American Academy of Actuaries

July 10, 2023

In advance of the open meeting on July 18, in which the Department of Labor will consult with the ERISA Advisory Council on section 2509.95-1 of Title 29, Code of Federal Regulations, please find below:

1) Materials prepared by the American Academy of Actuaries' Life Investment and Capital Adequacy Committee outlining the state insurance regulations applicable to life insurance companies operating in the United States. The materials focus on the regulatory framework governing solvency requirements, including the establishment of liabilities and required capital for benefit obligations that are the result of a pension risk transfer.
2) An issue brief authored by the Pension Committee of the American Academy of Actuaries focusing on "buy-out" annuity contract transactions.

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Solvency and Reserve Standards for U.S. Life Insurance Companies

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Discussion Topics

A. Overview of the Protection System for Life Insurance Companies

B. Overview of the Regulation of U.S. Life Insurance Companies
   - Liabilities
   - Required capital
   - Investments

C. Summary

Insurance Protection System Overview

- State insurance commissioner has primary responsibility to regulate insurer solvency, including authority to directly intervene in insurance operations
- Existing solvency regulations were implemented in early 1990s with key features:
  - Risk-based capital requirements
  - Two NAIC receivership model acts
  - New NAIC model laws regarding insurer investment practices
  - Codification of statutory accounting and new audit requirements
  - New state insurance department accreditation system, which is designed to ensure uniformity of important aspects of solvency regulation.
- State guarantee associations (GAs) provide protections under insolvency and liquidation
  - Funded by assessments against other insurers licensed to do business within the state and the assets of insolvent insurers
  - Like PBGC, GAs are not funded by tax revenue nor backed by full faith and credit of state gov't

U.S. Insurance Regulatory Oversight

- Insurance regulation is transaction-based and does not vary by the form of company ownership (e.g., mutual, stock, or fraternal). The owner of the insurance company (e.g., policyholders, shareholders, private equity) does not affect insurance regulation; every owner must comply with insurance regulations.
- Pension risk transfer (PRT) transactions are approved by the insurance company's domiciliary state regulators. If approved, the insurance company is responsible for the liabilities assumed from the plan sponsor.
- If the direct insurer chooses to cede the risk to a reinsurer, that transaction is also subject to regulations.
  - U.S. life insurers may choose to reinsure some or all of a group annuity to offload risk and manage capital; the decision to reinsure may be contemplated while bidding on the transaction or at any subsequent point after the PRT has been completed.
  - In order for a company to take credit for reinsurance, regulators require sufficient assets be held by the reinsurer to support the liability.
  - Reinsurers (U.S. or non-U.S.) are subject to regulations, providing varying levels of solvency protection to the direct insurer.
  - The direct insurer maintains the ultimate responsibility for the liabilities even if reinsured.

Measurement of Insurance Liabilities

- Insurance company liabilities (i.e., statutory reserves) are established to pre-fund benefit obligations; reserves are held to a moderately adverse standard
  - Maximum discount rate and mortality assumptions are prescribed by regulation. The assumptions prescribed by insurance regulators are typically more conservative than the assumptions used by the insurer in pricing the PRT deal.
  - Company reserves are tested annually and strengthened if the specific characteristics of a company block of business warrant. The testing projects the cash position under different conditions (e.g., higher claims, changing capital market conditions).
  - Reserves include provision for future operational expenses and asset defaults.
- Insurance company assets are required to exceed statutory reserves at all times

Insurance Statutory Reserves

Each pension risk transfer transaction is reviewed by the state regulators to set appropriate reserves for the transaction. State regulators work with the insurance company to understand each pension plan's size, populations, expected mortality, and expected cash flows and determine a set of prudent reserve assumptions for the plan liabilities that are transferred to the life insurer:

- Interest rate
- Appropriate margin
- Periodic experience study of the specific pension plan to monitor the actual/realized mortality and pension beneficiary's behaviors

In addition to prescribed reserves, the company's reserves must be evaluated each year. This analysis is performed by the company's Appointed Actuary, who evaluates the adequacy of the assets under varying economic scenarios. The Appointed Actuary (subject to professional standards) must opine that the assets produce sufficient cash flows to cover the liability obligations under a wide range of assumptions.

Risk-Based Capital Requirements for Life Insurance Companies

- Insurers hold additional capital above and beyond liabilities to protect against adverse events
- Insurers hold capital at different levels, depending on risk appetite:
  - Regulatory minimum capital level (RBC) (e.g., 200% Company Action Level)
  - Additional capital needed to maintain desired credit rating from a Credit Rating Provider
  - Free capital for expansion and other initiatives requiring capital
- An analysis of solvency levels for the life insurance industry in aggregate (at Dec. 31, 2021) showed the following:
  - Total Adjusted Capital = $711 billion (includes all life insurer capital for 750 companies, not just supporting annuity products)
  - Aggregate capital ratio = 886% of Authorized Control Level RBC
  - 4 companies reported capital below 200% of Authorized Control Level RBC

RBC Capital Overview

The NAIC RBC formula establishes minimum capital levels focused on major risks

1. Asset Risk
   - Requires capital for investment risks (e.g., credit, prepayment, volatility, etc.)
   - For funded PRT, asset risk is a major driver of capital requirements
2. Underwriting Risk (Mortality, Longevity)
   - Requires capital for the risk that actual mortality experience will be greater than expected (i.e., unexpected levels of claims)
   - Requires capital for the risk that policyholders will live longer than expected
3. Market and Interest Rate Risk
   - Requires capital for the risk that assets and liabilities are not well matched, leading to a cash flow deficiency in certain economic environments
   - This is a smaller capital component for PRT writers whose assets maturities are well matched to liabilities
4. Other Risk
   - Includes operational and general business risk
   - Comprises only a small portion of total capital requirement for PRT

Asset Quality

- State insurance regulations define both the type and amount of permissible asset class (e.g., bond, equity, real estate, etc.)
  - Insurers restricted from investing more than 20% of admitted assets in equities
  - Required to diversify investments with generally no more than 3% in a single entity

- Life insurance companies' investment policies tend to include longer-maturity, investment-grade bonds that provide stable cash flow to match their long-term liabilities.

Summary: Insurer Solvency

- Insurance solvency is regulated at the state level through a multifaceted series of protections: statutorily prescribed reserves that are calculated using conservative methods and assumptions, overlay of annual asset adequacy testing, and minimum risk-based capital requirements.
- In addition, insurers are subject to regulations covering investment policy, risk management, statutory accounting standards, and periodic regulatory examinations.
- State guaranty funds provide a backstop for insolvent insurers. State guaranty funds are funded by insurance companies. They are rarely needed for life insurers due to the strength of existing state regulatory frameworks.

QUESTIONS?

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American Academy of Actuaries

Issue Brief

Buy-Out Group Annuity Purchase Primer

Pension Plan Sponsor's Role and Considerations

JULY 2023

Key Points

- Pension plan sponsors typically employ the following process when purchasing a "buy-out" group annuity contract:
  - Determine rationale for executing a buy-out
  - Engage experts to assist with soliciting bids from insurers
  - Perform due diligence on bidding insurers, which includes assessments as outlined in the DOL Interpretive Bulletin 95-1
  - Consider changes in participant protections from the PBGC to the state guaranty associations when the liabilities are transferred
  - Communicate with participants about the transfer
  - Assess the impact to the funded status of the remaining plan and any implications for remaining participants
- Ultimately, it is the plan sponsor's responsibility to ensure that what is transferred to the insurer is representative of the plan benefits, and that thorough due diligence is performed to select an insurer.

A traditional pension plan is designed to provide participants with a steady stream of income once the participant retires. Plan sponsors are increasingly active in transferring the responsibility for making pension payments, and the associated risks, to another party. Although plan sponsors have several ways to transfer risk, this issue brief will focus on "buy-out" annuity contract transactions.

Types of pension risk transfers

Financial risks associated with pension plans, often referred to as "pension risk," can typically be transferred from the plan sponsor to an insurer or to the participant. Pension risk reduction occurs in various degrees by employing different methods such as buy-outs, buy-ins, and lump sum payments to meet plan sponsor de-risking objectives.

Both buy-ins and buy-outs transfer risk from the plan sponsor to an insurer:

- **Buy-in transaction:** The insurer provides a commitment to fund future benefit payments to plan participants. Buy-ins are often used as an investment management strategy for the plan sponsor or to lock in pricing for a future buy-out. The liability and assets remain on the plan sponsor's balance sheet. The plan sponsor continues to pay Pension Benefit Guaranty Corporation (PBGC) premiums as the sponsor retains default risk. The insurer provides funding to the plan sponsor for benefit payments until either all obligations have been satisfied, a buy-out conversion occurs, or the plan sponsor revokes the contract.
- **Buy-out transaction:** The insurer provides an irrevocable commitment to directly make all future benefit payments to the plan participants included in the transaction through an annuity contract. The benefit obligation associated with participants included in the transaction is transferred from the plan sponsor to the insurer.

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Lump sums, on the other hand, transfer pension risk from the plan sponsor directly to the participant. A lump sum is a one-time payment equal to the present value of the expected payments due to the participant under the plan. No additional benefits are payable to the participant, any spouse, or beneficiary in the future.

Overview of buy-out transactions

Under a buy-out, the plan pays a single sum premium to the insurer to take full responsibility for making benefit payments associated with the transferred participants' benefits until all obligations have been satisfied. This type of transaction eliminates all liabilities and risks associated with the benefits of the transferred participants for the plan sponsor. Participants currently receiving their pension payments from the plan would continue to receive the same amount and in the same manner, but the insurer would be responsible for making the payments instead of the plan sponsor. The insurer would be also responsible for commencing and paying future benefits for any active or deferred participants included in the transaction, based on the terms of the plan which are transferred to the insurer.

A buy-out transaction can be implemented for a subset of the overall plan population ("lift-out") or in conjunction with a plan termination ("complete risk transfer").

- **Lift-outs** reduce the size of the plan and overall risk exposure for the plan sponsor by targeting a subset of the total plan participants, often retirees who are already receiving monthly pension payments. Lift-outs are an effective de-risking strategy that can be implemented in a relatively short time period with minimal participant interaction. There has been a trend for single-employer plan sponsors to execute lift-outs for retirees receiving smaller monthly benefits first, because the carrying cost for maintaining these retirees is higher due to PBGC premiums and other plan per-participant fees including administration. Although a lift-out may include deferred vested participants, purchasing annuities for retirees is typically less expensive because their future benefit payment amounts and forms of payments are known.

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- **Complete pension risk transfers** are generally a result of plan termination and eliminate future risk completely, including all future accounting costs and cash contribution requirements. The annuity purchase is the culmination of the plan termination process, which includes a buy-out not only for retirees in pay status but also deferred and active participants. There are numerous required participant notices to execute a plan termination and the overall process can take over a year from the time participants are notified of the termination until benefits are transferred to an insurer. Ultimately, with plan terminations, all obligations are transferred from the plan sponsor to either the participant (via a lump sum distribution), to an insurer, or to the PBGC.

Employer rationale for buy-outs

There are many rationales for a buy-out transaction, whether a lift-out or a plan termination.

Factors driving the desire for reduction or elimination of risk include:

- Increasingly competitive buy-out pricing;
- Uncertain market risks;
- Interest rate volatility;
- Legislative changes;
- Increasing administrative costs;
- Additional administrative complexities to manage;
- Increasing PBGC premiums that are not risk-based;
- Difficult-to-predict participant behavior, such as employees delaying retirement;
- Uncertainty of longevity risk;
- Desire to eliminate risks that are unrelated to the plan sponsor's core business such as pension plan performance; and
- Experiences or opinions of board members or executives.

Many of these factors impact employer cost, as well as the volatility of contribution requirements and/or accounting costs.

Administrative expense savings for plan sponsors resulting from a buy-out may include:

- Decrease in the PBGC flat rate premiums by reducing participant headcount;
- Decrease in the PBGC variable rate premium for a plan sponsor subject to the variable rate cap by reducing participant headcount;
- Elimination of future required participant notices, such as the annual funding notice or summary of material modifications, as they would no longer need to be sent to the transferred participants; and

- Tax reporting and ongoing plan administrator fees (whether hard dollar costs if the plan is outsourced to a third party or internal resources needed to maintain the plan) would be reduced or no longer apply.

Lift-outs are relatively easy transactions to execute over a short period of time. A typical transaction may take anywhere from three to six months.

Before an annuity buy-out

Before an annuity buy-out, the plan sponsor will take a number of preparatory steps to define the scope of the transfer including:

- Determine eligible group for the lift-out, if applicable
- Assess data completeness/accuracy and potentially perform data remediation to locate missing information—for example, ensure complete beneficiary information is available for joint-life benefits
- Estimate financial impacts, both for plan funding and plan accounting
- Draft amendment(s), if necessary

The process for implementing an annuity buy-out

There are two main components to implementing an annuity buy-out:

1. Bid process
2. Insurer due diligence

Annuity purchase bid process

Decisions made regarding the disposition of qualified plan assets are subject to a fiduciary duty under the *Employee Retirement Income Security Act of 1974* (ERISA). In a buy-out pension risk transfer transaction, money comes out of a qualified plan and is transferred to an insurance company. Therefore, the plan's fiduciary committee or a delegate of the committee is responsible for making the selection of the insurer as with any other plan investment—most notably, they are required to make the selection only in the interest of plan participants. Because most plan sponsor fiduciaries do not have the internal expertise to analyze the various insurers that may take over their pension liabilities, they routinely engage with providers to help with this analysis.

Many plan sponsors hire third-party service providers to run the placement process with the insurers. Service providers have a range of processes that they follow for soliciting bids from interested insurers or roles in the process. The fiduciary committee should consider and understand the process and be comfortable with it. Different providers will have different ways of quantifying the effectiveness of the selection process.

Insurers may have different criteria for whether or not they will bid on a particular case. These criteria tend to be based on size, types of benefits (in-pay vs deferred), characteristics of benefits (traditional annuity benefits, hybrid plans, ancillary benefits, etc.), and location of participants.

In large transactions, plan sponsors may want to consider transferring some assets in kind to the insurer rather than paying the full annuity premium in cash. Transferring assets in kind means that the plan sponsor will transfer certain investments held by the plan directly to the insurer. This transfer may be done to avoid transaction costs in liquidating the assets by the plan sponsor and in reinvesting the assets by the insurer. Different insurers price assets for in-kind transactions differently and most insurers are interested in only specific investment classes.

Mortality experience may be provided in any size transaction where credible mortality experience for the plan is available. Insurers may expect the plan sponsor to provide the relevant historical mortality experience of the plan as a part of the pricing process for a large transaction.

Plan sponsor fiduciaries may approach an annuity purchase transaction in various ways, including using several different service providers. As a best practice, many plan sponsors consider utilizing a transaction specialist and an independent expert—from the same or different firms. Companies that don't use both of these types of service providers may have an increased risk of violating their fiduciary duties. An independent fiduciary is optional but often used in larger transactions.

- **Transaction specialist**—This is the party that is hired to run the bid process and solicit bids from the insurers. This may include communicating the participant data and proposed provisions of the contract reviewed by counsel, answering the insurers' questions during the pricing period, negotiating with the insurers, and providing information to the fiduciary committee or independent fiduciary that will ultimately select the insurer. After the insurer is selected, transaction specialist may help the plan sponsor with implementation.
- **Independent expert**—Department of Labor (DOL) Interpretive Bulletin 95-1 provides criteria for due diligence on an insurer in a buy-out (see more on this below). The independent expert is hired to provide this due diligence. Plan sponsors should find out whether this provider is acting in a fiduciary capacity or just providing information to the plan sponsor committee to make their own determinations. In the latter case, the plan sponsor committee retains all of the fiduciary responsibility for the insurer selection.
- **Independent fiduciary**—Plan sponsors may decide to outsource the entire selection process of the insurer to a third party. Independent fiduciaries are generally hired to help plan sponsor committees avoid any potential conflicts of interest while acting in the best interest of plan participants. Ultimately, the independent fiduciary selects the insurer.

The independent fiduciary may hire their own independent expert as part of their engagement. They may also look at other factors including the change in the plan's funded status resulting from the transaction, the plan sponsor's financial condition in the context of its ability to make future contributions to the plan, and the impact of the annuity purchase on the current and future asset allocation of the plan (including the plan's liquidity needs). They may also review contract provisions and negotiate these provisions with the selected insurer to ensure that the contract is in the best interest of plan participants.

Ultimately, it is the plan sponsor's responsibility, often with the assistance of legal counsel, to carefully review the provisions of the group annuity contract with the insurer to make sure that what is transferred to the insurer is representative of the plan benefits defined in the plan document. The insurer will pay benefits based on the provisions of the group annuity contract and does not rely on the original plan document. If any discrepancies between the contract and plan document arise, the plan sponsor may owe the insurer additional premiums to cover any discrepancies. Once benefits are transferred from a qualified plan, the ERISA coverage ends—meaning insurers are not subject to the ERISA standards for the benefits that they are insuring.

Insurer due diligence

The plan sponsor has fiduciary responsibility and will want to perform due diligence for all bidding insurers. As noted above, the fiduciary (plan sponsor) may bring in independent advisers to help with those duties. This section discusses potential, but not exhaustive, due diligence that the plan sponsor and advisors may perform.

Investment advice

The current fiduciary rule enforced by the DOL[1] has a five-part test for determining whether or not advice given to fiduciary committees constitutes "investment advice" that would subject the service provider to the same fiduciary standards as the plan sponsor's committee that oversees pension investments. One aspect of that five-part test is whether the advice is given "on a regular basis." Because pension risk transfers are typically viewed as one-time transactions, this a gray area for pension plan fiduciaries to consider when selecting experts to advise them on the potential insurers with which they would be contracting.

Interpretive Bulletin 95-1

Regardless of how a plan sponsor is making its decision, as part of the due diligence process, there is a widely accepted standard (but not law or regulation) for analyzing potential insurers that would be party to a pension risk transfer transaction. The fiduciary standard for selecting insurance companies is found in the DOL's Interpretive Bulletin 95-1 (IB 95-1). This standard has ambiguity on how it should be interpreted because it is not law or regulation.

1. "New Fiduciary Advice Exemption: PTE 2020-02 Improving Investment Advice for Workers & Retirees Frequently Asked Questions"; U.S. Department of Labor, Employee Benefits Security Administration; April 2021.

Pension plan fiduciaries should be comfortable in how they are selecting the insurer in consideration of IB 95-1. A pension plan fiduciary must discharge their duties with respect to the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. As it relates to a pension risk transfer,

- Pension plan fiduciaries must take steps to obtain the "safest" annuity available when selecting an insurance company, unless under the circumstances, it would be in the interests of the plan participants and beneficiaries to do otherwise.
- Pension plan fiduciaries must act prudently and conduct an objective and thorough analysis to identify and select an insurance provider.
- The terms of plan documents should be followed to the extent that the terms are consistent with ERISA. Pension plan fiduciaries should ensure that the insurance company understands the terms of the plan and that the contract clearly indicates the amount and forms of the benefits to be paid.
- Finally, pension plan fiduciaries should avoid conflicts of interest. In the case that conflicts of interest between the plan's fiduciary and the insurer arise, the plan's fiduciary should follow independent expert advice.

According to the IB 95-1, there are several factors for the pension plan fiduciary to consider when selecting the "safest available annuity provider":

- 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 annuities, such as the use of separate accounts; and
- The availability of additional protection through state guaranty associations and the extent of their guarantees.

IB 95-1 says other criteria can be used to assess the insurer:

- Costs can play a role in the selection of an insurer. However, IB 95-1 explains that a fiduciary decision to purchase lower-priced annuities that may be riskier would violate the tenet that fiduciaries act solely in the best interest of the plan participants and beneficiaries. Similarly, the fiduciary must not purchase lower-priced, riskier annuities due to insufficient assets in the plan's trust. Rather, additional employer contributions would be required.[2]

2. Interpretive Bulletin 95-1-d. Costs and Other Considerations.

- A fiduciary may also assess administrative capabilities and participant protections, such as cybersecurity and the insurer's process for finding missing participants.
- In the case of a lift-out, the plan sponsor also has a fiduciary responsibility to any remaining participants in the plan. The plan sponsor may not want to overpay for the lift out and reduce the funded status of the remaining plan.

The result of the plan sponsor's due diligence can result in multiple insurers meeting the safest available insurer criteria.

The *SECURE 2.0 Act of 2022* directs the Department of Labor in consultation with the ERISA Advisory Council to take a fresh look at IB 95-1. One of the catalysts for the review was stakeholder comments to Congress about the emergence of private equity firms backing insurers/reinsurers in the pension risk transfer market. The DOL's report to Congress is due within one year of the enactment of SECURE 2.0..

General and separate accounts

Depending on the size of the transaction and the insurers bidding, the due diligence process may also include a decision by the plan sponsor between selecting a group annuity contract where the assets backing that contract are in a general or separate account.

General account assets are owned by the insurance company and are held in the insurer's general account. These assets are used to pay claims and operating expenses. If the plan's assets are included in the general account, they are subject to the creditors of the insurer.

An insurance company **separate account** is an account whose assets are segregated from the general account assets of the insurer and are not subject to the claims of the insurer's creditors, which provides a substantial layer of additional protection to policyholders. This type of account was historically used primarily for variable annuities, but in recent years, it has become more common for pension buy-out contracts. See the "Benefit protections associated with annuity purchase transactions" section for additional discussion on interaction of these accounts and state guaranties.

Splitting transaction among multiple insurers

When doing a buy-out, the plan sponsor can use one insurance company for the whole transaction. Alternatively, the plan sponsor can consider splitting the benefits in the buy-out across multiple (usually two) insurance companies; the split can be a set percentage of each benefit that goes to each insurance company (for example, 50% to insurance company A and 50% to insurance company B) or the group of participants can be split (for example, retirees in division A go to insurance company A and retirees in divisions B and C go to insurance company B). Some considerations for the plan sponsor include:

- Even with the state guaranty system, there may be a small risk to some of a participant's benefit if the insurance company fails in cases where benefits exceed the guaranty limit. That risk can be reduced if a participant's benefit is split across multiple insurance companies. If each annuity is less than the state guaranty, participants will be guaranteed their annuity amount even if an insurance company goes bankrupt. See the "Benefit protections associated with annuity purchase transactions" section for additional details.
- Some insurers prefer to bid only on retiree benefits, so splitting a transaction that includes actives or deferred participants may allow more insurers to participate.
- Some insurers are not licensed in New York, so if there are any participants in New York, a split between insurers may be necessary.
- Plan sponsors will need to go through the process of selecting multiple insurers that each satisfy all the fiduciary requirements of the plan.
- While the financial obligation to make the payment for a single retiree may be split between two insurers, typically the retiree would receive only a single check from the coordinating insurer. Such coordination can create an additional layer of administrative complexity for the insurers and the sponsor during implementation. The pension plan fiduciary will need to understand the cost of the total premium relative to the level of potential risk reduction.

Communication

The level of required communication to participants from the plan sponsor varies between a lift-out and a full plan termination.

Lift-out

With a lift-out, there is little plan sponsor interaction with participants as there is no required participant notification. However, plan sponsors may find it useful to communicate with participants to help them understand what is happening with their benefit. It is useful for participants to receive notification from the plan sponsor that their benefits will be paid by an insurer instead of the plan. Additional information may be sent to retirees to notify them of the change of payor to help assure retirees that they will continue receiving benefits in the same manner as they currently receive. This proactive communication may help to avoid potential disruption to human resources or third-party administrator staff.

Some additional communications, though not required, may be provided to participants to help them understand the process and what will happen to their benefits. Prior to the insurer commencing payments to participants, the insurer will typically send a welcome kit to validate information and ensure the retiree has the new contact information should they need to make any changes to their payment information or if they have any questions.

Plan Termination

Plan sponsors have multiple touch points with participants throughout the plan termination process due to multiple required participant notices as prescribed by the Internal Revenue Service (IRS) and PBGC. Though not required, plan sponsors may want to send additional communications to provide supplementary background and insight into the termination process, or to explain upcoming notices and potential action items that may be needed from participants. Participant notices required by the PBGC include the Notice of Intent to Terminate, Notice of Plan Benefits, Notice of Annuity Information and Notice of Annuity Contract. IRS requirements include the Notice to Interested Parties if the plan sponsor files for a determination letter from the IRS. After an insurer is selected, coordinating between all parties (HR, administrator, insurer) on the timing of participant communications will ensure a seamless transition. Similar to the lift-out, the plan sponsor and insurer typically will send information about the change in payor to participants prior to the insurer taking over administration of the plan.

Benefit protections associated with annuity purchase transactions

Once the plan sponsor completes the due diligence review of bidding insurers and an insurer is selected, an annuity premium is paid to the selected insurer, generally within a week after the insurer is selected. This action effectively transfers the liability from the plan sponsor to the insurer with an associated "liability takeover date." As the insurer is then responsible for the pension obligation, the PBGC guaranty protections end, and state guaranty protections begin.

A paper commissioned by the National Organization of Life and Health Insurance Guaranty Associations (NOHLGA) in 2016 titled "Consumer Protection Comparison: The Federal Pension System and the State Insurance System" provides detailed information regarding these two types of benefit protections. The section below is a summary of some of the points made in that paper.

PBGC protections for single-employer plans

Most traditional pension plan benefits sponsored by private-sector employers are guaranteed by a federal government agency—the PBGC. A participant's benefit is covered by the PBGC, up to a maximum guaranteed amount, while there is a benefit due from the pension plan. The PBGC trust is funded by premiums paid by plan sponsors at a level set by federal legislation.

The guarantees come into effect for underfunded plans that terminate under distress while under the provisions of ERISA. If a plan fails, the PBGC becomes responsible for the plan's benefit obligations and will cover benefit payments up to certain limits. Most of these plan terminations occur when the employer sponsoring the plan becomes bankrupt. During fiscal year 2022, PBGC made benefit payments of over $7 billion to more than 960,000 participants in nearly 5,000 terminated single-employer plans. It expects to pay benefits in the future to an additional 500,000 participants in these failed single-employer plans.[3]

Up to certain limits, the PBGC guarantees the earned pension benefits of plan participants and their survivors as well as certain disability benefits. The limits increase (decrease) at older (younger) ages. To determine the amount to pay each person, the PBGC takes into account (a) the vested benefit that the participant had accrued in the terminated plan, (b) the availability of assets from the terminated plan to cover non-guaranteed benefits, (c) how much PBGC recovers in bankruptcy from the plan sponsor for plan underfunding, and (d) the limits on guaranteed benefits provided under ERISA. These limits for participants in a single-employer plan in 2023 are approximately $81,000 per year for a participant receiving a single life annuity (that is, with no survivor benefit) payable at age 65 and $72,900 per year if the same participant has a joint and 50% survivor annuity payable to a spouse who is 65 years old.[4]

The PBGC's single-employer program had a $36.6 billion surplus as of the end of fiscal year 2022.[5]

State guaranty

When an annuity is purchased from an insurer, the participant's benefit is then covered by state guaranty associations, which cover participant benefits if the insurer becomes insolvent.

Whereas private pension plans are regulated on a federal level, insurance companies are regulated by the states in which they are licensed to do business. State regulators monitor an insurance company's financial health to ensure it is holding enough assets to cover its obligations, plus a significant risk-based margin. If an insurer's level of capital begins to decline, the state regulator follows a series of steps depending on the severity of the situation. In the initial steps, the regulator works with the insurer on corrective actions. If those steps fail, the regulator attempts to rehabilitate the insurer and/or evaluate other alternatives but may ultimately declare it insolvent.

If an individual is receiving pension benefits from an insurer that is declared insolvent, a state guaranty association will be responsible for continuing the payments. All 50 states, Puerto Rico, and the District of Columbia have a guaranty mechanism in place for the payment of covered claims arising from the insolvency of insurers licensed in their state or domicile. These associations are funded by the assets of the failed insurer, plus assessments on other insurers that write the same kind of business in that state.

3. 2022 Annual Report; Pension Benefit Guaranty Corporation; Nov. 15, 2022
4. See "Guaranteed Benefits" on the PBGC website for more details.
5. 2022 Annual Report, Op. cit.

State guaranty coverage levels

Fiduciaries typically consider how much coverage the state guaranty associations would provide to participants included in a potential transaction.[6] Because coverage limits vary by state, plan sponsors must perform an analysis based on where impacted participants reside.

The current state guaranty coverage limit in all states is at least $250,000 in present value of annuity benefits per life, with some states having limits up to $500,000.[7,8] Most states also apply an overall cap of $300,000 to cover all policies an individual holds with a particular insurer.[9] Therefore, if a participant has his or her pension transferred to an insurer from which he or she already owns a product, that will limit the state guaranty coverage if the insurer becomes insolvent.

In addition, the state guaranty coverage limits are expressed as an expected present value of future benefits without regard to past benefits received. This means that potential coverage will also vary based on the participant's age at insurer insolvency. Older participants will have fewer future expected payments, so more of their benefits may be covered up to the guaranteed limit compared to younger participants.

For example,[10] assume participants A and B are both covered by single life annuities of $2,000 per month. Participant A is 80 years old, while Participant B is 70 years old, and they both live in states where the maximum state guaranty coverage is $250,000 per life.

- The present value of Participant A's future expected benefits is $185,000. This is below the $250,000 limit, so they will receive their full $2,000 monthly benefit from the state guaranty association if the insurer went bankrupt in that initial policy year.
- Participant B has the same monthly benefit but is 10 years younger at the time of insurer insolvency. Therefore, the present value of their future expected benefits is higher, at $300,000. This is over the coverage limit, so only 83% ($250,000 divided by $300,000) of their benefit would be covered in the initial policy year. They would receive $1,667 (83% of $2,000) per month from the state guaranty association if the insurer went bankrupt in that initial policy year. But note they would likely receive at least a portion of the uncovered $333 monthly benefit from the insurer's estate, as addressed in the next section.
- If the insolvency occurred in 10 years' time, note that Participant B would have an approximate present value of $185,000, which is under the limit. So, they would receive their full monthly benefit from the state guaranty association if the insurer went bankrupt at that time. The more time that has passed from the buy-out to the point of insurer insolvency, the more likely that participants' present value of benefits will fall below the maximum state guaranty coverage limit.

6. Interpretive Bulletin 95-1.
7. Puerto Rico Life and Disability Insurance Guaranty Association covers up to $100,000 in present value of annuity benefits.
8. "The Life & Health Insurance Guaranty Association System—The Nation's Safety Net"; NOLHGA; 2022; page 5.
9. https://www.acli.com/industry-facts/guaranty-associations — [[[DEAD LINK]]]
10. Present values are illustrative only and not based on actual present value conversion factors.

Coverage limits are generally expressed on a "per life" basis. This means that if a participant is covered by a joint and survivor annuity, the present value of future expected benefits will be calculated separately for the primary and secondary annuitant. Each portion of the benefit would be covered up to the "per life" limit.

Benefits in excess of state guaranty maximums

Annuity benefits up to the state guaranty association's maximum will be covered in full. Any amount above the state guaranty association's benefit level becomes a claim against the failed insurer's estate. In the case of insolvency, policyholders are given the highest priority claims against the insurer's general account, above general creditors.[11] An even more valuable claim is available to participants if the policy is in a separate account; in effect, participants would be granted "secured creditor" status if the insurer fails.[12] Separate accounts are discussed in more detail in the following section.

In the prior example, Participant B is due $2,000 per month ($300,000 in present value of benefits), but their state guaranty association will only cover 83%, or $1,667 ($250,000 in present value). The remaining $333 per month becomes a claim against the insurer's estate.

- If the insurer has enough assets to cover 75% of policyholder claims, Participant B will receive $250 (75% of $333) from the insurer's estate, for a total of $1,917 per month ($1,667 in state guaranty association coverage and $250 from the insurer's estate). In this case, 96% of the original benefit would be protected.
- In a case where the insurer has enough assets to cover 100% of policyholder claims, Participant B will receive the full remainder of benefits from the insurer's estate.

Other considerations in benefit protections

Split transactions

Plan sponsors can diversify solvency risk and increase state guaranty coverage by splitting a participant's benefit across two insurers. State guaranty limits are imposed on a "per insurer" basis, so if a participant's benefit was spread equally across two insurers, their guaranty limit would be effectively doubled.

Following the earlier example, assume Participant B's benefit had been evenly split across two insurers, and they were receiving $1,000 per month from each. If one or both insurers failed, their present value of future benefits would be calculated separately per insurer at $150,000. This is below the $250,000 coverage limit, so their entire benefit would be paid by the state guaranty association.

11. *Consumer Protection Comparison—The Federal Pension System and the State Insurance System*; NOLHGA; May 22, 2016; page 15.
12. Ibid., page 16.

Separate accounts

As discussed above, pension plan fiduciaries must consider the structure of an annuity contract when evaluating annuity providers.[13] Utilizing a separate account structure provides increased benefit protection for participants. If a separate account is established to back a group annuity contract, assets held in the account can only be used to pay the pension benefits promised under that contract.

Note that the insurer remains obligated to pay out the promised benefits regardless of how the separate account assets perform. And if the separate account assets dip below the obligation, the insurer must hold a general account reserve to make up the difference.[14] If the separate account is insufficiently funded, the policyholder retains a claim against the general account as well.

For example, if the separate account was 90% funded at the time of insurer insolvency, participants covered by that group annuity contract would receive 90% of their benefits from separate account assets. The impacted participants would receive at least a portion of their remaining benefits from the state guaranty association. And they would be able to make a claim against the insurer's estate for any additional shortfall in benefits.

Likelihood of insolvency

In addition to considering the difference in guaranties in the event of a pension plan insolvency versus an insurer insolvency, it is also important to consider the likelihood of such an event. The NOLHGA report found that "insurance regulation generally holds life insurance companies to stricter financial standards and more intensive oversight than are applied by pension regulation to single employer pension plans." While no insurer that provides pension annuity benefits has failed since the 2008 financial crisis, 931 single employer plans have failed.[15]

Other considerations

In addition to the items discussed in this issue brief, there are other considerations that plan sponsors will want to ensure that they address that could affect the outcome of their pension risk transfer. These issues can dissuade insurers from bidding on a pension risk transfer or require higher risk premiums in order to transact. Some of these issues include:

- New York—The state of New York has relatively more rigorous regulations for insurance operations. Because of these regulations, some insurers have a separate New York-based entity and will provide a two-contract solution to cover all plan participants (one for New York participants and one for non-New York participants). With respect to pension risk transfers, some insurers have decided not to participate in transactions with a New York state of issue.

13. Interpretive Bulletin 95-1.
14. *Consumer Protection Comparison—The Federal Pension System and the State Insurance System*, Op. cit.; page 15.
15. Ibid.; page 4.

- Cash balance plans and lump sum forms of payment—Hybrid plans and plans that allow for lump sum forms of payment are more complicated for insurers to take on as the benefits are not as easy to hedge compared to traditional annuity benefits and insurers must maintain more liquidity to pay out lump sums which can increase the price of the annuity.
- Unusual plan design considerations—Plans with unusual features may be more difficult for insurers to administer or hedge and may increase the price of the transaction (e.g., cost-of-living adjustments, complicated optional forms of payment, floating actuarial equivalence bases).

Small plans—Plans with a small number of participants or a small amount of liability to be transferred might not be as attractive to insurers that participate in the pension risk transfer market.

Deferred participants—Insurers are increasingly accepting participants who have not yet retired, despite additional complexity and risk. But some insurers prefer that these participants make up a smaller proportion of a given deal. Deals that include a large percentage of deferred participants may be less attractive to insurers.

After the lift-out

After the premium is paid, the insurer will start the transition process. This process includes reviewing the final data, drafting the group annuity contract, and issuing certificates. As part of the final data review, there may be a premium true-up or refund, depending on any data corrections that are made during the data reconciliation process.

The plan sponsor will want to consider whether to make a contribution to the remaining plan to maintain the funded status (either $ or %), especially if the plan was underfunded prior to the transaction. Plan sponsors will also want to study impacts to the future benefit security of the remaining participants and any impacts to plan operations, such as benefit restrictions if the plan crosses certain funded status thresholds. The plan sponsor may also consider future PBGC premiums, and the funded status on the balance sheet before and after the transaction.

Once the pension risk transfer is complete, it is also important to keep in mind that the participants remaining after a lift-out transaction may have a different demographic makeup that may warrant special considerations. The remaining risk profile may be significantly different depending on the group settled. Plan sponsors should therefore consider reviewing the assumptions used for the remaining participants. For a retiree lift-out that involves settling participants with smaller benefits that may fit a shorter longevity profile, there may need to be a change to that mortality assumption for the remaining participants to reflect the longer average longevity profile.

Plan sponsors may also wish to reassess the investment allocation after the lift-out as the cash or assets in kind may have resulted in a deviation from the plan's investment policy. For example, if the lift-out used a lot of the cash and bonds in the plan, the portfolio may need to rebalance away from the risk seeking assets remaining. Or the liability hedging portfolios may need reassessment as the duration of the liability for the remaining participants may have changed.

Some employers may execute multiple lift-outs over a number of years with different tranches of participants involved in each transaction, making these considerations important to keep in mind after each transaction. Plan sponsors may want to consider keeping some retirees in the plan to ensure a competitive bidding process with insurers for a potential future plan termination because retirees are the most attractive demographic among insurers. A complete pension risk transfer via a plan termination would have no remaining participants.

Conclusion

As outlined in this issue brief, there are some considerations to keep in mind and some key processes to follow for a buy-out pension risk transfer strategy, whether through a partial risk transfer via a lift-out or a full risk transfer via plan termination. Ultimately, it is the plan sponsor's responsibility to ensure that what is transferred to the insurer is representative of the plan benefits and ensure that a thorough due diligence is performed to select an insurer that meets the safest available annuity criteria as outlined by the Department of Labor (Interpretive Bulletin 95-1) in addition to other factors that plan sponsors may find important. As the trend for pension risk transfers continues to increase, plan sponsors should assess their plans to explore which option is most appropriate.