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September 13, 1974

Historic Labor Day

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-

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age pay—would rise to unsupportable heights. Robert D. Paul, a leading pension consultant, examines these problems in the current issue of the **Harvard Business Review.**

Pensions and inflation

To most pension experts, the optimum form of pension is the final-average-pay plan, in which retirement benefits are based on the average earnings in the years (generally 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 requirements.

Plans of this type worked well during periods of low inflation, but they can't be considered economically sound during periods of prolonged high inflation. An actuary, when determining the annual contribution rate needed to support a given plan, generally makes no explicit assumptions about investment yield to accommodate modest price increases. For example, if the actual yield on investments is 2 to 3 percent higher than the typical 5-percent yield assumption, the difference 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 legislation?"

Other cost problems

Spiraling prices tend to create demands 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 retirement. A considerable number of public and private plans have already added post-retirement cost-of-living increases to pensions—witness this year's pathbreaking settlements in the aluminum and steel industries. With pensions increasing (say) 0.5 percent for each 1.0-point increase in the consumer price index, at present rates of inflation the amount of the average pension would double well before the pensioner 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 current 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 periods 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.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/21/74	Change from 8/14/74	Change from year ago Dollar	Change from year ago Percent
Loans (gross) adjusted and investments*	83,251	− 585	+8,280	+ 11.04
Loans gross adjusted—	65,782	− 94	+7,950	+ 13.75
Securities loans	1,177	+ 19	+ 36	+ 3.16
Commercial and industrial	23,526	+ 52	+3,033	+ 14.80
Real estate	19,782	+ 42	+2,610	+ 15,20
Consumer instalment	9,441	− 3	+ 723	+ 8.29
U.S. Treasury securities	4,633	− 336	− 499	− 9.72
Other Securities	12,836	− 155	+ 829	+ 6.90
Deposits (less cash items)—total*	79,631	− 146	+6,936	+ 9.54
Demand deposits adjusted	21,609	− 777	+ 640	+ 3.05
U.S. Government deposits	536	+ 226	+ 74	+ 16.02
Time deposits—total*	55,968	+ 429	+5,846	+ 11.66
Savings	17,758	− 7	+ 13	+ 0.07
Other time I.P.C.	28,840	+ 292	+5,431	+ 23.20
State and political subdivisions	5,954	+ 18	− 236	− 3.81
(Large negotiable CD's)	15,787	+ 428	+3,762	+ 31.28

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

*Includes items not shown separately.

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