

TESTIMONY OF PAMELA PERUN, POLICY DIRECTOR
ASPEN INSTITUTE INITIATIVE ON FINANCIAL SECURITY
BEFORE THE DOL/TREASURY PUBLIC HEARING
ON LIFETIME INCOME

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My name is Pamela Perun, and I am the Policy Director of the Aspen Institute Initiative on Financial Security. At Aspen IFS, our focus is on the ordinary saver, those with modest to medium-size nest eggs, and our perspective on lifelong income products is intended to keep their interests in mind. I am here today to testify on the topic of a Fiduciary Safe Harbor for Selection of Lifetime Income Issuer or Product. In 2007, I published a paper on this topic titled “Putting Annuities Back in Savings Plans,” which elaborates on the comments I will make today. I will be submitting this paper for the public record along with my comments today.¹

I am an ERISA attorney, and my special interest is in keeping the private pension system a hospitable place for the small employer. It is important to remember that 90% of defined contribution plans have less than 100 participants. These plans cover about 15% of plan participants, and they represent an important constituency that we need to keep in the private pension system.

I believe that we are not asking the right question here. The question is really not how can we get a better fiduciary liability safe harbor for employers. The relevant question is what happens when something goes wrong in a lifetime income product. There is no fiduciary liability until something goes wrong. So we should be asking: when something goes wrong what should be the extent of the protection available to participants, both inside and outside a plan, and who should provide such protection.

Current ERISA regulations make the employer a potential final backstop for participant protection. The rationale for this stems from a change in the law in the Pension Annuity Protection Act of 1993. In the early 1990s, a number of insurance companies failed, including

¹ Perun, Pamela J., “Putting Annuities Back in Savings Plans,” Chapter 8 in T. Ghilarducci and C. Weller, eds., *Employee Pensions: Policies, Problems, and Possibilities*, Champaign, IL: Labor and Employment Relations Association, 2007.

the Executive Life Insurance Company of California. This put into jeopardy the benefit payments to former plan participants in terminated defined benefit plans whose pension obligations had been transferred to insurance companies. Subsequent investigations revealed that a number of defined benefit plan sponsors had chosen very low bids from Executive Life and other companies to pay promised plan benefits rather than those of higher-rated companies. Choosing a low bidder enabled these sponsors to increase the amount of plan assets they would re-capture after annuities had been purchased to pay plan participants. Two court cases, *Mertens v. Hewitt Associates* and *Kayes v. Pacific Lumber*, seemed to block former plan participants from either suing their employer for putting their own interests ahead of plan participants or receiving monetary damages to make their pension promise whole. The legislative history of the Pension Annuity Protection Act reveals that Congress merely intended to reaffirm the original intent of ERISA to provide such remedies, and its primary concern was with defined benefit plans.

But since then, in reaction to the abuses observed in the Executive Life case and others, regulatory guidance has morphed the fiduciary duties of employers with respect to distribution annuities in ways that this legislation never contemplated or intended. And, I believe, that guidance fails to distinguish between the risks posed to participants in a defined benefit plan versus a defined contribution plan. In a defined contribution plan, there is no such thing as a reversion so there is no need to protect against this conflict of interest between employers and employees. In a defined contribution plan, there is no promise of a guaranteed accrued plan benefit that purchased annuities must provide. In a defined contribution plan, the accrued benefit of a participant is merely the dollar amount in the account at a particular point in time. And how a participant chooses to invest that account balance in an investment product is primarily that participant's business.

Merely providing a softer safe harbor will not encourage many more employers to offer lifetime income products. Frankly, ERISA lawyers like myself will continue to advise our clients not to include them in their defined contribution plans because of the expense and potential long tail of fiduciary risk involved. So I urge you as regulators to go back to basics and think through what makes sense from an ERISA perspective in a defined contribution, NOT a defined benefit, plan context. What are the risks, who should bear them, and should protection differ depending on the type of investment product available in a defined contribution plan. We don't need a softer safe harbor, we need a reasonable process that enables employers to choose

good lifetime income products without fear of long-term liability and enables participants to purchase the investment product that meets their needs.

When something does go wrong, the first step should be to look for protection, not to employers, but to the state guaranty associations standing behind these products. I understand that the Government Accountability Office is analyzing and evaluating the current strength of these funds, and I look forward to that report. I would like to point out, however, the private pension system had its first extensive experience with these funds in the early 1990s as part of the Executive Life crisis. I had just started to practice law at that time and the firm where I worked, as well as many other large firms, worked on behalf of employers – primarily large employers - with these funds to obtain redress, not just for annuitants but for participants in GICs and other investment products.

I think it's fair to say that this was an expensive, time-consuming and not wholly-satisfactory experience. Seeking redress for participants required a lot of individual fact-finding as well as preparing complicated regulatory filings. Large employers have the resources and the will to pursue these avenues for relief when necessary but it is not likely that small employers will. We also learned that there were significant gaps and differences in coverage across states that led to uneven outcomes.

This seems to me to be unacceptable for a private pension system that is governed by federal law and that provides the same protections to participants, no matter where they live or work. If we are going to continue to rely on a state-based backup for lifetime income products, we need to call for changes at the state level, whether it's uniform contracts, higher guarantee amounts, or special status under state insurance codes for qualified plan investors. Many have called for federal regulation and guarantees instead, and that is something to be considered, although that would require the federal government to have a much larger role in regulating the insurance industry than it has ever had.

My final point is that as we move forward we have to be mindful to balance the costs and benefits of new regulations under ERISA to secure the promise of lifelong income products. Every regulation that requires the plan sponsor to hire an expert, every new requirement for additional participant education and disclosure, every increase in state or federal protection will have its cost. A defined contribution plan has no unallocated pool of funds to pick up these expenses. In a defined contribution plan context, it is participants who will pay these costs,

whether or not they themselves invest in such products, and these are dollars that will not be available to build retirement income.

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CHAPTER 8

Putting Annuities Back into Savings Plans

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*Economy does not lie in sparing money, but in spending it wisely.*¹

Every year, millions of dollars flow into 401(k)-type and other savings plans. As large numbers of baby boomers begin to retire in a few short years, millions of dollars will start to flow out. Most workers will be on their own in managing their savings during retirement because most plan sponsors deliberately restrict plans to lump sum distributions. Although annuities are a well-respected technique for managing income in retirement, they are virtually absent from savings plans in the private pension system.

This chapter analyzes why savings plan sponsors shun annuities and what might be done to change the situation. It begins with a discussion of an apparent puzzle: just as the shift to savings plans in the private pension system began to accelerate in the 1990s, annuities began disappearing from savings plans. I explain how legal reforms in the early 1990s, largely intended to protect participants in defined benefit (DB) plans, increased the risk of fiduciary liability associated with annuities. Employers responded by abandoning annuities as a distribution option in savings plans wherever possible, leaving to workers the responsibility for managing their savings in retirement. I also describe how one proposal for a federal charter option for life insurance companies could hold some promise for persuading plan sponsors to put annuities back into savings plans.

Savings Plans and the Case for Annuities

The Shift to Savings Plans

In recent years, the paramount goal of the U.S. private pension system has been to encourage saving for retirement. With the retirement of

the baby boom generation approaching and other sources of retirement income such as Social Security under stress, there is a great deal of concern that millions of Americans will reach retirement without adequate resources (Employee Benefits Research Institute 2006). This concern has been prompted by a fundamental shift in the type of retirement income produced by the private pension system.

Historically, employers provided their workers with retirement benefits through DB plans. Typically financed entirely by employers, these plans provide a worker with income in retirement, usually payable for life, based on years of service and amount of compensation. But employers today prefer to offer savings plans, such as the popular 401(k) plan, to which both employers and workers contribute. Rather than generating a stream of retirement income, these plans accumulate a pool of assets based on contributions and their earnings. This trend to savings plans has largely shifted the risk of preparing for retirement from employers to workers. It is now well recognized that, in 401(k)-type savings plans, workers must take the initiative in saving. For many, their own savings will provide the bulk of retirement income along with, perhaps, some employer matching contributions. Workers must also assume investment responsibility for their savings. Now that savings plans dominate the private pension system, encouraging as many workers as possible to save as much as possible and to invest wisely has become a national priority.

A Role for Annuities in Savings Plans

The shift to savings plans, however, imposes another burden on workers that has not yet received much attention (Mitchell 2004). DB plans have traditionally provided retirement income in one standard form: monthly payments guaranteed to last for life. Workers in DB plans arrive at retirement with a known, guaranteed, lifetime stream of income. Workers in savings plans arrive instead with an account balance that must be converted into income for retirement through a process often referred to as self-annuitization. The growth in savings plans has shifted to workers the risk of living longer than their income. In order to avoid outliving their resources, workers must now learn how to manage their assets in retirement wisely.

For most workers in savings plans, it will not be obvious how to apportion and spend their accumulated assets throughout retirement. For instance,

[i]ndividuals face a variety of risks in managing their assets, income, and expenditures at and during retirement. For

example, retirees may outlive their pension or retirement savings plan assets. In addition, inflation may erode the purchasing power of their income, investments may yield returns that are less than expected or decline in value, and large unplanned expenses, such as those to cover long-term care, may occur at some point during retirement (Government Accountability Office 2003:10).

Deciding how to allocate resources during retirement is difficult and fraught with uncertainty. It requires workers to estimate with some degree of accuracy how long they will live and how much they will need to spend. In addition, they must continue to manage their assets to generate income in retirement. This requires deciding how to invest assets appropriately for the 20, 30, or even 40 years of retirement that are becoming increasingly common.

At least some of the financial uncertainty inevitable in retirement can be mitigated through the use of a life annuity. There are many types of annuities: variable, fixed, immediate, deferred, and so on. The focus of this chapter is on the traditional form of annuity, the life annuity, either immediate or deferred. A life annuity is an investment product available from an insurance company, purchased through a single premium payment. In exchange for the payment, the insurance company contracts to pay a guaranteed amount, usually monthly, for life. Life annuities generally provide income only for the life of the annuitant, although it is also possible to purchase joint and survivor annuities that continue to provide income for the life of a named beneficiary. Purchasing a life annuity is an irrevocable decision—there are no opt-out provisions for buyers who change their minds.

According to economic theory, life annuities enable workers to manage their consumption appropriately in retirement and help mitigate financial uncertainty.

By trading a stock of wealth for a life-contingent stream, a healthy individual is able to sustain a higher rate of consumption than in the absence of annuitization. . . . If an individual does not have access to annuitization then she must allocate her wealth in a manner that trades off two competing risks. The first is the risk that if she consumes too aggressively, she increases the likelihood of facing a future period in which she is alive with little or no income. The second is that if she self-insures by setting aside enough wealth to be certain it cannot be outlived, then she risks dying with assets that could have been used to increase consumption while alive. (Brown and Warshawsky 2004)

By purchasing a life annuity, workers transfer at least a portion of their mortality risk, that is, the risk of living longer than their assets, to the insurance company in exchange for a stream of income that continues for the rest of their lives, no longer how long they live. In addition, the amount they will receive from the insurance company is both known and guaranteed. A life annuity also helps workers reduce at least a portion of their investment risk, the risk their savings will produce less than their anticipated income in retirement.

Life annuities are one means by which workers in savings plans could obtain the lifetime, guaranteed stream of income produced by DB plans. But life annuities are not a popular or well-understood insurance product in the United States today. More popular forms of annuities are purchased as investment products, in part because they enjoy special tax benefits (Mitchell 2004). A "deferred annuity" can be obtained in either a variable form, where its value fluctuates according to the investments chosen by the policyholder, or a fixed form, where the insurance company promises a specific rate of return. Under tax law, an individual can invest any amount in an annuity contract and postpone tax on its increased value (its "inside build-up") until it is paid out to the policyholder. This gives annuities tax advantages similar to those in an employer-based savings plan but without annual limits on contributions. Few purchasers of investment annuities convert the value of those contracts into life annuities: fewer than 1% of such contracts are ever converted into fixed annuities (Beatrice and Drinkwater 2004; Bernard 2005).

Industry analysts believe that the market for life annuities holds great potential.

[T]he annuitization market remains underdeveloped. According to one estimate, the annuitization market among the currently retired has the potential to exceed \$114 billion. . . . Both the need and desire for annuitization already exist. Half of all individuals aged 50 to 75 with household financial assets of \$50,000 or more will need to tap into savings during retirement in order to pay for basic living expenses. . . . Nearly half of those people are interested in converting some of their savings into guaranteed lifetime income. If all these people eventually annuitize a portion of their assets, the total amount annuitized would exceed \$200 billion. (Sondergeld and Drinkwater 2004)

But at the present time, life annuities represent a small fraction of the industry's sales. For example, in 2004 there were \$212.4 billion in new individual annuity sales, but fixed immediate life annuities

accounted for only \$5.6 billion of that amount (Bernard 2005; Whitehouse 2005).

Research into the unpopularity of life annuities typically focuses on two sets of factors: people and their individual needs, and problems with the product itself. The research indicates that some potential purchasers have liquidity concerns and so are reluctant to commit their savings irrevocably to an annuity. Others are unsure about their health and question whether buying the lifetime income provided by an annuity is a good investment for them (Brown and Warshawsky 2004). Many potential purchasers try to conserve their assets for bequests to their families or to charity and therefore find an annuity unappealing. Still others prefer to rely on Social Security for a guaranteed income stream in retirement (Ameriks and Yakoboski 2003). The life annuity market is still developing, and the product is perceived to have a number of problems. For example, the issue of whether life annuities are fairly priced is an open one (Ameriks and Yakoboski 2003), leading some to question whether annuities are an attractive investment. And the market currently lacks an annuity product that protects against inflation (Brown and Warshawsky 2004).

Missing in Action: The Employer

These factors explain some of the unpopularity of annuities, but there could be another important but generally overlooked factor: the absence of annuity options in savings plans. For many people, the most significant source of information about and support for retirement planning is their employer's savings plan. Employers are important intermediaries in saving. They provide a plan and payroll deduction services, educate workers about the need to save, select a menu of investment options, and, often, encourage additional saving through financial incentives such as matching contributions. Most workers learn about and implement saving for retirement through their employers' plans.

Employers, however, deliberately play a hands-off role in educating workers about managing their savings in retirement. A Government Accountability Office (GAO) study observed that

[p]lan sponsors . . . generally did not provide information on considerations relevant to managing pension and retirement savings plan assets at and during retirement. . . . [P]lan sponsors generally do not discuss the potential pros and cons of available payout options as related to managing pension assets during retirement. . . . [T]hey typically do not discuss risks retirees may face in managing their assets during retirement or provide information on how to assess needs at or during retirement (Government Accountability Office 2003:14).

TABLE 1
Savings Plans Offering Annuities

Study	Sample	Findings
Bureau of Labor Statistics (1999)	Sample of private firms employing more than 100 workers in 1997	27% of full-time employees in 401(k) plans had annuity options.
Government Accounting Office (2003)	Private firm data from the National Compensation Survey of the BLS in 2000	Annuities available to 38% of participants in defined contribution plans.
Hewitt Associates (2003)	About 500 401(k) plans surveyed in 1999, 2001, and 2003	Percentage of plans offering annuities fell from 31% in 1999 to 17% in 2003.
Profit-Sharing/401(k) Council of America (2004)	Survey of about 1,000 profit-sharing, 401(k), and profit-sharing/401(k) combination plans in 2002	26% of plans offered retirement annuities; more smaller plans offer annuities (36% of plans with 50-199 participants, 26% with fewer than 50) than large plans (19% of plans with more than 5,000 participants); in 2001, 28% of plans offered annuities (Government Accountability Office 2003).

Not only do employers not provide advice or education about managing assets in retirement, savings plans in particular typically constrain workers to a lump sum of cash when leaving (Government Accountability Office 2003). As Table 1 illustrates, the available data suggest that only a minority of savings plans offer annuities as a distribution option, and even that number appears to be shrinking over time.

The absence of annuities from savings plans does not mean that workers have lost their only opportunity to purchase one. They can always use a lump sum distribution of their plan account to buy an annuity directly from an insurance company or purchase one later through an individual retirement account (IRA). But with the employer sitting on the sidelines, both workers and the life annuity market have lost the services of an important intermediary. Workers do not learn about the benefits of annuities or receive help in obtaining one through their savings plan, and the life insurance industry has lost an important ally. If savings plan sponsors do not expand the distribution options in their plans to include annuities, the rate of annuitization may not increase significantly in the future. But, as I go on to describe, recent developments in the law have discouraged plan sponsors from offering annuities.

Why Savings Plan Sponsors Avoid Annuities

Several factors explain the absence of annuities in savings plans. First, while DB plans are required to provide annuities, savings plans are

generally exempt from this requirement. Under Internal Revenue Code (IRC) § 401(a)(11)(B)(iii) and the Employee Retirement Income Security Act (ERISA) § 205(b)(1)(C), most DC plans are not required to offer annuities as long as the spouse of a deceased participant inherits the decedent's account automatically under the terms of the plan. The exception to this rule is a type of DC plan that is not a savings plan known as a money purchase plan. Most savings plan sponsors thus are not obliged to offer annuities as distribution options. Second, as researchers have observed, plan sponsors avoid annuities to minimize their administrative and regulatory burdens (Brown and Warshawsky 2004). But legal advisers know the real reason why plan sponsors don't offer annuities: because those advisers strongly counsel clients against them. In their view, annuities expose plan sponsors to a significant and long-term risk of fiduciary liability, a risk that can be avoided by not offering annuities in employee savings plans. And plan sponsors, more often than not, heed that advice.

ERISA and Fiduciary Liability

The fiduciary liability associated with savings plans arises out of the legal requirements under ERISA, administered by the Department of Labor (DOL), that set standards for savings plans. The rules set forth in ERISA control how a plan should be operated and impose penalties for breaching those standards. ERISA § 402 holds individuals with discretionary authority over the operation and administration of a plan to a high standard of conduct as fiduciaries. ERISA § 404 requires a fiduciary, when acting on behalf of a plan, to act solely in the interests of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan, and with the care, skill, prudence, and diligence that a prudent person would use under similar circumstances. Fiduciaries are personally liable to make a plan whole for any losses it suffers when they breach that standard of conduct.² In addition, a fiduciary involved in a settlement agreement or lawsuit as the result of a fiduciary breach is also subject to a 20% special civil penalty. The DOL is required to assess this penalty unless it finds that the fiduciary acted reasonably or in good faith, or will suffer severe financial hardship without a waiver or reduction of the penalty under ERISA § 502(l).

Under ERISA, a plan sponsor is not acting as a fiduciary when it chooses the distribution options in a plan, because plan design is considered to be a business, rather than fiduciary, decision. Plan sponsors thus have complete discretion when deciding to include or exclude annuities from their plans. Liability potentially arises only when a participant

chooses an annuity in a plan that offers them, and the plan sponsor or other fiduciary must decide how the annuity will be provided. This is less of an issue with ongoing DB plans because annuities are typically paid directly from the plan. DC plans, however, are different. If a participant chooses an annuity form of distribution, the plan must purchase an annuity from an outside provider. The choice of annuity provider is an investment decision, subject to the fiduciary standards of ERISA. This distinguishes annuities from other forms of distributions, such as lump sum or installment distributions, for which the participant, not the plan, makes all investment decisions. Any plan official who makes a discretionary decision about an annuity purchase for a participant is therefore acting as a fiduciary and is liable for that decision unless he or she exercised due care when making it and put the best interests of the participant first.³

Executive Life and Its Aftermath

Until the early 1990s, the fiduciary liability associated with annuities did not seem particularly problematic, and many savings plans offered them. But, just as the shift to savings plans was accelerating in the late 1980s and 1990s, a number of large insurance companies failed, including Executive Life Insurance Company of California and Mutual Benefit Life of New Jersey (Government Accountability Office 1992a, 1992b; Government Accountability Office 1995). At that time, as the GAO (Government Accountability Office 1991) has estimated, about one third of all pension plan assets were invested in insurance company products, and some 3 to 4 million retirees held annuities purchased from insurance companies. The failure of these companies caused a crisis within the private pension system whose repercussions are still being felt today.

Most affected by the crisis were DB plans, primarily those that had purchased group annuity contracts for retirees or for terminating plans. Savings plans were affected only secondarily, but, ironically, not because of the annuities they provided. Instead, some savings plans became vulnerable because they or their participants had invested in such insurance company products as guaranteed investment contracts that could not pay their promised return. Even though the life annuities offered by savings plans were not generally implicated, the crisis exposed regulatory weaknesses that persuaded savings plan sponsors that annuities were too risky. In addition, although the crisis with life annuities was largely confined to DB plans, the regulatory response was overly broad, increasing the administrative burden and fiduciary risk associated with annuities even for savings plans.

The first regulatory weakness exposed was within the insurance industry itself. In the United States, the insurance industry is largely regulated by states rather than the federal government. States license insurance companies, oversee their financial health, and, when a company becomes insolvent, take charge of the liquidation process. When an insurance company fails, policyholders must turn to the relevant state guarantee associations for redress. These associations are neither state agencies nor funded by the states. Instead, they are an association of insurers in each state that have the power to assess member insurers when an insurance company becomes insolvent. Although these funds are called "guaranty" associations, they do not in fact provide a guarantee that they will have sufficient funds to cover the obligations of failed insurers. In addition, while these associations initially bear the cost of an insurance company insolvency, most states allow insurance companies to recover assessments through reductions in state premium taxes (American Council of Life Insurers 2004d) or rate increases. So ultimately the cost of an insurance company failure is borne by policyholders or taxpayers (Government Accountability Office 1992c).

The failure of Executive Life and the other companies gave employers and their employee benefits lawyers their first large-scale encounter with state guaranty associations and, for many it was a disturbing experience. There are no statistics available about the relief actually obtained from state guaranty associations, but contemporary accounts report a number of significant problems encountered by plans seeking to recoup losses:

- State guaranty funds generally did not provide coverage for guaranteed insurance contracts and similar products in DB plans, and only a few provided coverage for DC plans (Government Accountability Office 1991; Harrington 1992).
- "Variations in state rules cause gaps and significant differences in coverage," such as different rules for who is protected and the types of policies and annuities protected (Government Accountability Office 1992c).
- Coverage was "generally limited to a maximum of \$300,000 for individual claimants with no more than \$100,000 for cash values of life insurance and annuity contracts" (Harrington 1992). (The same limits were still in effect in 2004 [American Council of Life Insurers 2004d].)
- Some states provide coverage to all if the insurance company is headquartered in that state, but others provide coverage only for state residents of companies doing business in that state (Government Accountability Office 1991).

Although the National Association of Life and Health Guaranty Associations exists to help coordinate guaranty association activities when an insurance company operating in several states fails (American Council of Life Insurers 2004d), there is no parallel coordinating mechanism for employee benefit plans. Employers found that dealing with multiple state guaranty funds was expensive and time-consuming. In addition, the patchwork of coverage available led to uneven outcomes among participants, and even no protection for large numbers of participants. In the end, many in the employee benefits community concluded that, whatever the merits of the state guaranty association system, it is not well suited to the needs of employer plans, particularly those with employees in a number of states.

The second regulatory weakness exposed was within the private pension system itself. Some employers as well as those frustrated by the state guaranty association system chose a different route. They proposed to make additional contributions to their plans to make participants whole. On the surface, this appeared to be a simple, reasonable solution to a difficult problem. But the private pension system, never having grappled with such a situation before, had no mechanism permitting this. In addition, these contributions actually raised a number of significant legal questions. For example, under tax law, there were issues about whether these contributions would violate the exclusive benefit rule of IRC § 401(a)(2), the nondiscrimination rules of IRC § 401(a)(4), the limits on deductions under IRC § 404, and the limits on benefits under IRC § 415, as well as various excise tax provisions. Under ERISA, there was a great deal of uncertainty about whether such contributions would be an admission of fiduciary liability, triggering the special 20% civil penalty for fiduciary breaches.

After some consideration by the Internal Revenue Service (IRS) and the DOL and consultation with employer groups and benefits experts, the legal issues were resolved. Employers were given the ability to make such "restorative" payments to their DC plans, but only after they had received regulatory approval. The IRS created a special program for this purpose.⁴ To participate in this program, employers also were required to obtain an exemption from the DOL for relief from fiduciary liability. This meant that employers had to provide information to the DOL about their plans, their failed contracts, and their affected plan participants. Employers who volunteered to make their participants whole found themselves involved in an expensive and time-consuming regulatory process.

By themselves, these regulatory issues would probably not have been significant enough to turn savings plan sponsors against annuities. But

litigation surrounding the collapse of the Executive Life Insurance Company of California led to a major change in law with just that effect. The leading case was *Kayes v. Pacific Lumber*.⁵ The Maxxam Group obtained control of the Pacific Lumber Company through a hostile takeover, then terminated its overfunded DB plan. It selected Executive Life, an insurance company whose bid was \$2.7 million lower than other companies, to provide annuities to participants and received \$62 million in surplus plan assets that were then used to pay off debt from the leveraged buy-out. When this insurance company subsequently failed, litigation on behalf of annuitants, seeking to impose liability on plan fiduciaries for their self-interested selection of Executive Life, ran into a legal Catch-22. Because their annuities were fully guaranteed by an insurance company, they no longer satisfied the definition of plan "participant" under ERISA and therefore had no standing to sue.⁶

To many, *Kayes v. Pacific Lumber* signaled a problem with ERISA's fiduciary rules that needed to be fixed. Its holding, although legally correct, suggested that plan fiduciaries could violate with impunity ERISA's requirement that they act solely in the best interests of plan participants when purchasing annuities. Congress concurred and swiftly enacted the Pension Annuitants Protection Act of 1994 (PAPA). PAPA amended ERISA to grant annuitants standing to bring suit against plan fiduciaries for breaches of duty in connection with the purchase of insurance contracts and annuities.⁷ This not only gave annuitants the right to sue, it also greatly expanded the period of time during which fiduciaries could be at risk for a claim of breach of fiduciary duty.⁸ In addition, it authorized courts to award appropriate relief and money damages, including the purchase of backup annuities, remedies that are generally not available under ERISA.

In interpreting the new rules under PAPA, the DOL issued regulations about annuity purchases that were highly controversial. As the GAO (Government Accountability Office 1993) noted during the height of the Executive Life crisis, fiduciaries had no guidance from the DOL about the process they should follow or the criteria they should observe when selecting annuity providers for participants to comply with ERISA's requirements. In 1995, however, the DOL issued an interpretive bulletin for that purpose. Its central holding was that ERISA required plan fiduciaries to select "the safest annuity possible."⁹ To do this, in the DOL's view, fiduciaries are required to conduct an objective and thorough search for potential providers, generally with the assistance of an independent expert. In particular, they should analyze each provider's creditworthiness and claims-paying ability. They should conduct their own evaluation of the safety of possible providers and not just

rely on a rating from a commercial rating service. Factors to be considered include the quality and diversification of each company's investment portfolio, its capital level and surplus, and its lines of business and exposure to liability as well as the structure of the proposed annuity contract and its guarantees. In the DOL's view, a proper review should include analysis of the adequacy of state guaranty fund protection. In 2002, the DOL amplified that guidance by advising plan fiduciaries to examine "whether the provider and the annuity provider are covered by state guarantees and the extent of those guarantees, in terms of amounts (e.g., percentage limits on guarantees) and individuals covered (e.g., residents, as opposed to non-residents, of a state)" (Department of Labor 2002).

The DOL's attempt to add clarity was not well received. Some courts refused to apply the interpretive bulletin's guidance when evaluating the conduct of fiduciaries, even in cases related to Executive Life.¹⁰ Moreover, Congress itself has recently rejected "the safest possible annuity" standard. In the Pension Protection Act, passed in mid-2006, Congress noted that it was not its intention that there "be a single safest annuity available contract" (Joint Committee on Taxation 2006:149).¹¹ Congress directed the DOL to issue new regulations within 12 months setting standards more closely tied to ERISA's general standard of prudence for fiduciaries. It also strongly indicated that the DOL's interpretive bulleting standards were too stringent by indicating its preference that new guidance not "restate all the factors contained in the interpretive bulletin" (Joint Committee on Taxation 2006:149).

The cumulative effect of the Executive Life crisis and the regulatory struggle over appropriate fiduciary standards for annuity purchases largely explains why savings plan sponsors shun annuities. This is an ironic outcome because the reforms brought about by PAPA make sense only for DB plans. Given the volume of annuities that DB plans typically purchase, it seems reasonable to require a formal evaluation process of providers to satisfy fiduciary standards. In addition, the price paid for annuities inevitably affects the funded status of DB plans, so plan fiduciaries have an inherent conflict of interest regarding the cost of the annuity provider they choose. It seems reasonable to ensure that plan participants have redress against fiduciaries that put the costs of annuities first and the safety of the annuities they purchase for participants second. It also seems reasonable to believe that annuities, given their long-term and irrevocable nature, deserve extended protection against fiduciary misconduct in ways lump sum and installment distributions do not.

But it is hard to understand why fiduciaries of savings plans should be held to the same standards as their counterparts in DB plans. Savings plans purchase annuities infrequently and usually one at a time. Many

plans are sponsored by small employers who lack the staff, the expertise, and the funds to follow the procedures the DOL recommends. There is no conflict of interest when a savings plan buys an annuity because it can only use a participant's own account assets for that purpose.

In the end, savings plan participants lost more than they gained by the post-Executive Life reforms. These reforms prevented what was a small risk to plan participants by imposing a big risk on plan fiduciaries. Savings plan sponsors responded by concluding the fiduciary liability attached to annuities should be avoided wherever possible. They also observed that state guaranty associations do not provide adequate or even protection when an insurance company fails. Even volunteering to make their participants whole would be complicated, requiring cumbersome regulatory approvals. But, primarily, they decided they did not want to be the potential guarantors of private annuity providers under PAPA. They looked at their increased fiduciary liability and concluded that offering annuities was just not worth the risk when participants could always buy annuities on their own. The law offers savings plan sponsors an out, and many take it by deciding not to offer annuities. That leaves savings plan participants without the assistance of an important intermediary, their employer, and a valuable product, a life annuity, as they make the transition to retirement.

How Proposed Insurance Reforms Could Help

Proposals for Changing Pension Law

The absence of annuities from savings plans has not gone unnoticed, and various options have been proposed to reinstate them (Government Accountability Office 2003). Among the most prominent are proposals for some form of mandatory annuitization. These would change existing law to compel plans to provide and/or participants to receive annuities as distribution options. The most extreme proposal would eliminate participant choice and require all benefits, regardless of the type of plan, to be paid in the form of annuities. Under a more moderate proposal, the current exemption for savings plans under IRC § 401(a)(11) would be repealed. Savings plan participants would be required to receive their benefits as an annuity unless they, with spousal consent, chose an alternative. Another proposal would merely require savings plans to offer annuities.

These proposals are appealing in their simplicity: just amend pension law and the problem will be solved. The trend in the law, however, is moving strongly in the opposite direction, that is, to give savings plan sponsors more flexibility, not less, with respect to annuities. For example,

the IRS has recently revised long-standing regulations and now permits savings plans to eliminate all forms of annuity distributions.¹² In addition, it is likely that these proposals would exacerbate the coverage problem currently facing the private pension system. Plan sponsors would be likely to respond to an annuity mandate that would expand their fiduciary liability by refusing to sponsor new plans or terminating their existing plans.

Plan sponsors' negative response to PAPA suggests that these proposals will not achieve what they intend. First, it is unrealistic to assume that plan sponsors will willingly assume responsibility for what they cannot control, namely the financial health of the insurance companies from which they purchase annuities. Plan sponsors are not eager to become potential guarantors for annuity providers, especially given the extended period under ERISA's statute of limitations during which they could be at risk for litigation. Second, pension law, by itself, cannot make annuities a safer or more appealing product to either plan sponsors or plan participants. These are issues that lie primarily within the control of the life insurance industry, not pension law.

A Proposal for Changing Insurance Law

The life insurance industry itself has recently proposed reforms with the potential to make annuities again an attractive option for savings plan sponsors. It has asked Congress to create a new model for insurance company organization and regulation: an optional federal charter for life insurance companies.¹³ This initiative for change comes at a time when the traditional lines between the insurance, banking, and securities industries have been blurring. In addition, recent legislation, notably the Gramm-Leach-Bliley Act of 1999, has modernized federal regulation over most of the financial services industry. Similar reform has not yet been attempted on a broad scale within the life insurance industry, which remains a creature of state law.

As one industry spokesperson has noted, however,

for the insurance business to remain viable and serve the needs of the American public effectively, our system of life insurance regulation must become far more efficient and responsive to the needs and circumstances of a 21st century global business. Life insurers today operate under a patchwork system of state laws and regulations that lack uniformity and is applied and interpreted differently from state to state. The result is a system characterized by delays and unnecessary expenses that hinder companies and disadvantage their customers. (American Council of Life Insurers 2004d)

Proponents believe that "insurance regulatory reform is integral to maintaining America's leading role in the international financial services marketplace. The current antiquated, state-by-state regulatory system reduces U.S. competitiveness in the global insurance arena, when competing head-to-head with more efficient and modernized foreign markets." (American Council of Life Insurers 2006). They also argue "consumers are . . . harmed because they ultimately pay the costs for a regulatory system riddled with redundancies and red tape that ultimately deprives consumers of the best possible services and product innovations" (American Council of Life Insurers 2006). A recent survey of 100 insurance companies estimated that 55% of all regulatory costs, or more than \$250 million annually, are directly related to complying with the regulatory requirements of multiple jurisdictions (Computer Sciences Corporation 2005).

The solution proposed by the American Council of Life Insurers is to create an optional federal charter system for life insurance companies, modeled on the dual federal-state charter system long in effect in the banking industry (American Council of Life Insurers 2003, 2004a, 2004b). Under legislation recently introduced into Congress, the National Insurance Act of 2006 (NIA) would create an optional federal charter program for life insurers.¹⁴ The NIA would establish a single federal regulator, the Office of National Insurers (ONI) to be housed in the Treasury Department, to license, regulate, and supervise insurance companies that opt-in to a federal charter. The legislation promises to ensure the financial stability of national insurers by requiring stringent accounting principles and audit standards and strong risk-based capital requirements. It would also safeguard insurance company assets by applying strong, uniform investment and valuation standards. The ONI would have broad powers to regulate the market conduct and perform financial examinations of national insurers. It would also license and supervise agents and approve the terms and conditions of policies.

Although the proposal creates new federal law for most functions of national insurers, it continues to rely on the existing state-based system in one important respect. The NIA does not propose a new federal guaranty system to protect policyholders in the case of insurer insolvencies. Instead, it would continue to rely on state guaranty associations but attempt to upgrade and standardize their protection. Every national insurer will be required to become a member of the guaranty association of each "qualified" state in which it does business. A qualified state is one whose guaranty association meets the NIA standards, which are based on the Life and Health Insurance Guaranty Association Model Act proposed by the National Association of Insurance Commissioners, the policy association of U.S. insurance regulators. These standards include providing

protection, on a per-person basis, of \$300,000 in life insurance death benefits but not more than \$100,000 in net cash surrender and withdrawal values and not more than \$100,000 in present value for annuity benefits, including net cash surrender and withdrawal values. Residents in a nonqualified state, however, would receive comparable protection through a new guaranty corporation chartered in the District of Columbia to which all national insurers will be required to belong. This corporation would be regulated by the ONI but would not itself be a federal agency, and its obligations would not be backed by the full faith and credit of the federal government.

The optional federal charter proposal holds a great deal of promise for making annuities more attractive to savings plan sponsors.¹⁵ Its single most important contribution is that it achieves uniformity and standardization among annuity providers and their products. This alone significantly reduces the fiduciary exposure of plan fiduciaries. Under ERISA, to the extent that there are uniform annuity products and standardized annuity providers available, plan fiduciaries would not have to exercise discretion, and would therefore not be exposed to liability, when they select an annuity provider.

The federal charter proposal contains several elements that help minimize the discretion required of plan fiduciaries when selecting an annuity provider. First, the proposal would create standard annuity policies. Second, agents and insurance companies would be subject to uniform sales, marketing, and licensing standards. Third, the financial health of annuity providers would be monitored and supervised by a single federal regulator. National insurers would be subject to uniform accounting, investment, and valuation standards as well as risk-based capital requirements. Fourth, the proposal would be based on federal law, as are employee benefit plans, rather than on the laws of the current 50-plus different insurance jurisdictions.

But it is also important to recognize that the proposal in its current format has a significant drawback. Many plan sponsors would be dismayed by the continued reliance on state guaranty funds. In addition, the coverage amounts provided by these funds, although comparable to what is available today, could be perceived as inadequate for the large account balances often accumulated in savings plans. Even though the proposal achieves greater uniformity among state guaranty funds, as a matter of prudence under ERISA, plan fiduciaries would likely be required to investigate the adequacy of individual funds, often in several states, when selecting a provider. In the event of an insurance company insolvency, plan sponsors would still have to deal with multiple jurisdictions as well as its own federal regulators.

From the perspective of plan sponsors, it would be preferable to have a single guaranty fund under the jurisdiction of a single regulator and federal law. How significant this omission is, given the benefits of the proposal, is open to question. There are, however, some improvements, short of a single guaranty fund, that could be made to the proposal that plan sponsors might find helpful. For example, perhaps the proposal could include some sort of explicit coordination mechanism for employee benefit plans in the event of a multiple-jurisdiction insolvency. Alternatively, a single jurisdiction, perhaps that of the employer, could be designated for annuities purchased through an employee benefit plan. Changes like these could improve the efficiency of the guaranty system for plan sponsors without adversely affecting the protection available for plan annuitants.

Conclusion

At a minimum, the federal charter proposal would enable plan fiduciaries to minimize their fiduciary exposure when helping participants purchase annuities. That, by itself, might be sufficient to persuade more plan sponsors to offer annuities. From the perspective of pension law, this would be a practical and welcome solution to a problem largely created by pension law. But the federal charter proposal holds the potential for some positive changes to pension law as well. With a strong federal regulator, the risks of insolvency by national insurers would presumably be greatly reduced, and the need to give plan participants additional protection under ERISA would correspondingly decrease as well.

If so, why not make annuities more attractive to savings plan sponsors by reducing their exposure to fiduciary liability proportionately. One possible way to do that is to amend pension law so that the purchase of an annuity from a federally chartered insurance company by savings plan fiduciaries automatically satisfies ERISA's fiduciary provisions. If the federal charter proposal fulfills its promise, such a change would undo the damage that PAPA has inflicted on savings plans. It would give savings plan sponsors a more appropriate role as facilitators, not guarantors, of annuities. And it would be a helpful step toward making annuities once again a standard feature of savings plans and making workers more receptive to annuities.

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Endnotes

¹ Attributed to Thomas Henry Huxley, *The Columbia World of Quotations*. Available at <http://www.bartleby.com/66/4/30104.html>.

² See ERISA § 409(a). The concept that fiduciaries are personally liable for plan losses caused by the breach of their fiduciary duties is further emphasized in ERISA § 410(a), that any agreement or provision that attempts to relieve a fiduciary of his or her responsibilities or exculpate a fiduciary from the consequences of his or her actions or omissions is void as a matter of public policy. ERISA § 410(b) does permit a plan to purchase insurance to cover fiduciary liability or make a plan whole as long as the insurance company has a right of recourse (the right to recover any damages paid from the fiduciary).

³ See ERISA Regulation § 2550.404a-1.

⁴ This special program for plans involved in state life insurance company delinquency proceedings was originally authorized as a temporary program under Revenue Procedure 92-16, I.R.B. 1992-7 (February 18, 1992), went through several subsequent revisions, and then was extended indefinitely in Revenue Procedure 95-52, I.R.B. 1995-51 (December 18, 1995). The IRS has recently released additional guidance permitting such contributions generally, provided they "are made to restore losses to the plan stemming from fiduciary actions that could reasonably be expected to create a risk of liability for breach of fiduciary duty." See Revenue Ruling 2002-35, I.R.B. 2002-29 (July 22, 2002).

⁵ *Kayes v. Pacific Lumber Co.*, 1993 U.S. Dist. LEXIS 7280 (N.D. Cal. May 17, 1993), affirmed in part, reversed in part, and remanded in 51 F.3d 1449 (9th Cir. 1995).

⁶ See ERISA Reg. § 2510.3-3(d)(2)(ii)(A) and ERISA § 502(a).

⁷ See ERISA § 502(a)(9), which applies to any legal proceeding pending or brought on or after May 31, 1993.

⁸ In general, under ERISA § 413, participants may sue for a breach of fiduciary duty until the earlier of a) six years after the breach occurred or b) three years after the earliest date on which they have "actual knowledge" of the breach. In at least one case also associated with the Executive Life crisis, *Maher v. Strachan Shipping Co.*, 68 F.3d 951 (5th Cir. 1995), the court applied the six-year statute of limitations to a claim of breach of fiduciary duty in the selection of an annuity provider.

⁹ ERISA Reg. § 2509.95-1.

¹⁰ See *Bussian v. RJR Nabisco*, 223 F.3d 286 (5th Cir. 2000), reversing 21 F.Supp2d 680, DC-Texas (1998).

¹¹ See Section 624 of the Pension Protection Act of 2006 (Public Law 109-280).

¹² Treas. Reg. § 1.411(d)-4, Q&A-2(e).

¹³ This chapter discusses the American Council of Life Insurers proposal for an optional federal charter for life insurance companies. A number of similar proposals also under consideration are discussed in Bair (2004) and Broome (2002).

¹⁴ The National Insurance Act of 2006 was introduced in the Senate on April 5, 2006, by Senators John Sununu and Tim Johnson as S. 2509 and in the House on September 28, 2006, by Representative Edward Royce as H.R. 6225.

¹⁵ A discussion of the merits of this proposal outside the qualified plan context is beyond the scope of the chapter. Interested readers can obtain a broader analysis of the proposal from Bair (2004) and Broome (2002).

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CHAPTER 9

U.S. Federal Pension Policy: Its Potential and Pitfalls

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This chapter examines how U.S. federal pension policy has evolved since the enactment of the country's major pension law: the Employee Retirement Income Security Act of 1974 (ERISA; P.L. 93-406). Pension policy has had to balance the need for a reliable pension supplement to Social Security within a voluntary system of employer-provided employee benefits. Although experts have long known that tax incentive-based systems do little to promote extra savings for retirement, such incentives remain the most popular and attractive public policy tool. As individual-based retirement plans, such as 401(k) plans, have become the dominant form of retirement savings, it is becoming clearer that individuals are unreliable managers of long-term savings and that employers have an inconsistent history in managing 401(k)s and large incentives not to extend them to the lowest earners. This chapter outlines the predictable issues that arise in federal pension policy and suggests directions future policy might take. One of the current challenges is to encourage individual savings plans to adopt more traditional guaranteed benefit features to ensure needed minimum long-term retirement security.

Pension policy was largely unregulated until the enactment of ERISA, which has been described as the triumph of Congress over the affected special interest groups: employers and unions (Wooten 2004). For much of the past 30 years, congressional amendments to ERISA have tested this unusual policy dynamic, sometimes balancing and sometimes failing to find a balance between the interests of public policy, organized labor, and business.

Participant Activism to Perfect ERISA

Throughout the 1980s, participant advocates sought and fought to close the gaps in the private pension system that ERISA failed to