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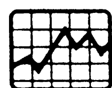
A New Challenge for Plan Fiduciaries

by Joseph B. Bellersen, Jr.



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Annuity Selection Standards

A New Challenge for Plan Fiduciaries

By JOSEPH B. BELLERSEN, JR.

The proposed "gilt-edge standard" for selecting an annuity issuer when terminating a defined benefit plan threatens to narrow the choice to the point of creating a near-monopoly for the highest-rated insurance companies.

The renewed interest the Pension and Welfare Benefits Administration (PWBA) has taken in the annuity selection process poses new challenges for plan fiduciaries. A proposed Interpretive Bulletin–to be released pursuant to the suggestions in the General Accounting Office (GAO) report on private pension protection for annuities–proposes to establish strict criteria for plan fiduciaries in selecting an annuity issuer when terminating a defined benefit plan. This action could leave a scar on the life insurance industry and affect untold billions of dollars of group annuity contracts (GACs), guaranteed investment contracts (GICs), single premium group annuity (SPGA) contracts, and terminal funding annuity (TFA) contracts currently in force. The PWBA has discussed the draft version of its Interpretive Bulletin with the industry and plan sponsors; however, the draft has not been made available publicly. The views expressed in this article are based upon discussions with the PWBA and research conducted with professionals from the life insurance industry and associations who are aware of the bulletin in draft form.

The PWBA originally expressed its concerns about the annuity selection process in its advanced notice of proposed rule making, "Annuitization of Participants and Beneficiaries Covered Under Employee Pension Plans." [29 CFR 2510, June 18, 1991] At that time the Pension Benefit Guaranty Corporation (PBGC) simultaneously issued a report entitled "Selection of Annuity Providers For Terminating Pension Plans" [29 CFR 2617 on June 21, 1991] and subsequently initiated action requiring plan trustees and sponsors of terminating defined benefit plans to make the selection of an annuity vendor subject to advance disclosure. The PWBA had not taken any formal action but continued its enforcement through the courts. The GAO recommended that the DOL take action in its study "Private Pensions—Protection For Retirees' Insurance & Beneficiaries Can Be Strengthened." [April 23, 1993]

The scope of the examination by the DOL in 1991 included a number of factors to be used in evaluating annuity providers:

1. Processes for selecting annuity providers
2. State regulatory requirements and guarantees
3. Rating by nationally recognized rating services
4. Other criteria concerning financial security
5. Reinsurance and other risk- and cost-sharing arrangements in the insurance industry
6. Impact of possible regulatory activity

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The action was prompted by the failure of two major life insurers: Executive Life Insurance Co. and Mutual Benefit Life Insurance Co. Executive Life issued a substantial number of terminal funding group annuity contracts (TFAs) for terminating plans and had been a large issuer of individual single premium immediate annuities (SPIAs) that were also purchased by plan trustees and participants.

Under the rehabilitation plan for Executive Life, most annuitants who were in pay status (receiving periodic checks) continued to receive payments, but in a reduced amount of 70 percent for the first year of the rehabilitation. In the case of Mutual Benefit Life, annuitants from both GACs and individual SPIA contracts continued to receive 100 percent of their benefit amount without limitation. Now, Confederation Life has failed. However, annuitants under SPGAs, TFAs, and individual SPIA contracts continue to receive 100 percent of the annuity income under the contracts without curtailments.

THE PURPOSE OF THE NEW STANDARD

The PWBA has expressed concern that plan sponsors do not sufficiently consider the interests of plan participants when purchasing annuities for terminating defined benefit plans. This issue, however, extends to many annuity contract forms and to defined contribution plans as well. The imposition of a purchase standard is based on the use of agency ratings as a "safest available" standard. However, other financial considerations must be evaluated. Executive Life was once rated within the highest category by two rating agencies, and Confederation Life was classified in the highest category by three agencies. Fiduciaries are compelled by ERISA standards of prudence to act in the exclusive interests of participants. PWBA is concerned that a plan sponsor may be compelled to act in the interests of stockholders and owners by purchasing an annuity from an issuer at the cheapest cost, without regard to the best interests of participants.

PWBA has recommended that such a standard would direct the trustee or sponsor to select only the "safest available" insurer for its participants. Failure to adhere to this "safest available" standard would potentially be a breach of fiduciary responsibility if any other issuer subsequently failed.

ASSESSING ISSUER QUALITY

The recent failure of Confederation Life is another example of the difficulty in assessing issuer quality. Confederation Life was a major issuer of terminal funding annuities, GICs, and SPIAs. It was rated AAA (highest) by Standard & Poor's until January 13, 1992; AAA (highest) by Duff & Phelps until October 26, 1992; and A+ (second highest) by A. M. Best until October 18, 1993. (A. M. Best introduced its A++ (highest) rating for 1991 financial data but cautioned that an A+ was not to be considered a downgrade.)

Currently there are only three issuers rated AAA or the equivalent by Moody's, Standard & Poor's, Duff & Phelps, and A. M. Best: New York Life, Northwestern Mutual Life, and Guardian Life. These issuers would be deemed to fit this "safest available" standard for the annuity selection under the proposed Interpretive Bulletin, since these issuers have been evaluated by each of the rating agencies and found to be of a caliber sufficient to garner the highest rating. However, of these, only New York Life issues SPGA and TFA contracts designed to mirror the plan provisions. Individual SPIAs can be obtained from any of the above issuers to provide many forms of retiree benefits.

THE GILT-EDGE STANDARD

In a September 12, 1994, letter to Assistant Secretary Olena Berg of the PWBA, Qualified Annuity Services characterized the proposed standard as a "gilt-edge" standard. Since PWBA has indicated that ratings are to be used as the major criterion, such a standard implies that fiduciaries must purchase from insurers rated in the highest category by the rating agencies. To do otherwise would risk a breach of fiduciary responsibility. Such a standard has the possibility of creating a monopoly with regard to the issuance of SPGA and TFA contracts.

History has shown that the highest-regarded rating agencies are unable to accurately evaluate the long-term financial solvency of life insurers. Therefore, it seems that a plan sponsor or trustee would be no more able to determine the relative solvency of one insurer over another. The PWBA may issue its bulletin, but plan sponsors would be hard-pressed to challenge the capabilities of the rating agencies in comparing the strength or weakness of an insurer rated AAA versus one rated AA+.

Plan sponsors would be inclined to rely strictly on the rating agencies. Since New York Life is the only issuer rated AAA or the equivalent which issues SPGA and TFA contracts, this creates a virtual monopoly.

In today's markets, insurers covet AAA ratings. Insurers write new business when all pricing factors

are favorable. These factors include access to an adequate supply of high-quality liquid investments and adequate pricing margins. Insurers will not sacrifice prized AAA ratings in order to write large amounts of new annuity business. Rating agencies scrutinize insurers for large increases in new business, particularly interest-sensitive annuity business. A gilt-edge insurer will be required to raise prices in order to compensate for increased amounts of annuity business beyond its prudent financial means.

The gilt-edge standard will thus require the insurer to overcharge in order to retain adequate levels of capital for all available business. No insurer can accept all available annuity business at its standard market rates. The gilt-edge insurer will win a large portion of bids at whatever price it sets. Plan trustees will have the sole alternative of amending their plan to offer lump-sum distributions at PBGC rates in order to reduce ultimate pension termination cost. Studies have shown that lump-sum distributions are frequently squandered by participants, jeopardizing the long-term security created through pensions.

SELECTING AN ANNUITY PROVIDER

The process of selecting an annuity provider is initially based on fundamental contract design criteria. If issuers are not interested in quoting certain benefit forms, many plans may be forced to select an annuity from other than the "safest available" standard, since this is being narrowly defined by PWBA as two or three AAA/AA+ issuers.

After screening potential insurers, fiduciaries will be compelled to evaluate them further on the basis of financial criteria which may include:

- Asset quality
- Asset diversification
- Asset liquidity
- Exposure to mortgages
- Exposure to real estate investments
- Leverage
- Asset/liability matching
- Underwriting skills
- Underwriting experience
- Administration

Evaluating and selecting an annuity issuer is not a frequent practice for most plan trustees. It seems unlikely that a plan sponsor would be experienced in selecting annuity issuers, since experience implies selecting an annuity issuer on more than one occasion.

Yet the PWBA assumes that a plan sponsor has both the means and the resources to evaluate insurer statutory and GAAP accounting statements. This seems to be an unrealistic expectation. Clearly, the rating agencies have had many surprises even after thoroughly examining these documents and conducting annual on-site financial reviews. The major rating agencies have gone so far as to issue strong disclaimers that plan sponsors should not rely solely upon their ratings in selecting annuities.

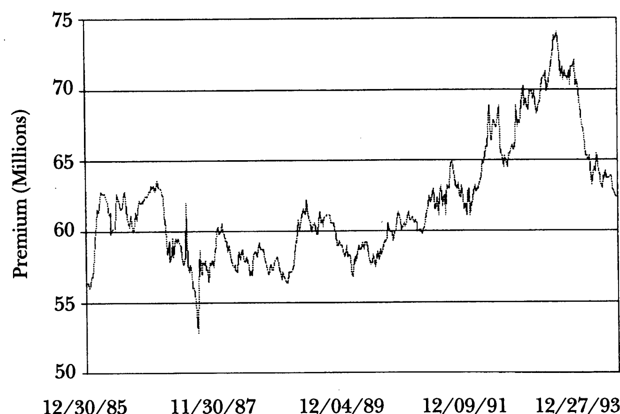
THE NARROWING ANNUITY MARKET

Terminal funding and single premium annuity contract sales have declined markedly since the imposition of the 50 percent excise tax on reversion assets in 1991. This surtax substantially curtailed the termination of defined benefit plans as a means of financing corporate takeovers. Adding to the decline in plan terminations was the precipitous decline in interest rates. The ensuing decline in interest rates has sent PBGC valuations and annuity prices through the roof (see Chart 1).

On August 15, 1994, Allstate Life Insurance Co., a major issuer of SPGA and TFA business, withdrew from issuing bids on cases of less than $10 million. This trend has continued to create an exodus of issuers from the small case market. Plan sponsors may be forced to accept prices dictated by a narrow annuity market. This lack of competitive available bidders will encourage sponsors to offer lump sums at termination, thus forfeiting years of funding in creating a viable long-term retirement plan for employees.

Although the proposed gilt-edge standard nearly establishes a monopoly for these transactions,

Chart 1. Single Premium Annuity—Sample Settlement Cost



Source: The New York GIC Exchange

many plan sponsors cannot purchase contracts from these few issuers because of the following limitations:

- Type and nature of plan benefits. Some plan designs include cost-of-living increases or lump sums based upon external indexes. Reference to indexes such as the Consumer Price Index creates exposure to market forces substantially out of prudent pricing capabilities of the insurer.
- Case size. There is no standard for plan size. Defined benefit plans may cover as few as one employee.
- Retiree life content. Small numbers of retiree lives do not receive underwriting approval because each group contract may be required to be filed as a separate contract within the state of issue. This filing cost can be deemed an excessive cost for small contracts.
- Deferred life content. Deferred lives are discounted at interest resulting in small balances per employee. Deferred life cases also create longer liabilities for insurers. The longer the liability, the greater the chance for pricing error.
- Average-size premium per participant. Small benefit amounts do not generate large premiums. Regardless of the average premium, expenses are the same for contract set-up and issuance of monthly participant checks. Insurers would prefer to have a high average premium per annuitant to gain economy of scale.
- Disability coverage requirements. Some plans offer disability benefits which provide for the full accrued benefit at normal retirement date to be paid in the event of total and permanent disability. Disability can occur at an early age, subjecting the plan and the insurer to substantially greater losses because benefits would be due for a much longer term.
- Death benefits. Some plans allow lump-sum death benefits even when there is no surviving spouse. Procedures for determining the benefit calculations are not always specified. In such a case, the insurer is unable to price or administer the benefit.
- Contributory account balances. Defined benefit plans with mandatory employee contributions require additional administrative capabilities and investment flexibility. Participants have the option to withdraw contributory account balances (which accrue at interest) at any time prior to retirement.
- Social security leveling. This option is found in a number of plans where an employer has downsized its staff and has offered an inducement for employees to take early retirement. Such benefit forms adjust the early benefit until social security benefits are due to start. These benefit forms require special administrative capabilities.
- Optional benefit forms and lump-sum options. These sometimes create pricing problems. One example is a plan that provides for a lump sum as an optional form of benefit. The insurer has a long-term obligation if the participant selects a joint and survivor life annuity and an immediate demand obligation if the participant wants to receive a lump-sum distribution.
- State of issue. Not all insurers have been approved to all states. Obtaining approval to all 50 states is not easy.

Insurance industry financial quality has improved dramatically in the past few years. The Confederation Life seizure may seem to make a case for the gilt-edge standard. However, as noted, annuity checks are being disbursed at 100 percent as first priority claims. There continues to be rating disparity, which undermines the credibility of the rating system itself. It will be difficult, if not impossible, for any additional issuers to gain access to SPGA and TFA business with such high standards. Thus, business will be concentrated in a few issuers.

The PWBA has suggested that the gilt-edge standard also applies to defined contribution plans. Large account balances may accrue in defined contribution plans funded by insurance company group annuity contracts. These open-end contracts satisfy insurers' long-term investing needs by using annuities to fund retirement benefits. If these insurers do not meet this new standard, trustees may be compelled to withdraw large sums from these contracts to purchase annuities from qualifying gilt-edge insurers.

As a result, the trustee or plan sponsor may face this dilemma: Should the trustee choose an annuity from a highly rated gilt-edge insurer or accept a higher-yielding annuity under its group annuity contract? Should the trustee compromise the financial security of a retiring participant or face exposing the employee to insurer credit risk? An example is given in the table below.

Participant:	Male, age 65
Account Balance:	$100,000
Annuity Form:	Life annuity
Offer under AA-rated GAC:	$1,400.00 monthly
Alternative AAA Gilt Edge:	$1,200.00 monthly

The Interpretive Bulletin will apply to both termination annuities and annuity purchases by ongoing plans. The Department of Labor's fiduciary standards carry so much clout in the marketplace that the gilt-edge standard will affect purchases of GICs, individual annuities, and group annuities. The landscape of all forms of investment contracts and insurance contracts may change forever.

TRUTH AND CONSEQUENCE

The following questions were raised directly with the DOL to underscore the long-term consequences of this action:

- If the DOL applies a gilt-edge standard to plan termination annuities, how could the DOL possibly think that such a standard would not apply to other ERISA plans?
- If the DOL applies a gilt-edge standard to defined benefit plans, what is the immediate consequence of a participant receiving a payout annuity issued by a AA-rated insurer from his or her profit-sharing plan?
- If trustees establish a plan that accumulates deposits into a group annuity contract toward a payout annuity at retirement, what is the consequence of the selection of a AA-rated insurer for funding its ongoing deposits?
- If the DOL establishes a gilt-edge standard, will this be considered a safe harbor for fiduciaries against recourse in the event of failure?
- If the DOL establishes the gilt-edge standard and the insurer subsequently fails, what policy will be considered prudent?
- If the DOL establishes a gilt-edge standard, what would the DOL expect of defined contribution plans that invest into group annuity contracts issued as IPG contracts with the purchase of annuities as the retirement payout vehicle?
- If the DOL establishes a gilt-edge standard, what will become of the group annuity contracts issued as IPG contracts by insurers?
- If the DOL issues a gilt-edge standard, what are the consequences for a plan that invested into group annuity contracts issued as IPG contracts that are not breakable as to retiree benefits and the insurer is now rated AA–?
- If the DOL issues a gilt-edge standard, how can the DOL establish 404(c) rules of diversification for participant-directed accounts but issue a mandate that essentially directs fiduciaries to place billions of dollars of fixed annuity pension contract business for all retirement plans into annuities issued by one, two, or even three insurance companies?

As of this writing, there has been no response to these questions from the DOL.

CONCLUSIONS

The adoption of a gilt-edge standard doesn't provide protection to participants, nor does it eliminate risk. Trustees and participants may incorrectly rely upon this standard for coverage if it is followed. This opens the door for additional federal guaranty legislation. The Executive Life failure may have dealt a blow to insurer solvency, but substantial participant protection was provided via the state guaranty system. Annuities of pensioners are being paid as priority claims.

The DOL has no equivalent gilt-edge standard for any other form of pension investment and was unsuccessful in defining government bond funds as a safe-harbor investment in establishing 404(c) diversification requirements for participant-directed accounts. A "safest available" standard will create conflicts and misconceptions that go far beyond setting standards for fiduciary responsibility in either defined benefit or defined contribution plans.

The DOL should continue its efforts at enforcement through the courts. This is the appropriate forum for establishing fiduciary standards.

The DOL hopes to eliminate potential conflicts of interest by preventing the purchase of the cheapest annuity without regard to the long-term financial impact upon participants. It is unnecessary to create an annuity monopoly in order to achieve this goal. Industry leaders must work with the DOL in creating sound principles and policies that have long-term beneficial effects for the pensions and retirement plans. This should include a spirit of promoting the development of rules and regulations to create additional plans—not to discourage them from being formed.

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