PUTTING ANNUITIES BACK
INTO SAVINGS PLANS

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Abstract

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 their plans to lump sum distributions. This paper explains how legal reforms in the early 1990s increased the risk of fiduciary liability associated with annuities, a well-respected technique for managing income in retirement, and decreased their popularity among plan sponsors. It argues that those reforms, largely intended to protect participants in defined benefit plans, have proved counter-productive for savings plan participants. It then describes how a 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.
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Economy does not lie in sparing money, but in spending it wisely. \(^1\)

**Introduction.** 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 paper analyzes why savings plans sponsors shun annuities and what might be done to bring annuities back into savings plans. It begins with a discussion of an apparent puzzle. Just as the shift to savings plans in the private pension system began to accelerate, annuities began disappearing from savings plans. The paper examines how legal reforms in the early 1990s, largely intended to protect participants in defined benefit plans, have proven counter-productive for savings plan participants. Employers responded to the increased risk of fiduciary liability associated with annuities by abandoning them as a distribution option wherever possible, leaving to workers the responsibility for managing their savings in retirement. The paper also describes one proposal for a federal charter option for life insurance companies and discusses its promise for persuading employers to put annuities back into savings plans.

I. 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

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\(^1\)Attributed to Thomas Henry Huxley, The Columbia World of Quotations. Available at: http://www.bartleby.com/66/4/30104.html
resources (EBRI, 2004). 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 defined benefit plans. These plans generate income, usually payable for life, based on a worker’s years of service and compensation. But employers today prefer to offer savings plans, such as the popular 401(k) plan, instead. Rather than generating a stream of retirement income, these plans accumulate a pool of assets based on contributions and their earnings. The shift to savings plans has moved the burden of preparing for retirement 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 their 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 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). Defined benefit plans have traditionally provided retirement income in one standard form: monthly payments guaranteed to last for life. Workers in defined benefit 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 example,

[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 (GAO, 2003: 10).

Deciding how to allocate resources during retirement is difficult and fraught with uncertainty, requiring 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 them to decide how to invest their 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 well-established investment product known as a life annuity. A life annuity is a product available from an insurance company, typically purchased through a one-time lump sum or single premium payment.\(^2\) 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 an annuity is an irrevocable decision as life annuities do not have opt-out provisions for buyers who change their minds.

\(^2\)There are many types of annuities, e.g., variable, fixed, immediate, deferred and so on. The focus of this paper is on a specific type of annuity, the life annuity, either immediate or deferred, which a savings plan participant might purchase on termination of employment through a single premium payment and which, once payments begin, provides income for the remainder of his or her life.
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, 2000, 3).

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, that is, 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 defined benefit plans. But, in the U.S. today, life annuities are not yet a popular or well-understood insurance company product. More popular forms of annuities are purchased as an investment product, in part because they enjoy special tax benefits (Mitchell, 2004). Few purchasers of investment annuities convert the value of their investment annuity contracts into life annuities. In 2003, for example, less than 0.8% of such contracts were converted into fixed annuities (Beatrice and Drinkwater, 2004: 17). Industry analysts believe that

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3This type of annuity is typically called a “deferred annuity” and can be obtained in either a variable form where its value fluctuates according to the investments chosen by the policy holder or a fixed form where the insurance company promises a specific rate of return.
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 2003, there were $218.8 billion in new individual annuity sales but fixed immediate life annuities accounted for only $4.8 billion of that amount (Beatrice and Drinkwater, 2004: 6 and 8).

Research into the unpopularity of life annuities typically focuses on two sets of factors: 1) people and their individual needs; and 2) problems with the product itself. It 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, 2000). 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 upon Social Security for a guaranteed income stream in retirement (Ameriks and Yakaboski, 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 Yakaboski, 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, 2000).

**Missing In Action: The Employer.** These factors explain some of the unpopularity of
annuities but there could be another important but generally overlooked factor as well: the absence of annuity options in savings plan. 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 their 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 recent study observed that

[plan sponsors ... generally did not provide information on considerations relevant to managing pension and retirement savings plan assets at and during retirement ... plan sponsors generally do not discuss the potential pros and cons of available payout options as related to managing pension assets during retirement ... they 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 (GAO, 2003: 14).]

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 (GAO, 2003). As Table 1 illustrates, the available data suggest that only a minority of savings plans offer annuities as a distribution option and, over time, even that number appears to be shrinking.
Table 1. Savings Plans Offering Annuities

<table>
<thead>
<tr>
<th>Study</th>
<th>Sample</th>
<th>Findings</th>
</tr>
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<tbody>
<tr>
<td>BLS (1999)</td>
<td>Sample of private firms employing more than 100 workers in 1997</td>
<td>27% of full-time employees in 401(k) plans had annuity options</td>
</tr>
<tr>
<td>GAO (2003)</td>
<td>Private firm data from the National Compensation Survey of the BLS in 2000</td>
<td>annuities available to 38% of participants in defined contribution plans</td>
</tr>
<tr>
<td>Profit-Sharing Council (2004)</td>
<td>Survey of about 1,000 profit-sharing, 401(k) and profit-sharing/401(k) combination plans in 2002</td>
<td>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 (GAO, 2003)</td>
</tr>
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The absence of annuities from savings plans does not mean that workers have lost their only opportunity to purchase one. They can always use their lump sum distribution to buy an annuity directly from an insurance company or purchase one later through an 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 described below, recent developments in the law have discouraged plan sponsors from offering annuities.

II. Why Savings Plan Sponsors Avoid Annuities

There are several factors that explain the absence of annuities in savings plans. First, while
Why Savings Plan Sponsors Avoid Annuities

- No legal requirement to offer
- Increased administrative and regulatory burden

**FIDUCIARY LIABILITY**

defined benefit plans are required to provide annuities, savings plans are generally exempt from this requirement. Savings plan sponsors are not obliged to offer annuities as distribution options. Second, as researchers have observed, plan sponsors avoid annuities to minimize their plan administrative and regulatory burdens (Brown and Warshawsky, 2002: 17-20). But legal advisers know the real reason why plan sponsors don’t offer annuities. It is because they strongly advise their clients against them. In their view, annuities expose plan sponsors to a significant and long-term risk of fiduciary liability. And plan sponsors, more often than not, heed their advice.

**ERISA and Fiduciary Liability.** The fiduciary liability associated with savings plans arises out of the Employee Retirement Income Security Act (“ERISA”) that is administered by the Department of Labor (“DOL”). ERISA sets standards for how a plan should be operated and imposes penalties for breaching those standards. In particular, it holds individuals who have discretionary authority over the operation and administration of a plan to a high standard of conduct as fiduciaries. When acting on behalf of a plan, a fiduciary must act solely in the interests of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and

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4 Under Internal Revenue Code § 401(a)(11)(B)(iii) and ERISA § 205 (b)(1)(C), most defined contribution plans are not required to offer annuities as long as the spouse of a deceased participant inherits his or her account automatically under the terms of the plan. The exception to this rule is a type of defined contribution plan known as a money purchase plan that is not a savings plan.

5 ERISA § 402.
beneficiaries and defraying the reasonable expenses of administering the plan, and with the care, skill, prudence, and diligence that a prudent man would use under similar circumstances.\textsuperscript{6} Fiduciaries are personally liable to make a plan whole for any losses it suffers when they breach that standard of conduct.\textsuperscript{7} 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 (1) acted reasonably or in good faith or (2) will suffer severe financial hardship without a waiver or reduction of the penalty.\textsuperscript{8}

Under ERISA, a plan sponsor is not acting as a fiduciary when it chooses the distribution options in a plan.\textsuperscript{9} Deciding to include or exclude annuities is not a fiduciary decision. 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 on-going defined benefit plans because they typically pay annuities directly from the plan. Defined contribution 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

\textsuperscript{6}The obligations of plan fiduciaries are generally described in ERISA § 404.

\textsuperscript{7}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 whole plan as long as the insurance company has a right of recourse, that is, the right to recover any damages paid from the fiduciary.

\textsuperscript{8}ERISA § 502(l).

\textsuperscript{9}The creation and design of a plan are considered to be business, rather than fiduciary, decisions.
the participant, not the plan, makes all investment decisions. Anyone who makes a discretionary decision about an annuity purchase is 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 participants first.10

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 such as Executive Life Insurance Company of California and Mutual Benefit Life of New Jersey failed (GAO, 1992a, 1992b, 1995). At that time, as the GAO (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 insurance companies caused a crisis within the private pension system whose repercussions are still being felt today.

Most affected by the crisis were defined benefit 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 investment 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 defined benefit plans, the regulatory response was over-broad, increasing the administrative burden and fiduciary risk

10 See ERISA Regulation § 2550.404a-1.
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.

The first regulatory weakness exposed was within the insurance industry itself. In the U.S., the insurance industry is largely regulated by the states rather than the federal government. States license insurance companies, oversee their financial health, and, when a company becomes insolvent, takes charge of the liquidation process. When an insurance company fails, policy holders must turn to the relevant state guarantee associations for redress. These associations are not state agencies or funded by the states. Instead, they are an association of insurers in each state that have the power to assess member insurers when an insolvency occurs.\textsuperscript{11} Although these associations initially bear the cost of an insolvency, most states allow insurance companies to recover assessments through reductions in state premium taxes (ACLI, 2004d) or rate increases. So ultimately the cost of an insurance company failure is borne by policy holders or taxpayers (GAO, 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:

\begin{itemize}
  \item State guaranty funds generally did not provide coverage for guaranteed insurance contracts and similar products in defined benefit plans, and only a few provided coverage for defined contribution plans (GAO, 1991; Harrington, 1992).
  \item “Variations in state rules cause gaps and significant differences in coverage,” such as different rules for who is
\end{itemize}

\textsuperscript{11}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.
protected and the types of policies and annuities protected (GAO, 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 are still in effect in 2004 (ACLI, 2004d).)

- Some states provide coverage to all if the insurance company is headquartered in that state but others only provide coverage for state residents of companies doing business in that state (GAO, 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 (ACLI, 2004d), there is no similar 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 through the state guaranty association system 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 another 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 Internal Revenue Code ("IRC") § 401(a)(2), the non-discrimination 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 defined contribution plans, but only after they had received regulatory approval. The IRS created a special program for this purpose. 12 As part of its requirements, employers were also required to file for an exemption from the DOL with respect to fiduciary liability issues. 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.

12This special closing agreement 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).
The leading case was *Kayes v. Pacific Lumber*. The Maxxam Group obtained control of the Pacific Lumber Company through a hostile takeover, then terminated its over-funded defined benefit plan. It selected Executive Life, whose bid was $2.7 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 buyout. 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.

To many, *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. 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. In addition, it

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14See ERISA Reg. § 2510.3-3(d)(2)(ii)(A) and ERISA § 502(a).

15See ERISA § 502(a)(9) which applies to any legal proceeding pending or brought on or after May 31, 1993.

16In general, under ERISA § 413, participants may sue for a breach of fiduciary duty until the earlier of a) 6 years after the breach occurred or b) 3 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 longer 6-year statute of limitations to a claim of breach of fiduciary duty in the selection of an annuity provider.
authorized courts to award appropriate relief and money damages, including the purchase of back-up annuities, remedies that are generally not available under ERISA.

Finally, the DOL itself added to the administrative burden of purchasing annuities for savings plan sponsors. As the GAO (1993) noted during the height of the Executive Life crisis, the DOL had never issued guidance about the process that fiduciaries should follow or the criteria they should observe when selecting annuity providers for participants. That guidance was finally issued in 1995. It sets a general standard requiring fiduciaries to select the “safest annuity possible.” To do this, fiduciaries are required to conduct an objective and thorough search for potential providers, generally with the assistance of an independent expert. They should conduct their own evaluation of the safety of possible providers and not just rely on a rating from a commercial rating service. In the DOL’s view, that review should include analysis of the adequacy of state guaranty fund protection. In 2002, the DOL amplified that guidance by advising

17ERISA Reg. § 2509.95-1.
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” (DOL, 2002). The DOL guidance is advisory, not mandatory, and some courts have refused to apply it, even in cases related to Executive Life.18 Nevertheless, it is a standard that few plan fiduciaries can afford to ignore.

The cumulative effect of Executive Life and its aftermath was to discourage savings plan sponsors from offering annuities. The reforms brought about by PAPA and the DOL’s “safest annuity possible” standard are primarily intended to address defined benefit plan issues. Given the volume of annuities that defined benefit 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 defined benefit plans so plan fiduciaries have an inherent conflict of interest regarding the cost of the annuity provider they choose. It seems reasonable to insure that plan participants have redress against fiduciaries who 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 defined benefit plans. Savings plans purchase annuities infrequently and usually on a one-at-a-time basis. 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 allocated participant 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 that satisfying the DOL standard for buying annuities would be too difficult, expensive and time-consuming. 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 offered savings plan sponsors an out, and they took it by deciding not to offer annuities. The aftermath of the Executive Life crisis left savings plan participants without the assistance of an important intermediary, their employer, and a valuable product, a life annuity, in helping them prepare for retirement.

III. 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 (GAO, 2003; 22-26). 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.19 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 which 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

19Treas. Reg. §1.411(d)-4, Q&A-2(e).
proposed reforms with the potential to make annuities an attractive option for savings plan sponsors again. It has proposed a new model for insurance company organization and regulation: an optional federal charter for life insurance companies. This initiative for change comes at a time when the traditional lines between the insurance, banking and securities industry 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 (ACLI, 2004d).

Proponents of reform believe that “the state insurance regulatory mechanism [has] serious shortcomings that need to be addressed to bring insurance products to consumers in the most efficient manner and at the lowest cost” (ACLI, 2002). Primary issues targeted for change are “the lack of uniformity of laws, regulations and interpretations from state to state, the administrative burden of dealing with 51 jurisdictions and the excessive time required to get approval to offer new products” (ACLI, 2002). The solution proposed by the American Council of Life Insurers (ACLI) 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 (ACLI, 2003a, 2004a, 2004b).

20 This paper discusses the ACLI proposal for an optional federal charter for life insurance companies. There are a number of similar proposals also under consideration that are discussed in Bair (2004) and Broome (2002).
Under the ACLI proposal, legislation in the form of the proposed “The National Insurer Act” (“NIA”) and “the National Insurer Solvency Act” (“NISA”) would create an optional federal charter program for life insurers (ACLI, 2003b, 2003c). 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 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 NISA 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 (ACLI, 2004c). 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 NISA 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 that $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 “non-qualified” 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.21 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 there are uniform annuity products and standardized annuity providers available, plan fiduciaries do not have to exercise discretion, and are therefore not exposed to liability, when they select an annuity provider.

The federal charter proposal contains several elements that helps minimize the discretion

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21 A discussion of the merits of this proposal outside the qualified plan context are beyond the scope of the paper. Interested readers can obtain a broader analysis of the proposal from Bair (2004) and Broome (2002).
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+ 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, the “safest annuity possible” would require plan fiduciaries to investigate the adequacy of individual funds, often in several states, when selecting a provider. In the event of an 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

<table>
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<th>Benefits of a Federal Charter System for Savings Plans</th>
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<tr>
<td>• Federal law applicable nationwide</td>
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<tr>
<td>• A single regulator</td>
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<tr>
<td>• Standard policies</td>
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<tr>
<td>• Uniform sales, marketing and licensing standards</td>
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<tr>
<td>• Minimizes fact-finding about policies and insurers</td>
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<td>• Minimizes choices, lessens discretion of fiduciaries and their liability exposure</td>
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<td>• <em>But:</em> is the guaranty system strong enough and does it provide enough protection?</td>
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But: is the guaranty system strong enough and does it provide enough protection?
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 regulator, 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 satisfy the “safest annuity possible” standard of the DOL more efficiently. That, in itself, might 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. Its strong, uniform regulation of annuity providers and their products may, by itself, produce the “safest possible annuity.” 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 is not covered by 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 towards making annuities once again a
standard feature of savings plans and making workers more receptive to annuities.
References


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