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Insurance Company Failures
Threaten Retirement Income

Statement of
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Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
House of Representatives

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Summary of Statement by Joseph F. Delfico
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Pension plans frequently purchase annuities for their participants from insurance companies. An estimated 3 to 4 million retirees and their survivors receive pensions in the form of insurance company annuities. While some of these annuities are from plans that terminated, most are from ongoing plans.

When defined benefit plans purchase annuities for their participants, the federal guarantee of benefits through the Pension Benefit Guaranty Corporation (PBGC) ceases. Defined contribution plans are not covered by PBGC. In the event of an insurance company insolvency, retirees of defined benefit plans, defined contribution plans, and others that own such annuities, must rely on the protections provided by state guaranty laws.

The state guaranty system can provide some protection for annuitants in the event of insurance company failure. However the coverage varies across states and is incomplete. Currently, three states and the District of Columbia have no provisions for protecting annuitants. State coverage depends on where annuitants live and whether the insurance company is headquartered or licensed in the state. States may also cover a smaller portion of benefits than would have been protected by PBGC. Thus, some pensioners may be unprotected or only partially protected and may experience interruptions in benefit payments when an insurer becomes insolvent. Further, annuitants are not routinely informed that guarantee responsibility has been transfered from the federal government to the state governments.

Pension plans also invest funds with insurance companies through arrangements called unallocated funding instruments, which include guaranteed investment contracts (GICs). State guaranty associations generally do not cover such investments for defined benefit plans and only 15 states provide coverage for defined contribution plans. In the event of insurance company failure, participants of defined contribution plans that are not covered are subject to losses in the value of their retirement income. Losses incurred by defined benefit plans will have to be made up by the plan sponsor, and this could have implications for PBGC's liabilities should such funding losses result in plan termination.

The patchwork of state coverage means that some retirees do not have the same level of pension coverage as that provided by PBGC. If the Congress wishes to extend federal protections to insurance annuitants, it must consider significant administrative, funding and regulatory issues.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to participate in your hearing on insurance company insolvencies. At your request, I will focus on how problems in the insurance industry may affect pensioners.

When pension plans purchase insurance annuities and invest funds through insurance companies, retirees and workers are vulnerable to losses when the insurer becomes insolvent. Pension plans have purchased annuities for 3 to 4 million retirees and have invested about one-third of all pension assets with insurance companies.

Recent developments in the insurance industry have raised concern about the security of private pensions. Between January 1975 and December 1990, 170 life insurance companies failed--40 percent during 1989 and 1990. Most of these failed insurance companies were small. In April 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. Recently, a few other life insurance companies have been placed in conservatorship.

The basic problem is that despite the presence of a federal pension guaranty agency and a network of state insurance guaranty associations, some pensioners risk losing a portion of their retirement income due to an insurance company insolvency. In certain cases pensions have no guarantee coverage and in others they receive incomplete protection. Furthermore, pensioners are not routinely informed when they lose federal protection. Although extending federal guarantee coverage to annuitants would improve the security of their benefits, this extension would raise significant administrative, funding, and regulatory issues.

The first part of my testimony describes the guaranty system that protects pension plan annuitants. The second part focuses on how the guaranty system applies to pension plan investments.

INSURANCE ANNUITIES NOT COVERED BY FEDERAL GUARANTEES

An estimated 3 to 4 million retirees and their survivors receive pensions in the form of annuities purchased by their pension plans from life insurance companies.[1] Almost all of these pensioners came from defined benefit plans, which are guaranteed by the Pension Benefit Guaranty Corporation (PBGC), a corporation created by the Employee Retirement Income Security Act (ERISA) of 1974. A small percentage of these pensioners came from defined

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[1] Most of these retirees received their annuities through ongoing (rather than terminated) pension plans. Some defined benefit plans routinely annuitize retirees each year, thereby lowering administrative costs and avoiding PBGC premiums. For more information, see Private Pensions: Millions of Workers Lose Federal Benefit Protection at Retirement (GAO/HRD-91-79, Apr. 25, 1991).

contribution plans, which are not guaranteed by the federal government.

As participants in defined benefit plans, retirees and their survivors were protected by PBGC in case their plans terminated with insufficient funds. However, when these plans purchased annuities from insurance companies for these individuals, federal protection ended. Insurance annuitants from both types of plans are dependent on the insurance guarantee laws of the states for protection of their annuities.

STATES DO NOT ALWAYS ENSURE PROTECTION OF ANNUITIES

State insurance guaranty laws expose some pensioners to the risk of losing a portion of their annuity or encountering delays in payment when an insurance company insolvency occurs. Varying guaranty law provisions among the states have produced a system with gaps in coverage as well as coverage limits that in many cases are lower than PBGC limits.

The protection that states provide for annuitants depends on where they live, where the insurance company is headquartered, and whether it is licensed to do business in their state of residence. State guaranty laws, which establish guaranty associations,[2] generally follow one of two models. Under the "extra-territorial" model, state law guarantees benefits for annuitants of companies headquartered in a state, regardless of where they reside.[3] Under the "residents-only" model, state laws guarantee their own residents against loss when a failed company was licensed to do business in the state at the time it failed, regardless of where the company was headquartered.[4] (Figure 1 depicts the coverage that has resulted from the two models and attachment 1 provides information on each state's coverage.)

No Guarantee Coverage in Some Cases

In most cases, pensioners' annuities are covered by one of the 47 states that has a guaranty association. However, residents of every state are at risk of not having annuity coverage under certain circumstances. These circumstances vary, depending on the kind of guaranty system in the annuitant's state of residence. The following discussion describes the circumstances under which annuitants lack coverage under each kind of system.

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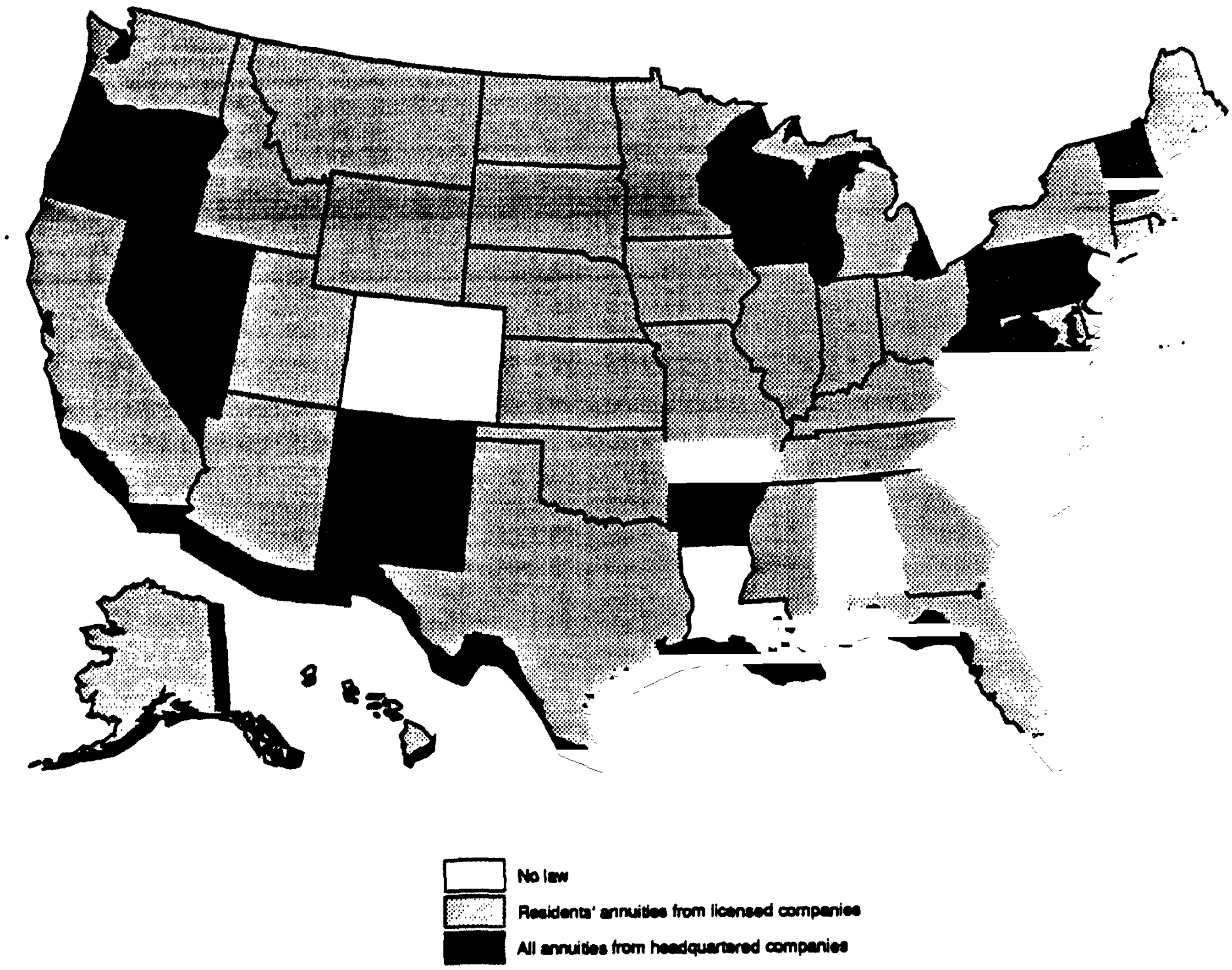
[2]State guaranty associations are non-profit legal entities whose members comprise all insurance companies licensed to write life and health insurance or annuities in a state.

[3]This model also provides coverage of annuities when non-headquartered companies are licensed in the annuitant's state of residence.

[4]This model also provides out-of-state coverage under certain conditions.

Figure 1: Coverage of State Guarantees Varies



Note: Colorado has passed legislation establishing a state guaranty association, effective July 1, 1991.

Residents of states without a guaranty association

Colorado,[5] Louisiana, New Jersey, and the District of Columbia do not currently have a state guaranty association. A resident of any of these jurisdictions would receive state guarantee coverage only if the insurance company was headquartered in one of the 13 states with extra-territorial coverage. If the company was headquartered in any other state, the individual's annuity would not be covered (see attachment 2, fig. I.1).

Residents of states with residents-only coverage

Thirty-four states have residents-only guaranty systems. A resident of one of these states would receive no annuity coverage in the following situations: (1) the company providing the annuity is headquartered in a state with no guarantee association and is not licensed in the resident's state or (2) the company is headquartered in another state with residents-only coverage, and the company formerly held a license in the annuitant's state of residence. The first situation could occur, for example, if an annuitant had moved to another state. The second situation could occur, among other reasons, if a company had decided not to renew its license in a state (see attachment 2, fig. I.3).

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[5]Colorado has passed legislation establishing a state guaranty association, effective July 1, 1991.

Residents of states with extra-territorial coverage

A resident of a state with extra-territorial coverage would have no annuity protection if the insurance company was headquartered in a state with no guaranty association and not licensed in the resident's state (see attachment 2, fig. I.2).

U.S. citizens residing in foreign countries

The annuities of U.S. citizens residing in foreign countries would have no guarantee coverage if the insurance company were headquartered in a state with no guaranty association or a state with a residents-only system.

Incomplete Guarantee Coverage of Some Annuities

Coverage by a state guaranty association does not ensure that the full value of a pensioner's annuity will be protected in an insolvency. Most state laws limit the liability of guaranty associations for the annuity contracts of insolvent insurers. Annuitants may recover some portion of their benefits through the process by which the insurance company is liquidated. However, to the extent that assets from the liquidation process are not available to fully fund these benefits, state liability limits may prevent guaranty associations from making up the difference for all annuitants.

Guaranty association liability limits vary considerably by state. California, for example, guarantees no more than 80 percent of an annuity. In addition, California and 21 other states limit total annuity coverage to $100,000 in present value, or about $994 per month (see fig. 2).[6] Census data indicate that almost 900,000 pensioners receive monthly benefits greater than $994.[7] By contrast, PBGC guarantees plan participants' pensions up to about $2,165 a month at the age of 65, which is greater than the benefits paid to 98 percent of pensioners.[8]

Potential for Delays in Payment

Even if annuities are covered to their full present value by a state guaranty law, annuitants may have to wait for their money if their insurance company fails. The failure of a large company could strain the resources available to a state guaranty association.

None of the state laws (except New York's) provides for the maintenance of reserve funds. Instead, when an insurance company fails, the future cost of paying claims is estimated and

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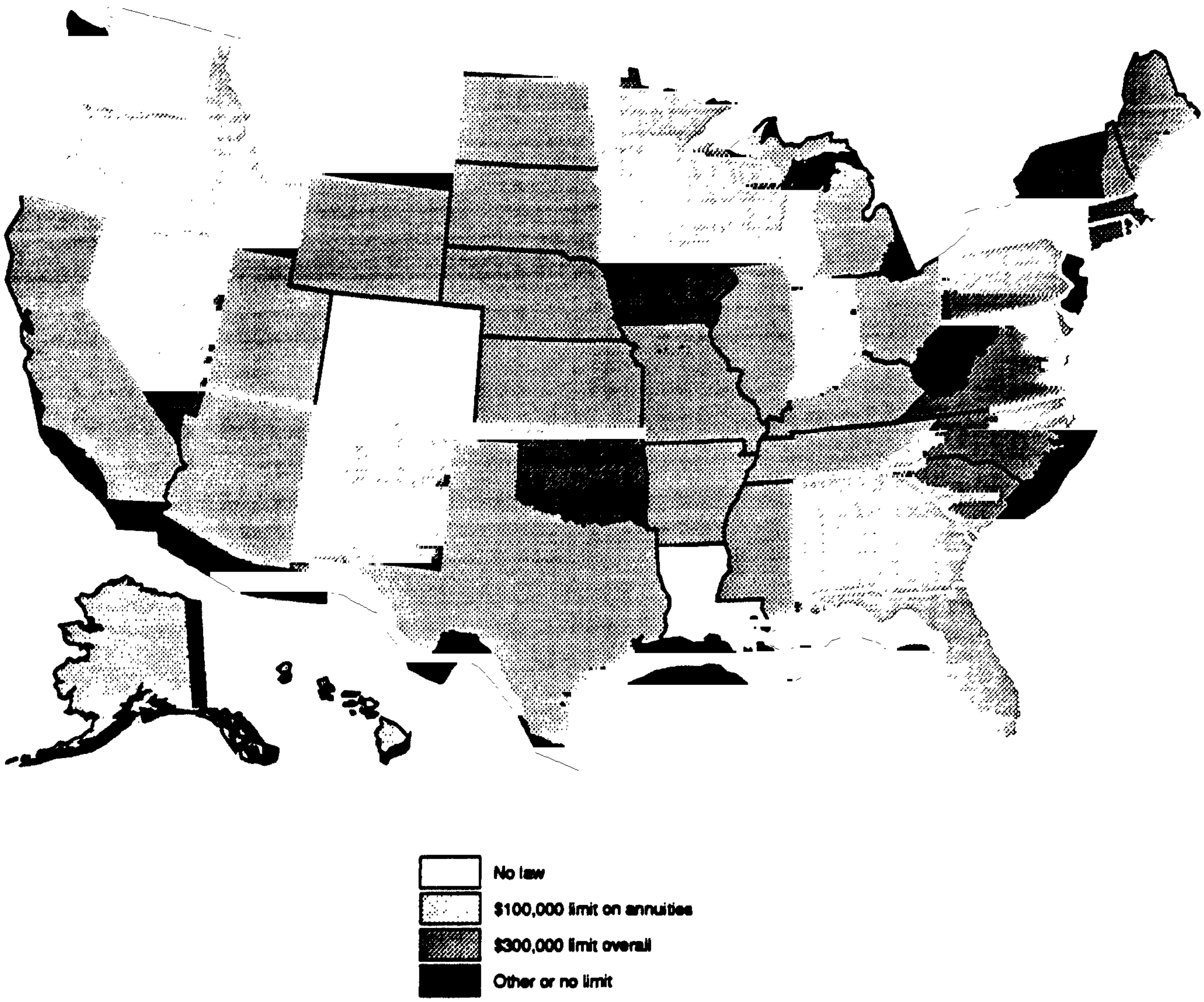
[6]Calculated based on PBGC's standard interest rate of 7.25 percent and life expectancy for a 65-year-old male.

[7]Because of limitations in the Census data, we were unable to determine what proportion of these pensioners hold insurance annuities.

[8]PBGC's coverage amount is indexed upward every year. The amount shown represents the coverage for pension plans terminating in 1990. States generally have not indexed their coverage limits.

Figure 2: Dollar Limits of State Guarantees Vary



Note: Colorado has passed legislation establishing a state guaranty association, effective July 1, 1991.

surviving insurance companies are assessed a percentage of their in-state insurance activity to pay the claims as they are reported. Many states permit insurance companies to take a 100-percent tax offset on their assessments, usually in the form of a 20-percent tax credit for each of the 5 years following the assessment. In essence, these states are passing the cost of paying an insolvent insurer's claims on to taxpayers.

Because state laws generally limit the amount of assessments for annuities that can be charged in a given year, the necessary funds may have to be collected over several years. Most states limit assessments to 1 or 2 percent of premiums written for annuities in the state. As a consequence of these limits, annuitants may experience delays in payment.

MOST LOSSES ON PENSION PLAN INVESTMENTS NOT INSURED BY STATES

Our discussion to this point has focused on those pensioners who receive insurance company annuities. Pension plans also make investments with insurance companies to fund benefits for active participants. Approximately one-third of all pension plan assets are invested with life insurance companies.[9] When insurance company insolvencies occur, plans may incur losses.

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[9]American Council of Life Insurance, 1990 Life Insurance Fact Book.

Some state guaranty associations insure defined contribution plans and their participants against investment losses. Other state associations do not. Investment losses experienced by defined benefit plans are generally not covered by state guaranty associations. These losses could reduce funding levels and place financial pressures on plan sponsors. In the event that this results in plan terminations, PBGC liabilities could increase.

Unallocated Funding Instruments

One set of arrangements under which pension funds are invested with insurance companies is through unallocated funding instruments.[10] Here, some or all of the pension plan's current and accumulated contributions are held by the insurance company in a pooled account until they are disbursed in benefit payments or applied to purchase paid-up annuities at retirement or termination of employment.[11] Among the types of unallocated funding instruments are the Group Deposit Administration contract and the Immediate Participation Guarantee contract, both of which are typically used by defined benefit plans.

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[10] These are also referred to as unallocated funding obligations or unallocated annuity contracts.

[11] In contrast, allocated funding instruments credit contributions to individual plan participants in such a manner as to give them a legally enforceable claim to benefits.

Another type of unallocated instrument used to invest pension funds is the much discussed "Guaranteed Investment (or Income) Contract." These contracts, which are more typically used by defined contribution plans,[12] promise a specified rate of return on a block of funds, and principal is secured by assets of the insurance company.

Unallocated obligations are generally not covered by state guaranty associations. Presently, only 15 states guarantee them.[13] This means that these investments are subject to risk of capital loss in the event of an insurance company insolvency and that pension plans, their participants, and the PBGC will be subject to different risks, depending on whether the plan is a defined contribution or defined benefit plan.

Defined Contribution Plan Participants' Losses May Not Be Insured

Under a defined contribution plan, participants' benefits depend on the rates of return earned on plan investments over the years

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[12]In a GAO study of 174 large pension plans, we found that at the end of 1987, 28 percent of defined contribution plan assets were held in GICs from insurance companies. In contrast, defined benefit plans held only 2 percent of their assets in GICs.

[13]Thirteen state laws explicitly exclude unallocated obligations from coverage and 19 states do not specify whether they are covered.

that the participant is covered. The risk of capital loss is borne by the participant.

In the event of an insurance company insolvency, the insurer may pay only a fraction of the amount invested in unallocated obligations. Thirteen of the 15 states that explicitly cover unallocated obligations limit their liability to either $1 million or $5 million per pension plan. Thus, while some participants are protected under state guaranty arrangements, many will be exposed to losses in the value of their retirement income.

Defined Benefit Plan Losses Not Insured

Active participants in defined benefit plans are generally not exposed to loss of benefits and are protected by PBGC in the event of plan termination. However, some defined benefit plans invest funds with insurance companies under unallocated funding arrangements, just as defined contribution plans do. If an insurance company insolvency results in investment losses, it is the plan, not the participants, that bears the loss. State guaranty associations in general do not cover losses arising from unallocated funding arrangements resulting from insurance company failures when the plan is covered by PBGC. This means that defined benefit plans experiencing losses will have to make additional contributions to maintain previously attained funding levels.

One implication of the lack of state guarantees is that maintaining funding levels may put excessive financial pressures on the plan sponsor. This could push some companies toward bankruptcy, increasing plan terminations and thus PBGC's liabilities.

CONSIDERATIONS IN IMPROVING THE BENEFIT SECURITY OF INSURANCE ANNUITANTS AND PLAN PARTICIPANTS

The system of state guarantees can provide some protection for insurance company annuitants when an insolvent insurer's assets fall short of its liabilities. However, the varying laws and coverages of the states create a patchwork system and some annuitants may experience a lack of coverage or delays in payment in the event of insurer insolvency.

The basic problem is that the pension plan and the insurer enter into an annuity contract to provide benefits for the retiree from a defined benefit plan and, in doing so, alter the security of the pension commitment. PBGC has concluded that it lacks authority to guarantee annuities purchased from an insurance company to satisfy pension obligations to retirees. While PBGC has a statutory basis for its position, this leaves retirees whose pensions are paid by insurance companies exposed to a risk not present for retirees whose pensions are paid directly by pension plans. Furthermore, annuitants are not routinely informed that they have lost federal protection.

If the Congress wishes to extend PBGC protection to insurance annuitants, it must consider significant administrative, funding, and regulatory issues.

Because 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 because PBGC is currently reporting an accumulated deficit of about $1.8 billion.

Regulatory issues also arise from extending such coverage, because 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. Further, assuring effective regulation of insurers to prevent insolvencies could also help to reduce risks to pension plans and participants.

If PBGC coverage is not extended to annuitants, the Congress may want to consider requiring pension plans that purchase annuities to inform their current workers and retirees about the guarantee system that applies to these annuities. Pension plans could notify pensioners that their annuities are not federally protected and also provide information about state guarantees so that they could determine if the annuities were protected in their specific circumstances.

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

Table 1: State Guaranty Coverage of Individual Annuities as of February 14, 1991 (000s omitted)				
STATE (1)	GUARANTY FUND (2)	PRESENT VALUE LIMIT FOR ANNUITY (3)	LIMIT ON ALL BENEFITS TO POLICY-HOLDER (4)	TYPE OF COVERAGE[a] (5)
Alabama	Yes	None	$300	E
Alaska	Yes	$100	$300	R
Arizona	Yes	$100	$300	R
Arkansas	Yes	$100	$300	E
California	Yes	$100	$250	R
Colorado[b]	No	n.a.	n.a.	n.a.
Connecticut	Yes	$100	$300	R
Delaware	Yes	None	$300	R
District of Columbia	No	n.a.	n.a.	n.a.
Florida	Yes	None	$300	R
Georgia	Yes	None	$300	R
Hawaii	Yes	$100	$300	R
Idaho	Yes	None	$300	R
Illinois	Yes	$100	$300	R
Indiana	Yes	None	$300	R
Iowa	Yes	None	$300	R
Kansas	Yes	$100	$200	R
Kentucky	Yes	$100	None	R
Louisiana	No	n.a.	n.a.	n.a.
Maine	Yes	None	$300	R
Maryland	Yes	None	None	R
Massachusetts	Yes	$100	$300	R
Michigan	Yes	$100	$300	R
Minnesota	Yes	None	$300	R
Mississippi	Yes	$100	$300	R

ATTACHMENT 1

Table 1: State Guaranty Fund Coverage of Individual Annuities as of February 14, 1991 (000s omitted)

STATE (1)	GUARANTY FUND (2)	PRESENT VALUE LIMIT FOR ANNUITY (3)	LIMIT ON ALL BENEFITS TO POLICY-HOLDER (4)	TYPE OF COVERAGE[a] (5)
Missouri	Yes	$100	$300	R
Montana	Yes	None	None	R
Nebraska	Yes	$100	$300	R
Nevada	Yes	None	$300	E
New Hampshire	Yes	None	$300	E
New Jersey	No	n.a.	n.a.	n.a.
New Mexico	Yes	None	$300	E
New York	Yes	None	$500	R
North Carolina	Yes	None	$300	E
North Dakota	Yes	$100	$300	R
Ohio	Yes	$100	$300	R
Oklahoma	Yes	$300	$300	R
Oregon	Yes	None	$300	E
Pennsylvania	Yes	None	$300	E
Puerto Rico	Yes	None	None	E
Rhode Island	Yes	$100	$300	R
South Carolina	Yes	None	$300	E
South Dakota	Yes	$100	$300	R
Tennessee	Yes	$100	$300	R
Texas	Yes	$100	$300	R
Utah	Yes	$100	$300	R
Vermont	Yes	None	None	E

Figure I.1: Annuity Coverage For Residents of States With No Guaranty System

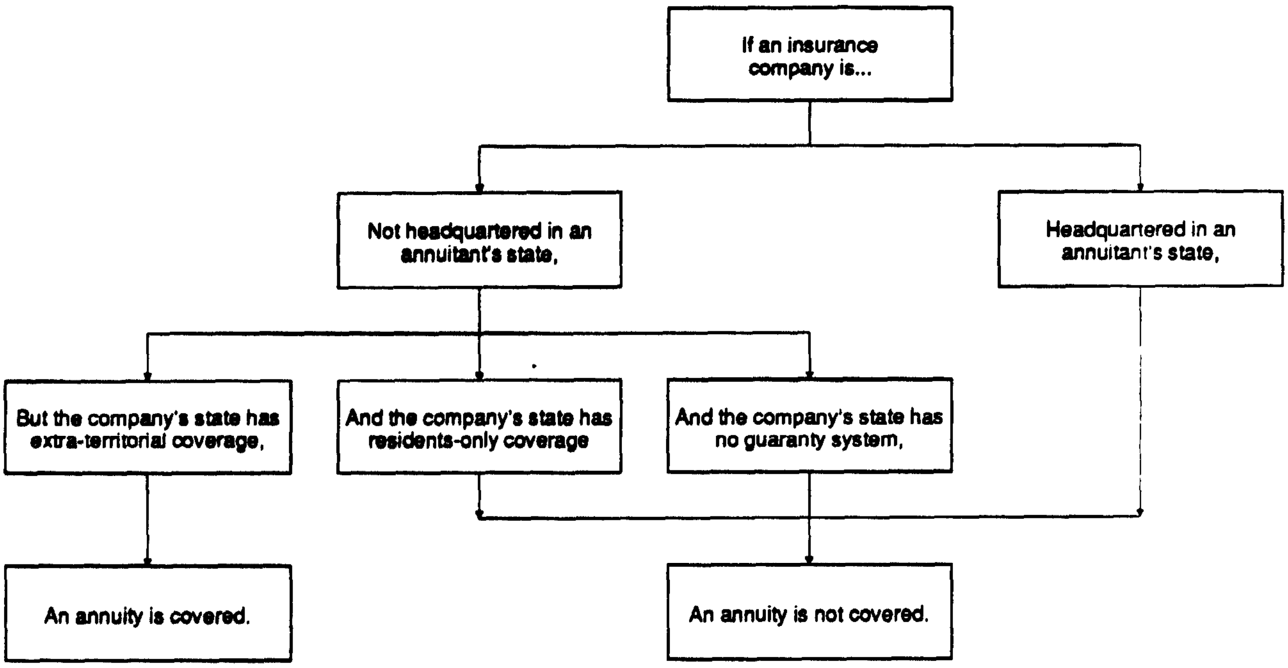
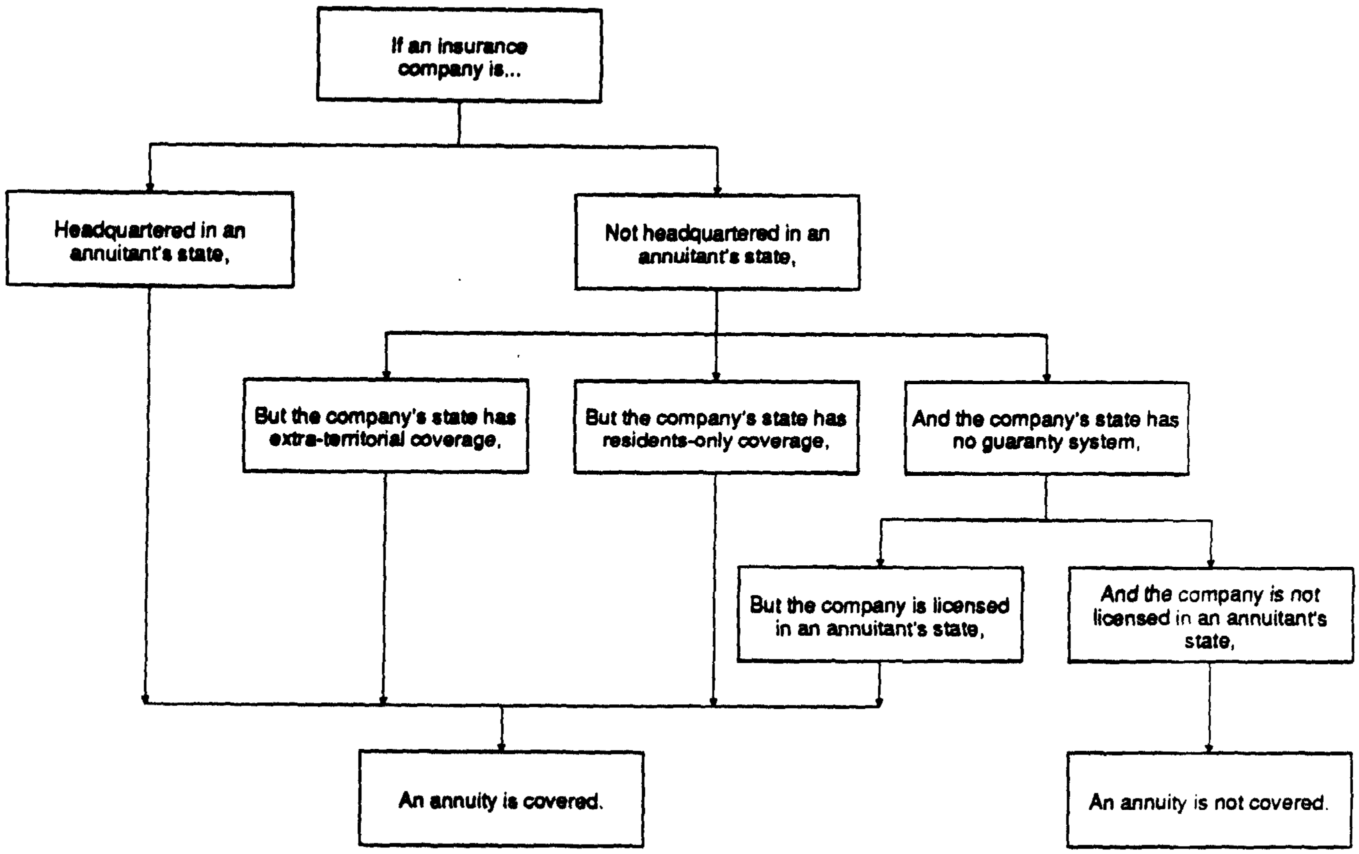


Figure I.2: Annuity Coverage For Residents of States With An Extra-Territorial Model



ATTACHMENT 1

Table 1: State Guaranty Fund Coverage of Individual Annuities as of February 14, 1991 (000s omitted)				
STATE (1)	GUARANTY FUND (2)	PRESENT VALUE LIMIT FOR ANNUITY (3)	LIMIT ON ALL BENEFITS TO POLICY-HOLDER (4)	TYPE OF COVERAGE[a] (5)
Virgin Islands	No	n.a.	n.a.	n.a.
Virginia	Yes	None	$300	E
Washington	Yes	$500	$500	R
West Virginia	Yes	None	None	E
Wisconsin	Yes	None	$300	E
Wyoming	Yes	$100	$300	R

Notes: a. "E" denotes extra-territorial coverage and "R" denotes residents-only coverage.

b. Colorado has passed legislation establishing a state guaranty association, effective July 1, 1991.

Source: Congressional Research Service

Figure I.3: Annuity Coverage For Residents of States With A Residents-Only Model