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IS THERE LIFE AFTER EXECUTIVE LIFE?

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- Insurer solvency issues for pension actuaries:
Is there life after Executive Life?

MS. PATRICIA L. SCAHILL: Dick Schreitmueller has spoken many times, so perhaps you've heard him before. Dick is an FSA and an EA. He's currently senior research actuary for the Alexander & Alexander Consulting Group. Dick is also the editor of the *Enrolled Actuaries Report*. Dick is going to talk to us about Executive Life and its many implications for pension actuaries.

MR. RICHARD G. SCHREITMUELLER: The short title of this session is "Is There Life after Executive Life?" because Executive Life does seem to be at the root of many of the issues that we'll be discussing. There are three phases that I'd like to discuss: first, what has happened so far; second, what everyone is doing about it (the damage control aspect); and finally, what this all means and where we are going.

SHUTTING DOWN EXECUTIVE LIFE

Well, it's hard to believe that only 18 months ago, none of this had happened. No one was even thinking about it. In fact, in December 1989, the PBGC put out a very routine announcement in which it issued procedures for terminating plans. Among them was a procedure that said that within 30 days afterwards, you had to tell the PBGC who the insurance company was. Well the following month, the rating bureaus, Standard & Poor's and Moody's, downrated Executive Life and things started to happen. One of the first things that happened was a little company called Coleman Corporation in Kansas got nervous about a current annuity purchase. This company managed to unwind it, and arranged to have the insurance company (Executive Life) give the money back. Coleman then found an insurance company that it liked better. And, of course, at the root of this, was the fact that Executive Life had a lot of junk bond holdings and the way that these were being valued at that time didn't make its surplus look very good.

So this got a lot of attention, particularly from Senator Kassebaum who is from Kansas. Elizabeth Dole, the head of the Department of Labor, is married to the other senator from Kansas, so there was plenty of federal involvement. Before two months had gone by, March 1990, the PBGC and the Department of Labor announced a new procedure. Now, when purchasing annuities, 45 days of advance notice has to be given including the name of the insurance company. This in effect means that the federal government has veto power over the insurance company, so it put Executive Life out of this business, as far as new clientele was concerned. And nobody is exactly sure how this procedure works. The following month, April 1990, the Senate had a hearing on this. The PBGC testified that it is not involved in an insuring sense. If Executive Life or some similar company were to go under, leaving some annuities behind, the PBGC did not guarantee those annuities.

Senator Metzenbaum, who has never been a friend of the insurance industry, criticized employers for using this low-bid mentality in picking companies such as

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Executive Life. He also was not a friend of reversions and he said, "Well, by the low-bid process, you maximize the reversion and that shows that there is something wrong here." He criticized the insurance industry as being underregulated. All this got a great deal of publicity and many employers and employees started asking questions. I suspect many of you here have helped answer those questions on behalf of your clients. You've also probably run up a few billable hours explaining the difference between different kinds of insurance companies.

About a year went by and less than two months ago, April 11, 1991, the State of California seized Executive Life. It seems to follow a pattern here, with several of these seizures recently. Executive Life came first and it started getting publicity. About a month or so before, it was being watched very closely, and all of a sudden, wham! There are new locks on the doors. Not long after that, First Capital, another family of companies, had a couple of its companies seized. Both of these were in California and New York. And finally, just last week, Monarch Life in Massachusetts was seized. These are three very big companies. The problems and the issues were somewhat different, the degree to which people can expect to get paid off. There are a lot of differences among them, but I believe for us in the pension world, the focus is on Executive Life of California. That's the big one, the one that's in the pension business.

IMPACT ON PENSION PLANS

In the years since 1974, when ERISA came along, there had been about an average of 10 insolvencies of life companies per year. Generally these are small; they are swept under the rug. They get merged in, life goes on and people get their benefits. But this is different. Executive Life is a very significant player. Executive Life has 75,000 annuity contracts in force, with a present value of about \$2.5 billion. They also have 300 plus guaranteed investment contracts that have a book value of another \$3 billion. And there are at least 50 employers who are using those GICs in their defined contribution (DC) plans. These average about \$10 million per GIC, so we're talking about real money. So when California came in, one of the first things that happened was it froze everything. And the GICs are still frozen.

A court order soon unfroze the annuities. The court said, "You can pay off at 70 cents on the dollar for annuities." They are in the process of selling off what's left of Executive Life and so Executive Life is just in that midstream state where nobody is quite sure where it's all going to end up.

Employers have stayed very well informed, but they've had a real conflict here. On the one hand many employers feel guilty that they have gotten their plan and their employees into this situation. From an employee relations viewpoint, they believe the right thing to do is bail these employees out. I believe most employers came to that conclusion very quickly. On the other hand, the rules at the state level and the federal level do not seem to facilitate this. One legal argument goes, "Well, if you go and make good on this, you're jeopardizing your position to collect from somebody else." A number of federal rules just are not set up with this in mind and so it's hard to get from here to there. And in the meantime, the fiduciary rules, Title I of ERISA, have been looming very big, because with all this hindsight, it's very easy to say that it was not a good decision to bring Executive Life in. At the same time, they have to

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pay attention to these IRS rules. It's a very unprecedented situation and people are making things up as they go along.

The GICs are most interesting in many ways. A couple of employers are in the process or have already bought these contracts. The first one was Georgia Pacific, a year ago, who had acquired another company that had an Executive Life GIC in its DC plan. Georgia Pacific didn't like the looks of that and so when it put the two DC plans together, it decided to buy this GIC with company money. It got the appropriate clearances from the federal government. That seems to be a pretty clean deal.

The State of Alaska is another one. A good bit of money in its DC plan is invested in Executive Life GICs. Alaska will have to pass a law, and I believe it has been signed or will be signed very shortly.

Another employer, Holiday Inn, has promised that it will make good. The others, to my knowledge, are still hanging back. Just last week it was announced that two of the biggest ones, Honeywell and Unisys, were sued by their employees. It was interesting to read the brief. The lawyers will throw the book at them on a case like this, alleging fiduciary violations for many millions of dollars. Other companies probably are waiting for that shoe to drop, because (1) they do seem vulnerable to a lawsuit and (2) it's hard to picture that somebody else is going to come in and bail them out. The rules for GICs don't generally work that way. There's a coalition of 20 large employers with GICs that's been formed, kind of a support group. They can trade stories and strategies and hope that they're not next on the list.

The preferred strategy on the surface would be for the employer to go in and buy the GIC with company money. By and large, the amounts involved are not so huge that a company cannot afford to do that. What is huge are the many technical problems. I'll just list some of the ones I've been reading about. First off is prohibited transactions. There's probably a way around that, but it takes time. Second, it's not clear how you deduct the money that you put in, and making a nondeductible contribution to a plan is certainly not something you want to go ahead and do. There are potential problems with the 415 limit on highly paid people. There are a lot of administrative problems. There are very specific rules in a DC plan about how you value an account. How do you determine whether an employee gets the account valued as of the last valuation date or the next valuation date? There was quite a bit of soul searching on that after the October 1987 stock market crash. I believe most plans use the last date, but that may make it difficult to amend the plan. So it's not that easy, just to sort it out from an administrative point of view.

The FASB has recently proposed to value GICs at market value. It's my understanding that that doesn't have a whole lot to do with this Executive Life situation, because there's an exception to that rule, which says that if a company is in trouble, all bets are off and it is just valued at an appropriate value, even though the new FASB rule has not come into effect. It would be inappropriate to continue using book value indefinitely in this kind of situation.

Another rule that you could run into is the minimum distribution at age 70 1/2. If you don't know how much is going to be paid, it's a little hard to know the minimum distribution. Similarly, you may have Executive Life GICs and other contracts. Let's

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say the Executive Life amounts to 20% of the fund and the other 80% is okay. Somebody leaves and you can say, "Here's 80% of your lump sum; I'll give you the other 20% when we can figure out what it is, if any." That's not a very satisfying answer. If he wants to do an IRA rollover or if he wants to take 5- or 10-year averaging, he is supposed to get his distributions in the same calendar year to count it as a lump sum distribution. Who knows when he's going to get that and how much it's going to be?

There are also back-door ways of making employees whole. For example, you make an interest-free loan to employees, to tide them over this interim period, but that has its own set of technical problems. And in the meantime, remember this is all supposed to be an employee relations tool. It's supposed to make employees feel very nice about the company. There are a lot of unhappy campers out there.

RESPONSE BY GOVERNMENT AND INSURANCE INDUSTRY

The response of regulators and insurers? First there is the state guaranty fund. Three jurisdictions as of today do not have state guaranty funds: New Jersey, Louisiana and the District of Columbia. In the other 48 states, the coverage does vary as to the amounts, what they will cover, who they will cover. For example, some of them cover based on the state in which the insurer is domiciled. If you're in that state and if the insurance company is domiciled in that state, then it's covered by that state fund. On the other hand, some states cover you by state of residence because, after all, if you're a resident there, you vote there. Because there are rules that don't all read the same, there could be overlaps or gaps or both. Anyway, in California, the state that is of most interest, there is a new law. And the rules say that California will pay off an annuity up to a present value of \$100,000. GICs either get low priority or no priority. And then a preexisting conditions rule says that if the insurer, were impaired, so to speak, when the law went into effect, such insurer may not be covered. So it's a little hard to know just where Executive Life comes out under that.

The insurance industry, to us who just read the papers, has been fairly quiet. There obviously has been a lot happening within the industry. The ACLI has got to be very concerned, has got to be working on solutions. It's very difficult to get the insurance industry all going in the same direction at the same time. We may look for solutions and leadership there, but it's going to be difficult to do. The industry has a support group. It consists of companies that issue GICs.

The National Association of Insurance Commissioners, the NAIC, obviously would like to avoid federal involvement, but it's not clear that it can.

And then at today's IRS session, there was a proposal that amounts to sort of an annulment of the annuity purchase, where the insurer would give the money back and just start over. I'm not sure how that would work or where it would fit in under the laws and regs, but it shows that there is a lot of creative thinking going on.

The three ERISA agencies are also involved. First, regarding annuity purchases, we know that the PBGC is due to issue some regs soon on how you go about selecting an insurer, how to be a good fiduciary. Some of the speculation is that there will be minimum financial standards for insurers. Or perhaps, it will be required that an independent fiduciary be entrusted with this decision of selecting a competent insurer.

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But this does not seem to deal with the diversification issue. That is, it still amounts to putting all your eggs in one basket, and it may be a very good basket, but it is a long way to carry that basket. This is one of the issues that was raised against Honeywell and Unisys: lack of diversification, where you had 15% or 20% with one company. So if there is 100% with one insurer, what has been done in the way of diversification might be harder to defend.

Beyond issuing regs on annuity purchases, the Department of Labor is investigating all the plans that are involved with Executive Life. The Congress says it, too, is going to investigate all the plans involved with Executive Life, and is going to investigate the Department of Labor, to see how things got to be the way they are.

Another interesting aspect is the PBGC reiterated its statement of a year ago; it is not backing up annuities. Furthermore, it says the employers are not backing up annuities. The PBGC takes a general position; I compare it to lump sum distributions. If employees are paid off with lump sum distributions, they're no longer participants. They've got their money, and you're through with them. The PBGC has said it would need higher premiums to cover this additional risk. Some analysts are not satisfied with that. They think the legal ground is shaky. Beyond the legal ground there's the policy ground. Is this really appropriate? If this is the way the law comes out, maybe it ought to be fixed. The California Insurance Commissioner said that would be *contrary to the spirit of ERISA*. And I think many of us would agree with that.

Over at the IRS, the employees are working very hard to cut the red tape in this area, and as in so many areas, there is a lot to cut.

Congress has not watched idly. For a year or so, it has been talking about regulating insurers. There's a lack of confidence in the regulation of the industry. There's a kind of consensus that there ought to be more uniform rules among the states. There ought to be minimum financial standards for insurers. And in the meantime, on a whole other track, there's an antitrust issue about the McCarran-Ferguson Act. The federal government really cannot back up the PBGC unless it has the authority. It has had enough of open-ended insurance arrangements and bail-outs, without any regulatory power, without having any teeth in it. And at the same time, there's concern about any kind of federal backup or bail-out, because if it did come to that, we'd be right back where we started. Employers would say, "Well, it's guaranteed, so let's use the low bid." So more than just backup would be needed; some controls would be needed.

The Joint Tax Committee had a very good report on Executive Life issues about a week ago, which covered many issues. On this PBGC insurance, it said that there is some support on both sides. You can argue for it or against it. But, entirely apart from the legalities, it does not seem likely that Congress will stand by helplessly while rank-and-file employees lose annuity benefits.

MAKING EMPLOYEES WHOLE

If a defined benefit (DB) plan has terminated and there are Executive Life annuities, there are several different sources of money: the state guaranty funds, employers who may want to make good, the insurance industry that may bail them out as it has

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bailed out other companies for many years, or maybe a new arrangement, some kind of a reinsurance pool. Also, the PBGC, under current law, if that's interpreted contrary to their statement, or possibly a new law, under which PBGC would take on a liability that they don't now recognize. We haven't even counted the lawsuits yet. If you were an employee hoping you'd get your money, I'd say you have a pretty good chance of getting it. But it may take a while and we're not sure whose name would be on the check.

A DC plan, with a guaranteed investment contract, is a little more direct. It seems as though the bill for making that good would probably go to the employer. If outside folks have been advising on GICs, they may find themselves helping pay that bill.

One other impact is that the GIC market is changing. Cash flow is shrinking. These products don't look as good as they did a while back. At the same time, this proposed new accounting rule from FASB, to use market value instead of book value, makes it a little harder to do some of the things with GICs that people have been doing.

There's also some impact on advisors who help select insurers. These people have a chance of being held accountable for their advice, depending on what advice they gave and what degree of control they exercised. For example, if you had been a consultant and you recommended the low-bid company, because it was the low-bid company, and that turned out to be Executive Life, you might not be very happy right now. On the other hand, if you said to look at the ratings, and Executive Life was rated well a few years ago, you'd have a little more to hang your hat on. The results still wouldn't be very good. If you had gone beyond that and said let's do an analysis and look at what their holdings are, that would be a more comfortable position to be in. "Look at these high-yield bonds; maybe they aren't very good, but after all, Mr. Employer, it's your decision." I can think of at least one employer that said, "Okay, we understand that; we're going to go in with our eyes open. We choose Executive Life."

Also, the communications material, by and large, has disregarded the possibility that an insurance company could go broke. The word *guaranteed* may or may not have appeared in the description the employees got. *USA Today's* headline read like this "Guaranteed Savings Plans Have Risk." People should know that. If they didn't know it in the past, they will know it in the future. It was one of the things mentioned in the lawsuits, that there was no perception of risk.

Another cheery note is that Moody's announced that the credit ratings for employers involved in these DC arrangements are going to be appropriately reduced to reflect the fact that they're going to have to make good on these. So you can see where they're betting their money on who's going to win these lawsuits.

What about the DB plans? There probably are some ongoing plans around that have had involvement. If you were the actuary for one of those plans, and you saw the asset statement included one of these GICs, I suspect you'd get ready to show an actuarial loss. If, on the other hand, that plan had a block of retirees that it had purchased as annuities, perhaps you'd have a kind of reverse settlement under

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Statement of Financial Accounting Standards (SFAS) 88. You'd have to decide whether these people have reverted to the plan or not.

At any rate, the losses do seem likely to be covered and in my humble opinion, I do not think that this is in any way comparable to the savings & loan disaster in terms of the amounts of money, or the culpability. I think it's one of these Murphy's Law things, where if anything can go wrong, it will. Still, there is plenty of blame to go around. Many of the parties that have just been mentioned, I believe, could have done more to keep this from happening. I don't believe anybody here wants this to happen again. The people who are involved in pensions, and the insurance industry and the insurance-buying public, would like to see confidence restored. We would all like to see the government and private sector work together to see that this does not get repeated. Pension benefits are supposed to be guaranteed. I think many of us would like to see that employees can count on getting their money. We're going to have to have leadership emerge to make this happen and I hope that some of us will be able to contribute to that.

MR. RICHARD S. RASKIN: I'd like to point out a couple of things. One of the issues you have is restoring public confidence in insurers. I think the real issue is maintaining the public confidence in the private pension system, because the people who are getting annuities used to think that they were getting guaranteed benefits. We all put that in the summary plan descriptions, that the benefits are guaranteed by an agency of the federal government. And they are guaranteed until annuities are purchased. So I think we have a big issue that affects not only the insurance companies, but also, for those of us who are consultants, our clients.

MR. SCHREITMUELLER: I couldn't agree more with that.

MR. RASKIN: I also think that you seem to imply that nobody would disagree with the fact that the PBGC, perhaps, ought to be responsible for picking up these annuities. I have a feeling that a lot of my clients would very much disagree with that. They think that other employers have benefitted in many ways by getting cheap annuities, by getting reversions back and that it's not fair to pass on the additional cost to them. I think a number of larger employers, in particular, are very concerned about the guarantees that the PBGC is having. They are beginning to question the fact that employers are allowed to improve benefits when the plan is poorly funded and pass on the cost to larger employers through the PBGC system.

I think the major issue that you have not discussed is the federal income tax that Executive Life owes according to the IRS. And I think in the positioning between the insurance industry and those employers who have purchased annuities, at least, the fact that the assets, whatever assets there are of Executive Life, may be taken by the IRS, if that position is upheld or maintained, that is something that's very crucial to the ultimate decision. None of the parties to this want to come up after and take over this liability, net of the assets that the IRS takes. No one assumes that there will be a savings and loan type bailout in the form of government guarantees. Hopefully the government won't make it worse by claiming that the Executive Life owes so much money. I forgot the number, but it's a very large number that affects the total liability. And I think that makes it a much more complicated situation than it appears

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to be on the surface, and I think the Congress when it deals with this issue, will have to deal with the IRS tax claim.

MR. SCHREITMUELLER: I understand that many large employers have not been happy with their support of the PBGC and would not look forward to being further sponsors or angels of that operation. At the same time, if you subscribe to the PBGC as something that ought to be there, it's a little hard to see that benefits shouldn't get paid.

MR. DONALD S. GRUBBS, JR.: For those employers who want to make up the losses, you pointed out some of the difficulties. The problems for the losses under the GICs and losses under annuities that have been purchased are entirely different. You pointed out some of the dilemmas with respect to the GICs, making most employers say, "Because of the uncertainties, we're just not going to take action at this time. I think it's clear we need a legislative remedy that will clarify the ability of employers who want to make good by purchasing these GICs back. However, informally, some employers are opposing such legislation because they would feel very uncomfortable if it were clear that they were allowed to do this, when they really don't want to do it.

The second problem is for annuities under terminated plans, the people who are now getting 70 cents on the dollar. If an employer decides it wants to make that up and start paying the 30 cents, it can probably do that. There are problems though with whether it would be giving benefits that might violate the limits under 415, but since it could be a nonqualified plan, there is no problem there. But nobody knows what the ultimate loss is. The 30 cents may get made up from the PBGC or the state guaranty funds or some other source and if the extra 30 cents is paid out now, there's no way the employer will get the 30 cents back. The retired employees may well come out ahead.

On the other issue that you mentioned, the federal involvement with insurers, I think it's clear that although insurance regulation is excellent in some states, it's bad in other states. And it's not a problem that relates solely to pensions. It's a problem that relates to all insurance. We need better regulation of insurance companies.

MS. JUDITH MARKLAND*: You had requested clarification on the number you had for Executive Life's GICs. That includes all the funding agreements as well. There's \$1.7 billion of funding agreements in the \$3 billion GICs. So the GIC total is actually \$1.3 billion and not all of that is for defined contribution plans.

The California Guaranty Fund Law was written specifically to take care of potential Executive Life problems. The law was written to exclude unallocated group pension contracts. So that certainly leaves GICs where they were.

In terms of the ACLI stance on the PBGC and the Department of Labor, the ACLI has been working with both organizations as have the rating agencies, in trying to develop

* Ms. Markland, not a member of the sponsoring organizations, is Vice President of Group Pension of John Hancock Mutual Life Insurance in Boston, Massachusetts.

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criteria for annuity purchases. And it submitted a package for discussion. The criteria for annuity purchases of \$5 million or more included things, such as: a good financial strength rating which is essentially an "A" or better rating from two of the major rating agencies; certification from an actuary comparable to Regulation 126, that the assets are adequate to meet the guaranteed reserves; a good business record and a substantial period of being in business, to prove good management; and then some no-excess insurance criteria or a reasonable proportion, no more than a certain amount of junk bonds and no more than a certain amount of subsidiary investments, to get around the Executive Life and Baldwin United problems.

The ACLI also submitted a proposal for an independent fiduciary standard to get around the self-dealing problem. And in terms of the self-dealing, I've been told that where it's a defined contribution problem, the Department of Labor would be very happy to expedite any request to get around prohibited transaction problems. When a plan wants to buy back a GIC at full book value, the DB problems are more complicated because they get into taxes and funding limitations and that kind of thing. But anyone who is working with a plan sponsor, or is interested in doing something like that, I don't think there should be a problem for a DC plan.

MR. WILLIAM E. NEAL: I would like to point out to Mr. Grubbs that state regulation may be imperfect, but it was the feds who regulated the savings & loan industry.

MR. CHARLES L. WALLS: It would seem that looking at the situation in the original context, the first place you would go is the employer. Then you would go to the PBGC. But if you view this whole thing as simply a transfer from one type of asset to another in the pension plan, then the employer has transferred these assets to insurance companies and so that's where you'd go first. And then if the employer is no longer around or insolvent or something of that nature, you'd go to the PBGC.

MR. RALPH J. BRASKETT: I would tend to agree with Charlie that the first person to go after is the employer, especially up to the amount of the reversion that was received when it terminated the pension plan. I would argue though that rather than the PBGC as the second source of money, the employers are going to take a pretty good swing on the benefit payments. I think on the GICs that the insurance industry can probably swallow what's left of a loss, when it comes up to it, if the guaranty fund in California can't. It seems to me that the PBGC should really not have involvement. It riles me to no end when I see the companies which got bigger reversions by going to Executive Life rather than Prudential or Metropolitan or whoever else . . . and now it's the PBGC. Which means my client's premiums are going to go up and here I am with small- and medium-sized pension plans that are fully funded and I have never participated in this reversion madness of the late 1980s. And now my clients may have to pay a price for it. And so it doesn't sit well with me nor would it with my clients, if I took the time to explain it to them. So I would have to agree that the PBGC should not be left holding the bag on this one.

MR. RICHARD DASKAIS: Dick Raskin mentioned the \$560 million or \$600 million IRS potential claim and Ralph just mentioned the possibility of shifting the payment in part to other insurance companies. I think we should recognize that any of that shifting would involve all of us and all of our clients, as policyholders of the insurance companies, or as taxpayers. So it may be easier to socialize the risk by asking the

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IRS to go a little bit easier on Executive Life or ask the Metropolitan and the Prudential and the John Hancock to pick up some of the pieces. But you know, eventually we are all going to pay for it.

A second completely unrelated point is, I think I saw in one of the daily papers that one of the employers with part of a plan that had a reversion, said that it was looking at picking up the pieces, making the employees whole, for those operations that it had retained. But as far as those operations they had sold to somebody else, that's the buyer's problem, not theirs.

MR. MARVIN R. NELSON: I have a little different perception of this reinsurance thing than the California Department apparently does. California has actually been fairly strict on surplus reinsurance and I think in most of the cases it could get money, if it went after the reinsurers. And I think it would be a disservice to the industry to paint the wrong picture of reinsurance, because it can be poor quality, but it can also be good quality. The reinsurers can be on the risk for some money. And I think in California they usually are.

MR. STANLEY H. TANNENBAUM: In addition to reinsurers, casualty insurers may end up paying some of the bill for benefits at Executive Life. Possibly a casualty claim would result from a fidelity bond, which I think must cover 10% of plan assets, in event the purchase of an Executive Life contract is found to involve wrongdoing in a criminal sense. Perhaps more likely, a casualty claim could result from liability insurance covering errors and omissions by a plan fiduciary or professional advisor who made an honest but imprudent mistake. Of course in a multi-line company, if the property-casualty side loses money, it affects the life operations anyway.

MR. SCHREITMUELLER: So this may be a lawyer's full-employment event, after all.