PRESENT LAW AND ISSUES RELATING TO PENSION BENEFIT GUARANTY CORPORATION GUARANTEES OF RETIREMENT ANNUITIES PAID BY INSURANCE COMPANIES

Scheduled for a Hearing

Before the

SENATE COMMITTEE ON FINANCE

on April 5, 1990

Prepared by the Staff

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CONTENTS

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 5, 1990, on Pension Benefit Guaranty Corporation (PBGC) guarantees of retirement annuities paid by insurance companies. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law provisions and a discussion of related issues.

The first part of this document is a summary. The second part is a description of present-law rules. The third part is a discussion of issues related to PBGC guarantees of retirement annuities paid by insurance companies.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Issues Relating to Pension Benefit Guaranty Corporation Guarantees of Retirement Annuities Paid by Insurance Companies (JCX-10-90), April 4, 1990.

I. SUMMARY

Background

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

Qualified plans are broadly classified into two categories, defined contribution plans and defined benefit pension plans, based on the nature of the benefits provided. Under a defined benefit pension plan, benefits are specified under a plan formula. Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant.

The qualification standards are generally defined to ensure that qualified plans do not discriminate in favor of highly compensated employees. They also define the rights of plan participants and beneficiaries and place certain limits on the tax deferral possible under qualified plans. In addition, the Code imposes minimum funding standards on defined benefit pension plans that are designed to ensure that such plans have sufficient assets to pay promised benefits.

Use of annuity contracts issued by commercial insurers

There has been recent concern about the security of pension plan benefits provided through commercial annuities. Commercial annuities may be purchased by or for a plan in several contexts. For example, an annuity contract may be purchased as an investment asset, annuity contracts may be used to entirely fund plan benefits, annuity contracts may be distributed to retiring participants, and annuity contacts may be purchased to provide benefits upon termination of a defined benefit pension plan.

Plan termination insurance program

Under present law, the Pension Benefit Guaranty corporation (PBGC), a Federal corporation within the Department of Labor, provides insurance for certain benefits under defined benefit pension plans in the event the plan is terminated at a time when plan assets are not sufficient to pay plan benefits. The PBGC generally guarantees nonforfeitable retirement benefits up to a certain dollar amount ($2,164.77 per month for 1990).

To help cover the cost of the guarantee program, premiums are charged with respect to covered defined benefit pension plans. A flat-rate premium of $16 per participant applies to all single-employer defined benefit pension plans. In addition, underfunded plans are required to pay an additional premium of up to $34 per participant based on the amount of underfunding. An individual who has received an irrevocable commitment from an insurance company (i.e., an annuity contract) to pay all the benefits to which the individual is entitled under the plan is not considered a participant for PBGC premium purposes, so that no premiums are assessed with respect to such individuals. In addition, premiums are not required to be paid after a plan has terminated and plan assets have been finally distributed.

A defined benefit pension plan may be voluntarily terminated by the employer or involuntarily terminated by the PBGC. A plan may be terminated by the employer only in a distress termination or a standard termination. A standard termination is permitted only if the plan has sufficient assets to satisfy all benefit liabilities under the plan. One of the requirements for a standard termination is that plan benefits be provided for through the purchase of annuity contracts or otherwise as permitted by the plan and regulations.

The PBGC currently takes the position that the PBGC guarantee does not apply to annuity contracts that have been distributed pursuant to a plan termination.[2] There is some support in present law both for the position that such contracts are subject to the guarantee and for the position that they are not.

<u>Standards for fiduciaries and insurance companies</u>

The Employee Retirement Income Security Act (ERISA) imposes standards of conduct on plan fiduciaries. These rules require, among other things, that a plan fiduciary act solely in the interests of plan participants and beneficiaries. Under present law, the choice of an insurance company to provide annuities for pension plan benefits is subject to ERISA's fiduciary rules.

Federal law does not contain any specific restrictions

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[2] The guarantee does not apply to contracts issued to retiring participants before termination because the guarantees do not come into operation until there has been a plan termination.

on standards on the companies that issue pension annuities. However, such companies are subject to extensive State regulation.

Issues

The possible extension of Federal guarantees to commercial annuities used to provide pension benefits raises a number of issues, including (1) the appropriate scope of guarantees of pension benefits, (2) whether the Federal government or the States should provide the guarantees, (3) the pricing of insurance of pension benefits, (4) the problems that result from inadequate pricing, and (5) possible alternatives to an expanded Federal guarantee program.

II. PRESENT LAW

A. Background

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred. Contributions to a qualified plan are held in a tax-exempt trust.

Qualified plans are broadly classified into two categories--defined contribution plans and defined benefit pension plans, based on the nature of the benefits provided.

Under a defined benefit pension plan, benefits are specified under a plan formula. For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit pension plan also may be specified as a flat or step-rate (i.e., increasing with years of service) percentage of the employee's average compensation or career compensation. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

Qualified plans are required to meet certain standards under the Code, including rules designed to prevent discrimination in favor of highly compensated employees, rules defining age and service requirements participants can be required to satisfy before becoming plan participants, and rules regarding the rate that benefits accrue (i.e., are earned) and become vested.

In addition, under the Code and ERISA, certain defined benefit pension plans are required to meet minimum funding standards. These standards are designed to ensure the benefit security of participants by requiring that the plan contains sufficient assets to meet plan obligations as they become due. These standards were substantially modified by the Pension Protection Act of 1987. Among the provisions of the Pension Protection Act was a requirement for an additional minimum funding contribution for plans that have current liabilities in excess of their assets (i.e., underfunded plans).

Use of annuity contracts purchased through commercial insurers

Commercial annuity contracts may be selected or purchased by plan fiduciaries for several reasons. An annuity contract may be purchased as a plan investment. For example, certain plans are funded solely through the purchase of insurance contracts (see, e.g., Code secs. 412(i) and 403(b)). Similarly, in the case of a defined contribution plan, an annuity or guaranteed income contract may be offered as an option in a plan that allows the participant to make investment decisions with respect to his or her account under the plan (e.g., qualified cash or deferred arrangements under section 401(k) of the Code).

In addition, an annuity contract may be purchased to satisfy the liability of a plan to a participant who has retired or otherwise separated from service. The contract may be distributed to the participant. Annuity contracts are also used to satisfy plan liabilities at the time a plan terminates.

B. Termination Insurance Program and the Pension Benefit Guaranty Corporation

In general

The Pension Benefit Guaranty Corporation (PBGC), a Federal corporation within the Department of Labor (DOL), was created in 1974 by the Employee Retirement Income Security Act (ERISA) in order to provide an insurance program for benefits under certain defined benefit pension plans maintained by private employers in the event a plan is terminated at a time when the plan does not have sufficient assets to provide benefits promised under the plan. Thus, the PBGC guarantees the payment of certain benefits in the event of the termination of a defined benefit pension plan with assets insufficient to satisfy benefit liabilities. The plan termination may be voluntary (by the employer) or involuntary (by the PBGC).[3] A termination by an employer can

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[3] The PBGC can commence a termination of a plan if the plan (Footnote continued)

be either a standard termination or a distress termination.

According to the PBGC's 1989 annual report, the single-employer insurance program currently covers more than 31 million participants in approximately 100,000 single-employer defined benefit pension plans.[4] PBGC revenues include premiums charged with respect to defined benefit pension plans, earnings on investments, and collections from sponsors of plans that are terminated with assets insufficient to pay all benefits under the plan.

As of September 30, 1989, the PBGC had assets of approximately $3.2 billion and liabilities of about $4.2 billion, resulting in an accumulated deficit of $1 billion. As of September 30, 1988, the PBGC's deficit was approximately $1.4 billion. In its 1989 annual report, the PBGC attributes the reduction in its deficit to increased premiums resulting from the changes in premium rates enacted in the Pension Protection Act of 1987 (discussed below), the absence of very large losses from plan termination, and strong investment results.

Covered plans

The PBGC insures most tax-qualified defined benefit pension plans established or maintained by an employer (or employee organization) engaged in commerce or in any industry or activity affecting commerce. Plans that are not insured by the PBGC include (1) defined contribution plans; (2) plans maintained by the Federal Government or by State or local governments; (3) plans maintained by churches; and (4) plans established and maintained by a professional service employer that does not at any time have more than 25 active participants.

Guaranteed benefits

Subject to limits, the PBGC guarantees basic benefits under a covered plan (ERISA sec. 4022). With respect to single-employer defined benefit pension plans, basic benefits consist of nonforfeitable retirement benefits other than those benefits that become nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for

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[3] (continued)
(1) does not satisfy minimum funding requirements, (2) cannot pay benefits when due, (3) made certain distributions to substantial owners, or (4) was in such a condition that the long-run loss to the PBGC is expected to increase unreasonably unless the plan is terminated.

[4] The PBGC also covers multiemployer pension plans.

inflation since 1974 ($2,164.77 for 1990).

Guarantees do not apply with respect to benefits in effect for fewer than 60 months at the time of plan termination unless the PBGC finds substantial evidence that the plan was terminated for a reasonable business purpose and not for the purpose of securing increased guaranteed benefits for participants. In cases in which such benefits are guaranteed, the guarantee is phased in over 5 years at the rate of $20 per month or 20 percent per year, whichever is greater, for (1) basic benefits that have been in effect for less than 60 months at the time that the plan terminates, or (2) any increase in the amount of basic benefits under a plan resulting from a plan amendment within 60 months before the date of plan termination.

The PBGC is authorized under ERISA to guarantee the payment of other classes of benefits (i.e., nonbasic benefits) and to establish the terms and conditions under which such other benefits are guaranteed. To date, the PBGC has not exercised this authority.

PBGC premiums

In order to cover the cost of PBGC guarantees, premiums are imposed with respect to covered plans. A flat-rate PBGC premium of $16 per-participant applies to single-employer defined benefit pension plans. For years beginning after December 31, 1987, an additional variable-rate premium based on a plan's funded status is imposed under the Pension Protection Act of 1987. The additional per-participant premium is $6 per $1,000 of the plan's unfunded vested benefits divided by the number of participants, with a maximum per-participant additional premium of $34 (i.e., a total possible premium of $50) (ERISA sec. 4006). Special rules apply with respect to the interest rate used to value unfunded vested benefits.

Both the plan administrator and the contributing sponsor of the plan (i.e., the employer) are liable for the premium. Further, if the contributing sponsor is a member of a controlled group, each member of the controlled group is jointly and severally liable for the premium.

For purposes of determining the amount of premiums due, PBGC regulations generally define a "participant" as (1) an individual (whether or not currently employed by the employer) who is earning or retaining credited service under the plan, (2) an individual who is retired or separated from service and who is receiving or is entitled to receive a benefit under the plan, and (3) a deceased individual who has one or more beneficiaries who are receiving or entitled to receive benefits under the plan (PBGC reg. sec. 2610.2). Under the regulations, the term participant does not include an individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the individual is entitled under the plan. The term participant also would not include an individual who has received a distribution of his or her total interest in the plan, for example, in a lump-sum distribution. The premium due for a year is based on the number of participants in the plan on the last day of the preceding plan year.

The obligation to pay PBGC premiums ceases at the end of the year in which plan assets are finally distributed pursuant to a plan termination. The plan may obtain a refund for amounts paid for the year the plan's assets are so distributed and after the later of (1) the date the assets are distributed, or (2) 30 days before the PBGC receives a certification that the distribution is made. (PBGC reg. sec. 2610.22(d)).

Termination procedures

A defined benefit pension plan is generally considered terminated when it is voluntarily terminated by the employer or involuntarily terminated by the PBGC. A plan may be terminated voluntarily only in a standard or distress termination (ERISA sec. 4041).

A standard termination is permitted only if the plan has sufficient assets to satisfy benefit liabilities under the plan. Benefit liabilities are, in general, all fixed and contingent liabilities to plan participants and beneficiaries earned as of the date of the termination of the plan (i.e., those liabilities described in Code sec. 401(a)(2)).

A plan may be terminated in a distress termination if the plan lacks sufficient assets to satisfy benefit liabilities and the employer meets certain requirements relating to financial distress. In the case of a distress termination, the PBGC will generally take responsibility for payment of benefits under the plan.

Plan termination procedures were substantially revised in the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA). Under SEPPAA, a plan may be terminated in a standard termination if: (1) the plan administrator provides 60-day advance notice of the intent to terminate to plan participants and other affected parties, (2) as soon as practicable after the 60-day notice is provided the plan administrator (a) sends to the PBGC an actuarial certification that the plan has sufficient assets to cover benefit liabilities and certain other information, and (b) notifies each participant and beneficiary of their share of benefit liabilities, and (3) the PBGC does not issue a notice of noncompliance with regard to the termination.

The PBGC is authorized to issue a notice of noncompliance if it determines that the standard termination procedures have not been satisfied or that the plan's assets are not insufficient to meet benefit liabilities. The PBGC has 60 days after the plan administrator notifies the PBGC of the proposed termination to issue a notice of noncompliance. This 60-day period may be extended by written agreement of the plan administrator and the PBGC.

If the PBGC does not issue a notice of noncompliance, the plan administrator is to proceed as soon as practicable with the final distribution of plan assets. In distributing plan assets, the plan administrator is to follow certain rules relating to the allocation of plan assets (ERISA sec. 4044). Further, the plan administrator is to purchase irrevocable commitments from an insurer to provide for all benefit liabilities under the plan or (in accordance with the provisions of the plan and any regulations) otherwise fully provide all benefit liabilities under the plan (e.g., pay a lump sum amount to a participant provided payment in such form is otherwise permitted under the Code and ERISA).

Under PBGC proposed regulations, the irrevocable commitment from an insurer must be a single premium, nonparticipating (except in the case of a plan that is sufficient for all accrued benefits), nonsurrenderable annuity that constitutes an irrevocable commitment by the insurer to provide the benefits purchased (PBGC proposed reg. sec. 2617.6). The plan administrator is required to give the participant or beneficiary the annuity contract or a certificate showing the insurer's name and address and clearly reflecting the insurer's obligation to provide the participant's or beneficiary's benefit (PBGC proposed reg. sec. 2617.18(c)). Neither the statute nor regulations require that the insurance company providing the irrevocable commitment meet specific standards except that the insurer must be a company authorized to do business as an insurance carrier under the laws of a State or the District of Columbia.

Within 30 days after the final distribution of assets is completed, the plan administrator is to certify to the PBGC that the plan's assets have been distributed to pay all benefit liabilities under the plan. Under proposed PBGC regulations, the certification is to include the name and address of the insurer from which annuity contracts were purchased. The PBGC has recently indicated that it will revise its procedures to require that the PBGC be provided with the name of the insurer prior to the final distribution of assets (see further discussion in Part III. C. below).[5]

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5 See, Request for OMB Approval of Information Collection,
(Footnote continued)

Extent of PBGC guarantee upon distribution of annuity contracts

ERISA does not explicitly state whether or not the PBGC guarantee extends to commercial annuities distributed to a plan participant in satisfaction of the plan's obligation for benefits. In the case of an annuity contract distributed from an ongoing plan, the PBGC guarantee would generally not apply, because the guarantee does not come into play until a plan is terminated. In the case of commercial annuities distributed pursuant to a plan termination, the current position of the PBGC and the DOL is that the guarantee does not apply in such circumstances because the participant has received his or her total benefits under the plan.[6]

There is some support under present law for the position that the guarantee does extend to commercial annuities distributed to plan participants. One could argue that the guarantee is not terminated when the benefit obligation is merely transferred to a third party (e.g., an insurance company), as opposed to being distributed to the plan participant (e.g., in a lump-sum distribution). Further, under ERISA, the PBGC is granted continuing authority to take certain actions after a plan has terminated and plan assets have been distributed (e.g., to bring a civil suit to enforce

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[5](continued)
55 Fed. Reg. 6138 (Feb. 21, 1989).

[6] The PBGC has previously indicated that the guarantee might apply. The preamble to the final regulations issued in 1981 (PBGC reg. sec. 2615) relating to the conditions under which the PBGC would issue a notice of sufficiency upon plan termination (prior to the enactment of SEPPAA) included the following in its discussion of the provision in the regulations concerning the requirement that benefits payable as annuities be provided in annuity form either by the PBGC or through the purchase of annuity contracts from an insurer:

> Under the regulation, an "insurer" is "a company authorized to do business as an insurance carrier under the laws of a State or the District of Columbia" (sec. 2615.2). Such companies are subject to strict statutory requirements and administrative supervision. In fact, the reason insurance companies are so extensively regulated is to ensure that their obligations can be satisfied. However, in the unlikely event that an insurance company should fail and its obligations cannot be satisfied (e.g., through a reinsurance system), the PBGC would provide the necessary benefits.

46 Fed. Reg. 9532, at 9534. This position is not necessarily consistent with the structure of the PBGC premium.

the termination under ERISA).

ERISA also provides that the certification by the plan administrator that the assets have been distributed and all benefit liabilities satisfied does not affect the PBGC's obligations under the provisions of ERISA relating to benefit guarantees (ERISA sec. 4041(b)(4)). While one reading of this provision would support the view that the PBGC remains liable for guaranteed benefits after a plan terminates and annuities have been distributed, the legislative history relating to the provision suggests a more modest purpose--to extend the PBGC guarantee to those situations in which it is subsequently determined that the certification was incorrect and all guaranteed benefits were not in fact distributed.[7]

In support of the PBGC's current position, it may be argued that the trigger for the insurance, i.e., the insurable event, is the plan termination. Once the benefits of plan participants have been provided for, the PBGC is no longer liable. Under this argument, the obligation of the plan to provide the benefit has been met when there has been a distribution of an annuity contract to the participant. The distribution of the contract satisfies the liability in the same manner as a lump sum would satisfy the liability of the plan if the participant requested such a distribution. Under this view, the PBGC has no further obligation if an annuity contract is distributed just as it has no further obligation if, for example, a former participant invested a lump-sum distribution in an IRA or used the distribution to purchase an annuity on his or her own.

It may also be argued that the premium structure of

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[7] This section of ERISA was added by SEPPAA. The legislative history to SEPPAA included the following explanation of the provision:

> Under the bill, the PBGC retains its existing authority under section 4003 of ERISA to conduct audits of plans, both prior to and after the termination of a plan. Even if the plan administrator has certified to the PBGC that the assets of the plan have been distributed so as to provide when due all benefit entitlements and all other benefits to which assets are allocated under section 4044, the PBGC is still obligated to guarantee the payment of benefits under section 4022 if it is subsequently determined that not all guaranteed benefits were in fact distributed under a standard termination, and the contributing sponsors of the plan and the members of their controlled groups do not promptly provide for the payments of such benefits.

H. Rpt. 241, 99th Cong., at 48.

ERISA does not contemplate a continuing obligation with respect to the PBGC after the termination of the plan and the distribution of plan assets. If the guarantee continues, then the premium should take into account the risk of the failure of the insurance company, not simply the risk that plan assets are not sufficient for benefit liabilities. Moreover, present law does not contain rules that would be necessary to coordinate such a continuing obligation with State laws regulating insurance providers and products.

C. Standards for Plan Fiduciaries and Insurers

Fiduciary rules

ERISA imposes certain standards of conduct on plan fiduciaries. Under ERISA, a fiduciary is required to discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying the reasonable expenses of administering the plan.[8] In addition, a plan fiduciary is required to discharge his or her duties (1) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in a similar enterprise, (2) by, in general, diversifying the investments of the plan so as to minimize the risk of large losses, and (3) in accordance with the plan document and other governing instruments insofar as such documents are consistent with ERISA.[9]

A fiduciary is generally defined as a person who, with respect to a plan (1) exercises any discretionary authority or discretionary control respecting management of the plan or exercises any authority or control respecting management or disposition of plan assets, (2) renders investment advice with respect to plan assets for a fee or other compensation, or (3) has discretionary authority with respect to the administration of the plan.

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8 A similar rule is included in the Internal Revenue Code. A plan will not be qualified if it is possible, at any time prior to the satisfaction of all liabilities under the plan, for any plan assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries (sec. 401(a)(2)).

9 There are additional rules under the Code and ERISA relating to fiduciaries who engage in certain prohibited transactions with a plan (e.g., self-dealing) (Code sec. 4975 and ERISA sec. 406).

If a fiduciary fails to meet ERISA's standards of conduct, the fiduciary is personally liable for any losses resulting from the breach of fiduciary duty. The Secretary of Labor, the plan administrator, and participants or their beneficiaries are permitted to bring an action against the fiduciary. Civil and criminal penalties may also apply.

Courts, as well as the DOL, have generally taken the position that the decision to terminate a plan is a settlor function (i.e., made in the discretion of the employer who is the plan sponsor) and is not subject to ERISA's fiduciary rules.[10] However, the selection and purchase of annuities by an ongoing plan or on plan termination is viewed by the DOL as an investment decision subject to the fiduciary standards.[11] Thus, for example, the selection by a plan sponsor of an insurance company from which to purchase annuities on plan termination could be challenged on the ground that the employer did not act solely in the interests of plan participants but acted only to maximize the employer's reversion.[12] The DOL has not issued any specific standards regarding annuity providers.

PBGC termination procedures

The PBGC has not issued final regulations regarding the post-SEPPAA termination procedures. The proposed regulations

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10 See, e.g., U.A.W. District 65 v. Harper & Row, Inc., 576 F. Supp. 1468 (S.D.N.Y. 1983).

11 The Department of Labor has taken this position in an opinion letter to the Advisory Council on Employee Welfare and Pension Benefit Plans dated March 13, 1986.

12 As discussed in Part II.A. of the text, plans may invest in commercial annuities in situations in addition to the termination of a defined benefit pension plan. The fiduciary rules may apply differently in other situations. For example, if an individual account plan permits a participant to exercise control over the assets in his or her account and the participant exercises such control, then, in general, no person who otherwise is a fiduciary is liable for losses which result from the participant's control of his or her account (ERISA sec. 404(c)). Thus, for example, a fiduciary may not be liable where the participant has directed the investment of his or her account under a qualified cash or deferred arrangement (Code sec. 401(k)) and the performance of such investment is unsatisfactory. However, under proposed regulations issued by the DOL, this exception to fiduciary liability does not apply with respect to the selection of the investment options available to the participant. Consequently, if the options are not sufficiently diversified, the fiduciary may be liable.

under the post-SEPPAA rules do not contain specific rules regarding selection of the annuity provider, other than that the insurer be authorized to do business as an insurance carrier under State law or in the District of Columbia.

As mentioned above, the proposed regulations under the post-SEPPAA rules provide that the certification required following final distribution of plan assets is to contain the name of the insurance company providing annuities. The PBGC has indicated that it will revise this procedure to require that the name of the company be provided before the distribution of assets. The PBGC has informally indicated that this additional period of time is intended to give the PBGC the opportunity to refer appropriate cases to the Pension and Welfare Benefits Administration (an agency within the Department of Labor) for examination under the fiduciary rules. The PBGC has not issued a formal notice regarding this procedure, or indicated what criteria it will use in referring cases for further examination.

State insurance laws

ERISA generally preempts State laws as they relate to any pension plan (ERISA sec. 514). This provision does not, however, apply to any State law regulating insurance. Thus, providers of annuities to terminating defined benefit pension plans are subject to whatever standards apply under State law.

A majority of states have established guarantee funds that are designed to cover the liabilities of failed insurance companies. While state laws relating to guarantee funds differ, these funds may provide some protection to defined benefit pension plan participants who hold a commercial annuity.

III. ISSUES RELATED TO PBGC GUARANTEES OF RETIREMENT ANNUITIES PAID BY INSURANCE COMPANIES

In order to help understand under what conditions pension benefit guarantees should be provided, this part discusses (1) the scope of guarantees of pension benefits, (2) whether the Federal Government or the States should provide the guarantees, (3) the pricing of insurance of pension benefits, including factors affecting pricing of insurance of benefits provided directly by the plan and by annuities, (4) the problems resulting from inadequate pricing, and (5) possible alternatives to an expanded Federal guarantee program.

A. Scope of Federal Guarantees of Pension Plans

Solvency of employer

Under present law, the Federal Government's guarantee of pension benefits (through the operations of the PBGC and the plan termination insurance program) is relatively limited. The guarantee does not extend to defined contribution plans, does not guarantee all benefits under a defined benefit pension plan, and is not triggered until a defined benefit pension plan is terminated.[13]

The plan termination insurance program was initially enacted in response to a large plan termination in which insufficient assets were available to pay promised benefits to plan participants under a defined benefit pension plan. The primary need for the insurance program was deemed to be the termination of defined benefit pension plans because any participant's contractual right under the plan was the right to plan benefits, rather than to a portion of plan assets or to an account balance in the participant's name. Once a plan terminated, the employer might no longer be willing or available to pay the promised benefits if assets were insufficient at the time of termination. The plan termination insurance program was designed to provide a backstop to satisfy employee expectations that a specified plan benefit would be paid after retirement.

Under the present-law system, the Federal Government regulates the minimum funding of defined benefit pension plans. This Federal regulation is another reason why the Federal guarantee of pension benefits generally is triggered only upon plan termination when plan funding stops. The primary concern under present law is the ability of an

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[13] The PBGC can control the occurrence and the timing of termination of a defined benefit pension plan under certain circumstances.

employer to discharge voluntarily its liabilities with respect to the defined benefit pension plan upon plan termination.

Arguments could be made for expanding the scope of the Federal guarantee to additional cases. For example, some might consider the solvency of an employer to be a more telling indicator of the potential inability to provide promised benefits than the solvency of the defined benefit pension plan. Thus, the employer's insolvency might hamper it's ability to fund the defined benefit pension plan, which would threaten the security of participants' benefits. This problem argues for the premium charged for Federal guarantee coverage to be related to the solvency of the employer rather than to the funded status of the plan.

Also, as defined contribution plans become more popular and replace defined benefit pension plans, issues arise as to the potential declines in value of assets allocated to a participant in a defined contribution plan. This loss could occur because of the trustee's investment decisions or because of the employee's investment decisions when self-directing of investments is permitted. Thus, the Federal guarantee could appropriately be extended to cases in which participants might otherwise face a risk of loss of benefits beyond the traditional event of plan termination.

Solvency of insurance company

A new issue also arises with respect to the payment of pension benefits -- the extent to which the Federal Government guarantee of pension benefits should extend to situations in which the employer is no longer liable for plan benefits. Such an extension could significantly broaden the potential scope of the Federal guarantee.

The element of this issue that is most analogous to the present-law plan termination insurance program occurs when an employer purchases an annuity contract for a plan participant that is distributed to the participant upon plan termination in satisfaction of the employer's liability to the participant.[14] Once the annuity contract is purchased, the insurance company has stepped into the shoes of the employer with respect to the liability to pay benefits to an employee. If the insurance company is unable to satisfy its liabilities to policyholders, the employee may not receive the promised benefits.

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[14] Some argue that payments under the annuity contract purchased by the employer are guaranteed by the PBGC under present law. See the discussion in present law, part II. B., above.

In this situation, it is necessary to determine the potential problems that extension of the Federal guarantee would address. Obviously, there is no longer a concern about the solvency of the employer because the employer is no longer liable to provide benefits. Thus, the concern that extension of the Federal guarantee would address must be the potential inability of an insurance company to satisfy its liabilities. Even in the case of the annuity contract purchased on termination of a defined benefit pension plan, the extension of the Federal guarantee to the failure of the insurer to satisfy its liabilities could be considered a significant expansion of the original plan termination insurance program.

If the expansion of the Federal guarantee to holders of annuity contracts after plan termination is considered appropriate, then questions arise as to whether additional situations should be entitled to a similar guarantee. For example, some employers satisfy the funding requirements of their defined benefit pension plans by purchasing annuity contracts -- these plans are referred to as fully insured plans. Plan termination as the triggering (i.e., insurable) event in the case of such a plan may not adequately protect plan participants whose benefits are tied directly to the solvency of the insurance company that issued the contracts. Thus, it may be necessary to consider expansion of the Federal guarantee to situations in which the potential failure of an insurance company could result in a loss of pension benefits.

If the solvency of the insurance company is a principal concern in evaluating the scope of Federal guarantees for pension benefits, than a similar problem may arise when an employer purchases an annuity contract on behalf of a retiring employee. This issue will arise whether or not the contract is distributed to the employee as long as the contract removes the employer's liability to the employee.

B. Federal versus State Guarantees

Under present law, the Federal Government assumes responsibility for the guarantee of pension benefits upon the termination of a defined benefit pension plan with assets that are insufficient to pay liabilities. However, in the case of the insolvency of an insurance company, the Federal Government is not involved because the regulation of the insurance industry has traditionally been left to the States. In addition, some States have enacted guarantee fund programs to insure the liabilities of insolvent insurance companies.

It must be determined whether the Federal guarantee of pension benefits should be extended to the loss of pension benefits due to the insolvency of an insurance company. If the Federal guarantee is extended in certain circumstances, the Federal Government could be at risk to bear significant losses because of the Federal Government's traditional lack of involvement in the regulation of the insurance industry. Thus, the States may not be fully cognizant of or may not be sensitive to the potential loss to the Federal Government if regulation of the industry is lax. An example of the problems created by Federal guarantees coupled with State regulation of a particular industry is the savings and loan crisis. Thus, it may be determined necessary for the Federal Government to intervene in the regulation of the insurance industry in order to protect against significant losses. In addition, assuming that the premiums charged by the PBGC will be adjusted to reflect the expanded scope of the Federal guarantee, the amount of the PBGC premium to be charged and to whom will be significant issues.

The primary advantage of Federal regulation of the insurance industry would be the uniformity of rules. This advantage must be balanced against the traditional role of the states in the regulation of insurance and the significant additional burden that would be imposed on the Federal Government.

In addition, certain States maintain guarantee funds under present law that are designed to protect the policyholders of insurance companies in the event of company insolvency. If Federal guarantees are extended in certain cases to protect the employees or retirees whose pension benefits are funded through insurance contracts, then it would be necessary to consider how the Federal guarantee interacts with a State guarantee fund. Would the State guarantee apply in addition to, or in lieu of, the Federal guarantee?

It might also be appropriate for the Federal Government to encourage the States to develop uniform guarantee fund rules that would eliminate the potential need for Federal Government guarantee of payments to annuity holders whose annuities arise in connection with a defined benefit pension plan.

C. Pricing of Pension Benefit Insurance

<u>In general</u>

Given a specified amount of insurance coverage, the primary factor in determining the correct price of insurance is the expectation that such coverage will actually be utilized.[15] Whenever it is possible to differentiate between

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[15] In economic terms, the correct pricing of insurance
(Footnote continued)

amounts of risk, a system of risk-based premiums is preferable to a system of premiums not adjusted for risk. For defined benefit pension plan participants, risks to future benefits are mainly determined by the prospects for continuing financial soundness of the benefits provider. Defined benefit pension plan benefits can generally be provided in two ways -- directly from the trust established to fund the plan or by a commercial annuity purchased with trust assets.

<u>Benefits paid by pension trust assets</u>

<u>In general</u>

In the case of pension benefits provided by employers through pension plans, the primary factor in determining full realization of benefits is the degree to which the trust established under the plan is funded. The financial soundness of the trust, and therefore the premiums for insurance coverage of the benefits funded by the trust, depend on such factors as the amount of assets relative to projected liabilities (the "funding level" or "funding ratio"), the riskiness of assets held by the trust, and the ability of the employer to make future contributions to the plan.

<u>Funding levels</u>

A substantial practical problem in determining the appropriate risk-based insurance premiums for pension benefits funded by pension plan trusts is the difficulty in establishing the adequacy of pension plan funding. For pension plans to be considered fully funded, the value of fund assets must equal or exceed accrued pension liabilities.[16] Pension liabilities equal the present value of future benefits owed for plan participants. One manifestation of the liability-valuation problem is the variety of accepted methods and assumptions that may be used in determining the value of future pension benefits both for funding purposes under the Code and ERISA and for financial reporting purposes. With regard to methods, it useful to distinguish between two general types: those measures which calculate pension benefits assuming employees' anticipated

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[15](continued)
requires the expected present value of future premiums to equal the expected present value of future benefits.

[16] Another possible measure of the funded status of a plan is the extent to which plan assets are sufficient to cover the present value of projected, rather than accrued, liabilities.

future levels of compensation and the narrower measures which calculate benefit levels based on current levels of employee compensation. With regard to assumptions, a critical assumption is the interest rate used for valuation of these liabilities. The present-law variable rate PBGC premium structure has attempted to deal with some of these issues, for example, by specifying the interest rate used to calculate vested unfunded benefits.

Data on funding of pension plans from Forms 5500 filed by plans with the DOL and the Internal Revenue Service indicate that funding ratios have improved substantially since ERISA was enacted. Since 1974, plans with full funding status have increased from 35 to 73 percent. These data are based on liabilities calculated using the plans' own actuarial assumptions and a method calculating accrued benefits assuming current employee levels of compensation. Such a method is generally referred to as valuation on a "termination basis," i.e., under the assumption that the plan had been terminated. The same data also show that assets held by plans in 1985 had value equal in the aggregate to 116 percent of the value of liabilities.[17] Although these data indicate that pension plans have a surplus in the aggregate, underfunded plans had a total shortfall of $60 billion in 1985.[18] Statutory changes enacted in 1986 and 1987 affecting allowable funding methods and assumptions used in calculating defined benefit pension plan liabilities have generally raised minimum funding standards and reduced the discretion of plan sponsors in choosing methods of calculating liabilities.

A variety of funding methods and assumptions are also allowed for financial reporting purposes. Standards for financial reporting have also been raised.[19] As an

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[17] See Deloris V. Stevens (1989), "Funding Status of Private Pension Plans, 1985: Termination Funding Ratios," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 119-136.

[18] See Arnold J. Hoffman (1989), "Funding Levels of Private Defined-Benefit Pension Plans by Industry, The Relationship between Output, Employment, and Funding 1985: Termination Funding Ratios," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 137-152.

[19] In 1980, the Financial Accounting Standards Board (FASB) issued Statement 36 which mandated reporting of accrued pension liability and market value of pension assets in a
(Footnote continued)

indication of the potential variability arising from the use of different assumptions and methods, it is useful to note the results of one study that reports the different defined benefit pension plan liabilities calculated under different methods. Performing simulations on data obtained from Form 10-K financial statement data filed with the Securities and Exchange Commission, the study shows that under previous financial reporting standards, 59 percent of plans were underfunded in 1981 and 79 percent of plans were underfunded in 1987; under these same rules, total defined benefit pension plan assets equaled 145 percent of estimated liabilities in 1987. Under recently revised rules, 54 percent of plans were underfunded in 1981 and 60 percent of plans were underfunded in 1987; under these same rules, total defined benefit pension plan assets equaled 110 percent of estimated liabilities in 1987.[20]

Financial soundness of the employer

If a defined benefit pension plan does not have sufficient assets to fully fund liabilities, the financial condition of the plan sponsor and members of the sponsor's controlled group is also an important determinant of the potential PBGC liability. To the extent that the plan sponsor has the ability to make contributions to the plan, the PBGC's liability is reduced. At least one study has shown that firms with low profits use assumptions about valuation interest rates which are more likely to result in lower reported pension liabilities.[21]

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[19](continued)
footnote to the balance sheet of a plan sponsor's financial statements. Under the methods of FASB Statement 36, future salary and benefit increases were not considered in the benefits calculation, and a wide range of valuation interest rates could be used. Financial accounting standards for defined benefit pension plans were substantially revised in 1985 when the FASB issued Statement 87. Under these new rules, which are mandatory by 1989, unfunded pension liability must appear on the balance sheet, rather than in a footnote. In addition, under Statement 87, pension liabilities must be calculated with and without taking account of projected salary increases and the valuation interest rate must be the settlement rate used by insurance companies or the PBGC valuation rate.

[20] See Michael J. Warshawsky (1989), "The Adequacy of Funding of Defined Benefit Pension Plans," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 137-152.

[21] See Zvi Bodie et al. (1987), "Funding and Asset Allocation
(Footnote continued)

Because the ultimate liability of the PBGC may depend on the solvency of the plan sponsor, some have suggested that a risk-related premium should reflect the financial position of the employer. On the other hand, some argue that such a premium would be difficult to calculate and would be inappropriate if the employer's defined benefit pension plan is otherwise adequately funded. In addition, some argue that higher premiums would be inappropriate for an employer already experiencing financial difficulty.

Pension annuities provided by life insurance companies

The transfer of pension benefit liability from benefit plan trusts to insurance companies issuing pension annuities significantly changes the nature of the financial risk faced by plan participants. In the case of an underfunded plan, such a transfer may reduce the risk of loss of a given level of benefits to the participant if it is more likely that the plan sponsor will become insolvent than that the life insurance company issuing the annuity contract will. However, this risk of loss may be increased in the case of a plan sponsored by a financially sound employer, particularly if the insurance company is not financially sound.

A risk-based premium for insuring commercial pension annuities would be based on the financial condition of the life insurance company, which could be measured by its capital, quality of assets, and various financial ratios. Currently, the regulation of the financial condition of private insurance companies is primarily the responsibility of the States. Thus, unless a Federal rules for regulating insurance companies were adopted, a risk-based Federal insurance premium would be heavily dependent upon State regulatory practices. State regulatory practices are in varying degrees influenced by the views of the National Association of Insurance Commissioners (NAIC), which plays a major role in the coordination of reporting standards and regulation among the States.

Beside State regulation of the financial condition of life insurance companies, existing insurance mechanisms at the State level could also be a factor in the pricing of a Federal risk-based premium. At least 40 States have guarantee laws that provide indemnification of losses suffered by policyholders of insolvent companies. Funds for indemnification are generally derived from assessments against solvent companies. Coordination of State and Federal law would be necessary to ensure that State law did not

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[21](continued)
in Corporate Pension Plans: An Empirical Investigation," in Zvi Bodie, John Shoven, and David Wise, eds., Issues in Pension Economics, University of Chicago Press.

undermine Federal policy, and also to avoid unduly burdensome or conflicting rules for insurance companies.

Timing of premium payments for pension guarantees

In general, the timing of insurance premiums may be determined under a wide variety of payment schedules. For example, insurance premiums may be paid in equal amounts over the life of the policy, or they may be made in one up-front premium. If insurance premiums are paid over the life of the policy, they may be paid according to a predetermined payment schedule (for example, level payments), or they may be adjusted periodically to reflect changing risk conditions. If payments are determined according to a predetermined schedule, the insurance policy is, in effect, a guaranteed renewal policy. Renewability imposes extra risk on the insurer because premiums cannot be adjusted for unforeseen changes in factors determining risk. Thus, insurance premiums for renewable policies are adjusted above expected premiums of nonrenewable contracts.

If Federal insurance is provided to commercial annuities acquired with pension plan assets, this coverage could theoretically be properly priced under a variety of payment schedules. For example, premiums for this increased coverage could be prepaid by increasing current PBGC premiums for all defined benefit pension plans over the life of the plan to reflect the of post-termination annuity coverage. Premiums for this increased coverage could also be prepaid by having the terminating plan pay a single up-front premium upon termination of the plan which would guarantee the annuities purchased to satisfy plan obligations. Alternatively, additional coverage for annuity contracts could be paid over the life of the annuity by the life insurance companies who issue the contract. Of course, if current premiums are at levels higher than necessary for current coverage, extended coverage to annuities acquired by pension plans may not require greater premiums. However, given the PBGC's current accumulated deficit, this seems unlikely.

D. Economic Consequences of Inadequate Pricing

Cross subsidization

In general, if insurance is inadequately priced, in order for the insurance fund to remain solvent it is necessary for some class or classes of insureds (i.e., lower risk insureds) to be overcharged and subsidize another class or classes of insureds that pay inadequate premiums (i.e., higher risk insureds). This subsidization could occur, for example, under the current PBGC premium structure if the risk-based premium does not adequately increase premiums to reflect the risk of underfunded plans.[22] Alternatively, this subsidization could occur over time if the aggregate level of current PBGC premiums were inadequate to meet future payments by the fund. Future premiums might need to be increased for losses on existing plans in order to prevent insolvency. If premiums were not increased on future plans to reflect these losses, the PBGC might not be able to meet its future obligations without direct Federal assistance.

Such subsidization encourages misallocation of resources that in turn results in economic inefficiency. For example, most sectors of the economy may maintain fully funded plans while just a few industries have substantially underfunded plans. With inadequate premiums on the riskier plans, the underfunded plans drain resources from other sectors and as a result reduce productivity and output and increase prices in the sectors of the economy with less risky plans.[23]

Moral hazard

If there is inadequate pricing of insurance, insureds do not have improper incentives for managing risk. With a flat rate premium structure, there is no incentive to reduce risk. With a premium structure inadequately adjusted for risk, companies may not adequately reduce exposure to risk. This is especially true for companies near insolvency. With little or no remaining equity, companies with inadequately funded plans would find it advantageous to increase the riskiness of pension asset portfolios. Large upside returns could reduce required contributions to plans.

Adverse selection

If there is inadequate pricing of insurance, lower-risk plans have an incentive to leave the PBGC insurance system. If PBGC insurance were not mandatory for most defined benefit pension plans, overcharged low-risk plans would not freely purchase pension benefit insurance. Since the system is mandatory for defined benefit plans, an employer can only leave the system by terminating its defined benefit pension plan and by providing in its place either a defined

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[22] For example, under the current PBGC premium schedule total annual premiums are capped at $50 per participant. This amount could substantially understate the cost of insurance for underfunded plans of firms in financial distress.

[23] Underfunded plans are heavily concentrated in the transportation, transportation equipment, and primary metals industries. See Arnold J. Hoffman (1989), "Funding Levels of Private Defined-Benefit Pension Plans by Industry, The Relationship between Output, Employment, and Funding 1985: Termination Funding Ratios," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 137-152.

contribution plan or by purchasing pension annuities on behalf of employees from insurance companies. Thus, if insurance premiums are not adequately adjusted to reflect risk, the insurance system may actually discourage provision of pension benefits through defined benefit pension plans. To the extent low-risk insurers leave the insurance system, the average riskiness of the remaining pool of insureds increases. Increased overall risk would require further premium increases or other sources of funding. This, in turn, could drive more low-risk insureds out of the risk pool and further exacerbate the problem.

Analogy to Federal deposit insurance

The provision of Federally provided insurance coverage for pension annuities issued by insurance companies raises many policy issues similar to those raised by Federal insurance of banks and thrift institutions. As mentioned above, poorly priced insurance could result in an inadequate insurance fund, a misallocation of resources, incentives to leave the insurance system, and excessive risk taking. Insurance of pension annuities could remove incentives of pension providers and participants to be concerned about the financial health of the insurance company issuing the annuity contracts. Just as insured depositors often seek the highest rate of interest without regard to the financial condition of the depository, purchasers of annuity contracts might seek the lowest price for an annuity without regard to the financial condition of the insurance company.
Like Federal deposit insurance, pension annuity insurance would allow financially unsound institutions to compete on an equal basis.

E. Federal Standards for Fiduciaries and Insurance Companies

Another possible approach to providing security for pension annuities issued by insurance companies is to impose Federal standards on the companies. Such standards could be adopted in addition to or in lieu of a Federal guarantee. Standards for pension annuity issuers could be imposed in a number of different ways. For example, the fiduciary standards under ERISA could be modified so that it is a violation of fiduciary duty to purchase a pension annuity from a company not meeting certain Federal standards. Such standards could also be incorporated into the PBGC plan termination procedures. Thus, for example, one of the conditions of a standard termination could be that annuities are purchased from a company meeting the Federal standards. The rules could also be incorporated into the qualification standards of the Code. A combination of these approaches might be necessary to ensure that the rules apply to purchases of annuities by ongoing plans as well as purchases on plan termination.

The Federal standards could take a variety of forms. For example, certain reserve requirements or limitations on the investments of insurance companies could be imposed.[24] Insurance companies from which pension annuities could be purchased could be limited to companies with a certain financial rating.

In order for Federal standards to have any affect, they would generally need to be in addition to or more strict than current State law requirements for insurance companies. If the requirements are not more strict than State law in general, then the Federal standards would be unnecessary. If the Federal rules are less strict than State law, there may be pressures on the States to lower their requirements. The standards could be coordinated with State law, however. For example, no additional Federal standards could be imposed if a State maintained a guarantee fund meeting certain requirements.

Care would need to be taken to develop appropriate standards. For example, if the standards are too strict, then few companies will meet them. This could reduce competition in the industry and unnecessarily raise the cost of annuities. Moreover, a limited number of insurance companies might not be able to sufficiently absorb the risk.

One of the major problems with this type of approach is that it may not be effective to protect pension benefits. Although the Federal standards might be met at the time the annuities are purchased, they would not prevent the insurance company from becoming insolvent later on.

Another possible approach is to attempt to deal with conflict of interest problems. Conflicts of interest can arise in the termination of an overfunded plan. After the benefits of plan participants are provided, the employer is generally entitled to any remaining assets.[25] Thus, the employer has an incentive to accept the lowest annuity bid, even though the company making that bid might not be the most secure. (On the other hand, a higher bid does not necessarily mean that the company is more secure.)

One approach to this type of problem is to require that an independent fiduciary select the insurer. This approach

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[24] Of course, such requirement could create conflicts between Federal law and State regulation.

[25] Such a reversion is generally permitted only if the plan provides that the employer is entitled to the excess assets and the plan provision has been in effect for at least 5 years before the reversion.

has been followed in some cases by the DOL in granting administrative exemptions to the prohibited transaction rules. This approach would not necessarily increase pension benefit security, however, because it would not guarantee the continued solvency of the insurer.