AMERICAN ACADEMY *of* ACTUARIES

July 3, 2014

Representative Tommy Thompson, Chair
Financial Services & Investment Products Committee
National Conference of Insurance Legislators

Re: Proposed Pension De-Risking Model Act

Dear Representative Thompson:

On behalf of the Pension Committee of the American Academy of Actuaries,[1] I appreciate the opportunity to provide comments on the proposed Pension De-Risking Model Act sponsored for discussion by Rep. George Keiser. The Pension Committee is comprised primarily of pension actuaries who advise plan sponsors with regard to the actuarial aspects of their pension plans. While our members do not work for or directly with insurance companies offering group annuity insurance products in designing or pricing those products, we do have exposure to some of the factors that affect design and pricing through colleagues who have worked for insurance companies and our experience assisting plan sponsors with the purchase of group annuity insurance products.

We believe that retirees should have access to monthly pension income that is secure and appropriately protected from risks that are outside their control, such as creditor risk from the entity funding their benefits. After reviewing this proposed model act, we have some significant concerns that we would like to share as you continue your discussions.

The model act, if enacted by a state in its current form, could significantly impact, even freeze, the annuity market for pension plan sponsors seeking to "de-risk" an ongoing plan or settle their pension obligations in conjunction with a pension plan termination. The phrase "de-risking" in the title of the model act defines these transactions solely from the standpoint of a pension plan sponsor. In this regard, a plan sponsor is "de-risking" their plan when engaging in a *risk transfer* transaction in which the future risks associated with providing a guaranteed lifetime income payment (e.g., investment return, interest rate and longevity risks) are transferred from the pension plan sponsor to an insurance company.

[1] The American Academy of Actuaries is an 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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Throughout the remainder of this letter we will refer to *de-risking* as it is used in the model act, but we encourage you to bear in mind that these transactions merely transfer risk, they do not eliminate risk. This caveat of course raises a critical question: which entity – plan sponsor, insurance company, or participant – is best equipped to manage these risks?

In our view, pension de-risking transactions do not necessarily need to be "limited," per se, as many retirees benefit from them. Retirees can benefit from de-risking transactions by their removal of the risk of benefit cutbacks associated with future plan sponsor insolvency. If a plan were to terminate without sufficient assets to cover all benefit obligations, pension plan participants could see their monthly income reduced.

U.S. Department of Labor (DOL) Interpretive Bulletin 95-1 requires that any plan fiduciary purchase a group annuity from the "safest available" annuity provider. This bulletin already limits which insurers can offer group annuities and require plan sponsors to consider, among other factors:

- The quality and diversification of the annuity provider's investment portfolio;
- The size of the insurer relative to the proposed contract;
- The level of the insurer's capital and surplus;
- The lines of business of the annuity provider and other indications of an insurer's exposure to liability;
- The structure of the annuity contract and guarantees supporting the annuity, such as the use of separate accounts; and
- The amount and extent of additional protection provided through state guaranty associations.

We suggest that NCOIL consider the DOL's rules when a comparison is made between the risk of transferring the future benefit obligation to an insurance company to leaving the risk at the employer level. Unlike insurance companies, employers are not obligated to issue financial statements on a solvency basis, and plan sponsors have far more latitude—and can take more risk—in the investments they can choose than do insurers. Solvency risk is, of course, directly related to benefit security. Insurance companies must be vetted and meet very stringent requirements in order to be selected to guarantee future pension benefits, yet any employer (regardless of its financial health) is permitted to sponsor a defined benefit plan.

Plans of failed companies are backstopped to an extent by the Pension Benefit Guaranty Corporation (PBGC). However, the PBGC[2] *maximum* guaranteed benefit at age 65 is currently $59,318 per year; at age 55 the maximum guaranteed benefit is currently $26,693.[3] Benefits that have been transferred to an insurer are backed by state guaranty insurance coverage, which varies by state. Thus, it is difficult to draw a general conclusion as to which is preferable; the analysis will differ by participant based on the individual circumstances (e.g., amount of benefit, which state's guaranty coverage applies, etc.)

[2] In 2014, the PBGC posted a $27.4 billion unfunded liability in the single employer insurance program. While this underfunding poses some threat to benefit security of those workers whose benefits have been transferred to PBGC, many believe that Congress would take action to fund PBGC-backed benefits in the case of insolvency.
[3] Additional reductions to both the amounts in this sentence are made for benefits that provide for continued payments to a beneficiary following the participant's death.

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We have not attempted to compile data, but from anecdotal observation, non-insurers fail at a far greater rate than insurers. On that basis alone, a participant would be better off having benefits secured by an insurer backed by a state guaranty association rather than an employer-sponsored pension plan backed by the PBGC. In underfunded plans with a plan sponsor nearing bankruptcy or otherwise unable to meet its financial commitment to the pension plan, having benefits guaranteed at their full amount by a "safest available" insurer would likely be a better alternative for plan participants than the PBGC insurance. Underfunded plans may be restricted by law from entering into a de-risking transaction (or simply be unable to afford one), however sufficiently funded plans should not be unduly restricted from engaging in a de-risking transaction as a means of reducing the risk of future underfunding.

<u>Specific Observations on the Provisions of the Model Act of Greatest Concern</u>

ERISA Preemption Risk

The Employee Retirement Income Security Act (ERISA) could preempt certain aspects of this model act once enacted if it is deemed to affect participants' benefits governed by federal statute rather than the insurance companies offering the products. The ERISA rules governing these transactions were designed to provide a uniform standard so as to avoid administrative complications for sponsors operating plans with participants spread across multiple states. While the purpose of the draft model act is to provide uniformity, if any state makes modifications we expect that insurers and plan sponsors will struggle to comply with the differences.

We recommend NCOIL ensure that the model act does not put states at risk of federal preemption lawsuits if enacted by avoiding provisions that cover areas already governed by ERISA. For example, Section 8 of the model act would allow a retiree to opt out of a de-risking transaction by electing a one-time lump sum payment as an alternative to continuing future monthly annuity payments from the insurer. The model act mandates the lump sum calculation be determined using an interest rate no greater than the 90-day average 10-year Treasury rate plus 200 basis points. This interest rate basis is in direct conflict with the rates mandated for minimum present value under ERISA in Internal Revenue Code §417(e), which most plan sponsors use to calculate lump sums. The Pension Committee believes this provision could place a state that adopts the model act at risk of a federal ERISA preemption if this results in a lower lump sum value than the §417(e) rates. There is also risk of an ERISA preemption because the model act would *require* sponsors to offer a benefit that is not otherwise available under a plan prior to the de-risking transaction.

Additionally, the language in the model act is not clear as to whether this provision would apply to all annuity purchases from ERISA plans (which includes annuity placement upon plan termination) or only partial annuitization or de-risking transactions entered into by an ongoing plan.

State Regulatory Approval of De-Risking Transactions

Section 5 of the model act, which requires regulatory approval by states where more than 25 percent of affected retirees reside, could cause large administrative complications, leading to lengthy time delays in completing de-risking transactions. Plan sponsors could be effectively unable to do a final annuity placement, discouraging them from entering into these transactions. For instance, under this provision, an ERISA trust sponsored by a company in Kentucky seeking

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to purchase an annuity from an insurer in New Jersey, would need to get approval in Ohio and Nevada if more than 25 percent of its employees resided in those states. To further illustrate, Arizona might receive requests from multiple insurers in different states regarding this same transaction and would need to coordinate their response to ensure that one insurer is not put at a competitive disadvantage due to an administrative delay.

Impingement on Plan Sponsor Settlor Rights

ERISA acknowledges that certain activities of the plan sponsor fall outside the scope of fiduciary obligation. Plan sponsors are given the freedom to establish a plan, choose which plan design features and level of benefits will be offered, and make the decision whether or not to amend or terminate a plan based on the company's business interests without falling under ERISA fiduciary responsibility. These functions are known as *settlor activities*, and are separate and distinct from fiduciary actions involving plan administration done in the sole interest of plan participants and beneficiaries.

The requirement under Section 8 and Section 11 of the model act that lump sum opt-out payments be offered to retirees that do not otherwise have that right under an ERISA plan, amounts to a state-legislated benefit increase imposed upon sponsors electing to engage in a de-risking transaction. Such a requirement impinges on the ability of the plan sponsor to design the benefit program offered to their employees and increases the cost of providing benefits beyond the commitment made by the sponsor to those employees during their period of employment (i.e., the period during which they earned the right to the deferred compensation offered through pension benefits). It changes the fundamental nature of the transaction from de-risking to a benefit increase and will discourage plan sponsors (acting in a settlor capacity) from engaging in these transactions. Further, an indication that a company's settlor rights are subject to elimination will greatly increase the company's perception of the risk inherent in establishing or maintaining a plan, likely decreasing the availability of defined benefit plans and the participant-friendly guaranteed benefits they provide.

Option Risk

Section 11 of the model act requires insurers to provide, at regular intervals, a lump sum payment option after a pension de-risking transaction takes place. Allowing lump sums at regular intervals allows retirees who know they are in failing health to exercise this option—a very valuable, expensive option in this case, and an option which to our knowledge is not available in any annuity contract on the market today, presumably because the cost associated with providing the option makes it untenable to consumers. Insurers will not absorb this cost, so they will have to charge employers for the option. Requiring a provision that encourages anti-selection to this extent will either raise costs significantly or cause insurers to leave the market entirely. The only alternative available to sponsors is to forgo the purchase of annuities entirely and either offer one-time lumps sum to retirees or simply continue to pay annuity benefits. As previously discussed, this leaves retirees' monthly pensions subject to risks related to the financial health of the plan sponsor.

Use of Separate Accounts

The limitation on pooling required in Section 9 of the model act could create a substantial disincentive to provide annuities. ERISA trusts do not operate for profit; most insurance companies do. This provision provides no ability to return profits earned (e.g., if the insured

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population experiences higher than expected mortality or the invested assets exceed expected return benchmarks) to shareholders. Thus, it appears the only option for insurance companies to earn profit under these transactions would be to charge higher investment management or administrative fees.

The language in Section 9 does not clearly indicate whether each plan would have a separate trust or if all plans would be in one trust. Regardless, this provision would inhibit the insurer's ability to pool experience with other lines of business. Unless the trust itself was quite large, the pooling advantages of insurance could be lost and the cost of purchasing an annuity policy would likely increase commensurately.

Mandatory Disclosures

The disclosures required under Section 7B significantly expand those required by ERISA and much of the disclosure is relevant only within the context of assessing the insurer's solvency, which would be very difficult for the participant to interpret even with the additional disclosures. For example, if interest rates were to rise substantially, the disclosures in 7B would likely show a large asset loss that might be perceived as a deterioration of funded position, which might not actually be the case.

These additional disclosures will create increased costs to insurers, providing incentives to leave this market or increase the cost of these annuity contracts, without actually making retirees more secure.

Third Party Guarantee or Reinsurance

Section 6 of the model act requires all de-risking transactions to include a third-party guarantee or reinsurance that effectively replicates the protections afforded by ERISA through the PBGC insurance program. The Department of Labor and PBGC have stated that the settlement of a plan sponsor's obligation to an insurer that meets the "safest available" standards in DOL Interpretive Bulletin 95-1 is an appropriate substitution for the protections provided by the PBGC under ERISA. While we see no reason that a state could not require inclusion of the guarantee of the same level of protections through contracts they approve, requiring these guaranty arrangements operates under the assumption that a market would exist to sell this insurance, which remains uncertain.

We note that the original provisions of ERISA allowed for a secondary insurance market above the guarantees provided by PBGC; no reputable insurers were found who were interested in providing that type of insurance.

We encourage NCOIL to consider the allowance made by the DOL and PBGC for the substitution of insurer carefully selected by plan fiduciaries when deciding whether this additional level of protection is needed on top of the state guaranty association protection.

Retirees can benefit from de-risking transactions, particularly when the pension plan providing benefits is less than fully funded. For a well-funded pension plan, a "de-risking" transaction to a "safest available" insurer, backed by state guaranty association coverage, could be a better alternative than exposing participants to the future risk of having benefits cut back to the PBGC guaranteed amount in the event the plan becomes severely underfunded in the future. We note

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that retirees whose benefits are transferred to an insurer through a de-risking transaction either affirmatively chose a guaranteed monthly lifetime income from their employer's plan in lieu of a lump sum, or participated in a plan where the employer exercised its right in designing the plan to decide that a lump sum option would not be available.

A comparison of PBGC coverage for an ongoing plan sponsor to state guaranty association coverage for benefits transferred to an insurer is multifaceted and requires complex analysis. We encourage NCOIL to continue its discussion of the model act to ensure that the desired outcome will be achieved without significantly compromising access to, and the affordability of, pension de-risking transactions in the future.

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The Pension Committee appreciates the opportunity to comment on this matter and would be happy to discuss any of these items with you at your convenience. Please contact Bill Rapp, the Academy's Assistant Director of Public Policy (rapp@actuary.org; 202-223-8196), if you have any questions or would like to discuss these items further.

Sincerely,

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Vice-Chairperson, Pension Committee
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