefits to the old worker is a feature of most traditional defined benefit plans, and any attempt to match it would reveal this backloading feature.

## **Requirement of Permanence**

To guard against tax abuse in the United States, the Internal Revenue Service (IRS) has promulgated rules that require that pension plans be permanent as opposed to a temporary arrangement used to capture tax benefits. Regulation 1.401-1(b)(2) states that "[t]hus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions there under, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited..." The IRS would have grounds to disqualify the plan retroactively, even if the plan sponsor initially got a favorable determination letter.

## **Qualified retirement plans**

Qualified plans receive favorable tax treatment and are regulated by ERISA. The technical definition of *qualified* does not agree with the commonly used distinction. For example, 403(b) plans are not considered qualified plans, but are treated and taxed almost identically.

The term *qualified* has special meaning regarding defined benefit plans. The IRS defines strict requirements a plan must meet in order to receive favorable tax treatment, including:

- A plan must offer life annuities in the form of a Single Life Annuity (SLA) and a Qualified Joint & Survivor Annuity (QJSA).
- A plan must maintain sufficient funding levels.
- A plan must be administered according to the plan document.
- Benefits are required to commence at retirement age (usually age 65 if no longer working, or age 70 1/2 if still employed).
- Once earned, benefits may not be forfeited.
- A plan may not discriminate in favor of highly compensated employees.
- A plan must be insured by the PBGC.

Failure to meet IRS requirements can lead to plan disqualification, which carries with it enormous tax consequences.

### **SIMPLE IRAs**

A SIMPLE IRA is a type of Individual Retirement Account (IRA) that is provided by an employer. It is similar to a 401(k) but offers simpler and less costly administration rules. Like a 401(k) plan, the SIMPLE IRA is funded by a pre-tax salary reduction. However, contribution limits for SIMPLE plans are lower than for most other types of employer-provided retirement plans.

### **SEP IRAs**

A Simplified Employee Pension Individual Retirement Account, or SEP IRA, is a variation of the Individual Retirement Account. SEP IRAs are adopted by business owners to provide retirement benefits for the business owners and their employees. There are no significant administration costs for self-employed person with no employees. If the self-employed person does have employees, all employees must receive the same benefits under a SEP plan. Since SEP accounts are treated as IRAs, funds can be invested the same way as any other IRA.

### **Keogh or HR10 Plans**

Keogh plans are full-fledged pension plans for the self-employed. Named for U.S. Representative Eugene James Keogh of New York, they are sometimes called HR10 plans.

### **Nonqualified plans**

Plans that do not meet the guidelines required to receive favorable tax treatment are considered *nonqualified* and are exempt from the restrictions placed on qualified plans. They are typically used to provide additional benefits to key or highly paid employees, such as executives and officers. Examples include SERP (Supplemental Executive Retirement Plans) and 457(f) plans.

### **Contrasting types of retirement plans**

Advocates of Defined contribution plan point out that each employee has the ability to tailor the investment portfolio to his or her individual needs and financial situation, including the choice of how much to contribute, if anything at all. However, others state that these apparent advantages could also hinder some workers who might not possess the financial savvy to choose the correct investment vehicles or have the discipline to voluntarily contribute money to retirement accounts.

### **Portability, Valuation**

Defined contribution plan have actual balances, that workers can know the value of with certainty by simply checking the balance. There is no legal requirement that the employer allow the former worker take his money out to roll over into an IRA, though it is relatively uncommon in the US not to allow this (and many companies such as Fidelity run numerous TV ads encouraging individuals to transfer their old plans into current ones).

However, because the lump sum actuarial present value of a former worker's vested accrued benefit is uncertain, the IRS (*in Section 417(e) of the Internal Revenue Code*) specifies the interest and mortality that must be used. This has caused some employers as in the Berger versus Xerox case in the 7th Circuit (Richard A. Posner was the judge who wrote the opinion) with cash balance plans to have a higher liability for employers for a lump sum than was in the employee's "notional" or "hypothetical" account balance.

When the interest credit rate exceeds the IRS mandated Section 417(e) discounting rate, the legally mandated lump sum value payable to the employee [if the plan sponsor allows for pre-retirement lump sums] would exceed the notional balance in the employee's cash balance account. This has been colourfully dubbed the "Whipsaw" in actuarial parlance. The Pension Protection Act signed into law on August 17, 2006 contained added provisions for these types of plans allowing the distribution of the cash balance account as a lump sum.

### **Portability: Practical, not a Legal difference**

A practical difference is that a defined contribution plan's assets generally remain with the employee (generally, amounts contributed by the employee and earnings on them

remain with the employee, but employer contributions and earnings on them do not vest with the employee until a specified period has elapsed), even if he or she transfers to a new job or decides to retire early, whereas in many countries defined benefit pension benefits are typically lost if the worker fails to serve the requisite number of years with the same company. Self-directed accounts from one employer may usually be 'rolled-over' to another employer's account or converted from one type of account to another in these cases.

Because Defined contribution plan have actual balances, employers can simply write a check because the amount of their liability at termination of employment which may be decades before actual normal (65) retirement date of the plan, is known with certainty. There is no legal requirement that the employer allow the former worker take his money out to roll over into an IRA, though it is relatively uncommon in the US not to allow this.

Just like there is no legal requirement to give *portability* to Defined contribution plan, there is no mandated ban on portability for defined benefit plans. However, because the lump sum actuarial present value of a former worker's vested accrued benefit is uncertain, the IRS mandate in Section 417(e) of the Internal Revenue Code specifies the interest and mortality that must be used. This uncertainty discussed in valuation of defined benefit lump sums has limited the practical portability of defined benefit plans.

### **Investment Risk borne by Employee or Employer**

It is commonly said that the employee bears investment risk for Defined contribution plan while the employer bears that risk in defined benefit plans. This is true for practically all cases, but pension law in the United States does not require that employees bear investment risk, it only provides an ERISA Section 404(c) exemption from fiduciary liability if the employer provides the mandated investment choices and gives employees sufficient control to customize his pension investment portfolio APPROPRIATE to his risk tolerance.

### **PBGC insurance: a legal difference**

The Employee Retirement Income Security Act (ERISA) does not provide insurance from the Pension Benefit Guaranty Corporation (PBGC) for Defined contribution plan,

but cash balance plans do get such insurance because they, like all ERISA-defined benefit plans, are covered by the PBGC.

Plans may also be either employer-provided or individual plans. Most types of retirement plans are employer-provided, though Individual Retirement Accounts (IRAs) are very common.

### **Tax advantages**

Most retirement (the exception being most non qualified plans) plans offer significant tax advantages. Most commonly the money contributed to the account is not taxed as income to the employee, but in the case of employer provided plans, the employer is able to receive a tax deduction for the amount contributed as if it were regular employee compensation. This is known as *pre-tax* contributions, and the amounts allowed to be contributed vary significantly among various plan types. The other significant advantage is that the money in the plan is allowed to grow through investing without being taxed on the growth each year. Once the money is withdrawn it is taxed fully as income. There are many restrictions on contributions, especially with 401(k) and defined benefit plans that are designed to make sure that highly compensated employees do not gain too much tax advantage at the expense of lesser paid employees.

Currently two types of plan, the Roth IRA and the newly introduced Roth 401(k), offer tax advantages that are essentially reversed from most retirement plans. Contributions to Roth IRAs and Roth 401(k)s must be made with money that has been taxed as income, but after meeting the various restrictions, money withdrawn from the account is tax-free.

### **EGTRRA and later changes**

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) brought significant changes to retirement plans, generally easing restrictions on the ability to roll money from one type of account to the other and increasing contributions limits. Most of the changes were designed to phase in over a period of 4–10 years. Unless they are extended, it will "sunset," or revert, at the end of 2010 to the previous laws.

## Chapter 11: Group schemes and Data Processing

'*Group insurance*' is an insurance that covers a group of people, usually who are the members of societies, employees of a common employer, or professionals in a common group. Group coverage can help reduce the problem of adverse selection by creating a pool of people eligible to purchase insurance who belong to the group for reasons *other than* for the purposes of obtaining insurance. In other words, people belong to the group not because they possess some high-risk factor which makes them more apt to purchase insurance (thus increasing adverse selection); instead they are in the group for reasons unrelated to insurance, such as all working for a particular employer.

Investopedia defines Group Life Insurance as "Life insurance offered by an employer or large-scale entity (i.e. association or labor organization) to its workers or members. Group life insurance is typically offered as a piece of a larger employer or membership benefit package. By purchasing coverage through a provider on a "wholesale" basis for its members, the coverage costs each individual worker/member much less than if they had to purchase an individual policy. . People who elect coverage through the group policy receive a "certificate of credible coverage," which will be necessary to provide to a subsequent insurance company in the event that the individual leaves the company or organization and terminates their coverage."

From the above paragraphs we can infer the following are the characteristics of Group Life Insurance

- a. there must be a group of people to be insured which should have something in common other than the purpose of obtaining insurance
- b. there must be a Master Policy Holder who will retain the contract on the behalf of the member and the carriers
- c. Such covers are typically available at a discount to the respective individual rates.

Insurable Groups can broadly be classified as mainly two types - " employer - employee " groups where all members work for the employer proposing to cover them or "affinity"



groups, whose members have a commonality other than employment - say deposit holders of a bank.

The Master Policy Holder of a Group Life Insurance Plan in the case of an "Employer Employee Group" is basically the Employer and for other groups would be the entity that has an insurable interest in the lives of its members. So in the case of a bank it could be said to have an insurable interest in the lives of its members who hold a deposit or have taken a loan. The Master Policy Holder also ensures each member gets their certificate of coverage stating the details of the premium paid, cover available, term of the cover and the claims process

A feature which is sometimes common in group insurance is that the premium cost on an individual basis is not individually risk-based. Instead it is the same amount for all the insured persons in the group. So, for example, in the United States, often all employees of an employer receiving health or life insurance coverage pay the same premium amount for the same coverage regardless of their age or other factors. In contrast, under private individual health or life insurance coverage in the U.S., different insured persons will pay different premium amounts for the same coverage based on their age, location, pre-existing conditions, etc. Group policies are also attractive to consumers because the average price per policy is often lower. Carriers are interested in gaining customers and will cut prices a bit to accommodate members of group. Data shows that, for example, drivers save 29% on average by attaching themselves to a group policy.<sup>[citation needed]</sup>.

All members for whom the premium is paid for the period and the risks in respect of such members accepted by the underwriters of the insurance company are generally eligible to purchase or renew coverage all whilst he or she is a member of the group subject to certain conditions. Again, using U.S. health coverage as an example, under group insurance a person will normally remain covered as long as he or she continues to work for a certain employer and pays the required insurance premiums, whereas under individual coverage, the insurance company often has the right to non-renew a person's individual health insurance policy when the policy is up for renewal, which it may do if the person's risk profile changes (though some states limit the insurance company's

ability to non-renew after the person has been under individual coverage with a given company for a certain number of years).

In Canada group insurance is usually purchased through larger brokerage firms because brokers receive better rates than individual companies or unions. There may be slight differences in terms of administration and market related practices world wide, even though the concept may be the same. For example, In India, broker procured group term insurance, unlike Canada, does not intrinsically have any price advantage to the buyer i.e. the Master Policy Holder.

Group Life Insurance covers may be either compulsory - in which case every member has no say in opting for the cover or voluntary where all eligible members may decide within an enrolment window to opt for the available Group Insurance. This is irrespective of who pays the premium.

Since compulsory covers offer no scope for adverse selection they come with far relaxed underwriting requirements than voluntary covers, Underwriting requirements even for Voluntary Group Life Covers are far lower than the respective requirements for individual lives.

Group Health Insurance is also provided in India. It provides healthcare coverage to a group of people belonging to a common community (typically as employees of a company). These plans are generally uniform in nature, offering the same benefits to all employees or members of the group.

Most professionally run companies today provide Group Health Insurance as a part of their Employee Welfare program. Each company however gets the plan customized based on the employee demographics.

## **Insurance Data Processing**

**Insurance Data Processing (IDP),** ) is a software and services vendor based in Wyncote, Pennsylvania.

IDP makes insurance software for property and casualty insurance carriers and agencies; IDP also provides statistical (bureau) reporting services and project planning consultation.

IDP was founded in 1949, by a group of five insurance companies and a reinsurance brokerage firm. These six entities formed a cooperative accounting and statistical unit; subsequent growth resulted in the formation of Mutual Tabulating Services, Inc. in 1953.

Over the next ten years, with the increasing use of computers in business operations, the company entered the field of computer-based data processing. In 1961, the name of the corporation was changed to Insurance Data Processing, Incorporated.

In 1967, IDP was acquired by Marsh & McLennan, Inc. (Guy Carpenter & Co., Inc.), and in 1985 it became a part of the Carlino Financial Group. In 1997, ownership evolved into a Carlino/Gilbert partnership.

Today, Insurance Data Processing, Inc, is known as IDP, or IDP::Insurance Data Processing, Inc. In addition to the corporate headquarters in Wyncote, PA, IDP also has facilities located in Solon, Ohio.m

### **Software and Services**

IDP's software is divided into two product platforms: IDP::Vision, a policy processing application hosted by IDP (Software as a Service); and IDP::Software, a line of policy administration applications that IDP sells separately or as a unit.

### **Review Question:**

- Q1. Write short notes on retirement schemes of India
- Q2. Describe pension for dependent
- Q3. Is there tax relief on contributions?
- Q4. Define COBRA
- Q5. Discuss the group Insurance

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