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Report to the Honorable William J. Coyne, House of Representatives

March 1993

PRIVATE PENSIONS

Protections for Retirees' Insurance Annuities Can Be Strengthened

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

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March 31, 1993

The Honorable William J. Coyne
House of Representatives

Dear Mr. Coyne:

This report responds to your request that we review the adequacy of protections available for retirees who receive their private pension benefits in the form of an insurance company annuity.

In the report we recommend to the Secretary of Labor that the Department issue formal guidance to assist pension plan fiduciaries in selecting annuity providers. To improve retirement benefit protections, we make additional recommendations to the Secretary and to the Executive Director of the Pension Benefit Guaranty Corporation (PBGC).

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 21 days from the date of this letter. At that time, we will send copies to the Secretary of Labor; Executive Director, PBGC; Director, Office of Management and Budget; and interested congressional committees. Copies will be made available to others upon request.

Please call Donald C. Snyder, Assistant Director, Income Security Issues, on 202-512-7204 if you or your staff have any questions. Major contributors to this report are listed in appendix V.

Sincerely yours,

Joseph F. Delfico

Joseph F. Delfico
Director, Income Security Issues

Executive Summary

Purpose

Insurance regulators seized control of several large life insurance companies in 1991 because of the insurers' solvency problems. These problems have raised questions about the adequacy of protections for the 3 to 4 million retirees and beneficiaries who receive benefits from their private pension plans in the form of insurance annuities. For example, after California regulators seized control of the Executive Life Insurance Company, the 44,000 retirees with Executive Life annuities received only 70 percent of their monthly annuities from the insurer for almost 13 months. Representative William J. Coyne asked GAO to assess (1) state guarantee coverage of insurance annuities received by retirees from private pension plans and (2) federal regulation and oversight of the selection by private pension plans of insurers to provide annuity benefits. He also requested that GAO examine options to improve protections for retirees' insurance annuities.

Background

Under the Employee Retirement Income Security Act of 1974 (ERISA), if a plan terminates without sufficient assets, the Pension Benefit Guaranty Corporation (PBGC) insures the benefits of participants in most defined benefit pension plans. However, the federal guarantee ceases in two situations. First, it ceases when an ongoing plan purchases allocated insurance annuities for participants who retire or leave a company.[1] Second, it ceases when a fully funded plan terminates (a "standard termination") and purchases allocated insurance annuities for participants. PBGC does not insure benefits in defined benefit plans sponsored by professional service employers (for example, physicians and lawyers) with 25 or fewer employees or in defined contribution plans. For all types of private pension participants who receive allocated annuities, state guaranty associations for life and health insurance assume responsibility for guaranteeing payment of benefits if an insurer fails. These associations, composed of the life and health insurance companies in each state, are empowered to assess member insurers up to specified limits to pay the obligations of failed insurers.

ERISA gave PBGC and the Department of Labor primary responsibility for protecting participants' benefits in private pension plans. PBGC pays benefits to participants from underfunded plans that terminate. PBGC also reviews plan selections of annuity providers in standard terminations and refers questionable selections to Labor.

[1]An allocated annuity is issued to, and owned by, an individual; an unallocated annuity is issued to, and owned by, a pension plan.

Labor has jurisdiction for enforcing ERISA's fiduciary rules, which apply to all private pension plans, with certain exceptions. These rules charge plan fiduciaries with managing plans in the best interests of participants and beneficiaries and acting prudently in purchasing annuities. Labor investigates all plans referred by PBGC and is conducting a comprehensive review of plans that purchased annuities from Executive Life.

Results in Brief

Because of variations in coverage provisions of state guaranty associations, some retirees risk losing part of their benefits if their insurers fail. First, there are gaps in coverage of allocated annuities. Second, guarantee limits sometimes do not fully cover the value of retirees' annuities. Finally, variations in guarantee limits can result in unequal protection for retirees with annuities from the same failed insurer.

Three factors limit the effectiveness of federal regulation and oversight of allocated annuities purchased by pension plans. First, Labor does not routinely monitor plan selection of annuities by certain types of plans. Second, Labor has not issued formal guidance to assist fiduciaries in meeting ERISA's requirements for purchasing annuities. Third, PBGC's recently established participant notification requirements are not comprehensive enough because they do not apply to ongoing plans that are insured by PBGC and do not require plans to inform participants about state guarantee coverage of their annuities.

GAO believes the most appropriate option to strengthen protections is for Labor to issue formal guidance to assist fiduciaries' compliance with ERISA's requirements for purchasing annuities. Labor also should extend the participant notification requirements for standard terminations to ongoing plans insured by PBGC. In addition, both PBGC and Labor should broaden the requirements to mandate that plans inform participants about state coverage of their annuities.

Principal Findings

State Guarantee Coverage Exposes Some Retirees to Risk of Benefit Loss

Gaps in coverage of annuities remain, despite the fact that all states and the District of Columbia now have an insurance guaranty association. For example, three states have no provision for covering nonresidents and most states do not cover U.S. citizens who reside in foreign countries.

Variations in guarantee laws can result in retirees with annuities from the same failed insurer receiving different amounts of coverage. Twenty-seven states limit the obligations of their guaranty associations for allocated annuities to $100,000 in present value. Most others and the District of Columbia provide coverage to $300,000. Among retirees from private pension plans who receive annuities, about one out of six has an annuity whose value exceeds $100,000. Furthermore, the percentage of retirees whose benefits would not be fully covered by state guarantees are likely to rise over time since only Minnesota indexes its coverage limits to reflect inflation.

No Federal Oversight of Certain Plans' Annuity Purchases

Labor does not routinely review selections of annuity providers by ongoing plans insured by PBGC, defined contribution plans, or defined benefit plans sponsored by professional service employers with 25 or fewer employees. Labor officials cited enforcement priorities and lack of adequate data on these selections as reasons for not monitoring them.

No Formal Guidance on ERISA's Fiduciary Requirements

ERISA established general requirements for fiduciaries: they must act prudently, diligently, and in the exclusive interest of participants and beneficiaries. Labor has provided some indication, in testimony before the Congress, of how it interprets these requirements as they pertain to selecting an annuity provider.[2] However, Labor has not issued formal guidance nor cited specific factors fiduciaries must consider in making a prudent annuity selection.

Participant Notification Requirements Not Comprehensive Enough

Regulations requiring certain plans insured by PBGC to give advance notice to participants about both the intended annuity provider and the change in their guarantee coverage are not comprehensive enough, either in applicability or content. For example, while plans undergoing a standard termination are required to meet these requirements, Labor has not mandated the requirements for ongoing plans insured by PBGC, even though participants from both types of plans face similar risks when insurance annuities are purchased. In addition, neither plans undergoing a standard termination nor ongoing plans insured by PBGC are required to inform participants about the state coverage that replaces the PBGC coverage they lose. Requiring plans to provide this information would

[2]Testimony of David George Ball, Department of Labor, before the House of Representatives, Committee on Government Operations, Subcommittee on Employment and Housing (Oct. 31, 1991).

create an incentive for them to consider state coverage provisions in purchasing an annuity.

Options to Strengthen PBGC and Labor Regulation and Oversight

Labor and PBGC presented several options to strengthen protections for plan participants in a pair of Advance Notices of Proposed Rulemaking, issued in June 1991. One option included in the advance notices is for the agencies to require plan fiduciaries to meet specified minimum standards in selecting an annuity provider. Another option presented is to specify factors fiduciaries are to consider in selecting a provider but not to establish minimum standards for these factors.

Setting minimum standards would provide a stronger preventive measure, but could present significant problems. The minimum standards would be in addition to, and independent of, ERISA fiduciary requirements. However, this may create confusion among fiduciaries about whether meeting the standards would satisfy the more strict ERISA requirements. Moreover, it may be difficult to establish appropriate minimum standards (see pp. 50-51). In contrast, specifying factors fiduciaries are to consider would avoid such problems and assist them in following a prudent selection process.

Recommendations

To assist fiduciaries in complying with ERISA's requirements, GAO recommends that the Secretary of Labor issue formal guidance that sets forth the Department's view of the factors fiduciaries should consider, at a minimum, in evaluating prospective annuity providers. In addition, GAO recommends that the Secretary of Labor require ongoing plans insured by PBGC to give participants who will receive insurance annuities (1) advance notice of the identity of the insurer or insurers from which annuities may be purchased, (2) advance notice that PBGC coverage ceases upon the purchase of insurance annuities, and (3) detailed information about the state guarantee coverage of the annuities that applies at the time of annuity purchase (see p. 54).

GAO also recommends that in standard terminations, the Executive Director of PBGC require that plan administrators give participants detailed information about the state guarantee coverage that applies at the time of annuity purchase (see p. 54).

Agency Comments

GAO solicited comments on a draft of this report from Labor, PBGC, and the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA). Labor's comments were prepared in coordination with PBGC (see app. IV.) Labor did not take a position on GAO's recommendations. However, it questioned the benefits of the recommendations and cited some costs and burdens that might be imposed on plan sponsors and the Department (see ch. 3).

NOLHGA maintained that variation in state guarantee coverage levels is not a problem because the guarantee system provides a floor of protection that covers a substantial percentage of annuity owners (see ch. 2). Labor and NOLHGA also made technical comments that we incorporated where appropriate.

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Abbreviations

ACLI	American Council of Life Insurance
ERISA	Employee Retirement Income Security Act of 1974
GIC	Guaranteed Investment Contract
NAIC	National Association of Insurance Commissioners
NOLHGA	National Organization of Life and Health Insurance Guaranty Associations
PBGC	Pension Benefit Guaranty Corporation
PWBA	Pension and Welfare Benefits Administration

Introduction

Insurance regulators seized control of several large life insurance companies in 1991 because of the insurers' solvency problems. These problems have raised questions about the adequacy of protections for retirees who receive benefits from their private pension plans in the form of insurance annuities.[1] Retirees from federally insured plans lose the federal benefit guarantee when plans purchase insurance annuities for them. If their insurers fail, retirees from these plans and from private pension plans not insured by the federal government are dependent on the protections of a state guarantee system.[2]

The failure of Executive Life Insurance Company dramatized, on a large scale, the vulnerability of retirees' income to insurer solvency problems. After California insurance regulators seized control of Executive Life in April 1991, the 44,000 retirees with Executive Life annuities received only 70 percent of their monthly annuities from the insurer for almost 13 months.[3] How much of their benefits retirees eventually recover will depend on the rehabilitation plan for the insurers that regulators adopt. However, even when state insurance guaranty associations begin to make payments under the plan, some retirees stand to lose a portion of their promised benefits because they are not eligible for coverage or their benefits exceed state coverage limits.

Ensuring adequate protection of retirees' insurance annuities is important for several reasons. First, private pensions are an important source of income to retirees and the federal government has a commitment to protect these pension benefits. In addition, the continuing growth in insurers' pension plan annuity business portends a steady increase in the number of retirees likely to receive insurance annuities. Finally, pension plan participants generally are not in a position to protect themselves because they typically have no direct voice in plan selection of an annuity provider.

[1] An annuity is a contract sold by an insurance company that pays a monthly (or quarterly, semiannual, or annual) income benefit for the life of a person, for the lives of two or more persons, or for a specified period of time.

[2] See Private Pensions: Millions of Workers Lose Federal Benefit Protection at Retirement (GAO/HRD-91-79, Apr. 25, 1991) and Insurance Company Failures Threaten Retirement Income (GAO/T-HRD-91-41, June 27, 1991).

[3] Many of these retirees have been receiving 100 percent of their annuities since May 1992, under a month-to-month "quick pay" plan, worked out by state life and health insurance guaranty associations. However, retirees who reside in Colorado, Louisiana, or the District of Columbia still receive 70 percent of their annuities because these states and the District did not have guaranty associations when Executive Life was seized by regulators.

Pension Plan Annuity Business With Insurers Has Grown

The continuing expansion of life insurers' pension plan business reflects a steady increase in the number of pension plan participants whose benefits are funded or distributed through insurance annuity contracts. In 1980, life insurers received $16 billion in premiums from these contracts—17 percent of their total premiums from annuities, life insurance, and health insurance. By 1990, this figure had risen to $75 billion—29 percent of their total premiums.

The bulk of pension plan annuity business with insurers takes place through group annuities. In group annuity contracts, insurance companies provide services such as investing pension plan funds and paying annuity benefits to retirees. Life insurance companies' reserves for private pension group annuity contracts more than tripled from 1980 to 1990 ($127 billion to $426 billion), according to the American Council of Life Insurance (ACLI).[4] About 43 million people were covered by these contracts in 1990, compared with 19 million in 1980.[5]

Terminal-funded group contracts constitute another part of pension plan annuity business with insurers. Plans with this type of contract manage their funds through some means other than an insurance company, but purchase insurance annuities to distribute benefits to participants when they retire or separate from a company. Life insurance companies' reserves for private pension terminal-funded group contracts increased tenfold from 1980 to 1990 ($4 billion to $40 billion). Approximately 2 million people were covered by these contracts in 1990, compared with 200,000 in 1980.

Allocated and Unallocated Annuities

Insurers categorize the annuities purchased by pension plans into two types: allocated and unallocated. An allocated annuity is issued to and owned by an individual, and the insurer guarantees payment of benefits to the individual. Pension plans purchase allocated annuities to distribute benefits to plan participants. In contrast, an unallocated annuity is issued to and owned by a pension plan. Pension plans purchase unallocated annuities to fund plan benefits. Guaranteed Investment Contracts (GICs), which are used to fund many defined contribution plans, are a type of unallocated annuity.[6]

[4]A reserve is the amount required to be carried as a liability in the statutory financial statement of an insurer to provide for future commitments under policies in effect.

[5]ACLI's figures overstate the numbers covered because some people are covered by more than one plan.

[6]GICs promise a specified rate of return on plan funds.

Retirees who receive their pension benefits in the form of an insurance annuity have allocated annuities.[7] Three to four million private pension retirees and surviving dependents receive allocated insurance annuities.[8] Many workers whose plans have purchased allocated annuities for them will begin receiving payments when they retire. Unless otherwise specified, all subsequent discussion of annuities refers to allocated insurance annuities.

Number of Life Insurer Insolvencies Has Increased

Increased numbers of insurer insolvencies and recent large insurer failures reflect a more stressful financial environment for life and health insurers. While some insurance-rating companies view the life and health insurance industry as financially sound, the heightened risk of insurer failures underscores the importance of assuring adequate protections for retirees' annuities.

Changes in the market for life insurance products in the 1980s affected the asset quality of many insurers' portfolios. In response to competition from other financial institutions and consumer demand for higher interest rates, insurers began to offer interest-sensitive products that yielded them narrower profit margins. To support these products, some insurers relied upon investments that were higher yielding and more risky than investments they had made earlier.

Competitive strategies like these have financially strained many insurers and increased the number of insurer insolvencies. From 1975 through 1982, the number of life and health insurer insolvencies averaged about four per year. Since that time, the average number increased to almost 18 per year, with 44 insolvencies occurring in 1989 and 27 in 1990 (see fig. 1.1). Our analysis of the characteristics of 67 of 112 companies that failed during 1986 through 1990 showed that most had assets of less than $50 million and were licensed in 10 or fewer states.[9]

[7]Pension plans also distribute benefits through lump-sum payments and periodic payments from the pension fund.

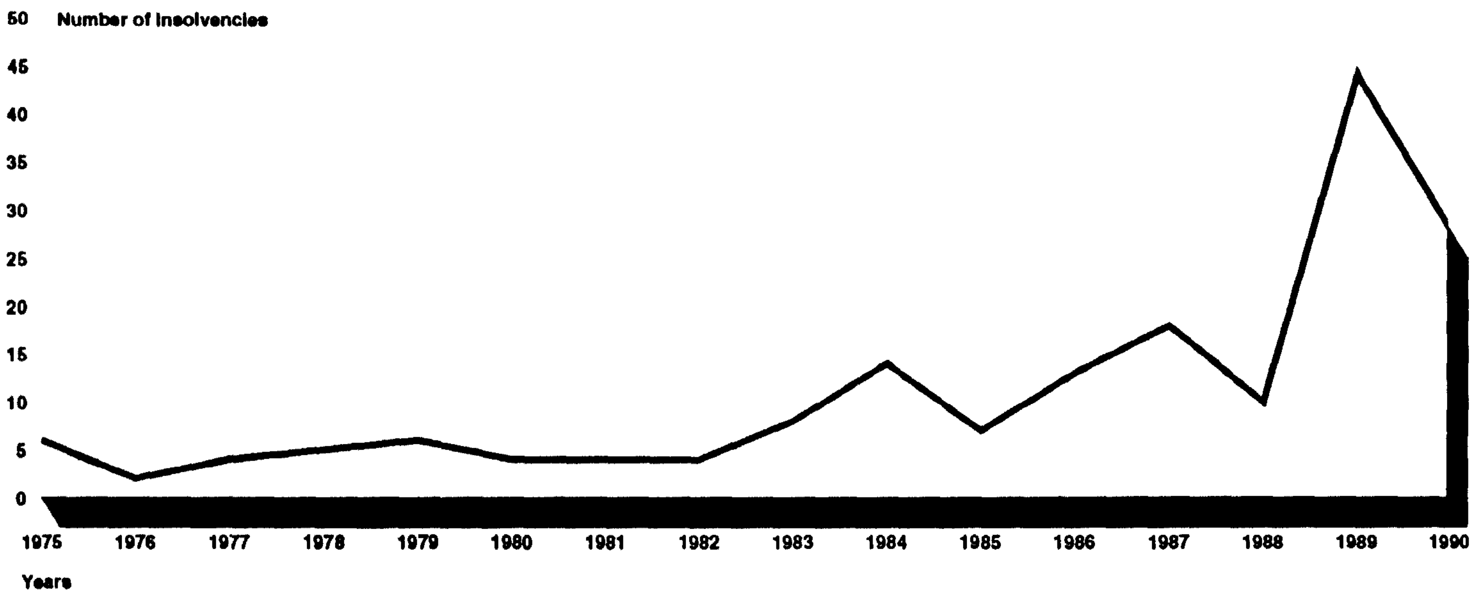
[8]Private Pensions: Millions of Workers Lose Federal Benefit Protection at Retirement (GAO/HRD-91-79, Apr. 25, 1991) describes the methodology used to obtain this estimate.

[9]Insurer Failures: Life/Health Insurer Insolvencies and Limitations of State Guaranty Funds (GAO/GGD-92-44, Mar. 19, 1992).

Junk Bond, Mortgage, and Real Estate Investments Contributed to Large-Insurer Failures

Several companies taken over in 1991 by insurance regulators did not follow previous patterns of insolvencies. Rather, these were sizeable companies (each with more than $3 billion in assets) that marketed a substantial amount of interest-sensitive, low-profit products, while making investments that exposed them to high risks of loss. High levels of investments in junk bonds,[10] mortgages, or real estate contributed to the solvency problems of these large insurers (see table 1.1). Several reported that they had more than a third of their assets invested in junk bonds. Mutual Benefit Life, the largest of the insurers seized, reported it had 38 percent of its assets invested in mortgages and real estate.

Figure 1.1: Life and Health Insurance Company Insolvencies Occurring Annually (From 1975 to 1990)



Note: See app. III for data on this and subsequent figures.

Source: National Association of Insurance Commissioners, National Organization of Life and Health Insurance Guaranty Associations, and individual state guaranty associations.

[10]Junk bonds are corporate bonds that commercial bond-rating agencies either do not rate or rate as below investment grade.

Table 1.1: Extent of Reported Investments in Junk Bonds, Mortgages, and Real Estate of the Large Insurers Seized by State Regulators (1991)

Insurer	Assets (in billions)	Junk bonds as a percentage of assets	Mortgages and real estate as a percentage of assets
Executive Life (Calif.)	$10.2	63%	1%
Executive Life (N.Y.)	3.2	64	0
Fidelity Bankers (Va.)	4.1	37	1
First Capital (Calif.)	4.5	36	7
Monarch (Mass.)	4.5	11	2
Mutual Benefit (N.J.)	13.5	3	38
Life/health insurance industry average	**1.0**	**3**	**21**

Notes: (1) Large insurers refers to those with more than $3 billion in assets. (2) This table shows insurers' assets as of December 31, 1990, as reported in their annual statutory financial statements. In our review of the failures of the first four insurers listed in the table, we found that their statutory financial statements overstated the value of their assets and understated their exposure to potential losses. See Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures (GAO/T-GGD-92-43, Sept. 9, 1992).

Source: Best's Insurance Reports (1991 Life/Health Edition); Best's Aggregates and Averages (1991 Life/Health Edition); Arthur Snyder, "Dispelling the Seeds of Doubt," Best's Life/Health Insurance Management Reports: Perspectives (Oct. 14, 1991).

Mortgage and Real Estate Asset Problems or Loss of Public Confidence Could Precipitate More Insolvencies

The life insurance industry as a whole is significantly more exposed to risks related to mortgage and real estate assets than to those associated with junk bond holdings. In 1990, about 3 percent of life and health insurers' assets were invested in junk bonds, compared with about 21 percent of assets invested in mortgages and real estate (see table 1.1).

Some industry analysts maintain that the most serious threat to insurer solvency is the diminished public confidence in the industry due to the failure of Executive Life and other large insurers. They point out that almost no insurer could withstand a policyholder[11] run generated by perceptions that the insurer is experiencing financial distress.

Protecting Pension Benefit Security

In light of the extensive and growing involvement of the insurance industry in private pensions, recent insurer insolvencies have heightened concern about the security of pension investments and benefits, particularly annuities. Three types of protections exist to safeguard retirees' insurance annuities:

[11]As used in this report, the term policyholder refers to a person or legal entity (for example, a corporation) that holds a life insurance policy, health insurance policy, or annuity contract with an insurance company.

- a state insurance guarantee system that covers certain policies and contracts of failed insurers,
- federal regulation and oversight of pension plans' annuity purchases, and
- state solvency regulation of insurance companies.

This report focuses on the first two protections. These operate in the context of the most basic protection for all insurance company policyholders—assuring that insurance companies are financially strong. Before turning to examine the first two protections, we briefly review the role of insurance solvency regulation and some of the problems we have identified in this area.

Regulating Insurance Company Solvency Is a State Responsibility

The states have primary responsibility for regulation of the insurance industry. They license companies to sell insurance, examine the financial health of licensed companies, and administer—as necessary—the liquidation of insolvent insurers. Effective solvency regulation protects policyholders by reducing the risk that insurance companies fail. Effective regulation is especially important in the case of insurance annuities because these are typically paid out over long periods of time—more than 20 years in many cases.

Recent GAO work has identified significant problems, both with state solvency regulation and efforts of state regulators to strengthen their regulation. Our review of the failures of Executive Life, Executive Life of New York, First Capital, and Fidelity Bankers found that state regulators were ill-equipped and unwilling to act effectively in handling the four insurers' problems.[12]

The National Association of Insurance Commissioners (NAIC) has attempted to strengthen solvency regulation by adopting a set of financial regulation standards and accrediting state insurance departments that meet the standards.[13] On the basis of our review, we found that the accreditation program does not convincingly demonstrate that those state

[12]For example, statutory accounting and reporting requirements failed to ensure that the insurers' financial statements presented the true magnitude of the deterioration in their financial condition. In addition, regulators have been slow in banning the questionable reinsurance arrangements used by the four insurers to artificially inflate their reported financial condition. See Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures (GAO/T-GGD-92-43, Sep. 9, 1992) and Insurance Regulation: The Failures of Four Large Life Insurers (GAO/T-GGD-92-13, Feb. 18, 1992).

[13]NAIC consists of the heads of the insurance departments of the 50 states, the District of Columbia, and four U.S. territories.

insurance departments that have been accredited can effectively regulate insurers within their borders.[14]

Addressing these and other problems with insurance solvency regulation could improve protections for insurance policyholders, including retirees receiving insurance annuities. However, the question of how best to deal with such problems raises a broader set of issues than we can address here.

Federal Government Insures Pension Benefits

To protect working Americans and their dependents from a loss of pension benefits, the Congress passed the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, the benefits for participants of most private defined benefit pension plans are insured by the Pension Benefit Guaranty Corporation (PBGC) in the event a plan terminates without sufficient assets. Defined benefit plans promise each employee a determinable monthly benefit at retirement. Employers are responsible for adequately funding their defined benefit plans so that the plans have sufficient funds to pay promised benefits. If an employer goes bankrupt and its plan contains insufficient assets to pay guaranteed benefits, PBGC takes over the plan and guarantees continued payments up to specified limits.[15]

In contrast, PBGC does not insure defined contribution plans. Under this type of plan, each employee has an account, to which the employer, the employee, or both contribute. Defined contribution plans do not promise a determinable benefit at retirement: the retirement benefit depends on the accumulation of contributions and the employee's proportionate share of the plan's investment gains and losses.

[14] For instance, states with weak regulatory authorities have been accredited as a result of permissive interpretation of the standards by accreditation review teams. Moreover, the accreditation program has too little focus on state insurance departments' implementation of their regulatory authorities. See Insurance Regulation: The Financial Regulation Standards and Accreditation Program of the National Association of Insurance Commissioners (GAO/T-GGD-92-27, Apr. 9, 1992) and Insurance Regulation: Assessment of the National Association of Insurance Commissioners (GAO/T-GGD-91-61, July 29, 1991).

[15] Some defined benefit plans are not covered. For example, one group of defined benefit plans—those sponsored by professional service employers (such as physicians, lawyers, and public accountants) with 25 or fewer employees—is not covered by PBGC guarantees.

Guarantee Responsibility Shifts When Plans Distribute Insurance Annuities

When plans insured by PBGC distribute benefits to participants through the purchase of insurance annuities, PBGC ceases to guarantee the benefits. The guarantee ceases in two situations: when ongoing plans distribute annuities to participants who retire or leave a company and when fully funded plans terminate and distribute annuities to participants. Responsibility for guaranteeing the benefits shifts from the federal government to state insurance guaranty associations. In the event of insurer failure, these associations cover the insurer's obligations to the extent specified in their conditions of coverage. The shift of guarantee responsibility has generated controversy because the state guarantee system exposes some retirees to a risk of benefit loss if their insurers fail.

Plans that are not insured by PBGC (for example, defined contribution plans) may also distribute benefits to participants in the form of insurance annuities. State guaranty associations assume responsibility for guaranteeing these annuities in the event of insurer failure.

Guaranty Associations Not Insured by State Governments

State life and health insurance guaranty associations are not state government agencies. Though established under state law, they are not funded by the states or staffed by state employees. Moreover, states do not guarantee that the associations will have sufficient funds to cover their obligations. The associations, composed of the life and health insurance companies in each state, are empowered to assess member insurers to pay the obligations of a failed insurer. All 50 states and the District of Columbia have established life and health insurance guaranty associations.

Forty-three states and the District of Columbia permit insurance companies to offset a percentage of their assessments through a reduction in their state tax liabilities or through premium rate increases. In effect, these provisions ultimately pass much of the costs of insolvencies to taxpayers through lost tax revenues or to insurance policyholders through higher premiums.

State guaranty associations differ in the insurance products they cover, their conditions of coverage, and their coverage limits. All associations cover allocated annuities, but coverage of unallocated annuities (for example, GICs) varies. Nineteen states cover unallocated annuities, 15 states (and the District of Columbia) explicitly exclude them from coverage, and 16 states do not specify whether such annuities are covered.

Federal Government Oversees Distribution of Plan Benefits

To protect the security of private pension promises, ERISA gave PBGC and the Department of Labor primary responsibility for overseeing plans' distribution of benefits to participants.[16] PBGC administers ERISA's statutory termination procedure for plans it insures. Most of the 8,000 to 11,000 plan termination requests PBGC receives each year are for fully funded plans ("standard terminations"). Before such plans can be terminated, the employer must satisfy specific legal requirements regarding notices to participants and PBGC. In addition, all benefits earned by participants must be distributed through the purchase of insurance annuities or by other form of distribution provided for under the plan. PBGC can disallow any termination that does not comply with these and certain other requirements.

PBGC also oversees the termination of underfunded plans. In these cases, PBGC assumes control of plan assets and pays benefits to participants when due.

Between 1986 and 1991, about 1-1/2 million participants from standard terminations received an insurance annuity purchased by their pension plans (see fig. 1.2). This estimate is based on PBGC's standard termination audit, which found that about 45 percent of participants in standard terminations receive an insurance annuity. Participants in larger plans are more likely to receive their benefits in the form of an insurance annuity. Approximately 14 percent of plans that terminated since 1990 indicated that they purchased insurance annuities for some of their participants.

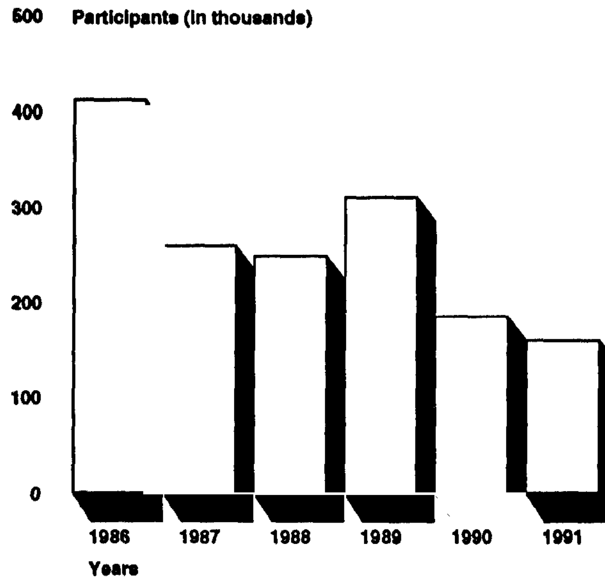
In figure 1.2, a downward trend is shown in the number of participants in standard terminations who received insurance annuities. The trend reflects decreases in both the average size of terminating plans and, since 1989, in the number of terminating plans.

PBGC Identifies Questionable Annuity Providers

Since March 1990, PBGC has reviewed the selection of annuity providers by terminating plans and referred questionable selections to Labor. PBGC initiated the referral process at the direction of the Secretary of Labor, in response to growing concerns about the safety of annuities purchased upon plan termination.

[16]A third agency, the Internal Revenue Service, oversees ERISA's participation, vesting, and funding standards.

Figure 1.2: Estimated Numbers of Participants in Standard Plan Terminations That Received Insurance Annuities



Note: Numbers are based on date of plan termination and assume that 45 percent of participants received insurance annuities.

Source: Pension Benefit Guaranty Corporation Management Report (March 1992).

Labor Enforces Compliance With ERISA's Fiduciary Rules

Labor has primary jurisdiction for those provisions of ERISA that contain the fiduciary, reporting and disclosure, and prohibited transaction provisions of the act. Within Labor, the Pension and Welfare Benefits Administration (PWBA) is the agency responsible for enforcing these provisions. PWBA's Office of Enforcement consists of a national office and 15 field offices. PWBA investigates all plans referred by PBGC. In addition, PWBA has identified plans that purchased annuities from Executive Life since 1985 and investigated some of them.

Objectives, Scope, and Methodology

In response to heightened public concern about insurer insolvencies, Representative William J. Coyne asked us to examine the adequacy of protections for retirees' insurance annuities. On the basis of discussions with Representative Coyne's staff, we agreed to (1) assess state guarantee coverage of insurance annuities received by retirees from private pension plans, (2) assess federal regulation and oversight of the selection by private pension plans of insurers to provide annuity benefits, and (3) examine options for improving protections for retirees' insurance

annuities. We agreed that state solvency regulation of insurers, which plays a major role in protecting the benefits of insurance company policyholders, would be outside the scope of our work.

We interviewed officials of the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and ACLI to collect information on the state insurance guarantee system. We obtained data on federal regulation and oversight of plans' annuity purchases by interviewing PBGC and Labor officials, reviewing agency documents and ERISA, and obtaining PBGC's responses to a set of questions about the agency's regulatory authority and oversight activities.

To estimate the extent to which state guarantee limits fully cover retirees' insurance annuities, we analyzed data from the Pension Supplement of the Census Bureau's December 1989 Current Population Survey. The Pension Supplement contains data on the amount of monthly pension benefits for private pension recipients.

We obtained information on options to improve protections for insurance annuities from several sources, including records of congressional hearings; public comments received by PBGC and Labor on their Advance Notices of Proposed Rulemaking; reports and minutes of work groups from NAIC, ACLI, and Labor's Advisory Council on Employee Welfare and Pension Benefit Plans; and literature on the topic.

We did our work from July 1991 to October 1992 in accordance with generally accepted government auditing standards. The Department of Labor provided written comments on a draft of this report. Labor's comments, which were coordinated with PBGC, are summarized and evaluated in chapter 3, and included in appendix IV. NOLHGA also reviewed a draft of this report and we incorporated its comments as appropriate. (See ch. 2.)

Guarantee Coverage of Retirees' Annuities

State guaranty associations provide a safety net in the event of an insurer insolvency for many retirees from private pension plans who receive insurance annuities. However, because of variations in state guarantee coverage provisions, some retirees risk losing part of their benefits if their insurers fail.[1] First, there are gaps in coverage of annuities. Second, some retirees are vulnerable to a loss of benefits because the value of their annuities exceeds the state guarantee limit. Third, the lack of uniformity in state guarantee limits can result in unequal protection for retirees with annuities from the same failed insurer.

The solvency problems of several large life insurance companies seized by state regulators in 1991 have raised concern about whether state guaranty associations have sufficient assessment capacity to handle one or more large company failures. The maximum percentage of insurers' premium income that a guaranty association can assess in a single year varies by state law from 1 to 4 percent.

Federal Guarantee Does Not Extend to Insurance Annuities

PBGC was established to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries of defined benefit plans. However, the transfer of responsibility for payment from a pension plan to an insurance company effectively ends any PBGC guarantee. Consequently, the failure of an insurance company leaves retirees from these plans dependent on the varying protections of the state guarantee system.

ERISA explicitly provides for PBGC to guarantee payment of benefits in the event of a plan termination. Yet the issue of PBGC's liability when responsibility for pension payments is transferred to an insurance company is not expressly addressed in ERISA. In its preamble to regulations published in 1981, PBGC said: "In the unlikely event that an insurance company should fail and its obligations cannot be satisfied...PBGC would provide the necessary benefits." However, PBGC's Executive Director testified before the Congress in 1990 that ERISA does not authorize PBGC to provide such coverage.

In a 1991 letter clarifying its position, PBGC affirmed its view that ERISA does not provide authority to guarantee annuities purchased from an insurance

[1]Specific references in this chapter to coverage provisions of the various state guaranty associations are based on information provided by NOLHGA. We did not independently verify this information.

company.[2] While PBGC has a statutory basis for its position, it leaves retirees whose pensions are paid by insurance companies exposed to a risk not present for retirees whose pensions are paid directly by pension plans.

PBGC reasons that it has no authority to extend guarantees in the case of failure of an insurance company to pay annuities. The only event identified in ERISA as triggering availability of federal guarantees is termination of a pension plan. PBGC notes that an insurance company's default is unrelated to plan termination and, therefore, cannot trigger the guarantee. PBGC also maintains that if the Congress had intended that PBGC guarantee insurance annuities, the Congress would have designed a premium structure to protect PBGC against this exposure.[3]

Some Retirees Not Protected by State Guarantees

Under state guarantee laws, which vary from state to state, some retirees may not be protected if their insurers should fail. Until recently, many retirees were unprotected because the states in which they resided had no guaranty associations. With the establishment, in 1991, of guaranty associations in California, Colorado, Louisiana, New Jersey, and, in 1992, the District of Columbia, every state now has an association. However, gaps in coverage of annuities remain.

State Coverage Based on Two Models

State guarantee coverage is generally based on one of two National Association of Insurance Commissioners (NAIC) models: the initial one adopted in 1970 or the revised model adopted in 1985.[4] Under the first model, a state guaranty association covers all policyholders (regardless of where they live) of failed insurers domiciled in the state. States with this model also cover their own residents when a licensed insurer domiciled in another state becomes insolvent, unless that other state provides coverage.

[2] See Private Pensions: Millions of Workers Lose Federal Benefit Protection at Retirement (GAO/HRD-91-79, Apr. 25, 1991), app. III.

[3] Some pension policy analysts have argued that the statutory language of ERISA does not support PBGC's position and that ERISA does provide a basis for PBGC liability for insurance annuities. See, for example, statement by Norman P. Stein before the House of Representatives, Select Committee on Aging, Subcommittee on Retirement Income and Employment, Hearing on Pension Annuity Protection and the Failure of Executive Life (June 25, 1991).

[4] NAIC develops and adopts model laws and regulations that state insurance commissioners collectively believe are needed to regulate the insurance business.

Under the revised model, coverage is limited to state residents for companies licensed to do business in a state, regardless of whether the company was domiciled in the state.[5] However, under this model, a guaranty association would also cover nonresidents when all of the following four conditions are met:

- the failed insurer was domiciled in the state,
- the failed insurer never held a license or certificate of authority in the state in which the policyholder resides,
- the policyholder resides in a state that has a similar guaranty association, and
- the policyholder is not eligible for coverage by the guaranty association of his or her own state.

As of December 1992, five states covered all policyholders and the remaining states (and the District of Columbia) have adopted some variation of residents-only coverage.

Sources of Coverage Gaps

To determine how variations in guarantee laws affect policyholders, our March 1992 report on state guaranty associations reviewed the insolvencies of six multistate insurers.[6] In four of the six failures, some policyholders were denied protection because of differences in the guaranty associations' coverage provisions.

Under current state guarantee coverage provisions, policyholders whose insurers fail may be denied coverage as a result of any of the following four conditions:

- no state provision for covering nonresidents;
- state has an additional requirement for nonresident coverage, which policyholder does not meet;
- no state coverage of policies or contracts issued to residents when an insurer is no longer licensed in the state; and
- no state provision for covering U.S. citizens who reside in foreign countries.

[5]The revised model also provides for coverage of policies and contracts issued by insurers whose state license has been suspended, revoked, not renewed, or voluntarily withdrawn.

[6]The insurers were domiciled, respectively, in California, Florida, Illinois, Indiana, Oregon, and Texas. See Insurer Failures: Life/Health Insurer Insolvencies and Limitations of State Guaranty Funds (GAO/GGD-92-44, Mar. 19, 1992).

Nonresident Coverage Varies

Three states (Indiana, Maryland, and Minnesota) have no provisions for covering nonresidents. As a result, if an insurer domiciled in one of these states failed, policyholders residing in a state in which the insurer had never been licensed would not be covered. A retiree might own an annuity from a company never licensed in his or her state of residence for several reasons. For example, after retirement, it is common for retirees to move to other states. In addition, a retiree may have lived or worked in a state other than that in which the employer was headquartered and in which the annuity was originally purchased.

New York's guarantee law stipulates a fifth condition (in addition to the four conditions previously cited) for nonresident coverage. Nonresidents are eligible for coverage only if they resided in New York when the policies or contracts were issued. Policyholders may be denied coverage if they do not meet this eligibility requirement.

State Licensure Lapses

Coverage gaps can also occur when an insurer issues annuities to residents of a state in which it is no longer licensed to sell insurance. An insurance company may no longer be licensed in a state for various reasons, for example, the company decided not to renew its license, or state regulators suspended or revoked its license. Under the NAIC's 1985 model guaranty act, a state guaranty association is not liable for any policy or contract issued in the state by an insurer formerly licensed in the state but not licensed at the time the policy or contract was issued.

Some policyholders were denied coverage for this reason in one of the multistate insurer insolvencies we reviewed. The guaranty association in their own state denied coverage because, while the insurer had been licensed in the state, the insurer was not licensed there at the time the policies were purchased. The association in the insurer's state of domicile would not cover these policyholders because nonresidents were covered only if the failed insurer had never been licensed in their state of residence.

No Provision for Covering Foreign Residents

The 1985 model guaranty act has no provision for covering U.S. citizens who reside in foreign countries. Thus, workers who retire and move to Mexico, Canada, or other countries may be vulnerable to a loss of benefits if their insurers fail and are not domiciled in one of the five states that covers all policyholders of domiciled insurers.

Variations in Guarantee Limits Allow Unequal Treatment of Retirees

PBGC guarantee limits are uniform for all covered participants.[7] In contrast, differences in state guarantee limits can result in unequal treatment of retirees receiving annuities from the same failed insurer.

Twenty-seven states limit the obligations of their guaranty associations for allocated annuities to $100,000 in present value, the limit recommended by NAIC (see app. I).[8] New Jersey and Washington have a $500,000 limit; Oklahoma, Pennsylvania, and the District of Columbia have a $300,000 limit. Maryland fully covers the contractual obligations of impaired insurers. California, which has a $100,000 limit for annuities, imposes a 20 percent deductible.

The remaining 18 states do not specify a limit for allocated annuities. Fourteen of these have a $300,000 limit for all benefits payable to an individual, regardless of the number of policies or contracts held. New York has a $500,000 limit, and the other three states (Montana, Vermont, and West Virginia) do not specify a limit for all benefits.

Annuity Values Sometimes Exceed Guarantee Limits

Among retirees from private pension plans who receive annuities, about one out of six has an annuity whose value exceeds the $100,000 coverage limit established by over half the states. Furthermore, the percentage of retirees whose annuities would not be fully covered by this limit is likely to rise over time since, with one exception (Minnesota), state coverage limits are not indexed to reflect inflation.

Many participants from defined benefit plans insured by PBGC face a reduction in benefit coverage when they receive insurance annuities. PBGC's 1992 monthly maximum guarantee amount for a 65-year-old was $2,352. In contrast, $100,000 in present value corresponds to about $1,000 per month for a 65-year-old man.

Retirees whose annuity values exceed the limit of the guaranty association risk losing a portion of their benefits should their insurers fail. Guaranty associations make up any shortfall in benefits from the available assets of failed insurers, up to the state limits. For example, suppose the present value of a retiree's annuity is $150,000 and the annuity is covered up to $100,000 by a state guaranty association. If the insurer fails and its available assets pay 71 cents on the dollar, the guaranty association is

[7]The limits are actuarially adjusted for retirement ages below the age of 65.

[8]The present value of an annuity is the amount that would be sufficient, if invested at a given interest rate, to fund the expected future stream of annuity payments.

liable for $29,000—the amount required to make up the shortfall up to $100,000. However, since assets from the insurer's estate will provide only 71 percent of the remaining $50,000 in benefits, the retiree's monthly annuity check will be reduced approximately 10 percent.

Pension Receipt Data Used to Estimate Extent of Benefit Coverage

We analyzed pension receipt data from the Pension Supplement of the Census Bureau's 1989 Current Population Survey to estimate the extent to which a $100,000 state guarantee limit would fully cover the annuities of retirees from private pension plans. For comparison, we also estimated the percentage of these annuities that would be fully covered by PBGC guarantee limits. Because of limitations in the Census data, we could not determine which retirees receiving retirement benefits payable for life had insurance annuities and which were paid by their plans. (See app. II for a description of our methodology.)

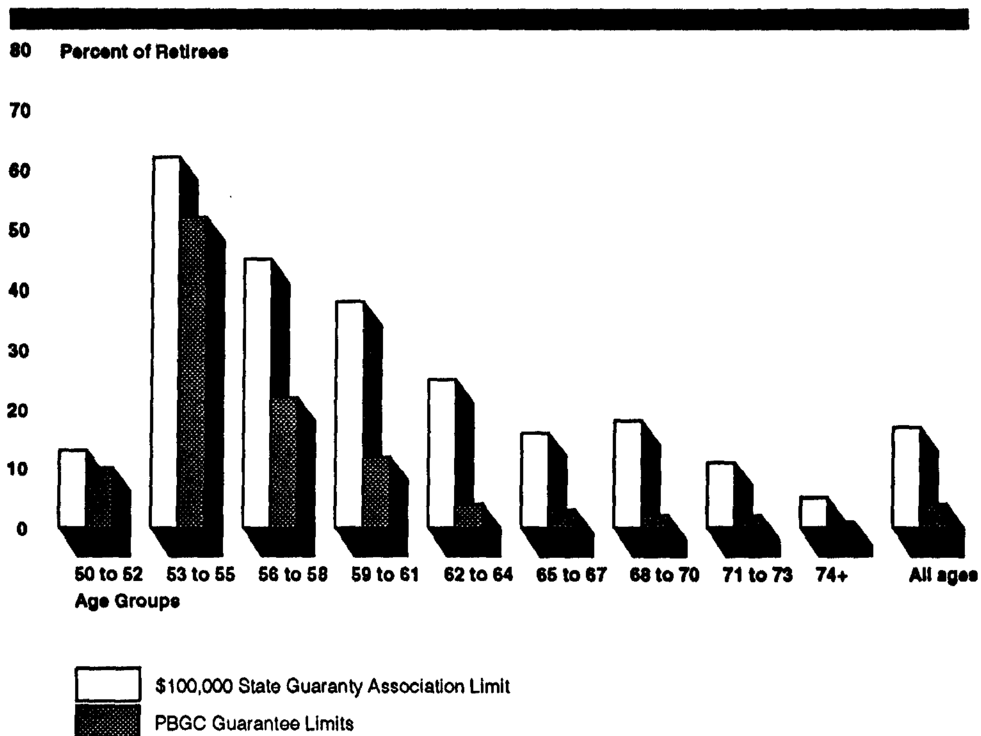
Overall, 17 percent of retirees with annuities receive benefits that exceed $100,000 in present value and 4 percent receive benefits that exceed PBGC guarantee limits (see fig. 2.1). Since men tend to have larger pensions than women, the percentages are higher for men: overall, 22 percent receive benefits that exceed $100,000 in present value and 6 percent receive benefits that exceed PBGC limits, compared with 7 percent and 1 percent, respectively, for women (see figs. 2.2 and 2.3).

A greater percentage of younger retirees receive benefits that exceed $100,000 in present value. For example, 27 percent of retirees aged 50 to 67 receive benefits that exceed this value, compared with 10 percent of retirees aged 68 and over. Annuity values tend to decrease with age, primarily because older retirees have shorter life spans.

Failure to Index State Guarantee Limits Leads to Erosion of Coverage

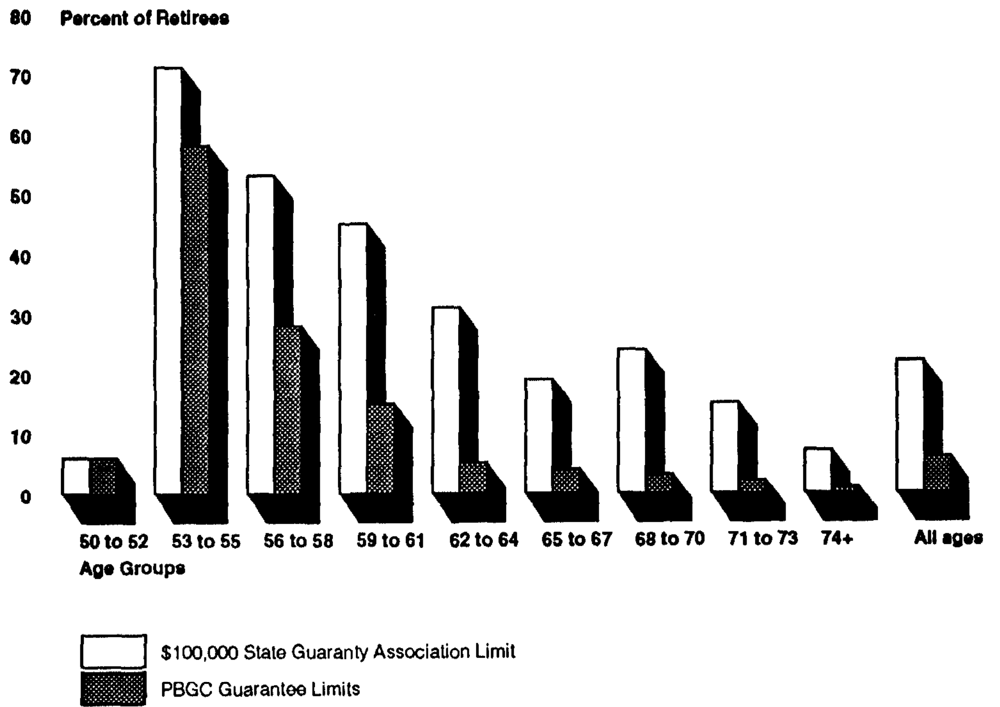
While PBGC's coverage limit for most plans is indexed upward annually, no state's law except Minnesota's provides for indexing guarantee coverage limits to inflation rates. Therefore, as rising salaries boost the value of future retirees' pensions, the percentage of younger retirees holding pensions that exceed state guarantee limits will most likely increase.

Figure 2.1: Retirees Receiving Annuities With Values Exceeding State Guaranty Association or PBGC Limits



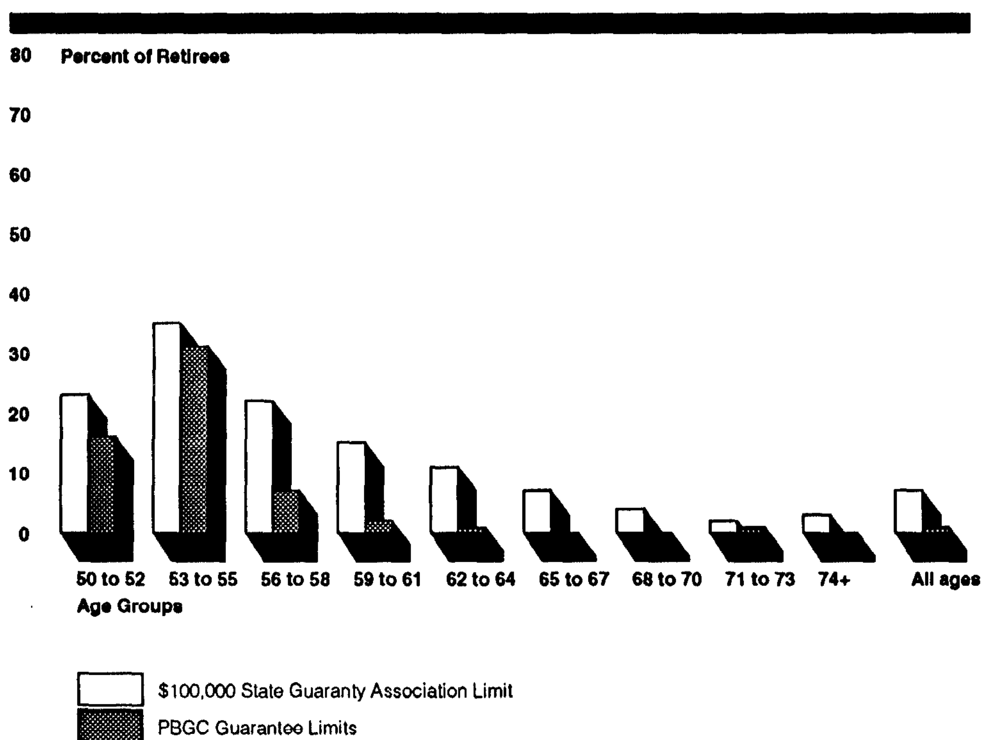
Source: December 1989 Pension Supplement to Current Population Survey, Bureau of the Census (Washington, D.C.: G.P.O., 1990).

Figure 2.2: Retirees Receiving Annuities With Values Exceeding State Guaranty Association or PBGC Limits: Men Only



Source: December 1989 Pension Supplement to Current Population Survey, Bureau of the Census (Washington, D.C.: G.P.O., 1990).

Figure 2.3: Retirees Receiving Annuities With Values Exceeding State Guaranty Association or PBGC Limits: Women Only



Source: December 1989 Pension Supplement to Current Population Survey, Bureau of the Census (Washington, D.C.: G.P.O., 1990).

Capacity of State Guaranty Associations Limited

The recent solvency problems of several large life insurance companies seized by state regulators have raised concern about the ability of state guaranty associations to handle one or more large company failures. As of December 1992, NOLHGA estimated the cost to the guaranty associations for paying Executive Life policyholders at $1.9 billion, which is almost three times the total amount assessed by state guaranty associations for all insurer insolvencies from 1975 to 1990.

Individual guaranty associations may not have sufficient capacity to handle an increasing number of insolvencies or the insolvency of several large insurers. The total nationwide assessment capacity for 1990 was approximately $3 billion ($1.1 billion for accident and life insurance, $784 million for annuities, and $1.2 billion for health insurance), according to NOLHGA. Yet the maximum amounts that can be assessed by law in a single year vary among the states. Forty-two states and the District of

Columbia limit assessments to 2 percent of insurers' premium income from the same type of business (for example, annuities) for which the association is making assessments. The other states have adopted assessment limits ranging from 1 to 4 percent of premium income.

Since many of the obligations of a failed insurer are spread over several years, the 1-year assessment capacity of a guaranty association is not conclusive in determining the ability of the association to cope with losses from a major insolvency. However, even though a guaranty association can repeat assessments in subsequent years if it reaches its annual assessment limit, this may result in partial or delayed payments of policyholder claims and benefits.

Options to Improve State Guarantee Coverage

The previous section discussed several problems with state guarantee coverage of retirees' annuities: gaps in coverage, coverage limits that sometimes do not fully cover annuities, and variations in coverage levels that can lead to inequitable treatment of retirees. The most direct approach to improving guarantee coverage is for the states to revise their guarantee laws to address these problems. NAIC's Guaranty Fund Task Force and ACLI's Study Group on Alternatives and Enhancements to the Current Guaranty Association Mechanism have discussed at least two means of implementing this approach. One option is for the states to create an interstate compact that standardizes coverage provisions. Another option is for the NAIC, as part of its Financial Regulation Standards for accrediting state insurance departments, to recommend the coverage provisions that should be included in each state's guaranty association law.

Develop Interstate Compact to Standardize Coverage

The first option is to develop an interstate compact. Interstate compacts are legal instruments that provide a constitutional basis for a contractual and statutory relationship among those states becoming party to them. These compacts require the consent of the Congress and generally cannot be modified by subsequent state legislation unless so provided in the contract.

NAIC's model guaranty association act, appropriately revised to eliminate coverage gaps and establish adequate coverage limits, could serve as the basis for a compact. The compact also could include provisions to improve administration of the state guaranty associations. For example, one proponent of the idea has suggested that the compact could provide

for a national association to help coordinate activities among the state associations with respect to specific insolvencies.

The interstate compact option may be difficult to implement successfully. First, interstate compacts generally take a long time to enact. One study found the average time required, excluding the period of negotiation, from the first state's ratification of the contract to the date of congressional consent, was nearly 5 years.[9] This length of time would be a problem because, in the meantime, some retirees with annuities from failed insurers would face the prospect of receiving no coverage or incomplete coverage. Second, since interstate compacts can diminish state sovereignty and states' ability to act independently, some states may be reluctant to adopt a compact concerning guaranty associations. Finally, obtaining agreement to raise coverage limits may be difficult. Some states may oppose raising the limits on the grounds that higher limits would increase taxpayer costs and may encourage consumers to purchase insurance products without considering the stability of the insurer.

Specify Guarantee Coverage Provisions in NAIC Financial Regulation Standards

The second option is for the NAIC to specify, in its Financial Regulation Standards, the coverage provisions necessary to establish adequate coverage limits and assure that gaps in coverage are eliminated. NAIC's current standards require that states have a guaranty association, but do not specify any coverage provisions that should be included in guaranty association laws.[10]

NAIC's Financial Regulation Standards, which it adopted in June 1989, establish minimum requirements for effective solvency regulation. In June 1990, NAIC adopted an accreditation program to encourage state insurance departments to comply with the standards. NAIC plans to have accredited states penalize insurers domiciled in states that do not become accredited. If the accredited states carry out the penalties, according to NAIC, this would give insurers the incentive to lobby for the increased authority and resources their home states need for accreditation.

[9] Fredrick L. Zimmerman and Mitchell Wendell, The Law and Use of Interstate Compacts, Council of State Governments (1976).

[10] In March 1993, NAIC's Financial Regulation Standards and Accreditation Committee recommended adding certain provisions of NAIC's guaranty association model act to the Financial Regulation Standards. The provisions deal with coverage of residents and nonresidents, as well as the definition of member insurers. NAIC's executive committee and plenary are slated to consider adopting this recommendation in June 1993.

Two considerations raise questions about the feasibility of this option as well. First, NAIC has no authority to require states to adopt or implement its model laws and regulations, which NAIC has had limited success in getting states to adopt. Second, states that do adopt model laws can—and do—modify them to fit their situations.[11]

Options for Federal Action to Improve Guarantee Coverage

Policy analysts have proposed at least two options for the federal government to improve guarantee coverage for retirees' insurance annuities. One option would establish a role for PBGC in backing these annuities. Analysts have suggested several ways of doing this. For example, the American Association of Retired Persons and the American Federation of Labor and Congress of Industrial Organizations have recommended that the Congress authorize PBGC to guarantee the insurance annuities of retirees from plans insured by PBGC. Two other kinds of guarantee roles for PBGC have been suggested.[12] One suggestion is to hold ongoing plans insured by PBGC liable for the insurance annuities they purchase and make PBGC a secondary guarantor if a plan terminates with insufficient assets to pay this liability. Another is to require plans intending to purchase annuities in a standard termination to purchase them from PBGC. A second option for federal action, which has been incorporated in two bills introduced before the Congress, is to establish a national guaranty corporation to cover life insurance company products.

Extend PBGC Coverage to Insurance Annuities Purchased by Plans Insured by PBGC

One way to establish a PBGC role in backing insurance annuities would be for the Congress to extend coverage to insurance annuities purchased by plans insured by PBGC and require these plans to pay an additional premium for this coverage. This would assure that participants from both standard terminations and ongoing plans insured by PBGC would be covered up to limits set by PBGC in the event the insurer providing their annuities failed.

The option would present funding problems, however. PBGC had a deficit of $2.7 billion in its single-employer fund at the end of the 1992 fiscal year. Unfunded liabilities in ongoing plans insured by PBGC currently total approximately $50 billion. PBGC estimates that extending coverage to insurance annuities purchased in standard terminations would increase its

[11]See Insurance Regulation: Assessment of the National Association of Insurance Commissioners (GAO/T-GGD-91-61, July 29, 1991).

[12]These are included in the comments received by PBGC and Labor on a pair of Advance Notices of Proposed Rulemaking issued in June 1991 (see p. 48).

potential liability by about $50 billion.[13] While PBGC's potential liability for annuities purchased by terminating and ongoing plans could be offset by premium income, establishing appropriate premium amounts to cover PBGC's long-term exposure would be difficult. PBGC would have to develop experience in rating the risks of insurance company failure. Furthermore, since the federal government does not regulate insurers, PBGC would lack any ability to control its liability. In addition, states would have an incentive to exclude coverage of annuities backed by PBGC, which would increase PBGC's potential liability.

Funding and administrative difficulties would arise if coverage was provided to former participants for whom plans purchased insurance annuities. Collecting a premium from these plans would be difficult because many have terminated. On the other hand, spreading the cost of covering these participants among plans that will purchase annuities would raise an issue of fairness. Furthermore, PBGC would encounter problems identifying these participants. Neither PBGC nor Labor maintains complete records of plan participants who receive insurance annuities, so they would have to be identified by their former pension plans, to the extent possible, or by data from the insurance companies that pay them.

Hold Ongoing Plans Liable for Retirees' Insurance Annuities

An alternative way to establish a PBGC role in backing insurance annuities is for the Congress to revise ERISA to stipulate that ongoing plans insured by PBGC will be liable for any loss of benefits experienced by former plan participants receiving insurance annuities.[14] In this alternative, ongoing plans would be required to pay an additional premium to fund PBGC coverage of these annuities. Thus, if retirees from an ongoing plan face a partial loss of benefits because of insurer insolvency and the plan lacks sufficient funds to make up the loss, the plan sponsor would be primarily liable for payment of the benefits. In such cases, PBGC would guarantee retirees' benefits up to PBGC coverage limits.

While this alternative would mitigate the increase in PBGC exposure, it would still place PBGC in the position of being unable to control its losses. As previously mentioned, states would have an incentive to exclude coverage of any annuities backed by PBGC. By making plans and plan sponsors the primary guarantors and PBGC the secondary guarantor, this

[13] ERISA authorizes PBGC to borrow up to $100 million from the U.S. Treasury. However, the federal government is not liable for any obligation or liability incurred by PBGC.

[14] Labor regulations currently provide that plans cease to be liable for participants' benefits when the plans purchase an annuity contract from an insurer to provide participants' entire benefit rights. See 29 C.F.R. section 2510.3-3.

alternative would increase PBGC's potential liability significantly less than making PBGC the primary guarantor of insurance annuities purchased by plans. However, PBGC's liability could grow if the alternative precipitated an increase in the number of standard terminations. This could occur if some plan sponsors terminate their defined benefit plans to avoid incurring liability for participants' insurance annuities.

Require Terminating Plans to Purchase Annuities From PBGC

A third alternative for establishing a PBGC role in backing retirees' annuities is for the Congress to require plans insured by PBGC to purchase annuities from PBGC if the plans intend to distribute insurance annuities in a standard termination. PBGC either could pay annuities directly or assume the role of guarantor by contracting with one or more insurers to provide the annuities.

While this alternative would improve guarantee coverage for retirees from terminated plans, it also has drawbacks. By taking annuity business away from insurers or restricting this business to a few insurers only, this alternative might impair the overall financial health of some companies that currently market pension annuities. In addition, if PBGC reinsures the annuities, it would tend to place them with insurers it views as the soundest in the industry. But without any authority to regulate insurers, PBGC could not assure that these insurers will not face solvency problems at some future time.

Establish a National Insurance Guaranty Fund

The second option is for the Congress to establish a national insurance guaranty fund. This would involve creating a national corporation authorized to collect assessments from insurance companies and administer guarantee payments to policyholders of insolvent insurers. By establishing uniform and adequate coverage levels, this option could improve guarantee coverage for retirees from all types of private pension plans who receive insurance annuities.

A national guaranty fund has the potential for achieving some administrative efficiencies over a state guarantee system. For example, providing centralized management and requiring insurers to pay assessments to one source may lower administrative expenses. In addition, in the event of insolvency of multistate insurers, a national fund may help avoid conflicts, which can occur under a state guarantee system, between state guaranty associations.

This option may be difficult to implement, however, because it would most likely require major revisions not only to the current insurance guarantee system but also to the system of insurance solvency regulation. This is because of the inherent hazards of the federal government's guaranteeing something over which it has no regulatory control. Even if the national guaranty corporation was chartered as a nonfederal agency and prohibited from using federal funds, an insurance industry solvency crisis that overwhelmed the national guaranty fund would raise the specter of a federal bailout. The national guaranty corporation could exert some control over its potential liability if the Congress authorized a federal role in insurance solvency regulation.[15] However, the delineation of an appropriate federal role in insurance solvency regulation involves a broad and complex set of issues.

Conclusions

Because of variations in state insurance guarantee coverage provisions, some retirees risk losing part of their benefits if their insurers fail. First, there are gaps in coverage of annuities. Second, coverage limits sometimes do not fully cover the value of retirees' annuities. Third, the lack of uniformity in state guarantee limits can result in unequal protection for retirees with annuities from the same failed insurer. The risk of loss for many retirees from plans insured by PBGC is especially significant because of a reduction in the amount of coverage for their retirement benefits when the federal guarantee ceases.

The solvency problems of several large life insurance companies seized by state regulators in 1991 have raised concern about whether state guaranty associations have sufficient assessment capacity to handle one or more large company failures. The maximum percentage of insurers' premium income that a guaranty association can assess in a single year varies by state law from 1 to 4 percent.

While several options have been proposed to improve guarantee coverage, each has significant drawbacks. Revising state guarantee coverage provisions would be the most direct way to address the problems noted above. However, this may be difficult to achieve because NAIC has no authority to compel states to adopt its guarantee coverage recommendations and an interstate compact would require considerable state coordination. The Congress has at least two options available to deal

[15]Two bills introduced in the 102nd Congress to create a national insurance guaranty corporation would also have established a federal commission with such regulatory authority. S. 1644, the Insurance Protection Act of 1991, was introduced August 2, 1991; H.R. 4900, the Federal Insurance Solvency Act of 1992, was introduced April 9, 1992.

with these problems. It could improve coverage for retirees from plans insured by PBGC by establishing a role for PBGC in backing retirees' insurance annuities. Analysts have suggested at least three types of guarantee roles for PBGC. Several factors, however, raise doubt about PBGC's ability to handle the resulting increase in its potential liability. Under a second option, the Congress could establish a national insurance guaranty fund. This could improve coverage for retirees from all types of private pension plans who receive insurance annuities. Yet this option raises concerns about federal liability and most likely would require extensive changes to the current system of insurer solvency regulation.

NOLHGA Comments and Our Evaluation

In response to our discussion of variations in state guarantee coverage limits, the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) emphasized that no state guarantees less than the NAIC model act limit of $100,000. NOLHGA maintains that the model act approach sets a floor of protection: If this limit fully covers a substantial percentage of annuity owners, as NOLHGA believes, and some states wish to provide a more generous benefit, then uniformity seems irrelevant to protecting the average annuity owner.

We think it is important to note that while California guarantees allocated annuities up to $100,000, it imposes a 20 percent deductible for them. Thus, California provides a level of protection lower than that recommended by NAIC.

We believe that uniformity of guarantee coverage is an important issue, especially for retirees from defined benefit plans. Retirees whose lifetime retirement benefits are paid directly by their defined benefit plans remain covered by PBGC's uniform guarantee limits. In contrast, those who receive insurance annuities may be covered by state limits that range from $100,000 to no limit. Our analysis indicates that about 17 percent of retirees who receive annuities would not be fully covered by a $100,000 guarantee limit if their insurers failed. Among retirees aged 50 to 67, about 27 percent would not be fully covered. These percentages suggest that a substantial number of retirees are subject to risks of partial benefit loss that vary, based on their state of residence.

NOLHGA also believes that the report overstates problems with state guarantee coverage for retirees who reside in a state where an insolvent insurer was never licensed. These problems have been rendered almost moot as a result of state legislatures establishing or amending guaranty

acts, according to NOLHGA. Furthermore, state guaranty associations in some cases have voluntarily covered individuals in this situation or U.S. citizens who resided outside the United States.

We agree that gaps in state guarantee coverage of allocated annuities have been reduced substantially in recent years. However, in light of the federal government's interest in the security of private pension benefits, it is important to identify situations in which benefits that were insured by the federal government may not qualify for state guarantee coverage. There are two situations in which retirees who reside in a state (or country) where an insolvent insurer was never licensed are not entitled to coverage. The first is when an insolvent insurer is domiciled in one of the three states that has no provision for covering nonresidents. The second is when an insolvent insurer is domiciled in a state that enacted the nonresident coverage provisions in the NAIC's 1985 model act. These do not provide for coverage of U.S. citizens who reside in foreign countries. In both situations, retirees have no legal right under current laws to state guarantee coverage of their annuity benefits, which can result in a partial loss of retirement income.

Federal Regulation and Oversight of Plan Selection of Annuity Providers

While federal regulations and joint PBGC and Labor oversight of plan selection of annuity providers afford some protection for participants, three factors limit the effectiveness of these measures. First, Labor does not routinely monitor annuity provider selections by certain types of plans. Thus, even though ERISA's fiduciary requirements apply to these plans, fiduciary breaches may go undetected. Second, Labor has not provided formal guidance about specific factors fiduciaries should consider in evaluating annuity providers. As a result, some fiduciaries may be uncertain about what they must do to satisfy ERISA's requirements for selecting an annuity provider. Third, regulations requiring certain plans to give advance notice to participants about both the intended annuity provider and the change in their guarantee coverage are not comprehensive enough, either in applicability or content. For example, while plans undergoing a standard termination are required to meet these disclosure requirements, the requirements have not been mandated for ongoing plans insured by PBGC, even though participants from both types of plans face similar risks when insurance annuities are purchased. In addition, neither plans undergoing a standard termination nor ongoing plans insured by PBGC are required to inform participants about the state coverage that replaces the PBGC coverage they lose.

PBGC Has Minimal Requirement for Annuity Purchases in Standard Terminations

Under its current regulations for standard terminations, PBGC cannot deny a plan termination if it views as imprudent a plan's choice of annuity provider. These regulations establish a single requirement for plan selection of an insurer: Annuities must be purchased from a company authorized to do business as an insurance carrier under the laws of a state or the District of Columbia. PBGC can issue a notice of noncompliance to deny a termination if a plan fails to meet this requirement.

PBGC Has Authority to Strengthen Its Requirement

PBGC possesses legal authority to establish additional requirements to regulate plan selection of annuity providers in standard terminations. ERISA provides PBGC with broad authority to issue substantive regulations to enforce the act. In addition, ERISA charges PBGC with responsibility for ensuring the timely and uninterrupted payment of benefits to participants and beneficiaries.

ERISA's Fiduciary Requirements Establish a Standard of Prudence for Annuity Purchases

Labor is responsible for enforcing compliance with ERISA's fiduciary requirements, which apply to all private pension plans, with certain exceptions.[1] In a 1986 opinion letter, the Department stated its position: the selection of an annuity provider is an act governed by the fiduciary responsibility provisions of ERISA, including the prudence requirement.[2] ERISA requires that fiduciaries discharge their duties to a plan for the exclusive purpose of providing benefits to participants and beneficiaries, as well as defraying reasonable expenses of administering the plan; this is to be done "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

ERISA also prohibits fiduciaries from engaging in various kinds of transactions between a plan and parties with an interest in the plan. For example, ERISA prohibits fiduciaries from purchasing annuities from an insurer that owns more than 10 percent of stock in the plan sponsor.

Labor Has Not Issued Formal Guidance on ERISA's Fiduciary Rules for Annuity Purchases

Labor has not provided fiduciaries with formal guidance on selecting an annuity provider. ERISA does not specify what its prudence standard requires in making these selections. In addition, there are no specific case precedents involving the application of fiduciary standards in selecting an annuity provider. As a result, fiduciaries may be uncertain about what they must do to satisfy ERISA's prudence standard.

In testimony before the Congress and public speeches, Labor has provided some indication of how it interprets ERISA's requirements. For example, in an October 31, 1991 testimony,[3] PWBA's Assistant Secretary made the following points:

- ERISA requires that fiduciaries must attempt to obtain the safest annuity available to the plan unless it can be demonstrated that under the circumstances, purchasing a less expensive but somewhat lower quality annuity is in the interests of the plan's participants.

[1]See 29 U.S.C. section 1101.

[2]Labor Department, letter to John Erlenborn (Mar. 13, 1986).

[3]Testimony of David George Ball, Department of Labor, before the House of Representatives, Committee on Government Operations, Subcommittee on Employment and Housing (Oct. 31, 1991).

- At a minimum, compliance with ERISA's fiduciary rules requires that plan fiduciaries conduct objective, thorough, and analytical processes to select annuity providers.
- In standard terminations, fiduciaries cannot purchase a cheaper, riskier annuity to maximize the reversion of excess assets to the employer.
- Fiduciaries who have an interest in the sponsoring employer that might affect their judgment will usually, at a minimum, need to obtain and follow independent expert advice in selecting an insurer.

Holding fiduciaries to high standards is critical, but so too is ensuring that they have been sufficiently apprised of what is required to satisfy the standards. While these points provide a broad sketch of the process fiduciaries should follow, no mention is made of any specific factors that should be examined in assessing prospective annuity providers. For example, if it is not prudent to rely exclusively on ratings by national rating services in selecting an annuity provider, what additional factors must a fiduciary consider to demonstrate that the selection was prudently made? These points provide no answer. In addition, they do not mention whether fiduciaries must consider the relevant state guarantee coverage provisions.

PBGC Oversees Annuity Purchases in Standard Terminations

On the basis of information submitted by plans as part of their standard termination paperwork, since 1990 PBGC has referred to Labor, for investigation, about one out of every eight plans that purchased insurance annuities. Responding to recent concerns about the security of annuities, PBGC recently established additional participant notification requirements for plans undergoing a standard termination. PBGC and Labor could improve protections for participants by extending these requirements to ongoing plans insured by PBGC and by broadening them to require plans to inform participants about their state guarantee coverage.

Paperwork and Notification Requirements for Standard Terminations

PBGC's standard termination process requires plans to submit various paperwork at specified times. For example, plans must notify participants of their intent to terminate a plan at least 60 days prior to the proposed termination date. They must also file the Standard Termination Notice with PBGC as soon as practicable after they notify participants of their intent to terminate the plan. PBGC has 60 days after receiving a complete notice to review the form and issue a notice of noncompliance (which

prevents termination) if it determines this action is warranted.[4] Concurrent with, or prior to, filing the Standard Termination Notice, plans must deliver a notice of accrued plan benefits to each participant and beneficiary. Within 30 days of the final distribution of assets to participants and beneficiaries, the plan must return the Postdistribution Certification to PBGC. The plan administrator certifies on this form that all plan participants and beneficiaries have received all the benefits to which they are entitled.

A recent PBGC regulation (29 C.F.R. part 2617), effective June 26, 1992, requires plans undergoing a standard termination to inform participants about both the insurer from which annuities will be purchased and their loss of federal benefit coverage when annuities are purchased. At least 45 days prior to distribution of plan assets, plans are required to inform PBGC and plan participants of the identity of the insurer or insurers from which annuities may be purchased. PBGC envisioned that this information would assist participants in taking advantage of several alternatives when they have concerns about the insurer or insurers selected: (1) bringing their concerns to the attention of the plan administrator, (2) pursuing their private rights of action under ERISA if they believe a fiduciary breach has occurred, and (3) considering the insurer's identity when they can elect to receive their benefits in a form other than an annuity.

Recognizing that some plans may not have selected an insurer this far in advance of distribution, the regulation allows them to submit a list of insurers from which bids have been or will be solicited. In many cases it may not be possible for plans to give advance notice of the specific insurer they intend to use because plans generally have a short time period to accept a bid (for example, less than 24 hours) once insurers submit their final bids.

PBGC's regulation also requires plans undergoing a standard termination to inform participants that PBGC's guarantee of benefits ends when plan assets have been distributed either by the purchase of insurance annuities or another form of distribution. Plans are required to include this information in their notice of intent to terminate.

[4]The Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA) altered PBGC's role in the standard termination process. SEPPAA was enacted in part to reduce the administrative burdens on PBGC and plan sponsors. Prior to SEPPAA, PBGC was required to issue a "notice of sufficiency" before plan administrators could distribute assets.

Participant Notification Requirements Not Sufficiently Comprehensive

While PBGC's participant notification requirements may provide additional protection for participants in standard terminations, the requirements are not comprehensive enough in either applicability or content. First, Labor has not mandated the requirements for ongoing plans insured by PBGC, even though participants from both these plans and standard terminations face similar risks when insurance annuities are purchased. For example, the purchase of annuities by plans insured by PBGC can present a potential conflict between the interests of a plan's participants and sponsor. By purchasing lower-priced (and possibly less safe) annuities, the plan sponsor in a standard termination can either increase the size of any asset reversion or reduce the amount it must contribute to enable the plan to terminate. Likewise, the sponsor of an ongoing plan can reduce the amount of contributions necessary to fund the plan. Furthermore, the shift in guarantee responsibility for participants' benefits from PBGC to the state guarantee system exposes many participants to a reduction in benefit coverage level and some to a partial benefit loss if their insurers fail.

Second, neither plans undergoing a standard termination nor ongoing plans insured by PBGC are required to inform participants about the state guarantee coverage that replaces the PBGC coverage they lose. Requiring plans to provide this information would create an incentive for them to consider state coverage provisions in selecting annuity providers. This requirement would also make participants aware of whether or not their annuities would be fully covered if their insurers should fail.

Data on Selection of Annuity Providers Collected at Two Points in Termination Process

PBGC collects information about plan selection of annuity providers at two points in the standard termination process. Since March 1990, PBGC has asked plans to complete a predistribution notification form that requests the name of the insurer or insurers that may be providing annuities to plan participants. Prior to June 1992, plans were not required to provide this information to PBGC; although the majority of plans complied with PBGC's request for information, some did not.

The Postdistribution Certification form is the other source of PBGC information about plan annuity selections. PBGC requires plan administrators to indicate on this form the name of the insurer, if any, selected to provide annuity benefits.

PBGC Refers Questionable Annuity Purchases to Labor

To assist Labor in its responsibility to enforce ERISA's fiduciary standards, PBGC reviews information submitted on the predistribution notification form and Postdistribution Certification and refers questionable insurer

selections to Labor. PBGC has not publicized its referral criteria because it believes that their disclosure could interfere with Labor's enforcement of ERISA's fiduciary requirements.[5]

Of the 16,002 Postdistribution Certification forms PBGC reviewed (as of May 22, 1992), 2,238 contained the name of one or more insurers; PBGC referred almost 13 percent of these (283) to Labor. Of the 16,187 predistribution notification forms reviewed, 3,237 contained the name of one or more insurers and PBGC referred 13 percent of these (434) to Labor (see fig. 3.1).

Three Components to Labor's Oversight of Plan Annuity Selections

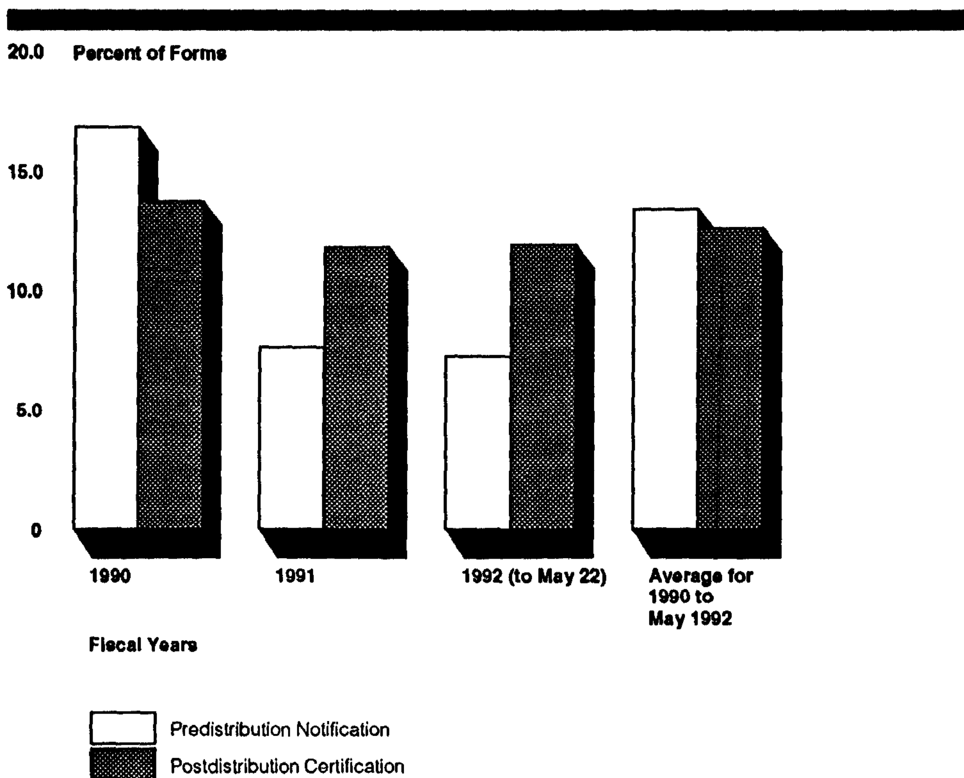
Labor's oversight of plan annuity selections has three components. One is the investigation of plan selections referred by PBGC. Another is the investigation of selected annuity purchases from Executive Life. A third is correspondence with plans that purchased annuities from Executive Life since 1985.

PBGC Referrals

In April 1990, Labor began investigating annuity selections of plans referred by PBGC. Labor sends a letter to the plan sponsor (or contact person) of each plan referred by PBGC. The letter requests information about the process followed in selecting the annuity provider, including the names of the insurers who bid on the contract and the amounts of their bids, the criteria used in evaluating the providers, the use of consultants, and any relationship between the insurance company and the plan or plan sponsor.

[5] In September 1990, PBGC denied a request filed by the American Society of Pension Actuaries (ASPA), under the Freedom of Information Act, for PBGC documents on these criteria. In denying ASPA's appeal of its decision, PBGC argued that the documents are exempt from disclosure under the act's exemption of disclosure for records or information that could interfere with law enforcement proceedings.

Figure 3.1: Forms With Insurer Names That PBGC Referred to Labor



Source: Pension Benefit Guaranty Corporation.

Labor uses internal criteria to screen the responses. Cases that meet the criteria are referred to a field office for an on-site fiduciary investigation. As of December 1992, Labor had initiated on-site investigations in 47 cases referred by PBGC. Labor has not publicized its criteria because the Department believes this could undermine its enforcement capability.

Selected Annuity Purchases From Executive Life

Beginning in May 1991, Labor began conducting on-site fiduciary investigations of selected annuity purchases from Executive Life. The sources of these investigations included a list, provided by Executive Life, of its Custom Qualified Retirement Annuities,[6] a list distributed at a

[6]A type of annuity that Executive Life developed primarily to meet the needs of large pension plans.

congressional hearing, of plans that purchased Executive Life annuities,[7] and inquiries by plan participants. As of December 1992, Labor had initiated 38 on-site investigations based on these sources.

Inquiry Letters to Plans That Purchased Executive Life Annuities

In June 1991, Labor initiated a program to identify all plans that purchased Executive Life annuities and determine whether additional plans from this group should be selected for on-site investigations. Executive Life provided a list that it said contained the names of all plans that had purchased annuities from Executive Life since 1985. Labor sent an inquiry letter to each plan requesting information about the annuity selection process. As of December 1992, Labor had received responses from 753 of the 1,109 plans.

Half of On-Site Investigations Involve Executive Life Cases

Forty-three of the 85 on-site investigations initiated by Labor involve the purchase of annuities from Executive Life. The Department estimates, on the basis of information it received from Executive Life, that these 43 cases represent 73 percent of the total dollar value of the annuity contracts Executive Life had sold to pension plans since 1985.

No Labor Oversight of Annuity Selections by Some Types of Plans

Labor does not routinely monitor annuity provider selections made by ongoing plans insured by PBGC, defined contribution plans, or defined benefit plans sponsored by professional service employers with 25 or fewer employees. Department officials cited enforcement priorities and lack of adequate data on these selections as reasons for not monitoring them.

Oversight of Terminating Plans' Annuity Selections Has Higher Priority for Labor

Reviewing the annuity selections of plans undergoing standard terminations has higher enforcement priority for Labor for two reasons. First, standard terminations present a greater potential conflict between the interests of a plan's participants and sponsor because the sponsor may be able to recover any excess plan assets. Second, remedying fiduciary breaches may be difficult once a plan ceases to exist, especially if the plan sponsor is out of business.

[7] Senate Committee on Labor and Human Resources, Subcommittee on Labor, Hearing on Retirees At Risk (June 20, 1991).

Format and Timeliness of Annual Pension Data Limit Their Usefulness

Even though Labor receives yearly data on pension plans' contracts with insurance companies, the format and timeliness of the data limit their potential usefulness in monitoring allocated annuity purchases. Through IRS, Labor receives an annual report (form 5500) from about 900,000 pension and welfare plans. The report includes a form (Schedule A) on which plans provide information about their contracts with insurance companies. However, plan sponsors are not required to file the form 5500 until 7 months after the close of the plan year and may be granted a 2-1/2 month extension. As a result, a form 5500 may contain information relating to transactions that occurred more than 21 months earlier.

Before it obtained a list of Executive Life's annuity contracts from the insurer, Labor made a one-time computer run of Schedule A data in an attempt to identify plans that purchased allocated annuities from Executive Life. In many cases, however, Labor was unable to determine from the data what kind of insurance products plans had purchased from Executive Life.[8]

Labor Took Legal Action Against Some Plans It Investigated

As of December 1992, Labor had taken legal action in 14 cases. The plans involved in these cases purchased insurance annuities for more than 14,000 participants. The Department's legal action has taken two forms: demand letters and lawsuits.

Sent Seven Demand Letters

Labor sent demand letters to plan fiduciaries in seven cases. These cases involve insurers other than Executive Life. The letters demand that the fiduciaries guarantee the annuities through another insurer to avoid litigation by the Department. As of December 1992, none of the fiduciaries had complied with Labor's request and settlement negotiations are continuing. Labor filed a lawsuit against fiduciaries in one of these cases after settlement negotiations proved unsuccessful.

Filed Eight Lawsuits

Labor filed lawsuits against plan fiduciaries in eight cases. Executive Life was the insurance company in seven of these cases; Presidential Life was the company in the other case (see table 3.1).

The Department's lawsuits allege a variety of ERISA violations. These differ by case, but include the following: (1) failure to implement a bid process designed to identify the safest available provider, (2) failure to properly investigate the financial stability, creditworthiness, or claims-paying ability

[8] Labor is currently studying ways to improve the usefulness of form 5500 data.

ability of the insurer selected, (3) imprudently selecting the insurer despite negative findings by an independent expert, and (4) purchasing annuities from an insurer that owned more than 10 percent of stock in the plan sponsor, which is a prohibited transaction.

Table 3.1: Labor Lawsuits Alleging Plans Violated ERISA When They Purchased Insurance Annuities (as of Dec. 1992)

Plan sponsor	Year annuities purchased	Cost of annuities (in millions)	Participants receiving annuities	Status of lawsuit
Maxxam/ Pacific Lumber	1986	$37.2	4,000	Pending
MagneTek	1985	23.4	1,900	Settled
AFG Industries/ Fourco Glass	1985	12.4	1,300	Pending
Halliburton/ Geosource	1985	26.6	2,954	Settled
Strouse Adler	1990	1.3	117	Pending
Smith International	1986	51.0	3,100	Pending
BMC Industries	1986	2.5	94	Pending
Raymark Industries	1986	49.4	[a]	Pending

Note: In the Strouse Adler case, annuities were purchased from Presidential Life; in all of the other cases, annuities were purchased from Executive Life.

[a]Not available.

Source: Department of Labor.

Two of the eight lawsuits have been settled, and the settlements provide that participants and beneficiaries of these plans will receive their full pension payments. MagneTek, Inc., which had been making up the 30-percent benefit shortfall to retirees, agreed to purchase a back-up annuity contract to cover participants' benefits. In the Halliburton/Geosource case, Halliburton Geophysical Services, Inc., agreed to make up any shortfalls in annuity payments and its parent company agreed to guarantee these benefit payments.

Number of Fiduciary Breaches in Department's Caseload Unclear

Statistics on the outcomes of annuity cases Labor has opened do not allow us to infer the number of fiduciary breaches in cases for which the Department has taken no legal action. First, some of these cases are still under investigation. Second, the lack of any legal precedent pertaining to ERISA's fiduciary requirements for selecting an annuity provider creates a difficulty for Labor in deciding where to draw the line in alleging fiduciary

breaches. As a result, the cases in which the Department has pursued legal action are those which it views as having the greatest potential for a successful outcome.

Agencies Issue Advance Notices of Proposed Rulemaking

In a pair of Advance Notices of Proposed Rulemaking issued in June 1991, PBGC and Labor solicited public comment on several options to strengthen protections for participants who receive insurance annuities. PBGC listed three options that would apply to plans that purchase insurance annuities in a standard termination: (1) require plans to obtain the opinion of an independent expert on the financial condition of prospective annuity providers, (2) require plans to consider criteria specified by PBGC in evaluating prospective annuity providers, and (3) require plans to meet minimum standards specified by PBGC in selecting an annuity provider. Labor presented a single option that would apply to all private pension plans under ERISA: require plans to meet minimum standards specified by the Department in selecting an annuity provider.[9]

The agencies received comments from a broad group of interested parties, including insurers, insurance regulators, an association of pension plans, pension plan consultants, labor unions, Members of Congress, and private citizens. Commenters expressed a wide range of opinions on the merits of these options. While some argued that none of them are appropriate and that no rules should be proposed, each option was endorsed by some commenters. The following discussion presents our analysis of some of the pros and cons of these options and also considers the merits of some other options for PBGC and Labor.

Options to Strengthen Federal Regulation and Oversight

Require Use of Independent Expert

Requiring plans undergoing a standard termination to consult an independent expert when they select an annuity provider could potentially improve the objectivity and rigor of plans' analysis of prospective insurers. Fiduciaries are bound by ERISA to act in the exclusive interest of plan participants and beneficiaries. However, fiduciaries may face pressure to

[9]As of December 1992, PBGC and Labor were reviewing comments received on the advance notices to determine whether issuing rules would be appropriate.

maximize the size of the plan sponsor's asset reversion or minimize the amount of any required funding contribution by purchasing a lower-priced (and possibly less safe) annuity. By mandating the use of independent experts, PBGC could lessen the chances that the cost of annuities might bias plans in assessing prospective annuity providers. In addition, to the extent that consultants possess greater expertise than fiduciaries, consultants can provide a more accurate evaluation of insurers' financial condition.

While the option may provide an additional safeguard in many cases, there is no assurance it would yield a sufficient level of protection for all plan participants who receive annuities. In the absence of PBGC or Labor standards for what constitutes an adequate analysis of insurers, PBGC would lack any basis for assuring that independent experts provide an adequate analysis. Moreover, the regulation would impose a cost that would be burdensome for certain small plans and unnecessary for some plans with in-house expertise.

Specify Factors Fiduciaries Should Consider

Another option is to specify factors fiduciaries should consider in evaluating prospective annuity providers, but not establish minimum standards for these factors. This could be done through regulation or guidance. PBGC could require plan fiduciaries in standard terminations to consider criteria specified by PBGC. Alternatively, Labor could issue formal guidance about ERISA's fiduciary requirements that specifies factors fiduciaries should consider in evaluating annuity providers. The advantage of Labor guidance over a PBGC regulation is that the former would apply to all private pension plans covered by ERISA, whereas the latter would apply only to defined benefit plans undergoing a standard termination.

Specifying factors fiduciaries should consider would provide greater assurance to PBGC or Labor that fiduciaries understand their ERISA responsibilities and follow a prudent annuity selection process. The Work Group on Annuities of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans cited a need for official guidance on selecting an annuity provider. The group's 1990 report maintained that there was a lack of adequate criteria for determining whether a selection decision on an annuity provider fully measures up to ERISA fiduciary standards. The report went on to say that this problem had been compounded by the lack of specific official guidance on selecting an annuity provider.

One argument against the option is that it would not prevent imprudent annuity selections. By not setting a minimum level for each factor or specifying how the factors should be weighted, the option would give fiduciaries discretion in determining how to evaluate information about annuity providers. As a result, oversight of plan annuity selections would continue to focus on detection of imprudent selections after the purchase of annuities has already occurred.

Another argument against the option is that it could obstruct Labor's litigation of fiduciary breaches. This might occur in court cases if fiduciaries offer, in their defense, evidence that they considered all of the specified factors. Such cases might arise if fiduciaries failed to consider certain factors a prudent person would have considered, but which were not included on PBGC's or Labor's list. Given the difficulty of designing a comprehensive list, Labor could attempt to minimize this problem by making clear that the list represents a set of minimum requirements for fiduciaries.

Set Minimum Standards for Annuity Provider Selections

A third option, which was listed by both PBGC and Labor, is for the agencies to set minimum standards for selection of an annuity provider. These could be based on a wide range of criteria, including an insurer's ratings by rating services, the amount of an insurer's reserves, an insurer's levels of certain high-risk assets, and the presence and amount of annuity coverage by state guaranty associations.

This option would be more effective than the previous one in preventing plans from selecting insurers that may not provide a sufficient level of safety. Plans undergoing a standard termination would be required to meet the minimum standards in order to terminate. Ongoing plans would cease to be responsible for the benefits of participants who receive insurance annuities only if these plans meet the minimum standards.

The option could present significant problems, however. For example, the option might create confusion among fiduciaries about what, if anything, they must do to satisfy ERISA's fiduciary requirements above and beyond selecting an insurer that meets the minimum standards. Fiduciaries would have an incentive to select insurers right at, or just above, the minimum standards, who may provide less expensive annuities than the safest insurers. However, as described in Labor's advance notice of proposed rulemaking, the minimum standards would be in addition to, and independent of, ERISA's fiduciary requirements. ERISA requires fiduciaries to

attempt to obtain the "safest available annuity," according to Labor. Establishing both a "safest available" fiduciary standard and "minimum" standards for termination of plan responsibility for participants' benefits might create confusion about whether selecting insurers at or just above the minimum standards would satisfy ERISA's fiduciary standards.

Furthermore, establishing and maintaining standards for what constitutes an acceptable annuity provider could present difficulties for PBGC or Labor. The standards would have to incorporate the many factors that can generate solvency problems for a life insurance company. However, insurance company rating services, which have considerable experience rating insurers, have had difficulty in accurately assessing insurers' risks of failure. PBGC or Labor standards that do not accurately reflect the risks of insurer failure could result either in (1) excluding some insurers from the pension annuity market without a corresponding increase in protection for pension plan participants or (2) permitting some insurers that pose an unacceptable risk of failure to sell annuities to pension plans.

The option could also impose various costs on affected parties. For example, by establishing standards that determine which insurers are acceptable, PBGC or Labor could be subjected to pressure to make up any shortfall in retirees' pension benefits arising from the insolvency of an insurer approved by either agency. In addition, the option may result in higher costs to some plans for annuities because the insurers eliminated from the market would tend to be those that took greater investment risks and offered lower-priced annuities. Furthermore, if the standards influence insurance consumers' purchases, the option could impair the business of some insurers that do not market annuity products to pension plans.

Require Certification of Guarantee Coverage

Another option is to require administrators of plans insured by PBGC to certify that all participants who receive insurance annuities have state guarantee coverage at the time annuities are purchased. This would reduce the possibility that some participants' annuities would not be covered by state guarantees. However, the option would not ensure that plan participants would be covered if their insurers fail. If participants move to another state, their coverage may change and in certain cases they may no longer be covered.

The main drawback of this option is that the requirement would be too stringent. For example, if some plan participants reside outside the United

States, the state of domicile of the insurers willing to bid on a plan's annuity contract may not yield any situation in which all participants would be covered by a state association. In some cases, plans may be able to satisfy the requirement only by selecting a financially weaker insurer from among those providing bids. This could occur, for instance, if three insurers submit bids for a plan's annuities, but, as a result of applicable state coverage provisions, all participants would be covered only in the case in which the plan purchased annuities from the weakest of the insurers. In such cases, the cost of assuring that every participant is covered would be that participants receive annuities from an insurer that has a greater risk of failing.

A more feasible way to reduce the chances that participants from plans insured by PBGC lack state guarantee coverage would be to require these plans to inform participants of the applicable state guarantee coverage of their annuities. This requirement would provide an incentive for fiduciaries to consider state coverage provisions in selecting a provider, but allow them the flexibility to weigh multiple factors.

Conclusions

PBGC and Labor are responsible under ERISA for protecting the benefits of private pension plan participants. PBGC and Labor regulations and oversight provide some protection for participants. However, the effectiveness of these protections is limited by the lack of formal guidance regarding fiduciary requirements, a lack of routine oversight of annuity purchases by some types of plans, and insufficient participant notification requirements for plans insured by PBGC.

Formal Labor Guidance Needed

The most viable approach to assisting compliance with fiduciary requirements is for Labor to issue formal guidance about the factors fiduciaries should consider, at a minimum, when selecting an annuity provider. This approach incorporates a preventive focus, but avoids the problems associated with establishing minimum standards for annuity selections. The limited scope of Labor's oversight indicates the need for well-defined fiduciary requirements. Since the Department does not routinely review the annuity selections of some types of plans, formal guidance is needed to encourage compliance by fiduciaries of these plans with their ERISA responsibilities.

Labor's formal guidance should cite state guarantee coverage as one factor fiduciaries should consider in evaluating prospective annuity providers. As

long as the state guarantee system contains gaps in coverage, consideration of coverage provisions is a critical element in assessing the safety of annuities. Considering these provisions involves determining the state coverage plan participants would receive under different insurer-selection scenarios.

Participant Notification Requirements for Plans Insured by PBGC Should Be More Comprehensive

Protections for participants from plans insured by PBGC could be improved by (1) extending recently established participant notification requirements for standard terminations to ongoing plans and (2) broadening the requirements to include informing participants about their state guarantee coverage.

Ongoing Plans Should Be Required to Inform Participants About Insurers and Loss of Federal Coverage

For ongoing plans insured by PBGC, Labor should establish the PBGC disclosure requirements for standard terminations because participants from both types of plans face similar risks when insurance annuities are purchased. PBGC requires plans undergoing a standard termination to provide participants advance notice both of (1) the identity of the insurer or insurers from which annuities may be purchased and (2) the cessation of federal guarantee of their benefits when insurance annuities are purchased.

Plans Insured by PBGC Should Be Required to Inform Participants About State Guarantee Coverage

PBGC and Labor should require both plans undergoing a standard termination and ongoing plans insured by PBGC to inform participants about the state guarantee coverage that replaces PBGC coverage when insurance annuities are purchased. Plans should be required to tell participants (1) which state guaranty association (if any) covers their annuities at the time of purchase, (2) the amount of coverage, and (3) that a change in state of residence can alter their coverage. Requiring plans to provide this information would create an incentive for them to consider state coverage provisions in selecting an annuity provider. This requirement would also make participants aware of whether or not their annuities would be fully covered if their insurers should fail.

Strengthening Insurance Solvency Regulation Would Enhance Protections for Retirees' Annuities

Providing formal guidance to fiduciaries and requiring that plans inform participants of their guarantee coverage and the name of the intended annuity provider would improve protections for retirees' insurance annuities. However, neither these nor any of the other options discussed in this chapter can ensure that insurers selected to provide annuities will not fail. Annuities are typically paid out over long periods of time—more than 20 years in many cases. Effective solvency regulation of insurance

companies is the most basic protection for all insurance policyholders. Addressing the problems GAO has identified with both state solvency regulation and efforts of state regulators to strengthen solvency regulation would enhance protections for retirees' insurance annuities.

Recommendations

To assist fiduciaries in complying with ERISA's requirements, we recommend that the Secretary of Labor issue formal guidance that sets forth the Department's view of the procedures necessary to satisfy these requirements when selecting an annuity provider. The guidance should specify those factors fiduciaries should consider, at a minimum, in determining the suitability of prospective annuity providers. In light of coverage gaps in the state guarantee system, one factor should be the applicable state guarantee coverage provisions. Considering these provisions involves determining the state coverage plan participants would receive under different insurer-selection scenarios.

We also recommend that the Secretary of Labor require ongoing plans insured by PBGC to give participants who will receive insurance annuities (1) advance notice of the identity of the insurer or insurers from which annuities may be purchased, (2) advance notice that PBGC coverage ceases upon the purchase of insurance annuities, and (3) detailed information about the state guarantee coverage of their annuities that applies at the time of annuity purchase. With regard to this last disclosure requirement, plan administrators should be required to inform participants (1) of the name of the state guaranty association, if any, that guarantees their annuities and the amount of its annuity guarantee limit and (2) that changing their state of residence may alter their coverage.

We recommend that in standard terminations in which insurance annuities are purchased, the Executive Director of PBGC require that plan administrators provide participants detailed information about the state guarantee coverage that applies at the time of annuity purchase. Plan administrators should be required to inform participants (1) of the name of the state guaranty association, if any, that guarantees their annuities and the amount of its annuity guarantee limit and (2) that changing their state of residence may alter their coverage.

Agency Comments and Our Evaluation

Labor did not take a position on our recommendations. However, it questioned the benefits of the recommendations and cited some costs and burdens that might be imposed on plan sponsors and the Department.

Labor's comments also include technical corrections that we incorporated when appropriate.

In response to our recommendation that Labor provide formal guidance to fiduciaries, the Department cites several of the drawbacks that are mentioned in our analysis. For example, developing a comprehensive list of factors may be difficult and plan fiduciaries would have considerable discretion in determining the importance of any factor, unless the factors are weighted. In addition, it may be difficult to avoid having the guidance characterized as a "safe harbor," thereby forcing the Department, in challenging an annuity selection, to prove that factors not specified in the guidance should have been considered.

These concerns are reasonable. However, on balance, providing formal guidance would improve protections for participants who receive insurance annuities. First, it is in the interests of participants for fiduciaries to have a clear and accurate understanding of their responsibilities under ERISA when selecting an annuity provider. Formal guidance would help fiduciaries meet their responsibilities. The Work Group on Annuities of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans identified a need for such guidance in its 1990 report.

Second, providing guidance in a specific, written form could help protect the interests of plan participants even if public attention to insurer solvency wanes or Labor shifts some enforcement resources from investigating annuity selections to other areas.

Third, since gaps in state guarantee coverage of allocated annuities remain, it is essential that fiduciaries consider state coverage when selecting an annuity provider. Providing formal guidance that specifies this as a factor to be considered could help prevent plans from purchasing annuities that are not guaranteed.

The Department raises two issues about our recommendation that plans insured by PBGC be required to inform participants about state guarantee coverage of their annuities: the value of this information and the cost of providing it. Labor notes that information provided to participants may no longer be valid when their annuity payments begin because participants may have changed their state of residence or state laws concerning either guarantee coverage or residency may have changed. Labor also maintains that implementing the recommendation would impose costs on plan

sponsors because, in many circumstances, they would need to hire legal counsel or other consultants to obtain the information.

One benefit of requiring disclosure is to make participants aware of any change in their risk of benefit loss that occurs as a result of the shift from federal to state guarantees. The fact that state coverage of an annuity may change if a retiree changes his or her state of residence or state laws change does not negate the value of providing the information. Rather, this fact emphasizes the importance of informing participants that their coverage may change. Another benefit of disclosure is that it reinforces the need for fiduciaries to consider state coverage in selecting annuities, which is consistent with our recommendation that Labor issue formal guidance.

Plans could minimize costs associated with disclosing information about guarantee coverage by requesting this information from their insurers as part of an annuity purchase. The American Council of Life Insurance and the National Association of Insurance Commissioners are working on a consumer disclosure form to advise purchasers of insurance products about their guarantee coverage. Additional benefits from requiring disclosure to plan participants may be realized because reducing the cost of compiling state guarantee coverage information could act as an incentive for the insurance industry to improve and coordinate state guarantee coverages.

Limits of State Life and Health Guaranty Association Liability

State	Scope of coverage[a]	Limits	
		Allocated annuities	All benefits
NAIC model law	Residents only	$100,000	$300,000
Alabama	All policyholders	Not specified	300,000
Alaska	Residents only	100,000	300,000
Arizona	Residents only	100,000	300,000
Arkansas	Residents only	100,000	300,000
California[b]	Residents only	100,000	250,000
Colorado	Residents only	100,000	300,000
Connecticut	Residents only	100,000	300,000
Delaware	Residents only	100,000	300,000
District of Columbia	Residents only	300,000	300,000
Florida	Residents only	Not specified	300,000
Georgia	Residents only	Not specified	300,000
Hawaii	Residents only	100,000	300,000
Idaho	Residents only	Not specified	300,000
Illinois	Residents only	100,000	300,000
Indiana	Residents only	Not specified	300,000
Iowa	Residents only	Not specified	300,000
Kansas	Residents only	100,000	200,000
Kentucky	Residents only	100,000	Not specified
Louisiana	Residents only	100,000	300,000
Maine	Residents only	Not specified	300,000
Maryland	Residents only	No limit	No limit
Massachusetts	Residents only	100,000	300,000
Michigan	Residents only	100,000	300,000
Minnesota	Residents only	Not specified	300,000
Mississippi	Residents only	100,000	300,000
Missouri	Residents only	100,000	300,000
Montana	Residents only	Not specified	Not specified
Nebraska	Residents only	100,000	300,000
Nevada	Residents only	100,000	300,000
New Hampshire	All policyholders	Not specified	300,000
New Jersey	Residents only	500,000	500,000
New Mexico	All policyholders	Not specified	300,000
New York	Residents only	Not specified	500,000
North Carolina	Residents only	Not specified	300,000
North Dakota	Residents only	100,000	300,000

(continued)

State	Scope of coverage[a]	Limits	
		Allocated annuities	All benefits
Ohio	Residents only	100,000	300,000
Oklahoma	Residents only	300,000	300,000
Oregon	Residents only	100,000	300,000
Pennsylvania	Residents only	300,000	300,000
Rhode Island	Residents only	100,000	300,000
South Carolina	All policyholders	Not specified	300,000
South Dakota	Residents only	100,000	300,000
Tennessee	Residents only	100,000	300,000
Texas	Residents only	100,000	Not specified
Utah	Residents only	100,000	300,000
Vermont	All policyholders	Not specified	Not specified
Virginia	Residents only	Not specified	300,000
Washington	Residents only	500,000	500,000
West Virginia	Residents only	Not specified	Not specified
Wisconsin	Residents only	Not specified	300,000
Wyoming	Residents only	100,000	300,000

[a] All states (and the District of Columbia) with residents-only coverage also cover nonresidents under certain circumstances, except Indiana, Maryland, and Minnesota.

[b] California's guarantee law imposes a 20 percent deductible for allocated annuities.

Source: National Organization of Life and Health Insurance Guaranty Associations (NOLHGA).

Methodology for Estimating Percentages of Retirees Receiving Annuities That Exceed State or Federal Guarantee Limits

We followed a three-step procedure to estimate the percentages of retirees in private pension plans receiving annuities whose annuities exceed (1) $100,000 in present value (the guarantee limit in 27 states) or (2) PBGC's guarantee limits. First, we used pension data collected by the U.S. Census Bureau to construct a breakdown, by age groups for men and women, of the annual amounts received from private pension annuities. Second, for each age group, we converted $100,000 in present value into an equivalent annual benefit and calculated the percentage of retirees who receive an amount that exceeds this benefit. Finally, we used PBGC's guarantee limits to determine the percentage of retirees in each age group who receive an amount that exceeds the guarantee limits.

Census Bureau Survey Provides Data on Pension Income

The Census Bureau's December 1989 Pension Benefits Survey provides data on monthly pension receipt for retirees receiving benefits payable for life (annuities) from private plans. The survey was conducted as a supplement to that month's Current Population Survey (CPS), which is a monthly labor force survey conducted in approximately 57,000 households across the nation.

On the basis of responses to the December 1989 survey, the Census Bureau projects that there are 7.4 million retirees aged 50 and over receiving annuities from private pension plans. After excluding survey responses with missing or questionable data,[1] we had data on monthly pension amounts for 6 million retirees: 4.2 million men and 1.8 million women. We were unable to determine the distribution of insurance annuities by monthly benefit amounts because the survey did not ask respondents whether their annuities are paid by their plans or by insurance companies. However, we estimate, based on previous work, that between 3 and 4 million private sector retirees and their survivors receive annuities from insurance companies.[2] In our analysis of the Census data, we assume no differences in the distribution of monthly benefit amounts between retirees paid by insurance companies and those paid by pension plans.

We began our analysis with data on the total amount of private pension benefits (excluding Social Security) that retirees aged 50 and over receive

[1]We eliminated responses in which the reported monthly pension amount was (1) missing, (2) $0, or (3) $8,333 or over (the CPS data reported any amounts over $8,333 as $8,333).

[2]See Private Pensions: Millions of Workers Lose Federal Benefit Protection at Retirement (GAO/HRD-91-79, Apr. 25, 1991).

each month.[3] After converting these to annual amounts, we segregated the age group data by 3-year intervals (for example, 50 to 52 years of age, 53 to 55 years of age) for men and women up to the age of 73. We placed male retirees aged 74 and older in a single age group and did the same for female retirees aged 74 and older. Finally, we classified retirees in each age group on the basis of amounts of their annual pension income (for example, less than $5,000; $5,000 to $5,999; and $6,000 to $6,999).

Estimating Annuity Coverage of $100,000 State Guarantee Limit

Our analysis estimates the extent to which retirees' annuities would be fully covered if their insurance companies became insolvent in 1992 and their annuities were covered by a $100,000 state guarantee limit. The coverage we assume differs somewhat from actual state guarantee coverage conditions: while 27 states limit annuity coverage to $100,000, the other states and the District of Columbia have varying limits.

In our analysis, we used data on the amounts of retirees' annuities to estimate, for each age group, the percentage of retirees receiving an annuity that exceeds $100,000 in present value. We developed these estimates by first converting $100,000 in present value to its equivalent annual benefit for each age group and then calculating the percentage of retirees in each group who receive an amount that exceeds this benefit.

We used the midpoint age of each age group to calculate the annual benefit equivalent to $100,000 in present value for the group. In our calculations, we assumed a 7-percent interest rate and used the Unisex Pension 1984 mortality table to estimate how long retirees will live.[4] For example, $100,000 in present value is equivalent to an annual benefit of $10,188.49 for men aged 59 to 61.

We then adjusted these annual benefits to reflect the fact that some retirees' annuities have a joint and survivor provision.[5] Such an annuity is usually lower than the amount a retiree would have received from an annuity that spans only his or her lifetime. To make this adjustment, we calculated a weighted joint and survivor reduction factor for each age

[3]About 8 percent of retirees receive benefits from more than one pension plan. As a result, our use of data on retirees' total monthly benefits overstates the percentages of retirees whose annuity exceeds the $100,000 state guarantee limit. Overstatement occurs in cases for which the present value of total benefits exceeds $100,000, but no single annuity exceeds $100,000 in present value.

[4]We adjusted this mortality table by setting back women's ages 5 years in calculating the probabilities of their dying at various ages.

[5]Generally, a joint and survivor provision includes payment of a reduced portion of the annuity to the surviving spouse if the pensioner dies first.

group on the basis of the percentage of retirees in the group who report having this provision. In our calculations, we assumed that these retirees have a two-thirds joint and survivor provision (that is, a surviving spouse receives two-thirds of the annuity) and that husbands are 3 years older than their wives. The weighted joint and survivor reduction factor for men aged 59 to 61 is .896, which lowers to $9,128.88 the annual benefit equivalent to $100,000 in present value.

Finally, we determined the percentage of retirees in each age group who receive an amount that exceeds these adjusted benefits. In addition, we calculated the aggregate percentages for all retirees, men only, and women only (see figs. 2.1-2.3).

Estimating Annuity Coverage of PBGC's Guarantee Limits

For comparison, our analysis also estimates the extent to which retirees' annuities would be fully covered if their insurance companies became insolvent in 1992 and their annuities were covered up to PBGC's guarantee limits. PBGC's 1992 maximum monthly guaranteed benefit for an annuity commencing at the age of 65 was $2,352.27. PBGC actuarially adjusts its guarantee limit for annuities that commence at earlier ages. For example, its maximum guaranteed benefit for an annuity commencing at the age of 60 was $1,528.98.

We took the PBGC maximum monthly guaranteed benefit for the midpoint age of each group as the group's guarantee limit.[6] To calculate the weighted joint and survivor reduction factors, we used both PBGC's joint and survivor reduction factors and data on the percentage of retirees in each age group who have a joint and survivor provision. As before, we assumed that these retirees have a two-thirds joint and survivor provision and that husbands are 3 years older than their wives.

We multiplied the PBGC monthly guarantee limit by the joint and survivor weighted reduction factor to determine the monthly guarantee limit amount for each group. We then converted these to annual benefits and determined the percentage of retirees in each group who receive an amount that exceeds the benefits (see figs. 2.1-2.3).

[6] Since our analysis does not link monthly annuity amounts with the age at which annuities commenced, our results understate the percentage of retirees whose annuities exceed PBGC guarantee limits. For example, the monthly guarantee limit we assign to retirees in the group 59 to 61 years of age ($1,528.98) is higher than the limit that actually would apply to those whose annuities commenced at the age of 57 ($1,246.70).

List of Values for Figures in Report

Values for figure 1.1

Year	1975	1976	1977	1978	1979	1980	1981	1982
Number of insolvencies	6	2	4	5	6	4	4	4

Year	1983	1984	1985	1986	1987	1988	1989	1990
Number of insolvencies	8	14	7	13	18	10	44	27

Values for figure 1.2

Year	1986	1987	1988
Number of participants	411,250	259,301	248,155

Year	1989	1990	1991
Number of participants	309,306	183,824	159,001

Values for figure 2.1

Age groups	50 to 52	53 to 55	56 to 58	59 to 61	62 to 64
Percent over state limit	13	62	45	38	25
Percent over PBGC limits	10	52	22	12	4

Age groups	65 to 67	68 to 70	71 to 73	74+	All ages
Percent over state limit	16	18	11	5	17
Percent over PBGC limits	3	2	2	1	4

Values for figure 2.2

Age groups	50 to 52	53 to 55	56 to 58	59 to 61	62 to 64
Percent over state limit	6	71	53	45	31
Percent over PBGC limits	6	58	28	15	5

Age groups	65 to 67	68 to 70	71 to 73	74+	All ages
Percent over state limit	19	24	15	7	22
Percent over PBGC limits	4	3	2	1	6

Values for figure 2.3

Age groups	50 to 52	53 to 55	56 to 58	59 to 61	62 to 64
Percent over state limit	23	35	22	15	11
Percent over PBGC limits	16	31	7	2	1

Age groups	65 to 67	68 to 70	71 to 73	74+	All ages
Percent over state limit	7	4	2	3	7
Percent over PBGC limits	0	0	1	0	1

Values for figure 3.1

Fiscal years	1990	1991	1992 (to May 22)	Average for 1990 to May 1992
Percent of predistribution forms	16.8	7.6	7.2	13.4
Percent of postdistribution forms	13.7	11.8	11.9	12.6

Comments From the Department of Labor

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, DC 20210

DEC 18 1992

Mr. Lawrence H. Thompson
Assistant Comptroller General
Human Resources Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Thompson:

In reply to a letter from Joseph L. Delfico, Director, Income Security Issues to Secretary Martin requesting comments on the draft GAO report entitled "PRIVATE PENSIONS: Protections for Retirees' Insurance Annuities can be Strengthened," the Department's response is enclosed.

I would like to take this opportunity to note that, subsequent to publishing an Advance Notice of Proposed Rulemaking in June 1991, we received comments on many aspects of the issues and recommendations presented in this report. However, as GAO noted on page 83 of the draft report, "Commenters expressed a wide range of opinions on the merits of these options." Accordingly, the Department believes that determinations as to the merits of the GAO's recommendations should be deferred for consideration by the new administration.

The Department appreciates the opportunity to comment on this report.

Sincerely,

David George Ball

DAVID GEORGE BALL
Assistant Secretary

Enclosure

Enclosure

U.S. DEPARTMENT OF LABOR'S RESPONSE TO THE
DRAFT GENERAL ACCOUNTING OFFICE REPORT ENTITLED
"PRIVATE PENSIONS: PROTECTION FOR RETIREES'
INSURANCE ANNUITIES CAN BE STRENGTHENED"
GAO DRAFT REPORT NO. GAO/HRD-93-29

GAO RECOMMENDATION

"GAO recommends that the Secretary of Labor:

* Issue guidance that sets forth the Department's view of the procedures necessary to satisfy ERISA's fiduciary requirements when selecting an annuity provider. The guidance should specify those factors administrators should consider, at a minimum, in determining the suitability of prospective annuity providers. In light of coverage gaps in the state guaranty system, one factor should be the applicable state guaranty coverage provisions. Considering these provisions involves determining the state coverage plan participants would receive under different insurer-selection scenarios."

RESPONSE

See p. 55.

As noted in the draft report, the issuance of guidance delineating specific factors to be considered by plan fiduciaries in selecting annuity providers is not without problems. First, as indicated in the report, mere issuance of such guidance would not prevent imprudent annuity selections. Second, given the varying circumstances surrounding annuity selections and purchases, it may, as noted in the report, be difficult to develop a comprehensive list of factors applicable to every annuity purchase. Moreover, whatever caveats might accompany such a list, it may be difficult to avoid such guidance being characterized as a "safe harbor", thereby placing a burden on plan participants and the Department challenging an imprudent annuity selection to prove factors not specified in the guidance should have been taken into account by plan fiduciaries in making their particular annuity selection. Similarly, as noted in the report, unless the factors are weighted, plan fiduciaries will have considerable discretion in determining the importance of any given factor in their annuity selection, which, in turn, may also place plan participants and the Department in the position of having to argue that a particular factor, while considered by the fiduciary, should have been given greater weight in the annuity selection process. On the other hand, like the difficulties attendant to developing a comprehensive list of factors to be considered by fiduciaries in making their annuity selections, it may be difficult to attribute a level of importance to each specified factor that would be appropriate in every instance.

GAO RECOMMENDATION

"GAO recommends that the Secretary of Labor:

* Require plan administrators in ongoing PBGC-insured plans where insurance annuities are purchased to provide participants (a) advance notice of the identity of the insurer or insurers from whom annuities may be purchased, (b) advance notice that PBGC coverage ceases upon the purchase of insurance annuities, and (c) detailed information about the state guaranty coverage of their annuities that applies at the time the annuities are purchased. With regard to this last disclosure requirement, plan administrators should be required to inform participants of the name of the state guaranty fund, if any, that guaranties their annuities and the amount of the fund's annuity guaranty limit, and to inform them that changing their state of residence may alter their coverage."

RESPONSE

As discussed below, we believe that there are questions concerning the benefits and burdens attendant with a requirement that plan administrators provide participants information concerning state guaranty fund coverage.

GAO RECOMMENDATION

"GAO also recommends that the Executive Director of PBGC:

* Require plan administrators in standard terminations where insurance annuities are purchased to provide participants detailed information about the state guaranty coverage of their annuities that applies at the time the annuities are purchased. Plan administrators should be required to inform participants of the name of the state guaranty fund, if any, that guaranties their annuities and the amount of the fund's annuity guaranty limit, and to inform them that changing their state of residence may alter their coverage."

RESPONSE

As noted in the draft report, PBGC recently established additional participant notification requirements for plans undergoing a standard termination. An interim rule, which became effective December 16, 1991, requires plan administrators to inform participants (and other affected parties) in the notice of intent to terminate issued to begin a standard termination, that all benefit liabilities with respect to each participant will be provided and that the PBGC's guarantee is extinguished with respect to a participant upon distribution of plan assets in full

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satisfaction of that participant's benefit liabilities. In addition, PBGC issued a final rule, which became effective June 26, 1992, that requires plan administrators to inform both plan participants and the PBGC of the identity of the insurers from whom annuities may be purchased no later than 45 days before the distribution of plan assets. We believe that these requirements assure that participants will receive timely information about their plans' intended annuity purchase, which they may supplement by making their own inquiries concerning annuity providers and state guaranty fund protection.

See pp. 55-56.

There is a question, however, whether requiring plan administrators to provide additional information concerning state guaranty coverage of annuity contracts would result in any more than negligible benefits to participants. One difficulty is that, because laws concerning guaranty fund coverage and residencies change, the information provided would be valid for only a single point in time. The information provided on guaranty fund coverage might be irrelevant when the time to commence payment of the annuity arrives, or if the participant changes his or her state of residency, and therefore, might be misleading or create a false sense of security.

Consideration must also be given to whether implementation of the recommendation would add costs to the termination process. Plan sponsors in many circumstances would need to employ legal counsel or other outside consultants to research state law and match up the laws to the state of residence of each annuitant. For many plans, especially those with participants residing in multiple states, this could be an expensive, time-consuming effort.

ADDITIONAL COMMENTS

Now on p. 4.
See comment 1.

Page 8, 1st full paragraph: GAO states that ". . . DOL has not mandated the requirements for ongoing PBGC-insured plans [for advance notice to participants about the intended annuity provider and the change in their guaranty coverage], even though participants from both types of plans face similar risks when insurance annuities are purchased." The Department notes that the regulatory options for implementing GAO's recommendation are limited.

Now on p. 33.

Page 57, 1st paragraph: The specific authority for the proposition that the purchase of an annuity for a participant terminates a plan's liability for his or her benefits is set forth in the Department's regulations at 29 C.F.R. 2510.3-3.

Now on p. 45.

Page 63, 2nd sentence; page 75-77, beginning with the last partial paragraph: GAO states ". . . neither PBGC nor DOL routinely monitors annuity provider selections by certain types of plan." We do have serious concerns about the selection of

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annuity providers and have devoted a substantial portion of available resources to this area. It is important to note, however, that this is only one of many areas of potential abuse; the Department of Labor's responsibilities under Title I of ERISA cover a vast universe of private sector pension plans and health benefit arrangements. Investigations opened by PWBA may focus on any possible fiduciary breach or violations of Title I of ERISA which may have occurred. These investigations are opened as the result of a more systematic review against certain criteria (as opposed to random audits) in order to maximize the use of limited enforcement resources. To go beyond this approach would result in taking resources from other equally serious enforcement issues.

Now on p. 39.

Page 66, 1st point: We feel it is necessary to include additional information to more fully reflect the point being made by Assistant Secretary Ball regarding the "safest available rule". The sentence should read as follows:

> -- ERISA requires that fiduciaries must attempt to obtain the safest annuity available to the plan unless it can be demonstrated that, under the circumstances, purchasing a less expensive but somewhat lower quality annuity is in the interest of the plan's participants.

Now on p. 40.

Page 67, last partial paragraph: GAO states "Based on information submitted by plans as part of their standard termination paperwork, PBGC has referred to DOL for investigation about one out of every eight plans that purchased insurance annuities since 1990." The understanding between PBGC and PWBA provides for a referral of information on specific situations for purchase of annuities in which there is a plan termination based upon certain agreed upon criteria. The receipt of this information initiates an investigation to gather facts as to the circumstances and process in the selection of the annuity provider on the specific plan referred by the PBGC. On every PBGC referral received, PWBA opens an investigation and sends out a standard letter to solicit additional information on the annuity selection process. Based on the information provided in the response, and other criteria, some of the plans are selected for an on site investigation.

Although the referral process was implemented in 1990, some of plans referred by the PBGC had purchased annuities prior to 1990.

See comment 2.

Page 72, 1st full paragraph: GAO states that "PBGC has developed a list of "safe" insurers based on criteria developed by PBGC and PWBA." No such list has been developed. PBGC has identified, using specific criteria, certain insurers whose selection as an annuity carrier by plan officials may warrant further examination by the Department. This is more in the nature of an investigative selection method to determine those plans on which more information will be sought, rather than a bright line

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determination as to the actual safety or risk presented by a specific insurance company.

Now on p. 43.
See comment 3.

Page 73, 1st full paragraph: In the section called TWO COMPONENTS TO DOL'S OVERSIGHT OF ANNUITY PURCHASES, the report combines a three component process into two components. The three components of PWBA's enforcement efforts are discussed below.

1. PBGC Referrals

The PBGC referral process is described on pages 72 and 73 of the draft report and clarified in our comments above with respect to pages 67 and 72. Included in the plans referred from the PBGC were a number of plans, approximately 25, which purchased annuities from Executive Life Insurance Company (ELIC). Of these 25 referrals, five on-site ELIC investigations were opened. This process also resulted in the opening of 42 on-site investigations of plans which had purchased annuities from insurance carriers other than ELIC. As of this date, PWBA has sent out a total of 551 letters based on the PBGC referrals and has received 487 responses. (Understandably, a number of the sponsor companies no longer are in business.)

2. Selected Executive Life Annuity Purchases

PWBA has conducted a total of 43 on-site investigations with respect to plans which had purchased annuities from ELIC. Of these investigations, 38 were initiated by the Department based on various sources (five investigations were based on PBGC referrals - see above paragraph). These sources included a listing of Custom Qualified Retirement Annuities ("CQRAs"), provided by Executive Life; lists provided by Senator Metzenbaum's staff; plan participant inquiries; and PBGC referrals.

3. ELIC Correspondence Inquiry Letters

In June 1991, after PWBA had become aware of many of the large annuity purchases which plans had made from ELIC (and had opened investigations on some of these plans), PWBA sought to more completely identify plans which had purchased annuities from ELIC. PWBA requested that the conservator for ELIC provide a complete list of all plans which had purchased annuities from ELIC. Over several months, ELIC provided a list which it has represented as all plans which purchased annuities from it from 1985.

PWBA sent out a standard letter to request basic information on the annuity selection process, to each of the plans on this list and opened an investigation on each of these plans. PWBA sent letters to 1,109 plans and received 753 responses to date. (Note: Please see our comments on page 78 regarding the

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correction of data previously provided to GAO.) This correspondence program was undertaken to ascertain the potential universe of plans which purchased ELIC annuities, and to determine if there were other plans which should be selected for on-site investigations. However, due to the extended period of time required to get a complete list of the plans, and implement the extensive correspondence, the sources identified above in item 2 were, in fact, relied on to target plans purchasing ELIC annuities for on-site investigations.

Most of the 43 plans purchasing ELIC annuities which were subject to on-site investigations were selected due the large dollar amount of the annuity contract or number of participants involved. We estimate the total dollar amount of annuity contracts sold to pension plans by Executive Life since 1985 was $1,279,953,969.[1] The 43 PWBA Executive Life on-site investigations cover $938,101,010 of this total amount, or 73 percent of the total universe of annuities purchased based upon the monetary value of the annuities. (Monetary amounts based upon information furnished by ELIC). When viewed from this perspective, PWBA's enforcement efforts with respect to plans purchasing ELIC annuities have been much more comprehensive than would be indicated by simply considering the number of plans subjected to detailed investigations out of the potential universe of such plans.

Now on p. 46.

Page 77, last partial paragraph: Current statistics show that since March 1992, DOL has filed one additional lawsuit, against Raymark Industries, bringing the number of annuities lawsuits involving Executive Life to seven. As previously noted, we have received responses from 753 of the 1,109 letters sent out in the ELIC correspondence process.

Now on p. 46.
See comment 4.

Page 78, 1st full paragraph: This paragraph implies that the Department is not involved in settlement negotiations with any demand letter recipients. The Department has met with several recipients of these demand letters and settlement negotiations are continuing.

See comment 5.

Page 78, last partial paragraph: This paragraph should be updated to include a seventh case, Raymark, filed on October 22, 1992. The paragraph incorrectly implies that these lawsuits resulted from cases involving the 1,109 plans on the listing provided by Executive Life from which the Department sent inquiry letters. The seven suits were a result of the 43 on-site ELIC investigations conducted by the Department.

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[1] This number was estimated by adding the dollar amounts of all 1,109 small plan purchases on the listing provided by Executive Life, to the large plan purchases on the CQRA list.

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It should also be noted that only 1,109 plans were sent letters. Since the time we initially provided these statistics to GAO, we have refined our database and eliminated some duplications.

See comment 6.

Page 79, Figure 3.2: As discussed in our comments with respect to page 73, the chart gives an incorrect impression regarding the nature and scope of our enforcement process. Of particular importance is the statistic that the investigations we have conducted account for 73 percent of the dollar value of all of the Executive Life annuities. Thus, while the number of cases is small in proportion to the number of plans, in terms of dollars, the Department has covered a large amount of the "universe." Also, these larger plans most likely cover a great percentage of the participants receiving annuities.

Now on p. 47.

Page 82, 1st full paragraph: GAO states that ". . . the lack of any legal precedent pertaining to ERISA's fiduciary requirements for selecting an annuity provider creates a difficulty for DOL in deciding where to draw the line in alleging fiduciary breaches." While there is no specific case law on the issue of the selection of an annuity, the Department believes that the selection of an annuity provider is a fiduciary decision, and that the persons responsible for making that decision must exercise the requisite care, skill, prudence and loyalty which the statute mandates when making a fiduciary decision.

TECHNICAL CORRECTIONS: We have annotated technical corrections on the attached pages.

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The following are GAO's comments on the Department of Labor's letter dated December 18, 1992.

GAO Comments

1. We believe that requiring ongoing plans to provide advance notice to participants would improve benefit protections. As a result, we believe the Department should take whatever options it has available to implement this requirement.

2. We deleted this sentence from the report.

3. We revised our description of Labor's oversight of annuity purchases to distinguish the three components of this process.

4. We revised this paragraph to make clear that settlement negotiations are continuing.

5. We updated the report to include the Raymark case and clarified the source of lawsuits in the Executive Life cases.

6. We deleted figure 3.2 and added the 73 percent statistic to the report.

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