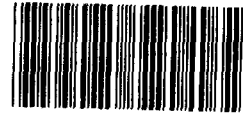


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Private Pensions:  
Risks to Retirees Posed by  
Insurance Company Failures

Statement of  
Joseph F. Delfico,  
Director, Income Security Issues  
Human Resources Division

Before the  
Subcommittee on Retirement  
Income and Employment  
Select Committee on Aging  
House of Representatives



## SUMMARY

Pensioners from defined benefit plans whose plans purchase insurance annuities for them lose the federal guarantees they had from the Pension Benefit Guaranty Corporation (PBGC). They wind up with coverage from state life insurance guarantee laws, which may not provide protection from an insurance company insolvency.

Problems in the insurance industry could also affect retirees and participants in defined contribution plans, whose benefits, unlike those from defined benefit plans, have not been guaranteed by PBGC.

An estimated 3 to 4 million retirees and their survivors receive their pensions in the form of annuities purchased by their pension plans from life insurance companies. Almost all of these pensioners came from defined benefit plans. When these liabilities were transferred federal protection ended, according to PBGC, leaving the retirees dependent on the insurance guarantee laws of the various states.

These state laws provide incomplete and varying coverage. Currently, three states and the District of Columbia have no provisions for guaranteeing insurance annuities. Many of the remaining state laws cover a smaller portion of benefits than the federal guarantee covers. Thus, some pensioners will be unprotected, only partially protected, or may experience interruptions in benefit payments, should the insurance companies providing their annuities become insolvent.

This patchwork of coverage allows some retiree annuitants to slip through the cracks of state protections. The transfer of pension responsibility occurs without their knowledge--they do not have to be told about the transfer of guarantee responsibility to states. There is no statutory requirement for plan administrators to take into account the availability of state guarantees when they buy annuities. Additionally, former U.S. workers who retire to a foreign country may have no protection at all.

To date, according to industry and government sources, no retiree has lost benefits due to an insurance company failure. However, since 1975, 170 life insurance companies have failed--40 percent of them in the last 2 years. Recently, the California Insurance Commissioner placed the Executive Life Insurance Company in conservatorship. If this company eventually fails and results in guarantee payments, some losses may occur because, under California law, only 80 percent of their benefits are covered up to \$100,000.

The patchwork pattern of state coverage means that all retirees do not have complete coverage of their pension benefits as afforded by PBGC. If the Congress wants to extend federal protections to retiree annuitants, it must consider numerous funding and administrative issues.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to participate in your hearing on current issues in pension protections. At your request, I will focus on how recent events in the insurance industry may affect pensioners.<sup>1</sup>

First, I will discuss the risks faced by pensioners when their pension plans purchase insurance annuities for them. Payments from defined benefit plans are guaranteed by the Pension Benefit Guaranty Corporation (PBGC), but PBGC considers that this guarantee ends once the insurance annuity is purchased. The annuity purchased may or may not be protected by state guarantee laws. Using examples from four states, I will attempt to describe the patchwork of state guarantees now in effect.

Second, I will also comment on how problems in the insurance industry could affect participants in defined contribution plans. Benefits from these plans, unlike those from defined benefit plans, have not been guaranteed by PBGC.

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<sup>1</sup>Much of the information we are discussing today was developed in response to a request by Chairman Riegle, Senate Committee on Banking, Housing, and Urban Affairs. Our report to Chairman Riegle, entitled Private Pensions: Millions of Workers Lose Federal Benefit Protection at Retirement (GAO/HRD-91-79, April 25, 1991), provides additional details on this subject.

Finally, I will address some issues associated with extending federal guarantees to insurance annuitants.

INSURANCE ANNUITANTS WILL HAVE TO RELY ON STATE GUARANTEES,  
SINCE NO FEDERAL GUARANTEES ARE AVAILABLE

An estimated 3 to 4 million retirees and their survivors receive their pensions in the form of annuities purchased by their pension plans from life insurance companies. Almost all of these pensioners came from defined benefit plans, which are guaranteed by PBGC, a corporation created by the Employee Retirement Income Security Act (ERISA) of 1974. While they were participating in these plans, these individuals enjoyed the protection of ERISA, which through PBGC guaranteed their retirement income in case their plans terminated with insufficient funds. But as soon as these liabilities were transferred to the insurance companies, federal protection ended, according to PBGC, leaving the retirees dependent on the insurance guarantee laws of the various states.

The problem with this situation is that state guarantees provide incomplete and varying coverage. Currently, three states and the District of Columbia have no provisions for guaranteeing insurance annuities. Many of the remaining state laws cover a smaller portion of benefits than the federal guarantee covers. Thus, some pensioners will be unprotected, only partially protected, or may experience interruptions in benefit payments,

should the insurance companies providing their annuities become insolvent.

This patchwork of coverage allows some retiree annuitants to slip through the cracks of state protections. To our knowledge, these retirees are not routinely informed about the transfer of responsibility for the protection of their pensions to the various states. Additionally, there is no statutory requirement for pension administrators to transfer retirees to an insurance company that is backed by a guarantee.

We are unable to determine the likelihood or magnitude of potential pension annuity losses, because data are limited.<sup>2</sup> To date, according to industry and government sources, no retiree has lost benefits due to an insurance company failure. However, since 1975, 170 life insurance companies have failed--40 percent of them in the last 2 years. Most of these failed insurance companies were small. On April 11, 1991, however, the California Insurance Commissioner placed the Executive Life Insurance Company in conservatorship. If this company eventually fails, it will be the largest U.S. insurance company ever to do so. If that failure were to result in guarantee payments under California law, former

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<sup>2</sup>On February 27, we testified on concerns about property-casualty insurance solvency regulation before the Senate Committee on Commerce, Science and Transportation. See Insurance Industry: Questions and Concerns About Solvency Regulation (GAO/T-GGD-91-10).

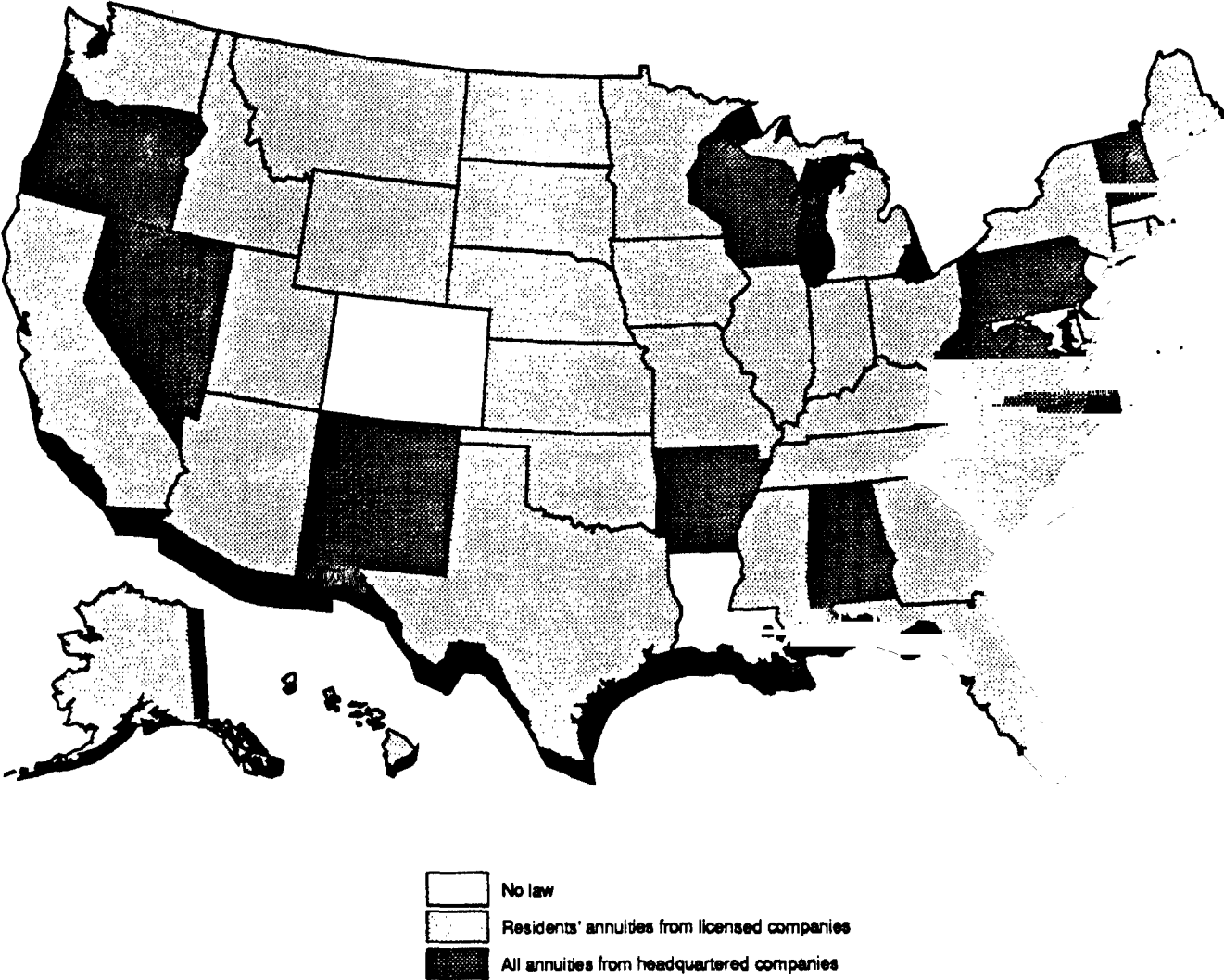
pension plan participants who hold Executive Life annuities could lose at least 20 percent of the present value of their benefits, as that state covers only 80 percent of benefits up to a maximum of \$100,000.

#### CHARACTERISTICS OF STATE GUARANTEE LAWS

The patchwork pattern of coverage, and the varying amounts guaranteed, means retirees may or may not have complete coverage of their pension benefit. The protection states provide annuitants depends on where they live, where the company is headquartered, and whether it is licensed to do business in their state of residence.

State guarantee laws generally follow one of two basic models. Under the first model, state laws guarantee benefits for annuitants, regardless of where they reside, who hold annuities issued by companies headquartered in the state. Under the second model law, state laws guarantee their own residents against loss, if the failed company was licensed to do business in the state at the time it failed, regardless of whether the company was headquartered in the state. The second model law also provides out-of-state coverage in certain circumstances. (Figure 1 shows the patchwork of coverage that has resulted from the two models.) To our knowledge, U.S. workers who reside in foreign lands would

Figure 1: Coverage of State Guarantees Varies



only be covered if the state in which the insurance company is headquartered extends such guarantees.

States also place varying limits on the amount of individual coverage. For example (as shown in fig. 2), 22 states limit coverage of individual annuities to \$100,000 in present value, or about \$994 per month.<sup>3</sup> Census data, however, indicate that almost 900,000 pensioners report they receive monthly benefits greater than this amount.<sup>4</sup> Other states limit coverage to \$300,000 (sometimes more) for all types of policies--life, health, and annuity. In these states, if an annuity is the only policy the pensioner holds from the company, the law would usually provide up to the full \$300,000 guarantee.

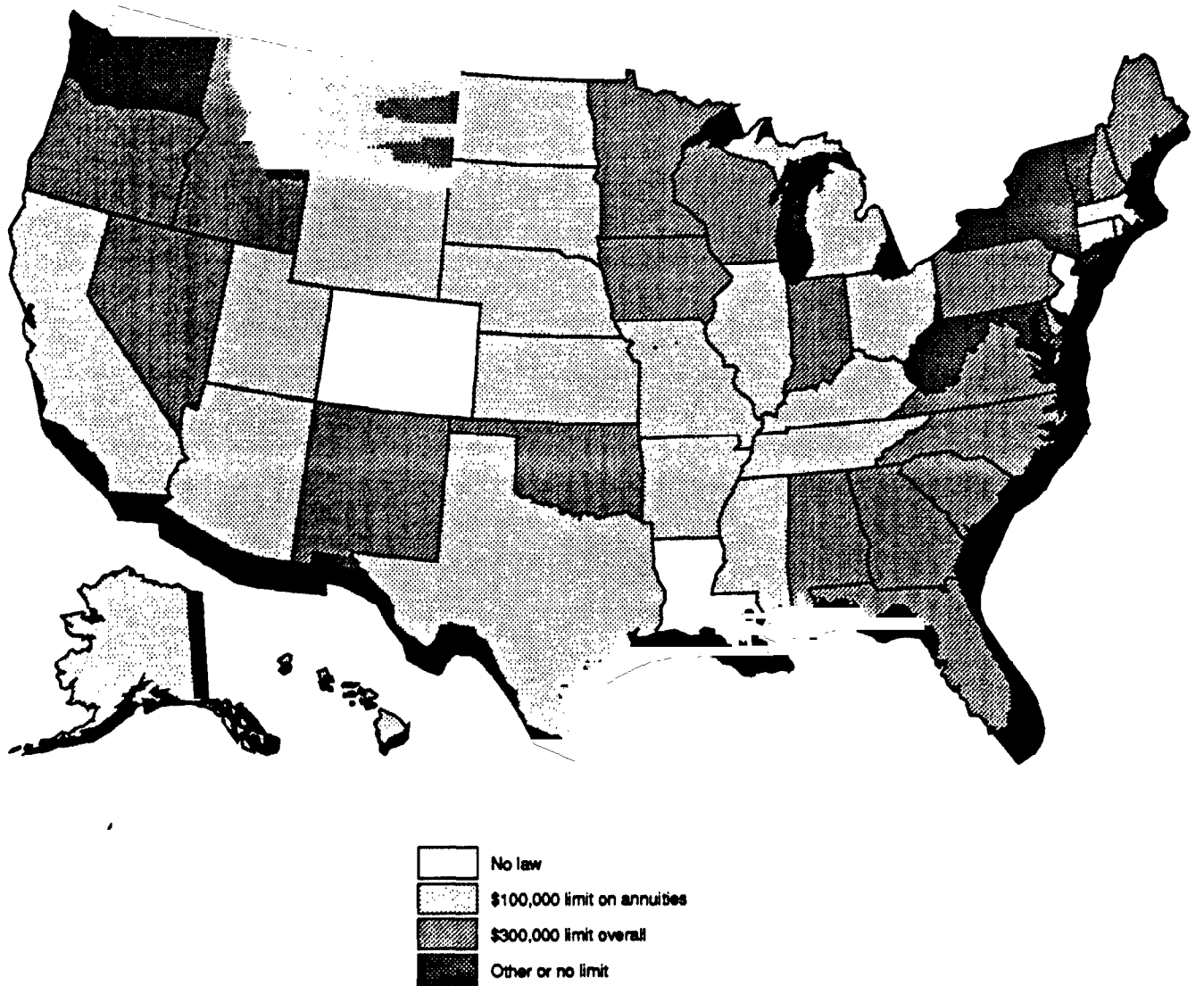
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<sup>3</sup>Calculated based on PBGC's standard interest rate of 7.25 percent and life expectancy for a 65-year-old male.

<sup>4</sup>Because of limitations in the Census data, we cannot determine what proportion of these pensioners hold insurance annuities.



**Figure 2: Dollar Limits of State Guarantees Vary**



Additionally, even if coverage exists, annuitants may have to wait for their money if their insurance company fails. None of the state laws provide for the maintenance of reserve funds. Instead, when an insurance company fails, the future cost of paying claims is estimated and surviving insurance companies are assessed a percentage of their in-state insurance activity (usually 1 to 2 percent) to pay the claims as they are reported. Since state laws limit the amount of such assessments that can be charged in a given year, the necessary funds may have to be collected over several years. As a consequence, annuitants may experience delays in payment.

State guarantee laws are not the only source of recovery, however. Pensioners may file claims in the liquidation process to recover losses not covered by the state guarantee. When an insurance company is liquidated, annuitants may present their claims to the liquidator and receive a share of the insurance company's assets. Also, in some instances, the insurance industry has voluntarily contributed to cover the potential losses of policyholders.

#### ILLUSTRATIVE EXAMPLES OF STATE

#### GUARANTEE COVERAGE

Residents of one state may have their annuity guaranteed by the laws of their state of residence or by the laws of another

state. Thus, coverage may or may not be available depending on various combinations of their residence and the location and operations of the insurance company.

To better understand how the guarantee laws may affect annuitants, we present four examples of how pensioners' annuities might be affected if their insurance company should fail. For purposes of simplification, we will not address the amount of the annuity payment nor the states' dollar limitations on coverage.

#### New Jersey

Consider a pensioner in New Jersey, a state which has no guarantee law. If the failed insurance company's headquarters are in New Jersey, or one of the other jurisdictions without a guarantee law, such as the District of Columbia, the pensioner would not receive any protection. Similarly, if the insurance company was headquartered in a state such as Texas or Florida, which only guarantee their own residents, there would not be any protection. A New Jersey resident would be protected only if the failed insurance company was headquartered in a state, like Virginia or Pennsylvania, that guarantees all company policies regardless of where the pensioner resides.

### New York

A pensioner in New York, which guarantees residents' annuities, would be protected if the failed insurance company was licensed in New York. If the company was not so licensed, the pensioner may still qualify to be covered by the insurance laws of the state in which the company is headquartered. For example, if the company's home state guarantees all annuities of companies headquartered in that state, such as Oregon or New Mexico, coverage would be provided. However, if the company was not licensed in New York and was headquartered in a state without a guarantee law, such as New Jersey, no guarantee would apply.

### California

A California pensioner is in a similar position to one in New York. However, California law guarantees only 80 percent of any covered losses. Therefore, a California pensioner would have to look to the liquidation process to recover his or her full pension.

### North Carolina

Finally, consider a pensioner in North Carolina, which guarantees all annuities paid by companies headquartered in that state. Such a pensioner is protected under North Carolina's

guarantee law if the company is headquartered in the state. North Carolina's protections would also apply in those cases where the company is licensed in North Carolina but headquartered in a state, like Illinois, which basically limits coverage to its own residents. If the company is neither headquartered nor licensed in North Carolina, guarantee coverage would be solely dependent on the laws of the state in which the company was headquartered.

#### RISKS TO DEFINED CONTRIBUTION PLANS

##### RELATED TO THE INSURANCE INDUSTRY

Our discussion to this point has focused on pensioners from defined benefit plans. However, participants in defined contribution plans can also be affected by the insurance industry. The number of these plans has grown in recent years, although they do not yet have large numbers of retirees. This type of plan does not promise a specified benefit. Instead, each employee has an account, to which the employer and/or the employee contribute. The retirement benefit depends (1) on the accumulation of contributions made and (2) the employee's proportionate share of the plan's investment gains and losses. Thus, if the plan suffers losses, the employee will receive a lesser benefit at retirement. This type of plan is not guaranteed by PBGC.

Defined contribution plans often are invested with insurance companies, and retirees from these plans may receive insurance

annuities. Thus, problems in the insurance industry could also affect workers and retirees from these types of plans.

The problems associated with insurance annuities have already been discussed. Additionally, in a GAO study of 174 large pension plans, we found that 28 percent of defined contribution plan assets were held in "guaranteed investment contracts", or GICs, from insurance companies. In contrast, defined benefit plans held only 2 percent of their assets in GICs. These contracts promise a specified rate of return and the principal is secured by specified assets of the insurance company. However, only 15 state laws explicitly guarantee GICs, and these laws limit the amounts of the guarantees, regardless of the number of employees involved. In any case, if an insolvency occurs, employees participating in defined contribution plans with GICs will see proportionate losses in the value of their retirement savings.

FUNDING AND ADMINISTRATIVE ISSUES  
ASSOCIATED WITH EXTENDING FEDERAL  
GUARANTEES TO INSURANCE ANNUITANTS

Finally, you asked about the benefits and problems associated with extending PBGC coverage to insurance annuitants. The benefits to retirees with such annuities are obvious. Extending federal guarantees to all retirees with insurance annuities would protect

most workers from loss of the pension benefits that they had earned.

However, there are numerous problems associated with extending PBGC coverage to such annuitants. Since PBGC collects premiums from plans to fund its guarantee, a means of collecting premiums for insurance annuitants would have to be found. This may not be overly difficult for future retirees, but would present serious problems with regard to existing annuitants--first, in identifying all of the insurance annuitants, and second, in determining who would be responsible for the premiums. It should be noted that the issue of funding for existing annuitants is particularly important since PBGC is currently reporting an accumulated deficit of about \$1.8 billion.

There also would be regulatory issues that stem from extending such coverage, since life insurance companies are now regulated by the individual states and not the federal government. Without regulatory changes, PBGC would in effect be guaranteeing insurance annuities against company failure, without any regulatory leverage over how and whether the companies are preparing to meet their annuity liabilities.

In considering the extension of federal protection to pensioners holding annuities, it should be recognized that there may be mechanisms other than PBGC to accomplish this objective.

For example, a new regulatory structure could be created to oversee insurance company financial solvency. Another possibility would be for pension plans and/or the insurance industry to propose ways to provide additional protections.

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This concludes my statement, Mr. Chairman. I would be glad to answer any questions.