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WASHINGTON, D.C. 20548

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RELEASED

SEPTEMBER 27, 1984

The Honorable James J. Florio  
Chairman, Subcommittee on Commerce,  
Transportation and Tourism  
Committee on Energy and Commerce  
House of Representatives



125453

Dear Mr. Chairman:

Subject: Comments on the Economic Implications  
of the Proposed Florio Amendment to the  
Nondiscrimination in Insurance Act  
(GAO/OCE-84-6)

On April 13, 1984, you asked us to analyze your substitute to H.R. 100, the proposed Nondiscrimination in Insurance Act. As originally introduced, H.R. 100 was the equivalent of S. 372, the proposed Fair Insurance Practices Act, whose economic effects were analyzed in our recent report, "Economic Implications of the Fair Insurance Practices Act" (GAO/OCE-84-1, April 6, 1984).

Our analysis shows that some of the economic effects of your substitute bill would be significantly different from those of the originally proposed legislation. In particular, the increases in unfunded liabilities created by the original bill for life insurance companies and pension plans would be reduced by between \$18.3 and \$21.6 billion. These reductions would result largely from allowing sex distinctions to continue in existing life insurance contracts and in pensions and annuities currently being paid to retirees. Further, because the substitute bill would reduce unfunded liabilities and extend the period for implementing the act's requirements, it would virtually eliminate the risk of insurance company insolvency resulting from the legislation.

THE PROPOSED UNISEX INSURANCE LEGISLATION

The proposed unisex insurance legislation (H.R. 100/S. 372), as originally introduced, would have prohibited distinctions based on race, color, religion, sex, or national origin in the marketing and pricing of insurance and pensions. So far as we know, the only one of these characteristics which is explicitly used as a risk factor in the pricing and marketing of insurance and pensions is sex. The bill would have required that sex-distinct premiums and benefits in existing and future insurance and pension contracts be equalized. A "topping-up" provision in the bill would have required that no one's benefits be reduced as part of the equalization process.

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PROVISIONS OF THE SUBSTITUTE BILL

As compared with the original bill, the major changes in the substitute bill are that it:

1. allows sex distinctions to continue in pensions and annuities in course of payment, i.e., pensions and annuities currently being paid to retirees [Sec. 4(b)];
2. allows sex distinctions to continue in existing life insurance contracts [Sec. 4(c)];
3. allows sex distinctions to continue in individual annuity contracts whose benefits have been fixed before the effective date of the act [Sec. 4(d)];
4. deletes the topping-up provision [Sec. 4(c)(2) in the original bill];
5. prohibits targeted marketing of insurance, i.e., seeking out or avoiding particular groups of people in the marketing of insurance [Sec. 4(a)(4)]; and
6. extends the "transition period" between the date of enactment and the legislation's effective date from 90 days to slightly in excess of 1 year [Sec. 11].

OBJECTIVES, SCOPE, AND METHODOLOGY

To respond to your request, we used the same approach as we used in our earlier report on the original unisex insurance bill. We analyzed four major categories of economic effects of the substitute bill--(1) unfunded liabilities (the increase in liabilities for pension funds or insurance companies resulting from the bill which would not be matched by any corresponding increase in assets); (2) redistributive effects (shifts of money from one group of people to another); (3) economic efficiency effects (changes in how cost-effectively the industry satisfies consumer demands); and (4) administrative costs (costs to insurance companies of revising existing policies and preparing new ones). Our analysis is limited to the ways in which the economic effects of the substitute bill would differ from those of the original bill; a full analysis of the economic effects of the original bill is contained in our earlier report. Our review was made in accordance with generally accepted government auditing standards.

ECONOMIC EFFECTS OF THE SUBSTITUTE BILLUnfunded liabilitiesLife insurance

The unfunded liabilities created by the original bill for life insurance companies would be reduced by \$16.2 to \$16.6 billion--i.e., unfunded liabilities would drop from the maximum of \$17.1 billion we estimated for the original bill to a range of \$0.5 to \$0.9 billion. The remaining unfunded liabilities would be associated primarily with accident and health policies. The reductions would occur as a result of exempting existing life insurance contracts (\$15.7 billion), exempting annuities in course of payment (\$0.5 billion), and exempting individual annuity contracts whose benefits have already been fixed (up to a maximum of \$0.4 billion).

As discussed in our earlier report, the estimates of unfunded liabilities for life insurance companies are based primarily on data from the American Council of Life Insurance (ACLI). ACLI surveyed its members and asked them to estimate the unfunded liabilities which the original unisex insurance bill would have created for them, assuming equalization occurred through topping-up of men's coverages in life insurance and women's coverages in annuities. We adjusted their estimates to reflect the fact that some firms were omitted from the ACLI survey. The resulting estimate was that, under the original bill, changes in existing life insurance contracts would increase liabilities by \$15.7 billion and that changes in annuities in course of payment would increase liabilities by \$0.5 billion. Under the substitute bill, the changes that produced these increases in liabilities would no longer be required. We estimated that, under the original bill, changes in individual deferred annuities would increase liabilities by \$0.4 billion. The need for some of these changes might be eliminated by Sec. 4(d) of the substitute bill if the benefits for these annuities have already been fixed. Because we do not know what portion of the additional liabilities, if any, would be avoided by this provision, we show the reduction here as a range from \$0.0 to \$0.4 billion.

Pension plans

In our previous report, we estimated that the changes required by the original bill would increase pension plan unfunded liabilities by \$7.7 to \$15.1 billion. By exempting annuities and pensions in course of payment, the substitute

would reduce this figure by \$2.1 to \$5.0 billion.<sup>1</sup> By exempting individual annuity contracts whose benefits have already been fixed, the substitute could also reduce or eliminate the additional unfunded liabilities associated with equalizing past accruals in some defined contribution pension plans.<sup>2</sup> This would occur to the extent that individual deferred annuities with benefits fixed in advance are purchased in these plans. We had estimated these unfunded liabilities for past accruals in defined contribution plans as being as high as \$2.8 billion. Taken together, these changes would reduce our earlier estimates of the additional unfunded liabilities for pension funds to a range of \$5.6 to \$10.1 billion.<sup>3</sup>

The actual additional unfunded liabilities that would remain under the substitute are those created by the requirement to equalize that portion of the benefit to be paid future retirees which is based on past accruals. For several reasons, our estimate of \$5.6 to \$10.1 billion in additional unfunded liabilities due to this requirement in the substitute bill (as well as our earlier estimate of this portion of the additional liabilities created by the original bill) may be too high. First, as our prior report noted, our estimate overstates the size of these additional unfunded liabilities if, as several independent actuaries have reported to us, a substantial number of pension plans have switched to unisex benefits since 1977, when the Department of Labor gathered the data on which our estimates are based.

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<sup>1</sup>The \$2.1 billion figure is the low estimate of "type 1" costs (i.e., costs for retired employees) reported in table 1 of our earlier report. The \$5.0 billion figure is the "type 1" portion of the maximum estimate of \$15.1 billion in pension plan liabilities based on Milliman & Robertson data reported on page 12 of appendix I in our earlier report.

<sup>2</sup>A defined contribution pension plan is one in which specified annual contributions are accumulated in a separate account for the employee.

<sup>3</sup>The range of \$5.6 to \$10.1 billion is derived by subtracting the \$2.1 to \$5.0 billion from the \$7.7 to \$15.1 billion. The possible reduction of up to \$2.8 billion for individual annuities with benefits fixed in advance would not affect the range. It does not affect the minimum estimated liabilities, because these liabilities for defined contribution plans had already been eliminated from the minimum estimate in our earlier report. Nor does it affect the maximum estimated liabilities, because these reductions are uncertain and may not occur. In effect, this possible reduction increases the likelihood that the actual liabilities will be near the lower end of the range, but they do not affect the limits of the range itself.

Second, our earlier estimates of the additional unfunded liabilities for pension plans were based on two assumptions about how conversions to unisex benefits would take place. We assumed that the "topping-up" requirement in the act would require plans to equalize benefits at the higher of the two sex-distinct levels previously received (they would increase the benefits received by the "disadvantaged sex" to the level received by the "advantaged sex"). We also assumed that plans would not reduce the normal rate at which benefits accrued, so that aggregate benefits would not only be increased in the short run, but would remain permanently higher than they otherwise would have been. In our earlier report, we acknowledged the possibility that plans might try to recover some of the costs of increased benefits by reducing rates of future accruals. However, we did not incorporate adjustments to reflect this possibility in our estimates of the additional unfunded liabilities for pension plans, because we had no basis for estimating what percentage of plans would seek to recover these costs through reduced accruals of benefits.

Based on our more recent conversations with a number of independent actuaries, it now appears that plans which have converted to unisex benefits in response to the Supreme Court's decisions in Manhart (1978) and Norris (1983) have, in many cases, systematically reduced future accruals so as to reduce the increased liabilities associated with converting to unisex benefits. We have not been able to find data that quantify the prevalence of different adjustment strategies. However, we have been told that one common approach in plans that offer sex-distinct optional benefits is to raise the optional benefits paid to the disadvantaged sex to a unisex level--the same level for both sexes--between the previous male and female optional benefit levels. After this conversion date, benefits for the formerly disadvantaged sex continue to accrue at the previous rate. Meanwhile, optional benefits for the formerly advantaged sex are frozen at the dollar level attained at the time unisex rates are established, and do not begin to accrue again until the lower unisex optional benefit level has caught up to the optional benefit level of the previously advantaged sex. Under this approach, the pension plan faces an increased liability for members of the disadvantaged sex who retire or leave the plan with vested benefits during this "catching-up" period (which normally lasts from 6 to 18 months) because their optional benefits have increased with no corresponding decrease in the optional benefits of the advantaged sex. However, after the end of the catching-up period, both sexes receive optional benefits at the new unisex level, which is calculated so as to represent no increase in liability over the sex-distinct optional benefits previously paid.

Consider a numerical example. Suppose a defined benefit plan offers its male and female employees equal basic monthly benefits but also offers optional joint-and-survivor (J/S) benefits on a sex-distinct basis. Suppose further that two vested employees, one male and one female, have identical work histories and, if they left their employer on January 1, could receive at retirement a basic monthly benefit (single life annuity) of \$1,000/month for the rest of their lives. Alternatively, the employees can elect to receive the optional joint-and-survivor benefit under which their spouses would continue to receive a benefit from the pension plan for the rest of the spouse's life should the spouse outlive the employee. Under the J/S option, the potential extra cost of providing monthly benefits to a surviving spouse is recovered by reducing the monthly benefits paid to the employee. When this adjustment is made on a sex-distinct basis, benefits of female employees will be reduced by less than the benefits of similarly-situated male employees to reflect the fact that the female employee is less likely to leave a surviving spouse than is the male employee. For the purpose of this example, we will assume that the sex-distinct J/S adjustment produces a \$750 monthly benefit for the male employee and an \$850 monthly benefit for the female employee. We also assume that the unisex J/S benefit level (the benefit level which, if paid to both male and female employees, would cost the plan the same as paying the previous sex-distinct benefits) is \$800/month for these employees as of January 1. Under the rules of most defined benefit plans, earned benefits increase as the employee works more years for the employer. For these particular employees, let us assume that each additional year of work has the effect of increasing the amount of benefits under either the single life annuity or the J/S option by \$50/month.

If the plan begins its conversion to unisex benefits on January 1, the man's J/S benefits are immediately raised to the unisex level of \$800/month. The woman's J/S benefits are frozen at \$850/month. The man continues to earn increased benefits as he continues to work, but the woman earns no increased J/S benefits until the unisex benefit level has caught up to hers. After a year, the man's unisex benefits have risen, through the accrual of benefits at the normal rate, to \$850/month. Both the man and the woman thus now have the option of J/S benefits of \$850/month or single life annuities of \$1050/month. Thereafter, accruals of benefits, whether for normal or for J/S benefits, continue at the same rate for both the man and the woman. In this example, the plan bears an unfunded liability for any man who retires or leaves the firm during the one-year catching-up period, because the man's J/S benefits have been raised without any corresponding reduction in the woman's benefits. But after the catching-up period is completed, both men and women can retire with equal J/S

benefits, with no increase in liability for the plan, because the unisex benefit level has been chosen to have the same actuarial present value as the combination of separate male and female benefit levels previously used.

If pension plans used this approach to comply with H.R. 100/S. 372 (whether in its original form or as specified in your substitute), the procedure would be slightly different from that just outlined. Under either bill it would be necessary to pay all those retiring during the catching-up period who choose the J/S option the J/S benefit level guaranteed to the advantaged sex. (In the example used previously, men would have to be offered the \$850 guaranteed to females rather than the \$800 unisex benefit.) For this reason, the liability for the J/S benefits paid to those retiring during the catching-up period would be higher than for the voluntary conversions which have occurred previously. However, aggregate liabilities for persons retiring after the catching-up period would be no higher than they had been prior to the conversion to unisex. Single life annuity benefits, and the liabilities incurred to pay for them, would not be affected.

To our knowledge, conversions of this type have not been challenged in court on breach of contract grounds, and the Department of the Treasury does not regard them as violating the anti-cutback rule under the Employee Retirement Income Security Act (ERISA), which prohibits reductions in accrued benefits. It is not certain whether this approach would have been ruled by the courts to be consistent with the topping-up provision in the original bill, and it may be inconsistent with some state constitutional provisions governing state employee pensions. However, the elimination of the topping-up requirement from the bill appears to make it more likely that such conversions would occur. To the extent that conversions to unisex benefits took this form, and were not successfully challenged on legal grounds, the additional unfunded liabilities for pension plan benefits based on past accruals, whether in the original bill or in your substitute, would be reduced substantially.

#### Redistributive effects

The redistributive effects of the substitute bill would be smaller than those of the original bill, primarily because redistributions associated with pensions currently being paid and with existing life insurance contracts would be eliminated. Redistributive effects associated with new policies would be the same, except that the redistributive effects in automobile insurance could be affected by how Sec. 4(f) of the substitute bill was interpreted.

Sec. 4(f) of the proposed substitute bill states that no automobile insurer may charge different rates for men and women "except for nongender related risk-based reasons." We find the meaning of this provision ambiguous. The provision could be interpreted to mean "except for those risk-based reasons not explicitly based on sex," in which case it appears merely to restate the prohibition on sex discrimination contained in Sec. 4(a). Alternatively, it could be interpreted to mean "except for risk-based reasons not correlated with sex," in which case it would foreclose the greater use of alternative risk factors, such as mileage and accident and violation record, which we have suggested could be a possible consequence of the original bill. Because these risk factors are correlated with sex, their use would be illegal under this interpretation of the proposed Sec. 4(f). If the courts sanctioned this interpretation, the redistributive effects between men and women in auto insurance would be even larger than the \$700 million estimate by the American Academy of Actuaries mentioned in our earlier report. The industry could not only not make greater use of these sex-correlated alternative risk factors, but would have to discontinue their current use of these risk factors. Men's premiums would fall even more than under the original bill, because men could no longer be charged more on account of their higher accident, violation, and mileage rates. Women's premiums would rise more, because they would no longer get discounts on account of their lower accident, violation, and mileage rates. The redistribution in favor of men would thus be greater.

#### Efficiency effects

The efficiency effects, in general, would be the same under the substitute bill as under the original bill, unless Sec. 4(f) were interpreted to prohibit the use of risk factors correlated with sex. In this case, efficiency losses would increase because the size of the price changes for male and female policyholders would increase, and policyholders would be more likely to change their purchases of insurance. Also, the positive efficiency effects associated with substituting other risk factors would no longer be possible.

#### Administrative costs

The original bill would have required changing existing life insurance contracts, and these changes would have imposed administrative costs of \$800 million, according to the American Academy of Actuaries. By exempting existing individual life insurance contracts, the substitute bill makes these changes unnecessary, and thus would eliminate these administrative costs.



Eliminating this category of costs would reduce total administrative costs from \$1.3 billion to \$0.5 billion. The Academy's estimate was based on a transition period between the bill's date of enactment and its effective date of 12 to 18 months. Their estimate is thus consistent with the transition period provided for in the substitute bill.

The targeted marketing provision of the bill [Sec. 4(a)(4)] could affect the marketing practices of insurers. We have no basis for saying, however, whether additional costs such as advertising expenses would be incurred by insurers because of this provision.

### CONCLUSIONS

Your substitute bill addresses the concerns that were raised in our report about the economic effects of the original legislation. Specifically, it eliminates the applicability of the bill to existing life insurance contracts and extends the transition period to slightly more than 1 year. As a result, it virtually eliminates the risk of insolvency among life insurance companies, which we viewed as the most adverse economic effect of the original bill. The exemption of existing life insurance contracts also substantially reduces the bill's administrative costs. In addition, the substitute bill reduces the amount by which unfunded liabilities for pension plans would rise by eliminating the applicability of the bill to existing retirees, and may further reduce these increases in unfunded liabilities by eliminating the "topping-up" requirement. The exemption of existing life insurance contracts would also reduce somewhat the redistributive effects of the bill, though the efficiency effects would remain the same. However, both the efficiency and redistributive effects could be affected by the restrictions on risk classification in automobile insurance that are proposed in Sec. 4(f). This section of the substitute bill is ambiguous and should be revised to make its intent clear.

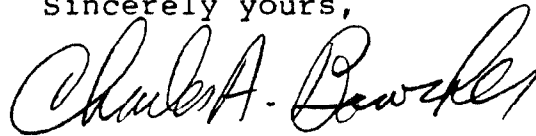
### RECOMMENDATION

The ambiguity in Sec. 4(f) of the substitute bill has the potential to increase the redistributive and economic efficiency effects of the substitute bill, perhaps in a way which was not intended. We recommend revising this provision to make clear whether it is intended to prohibit only risk factors explicitly based on sex, or risk factors correlated with sex as well.

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As arranged with your office, further distribution of this report will be restricted for thirty days. At that time, we will make the report available to those who request it.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Charles A. Bowles".

Comptroller General  
of the United States