ANNUITY PURCHASES AND GUARANTEED SEPARATE ACCOUNTS

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Introduction

Plan sponsors completing an annuity purchase have a fiduciary duty to select a safe insurance provider, and a common factor in that decision is the use of a Guaranteed Separate Account (GSA) by the insurer.

A GSA adds an additional safety net and makes the promise to pay benefits from a particular insurer more secure than it otherwise would be without it. This article describes GSAs, quantifies how much additional security GSAs can provide to participants, and describes how plan fiduciaries should analyze GSAs when making the annuity provider selection.

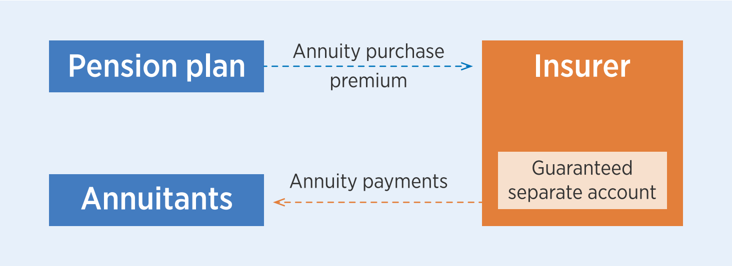
Insurer's General Account

All insurance companies hold invested assets from which insurance claim payments, including pension benefits, are made. When an insurance provider writes new pension business, the premium received will be invested in one of the insurance provider's investment accounts. If the insurer is solvent and writing new business, the insurer will have more assets than are expected to be required to pay claims obligations. Most invested assets are typically held in the insurer's "General Account," which will contain a variety of asset types supporting all kinds of insurance products, such as annuities (including pension annuities), savings products, life insurance or anything else the insurer writes.

What is a Guaranteed Separate Account?

A GSA is a separate set of financial statements held by the insurance company, maintained to report assets and liabilities that are separated from the insurer's general account. The portfolio of assets in the GSA is contractually devoted to meeting the liabilities of the GSA ahead of that insurer's other obligations, i.e., the GSA is "insulated" from the general account creditors.

If an annuity purchase contract is supported by a Guaranteed Separate Account, the premium received will be invested in that account and will be devoted to supporting pension payments of its pension risk transfer (PRT) business to which the account is devoted, rather than any other obligations of the insurer. In the event assets devoted to the Separate Account are depleted, the insurer remains obliged to meet the pension obligations from its other General Account assets. **Thus, an annuity purchase written out of a Separate Account is contractually more secure than a purchase written out of that same insurer's General Account.** The Separate Account is providing an additional buffer protecting against pension benefits being cut in the unlikely event the insurer fails.



How Much Additional Security Does a Separate Account Provide?

A separate account-backed transaction definitively provides an improvement to policyholder security compared to a general account-backed transaction with the same insurer, but the actual additional benefit can vary depending on the situation. Also, this improvement is only relevant in practice once an insurer has actually failed, which is an unlikely event in the first place. Even if an insurer fails, the presence of the state guaranty association system in each state guarantees participant benefits up to certain levels.

Consider a $100M annuity placement where 99.5% of the present value of benefits would be protected by the state guaranty system if the insurer were to fail. This is a fairly typical ratio, given the average state system covers benefits for individuals up to a present value of $250,000. 0.5% of the present value of benefits, or $500,000 in this example, is 'at risk' of being cut should the insurer fail.

FAILURE SCENARIO A:

Insurer assets cover all outstanding insurer liabilities (100% recovery in General Account)

A very plausible scenario, in the event that an insurer is insolvent or close to being insolvent, is that there will be sufficient assets for the insurer to pay all policyholders. No benefits are impacted. There are several reasons why this may be the case, not least the fact that various regulatory powers apply as an insurer's capital position deteriorates, resulting ultimately in state regulators taking control of the insurer before assets fall below the level of statutory reserves. Regulators could oversee corrective actions, such as investment de-risking. Perhaps the investment portfolio credit quality was impaired following a crisis, and economic conditions ultimately improve, as we saw following the 2008 Global Financial Crisis.

In this more optimistic scenario, since the General Account can pay for all liabilities, the presence of a Separate Account has not improved the outcome. **Participant losses = $0.**

FAILURE SCENARIO B:

Assets cover 85% of liabilities in the General Account, no Separate Account support

In this scenario, the transaction is written out of the general account with no Separate Account. Total participant losses = (1-85%) x $500,000 = **$75,000.**

FAILURE SCENARIO C:

Assets cover 85% of reserves in the General Account and 80% of reserves in the Separate Accounts

We now introduce the mechanics of the Separate Account. The Separate Account is established to cover 100% of statutory reserves in this example, meaning that if assets in the Separate Account are only 80% of this obligation, the remaining obligation of 20% falls back to the General Account. That obligation, in this scenario, is then also substantially covered by General Account assets, which cover 85%. Therefore, of the original pension liability at risk, the total participant losses are (1-80%) x (1-85%) x $500,000 = **$15,000** (i.e., 99.985% of total benefits are fully covered).

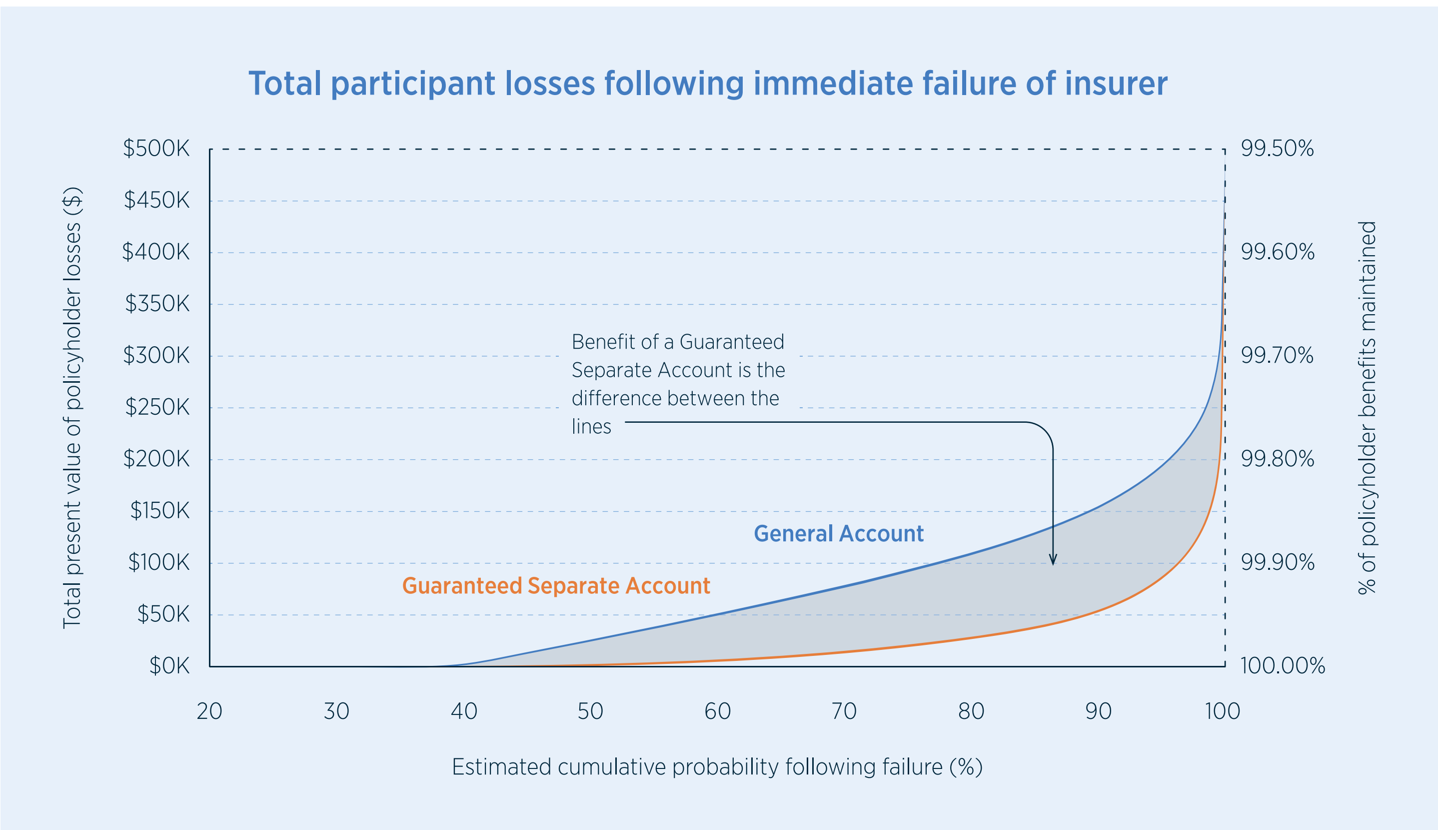
The use of a Separate Account in this scenario has prevented $60,000 ($75,000 from Scenario B minus $15,000 in Scenario B) worth of benefits from being cut. This means that the total value of benefits that are not cut is 99.925% of the initial present value on the general account only basis and 99.985% on the Separate Account basis — a difference of 0.06%.

In the example above, the Separate Account is adding a modest amount of security (both as a percent of liability and also in absolute dollars). It may be reasonable as a fiduciary in this situation to place the annuity contract with a safe provider who does not offer a Separate Account.

Loss Distributions

To further illustrate the point, we modelled the probability distributions for participant losses using Monte Carlo scenario analysis. See footnotes for the modelling assumptions used. The vertical axis in the chart below shows the level of policyholder losses for a general account only backed contract in blue and for a separate account-backed contract in red. The level of losses is shown at different likelihoods, which are varied on the horizontal axis as a cumulative probability. For example, there is a ~65% probability, once insurer failure has occurred, that participant losses will be $75K or less for a general account back contract (as described in scenario B). Moving over to the right are more severe and less likely outcomes, e.g., there is a ~90% probability that losses will be less than $150K, and there is a very small chance all insurer assets are lost, in which case benefits are cut by $500K to state guarantee levels.

The difference between the blue and red lines is effectively the benefit that the Separate Account is offering. There is no benefit in milder failures where assets are sufficient to meet claims (as described in scenario A above). **While highly dependent on the assumptions used, we find that the Separate Account provides between $0 and $100,000 of benefit for this $100M transaction, with most scenarios being at the lower end of this range when asset recoveries are high. This is equivalent to an improvement in the recovery of up to 0.10% of liabilities in the scenario when the insurer actually fails.**



At point of failure, company has zero statutory surplus and separate account has zero statutory surplus. From point of failure to resolution, surplus ~ N(-R*8%,R*20%), where R is statutory reserves. In the Separate Account, S ~ N(-8%*Rs, 25%*Rs), where Rs is statutory reserves of Separate Account. Loss distributions are combined with a gaussian copula with correlation of 80% to obtain the total loss. State Guaranty system is expected to be fully functional.

Commingled vs Dedicated Separate Account

Some very large transactions (typically over $1B) may be placed into a dedicated Separate Account where the only liabilities are those related to one particular PRT transaction. More common is a commingled Separate Account offering where the PRT transaction is added to a pre-existing account that already contains assets and associated liabilities from other PRT transactions, with more potentially added in the future. So, which of these situations is safer?

In our role as an independent advisor, we examine the assets and liabilities in existing commingled Separate Accounts. If existing assets and liabilities are riskier than those being added as part of the immediate transaction, then it could be the case that a dedicated Separate Account would be a safer solution. However, we typically favor a commingled Separate Account where the presence of liabilities from other pension plans and assets that have been added at different points in time add a degree of diversification, thus reducing the risk that Separate Account assets are exhausted.

Other Considerations

Aside from the possibility of a dedicated account, there are other considerations that can cause Separate Account arrangements to differ between insurers. At a given point in time, one insurer's Separate Account may have a lower asset value, relative to liabilities, than another insurer's. Thresholds and the frequency that excess assets are swept out of the Separate Account may exist. Insurers may also reinsure the Separate Account assets and liabilities they assume and the counterparty risk associated with that reinsurance can vary.

Factoring Separate Accounts into the Selection Process

The presence of a Separate Account is just one factor in evaluating an insurance company. While a positive for safety, a Separate Account does not make up for an insurance company being weaker in other areas, and there may be circumstances where a 'General Account' contract from a stronger insurer is preferable to a 'Separate Account' contract from a weaker insurer. Conversely, on occasion, we regard some insurers' general account offerings as weaker than their peers, and we are only comfortable with those insurers if they offer a Separate Account, i.e., the Separate Account is getting them on par with other insurers who do not offer a Separate Account.

Further, if an insurer is strong, and particularly if state guarantee coverage levels are high, we may opine that a Separate Account is not necessary for the transaction to be deemed safe, i.e., it is a "nice to have" but does not add enough additional security to eliminate the general account from consideration.

In summary, the presence of a Separate Account offering is an important consideration in the selection of an insurance company as part of a PRT transaction, but the precise impact on any decision will depend on the wider circumstances, including the nature of the liabilities, level of state guaranty coverage, the offerings of other bidders and the inherent riskiness of the insurers involved.