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The market for safe annuities

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The safety of annuities is of interest to actuaries in many areas of the profession as well as to institutional buyers, consumers, government, and annuity issuers. When the U.S. Department of Labor stepped into the fray in 1995 — ruling that private pension plans buying annuities had the fiduciary obligation to choose the "safest available" provider — the SOA responded with a study of implications for the marketplace.

Federal pension regulators began worrying about annuities in the early 1990s, when several large U.S. and Canadian life insurers teetered on the brink of insolvency and finally collapsed. The public soon learned that the PBGC did not back up annuities that were issued when pension plans terminated. At the state level, concerns about insurer solvency gave rise to more stringent capital and reserve requirements while raising new questions about the level of protection afforded by state guaranty funds. Financial rating agencies downgraded the once pristine marks of many insurance companies, including major ones.

In March 1995, some four years after Executive Life and Mutual Benefit Life went under, the U.S. Department of Labor issued its "safest annuity" provision (DOL Interpretive Bulletin 95-1). Of course, annuity buyers had begun stressing quality as soon as they heard the first rumblings of insolvency. This made annuity purchases a whole new ball game, and by 1995 the labor department announcement was no great surprise. But actuaries from the insurance and pension worlds had to wonder about the implications for annuity markets. Would one "safest" insurer have a monopoly on annuity business for pension plans? Would this market self-destruct as providers dropped out and prices spiraled upward? Could pension plans still buy annuities on reasonable terms?

Impact on the marketplace

During 1995-97, a working group of the SOA Committee on Retirement Systems Research looked into such questions, and the answers were reassuring.

Are terminating pension plans buying fewer annuities? Yes, the market has shrunk. But concerns about safety and the labor department ruling have had less impact than other causes, primarily:

- Higher taxes on reversions of excess pension plan assets have thrown cold water on corporate financial strategies that encouraged the termination of overfunded pension plans.
- Interest rates have declined, raising the cost of annuities.
- 1994 pension legislation ("GATT") has made it less costly for defined benefit plans to pay lump sums in lieu of annuities.

Do pension plans that buy annuities recognize more than one "safest" insurer? Yes. Although the market has become more concentrated among the strongest insurers, no insurer has anywhere near a monopoly. This question calls to mind the ERISA rule enacted in 1974 requiring "best estimate" assumptions; pension actuaries needed several years to reach a consensus that the new term could mean a range, not just a single point. Annuity buyers do not use published financial ratings to determine which insurer is safest, but the financial ratings are still a critical step in the initial screening process.

Are insurers leaving the market anyway? Yes. Some major players have exited the annuity market, citing capital and reserving constraints as well as market opportunities that are less risky and more profitable.

In exploring these issues, the working group surveyed both sellers (i.e., insurance companies that are active in the annuity market) and buyers (represented by consultants who negotiate annuity purchases on behalf of pension plan sponsors). The working group also analyzed PBGC data on standard plan terminations as well as industry data on annuity sales to corroborate the findings. The working group's report will be published in the *TSA Reports*.

The need is growing for safe annuities

There is good reason to be concerned about the security of retirement income in view of the rapid growth of defined contribution plans with low participation and annuitization, disenchantment with defined benefit plans, and proposals for personal savings accounts in the U.S. Social Security system. In this environment, retirement security is threatened by inadequate savings, by spending of retirement funds for nonretirement purposes, and by difficulty in drawing down personal retirement savings over one's retirement years (a difficulty that guaranteed annuities can overcome).

The insurance industry has traditionally been in the forefront of risk protection. Longevity is increasing, and future retirees face many uncertainties. A challenge for actuaries is to find new ways to offer annuities that are secure yet attractive, gaining the public confidence and appeal needed to get millions of informed retirees to entrust annuity providers with their savings in the next century.

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