TO: Members of the Board

FROM: Office of the Secretary

March 20, 1970

3/20/70

Attached is a copy of a letter to the Board dated March 16, 1970 from Mr. Galusha as Chairman of the Joint Committee on the Retirement System. The express purpose of the letter is to request that the Joint Board-Presidents' Conference Committee have an opportunity to meet with the Board to discuss funding of Retirement System liabilities. In addition to Mr. Galusha's letter, there is included a copy of a letter addressed to him by Governor Maisel under date of January 26, 1970 transmitting a memorandum regarding investment policies.

Governor Maisel has suggested that these materials be distributed to the members of the Board for consideration at a meeting in the near future at which all Board members can be present. Following a preliminary discussion by the Board, it would seem desirable for the Board to meet with the President members of the Joint Committee or perhaps with the entire membership of the Conference of Presidents for the purpose of discussing the handling of investments for the pension system and arriving at a decision on the broad outlines of the funding procedure to be developed in the future. A memorandum presenting additional material relative to that subject will be distributed shortly.

Attachment

Please look at this

FEDERAL RESERVE BANK

OF MINNEAPOLIS

55440

OFFICE OF
THE PRESIDENT

March 16, 1970

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Gentlemen:

This is a progress report on the Benefit System, and a request for a policy decision. As to our progress:

The benefit levels of the pension plan have been revised; the thrift plan installed, with 89 per cent of the 19,916 employees participating; the salary continuation coverage in cases of death and disability while in active service is now in force; and the first Systemwide school designed to educate representatives of each Bank and Branch in administration of the benefit system has been held with great success.

Left to be done are these things:

(a) Consideration of possible changes in the structure of the Retirement System. Some of the objectives advanced are:

(1) To tie together the administration of the elements of the Benefit System (the pension plan, the thrift plan, and the insured benefits plan) within a single staff. This staff would be the one presently comprising the Retirement System office.

(2) To fix responsibility for policy formulations within a group of individuals who would have a common role in all three legal structures. Membership would rotate among the Banks and the Board.

(3) To place aggregate responsibilities for the collection of funds, performance of the contractors (insurance companies, mutual funds, commercial banks), and the evolution of the Benefit System within the central administration staff. To the Reserve Banks

would be given the responsibility for administering individual program relationships for those presently employed, as well as retirees.

Requests have been made to the Trustees for comment. A suggested model is attached to show you one form it might take. This is only to inform you; we have no recommendation at this time.

(b) Revision of the spouse's benefit. This is the limited life income benefit provided dependents of a deceased employee. A question has arisen because this is a substantial life insurance benefit. To the extent the benefit exceeds $50,000, taxable income is generated each year to the extent of an imputed annual premium computed under the Internal Revenue Code on the excess. An illustrative table is attached.

The benefits are considerable; there is total agreement on their value in attracting and holding younger and middle aged employees. A question has been raised by some senior and relatively high paid employees who, because the insurance is in five-year term components and goes up sharply in the later years, may be adding more in the form of the imputed premium to their taxable income than they think the benefit to their surviving spouse is worth. There may be an answer to their objection by making this benefit an optional one. You will recall our basic death benefit is the equivalent of two years' salary, with the spouse's benefit substituting for one of the two salary increments when surviving dependents are left. An employee could, if the plan is so modified, waive the spouse's benefit and take in its place the second year's salary. There may be alternative solutions to the waiver; the Coordinative Committee should have a report on this shortly.

If assignment to a primary beneficiary is permitted, the estate tax can be minimized. This is being explored, as is the possibility of convertibility at the time of resignation or retirement. This is a progress note only. We have no recommendation to make at this time.

(c) Funding, and its administration. The present Retirement System holds a considerable body of marketable securities (stocks, corporate bonds, government bonds) to fund liabilities to employees already retired (retirees), and to employees presently in service to whom representations have been made about benefits which will be payable to them at retirement (future benefits).

There does not seem to be any substantial difference of opinion about the administration of the funds which offset the liability to retirees. Tentatively, it appears the purchase of annuities for the benefit of retirees would be advantageous.

There appears to be a division of opinion among us about the funding of future benefits. The question as originally posed revolves around a potential political problem posed by the present pattern of administration of the funding of the present and future liabilities of the Retirement System.

The root of the question is in the fact the Retirement System administers its own fund. The annuities comprising the fund are kept at the New York Fed, the Northern Trust Company of Chicago has acted as counselor, and the investment policy has been set by the Investment Committee which is a standing committee of the Board of Trustees of the Retirement System. Because some Federal Reserve Bank presidents serve on the Investment Committee and all are Trustees of the Retirement System, there are those within the System who have been fearful of the potential criticism derived from the fact these men are privy to the FOMC deliberations and therefore in a position to better the performance of the Retirement System (of which they are beneficiaries) by anticipating changes in the securities markets.

Not directly derivative from the argument of self interest, although that too is relied upon by its proponents, is the philosophic one that the Federal Reserve ought not to seek to maximize the return on any security fund. In addition they argue the Federal Reserve, as an instrument of the federal government, ought not to invest in any securities other than those of the U.S. Treasury. In their view the Retirement System funding has the same operating limitations as the Open Market portfolio.

Opponents to this view argue that the Retirement System funding is by industry practice and Internal Revenue Code definition a production asset which exists for a specific internal operating purpose, viz., funding actuarially determined liabilities. In this view, operating efficiency and cost reduction are conventionally associated goals.

In summary, and by whatever road reached, there seem to be two broad choices:

(1) Selecting that method of funding which, without regard to cost to the System, will provide political insulation and satisfy the philosophic objection to an administered fund; restriction to special trust account non-marketable Treasury obligations, or even going on a

pay-as-we-go-basis, would be alternatives, and there may be more.

(2) Selecting a method that would minimize the possibility of potential criticism and yet make it possible to administer the funds accumulated to pay future retirement benefits at a lower cost to the System than would be true under the first alternative.

Illustrative of the difference in cost are the comparisons made by Dan McGill of the difference between the cost to the System of funding the liability to retirees with insurance policies, on the one hand, and an administered portfolio of government bonds, on the other. In his analysis (4-17-69) he said that "an interest difference of ¼ per cent is considered to be the equivalent of a cost difference of 2 per cent in the purchase of immediate annuities."

It would logically follow that the conventional pattern of funding non-insured plans with a balanced portfolio would be a further saving. By use of a blind trust, for example, where the identity of the assets would be merged with pooled assets and the account managers given sole investment discretion, a degree of insulation would be attained. It would not be the total insulation which it might be argued would flow from automatic investment in non-marketable Treasury issues; but it, or some other device, would meet the potential political criticism which some others also believe possible if the System is not operated with an eye to cost control.

There is no reason to spend the time and the resources in an investigation of the second possibility if the assessment by you of the issue makes only the first, or a variation of it, possible. Stated another way, if you decide cost saving has zero utility in this circumstance, there is no middle position.

The Joint Board-Presidents' Conference Committee would like to meet with the Board to discuss this point with you and obtain your policy guidance. This report attempts to summarize, but only in the broadest form, the rationale of the various positions. It undoubtedly has its inadequacies, and there may be other arguments and alternatives not reported here.

Yours very truly

Hugh D. Galusha

Hugh D. Galusha, Jr., Chairman
Joint Committee on the
Retirement System

HDG:ck
Attachments

Suggested Organization
for
RETIREMENT PLAN

BD.OF GOV. | FRB 1 | FRB 2 | FRB 3 | FRB 4 | FRB 5 | FRB 6 | FRB 7 | FRB 8 | FRB 9 | FRB 10 | FRB 11 | FRB 12

Board of Trustees. Nine members - one designated by Board of Governors, one Reserve Bank President and one elected Trustee from each of four groupings of three banks each, as established by the Conference of Presidents. The Presidents and the elected members shall be from different banks. Bank representation on a rotation basis. Every two years (initially one year for two banks) representation passes from one to another of each trio of banks. Chairmanship shall pass in a predetermined biennial rotation. Chairmanship and Presidents' membership on Board of Trustees shall be identical to composition of Presidents' Conference Committee on Management and Personnel. Powers and duties: Ultimate responsibility and authority for Retirement Plan but would act largely through delegation. Would function primarily in broad policy areas.

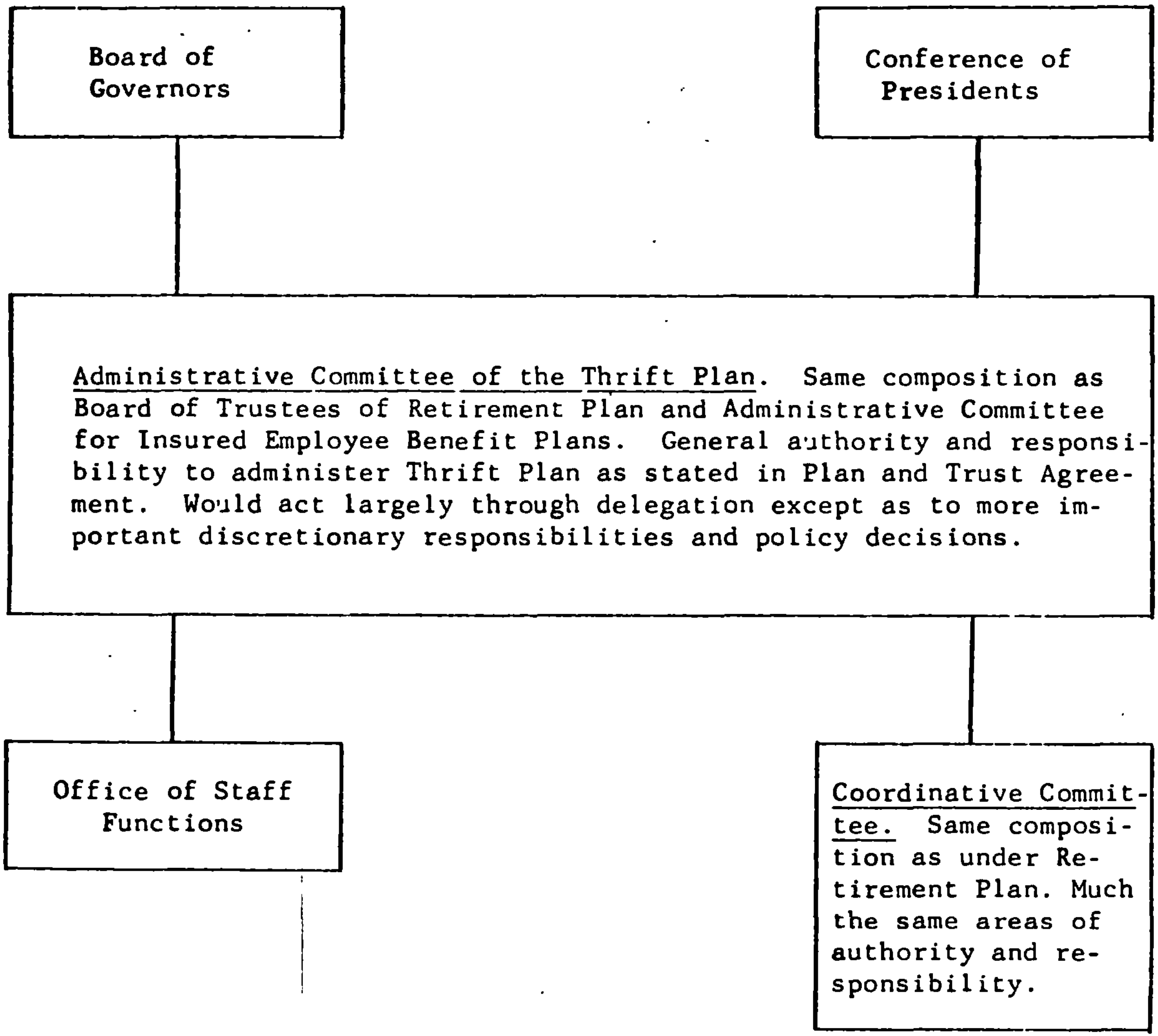
Office of Staff Functions for Retirement, Thrift & Insured Employee Benefit Plans.

Coordinative Committee. Six members, one designated by the President of each Bank not currently represented on the Board of Trustees by either a President or an elected member, one by the Board of Governors, and the Director of the Office of Staff Functions as Chairman. Powers and duties: Decision making as delegated by Board of Trustees; general administration; continuous evaluation of Plan and furnishing reports to Board of Trustees with pertinent recommendations for any changes seen to be necessary or desirable.

Ad hoc committees as needed.

11-21-69 Rev.

Suggested Organization for THRIFT PLAN



11-20-69

Suggested Organization
for
INSURED EMPLOYEE BENEFIT PLANS

Board of Governors

Conference of Presidents

Administrative Committee for Insured Employee Benefit Plans. Same composition as Board of Trustees of Retirement Plan and Administrative Committee for Thrift Plan. General authority and responsibility for administration of Insured Employee Benefit Plans, including life insurance (both lump sum and income benefit), disability insurance, travel accident insurance, and major medical insurance. Would act largely through delegation to Coordinative Committee, the Reserve Banks, and the Office of Staff Functions.

Office of Staff Functions

Coordinative Committee. Same composition as under Retirement Plan and Thrift Plan.

11-20-69

Federal Reserve Banks - Equivalent Insurance Amounts

Salary Multiplier - W-2 Earnings

Age of Wife	Wife* Only	Wife* & Children	Wife* & Dep. Parent	Wife*, Children & Parent
20	2.60	1.75	6.35	2.80
25	3.17	1.95	6.07	2.90
30	3.85	2.68	5.85	3.39
35	4.48	3.18	5.77	3.60
40	4.88	3.44	5.64	3.78
45	5.01	3.82	5.46	4.10
50	4.83	4.01	5.10	4.24
55	4.23	3.70	4.44	3.89
60	3.64	3.40	3.86	3.55

*or Disabled Dependent Husband

Child(ren) Only

Age of Youngest Child	Factor
0	3.33
5	2.93
10	2.36
15	1.56
20	1.00

Parent(s) Only

Age of Dependent Parent(s)**	Factor
50	5.41
60	4.66
70	3.70
80	2.64

**Use age of youngest Dependent Parent

5 year age bracket	Cost per $1000 Anually
Under 30	$ .96
30 to 34	1.20
35 to 39	1.68
40 to 44	2.76
45 to 49	4.80
50 to 54	8.16
55 to 59	13.20
60 to 64	19.56

Example - Age 35 with wife and children
$20,000 Salary

$20,000 x $3.18 = $63,600 Equivalent Insurance
$63,600 - $50,000 = $13,600 Subject to Tax
$13,600 x $1.68 = $22.85 Taxable Income