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GUARANTEES OF RETIREMENT ANNUITIES

HEARING

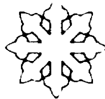
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

APRIL 5, 1990



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GUARANTEES OF RETIREMENT ANNUITIES

THURSDAY, APRIL 5, 1990

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:14 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Pryor, Packwood, Heinz, and Durenberger.

[The press release announcing the hearing follows:]

[Press Release No. H-18, Mar. 7, 1990]

SENATOR BENTSEN ANNOUNCES HEARING ON GUARANTEES OF RETIREMENT ANNUITIES; BENEFITS PAID BY INSURANCE COMPANIES SHOULD NOT BE AT RISK, CHAIRMAN SAYS

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman, announced Wednesday that the Senate Finance Committee will hold a hearing next month on Pension Benefit Guaranty Corporation insurance of retirement annuities provided by insurance companies.

The hearing will be held on Thursday, April 5, 1990 at 10 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"I am concerned that the pension benefits of American workers and retirees should not be jeopardized when their pension benefits are being paid by an insurance company, instead of by their former employer directly through a pension plan. I intend to make sure that their retirement security is not at risk. But recent concerns over the financial status of certain insurance companies have raised questions about whether retirement annuities purchased from insurance companies by pension funds have the same protection under the Employee Retirement Income Security Act of 1974, also known as ERISA, as pension benefits paid by the plan directly," Bentsen said.

"As one of the original authors of ERISA, I believe we need to clear up this matter to provide peace of mind to active employees, retirees and their families," Bentsen said.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order.

ERISA passed the Senate by a unanimous vote back in 1974. But, as one of the authors of that legislation, I want to tell you it wasn't all that easy. There were a lot of hurdles to jump. For 7 long years, Senators Williams and Javits had tried to get ERISA through the Senate. It was reported by the Labor Committee. But then it was not acted on by the Finance Committee. So when I joined the committee in 1973, I prevailed on the chairman to set up a subcommittee on pensions. We went to work on ERISA, and we were able to act on it.

One of the reasons that it was enacted, and that Congress agreed to it, was the belief that American workers were entitled to the pension benefits they had been promised. I knew of one instance back in Houston, where a particular chain of companies had a 30-year vesting requirement. The company could wait until the 29th year and fire the worker to deny him pension benefits; and there were cases where that had happened. That was a fundamental flaw in the law, which we corrected.

The other major reform we made was that, if the company went broke, there would be a guarantee that would protect that pension. I can recall when we were talking about setting the amount of the payment that the employer would make to the PBGC, they came in and recommended to me that it be 50 cents per employee. I said, well, I have had some experience in that business and have found that the actuaries sometimes are wrong. So why don't we just go for broke and double that and make it a whole dollar. And that is what we did. I have forgotten what the number is now, but it is far higher.

Senator PACKWOOD. $16.00 now.

The CHAIRMAN. $16.00 now they tell me.

But, what happens when a company turns its pension funds over to an insurance company? Let's say that insurance company went out and bought a bunch of junk bonds to get a high rate of return, allowing it to make unrealistic bids on annuities in order to take over the pension business. What would happen if that insurance company went broke?

Will those benefits be insured by the PBGC? I do not want to wait until we have a crisis before trying to come to some determination on that question. That is one of the concerns we will be addressing today, because the American workers should not have to be concerned about receiving pension benefits they are entitled to. We want to give them some peace of mind. Their pension checks ought to be in the mailbox month after month as promised.

I hope this hearing will shed some light on that.

I now defer to my colleague, Senator Packwood.

[The prepared statement of Senator Bentsen appears in the appendix.]

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Thank you, Mr. Chairman. As I told you, I have to go to a doctor's appointment. I'm going to leave after this opening statement, but I share your views and would like to make one or two additional points.

There is no question but what this committee wants to make sure that what we intended in ERISA works. If you earn a pension, you have a right to expect you will receive that pension. The Government wants to do as much as it can to ensure that retirees' pensions are paid. But I think I want to be careful, Mr. Chairman, of getting ourselves into an S&L situation whereby the Pension Benefit Guarantee Board guarantees all pensions. Insurance companies would then feel free to go out and speculate because we are going to take care of their pension obligations.

The CHAIRMAN. I could not agree with you more on that, Senator.

Senator PACKWOOD. So it is a thin line between saying to retirees, the Government will make sure your pension is guaranteed, without at the same time saying to insurers or employers that no matter what insurers or employers do with pension monies, the Government will cover all their mistakes.

If we say that, then I hesitate to think what kind of speculation we might encourage because people won't worry about it, thinking Senator Bentsen said he will take care of it.

So I am going to follow these hearings with interest and I apologize that I have to leave now.

The CHAIRMAN. Let me say, Senator Bentsen did not say he was going to take care of it. What we are trying to do today is get some answers and get the recommendation of experts.

Thank you very much.

This morning we have Mr. James Lockhart, who is the Executive Director of the Pension Benefit Guaranty Corporation.

Will you proceed?

STATEMENT OF JAMES B. LOCKHART III, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, ACCOMPANIED BY CAROL CONNOR FLOWE, GENERAL COUNSEL

Mr. LOCKHART. Thank you, Mr. Chairman, for inviting me to appear before you today. I am pleased to be here to discuss the Pension Benefit Guaranty Corporation and Pension Annuities. The PBGC insures defined benefit pension plan participants against loss if their are underfunded defined benefit pension plan his terminated.

We are a Government corporation that provides vital insurance protection for 40 million active and retired American workers in about 100,000 defined benefit pension plans. Companies that sponsor these plans pay for this protection through their premiums.

In 1989 we reduced our deficit by 30 percent, but it still stands at $1 billion, without any reserves for LTV Corporation. We expect the Supreme Court to rule in that case by June. A loss could more than double our deficit and, even worse, set the stage for "copycat cases." As the graph over there of our 10-year forecast shows, our future is difficult to predict. There are three scenarios there; and the range from the optimistic to the pessimistic forecast is almost $10 billion. In the optimistic forecast we see about a $1 billion surplus after 10 years; and in the pessimistic we should see almost an $8 billion deficit.

To try to prevent that pessimistic case, we have adopted a tough negotiating posture and loss prevention strategy. The President's budget discusses two topics that affect our future. They are "hidden Pacmen" and "moral hazards." Hidden Pacmen are Federal liabilities that are not fully visible, including the $820 billion of pension liabilities that we insure. These liabilities are backed first by well over $1 trillion in plan assets and then the net worth of the plan sponsors. The real exposure to the PBGC is approximately $20-30 billion in underfunded plans concentrated in the auto, steel and airline industries.

A "moral hazard" occurs if an insured is willing to take a higher risk if he knows that the insurance company will pay. Another moral hazard occurs when a Government insurance company insures losses over which it has no regulatory control. As the budget states, and I quote, "A 'moral hazard' should be balanced by controls or offsetting incentives."

Now turning to the subject of annuities purchased from insurance companies, we are concerned that retirees receive sound annuities and we are taking steps to ensure that that happens. We are also concerned about the potential for another hidden Pacman. If we were to insure without proper premiums and regulatory control over insurance companies, large losses could occur.

When a fully funded defined benefit pension plan terminates, the plan administrator must provide annuities from an insurance company to all participants and beneficiaries, unless they elect a lump sum distribution. Many ongoing plans also purchase annuities for retirees. The annuity requirement was adopted so that participants would have the option of receiving their benefits as a lifetime monthly income.

We know of no one who has lost benefits from annuities purchased upon plan termination. Insurance companies are subject to State regulation and now, with the recent addition of Wyoming, 45 States have guarantee arrangements. These arrangements are not prefunded and do have limits. Nevertheless, in the one major case—Baldwin United—the insurance industry and the States of Arkansas and Indiana made sure that all annuity holders were paid in full.

It is our legal analysis that Title IV does not authorize us to guarantee annuities. An earlier statement was made without the benefit of this analysis. In a January 1981 Preamble to a regulation on termination procedures, we responded to a comment by indicating that the agency would pay guaranteed benefits if an insurer defaulted and the State insurance funds did not cover the loss.

After questions were raised about the statement, the Administration made a proposals, in 1983 and 1985, to add language to Title IV clarifying that PBGC did not guarantee annuities. The legislative history does not explain why it was not adopted, nor does the history indicate any disagreement with the clarification. We believe that if Congress had intended us to insure annuities, it would have expressly said so.

Title IV provides that the only "insurable event" is termination of a plan. When an underfunded plan terminates, PBGC is required to pay guaranteed benefits. When a fully funded plan terminates, the Plan Administrator certifies to us that he has distributed assets to satisfy all benefits. If the Administrator makes an error and does not correct it, we will then pay guaranteed benefit. Once the correct distribution is made, the agency is no longer liable.

We do not receive premiums for these annuities, and insuring them would add up to $50 billion in additional exposure. Our insurance might give the plan sponsor an incentive to buy the lowest acceptable quality annuity, or for the insurance company to invest in lower quality assets. As the insurance companies are regulated

by the States, the Federal Government would have no power to regulate the annuity company.

The creation of a sound Federal insurance program for annuity companies raises many complex and contentious issues that should not be underestimated: How can we set risk adjusted premiums with no loss experience; how do we identify and handle the $50 billion in annuities already in place; how would we integrate a Federal program with the existing State guarantee arrangements; what priority should our claims against an insolvent insurance company have; what impact would the guarantee have on the marketplace; what guarantee limits should be set.

The answer is that the guarantee function should be left at the State level. If arrangements are not adequate, the States and the industry should be encouraged to make the guarantee arrangements acceptable.

We want retirees to receive a safe annuity. The Plan Administrator's selection of an insurer is a fiduciary responsibility subject to Title I of ERISA, which is enforced by the Department of Labor.

We are working with Labor to ensure that the fiduciary standards are followed. And as a first step, the PBGC and PNBA are requiring sponsors to inform us of the annuity company they will use before the termination is completed. We will incorporate this requirement into new regulations. Labor will investigate selections where appropriate. In addition, we are considering standards for Plan Administrators to follow in the selection of an insurance company.

We are committed to the long-term health of the private pension system. We will enforce standards to encourage sponsors to prudently select annuity providers. We will remain tough in preventing unwarranted claims and protecting participants. In this way, we will continue to protect the insurance fund and the nation's retirees.

Thank you for the opportunity to speak before the committee. I welcome any questions you may have.

[The prepared statement of Mr. Lockhart appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Lockhart.

It concerns me that we do not have direct supervision over the insurance companies. That job is left to the States. There is substantial variance among the States in the level and degree of supervision.

I can recall starting a life insurance company back in Texas in 1954, the worst time I could have started one. At that time, there were all kinds of reports of fraud. I immediately decided the thing for me to do was to buy a company in a State that had a reputation for being very conservative, and I merged my Texas company with it. Since then, Texas has made major changes in its supervision.

The variation in supervision from State to State disturbs me. I do not see any way that the Federal Government, at this point, is going to substitute Federal supervision for State supervision.

What I am probing for is what happens when the individual beneficiary has had absolutely no say in the choice of the company that is carrying his annuity. That is not an easy issue to resolve. That is the purpose of this hearing.

Mr. LOCKHART. I agree with you. It is not an easy question. I think you have to go back again to the standards of Title I of ERISA where there are requirements, fiduciary standards in ERISA. An Administrator choosing an annuity has to follow those standards. And I think generally it has worked out well.

As I said in my testimony, there is no loss experience in this area.

The CHAIRMAN. Well, let me give you another example. You talked about the funds set up in a number of States to protect against this situation. I know that, in one of the States that set up such a fund, some companies went broke. Yet, they have paid no claims against the Fund, and they have been resisting such claims. Again, that concerns me.

But let me ask you about a 1981 PBGC regulation, which stated, "In the unlikely event that an insurance company should fail and its obligations cannot be satisfied, the PBGC would provide the necessary benefits."

Would you expand on that for me?

Mr. LOCKHART. Yes. That is the Preamble to the 1981 regulation that I mentioned. It is a Preamble and, therefore, it does not have legal standing.

As I said in my testimony, we feel that that statement was made in error. We are putting out a new regulation. It went out for comments in 1987 and should be out this fall; and there certainly will not be a preamble like that to the new regulation.

The CHAIRMAN. Are you an attorney?

Mr. LOCKHART. No, sir. My general counsel is sitting next to me though.

The CHAIRMAN. Well, you attorneys continue to amaze me the way you split hairs on some of these things. [Laughter.]

As one who has a license, I can say that.

Senator Durenberger?

OPENING STATEMENT OF HON. DAVE DURENBERGER, A U.S. SENATOR FROM MINNESOTA

Senator DURENBERGER. Mr. Chairman, thank you very much; and thank you for your comments. I just want to say why I'm here. Not because it is a really exciting subject. It is not. I do not know how we can fill up a room on this subject with so many interesting looking people. But I am here because you are here, Jim; and I am here because I am also on Labor and Human Resources, which is the other half of the pension business.

But principally I guess I am here because I spent a year of my life—and part because I am on this committee, I guess—as a member of the Pepper Commission. And out of that came a strong interest in income security reform generally. In other words, how are we going to guarantee 20 years from now the medical, long-term care, all the rest of those things? And don't we have a system that got built in the 1940s predicated on the prices of the 1950s and the 1960s that is kind of out of hand. So anyway, that is why I am here.

Specifically, though, with regard to the insurance company annuity issues, do you have a system now or a set of criteria now that are used for rating insurers that you have confidence in?

Mr. LOCKHART. We have set up a procedure with the Department of Labor, the Pension Welfare Benefits Administration, which has responsibility for Title I of ERISA and we have agreed to criteria. When a plan intends to terminate, the plan administrator must submit information to us. And we are requiring plan administrators to tell us what insurance company they are going to use. If there is a questionable insurance company we will send it to the Department of Labor for possible investigation.

Senator DURENBERGER. Now what is a questionable insurance company?

Mr. LOCKHART. We are reviewing some internal guidelines I do not want to spell out at this point.

Senator DURENBERGER. You do not want to?

Mr. LOCKHART. No, sir. Because I think it could have some impact on the marketplace at this point. They are preliminary guidelines, and we want to work through the system before we publish them. That is why I said in my testimony that we are thinking of coming up with specific guidelines that we would publish. But at this point we are using working criteria.

It really is a combination of credit ratings from several of the various credit rating agencies, as of the initial cut off list for referral to PWBA. And then PWBA will then use those referrals and decide whether it is appropriate to investigate.

Senator DURENBERGER. Are you contemplating looking at all beyond the credit ratings at the nature of the investments that some of these insurance companies are making? I am thinking, of course, about speculative real estate, junk bonds, that sort of thing. Are you going to take this another step?

Mr. LOCKHART. It certainly has been suggested. But one of the issues is that we have 50 States looking at that. They have long sets of procedures. We would have to recreate all this at the Federal level. So we would prefer to try to set up criteria. I mean, the obvious criteria would be to have an acceptable State guarantee fund. That would be, to us, the best thing.

Beyond that, we would then look at perhaps credit rating of insurance companies. If we felt that was not acceptable, we would have to go to the kind of detail that you are suggesting, Senator.

Senator DURENBERGER. When we see your rating system, what might we see in there by way of a future protection? I could see a situation which you could pick a AAA rated 1990 company. But how are we going to know whether or not in 1994, 1998, 2005, you know, that sort of thing, it is still a AAA company and what role do you see in that whole process?

Mr. LOCKHART. That is a difficult issue. The rating agencies in theory are trying to look ahead and they are trying to predict the future. But it is difficult. You can have a change of management. You can certainly have a change in the marketplace, which the junk bond situation had. And there is really no protection against that kind of change. I think it is up to the State regulatory authorities to stay on top of these companies to make sure that these events do not occur.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The leadership has called a meeting that I have to attend. So I would like to call the next three witnesses as a panel so I will have an opportunity to hear them. So I would ask Mr. Bywater to please come forward and Mr. Crites, and Mr. Minck.

Senator DURENBERGER. Mr. Chairman, I have a statement that I would appreciate being able to insert in the record.

The CHAIRMAN. That will be done.

[The prepared statement of Senator Durenberger appears in the appendix.]

Senator DURENBERGER. Thank you, Mr. Chairman.

The CHAIRMAN. What we have set out to do here is to try to get the viewpoint of all the interested parties. First, we heard from the Executive Director the Pension Benefit Guaranty Corporation. And next, Mr. Bywater, who is the president of the International Union of Electrical Workers, is testifying on behalf of the AFL-CIO; Mr. Dennis Crites is a member of the National Legislative Council of American Association of Retired Persons, from Norman, OK; and Mr. Richard Minck is the executive vice president of American Council of Life Insurance from Washington, DC.

Mr. Bywater, would you lead off, please.

STATEMENT OF WILLIAM H. BYWATER, PRESIDENT, INTERNATIONAL UNION OF ELECTRONIC WORKERS, WASHINGTON, DC, ACCOMPANIED BY MEREDITH MILLER, ASSISTANT DIRECTOR, DEPARTMENT OF EMPLOYEE BENEFITS, AFL-CIO, AND JAMES MAURO, COUNSEL, INTERNATIONAL UNION OF ELECTRICAL WORKERS, WASHINGTON, DC

Mr. BYWATER. Senator, I just want to say your opening statement was excellent. We totally agree with you.

The CHAIRMAN. Thank you.

Mr. BYWATER. My name is Bill Bywater and I appear before the committee on behalf of the AFL-CIO and the IUE and the workers we represent at the Louis Allis Division, Magnetek Corporation plants in Milwaukee and New Berlin, WI whose retirement security is threatened.

We are grateful for the opportunity to appear today and for the Finance Committee's interest in determining whether benefits payable under retirement annuities by insurance companies are guaranteed by the Pension Benefit Guarantee Corporation. We maintain that current law requires that the PBGC guarantee pension benefits payable by annuities. Plan participants and beneficiaries would also benefit from an inquiry into the consequences of companies which purchase annuities as a device to milk pension plans for the benefit of financial manipulators.

A dramatic example of the manipulation of the pension funds to the detriment of the beneficiaries continues to unfold at the Louis Allis plants represented by the IUE. While this potentially tragic situation is typical of others where annuities have been purchased from a financially troubled Executive Life Insurance Company of California, linked to Drexel Burnham Lambert and its "junk-bond" dealings, in other ways the Louis Allis story dramatically differs.

The AFL-CIO and the IUE have in other forums, supported the basic right of workers to have a voice in the investment of their pension assets as reflected in H.R. 2664, introduced by Congressman Visclosky. We also appreciate the efforts of various Senators to stem the tide of employer seizures of the assets of so-called over-funded pension plans.

Magnetek was created in 1984 by the much publicized high-yield or junk bond department of Drexel Burnham Lambert in Hollywood, CA for the express purpose of purchasing the Magnetics Division of Litton Industries. Drexel Burnham not only created the funding device for underwriting the company, but became, and has remained, a principal owner of Magnetek.

At the time of its organization, more than 10 percent of the junk bond underwriting of Magnetek was purchased by the Executive Life Insurance Co. of California another interest with close ties to Drexel Burnham and, perhaps, the country's largest purchaser of junk bond issues.

Shortly after taking control of the over-funded Louis Allis Division employees' pension plan, now called the "Magnetic General Retirement Plan," which had assets of approximately $23 million, covering more than 1200 employees, the new company made no contributions to the plan, even though employees were required to contribute between 2 and 4 percent of their annual earnings. Magnetek's Pension Plan Trustees, including at least two associated directly with Drexel Burnham, reached an understanding with Executive Life Insurance Company which has resulted in the transfer of approximately $25 million from the pension plan to Executive Life Insurance in return for annuity contracts covering accrued past service liability prior to July 1, 1988. Despite the protests of the IUE, the growing concern of Louis Allis employees for the safety of their retirement income and the deepening crisis in the junk bond market and the affairs of Executive Life Insurance Company; Magnetek has continued to sell off pension plan assets to Executive Life in exchange for annuity promises—and I emphasize promises.

It is important to note that Magnetek has never terminated this pension plan. It kept the shell to transfer monies to a principal stockholder, Executive Life. This was done to avoid scrutiny by the Federal regulators into these transactions, and to continue to collect contributions from Louis Allis workers for the purpose of satisfying the underfunded liability of pension plans covering other acquisitions Magnetek has made in recent years.

Furthermore, the committee should be aware that all of these steps, which are of vital significance to Louis Allis employees, were taken by the Company, without the knowledge of the beneficiaries of these plans or the Unions which represent them. On the contrary, requests for information about these transactions have been met with misleading and inaccurate statements to the Union.

It has also caused alarm among the beneficiaries of the Plan, that despite the approximately $25 million which has been transferred by Magnetek to Executive Life since 1985, no annuity certificates have been issued to IUE-represented employees or retirees and nothing more than a bare-bones insurance proposal and acceptance exists to substantiate the transaction between Magnetek and Executive Life.

Magnetek has advised the IUE that the $25 million in annuity contracts with Executive Life are no longer reported as plan assets—or, for that matter as plan liabilities—and no premiums are being paid to the PBGC on these amounts. This, we believe, is totally wrong. Consequently, largely for these reasons, it has been the position of the U.S. Department of Labor and the PBGC that this type of annuity contract is not protected by the PBGC and that should the position of Executive Life Insurance continue to deteriorate and the annuities dishonored, Louis Allis employees would not have recourse under PBGC protections.

Therefore, our concerns for the security of paid for retirement benefits are deepened by the Federal Government's disinclination to guarantee these benefits. For decades the IUE and its local Unions have established a pension program which will permit our members to retire with financial security and dignity through hard-fought negotiations.

The CHAIRMAN. Mr. Bywater, if you would summarize because I want to hear the other witnesses.

Mr. BYWATER. Okay. Well what it comes down to, sir, is that we feel these abuses cry out for congressional scrutiny and legislative action. And the IUE and the AFL-CIO welcome the opportunity of working with you to develop programs to give workers a voice in running their pension plans and in preventing the type of manipulations we have experienced.

Thank you very much.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Bywater appears in the appendix.]

The CHAIRMAN. Dr. Crites, if you would give us your testimony, please.

STATEMENT OF DENNIS M. CRITES, PH.D., MEMBER, NATIONAL LEGISLATIVE COUNCIL, AMERICAN ASSOCIATION OF RETIRED PERSONS, NORMAN, OK, ACCOMPANIED BY DAVID CERTNER, LEGISLATIVE REPRESENTATIVE

Dr. CRITES. Thank you. My name is Dennis Crites and I am a member of the AARP National Legislative Council. With me is David Certner of the AARP Federal Affairs staff. AARP is pleased to testify today on the Pension Benefit Guaranty Corporation's protection for retirement annuities.

The PBGC was created as part of the ERISA to ensure that participants of defined benefit pension plans would be guaranteed promised benefits, at least up to the specified maximum level. The PBGC provides protection if a company cannot meet its benefit obligations. Pension plans do not, however, always pay benefits directly to retirees. Often a plan purchases annuities from an insurance company which in turn provides the benefits.

Our Association believes that current law also requires the PBGC to guarantee retirement benefits that are paid through an insurance company. While this issue has not been tested, the Association believes the following references compel this result.

First, the basic thrust of ERISA is to ensure the payment of promised benefits. Consistent with this goal, the PBGC was cre-

ated. In particular, one of the explicit statutory purposes of the PBGC is to "provide for the timely and uninterrupted payment of pension benefits."

Second, the PBGC itself, in regulations published in 1981 stated that if an insurance company failed and the insurance industry could not satisfy the obligations, then the PBGC would provide the necessary benefits.

Third, Congress affirmed this position in the 1986 Single- Employer Pension Plans Amendment Act by obligating PBGC to continue its guarantee if all benefits were not paid. These reasons, considered in the context of ERISA's intended benefit protections, make it clear that the original PBGC benefit guarantee must continue.

It is incongruous to say that the basic PBGC guarantee is lost merely because an insurance carrier is the vehicle chosen to provide the guaranteed benefits. While no insurance carrier has yet failed to make an annuity payment, the importance of the continued PBGC guarantee has recently been highlighted. In particular, some have questioned the financial soundness of certain insurers, especially those with large junk bond holdings or other declining investments.

This situation has been exacerbated by the past decade's unprecedented raid on pension assets. In these pension stripping terminations for reversions, assets intended for future retirement security revert to the employer, while past liabilities are currently provided by the purchase of annuities.

The employer in this situation has a financial incentive to purchase annuities from the least expensive and often the least secure insurance carrier in order to maximize the reversion amount. Already over $20 billion has been taken from pension funds and over 2 million workers and retirees have been affected.

The Association recommends three steps to better ensure promised benefits for workers and retirees. First, this committee may need to clarify that current law does require the PBGC to guarantee insurance annuities. To prevent undue financial exposure for PBGC, State reinsurance systems should remain the first line of guarantee. This committee should consider requiring that pension annuity carriers be backed up by State reinsurance systems.

However, the PBGC must remain the ultimate guarantor that benefits will be paid. If PBGC is exposed to additional risk, then an additional premium should be assessed. This could be collected from an ongoing plan or collected as an additional amount upon plan termination.

Second, PBGC, working with the Department of Labor, should require pretermination review of the choice of insurance carrier. The Department of Labor should vigorously enforce the fiduciary duties of prudence and diligence in the employer's choice of an insurer.

Third, terminations for reversions which reduce assets intended for retirement benefits and increase the purchase of annuities should be restricted.

The Association believes these changes will better secure the payment of promised retirement benefits and fulfill the PBGC mandate to guarantee these benefits.

Thank you.

The CHAIRMAN. Thank you very much, Dr. Crites.
[The prepared statement of Dr. Crites appears in the appendix.]
The CHAIRMAN. Mr. Minck.

STATEMENT OF RICHARD V. MINCK, EXECUTIVE VICE PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE, WASHINGTON, DC, ACCOMPANIED BY PAUL REARDON, DIRECTOR OF INVESTMENT RESEARCH

Mr. MINCK. Thank you, Mr. Chairman, gentlemen.

I am Richard Minck, executive vice president of the American Council of Life Insurance. With me is Paul Reardon who is our director of investment research. We both appreciate the opportunity to discuss the security of retirement annuities issued by life insurance companies.

To put my statement in some context, it is important to note that all of a life insurance company's general account assets, including its surplus, stand behind all of its general account promises and guarantees. A question of the soundness of annuity guarantees cannot be separated from the issue of the soundness of our business as a whole.

That business is basically sound and secure. Our companies have a long history of making conservative long-term investments and our investment portfolios are widely diversified. Obviously, all companies are not of the same strength and financial condition. And, as is true in all segments of the business community, a handful of companies may have taken more risk than is wise. But just as clearly, there is no emergency which threatens the annuity guarantees our companies have made.

Our statement discusses in some detail the current financial status of the life insurance business and the protections that are in place to ensure that we are appropriately managing our affairs so as to be able to carry out our contracts. It also describes current actions by the National Association of Insurance Commissioners and by committees of the ACLI to determine if any added measures need to be taken to protect the public's trust in us.

I would like to briefly summarize a few more key points that are made in the statement and I hope the statement will be included in the record.

The CHAIRMAN. Without objection, that will be done.

Mr. MINCK. Thank you.

[The prepared statement of Mr. Minck appears in the appendix.]

Mr. MINCK. Unfortunately, there is a catchy phrase on Wall-street—namely "junk"—being used to describe a broad array of bonds. Many of these issues are appropriate and profitable components of a well managed portfolio. They can, as a small addition to a more conservative bond portfolio enhance the average yield without much increase in risk. Investment managers, including life insurers, buy them because they are sound investments and such issues provide access to capital for some of America's most promising growth companies.

There are only about 800 corporations in the U.S. that can issue investment grade bonds. So that whatever the rest of the corporations issue is included in this label of "junk".

Of the general account assets of life insurance companies about 3.5 percent are invested in this whole array of less than investment grade bonds. If you had a large drop in values in this bond market, it would have a limited impact on the life insurance business and on the people that it serves. Currently bonds in default constitute about an eighth of 1 percent of general account assets.

Now a severe drop in market values might occur if you had either a severe recession or rampant inflation. Our economists do not think either of those is on the immediate horizon. But just as actuaries are sometimes wrong, economists have occasionally been optimistic too.

Our business is closely supervised by the States, as is explained in some detail in the statement. The primary purpose of the regulation is to ensure company solvency. This is not a static system. Many changes have been made to strengthen the system in recent years. There are better laws, larger staffs, increased use of computer technology, and more urgency.

The combination of well-managed, conservative investment practices and State supervision and guarantees has produced an unblemished record since the enactment of ERISA. As Secretary Dole observed, not one retiree or beneficiary has lost a penny of retirement benefits provided by annuities issued by life insurers. The public's confidence it will continue this record is terribly important to us. Keeping the trust of the public is necessary if we are to remain in business.

We cannot, of course, guarantee a perfect record for all companies forever. But we do not see an immediate crisis. We think there is no need to take precipitous action now, particularly action that might cause significant or needless dislocations in our business or in the operations of the PBGC. We think time needs to be taken to examine the problem. And if there is a serious problem that needs action, then to design an appropriate response. We think that analysis has not been done yet.

We have a chief executive officer group studying the question. Their report will be available before the end of this year; and we think it will make a valuable contribution to the process.

We thank you for the opportunity to testify this morning. Mr. Reardon and I will be glad to try to answer any questions that you may have.

The CHAIRMAN. Mr. Minck, I am going to have to leave because of my other meeting. Senator Pryor will be residing.

I would certainly agree with you that the vast major of insurance companies are sound and prudently managed. Did I understand you to say that the average amount of so-called junk bonds held by insurance companies was 3.5 percent?

Mr. MINCK. Yes, sir.

The CHAIRMAN. Well I think that that would certainly come within the province of the prudent man rule. As far as I am concerned, they can put it in gold, stock or whatever they wanted to, if it was 3.5 percent of the portfolio. But if you have one company that has 30 percent of its assets in junk bonds, making up that average of 3.5 percent, then that company is in real trouble and that is not prudent management. That is what concerns you.

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And then we have the debate here—Mr. Bywater believes there is a legal obligation in the regulations for the PBGC to insure these contracts. On the other hand, Mr. Lockhart is contending that that is not the case. So obviously, the legal question involved will take some time to resolve.

The question to decide is whether we take care of this problem by more vigorous management by the PBGC to ensure that these policies are held by companies that have been prudent and are solvent or by having the PBGC guarantee these annuities. I am trying to hear from both sides of the argument so that we can better resolve how to address this problem.

Senator PRYOR. Thank you, Mr. Chairman.

Mr. Bywater, have you made your statement yet?

Mr. BYWATER. Yes, I have.

Senator PRYOR. You have made your statement. Mr. Minck has made his statement. Dr. Crites has not made his statement, I believe.

Dr. CRITES. No, I have made it, sir.

Senator PRYOR. Oh, you have made it. Well I am sorry I missed hearing from the AARP. Now, are there other panelists that have not yet made their statement?

[No response.]

Senator PRYOR. I was going to yield to Senator Durenberger but I see that he is gone. So I will yield to myself here for a few questions. [Laughter.]

Mr. Minck, let me ask this question of you. I do not think the Congress right now, as an institution, grasps the magnitude of what we are talking about here. I am not saying we are in a crisis. What I am saying is we want to prevent a crisis. What should the Congress do? How should we address this issue? Should we do nothing? Should we let things percolate, or should we take action at this time?

Mr. MINCK. Senator Pryor, our view is that the problem is intimately tied up with the solvency of life insurance companies and that traditionally has been the concern of the States, both in their regulatory side from preventing insolvencies and in the guarantee fund area to clean up after those relatively few insolvencies that occur.

The number of insolvencies per year of life insurance companies in the last decade has arranged about 20 or so. Last year there were, I think, 36, of which perhaps 18 were in one State. None of them, I believe, involved losses to policyholders.

Whenever a company goes insolvent there is a large body of assets that are the first source of payment to the people with claims. Beneficiaries and policyholders are in the prime situation for being repaid from these assets. Creditors, including the Federal Government and the State Government, stand behind the beneficiaries. The stockholders stand at the very end. If you do catch an insolvency immediately after it occurred, there is very little in the way of losses for policyholders on beneficiaries to be made up by guarantee funds.

But, solvency is a matter that has been of concern to the life insurance business. We have formed a board lėvel committee last

year to start working on it. They have done a fair amount of work. We think their analysis will be complete before the end of the year.

The NAIC, the State regulators, are also concerned. They are working on the problem. They are having a meeting this month, in fact in the coming week, to make some suggested changes in matters related to solvency.

I guess my advice to the Congress would be to let those two things play out. Because I think that you will see improvement and changes within the year and I do not see there being a catastrophe in that time frame.

Senator PRYOR. In those cases where insurance companies have become insolvent, have the States been able to come forward and pay the claimants 100 percent through reinsurance or some other means?

Mr. MINCK. Typically the process is that the State conservators would attempt to find companies to reinsure blocks of the business. That often occurs. To the extent that there are still benefits to be paid in those States with guaranty fund laws, a guaranty fund pays the remaining benefits. There are some four or five States that do not have guaranty fund laws yet.

Senator PRYOR. I would like to ask about those four or five States. I would like to ask this question: That is, should the PBGC prohibit the purchasing of annuity contracts from those companies in those States?

Mr. MINCK. Well, again, there are some complications. Because there are two general forms of State laws. One covers purely the people that live in the State, so that if a company from a State without a guarantee law were to become insolvent the guarantee laws of the State in which the people who had purchased the contracts live would step up and pay the benefits.

Correspondingly, some of the States have laws that guarantee benefits promised by insolvent companies from those States wherever the contract holders live.

So I think if you were to go into something like that you would have to look very closely and more careful distinctions. Again, I think that any time you reduce the number of participants in the market you may be doing some damage to the market.

Senator PRYOR. The reason I am moving over here, is that I think this microphone is better. I have always wondered how the Chairman preempted the rest of us. I see he has the loudest microphone. I have just discovered a secret here. [Laughter.]

Dr. Crites, you are our good neighbor to the west. Arkansas and Oklahoma have always been good neighbors and I know that we have thousands of retirees in our States. They are becoming nervous about these pension funds. They are beginning to see information that gives them the jitters about their retirement checks and whether or not these funds are guaranteed.

How deep is this sentiment out there?

Dr. CRITES. I have no way of measuring precisely how deep this sentiment is. There is a growing uncertainty and question, however, as the newspapers are filled with references to maybe one or two insurance companies that are inducing a precarious condition.

Certainly on the part of the employees of firms where there have been reversions, where there is the possibility of a takeover, there

is great, great concern about the guarantee of their retirement benefits.

Senator PRYOR. There is great concern. Would you say the concern is growing at this time?

Dr. CRITES. I would say it is growing. And on the part of employees where they see their company at risk, it is a very great concern.

Senator PRYOR. Mr. Bywater has talked, I think at length in his statement—I do wish I could have heard your statement, Mr. Bywater—about those situations where pensions were actually at risk. And when the claimant actually had to seek their pension or seek the sum they were owed. What happens in the court system? How long does it take such a claim to be processed? How long does it take a retiree to receive his or her funding?

Mr. BYWATER. Well so far the retirees that we have now have been paid. Our concern is about the future.

When I heard Mr. Minck testify and say that the economists are saying everything looks rosy for the foreseeable future, you do not base a pension plan on a matter of a few years ahead. You base it on a matter of 30 years or more, when you are talking about pension plans. Our people are very much concerned about the junk bonds that are in effect backing up the pension plans of these individuals.

The fact is that our members have paid into that pension plan. Their money has been used. And when we try to get information from the company about this, they are very evasive. It took us months to get information from the company. They did not notify us that they are selling off to Executive Life Insurance Company.

And as you know, and I am sure you have read in the paper, I would say they are on shaky ground—Executive Life Insurance Company. I hope they do not collapse for the sake of our own people, but there is no guarantee there. I think that something has to come out of Congress that will guarantee to the workers of this country that there is no way that they are going to lose their pension benefits.

Once those people lose their pension benefits, they wind up on relief. And that means the States then have an obligation to take care of them, and the Government. That becomes something that is saddled on all taxpayers and that is not fair either.

So I do not see any comfort, for example, in life insurance companies saying, well only 5 percent of the companies go down the drain. That 5 percent that goes down the drain, those people that are affected, you tell them, hey, the other 90 percent are doing great, they are going to get their money. That does not help them any.

We have to have a system that is going to protect all workers. I think one of the guarantees of a system that would protect the workers is that workers themselves could be involved as being directly involved in a pension plan themselves and where the assets go and so forth. That is certainly something we want to see changed in the law.

Senator PRYOR. Recently the Inspector General for the Department of Labor was very critical of his Department for the lack of

proper enforcement and aggressive enforcement of the fiduciary rules and regulations of ERISA.

I wonder if any members of the panel this morning might like to comment on the Inspector General's recent findings.

Ms. Miller?

Ms. MILLER. Yes. We are very much concerned about those findings in terms of the personnel and the number of resources that are devoted to that. I think that the question becomes even if in the enforcement area we beefed up the number of folks who were monitoring and policing pension plans, there still remains, unfortunately, in this area that we are dealing with today, the issue of what is it that they should be guaranteeing, what is it that makes a good and secure annuity, and whose obligation is it.

So while we are very much concerned about enforcement we are unclear, that unless we get some clear resolution from Congress that supports our position that these annuities are already guaranteed by the PBGC, that that might help.

Senator PRYOR. Any other comment on the Department of Labor's Inspector General's report?

Mr. CERTNER. I would just add to that that one of the things that we have called for is increased Department of Labor enforcement of the insurance guarantee, to make sure that the insurance company from which the annuity is purchased is on sound footing.

Now the Department of Labor may be able to do that with stepped up enforcement at this point in time. However, even a company that may be on sound financial footing today, 5 years down the road may not be. And there is nothing the Department could do to prevent that situation from happening. That is why it is important to affirm that the PBGC guarantee continues.

Senator PRYOR. Has the issue of the PBGC guaranteeing insurance annuities ever been litigated in any court?

Mr. CERTNER. Not to our knowledge.

Dr. CRITES. Not to our knowledge.

Senator PRYOR. If it were to be litigated, how long would it take?

Mr. CERTNER. Well it certainly would not be desired if the outcome was a losing one for the retirees. We would like to clarify this issue up front before someone is at risk.

Mr. MAURO. Senator Pryor?

Senator PRYOR. Yes, sir.

Mr. MAURO. We are faced with that possibility, as the representative of the employees at Magnetek. Heaven help us that we ever get to that point. But I do not think there is a lawyer in this room that would think that a final decision in a case like that would be decided in less than 5 or 6 years. And in the meantime, those employees are without pension benefits. And as President Bywater mentioned, they are on welfare or they are the wards of the State or the Federal Government.

Senator PRYOR. If such a case were pending for a period of 5 or 6 years, what sort of concerns would run through the retiree community? Would there be increased uncertainty until the courts finally decided?

Mr. MAURO. I think, Senator, there is increased uncertainty that exists right now. When daily the retirees of companies that are participants in the junk bond process are reading that their insur-

ance companies that insure their annuities are on the verge of potential collapse. That would just exacerbate the problem if it would, in fact, happen and litigation were brought.

We would hope that Congress would act to avoid that and to avoid—I believe Mr. Lockhart mentioned—the hidden Pacmen. It is our members and the retirees of our companies that are the ones that are going to be eaten up by this process, unfortunately, as well as major portions of the Federal budget.

Senator PRYOR. Mr. Minck, do you have a comment on this?

Mr. MINCK. I have one observation. First of all I would like to make clear what I did say about insolvency rates, I listed something like 36 companies of becoming insolvent last year. That includes some property and casualty companies. It amounted to about 1 percent of the companies and I think none of them were in this market and nobody lost anything from these insolvencies either in annuities of in other coverage.

I think I would also like to make it clear that we are very much concerned that nobody ever lose anything. We want every pensioner to get every dollar coming to him. I think our interests are identical with the other witnesses from that point of view.

I think one reason that the question of whether the PBGC guarantee annuities has never been before a court is that nobody has ever lost anything. There has been nothing that would get you into court. And again, we would hope that that would continue to be the case.

And lastly, the reason I mentioned the economic situation looking fairly good was in the context of Congress perhaps not having to do anything this week or this month, but perhaps waiting to see how the changes being worked on by the States and the insurance companies worked out, so that you knew what it was you were trying to fix. Because it is a fluid situation and factors are changing.

Senator PRYOR. I have exhausted my questions this morning. I really appreciate all of our witnesses. I wonder if there are any final comments by any of the witnesses.

[No response.]

Senator PRYOR. We appreciate this very distinguished panel coming before the Finance Committee. This will contribute a great deal to the debate and to our further understanding of this issue.

We thank all of you and our committee stands adjourned.

[Whereupon, the hearing was adjourned at 11:10 a.m.]

APPENDIX

Additional Material Submitted

Prepared Statement of Senator Lloyd Bentsen

ERISA passed the Senate by a unanimous vote in 1974. But as one of the authors of that legislation, let me assure you that it wasn't easy. There were a lot of hurdles to jump. Senator Javits had been trying to get pension legislation enacted for 7 long years. When I first joined the Finance Committee in 1973, enactment of ERISA became my highest priority. Working with Jake Javits and Harrison Williams of New Jersey, who was then Chairman of the Labor Committee, we jumped all those hurdles. The Senate passed the bill in 1973 and President Ford signed the bill in the Rose Garden on Labor Day of 1974.

The reason ERISA was enacted was that enough members of Congress agreed on this basic point: American workers are entitled to the pension benefits they have been promised all of the pension benefits. They shouldn't be denied their pension because they got fired the day before becoming vested. They shouldn't be denied it because their employer didn't fund the plan and later went bankrupt.

That was and continues to be the fundamental goal of ERISA—making sure people get the pension benefits that they are due, and the Pension Benefit Guaranty Corporation has helped guarantee that. The PBGC was established, according to ERISA, to provide "for the timely and uninterrupted payment of pension benefits to participants and beneficiaries." The PBGC guarantees that if a company goes broke, the worker who earned a pension will get it.

But what happens when a company turns its pension funds over to an insurance company? Recently, concerns over the financial status of some insurance companies have raised questions about the soundness of the retirement benefits those insurance companies have been entrusted to provide. This in turn has raised another question: will those benefits be insured by the PBGC if the insurance company folds?

I don't want to wait until a crisis arises for an answer to those questions. Whether pension benefits are handled directly by a pension plan or through an insurance company, American workers and retirees should not have to worry about whether they'll be receiving what is rightfully theirs.

We need to clear up this matter and provide peace of mind to active employees, retirees and their families. People shouldn't have some insurance company telling them their pension check is in the mail. Pension checks should be in the mailbox—month after month, just like they've been promised. I hope today's hearing will begin to shed some light on this issue.

Attachment.

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

[Prepared by the Staff of the JOINT COMMITTEE ON TAXATION, April 4, 1990, JCX-10-90]

Introduction

The Senate Committee on Finance has scheduled a public hearing on April 5, 1990, on Pension Benefit Guaranty Corporation (PBGC) guarantees of retirement

annuities paid by insurance companies. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law provisions and a discussion of related issues.

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

I. SUMMARY

Background

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

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

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

Use of annuity contracts issued commercial insurers

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

Plan termination insurance program

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

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

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

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

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

Standards for fiduciaries and insurance companies

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

Federal law does not contain any specific restrictions on standards on the companies that issue pension annuities. However, such companies are subject to extensive State regulation.

Issues

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

II. Present Law

A. Background

In general

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

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

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

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

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

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

contribution for plans that have current liabilities in excess of their assets (i.e., underfunded plans).

Use of annuity contracts purchased through commercial insurers

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

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

B. TERMINATION INSURANCE PROGRAM AND THE PENSION BENEFIT GUARANTY CORPORATION

In general

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

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

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

Covered plans

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

Guaranteed benefits

Subject to limits, the PBGC guarantees basic benefits under a covered plan (ERISA sec. 4022). With respect to single-employer defined benefit pension plans, basic benefits consist of nonforfeitable retirement benefits other than those benefits. that become. nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for inflation since 1974 ($2,164.77 for 1990).

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

[4] The PBGC also covers multiemployer pension plans.

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

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

PBGC premiums

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

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

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

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

Termination procedures

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

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

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

Plan termination procedures were substantially revised in the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA). Under SEPPAA, a plan may be terminated in a standard termination if: (1) the plan administrator provides 60-day advance notice of the intent to terminate to plan participants and other affected parties, (2) as soon as practicable after the 60-day notice is provided the plan administrator (a) sends to the PBGC an actuarial certification that the plan has sufficient assets to cover benefit liabilities and certain other information, and (b) notifies each

participant and beneficiary of their share of benefit liabilities, and (3) the PBGC does not issue a notice of noncompliance with regard to the termination.

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

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

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

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

Extent of PBGC guarantee distribution of annuity contracts

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

There is some support under present law for the position that the guarantee does extend to commercial annuities distributed to plan participants. One could argue that the guarantee is not terminated when the benefit obligation is merely transferred to a third party (e.g., an insurance company), as opposed to being distributed to the plan participant (e.g., in a lump-sum distribution). Further, under ERISA, the

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[5] See, Request for OMB Approval of Information Collection, 55 Fed. Reg. 6138 (Feb. 21, 1989).

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

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

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

PBGC is granted continuing authority to take certain actions after a plan has terminated and plan assets have been distributed (e.g., to bring a civil suit to enforce the termination under ERISA).

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

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

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

C. STANDARDS FOR PLAN FIDUCIARIES AND INSURERS

Fiduciary rules

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

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

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

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

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

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

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

other compensation, or (3) has discretionary authority with respect to the administration of the plan.

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

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

PBGC termination procedures

The PBGC has not issued final regulations regarding the post-SEPPAA termination procedures. The proposed regulations under the post-SEPPAA rules do not contain specific rules regarding selection of the annuity provider, other than that the insurer be authorized to do business as an insurance carrier under State law or in the District of Columbia.

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

State insurance laws

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

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

III. Issues Related to PBGC Guarantees of Retirement Annuities Paid by Insurance Companies

In order to help understand under what conditions pension benefit guarantees should be provided, this part discusses (1) the scope of guarantees of pension benefits, (2) whether the Federal Government or the States should provide the guarantees, (3) the pricing of insurance of pension benefits, including factors affecting pricing of insurance of benefits provided directly by the plan and by annuities, (4) the

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

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

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

problems resulting from inadequate pricing, and (5) possible alternatives to an expanded Federal guarantee program.

A. SCOPE OF FEDERAL GUARANTEES OF PENSION PLANS

Solvency of employer

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

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

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

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

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

Solvency of insurance company

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

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

In this situation, it is necessary to determine the potential problems that extension of the Federal guarantee would address. Obviously, there is no longer a concern about the solvency of the employer because the employer is no longer liable to provide benefits. Thus, the concern that extension of the Federal guarantee would ad-

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

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

dress must be the potential inability of an insurance company to satisfy its liabilities. Even in the case of the annuity contract purchased on termination of a defined benefit pension plan, the extension of the Federal guarantee to the failure of the insurer to satisfy its liabilities could be considered a significant expansion of the original plan termination insurance program.

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

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

B. FEDERAL VERSUS STATE GUARANTEES

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

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

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

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

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

C. PRICING OF PENSION BENEFIT INSURANCE

In general

Given a specified amount of insurance coverage, the primary factor in determining the correct price of insurance is the expectation that such coverage will actually

be utilized.[15] Whenever it is possible to differentiate between amounts of risk, a system of risk-based premiums is preferable to a system of premiums not adjusted for risk. For defined benefit pension plan participants, risks to future benefits are mainly determined by the prospects for continuing financial soundness of the benefits provider. Defined benefit pension plan benefits can generally be provided in two ways—directly from the trust established to fund the plan or by a commercial annuity purchased with trust assets.

Benefits paid by pension trust assets

In general

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

Funding levels

A substantial practical problem in determining the appropriate risk-based insurance premiums for pension benefits funded by pension plan trusts is the difficulty in establishing the adequacy of pension plan funding. For pension plans to be considered fully funded, the value of fund asset must equal or exceed accrued pension liabilities.[16] Pension liabilities equal the present value of future benefits owed for plan participants. One manifestation of the liability-valuation problem is the variety of accepted methods and assumptions that may be used in determining the value of future pension benefits both for funding purposes under the Code and ERISA and for financial reporting purposes. With regard to methods, it useful to distinguish between two general types: those measures which calculate pension benefits assuming employees' anticipated future levels of compensation and the narrower measures which calculate benefit levels based on current levels of employee compensation. With regard to assumptions, a critical assumption is the interest rate used for valuation of these liabilities. The present-law variable rate PBGC premium structure has attempted to deal with some of these issues, for example, by specifying the interest rate used to calculate vested unfunded benefits.

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

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

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[15] In economic terms, the correct pricing of insurance requires the expected present value of future premiums to equal the expected present value of future benefits.

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

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

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

[19] In 1980, the Financial Accounting Standards Board (FASB) issued Statement 36 which mandated reporting of accrued pension liability and market value of pension assets in a footnote to the balance sheet of a plan sponsor's financial statements. Under the methods of FASB State-

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

Financial soundness of the employer

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

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

Pension annuities provided life insurance companies

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

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

Beside State regulation of the financial condition of life insurance companies, existing insurance mechanisms at the State level could also be a factor in the pricing of a Federal risk-based premium. At least 40 States have guarantee laws that provide indemnification of losses suffered by policyholders of insolvent companies. Funds for indemnification are generally derived from assessments against solvent companies. Coordination of State and Federal law would be necessary to ensure that

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

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

[21] See Zvi Bodie et al. (1987), "Funding and Asset Allocation in Corporate Pension Plans: An Empirical Investigation," in Zvi Bodie, John Shoven, and David Wise, eds., *Issues in Pension Economics*, University of Chicago Press.

State law did not undermine Federal policy, and also to avoid unduly burdensome or conflicting rules for insurance companies.

Timing of premium payments for pension guarantees

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

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

D. ECONOMIC CONSEQUENCES OF INADEQUATE PRICING

Cross subsidization

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

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

Moral hazard

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

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

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

Adverse selection

If there is inadequate pricing of insurance, lower-risk plans have an incentive to leave the PBGC insurance system. If PBGC insurance were not mandatory for most defined benefit pension plans, overcharged low-risk plans would not freely purchase pension benefit insurance. Since the system is mandatory for defined benefit plans, an employer can only leave the system by terminating its defined benefit pension plan and by providing in its place either a defined contribution plan or by purchasing pension annuities on behalf of employees from insurance companies. Thus, if insurance premiums are not adequately adjusted to reflect risk, the insurance system may actually discourage provision of pension benefits through defined benefit pension plans. To the extent low-risk insurers leave the insurance system, the average riskiness of the remaining pool of insureds increases. Increased overall risk would require further premium increases or other sources of funding. This, in turn, could drive more low-risk insureds out of the risk pool and further exacerbate the problem.

Analogy to Federal deposit insurance

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

E. FEDERAL STANDARDS FOR FIDUCIARIES AND INSURANCE COMPANIES

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

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

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

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

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

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

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

One approach to this type of problem is to require that an independent fiduciary select the insurer. This approach has been followed in some cases by the DOL in granting administrative exemptions to the prohibited transaction rules. This approach would not necessarily increase pension benefit security, however, because it would not guarantee the continued solvency of the insurer.

PREPARED STATEMENT OF WILLIAM H. BYWATER

Mr. Chairman and members of the Committee: Good morning.

My name is William Bywater and I appear before the Committee on behalf of the AFL-CIO and on behalf of the International Union of Electronic, Electrical, Salaried, Machine and Furniture Workers, AFL-CIO and the workers we represent at the Louis Allis Division, Magnetek Corporation plants in Milwaukee and New Berlin, Wisconsin whose retirement security is threatened.

We are grateful for the opportunity to appear today and for the Finance Committee's interest in determining whether benefits payable under retirement annuities by insurance companies are guaranteed by the Pension Benefit Guarantee Corporation. (PBGC). We maintain that current law requires that the PBGC guarantee pension benefits payable by annuities. Plan participants and beneficiaries would also benefit from an inquiry into the consequences of companies which purchase annuities as a device to milk pension plans for the benefit of financial manipulators.

A dramatic example of the manipulation of the pension funds to the detriment of the beneficiaries continue to unfold at the Louis Allis Plants represented by the IUE.[1] While this potentially tragic situation is typical of others where annuities, have been purchased from financially-troubled Executive Life Insurance Company of California, linked to Drexel Burnham Lambert and its "junk-bond" dealings, in other ways the Louis Allis story dramatically differs.

The AFL-CIO and the IUE have in other forums, supported the basic right of workers to have a voice in the investment of their pension assets as reflected in H.R. 2664, introduced by Congressman Visclosky. We also appreciate the efforts of various Senators to stem the tide of employer seizures of the assets of so-called overfunded pension plans.

The Louis Allis plants were originally a family controlled, internationally-recognized manufacturer of large motors and generators, which continues to play a major role in supplying industry and tile national defense effort with critical electric generating equipment. Even during the stormy labor relations which characterized the ownership of these plants by Litton, collective bargaining with the IUE resulted in a stable, fully funded Pension Plan by the early 1980's.

"Magnetek" was created in 1984 by the much publicized high-yield or "junk bond" department of Drexel Burnham Lambert in Hollywood, California, for the express purpose of purchasing the "Magnetics Division" of Litton Industries. Drexel Burnham Lambert not only created the funding device for underwriting the Company but became and has remained a principal owner of Magnetek. Throughout the five year history of Magnetek, interests closely associated with Drexel Burnham Lambert have remained in firm control of the Company.

At the time of its organization, more than 10% of the junk bond underwriting of Magnetek was purchased by the Executive Life Insurance company of California another interest with close ties to Drexel Burnham and, perhaps the country's largest purchaser of junk bond issues.

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

[1] Appendix No.1; *Wall Street Journal*, February 12, 1990.

Shortly after taking control of the overfunded Louis Allis Division employees' pension plan, now called the "Magnetek General Retirement Plan," which had assets of approximately $23,000,000, covering more than 1200 employees, the new Company made no contributions to the Plan, even though employees were required to contribute between 2 and 4% of their annual earnings. Magnetek's Pension Plan Trustees, including at least two associated directly with Drexel Burnham Lambert, reached an understanding with Executive Life Insurance Company which has resulted in the transfer of approximately $25,000.000 from the pension plan to Executive Life Insurance in return for annuity contracts covering accrued past service liability prior to July 1, 1988. Despite the protests of the IUE, the growing concern of Louis Allis employees for the safety of their retirement income and the deepening crisis in the junk bond market and in the affairs of Executive Life Insurance Company, Magnetek has continued to sell off pension plan assets to Executive Life in exchange for annuity promises.[2]

It is important to note that Magnetek has never terminated this pension plan. It kept the shell to transfer monies to a principle stockholder (Executive Life). This was done to avoid scrutiny of the Federal regulators into these transactions, and to continue to collect contributions from Louis Allis workers for the purpose of satisfying the underfunded liability of pension plans covering other acquisitions Magnetek has made in recent years.

Furthermore, the Committee should be aware that all of these steps, which are of vital significance to Louis Allis employees, were taken by the Company without the knowledge of the beneficiaries of these plans or the Unions which represent theme On the contrary, requests for information about these transactions have been met with misleading and inaccurate statements to the Union and unconscionable delays in providing information, all to keep the Union in the dark while these events unfolded.

It has also caused some alarm among the beneficiaries of the Plan, that despite the approximately $25,000,000 which has been transferred by Magnetek to Executive Life since 1985, no annuity certificates have been issued to IUE-represented employees or retirees and nothing more than a bare-bones insurance proposal and acceptance exists to substantiate the transaction between Magnetek and Executive Life.[3]

Magnetek has advised the IUE that the $25,000,000 in annuity contracts with Executive Life are no longer reported as plan assets (or, for that matter as plan liabilities) and no premiums are being paid to the PBGC on these amounts. Consequently, largely for these reasons, it has been the position of the United States Department of Labor[4] and the PBGC that this type of annuity contract is not protected by the PBGC and that should the position of Executive Life Insurance continue to deteriorate and the annuities dishonored, Louis Allis employees would not have recourse under PBGC protections.

For the reasons set forth in the presentation submitted to the Committee by the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) on this date, we maintain that current law requires that the PBGC guarantee pension benefits payable by retirement annuities. Therefore, our concerns for the security of paid-for retirement benefits are deepened by the Federal Government's disinclination to guarantee these benefits.

For decades, the IUE and its Local Unions have established a pension program which will permit our members to retire with financial security and dignity through hard-fought negotiations. Our members have faithfully contributed to these pension plans assuming that the law protected the security of their pensions and their retirements.

Now, we find that those who have personally reaped billions of dollars during the decade of greed may have undermined this collective bargaining process, and threatened the security of thousands of our members and their families.

The Company insists that it ultimately guarantees the pension benefits of its employees and this of course is true. But the same type of guarantees by other corporate entities which have emerged through the junk-bond financing mechanisms have turned to dust.[5] We obviously wish Magnetek as the employer of 10,000 work-

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[2] Appendix No. 2; New York Times, February 15, 1990; New York Times, April 3, 1990; Wall Street Journal, April 3, 1990.

[3] See Appendix No. 3; Proposal and Acceptance by Magnetek dated February 6, 1987.

[4] Appendix No. 4; Letter of United States Secretary of Labor Elizabeth Dole to Senator Howard Metzenbaum dated February 12, 1990.

[5] See Testimony of PBGC Executive Director James B. Lockhart III before the House Committee on Government Operations Employment and Housing Subcommittee dated March 26, 1990.

ers, continues to thrive and provide employment for our members across the country. But we cannot turn our back upon this long-term threat to these employees' retirement security. We hardly think that this type of pension plan manipulation is what Congress contemplated when ERISA was adopted.

Unfortunately, we have reason to believe that the Magnetek story has been repeated with dozens of other companies around the country.[6] These abuses cry out for Congressional scrutiny and legislative action and the IUE and the AFL-CIO welcome the opportunity of working with you to develop programs to give workers a voice in running their pension plans and in preventing the type of manipulations we have experienced.

Thank you.

[6] Appendix No. 5; *The Wichita Eagle*, February 1, 1990.

THE WALL STREET JOURNAL MONDAY, FEBRUARY 12, 1990

Peril to Pensions

Junk-Bond Woes Put Retirement Benefits In Danger for Many

Employers Bought Annuities From First Executive, Holder of Risky Issues

Coleman's Worried Workers

By FREDERICK ROSE And DAVID WESSEL
Staff Reporters of THE WALL STREET JOURNAL

Ripples from the junk-bond market's troubles are reaching the graying workers at an 89-year-old factory in Milwaukee—and they're angry.

The bulk of their pension fund, they discovered, was turned over four years ago to First Executive Corp., a now-wounded insurance company that holds junk bonds with a face value of $8 billion.

Right from the first, employees at the MagneTek Inc. plant were worried. "We heard about the large percentage of junk bonds" in First Executive's portfolio, says Lee Gierke, a 12-year veteran at the company, which, like First Executive, is based in Los Angeles.

Then, the workers' union sought information about the pension-fund restructuring but ran into roadblocks. And later, it realized that, in a leveraged buy-out, First Executive had become a major debt- and stock-holder of MagneTek, along with Drexel Burnham Lambert Inc. The investment banker and partnerships controlled by its employees were the largest single shareholders in MagneTek, following a Drexel-led buy-out of the company months earlier. The union challenged the pension-fund changes in a still-pending arbitration case and is considering a lawsuit.

Many Plans Terminated

Over the past decade, thousands of companies have terminated pension funds and withdrawn more than $20 billion in so-called surplus assets, money beyond what accountants and actuaries said was needed to assure workers' pensions. To pay those pensions now and in the future, many companies bought insurance-company annuities—contracts promising to distribute set sums in the future—and pocketed the substantial difference.

Now, First Executive's [illegible] have spooked employees at many companies. Scores of employers had turned to the insurer simply because it offered the lowest price. First Executive, headed by Fred Carr, had become one of the country's largest purchasers of [illegible] bonds—some of them purchased from companies that then terminated their own pension plans. Though the bonds [illegible], their higher yield enabled First Executive to charge less than its competitors did. That worked fine [illegible].

But [illegible] the junk-bond [illegible] [illegible] questions about the [illegible] pensions [illegible]

Under Scrutiny

Complaints from workers at Coleman Co., a camping-equipment maker in Wichita, Kan., reached Senate Republican Leader Bob Dole of Kansas, whose spouse is Labor Secretary Elizabeth Dole. Now, a Senate committee, the Labor Department and the Pension Benefit Guaranty Corp. are all examining how Coleman's new owner—New York investor Ronald Perelman's MacAndrews & Forbes Holdings Inc.—turned over Coleman's pension obligations to First Executive.

"It's one thing for wealthy investors to risk their own money on junk bonds, but it's wrong for them to gamble with their workers' retirement money," says Sen. Howard Metzenbaum, a long-time champion of workers' pension rights, who has called hearings tomorrow into the Coleman case.

Among other concerns are doubts about whether the Pension Benefit Guaranty Corp., the federal agency that insures private pensions, would stand behind the annuities in the event First Executive's financial condition deteriorated to the point where it can't pay its annuity holders. The agency argues that it isn't obliged to do so, an assertion that some pension lawyers and members of Congress challenge. In any case, the agency says it has never had to make good on an annuity and guaranteeing annuities "would add tens of billions" to the $800 billion in pension liabilities already insured.

Insurer Cites Reserves

Failing federal guarantees, claims against insurers depend on state guaranty funds—where they exist. California, where First Executive is headquartered, doesn't have one. First Executive says that, despite its current financial problems, it has more than $2.5 billion in liquid assets and substantial accounting reserves. (Though previously rebuffed, Rosewood Financial Partners is understood to be preparing another offer for First Executive. See story on page A3.)

Use of insurance policies to supplant pension funds remains popular, as was expected when the Employee Retirement Income Security Act of 1974 and subsequent pension laws were passed. "The underlying assumption was that there wasn't going to be much of a problem. The private insurance industry was strong. It was regulated reasonably well by the states," says Michael Gordon, a Washington pension

Please Turn to Page A1, Column 1

APPENDIX 1

Peril to Pensions: Junk-Bond Skid Puts Retirement Benefits at Risk

Continued From First Page

lawyer who, as a Senate staffer, helped draft ERISA.

Today, all that has changed. "A retiree with a perfectly sound, federally insured pension can suddenly learn that his pension fund is being terminated and replaced by an annuity from an insurance company he has never heard of with no apparent backing by the federal government," complains Kansas Sen. Nancy Kassebaum.

Pension funds usually are invested in a variety of assets, including stocks, bonds, real estate and bank deposits. Extracting cash from them goes by various names: "Reversion" is the legal jargon, but "stripping" is a term favored by some critics.

Most transactions work the same way: A company with pension money to spare applies to the Pension Benefit Guaranty Corp. to terminate the existing fund. Provision must be made for the actual pension liabilities – either through purchase of annuity or lump-sum payments to beneficiaries, and generally an agreement is struck with an insurance company long before a formal application is filed with federal officials. Before the fund can officially be terminated, two notices must be sent to employees, and the Pension Benefit Guaranty Corp. must approve the transaction. About 80% of the applications are approved, in only 60 days. Any money that is left over belongs to the employer.

There are variations on the theme. Like some other employers, MagneTek didn't terminate its pension fund and so didn't have to notify employees of changes. Instead, it sold fund assets and paid First Executive about $23 million for an annuity covering its workers in Milwaukee and elsewhere. The transactions, in 1985 and 1986, followed the $96.5 million Drexel-led leveraged buy-out of what had been the Magnetics Group of Litton Industries Inc.

Just why and how the pension restructuring occurred is stirring intense debate. MagneTek says First Executive's main operating unit, Executive Life Insurance Co., was, at the time, top-rated by outside agencies and "offered the best terms available." It was selected in July 1985 after competitive bidding and, MagneTek adds, "has met and is meeting its financial obligations under the agreement," which the company says "is benefiting MagneTek's employees." MagneTek declines to comment further. Drexel won't comment.

'Sordid Record' Cited

In a brief filed with the National Labor Relations Board, the International Union of Electrical Workers terms MagneTek's ac- …tions a "sordid record" of "delay, [illegible] ance, cynical manipulation, and [illegible]." MagneTek's motive, the union says, was to merge the Milwaukee plant's amply funded pension plan with an underfunded plan at another facility, saving the company millions of dollars in future pension outlays and giving it an immediate accounting gain.

MagneTek hid all of this, the union alleges, by withholding requested documents and by reporting an abbreviated fiscal period, ended Dec. 30, so that vital transactions on Dec. 31 didn't surface in legally required disclosures for some time. The union remained unaware of the change. Despite repeated requests for data, the union says MagneTek dragged its heels so that some details of three-year-old transactions are emerging only now.

The union questions whether First Executive's investment in MagneTek helped it win the annuity contract. With some narrow exceptions, federal law generally prohibits owners of more than a 10% stake in a company from doing business with that company's pension plan. According to a Securities and Exchange Commission filing, First Executive, through a unit, held about 18.5% of MagneTek's outstanding stock as well as a substantial amount of the company's bonds around the time it was selling the annuities. Although companies can get waivers from the Labor Department, the department says it never granted one to MagneTek.

First Executive's Mr. Carr didn't respond directly to questions concerning MagneTek. Speaking generally, he said, "I have been at this company 15 years, and there has never been – let me emphasize – never been any quid pro quo or arrangement for any piece of business." Since the annuity sale, First Executive's holding of MagneTek stock has slipped to about 8%.

Insurer's Major Role

The questions MagneTek workers are raising aren't unusual. Indeed, if Drexel Burnham Lambert was the investment banker of choice for corporate raiders in the 1980s, First Executive was almost certainly the most popular insurer – buying billions of dollars of junk bonds in companies while facilitating the restructuring of some of their pension funds.

Although a relatively small part of its $19 billion in assets, First Executive's annuities cover tens of thousands of employees whose companies were acquired in the heyday of junk bonds. First Executive hasn't disclosed just how much money it owes group-annuity beneficiaries. Financial disclosure by individual companies of their pension plans and by insurers of their obligations is at best murky.

Though generally disclosed only in the fine print of financial footnotes, pension terminations are valuable sources of cash to raiders. In its $1.8 billion takeover of what is now Revlon Group Inc., for example, MacAndrews & Forbes Holdings was able to free up nearly $100 million of excess cash in a 1986 pension-fund restructuring. The $85 million annuity that made this possible was bought from First Executive on the advice of a consultant and after competitive bidding, according to MacAndrews & Forbes.

In the Coleman case, MacAndrews & Forbes stands to gain about $32 million in excess funds from $83 million in pension assets. But rather than waiting for approval from the Pension Benefit Guaranty Corp., MacAndrews & Forbes paid First Executive a $45 million "premium deposit" last August and arranged for the insurer to start processing checks [illegible] sioners at the start of this year. Final payments and [illegible] were [illegible] later, when the Pension Benefit Guaranty Corp. was finishing its approval process.

Big Write-down

But, as the junk-bond market soured, First Executive announced last month a $515 million writedown on its bonds, a move that still leaves the portfolio's book value some $1.4 billion above its market value on Dec. 31. First Executive's stock plunged after the announcement, and rating agencies chopped several notches from their ratings of Executive Life's claims-paying ability.

Now that the controversy over the Coleman contract has become public, MacAndrews & Forbes is trying to get its money back—so far without success. The New York-based holding company says Executive Life, with its lower claims ratings, no longer meets the specifications set for annuity bidders. On Friday, Coleman and the Pension Benefit Guaranty Corp. agreed that the Coleman pension won't be terminated until the company signs up a "triple-A-rated" insurer for the group annuity intended to cover 6,250 Coleman employees and pensioners.

Some Coleman pensioners are suspicious of the entire affair, citing a huge, $310 million First Executive investment in Revlon takeover debt. "It sure looks fishy to me," says Keith Holder, who headed Coleman's data-processing operations until his retirement in 1983. Despite MacAndrews & Forbes's assurances, Mr. Holder says he and fellow pensioners worry "about having worked a lifetime and ending up with nothing."

It was just such a risk that ERISA was designed to eliminate. Before its passage in 1974, pension-fund managers operated almost entirely without federal restrictions. ERISA set standards, requiring pension-fund administrators to carry out their duties for the "sole and exclusive benefit" of beneficiaries. Administrators also are required to use "the care, skill and diligence [of] a prudent person," according to a Labor Department summary. But what is "prudent"?

Pacific Lumber Takeover

In 1986, Maxxam Group Inc. took over Pacific Lumber Co., based in Scotia, Calif., in a $900 million, Drexel-financed junk-bond transaction. It quickly replaced Pacific Lumber's pension plan with a $37.3 million annuity purchased from First Executive and recovered more than $53 million in excess assets.

Though straightforward on its face, the transaction subsequently raised questions. According to corporate documents and testimony gathered by the House Subcommittee on Oversight and Investigations, First Executive wasn't included in the initial bidding and popped up late in the process. Moreover, at least some Pacific Lumber officers opposed its selection.

Rep. John Dingell, the subcommittee chairman, requested a Labor Department investigation in 1988, which the department says is continuing. In a letter to the department, the Michigan Democrat asserted possible violations of ERISA, including prohibited transactions, violation of the principle that a pension fund should be operated for the sole and exclusive benefit of its beneficiaries, and the "prudent man" rule.

Maxxam disputes the allegations. "There is a lot of speculation about what took place, and it really is mythical compared to the cold, hard facts," says An[illegible], Maxxam's general counsel. Mr. [illegible] says First Executive's Executive Life [illegible] was selected for the annuity because it was the lowest bidder. Charles Hurwitz, Maxxam's chairman, told the Dingell subcommittee that after the First Executive bid, the next lowest bidder, with a price about $1.5 million higher, [illegible] an opportunity to match or come close to First Executive's bid, but could not.

First Executive's Mr. Carr says the [illegible] purchase of Pacific [illegible] and its sale of the annuity [illegible] [illegible] transactions [illegible]

However, evidence amassed by the subcommittee suggests that First Executive may have had an inside track that helped it overcome internal resistance. An internal memo subpoenaed by the subcommittee from Vincent Garner, Pacific Lumber's former vice president/finance, criticized the then-pending choice of First Executive. The memo pointedly noted that First Executive had been a major backer of Maxxam's takeover of Pacific Lumber. (According to the latest available information, First Executive holds $343 million of Pacific Lumber bonds, its largest single holding of corporate debt.) Mr. Garner subsequently declined to approve the selection of First Executive, kicking final approval to his superiors.

Another Indication

The subcommittee found another sign of dissension: Four other Pacific Lumber officials involved in the selection flew to Maxxam headquarters in Los Angeles to object to the choice of First Executive.

In the future, government regulators may well dictate or at least scrutinize how an insurer is selected. Among the concepts now being discussed are "prudency audits" that would examine in detail the decisions of pension trustees to terminate their funds as well as decisions about how to disburse assets.

Currently, government regulation requires only that an insurer issuing an annuity be licensed in a single state, leaving open the possibility of fly-by-night operators. Congress has long prodded the Pension Benefit Guaranty Corp. to examine this issue.

More broadly, there are worries that even current regulations go unenforced. Last year, the Labor Department's inspector general warned that "unless steps are taken now, today's S&L bailout may become tomorrow's ERISA nightmare." The problem, he said, is lax auditing requirements and inadequate manpower.

Even with a knowledge of the insurance business and experienced outside advice, companies can't be assured that their pension-termination plans will work out. Consider the case of Central Benefit Mutual Insurance Co., which last year decided to terminate its plan and purchase a group annuity covering its 800 employees.

After an analysis by an outside consultant and competitive bidding, Central Benefit Mutual settled a few months ago on First Executive's Executive Life and paid "several million dollars" for the annuity for which a formal agreement hasn't been completed, a company official says.

"As of December, First Executive was represented to us as an A-plus company, but not in January," says Gerald Morrow, the vice president of operations at Central Benefit Mutual, which is based in Columbus, Ohio. Central Benefit Mutual, currently trying to get its money back from Executive Life, now marvels that it forwarded funds to Executive Life without a firm contract. "It's amazing when you think about it," Mr. Morrow adds.

Others didn't voluntarily put their money with First Executive, but it's there nonetheless. At Magnetek's Louis Allis Division in Milwaukee, [illegible] Reedy, a [illegible] [illegible] [illegible] whether to [illegible] company. "I [illegible] it, but with [illegible] place with our pension plan, I felt a little insecure. I want to [illegible] year by June," says Mr. Reedy, who [illegible] has been contributing [illegible] to the pension plan.

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THURSDAY, FEBRUARY 15, 1990
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Business T

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The New York Times

High-Risk Strategy Taking Toll

First Executive Was Big Drexel Customer

By RICHARD W. STEVENSON

Special to The New York Times

LOS ANGELES, Feb. 14 — Few companies were as closely tied to the "junk bond" factory at Drexel Burnham Lambert Inc. as the First Executive Corporation, and today the big Los Angeles insurer is paying the price.

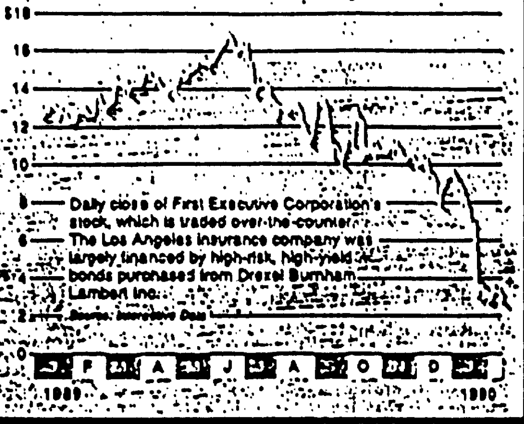
First Executive's rapid growth during the 1980's was largely financed with high-yield, high-risk junk bonds purchased from Drexel. While other insurers invested in junk bonds as well, none came to rely on them as heavily as First Executive and its chairman, Fred Carr.

First Executive is one of a handful of companies whose futures are now clouded by their big junk bond investments. The Columbia Savings and Loan Association of Beverly Hills, Calif., and Imperial Savings of San Diego, both of which were big Drexel customers, now face financial problems related to the erosion in junk bond prices.

Rating Is Lowered

First Executive, believed to have been Drexel's largest junk bond customer, is scrambling to survive both the plunge in the junk bond market that began last fall and the accompanying loss in public confidence in the company. First Executive's bond portfolio has suffered huge losses, the stock price is down sharply, the company's policyholders are starting to cash in their insurance policies, and First Executive's biggest shareholders are putting together takeover plans.

Rating services have downgraded their assessments of First Executive's ability to pay claims. And state insurance regulators, particularly in California, are closely watching the company's financial position.



The New York Times/Feb. 15, 1990

"New business has come to a screeching halt for them, and redemptions have undoubtedly picked up materially," said Thomas O. Rosencrants, an analyst at Interstate/Johnson Lane. "I'm not going to speculate on the possible outcome, but every day of further deterioration in the junk bond market increases the odds of the regulators stepping in."

Indeed, the mounting concern about First Executive's future extends well beyond its shareholders and holders of the company's life insurance and other policies. Workers at companies that have purchased annuities from First Executive to fund pensions also worry whether their retirement benefits will withstand the battering being taken by the company.

"The question is how heavily should an insurance company be invested in junk bonds, especially when that company is backing up long-term pension benefits," said Senator Howard M. Metzenbaum, a Democrat of Ohio, who led Senate hearings this week on First Executive's role in providing pension annuities.

Industry analysts have long had qualms about the junk bond strategy pursued by Mr. Carr, a go-go money [illegible]

The Los Angeles Times/Marsha Traeger

Fred Carr, chairman of the First Executive Corporation.

manager as far back as the 1960's, and a close business association of Drexel's former junk bond impresario, Michael R. Milken. Mr. Carr used the high yields on junk bonds to subsid[illegible]

Continued on Page D[illegible]

...yesterday, security guards stopped everyone and ... from the building

...s Everywhere

...tion was subsequently dropped. Mr. Milken is Drexel's largest individual shareholder, with about 5.62 percent of the stock in the now bankrupt parent, Government documents show.

Alan Miller, a lawyer with Weil, Gotshal & Manges, the firm representing Drexel in the bankruptcy, said yesterday that a conscious decision had been made not to include Mr. Milken on the bankruptcy list for the creditors committee. "We wanted people who were independent," he said. "He knows that there will be a creditors committee, and if he wants to apply to the court to join, he can."

The bankruptcy will also leave with nothing nine states that have been negotiating settlements of state securities law violations, Drexel officials said.

A number of those states, which include New York, Connecticut, New Jersey and Michigan, had been hoping to gain more money than Drexel had offered or obtain different terms for the settlement. "I guess we showed them," one Drexel executive said. "You don't take the bid? Fine. We'll fold."

Saul Cohen, the general counsel for Drexel who has negotiated the settlements, said: "We have stopped working settlements with the additional nine because there is no point to it. There is no reason to seek agreement on the use of a state license if the firm isn't going to be around to use the license."

Others affected by the Drexel collapse include law firms throughout Wall Street that have relied on the firm for a steady stream of business from both its mergers activity and its criminal problems.

Perhaps one of the hardest hit will be the New York firm of Cahill, Gordon & Reindel, which has been Drexel's principal legal adviser for years. The firm, which is said to have earned tens of millions of dollars from Drexel last year, moved yesterday to try to get new business. A petition to the bankruptcy court was being written by the firm in an effort to be appointed co-counsel in the case.

Lawyers at the firm said yesterday, however, that they were not greatly concerned about the recent events.

"I'm highly confident that we are going to do fine," said Irwin Schneiderman, a lawyer at the firm and a principal adviser to Drexel. "There may be opportunities in the future that were foreclosed in the past because of our large commitment to Drexel."

A number of Wall Street firms, meanwhile, see opportunities in Drexel's problems. Salomon Broth...

Takes Toll at First Executive

(Continued From First Business Page)

dite an aggressive pricing policy in First Executive's insurance business, allowing the company to attract many new policyholders.

But for the most part investors put aside their fears as long as junk bond prices remained relatively stable. The higher yields First Executive derived from its portfolio enabled it to beat its competitors' prices on many insurance policies and investment products.

Focus on Risks

When First Executive announced last month that it would take a $515 million charge in its financial results for the fourth quarter of 1989 to reflect the falling value of its bond portfolio, however, the fears of investors, customers and agents crystallized.

Suddenly, attention was focused on the risks of First Executive's junk bond strategy instead of the company's impressive growth. For example, of First Executive's $19 billion in assets, $6 billion are in junk bonds. But the $6 billion figure is the face value of the high yield bonds. Today, many junk bonds are trading at 60 percent to 65 percent of their face value.

Analysts are concerned that further write-downs may soon be necessary, since the market value of the company's bond portfolio on Dec. 31 was $1.4 billion less than its value on the company's books, even after the $515 million charge.

Customers started cashing in policies at a higher than usual rate, prompting fears among regulators of a "run" that could deplete the company's cash reserves and cause a liquidity crisis. The Securities and Exchange Commission began investigating whether the company had misled investors about its financial condition.

The troubles at Drexel this week, and the accompanying turmoil in the junk bond market, raised even more questions about First Executive's prospects.

Problem of 'Perceptions'

Company executives continue to maintain that First Executive is stable, with nearly $3 billion in cash on hand, despite the write-off and the loss it will force the company to take for 1989. They say that they do not anticipate any further write-downs in the bond portfolio, and they say the biggest problem now is in convincing customers and investors that First Executive can ride out the downturn.

"Our problem is not capital or earnings," said one executive at the company. "It's perceptions."

First Executive said there had been an increase in redemptions but added that they had been manageable so far. Moreover, if the junk bond market stabilizes after Drexel's collapse, First Executive could well weather the present period of uncertainty. Prices in the high-yield bond market rallied today after Drexel's parent company filed for bankruptcy protection under Chapter 11 of the Federal Bankruptcy Code. Traders seemed optimistic that further damage to the junk bond market might be limited.

Analysts agree that the company can weather the immediate effects of the write-down and its subsequent loss of business. "They have significant financial strength left," said Thomas G. Richter, an analyst at the Robinson-Humphrey Company.

Still, analysts said the company faced difficult times as it tried to limit redemptions of policies and to reinstill faith in the company's prospects among investors, new customers and regulators.

"The company's financial position would enable it to handle substantial redemptions without liquidating the troubled part of the portfolio," said Mr. Rosencrans of Interstate/Johnson Lane. "But you have to assume there will be intense pressure put on them by insurance regulators."

Mr. Rosencrans said it was possible that California insurance regulators, who recently rejected one plan formulated by Mr. Carr to minimize the reserves the company would have to set aside for losses on its junk bonds, might eventually force the company to add more capital if the bond portfolio continues to deteriorate. First Executive would probably then have to find a merger partner to bring in more capital or, failing that, could even face a regulatory takeover.

On Tuesday, Moody's Investors Service Inc. lowered its rating of the financial strength of First Executive's major operating unit, the Executive Life Insurance Company of California. L. Antony Fisher, an analyst at Moody's, said the action reflected "the continued turmoil in the high yield bond market and the effects that this may have on the company's growth and profitability prospects."

Mr. Carr is already under pressure from the company's largest shareholders to arrange a merger, with many large holders calling bluntly for him to leave the company. Rosewood Financial Inc., a Dallas investment concern that owns nearly 10 percent of First Executive, has made one highly conditional offer for the company — and the major condition was the departure of Mr. Carr.

Many analysts question whether Rosewood or any of First Executive's other large holders are likely to make a serious bid for the company while the degree of potential losses from the junk bond portfolio remains unknown. They see Rosewood's offer, which was formally rejected by First Executive on Tuesday, as being designed primarily to increase public confidence in the insurance company by suggesting that Rosewood is willing to step in with new capital.

The company must also deal with a loss of public confidence.

Rosewood's advisers said they were considering a revised offer for First Executive.

Carr Maintains Control

For now, Mr. Carr is holding on. This week he formally rejected the bid by Rosewood, which is controlled by Caroline Rose Hunt of Dallas. And he continues to try to convince shareholders, agents and customers that there is a lot of value in the bond portfolio despite the current market conditions.

Even if Mr. Carr can survive and keep the company intact, he now faces the certainty of having to reshape the company's strategy, since he is unlikely to attempt to fuel future growth by acquiring more junk bonds. And, analysts say, he faces a difficult task in winning back the confidence of agents and potential customers, many of whom are likely to associate First Executive with the junk bond debacle for years.

"In terms of the assets they use to back their products and the aggressiveness with which they go after new business on a price basis, there could be some significant changes," said Mr. Richter of Robinson-Humphrey. "Right now they're not in a fight for survival from the standpoint of staying in business in the short run, but they do face a fight for credibility so they can continue to operate in the long run."

Junk Bonds' Cause Loss At Insurer

By RICHARD W. STEVENSON

Special to The New York Times

LOS ANGELES, April 2 — The First Executive Corporation, one of the companies most heavily invested in "junk bonds," today reported a larger-than-expected loss for the fourth quarter of last year, reflecting the turmoil in the market for the high-risk, high-yield securities.

First Executive, a life insurance holding company based here, said that it lost $835.6 million in the period, in contrast to earnings of $45.2 million for the fourth quarter of 1988.

First Executive said in January that it would set aside $515 million because of the rapid deterioration in the value of its junk bond holdings. The company's chairman, Fred Carr, said then that the amount would more than cover the problems in its portfolio.

But the company said today that because of the continued slide in junk bond prices during the first quarter of this year, it had decided to add $344 million in charges to the money it had set aside. After taking the charges and adjusting its books to reflect some of its losses on the junk bonds, First Executive said its bond portfolio had a market value on Dec. 31 of $1.1 billion below its cost.

The company's junk bonds, which have a face value of about $8 billion, represent more than half the company's securities portfolio and more than 40 percent of its total assets of $19.2 billion.

First Executive is the second pri-

Continued on Page D16

New York Times
Business Digest
April 3, 1990

First Executive Discloses Big Loss From 'Junk Bonds'

Continued From First Business Page

mary junk bond customer of Drexel Burnham Lambert Inc., whose parent company has sought Federal bankruptcy protection, in as many days to report a huge loss. The Columbia Savings and Loan Association in Beverly Hills, Calif., said on Sunday that it had lost $379.1 million in the fourth quarter and $200 million in the first two months of this year because of its junk bond problems, leaving the institution insolvent.

The string of bad news about First Executive over the last three months has led customers to cash in their insurance policies and annuities at rates that some analysts had worried were becoming alarming.

'Normal Levels'

Mr. Carr said in a statement that the rate of policy surrenders, which affect insurance companies in much the same way deposit withdrawals affect banks, "has been declining and is approaching normal levels," although he conceded that news of the fourth-quarter loss "may have an adverse impact."

The industry experts said First Executive and its main operating units, the Executive Life Insurance Company and Executive Life of New York, remain relatively healthy and stable, despite the losses and the policy surrenders.

"The situation is worse than we thought, but there's no reason for policyholders to panic," said Fred Hill, an analyst at Firemark Insurance Research in Parsippany, N.J. "There doesn't seem to be any way there could be such a run on the bank that they would have to sell junk bonds to meet it. They have enough good assets to meet any surrenders."

By taking a large charge against its fourth-quarter earnings to reflect the continued decline in junk bond prices this year, First Executive appears to have reduced the chances it will have to take further charges against its first-quarter earnings.

The company's earnings were also affected by a decision to charge an additional $53 million in policy acquisition costs to fourth-quarter results. The move reflected the surrender of policies that otherwise would have been held for a longer period, allowing the company to charge off the acquisition costs, primarily agents' commissions, over many years.

First Executive's stock closed unchanged at $2.75 a share today in over-the-counter trading. The company's results are certain to bring more unhappiness to First Executive's investors, a number of whom have been considering whether to bid for the company.

Among First Executive's largest shareholders is Rosewood Financial Inc., an investment concern controlled by Caroline Rose Hunt of Dallas.

A spokesman for Rosewood, which has made a conditional offer for First Executive, had no comment on its intentions now.

WALL STREET JOURNAL TUESDAY, APRIL 3, 1990

First Executive Posts a 4th-Quarter Loss Of $835.7 Million; SEC Probe Disclosed

By FREDERICK ROSE
Staff Reporter of THE WALL STREET JOURNAL

LOS ANGELES—First Executive Corp., sharply boosting charges against its giant junk-bond portfolio, reported an $835.7 million fourth-quarter loss and disclosed that policy surrenders totaled $558 million in January and February this year.

The wounded insurance holding company also said that the Securities and Exchange Commission has opened a formal investigation of possible securities violations by the company.

In its annual report, First Executive said California regulators have compelled the company's principal unit, Executive Life Insurance Co., to refrain from junk bond purchases and any major transactions with affiliates without the prior approval of regulators.

Despite higher reserves than earlier announced for potential bond portfolio losses, First Executive said the approximate market value of its fixed-maturities investments remains about $1.5 billion below the $15.27 billion book value.

With year-end assets of $19.2 billion, Los Angeles-based First Executive is one of the nation's larger insurance companies. The company was for many years one of the largest purchasers of junk bonds from Drexel Burnham Lambert Inc., now in bankruptcy proceedings.

In recent months, First Executive's financial woes have widened, prompting a plunge in the company stock and a torrent of surrenders from policy holders. Yesterday, in national over-the-counter trading, First Executive common closed unchanged at $2.75 a share on volume of 961,500 shares.

The $558 million of surrenders reported for the first two months of the year was substantially lower than some analysts had speculated. However, the closely watched pace of those surrenders was almost treble last year's already-accelerated $1.3 billion in policy returns.

Just as troubled banks can be strained by a surge in withdrawals, demands for policy returns pose substantial burdens on insurance companies. First Executive said it has been "encouraged" lately by a decline in surrender requests. Also, analysts have been told that telephone calls seeking information about how to surrender policies have declined. However, the company warned that its announcements may reverse that favorable trend.

First Executive said it believes it has sufficient liquidity to weather current spates of policy surrenders. At March 23, cash and short-term investments totaled about $2.5 billion, up from $2 billion at year end, the company said.

At the root of the company's larger-than-expected loss was a surprising $344 million increase in the charge taken for prospective bond losses. In January, First Executive said it expected to take a $515 million one-time charge, net of taxes, to clean up the portfolio. However, with the increase, that charge totals $859 million.

Fred Carr, First Executive's chairman and chief executive officer, attributed the increase to "further turmoil" in the junk-bond market after the company's January calculations.

With the charge, First Executive's fourth-quarter net loss totaled $835.7 million, or a loss of $9.98 a share, compared with net income of $48.2 million, or 42 cents a share, a year earlier. Counting realized securities losses of $1.06 billion in the latest quarter, revenue was a negative $340.5 million, compared with $552.4 million the year earlier.

The latest quarter's results brought losses for the year to $775.6 million, or $9.67 a share, compared with net income a year earlier of $174.5 million, or $1.51 a share. Revenue, including realized securities losses of $1.76 billion, was $2.19 billion

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requires it to submit a restructuring plan before May 31 and complete the restructuring by Dec. 1.

While a Southland spokeswoman conceded that the company's financial position is troubled, she said the company is confident that it has begun work on a restructuring plan "well in advance" of a crisis.

Reasoning on Write-Off

In disclosing its quarterly loss, Southland said it decided to take the huge write-off of good will, or the amount over the fair value of the assets acquired in the company's $4.9 billion leveraged buy-out, after it and its auditor, Deloitte & Touche, evaluated the convenience store industry and tried to determine the true value of that good will. As the good will initially was to be amortized over 40 years, the write-off eliminates a $28 million-a-year non-cash expense and won't affect Southland's liquidity or its tax liabilities.

In the year-earlier fourth quarter, Southland had a net loss of $37 million. Revenue for the latest fourth quarter was $2.06 billion, up 4.4% from $1.97 billion in the 1988 period. The company said that on an inflation-adjusted basis, its merchandise sales at stores open more than a year fell, as did its gasoline profits. The company attributed the decline in gasoline profits to its fewer stores owned and to a drop in gas sales per store, a possible reflection of its decision to sell a brand-name gas and to abandon its policy of offering the cheapest price on the block.

For the year, Southland had a loss of $1.32 billion, compared with a loss of $255.2 million in 1988. In addition to the write-off of good will, the company had a $56 million charge related to a debt swap a year ago and $89.4 million in income from discon-

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First Executive Posts 4th-Quarter Deficit Of $835.7 Million

Continued From Page A3

widened charges for bond losses in its publicly reported numbers, based on generally accepted accounting principles, don't require changes in recently reported year-end results to regulators. They are calculated on very different, statutory assumptions.

The SEC's investigation, titled "In the Matter of First Executive," was opened last month, according to the company. It deals with possible violations of securities laws since June 1988, when First Executive announced plans for a $254 million rights offering. The company said it was cooperating with the investigation, which supercedes an "informal" probe begun in January.

A company official declined to elaborate on the investigation. However, it is believed to focus on questions of timely disclosure of material information, the absence of which may have induced stock purchases at inflated prices.

Stock was sold in the rights sale at $15 a share in October. Within three months, First Executive disclosed its $515 million write-down and other woes. A number of civil suits have been launched alleging securities violations related to the rights offering. The company has said its disclosure was timely and accurate.

Other investigations also were disclosed, among them inquiries by the federal Pension Benefit Guaranty Corp. and the Labor Department into the issue of annuities by Executive Life related to pension terminations. The company's business in this area was the subject of a page one article in this newspaper.

First Executive's disclosure of strictures by California regulators suggests closer controls over its Executive Life unit than previously indicated. California's Department of Insurance has placed permanent observers at the company.

Now, however, all new transactions with affiliates in amounts exceeding 3% of Executive Life's capital and surplus must be approved in advance by regulators. At Dec. 31, Executive Life Insurance Co. had capital and surplus totaling $458.2 million, indicating that regulators require prior approval of transactions of more than about $3 million.

CORRECTIONS & AMPLIFICATIONS

ARTHUR J. WEISS is chairman of Southmark Corp. His company affiliation was misstated in yesterday's edition.

Spend-a-day

MagneTek, Inc.

VIA AIRBORNE

February 6, 1987

Mr. Steven B. Schwartz, F.S.A.
President
First Annuity Corporation
of New York
100 Executive Drive - Suite 330
West Orange, N.J. 07052

RE.: Proposal for Annuity Purchase for MagneTek, Inc.

Dear Steve:

I am returning an executed copy of the Proposal for Annuity Purchase for MagneTek, Inc.

I want to thank each of you for your dedication in accomplishing this very important transaction for MagneTek and its employees. I know it has been a long struggle, but the results made it all worthwhile.

Thanks again.

Sincerely yours,

William R. Jenkins
Senior Vice President Finance
Chief Financial Officer

c.c.: Stephen Fernstrom (PC&M)
Warren Weiner (PC&M)
Rich Mandell
Jed Brickner (L&W)
Robert Jennings
James Kaja
Ning Chen (PC&E)

APPENDIX 3

Steven B. Schwartz, F.S.A.
President

FIRST ANNUITY CORPORATION of NEW YORK

January 20, 1987

Mr. Stephen C. Fernstron
Manager, Administration/Compliance
Powers, Carpenter & Hall, Inc.
231 South Bemiston
St. Louis, MO 63105-1982

Re: Proposal for Annuity Purchase for MagneTek, Inc.

Dear Steve:

This letter confirms our offer and the acceptance by MagneTek, Inc. of the enclosed proposal on behalf of Executive Life Insurance Company for a nonparticipating single premium annuity purchase contract to cover benefits for all participants included in data submitted to us for the MagneTek, Inc. Retirement Plans.

The total cost, subject to the following conditions and assumptions, is shown on the attached Exhibit 1. The basis for our offer is as follows:

- premium deposits were received on July 12, November 12, and November 15, 1985.
- the premium was calculated assuming that Executive Life would make monthly annuity payments to retirees beginning with the payments due on July 1, 1985. The Plan's trustee will be reimbursed for any benefit amounts that are paid by the trustee on and after July 1, 1985.
- the single premium cost shown in Exhibit 1 is subject to change to reflect any further changes in the final data submitted.

U S DEPARTMENT OF LABOR

SECRETARY OF LABOR
WASHINGTON, D.C.

APPENDIX 4

FEB 12 1990

The Honorable Howard M. Metzenbaum
Chairman, Subcommittee on Labor
Committee on Labor and Human
Resources
Washington, D. C. 20510-6300

Dear Mr. Chairman:

Thank you for your letter in which you raised some important issues regarding the security of pensions that are provided through the purchase of annuity contracts from insurance companies upon plan termination. I am deeply committed to the security and integrity of our private pension system and share many of your concerns on this issue.

In order to address any immediate problems which may exist, I have directed that the Pension and Welfare Benefits Administration (PWBA) and the Pension Benefit Guaranty Corporation (PBGC) develop procedures for dealing with any terminations where benefits of participants might be at some risk as a result of the selection of the insurance company to provide annuities. Under PBGC's current procedures, terminating plans must provide the agency with the name of the insurer providing annuities within 30 days after the final distribution of the plan's assets. PBGC is modifying that procedure to require that the agency be given that information prior to the distribution of the plan's assets. These modified procedures would cover the PBGC's current inventory of pending standard terminations, as well as future terminations. PBGC will refer to PWBA cases where further inquiry may be appropriate under the fiduciary standards of Title I of ERISA. It is important to note that while PBGC currently has an inventory of 13,000 standard terminations pending, substantially less than half - preliminary data indicate approximately 25% - of these cases involve the purchase of annuity contracts. PWBA will consider these referrals and determine whether an investigation for compliance with ERISA fiduciary standards is appropriate. In addition, PBGC is going to consider whether additional standards of insurer reliability are needed in connection with their pre-termination review.

I have been advised by the Executive Director of PBGC that PBGC has not had a case in its 15-year history of an insurance company failing and not paying annuities. I have been further advised that no evidence exists that Congress ever intended PBGC to guarantee annuities, and PBGC receives no premiums for such liability. Under longstanding law, states have regulated the insurance funds, and most states have guarantee funds. A federal guarantee of annuities would add tens of billions to the $800 billion in liabilities PBGC already insures. I believe that the actions that we are undertaking will reinforce the obligation plan fiduciaries have under ERISA when selecting insurance companies. Where we find problems, we will certainly take whatever enforcement actions are necessary.

I understand and share your concerns and will keep your Committee advised of the results of our enforcement efforts in this area. In the meantime, if I can be of further assistance, please do not hesitate to let me know.

Sincerely

Elizabeth Dole

APPENDIX 5

THURSDAY
February 1, 1990

The Wichita Eagle

KANSAS
EDITION
35 Cents

Coleman changes investment plans for pensions

By John R. Engen and Alfonso [illegible]
The Wichita Eagle

WASHINGTON — Assets from two Coleman Co. pension plans will not be invested in annuities with an insurance company that has holdings in speculative "junk" bonds.

Officials from Coleman and its parent, MacAndrews & Forbes Holdings, told members of the Kansas congressional delegation on Wednesday that they would seek a higher-rated insurance company than Executive Life Insurance Co. to provide for employee retirement benefits.

Larry Jones, Coleman's chief executive, said the decision was made because Executive Life's industry rating was downgraded last week. The California-based company, the major subsidiary of First Executive Corp., has about 45 percent of its assets in speculative "junk" bonds.

"We have had face-to-face assurances from highly respected people in Wichita and New York that the pension funds will be invested with a triple-A company," Sen. Bob Dole said after meeting with Jones and Howard Gittis, vice president of MacAndrews & Forbes.

Sen. Nancy Kassebaum, R-Kan., and Rep. Dan Glickman, D-Kan., also attended the meeting.

MacAndrews & Forbes still intends to go through with plans to terminate the pension plans, valued at about $83 million. By doing so, it has projected it will get about $32 million in excess money for its own use.

Earlier this week, Dole's office said it did not think the plans should be terminated at all. But Wednesday, they weren't so sure.

"If we can be satisfied that the employees would be as well-off as they were under the old plan, it might be acceptable," said Dole spokeswoman Quelyn Sealy.

However, the larger issue of pension terminations remains alive on Capitol Hill.

Soon after [illegible] announcement, Sen. Howard Metzenbaum, D-Ohio, issued a statement saying: "Coleman workers and retirees may be able to breathe a little easier now. But what about the tens of thousands of others who may be stuck with 'junk' pensions?"

Last week, Metzenbaum, chairman of the Senate Labor Subcommittee, opened an in-

See COLEMAN, Page 8A

"We have had face-to-face assurances ... that the pension funds will be invested with a triple-A company."

Sen. Bob

COLEMAN

From Page 1A

vestigation into the Coleman pension plan terminations. He said Wednesday the investigation would continue.

A Metzenbaum spokesman said the subcommittee had also requested from MacAndrews & Forbes all information and documents relating to the Coleman pension terminations and similar terminations at Revlon.

The Ronald Perelman-owned company acquired Revlon in 1985 and terminated that company's pension plans shortly afterward, investing employee retirement assets in annuities with Executive Life. At the close of 1988, Executive Life held more than $150 million in Revlon bonds, raising the possibility of conflict of interest.

Jones said MacAndrews & Forbes would invest the Coleman pension funds only in a company with the highest rating. He said the company was negotiating with New York Life Insurance Co., Aetna and Prudential.

Gittis left for Los Angeles late Wednesday to negotiate with Executive Life officials about the Coleman annuity-purchase agreement.

It was not clear what the cost ending the agreement with Executive Life might be for MacAndrews & Forbes, according to spokesman Jim Conroy.

"Obviously, we hope it won't cost us too much," he said.

If all goes well, a new insurance company should be selected "in a matter of two or three weeks," Conroy said.

In the meantime, the several hundred Coleman retirees who have been getting checks from Executive Life will continue to receive them until a new insurer is in place.

Conroy also said MacAndrews &

Sen. Bob Dole, left, meets with Coleman's chief executive, Larry Jones, center, and Howard Gittis, vice-chairman of MacAndrews & Forbes, which bought Coleman last year.

"We've heard that no annuity plan has ever failed, but our concern is that there is always a first time."

Dave Bartel, aide to Sen. Nancy Kassebaum

Forbes would not terminate the pension plans until the Pension Benefit Guaranty Corp. gave its approval, even if that were to take several months.

The government agency, which must approve all pension fund terminations, requested Tuesday that the company wait until mid-April while it and the Department of Labor reviewed the proposal.

Dole and Kassebaum met with officials of the Labor Department on Wednesday to discuss the standards required for companies that terminate pension plans and replace them with annuities.

The only requirement now is that the annuity be bought from an insurance company that is licensed in at least one state.

"We've heard that no annuity plan has ever failed, but our concern is that there is always a first time," said Dave Bartel, Kassebaum's administrative assistant.

If the annuity plan did fail, it is unclear whether pensioners would lose everything or whether the federal government would be liable.

Both Kassebaum and Glickman are planning to introduce bills that would increase the regulation of such pension plan reversions. Kassebaum wants to put an 18-month moratorium on all pension plan reversions.

Glickman's bill would make the parent company liable for the pension plan payments and raise the standards required for pension fund

Prepared Statement of Dennis M. Crites

The American Association of Retired Persons is pleased to testify before this committee on the issue of Pension Benefit Guarantee Corporation (PBGC) protection of retirement annuities issued by insurance companies. The Association believes that PBGC insurance currently exists for pension payments whether they are made by a pension fund or an insurance company.

BACKGROUND

As part of the overall thrust of ERISA to ensure pension benefits, the PBGC was created to help guarantee that participants of defined-benefit pension plans would not lose benefits in the case of plan terminations. The PBGC administers the termination insurance program established under Title IV of the Employee Retirement Income Security Act (ERISA).

Pension reforms recently enacted restrict an employer's ability to terminate a plan when there are insufficient funds (underfunded plans). If the employer can satisfy certain financial hardship tests, the employer may qualify for a "distress" termination. The PBGC, taking trusteeship of the plan, will then pay benefits to plan individuals (up to a statutory maximum amount). At the end of fiscal year 1989, the PBGC had trusteed approximately 1500 underfunded terminated plans.

Title IV also permits a plan sponsor to terminate a plan which has sufficient assets to cover all benefit liabilities. With limited exceptions (for roll-overs and lump sum distributions provided under the plan), ERISA requires that a terminating plan provide benefits by purchasing annuities for individuals under the plan. PBGC received about 11,400 notices of standard terminations of fully funded plans in fiscal year 1989. In addition, many ongoing plans purchase annuities for individuals at retirement.

The Department of Labor has stated (Feb. 12 letter to the Chairman of the Senate Labor Subcommittee on Labor) that preliminary data indicate that PBGC currently has an inventory of approximately 3500 standard terminations pending that involve the purchase of annuity contracts.

In order to terminate a plan, the plan sponsor must give 60 days notice to participants of the proposed termination and give plan participants information as to their benefit entitlements under the plan. The termination notice filed with the PBGC must contain certain information, and during a 60 day waiting period following the filing with PBGC, the PBGC is required to determine that the statutory requirements under Title IV are met.

This procedure, which applies in all standard terminations (where there are sufficient assets to meet benefit liabilities), also applies in cases of terminations for reversions. The problem of terminations merely for the purpose of gaining access to plan funds, a purpose inconsistent with ERISA's "exclusive benefit" rule and the tax code's subsidized prefunding requirements, has exacerbated the number of plan terminations and increased the purchase of annuities.

Since 1980, over 2000 large plans with reversions over $1 million have terminated. Over 2 million plan participants have been affected; the majority of these individuals receive their benefits through annuity payments. An additional large number of small plans have terminated for reversions, although information for these plans is not readily available.

ANNUITY PURCHASES—CURRENT SAFEGUARDS

Under current PBGC procedures, terminating plans must provide the agency with the name of the insurer providing the annuity within 30 days of the asset distribution. PBGC is currently working with the Department of Labor (DoL) to modify the procedure to require that the name of the insurer be given to PBGC for review *before* the distribution. This change is to apply to all pending and future terminations.

The Association believes that this pre-termination review is essential to safeguard the rights of plan participants. The choice of an insurance company is clearly subject to the current fiduciary provisions of Title I of ERISA. These fiduciary duties, enforced by the Department of Labor, require the plan trustee to use care, skill, prudence and diligence in choosing an insurance carrier. Title I also prohibits certain transactions involving pension assets that are not conducted at "arm's length." These provisions must also be enforced by DoL to ensure proper dealing and prevent conflicts-of-interest, thereby safeguarding the pension benefits of plan participants.

PBGC, in their review, should refer potential violations to the DoL, which should then vigorously pursue compliance with the appropriate ERISA standards. In this way, problems with insurance carriers may be avoided up front. Plan participants

should not have their retirement benefits subject to the insecurity of questionable insurance companies.

ANNUITY PURCHASES—PBGC GUARANTEE

Even with improved standards for annuity purchases, some question whether PBGC will continue to guarantee insurance annuities. The Association believes that current law requires that PBGC continue to guarantee benefits in the event the insurance carrier can no longer meet their obligations. If this current guarantee is deemed in question, the law should be clarified to ensure ongoing PBGC protection.

Under ERISA, the PBGC is given the following three explicit statutory purposes under Section 4002(a):

(1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants,

(2) to provide for the timely and uninterrupted payment of pension benefits . . ., and

(3) to maintain premiums . . . at the lowest level consistent with carrying out its obligations.

Consistent with the thrust of ERISA in establishing PBGC to guarantee certain benefit payments, and consistent with the PBGC's own mandate to ensure the timely payment of benefits, current law requires the PBGC to insure benefits paid through an insurance company annuity. It is incongruous to say this guarantee is lost merely because an insurance carrier is the vehicle chosen to provide the guaranteed employer-provided benefits.

This understanding of current law was apparently shared by the PBGC itself in regulations it issued in 1981 under 29 CFR Part 2615 (46 Fed. Reg. 9532, Jan. 28, 1981). The question was raised as to whether the PBGC "would provide benefits to participants or beneficiaries of a terminated plan that closed out under a Notice of Sufficiency if the insurance company from which annuity contracts had been purchased should prove unable to meet its obligations." The relevant response was as follows:

> ". . . In fact, the reason insurance companies are so extensively regulated is to ensure that their obligations can be satisfied. However, *in the unlikely event that an insurance company should fail and its obligations cannot be satisfied (e.g. through a reinsurance system), the PBGC would provide the necessary benefits.*" (emphasis added)

In addition, under the Single Employer Pension Plan Amendments Act (SEPPAA), this position appears to have been reaffirmed by the Congress. Section 4041(b) (4), the section on continuing authority, states that " . . . A certification . . . shall not affect the (PBGC'S) obligations under Section 4022." (Section 4022 is the ERISA section on guaranteed payment of benefits upon termination). The Conference report adopted explanatory committee report language which stated:

> "Even if the plan administrator has certified to the PBGC that the assets of the plan have been distributed so as to provide when due all benefit entitlements and all other benefits to which assets are allocated under Section 4044, *the PBGC is still obligated to guarantee the payment of benefits under Section 4022 if it is subsequently determined that not all guaranteed benefits were in fact distributed under a standard termination*, and the contributing sponsors of the plan and the members of their controlled groups do not promptly provide for the payment of such benefits. (emphasis supplied)

The above statements of the PBGC in its own regulations, as well as the affirmation in SEPPAA of continuing PBGC guarantees, simply buttresses the basic intent of ERISA to insure that pension payments are made, and that the PBGC guarantee the continued timely payment of benefits of certain plans regardless of the vehicle of payment.

While no insurance carrier has yet failed to make an annuity payment, a number of questions have arisen surrounding the financial soundness of certain insurers. In particular, those with large holdings of high-yield "junk" bonds and/or troubled real estate holdings or other declining investments may eventually experience problems. While these companies may have been sound when chosen, later events may undermine benefit security. In addition, there is still the possibility that some questionable insurance companies have been chosen to provide benefits, even if these instances are limited to situations before stepped-up DoL enforcement.

IMPORTANCE OF PBGC GUARANTEE OF ANNUITIES

Given the number of questions raised recently regarding the financial soundness of certain insurance carriers, the affirmation of PBGC guarantees becomes increasingly important. State reinsurance guarantees currently exist in the event that an insurance company cannot meet its obligations. However, according to PBGC, this reinsurance system is limited to 44 states, and the guarantee arrangements have limits and exclusions. In addition, these state reinsurance guarantees are generally not financed with money up front, but are based on assessments on the industry after a problem occurs.

For those states without a reinsurance system, such as California, pension beneficiaries are clearly left with little protection if the PBGC does not also provide an ultimate guarantee of benefit payment. In addition, while no problems have thus far surfaced, it is not clear how effectively the various states with reinsurance guarantees would react to a financial problem in the insurance industry.

In particular, the Association remains highly concerned with the trend towards terminations for reversions and the resulting increase in the purchase of annuities. This past decade has seen an unprecedented raid on pension assets. In these instances, which have resulted in over $20 billion dollars stripped from pension plans, employers generally terminate their plans and purchase annuities that pay benefits earned only up to the day the plan terminates. Prefunded assets that remain in the tax-favored plan, once required for future retirement security, now revert to the employer.

By minimizing the cost of the annuities, the employer can thus maximize this reversion. The employer, whose main purpose for the termination has been to recapture funds, thus has a strong financial incentive to purchase the most inexpensive annuities. This financial incentive for the employer may often result in pressure to choose a cheaper—and less secure—insurance carrier, thus increasing the risk for workers and retirees.

The Association strongly believes that pension terminations for reversions should be restricted. Not only would this ensure continued funding stability, but it would also better meet the retirement security needs of both workers and retirees.

PAYING FOR THE BENEFIT GUARANTEE

Given the Association's belief that current law requires the PBGC to insure benefits provided through annuities (or that this benefit protection must be clarified), the question arises as to whether PBGC must be further financed against this exposure to risk. The PBGC has recently stated (in testimony before the House Employment and Housing Subcommittee, March 29) that "Congress has established premiums based solely on PBGC's exposure from insufficient plans and failed sponsors and not on any exposure that might result from annuities purchased by a terminating sufficient plan." If this is the case, then additional premiums may be warranted.

Assessing this risk may be difficult, since there is no evidence of any failure to meet an insurance annuity payment. In addition, it can be argued that employers who have paid into the insurance system over the years have already paid for continued PBGC protection.

In any event, the Association believes that state reinsurance systems should continue to be the first line of guarantee. Under state reinsurance arrangements, retirees may also have a better chance of receiving their full pension promise, since the PBGC has a statutory maximum guarantee. In order to further reduce PBGC exposure, the law may need to be modified to require that any pension annuity be backed-up by a state reinsurance guarantee.

Even with state reinsurance arrangements, the PBGC must remain the final line of guarantee. The Association does not believe that pension funds should be required to pay twice for the same protection (the Association assumes the premium increase, whether or not assessed on the employer or insurance carrier, will be passed on to the pension fund). If risk still remains, however, then a premium should be assessed. This premium could be paid by the ongoing plan in the case of annuities purchased from an ongoing plan, or the additional premium could be assessed at the time of the termination of the plan. The end result should be that retirement benefits are ultimately secured by the PBGC, which is adequately financed to ensure continued timely payments.

CONCLUSION

The intent of ERISA to provide for continued benefit guarantees should not be undermined simply because the payment is made through an insurance carrier. While state reinsurance systems should remain the first guarantee of continued an-

nuity payments, the PBGC must continue its role as the ultimate guarantor that benefit payments will be made. if additional PBGC premiums are required, then appropriate assessments to ensure continued security should be established.

Prepared Statement of Senator Dave Durenberger

Mr. Chairman, when Congress enacted ERISA in 1974, we sought to alleviate the concerns of the working people of this country that when they retired the pension promise made their employers would be fulfilled. As part of that commitment, we created the Pension Benefit Guaranty Corporation to ensure that accrued pension benefits would not evaporate because of the financial mismanagement of pension funds or the economic deterioration of an industry.

The need for the PBGC guarantee program arose from cases like Studebaker Packard which went out of business in the 1960's, leaving long service pension plan participants with little or no retirement benefits. In my view, the guarantee program has worked well for the nearly quarter of a million Americans whose benefits would otherwise have been substantially reduced when their underfunded plans terminated during the last 15 years.

But this hearing is not about underfunded pension plans. This hearing concerns PBGC's guarantees relative to those plans that terminate with enough assets to cover promised benefits, but which substitute an insurance company annuity for a pension benefit. It is my understanding that more than 50 billion dollars in annuity sales for the insurance industry have occurred over the last 15 years as a result of pension terminations.

But what happens to the retiree, if the insurance company that sold the annuity is not financially sound. What if the insurance company fails? Wouldn't that fundamentally undermine the Federal Government's 1974 commitment to insure pension benefits?

It has been suggested by some commentators that the PBGC should be liable if an insurance company that has issued termination annuities fails. As we all know from yesterday's floor debate on the S&L industry, the Federal Government does not have a stellar track record in insuring financial institutions, and I don't believe that now is the time to talk about adding another "PacMan" to the U.S. Treasury. Certainly, any Federal guarantee of life insurance companies would require substantial new PBGC premiums be assessed and that a new bureaucracy be established to regulate the investment and reserving practices of the insurance industry. I do not think that such a step is either advisable or warranted at this time.

However, the PBGC's annuity purchase requirement has created a multi-billion dollar market for the life insurance industry—a market that other financial institutions such as banks and mutual funds cannot participate in. The industry should be held to the highest standards in order to participate in this government sanctioned, exclusive market. For this reason, I think that PBGC's regulations should be strengthened to permit only the strongest and most prudent insurance companies to be allowed to issue termination annuities in the future. Such a step will further assure American workers that their pensions will be paid when they reach retirement.

Prepared Statement of James B. Lockhart III

Thank you, Mr. Chairman, for inviting me to appear before you today. I am pleased to be here to discuss the Pension Benefit Guaranty Corporation (PBGC) and pension annuities.

The PBGC was established under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA) to insure private, defined benefit pension participants against loss if their pension plan is terminated without adequate funding. The PBGC is by statute a self-financing, wholly owned Government Corporation that provides vital insurance protection to nearly 40 million active and retired American workers in about 100,000 defined benefit pension plans. Covered plans are required by law to pay a premium that is the PBGC's major source of revenue.

We take very seriously the mission that Congress gave us when establishing the PBGC in 1974. We even put the mission on the cover of this year's annual report. It is:

(1) To encourage the growth of the private pension system.
(2) To ensure the timely payment of pensions.

(3) To keep premiums at the lowest level consistent with carrying out our statutory obligations.

The best way for us to fulfill this mission and achieve our goal of reducing our deficit is to manage the insurance program effectively and to prevent losses. As we reported recently, in 1989 we had very strong revenues and profits because of excellent investment results and moderate losses. We reduced our deficit by 30% from $1.5 billion in 1988. However, PBGC's deficit still stands at $1 billion, and the picture could change dramatically depending on the outcome of our case against the LTV Corporation, which is before the Supreme Court. A loss for PBGC could more than double our deficit and, even worse, set the stage for "copy cat cases." We expect the Court to rule by June.

As our 10 year forecasts in our 1989 annual report show, the PBGC's future is difficult to predict. The range of our optimistic to pessimistic forecasts, from a surplus of $1.5 billion to a deficit of $7.9 billion, is almost $10 billion.

In order to prevent a large deficit, we have a strong loss prevention strategy which uses the legislative tools Congress has given us, most recently in 1986 and 1987. These tools are supplemented by regulation, litigation and negotiations. The loss prevention strategy has three elements:

(1) Encouraging sponsors to better fund their plans and avoiding uncompensated risks.

(2) Discouraging companies from terminating underfunded plans through tough negotiation and litigation.

(3) Minimizing losses, if there is a termination, by increasing recoveries.

In the President's FY 1991 Budget, OMB Director Richard Darman discussed two topics that bear directly upon PBGC, "hidden PACMEN" and "moral hazards." They are closely related to our loss prevention strategy.

"Hidden PACMEN" refers to Federal liabilities that are not fully visible. The PBGC insures $820 billion of defined benefit pension liabilities. The number is massive, but it should be remembered that these liabilities are backed first by well over a trillion dollars in plan assets and then the net worth of their sponsors. The real exposure to the PBGC is approximately $20-$30 billion in underfunded plans. Most of these plans were underfunded when the PBGC was established. They are concentrated in the auto, steel and airline industries.

Although this exposure represents less than 4% of the total liabilities, it is large in comparison to our annual premium income of $600 million. Our capacity to absorb new losses is relatively limited. Therefore, it is critical that we make sure the majority of this exposure never becomes losses.

A "moral hazard" occurs if the interests of the insured and the insurance company are not aligned. An insured party may be willing to take a higher risk if he knows that the insurance company will pay. A moral hazard also exists when a government insurance company insures losses over which it has no regulatory control. As the *Budget* states, a "'moral hazard' should be balanced by controls or offsetting incentives." Otherwise, perverse incentives are created that may seriously increase our risk of losses.

With that background, I would now like to address the subject of annuities purchased after a plan is terminated. The decline of the "junk bond" market and the exposure of specific annuity companies to this market have raised the fear that annuities purchased from insurance companies may leave retirees unprotected. We are very concerned that retirees receive sound annuities, and we are taking steps to ensure that happens. We are also concerned about the potential for another hidden PACMAN. If the PBGC were to insure annuities against default, without proper pricing of that insurance and regulatory control over insurance companies, we would be exposed to severe risk of loss.

When a single-employer defined benefit pension plan terminates with enough assets to provide all benefits, the law requires the plan administrator to provide annuities from an insurance company to all participants and beneficiaries, except those who elect a lump sum distribution or rollover. Many ongoing plans similarly purchase annuities for participants when they retire.

The requirement to provide annuities initially was instituted by the PBGC as a way to carry out Congress' mandate to plan administrators to make a final distribution of assets after plan termination. The PBGC adopted the annuity requirement so that participants would have the option of receiving their benefits as a lifetime monthly income rather than be required to take a lump sum cash payment.

PBGC feared that if participants elected a lump sum distribution, they would spend it or invest it unwisely, jeopardizing their retirement income. Because of this concern, PBGC's 1981 termination regulations required, if a plan offered forms of

distribution other than annuity contracts, that the plan administrator advise participants of the potential risk inherent in alternative forms of distribution and that PBGC did not insure that risk. In proposed regulations issued in September 1987 that would supersede the 1981 regulations, as well as in the recently issued standard termination forms, this requirement was deleted as inappropriately paternalistic.

Another reason for the annuity purchase option was PBGC's belief that Congress intended PBGC's insurance funds to be used only for plans that did not have sufficient assets to provide guaranteed benefits, and not to provide annuities directly. Also, we did not want to disrupt the private insurance market by mandating or permitting the purchase of annuities from a government corporation.

In the 15 years of PBGC's existence, we know of no participant or beneficiary who has lost benefits because of default by an insurance company on annuities purchased upon plan termination. Insurance companies are subject to state regulation, and 44 states have guarantee arrangements that protect annuities sold by insurers. These guarantee arrangements are not normally pre-funded and have limits and exclusions. Nonetheless, in the one case in which there was a major problem—Baldwin United—the insurance industry and the State of Arkansas stepped in and made certain that all holders of Baldwin United annuities would be paid in full.

When Congress revamped the single-employer insurance program in 1986, it incorporated PBGC's regulatory requirement for annuity purchases into Title IV's statutory requirements. The law now requires that plan administrators purchase annuities for all participants in plans terminating in a standard termination unless the participant has elected another form of distribution. The annuity purchase requirement applies whether or not there is a reversion of assets to the employer.

Congress established the PBGC to insure payment of benefits when a plan terminates with assets insufficient to provide those benefits. The PBGC does not believe that Title IV of ERISA authorizes us to use our insurance funds to guarantee annuities purchased from insurance companies.

Title IV provides that the only "insurable event" is termination of a plan. When an underfunded plan terminates, PBGC is required to pay guaranteed benefits from its funds. When a fully funded plan terminates in a standard termination, the plan administrator is required to dilute plan assets in full satisfaction of all benefits. The plan administrator must certify to PBGC that this distribution has been made. There may be cases where a plan administrator certifies a distribution to be complete, but a participant is overlooked or paid an incorrect amount. The law provides, in section 4041(b)(4), that the PBGC is responsible for payment of guaranteed benefits if the plan administrator does not correct an error in distribution. It is the distribution of assets in the correct amount, and not the plan administrator's certification, that extinguishes the guarantee.

Once the distribution is made, however, PBGC is no longer liable. The subsequent failure of an insurance company is not an insurable event under the statutory framework.

Congress has established premiums based solely on PBGC's exposure from insufficient plans and not on any exposure that might result from annuities purchased by a terminating sufficient plan. If the PBGC were to insure annuities, it would be guaranteeing additional benefits which we estimate may reach $50 billion. In addition, this insurance would give the sponsor a perverse incentive to buy the lowest acceptable quality annuity to minimize the cost of the purchase or to maximize the asset reversion. The insurance company could also be tempted to invest in higher risk assets. As insurance companies are regulated by the states and not by the Federal government, the Federal government would have no power to regulate the annuity company.

The difficulty of creating a sound Federal insurance program for annuity companies should not be underestimated. Some of the many issues that would have to be addressed include:

How can we set premiums with no loss experience? Could they be risk adjusted?

How do we identify and handle the $50 billion in annuities already in place?

How would we integrate a Federal program with the present state guarantee arrangements?

What priority in bankruptcy should our claim against the insurance company have? If we are to receive a priority, why not grant it directly to the individuals who own the annuities instead?

What impact would our insurance have on behavior and the marketplace?

What guarantee limits should be set? If they are the same as in our present program, will beneficiaries end up worse off?

It is our belief that the guarantee function is, therefore, best left at the state level. To the extent these arrangements are felt not to be adequate, the states and the industry should be encouraged to make the guarantee arrangements acceptable.

Our conclusion that Title IV does not authorize PBGC to guarantee benefits distributed through the purchase of irrevocable commitments purchased from insurance companies is based upon our legal analysis of the statute. Some earlier statements were made without the benefit of this analysis. For example, in January 1981, in a preamble to a regulation on termination procedures, the PBGC responded to a comment on an earlier version of the regulation by indicating that the agency would pay guaranteed benefits if an insurer defaulted and the state insurance funds did not cover the loss.

After questions were raised about the statement, PBGC and the Administration made a legislative proposal, in 1983 and 1985, to add language to Title IV *clarifying* that PBGC did not guarantee against insurance company insolvency. The proposal was not enacted. The 1983 legislative package that included this proposal died when the 98th Congress ended its session without acting on it. The Administration's legislative package was introduced again in 1985, as was this clarifying amendment, but the bill that was ultimately enacted as SEPPAA did not include the clarifying language PBGC had proposed. While legislative history does not explain why the language was dropped, we have no reason to believe that it was because it was considered to be incorrect. We do believe that if Congress had intended for PBGC to insure annuity companies that are regulated by the States, it would have expressly said so in the statute.

We want retirees to receive sound annuities. The purchase of annuities following a plan termination is subject to the fiduciary provisions, including the prudence requirement, of Title I of ERISA. These requirements are enforced by the Pension and Welfare Benefits Administration. We are working closely with the PWBA to ensure the integrity of the selection process.

The PBGC is responsible for processing standard terminations. The agency has not imposed specific standards above those of Title I. However, a case recently occurred in which we did get involved in the annuity selection process. Coleman Company had an application pending for a standard termination when the annuity company announced a large loss and was downgraded by the rating agencies. Ultimately, Coleman agreed to buy the annuities from a very highly rated company instead.

We are working with PWBA to ensure that the fiduciary standards are followed. As a first step, we are requiring sponsors with pending termination applications to inform us of the annuity company they will use before the termination is completed. We will incorporate this requirement in the new regulations. PWBA will investigate where appropriate.

In addition, the PBGC and PWBA are considering standards for plan administrators to follow in the selection of the insurance company. We are having discussions with the credit rating agencies, the industry, the state regulators and the guarantee funds.

The PBGC is committed to the long-term health of the private pension system. We believe the appropriate role of the Federal government is to encourage sponsors to prudently select insurers for pension annuities and to enforce standards. We do not believe that another large risk fraught with moral hazard should be placed upon the PBGC insurance program. We will remain tough in preventing unwarranted claims and protecting PBGC's and participants' interests when claims do occur. Only in this way can we continue to protect the insurance fund and the nation's retirees.

Thank you for the opportunity to speak before the Committee. I welcome any questions you may have.

PREPARED STATEMENT OF RICHARD V. MINCK

Good morning. My name is Richard Minck and I am an Executive Vice President with the American Council of Life Insurance. I am accompanied today by Paul Reardon, Director, Investment Research. I appreciate this opportunity to present the views of the ACLI on the security of retirement annuities provided by life insurance companies. The Council is the major trade association of the life insurance business. The Council has a membership of 616 life insurance companies which, in the aggregate, have approximately 94 percent of the life insurance in force in the United States and hold approximately 99 percent of the reserves for insured pension plans.

Introduction and Summary

My comments deal with the current financial status of the life insurance business and the protections that are in place to ensure that we are appropriately managing the money entrusted to us. I will also describe current actions by the National Association of Insurance Commissioners (NAIC) and the ACLI to determine if any added measures need to be taken to protect the public's trust in us.

The life insurance and pension business is extremely competitive, and thus all life insurance companies are not of the same strength, size, and financial condition. As is true in all segments of the business community, companies assess risk differently, and a small handful of companies may have taken more risks than will turn out to be wise. However, life insurers have a long history of making conservative, long-term investments, and our investment portfolios are among the most widely diversified of any industry. I strongly believe our industry is sound and secure, and some conclusions being drawn from recent newspaper articles and testimony given at some Congressional hearings are not appropriate. My testimony sets forth the reasons why there is clearly no emergency which should cause Congress to take action at this time.

FINANCIAL STRENGTH AND QUALITY OF INVESTMENTS IN THE BUSINESS

Any review of the financial strength of the life insurance business must begin with an orientation overview of the quality of its assets and the integrity of its investment practices. It is generally agreed among investment managers that the fixed-income bonds and mortgages invested in by life insurance companies are very conservative investments. Generally, life insurance commercial mortgages are not made until properties are producing a steady stream of income. Both mortgage borrowers and bond issuers are contractually obligated to make periodic payments to life insurance companies.

Consider the life insurance industry investment portfolio. The bulk of investments has normally been in fixed-income securities and mortgages which generate a steady cash flow. For example, total corporate and government bonds as a percent of total general account assets has not been less than 41 percent throughout the postwar period and stood at 57 percent in 1988. Total investment in bonds plus mortgages was 87 percent of general account assets in 1950 and 79 percent in 1988. Real estate holdings over the years have been less than 5 percent of general account assets. Investment in common and preferred stocks as a share of assets has never been higher than 7 percent in the last 45 years and was 5 percent in 1988. The common stock share stood at only 4.1 percent at the end of 1988. Commercial mortgages, which are backed by income-producing properties, comprise 92 percent of total mortgage holdings.

As suggested above, the industry's investments are well diversified with very small exposure to the volatility of the stock market. Commercial mortgages are diversified across U.S. regions and types of properties. The bond portfolios are diversified among government obligations, foreign government bonds and corporate bonds. Corporate bonds are also diversified, not only among companies and industries, but also by maturities.

The NAIC Securities Valuation Office (SVO) categorizes, by credit quality, all public and privately placed bonds held by life insurance companies. The NAIC rating system is based on mechanical, financial tests, and their ratings are only loosely correlated with corresponding ratings by the public bond rating agencies. Bonds of the federal government and its agencies are in an exempt category because there is no credit risk (11 percent of general account assets). The categories for other bonds are investment-grade, noninvestment-grade average quality, noninvestment-grade below-average quality, and bonds in default.

Ownership of noninvestment-grade corporate bonds among our companies has been limited. At the end of 1988 only 3.6 percent of general account assets in member companies were in such noninvestment-grade bonds. Bonds in default were less than one-eighth of one percent (.0012) of general account assets. A large amount of noninvestment-grade bonds held by major life insurance companies are private placement bonds, not public bonds. Life insurance companies have been the biggest provider of privately placed loans for many years. In comparison with public bonds, private placements provide insurance companies with additional financial protections in the form of covenants and collateral. Companies making these loans have long experience in evaluating these privately placed loans, and default experience has been good. In the years from 1978 through 1988, the bond default rate as a percent of general account assets went above one-fourth of one percent of the general account only twice (.26% in 1983; .28% in 1987). Moreover, under the Mandatory Securities Valuation Reserve (MSVR) requirements of the NAIC, our companies are required to accumulate higher reserves against bonds with higher credit risk.

A reasonable level of holdings of noninvestment-grade direct placements and public bonds should not be of concern since, in any solvency threat, all the assets of the general account and company surplus stand behind insurance company guarantees. This will be explained further below.

With respect to the quality of life insurers' mortgage portfolios, the average mortgage delinquency rate stood at 2.47 percent of the total mortgage portfolio at year-end 1989, the lowest level since year-end 1985. This equates to slightly more than one-half of one percent of general account assets. Most insurers with significant commercial mortgage holdings are national lenders and are able to diversify both geographically and by property type. One of the major problems of failed thrifts was that they were mainly local lenders and could not reduce their risks substantially through regional diversification. In addition, the intermediate to long-term nature of insurance company liabilities permits life insurance companies to provide fixed-rate, long-term mortgages on leased properties already generating income, instead of floating-rate construction loans which are inherently more risky. Other financial institutions with short-term, variable-rate liabilities provide these riskier short-term loans.

The recent downturn in the noninvestment-grade bond market does not markedly impair the financial strength of the insurance industry. The industry has shown its resilience in managing economic dislocation in its experience with weathering high inflation followed by deep economic recession.

Double-digit inflation and a deep recession in the years from the late 1970s through 1982 provided serious new challenges to the industry and its investments. Those challenges did not seriously impair the financial strength of the life insurance industry as a whole. In those years there was a decline in margins on products being sold. At the same time, there arose a threat of disintermediation, manifested in an increase in policy loans at contractually guaranteed low interest rates which peaked at 10.1 percent of assets in 1981. Another challenge introduced at that time was the growing range of interest-sensitive products which put further pressure on companies to earn high returns on investments.

The following measures of financial strength indicate that, in the aggregate, companies remained sound during that trying period from the late 1970s into the Eighties. Bonds in default comprised .07 percent of general

account assets at year-end 1979, peaked at .26 percent at year-end 1983, and stood at .12 percent in 1988. Policy loans as a percent of general account assets fell to 7.4 percent in 1985 and were down to 5.2 percent of assets in 1988. The industry's capitalization ratio, which was 6.7 percent in 1977, stood at 7.1 at the end of 1988. Liquidity in terms of cash plus short-term assets was 1.9 percent of assets in 1979; companies increased this to 4.2 percent in 1983, and it was 3.4 percent at year-end 1988.

Life insurance companies took major steps and have been very aggressive in moving to improve matching of assets and liabilities. This can be seen in the shortened maturities in their bond and mortgage portfolios in the early 1980s. Bond acquisitions in over 10-year maturities fell from 85 percent of acquisitions in 1980 to 53 percent in 1983 and 36 percent in 1988. Similarly, the over 10-year share of mortgage acquisitions fell from 95 percent in 1980 to 48 percent in 1983 and 17 percent in 1988. This enabled companies to better match the maturities of their assets with maturities of their liabilities. The purpose of this has been to better manage risk inherent in volatile market interest rate movements.

OVERVIEW OF GENERAL ACCOUNT OPERATIONS: HOW ANNUITANTS ARE PROTECTED BY OPERATIONS OF LIFE INSURANCE COMPANIES

An insurer's general account is most properly characterized as the assets of a large and diversified operating business which primarily involves the assumption and management of risks and other obligations in return for compensation. Assets in the general account are derived from all classes of business, including life insurance, health insurance, and pensions. In any solvency threatening environment, all general account assets, including surplus, are available to support the insurer's liabilities. The principal functions which an insurer must perform in managing its business, including the investment and management of its assets, all require the insurer to consider and to balance corporate-wide objectives and constraints with the objectives and constraints of particular contracts or classes of business.

In managing its business, an insurer must perform several major functions on an ongoing basis, including the selection and control of its insurance risks ("underwriting"), investment and management of its assets, and determination and allocation of its surplus. To varying extents, each of these functions is carried on with separate reference to the particular classes of business which the insurer manages and the particular types of risks assumed within each class of business. However, none of these functions is carried out without careful consideration of the corporate-wide objectives of the insurer, in particular: (1) the need to maintain sufficient assets, surplus, and cash flow to meet all of its different obligations to its present and future contractholders and other constituents, and (2) the need to maintain equity among such contractholders and other constituents in terms of the considerations which it charges and the manner in which surplus is allocated and distributed. There are tight controls on the deposits and withdrawals that are permitted under most insurance and annuity contracts. For purposes of this testimony, we will concentrate on the investment function only.

A life insurance company must invest its funds so both its immediate and long-term obligations can be met and its surplus may be increased. Insurance companies seek to balance the traditional objectives of attaining optimal portfolio yield, considering investment risk, and preserving principal and liquidity. The particular nature of an insurer's general account and the obligations supported by its general account require the insurer to take into account several considerations which are somewhat different from the considerations of others such as investment advisors, trustees, or those having no obligations other than to return to their beneficiaries or clients a pro-rata portion of a specified pool of assets.

First, the general account investments of insurance companies are subject to state insurance regulations, which limit the types of investments an insurer can make and require certain kinds of investment diversification.

These regulations are primarily intended to ensure that the insurer can satisfy all of its obligations. Moreover, in view of the fact that all of the general account investments support all of the insurer's liabilities on an unsegregated basis, such regulations are applicable to the insurer's investments as a whole, and not to specific lines or classes of business.

Also, most of an insurer's obligations generally are of a medium-term to long-term nature, and the considerations collected by the insurer to support them will be sufficient only if the insurer earns investment income and cash flow at an assumed rate for an assumed period of time. Prudent management requires the insurer to exercise sufficient conservatism in determining the investment assumptions to be used in managing its obligations. These characteristics of their liabilities have caused life insurance companies to become primarily medium-term and long-term lenders. Earning a sufficient return and cash flow to match their investment assumptions is a critical, if not the primary, investment objective.

HOW ANNUITANTS ARE PROTECTED BY STATE REGULATION OF LIFE INSURANCE COMPANIES

When assessing the safety and soundness of so-called "close-out annuities," careful scrutiny must be made of the current regulatory framework which has been crafted to assure the safety and soundness of life insurance companies. As has been noted by Secretary of Labor Elizabeth Dole, in the 15-year history of ERISA, there has never been an instance where an insurance company failed to pay a pension annuity. The principal reason for this flawless record has been the generally conservative management of life insurance companies and their investment practices as described above. This has been supported by state laws and regulations which serve to protect the pension-annuitant through such mechanisms as financial examinations, regulation of underlying investments and guaranty fund coverage. The following sections will illustrate the array of state laws and regulations which provide substantial protections for insurance policyholders and annuitants.

Investment Laws. Each state in the country has a comprehensive statutory framework governing the investment practices of its domestic insurers. The objectives of this framework are well illustrated by the Wisconsin Insurance Code:

"(a) Safety of principal, and to the extent consistent therewith, maximum yield and growth;

(b) Stability of value, except where higher risk and possible fluctuations of value are compensated by a commensurate increase in yield and growth possibilities, and either special reserves or surplus is available in sufficient amount to cover reasonably foreseeable fluctuations in value;

(c) Sufficient liquidity to avoid the necessity in reasonably expected circumstances for selling assets at undue sacrifice;

(d) Reasonable diversification with respect to geographical area, industry, maturity, types of investment, individual investment and other relevant variables; and

(e) Reasonable relationships between liabilities and assets as to term and nature."

The primary goals which these objectives seek to accomplish are prevention of insolvency, maintaining sufficient liquidity, and earning reasonably high returns which may be passed on to insureds in the form of reduced premiums or larger dividends. Efforts to obtain these objectives and goals are supported by extensive state regulation of the form and amount of investments which may be made by insurance companies. Permissible investments (government securities, corporate securities, and real property) are set forth by statute as are those investments which are flatly prohibited.

These same statutes will also impose earnings tests for certain investments (i.e., five percent of par value of a preferred stock over a seven-year period) and quality requirements. A further control is the imposition of limitations on the percentage of an insurer's assets which may be placed in a certain category of investment, most frequently with regard to common and preferred stocks and real property investments. Finally, insurers are limited in the percentage of their total assets which may be placed with one issuer, as well as the extent to which the insurer may control the stock of another corporation (often limited to 10 percent of that corporation's stock).

Additionally, states will impose safety or quality restrictions on various investments. Typically, secured loans will be limited to a certain percentage of the collateral supporting the loan, and investments in certain companies may be limited to firms over a certain size (i.e., assets of $25 to $50 million). The term of mortgages may be limited to the extent of a leasehold security, a history of nondefault is required for investments in corporations, and those investments may be limited by the length of existence of the corporation and/or a demonstrated earnings history.

State laws generally require that investments of a life insurance company be authorized or approved by the company's board of directors or a committee of the board. While authority to make certain investments between board or committee meetings may be delegated to certain officers of such companies, the board or committee provides guidelines for and imposes significant limitations on such delegated authority and (pursuant to law) requires that all investments made under that authority be reported to the board or committee of the board. Meetings of the board or committee to review and approve investments are held frequently -- at least once and, more generally, twice a month.

Mandatory Deposits. Most states require that insurance companies doing business within their borders maintain a deposit with the state in an amount equal to the minimum capital required by that jurisdiction. Often states defer to the deposit made with the insurance department of the state of domicile. Conversely, states may, in certain circumstances, require that companies post a special deposit for the security of policyholders residing within that state. In either event, the form of the deposit may be restricted to certain forms of investment. Finally, the department of insurance is empowered to require adjustment of the deposit amount to reflect increased reserve liabilities of the life insurer.

Solvency Surveillance. Each insurer doing business within a state must submit to the insurance commissioner an annual statement of its financial affairs in a form prescribed by the department which contains a comprehensive disclosure of all financial activities of the corporation during the preceding year. The statement must be verified by the officers of the corporation under oath and must also be filed with the NAIC. A significant number of states now require that these annual reports be submitted in computer useable form (diskette) so that these data can be quickly entered into the sophisticated data base maintained by the NAIC. These data then become a part of the Insurance Regulation Information System (IRIS) which compares the operating results of the insurance company against numerous ratios which serve as indicators to determine if the insurer has experienced any substantial deviations from industry norms. In the event that a company shows a number of abnormal results, a special analysis is conducted by the NAIC to determine whether there is cause for regulatory concern. The data and the analytical conclusions are shared with state insurance departments for appropriate action.

In an increasing number of states, domestic insurers are also required to submit comprehensive annual audited financial reports to the insurance department. The report must address the financial condition of the company for the preceding calendar year as well as the results of operations, cash flow, and changes in capital and surplus. Any differences between the annual statement and the audited financial report must be reconciled. The independent auditor must also furnish the insurance commissioner with an evaluation of the insurer's system of internal accounting control, including any proposed or implemented remedial actions.

Financial Examinations. A state insurance department may examine the affairs of any insurer doing business within its borders as it may deem necessary. Moreover, every domestic insurer is subject to comprehensive financial examinations whenever deemed necessary, and many states require additional mandatory examinations on a periodic basis, usually no less frequently than every three years. The examination is conducted by a team of trained professionals, often representing more than one state insurance department. The examination is conducted in accordance with clearly established guidelines which have been developed by the National Association of Insurance Commissioners designed to explore every facet of the financial affairs of the company under review. Upon completion of the examination, a full report on the condition of the insurance company is made to the domestic insurance department and the insurance company after which the examination report is reviewed so that action can be taken as the commissioner may deem pertinent.

Insolvency Proceedings. In the rare event that a company is deemed to be financially impaired, the insurance commissioner may conserve, rehabilitate or liquidate the corporation. If it is not possible to rehabilitate or conserve the company and it becomes necessary to liquidate the company, the reporting and examination procedures outlined above ensure that a company which becomes subject to the supervision of the insurance commissioner will, nonetheless, have substantial assets from which to meet a sizeable percentage of the obligations of that insurer. In fact, the estate of the insolvent insurer will be distributed under an order of priority established by state statute. Typically, this order of distribution places policyholders in a preferred priority. The order of distribution requires costs and expenses of administration to be paid from the estate followed by debts due to employees for services rendered (with limits) as the only claims which precede those of policyholders. The NAIC Model Act grants policyholder claims a higher priority than the claims of federal, state or local governments, general creditors and claims of shareholders or other owners.

The difference between the funds available for distribution in the liquidation process and the amount of claims of policyholders is addressed in 45 states by the state guaranty association. Under this mechanism, all insurers doing business in the state will be assessed a portion of the deficit which must be met in order to satisfy policyholder claims. The extent of protection afforded by this system is typically up to $100,000 of the present value of an annuity for each annuitant of the insolvent insurer.

The states generally specify one of two forms of coverage: "residents only" and "state of company domicile." Under the "residents only" approach, the state guaranty association will provide coverage for all residents of that state, regardless of the domicile of the insolvent company. Under the "state of company domicile" approach, the guaranty association in the state where the insolvent company is domiciled will cover all insureds of that company, regardless of their state of residence. It is important to note that, if the insolvent insurer is domiciled in a state which does not have a guaranty association, policyholders residing in any state which has a guaranty association would receive coverage by that guaranty association.

Clearly, the combination of statutory protections (priority of claims against the insolvent insurer and guaranty association assessments) and sound, practical dealings by the liquidator provides a very substantial "safety net" for life insurance and annuity policyholders.

CURRENT ACTION BY THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NAIC TO IMPROVE PROTECTION OF ANNUITANTS AND POLICYHOLDERS

Moreover, even given the substantial protections afforded under the current system, this system is not static. Investment laws are under constant review and are amended to reflect changing market conditions. Technological advances continue to make it possible to refine the financial examination and reporting process in order to further enhance the ability of individual states to share information and expertise and thereby to further strengthen financial surveillance of insurers. The NAIC has placed solvency

issues at the top of its regulatory agenda. A recently developed set of financial regulation standards has been defined by the NAIC for use by individual states in undertaking their solvency surveillance duties. The NAIC is also carefully scrutinizing recently emerging surplus financing mechanisms as well as the impact of reinsurance transactions on company solvency.

The ACLI has also placed a very high priority on the question of life insurance company solvency by the appointment of a board level task force on solvency concerns. The objectives of the task force are to review the solidity and solvency of the life insurance industry in recent years to determine if a solvency problem exists today (and to what extent) and to identify any changes necessary to reduce the likelihood of future insolvencies in the life insurance industry. Substantial work has already been done toward achieving these objectives and a final report will be completed before the end of this year.

Conclusion

As our testimony has indicated, while there may be some areas that need to be closely monitored, there is no current financial crisis in the life insurance business. At the time ERISA was passed in 1974, there were no problems with pension benefits being paid by life insurance companies under annuity contracts to retirees and beneficiaries. Moreover, since the enactment of ERISA almost 16 years ago and through today, not one retiree or beneficiary has failed to receive every penny of pension annuity benefits promised by life insurance companies.

Many factors are responsible for this track record:

-- The life insurance business has a long history, which continues today, of conservative investments to back its guarantees. Moreover, its investments are well diversified to prevent undue exposure to regional or market sector problems. Below investment-grade corporate bonds, while having a legitimate role in an investment portfolio, represent only a very small percentage of total industry assets.

-- The life insurance business also has a history of being quick to adapt to changing economic conditions. It came through the troubling economic conditions of the late 1970s and early 1980s in good financial shape.

-- The very nature of the insurance company promise, which is to back its guarantees with all its general account assets, including surplus, gives policyholders a high degree of protection.

-- The safety and soundness of the life insurance business is buttressed by state laws and regulations to protect policyholders through such programs as financial examinations, regulation of investment practices, and guaranty fund coverage.

We, of course, cannot guarantee a perfect record for all time. But there is clearly no immediate crisis and no need for Congress to take precipitous action which could cause significant, and most likely, needless dislocations in our business. Instead, time should be taken to determine if a problem really exists and, if so, to define it and design an appropriate response. We do not think this very necessary analysis has yet been done. The results of our CEO Group's study will be a valuable contribution to this process.

Thank you for the opportunity to present the views of the ACLI on this very important subject. If you have any questions, we will be glad to attempt to answer them.

COMMUNICATIONS

STATEMENT OF THE C&B CONSULTING GROUP

C&B Consulting Group, a division of Corroon and Black Corporation, is an employee benefits consulting firm with a national client base. We are pleased that the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service is studying the growing complexity of rules governing the private pension plan system. As consultants for a wide variety of plans -- including those maintained by corporations, governmental units and tax-exempt entities, as well as multiemployer plans -- we are alarmed at the accelerating complexity of plan administration resulting from legislation aimed at employee benefit plans over the past decade. We would like to take this opportunity to point out a few examples of the needlessly burdensome consequences recent legislation has had on pension plan administration (illustrated in some cases by actual circumstances faced by our clients), as well as suggest possible alternatives for the future.

Introduction

In recent years, legislation governing pension plans has been driven by two or three very different policy initiatives. One of the major thrusts in pension legislation involves protection of employee rights to pensions, with particular emphasis on attempting to prevent discrimination in favor of highly paid plan participants and increasing portability of benefits. There have also been attempts to encourage expanded pension coverage in the U.S. work force.

On the other hand, pension legislation has also been shaped to a great extent by revenue considerations. The tax incentives that serve as the foundation to our private pension system have been an inviting target in these revenue sensitive times.

These policy objectives are not fundamentally compatible. In our view, the gradual implementation of these disparate objectives over the past decade has created an administrative nightmare that threatens the long-term health of our private pension system. No one's interests are served if the exorbitant cost of attempting to comply with burdensome, contradictory (and sometimes unknown) requirements deters employers from maintaining pension programs that contribute significantly to the well-being of employees in their retirement years. Each year, employers face increasing administrative costs associated solely with compliance with changes in the law. This is money that could be better spent on pension benefit improvements or other employee benefit plans.

Anticipation of Legislative Impact

Employee benefits legislation that seems like a good idea on paper sometimes creates practical administrative problems that make it difficult, if not impossible for employers to comply with the law. The impact of §89 was an obvious case in point; however, this problem is often felt in many other ways in the employee benefits area. Frequently, complex rules designed to prevent specific abusive practices by a minority of plan sponsors cause unintended (and unforeseen) hardships for the majority of plans that are not abusive in any way.

While it is difficult to foresee all of the implications proposed legislation may have, efforts to thoroughly investigate possible "side effects" in this area serve as an important safeguard

- **Quarterly Contribution Rules** -- One example of the difficulties faced by many of our clients has been in the operation of the quarterly contribution rules. In 1987, Congress passed legislation requiring quarterly contributions to pension plans (later clarified to apply only to defined benefit plans). This legislation was enacted to accelerate funding by preventing plan sponsors from delaying until 8 1/2 months after the end of a plan year to make a required contribution. While we understand that ensuring adequate funding of plans is an important policy objective, the quarterly contribution rules have placed unnecessary burdens on those plans which are making an effort to maintain their funded status.

Many sponsors of defined benefit plans typically make annual contributions that exceed the minimum contribution required under §412 of the Code. The higher contributions are often motivated primarily by benefit security considerations rather than increased employer tax deductions. Regardless of the motivation, well funded plans frequently become constrained by the "full funding limitation" of Code §412(c)(7). Because of favorable actuarial experience and as a result of the sensitivity of full funding limitation threshold (especially after full funding was modified by OBRA '87), contributions are frequently limited by the full funding limitation for a plan year immediately following a year for which the limit did not apply. Quarterly contributions for plans in this situation are particularly troublesome.

Because of the time and resources needed to compile employee data and perform actuarial valuations, plan year contribution requirements generally are not known when the first quarterly contributions for a plan year become due. As a result, the first (and perhaps subsequent) quarterly contribution(s) must be determined based on the funding requirements for the preceding year, as is permitted under OBRA '87. If it turns out that the full funding limit applies where it did not in the preceding year, the plan may have been forced to make a nondeductible contribution. Such a contribution generates a recurring penalty tax until it can be deducted -- which for some plans may be years down the road.

While the IRS has established a procedure for revoking a nondeductible contribution in this situation, the procedure is sufficiently burdensome that very few plans have opted to take advantage of it. The procedure, as described in Revenue Procedure 89-35, requires collection and submission to the IRS of a substantial amount of material intended to demonstrate the nondeductibility of the contributions involved. In addition, certification by an enrolled actuary and payment of a user fee are involved. For many plan sponsors, it is simply cheaper to pay the penalty tax than to recover the nondeductible contribution. In effect, these plan sponsors pay a tax for making a good faith effort to comply with the law.

One alternative left to plan sponsors wary of the burdens imposed by making nondeductible contributions is to simply not make quarterly contributions while they await the results of the current year's valuation report. If it later turns out that a quarterly contribution was due under the new valuation, the plan sponsor will be in violation of ERISA unless proper written notice of the missed contribution was given to each participant within sixty days of the due date. The penalty for failure to properly notify is up to $100 per day per participant. In many cases, the maximum penalty would be much larger than the required contribution for the entire year. The threat of such a penalty essentially forces employers to notify participants that they *may* be missing a quarterly contribution -- even though the company has no way of knowing whether the contribution is even due for the year.

If participants are properly notified under ERISA, the only penalty for a late quarterly contribution involves additional interest payments to the plan. For those plan sponsors for whom notification would not create a serious employee relations problem -- generally very small employers -- the only hardship this penalty imposes is increased complexity in minimum funding contribution calculations. In some respects, the added burden of computing quarterly contribution amounts and cutting quarterly checks is as much of a hardship as the penalties imposed for failure to make the required installments.

While it was only a short-term problem, the fact that 1989 plan year quarterly contribution amounts were due before the full 1988 contribution has been a source of considerable confusion for plan sponsors.

Real world examples

- *One large manufacturing corporation with with over 20,000 employees maintained a number of separate defined benefit plans which were merged in 1989. Only one of the pre-merger plans was not fully funded in 1988. While the consolidated plan was almost certain to be fully funded for 1989, there was no way to be sure before 1989 quarterly contributions became due for the 1989 plan year (because of time constraints in producing a 1989 valuation). Nevertheless, the company felt obligated to make a quarterly contribution on the basis of the 1988 minimum funding requirements for the non-fully funded plan in order to be confident of compliance with the quarterly contribution rules. As a result, the company was penalized for its good faith compliance effort with all of the*

headaches associated with having nondeductible contributions in the plan. Moreover, the consolidated plan is expected to remain fully funded for a number of years.

An integrated defined benefit plan's formula required major changes to satisfy TRA '86 requirements. The plan made its first two 1989 quarterly contributions on the basis of 1988 plan year funding requirements. By the due date for the third quarterly contribution, the plan sponsor had tentatively selected a new plan design to be effective 1-1-89 in accordance with the requirements of TRA '86, and preliminary studies indicated that the plan would be fully funded for 1989 on the basis of the new plan design. Based on this information and concern about nondeductible contributions, the plan sponsor did not make the third quarterly contribution. Actual valuation results for 1989, however, later indicated that the plan was not fully funded for 1989. The plan was not in compliance with quarterly contribution requirements directly as a result of the unpredictable nature of the full funding limitation.

In total, problems that have been and will continue to be associated with the quarterly contributions certainly raise the questions of whether the intended result was worth the trouble caused.

Interest Rate Assumptions for Employee Contributions -- OBRA '87 also changed the requirements for determining employer-purchased benefits (which are typically subject to vesting requirements) in a contributory defined benefit pension plan. These rules, which were clarified in IRS guidance issued in Spring 1989, apply to the benefits of contributory plan participants terminating after the start of the 1988 plan year.

These rules were significantly revised in a "technical correction" in OBRA '89. While the changes would not have been particularly burdensome if implemented initially under OBRA '87, the fact that the rules are to be applied *retroactively* to the beginning of the 1988 plan year is a nightmare for contributory plan administrators.

Real world example

- *One large corporation maintains a contributory defined benefit plan. Several thousand employees terminate employment each year. Upon termination, vested benefits are calculated and communicated to each former employee. Since the beginning of the 1988 plan year, these calculations have been made in accordance with the OBRA '87 rules. The 1989 IRS guidance on this topic confirmed that the procedures used by the company were in accordance with the statute.*

  In order to comply with the OBRA '89 calculation rules, calculations will have to be redone for all employees who terminated employment since January 1, 1988. The company has over 30 separate plant locations and plan administration functions are not centralized.

  To further complicate matters, the revised statutory requirements for the calculations are not entirely clear. The company does not expect clarifying guidance from the IRS anytime soon. Taking into account all factors, the company has elected, at least for the time being, not to recalculate benefits for employees who terminated after 1987. The company will reevaluate this position once IRS guidance on the new requirements is issued, rather than risk having to undertake a second recalculation of benefits for several thousand employees.

Return of Excess Contributions -- To prevent excessive discrimination in 401(k) and other individual account plans, Congress imposed limits on before tax-and after-tax contributions available to highly compensated employees. The limits are dictated by the level of participation of nonhighly compensated employees.

It is fairly common for these limits to be exceeded in any given plan year. In accordance with regulations, excess amounts are typically refunded to highly compensated employees during the 2 1/2 month period following the plan year to avoid penalty taxes to both the employee and employer.

The refund amounts are often very small. The cost of processing refunds for the company (cutting refund checks, tax reporting, etc.) often greatly exceeds the amount of the refund.

Real world example

- *A company maintains a 401(k) plan. Upon performing an actual deferral percentage (ADP) test on elective deferrals at the end of the plan year, the plan typically has to process several hundred refunds of $2.00 or less. The company estimates that each refund costs the company about $7.00 to process.*

This problem can be fixed. For example, return of de minimis amounts of excess contributions could be waived based on reasonable expectations of refund processing costs. Perhaps more importantly, this problem could have been avoided in the first place if fundamental practical issues had been anticipated in either the legislative or regulatory process.

Guidance Needed for Implementation

Plan sponsors rely heavily on guidance from the IRS, DOL and PBGC for the operational rules necessary to comply with pension plan statutes within the Internal Revenue Code and ERISA. Repeated changes in pension law over the last decade have made it difficult for these regulatory bodies to issue necessary guidance on a timely basis. As a result, plan sponsors have frequently found themselves attempting to comply with newly effective laws without adequate guidance. While plans are not usually penalized for attempting "good faith compliance" in implementing administrative procedures, it is often quite expensive sorting through possible compliance alternatives. Moreover, plan sponsors are often forced to modify their "good faith" approaches when guidance does become available, resulting in even greater expense.

Unfortunately, the cumulative effect of the many changes in the law is that conscientious employers who make an effort to comply with the rules on a timely basis are penalized for their efforts with added administrative burdens and constant changes to plan provisions. Those which simply ignore the law until regulations are finalized are rewarded by avoiding what often turns out to be useless (and costly) administrative activity during the interim period.

- The Conference Committee Report on the Pension Protection Act of 1987 *required* issuance of regulations providing rules concerning the full funding limitation of IRC §412(c)(7) by August 15, 1988. These rules have significant impact on the amount of deductible contributions available to many plans, effective for all plan years beginning after 1987. No such guidance has been forthcoming, even in this instance where guidance was explicitly mandated by Congress. Plan funding calculations for 1988 and 1989 plan years have been made on a "best guess" basis, without benefit of a precise definition of "current liability" or specific amortization periods for certain aspects of the required calculations. Considerable effort was required to analyze the statute and develop reasonable interpretations of the requirements. Timely issuance of guidance *as required by law* would have prevented this problem.

- In many cases, temporary or incomplete guidance has been as troublesome as no guidance at all. IRS rules on permitted disparity (integration) serve as an example of this problem. Proposed IRS regulations to §401(l) effectively did away with benefit formulas that explicitly offset Social Security benefits. Statements by IRS staffers suggested that there would be no way for these plans to demonstrate nondiscrimination on the basis of plan design. As a result, many sponsors substantially redesigned their integrated plans so that nondiscrimination could be demonstrated through compliance with §401(l). Actuarial studies analyzing the cost of overhauling benefit formulas represent a significant cost to plan sponsors, especially smaller ones.

  A year and a half after issuance of the proposed regulations (effective for the 1989 plan year), the Service is now suggesting that the issue of Social Security offset formulas will likely be revisited, and that it will be possible to demonstrate that these formulas are nondiscriminatory without specifically testing the employee group. As a result, plan sponsors who relied on tentative pronouncements may have needlessly spent time and resources to substantially rework pension formulas which were presumably designed in the first place to satisfy specific objectives of the employer.

Real world example

- *One large company relied on the §401(l) regulations and IRS verbal pronouncements about the fate of Social Security offset plans and redesigned its defined benefit plan accordingly. Because the company felt in was unfair to cut back future accruals of some of its most valued employees, the formula redesign directly resulted in an annual increase in required contributions of $600,000 (in 1989 dollars). This increase represented about 20% of total annual company costs for the plan. Now, it appears that by waiting, the plan could have retained a formula much like the original offset formula and still satisfy nondiscrimination requirements on a design basis. While final rules are not yet available, it appears that the company could have spared itself substantial ongoing cost by taking the seemingly irresponsible approach of delaying action with the hope of regulatory relief.*

As enacted under TRA '86, §401(a)(26) (minimum participation rules) did not include any accommodation of plans assumed by an employer though the acquisition of other companies. Vigilant plan sponsors who anticipated §401(a)(26) problems for acquired plans took remedial action in 1988 in advance of legislation and regulations which ultimately provided significant relief in this area.

Real world example

- *A company heavily involved in acquisitions sponsored a large number of plans formerly maintained by acquired companies. In response to the original TRA '86 statutory requirements, the company determined that the acquired plans would fail §401(a)(26) as of January 1, 1989, unless they were merged so that a sufficient number of employees could be viewed as "participating" in the consolidated plan. TAMRA and proposed regulations (which came out in late 1988 and early 1989 respectively) provided transition rules for acquisition situations. As a result, the company wasted time and money on an unnecessary plan consolidation.*

Not all delays and gaps in regulatory guidance can be attributed to overload caused by repeated changes in tax and labor law affecting pension plans. For example, the Department of Labor has been notoriously slow, even in promulgating regulations under ERISA as it was enacted in 1974. Nevertheless, frequent changes in pension law have certainly exacerbated this problem.

Regulatory Restraint

In many cases, pension legislation has been intentionally vague, leaving the details to be filled in by regulation. The ensuing problems resulting from delayed guidance have already been outlined above. Another problem is the free reign that loosely drafted legislation provides regulators.

- A case in point is the minimum participation rules of §401(a)(26). While the statute calls for compliance on a plan-by-plan basis, the statute also leaves room for the Secretary of the Treasury to apply §401(a)(26) to separate benefit structures within a plan. In its proposed regulations to §401(a)(26), the Service took full advantage of this latitude, identifying a myriad of separate benefit structures to be individually tested. As a result, many larger plans with special features designed to meet the needs of subsets of the employee group faced significant redesign or termination.

  As in the case of Social Security offset plans, the IRS is apparently bowing to public pressure and rethinking its position on §401(a)(26) (some have called §401(a)(26) the pension equivalent of §89). In some instances, pension plans were actually terminated solely because of perceived §401(a)(26) problems that will eventually turn out to be benign under future guidance -- a result clearly in conflict with growing Congressional concern over the number of plan terminations during the last decade.

Real world example

- *An example of the obviously unintended effects of §401(a)(26) involves a nonintegrated defined benefit plan that was modified in 1984 to become integrated. Since this change would reduce future benefit accruals for low paid employees, the plan sponsor decided to preserve the nonintegrated formula for the future accruals of employees working at the time of the plan change. Now that §401(a)(26) has come along, this "grandfather" formula is doomed to fail once the covered group dwindles due to attrition. Under IRS rules, the plan will be forced to shut off a benefit formula now maintained exclusively to the advantage of the lowest paid employees -- most of whom earn less than $30,000 per year.*

Coordination of Guidance

A particularly frustrating problem for plan sponsors is lack of consistency in guidance promulgated by different regulatory concerns. Sponsors occasionally face conflicting requirements, and are put in the position of willfully violating one set of rules as a direct result of compliance with other requirements.

- Plans which offer loans to participants are facing this kind of dilemma. Recent Department of Labor regulations (and follow up guidance) generally prohibit restricting a loan program to active participants. (Plans typically have limited loans to the active participant group to facilitate repayment through payroll deduction.) On the other hand, the DOL rules only require extending the loan program to inactive "parties in interest."

  The IRS is apparently going to take a dim view of plans that make loans available to inactive parties in interest while excluding other inactive participants. Their objections are based on the fact that inactive parties in interest are almost exclusively former highly compensated employees. The lack of coordination between the IRS and the DOL on this issue, however, may by default require plans with loan programs to make loans available to all inactive participants.

  This is not a desirable result for plans with loan programs, since it complicates administration and raises loan security issues. Nevertheless, this requirement would be easier for plans to accommodate if it was an explicit requirement of either the IRS or DOL rules, rather than an implicit requirement resulting from the interrelation of the rules of these organizations. If left uncorrected, this situation will likely result in few plans making loans available. This may be detrimental to participants from a retirement security standpoint because unlike withdrawals, loans amounts are repaid to the plan and remain available for retirement.

- As another example, PBGC requirements for processing a plan termination are structured so that a plan is supposed to be closed out and assets distributed before an IRS determination letter is likely to be issued. Very few plan sponsors would be comfortable finalizing a plan termination without final blessing from the IRS. While coordination of the PBGC and IRS procedures at plan termination is apparently going to be addressed, it is unfortunate that such a difficult situation was created in the first place.

Transition Problems

The scatter gun approach to pension legislation in the 1980s has left most plans in a constant state of transition. Repeated changes in basic plan requirements have created the need for repeated modifications to plan documents and summary plan descriptions. Since careful and conscientious plan sponsors seek IRS approval of plan language changes, frequent plan language changes are costly, especially in our new "user fee" environment.

It is helpful that plan changes required by the 1986 Tax Reform Act and subsequent legislation have been lumped together for amendment due date purposes. Fortunately, plans have also been given liberal remedial amendment periods for completion of consolidated amendments to plans. This current period of limbo, however, a necessary state for many plans as a result of limited guidance in some areas, creates additional headaches for plan sponsors.

- In response to anti-cutback requirements for accrued benefits imposed by Code Section 411(d)(6), the IRS created a series of transition "model amendment" approaches. Plan sponsors were instructed to adopt one of a number of transition amendment approaches to address the possible technical violation of anti-cutback rules during the period between the

effective dates of required plan changes and the ultimate amendment of plans. (Impermissible cutbacks would be considered to occur if a plan benefit or allocation formula provided reduced benefits on an ongoing basis after being retroactively modified to comply with new rules.)

The IRS views these temporary amendments as a necessary response to conflicting statutory requirements. However, due to the timing and lack of clarity of the guidance (the rules have come out in a piecemeal fashion), many plan sponsors have had difficulty coping with the transition amendment rules. The problems are made worse by the fact that the transition period has become considerably longer than was contemplated when the transitional amendment requirements were first put forth.

The fact that many plans are operating in compliance with statutory and regulatory requirements without the benefit of written plan language consistent with that operation is a troublesome concept. It is clear that the interests of plan participants are not being served when all of the critical aspects of their retirement programs are not committed to writing. Certainly, the situation opens up plan sponsors to legal action by employees who press their rights to proper notification of plan provisions. It is very difficult for plan sponsors to know what to do in an environment where they cannot finalize plan provisions due to lack of guidance or anticipation of changes in requirements.

A Need for Vision

Congress needs to take into account the prevailing standards of business operation in designing rules applied in the employee benefits area. Recent legislation has focused on identifying highly compensated employees for nondiscrimination testing and defining compensation for plan purposes. Factoring compensation into employee benefit rules requires a sensitivity to the payroll practices and limitations of employers.

Developing a workable set of definitions and parameters for use in the employee benefits area and remaining committed to those concepts would go a long way toward providing some stability in the benefits area. As the following chart demonstrates, there are still four different definitions of high paid employees for use in welfare plan nondiscrimination testing. These definitions should be standardized so that employers -- most of whom are *not* providing discriminatory benefits -- would be able to perform nondiscrimination testing efficiently, and spend their energies providing employees with the benefits they need to insure their well-being and retirement security.

Comparison of Definitions of "Highly Compensated Employees" for Nondiscrimination Testing

Group Term Life Insurance	Medical Plans	Cafeteria Plans	Dependent Care Plans (same as qualified plans)
"Key Employees"	"Highly Compensated Employees"	"Highly Compensated Group"	"Highly Compensated Employees"
5% owners	10% shareholders	5% shareholders	5% owners
Officers earning more than $51,291 (1990)	5 highest paid officers	Officers	Officers earning more than $51,291 (1990)
10 employees earning more than $30,000 (1990) and owning largest interests in employer	Highest paid 25% of all employees	Highly compensated employees	Employees earning more than $85,485 (1989)
1% owners earning more than $150,000		Dependents and spouses of the categories above	Employees earning more than $56,990 (1990) and in the top paid group

While the preceding example does not directly involve pension plans, the definition described in the fourth column of the chart does apply to pension plans (§414(q)), as does a different definition of "key employee" for purposes of determining top-heavy status under Code §416. Ideally, sponsors of both pension and welfare plans should be able to demonstrate nondiscrimination for all benefit programs on the basis of a single determination of the highly paid group of employees.

Conclusion

The situations described in this discussion are not intended to represent a comprehensive list of problems affecting pension plans. Rather, they are intended to give members of the Subcommittee a flavor of the tremendous hardships faced by plan sponsors that can be attributed to the remarkably complicated state of legislation and regulation in this area.

The nation's private pension system serves a critical dual role in our economy. Not only do pension plans serve as a primary source of income for the nation's older citizens (along with Social Security and, to a lesser extent, private savings), pension plan assets are one of the largest sources of investment and savings in the economy. Furthermore, the role of the private pension system in our economy should be expected to increase in significance as our population continues to age.

In order to ensure the continued health and growth of the pension system, Congress needs to adopt a comprehensive, long-term approach to pension legislation. The public policy issues surrounding the pension area -- coverage, non-discrimination, portability of benefits, security of assets -- deserve to be addressed from the standpoint of a focused, coordinated approach. Policy objectives should be identified and implemented as a coherent package. The traditional approach of tackling these important issues on a piecemeal basis through attachment to unrelated legislation has created many of the vexing problems that serve to dissuade employers from continuing to sponsor existing plans or establishing new ones. If the private pension system is to be viewed as a long-term asset and major engine of the U.S. economy, legislation in this area should be afforded the undivided attention it deserves.

Such a long-range approach to legislation in any area would be challenging, even under the best of circumstances. Current federal deficit concerns make this approach even more difficult in an area so imbued with tax incentives. Continued tinkering with the tax incentives built into the private pension system may seem like a painless way to generate needed federal revenues. Congress must, however, continue to carefully consider the threats this approach to legislation pose to the stability of our nation's pension plans.

As a practical matter, Congress must be cognizant of the administrative burdens created by any legislative changes in the pension area. We think the following steps would greatly ease the financial and resource burdens which seem to go hand in hand with any changes in pension legislation.

- Pension legislation should be considered separately, on its own merits, outside of the annual budget reconciliation process. Several states have recently passed laws that forbid the consideration by the state legislature of a new "mandated benefit" in the health insurance field without an accompanying "cost-benefit" analysis of the effects of the bill. Perhaps a requirement of this kind could be implemented at the federal level with respect to changes in employee benefits law.

- Congress should actively seek additional input from professional organizations working in the pension area (American Academy of Actuaries, American Society of Pension Actuaries, Association of Private Pension and Welfare Plans, Society of Actuaries, etc.), as well as from individual professionals with expertise, in the formative stage of pension legislation.

- New legislation affecting pension plans should not become effective until final guidance is promulgated by the responsible agency (IRS, DOL, PBGC, etc.).

- Coordination among regulatory agencies should be mandated when legislative changes affect areas of shared regulatory jurisdiction (such as the IRS and DOL in the area of plan loans). Guidance in such instances should be issued jointly by the agencies involved.

C&B Consulting Group thanks the Subcommittee for the opportunity to express its views on the very important topic of pension simplification.

STATEMENT OF THE INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

This statement is submitted on behalf of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW). The UAW represents 1.4 million active and retired workers, most of whom are covered under negotiated single-employer defined benefit pension plans.

The UAW commends Chairman Bentsen for holding hearings on the issue of whether benefits payable under retirement annuities provided by insurance companies are guaranteed by the Pension Benefit Guaranty Corporation (PBGC) under the pension plan termination insurance program established under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA). We are deeply concerned about recent statements by the Secretary of Labor and the PBGC which suggest that retirement annuities may not be guaranteed by the PBGC. In our view, this represents an outrageous attempt to evade their responsibilities under current law. Retirement annuities have always been covered under the pension plan termination insurance program. This was confirmed in regulations issued by the PBGC in 1981. And it was reconfirmed in the provisions added by the Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA). Thus, we urge the Finance Committee and the entire Congress to reject the new interpretation by the Secretary of Labor and the PBGC, and to take whatever steps may be necessary to establish that *under current law* benefits payable under retirement annuities provided by insurance companies are already guaranteed by the PBGC.

Under the pension plan termination insurance program as it was originally structured under ERISA, a plan administrator was required to file a notice of intent to terminate a pension plan ten days prior to the proposed termination. After receiving this notice, the PBGC was then required to determine whether the plan contained sufficient assets to pay all guaranteed benefits. If the plan was clearly insufficient, the PBGC was required to place the plan into trusteeship (i.e., to take over the operations of plan), and to guarantee certain benefits payable under the plan. If the plan was not clearly insufficient, the plan administrator was required to provide certain information to the PBGC demonstrating that the value of the plan's assets exceeded the liability for guaranteed benefits. If, on the basis of this information, the PBGC was able to conclude that the plan did in fact contain sufficient assets to pay all guaranteed benefits, the PBGC would then issue a notice of sufficiency. Upon receipt of the notice of sufficiency, the plan administrator was permitted to proceed to close out the plan. *See* Section 4041 of ERISA, 29 U.S.C. §1341.

In order to provide guidance to plan administrators, the PBGC issued regulations on January 28, 1981 dealing with the determination of plan sufficiency and the termination of sufficient plans. *See* 29 CFR Part 2615, 46 Federal Registrar 9532, January 28, 1981. A copy of these regulations is attached. These regulations specifically provided that if benefits under a plan were payable in an annuity form, then upon the termination of the plan those benefits still had to be provided to participants in annuity form, either by the PBGC or through the purchase of annuity contracts from an insurer, unless the participants elected another form of distribution provided by the plan. The regulations insisted on this annuity requirement in order to further one of the fundamental purposes of the termination insurance program: that is, providing for the timely and uninterrupted payment of pension benefits.

When this annuity requirement was first suggested by the PBGC in its proposed regulations, several commentators expressed concern about the possibility that an insurer might become insolvent. These commentators specifically inquired whether the PBGC would guarantee benefits in situations where a terminated plan was closed out under a notice of sufficiency, annuity contracts were purchased from an insurer, and the insurer subsequently became insolvent and was unable to meet its obligations. In the final regulations the PBGC responded to these concerns by stating that there was little risk that insurers would become insolvent, and by reassuring the commentators that if this occurred the PBGC would still guarantee the pension benefits.

The preamble to the final regulations specifically states:

> Two comments that addressed the requirement that annuity contracts be purchased from an insurer were concerned about the possibility comments expressed uncertainty as to whether the PBGC would provide benefits to participants or beneficiaries of a terminated plan that closed out under a Notice of Sufficiency if the insurance company from which annuity contracts had been purchased should prove to be unable to meet its obligations. The PBGC does not believe that the concern expressed by the comments is warranted.

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

Thus, the PBGC's own regulations made it clear that benefits payable under retirement annuities provided by an insurance company are guaranteed by the PBGC under the termination insurance program.

The procedures originally established under ERISA for terminating sufficient plans were criticized by employers and plan administrators for being unnecessarily complex and burdensome. In particular, there were complaints that it took the PBGC too long to issue a notice of sufficiency, even in situations where pension plans clearly had sufficient assets to pay all benefits. Thus, the distribution of assets and the closing out of these plans were often delayed unnecessarily.

To remedy these problems, the Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA) established a streamlined procedure, known as a "standard termination," for terminating sufficient plans. Under this new procedure, plan administrators are simply required to submit a private actuarial certification that the assets of a plan are sufficient to pay all benefits. Upon receipt of this certification, the PBGC has sixty days to issue a notice of noncompliance if it has any doubts about the sufficiency of a plan (or if the plan administrator has failed to comply with any other requirements for the plan termination). If the PBGC does not issue a notice of noncompliance within sixty days, the plan administrator may proceed to close out the plan by making a final distribution of assets. This final distribution of assets may be accomplished through the purchase of annuities or through other mechanisms. The plan administrator must then certify to the PBGC within 30 days that the plan assets have been distributed so as to pay all benefit liabilities under the plan. *See* Section 4041(b) of ERISA, 29 U.S.C. §1341(b).

When these new streamlined procedures were being considered, a question was raised about whether the PBGC would continue to guarantee benefits in situations where a plan was terminated in a standard termination, the plan assets were distributed by purchasing retirement annuities from an insurer, and the insurer subsequently became insolvent. Under the streamlined procedures, the PBGC's ability to review the distribution of plan assets, including the purchase of annuities from an insurer, would be diminished. The labor movement and other groups expressed concern that some employers might abuse the streamlined procedures by purchasing annuities from a "fly-by-night" insurance company (which might be offering attractive rates on retirement annuities). If the insurer subsequently became insolvent, there was concern that the participants and beneficiaries should not be left without any protection.

To make sure that the streamlined procedures for terminating sufficient plans under a "standard termination" did not leave participants and beneficiaries unprotected, the House Education and Labor Committee included a provision, Section 4041(b)(4), which specifically stated:

> (4) *Continuing authority.*—Nothing in this section shall be construed to preclude the continued exercise by the corporation after the termination date of a plan terminated in a standard termination under this subsection, of its authority under Section 4003 with respect to matters relating to the termination. *A certification under paragraph (3)(B) shall not affect the corporation's obligations under Section 4022.* (emphasis supplied)

The report filed by the Education and Labor Committee described the purpose of this provision as follows:

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

> trolled groups do not promptly provide for the payment of such benefits. (emphasis supplied)

Significantly, the conference report on SEPPAA adopted this provision in the Education and Labor Committee bill. Copies of the relevant portions of the Education and Labor Committee and Conference Committee reports are attached.

The language in Section 4041(b)(4), coupled with the description of this provision in the report filed by the Education and Labor Committee, make it clear that the benefits provided under retirement annuities are still guaranteed by the PBGC. Even though a plan administrator has certified under a standard termination that plan assets have been distributed so as to satisfy all benefit liabilities under the plan, this still does not affect the PBGC's obligation to guarantee benefits under Section 4022. If it subsequently turns out, due to the insolvency of an insurance company or some other reason, that all benefit liabilities were not in fact satisfied, then the PBGC is still obligated to guarantee the payment of the benefits in the event the employer does not promptly make up any shortfall Thus, employers cannot abuse the streamlined procedures under a standard termination by purchasing annuities from some fly-by-night insurance company. If the insurance company subsequently becomes insolvent, the PBGC is still obligated to guarantee those benefits.

During consideration of SEPPAA, the PBGC tried to get an amendment which would have expressly exempted benefits provided under annuity contracts from the termination insurance program. The Administration submitted a detailed package of proposals for amending the termination insurance program to Congress on July 3, 1985. Representative Roukema subsequently introduced a bill (H.R. 2995) on July 15 which incorporated verbatim all of these proposals. Significantly, Section 112(a) of this bill would have amended Section 4005(b)(2) of ERISA (29 U.S.C. §1305(b)(2)), which deals with how the PBGC's funds can be spent, to specifically provide that:

> no amount in such fund shall be available to pay benefits in the event of the insolvency of an insurance company with respect to an insurance contract. (emphasis supplied)

See Section 112(a) of H.R. 2995, 99th Congress, 1st Session (July 15, 1985). This proposed amendment was rejected by Congress (even though other changes were made in Section 4005(b)(2) of ERISA). The fact that the Administration, through Representative Roukema, proposed this amendment demonstrates that it believed retirement annuities were guaranteed by the PBCC under pre-existing law. Furthermore, the fact that Congress rejected this amendment in favor of the provision contained in the Education and Labor Committee bill reinforces the conclusion that retirement annuities must be guaranteed by the PBCC under current law.

In attempting to evade their responsibilities under current law, the Secretary of Labor and the PBCC have raised a number of bogus arguments. In a letter to Senator Metzenbaum dated February 12, 1990, Secretary Dole stated:

> I have been advised by the Executive Director of PBCC that PBCC has not had a case in its 15-year history of an insurance company failing and not paying annuities. I have been further advised that no evidence exists that Congress ever intended PBCC to guarantee annuities, and PBCC receives no premiums for such liability. Under longstanding law, states have regulated the insurance funds, and most states have guarantee funds. A Federal guarantee of annuities would add tens of billions to the $800 billion in liabilities PBCC already insures. I believe that the actions that we are undertaking will reinforce the obligation plan fiduciaries have under ERISA when selecting insurance companies. Where we find problems, we will certainly take whatever enforcement actions are necessary.

A copy of this letter is attached.

The assertion that "no evidence exists that Congress ever intended PBCC to guarantee annuities" is simply incorrect. As previously indicated, the inclusion of Section 4041(b)(4) in SEPPAA and the description of this provision in the report filed by the Education and Labor Committee, along with the rejection of the provision contained in the bill introduced by Representative Roukema, clearly demonstrates that Congress did in fact intend for retirement annuities to be guaranteed under the termination insurance program.

The assertion that a "Federal guarantee of annuities would add tens of billions to the $800 billion in liabilities PBCC already insures" is also misleading. As Secretary Dole admits in her letter, the PBCC has never had a case in its 15 year history where an insurance company failed to pay benefits under an annuity contract.

Thus, the PBCC's exposure will not be increased significantly by having to guarantee retirement annuities. There is very little risk that insurers will be unable to meet their obligations under annuity contracts.

The assertion that "PBCC receives no premiums for such liability" is simply beside the point. Whenever a pension plan is terminated, the plan sponsor stops paying premiums to the PBCC, regardless of the manner in which plan assets are distributed. No premiums are paid when plan assets are distributed by purchasing retirement annuities. But it is equally true that no premiums are paid when plan assets are distributed through lump sum payments or through a wasting trust. Since the PBCC continues to guarantee the payment of pension benefits when assets are distributed through a wasting trust or lump sum payments, they should also guarantee premium benefits when assets are distributed through the purchase of retirement annuities.[1]

As a matter of policy, there is simply no reason why the protection afforded to participants and beneficiaries under the pension plan termination insurance program should depend on the manner in which plan assets are distributed. After all, the participants and beneficiaries have no control over this decision. It is entirely within the control of the plan administrator (usually the employer). Furthermore, the manner in which plan assets are distributed does not affect the amount of benefits to which participants and beneficiaries are entitled under a plan. They will still have the same years of service, the same pension credits, etc. Thus, the expectation that they will receive their retirement benefits is just as legitimate.

Requiring that the PBCC to guarantee pension benefits payable under retirement annuities does not mean that participants and beneficiaries will be receiving "free" insurance coverage. The insurance protection was previously paid for through the premiums which the plan sponsor paid to the PBCC prior to the termination of the pension plan.

If the PBCC guarantee were to be eliminated for retirement annuities, this would open a huge loophole in the termination insurance program. Employers would have an incentive to distribute plan assets by purchasing annuities from fly-by-night insurance companies offering above market rates. When these insurers subsequently became insolvent, the participants and beneficiaries would be left without any protection, and the employers would be off the hook. The net result is that the PBCC guarantee would be made meaningless.

The PBCC is not simply a private insurance company. It was established by Congress in order "to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries" under terminated plans. See Section 402(a)(2) of ERISA, 29 U.S.C. §1302(a)(2). In order to carry out this Congressional purpose, the PBCC must guarantee pension benefits whenever a pension plan is terminated, regardless of the manner in which plan assets are distributed.

In conclusion, the UAW commends the Finance Committee for holding hearings on the question of whether pension benefits payable under retirement annuities are guaranteed by the PBCC. We strongly object to recent statements by the Secretary of Labor and the PBCC which suggest that such benefits are not guaranteed. The PBCC's own regulations, as well as the language and legislative history of SEPPAA, clearly demonstrate that retirement annuities are guaranteed by the PBCC. Accord-

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[1] In an ongoing pension plan, the plan sponsor pays premiums to the PBCC on behalf of all participants. This should be true regardless of where the plan assets are invested. Since annuity contracts issued by an insurer are simply one place plan assets can be invested, the plan sponsor should continue to pay premiums to the PBCC on behalf of all participants in an ongoing plan, even when their benefits are covered under a annuity contract purchased from an insurer.

Of course, conceptually there is no reason why plan sponsors (or insurers) could not also be required to continue paying premiums to the PBGC after a plan termination. This would simply be one means of extending the revenue base supporting the pension plan termination insurance program (rather than simply raising the level of premiums paid by plan sponsors). However, if Congress should decide to pursue this concept, the UAW urges the House and Senate to consider carefully all of the ramifications. For example, it would be important to explore whether the obligation to pay premiums can be extended to situations where plan assets are distributed through a wasting trust or in the form of lump sum payments, as well as situations where retirement annuities are purchased from an insurer. This would be necessary in order to maintain a "level playing field," and avoid creating a disincentive for the purchase of annuities. It would also be important to explore whether the obligation to pay premiums should be extended to insufficient, as well as sufficient plans. Otherwise, there might be an incentive for plan sponsors not to fully fund their plans prior to a plan termination.

The UAW wishes to underscore, however, that the PBCC is *already* required to guarantee pension benefits payable under retirement annuities *under current law*. Thus, this issue should not be linked or made contingent upon whether the obligation to pay premiums to the PBCC is extended to terminated plans

ingly, the UAW urges this Committee and the entire Congress to take whatever steps are necessary to reconfirm that retirement annuities are in fact guaranteed under the pension plan termination insurance program.

The UAW appreciates the opportunity to present our views on this important issue. We look forward to working with the Committee as it deals with this issue. Thank you.

Attachments.

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PBGC FINAL REGULATIONS ON DETERMINATION OF PLAN SUFFICIENCY AND TERMINATION OF SUFFICIENT PLANS

46 FR, 9532, Jan. 28, 1981

PENSION BENEFIT GUARANTY CORPORATION

29 CFR Part 2618

Determination of Plan Sufficiency and Termination of Sufficient Plans

AGENCY: Pension Benefit Guaranty Corporation.

ACTION: Final Rule.

SUMMARY: This regulation prescribes the conditions under which the Pension Benefit Guaranty Corporation (the "PBGC") will issue a Notice of Sufficiency to the plan administrator of a terminating plan and the rules for winding up the affairs of the plan. Section 4041 of the Employee Retirement Income Security Act of 1974 (*as amended by* the Multiemployer Pension Plan Amendments Act of 1980) (the "Act") provides that if a terminating single employer pension plan has sufficient assets to pay certain pension benefits, the PBGC will issue a Notice of Sufficiency to the plan administrator. Section 4041 of the Act further provides that a plan administrator who receives a Notice of Sufficiency may proceed with the termination of the plan in a manner consistent with Subtitle C of Title IV of the Act. This regulation is necessary because the Act does not establish procedures either for determining whether a plan is sufficient or for winding up the affairs of the plan. The intended effect of this regulation is to provide procedures for the orderly and efficient termination of sufficient plans, and to ensure that generally a participant or beneficiary with a benefit payable as an annuity under a terminating plan will receive his or her benefit in the annuity form specified in the plan through a funding medium that will assure timely and uninterrupted payment.

EFFECTIVE DATE: February 27, 1981.

FOR FURTHER INFORMATION CONTACT: Joan Segal, Staff Attorney, Office of the General Counsel, Pension Benefit Guaranty Corporation, Suite 7200, 2020 K Street, N.W., Washington, D.C. 20006, (202) 254-3010.

SUPPLEMENTARY INFORMATION:

Background

On November 3, 1976, the PBGC published in the Federal Register a proposed regulation on "Determination of Plan Sufficiency and Termination of Sufficient Plans" (41 FR 48504). The proposed regulation set forth a procedure for determining whether the assets held under a terminating plan, if allocated in accordance with section 4044 of the Act, are sufficient to discharge when due all obligations of the plan with respect to basic benefits. The proposal also set forth a procedure for winding up the affairs of a sufficient plan.

On January 9, 1978, the PBGC published as a final rule that portion of the proposal dealing with the conditions under which the PBGC will provide the early retirement benefit of a participant in a sufficient plan who had not retired before the plan terminated (43 FR 1334). The reason for making the early retirement ru' final at that time was that a number of plan administrators who had received a Notice of Sufficiency were unable or unwilling to close out the plan either because they could not obtain bids for the early retirement benefits, or the bids they obtained were unreasonable. Accordingly, the PBGC issued the final rule on early retirement benefits and continued its review of the remainder of the proposed regulation.

The PBGC has completed that review which included careful consideration of the numerous comments on the proposal received from the public. The final regulation set forth in this document differs substantively from the proposal in several respects; many of those changes have been made in response to the comments. Additionally, some non-substantive changes have been made that the PBGC believes simplify and generally clarify the regulation. Although no changes have been made in the substance of the early retirement regulation, the final regulation as published on January 9, 1978 is being revised by this document for the purposes of simplifying the early retirement rule and of incorporating in one instrument all rules on Determination of Plan Sufficiency and Termination of Sufficient Plans.

In the discussion that follows, references are to sections in the final regulation unless otherwise stated.

Overview of the Regulation

In order to make the regulation as clear as possible and to accommodate substantive changes from the proposal, the PBGC has restructured the final regulation. Unlike the proposal, the final regulation is divided into four subparts. Subpart A contains the general provisions of the regulation, including rules for determining whether a plan administrator must follow the procedure set forth in Subpart B for demonstrating sufficiency. Subpart A provides, as a general rule, that upon receipt of a Notice of Intent to Terminate a pension plan, the PBGC will determine, on the basis of all the facts and circumstances of the case, whether the plan is clearly insufficient. If the plan is clearly insufficient, the PBGC will issue a Notice of Inability to Determine Sufficiency to the plan administrator and proceed to place the plan into trusteeship. If the plan is not clearly insufficient, the plan administrator is required to follow the procedure for demonstrating sufficiency set forth in Subpart B of the regulation.

Subpart B prescribes the procedure for demonstrating whether a plan will be sufficient on the date the plan's assets are distributed. Basically, a plan administrator must demonstrate whether the value of the assets expected to be available for allocation on the intended date of distribution equals or exceeds the estimated liability of the plan for benefits in priority categories 1 through 4 as of that date. In order to determine the value of annuity benefits, the plan administrator is required to obtain a bid from an insurer to provide those benefits. A plan administrator who successfully completes the procedure prescribed by Subpart B will be issued a Notice of Sufficiency, and will then close out the plan in accordance with Subpart C. A plan administrator who is unable to demonstrate sufficiency will be issued a Notice of Inability to Determine Sufficiency, and the PBGC will proceed to place the plan into trusteeship.

Subpart C of the regulation sets forth the procedure for closing out a plan that a plan administrator must follow upon receipt of a Notice of Sufficiency. Within 90 days after the date of the Notice, the plan administrator must distribute the plan assets, purchasing from an insurer a contract or contracts to provide annuity benefits. If the plan administrator finds that plan assets are not adequate to provide all benefits in priority categories 1 through 4, he or she may take no further action to close out the plan and must notify the PBGC immediately. Upon receipt of the notice, the PBGC will revoke the Notice of Sufficiency and put the plan into trusteeship.

Subpart D prescribes the conditions under which the plan administrator of a terminating plan that is closing out under a Notice of Sufficiency may arrange for the PBGC to become responsible for the payment of early retirement benefits.

Subpart A—General Provisions

Purpose and Scope

Proposed § 2618.1(b) described the scope of the regulation. The PBGC has changed this provision to make clear that the regulation does not apply to multiemployer pension plans. This

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change was made in light of the recent enactment of the Multiemployer Pension Plan Amendments Act of 1980, which so altered the nature and consequences of plan termination for multiemployer plans that the rules set forth in this regulation are inappropriate to multiemployer plan terminations.

Determination Upon Receipt of Notice of Intent To Terminate

Proposed §§ 2615.4 and 2615.5 described the circumstances under which the PBGC would issue a Notice of Inability to Determine Sufficiency or a Notice of Sufficiency to the plan administrator of a terminating plan. In the interest of simplicity, the PBGC has rewritten and restructured the relevant provisions.

Section 2615.3(a) provides, as a general rule, that upon receipt of a Notice of Intent to Terminate a plan, the PBGC will determine, on the basis of all the facts and circumstances of the case, whether the plan is clearly insufficient. If the PBGC determines that the plan is clearly insufficient, the PBGC will issue a Notice of Inability to Determine Sufficiency to the plan administrator (§ 2615.3(a)(1)). The plan will then be placed in trusteeship, and PBGC will assume the obligation of paying guaranteed benefits under the plan in accordance with Title IV of the Act.

If the plan is not clearly insufficient, the PBGC will direct the plan administrator to follow the procedure set forth in Subpart B of the regulation for demonstrating whether the plan will be sufficient (§ 2615.3(a)(2)).

Proposed § 2615.4(b) provided that the plan administrator of a clearly insufficient plan could within 60 days after receiving the Notice of Inability to Determine Sufficiency, notify the PBGC of his or her intention to challenge the PBGC's determination by following the procedure for demonstrating sufficiency set forth in proposed § 2615.5(d). The PBGC has eliminated this provision in the final regulation. In determining whether a plan is clearly insufficient, the PBGC will take into account all of the relevant facts and circumstances of the case, including market conditions and the cost of purchasing annuities from an insurer. The PBGC believes that this broad approach will ensure that the PBGC will not determine that a plan is clearly insufficient unless it is certain that the plan will not be able to provide the necessary benefits. To permit a plan administrator to attempt to demonstrate sufficiency where it is clear that the attempt will fail would result in unnecessary delay and would expose the PBGC to the risk of absorbing post-termination decreases in the value of plan assets.

Like the proposal, the final regulation sets forth a special rule applicable to plans that have no participants entitled to receive benefits in priority categories 1 through 4 (proposed § 2615.5(b); final § 2615.3(b)). When the PBGC receives a Notice of Intent to Terminate such a plan, the PBGC will not require the plan administrator to follow the procedure set forth in Subpart B of the regulation for demonstrating whether the plan will be sufficient. Rather, the PBGC will issue a Notice of Sufficiency to the plan administrator directing the plan administrator to distribute assets and wind up the affairs of the plan in accordance with Subpart C of the regulation.

Proposed § 2615.5 (c) provided that the PBGC would, without requiring the plan administrator to follow the procedure for demonstrating sufficiency, issue a Notice of Sufficiency to the plan administrator of a plan that, as of the date of plan termination, had already purchased from an insurer all benefits in priority categories 1 through 4. The PBGC has examined this provision and concluded that it is unnecessary. If, as of the date of plan termination, a plan has provided all benefits in priority categories 1 through 4, the plan has no participants entitled to receive benefits in categories 1 through 4. Thus, the special rule set forth in § 2615.3(b) of the regulation is applicable to plans described in proposed § 2615.5(c).

In connection with this issue, it is important to note that the purchase of an annuity contract in contemplation of termination is considered to be an allocation of plan assets upon termination and is subject to the allocation rules set forth in section 4044 of the Act.

The Alternatives

The proposed regulation set forth for consideration and public comment two alternative methods for processing plans that are not clearly insufficient (proposed § 2615.5(d)). Alternative I provided that a plan administrator was not required to attempt to demonstrate sufficiency. Rather, the plan administrator had the option of following the procedure for demonstrating sufficiency or of permitting the PBGC to take the plan into trusteeship. Under Alternative II, the plan administrator was required to follow the procedure for demonstrating sufficiency. A plan administrator who succeeded in demonstrating sufficiency was required to close out the plan in the private sector by purchasing contracts from an insurer to provide annuity benefits.

Most of the comments on the proposa[l] addressed the issue of which alternativ[e] should be adopted. The comments that favored Alternative I stressed as its significant positive aspects the flexibility given the plan administrator, the reduction in the plan administrator' burden, and the possibility that the choice available under Alternative I might, particularly, in the case of small plans, result in increased benefit payments to participants. Additionally, one comment opposing Alternative II stated that it "appears to give the insurance industry an unreasonable advantage in the area of terminated plans."

Many of the comments that favored Alternative II stated that the private sector has served the pension community effectively, that under Alternative I the PBGC would compete with that sector, and that such competition would be unfair and would drive insurers out of the terminating plan market. One of the main arguments advanced in support of Alternative II was that Alternative I would expand the PBGC's role beyond the scope envisioned by the Act since the PBGC would be acting as an insurer of sufficient plans.

The PBGC gave careful consideration to the comments for and against each alternative and has decided to adopt Alternative II. The PBGC believes that, as a general rule, it should become involved with plans that can be closed out in the private sector only to the extent necessary to ensure that such plans are terminated in accordance with Title IV of the Act.

The PBGC notes that insurance companies compete with each other in the variety of annuity products offered, in the price of these products, and in the quality of their service. This competition has generally benefited plan participants. The PBGC's entry into the insurance market could adversely affect the market and ultimately be detrimental to participants of terminated plans.

A few comments, however, objected to Alternative II on the ground that it "provides no incentive for seeking competitive bidding." The comments were particularly concerned that a pl[an] administrator might not seek a better bid after obtaining a bid so high that although the plan could afford to pay all benefits in priority categories 1 through 4 using that bid, the plan would have no remaining assets to provide benefits in priority categories 5 or 6. In response, the PBGC points out that plan administrators have a fiduciary

obligation to act in the best interests of all plan participants. The PBGC believes that this obligation would, in the situation described above, compel a plan administrator to seek better bids if he or she had reason to think that they were available. Moreover, the PBGC reserves the right to request bids from an insurer or insurers on behalf of any plan (§ 2615.14(b)).

Although the PBGC is convinced that adoption of Alternative II will generally work to the advantage of all parties involved in plan terminations, the PBGC is somewhat concerned about Alternative II as applied to certain small pension plans. If experience under this regulation indicates that plan administrators of small pension plans are not able to obtain annuities at reasonable cost, the PBGC may consider providing a special procedure to help small plans do so. The PBGC is interested in learning of any difficulties administrators of small plans have in closing out their plans under this regulation.

The Annuity Requirement

Basic to the proposed regulation was the requirement that a participant with a benefit payable as an annuity under a terminating plan receive that benefit in annuity form, unless the participant elected another form of distribution provided by the plan (proposed § 2615.3).

Of the 18 comments received, only one disagreed with the requirement that annuity benefits be provided in annuity form, stating that "[t]he failure of the statute to specifically impose such a requirement indicates that Congress had no intention to alter the common and longstanding practice of allowing lump sum distributions upon termination of a plan." The PBGC has reviewed the annuity requirement in light of the above comment and believes that the requirement is necessary to implement Title IV of the Act. A major purpose of Title IV is "to provide for the timely and uninterrupted payment of pension benefits . . ." (Section 4002(a)(2) of the Act.) A pension is a retirement annuity. It would be inconsistent with the Act for the PBGC to grant a plan administrator the discretion to deprive a participant entitled to a retirement annuity of that annuity. Moreover, the PBGC notes that the annuity requirement does not preclude lump sum payments. The proposal provided that, notwithstanding the annuity requirement, a participant could elect to receive his or her benefit in an alternative form provided by the plan; the final regulation contains this and two additional exceptions to the annuity requirement (§ 2615.4(b)) (see discussion below).

To ensure the timely and uninterrupted payment of benefits required to be provided in annuity form, the proposal required that the benefits be provided by the PBGC or purchased from an insurance carrier (proposed § 2615.3(a)). A few comments questioned this rule and suggested that continuation of the plan's trust and periodic payment of benefits from the trust might, in some circumstances, be more advantageous to participants.

In response, the PBGC notes that continuation of the trust of a terminated plan could result in a violation of the allocation rules set forth in section 4044 of the Act. Those rules establish six categories of plan benefits and require that assets be allocated to benefits in the higher priority categories before the assets are allocated to benefits in lower priority categories. If a plan's trust were continued, older participants with benefits in priority category 3 that were funded on the allocation date might retire and begin receiving their benefits before all benefits in higher categories payable to younger participants has been paid. If the trust should then suffer losses, there might not be sufficient assets to pay the benefits in the higher priority categories. Thus, since the continuation of the trust of a terminated plan would not ensure payment of benefits in the manner required by section 4044 of the Act, the PBGC will not permit the annuity requirement to be satisfied by continuation of the trust.

As noted above, however, the requirement that benefits payable as annuities be provided in annuity form, either by the PBGC or through the purchase of annuity contracts from an insurer, does not preclude a participant from electing another form of distribution provided by the plan. Examples of such alternative forms of distribution are a single installment payment, transfer of the value of the benefit to an individual account plan, or continued participation by the participant in a trust after the date of plan termination. Thus, continuation of the trust is permissible, but only in the limited circumstances where the plan provides for such an option and the participant has elected that option. In connection with this issue, it should be noted that a trust will not continue to be tax-exempt unless it maintains its qualified status under section 401 of the Internal Revenue Code of 1954, as amended.

Two comments that addressed the requirement that annuity contracts be purchased from an insurer were concerned about the possibility that the insurer might become insolvent. Specifically, the comments expressed uncertainty as to whether the PBGC would provide benefits to participants or beneficiaries of a terminated plan that closed out under a Notice of Sufficiency if the insurance company from which annuity contracts had been purchased should prove to be unable to meet its obligations. The PBGC does not believe that the concern expressed by the comments is warranted.

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

Finally, the PBGC emphasizes that, except with respect to early retirement benefits, the annuity requirement can be satisfied only by the purchase of annuity contracts from an insurer. The PBGC will, however, provide for the payment of an early retirement annuity benefit if the conditions of Subpart D of the regulation are met. To avoid any misunderstanding regarding this matter, the final regulation states that "any benefit that is payable as an annuity under the provisions of the plan must be provided in annuity form, either through the purchase from an insurer of a contract to provide the annuity or by the PBGC under Subpart D of this part." (§ 2615.4(a)).

Exceptions to the Annuity Requirement

One comment stated that the annuity requirement appears to be inconsistent with § 2605.4(b) of the PBGC's Guaranteed Benefits regulation (Part 2605 of this chapter). Section 2605.4(a) provides, *inter alia*, that the PBGC will not guarantee or pay a benefit payable in a single installment, but will instead guarantee and pay the equivalent benefit payable in periodic installments. Section 2605.4(b) provides that there are three situations where Paragraph (a) of that section does not operate to preclude single installment payments. Only two of the situations are relevant to plans that close out under a Notice of Sufficiency. First, if the value of a guaranteed benefit is $1,750 or less, the benefit may be paid in a single installment. To conform to this rule, § 2615.4(b)(2) of this regulation permits a

plan administrator to cash out a participant or beneficiary whose annuity is worth less than $1,750. Second, § 2605.8(b) of the Guaranteed Benefits regulation provides that a participant of a plan that is closing out under a Notice of Sufficiency may receive his or her benefit in a single installment if the plan so provides. The final regulation, like the proposal, recognizes this exception to the annuity requirement (§ 2615.4(b)(3)).

The final regulation contains one other exception to the annuity requirement. A benefit that is payable as an annuity under the provisions of a plan may nevertheless be paid in a single installment if the monthly amount of the benefit is less than the amount normally provided by an insurer. Thus, if the value of a benefit payable as an annuity is greater than $1,750, but the plan administrator is unable to purchase a contract to provide the annuity because the monthly amount of the benefit is less than that normally provided by an insurer, the benefit may be paid in a single installment (§ 2615.4(b)(1)).

Participant Elections

As noted above, the proposed regulation provided that, notwithstanding the annuity requirement, "a participant with a benefit payable as an annuity under the plan may elect to receive his or her benefit in an alternative form provided by the plan" (proposed § 2615.5(b)). Proposed § 2615.5(d)(2) required that the plan administrator provide participants with certain information respecting the right of election before any election is made.

The PBGC has restructured and made some changes in these provisions. A new § 2615.4(b)(2) provides that, notwithstanding the annuity requirement, a benefit that is payable as an annuity need not be provided in annuity form if the plan provides for an alternative form of distribution and the plan administrator submits a statement to the PBGC certifying that the participant elected, in writing, the alternative form of distribution. The plan administrator's statement must also certify that the participant was notified, in writing, before he or she made the election, that the election would not be given effect unless the plan should close out under a Notice of Sufficiency, and that the PBGC does not guarantee the benefit payable in the alternative form. Like the proposal, the final regulation requires the plan administrator to inform the plan participant of any risks attendant to a non-annuity form of distribution. For example, if an alternative form of distribution provided by a plan is continued participation in a trust after plan termination, the plan administrator must inform the participant that the trust could suffer losses and be unable to provide the benefit to which the participant was entitled at termination.

Unlike the proposal, the final regulation also requires the plan administrator to certify that the participant was informed, in writing, before making the election, of the estimated amounts of the annuity and of the alternative form of distribution. The PBGC believes that this requirement is necessary in order to ensure that participants will have enough information to make a reasoned election.

The PBGC will not issue a Notice of Sufficiency with respect to a plan that is going to provide benefits in a non-annuity form unless it receives the certified statement described above (§ 2615.12(a)).

A number of comments addressed the issue of participant elections of non-annuity benefit forms. One comment suggested that the regulation "permit the plan administrator to impose a reasonable time limit by which elections must be made in order that the plan may then proceed within the time frame imposed by the regulation." In response, the PBGC notes that the regulation does not prohibit a plan administrator from requiring that participants make their elections within a certain period of time. In fact, as the comment indicated, a plan administrator will probably find it useful to set a time limit on participant elections, so that the plan administrator can proceed within the time frame established by the regulation. The PBGC does not believe, however, that it is necessary for this regulation expressly to authorize plan administrators to do this.

Another comment noted that some pension plans provide that a participant's election of a form of distribution other than an annuity is subject to the approval of the plan administrator or trustee. The comment was concerned about the possible effect of the proposal on such plan provisions. It was not the PBGC's intention to alter participant election provisions such as those described by the comment, and the language of the participant election provision of the final regulation has been changed from that of the proposal to remove any ambiguity that might have existed on this point (§ 2615.4(b)(3)).

Required Form of Annuity

The proposal stated that "the form of annuity that must be provided is an optional form of annuity contained in the plan elected by the participant before the date of plan termination, or if no optional form has been elected, the form that would be paid upon retirement" (proposed § 2615.5(a)). One comment suggested that this provision may be "unduly restrictive" in requiring that an election of an optional form of annuity be made prior to plan termination. The comment notes that insurance companies "offer annuities which allow the annuitant to defer until the date of annuitization the form of annuity pursuant to which his benefits will be paid." The PBGC believes that the flexibility recommended by the comment would be to the advantage of plan participants and has changed the final regulation.

Section 2615.4(c) of the final regulation provides that the plan administrator may honor a post-termination election of an optional annuity form payable under the plan, if the value of the annuity in the optional form is no greater than the value of the annuity in the form to which the participant was entitled on the date of termination. The plan administrator may wish to consult with the Internal Revenue Service as to whether elections under this provision are consistent with Internal Revenue Service rules in a particular case.

Section 2615.4(c) further provides that the plan administrator may purchase an annuity which permits the participant to elect to receive his or her benefit in a form that is provided by the plan or that provides for a series of periodic payments for the life of the participant or beneficiary, if the right of election does not increase the cost of the annuity.

Subpart B—Procedure for Demonstrating Whether a Plan Will Be Sufficient

Basic Test

Proposed § 2615.5(d) prescribed the method for demonstrating sufficiency, and this method has been retained in the final regulation (§ 2615.12). The basic test is whether the assets expected to be available for allocation on the date of distribution exceed the estimated liability of the plan for benefits in priority categories 1 through 4 as of the date of distribution. Section 2615.12 provides that the plan administrator must submit to the PBGC the valuation of plan assets and benefits, made in accordance with §§ 2615.13 and 2615.14. The valuation date prescribed by

U.S. DEPARTMENT OF LABOR

SECRETARY OF LABOR
WASHINGTON, D.C.

FEB 12 1990

The Honorable Howard M. Metzenbaum
Chairman, Subcommittee on Labor
Committee on Labor and Human
Resources
Washington, D. C. 20510-6300

Dear Mr. Chairman:

Thank you for your letter in which you raised some important issues regarding the security of pensions that are provided through the purchase of annuity contracts from insurance companies upon plan termination. I am deeply committed to the security and integrity of our private pension system and share many of your concerns on this issue.

In order to address any immediate problems which may exist, I have directed that the Pension and Welfare Benefits Administration (PWBA) and the Pension Benefit Guaranty Corporation (PBGC) develop procedures for dealing with any terminations where benefits of participants might be at some risk as a result of the selection of the insurance company to provide annuities. Under PBGC's current procedures, terminating plans must provide the agency with the name of the insurer providing annuities within 30 days after the final distribution of the plan's assets. PBGC is modifying that procedure to require that the agency be given that information prior to the distribution of the plan's assets. These modified procedures would cover the PBGC's current inventory of pending standard terminations, as well as future terminations. PBGC will refer to PWBA cases where further inquiry may be appropriate under the fiduciary standards of Title I of ERISA. It is important to note that while PBGC currently has an inventory of 13,000 standard terminations pending, substantially less than half - preliminary data indicate approximately 28% - of these cases involve the purchase of annuity contracts. PWBA will consider these referrals and determine whether an investigation for compliance with ERISA fiduciary standards is appropriate. In addition, PBGC is going to consider whether additional standards of insurer reliability are needed in connection with their pre-termination review.

I have been advised by the Executive Director of PBGC that PBGC has not had a case in its 15-year history of an insurance company failing and not paying annuities. I have been further advised that no evidence exists that Congress ever intended PBGC to guarantee annuities, and PBGC receives no premiums for such liability. Under longstanding law, states have regulated the insurance funds, and most states have guarantee funds. A federal guarantee of annuities would add tens of billions to the $800 billion in liabilities PBGC already insures. I believe that the actions that we are undertaking will reinforce the obligation plan fiduciaries have under ERISA when selecting insurance companies. Where we find problems, we will certainly take whatever enforcement actions are necessary.

I understand and share your concerns and will keep your Committee advised of the results of our enforcement efforts in this area. In the meantime, if I can be of further assistance, please to not hesitate to let me know.

Sincerely

Elizabeth Dole

EXCERPTS

99TH CONGRESS *1st Session*	HOUSE OF REPRESENTATIVES	REPT. 99-300

OMNIBUS BUDGET RECONCILIATION ACT OF 1985

REPORT

OF THE

COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES

TO ACCOMPANY

H.R. 3500

A BILL TO PROVIDE FOR RECONCILIATION PURSUANT TO SECTION 2 OF THE FIRST CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1986

together with

SUPPLEMENTAL, ADDITIONAL, AND MINORITY VIEWS

Serial No. R-2

OCTOBER 3, 1985.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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c. Requirements and procedures relating to distress terminations

In order to terminate a single-employer plan under a distress termination, certain requirements must be met. The plan administrator must give 60-day advance notice to affected parties and must provide pertinent information and certifications to the PBGC. Most importantly, the contributing sponsors and the members of their controlled groups must satisfy certain tests indicative of a financial inability to continue the funding of a plan.

If all of the criteria for a distress termination are met and the plan is terminated, as under current law, all future participation, funding, accrual and vesting cease. The PBGC trustees all plans which qualify for a distress termination *and* which do not have sufficient assets to cover guaranteed benefits. Plans in which the assets are sufficient to provide guaranteed benefits are closed out as under current law. The PBGC appoints a section 4049 trustee in those situations in which plans do not have sufficient assets to provide all benefit entitlements. The section 4049 trustee in turn establishes a trust which is used to accumulate certain profits liability payments from the contributing sponsors and members of their controlled groups, and to use the accumulated funds to pay to participants and beneficiaries the difference between benefit entitlements and guaranteed benefits.

i. Distress Termination Tests.—The Committee believes that the four tests for a distress termination contained in the bill describe the types of hardship situations in which a transfer of liabilities to the insurance program is appropriate. In fashioning these tests, the Committee tried to balance the need to limit access to the insurance system to cases of genuine need against the danger of making the tests so stringent that nothing short of total liquidation would qualify for PBGC assistance.

The first distress test requires that the contributing sponsors of a terminating plan have received funding waivers in at least three of the past five years, and thereby already have demonstrated "substantial business hardship" under section 303 of ERISA for each year a waiver was granted. The first distress test also requires that "substantial" controlled group members have received at least one recent funding waiver for all their other single-employer plans. This assures that the entire controlled group is experiencing financial distress. Otherwise, a strong controlled group could escape responsibility for the benefits promises by a weak member with a large underfunded plan. Applying the test on a controlled group basis discourages a controlled group from shifting assets within the group in order to leave a weak member with huge pension liabilities and then attempting to transfer those liabilities onto the insurance program.

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d. Conversion option

Present law

No provision.

House bill

Both H.R. 3128 and H.R. 3500 require that a conversion option be offered to qualified beneficiaries if under the plan the conversion option is otherwise available.

Senate amendment

Although Title IX of the Senate amendment follows the House bill, Title VII does not require that a conversion option be offered.

Conference agreement

The conference agreement generally follows the House bill and Title IX of the Senate amendment. Under the agreement, a qualified beneficiary must be offered a conversion option from any plan (including a self-insured plan) only if such an option is otherwise available under the plan to other participants.

Effective Date.—These provisions are effective for plan years beginning after June 30, 1986. In the case of a group health plan maintained pursuant to one or more collective bargaining agreements, the bill does not apply to plan years beginning before the later of (1) the date the last of the collective bargaining agreements terminate, or (2) January 1, 1987.

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3. Involuntary Plan Termination

Present law

Under present law, the PBGC is permitted, but not required, to commence proceedings to terminate a plan under a variety of circumstances including the inability of the plan to pay benefits when due.

House bill—H.R. 3128

No provision.

House bill—H.R. 3500

Under the bill, the PBGC is required to commence termination proceedings if the plan does not have assets available to pay benefits that are currently due under the terms of the plan.

Senate amendment—Title VII

No provision.

Senate amendment—Title IX

As under present law, the PBGC is permitted, but not required, to terminate a plan under certain circumstances. In addition, the PBGC may appoint a temporary receiver if the plan fails to meet minimum funding requirements, is not able to pay current benefits when due, or has been abandoned.

Conference agreement

The conference agreement follows H.R. 3500.

4. Waiver of Funding Standard

Present law

Present law authorizes the Internal Revenue Service to waive the requirements of the minimum funding standard no more frequently than 5 times in any 15-year period. In addition, the amortization period for liabilities under defined benefit pension plans may be extended, and a waiver previously granted by the IRS may be modified.

The IRS may grant a waiver on condition that appropriate requirements are met.

House bill—H.R. 3128

The IRS is authorized to require that security be provided as a condition of granting a waiver of the minimum funding standard, an extension of an amortization period and modifications of a previously granted waiver. The IRS is required to notify the PBGC before granting a waiver and is to consider the comments of the PBGC. The PBGC has a 15-day comment period after the date of receipt of notice.

The new provisions apply to waivers, extensions, and modifications granted on or after the date of enactment of the bill.

House bill—H.R. 3500

The bill is similar to H.R. 3128, except that (1) a "reasonable period" rather than a 15-day comment period is provided, and (2) the security, notice, and comment provisions do not apply to cases involving less than $1 million of outstanding waived liability. The bill requires that an employer that submits a request for a waiver of the minimum funding standard notify each affected party. The term "affected party" is defined under the bill as a plan participant, a beneficiary of a deceased participant, a beneficiary that has been designated as an alternate payee pursuant to a qualified domestic relations order, an employee organization representing participants in the plan and the PBGC.

Senate amendment—Title VII

No provision.

Senate amendment—Title IX

No provision.

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