President Ford signed an “historic” pension-reform bill on Labor Day—“historic in the sense that this legislation will probably give more benefits and rights and success in the area of labor management than almost anything in the history of this country.” Some analysts take a less exuberant view, noting in particular that although the new law solves many problems that have afflicted past retirees, it doesn’t really address itself to the problems created for pension plans by rapid inflation.

The private pension system, the subject of this legislation, has significance far beyond the 6 million retirees now receiving $10 billion a year in pension benefits. The system is important also to the more than 30 million Americans covered by pension plans, and to an economy which must deal with trust funds wielding $200 billion annually in assets. Retirement benefits have increased 30-fold over the past quarter century to $10 billion dollars in 1972, and continued rapid growth seems assured. After all, about one-half of the nonfarm workforce is still not covered by any retirement system, while the average retiree’s pension amounts only to about 25 percent of his terminal or maximum salary, compared to a 50 to 70-percent average in most European plans.

New legislation
Over the years a number of problems have arisen in the pension field, as could be expected in a voluntary system encompassing some 32,000 different plans. Legislation in 1958 corrected many of the most blatant abuses of the system, but other problems persisted. Many workers have lost their benefits, even after relatively long service, because their pension rights automatically ended when they were forced to leave their jobs. Others have sustained hardships because their employers went out of business, leaving insufficient funds behind to pay promised pensions. With the 1974 legislation, these problems should be corrected.

The act makes employees generally eligible to participate in pension plans at age 25 after one year’s service, with full vesting—guaranteed benefit rights—achieved after 15 years’ service. Government-sponsored termination insurance is available to qualified plans, to ensure that employees get their vested benefits if their employers are forced out of existence. Also, past service must be funded over 30 years for single-employer plans and 40 years for multi-employer plans, to ensure that sufficient funds are available when employees reach retirement age.

Despite these advances, the new legislation has not really focused on the problems of most immediate concern to pension planners. The pension structure is simply not compatible with the pattern of rapid wage-price increases that has emerged in recent years, for if the existing situation of inflation were to persist, the cost of the most prevalent type of plan—final aver-
age pay—would rise to unsuppor­
table heights. Robert D. Paul, a
leading pension consultant, ex­
amines these problems in the
current issue of the Harvard
Business Review.

Pensions and inflation
To most pension experts, the opti­
mum form of pension is the final-
average-pay plan, in which retire­
ment benefits are based on the
average earnings in the years (gen­
erally five years) immediately before
retirement. Most private plans are
of this type or of the equivalent flat-
benefit type—plans that pay fixed
benefits of (say) $300 a month to
everybody who meets eligibility re­
quirements.

Plans of this type worked well dur­
ing periods of low inflation, but they
can’t be considered economically
sound during periods of prolonged high inflation. An actuary, when
determining the annual contribu­
tion rate needed to support a given
plan, generally makes no explicit
assumptions about investment yield
to accommodate modest price in­
creases. For example, if the actual
yield on investments is 2 to 3 per­
cent higher than the typical 5-per­
cent yield assumption, the differ­
ce can offset the cost impact of
moderate 2- to 3-percent inflation.

But if the rate of inflation were to
persist in a 5- to 10-percent range
for an extended period, the typical
pension plan would require an
investment return in the 10- to 15-
percent range to maintain costs at a
level percentage of payroll. Paul
asks, “Are there such investments—
sound, secure investments—that
will meet the ‘prudent man rule’
written into the new pension legis­
lation?”

Other cost problems
Spiraling prices tend to create de­
mands for wage and salary increases
sufficient to offset rising living costs,
but they also lead to demands for
pension increases high enough to
maintain purchasing power after re­
tirement. A considerable number of
public and private plans have al­
ready added post-retirement cost-
of-living increases to pensions—
witness this year’s pathbreaking set­
tlements in the aluminum and steel
industries. With pensions increasing
(say) 0.5 percent for each 1.0-point increase in the consumer price in­
dex, at present rates of inflation the
amount of the average pension
would double well before the pen­
sioner reaches the end of his normal
life expectancy. Actuaries fear to
tread into such uncharted territory,
so the aluminum agreement simply
limits the pension adjustment to the
life of the contract. This eliminates
the need for funding consumer-
price increases, but it also means
that the companies have to pay
extra pension amounts out of cur­
rent income.

Aside from the serious impact of
inflation, various other factors also
tend to increase costs in one way or
another. For example, in earlier pe­
riods large numbers of women
passed through the work force
without accruing sufficient years of
service to qualify for retirement.
benefits, so that their forfeitures of benefits helped keep pension costs down. This is no longer the case; more and more women will earn vested benefit rights and costs will go up correspondingly. Another cost factor stems from the fact that women live longer than men; the average man retiring at 65 will receive 175 monthly checks before he dies, but the average woman at 65 can expect 210 monthly checks. Women workers may not be willing to accept actuarially reduced checks because of this fact of life.

Managing funds

Finally, the economy must deal with the fact that pension-fund assets could become an unwieldy factor in financial markets in future years. In the past decade, assets of private pension plans and state-local government plans increased at annual rates of 10.1 percent and 11.4 percent, respectively, reaching $166 billion and $72 billion by the end of 1972. By the end of the century, total assets of this type could approach $4 trillion, so that pension plans seem certain to expand their already dominant position in the nation’s financial markets.

In this situation, fund managers will have to develop new standards of investment performance. Certainly they can no longer follow the simple objective of beating the market, primarily because they are the market. Besides, their recent performance indicates they can’t even meet that basic standard. With almost 75 percent of all noninsured pension-fund assets invested in stocks, the value of their holdings fell over 20 percent during 1973—even worse than the dismal 15-percent decline in the total market, as measured by the Standard and Poor index. Further, with a 25-percent drop in the S&P index to date this year, the situation continues to appear bleak for the funds. Incidentally, many fund managers showed their expertise by staying out of the stock market during the expansive days of the 1960’s, and then shifting aggressively into equities at the beginning of the prolonged bear market in 1969. They could have improved their performance significantly over the past decade by simply rolling over Treasury bills every three months.

Since the bear market has destroyed the ability of fund managers to rely on large investment returns, corporations have been forced to expand their own contributions to meet their fund requirements. This of course can be a costly procedure, especially coming on top of the already substantial rise in pension costs of past decades. Indeed, supplements to corporate wages and salaries—a category which includes employer contributions to both private pension funds and social-insurance funds—jumped from $4 billion to $66 billion between the late 1940’s and early 1970’s, or from 4.8 percent to 15.8 percent of total wages and salaries. A quarter-century ago, supplements were only one-fifth as large as after-tax profits, but today they practically match the profits figure.

William Burke
### BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

<table>
<thead>
<tr>
<th>Selected Assets and Liabilities</th>
<th>Large Commercial Banks</th>
<th>Amount Outstanding 8/21/74</th>
<th>Change from 8/14/74</th>
<th>Change from year ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans (gross) adjusted and investments*</td>
<td></td>
<td>83,251</td>
<td>-585</td>
<td>+8,280</td>
</tr>
<tr>
<td>Loans gross adjusted—</td>
<td></td>
<td>65,782</td>
<td>-94</td>
<td>+7,950</td>
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<tr>
<td>Securities loans</td>
<td></td>
<td>1,777</td>
<td>+19</td>
<td>+36</td>
</tr>
<tr>
<td>Commercial and industrial</td>
<td></td>
<td>23,526</td>
<td>+52</td>
<td>+3,033</td>
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<tr>
<td>Real estate</td>
<td></td>
<td>19,702</td>
<td>+42</td>
<td>+2,610</td>
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<tr>
<td>Consumer instalment</td>
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<td>9,441</td>
<td>-3</td>
<td>+723</td>
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<tr>
<td>Other Securities</td>
<td></td>
<td>12,836</td>
<td>-155</td>
<td>+829</td>
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<tr>
<td>Deposits (less cash items)—total*</td>
<td></td>
<td>79,631</td>
<td>-146</td>
<td>+6,936</td>
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<tr>
<td>Demand deposits adjusted</td>
<td></td>
<td>21,609</td>
<td>-777</td>
<td>+640</td>
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<tr>
<td>U.S. Government deposits</td>
<td></td>
<td>536</td>
<td>+226</td>
<td>+74</td>
</tr>
<tr>
<td>Time deposits—total*</td>
<td></td>
<td>55,968</td>
<td>+429</td>
<td>+5,846</td>
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<tr>
<td>Savings</td>
<td></td>
<td>17,758</td>
<td>-7</td>
<td>+13</td>
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<tr>
<td>Other time I.P.C.</td>
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<td>28,840</td>
<td>+292</td>
<td>+5,431</td>
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<tr>
<td>State and political subdivisions</td>
<td></td>
<td>5,954</td>
<td>+18</td>
<td>-236</td>
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<tr>
<td>(Large negotiable CD's)</td>
<td></td>
<td>15,787</td>
<td>+428</td>
<td>+3,762</td>
</tr>
</tbody>
</table>

#### Weekly Averages

<table>
<thead>
<tr>
<th>Member Bank Reserve Position</th>
<th>Week ended 8/21/74</th>
<th>Week ended 8/14/74</th>
<th>Comparable year-ago period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Reserves</td>
<td>114</td>
<td>31</td>
<td>11</td>
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<tr>
<td>Borrowings</td>
<td>413</td>
<td>226</td>
<td>126</td>
</tr>
<tr>
<td>Net free (+) / Net borrowed (−)</td>
<td>-299</td>
<td>-195</td>
<td>-115</td>
</tr>
<tr>
<td><strong>Federal Funds—Seven Large Banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interbank Federal fund transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net purchases (+) / Net sales (−)</td>
<td>+739</td>
<td>+1,277</td>
<td>0</td>
</tr>
<tr>
<td>Transactions: U.S. securities dealers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net loans (+) / Net borrowings (−)</td>
<td>+528</td>
<td>+530</td>
<td>+142</td>
</tr>
</tbody>
</table>

*Includes items not shown separately.

Information on this and other publications can be obtained by calling or writing the Administrative Services Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, California 94120. Phone (415) 397-1137.